Coming to Grips With the Oil Sands: Is It Time to Buy Canadian Natural Resources (TSX:CNQ)?

Description

Crude's latest weakness coupled with fears of another oil price collapse in 2020 are weighing heavily on the energy patch. Many oil explorers and drillers have seen their market value fall sharply since the start of 2019, but the larger integrated oil sands operators such as **Canadian Natural Resources** (TSX:CNQ)(NYSE:CNQ) and **Suncor Energy** have bucked that trend to witness both gaining over 3%.

In addition, there's growing speculation that despite weaker oil and its poor outlook, now is the time to invest in Canadian Natural Resources.

Improved profitability

Technological and operational improvements have significantly reduced the industries environmental impact as well as operating costs. This has occurred because of the oil slump that forced industry players to introduce a wide range of efficiencies to reduce breakeven prices and boost profitability amid a difficult operating environment.

Since 2014, the breakeven price for various oil sands operations has fallen substantially. According to industry consultants HIS Markit, the costs associated with developing a new oil sands project have fallen by 25% to 33% since 2014 and operating expenses are down by around 40%.

That now sees steam assisted gravity drainage (SAGD) operations with average breakeven costs of around US$45 per barrel produced, while in-situ oil sands mining has fallen from US$100 a barrel to around US$65 per barrel.

This highlights that the profitability of oil sands operations has grown significantly over the last five years, helping to lift the profitability of the major oil sands operators including Canadian Natural Resources, Suncor and **Cenovus**.

The mandatory production cuts introduced by Edmonton at the start of this year also boosted industry profitability by causing the wide differential between the Canadian heavy oil benchmark Western

Canadian Select (WCS) and West Texas Intermediate (WTI) to close significantly. For these reasons, many of the oil sands majors reported improved second quarter 2019 results.

Canadian Natural Resources' adjusted net income declined by 19% year over year, primarily because of weaker oil prices and lower oil output, but its netback grew 18% year over year to $24.67 per barrel.

This is an important measure of operational profitability and can be attributed to a higher average sale price because of the significantly lower discount being applied to WCS.

A 7% year-over-year decrease in transportation costs as well as an 8% decline in production expenses also helped to boost Canadian Natural Resources' netback.

One of Canadian Natural Resources' key strengths is that its existing operational oil sands assets require very low amounts of sustaining capital to continue producing crude at current levels.

The company estimates that it needs to spend US$4.50 per barrel to sustain its current production levels, which is less than half of the US$11.50 forecast for U.S. shale oil.

The reason for this is quite simple: oil sands operations are very similar to mining. There are tremendous upfront costs involved in developing the asset and bringing it to commercial production, but once achieved, the expenses associated with sustaining output are very low.

Oil sands operations also have extremely low decline rates, keeping a further cap on expenses. Canadian Natural Resources estimates that its company-wide decline rate is less than 10% compared to an industry average of around 20% for shale oil, indicating that it's spending significantly less capital on drilling and well development than shale oil companies.

This indicates that Canadian Natural Resources can generate considerable cash flow even if oil weakens further, which is likely given the poor economic outlook and fears of another price crash.

Along with the company's focus on reducing costs, that has seen the operating costs for its oil sands operations fall by $22 per barrel between 2013 and 2018, and will further boost cash flow and profitability.

This will help Canadian Natural Resources deliver further value for shareholders and ensure the sustainability of its dividend, which, after being hiked for 18 years straight, has a very juicy 4.5% yield.

Foolish takeaway

Canadian Natural Resources is an attractively valued play on higher oil. The combination of lower production expenses, falling industry-wide breakeven costs and higher netbacks, means that it will unlock considerable value for investors.

While investors wait for that to occur, they will be rewarded by Canadian Natural Resources' sustainable steadily growing dividend yielding a tasty 4.5%.

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