Suncor Energy Inc.: It's the Oil Price, Stupid!

Description

Apologies to former U.S. President Bill Clinton for borrowing from his 1992 campaign logo, "It's the economy, stupid", but investors in **Suncor Energy Inc.** (TSX:SU)(NYSE:SU) are acutely aware that it is the price of oil that matters most when it comes to share price performance.

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In a lower oil price environment, the company will be less profitable and the fourth quarter results have already started to show the impact of the declining oil price.

Sharply lower fourth-quarter profits

Suncor announced an earnings per share of $0.06 for the fourth quarter, which was 80% lower than the comparable quarter last year. Operating earnings and cash flow per share, which are better measures of financial performance, declined by 59% and 35%, respectively.

The main reasons for the sharp declines were, first, the lower oil price, which impacted product price realisations, and an inventory write-down partly offset by the much weaker Canadian dollar. A considerable unrealised loss on debt held in U.S. dollars was also recorded and impacted net profit but not the operating earnings or cash flows.

The refining and marketing section (including Petro-Canada) recorded sharply lower operating profits as an inventory revaluation, necessitated by the lower oil prices, took a $372 million toll. Otherwise, the division performed well, with increased production and refinery utilisation.

Total upstream oil production was unchanged at 557,600 barrels of oil per day compared to the same quarter last year. The exploration and production division delivered an increase in production to 138,300 barrels of oil per day, mainly as a result of a temporary contribution from the Libyan facilities (which has now stopped).

The oil sands operations decreased production by 6% to 384,200 barrels per day compared to last year, mainly due to unplanned maintenance at Upgrader 2, while production at the Firebag reached record levels.

Price realisations per barrel of oil produced were generally lower as a result of lower benchmark prices than the previous year, but the weaker Canadian dollar and narrower discounts for Canadian oil compared to the international benchmarks cushioned the blow somewhat.

Operating production costs in the quarter amounted to $35 per barrel for oil sands and $45 per barrel for Syncrude, which in both cases represented a decline in cost. While total cost is obviously considerably higher, this implies that the company can still remain cash flow positive with regard to the oil-producing activities at the current oil price.

Weaker cash flow but a sound balance sheet

The cash flow of the business weakened considerably during the quarter, with an operating cash flow 37% lower than the previous year. Free cash flow (that is, operating cash flow minus capital expenditures) amounted to $2.1 billion for the year.

The company paid a $0.28 per share dividend during the fourth quarter, which was 40% higher than the previous year, while 42 million shares were repurchased from the market over the past year. Total cash returned to shareholders amounted to over $3.1 billion during 2014, which left a shortfall when compared to free cash flow and resulted in an increase in company debt.

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Despite an increase in net debt to $7.8 billion, the balance sheet remains in good shape, with net debt representing a very manageable 24% of total capital.

Further share purchases have now been suspended due to the lower oil price and weaker cash flow. The dividend, however, does not seem to be under threat for the foreseeable future, unless the oil price declines further and remains low for an extended period.

Outlook for 2015

The 2015 outlook was provided on January 15 when management stated its objective to reduce operating costs by $600 to 800 million over the next two years. Capital expenditure has also been lowered by $1 billion for 2015, although it will remain at an elevated level of around $6.5 billion.

Most importantly, company management was working with a West Texas Intermediate (WTI) oil price assumption of $59 per barrel for 2015, which may still prove to be somewhat optimistic.

It all depends on the direction of the oil price

Numerous factors, including the Canadian dollar exchange rate, play a role in the profitability of the Canadian integrated oil producers, but Suncor’s profit remains highly sensitive to the price of oil.

The average WTI price in 2014 was $93 per barrel compared with the current spot price of $48 per barrel. Should this become the average price level for 2015, the profits of Suncor and other oil producers will be seriously affected.

From an investment perspective, I would remain on the sidelines until the oil price settles.

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