The View from Burgundy

DECEMBER 2015

Not the Time to Sell

Suncor Energy Inc. (Suncor) announced a hostile offer to buy all of the outstanding shares of Canadian Oil Sands Limited (COS) on October 5, 2015. As the owner on behalf of our clients of COS shares, Burgundy will not accept the original Suncor offer. In this issue of The View from Burgundy, *we outline why. In short, COS owns a stake in a unique and extremely valuable long-term asset, a scarce resource that is almost impossible to replicate. And the price Suncor is offering, representing one-half of what it would cost to recreate this asset (if it was possible), is unacceptable.*

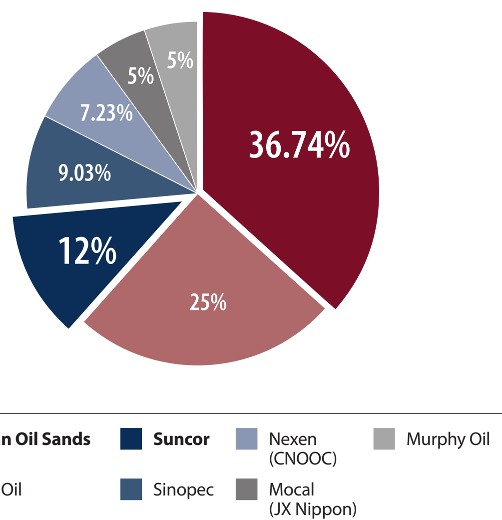
The Battle for Syncrude

COS IS A PURE PLAY "UPSTREAM" OIL PRODUCTION COMPANY. It owns 37% of the Syncrude Canada Ltd. (Syncrude) joint venture, an oil sands mining operation near Fort McMurray, Alberta (see Figure 1). Suncor is the largest oil company in Canada and owns a 12% stake of the Syncrude joint venture. Besides producing oil mainly in Alberta's oil sands, Suncor also has a large "downstream" business that processes the raw material into useable products and sells them to end users. This business unit operates in a very profitable oligopoly in Canada and is rewarded for scale economics. It is also benefiting from a glut of Canadian oil production that lacks sufficient pipeline takeaway capacity. This depresses its local raw material costs and allows it to earn fat margins on end products like gasoline that sell at higher prices based off of global benchmarks. As such, it is generating substantial profits, even in this depressed oil price environment.

Suncor acquired its stake in Syncrude through its 2009 acquisition of Petro-Canada. That deal worked out brilliantly for Suncor, coming as it did at the bottom of an earlier oil price cycle. Besides the Syncrude stake, the Petro-Canada purchase brought Suncor most of its downstream refining assets, whose profitability is allowing the company to ride out this current period of weak oil prices. To its credit, Suncor is trying to recreate this magic with the counter-cyclical COS offer.

Both COS and Suncor can trace their respective histories back to the two original oil sands mines in Alberta: Great Canadian Oil Sands and Syncrude. Suncor emerged from the Great Canadian Oil Sands consortium, which began production in 1967, while Syncrude started operating 11 years later. Both operations produce bitumen, or oil that is too heavy to flow on its own, which is extracted from oil-soaked sands located at the earth's surface using shovels and trucks. This "heavy oil" is then processed and upgraded into light oil that refiners prize because it can be converted into very valuable end products like diesel, jet fuel and gasoline.

Figure 1: **Syncrude Ownership**



(Source: Canadian Oil Sands Ltd. UBS – Energy 1x1 Conference, November 23, 2015.)

A Valuable Asset

Oil sands mines are attractive assets for several reasons. First, once built, they produce oil at steady rates for many decades. This stable production makes these assets very valuable. In contrast, conventional oil wells see their production rates steadily decline. Conventional producers are on a treadmill where they must continually discover or acquire and then develop new sources of production.

Canada's oil sands mines also contain huge reserves in a world where non-government oil companies are increasingly challenged to own resources. It is estimated that more than 85% of the world's oil and gas reserves are held by government-owned national companies like Saudi Aramco. As such, the ability for private sector companies to control billions of barrels of reserves and decades of future production is a valuable commodity.

In addition, many oil reservoirs are located in politically risky areas like Venezuela, Nigeria and the Middle East. Again, getting access to huge proven reserves in a safe political locale for shareholders is valuable.

Fewer Risks

The billions of barrels of reserves that oil sands mines control in a safe political locale means they have far less operating risks to manage. Importantly, oil sands mines have no reserve risks. Conventional oil properties can perform less than expected – they can "water out" or fall prey to other geologic risks. This exposes their owners to potentially large losses and wasted investment spending. With the oil sands mines, the reserves are there.

And oil sands mines have no exploration risk. Conventional oil companies that are on the treadmill caused by ongoing well declines must constantly replace their produced reserves via exploration or the acquisition of someone else's discovered reserves. Unlike the reserves at the oil sands mines, there are no guarantees that future exploration will be successful.

Lastly, once built, the oil sands mines are subject to limited capital spending risk. While intermittent projects to move equipment away from produced areas to undepleted zones must be undertaken, by their nature the oil sands mines do not face the consistent investment risks that conventional companies do as they continually attempt to replace their produced reserves. Again, there are no guarantees that conventional reserves can be replaced in a cost-effective manner.

A Scarce Asset

In economics, scarcity helps determine value. It is why diamonds, a non-vital commodity to most, are so much more valuable than water, which is a necessity for life. A high value is realized because diamonds are rare. Oil sands mines are rare too.

Alberta's oil sands are unique on a global scale. Oil sands production only accounts for 5% of global oil production. Only Venezuela has similarly sized deposits, but high political risk has led to minimal development. These are indeed scarce assets.

In addition, most of Alberta's oil sands are too deep to mine. Of the 140,000 square kilometres of oil sands, more than 135,000 are located far too deep where expensive steam must be injected to allow the oil to flow to surface. That is why there is only a half-dozen oil sands mines in Canada where the oil-soaked sand deposits are shallow enough to economically mine. So an ownership stake in a rare surface deposit like Syncrude's is a scarce asset.

A Pure Play

A "pure play" is an investment security that is made up of a single type of asset. In finance theory, because investors can optimize their own portfolios by selecting a collection of individual investments according to their unique risk tolerances and goals, pure plays are especially attractive. Pure plays typically trade for higher valuations as stand-alone securities, rather than when the assets are hidden inside conglomerates where a diverse collection of assets typically trades at a large "conglomerate discount."

COS's share of the Syncrude oil sands mine is its only asset. Moreover, all the other oil sands mines are owned inside large, multinational oil companies that have many assets. COS is thus the only way for investors to gain "pure play" exposure to oil sands mining, itself a scarce resource. While this uniqueness may not be worth much at the bottom of the oil price cycle, it can have very positive effects on valuation in stronger oil price environments, as we shall see.

Huge Exposure to the Price of Oil

Oil sands mines are fixed-cost businesses. Once a mine is operating and incurring expenses, it costs almost nothing extra to produce an incremental barrel of oil. So the mines produce what they can, regardless of the price of oil.

Operating costs to run a mine are higher than for many other types of oil production. So at the current depressed levels of oil prices, COS is not generating a lot of cash flow. But as with any fixed-cost asset, a very large percentage of every dollar increase in the oil price is profit. As such, COS has tremendous exposure to the commodity price. Historically, the correlation between the oil price and the COS share price has been about 98%.

Many investors also fail to appreciate that operating costs are not the only cost to consider when evaluating oil projects and companies. The profitability of an oil project is determined by both operating and investment costs. Many projects have lower operating costs per barrel than the oil sands mines, but once investment costs are factored in, and especially the lack of future investment needed to replace production as is required at conventional projects, oil sands mines earn competitive returns on investment at most points in the oil price cycle. That is why Suncor is plowing ahead with another oil sands mine, Fort Hills, as we write.

Let us illustrate how low investment spending helps COS ride out periods of low oil prices. COS management is forecasting C$338 million in free cash flow, after investment spending, in 2016, or C$0.70 per share, if the standard WTI oil price averages only US$50 per barrel. The limited investment spending required at a built oil sands mine like Syncrude allows for cash flow generation and flat production volumes in weak pricing environments. We struggle to identify other upstream oil companies that are expected to generate both flat production volumes and free cash flow at similar depressed oil prices. The quality of COS and its Syncrude asset really stands out.

As we have seen, once the mines are built, as in the case of Syncrude, future investment spending is limited, which enables positive project cash flow at almost all oil price levels. Since 2001, COS has distributed C$7.9 billion, or C$17 per share, to shareholders during a period when the oil price averaged US$65 per barrel. Moreover, valuation multiples for a scarce resource pure play like COS can stretch well above replacement values, as we shall see.

Private Market Value

One method to evaluate value is to look at prior transactions and estimate so-called "private market value." This is the valuation that an asset traded hands for in the private market.

Ownership positions of the Syncrude joint venture have changed hands in the recent past, including when Suncor acquired Petro-Canada in 2009 and when Chinese-controlled CNOOC Limited acquired Nexen Inc., which owns 7% of Syncrude, in 2013. The most recent deal for a pure play was in 2010 when Sinopec Group (Sinopec), another Chinese company, bought ConocoPhillips' 9% stake for US$4.65 billion.

For this recent pure play transaction, it is useful to determine what the multiple per percentage ownership of Syncrude equates to in terms of a COS share price. To be conservative, we assume Sinopec paid the same amount, but in Canadian dollars (since the Canadian dollar and the price of oil tend to move in lockstep, and both were significantly higher in 2010). When adjusted for the current level of COS debt, the value Sinopec paid equates to C$34 per COS share, which is more than three times the value of the Suncor offer.

This private market value example is an illustration of the upside potential of a scarce resource asset in a stronger part of the oil price cycle.

Because the valuation of commodity stocks is tied to where we are in the inevitable price cycle, some investors attempt to buy these cyclical stocks at the low end of the price cycle, and sell them at the high end, by guessing where we are in the cycle. This is tougher than it looks because cycles can last longer – and end quicker – than most predict. Rather than try to guess when the bottom is, based on investor sentiment, replacement cost analysis is more defensible.

Replacement Value Is a Useful Valuation Tool

Replacement cost analysis is another way to evaluate value. Besides the current Fort Hills project, many of the mines have been expanding, including Exxon Mobil Corporation and Imperial Oil Limited's Kearl project and Horizon owned by Canadian Natural Resources Limited. It is significant that these savvy long-term owners must have a positive long-term view on the economics of their mines.

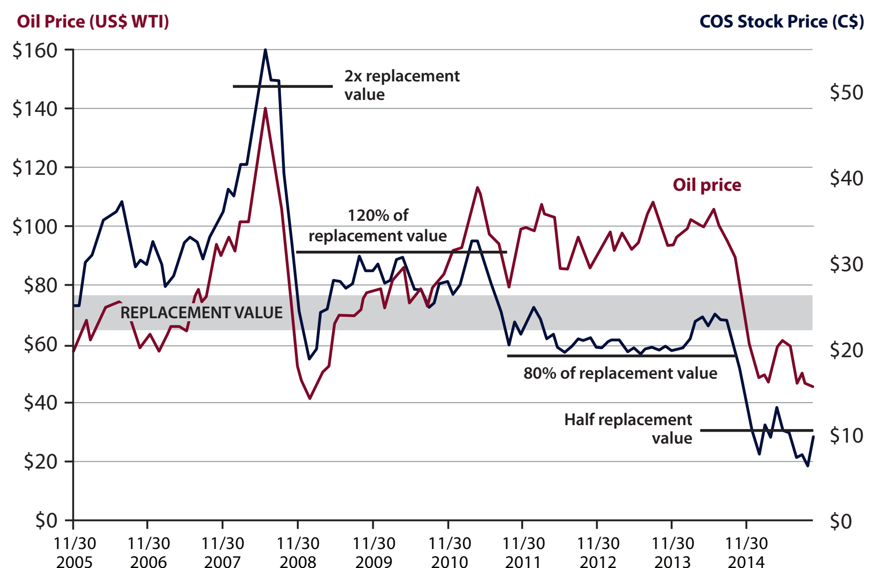
The investment cost of the recent and current projects allows for an estimation of replacement value, or what it would theoretically cost to build a project that replicated Syncrude. This is theoretical because none of the land appropriate for mining projects is available. It was tied up by savvy companies many years ago.

While replacement cost can be pro-cyclical – it rises during boom times because of inflationary pressure, and falls during industry lulls – mining investment costs haven't experienced any step changes in the past several years. So it can be a useful measure if applied with conservatism.

It is also noteworthy that the recent new builds have not included an upgrader, which processes the lower quality heavy oil into higher valued light oil. While this makes for cheaper projects, it exposes the new mines to the volatility of heavy oil prices, which is far greater than that for light oil. Syncrude has an upgrader, and as such is not exposed to these heavy oil price swings.

In addition, Syncrude's upgrader allows it to realize oil prices that are far higher than that earned by heavy oil producers. COS has typically received 40% to 55% greater prices for its upgraded light oil than those earned by the non-upgraded mines. This highlights the hidden value of its upgrader. Indeed, COS estimates that 75% of its free cash flow from 2009 has come from its upgrader.

***Figure 2:* Canadian Oil Sands Trading Price, Replacement Value and the Price of Oil**



(Sources: Bloomberg and Burgundy research.)

As Figure 2 outlines, the market has been very rational in its valuation of COS's pure play stake in the project. We estimate that over the past five years, with oil generally trading at levels approximating the marginal cost of production, which most analysts would suggest is the best predictor of long-term oil prices, COS traded between 80% and 120% of replacement value. It makes sense in a stable and reasonable market for an asset to trade at what it

would cost to replicate it. Of course, it is important to remember that, given the lack of available oil sands mining resources, Syncrude cannot be replicated.

We also note that in the very strong oil price environment of 2007 and early 2008, COS traded at more than twice replacement value. In the recent weak oil price environment of 2015, including the valuation that the Suncor offer is putting on COS, it has traded at about one-half of replacement value.

This suggests that selling at this current depressed level only makes sense if one believes that oil prices will not recover. This seems highly unlikely.

The Price of Oil Will Recover

The oil price will rebound because commodity prices are self-correcting. While no one can predict when, higher oil prices are as near a certainty as we get in the investment business.

Why are price cycles inevitable? Commodity prices cycle around their respective industry's marginal cost of production – the commodity price needed to justify developing the next so-called marginal or incremental project – because both supply and demand respond to price.

When prices are high, new projects are started and conservation kicks in. This eventually overwhelms the excess demand and causes prices to drop. And when prices are low, high cost production is shut in, new projects are cancelled and demand picks up. And in the case of oil where most non-oil-sands projects see declining production, natural declines set in. These forces eventually work off the excess supply, allowing prices to rise.

COS Can Ride Out the Weak Prices

Along with a strong balance sheet, no debt maturities until 2019 and debt covenants tied to its substantial asset value (not cash flow), COS is well positioned to ride out the current period of low oil prices. And when prices recover, given its fixed costs, cash flows and the share price will recover even more. And remember the 98% correlation between COS and the price of oil? This will work wonders for investors in an improving price environment. COS will be a revenant.

Short-term Wise Is Long-term Foolish

Yes, if the Suncor offer fails and another, superior one fails to emerge, the COS share price may drop in the short term. But that is a small price to pay for maintaining ownership of a pure play, scarce, long-term resource that will trade at much higher levels than the Suncor offer when oil prices recover. Investing is a marathon, not a sprint.

We Are Not Selling

Burgundy is not tendering to the original Suncor offer. Both its timing and, more importantly, its valuation are contrary to the long-term interests of COS shareholders. As oil prices recover to levels consistent with the marginal cost of production (US$75 to US$80 per barrel) over the next several years, COS's valuation should once again approach replacement value. As this level is double that of the recent Suncor hostile offer, we are turning it down. Giving up unique, irreplaceable and low-risk exposure to the price of light oil today, when oil prices are in a trough, is the exact opposite of what long-term investors should be doing.

This issue of The View from Burgundy
was written by David Vanderwood,
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