

# Bloomberg

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## Record Valuations Signal Canada Oil Stocks Reality Check

By Robert Tuttle

(Bloomberg) -- Canadian energy companies are trading at record valuations, signaling their shares haven't caught up to the reality of crude oil's continued decline.

Suncor Energy Inc., Canadian Natural Resources Ltd. and other stocks in the Standard & Poor's/TSX Energy Sector Index are priced at 63 times expected earnings, an all-time high and more than double the average of U.S. peers, according to data compiled by Bloomberg. Those valuations sit in contrast to crude, which touched \$42.03 a barrel for the U.S. benchmark last week, the lowest since March 2009.

As surging crude output strains storage facilities and pushes prices down in the U.S., Canadian producers are cutting thousands of jobs and reducing spending to weather the rout. High valuations suggest that might not be enough to help support earnings which are projected to drop 24 percent for the group in the second quarter from the first, according to data compiled by Bloomberg.

"The group, in general, is reflecting oil prices closer to \$60," Amir Arif, an analyst at Cormark Securities Inc. in Calgary, said by phone. "The longer oil stays at these levels, there is downside risk."

Oil prices have plunged more than 50 percent from June highs as the Organization of Petroleum Exporting Countries maintains output levels amid surging North American production, particularly from U.S. shale rocks. West Texas Intermediate, the U.S. benchmark, rose 6 cents to \$47.51 at the close in New York, while the Western Canadian Select benchmark traded at \$34.56 after falling below \$30 a barrel last week for the first time in six years.

### Lower Longer

The S&P/TSX Energy Index has fallen 24 percent since that June peak, yet it's still trading at 63 times projected fourth-quarter earnings. That compares with 29 for the U.S. S&P 500 Energy Index. Calgary-based Suncor, Canada's largest oil producer, is changing hands at 58 times projected earnings and Husky Energy Inc. is at 85 times, according to the data.

Suncor has declined 2.6 percent this year to C\$35.95 at the close in Toronto, Canadian Natural is up 5.6 percent to C\$37.93, and Husky has dropped 5.1 percent to C\$26.10.

Mel Duvall, a Husky spokesman, and Rob Larson, a spokesman Canadian Natural, declined to comment. Officials at Suncor's press office didn't respond to a request for comment.

Oil-sands producers must cut costs to remain competitive in the "new normal of lower oil prices for longer," Randy Ollenberger, a Bank of Montreal analyst said in a March 16 note.

Companies haven't been standing still. Canadian producers including Suncor have been reducing jobs and cutting spending plans.

## Market Overvalued

Still, oil-sands companies have some of the highest costs in the industry. Much of the country's crude is produced from bitumen, which must be dug or pumped out of the ground after it's melted using steam. The bitumen is upgraded into lighter synthetic crude or is diluted with condensate and shipped by pipeline or rail car to refineries, most in the U.S.

Canadian Oil Sands Ltd., among the largest five producers, needs a WTI price of about \$50 a barrel to sustain business with no production declines, Chief Financial Officer Robert Dawson said March 11.

WTI for delivery in two years is being traded at about \$60 a barrel, based on futures prices.

"If oil prices are not going above \$70, this market is overvalued," **Sam LaBell**, an analyst at **Veritas Investment Research** in Toronto, said yesterday by phone. Oil traders "who make their living on prices going up or down, they are not seeing a huge recovery next year. The longer this goes on for, the more pain this will be for producers."

## 'Nasty Business'

Declining share prices have reduced the average price-to-cash flow ratio, another closely watched metric in the energy industry, to 8.8 for Canadian producers in the index from 14 a year ago, according to data compiled by Bloomberg. That compares with the average 6.6 times cash flow for the U.S. energy index and still too elevated for some investors.

"Whether you look at P/E or price-to-cash flow, they're high," said Barry Schwartz, chief investment officer at Baskin Wealth Management in Toronto. "Either we're at the bottom and you should be buying or they're running on fumes."

Schwartz, who's firm manages about C\$800 million, is in the latter camp, saying it will be "nasty business" once oil company hedges peter out in 2016 if the price hasn't rebounded.

"We have no holdings in energy producers whatsoever," he said. "There won't be a quick snapback to levels that would make these stocks attractive."

Still, large companies like Suncor have refining operations that can help buffer them from the decline in the crude price. Some investors also have confidence the commodity will rebound.

## Irrational Zone

"The low current oil prices are not being capitalized into equity values because the market expects oil prices to recover," BMO's Ollenberger said in his note.

While 61 percent of the analyst recommendations on Suncor are still buys and 36 percent are holds, that's down from 85 percent buys and 15 percent holds in November, according to data compiled by Bloomberg.

"We are in that zone where things can get fairly irrational," Tim Pickering, chief investment officer and founder of Auspice Capital Advisors Ltd. said in a phone interview from Calgary. "At \$30 crude, something has to give."

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