

EQUITY RESEARCH

October 20, 2021

Beyond The Headlines

Oil Sands: The Self-funded Buyout

Stage Is Set For Oil Sands Companies To Accelerate Cash Return Via Buybacks

Our Conclusion

The Canadian energy sector continues to trade at valuations that are below historical norms despite the return of WTI to US\$82 and a potential setup for continued strength given underinvestment in the space. We understand that valuation alone is not enough to promote buying a stock, and that concerns around energy transition, carbon intensity and perceived terminal value risk are weighing on share prices.

However, the Canadian majors are generating substantial free cash flow. We expect a significant portion of cash will be distributed to shareholders through consistent increases to dividends, complemented by Normal-Course Issuer Bids (NCIBs) and, where applicable, Substantial Issuer Bids (SIBs). This could be a key catalyst in driving share price outperformance. We expect free cash flow from CNQ, IMO and SU could accrue disproportionately to shareholders. Given its leverage, we expect free cash flow allocation for CVE to be balanced between reducing leverage and shareholder returns.

Key Points

- **There is value in the space.** The Canadian oil sands group is trading at 2022E free cash flow (FCF) yield of ~23% on strip pricing and marks the widest spread compared to the risk-free borrowing rate and the interest rate-focused asset classes. At US\$45 WTI, the group will still show an FCF yield of ~8% suggesting an ability to sustain production, fund dividends and repurchase shares under NCIBs.
- **Oil sands companies are entering a period of harvesting free cash flow.** Allocations of capital spending on major oil sands projects have ended and these companies are in a period of harvesting cash flow (with minimal sustaining capex requirements). We expect that excess free cash flow will be used to moderate the current leverage and accelerate returns to shareholders, namely from buybacks given current valuations.
- **We view the focus on returning cash to shareholders as helping minimize terminal value risk.** We estimate at US\$50 WTI, the oil sands companies could free cash flow their enterprise value over ~12 years (on average). This shortens to ~8 years at US\$60 WTI. Given that these accelerated returns come well before the nearest timing for the start of an energy transition via the Sustainable Development Scenario in 2030, we believe a capital allocation strategy that focuses on buybacks could help moderate terminal value risk.
- **Persistent repurchases could catalyze share price outperformance.** On strip, the oil sands companies show ~\$28 billion of available 2022E free cash flow after capex and dividends. While we expect at least ~50% of this will be used to lower leverage in the near-term, it suggests ~\$14 billion of share repurchasing power from the oil sands group.

All figures in Canadian dollars unless otherwise stated.

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Sector:
Energy



Beyond The Headlines

Betting On Yourself

Valuations in the Canadian energy sector continue to trade well below historical norms despite the return of WTI to US\$82 and a potential setup for higher oil price given underinvestment in the space. We understand that valuation alone is not enough to promote buying a stock and that concerns around energy transition, carbon intensity and perceived terminal value risk have been factors on driving an exodus of funds flow out of energy.

Companies outlining plans to return a significant portion of cash to shareholders through consistent increases to dividends, complemented by Normal-Course Issuer Bids (NCIBs) and, where applicable, Substantial Issuer Bids (SIBs) could be a key catalyst in driving share price outperformance, especially when concerns around availability of supply move oil prices higher. Further, the oil sands companies are on the cusp of allocating material portions of free cash flow towards shareholder returns, which could stem and even turn the tide of outflows from Canadian energy.

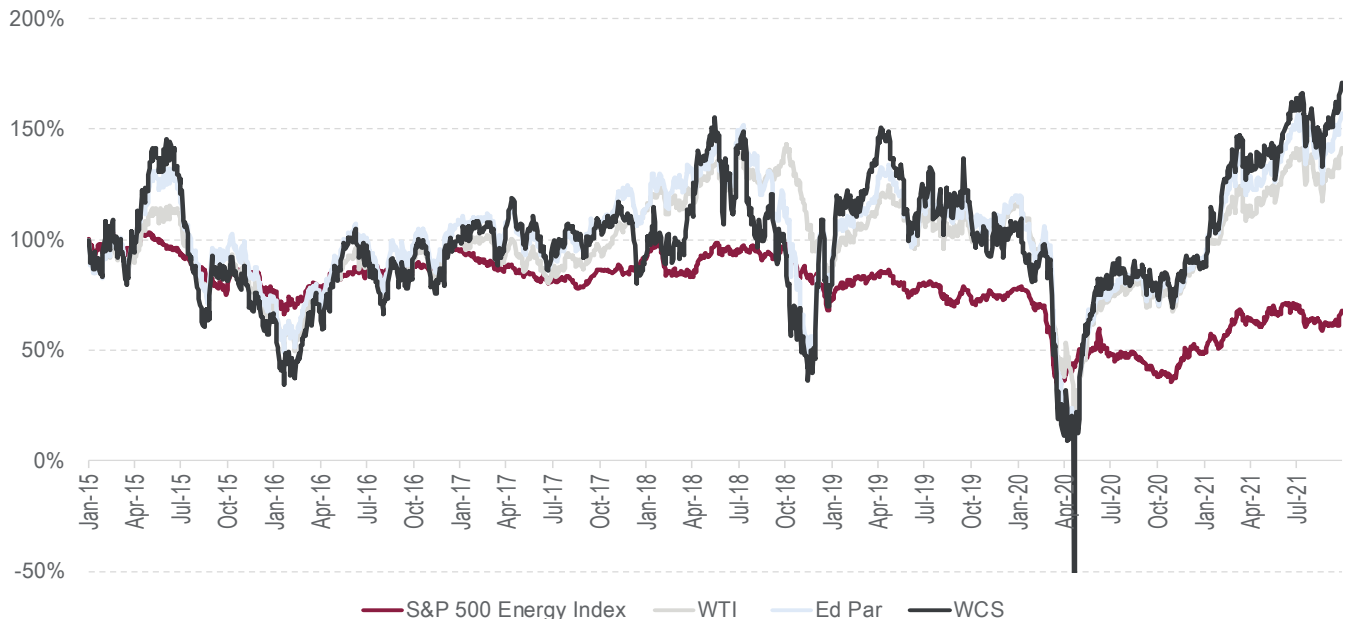
Today Is Not Like Yesterday

We understand the historical context of share buybacks for commodity-based companies have been relatively inefficient. In times of high oil prices, cash flows rise. However, the higher share prices moderate the effectiveness of repurchases. Historically, we've favoured buybacks for integrated oil and gas companies as downstream operations act as a natural hedge in supply-driven price volatility, helping improve the efficiency of share repurchases. Further, given the nature of the capital intensity of the oil sands companies, they will never have the same EBIT conversion into FCF as some other industries; but we view buybacks as accentuating the share price outperformance in what could be an eventual global supply deficit when the underlying commodity rises or this strength persists.

Today's context is also different from the past as we've seen a disconnection between share price performance and the underlying commodity, which significantly increases the potency of returning cash to shareholders through repurchases. The line chart in Exhibit 1 below shows the relative performance of the energy index as compared to WTI, Ed-Par and WCS.

A divergence in share prices vs. the underlying commodity performance suggests now is an efficient time to repurchase stock.

Exhibit 1: S&P 500 Energy & Commodity Benchmarks – Relative Performance, 2015 – Present



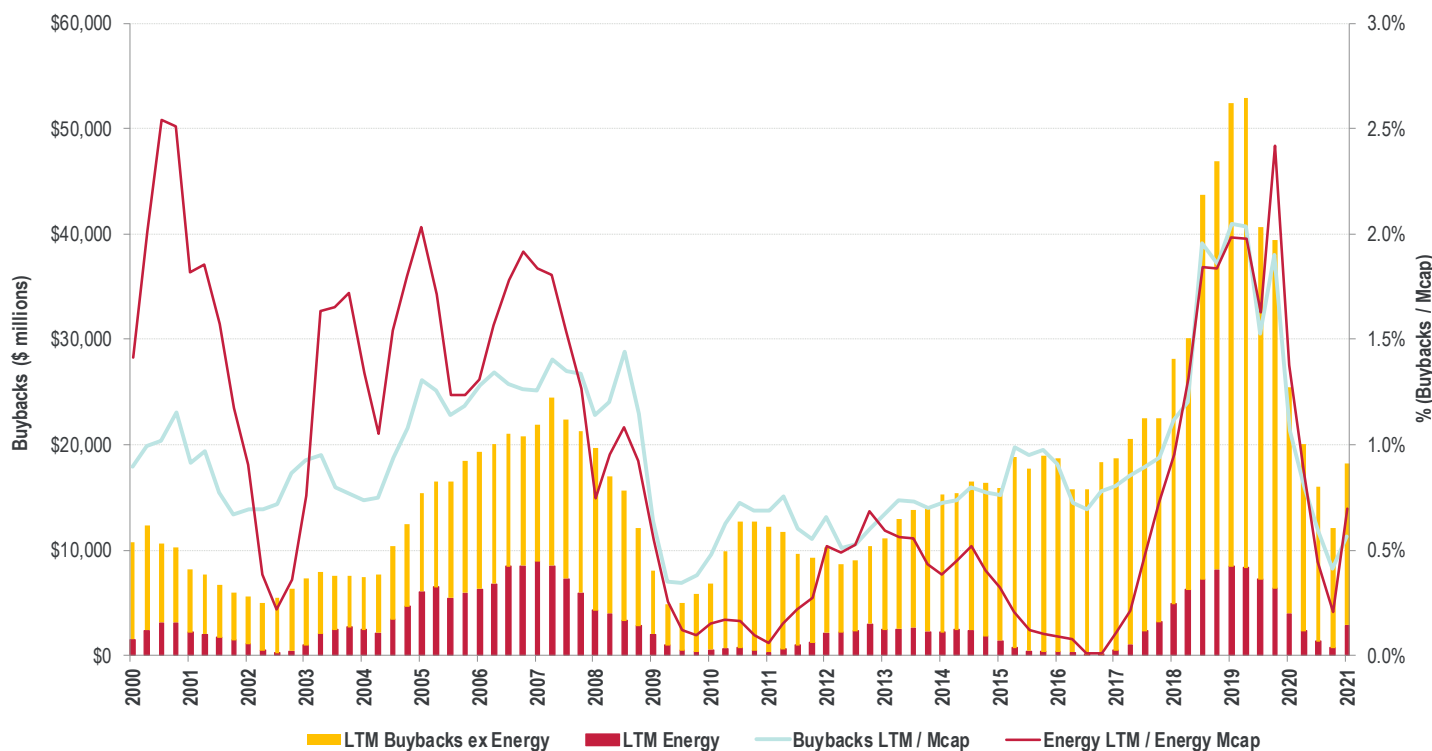
Source: Bloomberg and CIBC World Markets Inc.

From our NAV analysis, we estimate that companies are trading well below their intrinsic value and that, on average, the oil sands companies are pricing in long-term WTI of US\$55. We expect share buybacks should and will be a primary focus when looking at allocating free cash flow to shareholder returns.

Canadian Energy Companies Have A Track Record Of Repurchasing Large Quantities Of Stock

We highlight that energy companies have made up significant proportions of buybacks historically and represent ~14% of total buybacks from 2001–2021 (of the S&P/TSX). Given current pressure to return cash to shareholders, we expect consistent use of buybacks will re-emerge as a primary form of capital allocation. SIBs could be used as current FCF generation suggests that these companies are able to repurchase greater than the typical TSX-approved 5% of outstanding stock under an NCIB – or up to 10% of outstanding stock for dual-listed companies. In addition, corporate balance sheets have improved materially after the price volatility experienced last year through the pandemic, providing a backdrop to take advantage of mismatched performance in the underlying commodity vs. share prices. The chart in Exhibit 2 below highlights the historical proportion of buybacks in the energy industry vs. the S&P/TSX.

Exhibit 2: S&P/TSX/Energy - Historical Buybacks, 2000 - Present



Source: CapitalIQ, company reports and CIBC World Markets Inc.

Exhibit 3 below ranks the corporate contribution to share buybacks in the energy space. We note that Oviniv has repurchased over 100% of its current market capitalization reflecting the numerous spin-offs, portfolio optimization and divestitures the company has pursued over the past two decades. For Imperial Oil and Suncor, the companies have made up significant portions of historical S&P TSX buybacks and we expect this trend to continue. Most notably, Cenovus is missing from the list, but we expect given current valuation (and the disconnection between intrinsic value and current share price), this will be a focus for the company’s capital allocation plans.

Exhibit 3: Energy – Companies With Highest Level Of Buybacks, 2000 – Present

Company	Buyback Done as % of Last Available Market cap	% of Total Energy Buyback
IMPERIAL OIL LTD	135.6%	27.2%
SUNCOR ENERGY INC	273.3%	25.0%
OVINTIV INC	261.9%	22.5%
CANADIAN NATURAL RESOURCES	126.0%	6.6%
TALISMAN ENERGY INC	63.2%	5.0%
NEXEN INC	25.7%	1.4%
PAREX RESOURCES INC	48.7%	1.2%
SHAWCOR LTD	70.3%	1.0%
SHELL CANADA LTD -CL A	7.0%	1.0%
PROVIDENT ENERGY LTD	19.0%	0.7%
CAMECO CORP	4.5%	0.7%
NOVA CHEMICALS CORP	15.9%	0.6%
PETROKAZAKHSTAN INC	98.1%	0.5%
PETROMINERALES LTD	9.5%	0.5%
TC ENERGY CORP	2.4%	0.5%
SEVEN GENERATIONS ENERGY LTD	7.2%	0.4%
ENERPLUS CORP	4.2%	0.4%
FRONTERA ENERGY CORP	24.7%	0.4%
ALBERTA ENERGY CO LTD	4.2%	0.4%
PRAIRIESKY ROYALTY LTD	5.2%	0.4%
PARAMOUNT RESOURCES LTD	15.0%	0.3%
CRESCENT POINT ENERGY CORP	16.8%	0.2%
OPTI CANADA INC	7.0%	0.2%
TRICAN WELL SERVICE LTD	58.6%	0.2%
TOUCHSTONE EXPLORATION INC	13.4%	0.2%
BURLINGTON RESOURCES CDA INC	1.1%	0.2%
BROOKFIELD BUSINESS PRTNR LP	2.6%	0.2%
GRAN TIERRA ENERGY INC	5.2%	0.2%

Source: CapitalIQ, company reports and CIBC World Markets Inc.

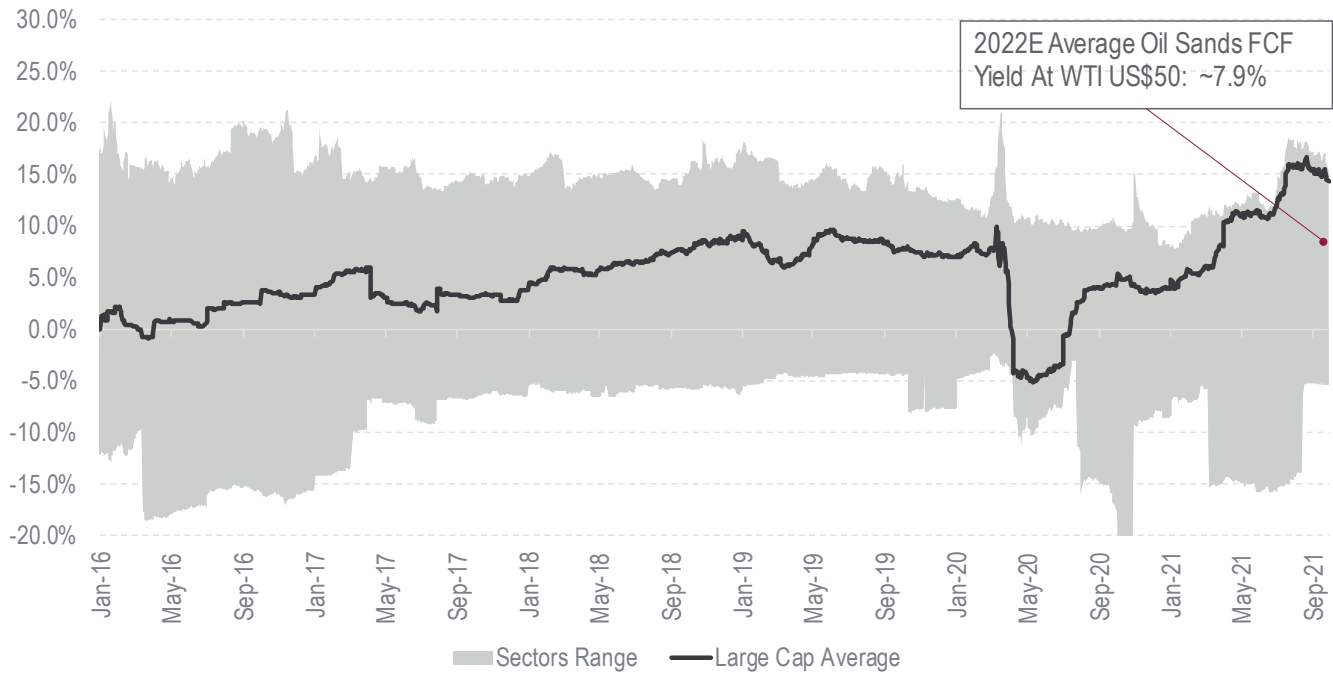
Oil Sands Companies Show Significant Value On FCF Yield

We believe that energy companies must compete for capital against other industries and not just against each other. That “value” must be derived from sustainable returns to shareholders that are resilient through the lows of a cyclical commodity. We estimate the Canadian oil sands group is trading at an EV-based FCF yield of ~17% on 2022E strip pricing and this marks the widest spread compared to the risk-free borrowing rate, the interest rate-focused asset classes (on Bloomberg consensus estimates) and the Canadian energy group’s historical EV-based free cash flow yield over the past 20 years of ~1%. The chart in Exhibit 4 below shows the free cash flow yield of the Canadian oil sands companies against other sectors on consensus estimates including the U.S. Majors, Super Majors, Canadian midstream, Telecom, Utilities and Mining industries.

Even at US\$50 WTI, we estimate that our oil sands coverage shows a competitive debt-adjusted EV-based free cash flow yield vs. other yield-focused industries.

Given the focus on cost reductions and the shift away from major capital projects, we estimate that the oil sands companies are still competitive on an FCF yield basis to other yield-focused industries. We have highlighted our estimated FCF yield at US\$50 WTI pricing, which is over US\$30 below the prompt month and ~US\$5 below the 2022 to 2030 forward curve for the oil sands companies against other industry averages based on Bloomberg consensus estimates.

Exhibit 4: Energy – Canadian Oil Sands EV-based Free Cash Flow Yield (%) Vs. Interest-Rate Focused Industries On Bloomberg Consensus, 2016 – Present



Note: Included Sectors - Oil & Gas (CDN / US / Super Major), CDN Midstream, Telecommunication, Utilities, and Mining

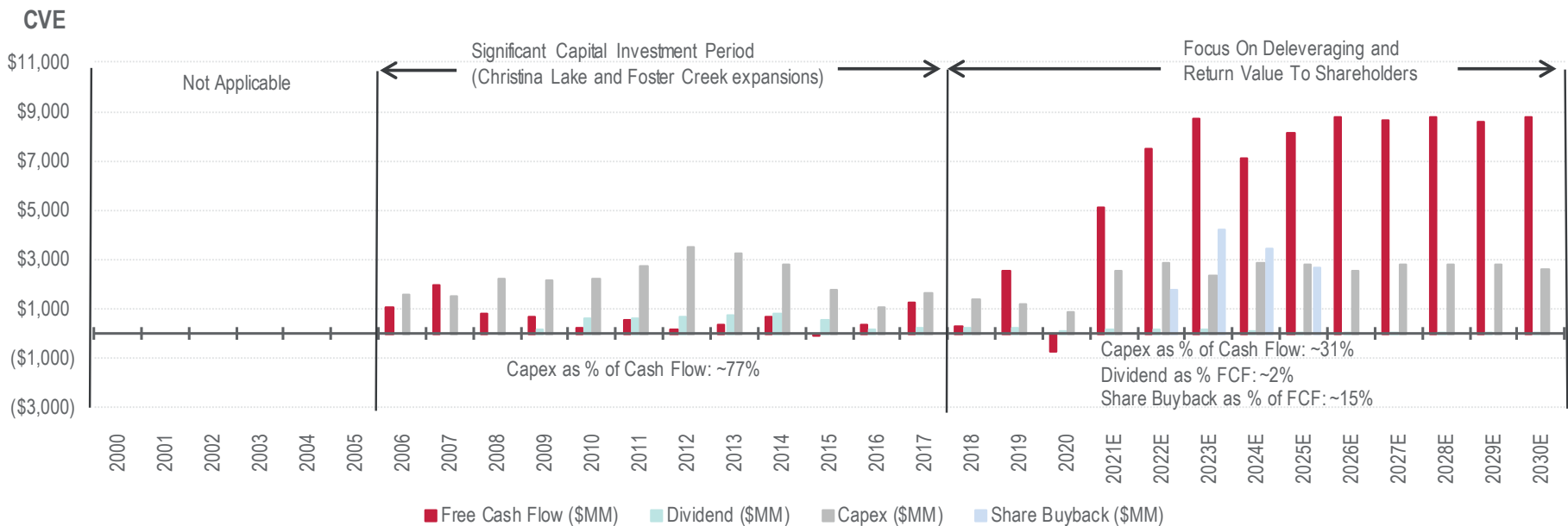
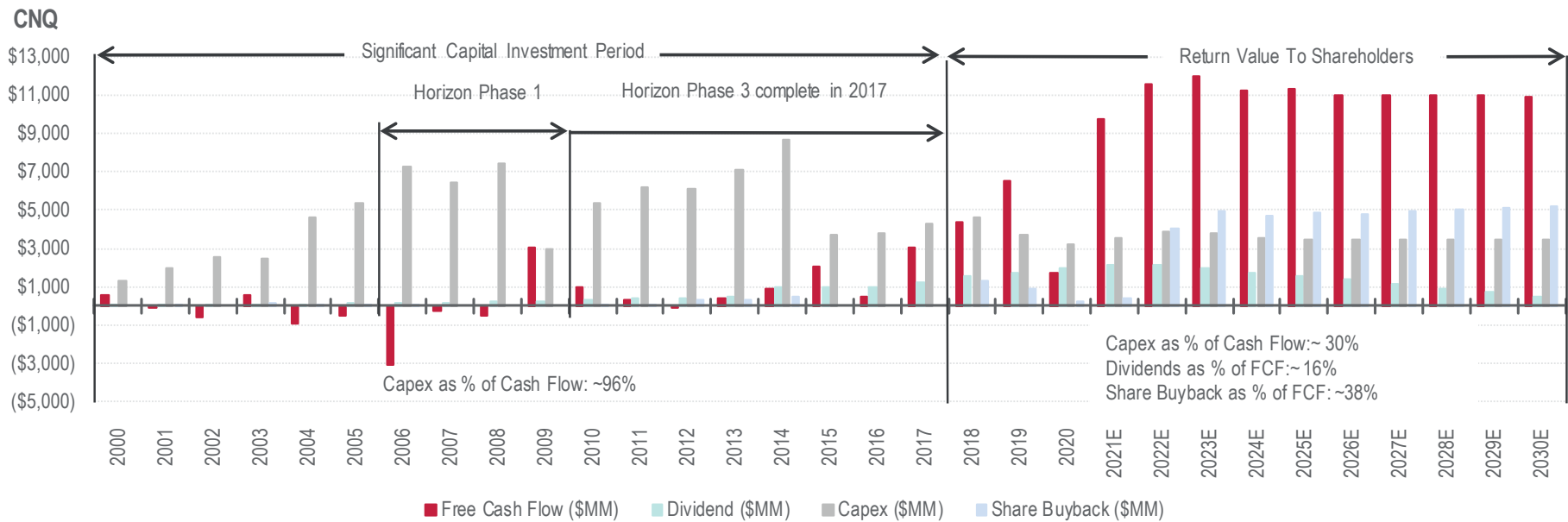
Source: Bloomberg, company reports and CIBC World Markets Inc.

Major Capital Spending Is Behind Us

We have highlighted several times in past publications our belief that the period of major oil sands growth is now behind us and that Fort Hills was likely the last greenfield project to be commissioned. Looking forward, we expect companies to move forward with smaller brownfield projects, debottlenecking work, and optimizing their existing assets. This is an important factor given oil sands companies have historically turned down capital allocation towards share buybacks in periods of higher (major project) spending. Further, we view large-scale consolidation in the oil sands as being mostly completed (with a couple exceptions).

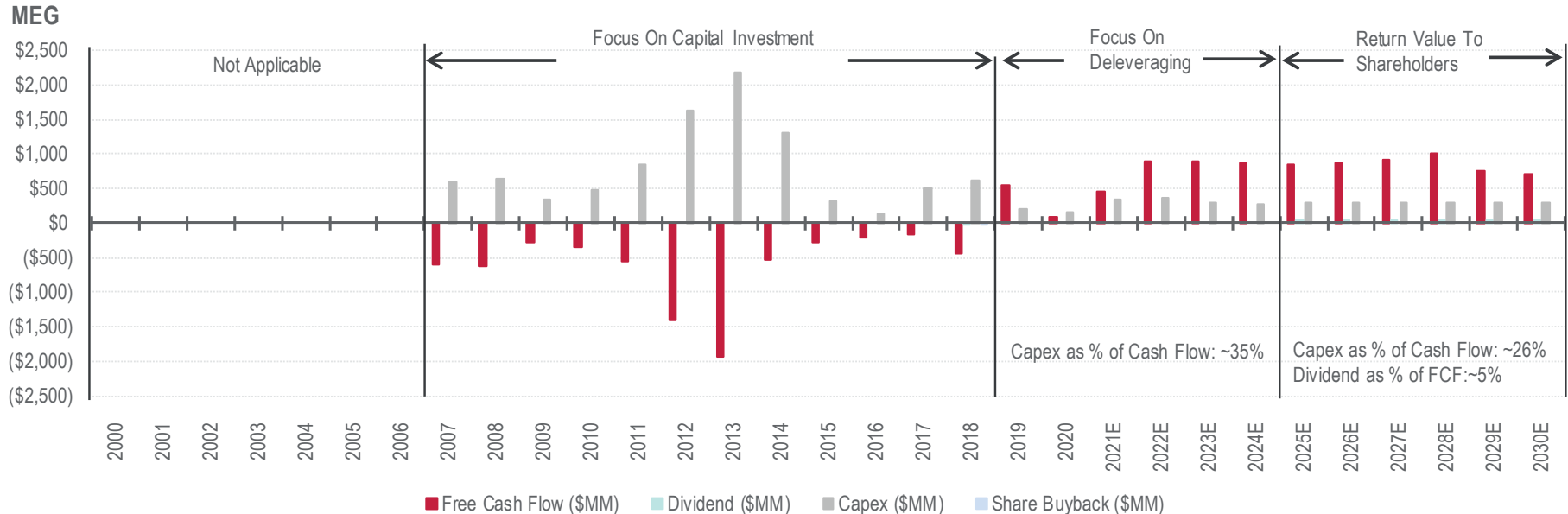
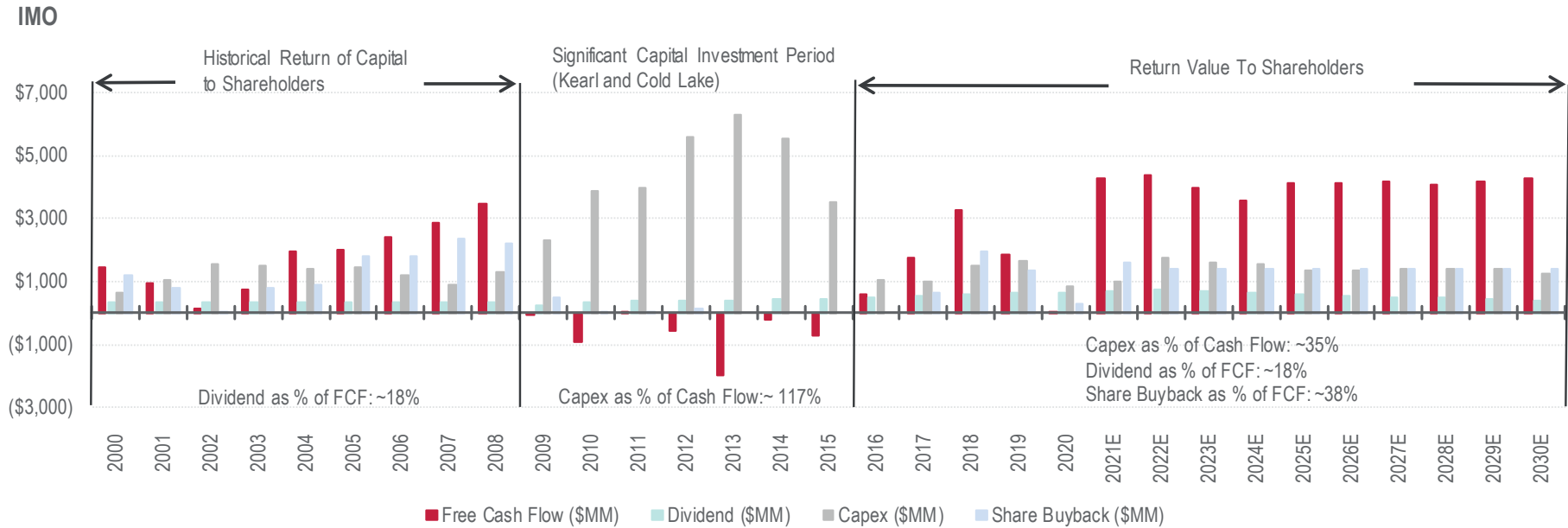
We estimate every one of the oil sands companies is entering a period of cash harvest from their oil sands assets with some spending directed towards debottlenecking, improved operating efficiencies and/or energy transition. This spending is not expected to disrupt any of the companies' ability to generate significant free cash flow. Further, in periods of higher oil prices, we believe the free cash flow that could accrue to shareholders will meaningfully increase as we do not expect companies to resume large growth projects with aggregate concerns over energy transition. The bar charts in Exhibits 5-7 below show the various periods of capital allocation towards major capital spending and share repurchases/cash returns to shareholders through time. Long-term pricing is based on CIBC Base Price forecast of US\$65 WTI, US\$13 WCS-WTI Basis, and \$0.76US\$/C\$ FX.

Exhibit 5: CNQ And CVE - Capital Allocation, 2000 – 2030E



Source: Company reports and CIBC World Markets Inc.

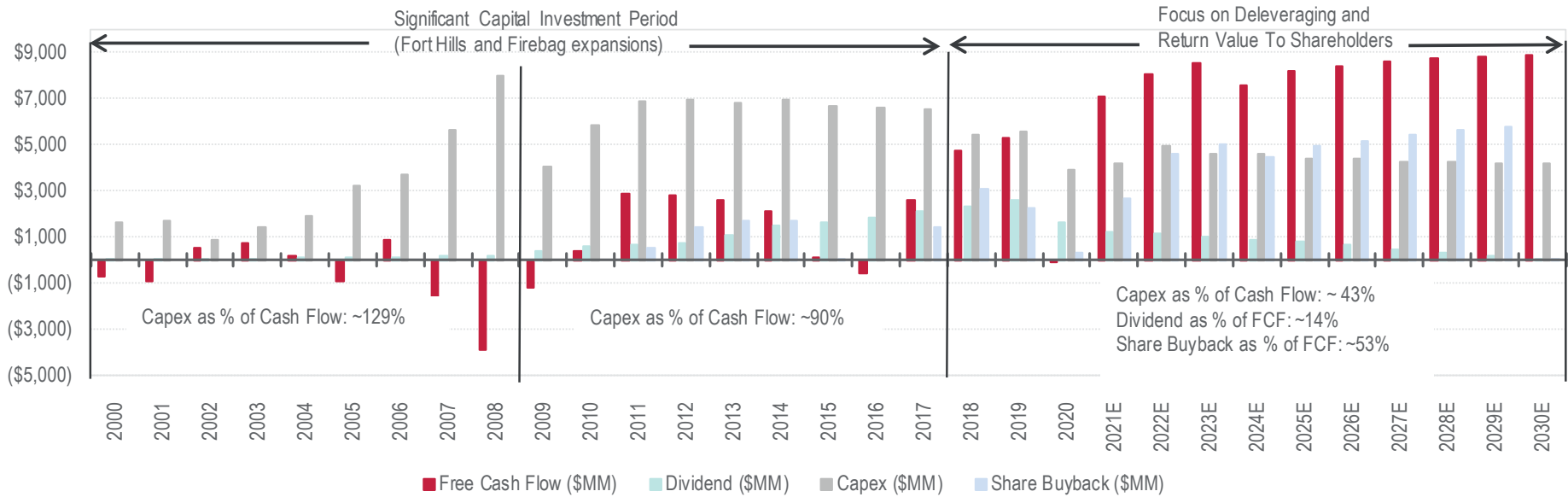
Exhibit 6: IMO And MEG - Capital Allocation, 2000 – 2030E



Source: Company reports and CIBC World Markets Inc.

Exhibit 7: SU - Capital Allocation, 2000 – 2030E

SU



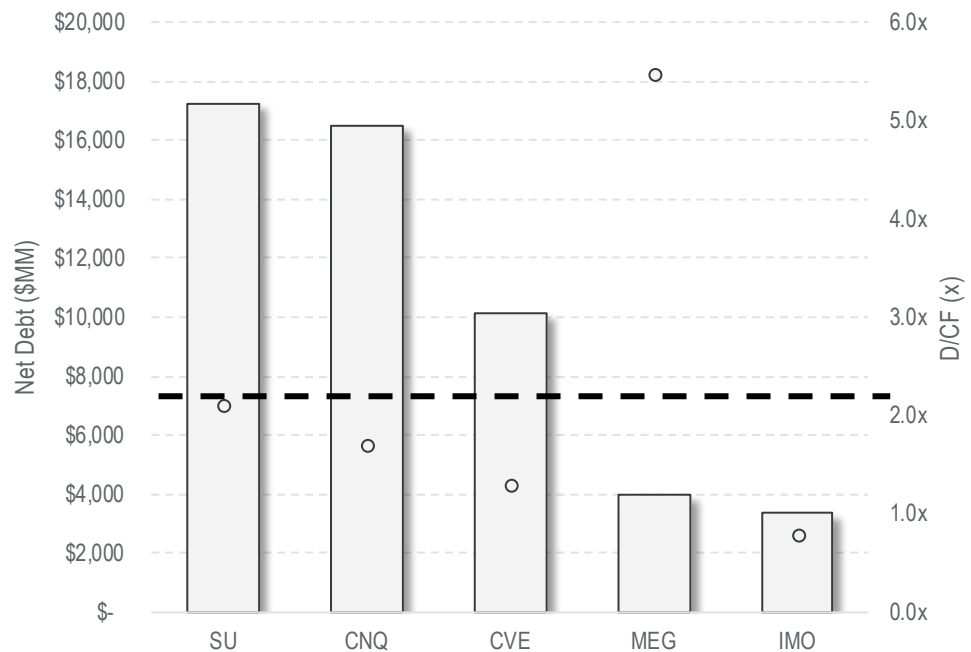
Source: Company reports and CIBC World Markets Inc.

Looking forward, we view capital spending from oil sands companies to represent ~26%-43% of cash flow at US\$65 WTI, helping drive a larger free cash flow margin than has been seen since the 1990s.

Leverage Is Comfortable Even At US\$50 WTI

Given the oil price volatility seen in 2020, coupled with concerns around continued access to capital, companies have taken a more conservative stance with respect to leverage and looked to lower outstanding debt. We estimate the oil sands group will show 2022E D/CF of 0.9x on strip pricing, and will continue allocating a portion of FCF to further lower outstanding leverage. In a downside scenario of US\$50 WTI, we estimate the group will show 2022E D/CF of 2.3x.

Exhibit 8: Oil Sands – Net Debt (\$MM) And D/CF At US\$50 WTI, 2022E



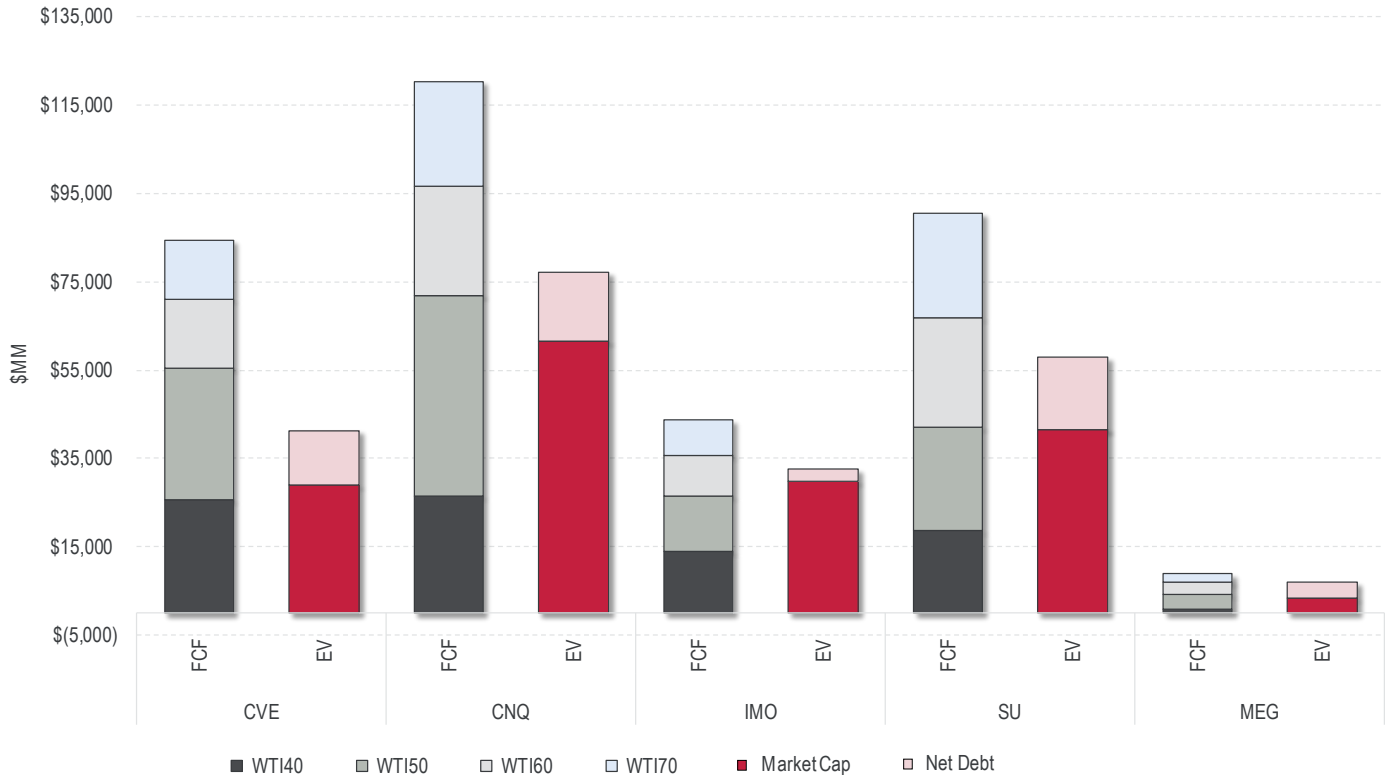
Source: Company reports and CIBC World Markets Inc.

The Market Is Over Estimating Terminal Value Risk

We believe there will be resiliency in demand for heavy and synthetic oils, suggesting that there will be a longer tail in oil sands production than the market is currently pricing in. We highlighted these factors in our report on the impact of electric vehicles on the oil sands ([Link](#)). On average (at US\$60/Bbl flat pricing) our oil sands coverage universe trades at a price to RNAV of ~86% and will free cash flow the enterprise value of the company within 9 years at US\$60 WTI (on average). We believe the oil sands companies can repurchase their entire market cap within eight years at US\$50 WTI. The bar charts in Exhibit 9 below highlight the cumulative free cash flow generated from 2021 to 2030, at US\$40 to US\$70 WTI pricing, and compare to the current market cap and enterprise value of the oil sands companies.

We believe oil sands companies will free cash flow their market cap at US\$50 WTI or lower by 2030.

Exhibit 9: Energy – Free Cash Flow Sensitivities, 2021E – 2030E



Note: Free Cash Flow / Enterprise Value for OVV is presented in USD

Source: Company reports and CIBC World Markets Inc.

Generating Their Own Demand

We estimate the oil sands group will generate ~\$28 billion in free cash flow each year after the dividend, sustaining capital spending requirements and modest growth projects at US\$65 WTI. This represents ~12% of the \$233 billion annual average value of shares traded over the past five years between both the Canadian and U.S. indices. We expect the timing of repurchases could stem and even help reverse the impact of funds flow leaving the Canadian energy sector. Further, we expect the significance of these buybacks could accentuate share price outperformance despite global concerns around a multi-year (or even multi-decade) energy transition and recommend investors look to accumulate shares in companies which frame a focus of capital allocation towards share repurchases.

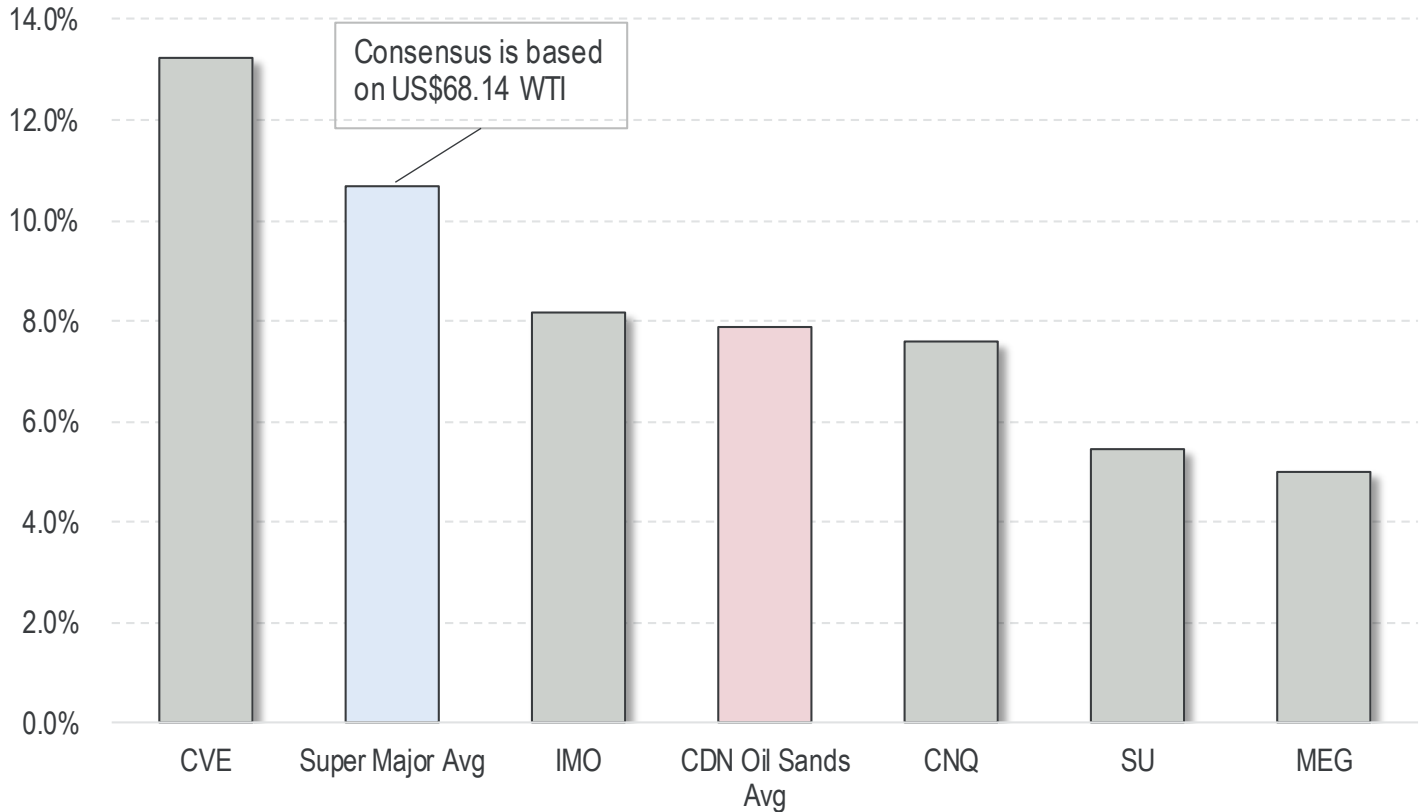
Key Observations: What We Like And Why

We highlight CNQ, IMO and SU as three companies where we expect free cash flow generation to disproportionately accrue to shareholders given their relative leverage. Despite the relatively attractive free cash flow valuation for CVE, we expect a balanced approach of capital allocation towards lowering leverage and returning cash to shareholders. We expect the company is on the cusp of accelerating free cash flow allocation towards shareholders as the company reaches its debt target in 2022 (oil price dependent). For MEG, we highlight a large focus on paying down debt, but if the oil price follows the forward curve, the company could begin discussing plans to return capital to shareholders in late-2022.

Our analysis suggests that the entire sector is showing an attractive valuation, but we view there to be a larger disconnection between the Canadian oil sands companies and the

movement in the underlying commodity. Despite having relatively lower sustaining capital requirements compared to more conventional plays, we believe investors have more than priced in concerns around energy transition and terminal value risk for the Canadian oil sands companies. The bar chart in Exhibit 10 below shows our estimated 2022E free cash flow yield at US\$50 WTI for the Canadian large-cap companies and Energy Supermajors on Factset consensus (which has an average 2022 WTI price expectation of ~US\$68).

Exhibit 10: Energy – EV-Based Free Cash Flow Yield (%) – CDN Oil Sands (US\$50 WTI) Vs. Consensus Estimates By Sector, 2022E



Super Majors Include: BP, CVX, COP, ENI, XOM, OXY, RDS, TOT, EQNR

Source: FactSet, company reports and CIBC World Markets Inc.

Risks

If commodity prices were to decline sharply, especially for sustained periods of time, the oil sands companies' revenue, cash flows, and financial flexibility would become more challenged. In addition to the aforementioned commodity macro risks, there is rising risk around Green House Gas legislation for the oil sands.

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