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Canadian Oil Sands hurt by persistent decline in oil prices

by LEE Yanru

With oil prices hitting a six-year low on Aug 24 (see Figure 1), oil sands companies in Canada have experienced a highly challenging period in the past one year. These companies, which typically incur a higher cost of production as a result of the intensive process of separating oil from sand deposits, have been adversely hit by the low oil prices. Moreover, higher transportation costs involved in transporting Canadian oil from its remote source in Alberta to the refineries is also a factor. The margin is compressed further by the discount in the trading price of Canadian crude oil, which is heavier and has higher sulfur content. Therefore, additional refining processes are required to extract useful condensates from the crude oil.

Canada's oil sands is the third-largest proven oil reserves in the world, after Venezuela and Saudi Arabia. Among the Canadian oil and gas producers with more than CAD 1bn in market capitalization, Canadian Oil Sands Ltd. is the worst hit by the fall in oil prices. Unlike other producers, who generate profits from various sources, Canadian Oil Sands' revenues primarily come from oil sands production. The company also has the largest stake of 36.74% in Syncrude Canada, a joint venture with the world's largest producer of synthetic crude oil from oil sands.

Following the plunge in the oil price and the 2% corporate tax hike, Canadian Oil Sands has recently taken up several cost cutting measures. The company cut its capital expenditure by 52% to CAD 155mn in Q2 2015, compared to Q2 2014. It also lowered the shareholders' dividends by 75% in Jan 2015. Considering that the breakeven cost for a barrel of oil is USD 43.46, Canadian Oil Sands loses about USD 6 for each barrel it produces, based on the settled price of synthetic crude of USD 37.37 per barrel on Aug 18. Furthermore, the afore-mentioned breakeven cost does not include interest payments, insurance and other costs. Canadian Oil Sands is expected to lose about USD 10 for every barrel sold, after these miscellaneous costs are also taken into account.

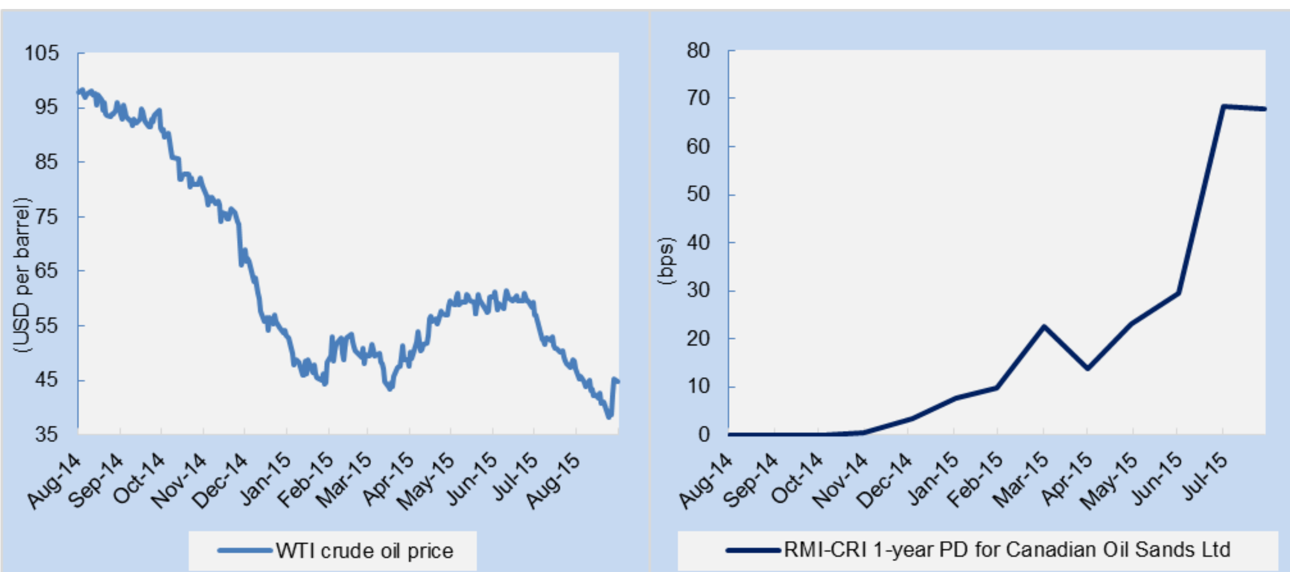

Figure 1: WTI oil price on the left panel; RMI-CRI 1-year PD for Canadian Oil Sands Ltd on the right panel. *Source: RMI-CRI, Bloomberg*

Given the adverse business conditions, the RMI-CRI 1-year Probability of Default (PD) for Canadian Oil Sands has increased from close to 0bps on August 29, 2014 to 67.83bps on August 28, 2015 (see Figure 1). Concurrently, its market capitalization has declined to its lowest point since 2004 of below CAD 3bn on August 19, 2015. This is also aligned with the persistent decline in the price of West Texas Intermediate (WTI) crude oil, a typical grade of crude oil used as an industry benchmark in oil pricing, to its six-year low of USD 38.24 on Aug 24. Table 1 shows the net interest margin and the total debt to equity ratio of Canadian Oil Sands. The profitability and the leverage of the company have been deteriorating since the beginning of 2014. In view of the company's financial difficulties, Moody's recently downgraded the rating of Canadian Oil Sands' senior unsecured debt from Baa2 to Baa3, just one notch away from speculative grade. Moody's rationale for downgrading the instrument was its elevated leverage metrics, such as its debt to EBITDA ratio. However, Moody's added that there will be a possibility of an upgrade in Canadian Oil Sands' credit rating, if the West Texas Intermediate crude oil price rises above USD 60 per barrel.

	Q1 2014	Q2 2014	Q3 2014	Q4 2014	Q1 2015	Q2 2015
Net Income Margin (%)	15.44	19.56	9.66	3.00	-29.34	-21.81
Total Debt / Equity (%)	34.99	33.63	40.50	42.01	53.03	59.24

Table 1: Financial figures of Canadian Oil Sands Ltd. *Source: Bloomberg*

Despite the financial challenges, Canadian Oil Sands has made clear that the shutdown of Syncrude's production is certainly not an option, due to the high costs incurred in temporarily halting its operations and later restarting them again. At present, the company has sufficient funds to cover its operations for the next one year. However, if oil prices do not stage a comeback during this period, the company's credit profile could worsen considerably.

Credit News

China's banks face tightening bad loans squeeze

Aug 30. China's banks are facing an even tighter squeeze as profits stagnate and bad loans jump while the economy continues to slow and heavily indebted companies struggle to survive. The country's big four state-controlled banks reported only marginal gains in net profit for the first half of the year, while official measures of non-performing loans surged. While the central bank eased policy last week, cutting the benchmark interest rate and lowering the reserve ratio requirement for banks, analysts expect China's lenders to remain under increasing pressure as they grapple with the most difficult market conditions they have faced in recent years. (FT)

Asian parts suppliers could be the next victim on China slowdown

Aug 30. The combined effects of China's economic slowdown, a maturing smartphone industry and market volatility are sending jitters through Asian electronic-parts suppliers, which have relied on Chinese consumer demand and manufacturing muscle to power their growth in recent years. After several years of torrid expansion, smartphone sales are slowing in China as stocks of unsold handsets are mounting in stores and warehouses. The slowdown in smartphone sales is expected to hit Asian semiconductor giants whose memory chips are widely used to store data in the devices and is also contributing to a decline in the price of liquid-crystal displays, which hurts screen makers. (WSJ)

Suppliers feel pain as coal miners struggle

Aug 30. The coal industry has been adversely affected by the competition from natural gas, strict regulations of coal's carbon footprint and the appreciating dollar. Equipment suppliers of coal miners are struggling to find new customers as the coal miners were hit by the bearish coal industry. One of the nation's biggest miners, Alpha Natural Resources Inc., declared bankruptcy on August 3. It is expected that other coal mining companies will follow suit. "A lot of these mines that are closing—particularly the smaller ones—I think are gone for good," Paul Lang, president of another Appalachian miner, Arch Coal Inc., said in late July. (WSJ)

Latin America is on the brink of a major debt crisis

Aug 27. Hot money in the past years have been flowing into the fast-growing developing and emerging markets of Latin America in a bid to attain high interest rates. However, the movement of hot money has reversed at a rapid rate recently and this has had adverse effects on Latin America. The Mexican peso has hit a new historical low against the dollar as it hit 17 peso to the dollar on August 24. Brazil, which is Latin America's largest economy, is facing its longest recession since 1930s. Two of the most important causes of Latin America's current woes are the sudden end of the bullish commodity market and the appreciating US dollar. (Business Insider)

British banks have biggest exposure to Chinese market instability

Aug 25. It has been disclosed that the British banks have the biggest exposure to the current market instability in China. The high growth rate of the Chinese economy had caused an increase in British banks lending to the Chinese. “Britain is a very open economy, we’re probably the most open of the world’s largest economies. And so we are affected by what happens; whether it’s the problem in the Eurozone or in Asian financial markets,” Chancellor George Osborne said during a visit to Finland. On August 24, UK witnessed the worst trading day against the Euro in six years. (RT)

Japan’s industrial production unexpectedly declines in July (Bloomberg)

American Apparel said to be planning bankruptcy filing (Bloomberg)

Saudi credit default swaps fall sharply on oil price recovery (Reuters)

Regulatory Updates

Banks warn over European privacy rules

Aug 30. European banks are lobbying Brussels over an overhaul of the privacy laws. The law, which includes the "right to be forgotten" rule that forced Google to remove personal information from search results when requested, was redefined as the "right to erasure" by EU lawmakers. The European parliament and national governments agreed to the plan and are pushing for it to be concluded by year end. Bankers warned that the law could affect their online services and even their fraud detection efforts. Banks that breach the new rules could be liable to fines of as much as 5% of global turnover, according to the draft regulations. (FT)

Stiffer capital rules for retail currency dealers rules

Aug 28. The Commodity Futures Trading Commission has endorsed a set of rules meant to improve the transparency and the capital adequacy of currency dealers to mitigate their risks from overseas transactions. The endorsement came on the back of a USD 300mn bailout of a leading brokerage, which resulted from the unpegging of the Swiss franc in January this year. (Bloomberg)

Mortgage risk pits Denmark against Basel as next collision looms

Aug 24. On the back of the proposal from the Basel Committee on Banking Supervision to set new capital floors for banks that currently use internal credit risk models, the Danish Bankers Association is readying its lobby group with support from its counterparts in Sweden, Finland and the Netherlands. Having won European backing to ignore the 2010 Basel proposal previously, the Danish banks challenged that the new rule, which aims to prevent under-reporting of possible losses, is a poor effort at regulating capital requirements. The regulators' aim at finding a single solution capable of global application risks punishing financial systems with track records of low losses. (Bloomberg)

Bank regulators considering concessions on key capital rule (Bloomberg)

Russian banks not stress tested for weak ruble (WSJ)

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