THE GLOBE AND MAIL

September 8, 2017

Why are investors paying a premium for analysts' least-liked TSX oil stock?

DAVID MILSTEAD

In the Canadian energy sector, where it has sometimes been difficult to recommend stocks, one in particular stands out for its lack of analyst enthusiasm: Imperial Oil Ltd., the oil and gas company majority owned by international giant Exxon Mobil Corp.

Of the 21 analysts who cover Calgary-based Imperial Oil, just two have buy ratings, while 13 have holds and six have sells, according to Thomson Reuters' Eikon database. No other energy stock in the S&P/TSX composite currently has more than two sell ratings.

Analysts, of course, can be wrong. In this case, however, it's more likely they're right and investors are incorrect. Despite a slide in the share price to levels closer to a 52-week low than high, Imperial Oil trades at a premium to the stocks of other "integrated" companies that combine exploration and production (E&P) with refining capacity. And yet, Imperial Oil has delivered worse performance, largely because of its botched Kearl oil-sands project, and provides less disclosure than other companies, making it harder to see whether the company is actually improving.

Imperial Oil itself knows that Kearl has been a disappointment, with shortfalls at the project contributing to its second-quarter misses in production numbers, earnings and cash flow. In its most recent quarterly earnings report, the company emphasized its plan "to achieve targeted production levels at Kearl" and is "taking actions to resolve reliability issues."

Analysts say the company overspent when building the project, which opened in 2013, and has since had multiple reliability issues that have led to the project repeatedly falling short of targeted production.

"The project from day one has been problematic," says BMO Nesbitt Burns analyst Randy Ollenberger, who has a "hold" rating and $43 target price on the stock, versus Friday's close of $37.28. By falling short of production targets, he says, Imperial Oil has to spread its fixed costs over fewer barrels of oil, making its output expensive on a per-barrel basis. It's going to be a "virtual impossibility" to get reasonable returns, he argues, without at least $80 (U.S.) per barrel oil, and maybe $100 per barrel oil.

Brian Bagnell of Macquarie Securities says "if any other large-cap oil sands companies had an asset that performed like Kearl, their stock wouldn't trade at the premium that Imperial's does. They massively overspent on the initial phase, and the project still is not at design capacity, years later."

The combination of poor performance and slim disclosures makes it all the more befuddling why Imperial Oil trades at a premium to peers. According to S&P Global Market Intelligence, Imperial Oil trades at an enterprise-value-to-EBITDA multiple of 10.7, while the other integrateds are cheaper: Suncor is under 9.2, Cenovus trades at 7.2, and Husky Energy is at 6.1. (Canadian Natural Resources, classified as an E&P, trades at 8.4.) Analyst Neil Mahta of Goldman Sachs, who uses a cash flow multiple in his analysis, sees the spread as even larger and says Imperial Oil's valuation "appears stretched versus peers." He has a $33 target price and "sell" rating.

Nima Billou, an analyst at ***Veritas Investment Research***, estimates that Kearl generated negative EBITDA, or earnings before interest, taxes, depreciation and amortization, of about $14 per barrel in the second quarter. ***Mr. Billou*** estimates Imperial Oil's intrinsic value at $33.50.

Part of the reason ***Mr. Billou*** and others must estimate Kearl's profitability is that Imperial Oil does not disclose any project-level cost data for Kearl or any other major project. Other Canadian E&Ps with projects of similar size give unit-level disclosure on royalties, operating expenses, transportation costs and prices realized, says Macquarie's Mr. Bagnell. "Imperial, at their investor day, has said they plan to get Kearl down to $20 a barrel U.S. operating cost, and we have no way to determine if they are actually doing that."

BMO's Mr. Ollenberger says Imperial Oil's disclosure "is terrible, and it's always been terrible. Not only do they not provide any level of detail, they provide even less detail on the day they report quarterly results. You have to wait for their U.S. regulatory filings a couple weeks later to get a glimmer of detail … it makes it hard to properly assess projects, accurately assess problems and opportunities, and it's evidence the company's not really run for the minority shareholders, it's clearly run as an Exxon subsidiary." (Exxon Mobil owns just under 70 per cent of Imperial Oil's shares.)

Exxon, as with other huge U.S. oil companies, does not provide project-level detail, but Lisa Schmidt, a spokeswoman with Imperial Oil, dismisses the idea that the company's disclosure policies are directed by Exxon. "Imperial is an independent company," she says. She also notes Imperial Oil is an integrated energy company with refining activities, versus a pure exploration and production company, and that's what drives its segmented results, as reported in its U.S. securities filings. "Relevant business metrics are reported consistent with this business segmentation," she says.

Mr. Bagnell of Macquarie says his "underperform" rating and $31 target price is because "we think that names like Canadian Natural and Suncor offer a better free cash profile with a lower valuation and higher reliability. Imperial's a stable company and investors tend to view it as a place to hide in the energy sector, but given poor returns from their oil sands investments in recent years, the stock probably deserves to trade at a discount, not a premium."

To be fair, we should check in with the minority of analysts who have a buy case for Imperial Oil. Jason Frew of Credit Suisse, who has a $49 target price on the stock, likes the company's strong balance sheet and improvements in free-cash-flow generation. Barclays' Paul Cheung, while acknowledging Kearl "has been a major disappointment," believes the company's cash-flow yield, a measure of cash generated versus sales price, points to the shares having appreciation potential.

And spokeswoman Ms. Schmidt, asked to comment on the company's valuation, said "it's important to note that while we acknowledge room for improvement at Kearl, the valuation of Imperial's shares represents more than the performance of a single asset," citing a strong balance sheet, dividend and attractive asset base. Kearl has an expected life of more than 40 years, she says, "and we have every confidence that it will perform as designed."

Imperial Oil's stock price suggests investors are buying the company's confidence rather than its recent performance.