# Independent Stock Idea

December 6, 2010

rating: contrarian buy
s&p 500: 1225

# Canadian Oil Sands Trust (COSWF)
## Buy on Stock Price Drop

| | | | |
|---|---|---|---|
| *Symbol* | COSWF | *Ebitda Next Twelve Months ending 12/31/11 (US$mm)* | 1,910 |
| *Rating* | Buy | *North American Natural Gas/Ebitda (%)* | -4 |
| *Price (US$/share)* | 25.00 | *Natural Gas and Oil Production/Ebitda (%)* | 100 |
| *Pricing Date* | 12/3/10 | *Adjusted Reserves/Production NTM* | 29.2 |
| *Shares (mm)* | 484 | *EV/Ebitda* | 7.2 |
| *Market Capitalization (US$mm)* | 12,100 | *PV/Ebitda* | 10.5 |
| *Debt (US$mm)* | 1,500 | *Probable Reserves (%)* | 48 |
| *Enterprise Value (EV) (US$mm)* | 13,600 | *Natural Gas and Oil Ebitda (US$/boe)* | 44.28 |
| *Present Value (PV) (US$mm)* | 19,900 | *Present Value Proven and Probable Reserves(US$/boe)* | 23.44 |
| *Net Present Value (US$/share)* | 38 | *Natural Gas and Oil Ebitda ($/boe)* | 51 |
| *Debt/Present Value* | 0.08 | *Earnings Next Twelve Months (US$/share)* | 1.95 |
| *McDep Ratio - EV/PV* | 0.68 | *Price/Earnings Next Twelve Months* | 13 |
| *Dividend Yield (%/year)* | 3.2 | *Dividend Next Twelve Months (US$/share)* | 0.80 |
| Note: Estimated cash flow and earnings tied to one-year futures prices for oil. | | | |
| Estimated present value presumes a long-term price for oil of US$75 a barrel. | | | |
| For historical analysis of COS since 2002 see www.mcdep.com/4cos.htm | | | |

**Summary and Recommendation**

A one-day drop in stock price of 11% presents opportunity, we believe, in Contrarian Buy-recommended **Canadian Oil Sands Trust (COSWF)** stock at a McDep Ratio of 0.68. Traders have reacted to a surprise 60% slash in the dividend rate as opposed to an expected reduction nearer 20%. Actually, current operations indicate no dividend reduction as management's projection of cash flow from operations of C$2.59 a share for 2011 amply covers the rate of C$2.00 indicated by the distribution just paid a few days ago. Instead, management has chosen to apply most of that cash flow to fund all 2011 capital investment and to husband debt capacity. As a result, COSWF now looks just like a conservative major oil company in financial strategy and will appeal to investors who like those stocks, but no longer to investors seeking high income. Meanwhile, the stock may soon attract new institutional owners because of the imminent change from a trust to a corporation, the consequent elimination of restrictions on non-Canadian ownership and a potential U.S. stock exchange listing. At the same time, the absence of a distinctive financial strategy for a business (37% of Syncrude) already managed by major oil company partners makes the acquisition of COSWF by its Syncrude partners a natural economic outcome. It is not efficient for ExxonMobil (XOM) to apply its proprietary technology and expertise to an asset only 25% owned. Moreover, XOM's partner Sinopec thirsts for more oil to supply China's future needs beyond the 9% of Syncrude it bought only seven months ago for a price equivalent to US$35 a share of COSWF. In a nutshell, an artificially depressed stock price, high appreciation potential, increasing marketability of the stock and the presence of natural acquirers make COSWF a timely investment in our opinion.

**Volume Growth of 6% a Year**

Taking an objective look at history, we project Syncrude volume at 314,000 barrels daily (bd) in 2011 with monthly variations dependent on past patterns (see of chart Syncrude Monthly Production on page 4). That is 4% higher than management's midpoint of 301,000 within their range of 279,000 to 315,000. Latest monthly production for November 2010 was 357,000.

Design capacity of 350,000 was reached in 2006 soon after the completion of new capacity, but has not been sustained yet. The experience is contradictory to ExxonMobil's vaunted operational excellence. We surmise that XOM engineers are choosing to fix suspected imperfections immediately rather than stretching out upgrades over future maintenance periods. The steady growth trend fits with the operational practice of capacity creep that characterizes major oil company processing plants.

The declared objective is to reach 425,000 bd of upgrading capacity and an additional 115,000 bd of bitumen capacity by 2020. On that basis the growth rate from 292,000 last year to 540,000 by 2020, would be 6% a year. Operational capacity lasts almost indefinitely without the volume decline of conventional oil production and shale oil production.

**Oil Price Rising**

Latest futures price for oil to be delivered in 2011 average $90 a barrel, 12% higher than $80 a barrel management assumes for its guidance. We use futures prices for our estimates not because we think they are an accurate forecast, but because the prices are widely quoted and automatically reflected in market conditions, at least partially.

**Strong Cash Flow Growth**

From C$1.677 billion on October 29, our current estimate of next twelve months cash flow (Ebitda) is up 14% to C$1.913 billion (see table Next Twelve Months Operating and Financial Estimates on page 5). Four percent higher volume and 12% higher oil price lead to 39% higher Funds from Operations than in management's budget case. Adding back non-production expense, which we regard as a capital investment, and subtracting an allowance for cash income taxes, we estimate cash flow before reinvestment of C$3.69 a share, more than four times the intended dividend rate of C$0.80 (see table Next Twelve Months Dividend Estimates on page 6).

**Income Stock Turning into Investment Growth Stock**

COSWF and its predecessor entities were founded in the 1990s with the specific intent of providing high income streams from capital intensive oil sands projects. While the concept proved to be successful, the Canadian government ended the tax treatment which allowed trusts to pay distributions without first paying a tax at the trust level. The trusts have been encouraged to convert to corporations where dividends are taxed twice, once before being distributed and again when received.

A high income strategy is still possible in corporate form. In reality, corporations pay little immediate tax as new investment can cause the tax to be deferred. Financing new investment with borrowed funds can enhance the tax shelter while interest on the borrowed funds also reduces corporate tax. The downside is that borrowing carries new risk. Insurance from futures and options can help manage that risk, but such insurance has its own costs.

**Appreciation Potential of 46% to a McDep Ratio of 1.0**

Characterizing COSWF's financial strategy as similar to that of a conservative major oil company is hardly negative as we have active buy recommendations on at least five of those stocks with enterprise value above a hundred billion dollars. In all our recommendations we look for oil and gas resource value wherever we can find it. We measure that by the McDep Ratio which compares enterprise value in the numerator and oil and gas resource value, or takeover value, if you will, in the denominator. Whether the denominator will ever be realized depends on a host of considerations including political, economic and industry conditions.

Management is motivated to achieve growth in investment value despite eschewing a high income strategy. As it communicates COSWF's investment outlook, the main differentiating factor will continue to be the pure play on a long-life oil resource. For the time being that resource is being priced lower in COSWF stock than in nearly all other large cap and small cap stocks in our coverage.

The valuation gap is particularly striking in comparison to small cap stocks. On a size basis COSWF at the low end of the size range for large caps ought to be at the high end of the value range for large caps. Common reasons for a premium for small caps include the potential for more rapid growth and for acquisition by a large cap.

The government move to shut down trusts may have been partly motivated by corporate executives who did not like the competition for assets and investors. In any case, a depressed stock price for what was the largest oil trust makes a choice asset appear more acquirable. Minimal debt further enhances COSWF as a consolidation candidate.

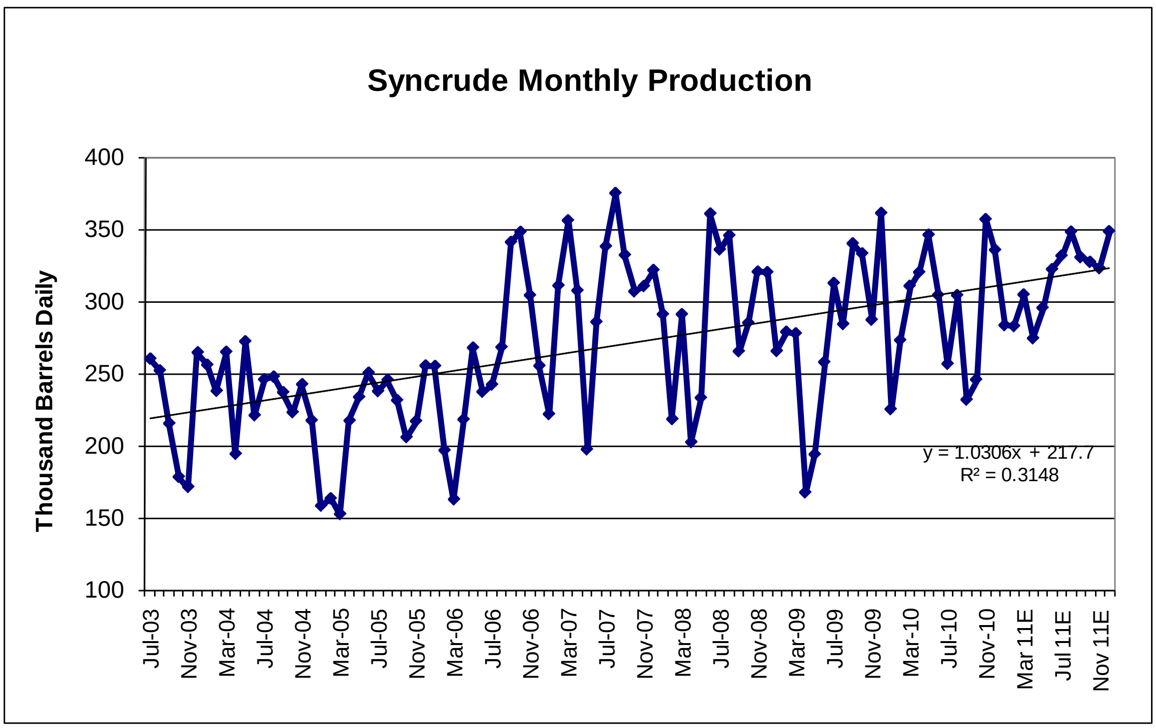
Nor need an acquirer be exclusively a Canadian company. Few governments like foreign control, but international ownership, like international trade benefits all parties for the most part. XOM exerts its control over Syncrude through Imperial Oil (IMO), owned 30% by public shareholders, primarily Canadian. Since XOM and Sinopec share ownership of a refinery in China, it is logical that the two companies are joint owners of oil producer Syncrude. With current ownership at 37% for COSWF, 25% for IMO and 9% for Sinopec, either IMO/XOM or Sinopec could own all of COSWF without any undue political concern, we believe.

While positioned to take advantage of an attractive buyout offer, if it materializes, investors have broader justification to own COSWF stock, we believe. Any investor who owns XOM, for example, could also own some COSWF as a concentrated participation in one of XOM's most attractive assets. In other words, investors can solve XOM's low participation problem in

Syncrude by owning more Syncrude through COSWF.  Should XOM eventually buy COSWF at a higher price, XOM investors who also own COSWF would be protected against possible dilution in the usual takeover sense.

The main point is that the valuation of COSWF seems out of line.  How that disparity gets narrowed is limited only by one's imagination.

Kurt H. Wulff, CFA



MCDEP LLC

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**Canadian Oil Sands Trust**
**Next Twelve Months Operating and Financial Estimates**
(Canadian Dollars)

| | *Q4* | *Q3* | *Q4E* | ***Year*** | *Q1E* | *Q2E* | *Q3E* | *Q4E* | ***Next Twelve Months*** |
|---|---|---|---|---|---|---|---|---|---|
| | *12/31/09* | *9/30/10* | *12/31/10* | ***2010E*** | *3/31/11* | *6/30/11* | *9/30/11* | *12/31/11* | ***12/31/11*** |
| **Volume** | | | | | | | | | |
| Syncrude (mmb) | 30.5 | 24.3 | 28.7 | **106.7** | 26.1 | 27.0 | 31.0 | 30.6 | **114.8** |
| Syncrude (mbd) | 331 | 264 | 312 | **292** | 290 | 297 | 337 | 333 | **314** |
| Trust share (%) | 36.0 | 36.5 | 36.7 | **36.7** | 36.7 | 36.7 | 36.7 | 36.7 | **36.7** |
| Trust Oil (mmb) | 10.97 | 8.88 | 10.55 | **39.1** | 9.60 | 9.93 | 11.38 | 11.25 | **42.2** |
| Trust Oil (mbd) | 119.3 | 96.5 | 114.7 | **107.3** | 106.7 | 109.2 | 123.7 | 122.3 | **115.5** |
| **Price** | | | | | | | | | |
| WTI Cushing (US$/bbl) | 76.09 | 76.08 | 85.13 | **79.43** | 89.58 | 90.08 | 90.12 | 90.11 | **89.97** |
| Currency (US$/C$) | 0.95 | 0.96 | 1.00 | **0.97** | 1.00 | 1.00 | 1.00 | 1.00 | **1.00** |
| WTI Cushing (C$/bbl) | 80.35 | 79.05 | 85.49 | **81.60** | 89.96 | 90.46 | 90.50 | 90.49 | **90.35** |
| Differential | (1.68) | (1.11) | (1.50) | **(1.06)** | (1.50) | (1.50) | (1.50) | (1.50) | **(1.49)** |
| Trust Oil Price (C$/bbl) | 78.67 | 77.94 | 83.99 | **80.55** | 88.46 | 88.96 | 89.00 | 88.99 | **88.86** |
| Henry Hub Nat Gas (US$/mmb | 4.16 | 4.38 | 3.80 | **4.40** | 4.34 | 4.33 | 4.46 | 4.81 | **4.49** |
| Henry Hub Nat Gas (C$/mmbt | 4.40 | 4.55 | 3.82 | **4.52** | 4.36 | 4.35 | 4.48 | 4.83 | **4.51** |
| AECO Natural Gas (C$/GJ) | 4.33 | 3.44 | 2.88 | **3.74** | 3.30 | 3.29 | 3.39 | 3.65 | **3.41** |
| **Revenue** (C$mm) | | | | | | | | | |
| Oil | 863 | 692 | 886 | **3,153** | 849 | 884 | 1,013 | 1,001 | **3,747** |
| Other | (0) | | | | | | | | |
| Total | 864 | 692 | 886 | **3,154** | 849 | 884 | 1,013 | 1,001 | **3,747** |
| **Expense** (C$mm) | | | | | | | | | |
| Production | 284 | 319 | 319 | **1,239** | 331 | 331 | 331 | 331 | **1,325** |
| Purchased Energy | 47 | 36 | 35 | **160** | 36 | 38 | 44 | 47 | **166** |
| Crown Royalties | 93 | 68 | 68 | **299** | 53 | 59 | 80 | 78 | **270** |
| Insurance | 3 | 5 | 3 | **13** | 3 | 3 | 3 | 3 | **10** |
| Administration | 6 | 1 | 9 | **26** | 7 | 7 | 7 | 7 | **26** |
| Reclamation Spending | - | - | - | - | 10 | 10 | 10 | 10 | **38** |
| Total | 433 | 429 | 434 | **1,737** | 439 | 446 | 474 | 475 | **1,834** |
| **Ebitda** | 431 | 263 | 452 | **1,417** | 410 | 438 | 539 | 527 | **1,913** |
| Deprec., Deplet., & Amort. | 312 | 95 | 100 | **392** | 100 | 100 | 100 | 100 | **400** |
| Non-Production | 35 | 26 | 37 | **118** | 36 | 36 | 36 | 36 | **145** |
| Exchange on U.S. Debt | (23) | (30) | | | | | | | |
| Other | (13) | (20) | | | | | | | |
| **Ebit** | 120 | 191 | 315 | **961** | 274 | 302 | 402 | 390 | **1,368** |
| Interest | 23 | 22 | 21 | **91** | 22 | 22 | 22 | 22 | **87** |
| **Ebt** | | | | | 252 | 280 | 381 | 369 | **1,281** |
| Income Tax | | | | | 66 | 73 | 99 | 96 | **333** |
| **Net Income** (C$mm) | 97 | 169 | 294 | **870** | 187 | 207 | 282 | 273 | **948** |
| **Shares** (millions) | 484 | 484 | 484 | **484** | 484 | 484 | 484 | 484 | **484** |
| Earnings per share (C$) | 0.20 | 0.35 | 0.61 | **1.80** | 0.39 | 0.43 | 0.58 | 0.56 | **1.96** |
| Ebitda Margin (E&P) | 50% | 38% | 51% | 45% | 48% | 50% | 53% | 53% | **51%** |
| Tax Rate | | | | | 26% | 26% | 26% | 26% | **26%** |
| **Funds from Operations** ($mm) | 373 | 215 | 394 | **1,262** | 352 | 380 | 481 | 469 | **1,681** |

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| Canadian Oil Sands Trust<br>Next Twelve Months Dividend Estimates<br>(Canadian Dollars) | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | ***Next Twelve Months*** |
| | *Q4* | *Q3* | *Q4E* | ***Year*** | *Q1E* | *Q2E* | *Q3E* | *Q4E* | |
| | *12/31/09* | *9/30/10* | *12/31/10* | ***2010E*** | *3/31/11* | *6/30/11* | *9/30/11* | *12/31/11* | ***12/31/11*** |
| **Ebitda** | 431 | 263 | 452 | **1,417** | 410 | 438 | 539 | 527 | **1,913** |
| Interest | 23 | 22 | 21 | **91** | 22 | 22 | 22 | 22 | **87** |
| Current Income Tax | | | | | 10 | 10 | 10 | 10 | **40** |
| **Cash Flow Before Reinvestment** | 408 | 241 | 431 | **1,326** | 379 | 406 | 507 | 495 | **1,786** |
| Non-Production Expense | 35 | 26 | 37 | **118** | 36 | 36 | 36 | 36 | **145** |
| Capital Expenditures | 101 | 137 | 168 | **511** | 232 | 232 | 232 | 232 | **927** |
| **Free Cash Flow** | 272 | 78 | 226 | **697** | 111 | 138 | 239 | 227 | **714** |
| **Per Share** | | | | | | | | | |
| Cash Flow Before Reinvestment | 0.84 | 0.50 | 0.89 | **2.74** | 0.78 | 0.84 | 1.05 | 1.02 | **3.69** |
| Free Cash Flow | 0.56 | 0.16 | 0.47 | **1.44** | 0.23 | 0.29 | 0.49 | 0.47 | **1.48** |
| Dividend (C$/share) | 0.35 | 0.50 | 0.50 | **1.85** | 0.20 | 0.20 | 0.20 | 0.20 | **0.80** |



**Research Methodology/Ratings Description:** McDep LLC is an independent research originator focused on oil and gas stocks exclusively. The firm applies the forty years of experience of its analyst to estimate a present value of the oil and gas resources and other businesses of covered companies. That value is compared with a company's stock market capitalization and debt. Stocks with low market cap and debt relative to present value tend to outperform stocks with high market cap and debt relative to present value. Buy recommendations are expected to deliver a total return better than 7% per year above inflation.