McDep Associates
Independent Stock Idea
July 29, 2003 (edited August 7)

Rating: Buy
S&P 500: 967

Canadian Oil Sands Trust
Ten-Bagger Potential

Symbol		*Price ($/sh) 6-Aug 2003*	*Shares (mm)*	*Market Cap (US$mm)*	*Net Present Value (US$/sh)*	*Debt/ Present Value*	*McDep Ratio*	*EV/ Sales NTM*	*EV/ Ebitda NTM*	*P/E NTM*	*Distrib. NTM (%)*	*PV/ Ebitda NTM*
COSWF	US$	26.74	86	2,310	45.00	0.19	0.67	3.2	5.5	5.4	5.4	8.2
COS _u.TO	C$	37.45										

McDep Ratio = **M**arket **c**ap and **De**bt to **p**resent value of oil and gas and other businesses		
EV = Enterprise Value = Market Cap and Debt:	US$mm	3,230
Ebitda = Earnings before interest, tax, depreciation and amortization:	US$mm	587
NTM = Next Twelve Months Ended June 30, 2003; P/E = Stock Price to Earnings		
PV = Present Value of oil and gas:	US$mm	4,810
Net Present Value	US$mm	3,880

Summary and Recommendation

Canadian Oil Sands Trust has characteristics of growth, long life, inflation protection, management and undervaluation that promise, but do not assure high payoff. We recommend a full position in the trust units for a diversified energy portfolio, up from a half position previously. The sole asset of the trust is 35% ownership of the Syncrude Oil Sands Plant in northern Alberta that currently produces 260 thousand barrels daily (mbd) of desirable light, sweet petroleum. Expansion is half complete to take that volume to 350 mbd in the first half of 2005. At the same time the price of oil currently at the low end of its real range for the past 35-year cycle may double, triple or quadruple in nominal terms before the new cycle is over. Capable trust management draws no excessive compensation and the trust benefits from the technological resources of partners **ExxonMobil (XOM)**, **ConocoPhillips (COP)**, **Petro-Canada (PCZ)**, **Murphy (MUR)** and Nexen. Remarkably, the unlevered valuation of the trust at 5.5 times cash flow is little more than a third of that for popular energy income partnerships. The timeliness of current purchase appears to be enhanced by a return to full operations after planned downtime, the completion of expansion of ownership from 22% to 35% and possible low dividend tax rate for U.S. investors. Risks include oil price, business interruption, environmental restrictions and taxes.

Potential Multiple Upgrade to 15 from 6

Successful growth investors make money by paying a price for current earnings (P/E) that turns out to be low when higher future earnings are achieved. A growth investor might salivate if the price of a stock promising high growth were the same P/E as a stock promising moderate growth. We explain how the same style of reasoning can be applied to energy stocks if we replace P/E with EV/Ebitda.

Energy earnings have less meaning because as reported they depend primarily on historical cost that bears little relationship to current value in a capital intensive, natural resource industry. What does it tell investors, for example, if current management reports high earnings on a lucky strike by long gone predecessor management? Instead, the performance standard in energy is cash flow before arbitrary depreciation and depletion charges.

The more useful cash flow standard is also before interest charges. The mere step of borrowing money does not affect the unlevered value of a resource. The levered presentation of results for a high debt company can easily be misinterpreted as better than they really are. We label unlevered cash flow Ebitda.

Beware inconsistent comparisons of Price to Ebitda. If the numerator is stock price and the denominator is Ebitda, it is nonsensical to compare a measure after the application of debt in the numerator with a measure before the application of debt in the denominator. We make the consistent comparison of market cap and debt, or Enterprise Value with Ebitda.

Energy companies typically generate today the cash flow that lies years into the future for growth stocks. Thus the analogous indicator to growth for energy producers is reserve life, i.e., how long might high cash flow from current resources last?

Though the previous discussion may seem repetitive, the implications are especially powerful for Canadian Oil Sands Trust (COS). The trust has an EV/Ebitda multiple that seems roughly in line with the low multiple of most energy producers. Yet COS has reserves that last forever, practically speaking. The highest cash flow multiples in the energy industry are enjoyed by pipeline partnerships at around 15. The multiple for COS could be 15 just as well. We don't necessarily count on 15 for COS, but we do expect at least 8.2 as we explain further.

McDep Ratio Spotlights Opportunity in COS

The calculation of EV/Ebitda is relatively straightforward for analysts using objective information, but the interpretation is more subjective. The McDep Ratio is our interpretation that incorporates what we think relative EV/Ebitda should be considering what we know about the situation concerning each stock. For purposes of relative valuation we say that EV/Ebitda should be PV/Ebitda in the current marketplace. In other words, COS ought to have a multiple within a year of 8.2 on today's estimated Ebitda. Subtracting debt and dividing by shares, or units, outstanding implies a stock price equal to net present value of US$ 45 a unit. The McDep Ratio, EV/PV, at 0.67 is among the lowest of stocks in our coverage.

Discounted Cash Flow Adds Rigor to the Positive Valuation Conclusion

Present value analysis expands our look at the interplay of important variables over time. The initial results of our model support more than net present value of US$ 45 a unit (see Table). We discuss the major variables briefly.

Volume Ignores Further Expansion and Arbitrarily Ends in 30 Years The first column on the left displays a trend of volume from existing facilities that does not decline, as would conventional oil production. The second and third columns include incremental volume from the current expansion underway.

Price Taken from the Futures Market Six year futures from the New York Mercantile Exchange are converted into C$. After six years, price is escalated at the inflation rate embedded in 10-year Treasury securities.

Operating Cost Split into Fixed and Variable Component Half of current cost remains fixed and the other half is escalated with revenue.

Provincial Royalty Encourages Investment For the next few years, only a minimum royalty of 1% of revenue is due the Province of Alberta. Thereafter we have projected royalty at 25% of profit. More likely, the plant would be expanded further and royalties would revert to the minimum rate during the expansion spending.

Capital Spending Provides for Ongoing Maintenance The present value calculation is not sensitive to remaining expansion capital spending. Management has gone to great lengths in hedging revenues, costs and currency, insuring against business interruption and maintaining a strong balance sheet to be sure that the trust can meet its capital requirements the next few years. Thereafter a rough allowance for continuing maintenance spending reduces present value.

Discount Rate Allows for Contingencies A discount rate of 9% per year is more than enough for a competitive rate of return on an investment equal to present value of the project. Perhaps we will learn that there are some costs that we have understated in our projection. Equity returns would be higher after leverage. The trust adds modest leverage and aggressive investors can add more if they wish.

Table COS-1
Canadian Oil Sands Trust
Present Value
(Canadian dollars)

Volume Decline (%/yr):	0	Price Escalation Post 2009 (%/yr):	1.9
Currency (US$/C$)	0.72	Discount rate (%/yr):	9.2
Royalty/Profit (%):	25	U.S. TIPS Inflation (%/yr):	1.9
Fixed Operating Cost ($mm):	300	U.S. 10 Year Yield (%/yr):	4.3
Variable Operating Cost (%):	21	Beginning Debt ($mm):	1281
PV/Volume ($/bbl):	5.01	Present Value (US$/unit):	45.00

Year	Basic (mmb)	Volume Enhanced (mmb)	Total (mmb)	Price ($/bbl)	Revenue ($mm)	Oper Cost ($mm)	Royalty ($mm)	Capital Exp. ($mm)	Cash Flow ($mm)	Disc Factor	Present Value ($mm)
Total 2004 through 2033; years ending on 6/30											
	996	335	1331	42.03	55960	20741	6136		25064	0.27	6674
2004	33.2	0.0	33.2	42.62	1416	587	14	800	15	0.96	14
2005	33.2	1.8	35.0	36.20	1267	566	13	300	388	0.88	340
2006	33.2	6.8	40.0	34.40	1376	589	119	150	518	0.80	415
2007	33.2	12.1	45.3	34.21	1550	625	148	150	626	0.73	460
2008	33.2	12.1	45.3	34.06	1543	624	147	150	622	0.67	418
2009	33.2	12.1	45.3	33.94	1538	623	146	150	619	0.62	381
2010	33.2	12.1	45.3	34.60	1567	629	152	150	636	0.56	359
2011	33.2	12.1	45.3	35.26	1597	635	158	150	654	0.52	338
2012	33.2	12.1	45.3	35.94	1628	642	164	150	673	0.47	318
2013	33.2	12.1	45.3	36.64	1660	649	170	150	691	0.43	300
2014	33.2	12.1	45.3	37.35	1692	655	176	150	710	0.40	282
2015	33.2	12.1	45.3	38.07	1724	662	183	150	729	0.36	265
2016	33.2	12.1	45.3	38.80	1758	669	189	150	749	0.33	249
2017	33.2	12.1	45.3	39.55	1792	676	196	150	769	0.30	234
2018	33.2	12.1	45.3	40.31	1826	683	203	150	790	0.28	220
2019	33.2	12.1	45.3	41.09	1861	691	210	150	811	0.26	207
2020	33.2	12.1	45.3	41.88	1897	698	217	150	832	0.23	195
2021	33.2	12.1	45.3	42.69	1934	706	224	150	854	0.21	183
2022	33.2	12.1	45.3	43.52	1971	714	232	150	876	0.20	172
2023	33.2	12.1	45.3	44.36	2009	722	239	150	898	0.18	161
2024	33.2	12.1	45.3	45.21	2048	730	247	150	921	0.16	152
2025	33.2	12.1	45.3	46.08	2088	738	255	150	945	0.15	142
2026	33.2	12.1	45.3	46.97	2128	747	262	150	969	0.14	134
2027	33.2	12.1	45.3	47.88	2169	755	271	150	993	0.13	126
2028	33.2	12.1	45.3	48.80	2211	764	279	150	1018	0.12	118
2029	33.2	12.1	45.3	49.75	2254	773	287	150	1043	0.11	111
2030	33.2	12.1	45.3	50.71	2297	782	296	150	1069	0.10	104
2031	33.2	12.1	45.3	51.69	2341	792	305	150	1095	0.09	97
2032	33.2	12.1	45.3	52.68	2387	801	314	150	1122	0.08	91
2033	33.2	12.1	45.3	53.70	2433	811	323	150	1149	0.07	86

Cash Flow Jumps with Volume and Increased Share

A next twelve months model looks at the variables in more detail (see Table). The trust issued a 26-page press release that thoroughly discusses recent results and gives detailed guidance for the rest of 2003. We summarize the results and make projections mostly consistent with the guidance.

Syncrude plant volume has returned to a normal level near 260 mbd after being lower for major maintenance completed in April. Normal volume is anticipated for the rest of the year. We continue that level for the first half of 2004. Perhaps there may be some downtime in the cold winter months either unanticipated or yet to be announced.

The share of volume accruing to the trust increased to 35.5% on July 10. That was the closing date for the second transaction that completed the acquisition of Encana's interest in the Syncrude plant.

We use the futures market for our oil price forecast. We leave out oil price hedging and assume no future currency changes. Management points out that there may be some erosion of Syncrude oil price relative to the industry benchmark as the output from a third oil sands producer comes into the market.

Purchased energy refers to natural gas used in the refining process. In a sense we could say that the trust has a negative 10% representation in North American natural gas, one of our favorite areas where we want a positive representation. We expect some further appreciation in natural gas relative to oil. The negative impact on COS is not great enough to have much effect on our otherwise positive case.

The combination of factors leads to a jump in projected Ebitda to C$225 million in the third quarter from C$75 calculated from second quarter disclosures. NTM Ebitda of C$815 million forms the base for our valuation comparisons. As we mentioned, the projections ignore hedging and will change from week to week with oil price.

Trust Dividends to U.S. Investors May Qualify for Lower Tax Rate

We are happy to conclude, until shown definitive interpretation to the contrary, that COS dividends qualify for the new 15% rate for U.S. taxpayers. Of course, we are not tax experts and no one should rely exclusively on our discussion for tax purposes.

Considering that COS has trust in its name, we assumed initially that the trust's distribution did not qualify for the new lower tax rate for U.S. investors. That cautious reaction was influenced by the knowledge that the trust already avoids certain Canadian income taxes. Yet we see that the trust did provide for some income taxes in the most recent quarter. Moreover future royalty payments to the Province of Alberta have the character of income taxes.

Table COS-2
Canadian Oil Sands Trust
Next Twelve Months Operating and Financial Estimates

	Q1 *3/31/03*	*Q2* *6/30/03*	*Q3E* ***9/30/03***	*Q4E* ***12/30/03***	***Year*** ***2003E***	*Q1E* ***3/31/04***	*Q2E* *6/30/04*	***Next Twelve*** *Months* *6/30/04*
Volume								
Syncrude (mmb)	17.0	19.2	23.9	23.9	**84.0**	23.4	23.7	**94.9**
Syncrude (mbd)	189	211	260	260	**230**	260	260	**260**
Days	90	91	92	92	**365**	90	91	**365**
Trust share (%)	25	31	35	35	**32**	35	35	**35**
Trust Oil (mmb)	4.21	5.89	8.37	8.37	**26.8**	8.19	8.28	**33.2**
Trust Oil (mbd)	46.8	64.8	91.0	91.0	**73.6**	91.0	91.0	**91.0**
Price								
WTI Cushing (US$/bbl)	34.03	29.07	31.57	30.92	**31.40**	29.28	27.89	**29.92**
Currency (US$/C$)	0.66	0.72	0.72	0.72	**0.70**	0.72	0.72	**0.72**
WTI Cushing (C$/bbl)	51.40	40.38	43.84	42.95	**44.64**	40.66	38.74	**41.55**
Differential	0.31	1.03	1.12	1.10	**0.31**	1.04	0.99	**1.08**
Trust Oil Price (C$/bbl)	51.71	41.41	44.97	44.05	**44.96**	41.70	39.73	**42.62**
Revenue ($mm)								
Oil	218	244	376	369	**1,207**	342	329	**1,416**
Hedging and other	(40)	(10)			**(50)**			**-**
Total	178	234	376	369	**1,157**	342	329	**1,416**
Expense								
Production	80	115	99	99	**393**	97	98	**393**
Purchased Energy	22	27	34	34	**117**	33	34	**135**
Crown Royalties	2	3	4	4	**12**	3	3	**14**
Other	10	15	15	15	**54**	15	15	**59**
Total	114	159	152	151	**576**	148	150	**601**
Ebitda	64	75	225	217	**581**	193	179	$\boxed{\textbf{815}}$
Deprec., Deplet., & Amort.	14	23	33	33	**104**	33	33	**133**
Currency	(44)	(41)			**(85)**			**-**
Ebit	94	93	191	184	**562**	160	146	**682**
Interest	13	17	21	21	**72**	21	21	**84**
Ebt	81	76	170	163	**490**	139	125	**598**
Income Tax	(2)	13						
Net Income ($mm)	83	63	170	163	**479**	139	125	**598**
Per Unit ($)	1.24	0.79	1.97	1.89	**5.89**	1.62	1.45	**6.93**
Units (millions)	67.2	79.6	86.3	86.3	**81.4**	86.3	86.3	**86.3**
Production ($/bbl)	18.99	19.52	11.83	11.83	**14.64**	11.83	11.83	**11.83**
Purchased Energy ($/bbl)	5.22	4.53	4.06	4.06	**4.35**	4.06	4.06	**4.06**
Prod&Purch En ($/bbl)	24.21	24.05	15.89	15.89	**18.98**	15.89	15.89	**15.89**
Crown Royalties	1%	1%	1%	1%	**1%**	1%	1%	**1%**
Other Expense ($/bbl)	2.35	2.51	1.77	1.77	**2.02**	1.81	1.79	**1.78**
Ebitda Margin	36%	32%	60%	59%	**50%**	57%	55%	**58%**
Deprec., D,& A ($/bbl)	3.33	3.90	4.00	4.00	**3.87**	4.00	4.00	**4.00**
Interest Rate (%/yr)	5.2	6.2	6.6					
Tax rate	-3%	17%	0%	0%	**0%**	0%	0%	**0%**
Distribution	0.50	0.50	0.50	0.50	**2.00**	0.50	0.50	**2.00**

We also know that when the trust had an opportunity years ago to elect whether or not to be taxed as a corporation in the U.S., it did elect to be taxed as a corporation. While a portion, about 11%, of last year's distribution qualified as a tax free return of capital to U.S. holders, the remainder was taxable like a dividend at ordinary income tax rates.

The new tax law appears to provide that dividends are eligible for the lower rate if the stock of the paying entity trades in the U.S. or the entity is headquartered in a country with a tax treaty with the U.S. COS qualifies on the latter point.

Canadian Withholding Tax Avoidable in Tax-Deferred Accounts

There is a 15% tax withheld from dividends paid to U.S. investors. Institutional investors managing tax-exempt or tax-deferred accounts are usually careful to go to the necessary effort to avoid that tax as current rules permit. Individual investors have probably paid that tax unnecessarily because the paying agent deducted it. Yet investors in a self-directed Individual Retirement Account, for example, should also be able to avoid the withholding tax. Some custodians are likely to be immediately responsive or even anticipate the issue while others may need prodding.

Meanwhile, the incentive to put a high dividend paying stock in a tax-deferred account is considerably diminished by the new tax law that reduces the rate on dividends to 15%. That compares to a likely higher rate on eventual withdrawals from a tax-deferred account.

Buy COS_u through a Canadian Broker or COSWF through a U.S. Broker

Large, experienced investors in Canadian energy stocks usually have direct contacts with Canadian brokers and do their buying and selling in Canada through them. Smaller investors dealing with U.S. brokers soon come across the symbol COSWF. It readily becomes apparent the COSWF does not trade in large volume or not even every day. As we understand it COSWF is more or less a record-keeping symbol for U.S. brokers who buy or sell the stock in Toronto directly or indirectly and convert the price to U.S. dollars. We have learned that buying and selling COSWF can be done through full service or online brokers efficiently. We think it is best to specify a price limit that takes into consideration the contemporaneous quote for COS_u in Toronto and the Canadian dollar exchange rate.

We are changing the symbol for COS in our weekly Meter Reader. We plan to use the symbol COSWF and will calculate price on the basis of the closing Toronto quote and the latest exchange rate.

As we can see, the lack of a U.S. stock exchange listing for COS need not be a deterrent to U.S. investors. It probably does translate to a lower stock price, which is still a good thing as we are building our interest in the stock.

Not having a U.S. listing also postpones the day when it could be necessary to limit U.S. purchases. In the past, Canadian rules have apparently sought to limit non-Canadian ownership of entities like COS to 50%. Such rules may disappear eventually. Meanwhile because COS trades only in Canada, it's makeup of stockholders is probably still under 40% U.S.

New Supply of Stock Absorbed

To finance in part a 61% increase in ownership of Syncrude this year, the trust expanded its share count by about 51%. A single U.S. institutional investor bought about a third of the increase in shares in a private placement. The remainder of the shares was placed publicly in Canada while the new stock was not offered in the U.S. We think COS stock has traded at a discount level for most of this year in order that the smaller Canadian market could absorb the new shares. Now with a large transaction behind us, there is a good chance, in our opinion, that the stock could make up some of that lost ground before long.

Distribution May Double and Triple in a Few Years

In our recommendation last year, we projected distribution to double to C$4.00 per unit in 2006 and triple to more than C$6.00 in 2007. Both levels are covered by cash flow in projections that we believe to be understated.

Kurt H. Wulff, CFA

