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Market Bulletin

Issue No. 228
November 4, 2013

Summary

Recommendations

- Canadian Oil Sands – Reiterate Buy for income and growth; target price $23.
- TransAlta – Reiterate Buy for dividend income; target price $16.

Commentary – Fed's reluctance to "take away the punch bowl" diminishes short-term risks, but exacerbates longer-term peril

ECB's quandary highlights central bank's dilemma – what options do they have left?

Elvis Picardo, CFA

The Federal Reserve had few surprises in its FOMC announcement last week, except for some tweaking of a few phrases. One notable deletion from the previous announcement in September was the Fed's observation that tighter financial conditions could slow the pace of improvement in the economy and labour market. Bond yields had been spiking higher since later-May, after Bernanke hinted that the Fed could scale down its bond-buying program. However, the Fed's unexpected decision at September's FOMC meeting to leave the program unchanged resulted in a significant retracement in bond yields.

The consensus view going into last week's Fed meeting was that it would continue to buy Treasuries and MBSs at an $85-billion monthly pace. While it did not disappoint on this account, the Fed's reluctance to take the punch bowl away may be exacerbating the longer-term risk to the US economy, in our opinion. Markets are getting too accustomed to this monthly dose of stimulus from the Fed, resulting in sustained increases in asset prices over the past couple of years, and increasing the risks of "bubble formation" in certain sectors of the economy. But in the short-term, the Fed's proclivity to maintain the status quo is keeping equities chugging along, diminishing the risk of an imminent market correction.

On the other side of the Atlantic, the European Central Bank is faced with limited options as consumer prices in Europe rise at the slowest pace in four years. With inflation running well below the ECB's 2% target, there is some concern about the risk of deflation. But with the ECB's benchmark interest rate already at a record low of 0.5%, the bank has few options to counter this risk apart from adding more liquidity to the financial system or making broad-based asset purchases like the Fed. The ECB's quandary highlights the fact that the major central banks are increasingly running out of options to combat risks to their economies.

Recommendations

(Update) Canadian Oil Sands – Reiterate Buy for income and growth

We reiterate our Buy recommendation on **Canadian Oil Sands (TSX: COS, $20.24)** for investors with moderate risk tolerance, with a target price of $23. The stock's dividend yield of 6.9% – currently the third-highest of the TSX-60 stocks – represents an attractive income opportunity in this era of low interest rates, in our opinion.

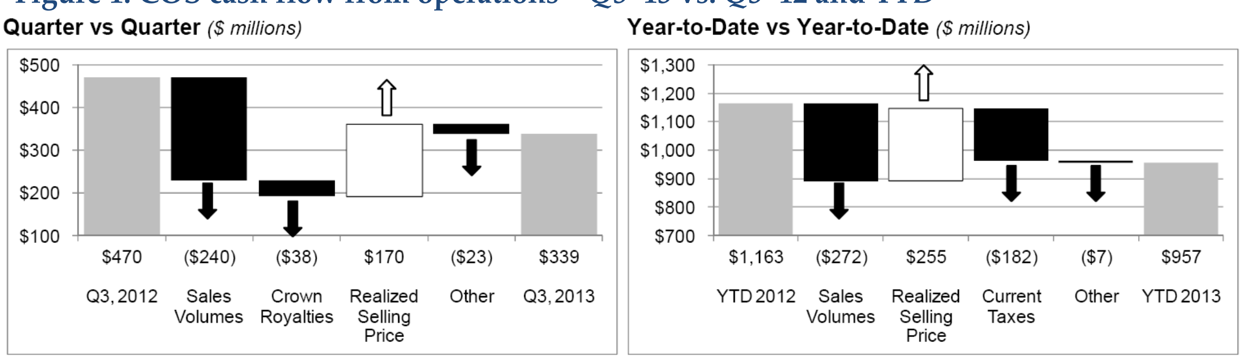
Highlights of the company's fiscal Q2 results reported on October 30 are as follows –

- Net income of $246 million or $0.51 per share declined 26% from $336 million or $0.69 per share a year earlier, reported EPS fell short of analysts' $0.53 estimate. Excluding items, primarily a foreign exchange gain of $31 million caused by the stronger Canadian dollar, adjusted EPS of $0.47 exceeded analysts' $0.42 estimate.

- Cash flow from operations for the quarter fell 28% from a year earlier to $339 million or $0.70 per share. The decline in cash flow was the result of lower sales volume (84,300 bpd on average vs. 113,300 a year ago) and Crown royalties, partly offset by a higher realized selling price (Figure 1). YTD, cash flow from operations is down 18% from the year-earlier period to $957 million or $1.97 per share, as higher current taxes and lower sales volume have largely offset a higher realized selling price this year.

- Synthetic crude oil (SCO) output from the Syncrude Joint Venture was lower than expected, with total production of 20.9 million barrels (227,000 barrels per day), compared with 28.8 million barrels (313,300 bpd) a year ago and 26.0 million barrels (282,600 bpd) forecast in the company's July 30 outlook. The plunge in output was caused by a delay in completing turnarounds on Coker 8-1 and other units; the turnarounds have been completed and the respective units returned to operation in late August and early September.

Figure 1: COS cash flow from operations – Q3 '13 vs. Q3 '12 and YTD



Source: Company filings

- Total operating expenses in Q3 declined 5% from a year ago to $357 million, but on a per-barrel basis, rose 28% to $46.15 (from $36.07), due to lower sales volumes. YTD operating expenses were unchanged at $1.106 billion but increased 9% to $43.43 (from $38.96) for the same reason.

- SCO's premium to WTI widened to a weighted-average of $2.51 per barrel in Q3, compared with a year-ago discount of $2.09, but was narrower than the $4.69 premium in Q2. As average WTI prices surged almost 15% in Q3 from a year ago (US$105.81 vs. US$92.20), the company's average realized selling price of $112.55 per barrel was $22.66 or about 25% higher from a year ago. YTD, COS' average selling price was up 11% from the year-earlier period to $102.83.

COS lowered its 2013 Syncrude production forecast for the third time this year, to 97-100 million barrels (from 100-104 million barrels previously); the single-point estimate of 98 million barrels represents a 4% reduction from the previous estimate of 102 million barrels. COS said that the production outlook reflected actual YTD results and assumes reliable operations for the rest of the year. With total output of 69.2 million barrels as of September 30, Syncrude has to produce 28.8 million barrels or an average of 313,400 bpd to meet the single-point output target of 98 million barrels.

COS' proportionate share of Syncrude output is forecast at 36-37 million barrels for this year. The company forecasts total sales revenue of $3.6 billion, based on an average realized selling price of $100.07 per barrel (an increase of $6 from its July forecast) , which is predicated on US$98 WTI, no SCO premium or discount to C$ WTI , and an exchange rate of $0.98 US/C$. The forecast for 2013 operating costs per barrel has increased by about 4% to $41.77.

Cash flow from operations for 2013 is estimated to increase by 5.6% over the July forecast to $1.33 billion or $2.75 per share (up from $2.60 in the July forecast). Estimated 2013 capex for the Syncrude project is forecast at $3.23 billion, with COS' share at $1.29 billion. The company's outlook sensitivity analysis is shown in Figure 2.

Figure 2: COS Sensitivity Analysis

Outlook Sensitivity Analysis (October 30, 2013)

		Cash Flow from Operations Increase	
Variable	**Annual Sensitivity**	**$ millions[1,2]**	**$ / Share[1,2]**
Syncrude operating expense decrease	Cdn$1.00/bbl	$ 21	$ 0.04
Syncrude operating expense decrease	Cdn$50 million	$ 11	$ 0.02
WTI crude oil price increase	U.S.$1.00/bbl	$ 22	$ 0.05
Syncrude production increase	2 million bbls	$ 45	$ 0.09
Canadian dollar weakening	U.S.$0.01/Cdn$	$ 23	$ 0.05
AECO natural gas price decrease	Cdn$0.50/GJ	$ 13	$ 0.03

1 Canadian Oil Sands anticipates recording approximately $300 million in current taxes in 2013. These sensitivities are after the impact of taxes.
2 These sensitivities assume Canadian Oil Sands pays Crown royalties based on net bitumen revenues in 2013. Lower bitumen revenues or higher deductible bitumen-related costs may result in minimum Crown royalties based on gross revenues which will change the sensitivities to these variables.

Our opinion that the company will be able to comfortably cover its $0.35 per-share quarterly dividend going forward is based on the following:

- The dividend payout ratio, based on forecast FY13 per-share CFO of $2.75, is now at 51% (compared with an estimated 54% based on its July forecast of $2.60).
- COS repaid US$ 300 million of senior notes when they matured on August 15. As a result, long-term debt to total capitalization as of September 30 was 25% (compared with 29% at end-Q2), well below the 55% threshold at which certain debt covenants kick in.
- Net debt continues to rise as expected, and was at $709 million as of September 30 (compared with $481 million at June 30, $361 million at March 31 and $241 million at December 31, 2012). Net debt is expected to rise to $1 - $2 billion by end-2014, as COS funds major capital projects. Although net cash declined to $840 million at end-Q3, from $1.42 billion at end-Q1, the company still has ample liquidity to meet its commitments.

The Street continues to be cautious on the stock's prospects, although EPS and CFPS estimates for 2014 have ticked up slightly. The average EPS estimate for FY13 is currently at $1.90, rising 6% to $2.01. Analysts' CFPS estimates continue to hold above the company's FY13 forecast, at $2.83 for FY13 and $3.15 for FY14. On that basis, the stock trades at an inexpensive 10.7x FY13 forecast EPS, and at 7.2x FY13 CFPS.

Note that COS' President & CEO Marcel Coutu plans to retire on January 1, 2014, although we expect little impact from his departure. In our view, the key risks to the company's outlook are production losses due to unexpected outages, and a decline in crude oil prices.

We reiterate our Buy rating on COS, with a target price of $23.

(Update) TransAlta – Reiterate Buy for dividend income

TransAlta (TSX: TA, $14.12) is holding up after missing earnings expectations yet again. We reiterate our Buy rating on the stock based on its 8.3% dividend yield – the second-highest on the TSX-60 – with a $16 target.

TransAlta reported a net loss of $9 million or $0.03 per share, compared with year-earlier net income of $56 million or $0.24 per share. The quarterly loss was due to a number of one-time items, primarily a $40 million write-off of deferred income tax assets related to Centralia Thermal. Although adjusted EPS of $0.15 fell short of analysts' $0.18 estimate, revenues of $623 million were up 19% from $522 million a year ago, and well above analysts' average revenue estimate of $565.5 million.

Comparable EBITDA for the quarter of $266 million rose 4% from a year ago (Figure 3), driven by steady performance of the Gas, Renewables and Trading businesses, as well as contributions from new growth projects. Fund flows from operations plummeted 25% from a year ago to $174 million due to differences in timing of cash proceeds associated with power hedges and coal inventories. While adjusted availability of 85.9% in Q3 was down significantly from 91.7% in Q2, excluding the *force majeure* at Keephills 1, availability of 91.1% was in line with the company's 89%-90% annual target.

Figure 3: TransAlta performance highlights – Q3 and YTD

	Q3 2013	Q3 2012		YTD 2013	YTD 2012
Comparable EBITDA	$266 million	$255 million		$780 million	$701 million
FFO	$174 million	$233 million		$550 million	$572 million
Adjusted Availability(1)	85.9%	91.7%		86.4%	90.3%
Adjusted Availability (excluding Keephills Unit 1 force majeure)	91.1%	91.7%		90.4%	90.3%

Source: Company filings

TransAlta made some notable strides in terms of its strategic plan in Q3. It secured a total of 369 MW in long-term contracts in Eastern Canada, Australia and the US, bringing the total for the year to 835 MW. A landmark development in Q3 was the company's spin-off of its Renewables Business, completed in August. The creation of TransAlta Renewables was the main reason for TransAlta's debt balances declining by $343 million in Q3. TransAlta continues to hold 92.6 million common shares or 80.7% of TransAlta Renewables.

Q3 also witnessed the return to service of Sundance 1 and 2, which were shut down in December 2010. An arbitration panel concluded in July 2012 that the units were not economically destroyed under the terms of the PPA, forcing TransAlta to restore the units to service. While the adverse decision cost TransAlta hundreds of millions in penalties, unforeseen expenses and write-offs, the return to service of the Sundance units (Unit 1 on September 2 and Unit 2 on October 4, 2013) hopefully brings that sorry episode to a close.

While the adverse Sundance arbitration was among the events that made 2012 an exceptionally challenging year for TransAlta, 2013 has been a period of consolidation and incremental improvement. The company's key power markets of Alberta and the Pacific North-West are strengthening, and may help improve TransAlta's performance in 2014. Although the stock looks pricey on the basis of its 24.8x forward P/E multiple (based on analysts' average FY13 ESP forecast of $0.57), it should be supported by its 8.3% dividend yield. **We reiterate our Buy rating on TransAlta, with a target price of $16**.

Market Snapshot

At close on Friday, November 1, 2013

S&P TSX	13337.46	-23.80	**Commodities**			**Yields (%)**	**Can.**	**US**
TSX Venture	955.33	-3.53	Canadian $ (US cents)	95.90	+0.02	90 Day T-Bill	0.89	0.04
DJIA	15615.55	+69.80	Gold (Spot)-US$	1315.29	-7.81	2-Year Bond	1.12	0.31
S&P 500	1761.64	+5.10	Oil (WTI-Dec.)	94.63	-1.75	10-Yr.Bond	2.50	2.62
NASDAQ	3922.04	+2.34	CRB Index	274.96	-2.90	30-Yr. Bond	3.07	3.70

Thought for the Day

"We cannot direct the wind, but we can adjust the sails." – Bertha Calloway

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IMPORTANT RESEARCH DISCLOSURES

(1) The analyst and/or a member of the analyst's household have a long position in the following stocks discussed in this report – **Canadian Oil Sands**, **TransAlta**

Research Rating System
Strong Buy: Expected total returns of 20% or more over the next 6 – 12 months.
Buy: Expected total returns of 10% to 20% over the next 6 – 12 months.

Speculative Buy: Significant gains expected over the next 6 – 12 months, but entire investment may be at risk.
Hold: Expected total returns of 0% to 10% over the next 6 – 12 months.
Reduce: Expected total returns of up to -10% over the next 6 – 12 months.
Sell: Expected total returns of over -10% over the next 6 – 12 months.

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