

# ExxonMobil Corporation XOM [NYSE] | ★★★

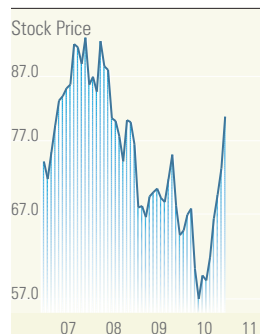
Last Price	Fair Value	Consider Buy	Consider Sell	Uncertainty	Economic Moat™	Stewardship	Morningstar Credit Rating	Industry
83.28 USD	86.00 USD	60.20 USD	120.40 USD	Medium	Wide	B	AAA	Oil & Gas Integrated

## In Addition to Upstream, Strong Results From Downstream, Chemicals Boost ExxonMobil's Earnings

by Allen Good  
Stock Analyst  
Analysts covering this company do not own its stock.

Pricing data through February 04, 2011.  
Rating updated as of February 04, 2011.

Currency amounts expressed with "\$" are in U.S. dollars (USD) unless otherwise denoted.



### Analyst Note Jan. 31, 2011

ExxonMobil reported a 53% rise in fourth-quarter earnings from the same period a year ago, thanks to strong results across all operating segments. Upstream earnings increased 29% from the year before, thanks to higher oil and natural gas price realizations as well as greater production volumes. As with the third quarter, the continued ramp-up of ExxonMobil's liquefied natural gas facilities in Qatar and the addition of XTO production volumes were the largest contributors to growth. As a result, natural gas drove growth with an increase in volumes of 37% compared with the same period a year ago. Oil volumes also benefited from the Qatar projects and the XTO acquisition, which offset natural field decline to produce volume growth of almost 6% during the quarter. We expect favorable comparable production growth figures to continue into the first and second quarter of 2011, thanks to inclusion of these volumes. However, volumes gains were not limited to the United States and Qatar. ExxonMobil realized total volume growth of almost 14% from operations in Russia and the Caspian Sea region as well as a rebound in European natural gas volumes. For the full year, ExxonMobil realized production growth of 13% led by gains in natural gas volume of 31%. Production of crude oil and natural gas liquids rose 1.4% year over year.

The downstream segment continued its recovery from a difficult 2009. Thanks to improved global refining margins, downstream operations posted fourth-quarter earnings of \$1.15 billion compared with a loss of \$189 million in the same period last year. For the full year, downstream earnings totaled \$3.6 billion compared with \$1.8 billion in 2009. The chemical segment reported quarterly earnings of \$1.1 billion, a 49% increase from the fourth quarter of 2009 thanks to higher margins, which offset slightly lower volumes. The chemical segment finished the year with record earnings of \$4.9 billion compared with \$2.3 billion a year ago. The size of ExxonMobil's downstream and

chemical operations sets it apart from many of its peers. While these segments registered lackluster results during the recession, a global economic recovery is now boosting profits. We expect downstream and chemical earnings to remain robust as long as U.S. economic growth accelerates and emerging markets remain strong. In this case, ExxonMobil has another avenue to capitalize on global economic growth in addition to higher oil prices. As previously announced, ExxonMobil repurchased \$5 billion worth of its own shares during the quarter. The company expects to repurchase another \$5 billion during the first quarter. We expect share repurchases to continue at this level, barring a drop in commodity prices. Also, ExxonMobil sold more than \$3 billion worth of assets in 2010. Continued asset sales in 2011 could go toward supporting the repurchase program.

### Thesis Sept. 15, 2010

ExxonMobil sets itself apart among the other supermajors as a superior capital allocator and operator. Through a relentless pursuit of efficiency, technology, development, and operational improvement, it consistently delivers higher returns on capital relative to peers. With a majority of the world's remaining resources in government hands, opportunities for the company to grow its large production base are limited. However, we believe ExxonMobil's experience and expertise, particularly with large projects, should allow it to successfully compete for resources.

Resource nationalism is becoming an increasingly greater challenge to international oil companies' (IOC) ability to grow production. Countries rich in oil and gas reserves are becoming less willing to allow outside energy companies free rein to exploit resources within their borders. Instead, they chose to look for dependable partners to work with their national oil companies (NOC) to explore for, produce, and transport to market their oil and gas reserves. In our opinion, governments cannot find a better partner than ExxonMobil. With its deep pockets, expertise, and

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Close Competitors	Currency(Mil)	Market Cap	TTM Sales	Oper Income	Net Income
ExxonMobil Corporation	USD	419,944	367,876	47,838	27,260
Royal Dutch Shell PLC	USD	217,453	356,046	28,957	15,298
Chevron Corporation	USD	195,427	199,577	29,110	16,799
BP Plc	USD	144,200	293,578	-5,673	-4,991

Morningstar data as of February 04, 2011.

integrated operations, it can tackle nearly any megaproject regardless of scale, location, or operational difficulty.

While we believe ExxonMobil is better suited than the other supermajors for the current environment, that does not necessarily mean production and reserve gains will come easily. ExxonMobil needs projects of a certain size in order to contribute meaningfully to its production profile. However, today fewer projects of that caliber exist than have in years past. In addition, investing exclusively in large projects exposes the company to a variety of risks. Given their long lead times, megaprojects have the potential for over investment risk if commodity prices crash during development. Failure to meet deadlines or material and labor inflation could create cost overruns that damage project returns.

Given that the few untapped large resource pools left in the world are under government control, megaprojects generally are done in partnership with NOCs. Competition for these projects is intense. In order to gain access, ExxonMobil must not only demonstrate its value but may also have to agree to production sharing agreements that are not as advantageous as in the past. Meanwhile, competitors eager for access may be more willing to agree to the NOCs' less favorable terms. More often, management is faced with a tough decision: take less favorable terms on more projects, or focus on projects where its expertise is highly valued by the NOC or pursue frontier locations.

## Valuation, Growth and Profitability

We are lowering our fair value estimate for ExxonMobil to \$86 per share from \$87 to reflect changes in commodity prices. Our fair value is based on ExxonMobil without any contribution from XTO, and is approximately 5.8 times our 2011 EBITDA forecast of \$73.5 billion. In our discounted cash-flow model, our benchmark oil and gas prices are based on Nymex futures contracts for 2010-12. For natural gas, we use \$4.60 per thousand cubic feet in 2010, \$5.02 in 2011, and \$5.42 in 2012. For oil, we use \$80 per barrel in 2010, \$86 in 2011, and \$88 in 2012. To arrive at our valuation we consider three scenarios--base, low, and high--and weight them 40%, 40%, and 20%, respectively. In our base scenario, we assume long-run oil prices of \$80 per barrel and natural gas prices of \$7.50 per mcf. This scenario values Exxon at \$81, approximately 5.4 times our 2011 EBITDA forecast. Our low-case scenario assumes long-run prices of \$50 oil and \$5 natural gas. This scenario values Exxon at \$36 per share. Our high case assumes long-run prices of \$150 oil and \$15 natural gas which values the company at \$197 per share. We assume a cost of equity of 10.5% in all scenarios. With the low- and high-price scenarios we also change our production cost, capital expenditure, and production growth assumptions to reflect the price environment. We believe Exxon can achieve annual production growth of roughly 2% over the next five years as large projects come on line. However, with production gains coming from large projects, growth may be uneven. The addition of XTO could add upward of 1% growth per year depending on future investment plans. We continue to assume refining margins will remain depressed in the short-term, but could gradually improve in the next few years. We have also decided to raise our uncertainty rating to medium from low to account for the recent XTO acquisition and the greater impact commodity prices may have on our valuation.

## Risk

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For a company with global operations, geopolitical risk is always an issue. Recent events in Russia, Nigeria, and Venezuela underscore the risk associated with doing business in those countries. These risks will only become greater as Exxon expands its global production portfolio through partnerships with NOCs. By investing in large, capital-intensive projects, Exxon also runs the risk that commodity prices will decrease dramatically, making those projects no longer economical. Deterioration of refining fundamentals in the U.S. and Europe may continue to damage profitability long after an economic recovery.

## Bulls Say

- Exxon's superior capital allocation and operational performance should drive high returns on capital.
- NOCs do not have the resources or expertise to effectively explore for and produce oil and gas in their countries. They will need to partner with private firms, and Exxon is the most attractive option.
- With high-performing operations and global integration, Exxon is one of the best-positioned firms to weather a drop in commodity prices. The diversity of its operations and a vast geographic footprint offer protection against regional economic weakness.
- Shareholder return is a focus of management. Over the past five years, Exxon paid \$39 billion in dividends and repurchased \$135 billion worth of stock, reducing shares outstanding by 23%.
- By combining XTO's expertise with ExxonMobil's operations management skills and financial resources, the company has a decided advantage in the development of unconventional resources.

## Bears Say

- As nations become more protective of their natural resources, the company will find it increasingly difficult

to increase production and book reserves

- Record-high commodity prices helped produce record profits. If commodity prices slip, so will profits.
- Exxon is very discriminating when evaluating investment opportunities. It is unlikely to sign less favorable contracts, which could slow growth.
- Production growth will come from partnerships with NOCs, politically unstable countries, and difficult environments, which means unfavorable production sharing agreements, increased geopolitical risks, and increased production costs.
- Heavy exposure to the U.S. and European refining markets could limit future downstream profitability with both markets facing long-term challenges.

## Financial Overview

**Financial Health:** As one of the few remaining firms with an AAA credit rating, ExxonMobil's financial health is beyond reproach. Cash flow from operations remains sufficient to finance capital expenditures while increasing dividend payments and buying back stock. More important, the large cash position and access to cheap debt give the company resources to make opportune acquisitions.

## Company Overview

**Profile:** Exxon is an integrated oil and gas company that explores for, produces, and refines oil around the world. In 2009, it produced 2.4 million barrels of oil and 9.3 billion cubic feet of natural gas a day. At year-end 2009, reserves stood at 14.95 billion boe (plus 8.03 billion for equity companies), 62% of which are oil. The company is the world's largest refiner, with 37 refineries, and it is one of the world's largest manufacturers of commodity and specialty chemicals.

**Management:** Rex Tillerson is chairman and CEO of Exxon,

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a role he assumed in 2006. Previously, he served as president after spending his career with Exxon, beginning in 1975 as a production engineer. Tillerson is likely to continue a disciplined capital allocation strategy and deliver the high returns that his predecessor did. Total compensation for Tillerson was only \$27 million in 2009, which is reasonable, considering the size of the company and his peers' compensation. Exxon has a typical compensation structure consisting of a salary, cash bonus, and equity awards. Performance is not evaluated by typical quantitative measures but by the executives' performance relative to achievement of the company's long-term goals. Exxon gets credit for delaying 50% of bonus payment until later periods' earnings targets are met, and requiring longer vesting periods for equity awards. Low executive equity ownership relative to total shares outstanding is understandable, considering the size and history of the company.

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Jan. 31, 2011

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same period last year. For the full year, downstream earnings totaled \$3.6 billion compared with \$1.8 billion in 2009. The chemical segment reported quarterly earnings of \$1.1 billion, a 49% increase from the fourth quarter of 2009 thanks to higher margins, which offset slightly lower volumes. The chemical segment finished the year with record earnings of \$4.9 billion compared with \$2.3 billion a year ago. The size of ExxonMobil's downstream and chemical operations sets it apart from many of its peers. While these segments registered lackluster results during the recession, a global economic recovery is now boosting profits. We expect downstream and chemical earnings to remain robust as long as U.S. economic growth accelerates and emerging markets remain strong. In this case, ExxonMobil has another avenue to capitalize on global economic growth in addition to higher oil prices. As previously announced, ExxonMobil repurchased \$5 billion worth of its own shares during the quarter. The company expects to repurchase another \$5 billion during the first quarter. We expect share repurchases to continue at this level, barring a drop in commodity prices. Also, ExxonMobil sold more than \$3 billion worth of assets in 2010. Continued asset sales in 2011 could go toward supporting the repurchase program.

Dec. 23, 2010

### Petrohawk Sells Fayetteville Assets

Petrohawk Energy announced it has completed the sale of its Fayetteville Shale assets to ExxonMobil for \$575 million, with an agreement to sell the Fayetteville Shale midstream assets for an additional \$75 million. The deal comes as

little surprise and prices near the high end of our forecast range of \$400 million-\$600 million. As we've noted in recent and past reports, this asset sale supports Petrohawk's goal to fund its 2011-12 budgets using a combination of cash flow and asset sales without leaning

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## Analyst Notes (continued)

too much on its credit facility. To fulfill the remainder of its financing strategy, we expect Hawk will move to sell outright or publicly offer the remainder of its Kinderhawk

midstream business, possibly seeking a master limited partnership structure.

Oct. 28, 2010

### ExxonMobil Reports Strong Results Across All Segments

ExxonMobil reported a 55% rise in third-quarter earnings compared with the same period a year ago, thanks to higher crude oil and natural gas price realizations, improved refining margins, and strong chemical results. Earnings also benefited from a 20.6% increase in total production from the year-ago quarter. Production gains came primarily from the continued ramp-up of ExxonMobil's liquefied natural gas facilities in Qatar and the addition of XTO production volumes. As a result, natural gas drove growth with an increase in volumes of 49.5% compared with the same period a year ago. Oil volumes also benefited from the Qatar projects and the XTO acquisition, which offset natural field decline to produce volume growth of 3.7% during the quarter. Through the first nine months of the year, production volume increased 11% from the year-ago period, led by gains in natural gas volume of 28.7%. Benefiting from higher price realizations as well as increased production volume, third-quarter upstream earnings rose 36% from the third quarter of 2009. We expect the company to continue reporting strong production growth results for the rest of the year as benefits from the addition of XTO and higher volumes from Qatar.

The downstream segment extended its strong performance from the second quarter thanks primarily to a continuation of improved refining margins. While benchmark refining margins dipped from second-quarter levels, ExxonMobil still

posted downstream earnings for the quarter of \$1.2 billion compared with \$325 million the same period a year ago. Earnings also benefited from mix effects, higher volumes, asset sales, and foreign exchange effects, which helped offset poor marketing margins. The chemical segment posted earnings of \$1.2 billion, a 40% increase from the third quarter of 2009. Since the beginning of the year, the chemical segment has continued to perform well thanks to higher volumes and improved margins. The potential remains for the downstream segment to maintain its performance into the fourth quarter, given that refining margins appear to be holding up from the third quarter and global distillate demand remains robust. However, seasonal factors will probably take some toll on margins, and as a result, earnings could be lower than in the third quarter.

ExxonMobil repurchased about \$3 billion worth of shares during the quarter, bringing its full-year total to \$7.3 billion. The share count increased earlier in the year as a result of the XTO acquisition, which also prevented the company from repurchasing shares for a short time. For the fourth quarter, the company expects to repurchase \$5 billion worth of shares. The increase in the buyback rate is somewhat expected. We previously anticipated a potential increase after meeting with management earlier this year, when it indicated a willingness to undergo such moves to improve share performance.

## Disclaimers & Disclosures

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# ExxonMobil Corporation XOM

**Sales USD Mil** 367,876  
**Mkt Cap USD Mil** 419,944  
**Industry** Oil & Gas Integrated  
**Sector** Energy

Exxon is an integrated oil and gas company that explores for, produces, and refines oil around the world. In 2009, it produced 2.4 million barrels of oil and 9.3 billion cubic feet of natural gas a day. At year-end 2009, reserves stood at 14.95 billion boe (plus 8.03 billion for equity companies), 62% of which are oil. The company is the world's largest refiner, with 37 refineries, and it is one of the world's largest manufacturers of commodity and specialty chemicals.

5959 Las Colinas Boulevard  
 Irving, TX 75039-2298  
 Phone: 1 972 444-1000 Website: <http://www.exxonmobil.com>

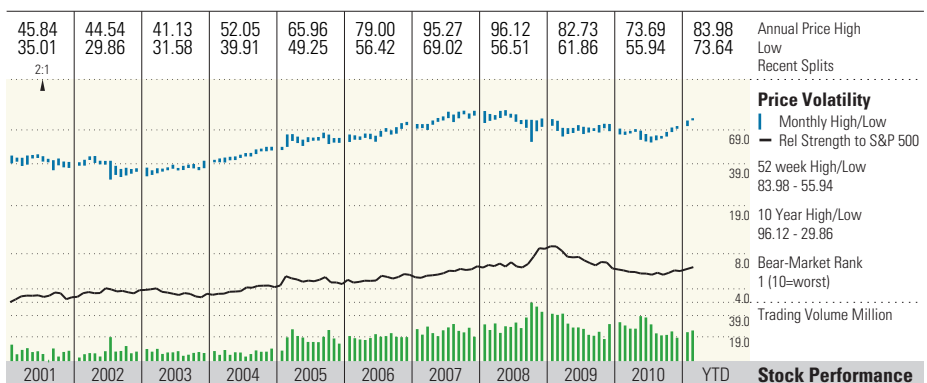
Growth Rates Compound Annual					
Grade: C	1 Yr	3 Yr	5 Yr	10 Yr	
Revenue %	-34.9	-6.3	0.8	6.8	
Operating Income %	-70.7	-20.5	-13.0	14.5	
Earnings/Share %	-54.2	-15.6	0.5	13.5	
Dividends %	7.1	9.1	9.4	7.1	
Book Value/Share %	5.3	6.2	8.2	6.0	
Stock Total Return %	31.4	1.1	8.2	8.3	
+/- Industry	7.2	2.8	2.9	1.2	
+/- Market	8.1	2.8	7.5	8.9	

Profitability Analysis				
Grade: C	Current	5 Yr Avg	Ind	Mkt
Return on Equity %	21.6	31.9	1.7	21.9
Return on Assets %	10.3	16.3	0.8	8.5
Fixed Asset Turns	2.2	3.3	1.9	7.2
Inventory Turns	18.8	21.8	11.5	14.6
Revenue/Employee USD K4558.6	4943.3*	—	897.0	
Gross Margin %	31.2	40.0	26.4	39.1
Operating Margin %	13.0	20.9	11.5	14.2
Net Margin %	7.4	9.2	0.7	9.5
Free Cash Flow/Rev %	4.9	7.5	3.8	0.1
R&D/Rev %	—	—	—	9.8

Financial Position		
Grade: A	12-09 USD Mil	09-10 USD Mil
Cash	10693	12244
Inventories	11553	14302
Receivables	27645	30244
Current Assets	55235	62633
Fixed Assets	139116	195440
Intangibles	7307	8748
Total Assets	233323	299994
Payables	8310	10443
Short-Term Debt	2476	3046
Current Liabilities	52061	61740
Long-Term Debt	7129	15248
Total Liabilities	122754	154963
Total Equity	110569	145031

Valuation Analysis				
	Current	5 Yr Avg	Ind	Mkt
Price/Earnings	14.7	12.7	15.0	16.4
Forward P/E	12.2	—	—	14.3
Price/Cash Flow	9.1	9.2	7.4	8.5
Price/Free Cash Flow	22.4	22.7	23.1	17.1
Dividend Yield %	2.1	—	2.7	1.7
Price/Book	2.9	3.4	2.1	2.3
Price/Sales	1.1	1.1	0.9	1.4
PEG Ratio	2.0	—	—	1.8

Morningstar Rating	Last Price	Fair Value	Uncertainty	Economic Moat™	Stewardship Grade
★★★	83.28	86.00	Medium	Wide	B



2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	YTD	Stock Performance
-7.5	-8.8	20.1	27.6	11.8	38.7	24.1	-13.1	-12.5	9.8	13.9	Total Return %
5.5	14.6	-6.3	18.6	8.8	25.1	20.6	25.4	-35.9	-3.0	9.7	+/- Market
32.0	-2.9	-19.1	-40.9	-11.5	13.4	-3.4	22.2	-30.8	5.2	6.2	+/- Industry
1.8	2.6	2.4	2.1	2.0	1.7	1.5	1.9	2.4	2.4	2.1	Dividend Yield %
268833	235108	271002	330693	349512	446944	511887	406067	322334	368712	419944	Market Cap USD Mil

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	TTM	Financials
232748	213488	204506	246738	298035	370680	377635	404552	477359	310586	367876	Revenue USD Mil
45.0	47.7	46.4	47.3	45.1	42.5	43.5	42.4	39.5	31.8	31.2	Gross Margin %
50438	46888	40157	56722	69918	91469	69107	103607	118578	34777	47838	Oper Income USD Mil
21.7	22.0	19.6	23.0	23.5	24.7	18.3	25.6	24.8	11.2	13.0	Operating Margin %
17720	15320	11460	21510	25330	36130	39500	40610	45220	19280	27260	Net Income USD Mil
—	2.21	1.68	3.23	3.89	5.71	6.62	7.28	8.69	3.98	5.66	Earnings Per Share USD
—	0.91	0.92	0.98	1.06	1.14	1.28	1.37	1.55	1.66	1.72	Dividends USD
—	6932	6821	6659	6512	6327	5967	5578	5149	4832	4816	Shares Mil
10.70	11.09	13.60	15.77	17.87	19.52	22.29	22.21	23.39	28.76	28.76	Book Value Per Share USD
22937	22889	21268	28498	40551	48138	49286	52002	59725	28438	43862	Oper Cash Flow USD Mil
-8446	-9989	-11437	-12859	-11986	-13839	-15462	-15387	-19318	-22491	-25964	Cap Spending USD Mil
14491	12900	9831	15639	28565	34299	33824	36615	40407	5947	17898	Free Cash Flow USD Mil

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	TTM	Profitability
12.1	10.5	7.8	13.2	13.7	17.9	18.5	17.6	19.2	8.4	10.3	Return on Assets %
26.4	21.3	15.5	26.1	26.4	33.9	35.1	34.5	38.5	17.3	21.6	Return on Equity %
7.6	7.2	5.6	8.7	8.5	9.7	10.5	10.0	9.5	6.2	7.4	Net Margin %
1.59	1.46	1.38	1.51	1.61	1.84	1.77	1.75	2.03	1.35	1.39	Asset Turnover
2.1	2.0	2.0	1.9	1.9	1.9	1.9	2.0	2.0	2.1	2.1	Financial Leverage

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	09-10	Financial Health
2208	5567	5116	7574	17396	27035	26960	27651	23166	3174	893	Working Capital USD Mil
7280	7099	6655	4756	5013	6220	6645	7183	7025	7129	15248	Long-Term Debt USD Mil
70757	73161	74597	89915	101756	111186	113844	121762	112965	110569	145031	Total Equity USD Mil
0.10	0.10	0.09	0.05	0.05	0.06	0.06	0.06	0.06	0.06	0.11	Debt/Equity

2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	TTM	Valuation
18.0	21.7	13.0	13.2	9.8	11.6	12.9	9.2	17.1	12.9	14.7	Price/Earnings
—	—	—	—	—	—	—	—	—	0.7	0.9	P/E vs. Market
1.3	1.2	1.1	1.1	1.0	1.2	1.3	0.9	1.1	1.0	1.1	Price/Sales
3.7	3.1	3.0	3.3	3.1	3.9	4.2	3.6	2.9	2.5	2.9	Price/Book
11.9	11.2	9.6	8.2	7.5	9.4	10.1	6.9	11.6	8.0	9.1	Price/Cash Flow

Quarterly Results						
Revenue USD Mil	Dec 09	Mar 10	Jun 10	Sep 10		
Most Recent Period	89841.0	90251.0	92486.0	95298.0		
Prior Year Period	84696.0	64028.0	74457.0	82260.0		
Rev Growth %	Dec 09	Mar 10	Jun 10	Sep 10		
Most Recent Period	6.1	41.0	24.2	15.9		
Prior Year Period	-27.4	-45.2	-46.1	-40.3		
Earnings Per Share USD	Dec 09	Mar 10	Jun 10	Sep 10		
Most Recent Period	1.27	1.33	1.60	1.44		
Prior Year Period	1.58	0.92	0.81	0.98		

Industry Peers by Market Cap				
	Mkt Cap USD Mil	Rev USD Mil	P/E	ROE%
ExxonMobil Corporati	419944	367876	14.7	21.6
Royal Dutch Shell PL	217453	356046	14.0	10.9
Chevron Corporation	195427	199577	11.6	17.4

Major Fund Holders			% of shares
Vanguard Total Stock Mkt Idx Inv			1.07
Vanguard 500 Index Investor			0.93
Vanguard Institutional Index Instl			0.73

\*3Yr Avg data is displayed in place of 5Yr Avg

TTM data based on rolling quarterly data if available; otherwise most recent annual data shown.

## Morningstar's Approach to Rating Stocks

### Our Key Investing Concepts

- ▶ Economic Moat™ Rating
- ▶ Discounted Cash Flow
- ▶ Discount Rate
- ▶ Fair Value
- ▶ Uncertainty
- ▶ Margin of Safety
- ▶ Consider Buying/Consider Selling
- ▶ Stewardship Grades

At Morningstar, we evaluate stocks as pieces of a business, not as pieces of paper. We think that purchasing shares of superior businesses at discounts to their intrinsic value and allowing them to compound their value over long periods of time is the surest way to create wealth in the stock market.

We rate stocks 1 through 5 stars, with 5 the best and 1 the worst. Our star rating is based on our analyst's estimate of how much a company's business is worth per share. Our analysts arrive at this "fair value estimate" by forecasting how much excess cash--or "free cash flow"--the firm will generate in the future, and then adjusting the total for timing and risk. Cash generated next year is worth more than cash generated several years down the road, and cash from a stable and consistently profitable business is worth more than cash from a cyclical or unsteady business.

Stocks trading at meaningful discounts to our fair value estimates will receive high star ratings. For high-quality businesses, we require a smaller discount than for mediocre ones, for a simple reason: We have more confidence in our cash-flow forecasts for strong companies, and thus in our value estimates. If a stock's market price is significantly above our fair value estimate, it will receive a low star rating, no matter how wonderful we think the business is. Even the best company is a bad deal if an investor overpays for its shares.

Our fair value estimates don't change very often, but market prices do. So, a stock may gain or lose stars based

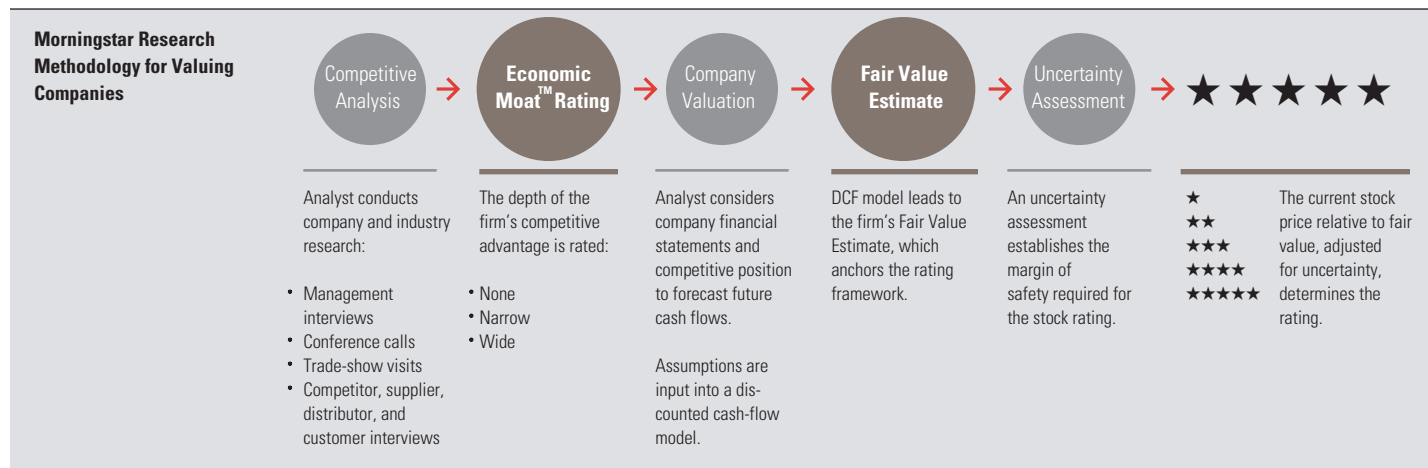
just on movement in the share price. If we think a stock's fair value is \$50, and the shares decline to \$40 without much change in the value of the business, the star rating will go up. Our estimate of what the business is worth hasn't changed, but the shares are more attractive as an investment at \$40 than they were at \$50.

Because we focus on the long-term value of businesses, rather than short-term movements in stock prices, at times we may appear out of step with the overall stock market. When stocks are high, relatively few will receive our highest rating of 5 stars. But when the market tumbles, many more will likely garner 5 stars. Although you might expect to see more 5-star stocks as the market rises, we find assets more attractive when they're cheap.

We calculate our star ratings nightly after the markets close, and issue them the following business day, which is why the rating date on our reports will always be the previous business day. We update the text of our reports as new information becomes available, usually about once or twice per quarter. That is why you'll see two dates on every Morningstar stock report. Of course, we monitor market events and all of our stocks every business day, so our ratings always reflect our analyst's current opinion.

### Economic Moat™ Rating

The Economic Moat™ Rating is our assessment of a firm's ability to earn returns consistently above its cost of capital in the future, usually by virtue of some competitive advantage. Competition tends to drive down such





## Morningstar's Approach to Rating Stocks (continued)

economic profits, but companies that can earn them for an extended time by creating a competitive advantage possess an Economic Moat. We see these companies as superior investments.

### Discounted Cash Flow

This is a method for valuing companies that involves projecting the amount of cash a business will generate in the future, subtracting the amount of cash that the company will need to reinvest in its business, and using the result to calculate the worth of the firm. We use this technique to value nearly all of the companies we cover.

### Discount Rate

We use this number to adjust the value of our forecasted cash flows for the risk that they may not materialize. For a profitable company in a steady line of business, we'll use a lower discount rate, also known as "cost of capital," than for a firm in a cyclical business with fierce competition, since there's less risk clouding the firm's future.

### Fair Value

This is the output of our discounted cash-flow valuation models, and is our per-share estimate of a company's intrinsic worth. We adjust our fair values for off-balance sheet liabilities or assets that a firm might have--for example, we deduct from a company's fair value if it has issued a lot of stock options or has an under-funded pension plan. Our fair value estimate differs from a "target price" in two ways. First, it's an estimate of what the business is worth, whereas a price target typically reflects what other investors may pay for the stock. Second, it's a long-term estimate, whereas price targets generally focus on the next two to 12 months.

### Uncertainty

To generate the Morningstar Uncertainty Rating, analysts consider factors such as sales predictability, operating leverage, and financial leverage. Analysts then classify their ability to bound the fair value estimate for the stock into one of several uncertainty levels: Low, Medium, High,

Very High, or Extreme. The greater the level of uncertainty, the greater the discount to fair value required before a stock can earn 5 stars, and the greater the premium to fair value before a stock earns a 1-star rating.

### Margin of Safety

This is the discount to fair value we would require before recommending a stock. We think it's always prudent to buy stocks for less than they're worth. The margin of safety is like an insurance policy that protects investors from bad news or overly optimistic fair value estimates. We require larger margins of safety for less predictable stocks, and smaller margins of safety for more predictable stocks.

### Consider Buying/Consider Selling

The consider buying price is the price at which a stock would be rated 5 stars, and thus the point at which we would consider the stock an extremely attractive purchase. Conversely, consider selling is the price at which a stock would have a 1 star rating, at which point we'd consider the stock overvalued, with low expected returns relative to its risk.

### Stewardship Grades

We evaluate the commitment to shareholders demonstrated by each firm's board and management team by assessing transparency, shareholder friendliness, incentives, and ownership. We aim to identify firms that provide investors with insufficient or potentially misleading financial information, seek to limit the power of minority shareholders, allow management to abuse its position, or which have management incentives that are not aligned with the interests of long-term shareholders. The grades are assigned on an absolute scale--not relative to peers--and can be interpreted as follows: A means "Excellent," B means "Good," C means "Fair," D means "Poor," and F means "Very Poor."