Exxon Mobil Corp XOM |

Exxon's returns are unlikely to reach historical levels, but free cash flow is set to rise.

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Analyst Note 04/29/2016

ExxonMobil's first-quarter earnings fell sharply to $1.8 billion from $4.9 billion a year ago, as surprisingly strong chemical results were insufficient to offset the negative impact of lower commodity prices and weaker refining margins on the upstream and downstream segments. Production grew nearly 2%, thanks to gains in liquids volumes from new project startups, which more than offset declines in natural gas production. Cash flow failed to cover capital expenditure and dividends during the quarter, and we expect a shortfall for the full year. However, Exxon's cash flow break-even should fall next year to about $40/barrel, resulting in the firm generating free cash flow after dividends at current strip prices. This marks the lowest break-even among its integrated group peers, and it enabled Exxon to increase its dividend, albeit modestly, earlier this week. Although we downgraded Exxon's moat rating to narrow from wide with our latest oil-price update, we still see it as the highest-quality integrated firm, given its collection of assets, ability to generate cash flow, and premium returns. However, we think all these factors are largely already priced into the shares. We plan to update our model with the latest results but do not expect a material change in our fair value estimate.

Investment Thesis 11/04/2015

ExxonMobil has historically set itself apart from the other majors as a superior capital allocator and operator, delivering higher returns on capital relative to peers as a result. We expect Exxon to maintain its lead in returns, but forecast a decline from historical levels, owing to reliance on higher-cost projects to replace reserves.

With Exxon exiting an investment cycle, growth in capital employed should slow with reduced investment levels. Traditionally, Exxon invested less on a per-barrel basis than its peers, which helped to support its superior returns. We expect this trend to continue over the next five years. Investment levels should also fall as Exxon brings on greater amounts of long-life production that requires less reinvestment to maintain production. Exxon will lead peers with nearly 50% of production from long-life assets in 2018.

In addition, nearly all of its new production capacity by 2018 will be liquids, leaving Exxon in a better position to capitalize on higher oil prices than over the past five years. This will allow it to hold margins relatively flat, whereas peers will see further narrowing in the coming years.

An inability to significantly improve earnings, primarily because of higher depreciation and lower oil prices, means returns are unlikely to attain historical levels without significantly higher commodity prices. That said, increased depreciation masks the improvement in cash margins, and by extension cash flow.

Despite the poor outlook for returns, the combination of higher cash margins and lower capital spending will result in a significant step-up in free cash flow through 2020. Reductions in capital spending levels bring cash flow break-even levels down to

Morningstar's Take XOM

Analyst

Price 05-20-2016	**Fair Value Estimate**	**Uncertainty**
89.74 USD	79 USD	Low
Consider Buy	**Consider Sell**	**Economic Moat**
63.2 USD	98.75 USD	Narrow

Stewardship Rating
Exemplary

Bulls Say

- Exxon will see its portfolio mix shift to liquids pricing as gas volumes decline and as new oil and liquefied natural gas projects start production. Cash margins should improve as a result.
- While Exxon will struggle to improve returns materially, it should deliver free cash flow growth to support dividend increases and, eventually, repurchases.
- With coordination between upstream and downstream operations, as well as integrated refining and chemical facilities, Exxon actually achieves a high level of integration that creates value, as opposed to simply owning the assets, as peers do.

Bears Say

- With rising resource nationalism, Exxon has found it increasingly difficult to increase production and book reserves. As a result, it's more reliant on higher-cost projects than in the past.
- Returns are unlikely to ever reach historical levels without higher commodity prices, potentially resulting in compression of Exxon's premium multiple.
- The expected decline in capital spending may prove only temporary, and Exxon may have to increase spending in several years to maintain production.

Competitors XOM

More...

Name	Price	% Chg	TTM Sales $ mil
Exxon Mobil Corp	**$89.74**	**-0.41**	**249,971**
Royal Dutch Shell PLC ADR Class B	$49.73	-0.18	253,042
Royal Dutch Shell PLC B	$24.80	-1.61	253,042
Royal Dutch Shell PLC ADR Class A	$49.22	0.04	253,042
Royal Dutch Shell PLC Class A	$24.30	-0.30	253,042
Chevron Corp	$99.79	-0.06	127,472

$40/barrel in 2017. Higher oil prices beyond that point will result in greater investment levels or a return of share repurchases.

Additionally, we continue to view the downstream segment as a source of competitive advantage for Exxon. We expect earnings and free cash flow to grow, thanks to the startup of new facilities and efforts to lower feedstock costs.

Economic Moat 11/04/2015

We continue to rate Exxon as the highest-quality integrated firm, given its ability to capture economic rents along the oil and gas value chain. While its peers operate a similar business model with the same goal, they fail to do so as successfully, as evidenced in the lower margins and returns compared with Exxon. Exxon generates its superior returns from the integration of low-cost assets (an intangible asset that we consider to be part of its moat source) combined with a low cost of capital; this combination produces excess returns greater than those of its peers. However, given our outlook for lower long-term oil and natural gas prices, we expect Exxon's returns to be lower than they have been in the past. Consequently, our confidence that it can continue to deliver excess returns for longer is diminished, resulting in the company no longer earning a wide moat. We now rate Exxon with a narrow moat.

Exxon's upstream segment holds a low-cost position based on an evaluation of Exxon's oil- and gas-producing assets, using our exploration and production moat framework. Its reserve life of 16 years, finding and development costs of $20/boe, and cash operating margins of 50% all easily clear our hurdles to consider the assets low-cost. Exxon also continually delivers upstream-segment margins and returns far superior to those of peers. Exxon's upstream margins in 2012 were 31%, compared with a peer average of 23%. Returns were 21%, compared with 18% for peers. We think this is in part due to integration with the downstream segment.

Exxon's size and integration between refining and chemical manufacturing give it a low-cost position, thanks to economies of scale and access to unique assets. During the past 10 years, Exxon's downstream averaged returns of 24%. Even in 2009, when the global refining and chemical markets buckled in the wake of the global recession, Exxon's downstream earned its cost of capital with returns of 10%, while others did not.

The integration between refining and chemicals is an unequaled advantage. As a result, Exxon delivers wider margins and higher returns than peers, despite a similar business model designed to capture the rents involved in hydrocarbon production and processing, irrespective of commodity prices.

Valuation 04/06/2016

After incorporating our lower long-term oil and natural gas price assumptions into our model, we are lowering our fair value estimate to $79 from $92 per share, which corresponds to a forward enterprise value/EBITDA multiple of 11.3 times our 2016 EBITDA forecast of $34.7 billion. Our fair value estimate is derived using Morningstar’s standard two-stage discounted cash flow methodology. With this methodology, a terminal value is derived using our assumptions for long-term earnings growth and return on new invested capital. This valuation methodology also more explicitly incorporates our moat rating, which reflects how long we expect a given firm to deliver excess returns on invested capital from a discounted cash flow analysis. In our DCF model, our benchmark oil and gas prices are based on Nymex futures contracts for 2016-18. For natural gas, we use $2.13 per thousand cubic feet in 2016, $2.79 in 2017, and $2.83 in 2018. Our long-term assumption is $3.00. For oil, we use Brent prices of $39 per barrel in 2016, $45 in 2017, $53 in 2018, and $70 in 2019. Our long-term oil-price assumption is $60. We assume a cost of equity of 7%. We forecast a CAGR for production of less than 1% during our forecast period. However, we expect Exxon to actually increase oil volumes at a greater rate than natural gas over our forecast period thanks to large project startups over the next five years. Our forecast is within management's production guidance of 4.0-4.2 mmboed through 2020. We expect strong results from Exxon's downstream operations as projects to improve yields and increase feedstock flexibility take hold and partially offset market weakness.

Risk 11/04/2015

For a company with global operations, geopolitical risk is always an issue. Past 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 national oil companies. 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.

Management 11/04/2015

Rex Tillerson became chairman and CEO in 2006; he served previously as president. He has spent his career with Exxon, beginning in 1975 as a production engineer. To date, Tillerson's one major decision was the acquisition of XTO Energy, which raised concerns that he may be straying from the returns-focused strategy that has made ExxonMobil great and is instead investing in growth for the sake of growth. ExxonMobil's subsequent performance has seemingly lent weight to this argument, as gas volumes have grown while prices have fallen, resulting in declining returns. However, while the acquisition proved to be ill-timed given the drop in natural gas prices, we think ultimately it can deliver returns that meet ExxonMobil's requirements as prices rise and the firm leverages XTO's knowledge to exploit unconventional plays globally.

In the past two years, Tillerson has focused his attention on improving upstream margins, which suffered in the wake of the XTO deal. To do so, Exxon has dramatically cut U.S. natural gas production, sold lower-margin assets, and exited fixed fee-per-barrel contracts. These efforts, combined with growing higher-margin liquids production, are already bearing fruit and narrowing the margin gap with peers. As a result, we think Exxon will be able to keep its top spot among peers with respect to returns on capital.

ExxonMobil's record of generating shareholder returns deserves an Exemplary stewardship rating, in our opinion. Despite the XTO acquisition, we think Tillerson and his team have been disciplined in their capital-allocation strategy. As a result, we are inclined to maintain our Exemplary stewardship rating.

Overview

Profile:

ExxonMobil is an integrated oil and gas company that explores for, produces, and refines oil around the world. In 2015, it produced 2.1 million barrels of liquids and 11.1 billion cubic feet of natural gas per day. At year-end 2014, reserves stood at 25.3 billion barrels of oil equivalent (including 6.0 billion for equity companies), 54% of which are liquids. The company is the world's largest refiner and one of the world's largest manufacturers of commodity and specialty chemicals.