

**Exxon Mobil Corporation XOM** | ★★★★★

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**Exxon is positioned to compete in a world with diminishing resources.**



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**Analyst Note** 05/01/2014

ExxonMobil's first-quarter results saw total oil and gas production decline sequentially by roughly 70mboe/d to 4.15mboe/d. This was driven by a few factors, notably the expiration of the ADCO license in the United Arab Emirates, lower volumes at the giant Gronigen gas field in the Netherlands, and reduced output in Iraq (Exxon sold a partial interest in its West Qurna stake last year).

Despite this fall in output, earnings were meaningfully up by \$1 billion. One driver of this earnings uplift was higher natural gas price realizations in North America (up \$1.40/MMBtu compared to the fourth quarter). But the biggest driver of the quarter was simply production mix, as Exxon's first quarter output on average included higher-value barrels. This makes sense, given that the ADCO licenses paid just \$1 per barrel produced, making it arguably the least valuable barrels in any of the oil majors' portfolios. The fiscal terms in Iraq also are well below average, meaning volume declines here also do not materially affect Exxon's earnings or cash flow figures. At the same time, 125mboe/d of new production entered the portfolio that on average was high-margin. The biggest source of new barrels in the quarter was the Permian in Texas, where production is now above 90mboe/d. The company is running 10 rigs in this basin at the moment, and with 1.5 million net acres has a lot of running room to meaningfully grow production here for the rest of the decade.

Overall, our Exxon thesis remains unchanged: we expect company will be able meaningfully improve its returns and free cash flows during the next few years as the recent period of high capital spending comes to a close this year. Our fair value and moat ratings are unchanged.

**Investment Thesis** 03/21/2014

ExxonMobil sets itself apart from the other majors as a superior capital allocator and operator and has historically consistently delivered higher returns on capital relative to peers. However, delivering returns on par with historical levels could be more difficult as it faces the ongoing challenge of reserve replacement. With a majority of the world's remaining resources in government hands, the firm's opportunities to expand its large production base are limited.

While we believe Exxon has an advantage in the current environment, that does not necessarily mean production and reserve gains will come easily or cheaply. Exxon's need for projects of a certain size in order to contribute meaningfully to its production profile and justify investment leaves it with a diminishing set of opportunities. Also, investing exclusively in large projects exposes it to a variety of risks including overinvestment risk, execution risk, and budgetary risk.

Greater competition is becoming an issue as more operators vie to partner in large projects with national oil companies. To gain access, Exxon must not only demonstrate its value but may also have to agree to terms that are not as advantageous as in the past. 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. A good example of the latter case is Exxon's recent deal with Rosneft to explore for oil in the Russian Arctic. If Exxon is able to exploit similar opportunities where it can add oil reserves with attractive terms thanks to its value proposition, then it can probably continue to deliver superior returns.

One way Exxon is tackling its growth/reserve replacement issues is by investing in projects like oil sands and LNG that produce at plateau production levels for longer than traditional projects and reduce its overall decline rates. Also, relatively little reinvestment is required after the large initial up-front capital, resulting in significant free cash flow generation after startup. Production for these projects will constitute more than half the 1 mboe/d of new production capacity Exxon plans to add by 2017.

**Economic Moat** 03/21/2014

Exxon earns a wide moat by integrating a low-cost upstream and downstream business 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. The superior returns Exxon generates 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 produces excess returns greater than peers'. Accordingly, we have greater confidence that Exxon can continue to deliver excess returns for longer, earning it a wide moat compared with a narrow moat for peers.

Exxon's upstream segment holds a low-cost position based on an evaluation of Exxon's oil- and gas-producing assets, using our E&P moat framework. Its reserve life of 16 years, finding and development, or F&D, costs of \$20/boe, and cash operating margins of 70% all easily clear our hurdles to consider the assets low-cost. Exxon also continually delivers upstream segment margins and returns far superior to 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

**Morningstar's Take** XOM

<b>Analyst</b>		
Price 05-21-2014	Fair Value Estimate	Uncertainty <sup>(?)</sup>
101.38 USD	109 USD	Low
Consider Buy <sup>(?)</sup>	Consider Sell <sup>(?)</sup>	Economic Moat <sup>(?)</sup>
87.2 USD	136.25 USD	Wide
Morningstar Credit Rating <sup>(?)</sup>	Stewardship Rating <sup>(?)</sup>	
AAA	Exemplary	

**Bulls Say**

- Exxon's superior capital allocation and operational performance should continue to deliver high returns on capital.
- NOCs do not have the expertise to effectively explore for and produce oil and gas in their countries and will need to partner with private firms. Exxon is one the most attractive options as its recent deal with Rosneft demonstrates.
- 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 like peers.

**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 and free cash flow in recent years. Higher levels of investment place free cash flow and cash shareholder returns at risk if commodity prices slip. Low natural gas prices are weighing on profitability currently.
- Exxon is very discriminating when evaluating investment opportunities. It is unlikely to sign less favorable contracts, which could slow growth.

**Competitors** XOM

More...

Name	Price	% Chg	TTM Sales \$ mil
<b>Exxon Mobil Corporation</b>	<b>\$101.38</b>	<b>0.71 ↑</b>	<b>436,671</b>
Royal Dutch Shell PLC ADR Class B	\$86.25	0.35 ↑	456,164
Royal Dutch Shell PLC Class B	\$42.85	-2.28 ↓	456,164
Royal Dutch Shell PLC ADR Class A	\$79.24	0.58 ↑	456,164
Royal Dutch Shell PLC Class A	\$39.03	-1.13 ↓	456,164
Chevron Corp	\$123.59	0.89 ↑	225,295

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 last 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** 03/21/2014

We are raising our fair value estimate to \$109 from \$97 after updating our model with the latest guidance from Exxon's recent analyst day and making adjustments to our methodology for valuing the oil majors.

We now are employing Morningstar's standard two-stage DCF methodology rather than applying a multiple to year-five EBITDA. With this methodology, a terminal value is derived using our assumptions of 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.

Our fair value estimate is approximately 6.5 times our 2015 EBITDA estimate of \$76 billion. In our DCF model, our benchmark oil and gas prices are based on Nymex futures contracts for 2014-16. For natural gas, we use \$4.53/mcf in 2014, \$4.23 in 2015 and \$4.23 in 2016. Our natural gas price assumptions for 2017 and 2018 are \$5.40. For oil, we use Brent prices of \$107 per barrel in 2014, \$103 in 2015 and \$99 in 2016. Our oil price assumptions for 2017 and 2018 are \$100. We assume a cost of equity of 8%.

We forecast a CAGR for production of less than 1% during our forecast period. However, growth is negatively affected by the loss of low-margin volumes from the UAE and Iraq. Volumes should remain flat in 2014, after falling 1.5% in 2013, due to reduced volumes from the Netherlands and the UAE.

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 slightly below management's forecast to compensate for the potential negative effects of higher oil prices related to production-sharing contracts as well as the risk associated with larger projects.

We expect strong results from Exxon's U.S. downstream segment as wide crude differentials shift to the U.S. Gulf Coast, benefiting Exxon, which has 1.5 mmbbl/d of refining capacity in the region. Additionally, it should benefit from wide differentials and processing of 100% advantaged crude through its Mid-Continent U.S. and Canadian refiners (600 mb/d). International weakness will likely continue, however, especially in Europe, where Exxon operates 1.7 mmbbl/d of refining capacity. We anticipate chemical earnings to remain tied to economic activity though operations in the U.S. should benefit as well from increased cost-advantaged feedstock.

#### **Risk** 03/21/2014

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 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.

#### **Management** 03/21/2014

Rex Tillerson became chairman and CEO in 2006 and served previously as president. He has spent his career with Exxon, beginning in 1975 as a production engineer. The acquisition of XTO Energy 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 lent weight to this argument as gas volumes have grown while prices have fallen, resulting in declining returns. However, while the acquisition has proven 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 it leverages XTO's knowledge to exploit unconventional plays globally. In addition, management has set out to improve Exxon's eroding margins and declining earnings per barrel. Although higher commodity prices will help, delivering improvement and lowering its cost structure will be the key element to Exxon keeping 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 is likely to continue a disciplined capital allocation strategy, given his previous statements. Recent efforts to exploit more lucrative Kurdistan reserves at the risk of losing pre-existing, but likely lower-returning, Iraqi contracts provides us some evidence to his focus on returns. As a result, we are inclined to maintain the exemplary rating.

#### **Overview**

Profile:

Exxon is an integrated oil and gas company that explores for, produces, and refines oil around the world. In 2013, it produced 2.2 million barrels of oil and 11.9 billion cubic feet of natural gas a day. At year-end 2013, reserves stood at 25.2 billion barrels of oil equivalent (including 7.0 billion for equity companies), 53% of which are oil. The company is the world's largest refiner and one of the world's largest manufacturers of commodity and specialty chemicals.

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