Exxon Mobil Corporation XOM

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

by
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Analyst Note

Exxon's Earnings Hurt by Downstream Weakness, but Upstream Offers Hints of Turnaround
by Allen Good, CFA, 10/31/2013

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Analyst Note 10/31/2013

Exxon reported a drop in third-quarter earnings to $7.9 billion from $9.6 billion the year before. The poor performance was confined to the downstream segment; in fact, the upstream offered hints of a turnaround. Downstream earnings were sharply lower, falling to $592 million from $3.2 billion the year before because of weaker refining margins. The results came as little surprise, given the weak market conditions during the quarter. However, we expect a rebound over the next year, beginning next quarter. The chemical segment fared much better, reporting earnings of $1.0 billion compared with $790 million a year ago. Long term, we continue to see Exxon's downstream segment, including chemicals, as a competitive strength. Exxon's integration among all three segments, but particularly refining and chemicals, and unique assets lead to superior returns compared with peers. Despite ongoing volatility, we expect Exxon to generate excess returns out of both segments and see them as a key component of the firm's wide economic moat. Our fair value estimate and moat rating are unchanged.

Upstream earnings increased to $6.7 billion from $6.0 billion the year before, largely due to higher realized prices. However, Exxon also registered year-over-year production growth, driven by liquids volumes. Total production increased 1.5%, with liquids growth of 3.9% offsetting a 1.3% decline in natural gas volumes. Exxon maintained its earlier guidance, implying that total production will still decline year over year.

Investment Thesis 08/15/2013

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, opportunities for the company 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 the company 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 on capital.

Morningstar's Take XOM

Analyst

Price 11-01-2013 88.72 USD	**Fair Value Estimate** 97.00 USD	**Uncertainty** Low
Consider Buy 77.60 USD	**Consider Sell** 121.25 USD	**Economic Moat** Wide
Stewardship Rating 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

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Name	Price	% Chg	TTM Sales $ mil
Exxon Mobil Corporation	**$88.71**	**-1.02**	**446,155**
Royal Dutch Shell PLC ADR Class B	$69.83	0.45	467,902
Royal Dutch Shell PLC Class A	$33.42	0.21	467,902
Royal Dutch Shell PLC ADR Class A	$66.73	0.08	467,902
PetroChina Co Ltd ADR	$112.92	-0.31	374,077
Chevron Corp	$117.19	-2.31	232,783

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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. We estimate nearly 40% of Exxon's production will come from these types of projects by 2016.

Economic Moat 08/15/2013

ExxonMobil achieves our wide moat rating largely thanks to its institutionalization of practices that continually deliver superior returns compared with its competitors. Embedded in ExxonMobil's culture is a relentless pursuit of cost savings and operational improvement. As a result, the company can ensure operational continuity throughout its global operations. This allows it to capitalize on worldwide integration of its upstream and downstream segments to drive costs out of the system. Integration, particularly with chemical production, also adds value to its refining operations, which we generally consider as not having a moat. Meanwhile, by leveraging its size, the company can achieve economies of scale to contain costs.

Additionally, ExxonMobil centralizes its capital allocation activities. Consequently, the company evaluates projects from around the world against one another, and only those with the most attractive returns receive funding. With a disciplined approach, the company avoids overinvesting at the height of commodity cycles. By the nature of its larger projects, the company must take a long-term approach that prevents it from counting on elevated commodity prices to drive project economics. Instead, the focus is on delivering projects on time and under budget, ensuring original economics remain in place. Part of the company's moat is attributable to its financial strength. Strong cash flow, large cash balances, and low debt levels enable the company to maintain a low cost of capital and to continue investing without reliance on capital markets.

Valuation 08/15/2013

We are maintaining our fair value estimate of $97, updating our model based on second-quarter results, and updating our commodity price deck. Our long-term forecasts and assumptions incorporate a more challenging operating environment as well as a decline in returns on capital relative to historical performance over our forecast period.

Our fair value estimate is approximately 5.6 times our 2014 EBITDA estimate of $83 billion. In our discounted cash flow model, our benchmark oil and gas prices are based on Nymex futures contracts for 2013-15. For natural gas, we use $3.61/mcf in 2013, $3.79 in 2014, and $4.04 in 2015. Our long-term natural gas price assumptions for 2016 and 2017 are $5.40. For oil, we use Brent prices of $108 per barrel in 2013, $103 in 2014, and $98 in 2015. Our long-term oil price assumptions for 2016 and 2017 are $100. We assume a cost of equity of 8%.

We forecast a compound annual growth rate for production of 1.6% during our forecast period. Growth should be more robust in outer years after falling approximately 1% in 2013. We expect Exxon to actually increase oil volumes (3%) at a greater rate than natural gas (0.2%) 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. Full realization of management's guidance could offer upside to our valuation.

Exxon has posted increasing downstream earnings as refining margins have staged a recovery in the past two years. We expect earnings growth to continue 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 continue to benefit from wide differentials and processing of 100% advantaged crude through its Mid-Continent U.S. and Canadian refiners which total almost 600 mb/d of capacity. This will likely be offset by continued weakness in Europe where Exxon operates 1.7 mmbbl/d of refining capacity. Meanwhile, 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 08/15/2013

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 08/15/2013

Rex Tillerson became chairman and CEO in 2006. Previously, he served as president. He has spent his career with Exxon, beginning in 1975 as a production engineer. The recent acquisition of XTO Energy raised concerns that he may be straying from the returns-focused strategy that has made ExxonMobil great and 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. Also, management has set out to improve Exxon's eroding margins and declining earnings per barrel. Though 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, and deliver the high returns that his predecessor did. 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 2012, it produced 2.2 million barrels of oil and 12.3 billion cubic feet of natural gas a day. At year-end 2012, reserves stood at 18.2 billion barrels of oil equivalent (plus 7.0 billion for equity companies), 51% 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.