# Exxon Mobil Corporation XOM |

**Analyst Research** Analyst Report Archive Top Rated Stocks in Sector

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

by
Allen Good, CFA

Authors can be reached at Analyst Feedback

Morningstar's Editorial Policies

**Analyst Note**

ExxonMobil's Earnings Negatively Affected by Downstream Downtime
by Allen Good, CFA, 08/01/13

**Discuss**

See what other investors are saying about XOM

### Analyst Note 08/01/13

ExxonMobil reported second-quarter earnings of $6.9 billion compared with $15.9 billion the year before. The significant drop is the result of the absence of asset sales this year compared with the last. Otherwise, earnings were lower due to refinery downtime. Excluding asset gains last year, downstream earnings fell about $900 million to about $400 million in the second quarter of 2013 as downtime for maintenance was exceptionally high with about 9% of total capacity offline during the quarter. The downtime has now abated and earnings should rebound in the third quarter. Upstream earnings were essentially flat at $6.3 billion during the quarter excluding the impact of asset sales last year and the reimbursement of costs to Rosneft. Higher worldwide natural gas realizations of almost $1/mmcf more than offset the decline in oil realizations of almost $4/bbl. Production continued to slide, falling 1.9%. Excluding the impact of entitlements and divestments, it was largely flat for both oil and natural gas. Exxon reiterated its full-year production guidance of a total production decline of 1% with a 2% increase in liquids production and a 5% decline in natural gas production. Production growth and additions remain back-end loaded, and will include the impact of Kearl, which started production in the second quarter.

Also of note during the quarter was future guidance of $3 billion worth of share repurchases, reduced from $4 billion in the second quarter and $5 billion in the

### Morningstar's Take XOM

**Analyst**

| **Price** 08-12-2013 | **Fair Value Estimate** | **Uncertainty** |
|---|---|---|
| 89.89 USD | 97.00 USD | Low |
| **Consider Buy** | **Consider Sell** | **Economic Moat** |
| 77.60 USD | 121.25 USD | Wide |

**Stewardship Rating**
Exemplary

**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.

**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. Low natural gas prices are weighing on profitability currently.

first quarter. The amount has dwindled partly due to lower cash flow, and because of reduced asset sales this year relative to the last. At the same time, Exxon has taken on debt that has helped to support the share repurchase amount. Going forward, we'd expect the share repurchase level to be set by excess cash flow from operations and asset sales. Operating cash flow should pick up over the next year as liquids priced production is added from long-life assets, which should help to support increases to the repurchases plan. In the near-term, though, any increase is likely more dependent on assets sales, of which little future clarity exists. We plan to incorporate the latest results into our model, but do not expect a change to our fair value estimate or wide moat rating at this time.

**Investment Thesis** 04/26/13

ExxonMobil sets itself apart from the other majors 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. However, we think ongoing low U.S. natural gas prices are likely to prove a drag on returns, which could fall behind those of more oil-exposed peers.

Longer term, we think Exxon will probably retain its top spot, but 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. However, we believe Exxon's experience and expertise, particularly with large projects, should allow it to successfully compete for resources.

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 an diminishing set of opportunities. In addition, investing exclusively in large projects exposes the company to a variety of risks including overinvestment risk, execution risk, and budgetary risk. Future projects will also probably rely on resources with higher extraction costs because of their lower quality (bitumen), location (deeper water)

- 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 |
|---|---|---|---|
| **Exxon Mobil Corporation** | **$89.89** | **-0.91** | **446,155** |
| Royal Dutch Shell PLC ADR Class B | $67.36 | -0.46 | 467,902 |
| Royal Dutch Shell PLC ADR Class A | $64.40 | -0.57 | 467,902 |
| PetroChina Co Ltd ADR | $117.78 | 2.18 | 360,920 |
| Chevron Corp | $121.80 | -0.57 | 232,783 |
| PT Sugih Energy Tbk | $— | — | 8 |

Compare These Stocks

**Video Reports** XOM More...

or stimulation requirement (fracturing).

Greater competition is also 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 production-sharing agreements 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.

Faced with these challenges, Exxon is turning to relative political safe havens to drive growth like in North America. In the U.S., growth will largely come from resources added with the acquisition of XTO. While the acquisition largely consisted of natural gas reserves and production, it also held acreage in tight oil plays to which Exxon has subsequently added, namely in the Bakken and Duvernay. It is now also shifting its drilling activities to these more liquid-rich plays in light of low prices. Exxon has cut its rig count and is using two thirds of those rigs in liquid-rich plays as opposed to less than half previously. The shift should be evident in 2013 when overall natural gas production is expected to fall 5%.

Exxon also has promising offshore discoveries in the Gulf of Mexico that should be developed in the coming years. In Canada, Exxon's reserves are primarily oil sands, both mining and in situ. Its largest project, Kearl, will come on line in late 2012. While Kearl initially will add about 100 thousand barrels a day of oil production, oil sands mining projects typically fall on the upper end of the cost curve. We think Kearl is better positioned than other projects because it does not require an upgrader, but it still is indicative of the move to higher-cost resources by Exxon in the face of increased resource nationalism.

Another 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, some up to decades, 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. However, most are large projects, especially the LNG developments, and thus hold the aforementioned risks.

Despite growing investment in the U.S., Exxon is not stepping off the international stage or away from political risk. Asia and Africa continue to be the company's largest producing regions and we expect them to continue as such, with numerous projects scheduled to come on line over the next five years in Nigeria, Angola, and Kazakhstan. Exxon also has the potential for shale resources in Europe and South America that would allow it to leverage its acquired unconventional technology and bolster its value proposition and competitive advantage in the global competition for resources.

**Economic Moat** 04/26/13

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** 04/26/13

We are maintaining our fair value estimate of $97, updating our model based on first-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 5.1 times our 2014 EBITDA estimate of $80 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 $4.04/mcf in 2013, $4.21 in 2014, and $4.26 in 2015. Our long-term natural gas price assumptions for 2016 and 2017 are $5.40. For oil, we use Brent prices of $104 per barrel in 2013, $98 in 2014, and $95 in 2015. Our long-term oil price assumptions for 2016 and 2017 are $99. We assume a cost of equity of 8%.

We forecast a compound annual growth rate for production of 1.7% 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** 04/26/13

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** 08/29/12

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.

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.

Returns to shareholders also remain a focus, with share repurchases the primary tool used to return excess cash. However, Tillerson recently acknowledged ExxonMobil's relatively low yield and indicated higher payouts could be in the future.

## 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.

---

S&P 500 index data: S&P 500 Copyright @ 2013

All data from Morningstar except U.S. intraday real-time exchange quotes, which are provided by BATS when available. End-of-day quotes for Nasdaq, NYSE, and Amex securities will appear 15 minutes after close. Graph times are Eastern Standard. @ Copyright 2013 Morningstar, Inc.