Exxon Mobil Corporation XOM

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

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Morningstar's Editorial Policies

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 due 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 175 thousand barrels oil equivalent per day of production growth 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, higher 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 by 2018. Even though spending will remain relatively high through 2017, the dividend is not at risk. With peer-leading coverage ratios, we expect that Exxon will still be able to adequately cover its dividend and continue repurchasing shares beyond 2015, assuming strip pricing.

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

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. 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 peers'.

Morningstar's Take XOM

Analyst

Price 11-13-2015	**Fair Value Estimate**	**Uncertainty**
78.1 USD	87 USD	Low
Consider Buy	**Consider Sell**	**Economic Moat**
69.6 USD	108.75 USD	Wide
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 continued dividend increases and share 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 like peers.

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. Also, an extended period of low oil prices would force Exxon to increase debt to avoid reducing share repurchases and slowing dividend growth.
- 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 Corporation	**$78.10**	**-1.65**	**296,351**
Royal Dutch Shell PLC Class B	$24.57	-1.13	306,146
Royal Dutch Shell PLC Class A	$24.30	-3.19	306,146
Royal Dutch Shell PLC ADR Class B	$48.48	-0.45	306,146
Royal Dutch Shell PLC ADR Class A	$48.34	-0.62	306,146
Chevron Corp	$88.68	-1.31	155,318

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 exploration and production moat framework. Its reserve life of 16 years, finding and development 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 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 11/04/2015

Our fair value estimate is $87 per share, which corresponds to a forward enterprise value/EBITDA multiple of 9.5 times our 2016 EBITDA forecast of $42.5 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 2015-17. For natural gas, we use $2.69 per thousand cubic feet in 2015, $2.57 in 2016, and $2.87 in 2017. Our assumptions for 2018 and 2019 are $4.00. For oil, we use Brent prices of $55 per barrel in 2015, $54 in 2016, and $59 in 2017. Our oil-price assumptions for 2018 and 2019 are $70. We assume a cost of equity of 7.5%. We forecast a compound annual growth rate for production of about 1% during our forecast period. However, growth is negatively affected by the loss of low-margin volumes from the United Arab Emirates and Iraq. Volumes should grow in 2015, after falling in 2014 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 crude differentials materialize on the U.S. Gulf Coast, benefiting Exxon, which has 1.5 million barrels a day of refining capacity in the region. Additionally, it should benefit from U.S. crude differentials and processing of 100% advantaged crude through its Mid-Continent U.S. and Canadian refiners (600 mb/d). International weakness is likely to continue, however, especially in Europe, where Exxon operates 1.7 mmb/d of refining capacity. We anticipate chemical earnings to remain tied to economic activity, though U.S. operations should benefit from cost-advantaged feedstock.

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 2014, 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.