# BP PLC BP [NYSE]

| Morningstar Rating | Last Price | Fair Value | Consider Buy | Consider Sell | Uncertainty | Economic Moat | Stewardship Grade | Industry | Sector |
|---|---|---|---|---|---|---|---|---|---|
| ★★★★★ | 60.02 | 89.00 | 66.80 | 115.70 | Medium | Narrow | — | Oil & Gas | Energy |

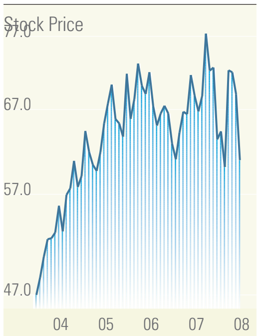
Per share prices in USD

## First Impression of BP's 2Q

by Elizabeth Collins
Senior Stock Analyst
Analysts covering this company do not own its stock.

Report updated on July 29, 2008.
Data and Rating updated as of August 08, 2008.

Currency amounts expressed with "$" are in U.S. dollars (USD) unless otherwise denoted.




**Analyst Note** Jul. 29, 2008

BP's second-quarter results were driven higher by lofty oil and natural-gas prices, flat reported oil and gas production (underlying production was up 6%), and improved refining throughputs. Offsetting these factors were higher upstream costs and dramatically lower refining margins. Meanwhile, BP remains locked in a battle over control of TNK-BP with the venture's other partners.

**Thesis** May 16, 2008

Historically, BP has focused on assembling a portfolio of topnotch assets, including high-potential oil and gas fields and advantaged refineries. The firm has paid less attention to the operation of its assets, which has resulted in accidents and depressed financial results. With a new CEO in place, BP is changing course and looks set to spend the next several years on operational improvements. If successful, this should allow the firm to take full advantage of its attractive assets.

Compared with peers ExxonMobil and Shell, exploration and production makes up a larger chunk of BP's business. We think most E&P operations enjoy an economic moat because OPEC helps maintain industrywide profitability. BP is no exception. Plus, the firm's enormous size and capabilities allow it to pursue projects that are risky but have the potential for huge rewards.

BP has several challenges ahead. In its quest to aggressively increase oil and gas production, the firm will be partnering with foreign governments and national oil companies in politically unstable regions. Although BP's capital resources and technological expertise make it a valuable partner, the upper hand often goes to the foreign governments because they have what matters most: oil and gas resources. BP could find it increasingly difficult to secure production agreements on favorable terms.

A political risk worth highlighting is BP's exposure to Russia. More than one third of BP's oil production comes from its share of TNK-BP, a leading Russian oil producer. No other supermajor is this dependent on Russian energy. Russia has become notorious for using its vast resources as a political weapon. The dismantling in 2004 of leading Russian oil producer Yukos, plus TNK-BP's own experiences with surprise back-tax bills and a coerced divestiture, does nothing to bolster our confidence for BP's investments in this country. Still, BP's strategy of applying technology and management savvy to Russia's enormous resources could bring handsome rewards.

BP is not alone in facing challenges to profitable upstream growth. With higher energy prices, international oil companies are battling stiffer terms from resource-holding countries; an increasing number of worthy competitors with the necessary capital, technological, and commercial resources; and escalating costs. Further, refining bottlenecks appear to be easing, and gasoline and diesel demand could suffer in a weakening economy, leading to lower refining margins than we've seen in the recent past.

**Valuation**

We're raising our fair value estimate to $89 from $77 per share, based on our higher oil and natural-gas price assumptions. In our discounted cash-flow model, our benchmark oil and gas prices are based on NYMEX futures contracts for 2008-10. For natural gas, we are currently using $11 per thousand cubic feet (mcf) in 2008, $11 in 2009, and $10 in 2010. For oil, we are currently using $117 per barrel in 2008, $122 in 2009, and $120 in 2010. Our model incorporates production increases of over 1% per year for the next few years, with 2012 production of roughly 4.0 million barrels of oil equivalent per day. Refining revenue is driven largely by product prices and how much crude oil is processed into end products such as gasoline, fuel oil, and jet fuel. We expect refining volume to get a boost as the Texas City refinery comes back on line after an explosion and a hurricane-related shutdown during 2005. After that, we project minimal refining

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Per share prices in USD

| Close Competitors | Currency(Mil) | Market Cap | TTM Sales | Oper Income | Net Income |
|---|---|---|---|---|---|
| **BP PLC** | USD | 189,418 | 318,625 | — | 24,124 |
| **ExxonMobil Corporation** | USD | 408,872 | 472,318 | 77,693 | 43,640 |
| **Royal Dutch Shell PLC** | USD | 209,941 | 396,604 | — | 33,728 |
| **Chevron Corporation** | USD | 173,397 | 265,879 | 38,023 | 19,736 |

Morningstar data as of August 08, 2008.

volume increases.

**Risk**

Our valuation of BP entails greater uncertainty than our valuations for ExxonMobil and Shell because BP's business model is less integrated and it has heavy exposure to Russia. As with all oil and gas firms, a sustained drop in oil and gas prices is one of the biggest risks BP faces. Lately, the company has been plagued by mishaps at its North American operations. Potential oil spills and environmental concerns are always issues for the industry, as are political conflicts that could disrupt operations.

**Bulls Say**

- We like BP's focus on oil and gas exploration and production. Of integrated energy firms' activities, we think E&P offers the best prospects for strong returns.
- BP has a very healthy project portfolio. Hefty investment in liquefied natural gas and deep-water oil and gas projects should pay off handsomely. BP has also ditched the least profitable portion of its chemical business, demonstrating its desire to trim some fat.
- BP's level of financial and operational disclosure stands out from its peers and highlights the company's efforts at transparency.

**Bears Say**

- BP has already been burned once in Russia, but it is plowing ahead and spending billions on its partnership there. Recent events--like the dismantling of Yukos as well as surprise back-tax bills--demonstrate that political risk in Russia remains high.
- Russian reserves are plentiful, but much of these hydrocarbons are stranded until new infrastructure gets built. Significant transportation bottlenecks and higher tax rates also decrease their value.
- Environmental, political, and commodity price risks are always present in the oil and gas industry. BP's production in OPEC member countries may be periodically curbed.
- BP's safety and compliance record has come under scrutiny recently after incidents such as the Texas City refinery explosion, pipeline leaks in Alaska due to corrosion, and price-manipulation investigations.

**Financial Overview**

Growth: Revenue growth will depend on prices for oil, natural gas, and petroleum products, in addition to oil and gas production levels and refining output. In the short run, production levels will depend on BP's ability to bring projects on line and maintain output at existing fields. In the long run, production will depend on BP's ability to acquire, discover, and develop additional resources. We expect BP to post modest growth in both oil and gas production and refining activity over the next several years.

Profitability: Profitability will depend on BP's ability to fully utilize its assets as well as operating and capital costs. BP is combating rising industrywide costs for people, equipment, and resources. Longer term, we expect some of these cost pressures to abate.

Financial Health: As a result of decades of profitability, BP has a nominal amount of debt for a company its size. This is the case even as it has been paying out a healthy dividend and repurchasing shares.

**Company Overview**

Profile: London-based BP is one of the largest international oil companies on the planet, along with ExxonMobil and Royal Dutch Shell. Formed by the 1998 merger of British Petroleum and Amoco, BP boasts proven reserves of 17.8 billion barrels of oil equivalent; in 2007, it produced 3.8 million barrels per day. BP has refining capacity of 2.8 million barrels per day, operates petrochemical plants, and sells petroleum through 24,100 service stations around the globe.

Strategy: To boost profits, BP seeks to leverage its scale through expanding production and trimming unit costs. After a long period of mergers, acquisitions, and consolidation, BP is now focused on generating growth internally. The firm is looking to its TNK-BP venture in Russia to support long-term growth, but it is also focusing on key project areas including the Asia Pacific region, Azerbaijan, Algeria, Angola, Trinidad, and the deep-water Gulf of Mexico.

Management: Tony Hayward became group chief executive of BP in May 2007, taking over from John Browne. Hayward was previously chief executive officer of BP's E&P segment, having joined the company in 1982. The past few years have been troubling ones for BP--the firm has been plagued by a massive refinery explosion, pipeline leaks, refinery shutdowns, and major project delays. Hayward will be focusing on improving BP's operational performance. There have also been management changes in BP's North American operations, and BP is increasing spending on safety and maintenance. Peter Sutherland is BP's nonexecutive chairman of the board, a position he's held since 1997. During 2007, BP bought back $7.5 billion worth of shares and paid $8.1 billion in dividends.

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## Analyst Notes

**Jul. 29, 2008**

### First Impression of BP's 2Q

BP's second-quarter results were driven higher by lofty oil and natural-gas prices, flat reported oil and gas production (underlying production was up 6%), and improved refining throughputs. Offsetting these factors were higher upstream costs and dramatically lower refining margins. Meanwhile, BP remains locked in a battle over control of TNK-BP with the venture's other partners.

**May 16, 2008**

### Oil and Natural-Gas Price Projections Raised

We are raising our long-term oil and natural-gas price assumptions. As such, our new price decks will positively affect our fair value estimates for numerous companies in the oil and gas industry.

Despite witnessing a slowdown in the demand for oil in the U.S. (especially on the West Coast), demand from emerging economies--largely driven by diesel demand--remains strong and continues to pull overall demand higher. Meanwhile oil supplies remain tight. So far this year, Russia's output is slipping year over year and OPEC's output is largely unchanged.

Natural-gas prices have benefited from a cold winter. Gas storage is much closer to its historical average for this time of year. We expect supply gains from the lower 48 states over the next few years, as new production from shale gas plays comes on line. However, the demand outlook for natural gas appears very rosy, especially when we look at the incremental demand coming from power generation--the largest source of gas demand in the U.S.

For both oil and natural gas, our new pricing assumptions will incorporate the futures curve for the first three years of the explicit forecast period in our discounted cash-flow models. Presently, that means we'll be using NYMEX WTI oil prices and NYMEX Henry Hub natural-gas prices of:

. . . . . Oil . . Gas
----------------------
2008: $117  $11
2009: $122  $11
2010: $120  $10

In year four (2011) and later, we're going to equally weight three scenarios in our models. We'll consider the following three pricing scenarios for oil and natural-gas prices:

. . . . . Oil . . Gas
----------------------
High: $150  $15
Base: $85   $9
Low:  $50  $5

We think this new oil and gas price assumption framework will enhance our valuations and company analyses. First, the three-scenario approach to our long-term oil and gas price assumptions better approximates the distribution of potential oil and natural-gas prices that could prevail over the next decade, leading to better company valuations. Second, the three-scenario approach will help analysts generate insights into which businesses will perform better or worse in especially high or low pricing environments. Third, we expect the three-scenario modeling exercise will better uncover investment risks and opportunities than a single-pricing scenario, which uses a point estimation of future prices, could.

Increases in our fair value estimates will vary. For

**Analyst Notes** (continued)

integrated firms employing little or no debt, we expect smaller changes. However, for firms largely focused on exploration and production and for those incorporating a greater degree of financial leverage, we expect larger adjustments. Please refer to the valuation section of each company's Analyst Report to see how our fair value estimates are changing on a firm-by-firm basis.

**Apr. 29, 2008**

### BP Nets $7.6 Billion in 1Q

BP reported first-quarter results Tuesday. Net income rose to $7.6 billion, up 63% from $4.7 billion in the first quarter of 2007. In the exploration and production segment, liquid prices increased 70% and natural gas prices increased 21%, while total oil and gas production was essentially flat. These factors drove a 59% increase in upstream operating income. BP's refining and marketing segment suffered from weaker refining margins. BP has continued to work on its refining operations. Full clean fuel capacity has been restored at the Whiting refinery in Indiana, and the Texas City refinery is still scheduled to have most of its economic capability online by mid-2008. BP spent $9.0 billion on capital expenditures and acquisitions in the first quarter.

**Feb. 05, 2008**

### BP Reports 2007 Results

BP reported 2007 results Tuesday. Net income fell to $20.8 billion for the full year, down 5% from $22.0 billion in 2006. Realized oil prices increased 14%, natural-gas realizations were down 4%, and refining margins increased. Oil and gas production fell 3%, to 3.818 million barrels of oil equivalent per day. During 2007, BP bought back $7.5 billion worth of shares, paid $8.1 billion in dividends, and invested $20.6 billion in its business.

Despite its portfolio of advantaged refining assets, BP's 2007 results were dragged down by poor reliability at its U.S. refineries and a complicated and burdensome overhead structure in the refining and marketing segment. The Whiting refinery is still scheduled to reach its full potential by mid-2008, but the Texas City refinery's expected return to fully operational status has slipped past the first half of 2008. BP is working on implementing the sweeping organizational changes it announced in the fall of 2007, and it now expects to reduce corporate overhead expenses by 15%-20%. Further, BP reiterated the long-term oil and gas production guidance it gave in February 2007. Finally, BP has lifted its oil price assumption for planning purposes to $60 per barrel from $40.

# BP PLC BP

| Sales Mil | Mkt Cap Mil | Industry | Sector |
|---|---|---|---|
| $318,625 | $189,418 | Oil & Gas | Energy |

London-based BP is one of the largest international oil companies on the planet, along with ExxonMobil and Royal Dutch Shell. Formed by the 1998 merger of British Petroleum and Amoco, BP boasts proven reserves of 17.8 billion barrels of oil equivalent; in 2007, it produced 3.8 million barrels per day. BP has refining capacity of 2.8 million barrels per day, operates petrochemical plants, and sells petroleum through 24,100 service stations around the globe.

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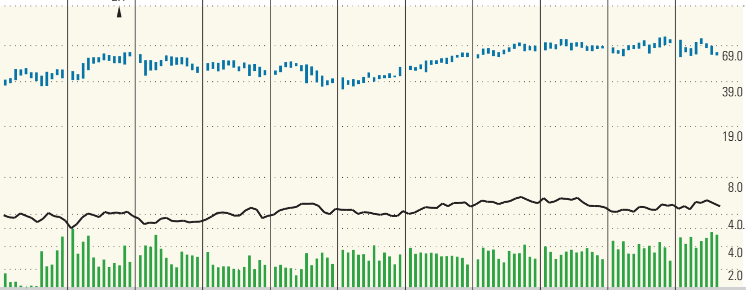
|---|---|---|---|---|---|
| ★★★★★ | $60.02 | $89.00 | Medium | Narrow | — |

| 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | YTD | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 48.66 | 62.63 | 60.63 | 55.20 | 53.98 | 49.59 | 62.10 | 72.66 | 76.85 | 79.77 | 77.69 | Annual Price High |
| 36.50 | 40.19 | 43.13 | 42.20 | 36.25 | 34.67 | 45.51 | 56.60 | 63.52 | 58.62 | 57.85 | Low |
| | 2:1 | | | | | | | | | | Recent Splits |




**Price Volatility**
Monthly High/Low
Rel Strength to S&P 500

52 week High/Low $
79.77 - 57.85

10 Year High/Low $
79.77 - 34.67

Bear-Market Rank
6 (10=worst)

Trading Volume Million

| 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | YTD | Stock Performance |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 17.9 | 34.0 | -17.3 | -0.9 | -9.9 | 26.0 | 22.1 | 13.5 | 7.9 | 13.2 | -16.0 | Total Return % |
| -8.8 | 14.5 | -7.2 | 12.1 | 13.5 | -0.4 | 13.1 | 10.5 | -5.7 | 9.7 | -4.3 | +/- Market |
| 24.1 | 17.1 | -7.2 | 9.5 | -1.6 | -8.5 | 2.0 | -11.5 | -12.5 | -13.8 | -0.8 | +/- Industry |
| 3.2 | 2.2 | 2.6 | 2.1 | 3.5 | 3.1 | 2.9 | 3.3 | 3.4 | 3.5 | 3.8 | Dividend Yield % |
| 146456 | 192609 | 155466 | 173886 | 151615 | 181958 | 209520 | 230400 | 231015 | 230918 | 189418 | Market Cap $Mil |

| 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | TTM | Financials |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 67700 | 82549 | 146001 | 172529 | 177447 | 230848 | 282910 | 239792 | 265906 | 291438 | 318625 | Revenue $Mil |
| 16.8 | 16.9 | 16.8 | 14.9 | 12.4 | 12.5 | 12.7 | 23.0 | 20.8 | 22.2 | 22.6 | Gross Margin % |
| 5090 | 7736 | 16156 | 14932 | 9284 | 16429 | 24427 | 26488 | 26032 | 38051 | — | Oper Income $Mil |
| 7.5 | 9.4 | 11.1 | 8.7 | 5.2 | 7.1 | 8.6 | 11.0 | 9.8 | 13.1 | — | Operating Margin % |
| 3260 | 5008 | 11870 | 8010 | 6845 | 10267 | 15731 | 22317 | 22601 | 21169 | 24124 | Net Income $Mil |
| 1.02 | 1.54 | 3.27 | 2.13 | 1.82 | 2.75 | 4.25 | 6.18 | 6.63 | 6.47 | 7.43 | Earnings Per Share $ |
| 1.45 | 1.33 | 1.25 | 0.98 | 1.41 | 1.53 | 1.66 | 2.09 | 2.30 | 2.54 | 2.73 | Dividends $ |
| 3198 | 3231 | 3606 | 3739 | 3732 | 3695 | 3636 | 3521 | 3365 | 3203 | 3188 | Shares Mil |
| 12.94 | 13.32 | 22.60 | 19.89 | 18.60 | 20.59 | 21.36 | 22.20 | 24.58 | 29.69 | 31.26 | Book Value Per Share $ |
| 8152 | 9346 | 14389 | 17487 | 15943 | 16040 | 28665 | 26721 | 28172 | 24709 | 27625 | Oper Cash Flow $Mil |
| -8431 | -6457 | -10037 | -12214 | -12116 | -12440 | -13035 | -12281 | -15125 | -17830 | -18620 | Cap Spending $Mil |
| -279 | 2889 | 4352 | 5273 | 3827 | 3600 | 15630 | 14440 | 13047 | 6879 | 9005 | Free Cash Flow $Mil |

| 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | TTM | Profitability |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 4.7 | 5.8 | 10.2 | 5.6 | 4.6 | 6.1 | 8.5 | 11.1 | 10.5 | 9.2 | 10.3 | Return on Assets % |
| 10.6 | 11.8 | 20.4 | 10.8 | 9.5 | 14.1 | 20.6 | 28.2 | 27.2 | 23.4 | 26.3 | Return on Equity % |
| 4.8 | 6.1 | 8.1 | 4.6 | 3.9 | 4.4 | 5.6 | 9.3 | 8.5 | 7.3 | 7.6 | Net Margin % |
| 0.98 | 0.95 | 1.25 | 1.21 | 1.18 | 1.37 | 1.53 | 1.20 | 1.25 | 1.28 | 1.36 | Asset Turnover |
| 2.0 | 2.1 | 2.0 | 1.9 | 2.3 | 2.3 | 2.5 | 2.6 | 2.6 | 2.5 | 2.6 | Financial Leverage |

| 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 03-08 | Financial Health |
|---|---|---|---|---|---|---|---|---|---|---|---|
| -940 | 202 | 2972 | -1506 | -1235 | 3881 | -647 | 3293 | -1037 | 1848 | 5573 | Working Capital $Mil |
| 10918 | 9644 | 14772 | 12327 | 11922 | 12869 | 12907 | 15861 | 16719 | 21904 | 16051 | Long-Term Debt $Mil |
| 41786 | 43281 | 73416 | 74367 | 69409 | 75938 | 76656 | 79661 | 84624 | 93690 | 98642 | Total Equity $Mil |
| 0.26 | 0.22 | 0.20 | 0.17 | 0.17 | 0.17 | 0.17 | 0.20 | 0.20 | 0.23 | — | Debt/Equity |

| 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | TTM | Valuation |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 44.4 | 38.5 | 14.6 | 21.8 | 22.3 | 17.9 | 13.8 | 10.4 | 10.1 | 11.3 | 8.1 | Price/Earnings |
| — | 1.4 | 0.6 | 0.9 | 1.1 | 0.8 | 0.7 | 0.6 | 0.6 | 0.7 | 0.4 | P/E vs. Market |
| 2.1 | 2.3 | 1.2 | 1.0 | 0.9 | 0.8 | 0.8 | 1.0 | 0.9 | 0.8 | 0.6 | Price/Sales |
| 3.5 | 4.5 | 2.1 | 2.3 | 2.2 | 2.4 | 2.7 | 2.9 | 2.7 | 2.5 | 1.9 | Price/Book |
| 17.8 | 20.5 | 11.8 | 9.9 | 9.5 | 11.4 | 7.4 | 8.7 | 8.3 | 9.7 | 6.9 | Price/Cash Flow |

## Growth Rates Compound Annual

| Grade: B | 1 Yr | 3 Yr | 5 Yr | 10 Yr |
|---|---|---|---|---|
| Revenue % | 9.6 | 1.0 | 10.4 | 15.0 |
| Operating Income % | 46.2 | 15.9 | 32.6 | — |
| Earnings/Share % | -2.6 | 15.1 | 28.8 | 11.8 |
| Dividends % | 10.2 | 15.2 | 12.5 | 6.7 |
| Book Value/Share % | 14.1 | 11.6 | 9.8 | 11.1 |
| Stock Total Return % | -9.0 | -1.1 | 11.0 | 7.7 |
| +/- Industry | -7.4 | -9.4 | -8.1 | -0.7 |
| +/- Market | 4.4 | -3.1 | 5.2 | 6.5 |

## Profitability Analysis

| Grade: B | Current | 5 Yr Avg | Ind | Mkt |
|---|---|---|---|---|
| Return on Equity % | 26.3 | 22.7 | 31.8 | 21.8 |
| Return on Assets % | 10.3 | 9.1 | 14.2 | 9.0 |
| Fixed Asset Turns | 3.3 | 2.9 | 2.6 | 7.3 |
| Inventory Turns | 10.6 | 13.6 | 18.5 | 12.8 |
| Revenue/Employee $K | 3264.6 | 2740.0* | 1709.2 | 949.5 |
| Gross Margin % | 22.6 | 18.2 | 29.4 | 31.9 |
| Operating Margin % | — | 9.9 | 15.3 | 17.8 |
| Net Margin % | 7.6 | 7.0 | 9.7 | 9.3 |
| Free Cash Flow/Rev % | 2.8 | 4.1 | 5.0 | 0.1 |
| R&D/Rev % | — | 0.0 | — | 11.0 |

## Financial Position

| Grade: B | 12-07 $Mil | 03-08 $Mil |
|---|---|---|
| Cash | 3562 | 4820 |
| Inventories | 26554 | 26855 |
| Receivables | 38725 | 44108 |
| Current Assets | 78916 | 88516 |
| Fixed Assets | 97989 | 99512 |
| Intangibles | 17658 | 17741 |
| Total Assets | 236076 | 252668 |
| Payables | 46434 | — |
| Short-Term Debt | 21799 | 13820 |
| Current Liabilities | 77068 | 82943 |
| Long-Term Debt | 21904 | 16051 |
| Total Liabilities | 142386 | 154026 |
| Total Equity | 93690 | 98642 |

## Valuation Analysis

| | Current | 5 Yr Avg | Ind | Mkt |
|---|---|---|---|---|
| Price/Earnings | 8.1 | 12.7 | 9.9 | 19.8 |
| Forward P/E | 5.8 | — | — | 14.1 |
| Price/Cash Flow | 6.9 | 9.1 | 6.6 | 12.8 |
| Price/Free Cash Flow | 21.2 | 26.6 | 18.9 | 22.7 |
| Dividend Yield % | 3.8 | — | — | 2.5 |
| Price/Book | 1.9 | 2.6 | 25.3 | 3.9 |
| Price/Sales | 0.6 | 0.8 | 0.9 | 2.6 |
| PEG Ratio | 1.5 | — | — | 1.3 |

*3Yr Avg data is displayed in place of 5Yr Avg

## Quarterly Results

| Revenue $Mil | Jun 07 | Sep 07 | Dec 07 | Mar 08 |
|---|---|---|---|---|
| Most Recent Period | 73083.0 | 72838.0 | 81492.0 | 89223.0 |
| Prior Year Period | 73466.0 | 73002.0 | 54422.0 | 62036.0 |

| Rev Growth % | Jun 07 | Sep 07 | Dec 07 | Mar 08 |
|---|---|---|---|---|
| Most Recent Period | -0.5 | -0.2 | 49.7 | 43.8 |
| Prior Year Period | -16.3 | -25.3 | — | -5.9 |

| Earnings Per Share $ | Jun 07 | Sep 07 | Dec 07 | Mar 08 |
|---|---|---|---|---|
| Most Recent Period | 2.29 | 1.38 | 1.36 | 2.40 |
| Prior Year Period | 2.23 | 1.89 | 0.89 | 1.44 |

## Industry Peers by Market Cap

| | Mkt Cap $Mil | Rev $Mil | P/E | ROE% |
|---|---|---|---|---|
| BP PLC | 189418 | 318625 | 8.1 | 26.3 |
| ExxonMobil Corporati | 408872 | 472318 | 9.8 | 36.2 |
| Royal Dutch Shell PL | 209941 | 396604 | — | 28.6 |

## Major Fund Holders

| | % of shares |
|---|---|
| | — |
| | — |
| | — |

## Morningstar's Approach to Rating Stocks

**Our Key Investing Concepts**

- Economic Moat
- Discounted Cash Flow
- Discount Rate
- Fair Value
- Uncertainty
- Margin of Safety
- Consider Buying/Consider Selling
- Stewardship Grades

At Morningstar, we evaluate stocks as pieces of a business, not as pieces of paper. We think that purchasing shares of superior businesses at discounts to their intrinsic value and allowing them to compound their value over long periods of time is the surest way to create wealth in the stock market.

We rate stocks 1 through 5 stars, with 5 the best and 1 the worst. Our star rating is based on our analyst's estimate of how much a company's business is worth per share. Our analysts arrive at this "fair value estimate" by forecasting how much excess cash--or "free cash flow"--the firm will generate in the future, and then adjusting the total for timing and risk. Cash generated next year is worth more than cash generated several years down the road, and cash from a stable and consistently profitable business is worth more than cash from a cyclical or unsteady business.

Stocks trading at meaningful discounts to our fair value estimates will receive high star ratings. For high-quality businesses, we require a smaller discount than for mediocre ones, for a simple reason: We have more confidence in our cash-flow forecasts for strong companies, and thus in our value estimates. If a stock's market price is significantly above our fair value estimate, it will receive a low star rating, no matter how wonderful we think the business is. Even the best company is a bad deal if an investor overpays for its shares.

Our fair value estimates don't change very often, but market prices do. So, a stock may gain or lose stars based just on movement in the share price. If we think a stock's fair value is $50, and the shares decline to $40 without much change in the value of the business, the star rating will go up. Our estimate of what the business is worth hasn't changed, but the shares are more attractive as an investment at $40 than they were at $50.

Because we focus on the long-term value of businesses, rather than short-term movements in stock prices, at times we may appear out of step with the overall stock market. When stocks are high, relatively few will receive our highest rating of 5 stars. But when the market tumbles, many more will likely garner 5 stars. Although you might expect to see more 5-star stocks as the market rises, we find assets more attractive when they're cheap.

We calculate our star ratings nightly after the markets close, and issue them the following business day, which is why the rating date on our reports will always be the previous business day. We update the text of our reports as new information becomes available, usually about once or twice per quarter. That is why you'll see two dates on every Morningstar stock report. Of course, we monitor market events and all of our stocks every business day, so our ratings always reflect our analyst's current opinion.

### Economic Moat

This is our assessment of a firm's ability to earn returns consistently above its cost of capital in the future, usually by virtue of some competitive advantage. Competition tends to drive down such economic profits, but companies

**Morningstar Research Methodology for Valuing Companies**

| Competitive Analysis → | **Economic Moat Rating** → | Company Valuation → | **Fair Value Estimate** → | Uncertainty Assessment → | ★★★★★ |
|---|---|---|---|---|---|
| Analyst conducts company and industry research:<br>• Management interviews<br>• Conference calls<br>• Trade-show visits<br>• Competitor, supplier, distributor, and customer interviews | The depth of the firm's competitive advantage is rated:<br>• None<br>• Narrow<br>• Wide | Analyst considers company financial statements and competitive position to forecast future cash flows.<br><br>Assumptions are input into a discounted cash-flow model. | DCF model leads to the firm's Fair Value Estimate, which anchors the rating framework. | An uncertainty assessment establishes the margin of safety required for the stock rating. | ★<br>★★<br>★★★<br>★★★★<br>★★★★★<br>The current stock price relative to fair value, adjusted for uncertainty, determines the rating. |

that can earn them for an extended time by creating a competitive advantage possess an economic moat. We see these companies as superior investments.

We're big fans of companies that are low-cost producers, create high switching costs for their customers, or have strong brands or long-lasting patents, because all of these characteristics allow companies to protect their competitive position. For example, Tiffany is far more profitable than a run-of-the-mill jewelry chain because it has a strong brand that creates a moat around its business, allowing it to charge more than competitors.

**Discounted Cash Flow**
This is a method for valuing companies that involves projecting the amount of cash a business will generate in the future, subtracting the amount of cash that the company will need to reinvest in its business, and using the result to calculate the worth of the firm. We use this technique to value nearly all of the companies we cover.

**Discount Rate**
We use this number to adjust the value of our forecasted cash flows for the risk that they may not materialize. For a profitable company in a steady line of business, we'll use a lower discount rate, also known as "cost of capital," than for a firm in a cyclical business with fierce competition, since there's less risk clouding the firm's future.

**Fair Value**
This is the output of our discounted cash-flow valuation models, and is our per-share estimate of a company's intrinsic worth. We adjust our fair values for off-balance sheet liabilities or assets that a firm might have--for example, we deduct from a company's fair value if it has issued a lot of stock options or has an under-funded pension plan. Our fair value estimate differs from a "target price" in two ways. First, it's an estimate of what the business is worth, whereas a price target typically reflects what other investors may pay for the stock. Second, it's a long-term estimate, whereas price targets generally focus on the next two to 12 months.

**Uncertainty**
To generate the Morningstar Uncertainty Rating, analysts consider factors such as sales predictability, operating leverage, and financial leverage. Analysts then classify their ability to bound the fair value estimate for the stock into one of several uncertainty levels: Low, Medium, High, Very High, or Extreme. The greater the level of uncertainty, the greater the discount to fair value required before a stock can earn 5 stars, and the greater the premium to fair value before a stock earns a 1-star rating.

**Margin of Safety**
This is the discount to fair value we would require before recommending a stock. We think it's always prudent to buy stocks for less than they're worth.The margin of safety is like an insurance policy that protects investors from bad news or overly optimistic fair value estimates. We require larger margins of safety for less predictable stocks, and smaller margins of safety for more predictable stocks.

**Consider Buying/Consider Selling**
The consider buying price is the price at which a stock would be rated 5 stars, and thus the point at which we would consider the stock an extremely attractive purchase. Conversely, consider selling is the price at which a stock would have a 1 star rating, at which point we'd consider the stock overvalued, with low expected returns relative to its risk.

**Stewardship Grades**
We evaluate the commitment to shareholders demonstrated by each firm's board and management team by assessing transparency, shareholder friendliness, incentives, and ownership. We aim to identify firms that provide investors with insufficient or potentially misleading financial information, seek to limit the power of minority shareholders, allow management to abuse its position, or which have management incentives that are not aligned with the interests of long-term shareholders. The grades are assigned on an absolute scale--not relative to peers--and can be interpreted as follows: A means "Excellent," B means "Good," C means "Fair," D means "Poor," and F means "Very Poor."