ExxonMobil Corporation XOM

by Allen Good

Analyst Note 05-05-2010 | by Eric Chenoweth, CFA

XTO Energy XTO announced first-quarter earnings Wednesday, with actual production results beating our forecast. The company will not host a conference call and has reduced the depth of disclosure in its press release, probably in conjunction with the planned closing of its sale to ExxonMobil XOM in the second quarter.

First-quarter average daily production was 2.90 billion cubic feet equivalent (bcfe) versus our expectation of 2.86 bcfe. Natural gas and natural gas liquids volumes both surprised on the upside to our estimates while oil volumes trailed our estimate.

Thesis 03-31-2010 | by Allen Good

ExxonMobil sets itself apart among the other supermajors 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. With a majority of the world's remaining resources in government hands, opportunities for the company to grow its large production base are limited. However, we believe ExxonMobil's experience and expertise, particularly with large projects, should allow it to successfully compete for resources.

Resource nationalism is becoming an increasingly greater challenge to international oil companies' (IOC) ability to grow production. Countries rich in oil and gas reserves are becoming less willing to allow outside energy companies free rein to exploit resources within their borders. Instead, they chose to look for dependable partners to work with their national oil companies (NOC) to explore for, produce, and transport to market their oil and gas reserves. In our opinion, governments cannot find a better partner than ExxonMobil. With its deep pockets, expertise, and integrated operations, it can tackle nearly any megaproject regardless of scale, location, or operational difficulty.

While we believe ExxonMobil is better suited than the other supermajors for the current environment, that does not necessarily mean production and reserve gains will come easily. ExxonMobil needs projects of a certain size in order to contribute meaningfully to its production profile. However, today fewer projects of that caliber exist than have in years past. In addition, investing exclusively in large projects exposes the company to a variety of risks. Given their long lead times, megaprojects have the potential for over investment risk if commodity prices crash during development. Failure to meet deadlines or material and labor inflation could create cost overruns that damage project returns.

Given that the few untapped large resource pools left in the world are under government control, megaprojects generally are done in partnership with NOCs. Competition for these

Morningstar Rating
★★★★★

Stock Price
As of 05-05-2010
$66.17

Fair Value Estimate
$87.00

Consider Buying
$69.60

Consider Selling
$108.80

Fair Value Uncertainty
Low

Economic Moat
Wide

Stewardship Grade
B

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.
- Shareholder return is a focus of management. Over the past five years, Exxon paid $39 billion in dividends and repurchased $135 billion worth of stock, reducing shares outstanding by 23%.
- By combining XTO's expertise with ExxonMobil's operations management skills and financial resources, the company has a decided advantage in the

projects is intense. In order to gain access, ExxonMobil 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. Meanwhile, competitors eager for access may be more willing to agree to the NOCs' less favorable terms. 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 by the NOC or pursue frontier locations.

Valuation

Our fair value estimate for ExxonMobil is $87 per share. In our discounted cash-flow model, our benchmark oil and gas prices are based on Nymex futures contracts for 2010-12. For natural gas, we use $4.60 per thousand cubic feet in 2010, $5.30 in 2011, and $5.74 in 2012. For oil, we use $81 per barrel in 2010, $84 in 2011, and $85 in 2012. To arrive at our valuation we consider three scenarios--base, low, and high--and weight them 40%, 40%, and 20%, respectively. In our base scenario, we assume long-run oil prices of $80 per barrel and natural gas prices of $7.50 per mcf. This scenario values Exxon at $80. Our low-case scenario assumes long-run prices of $50 oil and $5 natural gas. This scenario values Exxon at $35 per share. Our high case assumes long-run prices of $150 oil and $15 natural gas which values the company at $205 per share. We assume a cost of equity of 9.5% in all scenarios. With the low- and high-price scenarios we also change our production cost, capital expenditure, and production growth assumptions to reflect the price environment. We believe Exxon can achieve annual production growth of roughly 2% over the next five years as large projects come on line. However, with production gains coming from large projects, growth may be uneven. The addition of XTO could add upward of 1% growth per year depending on future investment plans. We continue to assume refining margins will remain depressed in the short-term, but could gradually improve in the next few years.

Risk

For a company that has global operations, geopolitical risk is always an issue. Recent events in Russia, Nigeria, and Venezuela demonstrate 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.

Close Competitors	TTM Sales $Mil	Market Cap $Mil
ExxonMobil Corporation	**336,809**	**279,652**
* BP Plc	272,470	116,338
* Royal Dutch Shell PLC	313,713	158,506
* Chevron Corporation	183,685	143,176
* Total SA	171,209	112,920

* Morningstar Analyst Report Available

Data as of 03-31-10

Strategy

Exxon can attribute much of its returns to selective capital allocation and project execution. Management evaluates projects on a global basis to determine how they can be integrated with current operations before making any investments. To boost production, the company will focus on large projects, such as LNG and deepwater, where it can use its expertise, best practices, and technologies to deliver

development of unconventional resources.

Bears Say

- The company will find it increasingly difficult to increase production and book reserves as nations become more protective of their natural resources.
- Record-high commodity prices helped produce record profits. If commodity prices slip, so will profits.
- Exxon is very discriminating when evaluating investment opportunities. It is unlikely to sign less favorable contracts, which could slow growth.
- Production growth will come from partnerships with NOCs, politically unstable countries, and difficult environments, which means unfavorable production sharing agreements, increased geopolitical risks, and increased production costs.
- Heavy exposure to the U.S. and European refining markets could limit future downstream profitability with both markets facing long-term challenges.

production on time. With the acquisition of XTO, ExxonMobil hopes to create a platform for global expansion into unconventional resources.

Management & Stewardship

Rex Tillerson is chairman and CEO of Exxon, a role he assumed in 2006. Previously, he served as president after spending his career with Exxon, beginning in 1975 as a production engineer. Tillerson is likely to continue a disciplined capital-allocation strategy and deliver the high returns that his predecessor did. Total compensation for Tillerson was only $27 million in 2009, which is reasonable, considering the size of the company and his peers' compensation. Exxon has a typical compensation structure consisting of a salary, cash bonus, and equity awards. Performance is not evaluated by typical quantitative measures but by the executives' performance relative to achievement of the company's long-term goals. Exxon gets credit for delaying 50% of bonus payment until later periods' earnings targets are met and requiring longer vesting periods for equity awards. Low executive equity ownership relative to total shares outstanding is understandable, considering the size and history of the company.

Profile

Exxon is an integrated oil and gas company that explores for, produces, and refines oil around the world. In 2009, it produced 2.4 million barrels of oil and 9.3 billion cubic feet of natural gas a day. At year-end 2009, reserves stood at 14.95 billion boe (plus 8.03 billion for equity companies), 62% of which are oil. The company is the world's largest refiner with 37 refineries, and it is one of the world's largest manufacturers of commodity and specialty chemicals.

Growth

Production has essentially remained flat over the past five years. Despite adding production and replacing reserves, the company is dealing with a large mature production base declining at 5%-6% per year. The company expects production growth to average 2%-3% over the next few years, but growth may be lumpy, as gains will stem from large projects coming on line.

Profitability

Combining its operational efficiencies with high commodity prices, Exxon delivered returns on capital that outpaced its competitors'. Regardless of the future path of oil prices, Exxon should be able to deliver industry-leading profits.

Financial Health

As one of the few remaining firms with an AAA credit rating, ExxonMobil's financial health is beyond reproach. Cash flow from operations remains sufficient to finance capital expenditures while increasing dividend payments and buying back stock. More important, the large cash position and access to cheap debt give the company resources to make opportune acquisitions.

Authors can be reached at analyst feedback.