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MONDAY, NOVEMBER 16, 2009

BARRON'S COVER

What a Gusher!

By ANDREW BARY

Exxon is the biggest player in the oil patch -- and the best. Yet its stock is the second-worst performer in the Dow this year. Investors, grab this bargain while you can. Video: Exxon – Leader in the Oil Sector

THE BEST STOCKS SOMETIMES hide in plain sight. Prime example: **ExxonMobil**, the world's largest company, based on its stock-market value of \$345 billion -- \$80 billion more than No. 2 Microsoft.

Like many blue chips, Exxon has been a laggard in this year's rally, even though it boasts the energy industry's best management, best reserves, best returns and best balance sheet. Its shares, at around 72, are down 10% despite a near-doubling of oil prices in 2009. Exxon is the only member of the "supermajor" group of energy producers whose stock (ticker: XOM) is down this year, and it's the second-worst performer in the Dow Jones Industrial Average, behind Verizon Communications.

As the leading energy company with the most diversified revenue base, Exxon is the most defensive play in its group, which includes **BP** (BP), **Chevron** (CVX), **ConocoPhillips** (COP) and **Royal Dutch Shell** (RDS-A). Exxon's defensive characteristics and sheer size have worked against it because aggressive institutional investors now favor oil-and-gas-exploration stocks like **Apache** (APA) and **XTO Energy** (XTO), or oil-service stocks like **Schlumberger** (SLB) that offer more leverage to rising energy prices.



Bob Staake

After trailing the market and their smaller brethren this year, the big integrated outfits offer some of the best value in the energy sector, and Exxon looks like the most attractive one. The energy giant does command a higher price/earnings ratio than the other supermajors, but that gap has narrowed this year, enhancing Exxon's appeal. The stock could hit 90 in the next year.

TOP-NOTCH OPERATIONS RARELY come cheaply, and ExxonMobil is no exception. Warren Buffett has said it's better to buy a good company at a fair price than a fair company at a good price. That maxim applies to Exxon, which trades for 18 times projected 2009 profit of about \$4 a share, and under 13 times estimated 2010 profit of \$5.82. The other big integrated-oil stocks fetch about 10 times projected 2010 earnings.

The 2010 profit estimate for Exxon could prove conservative if the higher energy prices now anticipated by futures contracts materialize. Exxon could earn \$6.50 a share or more if 2010 oil and natural-gas futures prices pan out. The company made a record \$8.69 a share in 2008, a year when crude peaked at more than \$145 a barrel. Exxon's aftertax profit last year of \$45 billion was a record for any corporation.

Buffett, incidentally, violated his own rule and paid for that mistake when he invested more than \$7 billion in second-tier ConocoPhillips, on behalf of Berkshire Hathaway, rather than buying Exxon. ConocoPhillips shares are 35% below Berkshire's average cost, while an Exxon investment would have lost far less.

Kurt Wulff, who heads McDep Associates, an energy investment-advisory service based in Needham, Mass., calls Exxon "the industry's gold standard" and considers it unusually attractive now, trading for about 80% of what he considers fair value. By his calculations, Exxon typically fetches more than 100% of fair value.

"THIS IS A GREAT COMPANY and it's very well-managed. Everyone in the industry knows that," says Jeffrey Jacobe, director of investments at Fayed Sarofim, a Houston investment-management firm that runs the **Dreyfus Appreciation** Fund (DGAGX). Jacobe figures that investors effectively are paying nothing for Exxon's refining and chemical businesses, if the company's giant oil-and-gas exploration and production unit were valued in line with independent E&P companies like Apache, XTO and **Anadarko Petroleum** (APC).

The refining and chemical divisions could be worth \$75 billion, or \$16 per share. This suggests that fair value for Exxon is close to 90 a share. The stock appears to offer a good risk/reward trade-off because downside seems limited if markets reverse.

Exxon has the best refining assets in the world, with operations in North America, Europe, the Middle East and Asia. Its lucrative chemical business, which is integrated with its refining and energy-production operations, might be more valuable than industry leader DuPont if it were independent.

Most of the supermajors have good balance sheets, but Exxon's is the tops, with net cash (cash less debt) of \$2.9 billion at the end of the third quarter. The company is one of only a handful in the U.S. with a triple-A credit rating.

Fayed Sarofim is a rarity -- an investment manager with a big stake in Exxon, which is its No. 1 holding. Most large investors are significantly underweighted in the stock, relative to its 4% share of the Standard & Poor's 500 Index. S&P index funds, not active managers, are the largest holders.

While institutions are unimpressed, individuals have long been attracted to Exxon, and patient holders have been amply rewarded because the stock boasts one of the S&P 500's best historical returns.

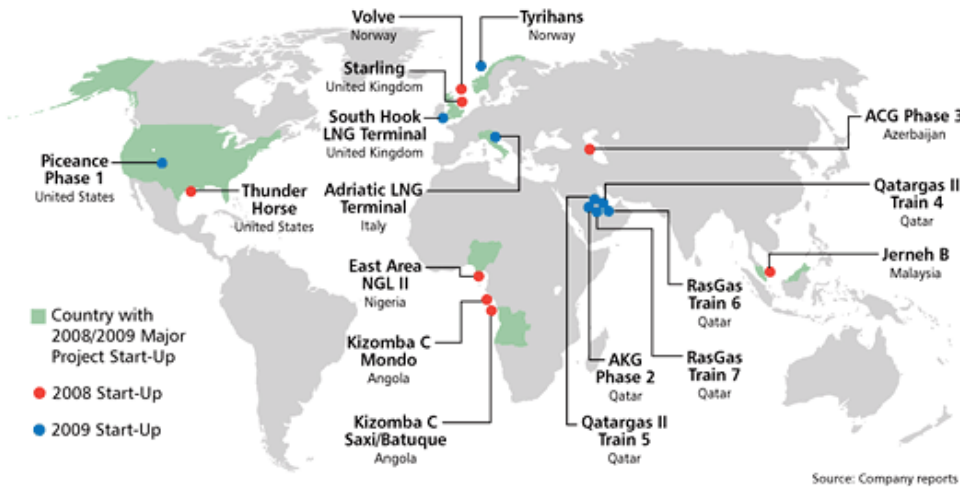
Since 1977, Exxon has returned 15% annually, including reinvested dividends, versus 11% for the S&P. Among the few companies with comparable or better returns are Wal-Mart Stores, Berkshire Hathaway and Altria (the former Philip Morris). One reason for Exxon's unpopularity among institutions is that it isn't a get-rich-quick stock. Over time, Exxon has delivered, and should continue to do so for investors, but it lacks the sizzle of smaller energy outfits. McDep's Wulff jokes that "you don't need oil analysts; you can just buy Exxon."

MOST OF THE KNOCKS AGAINST Exxon revolve around its size and the challenge it faces in replacing its energy reserves. The company produced the equivalent of 3.7 million barrels of oil a day in the third quarter, split 63%/37% between oil and natural gas. (Gas is translated into an oil equivalent, based on energy content.)

It isn't easy to maintain, let alone increase, such production, particularly because Exxon and its international

On Top of the World

Exxon's vast oil and gas operations, some of which are shown here, stretch around the world. Its proved energy deposits are equivalent to 23 billion barrels of oil, and it controls an additional 49 billion of potential reserves. This provides...



...the foundation for a share price that historically has commanded a higher valuation than peers. However, investors may be ignoring some of Exxon's strengths, including its reserve base, a top-notch chemical unit and the best balance sheet...

Company/Ticker	Recent Price	YTD Change	Mkt Value (bil)	EPS 2009E	EPS 2010E	P/E 2010E	Dividend Yield	Net Debt (bil)	Return on Capital
ExxonMobil/XOM	\$71.90	-10%	\$345	\$3.93	\$5.82	12.4	2.3%	\$2.9*	34%
BP/BP	57.27	22	179	4.24	6.12	9.4	5.9	26.3	21
Chevron/CVX	77.42	5	155	4.86	7.67	10.1	3.5	3.0	26
ConocoPhillips/COP	52.22	1	77	3.69	6.00	8.7	3.8	29.9	22
Royal Dutch/RDSA	61.24	16	186	4.00	6.43	9.5	5.5	22.0	17

E=Estimate *Net cash Source: Thomson Reuters; company reports

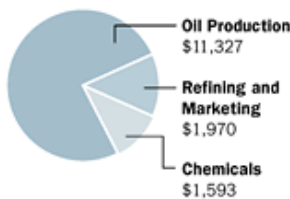
...among the oil majors. Throw in an ingrained focus on returns, and Exxon's enormous ability to whip up earnings becomes evident. Last year, at the height of the oil boom, it generated \$45 billion in profit, the most by any corporation in history.

By the Numbers

Daily Production	3.7 mil barrels
Oil/Gas Production	63%/37%
Proved Reserves	22.8 bil barrels
Reserve Life	15 years
Total Energy Resources	72 bil barrels
Finding Costs	\$7 per barrel
Reserve Replacement Ratio	132%
Annual Capital Expenditures	\$26 bil

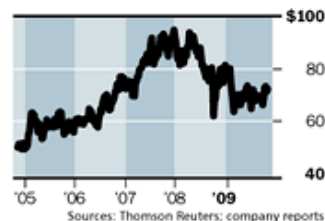
Profits (mil)

January - September, 2009



ExxonMobil (XOM - NYSE)

Weekly close on November 13



Exxon Is the Biggest Player in Oil Sector

1:19

Exxon shares have trailed those of flashier rivals in 2009. But when it comes to future gains, they could shine says Barron's Associate Editor Andrew Bary.



Exxon's production growth of 3% in the third quarter was deemed OK, not great, by Wall Street, which favors rival Chevron, which has stronger production gains.

In a research note last month, Deutsche Bank analyst Paul Sankey noted some disappointment with Exxon's production, which was going against an easy comparison in the corresponding 2008 period, in which production fell 8%. He wrote that when Exxon's output growth stalls, "the market rightly takes it as evidence that for all the financial strength in the world, the company is fundamentally challenged by a lack of scale opportunities. When Exxon is growing, the market takes its financial strength as

rivals face a diminishing set of opportunities, given increasing resource nationalism in the Middle East as well as in places like Venezuela and Russia. It's estimated that 85% of the world's oil reserves are locked up in OPEC countries and the former soviet Union, where access comes on tough terms to Western oil companies, if at all.

evidence of a superior management of a truly integrated and scale business model." He carries a Buy rating on the stock and an 80 price target.

The Street may focus too much on production growth, rather than returns. "You can grow production by spending money, and some companies are spending beyond their means," Jacobo says. "Exxon has a profit target, not a growth target."

Exxon is the energy industry's most disciplined capital allocator. Its return on invested capital was an impressive 34% last year, compared with 26% at Chevron, 21% at BP and 17% at Royal Dutch. The company is believed to demand a minimum return of 20% to 25% on new investments. An insular Exxon communicates little with the investment community. CEO Rex Tillerson, for instance, doesn't participate in conference calls and appears to take the view that Exxon's results should do the talking. Company executives were said to be unavailable to speak with *Barron's*.

The company's record is impressive. It has replaced more than 100% of its production in each of the past 15 years, and its average finding costs of \$7 per barrel from 2004 to 2008 were below its peers'.

A steady Exxon is spending \$26 billion on capital projects this year, little changed from 2008, despite sharply lower oil and gas prices. Exxon takes a conservative long-term view on energy prices, and tends to not ratchet up spending in good times or pull way back in bad times. Exxon now is benefiting from lower drilling costs, as financially pinched energy outfits scale back on exploration. When others retrenched in the Canadian oil sands earlier this year after oil prices plunged, Exxon moved forward with a project in Alberta that should be producing more than 100,000 barrels a day of crude by 2012 and is expected to have an extremely long reserve life.

Indeed, investors might not fully appreciate that much of Exxon's production growth is coming from long-lived reserves like the Canadian project or a gigantic natural-gas operation in Qatar. The company's goal is to get as much as 50% of its production from such sources by 2015. If that goal is reached, it could lead to lower capital spending and higher free cash flow -- some of which could be funneled to shareholders through dividends or share repurchases.

One of Exxon's advantages is that it can take on large-scale projects, such as the development of five facilities in Qatar that convert that country's huge natural-gas reserves into LNG, or liquefied natural gas, for shipment around the world. Three of those five facilities, or "trains," are now operating. When all five hit peak output by 2011, they will produce the equivalent of one million barrels of crude per day, of which Exxon's share is roughly 40%.

Deutsche Bank's Sankey values Exxon's Qatar gas business at about \$50 billion. Among Exxon's other prime assets is a 70% stake, valued at \$23 billion, in **Imperial Oil** (IMO), one of Canada's largest energy companies.

The advantage of Middle East LNG, as well as such other LNG projects in Australia, is that the gas can be sold worldwide for the highest prices or on favorable long-term contracts. The contracts typically are based on international crude prices, not on currently depressed U.S. gas prices. North American gas producers are getting less than \$5 per thousand cubic feet during the current supply glut.

Exxon had proved reserves of nearly 23 billion barrels of oil and natural gas at the end of 2008, enough to last 15 years at current production rates. Investors are paying \$15 a barrel for Exxon's reserves, based on the company's enterprise value (stock-market value less net cash), and the effective price is closer to \$12 when its refining and chemical operations are factored into the mix. That's below the valuation of many energy

exploration and production companies.

EXXON'S ENERGY RESOURCES total the equivalent of 72 billion barrels of oil and gas. The tally includes proved reserves and oil and gas deposits that don't yet meet the strict definition of proved reserves. To those who say Exxon lacks exploration opportunities, Sarofim's Jacobe points to its ability to simply develop these resources. And Exxon's energy-development projects cover the globe. It is tapping natural gas in the U.S. Rocky Mountains, off the Australian coast and in Canada, and pumping oil off Angola and Norway.

Exxon has been more cautious in Russia than BP. Its operations in that nation, notably in the Sakhalin region of far eastern Russia, have been conducted efficiently and without arousing the ire of Russian politicians. In contrast, some other energy outfits, including BP and Royal Dutch, have crossed swords with the Kremlin -- and regretted doing so.

One sticking point for many investors is Exxon's relatively low dividend yield of 2.3%, below that of Chevron and Conoco and less than half the yields of BP and Royal Dutch. But the dividend has doubled in the past 10 years, and could rise another 5% or more in 2010, analysts estimate.

EXXON HAS FAVORED share repurchases over dividends for the past five years, devoting \$132 billion to buybacks since the end of 2004, versus \$36 billion in dividends. This year alone, it has repurchased \$17 billion of stock; it is the only oil major with a substantial buyback program.

Exxon's total of outstanding shares has fallen by 25% since the end of 2004, to 4.7 billion at the end of third quarter. That has boosted reserves to the equivalent of five barrels of crude per share, even though Exxon's reserve base has grown moderately over that stretch.

However, Exxon has scaled back its repurchase program as its earnings have dropped, with profit down to 98 cents in the third quarter, from a record \$2.58 a year earlier. It also trimmed its net-cash position, to \$2.9 billion from \$26.4 billion in 2008's third quarter, to fund buybacks. The company sees \$2 billion of buybacks in the fourth quarter, half the pace of the third quarter, and analysts see a similar quarterly run rate in 2010.

Jacobe points out that Exxon's enterprise value is about \$340 billion, not much more than the \$300 billion in 1999 after the company made a rare big acquisition and bought Mobil. Since then, oil prices have more than tripled, and Exxon's earnings power is up substantially. He sees trough annual profit of \$4 a share and a peak of more than \$8.

Outside Wall Street, Exxon isn't going to win any popularity contests. As the poster child for Big Oil and one of the most profitable companies in the world, it's a target of politicians, especially when profits are high. Barack Obama regularly attacked Exxon on the presidential campaign trail last year (and maintained that his opponent, John McCain, was in the industry's pocket). Obama said that "while Big Oil is making record profits, you're paying record prices at the pump."

While some environmentalists expect relatively green energy sources to eventually dominate, the reality is that the world probably will remain heavily dependent on oil and gas for the remainder of this century.

While Exxon has softened its image somewhat since Rex Tillerson succeeded the combative Lee Raymond as CEO in 2006, it doesn't try to portray itself as "green," as BP does, although the bulk of Exxon's reserve growth is coming from clean-burning natural gas. The company's public image has been shaped in part by the disastrous 1989 Valdez oil spill in Alaska, but it actually has had an exemplary safety record in recent years, including zero oil spills in 2008.

CALL EXXON THE GOLDMAN Sachs of the energy business, but Exxon out-Goldmans Goldman. Like Goldman, Exxon has a distinctive "best-and-brightest" corporate culture, and relentlessly focuses on return on investment and efficiencies at the expense of egos. Exxon's best people tend to spend a career there, with the company's top five officers, including CEO Tillerson, having three or four decades of service. Tillerson, who joined the energy giant after graduating from the University of Texas in 1975, gives his full attention to the company. He doesn't serve on any other corporation's board.

Exxon is the clear leader in its field and there's no reason to think its shareholders won't do as well in the future as they've done in the past. There's still a lot of gas left in the energy titan's tank.

E-mail comments to editors@barrons.com

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