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Crude Question

Why are oil stocks so cheap when the stuff is so dear?

By ANDREW BARY

THERE'S A DISCONNECT BETWEEN the oil market and oil stocks. As crude prices have risen above $33 a barrel owing to concerns about an impending U.S.-led war against Iraq and lower oil production in Venezuela, shares of giant oil companies such as **BP**, **ChevronTexaco** and **Royal Dutch** lately have touched or skirted 52-week lows. The gulf between the robust market for oil and natural gas and the weak state of the oil stocks could present opportunity for investors, because major energy stocks are back to 1997 levels even though the earnings outlook for 2003 looks bright.

"We're extremely constructive on the oil group now," says Bruce Lanni, petroleum analyst at A.G. Edwards. "The market is saying that oil prices are coming down, and many investors don't want to own the stocks in front of that."

Energy investors fear a repeat of what happened after the outbreak of the Persian Gulf War in January 1991, when oil plunged to $20 a barrel from $34 a barrel almost immediately after the conflict began, ushering in a period when oil stocks badly lagged the strong performance of the overall market. The Standard & Poor's 500 index rose 26% during 1991, way ahead of the 4% gain in the oil sector.

The prevailing view is that it's foolish to own the big oils ahead of a sharp drop in crude prices because the stocks rarely do well in such an environment. Yet investors shunning oil stocks may be outsmarting themselves because the stocks already anticipate a sharp decline in crude prices and weakening company profits.

The price-earnings ratios on the big oils have gotten much more reasonable. Three of the four global giants or so-called super- majors -- BP, Royal Dutch Petroleum and ChevronTexaco -- are trading at 12 to 14 times projected 2003 earnings and offering solid dividend yields of 3.9% to 4.4%. The fourth super-major, **ExxonMobil**, the world's largest energy company, commands a wider-than-usual premium to its sisters, trading around 34, or 17 times estimated 2003 earnings. It yields 2.8%.

BP, at 38, Royal Dutch, at 41, and Chevron, at 63, are near six-year lows. Their P/Es based on future earnings also are near five-year lows. These three stocks trade at an appreciable discount to the S&P, which, at 850, fetches about 17 times estimated 2003 operating profits. A bullish Lanni thinks BP can hit 45 in the next year, Royal Dutch, 52, and ChevronTexaco, 85.

The smaller integrated oils are even cheaper than the majors. **ConocoPhillips**, at 48, trades for about 11 times estimated 2003 profits and **Marathon Oil** is around 21, less than 10 times projected 2003 earnings of $2.35 a share.

The oil group rallied last week on bargain-hunting, after President Bush took a hawkish stance against

Iraq in his State of the Union address. Crude oil futures traded around $33.50 a barrel Friday while natural gas stood at $5.50 per million BTUs. Gas prices have doubled in the past year while crude prices have risen 60%.

Oil-company profit reports for the fourth quarter of 2002 began to roll in last week and they showed strong gains against depressed results in the final three months of 2001. Exxon, for instance, said Thursday that its fourth-quarter profits, excluding special items, rose 32% to 56 cents a share. Full-year profits were down 25% in 2002 to $1.69 a share, due in part to weak refining margins for much of the year. ChevronTexaco Friday reported its fourth-quarter earnings had doubled, to $1.00 a share. Its 2002 profits of $4.21 a share were appreciably below 2001, when the company earned $6.41 a share.

The major oil stocks incorporate doubts about the industry's ability to hit current consensus earnings estimates for 2003, which call for gains of 15% to 20%, let alone more bullish estimates that call for increases of 25% or more.

The stocks probably are anticipating sharply lower oil prices of $20 to $22 a barrel. The Street consensus is that oil will average $23 a barrel during 2003. This extreme bearishness is at odds with the crude-oil futures markets, where traders and oil companies put their money on the line. Oil futures on the New York Mercantile Exchange are projecting declines, but nothing of the magnitude anticipated in the stock market. July oil futures trade for $30 a barrel and January 2004 futures are at $27 a barrel.

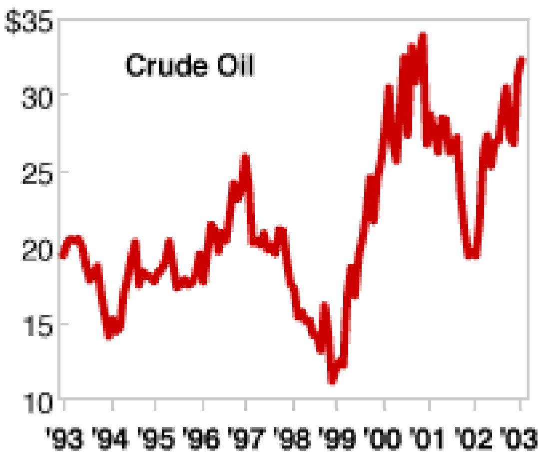
There's little doubt that the oil markets now reflect a war premium, but the big question is whether crude eventually settles in closer to $25 a barrel or to $20 a barrel. Crude bears like Fred Leuffer, the oil analyst at Bear Stearns, have said that oil could fall under $20 a barrel in a post-war Iraq as Iraqi production increases, and OPEC members face greater temptations to cheat on production quotas.

Part of the bearish scenario both for oil and oil stocks is that Iraqi petroleum production, which averaged an estimated 2 million to 2.5 million barrels per day in 2002, could rise to 3 million barrels under a U.S. occupation of the country. Eventually, the bears fear, it could hit six million barrels per day, as Iraq exploits its enormous oil reserves and seeks to generate revenue to rebuild its shattered economy. Iraq's reserves, which have been estimated at more than 100 billion barrels, are second only to those of Saudi Arabia.

OIL PRICES ARE PUMPEDUP...

Crude oil prices have risen sharply during the past year. Oil is now at $34 a barrel, reflecting feared dislocations from a war against Iraq and the continued effects of a strike in Venezuela.

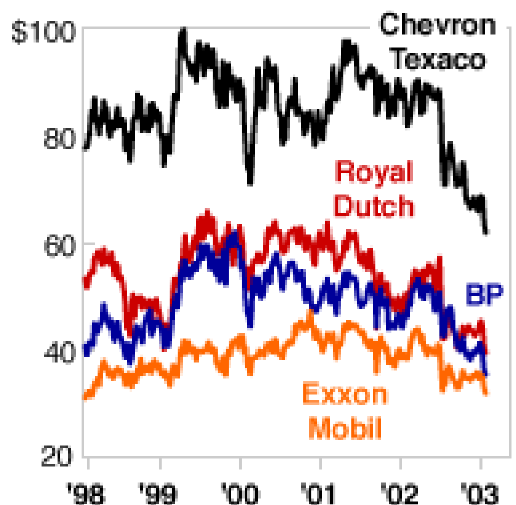
Price Per Barrel



...BUT THE STOCKS ARE NOT

Most of the big oil stocks are near six-year lows amid concern that a successful war with Iraq would prompt a plunge in oil prices.

Stock Price



Although many deem $20 a barrel to be a normal level for crude prices, the reality is that oil has rarely traded at that level in the past three years, Oil averaged $30 a barrel in 2000, and about $26 a barrel in both 2001 and 2002. But oil averaged about $20 a barrel in the 1990s.

Lanni and other bulls are betting that oil prices will hold at around $25 a barrel even if U.S.-led forces launch an attack on Iraq and quickly defeat Saddam Hussein's forces. His view is that prices will be supported by 1.5% annual growth in global oil demand in the current decade, and continued production declines from existing fields at a 4% annual rate.

As a result, by 2010 the world will need nearly 40 million barrels per day of new production to meet demand. That's nearly half of the current daily global demand of 78 million barrels per day. If this long-term trend plays out, it's apt to increase the power of OPEC and also result in greater exploration in riskier parts of the world, including Africa.

The bullish scenario for oil hinges in part on Asia, where 3.5 billion people now consume about as much petroleum as the nearly 300 million Americans. Marc Faber, a Hong-Kong-based investor and *Barron's* Roundtable member, said at the recent Roundtable that rising Asian oil demand could push oil prices up to $60 per barrel to $90 per barrel by 2010. He said Asian demand could easily double by 2010, generating the need for 20 million barrels a day of new supply.

Lanni doubts that Iraqi oil production can ramp up significantly, assuming the downfall of Saddam Hussein, because of the poor quality of the country's oil infrastructure and the likely concern among Western oil companies about getting involved in the country.

The consolidation in the oil business in the past few years has created a group of global companies that dominate the industry outside of the state-run oil operators in producing countries. Exxon paired with Mobil in 1998. Chevron bought Texaco in 2001. BP snapped up Amoco and Atlantic Richfield in the late 1990s. The Royal Dutch/Shell Group, once the largest oil company, largely sat out the merger game but last year made some smaller acquisitions, including Pennzoil and Enterprise Oil for $12 billion.

Looking at the super-majors, Exxon now commands an even bigger premium to its peers than it did a year ago. Exxon's premier position reflects its industry-leading returns on invested capital, greater earnings consistency than its peers and the group's strongest balance sheet. It ranks third in the overall stock market with a $228 billion market value, just behind General Electric. Microsoft has the largest market value.

The issue with Exxon comes down to valuation. Fans of the stock like Dave King, manager of the Putnam New Value Fund, think it's worth the price. Exxon may not garner glowing press due in part to the company's insular ways and the blunt statements of its chief executive, Lee Raymond. Yet King calls Exxon "one of the best-managed large companies in the world."

In addition to paying $6 billion in dividends last year, Exxon bought back $4.8 billion of stock. Unlike tech companies that buy back stock but make no dent in their shares outstanding due to heavy options issuance, Exxon succeeded in cutting its share count by over 100 million to 6.7 billion in 2002.

Royal Dutch Petroleum, the Dutch half of the Royal Dutch/Shell Group, came under pressure in 2002 when it was booted from the S&P 500 index along with other foreign stocks. Some investors think its management isn't as strong as that of Exxon and BP and that it overpaid for its 2002 acquisitions. Royal Dutch is more reliant on oil production in less developed parts of the world, raising its risk profile. And it has lagged its peers in reserve replacement in recent years.

Yet Royal Dutch, as noted in a *Barron's* article last month ("Well-Oiled Machine[2]," Jan. 6) remains a top-notch company with strong internal returns, an ample dividend yield and a still-solid balance sheet, although not as strong as several years ago, when the company had no net debt.

Lanni says that Royal Dutch, now trading at a 20% discount to Exxon based on a projected 2003 P/E, ought to trade for no more than a 5% to 10% discount. Royal Dutch's sister company, U.K.-based **Shell Transport and Trading**, trades for 36, a slight premium to Royal Dutch based on the formula that equates the two ADRs. Given the greater liquidity in Royal Dutch, there's little point in buying Shell now. To equate the two stocks, multiply Shell's stock price by 1.17. Royal Dutch owns 60% and Shell controls 40% of the Royal Dutch/Shell group, based on a nearly century-old merger.

One of the ironies about Exxon is that it boasts the industry's highest valuation even while producing minimal production growth -- just 1% last year. The key to its success is high returns on its huge amount of invested capital. Its capital exploration budget was $14 billion last year.

An ambitious BP, by contrast, has maintained an ambitious annual production growth goal of 5.5%. Yet BP last year backed away from that target because the company recognized that stemming declining production in mature oil and gas fields would require too much capital, penalizing returns.

BP, in effect, adopted an Exxon-type strategy of maximizing return on capital. BP's stock got hit on the news, but bulls on the stock argue that the company remains well positioned globally with the best reserve-replacement rate among the major oils. It's expected that BP may set a more realistic long-term goal to boost production by 2% to 3% a year when it reports 2002 earnings next week.

Chevron was pressured in 2002 by its disastrous investment in **Dynegy** and a series of profit misses, including a 22% shortfall from fourth-quarter estimates. Lanni says Chevron looks very attractive at 63, just 12 times his 2003 profit forecast. The consensus estimate for Chevron is for 2003 profits of $5.14 a share, but Lanni sees $5.40, mostly because his oil price forecast is more bullish than most of his peers.

Chevron yields 4.4%, tops in the group and above the rate on the 10-year Treasury note. If Chevron merely gets back to its 52-week high of 92 in the next five years, it would return over 10% annually.

Finally, if the double taxation of dividends is ended, U.S.-based oils would be advantaged relative to BP and Royal Dutch. Most or all of the dividends on Exxon and Chevron likely would be free of taxes, but only a small part of the payouts on foreign-based companies would be tax-free.

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Premium Shares at Regular Prices

The major oil stocks now are trading at their lowest price/earnings ratios in five years. Giants Royal Dutch Petroleum, ChevronTexaco and BP now fetch 12 to 14 times projected 2003 earnings while smaller integrated operators ConocoPhilips and Marathon trade for 9 to 11 times earnings. Dividend yields often top 4%.

	Price 1/30	Price ChangeYTD	52 Week High	52 Week Low	Earnings 2001	Earnings 2002	Earnings 2003E	Price Earnings Ratio 2002	Price Earnings Ratio 2003E	Market Value (bil)	Dividend Yield
SUPER MAJOR OILS											
BP	$37.51	-7.7%	54	34	$3.52	$2.32E	$2.67	16.2	14.0	$147.4	4.2%
ChevronTexaco	64.20	-3.4	92	61	6.41	4.21	5.14	15.2	12.5	68.6	4.4
Exxon Mobil	33.23	-4.9	45	29	2.26	1.70	1.94	19.5	17.1	223.6	2.8
Royal Dutch	40.62	-7.7	58	38	3.39	2.66E	3.04	15.3	13.4	144.4*	3.9
OTHER INTEGRATED OILS											
ConocoPhillips	47.45	-1.9	65	44	5.79	3.11	4.36	15.3	10.9	32.1	3.4
Marathon Oil	21.00	-1.4	30	18	4.80	1.81	2.35	11.6	8.9	6.5	4.4

E=estimate

*Includes market value of Royal Dutch's sister company, Shell Transport and Trading

Source: Thomson/Baseline

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