

Recommendation: BUY

Target Price until (01/01/2015): \$151.00

Project Selection and Management Execution: I recommend buying Chevron's (CVX) stock because of its management's ability to add long term projects and employ a proven investment process. CVX is excellent at finding new highly profitable energy fields and extracting the liquids at industry leading margins when compared to other major oil integrated companies. Its upstream performance, which consists of exploration and production, has the second highest operating margin within this industry. Chevron's continued growth comes from a diversified portfolio of international projects including conventional and unconventional onshore shale, tight gas, deep water, and liquefied natural gas (LNG) projects. These projects will help to meet or exceed market expectations for future growth in oil and gas production. CVX believes it can internally grow the business for the long run on by employing an organic growth process rather than acquiring other companies and paying more to achieve the same goal. In 2012 CVX produced 2.6 million barrels of oil-equivalent per day (MMBOED); its production growth rate (8 Yr CAGR of 6%) is obtained through Chevron's vast internationally diversified portfolio of projects. Its goal is to achieve 3.3 MMBOED, and it will achieve it through superior management and a defined cost-conscious investment process. Chevron's investment process focuses on internally building profitable projects vs. overpaying for similar assets on the market. First, Chevron considers what the geologic risk will be then it looks at the potential global economic risk, and finally political risk. Chevron decided to invest in two major projects using this investment process, the Australian Gorgon and Wheatstone LNG projects. CVX Management believes its large internal projects, Tengiz (\$25 Billion) Gulf of Mexico (\$12 Billion) Wheatstone LNG (\$29 Billion) and Gorgon (\$29 Billion), represent a better risk adjusted return. These projects are quite diverse, spread across 19 countries, from sour oil to gas. Management has been successful in finding new projects and adding capacity through internal growth.

Valuation and Financial Performance: CVX looks cheaper, on a P/E basis 9.89, compared to three other major oil integrated companies ExxonMobil at 12.14, ConocoPhillips at 10.93, Total SA 10.58, but at a premium to Royal Dutch Shell at 8.78 and British Petroleum BP 6.17. I believe the market is efficient and has everything priced in for the current valuation. What isn't priced in is the increased cash flow as capital expenditures come down after some of its largest projects are finished. This will lead to an increased ability to return cash to shareholders and buy back stock. Currently Chevron has a dividend yield of 3.39% and has increased it annually for the last 25 years (12% dividend growth rate) and share repurchases. It repurchased \$1.25 billion worth of common stock in the 3rd quarter of 2013, these share repurchases will help grow the dividend yield, which CVX will continue going forward. Its shareholder return is above peer group (RDS, XOM, TOT, and BP) and overall market (S&P 500). Shareholder return was 6.5% and 16.3% respectively for five years and 10 years.

Continued Growth, Production and Reserve Growth: The production of oil and gas, or net oil equivalent in million barrels of oil per day MMBOED, of 2.61 MMBOED has fallen 2% from 2011 to 2012 the long term upstream capital projects (Platong II, Usan and Agbami, Tahiti 2, and projects in the Gulf of Mexico) will help offset the decrease. 3rd quarter 2013 production increased to 2.59 million MMBOED from 2.52 MMBOED in the 3rd quarter of 2012. Proven reserve growth has grown on a long term basis, while only around 1% Chevron still continues to find valuable reserves. The growth strategy is a combination of continued core business development, long-term valuable projects, and a robust LNG business. CVX has more than 50 projects greater than \$250 million starting up by 2017, with 16 of these over \$1 billion. In 2013 Angola LNG came online. In late 2014, large deep water Gulf of Mexico projects will be coming online. In 2015, LNG cargoes from Gorgon will begin, followed by LNG shipments from Wheatstone in 2016.¹ Net income per barrel of oil-equivalent produced is one of the

¹ Jefferies 2013 Global Energy Conference, Chevron Presentation, Tuesday, November 12, 2013

more telling metrics that indicates how well managed Chevron is. Based on the YTD 3Q 2012 CVX earned around \$23 per barrel of oil produced where ConocoPhillips was \$12, BP was \$10 and ExxonMobil was \$8. CVX has had held this distinction for

Modeling note: I used GDP growth rates to forecast what sales would look like until 2015. "The demand for petroleum products is linked to the overall level of activity in the economy. Regression analysis spanning the past 20 years indicates that the level of gross domestic product (GDP) can explain about 95.0% of the demand for crude oil in the United States."²

Company Analysis

Chevron Corporation (CVX) is globally integrated oil and Gas Company was known as ChevronTexaco after a merger, now simply Chevron. Headquartered in San Francisco, they have operations worldwide in the upstream and downstream operating segments. Worldwide operations: are in Africa; Angola and Nigeria, Asia; Kazakhstan and Indonesia, South America; Suriname, Argentina, Brazil and Venezuela. North America; California, the Gulf of Mexico, Colorado, Michigan, New Mexico, Pennsylvania, Ohio, Oklahoma, Texas, West Virginia and Wyoming, Canada; Alberta and Athabasca, Europe; United Kingdom, Denmark, the Netherlands, Norway and operations in the North Sea.

Upstream Operations: Chevron's goal is continued growth in strategic areas of the value chain and to increase its position in exploring, developing, extracting and producing crude oil and natural gas, transporting liquefied natural gas LNG and regasification, crude oil transportation with pipelines, storage and marketing of natural gas, and LNG projects. Upstream operations are more than 85% of total Net Income, with 22% of that revenue coming from the US and the other 78% from international operations. Chevron's market share is 7.8% in the Oil & Gas Extraction.³ Downstream Operations: Its goal is to continue to commercialize the natural gas business while growing the global gas business. Downstream are refinery operations where crude oil is turned into petroleum products; transporting crude oil and refined products, manufacturing and marketing of commodity petrochemicals. Chevron's market share is 10.7% in petroleum refining, 8.1% in the petrochemical manufacturing, 13.3% in gasoline & petroleum bulk stations, and 6.1% in the gas station business.⁴ Chevron wants to differentiate through technology and invest in profitable renewable energy and energy efficiency solutions. (Chevron Corporate Fact Sheet)

Strengths - CVX benefits from economies of scale as one of the world's largest integrated oil and gas companies. Chevron's vertically integrated model of upstream operations and downstream operations essentially guarantees a market for their products. Two important aspect of the industry are how safely a company operates and how well they can negate oil spills. Since 2008 Chevron has lead other major oil integrated companies on total days away from work rate, lower than BP, RDS, and XOM. Along with the least amount of oil spills on land and water compared to BP, RDS, and XOM.⁵ Safety is at the core of CVX's culture, this leads to efficient, reliable, and profitable operations. "Our tenets remain unchanged - do it safely or not at all, and there is always time to do it right. We expect every person in our workforce, employee and contractor, to follow these principles."⁶

² IBIS World Industry Report 21111, Oil Drilling and Gas Extraction in the US, July 2013, James Crompton

³ IBIS World Industry Report 21111, Oil Drilling and Gas Extraction in the US, July 2013, James Crompton

⁴ IBIS World Industry Report 21111, Oil Drilling and Gas Extraction in the US, July 2013, James Crompton

⁵ <http://investor.chevron.com/phoenix.zhtml?c=130102&p=irol-EventDetails&EventId=4799762>

⁶ Barclays Capital 2013 CEO Energy-Power Conference, George Kirkland, Vice Chairman and Executive Vice President of Upstream, Wednesday, September 11, 2013

Weaknesses - The upstream business is built on finding more oil and gas to replace the already extracted liquids. Not only do they have to replace the productive wells but do it competitively and with operational efficiency. The most plausible internal weaknesses are Chevron's \$37 billion in planned capital expenditures, to replace the lost capacity. The production of crude oil and natural gas liquids have been decreasing 2% and 3% respectively the last two years, this is partially offset by lowering volumes to meet decreased demand. The "low hanging fruit" of the oil industry is already gone and now Chevron and companies alike have to spend more for the same amount of production.

Opportunities - Growing demand for natural gas in generating electricity will continue to replace traditional methods like coal and nuclear power. Utilities are starting to use natural gas as a means of electricity generation because of new technology. The drop in natural gas prices have added to its viability as means to generate power, along with its lower greenhouse emissions compared to coal and oil. Chevron acquired Atlas Petroleum in 2010 giving them a larger footprint in US shale formations, where natural gas is abundant. This acquisition added to other legacy positions in the US and North American basins. It also holds an international portfolio of natural gas proven reserves and refineries that turn natural gas into transportable LNG for global consumption if prices are stable or increase going forward this represents a great opportunity for Chevron's new LNG projects.

Threats - Potential risks for Chevron are legal, geopolitical, and environmental. In 2011 a court in Ecuador in Lago Arigo found CVX liable for damages and assessed a penalty of \$18 billion. CVX fought back with a civil suit of its own based on racketeering charges, filed in New York. In 2011 CVX appealed the \$18 billion judgment, but the judgment was upheld in Ecuador. The Lawsuit is based on seizure of assets which Ecuador can only laid claim to about \$500 million. In September CVX received a positive ruling in the \$18 billion judgment single a short term win. Other legal risk is from a leak in deep-water operations in the Brazilian Frade oil field. CVX was successful in stopping the leak. In 2012 Brazilian authorities filed suits against Chevron and Transocean for environmental damages, which amounted to \$11 billion. In September of 2014 CVX settled the suit with Brazilian authorities, being liable for only of \$41.6 million. Middle East unrest and the OPEC countries that can change supply have always been an issue within the industry, this is something that Chevron has no control over but can affect operations and financial results. Other environmental issues and low probable events which can impair its financial results include; hurricanes, earthquakes, cyber-attacks, and terrorists threats. Although these are low probable events they have to be considered. If there were to be increased regulation on greenhouse gas emissions, this would represent an operational cost risk and a demand risk for its products. If there is more attention on climate change or global warming this would adversely affect the capacity in which CVX operates and its financial results.

Industry Analysis

Oil Industry Supply and Demand: The outlook for global oil production is positive with the global economy recovering from recession. Demand from emerging economies has increased which will add to the overall increase in oil prices. The BRIC countries will demand the largest increases in oil consumption over the next 20 years. The use of energy is expected to increase by 40 percent by the year 2035, due to global economic expansion and emerging economies wanting to live the way western countries have lived for decades. Supply of 65 million barrels per day of new production will be required by 2035 to cover this increase in demand, which is over 390 billion barrels of cumulative new production in a 25-year period.⁷ The supply side of the energy equation will still heavily depend on traditional sources from oil and natural gas. Chevron believes the use of nontraditional renewable sources will triple over the next 25 years, although this is a substantial increase in alternative energy generation the global

⁷ Jefferies 2013 Global Energy Conference, Chevron Presentation, Tuesday, November 12, 2013

economy and consumer will still rely on fossil fuels in the long run. The majority of the future oil production will come from conventional proven reserves and unconventional resources like shale, sour oil, and oil sands.

Gas Industry Supply and Demand: The outlook for global natural gas production is positive also. The natural gas price appreciation isn't as positive because of the increased supply coming on the market. Natural gas prices have leveled off since decreasing substantially after the 2008 global recession, where prices are still a function of supply and demand. The overall long term demand for natural gas is expected to rise approximately by 43% by 2035, per the EIA. Since the US is a world leader in natural gas production, this represents opportunities for the industry to create jobs, and a source of future revenue. Recent growth in US oil and natural gas production has come from the development of horizontal drilling and fracking techniques to recover gas and oil deposits in shale formations. Fracturing or "fracking" are controversial techniques which have garnered much attention from environmentalists. The new methods and technology have advanced the industry but come with environmental risks.

Oil and Gas Industry Market Share: The oil and gas drilling and extraction industry is expected to grow at 2.5% from 2013 – 2018, 58.4 % from crude oil and 41.6% from natural gas.⁸ In order of production size per day ExxonMobil \$4 billion in revenue and a \$384 billion market capitalization, BP, Royal Dutch Shell, Chevron 241.9 billion in revenue and a 233 billion market capitalization, Total, and ConocoPhillips, are the major companies in oil and gas industry. This excluding state owned entities like Saudi Aramco, National Iranian Oil Company and Petroleos Mexicanos. The industry has been consolidating recently with

Industry Characteristics: The oil and gas industry life cycle is in the mature phase, having high; capital requirements, barriers to entry and competition. All the major oil integrated companies have global portfolios and firm concentration is low. One metric that defines the industry is capital intensity, highest among all industries, spending about \$5 on capital equipment to every \$1 spent on wages. Since 2000 over 2 trillion dollars has been invested in US capital projects to meet the demand for oil and natural gas.⁹ These massive capital intensive projects have long lead times, which returns sometimes take decades to be recognized. This is a very risky aspect of the industry because the capital projects timeline will not always match economic cycles. Merger and acquisition activity is expected for the industry, due to companies expansion desires.

The global economy recovery is expected to have a positive impact for the industry with the emerging countries requiring more energy for their expected growth. The price of crude oil has risen with the global economic recovery where the price of natural gas has not, which is due to glut in supply. The greatest threat to the industry is oil and natural gas prices which are expected to increase 0.4% and 4.1% annually for the next five years (IBIS). Profitability within the industry is tied the price and margins which are a function of demand at the pump and supply by producers. The industry does expect revenues to increase 2.5% per year.

⁸ IBIS World Industry Report 21111, Oil Drilling and Gas Extraction in the US, July 2013, James Crompton

⁹ http://www.api.org/statistics/earnings/upload/earnings_perspective.pdf

Appendix: Inputs into valuation using multiples

	2007	2008	2009	2010	2011	2012	2013	2014	2015
Stock Price	\$82	\$84	\$70	\$78	\$100	\$107	\$118	\$133	\$151
EPS	8.77	11.67	5.24	9.48	13.44	13.32	12.30	13.85	15.69
Sales	214,091	264,958	167,402	198,198	244,371	230,590	246,329	263,142	
P/E	9.40	7.27	13.39	8.24	7.50	8.07	9.64	9.64	9.64
P/S	0.82	0.66	0.84	0.79	0.83	0.92	1.02	1.01	1.01