

**Recommendation: BUY**

**Target Price until (12/31/2015): \$125.00**

## **1. Reasons for the Recommendation**

One of the main reasons for our recommendation of Chevron as a “Buy” is because of their plans for divestiture and asset restructuring. Chevron began implementing this \$10 billion divestiture plan at the beginning of 2014, and plans to continue until 2016. \$1.6 billion of divestiture proceeds have already been received, and \$2.5 billion in sales have been announced. Their asset restructuring strategy involves selling non-core assets, slowing expansion into new areas, and redeploying capital toward higher-margin projects. We believe that this strategy will help Chevron become more efficient, and produce at a higher level in the future.

One of the ways Chevron plans to redeploy this extra capital is through a stock repurchase plan, which they have already started executing. They repurchased \$1.25 billion worth of stock during the third quarter of 2014, and they plan to buy back a similar amount during the fourth quarter. Chevron has retired 5.5% of its share count since March 2011. Stock repurchases are not always done for the right reasons, but we believe this is a good area for Chevron to redeploy this extra cash. As a result, these stock repurchases should cause Chevron’s stock price to rise.

Although Chevron is implementing a divestiture and asset-restructuring plan, they do still have some new projects ongoing. For example, they are in the middle of two megaprojects called Gorgon and Wheatstone in Australia. Gorgon includes a facility with three processing units that are designed to produce 15.6 million metric tons of liquefied natural gas per year. The LNG tank #1 is complete, and tank #2 is on track to be complete in January. The project is expected to deliver its first shipment in the middle of next year. The Wheatstone project is about 49% complete, and includes a LNG facility that should be able to produce about 8.9 million metric tons of natural gas per year. LNG sales agreements have already been reached with customers in China, India, Japan, and South Korea. Since Chevron is currently spending about \$10 billion a year on these projects, once they are completed, shareholders will benefit from higher cash flow. Chevron is also increasing production in the Permian Basin, as they have drilled 460 new wells in this area already this year. The production forecast increases in this area are also attributed to the movement to horizontal wells with longer lateral lengths and more fractured stages. Furthermore, Chevron announced that the Tubular bells and Jack/St. Malo projects in the Gulf of Mexico will start in the current quarter as well.

Another aspect we really like about Chevron is its ability to invest in itself, which we determined through an analysis of its Capex Ratio. This ratio is any company’s capability to use free cash flow to obtain long-term assets. As firms experience sequences of large and small capital expenditures, the ratio between long-term assets and free cash flow will usually fluctuate variably. Chevron’s Capex ratio has continually grown from 2009, at 76.16%, to 2013 at 102.96%. This positive sign demonstrates that Chevron can use capital expenditures and increase its overall growth through its own financial capability to invest in itself. This increase is most likely due to the decrease in capital expenditures, and an increase in cash flows.

There are a few negatives to Chevron, of course. The main, overstretched one being that eventually the industry they are currently in will no longer exist as it is centered on a product that is going to run out at some point. However, first, that is not going to happen in the next three to five years so we do not have to worry about that coming to fruition as it does not fall in the timeframe of the portfolio's investment thesis. Second, the energy sector outside of the oil, gas, petroleum area is not large so the opportunity is there for Chevron to dedicate some of their resources to trying to expand upon their renewable offerings and take hold of that market before it becomes a necessity to join it. Chevron also is dealing with some lawsuits, and they do not insure themselves against all possible losses/lawsuits that may arise, so if something catastrophic were to happen like a British Petroleum oil spill, the livelihood of the company could be at stake.

## 2. Company Analysis

Chevron has two main segments, upstream and downstream. Upstream includes the finding and collection of oil, while downstream encompasses the manufacturing and sale of the product. The segments work in tandem with one another and profitability of both the segments of the business is a typical determinant of the earnings of the company. In 2013, 87% of their revenue came from upstream and 13% came from downstream. The price of crude oil is the principal element that affects the outcomes of the operations of the company. There has been a considerable decline in Chevron's revenues from 2011 to 2012, and even further in 2013. In 2011, Chevron had 23.8% growth of revenues from 2010. In 2012, it was -4.65%, and in 2013 it dropped to -5.4%. There are many factors that may be contributing to this decline. Recently, the entire oil and gas industry, including Chevron, went through a rise in some costs that surpassed the normal cost of inflation throughout many parts of the world.

Two of the company's key strengths include having one of the largest market shares in an industry that is fairly diluted, is the world's largest producer of geothermal energy of the companies within their industry. Weaknesses include increased pollution regulation and political instability in foreign markets as it is unpredictable but they have dealt with it in the past and is always going to be present. They have opportunities present in the form of continued advancement of hydraulic fracturing which will increase output and make it more affordable. They are able to shed operations with tight profit margins and focus on ones that are more efficient. Their major threats are that there is very high competition to fill the global demand for oil related products, which is both internal and external in regards to the industry.

The Asset Turnover Ratio (ATR) can vary greatly depending on the industry of the company, but generally, the higher the ratio is, the better the company can be considered to be doing. In order to determine whether or not Chevron had a good ATR or not, we compared them with Exxonmobil and Conocophillips, two of their main competitors. For years 2010 through 2013, Chevron had an average of 1.07 while Exxonmobil and Conocophillips came in at 1.30 and 0.45, respectively. Comparatively, Chevron is making better use of its assets to generate revenue than Conocophillips, but not as well as Exxonmobil. However, it is closer to Exxonmobil than it is to Conocophillips. It is also important to note that Chevron is consistent with its industry. From its peak year in 2011, it has declined approximately 26% from 1.21 to 0.90 in 2013. Exxonmobil and Conocophillips have also declined approximately 14% and 13%, respectively, during these years. Based on this analysis, Chevron needs to find a way to improve operational efficiency in coming years so that the ATR does not continue to decline.

Chevron has a low D/E Ratio, averaging approximately 0.10 for the five-year period. Usually capital-intensive industries have high D/E Ratios due to costly asset acquisitions. However, Chevron is finding other ways to finance its asset purchases other than through debt keeping interest expense low in 2010 and 2009 and immaterial in years 2011 through 2013. This shows that Chevron is less likely to be overcome by debt and file for bankruptcy, because they are financially self-sufficient to a large degree. Therefore shareholders can feel confident Chevron will maintain a strong presence in their industry for the near future. This is something that is currently enabled by their plan of cutting tight margin operations and selling off those related assets. This is something that will take another year or two to finish. At that

point, Chevron will no longer have unneeded assets to sell that generate cash so at that time, they will have to resort back to using debt to finance.

Chevron had steady increases in its EBIT margin and net income margin from 2009 to 2011. In 2012 and 2013, it began to decline back to levels it had in 2010. While analyzing the income statement we noticed that one significant source of this was due to the loss of revenue without a corresponding decrease in the company's cost of sales and operating expenses. Even though their expenses did decrease slightly during these years, it wasn't at the same rate as the decrease in their revenues. Another factor that contributed to the decline was the increase in depreciation and amortization expense. We think that Chevron's divestiture and asset restructuring plan may be a way that they are attempting to address this concern.

One of the most important risk factors for Chevron is further regulation of the greenhouse gas emissions that come from the use of their product. This is a risk that is not unique to Chevron, but is one that is faced by the entire industry, as well as the companies that use their products. Many developed countries in the world are becoming more and more strict on what are seen as acceptable standards for how anything that affects global warming is handled. This is extremely prudent because it is something that is always going to face the oil and gas industry and all companies associated with its use because it is a guaranteed side effect of the product. Automobile producers must come out with vehicles that meet a minimum miles per gallon rating, and have gone from making hybrids that use less gas to vehicles that run almost solely on electricity. If this trend continues, then gas being directly necessary for vehicles could be completely gone in the not too distant future. Other companies that use oil or gas for their everyday operations are also facing restrictions on how many emissions they are able to give release into the atmosphere and face fines if they fail to comply. There is already some degree of a carbon tax and cap and trade regulations set up that attempt to get companies to be more eco-friendly and they will have to be dealt with if they continue to grow in popularity and usability. As a counter to this inevitable and growing problem, Chevron has started researching and investing in geothermal energy and are the largest renewable energy producer of the major oil companies.

Another key risk is that of political instability and the possibility of changes within the regulatory environment. The 10-k states that this is a problem that can arise at any time and that they have been significantly affected by it in the past. They claim that they carefully consider all of these possibilities when choosing whether or not to move some aspect of their operations into a new area. It's good that Chevron takes a proactive approach and attempts to find these pitfalls before they jump into working with a new country or area, but obviously a number of these occurrences are unpredictable and cannot be seen with any amount of planning.

### 3. Industry Analysis

Chevron is part of the petroleum industry within the energy sector. Companies in this industry concentrate on the exploring, locating, extracting, refining, marketing, and selling of petroleum products which involves three processes; upstream, midstream, and downstream. Upstream includes the exploration, development, and production of oil and gas. Midstream includes gathering, refining, transporting, and storage of the product. Downstream includes the final stages of getting the product ready for sale and then the actual sale. Many of these companies have to deal with the OPEC, an international organization that works to influence world oil prices. The amount of product OPEC members produce directly influences the supply of the product across the world.

There is very strong competition throughout all aspects of the industry as companies attempt to fulfill the energy needs of customers worldwide. The industry generally faces competition on two levels: internal and external. Internal competition is comprised of factors that are common to most companies within the industry. Although factors such as crude oil grades, impurity levels and the heating value of gas play roles in the internal competition, since oil and gas are essentially commodities the companies mainly compete on a basis of price. There are major, fully invested companies within the industry, as well as national and independent smaller companies. These companies compete for rights to areas to explore for potential gas and oil opportunities through the form of leases, and then must further compete for the necessary equipment and labor required to operate in an area once they have been awarded control of that area.

External competition is comprised of threats from other industries, substitute products, and imports. The industry faces limited but growing external competition. Biodiesel and ethanol are the primary substitutes for oil as a transport fuel. Natural gas competes with coal in electricity generation, but natural gas has the advantage of burning more cleanly and producing less environmentally-harmful emissions. Solar and wind power are renewable energy sources that also compete with natural gas in electricity generation.

The overall performance of the industry is expected to be less volatile over the next five years. Industry revenue is also expected to grow at an annualized rate of 4.3% to \$5.6 trillion within this same five-year forecast. Profit is expected to grow even faster in the industry with an annualized growth rate of 4.9% in the next five years. The price of oil is expected to increase over the next five years because oil is continuously becoming more expensive to extract. As the price of oil continues to increase, research into alternative fuels will also continue to increase. Substitutes, such as natural gas and biofuels, are being used by companies in an attempt to diversify and decrease their reliance on oil. In response to continued economic growth, ongoing interest in using natural gas as a replacement fuel for oil and coal, further growth in supply infrastructure, and a relatively subdued price climate, the expansion in global natural gas production will be relatively strong compared to oil. New technologies will potentially enable natural-gas-fired electricity generation to become as affordable as coal fired generation, if not cheaper. It also has environmental advantages which increase its popularity.

Further advances in hydraulic fracturing, or fracking, will also allow the industry to increase the output of natural gas. Hydraulic fracturing is a process of pumping water, mixed with a small mix proportion of sand and chemicals, underground at high pressure to fracture the rock and release gas that

would otherwise be inaccessible. This increase in the supply of natural gas will also help lower prices, which is another indicator of its continued economic growth.

**Appendix: Inputs into valuation using multiples**

	2007A	2008A	2009A	2010A
Stock Price	80.83	79.98	67.85	79.45
Diluted EPS	8.77	11.67	5.24	9.48
Sales	220,904,000,000	273,005,000,000	171,636,000,000	204,928,000,000
Shares Outstanding (diluted)	2,131,000,000	2,050,000,000	2,001,000,000	2,007,000,000
Sales per share (diluted)	103.66	133.17	85.78	102.11
P/E	9.22	6.85	12.95	8.38
P/S	0.78	0.60	0.79	0.78

2011A	2012A	2013A	2014F	2015F
99.84	107.18	117.95	120.15	124.24
13.44	13.32	11.09	11.83	12.42
253,706,000,000	241,909,000,000	228,848,000,000	232,347,750,000	239,202,687,500
2,001,000,000	1,950,000,000	1,932,000,000	1,972,500,000	1,963,875,000
126.79	124.06	118.45	117.79	121.80
7.43	8.05	10.64	10.67	10.67
0.79	0.86	1.00	1.02	1.02

\* Analyst's own calculations. Source of basic data: company's 10-K; Yahoo! Finance

Sources:

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