Recommendation: BUY **Target Price until (12/31/2015): $141**

1. **Reasons for the Recommendation**

The primary reason for the "buy" recommendation is that: among all of the supermajor oil companies, Chevron has the highest "profit per barrel" (Helman). This indicates that the company operates more efficiently than any other supermajor. Chevron even outcompetes ExxonMobil despite the fact that Exxon is a larger company in terms of market capitalization. Both of these supermajors outperformed the S&P 500 over the past decade, but Chevron stands out between the two because of the profit per barrel measure. Complementing the company's profitability, is their willingness to use cash directly to benefit the shareholders. They do this in two ways: a regular dividend and a stock buyback program. The company has paid an uninterrupted dividend for over two decades, and it was even able to do this during the most recent financial crisis. Recently, the increases to the dividend have been at a rate that exceeding current the dividend yield. The stock buyback program has no set limits on the amount it will spend or the duration that the program will run. As long as the company is more profitable than the competition, and creating value for the shareholders, it is a good investment.

Since Chevron deals with depleting resources, it must bring on new projects to replace those that have gone into production decline. Currently, the company outspends many of the supermajors in exploration. In this way, it shows that it is investing in its future growth and that it is willing to spend more than its competitors in order to do so. Spending more than the competition might be a problem if the company were operating inefficiently, but based on its profit per barrel, that this is not the case. The company has new projects such as: Angola LNG, Wheatstone LNG, the Delaware Basin, the Kurdistan Region, and the Marcellus Shale project (10k FS-5). This list is not exhaustive, but it gives a good sample of projects being developed both in the US and abroad. Production declines will always be a problem in this business, but a good business is able to offset declines with new production. These investments will contribute to future production levels, and production for the company is projected to increase into 2017.

Chevron faces a range of risk factors that are common to the industry, and the biggest of these is the price of crude oil (10k 27). In addition to price risk, as an international company, Chevron is also subject to the geopolitical risks that exist in any country that it does business. Because it operates on 6 different continents, these variables are numerous and growing. However, by operating in so many different countries, the company also diversifies the risk, and the net effect is positive for the company.

Another challenge for the company is that the "low hanging fruit" has already been acquired, and so the only way to get the remaining resources is to use more sophisticated technology. Since the methods for resource extraction are more technically demanding than they used to be, they also present new risks to the company. Deepwater drilling, for example, has helped to offset production declines in the US, but with these benefits the company has the prospect of technical failure hanging over its head. We saw this with BP and the Deepwater Horizon oil spill. This event was a public relations disaster for BP, and it resulted in a loss of political capital. Furthermore, the spill cost BP money in terms of lost productivity, and it opened the company up to litigation. Deepwater drilling exposes Chevron to the same risks that BP directly experienced, and this is just one example of the risks with the new technology. As in the case of geopolitical risk though, the net benefit seems to be positive. If not for innovations like deepwater drilling, production in the US would be much lower than it currently is. Since the company is essentially dependent upon these new methods, it is in the company's interest to prevent the technical problems experienced by the competition. Right now, it is not clear whether the company is operating in a way that will prevent what happened with BP.

2. Company Analysis

The company's main strength lies in its upstream segment where most of the earnings are generated. This segment generates most of the earnings even though it accounts for less than a third of the operating revenue. Upstream refers to the extraction side of the business, and it includes all of the exploration aspects of the business as well. The company makes a lot of its revenue in this segment from US production, but it makes even more from its international production. The upstream segment is the key to the company's profit per barrel figure. The company also has strong market fundamentals such as: low debt, low P/E, low P/B, and a high dividend yield. From an investment standpoint, it is an attractive buy because it sells at a reasonable price, and it reliably provides value to the shareholders. The company sells a product with growing demand, and it does so more profitably than the competition.

That being said, there are some weaknesses in both its fundamentals and its market performance that need to be addressed. First of all, there are imbalances in the way that the company generates revenue and in how it generates profit. Close to 90% of operating revenue comes from downstream activities, but most of the earnings for the company are from the upstream segment. Another weakness for the company is that the risk-adjusted performance for the past 5 quarters was worse than the S&P 500 and the sector. The S&P 500 actually did better than both the company and the sector. These results, while disappointing, occurred in such a short time span that they do not take into account the larger picture. Chevron performed better than the S&P 500 over the past 10 years without including dividends. It is also worth considering that the company may be undervalued despite what the market might suggest in the near term. Its P/E ratio is low compared to the industry and the S&P 500. At the segment level, the biggest weakness is the increase in production costs along with the quality of the oil being produced. A major weakness for the downstream segment is its sensitivity to margins, and this is why the segment contributes less to income than the upstream even though it produces most of the revenue.

Opportunities for the company exist in both the upstream and the downstream segments. Chevron has not fully capitalized on the shale boom in the US, and the upstream segment could benefit immensely from moving more in this direction. The Marcellus Shale project is one step towards this, but, generally speaking, the company still lags noticeably in shale. The downstream segment of the business needs to be restructured in order to deal with the margin issue. The company is trying to address some of the problems in the segment by concentrating on the core business and by investing in chemical manufacturing. The Gulf Chemicals Project is one step by the company to reposition its downstream segment, but it is going to take more than this to really solve the margin issue.

In the long term, the biggest threat to the company is alternative energy. Since oil and gas are depleting resources, at some point, the economic viability of oil and gas may be eclipsed by a disruptive technology. So far, this has not been the case, but investing in Chevron must be done with enough foresight to know that this business model may not last forever. The timeframe for this change in the energy business has often been underestimated by commentators, and it seems that oil and gas will remain an energy staple until a major technological disruption or production declines that cannot be abated by new technologies. In addition to the possibility of disruptive technology, one must also consider incremental technological advances impacting the business. Consider the case of solar power where the efficiency of solar panels increases every year. In a scenario where the efficiency of solar power keeps increasing, eventually oil as a source of energy will be less competitive. Disruptive technologies, by their very nature, are unpredictable, but it is possible to look at incremental improvements in alternative energy and predict when these will affect Chevron's business. Although the company is invested in some

alternatives, it is not clear that it is in a position to dominate the alternative energy market should alternatives become more profitable.

3. Industry Analysis

The future prospects for the oil and gas businesses depend upon innovation, and the industry has proven itself capable of making technological advancements in response to declining conventional production. Although the industry is built upon limited resources, conditions are not as bleak as some have made them out to be. Predictions sometimes focus on conventional sources, as these sources and their production methods are better understood and hence easier to model (see Blanchard 242 for an example of this). While all can agree that oil and gas resources are limited, the economic viability of extraction changes with improvements in the technology. Production of oil in the United States was in decline for several decades, but new techniques such as hydraulic fracturing and horizontal drilling have caused US production to increase to the levels of the 1990s. Technology has proven to be more effective than some models have been able to predict, and this is a positive sign for the industry as a whole.

As an investment, supermajors like Exxon and Chevron, outperformed the S&P 500 over the past decade without including dividends. This is why the sector looks promising as an investment even though the sector has not done well within the past 5 quarters. Performance over a decade, of course, does not guarantee that supermajors will perform the same way over the next decade. However, the fundamentals of these businesses are, generally speaking, attractive to the investor looking for value. The supermajors stand out for this reason, and Chevron stands out even among its peers in terms of efficiency.

The largest players in the oil and gas industry are the supermajors and the national oil companies. Currently, the supermajors are feeling more pressure from the national oil companies like PetroChina. Like the supermajors, the national oil companies compete for some of the same land claims as the supermajors, and they are able to take financial risks that a publically traded company cannot. The nationals are essentially backed by a "government guarantee", and this is what allows them to invest in projects that the supermajors cannot afford. As oil exploration becomes less traditional and more risky, it is possible that the national oil companies will be able to leverage this government backing even more so than before. However, they will also still need to innovate in order to compete. This is one way in which the supermajors still maintain an edge over their government-backed competitors.

The demand for crude oil is dependent upon the growth in global economy, and supply and demand are more or less the two things that control the price of crude oil (O&G, p1) Most of the players in the industry must work within the limits set by the market in pricing the commodities. The exception to the rule is the cartel known as OPEC. The reason that they are an exception is because they act as the swing producer for the global market (O&G, p32) meaning that they can increase or decrease production enough to actually influence the price. Whether this influence will always be the case for the industry is yet to be determined. The rise in oil prices over the past decade has changed the economics of US oil production, and resources that were once considered uneconomical are now being pursued. This is so significant that Saudi Arabia, OPEC and the world's largest producer, has taken notice of this new trend (O&G, p11). If OPEC loses its status as the default swing producer it is not clear who will replace them—if anyone at all. Prior to the rise of OPEC, a swing producer existed in the United States. Now that US production levels are near their peak levels, this swing producer status will probably not return because the nature of the market is completely different from what it was in the 1970s. The revolution in hydraulic fracking may have helped to offset US production declines for now, but this raises questions about price stability. If scarcity turns to abundance, there is the possibility of a price collapse. Such an event occurred in the mid 1980s, and the large industry players were able to weather it. However, survival did require consolidation and cost- cutting (Carollo, 35-37 & 44).

Appendix: Inputs into valuation using multiples

	2007	2008	2009	2010	2011	2012	2013
Median Stock Price	$83.17	$84.78	$69.76	$77.66	$101.48	$107.18	$120.36
Diluted EPS	$8.77	$11.67	$5.24	$9.48	$13.44	$13.32	$11.09
Sales	$214,091	$264,958	$167,402	$198,198	$244,371	$230,590	$220,156
Shares outstanding	2,132	2,050	2,001	2,007	2,001	1,965	1,932
Sales per share	$100.42	$129.25	$83.66	$98.75	$122.12	$117.35	$113.95
P/E (median price)	9.48	7.26	13.31	8.19	7.55	8.05	10.85
P/Sales per share	0.83	0.66	0.83	0.79	0.83	0.91	1.06

	2014F	2015F
Median Stock Price	$138	$141
Diluted EPS	$13	$13
Sales	$254,855	$257,389
Shares outstanding	1,896	1,863
Sales per share	$134	$138
P/E (median price)	10.85	10.85
P/Sales per share	1.03	1.03

Sources

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