Schlumberger Limited (SLB (NYSE))
Analyst: Sam Snelling Fall 2014
Brian Watkins

Recommendation: BUY **Target Price until (12/31/2015): $111**

1. Reasons for Recommendation

Schlumberger is a key player in the oilfield services sector. The buy recommendation and stock price projection considers Schlumberger's relationship with oil prices. Increased oil demand is expected relating to the emerging global economy and political and macroeconomic pressure. The 2015 expected total returns (including dividends) are 19.75%. The recommendation is appropriate given the stocks level of volatility, the opportunity cost of capital, and current low yields on low risk investments. Schlumberger is positioned to take advantage of the pending merger between Halliburton and Baker Hughes. Information for analysis was derived predominantly from public filings, Ibisworld reports, and Morningstar.

Schlumberger's biggest customers are private and state run oil companies. When oil prices rise oil companies move resources to prospect, drill, and extract more oil. Coincidentally, the three main divisions of Schlumberger are reservoir characterization, drilling, and production. Hydraulic fracturing is a process which Schlumberger helped pioneer. "Fracking" and the energy boom has been attributed to the United States' economic recovery and shale oil has elevated the United States to be the largest oil producer in the world. The average break-even point for fracking to be continually profitable is $80/ barrel. Currently oil is near $75/ barrel and a reflection of increased supply and increased dissention amongst countries in the OPEC cartel. Higher oil prices reflect an increased demand for fracking and other drilling services and increase revenues, profit margins, and the stock price of Schlumberger and all companies in the oilfield services sector (Ritenbaugh, 2013). As the leading company in the sector Schlumberger stands to gain the most from a rebound in oil prices. Political factors in Russia, OPEC countries, and the United States will cause oil prices to rise after Thanksgiving and continue into 2015. The low oil price discourages high cost production avenues, including fracking, and thus the buy recommendation. This correlation is expected to continue moving forward. Schlumberger's stock price dependence on a commodity with a complicated intersection of political, geographic, social, legal, and regulatory variables presents volatility risk. Costs associated with fracking will decrease in the near future improving margins. Natural gas is 5% of revenue and is not considered a key factor affecting stock price.

Schlumberger's stock price volatility is magnified by their global presence. Schlumberger's comparative advantage is their global footprint and business relationships with state run oil companies (Ritenbaugh, 2013). The competition on U.S. soil is extremely keen and operating overseas presents higher profit margins. International business is not without risk and in 2013 Schlumberger recorded a loss related to foreign currency in Venezuela of $92 million (Schlumberger, 2013). Similarly, Schlumberger is exposed to losses related to sanctions from Iran and Russia. This is good for investors as fears over loses lower the stock price in the short term. The company has a much diversified global portfolio with only one country (United States) comprising more than 10% of its revenue. Schlumberger experiences 5% of its revenues from Russia. (Schlumberger, 2013) There is also an increased threat of regulation, lawsuits, and political ramifications associated with international business. Schlumberger has a much larger global footprint compared with its competitors (Schlumberger, 2013). Environmental activism and increased regulation relating to environmental protection are also forecasted to increase slightly in the next five years. Regulation and fines related to environmental protection have the potential to decrease revenue and net income.

Increased risk comes with dealing with foreign governments and currency. A benefit of a large global footprint is relying on and benefitting from goodwill established with state run oil companies. Proper global positioning has a large upside both in operations and foreign exchange. Schlumberger uses hedges to protect transactions between currencies. If the US dollar weakens Schlumberger will experience increased demand as a result of decreased effective price to its customers. If the US dollar continues to remain strong effective price of Schlumberger's services will increase and revenue will decrease.

In 2014 Schlumberger outperformed the broader Market Vectors Oil Service ETF and the iShares U.S. Oil Equipment & Services ETF (ETF Database, 2014). Schlumberger's annual revenue is 44 billion with net income averaging 15% of revenue over the past four years. The margins are not huge considering international and volatility risk. Cash increased to $3,472B in 2013 an increase of 82.26% from the year prior (Schlumberger, 2013). Cash is forecasted to continue increasing in the future at roughly 10% a year. Cash is being used in their accelerated buyback and to increase dividends.

In 2013 the board of directors approved a $10 billion buyback. Schlumberger had repurchased $5.3 billion of shares under this new share repurchase program as of September 30, 2014. Schlumberger has decided to accelerate this share repurchase program with the aim of completing it in 2.5 years as compared to the original target of 5 years (Schlumberger, 2013). In 2013 stock buybacks outpaced stock option exercises by 75.42% (Schlumberger, 2013). Analysis revealed no concerns related to abnormal buybacks related to stock options.

Schlumberger is exposed to risk related to foreign currency, impairment charges, litigation charges, foreign relations, and societal concerns related to fracking. Recently there was a $222 million and $142 million impairment charges related to investments in drilling businesses. Schlumberger has been developing their deep sea drilling comparative advantage. Deep sea drilling is another high priced process and Schlumberger is looking to increase their proportion of land based operations (Schlumberger, 2013). Going with a land based strategy is the deconsolidation of its deep sea drilling business (for $1.028 billion), and spin off of the formation of OneSubsea (underwater exploration) at a cost of $600 million (Schlumberger, 2013).

2. Company Analysis

Schlumberger operates in a highly competitive oilfield industry. They have three primary divisions of reservoir characterization, drilling, and production. Operations include seismic acoustical operations, drilling, well characterization, well completions, underwater operations, production, well intervention, and well testing (Schlumberger, 2014). Weather cycles and unexpected weather can affect transportation and personnel. Many wells are in remote locations with difficult access. .

Schlumberger's strength revolves around its global presence. Schlumberger has a positive relationship with many state owned oil companies. As a premier servicer for fracking, operations related to shale oil will increase in Asia, South America, and Europe (especially as oil prices increase). Schlumberger operates efficiently in offshore and onshore drilling markets. This is impressive given their depth and breadth of operations. Schlumberger is on the cutting edge of high end technology. They have experienced strong growth in drilling activity (Q4 Conference Call Schlumberger, 2014). Continual positive cash flow and stock buybacks are a strength even if it is possible that Schlumberger may be holding on to too much cash (Schlumberger, 2013).

The weakness of Schlumberger is that North American business yields to their global business priority. The United States recently surpassed Saudi Arabia as the world's largest oil manufacturer. Schlumberger does not have a comparative advantage in the U.S. To compare Schlumberger gets only a third of its revenue from North America whereas its competitors generate nearly half (Schlumberger, 2013).

Schlumberger has too many subsidiary companies to track. The volatility of the stock along with the stocks poor performance in 2014 is a weakness from a certain perspective (Yahoo Finance, 2014). The fourth quarter conference call revealed a mixed outlook as opposed to confident one (Q4 Conference Call Schlumberger, 2014).

Schlumberger's biggest opportunity comes with the merger of Halliburton and Baker Hughes. Halliburton paid a huge premium to acquire Baker Hughes and will be bogged down with logistics, regulation, and law associated with the merger. Schlumberger has the opportunity to make some strategic moves in operations and capital acquisition while the merger is still settling. Updated regulatory requirements and antitrust scrutiny of the merger will take attention away from Schlumberger providing a perfect opportunity to gain market share. Schlumberger may be in a good position to get a great deal on businesses and equipment that are sold or scuttled during the Halliburton/ Baker Hughes merger (Gold, 2014).

Another opportunity is that Schlumberger currently gets 70% of its total revenues from independent and state-owned oil companies. National oil companies own about 80% of the world's oil reserves (Oil & Gas Financial Journal, 2012). Having these key relationships are crucial to expanding future business overseas.

Five years down the road the merger between Halliburton and Baker Hughes may become a threat. Increased efficiency related to decreased competition and economies of scale will threaten Schlumberger in the future more than it will in the present. Continued global uncertainty revolving around Russia and Iraq increase volatility and decrease attractiveness threaten stock price. Expected turmoil in the Middle East related to the self-proclaimed Islamic State and black market oil are legitimate concerns. The future holds increased possibility of government regulations related to fracking. The potential for litigation related to environmental damage also exists. Weather is unpredictable and operating margins fluctuate a few percentage points based on winter natural gas demand (Campbell, 2012).

Schlumberger's main currency is US dollars. However they do a lot of international business, Schlumberger has heavy risk associated with future cash flows and foreign currency, assets and liabilities in foreign denominations. Of $6.2 billion in foreign currency contracts, $2.5 billion relates to hedging of debt, or 40.32% (Schlumberger, 2013). Schlumberger hedges against this risk through currency forward contracts and options. The instruments that protect against substantial loss do not eliminate exposure completely. If exchange rates are favorable Schlumberger can also post moderate gains. Moving forward exchange rate risk is not expected to be a major financial factor in stock price.

Schlumberger is poised to make efficiency gains in technology and improved logistical costs. North America offshore operating margin improved with market share gains and technology uptake. The improved margins in 2013 were not apparent because of losses related to weather and offshore current fluctuations. The improved margins have historically been offset by uncontrollable factors.

3. Industry Analysis

The current capital-constrained market will have a lasting, if not devastating, effect on the smaller players in the industry. We think that the low for the energy space is over, yet investors are skittish with fear levels still high. Typically, this is the type of sentiment seen close to market lows. We're expecting the news from OPEC to stabilize the price and give oil producers a chance to adjust. While the fastest growing regions internationally were in Latin America, (with sequential increases of revenue growing 10% (Q4 Conference Call Schlumberger, 2014)), Venezuela and Ecuador joined Iran in a call to reduce production of oil, but were met with high resistance from Saudi Arabia. This is an effort to return the price back to above $80 per barrel. Minimal U.S. producers are already reducing production, but OPEC producing countries do not expect U.S. shale production to be restrained much until prices get to $65 per barrel or less. "Russia, being the world's second largest oil producer, and Mexico, the tenth largest, both refusing to cut oil production has left OPEC with little more than a "patience strategy"; considering, neither country is a member of OPEC," said Paul Christopher, chief international strategist at Wells Fargo Advisers.

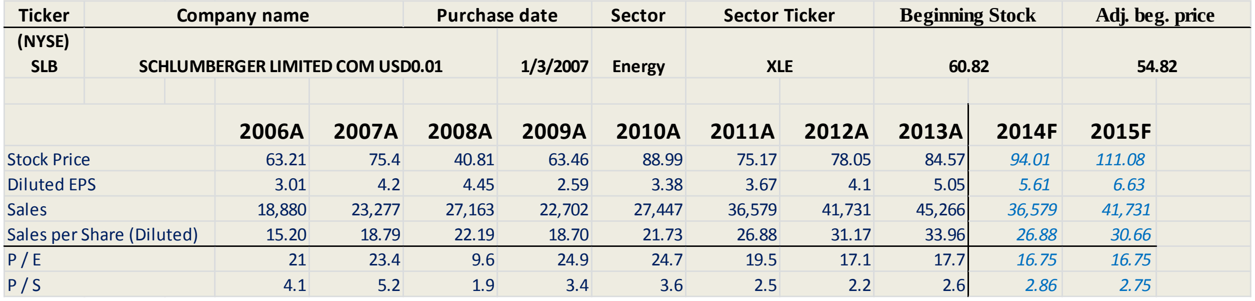
The recent drop in crude oil prices along with the stock price of most energy producers, drillers, and transporters of oil, has not deterred the confidence of management at Schlumberger. Paal Kibsgaard, chief executive officer was previously quoted in a statement saying that "The challenges of maintaining non-OPEC supply outside North America , the lack of growth in OPEC sustainable production capacity maintaining tightness in OPEC spare capacity, and the continuing geopolitical risks in some key producing regions all lead to a supply-demand situation that is relatively well-balanced." Schlumberger continues to describe the fall in crude oil prices as a "fear of short-term oversupply", and are steadfast on their goal of doubling 2013 earnings per share numbers by the year 2017. (Q4 Conference Call Schlumberger, 2014)

Schlumberger has the lowest market share in North America when we consider the largest four oilfield service providers (Weatherford International Plc., Halliburton Co, and Baker Hughes Inc.). This is important when we take into account the stringent laws and regulations the oilfield service providers are accustomed to when it comes to dealing with the United States (Oil & Gas Financial Journal, 2012).

As a litmus test for the industry Baker Hughes for the first time in more than a year reported a lower-than-expected profit. The long term outlook for sector demand is solid. Operators in deep-water and other complex environments need oil service companies to locate new fields and place wells properly. Improvements in prospecting, drilling, and production techniques are inevitable. The increased efficiencies will increase margins and profits. Discoveries around Brazil's deep-water market, in a "pre-salt" layer located under water two miles promise to be among the largest fields discovered anywhere in the world over the past 20 years, revealing the next phase of shale oil extraction.

The volatility of the oil and gas sector will have a lasting effect on service companies. This is due to the oil and gas industry forecasting the amount of drilling and production they plan to perform on a quarterly basis. Based on these forecasts, the oil and gas sector hires service companies to execute the work. Abundant supply and feeble demand have hit oil prices in recent weeks. With crude oil at low prices the opportunity has presented itself to buy more of a stake in Schlumberger.

Appendix: Inputs into valuation using multiples



Ticker	Company name	Purchase date	Sector	Sector Ticker	Beginning Stock	Adj. beg. price
(NYSE) SLB	SCHLUMBERGER LIMITED COM USD0.01	1/3/2007	Energy	XLE	60.82	54.82

	2006A	2007A	2008A	2009A	2010A	2011A	2012A	2013A	2014F	2015F
Stock Price	63.21	75.4	40.81	63.46	88.99	75.17	78.05	84.57	*94.01*	*111.08*
Diluted EPS	3.01	4.2	4.45	2.59	3.38	3.67	4.1	5.05	*5.61*	*6.63*
Sales	18,880	23,277	27,163	22,702	27,447	36,579	41,731	45,266	*36,579*	*41,731*
Sales per Share (Diluted)	15.20	18.79	22.19	18.70	21.73	26.88	31.17	33.96	*26.88*	*30.66*
P / E	21	23.4	9.6	24.9	24.7	19.5	17.1	17.7	*16.75*	*16.75*
P / S	4.1	5.2	1.9	3.4	3.6	2.5	2.2	2.6	*2.86*	*2.75*

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

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