Biggest, Safest, Cheapest, Best

Excerpted from the July 2006 *Extreme Value*
By Dan Ferris

I'm going to tell you to do something that's not exactly going to make you feel like a contrarian right now. I think you should take 15%-20% of your account, **BUY ExxonMobil (NYSE: XOM)** and hold onto it for at least 20 years. I think you should continue to buy whenever the price is right – which is almost always – in order to keep a large portion of your account in it. You should also reinvest all of the dividends you receive.

I imagine this advice doesn't seem terribly brilliant. But really, I'm just sticking to the promise I've made to all *Extreme Value* readers: that we will only recommend stocks that are safe enough and cheap enough.

Safety first.

ExxonMobil is safe for two main reasons: it's well managed, and it will protect you against inflation.

Few companies on earth – oil or otherwise – are as superbly managed as ExxonMobil. There's more evidence than I have space, but here are the highlights.

Oil bottomed in December 1998 near $10 a barrel. The following year, 1999, ExxonMobil earned its lowest return on total capital of the previous 10 years: 12.1%. That's what ExxonMobil did when oil was at the bottom of a two-decade bear market. I remember once a real, dyed-in-the-wool Texas oilman told me that ExxonMobil was so well managed, it could make money on $10 oil. The proof is right there in black and white, in the company's 1999 financials. With oil prices as high as they are, making huge returns on capital is easy for ExxonMobil. Last year, its return on average total capital employed was 31%.

Going back to 1996, Exxon's returns on total capital have moved around with energy prices, but the average has been about 18.3%. Think about how oil prices have been over the last decade: all over the map, from below $11 and now closing in on $80 per barrel. Then think about the prospects for oil and gas prices over the next decade or so. Then look at that poorest performance (12.1% on capital in 1999). Returns on total shareholder equity have only been slightly higher, since Exxon has always been conservative in its use of debt. Operating margins are and will likely remain in the low to mid teens. The margins' thickness isn't what's remarkable. It's the fact that they never go away, no matter what the price of oil.

Of course, in a business like oil and gas, there's a lot of noncash depreciation and depletion expense. Managed well, that can mean there's more cash than accounting income. With net income just over $36 billion last year, operating cash flow came in at $48.14 billion. From that we deduct capital expenditures ($13.84 billion) and

dividends paid ($7.16 billion) to arrive at free cash flow: $27.14 billion.

Free cash flow tells you how much excess cash is left over after the business expenses are covered, including reinvestment for maintenance and growth. $27 billion is, of course, an enormous sum. And what does ExxonMobil do with all those billions? It does what it's always done. It gives most of them back to the owners of the business. Let's put that in clearer terms. In 2005, ExxonMobil spent more on share repurchases than it did on capital expenditures. That's the first time it's ever done that. ExxonMobil bought $18.22 billion worth of its own shares. It sold about $941 million, resulting in a net share repurchase of $17.28 billion for the year. The pace is showing no signs of letting up. ExxonMobil spent a little over $3 billion on share repurchases in the first quarter of 2005. It spent $5.76 billion on them in the first quarter of this year. At ExxonMobil, share repurchases aren't just a good idea. Ongoing share repurchases are, always have been, and likely always will be, a way of life. Since 2001, ExxonMobil has reduced its share count by 11.5%. That's the rough equivalent of a tax-deferred 2.41% dividend yield. That puts the current yield at about 4.5%.

ExxonMobil pays cash dividends, too. ExxonMobil has paid a dividend every year for over 100 years. It has increased its dividend every year since 1983. The total cash distribution to shareholders in 2005 (via repurchases and dividends) was $23 billion. ExxonMobil has paid out more than $71 billion through share repurchases and dividends since 2001. It would be normal for this peak performance to moderate somewhat over the next few years. But oil would have to become obsolete to stop this flood of capital back to ExxonMobil's owners.

Another benefit to shareholders ExxonMobil delivers is debt reduction. In 2001, debt was 12.4% of total capital. Today, debt is about 6.4% of total capital. From an investor's viewpoint, though, ExxonMobil's debt situation is better than that. ExxonMobil has no net debt. As of March 31, cash and equivalents stood at $31.9 billion. That's not including restricted cash of $4.6 billion. Debt was a mere $6.22 billion. ExxonMobil could swallow all of its debt whole, *five times over.*

You could argue that one reason ExxonMobil has been so consistently profitable is that it's an integrated oil company. So it's not just an oil company. It's also in natural gas, coal, electric power, pipelines, transportation, oil refining, retail service stations… The fact that it has upstream and downstream operations doesn't automatically mean it does them well. A consistent earnings performance isn't guaranteed simply because you're diversified up and down the entire spectrum of the energy business. For most people in those businesses, the opposite guarantee (i.e., of failure) would get you closer to the likely result.

But take refining, for example. You can't build a refinery in the United States. It's just too hard, politically speaking. The last new one was built in the late 1970s. So it's unusual that you see a company grow its capacity much. And yet, ExxonMobil has increased its refining capacity by an average of 50,000 barrels per day. That's the equivalent of building a new grass-roots refinery *every three years.*

That sort of growth is quite a feat, since ExxonMobil is the largest public company in the world, with a massive market cap of $385 billion, and 2005 sales of $359 billion. Lee Raymond was Exxon's and then ExxonMobil's CEO from 1993 through 2005. He understood how to produce good financial results from a large commodity-oriented operation. He said so plainly, in a 2001 interview: "If you're the most efficient competitor on a large scale, then it's axiomatic in my mind that you're going to end up over time with a very sound financial result and a very strong cash flow and a high return on capital employed, which is what the objective of ExxonMobil is." The company's ability to make

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healthy returns no matter what the oil price clearly establishes its position as the low-cost provider.

Back in August of 2000, Lee Raymond showed analysts a chart that made it clear that he meant business about things like efficiency and flawless execution. It showed that, from 1990 to 1999, BP incurred $9.4 billion worth of project write-offs, Shell wrote off $2.9 billion, and Exxon wrote off nothing. Rex Tillerson, ExxonMobil's new CEO, states similar principles, also in plain language. In the 2005 shareholder letter, Tillerson says ExxonMobil's businesses are centrally managed. That's not what most businesses want to tell you today, but it's how you gain efficiency and economies of scale in such a gargantuan operation. Tillerson goes so far as to call it a competitive advantage. The term, "long-term" appears 35 times in its 52-page 2005 summary annual report.

Aside from being well managed, safety also comes from the downside protection you get with a hard-asset company. *Value Line* puts the pretax present value of ExxonMobil's reserves at $135 billion, as of December 31, 2005. But that's by the SEC rules. The way the SEC rules reckon it, ExxonMobil's proved reserve base is 22 billion barrels of oil equivalent (boe), about half of which is natural gas. But the company's total resource base is 73 billion boe. A lot of that will become proved in the next decade or so. So maybe the net present value is higher. It's almost certainly not 217% higher, as 73 billion is compared to 23 billion. But it could be 50% higher. That would put the reserves' present value at over $200 billion. I don't care what the number is. I just need to know that I've got a margin of safety equal to more than twice the proved reserves of the largest oil company on the planet.

I don't believe you'll ever be able to buy ExxonMobil's common stock for anywhere close to the present value of reserves. That'd be like waiting for Coke to trade at book value. It'll never happen, and what's the point, when it's proven its ability to rival the U.S. Treasury at minting money?

Finally, on the issue of ExxonMobil's safety relative to other investments… Like Berkshire Hathaway, ExxonMobil is one of few public companies garnering a AAA credit rating from Standard & Poor's and Moody's. Only two companies have consistently garnered a AAA rating since 1980: ExxonMobil and General Electric. The most recent list of AAA-rated public companies I could find was by Moody's, dated March 2005. It's an elite group:

- AIG
- Automatic Data Processing
- Berkshire Hathaway
- ExxonMobil
- General Electric
- Johnson & Johnson
- Pfizer
- United Parcel Service

That's a short list, and one with which we maintain a certain familiarity. Aside from Berkshire Hathaway, you'll notice two of Berkshire Chairman and CEO Warren Buffett's most recent purchases on the list: General Electric and UPS. Marty Whitman recently bought shares of Pfizer. I featured Johnson & Johnson in an in-house research note to Stansberry editors last week. And I wrote to S&A readers a few weeks ago about the large and growing stream of interest income ADP receives from its significant float. Adding ExxonMobil to our Model Portfolio will make it the second AAA-rated stock we've recommended. Are we becoming *mainstream*!? Perish the thought, but ExxonMobil is quite literally as safe as a stock can possibly get.

Now, is it cheap?

In fact, it's cheaper than most people acknowledge. ExxonMobil is currently trading at an enterprise value of about 5.9 times pretax earnings (at $64.07/share). Using price-to-earnings ratios to value highly cyclical businesses can be problematic. These stocks tend to trade at higher multiples when the stock is down, during cyclical lows, and at lower multiples during peak periods in the cycle. That's a general tendency, and if it bothers you, you're not going to be able to stomach ExxonMobil at 10 times net earnings, its lowest P/E ratio in decades (according to Value Line Investment Survey data). Also at an all-time low is ExxonMobil's dividend yield. It was over 5% in 1990. It's around 2% today. You're not going to feel much like a contrarian about that, either. To make matters even less palatable, there's a (*gulp*) growth story here: the dividend has grown from 62 cents a share in 1990, to $1.28 per share today, a growth rate of about 5% a year. If that keeps up, it'll be $2.66 per share in another 15 years.

Rex Tillerson explains the reason I'm okay with

using the P/E ratio as a valuation measure for ExxonMobil in his shareholder letter, "With projects lasting decades, they must be profitable across a range of price environments. As a result, today's oil and gas prices are almost immaterial to the many factors that must be considered before we will commit the Corporation's funds – your funds – to a development project. This long-term approach, combined with our unmatched financial strength, allows ExxonMobil to invest wisely and timely throughout the industry business cycle and as opportunities arise."

Tillerson's explanation makes sense. ExxonMobil's earnings aren't a volatile, commodity-like gamble. The way to consistently make money as a commodity producer is never to be the biggest player in town and never put yourself in a position of placing levered speculative bets on the short-term price momentum of the commodity. The long-term rhetoric bears out in the investment results. ExxonMobil shareholders have earned a pretax total return of over 14% annually since 1995… and since long before that, too. In his new book, *The Future For Investors*, Wharton professor Jeremy Siegel puts Exxon's and then ExxonMobil's pretax performance from 1950-2003 at about 14.42%. That's 8.77% a year in capital gains, and 5.19% a year in dividends. (In 1950, ExxonMobil was called Standard Oil of New Jersey.) Buying a low-P/E dividend payer with unstoppable earnings power can pay off over the long term. Siegel compares Standard Oil/Exxon to IBM during the same period. IBM grew faster than Exxon, but you could never get it cheap enough to make as much money on it as you could on ExxonMobil. Cheap stocks rule. Expensive ones drool.

I can't talk about oil without adding a much-needed sane word about oil market forces from Morningstar's equities strategist, Paul Larson. It's spot-on, and one of the reasons it's hard for me to expect oil prices to stay where they are (high $70s per barrel), much less go higher. Larson writes, "The laws of economics have not been repealed… Canada alone has almost 300 billion barrels in its oil sands, economical to process at prices above $30 per barrel and astonishingly profitable at $70. Ratchet prices up to $40 per barrel and coal-to-liquids (gasoline, diesel, etc.) becomes realistic, providing more than 50 years supply alone. At $70, oil shale – which could supply the world at current consumption levels for 100 years, becomes realistic. Finally, above $80, biomass-to-liquids, an essentially limitless source, becomes economical."

Oil closed yesterday near $77 per barrel. Every source on Larson's list is profitable right now except for biomass, and that's got about $3 to go. The higher the price, the bigger the supply. That'll never, ever change, no matter how many Chicken Littles predict the last drop of oil. It just doesn't work that way. Fortunately, it is nearly irrelevant to ExxonMobil shareholders. I urge you to **BUY ExxonMobil (NYSE: XOM) up to $66 per share** with a large portion of your account and hold forever. I'm adding it to the Model Portfolio immediately.

A final tidbit on ExxonMobil: According to a 2001 Bloomberg article posted at www.gasandoil.com, ExxonMobil is such a safe haven, that some large institutional investors use it like a bank. They store cash in ExxonMobil shares while waiting for something better to come along. That accounts for a phenomenon you may have noticed. On days when the Nasdaq is up, ExxonMobil is often down.

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