

**INTRODUCTION TO
OIL COMPANY FINANCIAL ANALYSIS**

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INTRODUCTION

The first edition to this book was inspired by the mergers and acquisitions (M&A) boom of the 1980s. I was involved early when Dome Petroleum launched this boom with its unsolicited tender offer for Conoco stock (see chapter 9). Dome was after the Canadian assets held by Conoco—Hudson’s Bay Oil and Gas (HBOG). I was sent to Indonesia and Australia for Dome to evaluate their newly acquired major holdings there. After that, I worked out of their Calgary offices as they sold off these international assets that came with the HBOG acquisition. I managed the data room. The assets held by the HBOG international subsidiary “Hudbay” were acquired by British Petroleum (BP) and London and Scottish Marine Oil (LASMO) for US \$300 million or so. Small potatoes.

Following the Dome acquisition, the industry got swept up in the M&A craze (known as the Fourth Wave discussed later in this chapter) and things happened fast. Margins between oil company stock trading values and break-up value were huge. Typically, a company break-up value was twice the trading value of the stock—fuel for a conflagration, so things got hot.

Many oil company executives did not have experience with the heady, fast-paced action triggered by an unexpected tender offer. The Wall Street folks took over. Things happened so fast that it was only when we had a chance to look back did many of us realize how badly some of the investment bankers had behaved. They operated under huge conflicts of interest. Some investment bankers would provide fee-based advice and consulting services as they did everything but protect the interests of their clients. Some of the stock offerings designed by these advisors were so exciting that the designers themselves would acquire the stock and the associated options and warrants and rights. Sometimes a stock offering would be fully subscribed by those

approach, however, gets lots of criticism. One of the strongest arguments is, “If they are right, they are right for the wrong reasons.”

This book promotes the fundamental approach, but it is important to understand the differences. Fundamentalists use some techniques that verge on technical analysis. When a financial analyst looks at past sales or earnings performance of a company to predict future growth potential, he has one foot in technical territory.

Technical Analysis

Technical analysts predict stock prices based on past prices, trading volumes, and other factors such as trading highs, lows, and the breadth of the market (advances vs. declines). Technical analysts are referred to (sometimes disparagingly) as *chartists* because of their use of bar charts and graphs to depict historical stock price trends and make predictions. The purpose of the charts and graphs is to interpret and predict stock performance. Analysts still use charts and graphs, but now they are computer-generated instead of hand-plotted. The advent of the computer and increased availability of information has considerably elevated and expanded the tools available to the technical analyst and the fundamentalist. See appendix 14 for examples.

Dow Theory

The technical system was either started or at least formalized by Charles H. Dow, the father of technical analysis. Dow, in what is called the Dow Theory, described the overall market as having three cycles of movement, similar to the movement of the sea, as follows:

Narrow	day-to-day	(ripples)
Short swing	2–4 weeks	(waves)
Main movement	4 years or more	(tide)

While the day-to-day movements are of little value, analysts watch the short-swing movements closely. The main movement, or primary trend, is called either a bull or a bear market. An example of a bear market trend is shown in figure 2–2.

Niels Bohr—early EMH proponent

The Danish physicist Niels Bohr had an interesting view of the stock market. He considered a case where one class of investors chose investments completely at random. They were, therefore, equally likely to win or lose when competing with the market rate of return. The aggregate performance of their investments would emulate the market itself.

He described another group of investors with inside information who would reap excess returns. But who would the losers be that would subsidize the inside traders? Those who bought and sold at random would neither win nor lose. They couldn't be the losers that provided the excess returns for the inside traders. The source, he proposed, would be from the investors who get limited historical and published information. Those who make investment decisions based on limited information then would do worse than those who buy and sell at random. The market exhibits a certain degree of efficiency. By the time the average shareholder receives his quarterly or annual report, the market has already responded, whether the report holds good or bad news. Large traders and institutional investors have access to financial information that does not wait for the mail.

Big news used to be delivered to the electronic news services long before the average shareholder had a chance to find out what was happening. Furthermore, when company management makes a pitch to institutional investors and brokerage house analysts, it is usually done through formal meetings and informal conversations that the average shareholder doesn't attend.

EMH advocates believe that by the time the stock broker called to say, "Have you heard the good news?" it was too late to capitalize on that news. SEC Reg FD is designed to change the way companies disseminate information and level the playing field.

From the point of view of the average individual shareholder, the market is plenty efficient, and a security is worth its market price. Any attempt to beat the market is futile. The only realistic investment strategy would be to buy and hold a diversified portfolio of stock and simply hope to achieve the market rate of return.

But if a stock is worth what the market is willing to pay for it, why do most takeovers end up paying a premium over MV? Where did that extra value come from? It usually comes from the willingness of a buyer to pay

Figure 2–11 looks at the potential of the ChevronTexaco investment from a cash flow perspective.

Cash Flow for the \$10,000 ChevronTexaco Investment							
<p>This cash flow shows the initial investment, the revenue stream for dividends over the 10-year period and the sale of the stock at the end of the 10-year period. Since we had already calculated the after tax interest rate at 9.6%, we used a discount rate of 10% in the table. The table verifies that the investment after tax return is close to 10%.</p>							
Year	Purchase & Sale	Dividend Per Share	# Shares	Dividends	After Tax (20%) Dividends	Discount Rate 10%	NPV
2004	-\$9,975	2.80	132	369.60	295.68	0.95	-9224.70
2005		2.88	132	380.69	304.55	0.87	264.05
2006		2.97	132	392.11	313.69	0.79	247.19
2007		3.06	132	403.87	323.10	0.72	231.34
2008		3.15	132	415.99	332.79	0.65	216.65
2009		3.25	132	428.47	342.77	0.59	202.92
2010		3.34	132	441.32	353.06	0.54	189.94
2011		3.44	132	454.56	363.65	0.49	177.82
2012		3.55	132	468.20	374.56	0.45	166.68
2013	\$18,198	3.65	132	482.24	385.80	0.40	7507.85

If the Net Present Value of the investment = zero then we picked the right discount rate. This is very close.

➔
-19.95

Assumptions: Stock price = \$75 per share
 Purchase was at beginning of year and sale of stock was at year end.
 Broker fees were \$75 to buy and \$150 to sell 10 years later.
 Stock prices doubled over the 10 year period.
 Dividends started at 2.80 in 2004 and increased by 3% over the 10-year period.
 Income tax rate was 20% and the capital gains tax rate was 15%.

Note: These assumptions show the stock price increasing faster than the dividend per share. This will not make future investors happy. If this really did happen, there would be a downward pressure on the share price. Chapter 4 will cover the relationship between dividends and share prices.

Fig. 2–11 Cash flow calculation for CVX investment.

posed by the accountant. It is a fair question, too, because at the point of discovery, the uncertainty as to the quantity and value of reserves is greatest. Fortunately, the analysis of a company does not end with the financial statements.

O&G company reserve values are not directly reflected on the balance sheet.

Another aspect of the realization concept is the accrual method of accounting for revenue and expenses. Under this method, revenue is recorded as it is earned, or is said to have accrued and does not necessarily correspond to the actual receipt of cash. This concept is important for the understanding of the statement of cash flows (SCF) and the concept of cash flow.

EXAMPLE 3-1

ACCRUAL VS. CASH. Assume that a company sold 1,000 barrels of oil for \$20 per barrel but had only received \$17,000 by the end of the accounting period. From an accrual accounting point of view, revenues are recorded as \$20,000.

Revenues	\$20,000	
Beginning Receivables	1,000	
Cash Flow Potential	21,000	
Ending Receivables	- 4,000	
Realized Cash Flow	\$17,000	= Sales less increase in receivables

The income statement would reflect \$20,000 because the accrual method of accounting realized the income at the point of sale, not at the point of actual cash exchange. The balance sheet would show the \$17,000 increase in cash as well as an increase in accounts receivable for the \$3,000 not yet received.

However, the actual cash received is \$17,000. This is why the statement of cash flows treats increases in the working capital account as a reduction in cash flows. As a business grows, the required amount of working capital also increases, and therefore, most detailed cash flow analyses include a negative adjustment for increases in working capital. (This is discussed further in chapter 4.)

Consolidated Balance Sheet			
Millions of dollars, except per-share amounts	Chevron 2000	Texaco 2000	ChevronTexaco 2001
Assets			
Cash and cash equivalents	\$1,896	207	2,117
Marketable securities	734		1,033
Accounts and notes receivable	3,837	5,583	8,279
Inventories			
Crude oil and petroleum products	631		2,207
Chemicals	191		209
Materials, supplies and other	250		532
	1,072	1,023	2,948
Prepaid expenses and other current assets	674		1,769
Deferred income and other current assets		194	
Total current assets	8,213	7,053	18,327
Long term receivables	802		1,225
Investments and advancements	8,107	6,889	12,252
Properties, plant and equipment, at cost	51,908		99,943
Less: accumulated depreciation, depletion & amortization	29,014		56,710
Net properties, plant and equipment		15,681	
Deferred charges and other assets	1,248	1,244	2,535
Total assets	41,264	30,867	77,572
Liabilities and stockholders' equity			
Short-term debt	1,079	376	8,429
Accounts payable	3,163	3,314	6,427
Accrued liabilities	1,530	1,347	3,399
Federal and other taxes on income	1,479	947	1,398
Other taxes payable	423		1,001
Total current liabilities	7,674	5,984	20,654
Long term debt	4,872	6,815	8,704
Capital lease obligations	281		285
Deferred credits and other noncurrent obligations	1,768	1,246	4,394
Noncurrent deferred income taxes	4,908	1,547	6,132
Reserves for employee benefits	1,836	1,118	3,162
Minority interests		713	283
Total liabilities	21,339	17,423	43,614
Stockholders equity			
Common stock shares issued at par value	712,487,068	567,576,504	1,137,021,057
Capital in excess of par value	534	1,774	853
Market auction preferred shares	2,758	1,301	4,811
Deferred compensation	(611)	300	
Accumulated other comprehensive income	(180)	(130)	(752)
Retained earnings	20,909	11,297	(306)
Treasury stock at cost	(3,485)	(788)	32,767
			(3,415)
Total stockholders equity	19,925	13,444	33,958
Total liabilities and stockholders' equity	41,264	30,867	77,572

Fig. 4-2 Consolidated balance sheet.