Valero Energy Corporation (VLO)

Updated May 22nd, 2018 by Aristofanis Papadatos

Key Metrics

Current Price:	$122	**5 Year CAGR Estimate:**	-1.4%	**Quality Percentile:**	N/A
Fair Value Price:	$72	**5 Year Growth Estimate:**	6.0%	**Momentum Percentile:**	N/A
% Fair Value:	169%	**5 Year Valuation Multiple Estimate:**	-10.0%	**Total Return Percentile:**	N/A
Dividend Yield:	2.6%	**5 Year Price Target**	$97	**Valuation Percentile:**	N/A

Overview & Current Events

Valero is the largest petroleum refiner in the U.S. It owns 15 refineries in the U.S., Canada and the U.K. and has a total capacity of about 3.1 M barrels/day. It also has a midstream segment, Valero Energy Partners LP, but its contribution to total earnings is less than 10% so Valero should be viewed as an almost pure play refining company.

Valero has significantly outperformed the market in the last 12 months, gaining 90% versus 14% for the S&P 500. There are two reasons for this impressive performance. First, U.S. oil production has reached an all-time high this year and is expected to grow even further in 2019. This supply glut in the domestic market has resulted in a wide spread between WTI and Brent. Consequently, Valero enjoys much higher margins than its international peers.

The other factor, which has triggered a 33% rally in less than two months, is that the government finally seems determined to reduce the biofuel blending costs of refiners. The cost has become markedly burdensome in recent years. To be sure, Valero expects its annual biofuel blending costs to rise from $750 M last year to $850 this year. In Q1, this cost "ate" 22% of its operating income. Therefore, this political development is certainly positive for domestic refiners. Nevertheless, the magnitude of the cost relief is unknown while it may take several months for all the details of the policy change to be finalized.

Moreover, it is critical to note that Valero has greatly benefited from the suppressed oil prices that prevailed until recently. When the price of oil began to collapse in 2014, the prices of oil products fell more slowly thanks to improved demand amid lower prices. As a result, refining margins greatly increased. However, thanks to the efforts of OPEC and Russia, the oil price has enjoyed a strong rally since last summer and now stands at a 3.5-year high. In addition, as OPEC and Russia will continue to support the oil price, the latter is likely to remain strong for the foreseeable future. Therefore, a major reason that boosted the refining margins in recent years is no longer in place.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	-$2.16	-$0.65	$1.62	$3.69	$3.75	$4.37	$6.85	$7.99	$4.94	$4.96	***$7.23***	***$9.67***
DPS	$0.57	$0.60	$0.20	$0.30	$0.65	$0.85	$1.05	$1.70	$2.40	$2.80	***$3.20***	***$4.50***

Thanks to the recent tax reform and the wide spread between WTI and Brent, Valero is expected to grow its EPS from $4.96 to $7.23 this year. Going forward, the company will also benefit from the expected policy change, which will reduce its biofuel blending costs. Moreover, as the management is shareholder-friendly, it is likely to continue to reduce the share count by about 4% per year, just like it has done in the last four years. On the other hand, as the oil price is likely to remain strong in the upcoming years, the refining margins do not seem to have meaningful upside. Instead they will have significant downside if the current domestic supply glut eases via an increase in exports. Refining is a highly cyclical business and it now seems to be closer to its peak than to its bottom. All in all, it is prudent to assume no more than 6.0% average annual EPS growth over the next five years, from $7.23 this year to $9.67 in 2023.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	N/A	N/A	11.5	6.7	7.2	9.2	7.5	7.7	11.9	14.3	***16.9***	***10.0***
Avg. Yld.	1.5%	3.1%	1.1%	1.2%	2.4%	2.1%	2.0%	2.8%	4.1%	4.0%	***2.6%***	***4.6%***

As Valero has almost doubled in the last 12 months, it is now trading at a P/E of 16.9, which is much higher than its 10-year average P/E of 9.5. As the stock is likely to revert towards its average valuation level in the long run, it is reasonable to expect its P/E ratio to revert to 10.0 within the next five years. In such a case, the stock will incur a 10.0% annualized drag due to the contraction of its P/E ratio.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	21.1%	6.3%	20.7%	24.0%	26.8%	22.8%	27.9%	16.1%	9.5%	9.1%	***10.0%***	***15.0%***
Debt/A	54.6%	58.6%	60.1%	61.6%	59.3%	57.8%	53.4%	51.7%	54.8%	54.3%	***54.0%***	***53.0%***
Int. Cov.	2.5	0.2	4.1	9.3	16.1	11.9	15.0	14.8	8.1	7.9	***9.0***	***10.0***
Payout	N/A	N/A	12.3%	8.1%	17.3%	19.5%	15.3%	21.3%	48.6%	56.5%	***44.3%***	***46.5%***
Std. Dev.	53.9%	44.9%	28.1%	47.4%	36.3%	41.0%	27.3%	29.6%	31.8%	16.7%	***17.0%***	***20.0%***

Refining is a cyclical business and hence all the refiners are vulnerable to recessions. This was evident in the Great Recession, when the demand for oil products greatly deteriorated and thus gasoline became cheaper than crude oil for almost three months. As a result, Valero posted losses instead of earnings in 2008 and 2009.

On the other hand, Valero has a competitive advantage over its peers, namely the high complexity of its refineries. As it has the highest Nelson Complexity Index in its group, it can benefit the most from the gyrations of the prices of oil and refined products by optimizing its blend of feedstock and products.

Nevertheless, investors should note that U.S. refiners have now lost a significant advantage of the past. During the fierce downturn of the refining sector within 2011-2013, about 20% of refineries worldwide went out of business. The domestic refiners were not affected, as they were protected thanks to the ban on oil exports that prevailed back then. However, now that the ban has been lifted, they will be more vulnerable whenever the next downturn shows up.

Final Thoughts & Recommendation

Valero has rallied 90% in the last 12 months and its positive momentum may continue in the short run, particularly given the favorable seasonality. However, despite its expected 6.0% annual EPS growth and its 2.6% dividend yield, Valero is likely to return -1.4% per year over the next five years due to a 10.0% annualized contraction of its P/E ratio. Valero is significantly overvalued at current prices. We recommend investors sell high on Valero and invest the proceeds elsewhere.

Total Return Breakdown by Year