Phillips 66 (PSX)

Updated July 30th, 2018 by Ben Reynolds

Key Metrics

Current Price:	$119	**5 Year CAGR Estimate:**	5.1%	**Volatility Percentile:**	54.1%
Fair Value Price:	$99	**5 Year Growth Estimate:**	6.0%	**Momentum Percentile:**	91.5%
% Fair Value:	120%	**5 Year Valuation Multiple Estimate:**	-3.6%	**Valuation Percentile:**	30.8%
Dividend Yield:	2.7%	**5 Year Price Target**	$132	**Total Return Percentile:**	28.8%

Overview & Current Events

Phillips 66 was spun off from ConocoPhillips in 2012. Phillips 66 operates in four segments; refining, midstream, chemicals and marketing. It is a diversified company, with each of its segments behaving differently under various oil prices. When the price of oil began to collapse in 2014, the refining segment became by far the most profitable segment, as low oil prices improved the demand for oil products and thus boosted refining margins. Despite the rally of the oil price since last summer, oil is still much cheaper than it was four years ago. As a result, the refining segment of Phillips 66 still earned as much as the other three segments combined last year.

Phillips 66 released 2 important announcements since our last update. On May 9th, the company announced a 14% hike in its quarterly dividend from $0.70/share to $0.80/share. Then, on July 27th, the company reported 2nd quarter earnings for fiscal 2018. The company realized adjusted earnings-per-share (EPS) of $2.80 in the quarter, versus adjusted EPS of $1.09 in the same quarter a year ago. Phillips 66' refinery segment accounted for 58% of company-wide earnings and grew *291% versus the same quarter a year* ago. This massive increase was driven by 100% utilization rate and significantly higher crack spreads combined with lower expenses. The company's midstream, chemical, and marketing segments grew by 100%, 34%, and -11%, and accounted for 13%, 17%, and 12% of company earnings, respectively. Phillips 66 also returned $602 million to shareholders through dividends and share repurchases, which comes to an annualized shareholder yield of 4.3% at current prices.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	----	----	----	----	$6.48	$5.92	$7.10	$7.73	$2.92	$4.58	***$7.02***	***$9.39***
DPS	----	----	----	----	$0.45	$1.33	$1.89	$2.18	$2.45	$2.73	***$3.00***	***$4.20***

As growth projects in the oil industry tend to take many years to start bearing fruit, there is a great lag between capital expenses and their resultant cash flows. Fortunately for the shareholders of Phillips 66, the company is currently in the positive phase of its cycle. While it has greatly reduced its capital expenses in recent years, it has begun to reap the benefits from its huge investments in 2014 and 2015, when it invested a total of $9.5 billion. This year, the company intends to invest only $2.3 billion, from which about half will be directed to growth and the other half to maintenance.

Thanks to the determination of OPEC and Russia, oil prices are likely to remain strong for the foreseeable future, particularly given the upcoming IPO of Saudi Aramco next year. This will benefit the midstream and the chemicals segment. Moreover, the crude oil from Canada and the Permian Basin are trading at a discount to WTI thanks to the rising output in these areas while the discount of WTI to Brent is widening for a similar reason. As a result, domestic refiners are enjoying much higher margins than their international peers. Thanks to these positive factors and the recent tax reform, we expect Phillips 66 to grow its EPS to $7.02 this year.

While Phillips 66 is highly diversified, it still operates in a cyclical sector, making long-term predictions difficult. Nevertheless, as the company has repurchased its shares at a 4% average annual rate in the last five years and has confirmed its intention to continue to repurchase its shares at a similar pace, it is reasonable to expect at least 6.0% average annual EPS growth over the next five years. If this growth rate materializes, the EPS will grow to $9.39 in 2023.

Disclosure: This analyst has no position in the security discussed in this research report, and no plans to initiate one in the next 72 hours.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	----	----	----	----	6.4	10.5	11.1	10.3	27.7	18.5	***16.9***	***14.1***
Avg. Yld.	----	----	----	----	1.1%	2.1%	2.4%	2.7%	3.0%	3.2%	***2.7%***	***3.2%***

Phillips 66's recent rally means it is now trading at a price-to-earnings ratio of 16.9, which is significantly higher than its 10-year average price-to-earnings ratio of 14.1. As it is reasonable to expect the stock to revert towards its average valuation over the next five years, the stock is likely to incur a 3.6% annualized drag due to P/E contraction until 2023.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	----	----	----	----	44.0%	38.7%	44.0%	43.8%	33.9%	33.6%	***32.0%***	***30.0%***
Debt/A	----	----	----	----	56.7%	55.0%	54.7%	50.7%	54.1%	49.6%	***53.0%***	***55.0%***
Int. Cov.	----	----	----	----	27.7	21.0	22.5	22.5	7.9	9.8	***10.0***	***11.0***
Payout	----	----	----	----	6.9%	22.5%	26.6%	28.2%	83.9%	59.6%	***42.7%***	***44.7%***
Std. Dev.	----	----	----	----	21.6%	29.3%	20.1%	26.0%	18.9%	15.2%	***15.0%***	***17.0%***

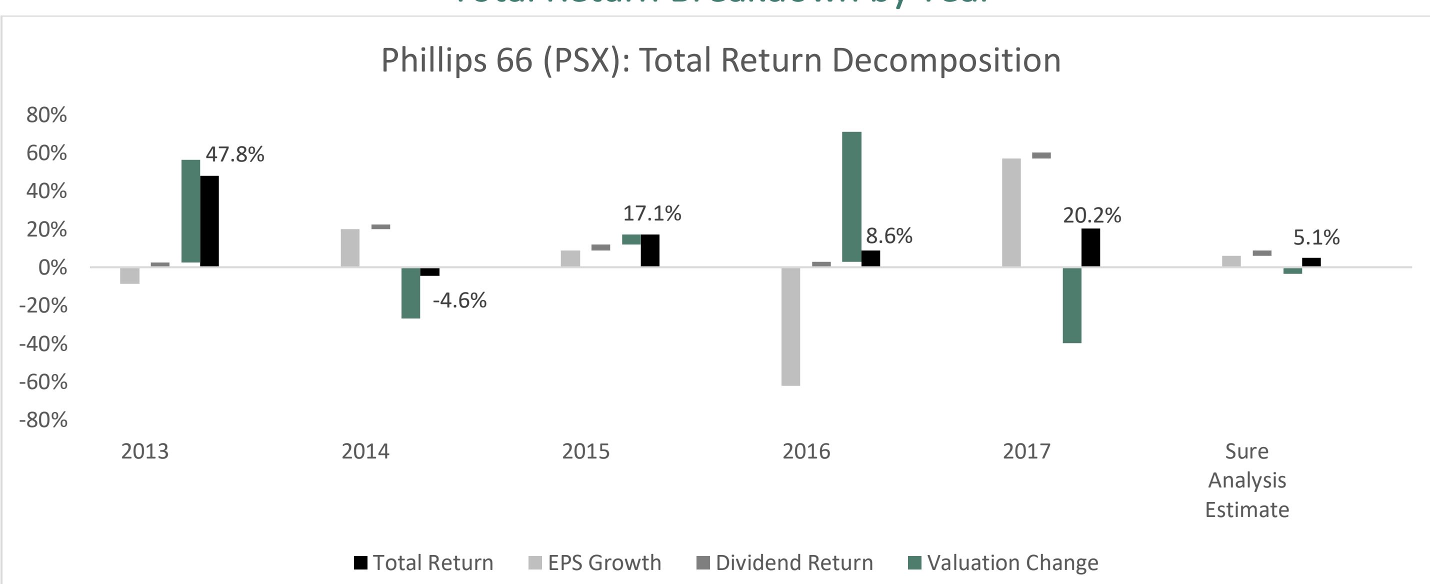
The management of Phillips 66 has repeatedly confirmed its shareholder-friendly character. It has more than doubled the dividend in the last four years while it has reduced the share count by 25% since the spin-off of the stock.

As low oil prices result in excessive refining margins, some investors may think that Phillips 66 is recession-proof. However, this is not the case. In the recent downturn of the oil sector, the low oil prices resulted in high refining margins thanks to the healthy underlying economic growth. During the Great Recession however, the price of oil products plunged along with the price of oil and resulted in low refining margins. Even worse, whenever the next recession shows up, U.S. refiners will not be protected by the ban on oil exports, which pressured domestic oil prices in the last recession. Therefore, as the next recession is likely to exert pressure on all the segments of Phillips 66, the stock will have significant downside risk in such an event, particularly given its breathless rally this year.

Final Thoughts & Recommendation

Phillips 66 is a well-managed and properly positioned for almost any scenario of oil prices. However, its 41% rally last year has significantly reduced its potential future returns. Over the next five years, the stock is likely to offer a 5.1% average annual return thanks to 6.0% EPS growth and a 2.7% dividend, which will be partly offset by a 3.6% annualized P/E contraction. This stock is a strong buy when trading at a discount to fair value, but is a hold at current prices.

Total Return Breakdown by Year



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