Valero Energy Corporation (VLO)

Updated July 27th, 2018 by Ben Reynolds

Key Metrics

Current Price:	$117	**5 Year CAGR Estimate:**	-0.5%	**Volatility Percentile:**	74.2%
Fair Value Price:	$72	**5 Year Growth Estimate:**	6.0%	**Momentum Percentile:**	97.7%
% Fair Value:	162%	**5 Year Valuation Multiple Estimate:**	-9.2%	**Valuation Percentile:**	2.8%
Dividend Yield:	2.7%	**5 Year Price Target**	$97	**Total Return Percentile:**	4.5%

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 under 10%. Valero should be viewed as a nearly pure play downstream refining business.

Valero reported 2nd quarter 2018 results on July 26th. The company reported adjusted earnings-per-share (EPS) of $2.15, *a 75% increase* versus the same quarter a year ago. The company also returned $672 million to shareholders via dividends and stock repurchases in the 2nd quarter, which translates to an annualized shareholder yield of 5.4% at current prices. The market responded favorably to Valero's quarterly results, sending shares 6.9% higher the day results were released.

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***

Refiners like Valero are not as sensitive to the *price* of oil as one might initially expect. Instead, what matters is the volume of oil they can refine, and the crack spread. The crack spread measures the difference between the price of crude oil and the price of refined petroleum products. The higher the crack spread, the more money refiners make, all other things being equal.

Due to the difficulty in predicting future crack spreads, we are maintaining our expected EPS for Valero at $7.23 for fiscal 2018. If earnings do come in above $7 per share, this will be the 2nd strongest year in Valero's corporate history, topped only by 2015. We expect Valero to generate rising EPS over full economic cycles.

Thanks to the recent tax reform and wide crack spreads, Valero is expected to grow its EPS from $4.96 to $7.23 this year. Moreover, as the management team 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. 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	***16.2***	***10.0***
Avg. Yld.	1.5%	3.1%	1.1%	1.2%	2.4%	2.1%	2.0%	2.8%	4.1%	4.0%	***2.7%***	***4.6%***

Valero stock has surged more than 70% in the last 12 months thanks to stronger than anticipated earnings. The rising share price has significantly increased the company's price-to-earnings ratio. Valero is currently trading for an earnings multiple of 16.2, 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 9.2% annualized drag due to the contraction of its P/E ratio.

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.

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 declining crack spreads. Crack spreads tightened significantly during 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 operating losses.

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. The company is also well-run and very shareholder friendly as evidenced by its long history of share repurchases. Share count has declined each year since 2010.

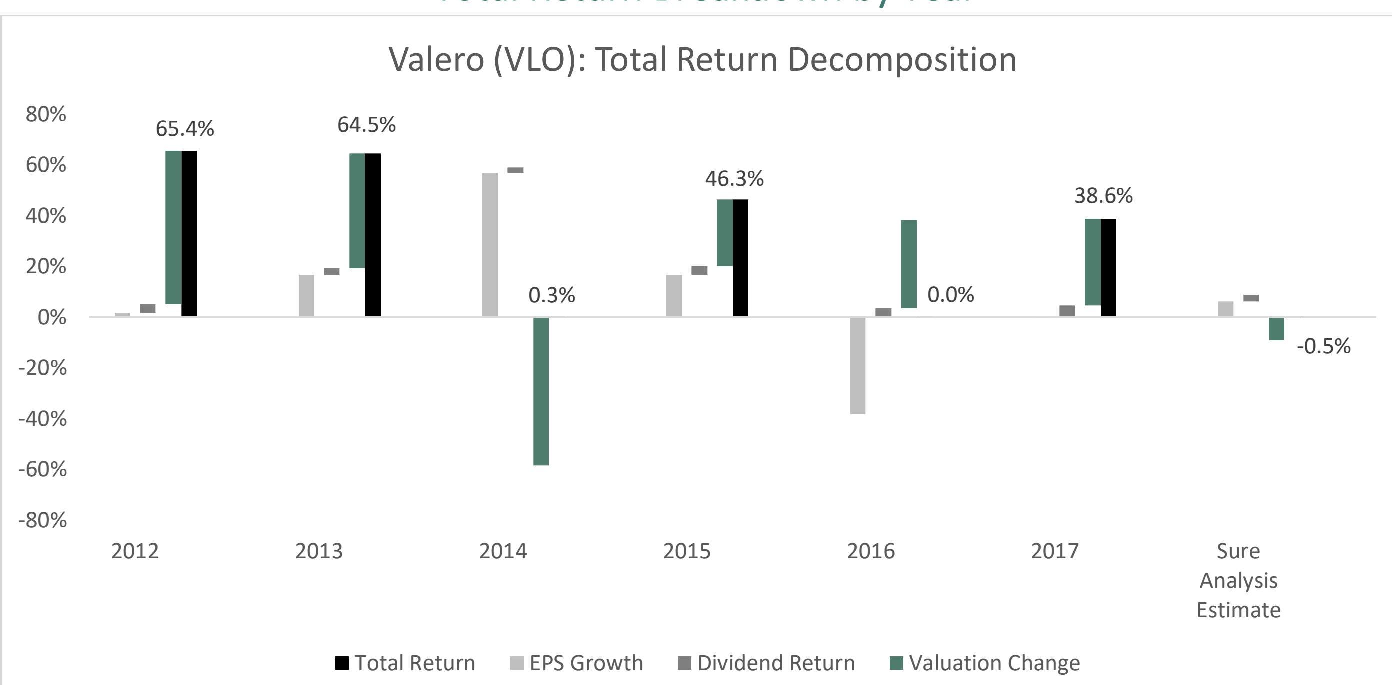
Nevertheless, investors should note that U.S. refiners have now lost a significant advantage of the past. During the fierce downturn of the refining sector within 2011-2013, about 20% of refineries worldwide went out of business. The domestic refiners were not affected, as they were protected thanks 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 ~70% in the last 12 months and its positive momentum may continue in the short run, particularly given the favorable seasonality. And there's much to like about Valero *as a business*.

However, *the* stock leaves much to be desired. Despite its expected 6.0% annual EPS growth and its 2.7% dividend yield, Valero is likely to return -0.5% per year over the next five years due to a 9.2% 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. Indeed, the stock is down since our last update *despite strong earnings results*. We believe this reflects the company's significantly overvalued status.

Total Return Breakdown by Year



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