Valero Energy Corporation (VLO)

Updated January 31st, 2019 by Aristofanis Papadatos

Key Metrics

Current Price:	$88	**5 Year CAGR Estimate:**	6.7%	**Volatility Percentile:**	80.4%
Fair Value Price:	$82	**5 Year Growth Estimate:**	3.9%	**Momentum Percentile:**	42.4%
% Fair Value:	107%	**5 Year Valuation Multiple Estimate:**	-1.3%	**Growth Percentile:**	22.0%
Dividend Yield:	4.1%	**5 Year Price Target**	$100	**Valuation Percentile:**	41.3%
Dividend Risk Score:	D	**Retirement Suitability Score:**	C	**Total Return Percentile:**	32.2%

Overview & Current Events

After the acquisition of Andeavor by Marathon Petroleum, Valero has become the second 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 completed the merger with Valero Energy Partners LP in early January. Valero and the other refiners will greatly benefit from the new international marine rules, which will come in effect from January, 2020. As per these rules, vessels that sail in international waters will be forced to burn low-sulfur diesel instead of heavy fuel oil from January 2020 onward. Diesel is more expensive than fuel oil, so the new standard will greatly benefit refiners. However, the U.S. government is trying to postpone the implementation of these rules in the U.S. so there is high uncertainty on this issue. A great part of the 27% plunge of Valero since early October can be attributed to this uncertainty. While postponement of the new rules cannot be ruled out, we feel confident that the new rules will come into effect eventually.

In late January, Valero reported (1/31/19) its financial results for the fourth quarter of fiscal 2018. The refiner smashed the analysts' earnings-per-share estimates ($2.12 vs. $1.07) thanks to a $510 million increase in refining earnings, which resulted from purchases of crude oil at opportune prices, and a 66% decrease in its biofuel blending costs, from $311 million to $105 million. The impressive cost advantage in crude oil purchases resulted from a series of pipelines projects, which gave access to cost-advantaged grades. Valero has beaten analysts' estimates for 11 consecutive quarters.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
EPS	-$0.65	$1.62	$3.69	$3.75	$4.37	$6.85	$7.99	$4.94	$4.96	$7.37	***$8.25***	***$10.00***
DPS	$0.60	$0.20	$0.30	$0.65	$0.85	$1.05	$1.70	$2.40	$2.80	$3.20	***$3.60***	***$4.60***
Shares	541	568	569	556	548	530	500	464	444	422	***407***	***340***

In our last research report (in October) we mentioned that U.S. refining margins seemed to be much closer to the peak of their cycle than their bottom. Since then, U.S. refining margins have plunged almost 50%, from about $13 to $7 per barrel. Part of the collapse can be attributed to adverse seasonality, as refining margins are much lower in the winter due to low demand for gasoline. However, refining margins are currently half of what they were last winter. While they will likely recover during the summer, their current depressed level, which has resulted from high product inventory, is concerning.

On the bright side, in the fourth quarter, Valero exhibited impressive resilience and posted earnings-per-share that were double the analysts' consensus thanks to its enhanced flexibility in purchasing cost-advantaged grades of crude oil. In fact, this level of earnings-per-share is typical of the summer season, not the winter season. Thanks to its strong momentum, its sustained share repurchases, and a possible tailwind from the new international marine rules, we expect Valero to grow its earnings-per-share to $8.25 this year and approximately $10.00 by 2024.

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.

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Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	N/A	11.5	6.7	7.2	9.2	7.5	7.7	11.9	14.3	13.8	***10.7***	***10.0***
Avg. Yld.	3.1%	1.1%	1.2%	2.4%	2.1%	2.0%	2.8%	4.1%	4.0%	3.1%	***4.1%***	***4.6%***

Valero is now trading at a P/E ratio of 10.7, which is slightly higher than our assumed fair P/E ratio of 10.0 for this stock. If the stock approaches our fair valuation estimate, it will incur a 1.3% annualized drag due to its P/E contraction.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	N/A	12.3%	8.1%	17.3%	19.5%	15.3%	21.3%	48.6%	56.5%	43.4%	***43.6%***	***46.0%***

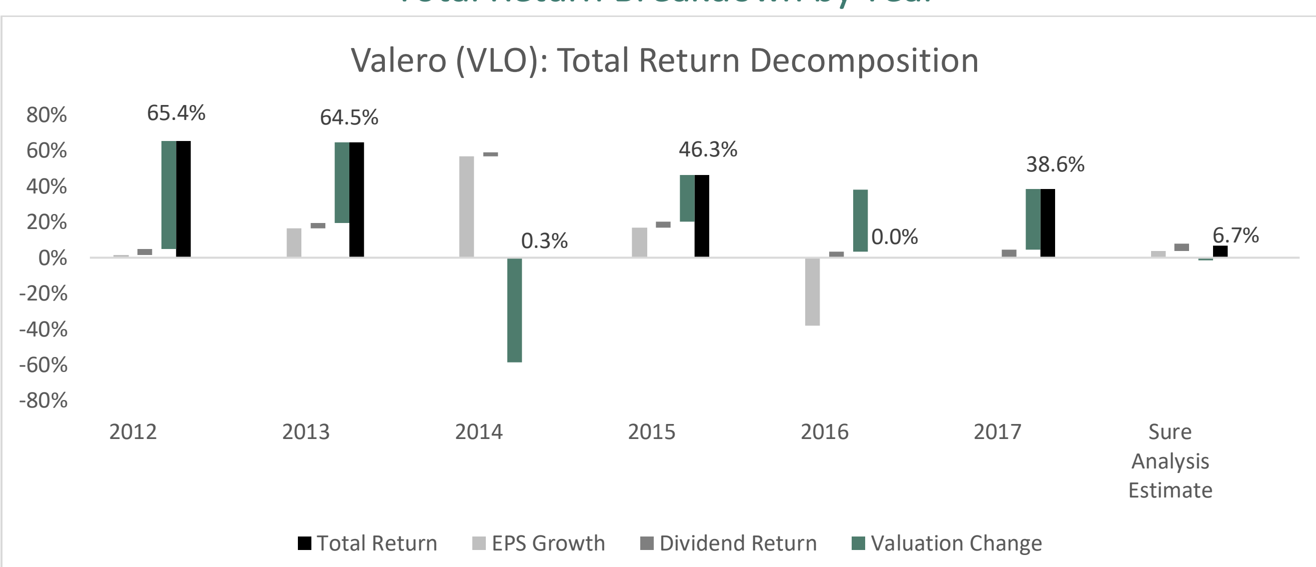
Refining is a highly cyclical business and hence all the refiners are vulnerable to declining crack spreads. Crack spreads tightened significantly during the Great Recession, when the demand for oil products greatly deteriorated and thus gasoline became cheaper than crude oil for almost three months. 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, which enables the company to benefit the most from the gyrations of oil prices and refined products by optimizing its blend of feedstock and products.

Nevertheless, investors should note that U.S. refiners have now lost a significant past advantage. 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

In our last research report, we assigned Valero a hold rating due to its somewhat overvalued status. Our thesis has played out, as the stock has gained only 2% since then despite its impressive results. According to our calculations, the stock can now offer a 6.7% average annual return over the next five years. As a result, it maintains its hold rating and may earn a buy rating if it revisits its recent lows in the $70s, which were recorded during the broad Christmas sell-off.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Revenue ($B)	113.1	64.60	82.23	125.99	138.39	138.07	130.84	87.80	75.66	93.98
Gross Profit	7260	2238	7775	10268	11908	10758	12703	7115	4391	4547
Gross Margin	6.4%	3.5%	9.5%	8.2%	8.6%	7.8%	9.7%	8.1%	5.8%	4.8%
SG&A Exp.	1327	572	531	571	698	758	724	710	715	835
D&A Exp.	1476	1527	1473	1534	1574	1720	1690	1842	1894	1986
Operating Profit	4875	305	1878	3680	5130	3957	5902	6358	3628	3599
Operating Margin	4.3%	0.5%	2.3%	2.9%	3.7%	2.9%	4.5%	7.2%	4.8%	3.8%
Net Profit	-1131	-1982	324	2090	2083	2720	3630	3990	2289	4065
Net Margin	-1.0%	-3.1%	0.4%	1.7%	1.5%	2.0%	2.8%	4.5%	3.0%	4.3%
Free Cash Flow	202	-483	1315	1683	2339	3443	2088	3993	3542	4103
Income Tax	1539	-43	575	1226	1626	1254	1777	1870	765	-949

Balance Sheet Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Total Assets	34417	35572	37621	42783	44477	47260	45550	44227	46173	50158
Cash & Equivalents	940	825	3334	1024	1723	4292	3689	4114	4816	5850
Acc. Receivable	2895	3779	4583	8366	8061	8582	5509	4105	5687	6786
Inventories	4620	4578	4947	5623	5973	5758	6623	5898	5709	6384
Goodwill & Int.	224	227	224	227	213	N/A	154	156	148	142
Total Liabilities	18797	20847	22596	26338	26382	27314	24306	22873	25319	27258
Accounts Payable	4323	5825	6441	9472	9348	9931	6760	4907	6357	8348
Long-Term Debt	312	237	822	7741	7049	6564	6386	7335	8001	8872
Total Equity	15620	14725	15025	16423	18032	19460	20677	20527	20024	21991
D/E Ratio	0.02	0.02	0.05	0.47	0.39	0.34	0.31	0.36	0.40	0.40

Profitability & Per Share Metrics

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Return on Assets	-2.9%	-5.7%	0.9%	5.2%	4.8%	5.9%	7.8%	8.9%	5.1%	8.4%
Return on Equity	-6.6%	-13.1%	2.2%	13.3%	12.1%	14.5%	18.1%	19.4%	11.3%	19.4%
ROIC	-5.5%	-12.8%	2.1%	10.4%	8.4%	10.5%	13.4%	14.2%	8.0%	13.4%
Shares Out.	524	541	568	569	556	548	530	500	464	444
Revenue/Share	215.9	119.41	144.78	221.42	248.91	251.96	246.88	175.61	163.06	211.67
FCF/Share	0.39	-0.89	2.32	2.96	4.21	6.28	3.94	7.99	7.63	9.24

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.

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