Valero Energy Corporation (VLO)

Updated July 31st, 2019 by Aristofanis Papadatos

Key Metrics

Current Price:	$85	**5 Year CAGR Estimate:**	8.4%	**Volatility Percentile:**	81.7%
Fair Value Price:	$80	**5 Year Growth Estimate:**	4.6%	**Momentum Percentile:**	11.7%
% Fair Value:	149%	**5 Year Valuation Multiple Estimate:**	-7.7%	**Growth Percentile:**	36.5%
Dividend Yield:	4.2%	**5 Year Price Target**	$100	**Valuation Percentile:**	47.2%
Dividend Risk Score:	F	**Retirement Suitability Score:**	D	**Total Return Percentile:**	41.2%

Overview & Current Events

After the acquisition of Andeavor by Marathon Petroleum, Valero – a $35 billion market cap business - 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 and the other refiners will greatly benefit from the new international marine rules, which will come in effect in January 2020. 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 much 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 some uncertainty on this issue. While postponement of the new rules cannot be ruled out, we feel confident that the new rules will come into effect eventually.

In late July, Valero reported (7/25/19) its financial results for the second quarter of fiscal 2019. While the refiner implemented major turnarounds in three refineries, it enhanced its capacity utilization from 92% in last year's quarter to 94%. However, the operating income of the refining segment fell from $1.4 to $1.0 billion due to narrower discounts of medium and heavy crude oil types to Brent. As a result, adjusted earnings-per-share fell from $2.15 to $1.51.

Although refining margins have improved in the running quarter, the lackluster margins in the first half of the year have led us to lower our earnings-per-share forecast for this year from $8.00 to $5.70. Investors should note that refiners never provide earnings-per-share guidance due to the dramatic sensitivity of their earnings to variations in margins. Despite the lackluster results of Valero, it is remarkable that the refiner has not missed analysts' earnings-per-share estimates for 13 quarters in a row.

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	***$5.70***	***$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***

Valero is likely to grow its earnings-per-share thanks to the new international marine rules, its growth projects and its meaningful share repurchases. The company successfully commissioned its new alkylation unit, which will enhance the margins of its Houston refinery, and has a promising pipeline of growth projects for the next three years. We expect the refiner to earn approximately $10.00 per share by 2024.

Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	---	11.5	6.7	7.2	9.2	7.5	7.7	11.9	14.3	13.8	***14.9***	***10.0***
Avg. Yld.	3.1%	1.1%	1.2%	2.4%	2.1%	2.0%	2.8%	4.1%	4.0%	3.1%	***4.2%***	***4.6%***

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Due to the dip in its earnings this year, Valero is now trading at a price-to-earnings ratio of 14.9, which is higher than our assumed fair price-to-earnings ratio of 10.0 for this stock. If the stock approaches our fair valuation estimate, it will incur a 7.7% annualized drag due to its price-to-earnings contraction. Investors should note that the valuation drag will be more than offset by our expected 11.9% annual earnings-per-share growth off this year's low base.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	---	12.3%	8.1%	17.3%	19.5%	15.3%	21.3%	48.6%	56.5%	43.4%	***63.2%***	***46.0%***

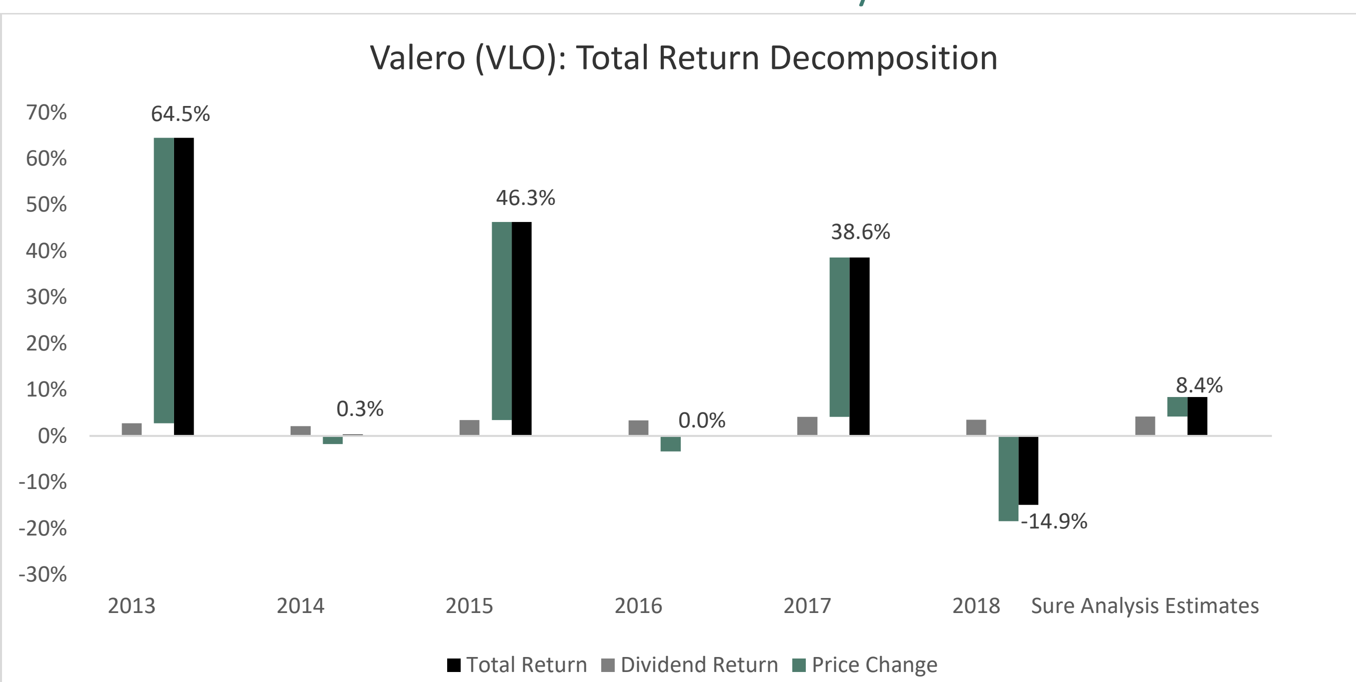
Refining is a highly cyclical business and hence all the refiners are vulnerable to declining crack spreads. Crack spreads tightened significantly during the Great Recession, when the demand for oil products greatly deteriorated and thus gasoline became cheaper than crude oil for almost three months. 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 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

Valero has promising growth prospects and could offer an 8.4% average annual return over the next five years. The market remains somewhat cautious on the implementation of the new marine standard in the U.S. If this is not postponed, the stock could enjoy a strong rally. Overall, Valero maintains its hold rating and may earn a buy rating if it revisits its 52-week 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	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue ($B)	64.60	82.23	125.99	138.39	138.07	130.84	87.80	75.66	93.98	117.03
Gross Profit	2238	3814	5785	7377	6435	8316	7115	4347	4505	5594
Gross Margin	3.5%	4.6%	4.6%	5.3%	4.7%	6.4%	8.1%	5.7%	4.8%	4.8%
SG&A Exp.	572	531	571	698	758	724	710	709	829	925
D&A Exp.	1527	1473	1534	1574	1720	1690	1842	1894	1986	2069
Operating Profit	305	1878	3680	5130	3957	5902	6358	3590	3563	4572
Operating Margin	0.5%	2.3%	2.9%	3.7%	2.9%	4.5%	7.2%	4.7%	3.8%	3.9%
Net Profit	-1982	324	2090	2083	2720	3630	3990	2289	4065	3122
Net Margin	-3.1%	0.4%	1.7%	1.5%	2.0%	2.8%	4.5%	3.0%	4.3%	2.7%
Free Cash Flow	-483	1315	1683	2339	3443	2088	3993	3542	4103	2619
Income Tax	-43	575	1226	1626	1254	1777	1870	765	-949	879

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets	35572	37621	42783	44477	47260	45550	44227	46173	50158	50155
Cash & Equivalents	825	3334	1024	1723	4292	3689	4114	4816	5850	2982
Acc. Receivable	3779	4583	8366	8061	8582	5509	4105	5687	6784	6984
Inventories	4578	4947	5623	5973	5758	6623	5898	5709	6384	6532
Goodwill & Int.	227	224	227	213	N/A	154	156	148	142	567
Total Liabilities	20847	22596	26338	26382	27314	24306	22873	25319	27258	27424
Accounts Payable	5825	6441	9472	9348	9931	6760	4907	6357	8348	8594
Long-Term Debt	237	822	7741	7049	6564	6386	7335	8001	8872	9109
Total Equity	14725	15025	16423	18032	19460	20677	20527	20024	21991	21667
D/E Ratio	0.02	0.05	0.47	0.39	0.34	0.31	0.36	0.40	0.40	0.42

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Assets	-5.7%	0.9%	5.2%	4.8%	5.9%	7.8%	8.9%	5.1%	8.4%	6.2%
Return on Equity	-13.1%	2.2%	13.3%	12.1%	14.5%	18.1%	19.4%	11.3%	19.4%	14.3%
ROIC	-12.8%	2.1%	10.4%	8.4%	10.5%	13.4%	14.2%	8.0%	13.4%	9.8%
Shares Out.	541	568	569	556	548	530	500	464	444	422
Revenue/Share	119.41	144.78	221.42	248.91	251.96	246.88	175.61	163.06	211.67	273.44
FCF/Share	-0.89	2.32	2.96	4.21	6.28	3.94	7.99	7.63	9.24	6.12

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

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