Amar Singh

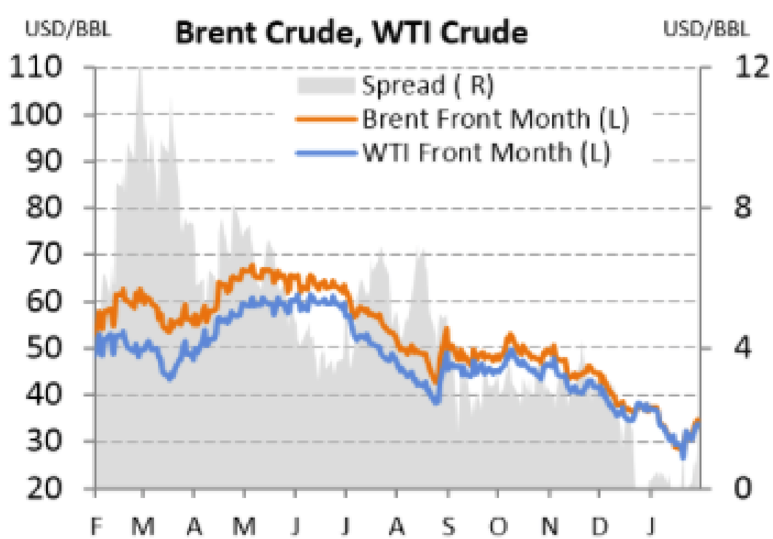
UVA Stock Pitch Competition Entry

Thesis:
Valero Energy (VLO) had a great 2015, profiting off of the increase in the spread between crude oil inputs and the 'sticky' price of refined products. This increase in crack spreads has translated into roughly a 40% increase in the price of VLO stock YOY (from ~$50 in January 2015 to ~$70 in January 2016). But this trend will quickly reverse in 2016. Over the next year, **a decrease in the price of refined products coupled with a potential rise in the price of oil will result in narrower crack spreads for VLO**. This trend will eat away at VLO's profits and put downward pressure on the company's stock over the next couple years (especially once oil prices eventually return to higher levels).

Core Pitch:
VLO's crack spread/profit margin is defined as the price of refined products less the price of crude oil. Under this definition, there are two main reasons why VLO's crack spread will narrow:

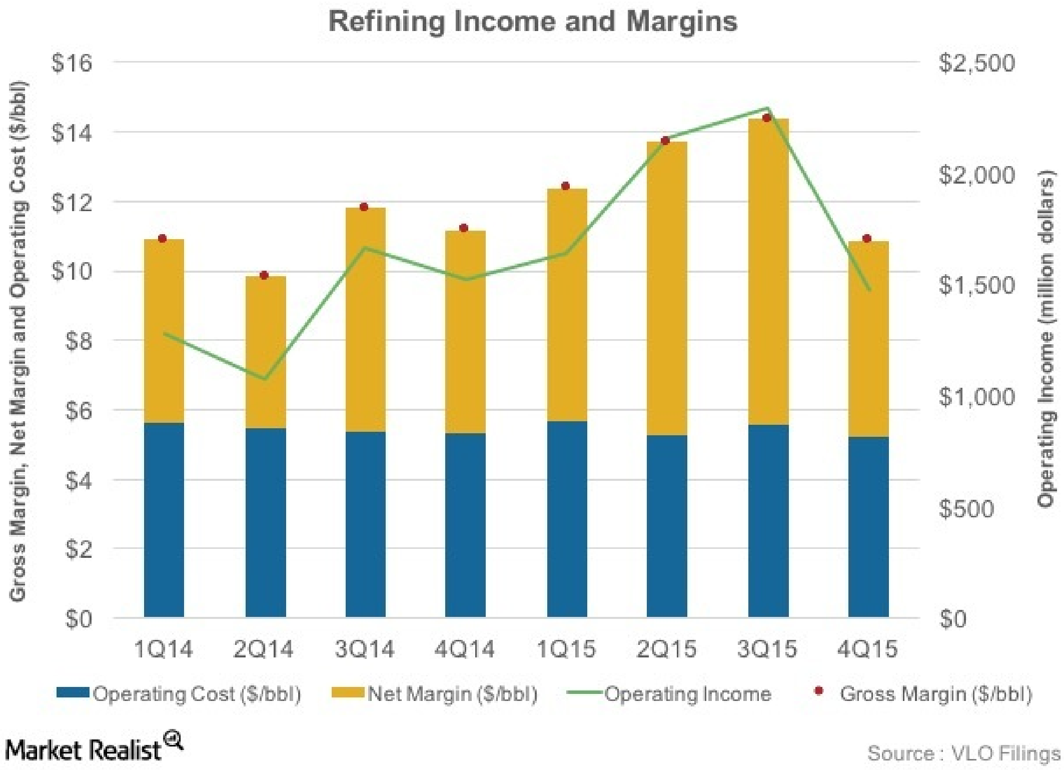
First, the price of refined products is falling and will continue to fall.
→The narrowing of the WTI-Brent spread (which can be attributed to the lifting of the US oil embargo) further squeezes crack spreads, decreasing the company's GRMs (gross refining margins).
→Competition will drive the price of refined products lower. Gas prices pose a good example of the way by which a decrease in the price of oil inputs eventually yields a decrease in refined product prices.
→Increased investment in refineries & downstream services from IOCs (integrated oil companies) yields an increase in supply, which puts downward pressure on the price of refined products.

Second, oil prices will likely either stay at current levels, or increase over the course of the next year. As long as oil prices don't decrease substantially (which is very unlikely), narrow crack spreads will be maintained by the steep decline in the price of refined products.



Crack Spreads Data:
In Q3 2015, VLO noted a rise in GRM (gross refining margin) by $2.60 per barrel to $14.40 per barrel compared to Q3 2014. Valero's peers also witnessed a rise in GRMs in Q3 2015: Marathon Petroleum Corporation (MPC), Tesoro Corporation (TSO), and Phillips 66 (PSX) saw their GRMs widen by $2.70, $5.60, and $3.10 per barrel over Q3 2014 to $17.30, $20.50, $14 per barrel in Q3 2015 respectively.

But in Q4 2015, VLO noted a fall in GRM to $10.90 per barrel compared to $11.20 per barrel in Q4 2014. With stable operating costs, the fall in GRM has led to a fall in the net refining margin by $0.20 per barrel over Q4 2014 to $5.60 per barrel in Q4 2015. The adjusted operating income from the refining segment fell by 3% over Q4 2014 to $1.48 billion in Q4 2015. I expect this trend to continue in 2016.



Other Key Developments:
In the ethanol segment, adjusted operating profit fell to $37 million from $154 million on weaker margins as ethanol prices declined while corn prices remained stable—this trend will repeat itself in VLO's other refined product areas. Overall, VLO reported a profit of $298 million ($0.62 per share) down from $1.16 billion ($2.22) a year earlier. VLO's biggest headwind is narrowing crack spreads for refined products; this problem will only worsen in 2016.

Moreover, VLO remains overly optimistic, raising its 2016 CAPEX guidance to $2.6 billion, compared with the previous CAPEX guidance of $2.4 billion. Valero Energy is specifically spending $300 million on a Houston alkylation project (a new refinery) to be completed in the first half of 2019. I believe this is irresponsible spending in light of the company's narrowing crack spreads which will translate into significantly less positive cash flow.

Crude Exposure:
Throughput volumes were reported in the following ranges: US Gulf Coast at 1.61 million to 1.66 million barrels per day; US Mid-Continent at 430,000 to 450,000 barrels a day; US West Coast at 245,000 to 265,000 barrels per day; and North Atlantic at 465,000 to 485,000 barrels per day. VLO's high exposure to WTI crude leads me to conclude that a decreasing WTI-Brent spread will hurt refining profits.

Upside Risks:
→The price of oil falls significantly from current levels.
→A Chinese economic rebound pushes the price of refined products higher on the back of increased consumer demand for distillates and gasoline. Increases in gasoline demand from India could also push prices higher.
→If recessionary fears come to fruition, low demand will contribute to the already existing supply glut in oil.

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Appendix

Fundamentals:

Current Price: $57.75		Price Target: $45	Time Horizon: 6 months
Beta: 1.06	EPS (ttm): 7.99	P/E (ttm): 7.23	PEG ratio: 0.89
P/B: 1.26	Qtrly Revenue Growth (yoy): -33%		Qtrly Earnings Growth: -74%
Book Value Per Share: $44.14			Total Debt/Equity: 33.75

Company Description: Valero Energy Corporation, through its subsidiaries, is an international manufacturer and marketer of transportation fuels, other petrochemical products and power. Valero subsidiaries employ approximately 10,000 people, and its assets include 15 petroleum refineries with a combined throughput capacity of approximately 3.0 million barrels per day, 11 ethanol plants with a combined production capacity of 1.3 billion gallons per year, a 50-megawatt wind farm, and renewable diesel production from a joint venture. Through subsidiaries, Valero owns the general partner of Valero Energy Partners LP (NYSE: VLP), a midstream master limited partnership. Approximately 7,500 outlets carry the Valero, Diamond Shamrock, Shamrock, and Beacon brands in the United States and the Caribbean; Ultramar in Canada; and Texaco in the United Kingdom and Ireland. Valero is a Fortune 500 company based in San Antonio.

For 2015 ***capital investment*** included $1.4 billion for stay-in business and $1 billion for growth. VLO returned $1 billion in cash for stockholders in the fourth quarter which included $240 million in dividend payment and $767 million for the purchase of 11.1 million shares of Valero common stock. For 2015 VLO purchased 44.9 million shares for $2.8 billion. For 2016, the company maintains a guidance of $2.6 billion for capital investments including turnarounds catalyst, joint venture and strategic investments. This consists of $1.6 billion for stay-in business and $1 billion for growth.

Q4 and Full Year Results: Reported adjusted earnings of $862 million, or $1.79 per share for the fourth quarter and $4.6 billion, or $9.24 per share. Actual net income was $298 million, or $0.62 per share, for the fourth quarter of 2015 relative to $1.2 billion, or $2.22 per share, for Q4 in 2014.

VLO approved $300 million alkylation unit at the Houston refinery, with completion expected in the first half of 2019. They also acquired a 50 percent interest in the Diamond Pipeline that will connect Cushing, OK to Memphis, TN. Previously they announced a 20% increase in the quarterly common stock dividend to $0.60 per share.

Valero ended Q4 of 2015 with $7.4 billion in total debt and $4.1 billion of cash and temporary cash investments, of which $81 million was held by VLP. The company's debt to capital ratio, net of $2 billion in cash, was 20 percent.

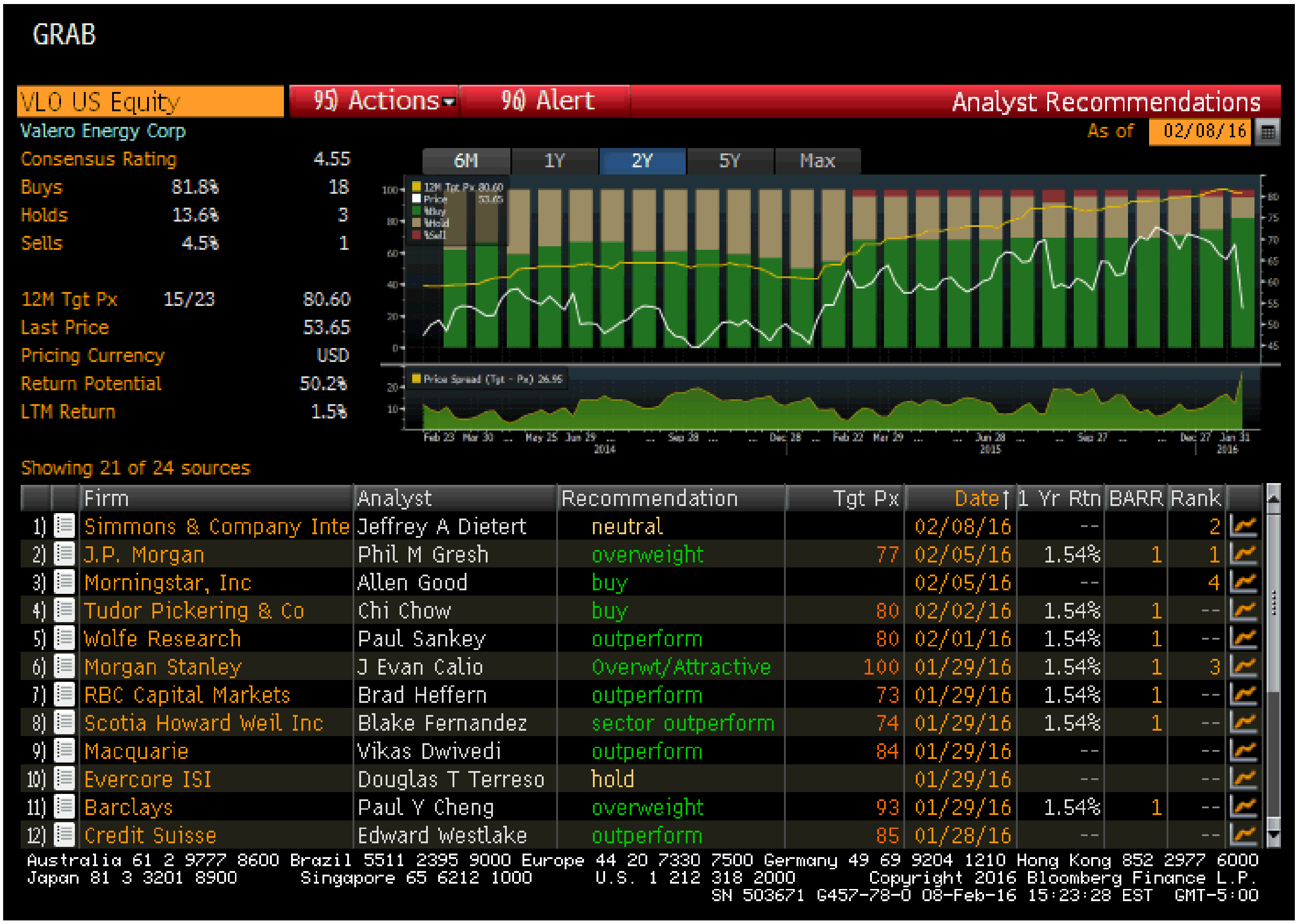
Feedstock (mb/d): Heavy Sour Crude Oil (438), Medium/light sour crude oil (428), Sweet crude oil (1, 208), residuals (274), other feedstock (140), total (2, 482)
Heavy Sour Crude Oil: 17.6%
Medium/light sour crude oil: 17.2%
Sweet crude oil: 48.7%
Residuals: 11.0%
Other feedstock: 5.64%
May not add to 100% due to rounding errors

2015 Yields (thousands of barrels per day): Gasoline and blendstocks (1, 364), Distillates (1,066), other products (408), total (2, 838)
Gasoline and blendstocks: 48.1%
Distillates: 37.6%
Other products: 14.4%

May not add to 100% due to rounding errors

<u>2015 Operating Income per Region</u> (millions of dollars): US Golf Coast (3,978), US Mid-Continent (1, 434), North Atlantic (1, 446), US West Coast (855), total (7, 713)
US Golf Coast: 51.6%
US Mid-Continent: 18.6%
North Atlantic: 18.7%
US West Coast: 11.1%
May not add to 100% due to rounding errors

<u>Total 2015 Adjusted Operating Income Breakdown</u> (millions of dollars): refining (7,713), Ethanol (192), total (7,905)
Refining: 97.6%
Ethanol: 2.4%
May not add to 100% due to rounding errors


GRAB

VLO US Equity | 95) Actions | 96) Alert | Analyst Recommendations

Valero Energy Corp

As of 02/08/16

Consensus Rating		4.55
Buys	81.8%	18
Holds	13.6%	3
Sells	4.5%	1
12M Tgt Px	15/23	80.60
Last Price		53.65
Pricing Currency		USD
Return Potential		50.2%
LTM Return		1.5%

6M 1Y 2Y 5Y Max

Showing 21 of 24 sources

	Firm	Analyst	Recommendation	Tgt Px	Date	1 Yr Rtn	BARR	Rank
1)	Simmons & Company Inte	Jeffrey A Dietert	neutral		02/08/16	--		2
2)	J.P. Morgan	Phil M Gresh	overweight	77	02/05/16	1.54%	1	1
3)	Morningstar, Inc	Allen Good	buy		02/05/16	--		4
4)	Tudor Pickering & Co	Chi Chow	buy	80	02/02/16	1.54%	1	--
5)	Wolfe Research	Paul Sankey	outperform	80	02/01/16	1.54%	1	--
6)	Morgan Stanley	J Evan Calio	Overwt/Attractive	100	01/29/16	1.54%	1	3
7)	RBC Capital Markets	Brad Heffern	outperform	73	01/29/16	1.54%	1	--
8)	Scotia Howard Weil Inc	Blake Fernandez	sector outperform	74	01/29/16	1.54%	1	--
9)	Macquarie	Vikas Dwivedi	outperform	84	01/29/16	--		--
10)	Evercore ISI	Douglas T Terreso	hold		01/29/16	--		--
11)	Barclays	Paul Y Cheng	overweight	93	01/29/16	1.54%	1	--
12)	Credit Suisse	Edward Westlake	outperform	85	01/28/16	--		--

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This is a very crowded long trade that should soon trigger an **aggressive sell-off**. This aggressive sell-off is the pitch's **main catalyst**.