Research Highlights

A weekly summary of our best ideas and developments in the companies we cover.

Morningstar Equity Research
March 5-9, 2018

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Interactive web-based models are available for our Best Ideas at Trefis.

Trump Signs Steel, Aluminum Tariffs

On March 8, U.S. President Donald Trump announced his administration's final tariff proclamation for steel and aluminum. The announcement aimed to fulfill campaign promises to revive America's steel and aluminum industries but was enacted as the result of a Section 232 investigation determining that the U.S. steel and aluminum imports represent a threat to national security. In the end, after much speculation, the U.S. will enact a 25% import tariff for steel and a 10% tariff for aluminum. The tariffs will take effect in 15 days, and their duration is indefinite as of now.

Canada and Mexico will be excluded from the tariffs because of the U.S.' "security relationships" with each country. However, these exemptions could be reversed pending the ongoing renegotiation of NAFTA. The proclamation leaves a pathway for other countries to apply for similar exemptions. U.S. Trade Representative Robert Lighthizer will be in charge of negotiating applications for these additional exemptions.

Although Trump had initially indicated that the tariffs would be applied in a blanket fashion across all trade partners, the final proclamation is consistent with our outlook that the final form would include exemptions. Therefore, our steel and aluminum price decks are unchanged since our previous update, on Feb. 19, published in the wake the Department of Commerce's release of its Section 232 investigation findings. Over the medium term, we continue to forecast that U.S. steel prices will maintain a $150 per ton premium over our estimate of the global marginal cost of production. This compares with our prior estimate for only a $100 per ton premium (which reflects typical storage and transportation costs in addition to other duties already enacted).

Accordingly, fair value estimates for the steel and aluminum companies we cover are unchanged. Future adjustments to our price deck would be required if other major steel or aluminum trade partners receive tariff exemptions.

During periods of stock price volatility across the steel and aluminum industries, we reiterate the importance of taking a long-term view. Tariffs aside, we continue to forecast materially lower steel and aluminum prices over the long term, driven by decelerating Chinese gross capital formation growth, sustained global overcapacity, and faltering cost support from declining raw material prices.

Accordingly, U.S. steelmaker and aluminum producer stocks we cover offer highly unattractive risk-adjusted return profiles. Although the Trump administration's rhetoric regarding the dangers of elevated import volumes might indicate otherwise, low-cost U.S. steelmakers have actually been generating near-record profits in recent quarters. In some cases, stressing our models in an effort to back into the expectations baked into current share prices requires us not only to sustain the heady margins achieved in recent quarters, but to assume further margin expansion for years to come.

We note that U.S. steelmaker and aluminum producer stocks we cover traded lower on March 8 when the tariff proclamation was announced. This likely stemmed from the exemptions for Canada and Mexico as well as the possibility that other countries could receive exemptions.

Canada is the largest exporter of steel to the U.S., accounting for 17% of steel imports in 2017 (6.1 million metric tons). Mexico was the fourth-largest steel exporter to the U.S. in 2017, accounting for 9% of import volumes (3.4 million metric tons). Other key steel exporters to the U.S. include Brazil, South Korea, Russia, Turkey, Japan, Germany, and Taiwan (in that order), each of which exported more than 1 million metric tons of steel to the U.S. in 2017.

Within that list, exemptions would be least likely for Russia and Turkey, given the bevy of steel trade sanctions that have already been levied against them in recent years due to illegal subsidization and dumping practices. We don't expect any additional exemptions to be made in the near future, although we would expect the Trump administration to use potential exemptions as a bargaining chip with various countries in trade negotiations. We note that, although Trump has cited China countless times as a primary offender of illegal steel and aluminum trading activities, China accounted for only 2% of steel exports to the U.S. in 2017 due to significant antidumping and countervailing duties that had already been levied in recent years (although, unofficially, more Chinese material entered the U.S. via other countries from illegal "trans-shipping" practices).

A source of additional uncertainty involves the high likelihood that various countries will appeal to the World Trade Organization that the U.S. tariffs are inconsistent with WTO statutes. If the WTO sides with the appealing countries (which it likely would, given the absence of evidence for illegal trade practices in most of the impacted countries), this would pave the way for those countries to "legally" retaliate with trade sanctions of their own against the U.S. (effectively spurring a trade war). This represents a major unintended, potential consequence of the tariff plan, although many believe that these steel and aluminum tariffs are the first of more to come across a variety of products in a number of different industries.

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Truckers' Pricing Power in High Gear, but Valuations Are Overheated

Following almost two years of anemic pricing, the truckload, or TL, shipping landscape saw a remarkable recovery in the second half of 2017. Capacity has rapidly tightened on accelerating freight demand, carriers' fleet reductions, and weather disruption. Highly constrained supply is driving a resurgence in TL carriers' pricing power—spot rates have rebounded to record levels and contract pricing won't be far behind.

We expect TL capacity to stay firm this year on the back of widespread electronic logging device, or ELD, adoption and the limited driver pool, enabling top-tier TL carriers to capitalize on an unusually strong pricing backdrop. Less-than-truckload, or LTL, carriers will also see healthy rate gains albeit to a lesser degree than the TL space (capacity isn't as tight), with help from spillover freight from the supply-constrained TL sector.

That said, throughout 2017, stock prices across the trucking space surged as spot-rates spiked, and due to optimism over U.S. tax reform. TL and LTL valuations have become quite lofty. We think the market is extrapolating carriers' strong operating performance too far out into the future. We've seen this before—trucking valuations spiked during the 2014 capacity crunch, but spent 2015 falling back down to earth as demand and pricing softened and reality set in. Once again, we would sell or avoid overvalued asset-based TL and LTL stocks despite the prospect of robust pricing conditions throughout 2018.

- ► The supply/demand balance should remain solidly in favor of large TL carriers in 2018, with incremental help from ELDs, which will temper productivity for a large swath of the carrier base.
- ► However, we would hit the brakes on many trucking stocks. TL carriers Knight-Swift and Werner, along with LTL truckers Old Dominion and ArcBest, are trading in overvalued territory, even after the recent pullback. The market seems to be overlooking the cyclicality of asset-intensive trucking stocks.
- ► Our take is that market-implied long-term performance assumptions (as reflected in stock prices) are overly optimistic, particularly in terms of pricing trends and fleet growth. Investors should keep in mind that year-over-year pricing comparisons will become very difficult by year-end 2018, and the limited driver pool will temper even the best carriers from grabbing significant volume growth by adding trucks.

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GM Set Up to Succeed Even Late in the Cycle

Although U.S. auto sales declined in 2017 year over year, we still think Best Idea GM's stock offers about 50% upside, trading in the high $30s. We see the company in a great position to succeed in two worlds: its legacy manufacturing business and the so-called Auto 2.0 world of autonomous vehicle ride hailing and mobility services. We see GM on the last stage of its multiyear product revamp, with the new generation of its most profitable vehicles, full-size pickups, entering the market late this year. This new architecture will then be used for the next-generation full-size SUVs, and Cadillac has several new models between 2018 and 2021, including three crossovers in segments in which Cadillac does not currently compete. The new-generation pickup will have launch costs this year, but offers eight models compared with five for the current generation. It should enable GM to increase its crew cab penetration and raise average transaction prices by thousands of dollars per vehicle, closing a gap with Ford's F-Series. The new platform will also last multiple product cycles, saving GM hundreds of millions or more in capital expenditure over time while delivering more profit per unit than the current generation. GM expects its Cadillac profit to roughly double by 2021 from undisclosed 2017 levels, and the brand is growing ferociously in China, with unit sales up 51% in 2017 and outselling Cadillac in the United States by about 19,000 vehicles.

GM's autonomous vehicle, or AV, efforts surprised the market when announced last fall and confirmed our longstanding opinion that Tesla, Uber, and other disruptors are not going to simply walk all over Detroit and turn it into the auto industry equivalent of Foxconn while the tech industry produces the value-added software and hardware. GM targets AV ride hailing beginning next year, which places it as one of the early leaders in AVs, the move to which we think will eventually be the most transformative event for society in the first half of this century. Over the next several years, the company will roll out improved lidar technology and in 2021 introduce a new battery platform for its battery electric vehicle AV fleet to drastically lower costs and enable profitable ride hailing, a market that can be in the multitrillion-dollar range over time.

- Transportation as a service today is only about 0.1% of vehicle miles in the U.S., but as more AVs enter the market, that percentage will only rise over time to a multitrillion-dollar market. We agree with GM management that AVs are the biggest thing since the Internet, but we think it may even be bigger because mobility affects everyone on the planet.
- We think GM is right to focus more on complex driving in San Francisco with its Cruise subsidiary rather than rack up miles mostly in suburban and closed-course driving as Alphabet’s Waymo has done. The vehicles can learn the most in a dense city, as GM’s data shows its AV fleet of 180 Chevrolet Bolts encounters special situations such as emergency vehicles up to 46 times more often in San Francisco than in suburban Phoenix. GM expands testing to New York City in 2018.
- The new-generation full-size pickup will have eight models, up from five currently, as GM seeks to increase its pricing after incentives via more crew cab penetration (GM is about 60% crew cab versus 70% for the industry) and more models in price points presently up to $55,000. This strategy is what GM should be doing, as Ford’s pickup pricing per unit of over $45,000 is a few thousand dollars above GM’s truck pricing of about $42,000, and we see no reason why GM cannot close at least some of the gap.

- One especially appealing element of GM's thesis is that 2018 is the beginning of a multiyear product launch of GM's most profitable vehicles, namely pickups, SUVs, and Cadillac. 2015 was the revamp of GM's sedans, 2016-17 was crossovers, and now it's the turn of the most lucrative parts of the lineup. It all starts late this year with the new-generation full-size pickups, and this platform will be used in 2020 for the next generation of full-size SUVs. Meanwhile Cadillac gets more crossovers starting this year with the XT4, which the brand desperately needs given Americans' love of light trucks.
- The two key 2018 launches in our opinion are the Cadillac XT4 crossover in the fall and the new generation of the Chevrolet Silverado and GMC Sierra full-size pickups due late in the year. These are some of the most profitable vehicles GM makes, and the product should be well-received by pickup-loving Americans and Cadillac customers, who currently have only one crossover, the XT5, to consider. Cadillac will then close its crossover gap through 2021 with the XT6 in 2019 and XT3 probably in 2021, as well as a new-generation Escalade SUV in 2020, according to Automotive News.
- Capital allocation for equityholders looks good to us, as GM continues to buy back its stock. Current authorization has $3.5 billion left in a total program of $14 billion. We like GM buying back its stock well below our fair value estimate. We also think the dividend is safe in a recession and, at about 4%, already yields more than the S&P 500. We do not see GM increasing the dividend before the next downturn, however, as we think the board wants it at a level sustainable throughout an economic cycle.
- New GM is far different from Old GM and is not done realizing the scale it should. Actions such as taking out $5.5 billion of costs from year-end 2014 levels, with at least another $1 billion to come by the end of 2018, much improved supplier relations, and platform consolidation have drastically lowered the firm's break-even point to enable a far healthier GM in a downturn. We think the market is still somewhat skeptical of how improved GM is and will need a downturn to believe management, but once it does we do not see GM trading at about 6 to 7 times forward earnings late in a cycle as it does now.

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Best Ideas

Interactive web-based models are available for our Best Ideas at Trefis.

Company and Industry	Morningstar Rating	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price / Fair Value	Market Cap (B)	Analyst
Basic Materials								
Cameco (CCJ)	★★★★★	$17	$9.11	High	Narrow	0.54	3.73	Inton
Compass Minerals International (CMP)	★★★★	$82	$62.75	High	Wide	0.77	2.12	Goldstein
Communication Services								
BT Group (BT.A)	★★★★	GBX 370	GBX 240.55	High	Narrow	0.65	23.87	C. Nichols
China Mobile (941)	★★★★★	HKD 110	HKD 72.2	Medium	Narrow	0.66	1478.33	Baker
Telefonica (TEF)	★★★★	$13	$8.17	High	Narrow	0.63	42.42	C. Nichols
Telstra (TLS)	★★★★	AUD 4.6	AUD 3.44	Medium	Narrow	0.75	40.91	Han
Consumer Cyclical								
Advance Auto Parts (AAP)	★★★★	$155	$115.75	Medium	Narrow	0.75	8.56	Akbari
Bapcor (BAP)	★★★★	AUD 7	AUD 5.88	Medium	Narrow	0.84	1.64	Ragonese
Bayerische Motoren Werke (BMW)	★★★★	EUR 110	EUR 84.97	High	Narrow	0.77	55.12	Hilgert
Domino's Pizza Enterprises (DMP)	★★★★	AUD 53	AUD 43.7	Medium	Narrow	0.82	3.83	Faul
General Motors (GM)	★★★★	$56	$37.84	High	None	0.68	53.00	Whiston
Great Wall Motor (2333)	★★★★	HKD 14.9	HKD 8.96	High	None	0.60	120.19	Hu
Hanesbrands (HBI)	★★★★★	$29	$19.54	Medium	Narrow	0.67	7.04	Weishaar
Mattel (MAT)	★★★★	$22.5	$15.97	High	Narrow	0.71	5.49	Katz
TripAdvisor (TRIP)	★★★★	$55	$42.45	High	Narrow	0.77	5.90	Wasiolek
Walt Disney (DIS)	★★★★	$130	$104.03	Medium	Wide	0.80	156.43	Macker
Williams-Sonoma (WSM)	★★★★	$65	$52.29	Medium	Narrow	0.80	4.40	Katz
WPP (WPP)	★★★★	GBX 1500	GBX 1230.5	Medium	Narrow	0.82	15.62	Mogharabi
Consumer Defensive								
General Mills (GIS)	★★★★	$61	$51.7	Low	Wide	0.85	29.42	Vora
Imperial Brands (IMB)	★★★★★	GBX 3900	GBX 2595.5	Low	Wide	0.67	24.75	Gorham
Kao (4452)	★★★★	JPY 8800	JPY 7662	Low	Wide	0.87	3707.35	Wei
Mondelez International (MDLZ)	★★★★	$51	$44	Medium	Wide	0.86	65.44	Lash
Procter & Gamble (PG)	★★★★	$98	$79.97	Low	Wide	0.82	201.60	Lash
Reckitt Benckiser Group (RB.)	★★★★★	GBX 7400	GBX 5752	Low	Wide	0.78	40.51	Gorham
Energy								
Cenovus Energy (CVE)	★★★★★	$21	$10.27	Very High	None	0.49	12.62	Gemino
Enbridge (ENB)	★★★★★	$64	$41.11	Medium	Wide	0.64	69.69	Gemino
Royal Dutch Shell (RDS.B)	★★★★	$76	$64.11	Low	None	0.84	264.38	Good
RSP Permian (RSPP)	★★★★	$55	$40.08	High	None	0.73	6.39	Meats
Total (TOT)	★★★★	$70	$57.19	Medium	None	0.82	145.31	Good
Financial Services								
American International Group (AIG)	★★★★	$76	$56.27	Medium	None	0.74	50.78	Horn
Assicurazioni Generali (G)	★★★	EUR 17.7	EUR 15.5	Very High	None	0.88	24.20	Heathfield
Capital One Financial (COF)	★★★★	$120	$98.15	Medium	Narrow	0.82	47.73	Plunkett
Invesco (IVZ)	★★★★	$42	$33.9	Medium	Narrow	0.81	13.80	Warren
Mitsubishi UFJ Financial Group (8306)	★★★★	JPY 880	JPY 717.1	Medium	None	0.81	9439.07	Kumagai
QBE Insurance Group (QBE)	★★★★	AUD 13	AUD 9.95	High	Narrow	0.77	13.53	Ellis
Westpac Banking (WBC)	★★★★	AUD 35	AUD 30.09	Medium	Wide	0.86	101.89	Ellis

Source: Morningstar. As of March 9, 2018

Best Ideas

Interactive web-based models are available for our Best Ideas at Trefis.

Company and Industry	Morningstar Rating	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price / Fair Value	Market Cap (B)	Analyst
Healthcare								
Allergan (AGN)	★★★★★	$263	$153.5	Medium	Wide	0.58	50.70	Waterhouse
Express Scripts Holding (ESRX)	★★★★	$92	$79.72	Medium	Wide	0.87	44.99	Lekraj
Healthscope (HSO)	★★★★	AUD 2.4	AUD 1.97	Medium	Narrow	0.82	3.42	Kallos
McKesson (MCK)	★★★★	$210	$153.98	Medium	Wide	0.73	31.77	Lekraj
Ramsay Health Care (RHC)	★★★★	AUD 82	AUD 64.11	Medium	Narrow	0.78	12.96	Kallos
Roche Holding (ROG)	★★★★★	CHF 321	CHF 229	Low	Wide	0.71	196.36	Andersen
Shire (SHP)	★★★★★	GBX 4890	GBX 3228.5	Medium	Narrow	0.66	29.40	Andersen
Industrials								
Anixter International (AXE)	★★★★	$107	$75.8	Medium	Narrow	0.71	2.52	Bernard
Beijing Enterprises Holdings (392)	★★★★	HKD 58	HKD 43.85	Medium	Narrow	0.76	55.34	Song
Brambles (BXB)	★★★★	AUD 11.2	AUD 9.42	Medium	Wide	0.84	14.99	Fleck
CK Hutchison Holdings (1)	★★★★	HKD 120	HKD 98.75	Medium	None	0.82	380.95	Tan
Fluor (FLR)	★★★★	$69	$57.17	High	Narrow	0.83	8.00	Silver
G4S (GFS)	★★★★	GBX 312	GBX 258.3	Medium	None	0.83	4.01	Field
GEA Group (G1A)	★★★★	EUR 47	EUR 38.43	Medium	Wide	0.82	6.99	Molina
Grupo Aeroportuario del Pacifico SAB de CV (GAP B)	★★★★	MXN 225	MXN 185.6	High	Wide	0.82	104.12	Higgins
Guangshen Railway (525)	★★★★	HKD 6.8	HKD 5.04	High	None	0.74	40.95	Song
Johnson Controls International (JCI)	★★★★	$53	$37.63	High	Narrow	0.71	34.85	Bernard
KION GROUP (KGX)	★★★★	EUR 86	EUR 71.16	Medium	Narrow	0.83	8.39	Molina
Royal Philips (PHIA)	★★★★	EUR 40	EUR 31.83	Medium	Narrow	0.80	29.06	Vonk
Stericycle (SRCL)	★★★★	$99	$63.81	Very High	Wide	0.64	5.46	Schoonmaker
Real Estate								
AVEO Group (AOG)	★★★★	AUD 3.1	AUD 2.69	Medium	None	0.87	1.56	Sherlock
Sun Hung Kai Properties (16)	★★★★	HKD 153	HKD 130	Medium	Narrow	0.85	376.61	Zhong
Vornado Realty Trust (VNO)	★★★★	$84	$67.62	Medium	None	0.81	12.85	Schwer
Technology								
Guidewire Software (GWRE)	★★★★	$100	$88.22	Medium	Wide	0.88	6.82	Nelson
KLA-Tencor (KLAC)	★★★	$125	$117	High	Wide	0.94	18.32	Davuluri
MYOB Group (MYO)	★★★★	AUD 4.05	AUD 3.1	Medium	Narrow	0.77	1.87	James
Qualcomm (QCOM)	★★★	$75	$61.82	High	Narrow	0.82	91.52	Davuluri
Sabre (SABR)	★★★★	$26	$22.65	Medium	Narrow	0.87	6.22	Wasiolek
Salesforce.com (CRM)	★★★★	$145	$126.36	Medium	Wide	0.87	91.27	Nelson
Synaptics (SYNA)	★★★★	$64	$48.53	Very High	None	0.76	1.67	Davuluri
TDK (6762)	★★★★	JPY 11500	JPY 9650	High	None	0.84	1217.83	Ito
Tencent Holdings (700)	★★★	HKD 492	HKD 447	High	Wide	0.91	4245.89	Tam
Utilities								
Contact Energy (CEN)	★★★★	NZD 6.2	NZD 5.35	Medium	Narrow	0.86	3.83	Atkins
Dominion Energy (D)	★★★★	$87	$72.83	Low	Wide	0.84	47.45	Fishman
FirstEnergy (FE)	★★★★	$40	$31.8	Low	Narrow	0.80	15.12	Fishman
Gas Natural SDG (GAS)	★★★★	EUR 21	EUR 18.71	Medium	Narrow	0.89	18.71	Fulop
SCANA (SCG)	★★★★★	$60	$41.2	Medium	Narrow	0.69	5.88	Miller

Source: Morningstar. As of March 9, 2018

Highlighted Stocks

Swiss Life Holding SLHN:CH

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Financial	Stable	CHF	385	337.90	Medium	None	0.88	10.78

Source: Morningstar. As of March 9, 2018

Swiss Life has been stuck in the doldrums, and the life insurance environment in Switzerland has made it increasingly difficult for the business to turn a meaningful profit.

Analyst Note, March 9, 2018

We are initiating coverage of Swiss Life with a CHF 385 fair value estimate and a stable moat rating of none. Swiss Life has been stuck in the doldrums, and the life insurance environment in Switzerland has made it increasingly difficult for the business to turn a meaningful profit. While Swiss Life is the largest life insurer in Switzerland, having taken market share lead from AXA Leben when the latter decided to stick to risk, we think there are essentially two elements within this market that will continue to make it very hard for Swiss Life to turn an economic profit.

First, Switzerland is generally viewed as a safe haven for currency, and this increases in times of political and financial uncertainty. The Swiss National Bank has managed this currency appreciation in order to combat deflation and economic pressure through low and negative interest rates. This has essentially brought compression on investment spreads as yields on 10-year Confederation bonds have declined. Though on the surface it looks to some degree like Swiss Life has been able to combat this and maintain some semblance of investment spread, the picture is misleading. What Swiss Life has actually done is combat this pressure by lowering average guarantee rates via reserve strengthening. Rates have stabilised and yields finally turned positive, but we don't expect a rate move higher from the Swiss National Bank until late in 2019. Though we think profitability will start to benefit from lower reserve strengthening.

Secondly, the Swiss pension system is built around three pillars, and of these three, pillar II is most important to life insurance companies. This is a mandatory workplace pension scheme with employers and employees contributing. The Swiss Federal Council sets minimum guaranteed interest rates and a conversion rate on the largest, mandatory, portion. This conversion rate has been reduced to 6.8% from 7.1% in 2007. However, in this low rate environment, we think this still remains too high, and life insurers are paying out pension pots for a higher and unaccounted for life expectancy. Attempts have been made to change this, but proposals have been rejected by the Swiss populace.

The overarching problem for any life insurance company is that in a low and declining rate environment, long-term savings and life protection become increasingly expensive.

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Imperial Oil IMO

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Energy	Stable	USD	35	27.34	High	None	0.78	22.61

Source: Morningstar. As of March 9, 2018

Its growth projects aren't expected to be placed into service for at least another five years, causing the market to undervalue the stock today.

Analyst Note, March 6, 2018
We are raising our fair value estimate for no-moat Imperial Oil to $35 (CAD 45) from $34 (CAD 44) on the basis of better-than-expected price realizations. With the shares trading near $27 (CAD 35), we see over 25% upside. Imperial stands at the head of its class in solvent-assisted technology development. However, its growth projects aren't expected to be placed into service for at least another five years, causing the market to undervalue the stock today.

Imperial reported fourth-quarter production of 399 thousand barrels of oil equivalent a day, flat with the year-ago quarter and slightly ahead of our expectations of 395 mboe/d. Increased production was driven by better than-expected production at Cold Lake. Imperial continues to increase reliability at Kearl, as it aims for gross production of 240 mbbl/d compared with current levels of 176 mbbl/d. Management expects 2018 production at the project to average 200 mbbl/d, an increase of 14% from the fourth quarter.

With its solvent-assisted steam-assisted gravity drainage growth projects still a few years away, Imperial is repurchasing its shares. During the quarter, the company repurchased 6.3 million shares at a cost of CAD 250 million, bringing the 2017 total to nearly CAD 630 million.

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ExxonMobil XOM

Morningstar Rating	Industry	Moat Trend	Currency	Fair Value Estimate	Current Price	Uncertainty Rating	Moat Rating	Price/Fair Value	Market Cap (Bil)
★★★★	Energy	Stable	USD	85	74.56	Low	Narrow	0.88	314.08

Source: Morningstar. As of March 9, 2018

While investors have been clamoring for greater capital discipline from integrated oils, Exxon's point of view is that it has a host of high-return projects in each of its business segments that leverage its integrated model. With the goal of increasing shareholder returns, it has decided to prioritize growth investment.

Analyst Note, March 9, 2018
ExxonMobil's analyst days are typically not newsworthy affairs, but this year was different. Breaking with integrated peers that have committed to restraining capital spending and increasing cash returns to shareholders, Exxon presented a plan to ramp up capital spending from $24 billion this year to $28 billion in 2019 and to $30 billion on average through 2025 with the goal of doubling earnings and cash flow from 2017 levels by 2025 and delivering a return on capital employed of 15% compared with 7% in 2017.

While it also committed to dividend growth closer to historical averages (5%) than last year, any specific targets including potential share repurchases, were absent. The market was disappointed, sending shares lower. While investors have been clamoring for greater capital discipline from integrated oils, Exxon's point of view is that it has a host of high-return projects in each of its business segments that leverage its integrated model. With the goal of increasing shareholder returns, it has decided to prioritize growth investment.

Incorporating the higher spending into our model and increasing our long-term growth rate assumption increases our fair value estimate to $85 from $82. Our narrow moat rating remains intact. While shares are undervalued, we see greater opportunity elsewhere in the sector.

We have long argued, and the historical returns support it, that Exxon is the highest-quality integrated overall and that its downstream and chemicals segments are key differentiators. As such, it stands to reason that it should invest to maximize those advantages. However, outside of investors having to wait to realize the benefits, at issue is that integrated oils have a spotty record of delivering on long-dated volume and return targets. Execution risk is then high. That said, Exxon is one of the better operators and developers in the world and its plan includes a high portion of operated projects, increasing the chances for success in our opinion. Also, while oil prices are likely to be volatile during the next seven years, it can cover its spending requirements and dividends at $40/bbl, ensuring their safety.

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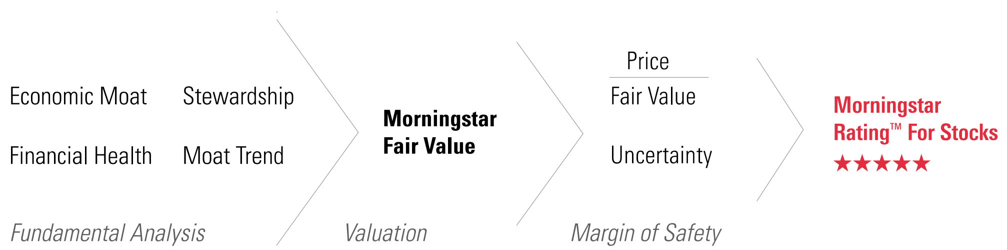
Research Methodology for Valuing Companies

Overview

At the heart of our valuation system is a detailed projection of a company's future cash flows, resulting from our analysts' research. Analysts create custom industry and company assumptions to feed income statement, balance sheet, and capital investment assumptions into our globally standardized, proprietary discounted cash flow, or DCF, modeling templates. We use scenario analysis, in-depth competitive advantage analysis, and a variety of other analytical tools to augment this process. Moreover, we think analyzing valuation through discounted cash flows presents a better lens for viewing cyclical companies, high-growth firms, businesses with finite lives (e.g., mines), or companies expected to generate negative earnings over the next few years. That said, we don't dismiss multiples altogether but rather use them as supporting cross-checks for our DCF-based fair value estimates. We also acknowledge that DCF models offer their own challenges (including a potential proliferation of estimated inputs and the possibility that the method may miss short-term market price movements), but we believe these negatives are mitigated by deep analysis and our long-term approach.

Morningstar's equity research group ("we," "our") believes that a company's intrinsic worth results from the future cash flows it can generate. The Morningstar Rating for stocks identifies stocks trading at a discount or premium to their intrinsic worth—or fair value estimate, in Morningstar terminology. Five-star stocks sell for the biggest risk-adjusted discount to their fair values, whereas 1-star stocks trade at premiums to their intrinsic worth.

Morningstar Research Methodology



Source: Morningstar.

Four key components drive the Morningstar rating: (1) our assessment of the firm's economic moat, (2) our estimate of the stock's fair value, (3) our uncertainty around that fair value estimate, and (4) the current market price. This process ultimately culminates in our single-point star rating.

Economic Moat

The concept of an economic moat plays a vital role not only in our qualitative assessment of a firm's long-term investment potential, but also in the actual calculation of our fair value estimates. An economic moat is a structural feature that allows a firm to sustain excess profits over a long period of time. We define economic profits as returns on invested capital (ROIC) over and above our estimate of a firm's cost of capital, or weighted average cost of capital (WACC). Without a moat, profits are more susceptible to competition. We have identified five sources of economic moats: intangible assets, switching costs, network effect, cost advantage, and efficient scale.

Companies with a narrow moat are those we believe are more likely than not to achieve normalized excess returns for at least the next 10 years. Wide-moat companies are those in which we have very high confidence that excess returns will remain for 10 years, with excess returns more likely than not to remain for at least 20 years. The longer a firm generates economic profits, the higher its intrinsic value. We believe low-quality, no-moat companies will see their normalized returns gravitate toward their cost of capital more quickly than companies with moats.

To assess the sustainability of excess profits, analysts perform ongoing assessments of the moat trend. A firm's moat trend is positive in cases where we think its sources of competitive advantage are growing stronger, stable where we don't anticipate changes to competitive advantages over the next several years, or negative where we see signs of deterioration.

Estimated Fair Value

Combining our analysts' financial forecasts with the firm's economic moat helps us assess how long returns on invested capital are likely to exceed the firm's cost of capital. Returns of firms with a wide economic moat rating are assumed to fade to the perpetuity period over a longer period of time than the returns of narrow-moat firms, and both will fade slower than no-moat firms, increasing our estimate of their intrinsic value.

Our model is divided into three distinct stages:

Stage I: Explicit Forecast

In this stage, which can last 5 to 10 years, analysts make full financial statement forecasts, including items such as revenue, profit margins, tax rates, changes in working capital accounts, and capital spending. Based on these projections, we calculate earnings before interest, after taxes (EBI) and net new investment (NNI) to derive our annual free cash flow forecast.

Stage II: Fade

The second stage of our model is the period it will take the company's return on new invested capital—the return on capital of the next dollar invested (RONIC)—to decline (or rise) to its cost of capital. During the Stage II period, we use a formula to approximate cash flows in lieu of explicitly modeling the income statement, balance sheet, and cash flow statement as we do in Stage I. The length of the second stage depends on the strength of the company's economic moat. We forecast this period to last anywhere from one year (for companies with no economic moat) to 10–15 years or more (for wide-moat companies). During this period, cash flows are forecast using four assumptions: an average growth rate for EBI over the period, a normalized investment rate, average return on new invested capital (RONIC), and the number of years until perpetuity, when excess returns cease. The investment rate and return on new invested capital decline until a perpetuity value is calculated. In the case of firms that do not earn their cost of capital, we assume marginal ROICs rise to the firm's cost of capital (usually attributable to less reinvestment), and we may truncate the second stage.

Stage III: Perpetuity

Once a company's marginal ROIC hits its cost of capital, we calculate a continuing value, using a standard perpetuity formula. At perpetuity, we assume that any growth or decline or investment in the business neither creates nor destroys value and that any new investment provides a return in line with estimated WACC.

Because a dollar earned today is worth more than a dollar earned tomorrow, we discount our projections of cash flows in stages I, II, and III to arrive at a total present value of expected future cash flows. Because we are modeling free cash flow to the firm—representing cash available to provide a return to all capital providers—we discount future cash flows using the WACC, which is a weighted average of the costs of equity, debt, and preferred stock (and any other funding sources), using expected future proportionate long-term, market value weights.

Uncertainty Around That Fair Value Estimate

Morningstar's uncertainty rating captures a range of likely potential intrinsic values for a company and uses it to assign the margin of safety required before investing, which in turn explicitly drives our stock star rating system. The uncertainty rating represents the analysts' ability to bound the estimated value of the shares in a company around the fair value estimate, based on the characteristics of the business underlying the stock, including operating and financial leverage, sales sensitivity to the overall economy, product concentration, pricing power, and other company-specific factors.

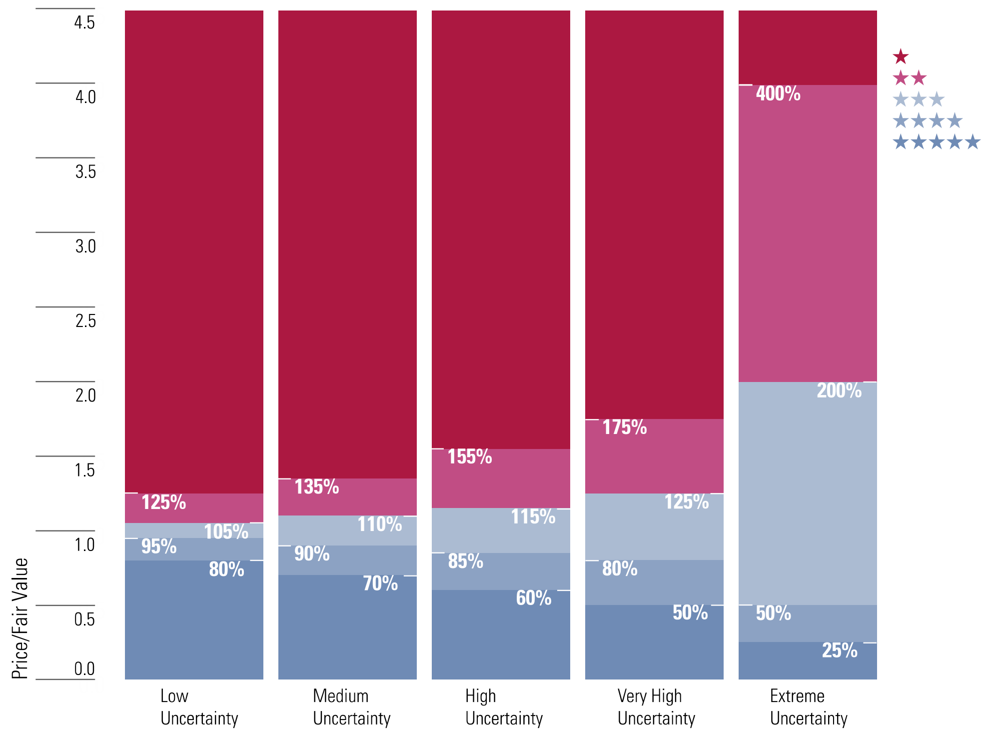
Analysts consider at least two scenarios in addition to their base case: a bull case and a bear case. Assumptions are chosen such that the analyst believes there is a 25% probability that the company will perform better than the bull case and a 25% probability that the company will perform worse than the bear case. The distance between the bull and bear cases is an important indicator of the uncertainty underlying the fair value estimate.

Our recommended margin of safety widens as our uncertainty regarding the estimated value of the equity increases. The more uncertain we are about the estimated value of the equity, the greater the discount we require relative to our estimate of the value of the firm before we would recommend the purchase of the shares. In addition, the uncertainty rating provides guidance in portfolio construction based on risk tolerance.

Our uncertainty ratings for our qualitative analysis are low, medium, high, very high, and extreme.

- Low: Margin of safety for 5-star rating is a 20% discount and for 1-star rating is a 25% premium.
- Medium: Margin of safety for 5-star rating is a 30% discount and for 1-star rating is a 35% premium.
- High: Margin of safety for 5-star rating is a 40% discount and for 1-star rating is a 55% premium.
- Very high: Margin of safety for 5-star rating is a 50% discount and for 1-star rating is a 75% premium.
- Extreme: Margin of safety for 5-star rating is a 75% discount and for 1-star rating is a 300% premium.

Morningstar Equity Research Star Rating Methodology



Market Price

The market prices used in this analysis and noted in the report come from the exchange on which the stock is listed, which we believe is a reliable source.

For more details about our methodology, please go to http://global.morningstar.com/equitydisclosures.

Morningstar Star Rating for Stocks

Once we determine the fair value estimate of a stock, we compare it with the stock's current market price on a daily basis, and the star rating is automatically recalculated at the market close on every day the market on which the stock is listed is open. Our analysts keep close tabs on the companies they follow and, based on thorough and ongoing analysis, raise or lower their fair value estimates as warranted.

Please note, there is no predefined distribution of stars. That is, the percentage of stocks that earn 5 stars can fluctuate daily, so the star ratings, in the aggregate, can serve as a gauge of the broader market's valuation. When there are many 5-star stocks, the stock market as a whole is more undervalued, in our opinion, than when very few companies garner our highest rating.

We expect that if our base-case assumptions are true, the market price will converge on our fair value estimate over time, generally within three years (although it is impossible to predict the exact time frame in which market prices may adjust).

Our star ratings are guideposts to a broad audience, and individuals must consider their own specific investment goals, risk tolerance, tax situation, time horizon, income needs, and complete investment portfolio, among other factors.

The Morningstar Star Ratings for stocks are defined below:

★★★★★ We believe appreciation beyond a fair risk-adjusted return is highly likely over a multiyear time frame. Scenario analysis developed by our analysts indicates that the current market price represents an excessively pessimistic outlook, limiting downside risk and maximizing upside potential.

★★★★ We believe appreciation beyond a fair risk-adjusted return is likely.

★★★ Indicates our belief that investors are likely to receive a fair risk-adjusted return (approximately cost of equity).

★★ We believe investors are likely to receive a less than fair risk-adjusted return.

★ Indicates a high probability of undesirable risk-adjusted returns from the current market price over a multiyear time frame, based on our analysis. Scenario analysis by our analysts indicates that the market is pricing in an excessively optimistic outlook, limiting upside potential and leaving the investor exposed to capital loss.

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