

## The Value-Creation Round-Up: Energy Sector (2007)

*Who's creating shareholder value? Who's destroying it? Why and how?*

The Energy sector rode the wave of high oil prices and strong profit margins in 2007 to create an unprecedented amount of wealth for investors. Per-barrel prices began the year in the low-\$50s, and surpassed record after record throughout the year, including a \$99.29 interday trading peak<sup>1</sup> November 21<sup>st</sup>. For the Russell 3000 Energy sector competitors, total Economic Value Added (EVA®<sup>ii</sup>) exceeded \$59 billion, representing 5.41% of total capital employed (see Figure 1). This landed Energy on top of the ten GICS sectors for the full year and marked a \$17 billion EVA improvement over the previous year.



Figure 1: EVA and EVA/ Capital by Sector

GICS SECTOR	EVA*	EVA/CAPITAL**
<b>Energy</b>	\$59,055	5.41%
Consumer Staples	\$26,251	3.38%
Materials	\$6,616	1.39%
Healthcare	-\$1,938	-0.23%
Information Technology	-\$16,541	-1.83%
Utilities	-\$24,315	-2.70%
Industrials	-\$28,868	-1.61%
Telecommunication Services	-\$45,270	-7.57%
Consumer Discretionary	-\$58,402	-3.24%

\*EVA in millions

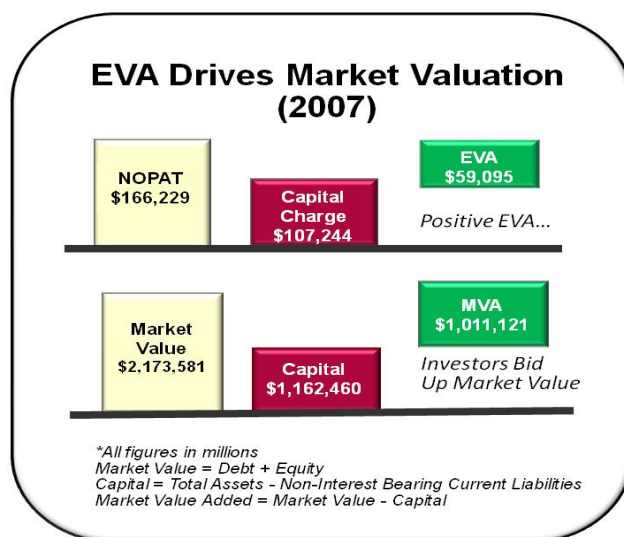
\*\*Capital measured as average of beginning and ending capital

\*\*\*Financials excluded

Economic Value Added is defined as the difference between the after-tax profits generated by the firm (Net Operating Profits After Tax, or "NOPAT") and the opportunity cost of capital employed. This means firms generating positive EVA in a given period create wealth for shareholders by earning

returns higher than required by a similar-risk investment.

Figure 2: Energy Sector Valuation (2007)

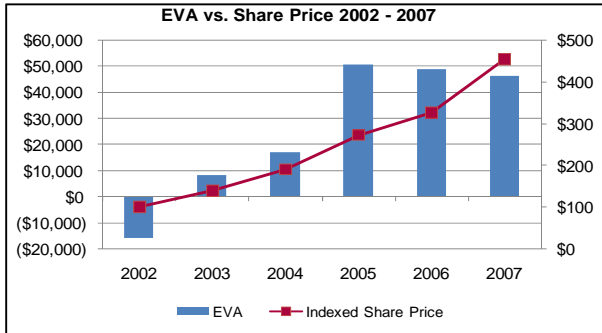


By definition, the expected long-run EVA/Capital for the economy as a whole is 0% (competition pushes the return on capital towards the cost of capital), so a 5.41% margin of wealth creation is a considerable achievement.

EVA is a particularly relevant measure for evaluating the performance of Energy firms, given the long-life nature of their assets and degree of capital intensity. And as Figure 3 demonstrates, the linkage between changes in market value and EVA growth was quite strong over the past several years for the top-10 wealth creators. This is very frequently the case across all sectors, because EVA, unlike other metrics like EBITDA and EPS, adopts an

investor's perspective in assessing performance.

Figure 3: Energy Sector EVA vs. Share Price



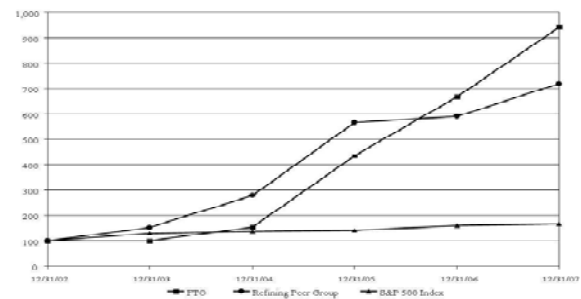
## Value Creation

It should come as no surprise to anyone that Exxon Mobil, a perennial champion of wealth creation, led the sector in EVA for the year. The company broke the US public company record it previously held for net income (\$40.6 billion vs. \$39.5 billion in 2006) and revenue (\$404.5 billion vs. \$377.6 billion in 2006). Exxon Mobil vice president Kenneth Cohen attributes the successful year to a "long-term, disciplined approach" and investments made a decade ago when oil prices were low<sup>iii</sup>; tactics consistent with long term value creation. Distributions under the company's share repurchase program totaled \$31.8 billion throughout 2007 and an additional \$48 billion over the previous two years. Such deployment of excess capital and maintenance of a target capital structure serves to increase EVA through lowering the amount and cost of invested capital.

A different winner is to be crowned for EVA *per dollar of capital employed*, essentially the spread between the return and cost of

capital. The leader in this category is Frontier Oil Corporation, a \$5 billion refining and wholesale marketing company in Houston, Texas. They have earned returns on invested capital above 40% for the past several years, and as a result their stock price has bested even the red-hot refining peer group by over 200%, itself ahead of the S&P 500 by over 600%.

Figure 4: FTO Share Price Performance



Frontier has also honed its ingenuity by employing share repurchase programs to distribute excess cash, and managed to limit the growth in operating expenses and working capital below the growth in sales throughout its expansion.

## Value Destruction

Not all competitors in the segment thrived off rising oil prices. Anadarko Petroleum Corporation destroyed \$5.4 billion of shareholder value, more than any of the other 195 companies in the group. Their Altman Z-score, a proxy for bankruptcy risk, landed below the 1.80 threshold at 1.51, signaling a high probability of default in the next two years. Also troubling is their drop in Corporate Governance Quotient<sup>iv</sup>, which at 5.84 on a scale of 100 demonstrates poor oversight by both management and directors to

protect the interests of shareholders (*note that the top-10 wealth creators for the period had an average CGQ score over 56*). The market's endorsement of management isn't exactly flattering either- the company traded just \$914 million above the book value of Capital of \$45 billion. Colorado-based Evergreen Energy also registered a low CGQ, likely for the questionable viability of their clean coal technology, and lack of disclosure surrounding the workings of their incentive plan. They fall second-to-last in the EVA/Capital rankings.

In one of the sector's biggest transactions of the year, National Oilwell Varco (NYSE:NOV) announced its acquisition of Grant Prideco on December 17<sup>th</sup>. The transaction was structured to give Grant Prideco investors \$23.20 in cash and 0.4498 shares of NOV for each of its shares, representing an acquisition premium of 22% at the time of announcement. Subsequently, NOV shares fell \$6.68 (8.71%) that day from its previous close, demonstrating that the market interpreted NOV to have overpaid. The S&P 500 was down only 1.50%, while an equal-weighted basket of peer company stocks dropped 2.11%<sup>v</sup>. Assuming NOV would have performed to the peer average that day, the deal announcement wiped out shareholder value to the tune of \$1.8 billion. Since the acquisition, the company has remained a laggard in terms

of stock performance compared to competitors. NOV ranks 18<sup>th</sup> in terms of EVA/Capital.

## **EVA and Growth**

Darden Professor Ed Hess uses EVA as a screening tool for his list of "Organic Growth All-Stars", which have exceeded the returns of investing in the S&P 500 by tenfold over a ten-year period<sup>vi</sup>. "Organic growth is growth the old fashioned way: more customers, more products, better operating efficiencies," says Professor Hess. "Organic growth represents the underlying strength and vitality of a company's business model. In contrast, there are many ways to create reportable earnings; accounting elections, valuations, income recognition changes, financial engineering, currency gains, investments, etc."

As the world struggles through a global economic crisis with no foreseeable end, the disciplined, value-oriented EVA framework will be as relevant as ever. The Economist magazine reports "No one will talk of EQ ("emotional intelligence quotient") any more. It will be EVA ("economic value added") instead... We will hear less of "vision" and much more of "value"<sup>vii</sup>.

**Figure 5: Energy sector EVA Rankings 2007**

Rank	Company	Industry	EVA	Capital	EVA/Capital	MVA	ROC	FGV	COV
1	Exxon Mobil Corp	Petroleum (Integrated)	\$17,068	\$179,027	9.53%	\$331,935	19.37%	30.58%	69.42%
2	Chevron Corp	Petroleum (Integrated)	\$4,120	\$111,264	3.70%	\$86,386	13.48%	21.84%	78.16%
3	Schlumberger Ltd	Oilfield Svcs/Equip.	\$3,443	\$18,405	18.71%	\$102,737	28.65%	55.29%	44.71%
4	Marathon Oil Corp	Petroleum (Integrated)	\$2,419	\$27,929	8.66%	\$17,809	18.06%	-15.73%	115.73%
5	Valero Energy Corp	Petroleum (Integrated)	\$1,836	\$30,284	6.06%	\$13,244	15.40%	-14.43%	114.43%
6	Occidental Petroleum Corp	Petroleum (Integrated)	\$1,695	\$29,104	5.82%	\$35,096	15.63%	27.25%	72.75%
7	Halliburton Co	Oilfield Svcs/Equip.	\$1,570	\$10,949	14.34%	\$26,495	24.15%	28.95%	71.05%
8	Apache Corp	Petroleum (Producing)	\$1,160	\$24,242	4.78%	\$13,943	13.67%	2.22%	97.78%
9	Plains Exploration & Production Co	Petroleum (Producing)	\$1,119	\$5,439	20.58%	\$465	32.18%	-98.33%	198.33%
10	XTO Energy Inc	Natural Gas (Div.)	\$996	\$14,515	6.86%	\$13,860	17.17%	13.43%	86.57%

\*EVA, Capital, and MVA in millions

**Figure 6: Energy sector EVA / Capital Rankings 2007**

Rank	Company	Industry	EVA/Capital	EVA	Capital	MVA	ROC
1	Frontier Oil Corp	Petroleum (Integrated)	41.27%	\$436	\$1,057	\$3,221	51.05%
2	Western Refining Inc	Petroleum (Producing)	27.43%	\$450	\$1,639	\$475	34.92%
3	Holly Corp	Petroleum (Integrated)	24.20%	\$184	\$762	\$1,840	34.11%
4	Cal Dive International Inc	Oilfield Svcs/Equip.	21.58%	\$143	\$661	\$804	30.90%
5	Plains Exploration & Production Co	Petroleum (Producing)	20.58%	\$1,119	\$5,439	\$465	32.18%
6	Schlumberger Ltd	Oilfield Svcs/Equip.	18.71%	\$3,443	\$18,405	\$102,737	28.65%
7	Noble Corp	Oilfield Svcs/Equip.	17.31%	\$779	\$4,501	\$10,849	27.24%
8	Bolt Technology Corp	Oilfield Svcs/Equip.	16.81%	\$8	\$48	\$139	26.91%
9	FMC Technologies Inc	Oilfield Svcs/Equip.	16.69%	\$190	\$1,136	\$6,310	26.73%
10	Abxaxas Petroleum Corp	Petroleum (Producing)	16.28%	\$19	\$115	\$133	24.89%

\*EVA, Capital, and MVA in millions

*This is the first in a series of reports analyzing the economic performance and value creation of US public companies.*

*Stern Stewart & Co. supports companies in their quest to continuously create value. Founded in New York 27 years ago Stern Stewart & Co. is now the leading international management consultancy for value management. It is our goal to help corporate executives to implement their goal to increase value in four key areas: corporate management, customer value management, organizational development, and incentive compensation.*

<sup>i</sup> Gelsi, Steve. "Triple-digit oil prices expected after 2007 records." MarketWatch. 17 Dec. 2007.

<<http://www.marketwatch.com/news/story/special-report-after-2007-records/story.aspx?guid={15E07F9D-B0F6-40D1-B95E-D60ADC29445F}&dist=hplatest>

<sup>ii</sup> EVA<sup>®</sup> is a registered trademark of Stern Stewart & Co. in the United States, Canada, Mexico, France, Australia, Germany and the United Kingdom.

<sup>iii</sup> Mufson, Steven. "Exxon Mobil's Profit in 2007 Tops \$40 Billion." The Washington Post. 2 Feb 2008: D01.

<<http://www.washingtonpost.com/wp-dyn/content/article/2007/02/01/AR2007020100714.html>>

<sup>iv</sup> The Corporate Governance Quotient (CGQ) attempts to measure the quality of corporate governance practices at public firms. For more information, visit <http://www.isscgq.com/abouttheratings.htm>

<sup>v</sup> Peer group consists of BHI, SII, WFT, OIS, GLF, and DRQ.

<sup>vi</sup> "Darden's Batten Institute Announces that Decade-Long Study of Corporate Earnings Points the Way to Outperforming Stocks." Batten Institute. 14 March 2008. <[http://www.edhlt.com/press\\_031408.htm](http://www.edhlt.com/press_031408.htm)>

<sup>vii</sup> Kellaway, Lucy. "The Year of the CFO." The Economist Nov 19, 2008.