Bottom fishers beware, refiners still priced for rather good times

Valuation perspective on four US refiners

We look at four US independent refineries VLO, TSO, FTO, and HOC, as part of an investigation for stocks which exhibit optionality, or substantial skewed upside potential. We compiled each company's current refining capacity, plus their historical capacities going back to 1998. We did the same for debt and market cap in order to create annual enterprise value estimates, one for each year. (using year-end debt, plus each year's stock price high and low)

This enabled us to examine where these companies have traded in terms of EV/Capacity from 1998 until present, both the highs and lows, and then to compare this to where their valuations are now. Such an analysis shows that US refiners are clearly not yet at any kind of trough valuations, and actually, they are still priced more expensively than the highs of each year during the 1998-2003 period, thus are priced for rather good times.

Not priced for disaster, still pricing-in a historically strong industry environment

Thus US refiners, despite their substantial share price declines in 2008, are still not priced for disaster as some might feel. In fact, US refiners still have an historically strong industry environment going forward priced-in, since they are priced as if we aren't returning to 1998-2003. Bottom fishers beware.

US Independent Refineries Historical EV/Capacity

	Valero Energy	*Tesoro Corp*	*Frontier Oil*	*Holly Corp*	
Current Stock Price	*23.3*	*13.8*	*13.3*	*18.7*	
Current EV/Capacity	**VLO**	**TSO**	**FTO**	**HOC**	
EV (US$m)	*18,275*	*3,444*	*1,733*	*1,275*	
Capacity (mbpd)	*3.070*	*0.658*	*0.182*	*0.131*	
EV/Capacity	**5,953**	**5,235**	**9,523**	**9,733**	*Higher than 1998-2003 Highs*
Performance if return to Low	*-59%*	*-57%*	*-72%*	*-82%*	
Performance if return to High	*147%*	*205%*	*223%*	*241%*	
EV/Capacity Est. Lows	**VLO**	**TSO**	**FTO**	**HOC**	
1998	2,642	3,342	4,685	2,818	
1999	2,428	2,360	2,658	2,427	*EV/Capacity Lows*
2000	2,467	2,237	2,660	1,716	*EV/Capacity Lows*
2001	3,428	4,022	2,561	2,636	*EV/Capacity Lows*
2002	4,172	3,626	3,218	3,858	
2003	3,920	3,341	3,665	3,500	
2004	4,348	3,964	3,869	4,614	
2005	5,582	5,547	5,111	7,594	*Currently Near These 2005 Lows*
2006	10,878	8,904	14,506	15,138	
2007	10,558	9,391	18,426	19,349	
2008	4,728	4,018	8,952	7,939	
EV/Capacity Est. Highs	**VLO**	**TSO**	**FTO**	**HOC**	
1998	3,709	4,283	7,934	4,985	
1999	2,713	3,654	3,167	2,821	*Current EV/Capacity Above*
2000	3,454	2,461	3,084	2,343	*is higher than the highs of the*
2001	4,416	4,553	4,689	5,597	*1998-2003 period*
2002	4,962	5,154	5,035	5,478	
2003	4,599	4,617	4,005	4,740	
2004	6,578	6,227	5,531	8,980	
2005	12,535	10,101	16,272	18,693	
2006	13,379	11,014	24,012	26,743	
2007	14,709	15,951	30,741	33,230	*EV/Capacity Highs*
2008	11,941	10,625	23,352	23,206	

Sources include Value Line, Bloomberg, SEC Filings. Note there was an HOC fiscal year change to Dec from Jul in 2002.

Why we use a broad EV/Capacity metric

Let us make clear that this EV/Capacity analysis is not meant to precisely rank individual companies against each other. Each company will of course have different mixes of refining complexity, plus other potential assets such as retail operations, pipelines, and storage facilities, which this analysis might not address.

This analysis is rather meant to merely give perspective for where US refiners have traded in terms of valuation vs. their own capacities, with each compared against themselves. If we venture to make a brief comment on relative comparisons, FTO and HOC appear to be more expensively priced than VLO and TSO based on our basic EV/Capacity metric, but seem to have a more complex mix of capacity, plus have recently increased debt for expansion of capacity. They also appear to have hit higher highs in terms of valuation in 2007, thus their apparently higher current valuations might be justified. Further relative analysis could be done by calculating complexity-adjusted capacities and then creating EV/Adj. Capacity, though this would still leave other potential assets for each company unaddressed.

For our current purposes, we find a basic EV/Capacity satisfactory as our current focus is less on relative value and more on just where these companies sit vs. their own histories, ie. where they have been. In this process we try to minimize the number of assumptions necessary, for example as might be needed for complexity adjustments to capacity. It is comforting that by our broad analysis, all four companies seem to be priced as if in the same stage of the cycle, since they are above and below their lows and highs by similar magnitudes. This gives us confidence that our broad EV/Capacity analysis is on the right track. We believe the overall argument outlined above, that still rather good times are priced-in, is very clear just by using a broad EV/Capacity metric vs. each company's own history.

Long term story indeed strong for US refining industry

We indeed acknoweledge the strong long term story for US refiners overall, in that adding capacity is extremely difficult due to not-in-my-back-yard issues and environmental regulatory issues. This undoubtedly contributed to the fact that capacity additions have lagged fuel consumption for over twenty years. Over last 10yrs US demand has grown 2% vs. refinery capacity at only 1.1% as per US EIA. Over the last twenty years, demand has grown 1.7% per year vs. only 0.6% growth in US refining capacity.

Historical CAGR (1987-2007)	**5-Yr**	**10-Yr**	**20-Yr**
US Distillate Sales	2.13%	2.02%	1.73%
US Refiner Distillation Capacity	0.77%	1.13%	0.55%
Est. Refiner Underinvestment	-1.36%	-0.89%	-1.18%

Source: US EIA

Nevertheless, a lot of this appears priced-in, despite share declines of 2008

Nevertheless, refiners do not yet appear dirt cheap nor distressed despite their fall from massive heights. They appear still priced for relatively robust demand going forward, thus in terms of stock optionality have less leverage on the upside than some of the more distressed companies where real panic has set in, and its harder to argue that they are below fair value. Surely if we return to the extreme industry valuations of 2007, then there is substantial upside to these shares, but this would be asking for more than a moderate recovery in industry fundamentals. Since industry capacity is currently being expanded as a result of recent years' strength, returning to 2007 highs seem a challenging prospect and thus US refiners don't yet offer extraordinary entry points for value investors.