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ANALYST INTERVIEW

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A Constructive Outlook for U.S. Integrated Oil, E&Ps and Refineries

EVAN CALIO — MORGAN STANLEY

EVAN CALIO is a Managing Director in equity research at Morgan Stanley and is the Lead Analyst for the integrated oil, large-cap E&P and refining industries. Prior to joining Morgan Stanley, he was energy specialist at J.P. Morgan Securities, managing energy risk and proprietary positions. Before that, Mr. Calio was an Investment Banker at Morgan Stanley in the global energy and power group and the Execution Group, primarily covering refiners, integrated oils and national oil companies.

SECTOR — ENERGY

(AGU801) TWST: Would you introduce yourself with a snapshot of your coverage universe?

Mr. Calio: I cover U.S. large-cap E&Ps. I cover the American-listed integrated oils, so **Exxon** (NYSE:XOM) and **Chevron** (NYSE:CVX), and the U.S. refiners.

TWST: How would you describe current investor sentiment on the space? What's driving that?

Mr. Calio: I think that's a very interesting question, because I think sentiment and positioning has driven a lot of the moves throughout the course of 2016. Investor sentiment has improved since earlier in this year when the group was under significant pressure. However, I think that some of the pressures that are facing a lot of our clients, whether that be from active management or relative-value hedge fund world, have clearly been challenging and remain challenging, and I think that those challenges have influenced the positioning and sentiment of the sector. So I feel that while sentiment has improved, it still doesn't feel to be a group in which there is a positive consensus outlook looking into 2017.

TWST: What would you add in terms of your own outlook on the space going forward?

Mr. Calio: You have to try to look through the fog of some challenging finance sector views. If I look at 2017, I don't believe you're going to repeat the kind of phenomenal performance that you've had from this group in 2016. Nonetheless, I do believe in our overweight sector view that you're going to outperform the S&P.

I look at the actions of OPEC and the reintroduction of the cartel, which should begin to draw global oil inventories in 2017, and I look at the 2018 period, which was always the year when we expected the inertia of the boom-era projects to cease, meaning that 2018 will be four years after the major correction in the oil price and the changed role of OPEC. It will have taken four years for the projects that were conceived — many of these oil projects are longer-term in nature — to be delivered into the market. So as we look at the 2018 period, that's when I believe the fact that very few large projects were sanctioned since 2014 will begin to bite the global supply outlook.

I think that 2017 in some ways is a transitioning year for oil inventories. But with 2018 behind it, when I think you'll be in oil supply deficit and in an environment that requires significant shorter-cycle growth, which is a concern of the market as it relates to the U.S. and the ability of the U.S. to produce into that, that sets up for a positive commodity outlook. And so as we move into 2017, we remain positive.

Again, I think there will be some tempered performance relative to a pretty phenomenal performance in 2016, but nonetheless, a sector that is producing into a commodity market that's healing, that within our coverage universe is disproportionately exposed to a U.S. resource base, which is cost advantaged in a global supply and time advantaged. Cost advantaged meaning on the lower part of the oil cost curve, but time advantaged in the sense that it's shorter-cycle, and investments can drive growth on a plus-six-to-nine-month basis. So we remain constructive for all sectors that we cover — integrated, E&Ps and refiners — into 2017.

TWST: Any thoughts on what you might expect in terms of impact from the incoming Trump administration?

Highlights

Evan Calio covers U.S. large-cap E&Ps, integrated oil companies and refineries. Mr. Calio says investor sentiment has improved on the sector, but he doesn't see a positive consensus outlook looking into 2017. He thinks there will be some tempered performance relative to a pretty phenomenal performance in 2016. Therefore, Mr. Calio is constructive on all the sectors he covers and shares his top recommendations in the current environment.

Companies discussed: Exxon Mobil Corporation (NYSE:XOM); Chevron Corporation (NYSE:CVX); Valero Energy Corporation (NYSE:VLO); PBF Energy (NYSE:PBF); HollyFrontier Corp (NYSE:HFC); Anadarko Petroleum Corporation (NYSE:APC) and Devon Energy Corp (NYSE:DVN).

There looks to be a lot of oil and gas friendly Cabinet nominations.

Mr. Calio: Let me comment from the perspective that we have written notes post the election, so it's not necessarily relating to the Cabinet proposals at this point, but in terms of your first broader question, the Trump administration, I can answer in the context of that.

A major change that's happened since 2010 has been the advent of shale and shale oil production. And from 2010 to 2014, the U.S. grew in excess of 4 million barrels a day of oil production from unconventional resource, which is the single largest amount of growth on an absolute basis of any nation. It's the availability of that resource and the potential of that resource to grow which I think does make energy independence, which is a national security as well as an economic benefit, an achievable objective. So in my view, an administration that is more supportive of a domestic energy business, an administration that will reduce some of the regulatory burden that has been incremental even during this period of significant growth — it grew despite what had been regulatory headwinds — I believe is positive for the industry.

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So at the end of the day, whether our call is correct and the outperformance of the sector is going to come down the macro factors — supply and demand and the oil price — you can't get away from that. That is the single most important factor. We've grown U.S. production, and we've had positive industry performance during administrations that have been less supportive and more supportive. It's important to put that in context. However, I think an administration that recognizes the potential of U.S. energy and what that means to our economy, and what I think had grown into a relatively significant regulatory burden in the past eight years, is positive for the industry.

I think the refining industry in particular has had some companies who have been disproportionately affected by the application of the Renewable Fuel Standard policy, as it is affected through the mechanism for compliance, which are called RINs. That has resulted in a very significant tax to **Valero** (NYSE:VLO), **PBF Energy** (NYSE:PBF) and **HollyFrontier** (NYSE:HFC). I think that this administration, as it relates to that particular subsector, is more likely to remedy the application of the RFS so that the RIN cost and RIN tax, the essential tax of the industry, will be significantly reduced.

I think tax reform, as it relates to refining, is something that will likely be a net positive. However, exactly how positive is a complicated answer. It's frankly a forecast, because it will relate to the details of the tax plan. And what I mean by that is, it's basically a 30% cash-tax-paying industry, so a lowering of the corporate tax rate would clearly be positive. However, some of these border-neutrality elements, and whether or not imported oil will be taxed or not taxed, or refined product imports will be taxed or not taxed, will affect — potentially offsetting on a positive the core profitability of the industry. So it isn't entirely clear, and it will become clear when those policy points become clear, and it really pivots on that one policy point of importing and exporting.

E&Ps aren't cash tax payers, so tax reform isn't necessarily as much of a change for that subsector. Again, the potential import tax could have some drag and a modest positive for the integrateds who are cash tax payers and also have an embedded refining business within their business mix. Overall, I think it's positive. It also is somewhat contingent upon what your interpretation of this administration means for growth, because energy is a cyclical business, and things that positively or negatively affect GDP growth will affect the macro demand. We're optimistic of what that could mean from a growth perspective, given an administration that will have a focus on lower regulation and lower taxation.

TWST: As we approach the fourth-quarter conference calls and earnings reports, what will you be paying attention to or looking for most?

Mr. Calio: As in every quarter, earnings achievability is always a focus. There are idiosyncratic elements to every stock in terms of whether or not they can beat or miss on a production or on a cash-flow basis. I think thematic across the E&P sector, there will be a focus on cost inflation. We've been through a long period, since 2014, of oilfield service cost deflation. There is speculation and comments that we are seeing the first round of cost increases that relates to pressure pumping in particular, which is a large component of well cost. So commentary about inflation and what that means to the industry cost structure, particularly in regions of the U.S. where there's expected growth, such as in the Permian Basin, I think that will be a broad thematic focus, not just in my companies' conference calls but also within the oilfield service industry in terms of when that may be witnessed or translated. That would be number one.

1-Year Daily Chart of Anadarko Petroleum Corporation

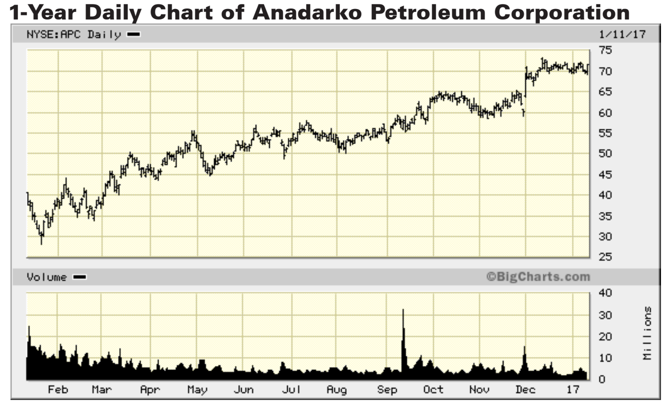

Chart provided by www.BigCharts.com

I think number two would be a similar trend. A trend since unconventionals began has been the outperformance and the continued application of technology to an unconventional resource that has improved the return profile. There are different tests to delineations, particularly in the SCOOP and the STACK and the Permian Basin, where we'd expect some continued positive momentum on well-performance-type curves and efficiencies. I think that's been a continuing trend in that that does provide some offset to my prior comments on cost inflation.

In the refining space, I'm sure the conference calls will have lots of questions for the industry, particularly because remember the conference calls will be in late January and February, so that's after the Trump administration will assume office. So there will be a lot of policy questions there as it relates to progress or dialogue or ways in which the EPA may look to regulate and/or change the point of obligation or the actual future RFS standard. The prior EPA, pursuant to the RFS, has essentially been mandating a greater amount of ethanol to be blended than can be blended by the industry, which is represented by the blend wall. Requiring more ethanol to be blended has led to some of this inflation of the RIN cost, etc. — so what's their view on whether the EPA will change that element, which is called the RVO.

I'm sure policy across all sectors will be something that's going to be focused on and something that maybe companies can provide more insight. Similarly, on the tax side, which is more complicated, I'm sure that they will have at least one question from analysts thematically on application of proposed or at least white-papered potential tax reform, and companies who have less transparency, such as repatriation holidays, how that could affect particularly the larger caps with international operations. I think there's going to be a lot, as there often is, to talk about on those diverging potential trends and how they translate to share price impact.

TWST: What are your top recommendations right now?

Mr. Calio: Among E&Ps, our top picks remain **Anadarko** (NYSE:APC) and **Devon Energy** (NYSE:DVN). In **Anadarko** it's a relative value call. In our view, the ability to deliver higher growth rate or debt-adjusted growth per share is a key driving element to forward performance, and we think that their ability to grow, particularly in the Delaware Basin, is undervalued relative to peers. My point being that **Anadarko** will be able to deliver a much higher growth rate than its current valuation implies, making it one of our top large-cap E&P selections.

Devon is disproportionately exposed to the SCOOP and the STACK, which is an unconventional play which we expect will continue to have some of the best NAV increases in 2017. It's a younger basin that's going through a delineation phase, and that faster delineation phase by the industry will provide more NAV upside. And as that basin, as well as their Delaware Basin, shifts into development mode in 2018, it's our view that the Street is significantly underestimating their growth potential and hence their value. In 2017, we expect for **Devon** to have continued NAV upside from the delineation of SCOOP/STACK, but maybe around midyear the market will focus on the forward year, which will be 2018, and we think their growth deliverability versus the consensus is significantly higher. So there are our top two large-cap stock picks in E&Ps.

Within the majors, **Chevron** remains our top pick, where we expect the single largest free-cash-flow inflection relative to the major oil peers. **Chevron** has the largest number of projects that are coming into the market. These are projects that they have invested in over a long period of time, the last five-plus years, that are going to begin production. So the free-cash-flow inflection is the capex rolling off, the production starting up, and with that large free-cash inflection amongst majors, we expect the recycle into their Permian Basin position, which is the most differentiated amongst the majors, to drive better dividend growth prospects and dividend coverage ratios relative to peers. So it's a combination of projects working through the portfolio and the free cash flow being invested into a relatively differentiated higher-return/shorter-cycle growth asset in Texas.

TWST: Are there any areas that you're more cautious about right now?

Mr. Calio: There are always concerns. I think from a macro context, the market remains concerned about potential U.S. oil production growth and the ability of that growth to oversupply the market, to tip the market. That's something that we watch. But we think it's a reasonably prescribed amount in 2017, given the time lag that it takes for production to get into the market and given the ability to fund that growth in 2017.

And from the other side, whether or not OPEC complies with announced cuts, there is clearly concern around the commodity. We're not on the floor for equities, so it does create a risk/reward skew that has some risk to the outlook, but that is not necessarily a specific concern. **Exxon** has a relatively richer valuation relative to its peers, so it's something where we see relatively less upside.

TWST: Any final thoughts or advice to wrap up?

Mr. Calio: I think there has been a lot of change in 2016, and I think investors have become pretty fatigued given the volatility and the real change in some of the circumstances throughout 2016. But I think when people settle into early 2017, the outlook for energy is going to be more constructive, and there's still some allocation that should follow that outlook. We remain constructive. People are clearly going to be watching the oil markets, and the U.S. production response is largely viewed as the swing producer in this market. That was a key debate in 2016, and I think will remain a key debate and focus into 2017.

TWST: Thank you. (MN)

Note: Opinions and recommendations are as of 12/14/16.

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