ConocoPhillips

NYSE:COP

Analyst: Patrick Donovan
Sector: Energy

SHORT

Price Target: $34.00

Key Statistics as of 5/7/16

Market Price:	$42.76
Industry:	Oil, Gas and Consumable Fuels
Market Cap:	$59.08B
52-Week Range:	$31.05-68.36
Beta:	1.09

Thesis Points:

- Massive 1Q losses will result in yearlong struggles for management
- Reduced budget and credit line will cut dividends further and drive down enterprise value
- Drastically reduced oil rig fleet will cut down on production and further diminish the firms earnings this year

Company Description:

ConocoPhillips was created in 2002 as a merger between Conoco Inc. and Phillips Petroleum Co. and is headquartered in Houston, Texas. Conoco was founded in 1875 and has been in the same industry ever since. The firm primarily explores for and produces natural gas, crude oil and other fuels all around the world. The company operates largely out of North America and Canada, but produces from assets in Europe, Asia and Australia as well. In the past decade the firm has widely changed its practices to include more unconventional exploration projects. ConocoPhillips is the world's largest independent pure-play exploration and production company.

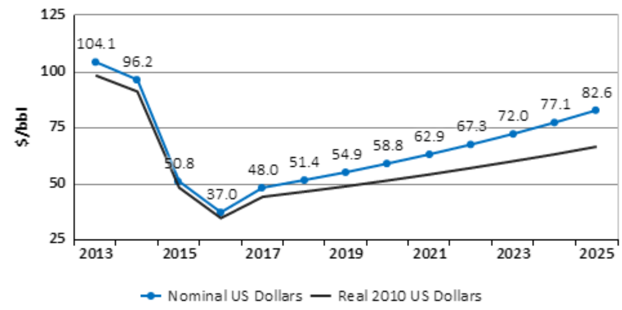
Thesis

ConocoPhillips is the world leader in independent oil and gas exploration and production. Over the past year, a decline in commodity prices has left the company exposed to losses due to decreased sales, challenges in production, and a serious cash flow problem. In the first quarter of 2016 COP suffered losses totaling $1.2 billion. To compare, last year in 1Q the firm reported losses of $222 million, since then the stock has returned roughly -30%. Management is awash with problems and a serious lack of cash flow may be their most dire. Without a sufficient cash flow management will be unable to satisfy the $29 billion dollars of long term debt the firm has managed to amass. In their most recent earnings call many questions were presented to the team regarding how they would deal with the heightened debt, especially considering management's target of no greater than $25 billion in long term debts. The best way to summarize their response would be dismissive. They referred to this is a medium-term problem and could not provide specifics. In order to attempt to cope with the lack of cash flows, the management team decided to once again look to debt. The firm acquired an additional $4.5 billion from the available credit line of $7 billion. With this being only the first quarter of 2016 and cash flows still looking uncertain, management has used more than half of the available debt capacity. This puts COP in a dangerous place, potentially exposing the firm to significant losses over the remainder of the year. Even if the rise the market value of oil continues to occur, there is very good reason to believe that ConocoPhillips has already incurred too much capex this year and will have to record massive losses. The firm will be unable to sustain the already severely reduced dividends, and may have to cut them all together during this year's remaining three quarters. Finally, the firms North American oil rig fleet, specifically the unit's operating within the 48 contiguous United States, has been reduced from 13 at year end 2015 to only 3 at the end of 1Q 2016. Production from U.S. based facilities has dropped 3% YoY, however look for that number to drop more significantly over the next three quarters.

Industry Outlook

Although there has been positive outlook for many of the firms in the exploration and production industry, ConocoPhillips has been the unfortunate victim of its size. Smaller firms, focusing more minutely on one specific resource such as natural gas or crude oil, are able to more thoroughly protect themselves against the dangers of a lower oil price. Focus allows them to more effectively mitigate against risk in the price of that commodity. According to their most recent earnings call, COP will be unprofitable on average, meaning across all of their business ventures, until oil hits $60 per barrel. Below is a graph showing the World Bank's forecast for crude oil price per barrel. It illustrates that analysts there believe it could take as long as 4 more years to see such a value.

World Bank: Crude oil, $/barrel



Source: World Bank Commodity Forecast Price Data, January 2016

World Bank: Crude oil, $/barrel

	2014	2015	2016	2017	2018	2019	2020	2025
Nominal US Dollars	96.2	50.8	37.0	48.0	51.4	54.9	58.8	82.6
Real 2010 US Dollars	90.9	48.0	34.4	43.9	46.2	48.6	51.2	66.3

Displayed in the price chart on the page above, ConocoPhillips has been fairly volatile within the industry over the past 2 years. According to the management team that $60 per barrel is necessary to make the business profitable again, which multiple analysts at Bloomberg believe could bring cash flows positive again, up to a potential billion dollars quarterly.

Segment Analysis

ConocoPhillips operates only one revenue bearing segment, Exploration and Production. It has been a consistent $50+ billion dollar per year segment for their business for several years, however in 2015 the firm recorded a drop in revenue of nearly 44%. Obviously the significant decline in value of crude oil played a huge role in that, however management decisions and especially risk hedging tactics have been questionable. At year end 2015 the firm was operating 13 oil rigs in the 48 contiguous United States, since then they have closed 10. One of the subdivisions of exploration and production is bitumen. Bitumen is a viscous mixture that is either naturally occurring, thus the necessity for mining, or as a residue from petroleum distillation. In the case of ConocoPhillips, this a relatively new venture and it has proven to be challenging to see profits. They have yet to net a return from their bitumen projects, analysts at Morningstar highlight that other firms have taken years to turn a profit on the material and most have had to open refining plants to do so, as the raw product is not ready for use in applications such as road surfacing and roofing.

Management

To focus on solely the errors of the management team in recent history would be unfair, as many of the decisions made by some of the current team have likely contributed to the success of COP in the long term. With that being said, the odds of the firm being unable to recover from this stumble are slim, however I believe it will take multiple years for such a rebound. Management has failed to prepare for a long term decline in the value of crude using hedging methods or diversification in the business. For decades there has been little reason to believe that the worlds' largest firm in the industry would end up in financial distress. Management has struggled to find ways to keep the production supply levels neutral, which is further hurting the firm because the issue requires a steady flow of cash. Cash, which at this point is being borrowed at a frightening rate from investor's perspective, seeing as more than half of the yearly borrowing capacity has been utilized one quarter in.

Porters Five Forces

Porters' five forces model is a useful analysis when comparing a company to the remainder of the industry. In the case of COP, the company has been an industry leader for many years and because of this they have unique advantages within their group of peers.

Barriers to Entry: High

In the oil and gas exploration and production business the barriers to entry are particularly high. In recent years Conoco has spent upwards of $100 billion on cost of goods sold annually, no small ticket for a new player in the industry. In order to compete reasonably a firm entering into the exploration and production arena would require massive funds.

Bargaining Power of Suppliers: Medium

ConocoPhillips is in the position at this point of operations that it has vertically integrated itself quite effectively. The company requires very little in terms of supplies from any outside organization, the majority of inputs, repairs, service parts etc.. are taken care of in house. Based on this, some suppliers who provide technical support, especially on advanced pieces of technology, can wield some power based on their expertise and unique focus.

Bargaining Power of Buyers: Low

At the end of the day the market determines the price of most of ConocoPhillips products, but the price of oil is the main contributor to costs in the industry. This means that when it costs more for COP and others to produce oil the price in the market will increase, buyers are essentially forced to pay the price because there is not yet an effective substitute for oil products as power sources.

Threat of Substitutes: Low

Within the industry there is very little threat in the near term of substitutes for oil products. ConocoPhillips certainly has a threat from other E&P firms, however this is minute. It would be very unlikely that even with the struggles the firm is currently enduring management would be unable to recover and continue leading the industry.

Intensity of Rivalry: Medium

Being the industry leader obviously has its perks and COP takes advantage of them. With a huge portion of sales being on contract within fairly rigid geographic territories, competition amongst other producers is not extreme. Of course there exists competition but the reality within the industry is that brand name and price are the only contributing factors to a customer's choice between options.

To summarize Porter's Five Forces, COP is in a fairly advantageous position within the industry. Despite going through a rough time financially, operationally the firm is very sound and will be able to last the storm.

Conclusion

As I have mentioned multiple times within the article, ConocoPhillips is obviously a highly experienced company with no real danger of complete failure. I do believe, however, that within the 6-12 month range the firm will continue to suffer losses similar to the first quarter of 2016. Just over 64% of borrowing capacity has been exercised in the first quarter, and close to half of that was used to pay dividends. Clearly the firm will have to cut dividends in the quarters to come. With production decreased as well it seems highly likely that management will have to endure significant losses throughout the year. I expect ConocoPhillips to drop in value for the 6-9 month term and recommend a short sell for that duration. Since first beginning my research on COP the stock value has decreased by roughly 10%, I see this trend continuing and based on Proforma DCF valuation combined with peer group analysis I am targeting a 1yr price of $34.00.

ConocoPhillips (COP)

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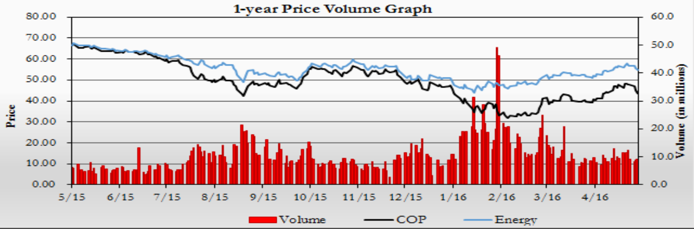
NEUTRAL

Analysis by Patrick Donovan	Current Price:	$42.76	Intrinsic Value	$22.42	Target 1 year Return: -16.44%
5/7/2016	Divident Yield:	4.0%	Target Price	$34.00	Probability of Price Increase: 40.33%

1-year Price Volume Graph



Description

ConocoPhillips explores for, produces, transports, and markets crude oil, bitumen, natural gas, liquefied natural gas, and natural gas liquids worldwide.

General Information

Sector	Energy
Industry	Oil, Gas and Consumable Fuels
Last Guidance	November 3, 2015
Next earnings date	July 27, 2016
Estimated Country Risk Premium	7.10%
Effective Tax rate	33%
Effective Operating Tax rate	11%

Market Data

Market Capitalization	$52,953.44
Daily volume (mil)	8.15
Shares outstanding (mil)	1238.39
Diluted shares outstanding (mil)	1242.86
% shares held by institutions	68%
% shares held by investments Managers	59%
% shares held by hedge funds	0%
% shares held by insiders	0.09%
Short interest	1.55%
Days to cover short interest	1.64
52 week high	$67.20
52-week low	$31.05
Levered Beta	1.33
Volatility	29.97%

Past Earning Surprises

Quarter ending	Revenue	EBITDA
3/31/2015	-31.30%	-18.80%
6/30/2015	-11.58%	-7.74%
9/30/2015	-11.39%	-50.66%
12/31/2015	-25.62%	-76.19%
3/31/2016	-19.49%	-18.38%
Mean	-19.88%	-34.35%
Standard error	3.9%	12.7%

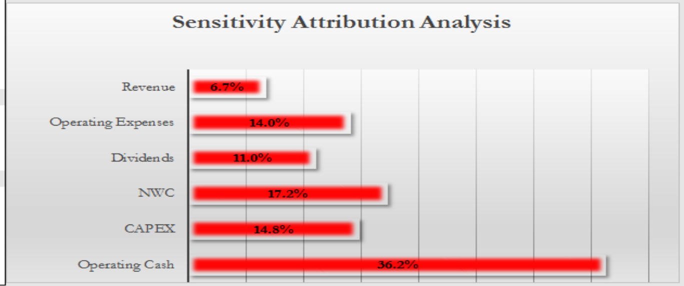
Peers

Devon Energy Corporation
Occidental Petroleum Corporation
Marathon Oil Corporation
Murphy Oil Corporation
EOG Resources, Inc.
Anadarko Petroleum Corporation
Chevron Corporation
Apache Corp.

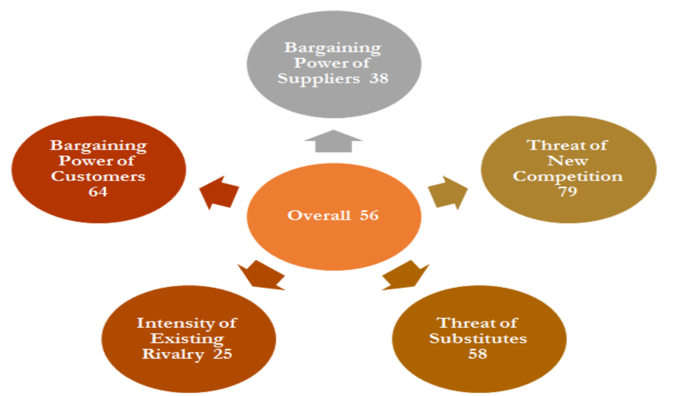
Management	Position	Total compensations growth	Total return to shareholders
Lance, Ryan	Chairman, Chief Executive Of	34.95% per annum over 5y	1.29% per annum over 5y
Wallette, Donald	Chief Financial Officer and	-3.42% per annum over 3y	2.71% per annum over 3y
Fox, Matthew	Executive Vice President of	-18.06% per annum over 3y	2.71% per annum over 3y
Hirshberg, Alan	Executive Vice President of	-10.01% per annum over 5y	1.29% per annum over 5y
Sheets, Jeffrey	Executive Officer	16.5% per annum over 5y	1.29% per annum over 5y
DeSanctis, Ellen	Vice President of Investor R	N/M	N/M

Profitability	COP (LTM)	COP (5 years historical average)	Industry (LTM)
ROIC	-6.9%	7.14%	-0.84%
NOPAT Margin	-12%	5.68%	-7.7%
Revenue/Invested Capital	0.56	1.26	0.11
ROE	-8.8%	5.55%	-3.11%
Adjusted net margin	-15%	4.50%	-15.4%
Revenue/Adjusted Book Value	0.58	1.23	0.20
Invested Funds	**COP (LTM)**	**COP (5 years historical average)**	**Industry (LTM)**
Total Cash/Total Capital	6.8%	5.9%	8%
Estimated Operating Cash/Total Capital	3.1%	4.4%	N/A
Non-cash working Capital/Total Capital	-1.3%	-0.3%	1%
Invested Capital/Total Capital	69.3%	70.4%	88%
Capital Structure	**COP (LTM)**	**COP (5 years historical average)**	**Industry (LTM)**
Total Debt/Common Equity (LTM)	0.64	0.34	0.61
Cost of Existing Debt	5.45%	5.38%	4.29%
Estimated Cost of new Borrowing	6.15%	4.55%	4.29%
CGFS Risk Rating	D	CCC	C
Unlevered Beta (LTM)	1.01	1.01	1.09
WACC	10.44%	10.69%	11.67%

Sensitivity Attribution Analysis



Porter's 5 forces (scores are out of 100)



Valuation

Period	Revenue growth	NOPAT margin	ROIC/WACC
Base Year	-42.1%	-12.4%	-0.66
3/31/2017	-25.5%	-22.1%	-0.56
3/31/2018	4.3%	-9.6%	-0.22
3/31/2019	3.7%	-10.8%	-0.17
3/31/2020	3.2%	-12.3%	-0.15
3/31/2021	2.7%	-13.8%	-0.12
3/31/2022	2.1%	-15.1%	-0.10
3/31/2023	2.1%	-14.6%	-0.07
3/31/2024	2.1%	-14.4%	-0.05
3/31/2025	2.1%	-13.6%	-0.03
3/31/2026	2.1%	-13.0%	-0.01
Continuing Period	2.1%	-12.4%	0.04

Period	Invested Capital	Net Claims	Price per share
Base Year	$64,447.60	$8,445.37	-$14.14
3/31/2017	$57,007.13	$1,709.82	-$14.49
3/31/2018	$55,482.56	$9,010.73	-$18.11
3/31/2019	$55,655.95	$15,699.86	-$22.51
3/31/2020	$49,164.64	$25,477.70	-$28.55
3/31/2021	$52,410.43	$37,007.57	-$36.17
3/31/2022	$42,128.55	$50,627.92	-$45.55
3/31/2023	$46,443.01	$66,678.36	-$57.00
3/31/2024	$49,251.85	$87,178.06	-$72.07
3/31/2025	$53,473.59	$114,185.51	-$92.09
3/31/2026	$57,236.03	$150,582.78	-$118.05
Continuing Period			