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Total SA: Despite being pessimistically priced, we value it optimistically

In this note we assess our investment case for **Total SA**. We start with a general macro view and then drill down into the particulars of the energy sector and finally the company itself. There is so much bad news already priced into the Total share price that we believe it is clearly already in deep value territory. If Total delivers on its turnaround strategy, and with some help from the oil price, we think the company is poised to deliver market-beating returns over the next two-to three-years.

Total's metrics are as follows:

Spot (EUR)	**38.80**
MKT Cap (EURmn)	**91 797.7**
12M trailing P/E	**8.27**
12M fwd P/E	**7.30**
10 Average P/E	**8.9**
10 Average DY	**4.28**
FYE	**31-Dec**
P/Book Ratio	**1.20**
12M trailing DY	**5.88**
12M fwd DY	**6.03**

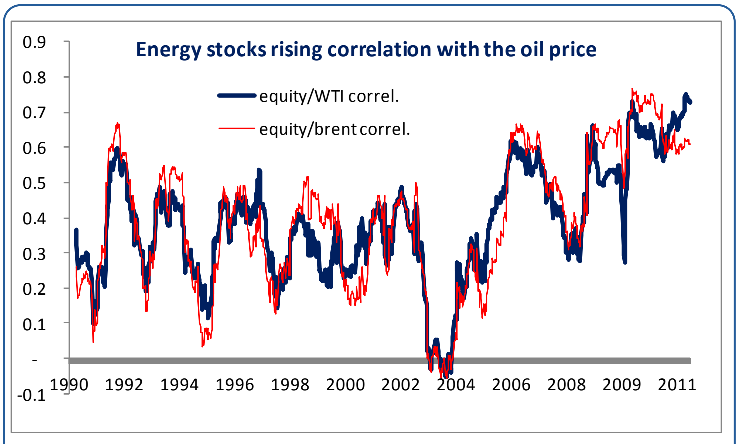
Source: Bloomberg, Anchor Capital

We also revisit the value proposition of the sector, highlighting its most important drivers and situating its value proposition within the broader context of asset markets (energy sector overview). Thereafter, we compare the major global energy stocks by looking at value drivers (ROE, earnings growth and P/E multiples). Finally, we consider Total SA in more detail.

Energy sector overview

We believe the theory of polarising correlations is important to the energy sector and is quite ubiquitous at present. On the negative side, the correlation between risky and safe assets is currently at extreme lows. However, conversely, correlations between risky assets are now very high.

This offers both an opportunity (because assets are more likely to be dragged away from their fair value when the market downplays their unique attributes or alpha) and a challenge (genuine diversification and hence risk optimisation is harder to achieve), in our opinion.



Source: Bloomberg, Anchor Capital

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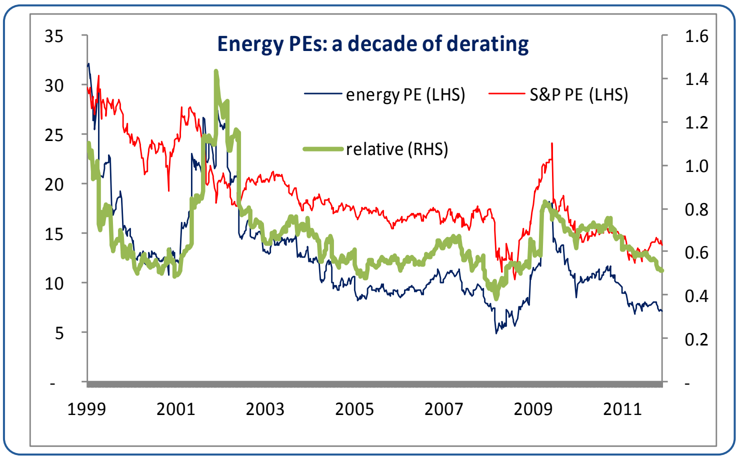
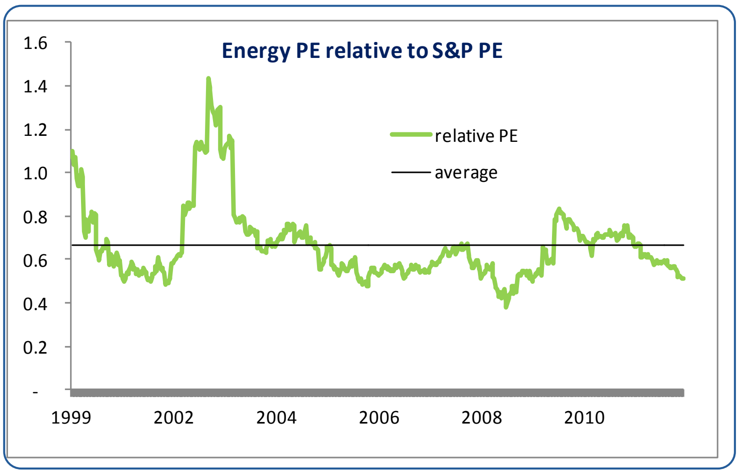
A fine example of rising correlations is the relationship between energy stocks and the oil price.

Another important correlation, in our view, is that between the S&P 500 Index and the energy stocks, particularly as this relates to the P/E rating of these two categories. Energy stocks have undergone a massive derating over the past 12 years, this is partly a generic equity theme (the S&P P/E has been compressing for over a decade) but also one that is accentuated in energy stocks (their relative P/E has gone from a premium rating to a large discount to the S&P P/E at present).



Source: Bloomberg, Anchor Capital



Source: Bloomberg, Anchor Capital

On average, over the past decade, energy stocks have traded at a 30%-35% P/E discount to the S&P. Currently, energy stocks trade at a c. 50% discount, which is a significantly wider discount than the historic average. Consensus earnings expectations are for close to zero growth in EPS for the oil stocks over the next two years but for meaningful earnings growth in the S&P (8%-10% p.a.). This differential closes part of the gap between the current P/E discount and its historic average (the discount contracts to c. 43% on consensus December 2012 earnings and c. 39% on consensus December 2013 earnings).

One way to consider the P/E discount of the energy stocks' is to split it into a structural and a cyclical component. If the series is mean-reverting, and this does seem to be the case, then it makes sense to take the long-term average as a structural level, *viz.* energy stocks have traded and will continue to trade at a 30% discount to the broader market over time. Like all things in finance this could be disputed from a number of angles but we are content to take this 30% discount as a fair rating discount for the sector, at least for the time being.

The second component of the P/E discount is the cyclical component. This is the difference between the actual P/E discount and its historic mean. The actual level of this discount is a function of differential growth expectations between the oil companies and the broader S&P Index. There are many possible drivers of this relationship but a particularly important one is the oil price. All things being equal, in a high oil price environment, when the equity market expects a downward correction in oil prices and hence oil company earnings, we would expect the actual P/E to be below its historic mean/structural level. Conversely, in a low oil price environment, when the equity market expects oil prices and oil company earnings to rise, we would expect the P/E discount to be narrower or even have crossed over into a premium rating.

What does all this mean for the oil stocks today? Are these stocks cheap, fairly priced or expensive? First we note that if consensus earnings are correct and oil stocks deliver close to zero growth over the next two years while the S&P delivers 8%-10% p.a. over the same period, it would only require one more year of similar earnings performance to return the P/E discount to its 'structural' level. If this is the case then the oil companies are probably fairly priced *relative to the S&P.*

Our view on the S&P is that it is in fair-value territory in absolute terms (we expect c. 6% real returns from the index over the next 12 months), but that it is cheap relative to government bonds. If the consensus earnings outlook is correct then the energy industry would also be fairly priced in absolute terms (we would however expect >6% return because it is higher risk), but cheap relative to government bonds.

Returning briefly to the question of the structural P/E discount, the whole issue turns on the relative risk profile and relative earnings growth outlook between the two indices (energy and S&P). We think the energy stocks are higher risk than the average S&P company, especially given that the average S&P company has become less risky since the banks fortified their balance sheets. Therefore, on this count, the energy counters do deserve a discount rating. What about the relative growth outlook? Our base-case expectation is for very long-term earnings growth rates to converge (on the long-term GDP growth rate). This implies no structural rating differential as a result of growth expectations (although there is a 'cyclical' expectation, which, based on consensus earnings, is eliminated after three years).

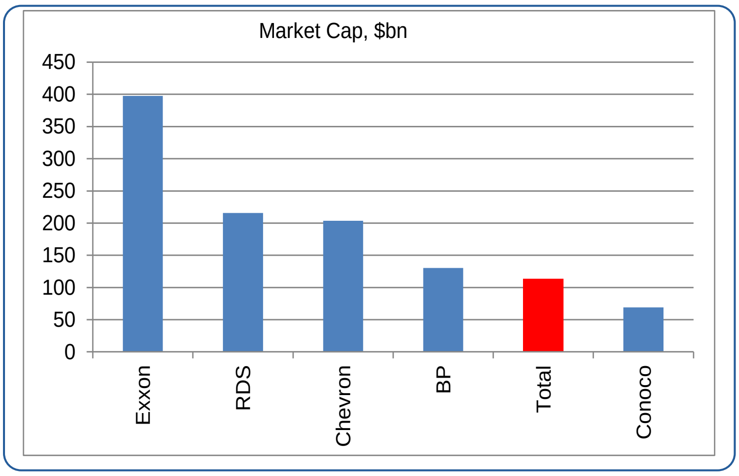
If this is correct, and the structural P/E discount is a function of higher risk only (and not a growth differential as well), then by our calculations it equates to an additional 2% cost of capital, or a beta of 1.5x, which we believe is fair.

Thus, if consensus earnings growth proves correct then the energy stocks, on average, are fairly priced relative to the S&P which seems fairly priced, in absolute terms, but cheap relative to bonds. However, our view is more bullish on the oil price and we expect energy stocks to grow earnings at more than the 0%-2% rate implied by consensus estimates. Despite the recent weakness in the oil price (which, is currently suffering its worst price slide since 2009 and trading at around $110.92/bbl), we are bullish on the long term oil price. Oil probably has at least 20%-25% upside potential (in real terms) before reaching a 'choke point' of demand destruction.

We think the current slide in the oil price, the abysmal sentiment towards the sector and its bombed-out technicals provide a buying opportunity, particularly for contrarian investors. We do not expect the oil company P/E discount to return to its structural level through relatively weak oil company earnings growth but rather through relatively strong price performance. So, the current extremely low P/E multiples are not absurd in our view, but instead represent a genuine valuation gap which we think is attractive. We estimate that the sector is undervalued by at least 10%-15% relative to the S&P and therefore we would look to be overweight on the energy sector.

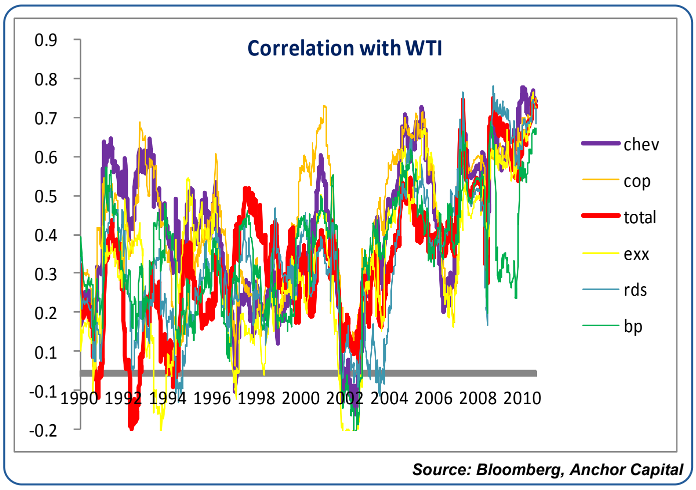
Comparing the major energy stocks

The previous section considered the energy sector at the index level (i.e. a high level of aggregation). This section will compare six of the world's largest energy companies (Chevron, ExxonMobil, Total SA, ConocoPhillips, Royal Dutch Shell [RDS] and BP) since, even though we think the index itself is attractive, it may turn out that certain of its constituents are more attractive and others less so. These more attractive constituents would present an opportunity for investors to outperform the index, in our view.



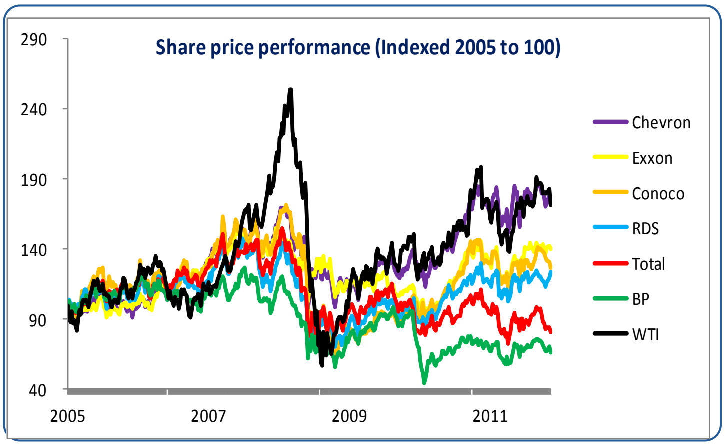
Source: Bloomberg, Anchor Capital

Note that the high correlation between energy shares and the oil price is not just apparent at the headline/index level but it is present in each of the stocks we considered:



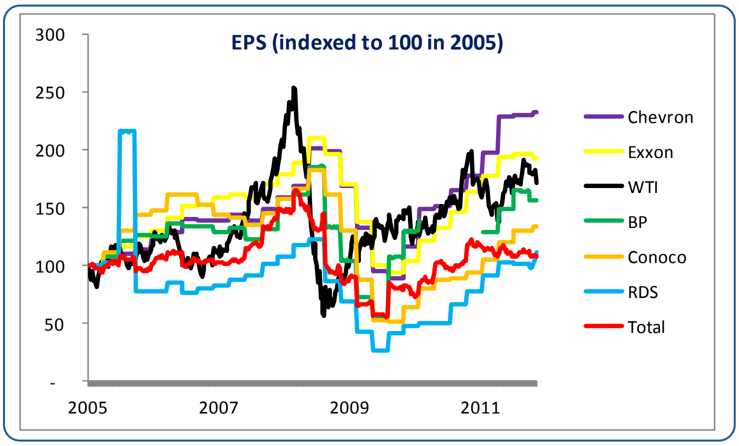
Source: Bloomberg, Anchor Capital

Of the six mega oil companies analysed, Chevron is the only company where the share price has kept pace with the oil price over the past seven years. Total and BP have delivered particularly disappointing returns with their share prices, lower than they were seven years ago.



Source: Bloomberg, Anchor Capital

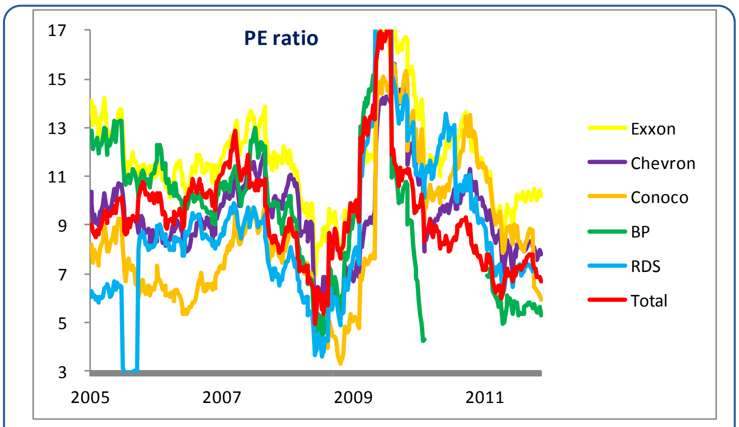
This disappointing performance is due to both a poor earnings performance and a derating in these companies' P/E multiples. Conventional wisdom has often viewed resource companies as leveraged plays on their respective commodity exposures; however recent history has called this into question as many resource companies have failed to deliver earnings growth much in excess of the commodity price appreciation. This 'calling into question' is manifest in, amongst other things, a lower P/E multiple). We also note that the best earnings performers (Exxon and Chevron) amongst the six stocks we chose, also had the best share price performance. Similarly, the worst earnings performers (Total and RDS) placed them at the bottom of the share price performance table (note that BP's dismal performance is materially attributable to the $30bn hole that the Gulf of Mexico oil spill blew in their balance sheet, as well as the lingering legal concerns around future liabilities regarding the spill).



Source: Bloomberg, Anchor Capital

Note Total's earnings have been translated into dollar from euro

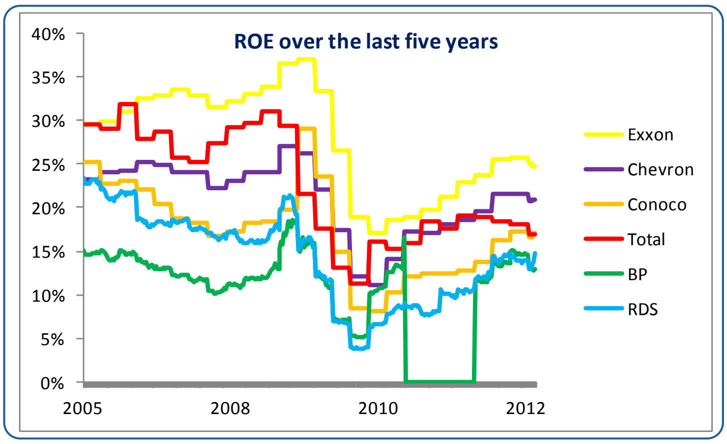
Turning to the P/E rating, all of these companies except RDS suffered a P/E derating over the past seven years. Exxon, Chevron, Conoco and Total SA all suffered a 25%-28% derating. RDS actually saw a modest rerating of 11% and BP took a massive hit with a 58% P/E derating over the period (mainly due to the financial impact of the Gulf of Mexico oil spill).



Source: Bloomberg, Anchor Capital

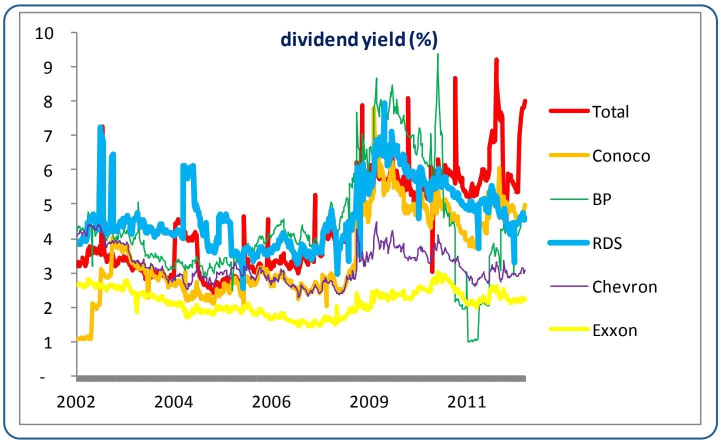
It has often been said that investors in oil stocks are only interested in three things: growth, growth and growth. This has unfortunately pushed these companies into focusing too heavily on growth and not enough on returns - both return on capital and return of capital. This is evident in the following graph which shows a declining trend in ROE across the board. Note that the star performers (Chevron and Exxon) are again showing up at the top of the graph with the highest ROE.

We further point out that the absolute minimum ROE, in our view, which these companies should be earning is 13%-15% which BP and RDS are currently earning. This would explain why these companies presently trade so close to their book value per share (BVPS), with BP trading at 1.06x book and RDS at 1.17x.



Source: Bloomberg, Anchor Capital

Turning now to return of capital, we begin by noting that there are generally two ways to return capital to shareholders – dividends and share buybacks. The graph below shows Total as the highest dividend payer (based on percentage yield) and Exxon as the lowest.



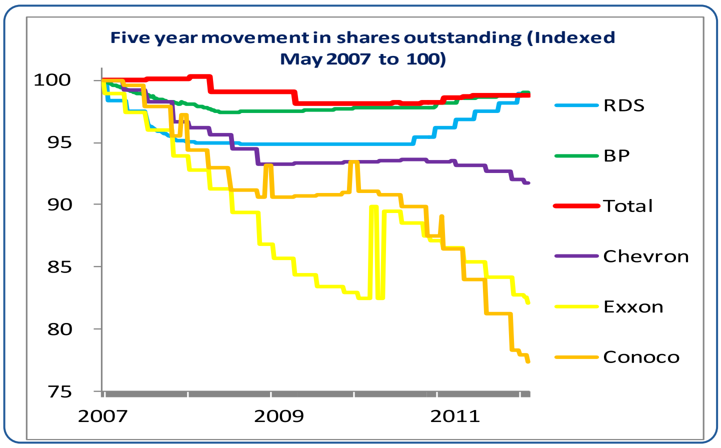
Source: Bloomberg, Anchor Capital

The second alternative for returning capital to shareholders – share buybacks – is shown below. Observe the interesting theme of a reduction in shares in issue across the board and in the case of Exxon and Conoco, this is a large and significant number. A number of conclusions can be made from this graph. First, it is clear that Total's chosen method of returning capital is through dividends and not through share buybacks.

Second, given BP and RDS' very poor ROE, these two companies should be returning a lot of capital to shareholders. However, we see that the opposite is in fact the case with both stocks paying mediocre dividends and buying back the least number of shares. These two companies certainly tie in first place for the 'flabby balance sheet award'.

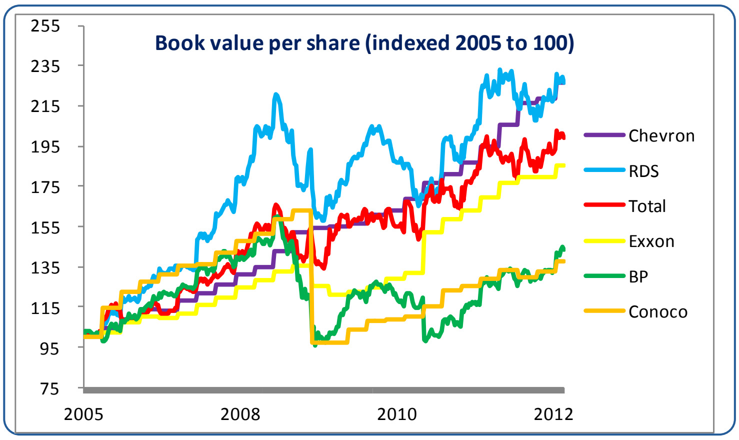
Third, Conoco pays the second-highest dividend and has bought back the most shares by far. This could be interpreted negatively (perhaps the company has no good investment opportunities) or positively (they are focused on capital allocation and returning a large amount of capital to shareholders is a priority). We are inclined towards the latter interpretation.

We also note that since energy stocks typically trade well above their BVPS, share buybacks would dilute the BVPS even though they would be value accretive if the share is truly underpriced.



Source: Bloomberg, Anchor Capital

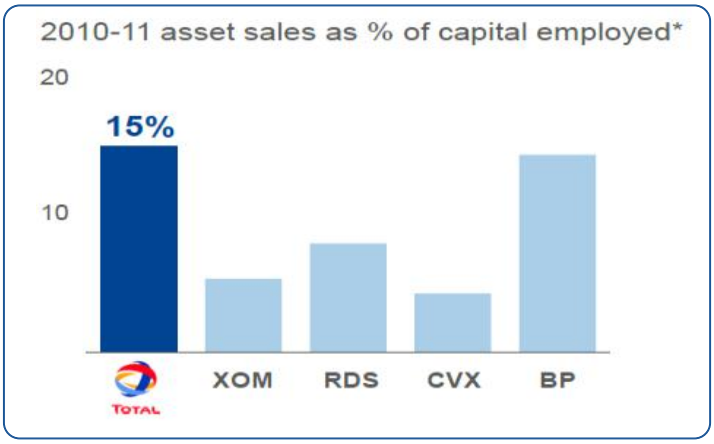
Turning to BVPS, it is important to note that this metric can grow for good and bad reasons, similarly it can contract for good and bad reasons. What is striking about the graph below is that RDS and Total have seen a large increase in their BVPS (which means a higher level of investment has occurred over the period) but their earnings have not grown at all. This is concerning as it may be painting a picture of these companies having to 'run faster just to stand still'.



Source: Bloomberg, Anchor Capital

This trend of lower returns being generated from larger balance sheets has culminated in these major companies actively restructuring their businesses. Specifically, there is a high level of divestment of low-return assets and simultaneously a high level of investment for future production. This frequently manifests itself in declining production volumes (as divestments are usually producing assets, whereas investments often take a number of years to reach production), which in turn creates an interpretation issue: usually declining volumes are seen as bad. If however the decline is due to divestment of low-return assets then the decline is potentially positive as it represents a move towards a higher-return business. However, the problem is that divestments can also function as a smokescreen for a genuinely poor production performance. This differentiation requires a more detailed investigation into the particulars of these companies and a fair measure of qualitative judgement.

The following bar chart shows the magnitude of asset sales (it doesn't show Conoco but this company has also undertaken some significant asset sales in the past few years and has unbundled its downstream operations as well) by the major oil companies. BP and Total have clearly been the most aggressive in this regard.



Source: Total SA Annual Report 2011

Divergences in underlying performance do not automatically translate into an investment preference – there is a time to buy a poor company and a time to sell an excellent one, it really depends on the valuation (which is forward looking) and the price an investor has to pay. The table below shows the forward P/E ratios for these companies based on analyst consensus earnings forecasts. Note that there is very little expectation of earnings growth to generate these numbers.

	P/E 2012	P/E 2013
EXXON	11.1	11.1
CHEVRON	8.6	8.7
CONOCOPHILLIPS	10.0	9.7
RDS	8.0	7.6
BP PLC	7.3	7.2
Total SA	7.3	7.2

Source: Bloomberg

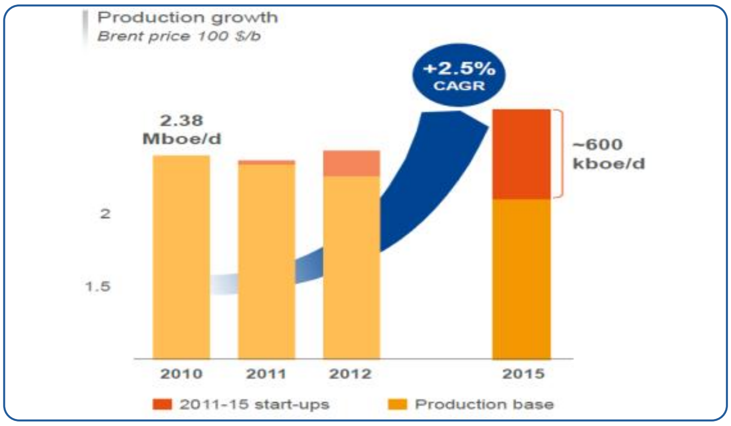
In concluding this section we note that BP and Total are clearly the cheapest and have been industry laggards over the past few years. However, these are also the companies with what seems to us to be the most aggressive turnaround strategies. Therefore, while we prefer energy to the S&P (at the index level), we think the bombed-out valuations of BP and Total provide an opportunity for these stocks to outperform the energy index. This does however depend on at least partial success in delivering their individual turnaround strategies.

Total SA: A detailed analysis

Total SA is an integrated oil and gas company with a market capitalisation of EUR91,797bn. About 85% of the value of the company is in its upstream operations (exploration and recovery of oil and natural gas) with the remainder in its downstream (refining and processing) and chemicals business.

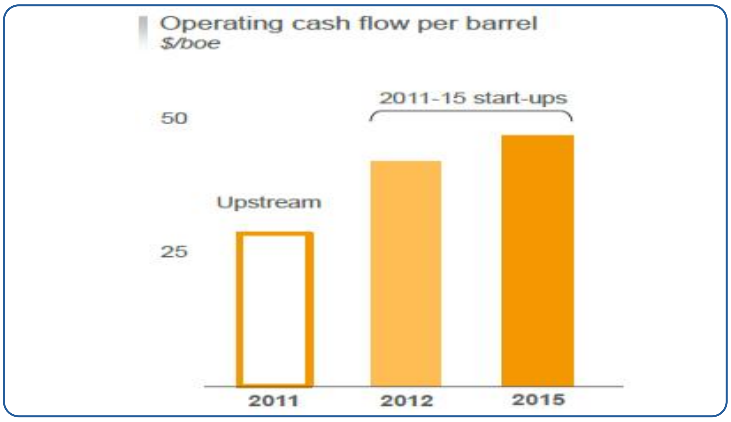
Total's key value drivers are as follows:

- The **oil price** is unquestionably the most important variable driving the value of Total. Although we have not outlined our view on oil we are long-term bulls and we expect the market to struggle to keep pace with rapidly expanding Emerging Market (EM) oil demand.
- **Volume growth** has been mediocre over the past few years. The company is however guiding the market to expect good volume growth going forward, somewhere in the region of 2.5% p.a.



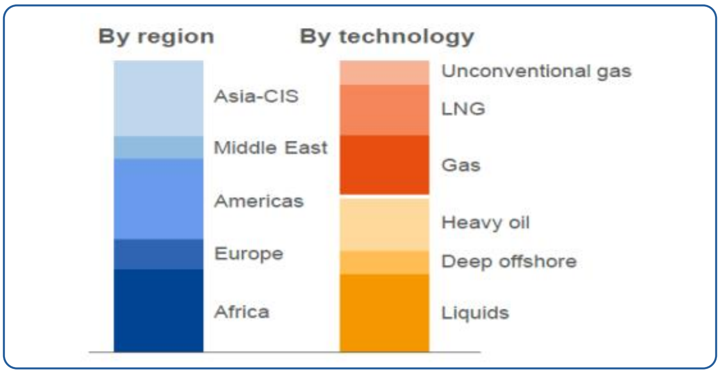
Source: Total SA Annual Report 2011

- **Cost control**: Total's new projects have the potential to be lower cost assets and to improve the company's profitability. The following bar chart shows the company's estimate of cash flow per barrel for their new projects in comparison with the 2012 average – note the dramatic improvement:



Source: Total SA Annual Report 2011

- **Exploration and project development** has been far more aggressive (this is connected to volume growth, while investment in exploration and project development will now drive future volume growth). The company's exploration budget has been increased in line with its "revitalised exploration strategy" and Total has reported three "giant" discoveries in 2011. The company is also counting on starting about 30 projects through 2015 after production setbacks this year.
- **Diversification:** Although the value of the business is significantly concentrated in its upstream operations (this is normal for integrated oil and gas companies), we believe it has good geographic and technological diversification within this category.



Source: Total SA Annual Report 2011

- **Reserve replacement** has been excellent, over 100% p.a. and particularly high in 2011 (185%). Total has 13 years of proven reserve life (total reserve life is higher because it would include probable reserves; also this does not take into account resource/reserve conversion and additional resources added through drilling and new discoveries). Taking resources into account the number is over 40 years of resource life.
- **Downstream operations** have seen very poor returns recently (9% ROE in 2010). The company has implemented a strategy for improving this metric to 14% by 2015.
- **Dividends** – the company expects to continue paying c. 50% of earnings as a dividend.
- **Political risk** – The company has a high resource concentration in Africa which brings with it a large degree of political risk. Furthermore, France's business climate is turning decidedly anti-business and as a French-listed company, Total may be exposed to more aggressive taxes and a generally less friendly regulatory environment.

Total has very much been one of the industry laggards and it is priced as an underdog: with the company's poor past performance indeed well reflected in its share price. Total is priced pessimistically relative to an industry which is in itself bombed-out (relative to a generally weak equity market!). This should make contrarians prick up their ears.

The company's market guidance for growth, costs and general turnaround are well argued and, if delivered upon, we think it should see Total materially outperform its peer group. This potential outperformance is however very much dependant on success in delivering high-return growth projects which come with some risk.

However, the bottom line, in our view, is that there is so much bad news already priced into the company's share price that it is clearly already in deep-value territory. We believe that a higher long term oil price and at least some success in delivering the company's turnaround strategy will see Total deliver market beating risk-adjusted returns over the next two-to three-years.

Blake Allen

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