Rating: Buy
S&P 500: 1285

Imperial Oil Limited
High Return, Deliberate Pace

Symbol	IMO	*Ebitda Next Twelve Months ending 12/31/06 (US$mm)*	4,500
Rating	Buy	*North American Natural Gas/Ebitda (%)*	21
Price (US$/sh)	103.16	*Natural Gas and Oil Production/Ebitda (%)*	75
Pricing Date	1/6/06	*Adjusted Reserves/Production NTM*	11.5
Shares (mm)	341	*EV/Ebitda*	8.4
Market Capitalization (US$mm)	35,100	*PV/Ebitda*	7.0
Debt (US$mm)	3,200	*Undeveloped Reserves (%)*	24
Enterprise Value (EV) (US$mm)	38,400	*Natural Gas and Oil Ebitda (US$/boe)*	31.80
Present Value (PV) (US$mm)	31,800	*Present Value Proven Reserves(US$/boe)*	16.93
Net Present Value (US$/share)	84	*Present Value Proven Reserves(US$/mcfe)*	2.82
Debt/Present Value	0.10	*Earnings Next Twelve Months (US$/sh)*	7.18
McDep Ratio - EV/PV	1.20	*Price/Earnings Next Twelve Months*	14
Dividend Yield (%/year)	0.8	*Indicated Annual Dividend (US$/sh)*	0.82

Note: Estimated cash flow and earnings tied to one-year futures prices for oil, natural gas and refinery crack.
Reported results may vary widely from estimates. Estimated present value per share revised only infrequently.

Summary and Recommendation

Buy-recommended **Imperial Oil (IMO)**, the resource gem of 70% owner, buy-recommended **ExxonMobil (XOM)**, earns high returns from a deliberate pace of development. High returns are good for shareholders. A deliberate pace of development allows more time to implement the most efficient engineering solutions. At the same time the slow pace of expansion may be frustrating to consumers and may be a boon to competitors. The stock's McDep Ratio borders on the limit of our buy range. Yet, a stock price that has held steadily above the 200-day average for the past three years shows no sign of changing trend. Moreover, if Imperial has relatively more unrecognized resources as management emphasizes, the McDep Ratio may understate ultimate potential. Current industry conditions are more favorable than the expectations in our estimate of net present value of $84 a share.

High Return, Deliberate Pace Paradox

Much as we like the energy resource potential in IMO and XOM, we ponder some puzzling questions. First, why does ExxonMobil, and by extension IMO, express such low oil price expectations in their public pronouncements? Second, if IMO has such extensive non-proven resources, more than 11 billion barrels by management's count, why is the pace of development so slow? Most of those resources are in oil sands, including 25% of Syncrude, the largest producing facility in oil sands. That leads to the third question, why didn't IMO buy Canadian Oil Sands Trust in the past? How could IMO let COS get 35% of Syncrude and a free ride on IMO's expertise? Why doesn't IMO buy COS today as buy-recommend **Canadian Oil Sands Trust (COSWF)** trades at a lower McDep Ratio than IMO?

We won't try to answer those questions except to suggest a few generalizations. First, it doesn't hurt an established oil company much to be overly cautious. If oil price turns out to be higher the resource-rich company is well positioned.

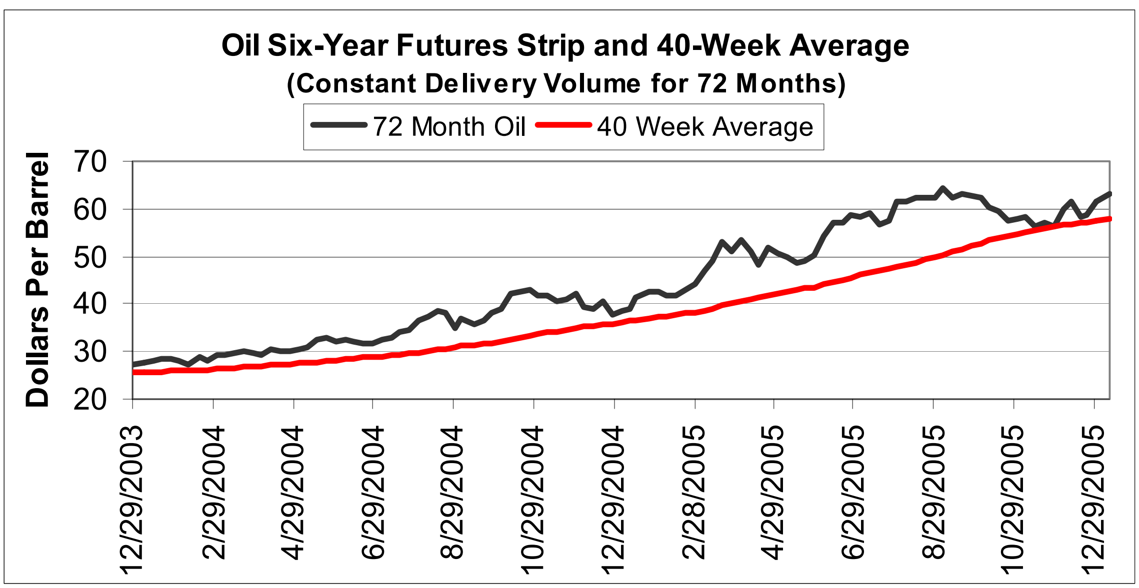
One consistency we have noted in XOM's expectations that lurk behind IMO's presentations is that the corporate energy forecast has an unusual amount of projected use of coal. Management may well believe that the world is going make the quality of life tradeoff increasingly in favor of dirty fuel, and thus more burning of raw coal and lower oil and gas price. We like other forecasts that have natural gas growing more rapidly than coal.

Second, the emphasis on unproven resources may help justify a higher multiple of enterprise value to cash flow. Alternatively, investors could conclude that if oil price is going to be higher than management would suggest, the company has resources that would be more valuable.

McDep Ratio Relates Oil Price to Opportunity

A McDep Ratio above 1.0 tells us that Imperial's market cap and debt, or enterprise value, is more than the estimated present value of its energy resources assuming a long-term real price of $50 a barrel for Light, Sweet Crude Oil. Alternatively we could say that Imperial's stock is priced for $60 oil, an approximation derived by multiplying $50 times the McDep Ratio.

Meanwhile six-year oil futures are about $63 a barrel. Momentum has been positive for more than three years as the current quote stays above the 40-week average (see chart Oil Six-Year Futures and 40-Week Average). Six-year oil has tripled in the four years we have been calculating it on a weekly basis. We do not need further gains in oil price to make money in buy recommendations. Yet our vision of $150 oil in 2010 implies additional scope to exceed common expectations.



Imperial's McDep Ratio ranks high among peer companies, but still well below that of a sell recommendation (see table Rank by McDep Ratio). Aside from the fundamental appreciation potential we outlined above, a McDep Ratio of 1.0 is an indication of takeover value. The McDep Ratio of buy-recommended **Burlington Resources (BR)**, increased to 1.0 immediately after buy-recommended **ConocoPhillips (COP)** announced its takeover offer. Imperial can be a takeover candidate only for its 70% owner. That seems unlikely as it has not happened in 125 years. Indirectly IMO is taking over itself every day as it repurchases stock in proportionate amounts from the public and from its parent.

Rank by McDep Ratio: Market Cap and Debt to Present Value

	Symbol/	Rating	Price ($/sh) 6-Jan 2006	Shares (mm)	Market Cap ($mm)	Net Present Value ($/sh)	Debt/ Present Value	McDep Ratio
Producer/Refiners - Large Cap and Mid Cap								
Kinder Morgan, Inc.	KMI	S2	95.48	135	12,930	33.00	0.71	1.54
Imperial Oil Limited (30%)	IMO	B	103.16	102	10,540	84.00	0.10	1.21
Marathon Oil Corporation	MRO	B	66.69	368	24,530	65.00	0.27	1.02
Petro-Canada	PCZ	B	42.05	525	22,090	42.00	0.19	1.00
Suncor Energy	SU	B	66.62	461	30,720	68.00	0.11	0.98
Lukoil Oil Company	LUKOY	B	62.90	830	52,000	65.00	0.03	0.97
Norsk Hydro ASA	NHY	B	110.00	251	27,600	130.00	0.17	0.87
PetroChina Company Ltd (10%)	PTR	B	85.75	176	15,070	120.00	0.01	0.72
Gazprom (50%)	OGZPF	B	80.20	1,013	81,200	120.00	0.03	0.68
Total or Median					*277,000*		*0.11*	*0.98*

Low Cash Flow Multiple

Unlevered cash flow multiples in single digits attest to low valuation (see table Rank by EV/Ebitda). Multiples may be low because investors do not think cash flow will last long at current levels. That depends on commodity price and reserve life. Cash flow estimated for the next twelve months, Ebitda NTM, reflects latest futures prices. Reserve life is measured as adjusted reserves divided by next twelve months production.

Rank by EV/Ebitda: Enterprise Value to Earnings Before Interest, Tax, Deprec.

	Symbol/	Rating	Price ($/sh) 6-Jan 2006	Adjstd Resrvs/ Prod NTM	PV/ Ebitda NTM	EV/ Ebitda NTM	P/E NTM	Divd or Distrib NTM (%)
Producer/Refiners - Large Cap and Mid Cap								
Kinder Morgan, Inc.	KMI	S2	95.48		8.5	13.1	20	3.1
Suncor Energy	SU	B	66.62	17.6	8.8	8.7	18	0.3
Imperial Oil Limited (30%)	IMO	B	103.16	11.5	7.0	8.4	14	0.8
Gazprom (50%)	OGZPF	B	80.20	20.0	11.0	7.5	13	0.5
Marathon Oil Corporation	MRO	B	66.69	7.4	5.1	5.2	8	2.0
Petro-Canada	PCZ	B	42.05	5.7	5.0	5.0	9	0.7
Norsk Hydro ASA	NHY	B	110.00	7.9	5.2	4.6	9	2.8
Lukoil Oil Company	LUKOY	B	62.90	19.8	4.5	4.3	7	1.6
PetroChina Company Ltd (10%)	PTR	B	85.75	13.8	6.0	4.3	9	4.4
Median				*12.7*	*6.0*	*5.2*	*9*	*1.6*

Concentration on Oil

Each oil and gas stock has its own unique mix of energy resources (see table Business Segments). Imperial's concentration on oil matches that of the median for peers. While we hold our present value estimates steady for months, prices of peer stocks may react in the short-term depending on relative changes in expectations for natural gas and oil. We recommend that investors have both natural gas and oil representation.

Home Country and Business Segments

	Symbol/	Rating	Non-U.S. Domicile	North Amer. Natural Gas (%)	Rest of World Natural Gas (%)	Oil Prod'n (%)	Down-stream (%)	Total Present Value (US$mm)
Producer/Refiners - Large Cap and Mid Cap								
Gazprom	OGZPF	B	Russia		100			251,000
PetroChina Company Ltd.	PTR	B	China	-	9	71	20	213,000
Lukoil Oil Company	LUKOY	B	Russia	-	-	62	38	55,700
Norsk Hydro ASA	NHY	B	Norway	-	29	38	33	39,500
Suncor Energy	SU	B	Canada	5	-	89	7	35,200
Marathon Oil Corporation	MRO	B		14	8	33	46	32,900
Imperial Oil Limited	IMO	B	Canada	13	-	62	25	31,800
Petro-Canada	PCZ	B	Canada	23	4	53	20	27,200
Median				*5*	*6*	*62*	*25*	*686,000*

Static Present Value Justified by Dynamic Cash Flow

Present value analysis presumes that fundamental value is measured by the projection of cash flows years into the future and bringing them to the present applying a real discount rate, currently 7% a year. We generally hold present value estimates static until there is justification to make new commodity price assumptions.

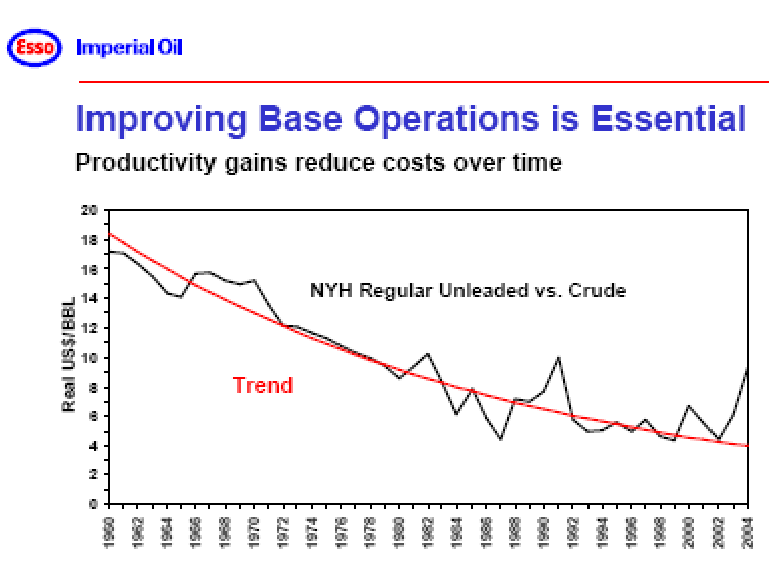
Next Twelve Months (NTM) cash flow represents the volumes and costs that form the base for future projections. Reserve life index tells how long cash flow will last. NTM cash flow and reserve life are the two main variables in our correlation by function for about 30 companies. Net present value indicated by the current combined correlation is about $4 a share lower than our ongoing standard estimate for the company (see table Functional Cash Flow and Present Value).

Imperial Oil Limited
Functional Cash Flow and Present Value

	NTM Ebitda (US$mm)	Adjusted R/P	PV/ Ebitda	Present Value (US$mm)	
North American Natural Gas	945	4.2	4.2	4,000	13%
Syncrude	937	20.0	10.8	10,100	32%
Oil - Conventional and Cold Lake	1,513	12.3	6.4	9,700	31%
Downstream	1,154		6.9	8,000	25%
	4,548	11.5	7.0	31,800	100%
Debt (US$mm)					3,200
Net Present Value (US$mm)					28,600
Shares (mm)					341
Net Present Value (US$/sh)					84
Over (-)/ Under (+) Correlation (US$/sh)					(4)

Downstream Dynamics Better Than Last Time

Among the charts in the company's presentation to investors last month a long-term display of gasoline margin, or "crack", in N.Y. Harbor got our attention (see chart below). In the broadest sense we are reminded that when crude oil price multiplied during the 1970s, refining was left behind. Indeed the gasoline crack declined. Now we see the trend turning up in the 2000s. So far, and it seems likely to continue, refining is participating along with crude oil, though not to the same degree, in the new trend. The main fundamental justification for refining to do better is the lack of spare capacity, continuing demand, and especially, an emphasis on cleaner fuels.



Imperial's current strategy for oil sands makes that point in a different way. We were surprised a few months ago when management declared that they were looking for production of 100,000 barrels a day by 2010 from a new oil sands mining project called Kearl. As it turns out all IMO intends to do is mine the bitumen without upgrading. That is relatively easy while upgrading is the critical step that takes the most capital and is subject to the greater cost inflation and construction lead time. The bitumen would be upgraded in the existing refining system either by Imperial or other refiners including XOM facilities in the U.S. We think that refining margins will have to be robust to absorb all the new heavy crude oil such as that from Kearl that does not have an immediate home. Thus, we might see more of the profit otherwise to be expected from Kearl to show up downstream. Such a development would also make Syncrude, where upgrading is conducted on site, more valuable than it already is.

Futures Prices Propel Estimated Cash Flow by Quarter

Cash flow for the next year is projected from a base through the latest reported quarter (see table Next Twelve Months Operating and Financial Estimates). Company disclosures provide the clues for future volumes and costs as well as geographic and quality differences in price. Futures prices from the New York Mercantile Exchange determine industry benchmarks for the next year in our model. Price differences by quality of crude oil are especially important to Imperial.

Kurt H. Wulff, CFA

Imperial Oil Limited
Next Twelve Months Operations
(Canadian Dollars)

	Q4 12/31/04	*Q3 9/30/05*	*Q4E 12/31/05*	***Year 2005E***	*Q1E 3/31/06*	*Q2E 6/30/06*	*Q3E 9/30/06*	*Q4E 12/31/06*	***Next Twelve Months 12/31/06***
Volume									
Natural Gas (mmcfd)	524	513	513	**515**	513	513	513	513	**513**
Oil (mbd)	242	209	208	**221**	208	207	207	207	**207**
Total gas & oil (bcf)	182	163	162	**673**	158	160	161	162	**641**
Total gas & oil (mbd))	329	295	294	**307**	293	293	292	293	**293**
Price									
Natural gas ($/mcf)									
Henry Hub ($/mmbtu)	7.10	8.56	13.00	**8.65**	10.24	9.41	9.54	10.24	**9.86**
Currency (US$/C$)	0.82	0.83	0.86	**0.83**	0.86	0.86	0.86	0.86	**0.86**
Henry Hub (C$/mmbtu)	8.66	10.29	15.16	**10.45**	11.94	10.97	11.12	11.94	**11.49**
Canada (C$/mcf)	7.12	8.80	12.96	**9.13**	10.21	9.38	9.51	10.21	**9.82**
Oil ($/bbl)									
WTI Cushing	48.31	62.52	59.99	**56.30**	63.17	65.76	66.25	66.46	**65.41**
WTI Cushing (C$/bbl)	58.94	75.14	69.93	**67.98**	73.63	76.65	77.22	77.47	**76.24**
Worldwide	43.85	63.00	60.42	**54.34**	61.11	63.59	64.04	63.25	**63.00**
Total gas & oil ($/mcf)	7.26	10.01	10.91	**9.08**	10.19	10.24	10.33	10.44	**10.30**
NY Harbor 3-2-1 ($/bbl)	5.72	16.70	9.05	**10.63**	10.50	13.19	13.51	9.42	**11.66**
Revenue ($mm)									
Natural Gas	343	415	612	**1,719**	471	438	449	482	**1,840**
Oil	976	1,211	1,159	**4,389**	1,144	1,200	1,219	1,205	**4,768**
Other	4,793	6,084	6,084	**22,218**	6,084	6,084	6,084	6,084	**24,338**
Total	6,113	7,711	7,855	**28,326**	7,699	7,722	7,752	7,771	**30,945**
Expense									
Fixed	305	328	328	**1,309**	328	330	330	330	**1,009**
Variable	305	328	357	**1,338**	326	330	336	340	**931**
Other	4,463	5,771	6,433	**21,768**	6,402	6,409	6,415	6,419	**16,286**
Ebitda ($mm)									
Exploration and Production	709	970	1,085	**3,460**	961	978	1,001	1,017	**3,957**
Other	331	313	336	**1,136**	336	336	336	336	**1,345**
Total Ebitda	1,040	1,283	1,421	**4,596**	1,297	1,314	1,338	1,353	$\boxed{\textbf{5,301}}$
Exploration	7	10	10	**47**	10	10	15	15	**50**
Deprec., Deplet., & Amort.	252	217	217	**891**	217	217	217	217	**868**
Other non cash		100		**100**					**-**
Ebit	781	956	1,194	**3,558**	1,070	1,087	1,106	1,121	**4,383**
Interest	1	-	-	**8**	-	-	-	-	**-**
Ebt	780	956	1,194	**3,550**	1,070	1,087	1,106	1,121	**4,383**
Income Tax	242	306	418	**1,193**	375	380	387	392	**1,534**
Net Income ($mm)									
Exploration and Production	389	592							
Other	186	183							
Unallocated	(37)	(125)							
Total	538	650	776	**2,357**	696	706	719	729	**2,849**
Shares (millions)	352	341	341	**343**	341	341	341	341	**341**
Earnings per share ($)	1.53	1.91	2.28	**6.87**	2.04	2.07	2.11	2.14	**8.37**
Ebitda Margin (E&P)	54%	60%	61%	**57%**	60%	60%	60%	60%	**60%**
Tax Rate	31%	32%	35%	**34%**	35%	35%	35%	35%	**35%**

Disclaimer: This analysis was prepared by Kurt Wulff doing business as McDep Associates. The firm used sources and data believed to be reliable, but makes no representation as to their accuracy or completeness. This analysis is intended for informational purposes and is not a solicitation to buy or sell a security. Past performance is no guarantee of future results.

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