

ChevronTexaco Corporation
Deflation Resistance, Growth Potential and Inflation Protection

<i>Symbol</i>	<i>Price</i>		<i>Market Cap</i>	<i>Net Present Value</i>		<i>McDep Ratio</i>	<i>EV/</i>		<i>P/E</i>	<i>Div'd NTM (%)</i>	<i>PV/ Ebitda NTM</i>
	<i>11-Nov 2002</i>	<i>Shares (mm)</i>		<i>Present Value (\$/sh)</i>	<i>Debt/ Present Value</i>		<i>Sales NTM</i>	<i>Ebitda NTM</i>			
CVX	67.18	1,063	71,400	101	0.17	0.72	0.9	6.5	14.6	4.2	9.0

McDep Ratio = Market cap and Debt to present value of oil and gas and other businesses
EV = Enterprise Value = Market Cap and Debt: US\$m 94,100
Ebitda = Earnings before interest, tax, depreciation and amortization: US\$m 14,500
NTM = Next Twelve Months Ended September 30, 2003; P/E = Stock Price to Earnings
PV = Present Value of energy businesses: US\$m 130,000

Summary and Recommendation

We continue our recommendation of current purchase of the common shares of ChevronTexaco Corporation (CVX) on (1) the basis of a strong balance sheet to resist deflation, (2) a cash return that provides real growth and (3) assets that would tend to keep their value if the dollar were to decline. The widespread deflation of debt as more companies approach bankruptcy makes CVX look much stronger in our view than its recent stock price decline might suggest. At the same time CVX's dividend growth is likely to exceed inflation and thus contribute to real investment growth. Finally, should the dollar weaken in global purchasing power, CVX's energy resource assets are likely to keep their real value. Investors can find high dividend income in energy utility stocks, but balance sheets are often precarious and the major oil companies have long learned to operate profitably in the competitive markets the utilities are increasingly facing. Investors can find higher yields on the popular energy infrastructure partnerships, but the valuations are high, the balance sheets are mostly precarious and the fees charged by the largest partnerships are sufficiently excessive as to endanger investment productivity. Meanwhile CVX's valuation at an EV/Ebitda ratio of 6.5 seems low considering it has an adjusted reserve life index of more than ten years. CVX's current dividend yield of more than 4% is higher than the current yield of the U.S. Ten-Year Note for the first time since 1974, almost thirty years ago. Though energy stocks have economic, political, financial and business risks, mega caps like CVX are among the strongest entities in the world economy.

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Balanced Risks

Energy stocks, specifically a mega cap energy stock like CVX, can offer what we believe is a combination of risks and rewards that can enhance the performance of a diversified investment portfolio in the uncertain environment ahead. Investors may be unbalanced on one or more of the three major characteristics of financial investments. For example, Growth investors may be shy of deflation resistance. Bond investors may need some inflation protection. Inflation protected investors may need some growth.

Deflation Probability May Be One-Third

There seem to be three modern historical parallels for the current stock market environment at least in the sense that we have seen a particularly steep stock market decline after a super boom. Two of the parallel periods were deflationary, the 1930s and Japan in the 1990s. The third was inflationary, the 1970s. Government bonds were the best large asset class in each of the deflationary periods. The performance of U.S. Treasury securities in the past six months looks a lot like government bond performance in deflation.

Low debt energy stocks might prosper in a relative sense in deflation. Economic activity might slow, but energy would continue to be used in large quantities. Because most oil and gas wells decline in producing capacity daily, supply could adjust automatically to a possible decline in demand. Deflation need not mean negative growth or declining prices, but it would mean financial failure for the weakest entities. The high debt utilities and infrastructure partnerships are vulnerable to collapse in deflation as we are already seeing. The mega cap energy companies with their nearly impregnable balance sheets would be among the last to be standing if it came down to that.

For the sake of discussion, let us say that the probability of continuing deflation is a third. In that case, it is conceivable that interest rates on ten-year government paper could decline to 2% a year or less.

Growth Probability May Be One-Third

There is a case to be made, and we have tried to do so in a small way, that stocks are the place to be for the next six months, or so, as they were in late 1932 and early 1933 and late 1974 and early 1975. Of course if that really happens, some other stock market sectors may advance even more than energy just as some of our other energy recommendations may advance more than CVX.

For the sake of discussion let us say that the probability of growth beating deflation and inflation is also a third. The likelihood of a better stock market for a while is probably higher. Yet the stock market bounces in 1932-33 and 1974-75 did not last and the overall market languished for another half dozen years or more.

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Inflation Probability May Be One-Third

The remaining economic outcome that investors need to consider is inflation. That was the bad news of the 1970s and a great time for most energy producers. While we had an up-tick in inflation expectations early in 2002, fears have diminished some since then. Possible sources of new inflation might be a decline in the dollar as a reaction to the international deficit balances we have accumulated. Military action can bring inflation should trade patterns be interrupted and spending on “unproductive” defense mount. Short-term interest rates below the rate of inflation as we now have, may stimulate unproductive speculation on price increases as well as productive investment.

For the sake of discussion let’s say that the probability of inflation dominating the investment outlook is also a third. Optimists, realists and pessimists may debate the magnitudes and probabilities.

Business Mix Covers Oil, Natural Gas and Downstream

Turning to some of the details of CVX, our cash flow model suggests that the value in the company may be about 65% oil price sensitive, 15% U.S. gas price sensitive and 20% refining and chemical margin sensitive. Because crude oil is an input to downstream operations there is some diversification of price risk. If lower crude oil price reduced production profits, it would also reduce refining and chemical raw material costs. Downstream margins are not particularly robust currently but could contribute more cash flow in better times.

Other mega cap energy companies have similar mixes of business. We like the North American gas part the best followed by non-U.S. operations. We would not seek downstream exposure, but do not mind owning the cash generating businesses at the low price implied by CVX’s stock price.

Nor do we have an especially strong preference for CVX over its peers. CVX’s lower McDep Ratio is the main justification for our relative emphasis. A new entrant to the mega cap category, CVX has not yet realized all of its efficiencies from the combination of Chevron and Texaco and it has a chance to gain relative recognition.

Equity Cash Flow Covers Dividend Four Times

Puzzled as to why investors can overpay for income, we ran a new check on the amount of equity cash flow behind cash distributions (see *Meter Reader*, November 4, 2002). Let’s do the calculation for CVX to illustrate the message. We project cash flow (Ebitda) for the next twelve months at \$14.5 billion (see Table). The estimate is reasonably objective and reproducible as it presumes a continuation of recent levels adjusted for futures prices for natural gas, oil and refining margins. Next we multiply cash flow by

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one minus the ratio of debt (1.00 – 0.17) to derive “equity cash flow” of \$12.0 billion. At the same time CVX’s current \$2.80 dividend rate implies total payments for the same period of \$3.0 billion. Thus equity cash flow covers dividends by some 4 times (12.0/3.0 = 4.0). If all the equity cash flow were paid out, CVX’s distribution would be more than 16% of current stock price.

At the other extreme energy infrastructure partnerships typically distribute more than the amount of equity cash flow. Though the partnerships may sport “yields” of 8%, it is a great exaggeration to value partnerships on a yield basis as analysts widely do.

Dynegy Tarnishes CVX, Impact May Be Exaggerated

As we recall, Chevron gained its initial ownership of Dynegy, the collapsed energy trader, when it swapped natural gas processing assets for part ownership of Dynegy’s predecessor, once known as Natural Gas Clearing House. Chevron’s acquisition of Gulf Oil in the mid 1980s included Warren Petroleum, a large player in a business that was small for Chevron. It was primarily those assets that became part of what became Dynegy. It all seemed to work out well up to a year ago.

With Chevron providing preferred financing, Dynegy did the deal that proved to be one too many by acquiring a natural gas pipeline from Enron. When Dynegy’s own fortunes spiraled downward, it resold the same pipeline it just acquired for a steep loss. Chevron failed to get full compensation for its latest financing and has also lost the value on the remaining equity.

While Chevron does not look too smart as a result of the experience, a billion dollars here or there written off on Dynegy is not noticeable in the total size of the mega cap company. If the Dynegy tarnish has translated to a weaker stock price for CVX than would otherwise be the case, we recommend acting on the opportunity.

Grateful for Our Long Association during which We Were Sometimes Critical

We started our first job out of college with Standard of California in San Francisco designing parts of oil refineries in California, Texas and Venezuela. Socal changed its name to Chevron. Years later after a career on Wall Street, we came within a slim margin of being voted a director of Texaco on an opposition slate. Nor did our association with Chevron inhibit us from speaking out. We were critical of Chevron’s accounting for Caltex, its joint venture with Texaco, in shareholder resolutions presented at annual meetings. The merger of Chevron and Texaco ultimately resolved much of the accounting problem that we saw. We later enjoyed Texaco’s hospitality in Indonesia on a tour of Caltex’s oil fields.

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McDep Associates
Independent Stock Idea
November 12, 2002

ChevronTexaco
Next Twelve Months Operating and Financial Estimates

	<i>Q1</i>	<i>Q2</i>	<i>Q3</i>	<i>Q4E</i>	<i>Year</i>	<i>Q1E</i>	<i>Q2E</i>	<i>Q3E</i>	<i>Next Twelve Months</i>
	<i>3/31/02</i>	<i>6/30/02</i>	<i>9/30/02</i>	<i>12/31/02</i>	<i>2002E</i>	<i>3/31/03</i>	<i>6/30/03</i>	<i>9/30/03</i>	<i>9/30/03</i>
Volume									
Natural gas (bcf)									
U.S. (or North America)	226	228	221	221	896	217	219	221	887
Overseas (or Int'l)	175	176	172	172	696	169	171	172	689
Total	401	404	394	394	1,592	385	389	394	1,576
Natural Gas (mmcf)									
U.S. (or North America)	2,509	2,504	2,406	2,406	2,456	2,406	2,406	2,406	2,430
Overseas (or Int'l)	1,948	1,932	1,874	1,874	1,907	1,874	1,874	1,874	1,888
Total	4,457	4,436	4,280	4,280	4,363	4,280	4,280	4,280	4,319
Days	90	91	92	92	365	90	91	92	365
Oil (mmb)	186	183	179	179	728	175	177	179	717
Oil (mbd)	2,071	2,014	1,947	1,947	1,994	1,947	1,947	1,947	1,964
Total gas & oil (mmb)	253	251	245	245	993	239	242	245	979
Price									
Natural gas (\$/mcf)									
Henry Hub (\$/mmbtu)	2.53	3.38	3.21	3.95	3.27	3.91	3.77	3.82	3.86
U.S. (or North America)	2.27	3.04	2.77	3.55	2.90	3.51	3.39	3.43	3.38
Overseas (or Int'l)	2.20	1.94	2.06	2.44	2.16	2.27	2.23	2.18	2.20
Total	2.24	2.56	2.46	3.06	2.58	2.97	2.88	2.88	2.87
Oil (\$/bbl)									
WTI Cushing	21.60	26.27	28.33	26.81	25.75	24.95	24.57	23.93	25.06
Worldwide	18.39	22.59	24.49	23.18	22.13	21.57	21.24	20.69	22.01
Total gas & oil (\$/bbl)	17.08	20.65	21.88	21.89	20.35	20.56	20.18	19.78	20.72
NY Harbor 3-2-1 (\$/bbl)	3.63	4.71	4.13	6.10	4.65	3.85	5.38	5.10	5.11
Revenue (\$mm)									
Natural Gas									
U.S. (or North America)	513	693	613	785	2,604	761	741	760	2,999
Overseas (or Int'l)	386	341	355	420	1,502	383	381	375	1,519
Total	898	1,034	968	1,206	4,106	1,143	1,122	1,135	4,518
Oil	3,427	4,140	4,387	4,152	16,106	3,779	3,763	3,706	15,777
Other	16,830	20,159	19,995	19,995	76,978	19,995	19,995	19,995	80,144
Total	21,155	25,333	25,350	25,352	97,190	24,917	24,880	24,836	100,439
Expense									
Production	1,773	2,121	2,196	2,096	8,186	2,009	2,002	1,993	8,219
Other	16,507	19,780	19,444	19,263	74,994	19,408	19,291	19,309	77,760
Ebitda (\$mm)									
Exploration and Production	2,552	3,053	3,160	3,261	12,026	2,914	2,884	2,848	12,076
Other	323	379	551	732	1,984	587	704	685	2,383
Total Ebitda	2,875	3,431	3,710	3,994	14,010	3,501	3,587	3,534	14,459
Exploration	85	135	166	166	552	166	166	166	633
Deprec., Deplet., & Amort.	1,205	1,241	1,514	1,514	5,474	1,514	1,514	1,514	5,783
Other non cash									
Ebit	1,585	2,055	2,030	2,314	7,984	1,821	1,907	1,854	8,043
Interest	147	160	117	117	541	117	117	117	511
Ebt	1,438	1,895	1,913	2,197	7,443	1,704	1,790	1,737	7,532
Income Tax	503	663	670	769	2,605	596	627	608	2,636
Net Income (\$mm)									
Exploration and Production	1,141	1,246	1,283						
Other	(46)	54	114						
Unallocated	(160)	(68)	(153)						
Total	935	1,232	1,244	1,428	4,838	1,107	1,164	1,129	4,896
Shares (millions)	1,062	1,062	1,063	1,063	1,063	1,063	1,063	1,063	1,063
Per share (\$)	0.88	1.16	1.17	1.34	4.55	1.04	1.10	1.06	4.61
Ebitda Margin (E&P)	59%	59%	59%	61%	59%	59%	59%	59%	60%
Tax Rate	35%	35%	35%	35%	35%	35%	35%	35%	35%

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