

Valero Energy Corporation (VLO-NYSE)

Current Recommendation

Prior Recommendation

Date of Last Change

Buy

Hold

04/25/2005

Current Price (09/05/06)

\$55.75

Six-Month Target Price

\$65.00

OUTLOOK

Valero Energy continues to be our core play on the U.S. refining market given the size, geographical diversity, and complexity of its operations. We believe that the broad contours of the U.S. refinery scene will continue to remain favorable, characterized by robust margins and wider crude-quality spreads. We are raising our 2006 earnings estimates to \$9.44 per share from \$8.32 per share before, to reflect the continued strong margin environment. Our 2007 EPS estimate remains unchanged.

SUMMARY DATA

52 Week High	\$69.10
52 Week Low	\$46.47
One-Year Return (%)	3.41
Beta	0.94
Average Daily Volume (sh)	8,688,631

Shares Outstanding (mil)	622
Market Capitalization (\$mil)	\$34,667
Short Interest Ratio (days)	1.22
Institutional Ownership (%)	73
Insider Ownership (%)	5

Annual Cash Dividend	\$0.32
Dividend Yield (%)	0.57

5 Yr. Historical Growth Rates

Sales (%)	48.3
Earnings Per Share (%)	69.1
Dividend (%)	26.8

P/E using TTM EPS	6.6
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P/E using 2006 Estimate	5.9
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P/E using 2007 Estimate	6.6
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Zacks Rank	3
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Risk Level

Type of Stock

Industry

Zacks Rank in Industry

Average

Large-Blend

Oil Refining&Mktg

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ZACKS ESTIMATES

Revenue

(In millions of \$)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2004	11,082 A	13,808 A	14,339 A	15,390 A	54,619 A
2005	14,953 E	18,032 A	23,283 A	25,894 A	82,162 A
2006	20,941 A	26,781 A	27,750 E	25,050 E	100,522 E
2007					98,410 E

Earnings per Share

(EPS is operating earnings before non-recurring items)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2004	\$0.45 A	\$1.14 A	\$0.79 A	\$0.95 A	\$3.33 A
2005	\$0.96 A	\$1.53 A	\$2.19 A	\$2.00 A	\$6.68 A
2006	\$1.32 A	\$2.98 A	\$3.10 E	\$2.04 E	\$9.44 E
2007					\$8.48 E

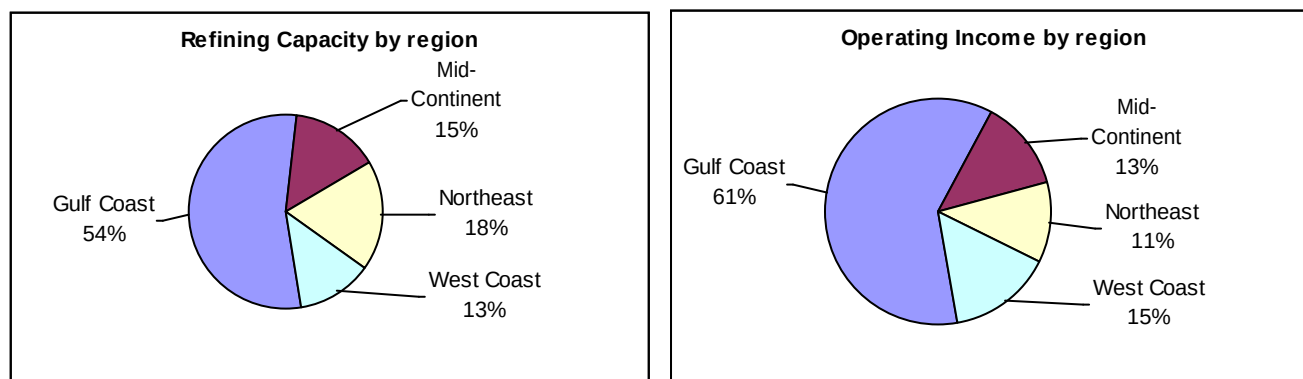
KEY POINTS

- Valero became the largest North American refiner following last year's acquisition of Premcor, with significant presence in each refining market.
- Valero enjoys the greatest leverage among refiners to the widening light-sweet/heavy-sour spreads as 70% of its total refining capacity is capable of processing heavy/sour crude grades.
- Management has established a track record of achieving growth, through a combination of acquisitions and organic means.
- A combination of slower than anticipated growth in global refining capacity, tighter fuel specifications, and continued demand growth are expected to continue to have a favorable impact on Valero's near to medium performance.

OVERVIEW

San Antonio, Texas-based Valero Energy Corporation (VLO) is the largest independent refiner and marketer of petroleum products in the U.S., with 3.3 million barrels per day in refining capacity (including Premcor's capacity) in its 18 refineries located throughout the U.S., Canada, and the Caribbean. The company is also one of the largest independent retailers of refined petroleum products in the central and southwestern U.S. and eastern Canada, with more than 5,000 retail outlets under various brand names, including Diamond Shamrock, Valero, Ultramar, and Beacon. Valero's retail operations contributed approximately 2.5% of its 2005 operating earnings (1.5% of first-half 2006 operating earnings), with the refining business accounting for the rest. The company also maintains a 23.4% ownership interest (comprising 2% general partner interest and 21.4% limited partner interest) in Valero Energy Partners, L.P. (VLI); a major master limited partnership with significant energy infrastructure assets.

Last year's \$8 billion acquisition of Premcor made Valero the largest refiner in North America with an installed capacity of 3.3 million Bbl/d.



Valero remains advantageously positioned to capitalize on two major refining industry trends: a favorable supply-demand environment for petroleum products in the U.S. and widening discounts for heavy and sour varieties of crude oil relative to the more in-demand light and sweet varieties such as the U.S. benchmark, the West Texas Intermediate (WTI). Given the size, geographical diversity (chart above), and complexity (more than two thirds of its refining capacity is capable of processing heavy/sour crudes) of its portfolio of refining assets, Valero enjoys greater leverage to this favorable macro environment than any other independent refiner. Another positive for the company is its management's impressive track record of achieving profitable growth through acquisitions as well as organic projects. The Premcor acquisition is the most recent in a long line of transactions that have made Valero the largest U.S. refiner. These positives, in our view, should help sustain the stock's recent price momentum.

Favorable trends in refined-product and crude oil supply/demand fundamentals have helped strengthen refining margins and widen light-sweet/heavy-sour spreads. Strong demand for refined petroleum products due to a steadily growing economy, coupled with constrained domestic refining capacity operating at an almost full utilization level and international suppliers' inability to meet the more stringent product specifications, has helped keep recent refining margins at robust levels, a trend that we believe is sustainable in the near- to medium-term. Another boost to margins for complex refiners such as Valero comes from their ability to process the lower-priced heavy-sour grades of crude, whose price discount to WTI continues to remain above historical trend levels.

Valero's throughput margin averaged \$11.14 per barrel in 2005, up more than 49% from the year-earlier level. The margin has further gone up in the first six months of the current year, increasing by 38% year-over-year to \$12.84 per barrel. The average price differential between WTI and Maya (a Mexican heavy/sour crude) widened to \$15.68/Bbl during the same time period. This extraordinary strength in the underlying refining industry fundamentals has helped Valero generate record earnings in the recent past.

The tightness in refined-product supplies that pushed margins to new highs in the recent past is not expected to ease any time soon. The contributing factors include the impact of more stringent environmental standards that have already come/ are coming into effect this year on product supplies (replacement of MTBE with ethanol and ultra low-sulfur diesel) and tight international conditions. On the demand side, growth trend has become positive this year after posting a flat-to-modestly down growth last year. Given these strong fundamentals, a full year of contribution from the Premcor assets, and an additional 100,000 barrels per day of capacity due to organic projects scheduled to come onstream next year, we estimate that 2006 will be another record year for Valero. The company's strong first half results are indicative of this fact.

We project that despite the roughly 31% jump in capital budget, Valero will generate approximately \$3 billion in free cash flow this year. While strengthening the balance sheet is expected to remain a priority, the company is also expected to steadily grow its dividend and buyback shares. The company increased its quarterly dividend in June by approximately 33% to the annualized rate of \$0.32 per share and repurchased more than 20 million of its own shares during the first half of 2006. For the full year, management is planning to reduce its outstanding share base by approximately 5% through buybacks. With balance sheet leverage expected to fall significantly by the end of 2006 (current net debt-to-capitalization ratio is around 19%) and this year expected to be the peak year for regulatory capital outlays, the long-term free cash flow outlook is even better going forward.

In addition to these positive fundamentals, management's track record of achieving profitable growth through acquisitions adds to the company's attractiveness. Over the years, the company has capitalized on attractive acquisition opportunities and then expanded and optimized the acquired assets for lower cost sour/heavy crude feedstock. The \$8 billion Premcor acquisition highlights Valero's growth-through-acquisitions strategy. This acquisition added four refineries and 790,000 Bbl/d in capacity to Valero's refining system, making it the largest North American refiner. Premcor is very similar to Valero in its strategic focus on growth through acquisitions and exposure to crude quality spreads. The 50-50 cash and stock deal is accretive to Valero's earnings and cash flows and will help the company capture approximately \$350 million in recurring synergies. During the first six months in the current year, Valero generated an operating income of approximately \$1.3 billion from Premcor refineries with average throughput volumes of 784,000 barrels per day. Management remains committed to its long-standing strategy of buying assets at attractive prices that are immediately accretive to earnings in evaluating future acquisition opportunities.

INDUSTRY OUTLOOK

Our outlook for the oil refining and marketing industry is positive. We are optimistic in our product-demand outlook and believe that the flat to modestly down demand numbers for 2005 were primarily reflective of hurricane-related disruptions. We project the U.S. petroleum-product demand growth to be in the range of 1.5% to 2% this year, driven by stable economic growth. Our positive outlook for independent refiners reflects this demand view.

Refining margins are extremely volatile and generally reflect the state of petroleum product inventories, demand for refined products, imports, regional differences, and capacity utilization in the refining industry. Another major determinant of refining profitability is the light/heavy and sweet/sour spreads. After experiencing trough-level refining and marketing margins for a very long period of time, margins rebounded nicely in 2003 and have largely remained above mid-cycle levels since then. And given the impact of ever more stringent environmental and product specification standards coming into force this year on the petroleum-product supply situation, margins will most likely stay at strong levels by historical standards over the next couple of years.

In addition to the outlook for refining margin – which is largely beyond an individual refiner's control – it is important to analyze each refiner's competitive position in the group. For example, scale (or size and the number of refineries) is important, since it allows the refiner to optimize its purchases of crude oil. Similarly, since the refining margin is largely local in nature (different regions have different margins at the same time) due to refining and pipeline capacity constraints, it is desirable to have a geographically diverse base of operations. And refiners that have a higher yield of light products (gasoline, diesel, and heating oil) are on average more profitable than those that produce a large amount of heavy, residual fuel oils.

Complexity is also an important attribute that enables the refiner to process heavy/sour crude. While there is a cost associated with maintaining the greater investment in such assets, complex refiners, on average, enjoy higher net margins. In the long run, high-complexity refiners who are able to process heavier and sour oils are expected to be better placed than others. Most of the new crude volumes over the next few years from regions such as Latin America (Venezuela) and Canada will be of the heavy/sour variety. This will help support a wider discount to light/sweet crude oil.

The need to make capital expenditures for compliance with new environmental regulations is a major issue with a large number of refiners. The Tier II standards unveiled by the Environmental Protection Agency (EPA) in 2000 significantly reduced the allowable sulfur content in gasoline from 300 parts per million (ppm) to 30 ppm by January 2006, with the first phase having started in January 2004. In diesel fuel, the new regulations are even more stringent, requiring a 97% reduction in sulfur content beginning this year (2006), with full compliance by January 2010. The need to comply with these stricter stipulations has diverted capital to compliance instead of capacity growth, a situation that is not expected to reverse in the near to medium term.

INDUSTRY POSITION

The refining and marketing industry continues to be highly competitive. Valero's competitors include major integrated oil companies, such as Exxon Mobil and ConocoPhillips, and other independent refiners and marketers such as Sunoco and Premcor that operate in its markets. However, the size and geographic diversity of its refining operations make Valero a leading industry player. Following the Premcor acquisition, Valero has become the largest refiner in the U.S., ahead of Exxon and ConocoPhillips. Valero also has one of the largest heavy/sour crude refining capacity, which reduces its feedstock costs and helps its margins. Valero is also a major retail player, particularly in the central and

southwestern U.S. and eastern Canada, which gives it an edge over most of its independent peers, as retail prices are relatively less volatile.

RECENT NEWS

On August 1, Valero Energy reported better than expected second-quarter 2006 earnings of \$1.9 billion or \$2.98 per share, significantly above the year-earlier level of \$847 million or \$1.53 per share. The strong second quarter results represent the highest quarterly net income in the company's history, driven by significantly higher gasoline and distillate margins, wider sour crude oil discounts, and higher throughput volumes due to the acquisition of Premcor Inc. Partially offsetting these factors was the impact of an approximately \$275 million or \$0.29 per share reduction in operating income from unplanned outages. We have raised our 2006 earnings estimate to \$9.44 per share from \$8.32 per share earlier, to reflect the quarterly gain and continued favorable refining environment. Our 2007 EPS estimate remains unchanged.

During the quarter, Valero's operating income from the refining segment increased 214% from the year-earlier level, driven by a 33% increase in throughput volumes and an increase in throughput margin of \$5.19 per barrel, partially offset by increased refining operating expenses. The company's average throughput margin increased to \$15.44/Bbl from \$10.25/Bbl in the year-earlier quarter and \$10.11/Bbl in the prior quarter. All the geographical segments witnessed strong margin improvements, with Gulf Coast (throughput margins of 15.92/Bbl), Mid-Continent (\$14.91/Bbl), Northeast (11.73/Bbl), and West Coast (\$20.29/Bbl) registering 51.5%, 74.8%, 61.1%, and 41.9% year on year growth, respectively. The continued strength in the refining product margins was primarily due to increased foreign and U.S. demand, limited capacity additions, major industry turnaround activity, and continuing hurricane related outages. The benchmark WTI-Maya spread was up 20.2% from the year-earlier level to \$15.68/Bbl. Discounts on sour crude oil during the quarter improved from the already strong discounts in the year-earlier quarter, due to continued ample supplies on the world market. Partially offsetting the above increases were lower margins on other refined products such as petroleum coke and sulfur due to significant increase in crude price during the last one year. Total throughput increased by 33% from the year-earlier level to 3.0 million barrels per day, primarily reflecting the volume contributed by Premcor's four refineries in the Valero system. The company went through a high level of turnaround activity during the quarter. It completed a major plant-wide turnaround at Quebec, on time and budget and also completed another turnaround and expansion of its cat cracker at Paulsboro. Operating income in the company's retail segment decreased marginally to \$46 million, from \$50 million in the year-ago quarter.

During the first six months, Valero incurred approximately \$2 billion towards capital expenditure (of which \$387 million was turnaround expenditure) and management expects the full-year capital expenditure to be \$3.5 billion. During the period, the company repurchased approximately 20.4 million shares for \$1.2 billion as a part of its 5% share buyback program. At the end of the second quarter, the company had cash and cash equivalents of \$968 million (including restricted cash of \$31 million) and a net debt-to-capitalization ratio of 18.9%, down from 23.5% in the prior quarter. Management has guided towards a third-quarter refinery throughput in the 2.98 to 3.03 million barrels per day range.

On July 19, Valero GP Holdings, LLC, an indirectly wholly owned subsidiary of Valero Energy and the general partner of Valero, L.P. (VLI), completed an IPO of 17.25 million limited partner units at \$22.00 per unit. Valero GP Holdings, LLC owns the general partner interest, the incentive distribution rights, and the 21.4% limited partner interest in VLI. Proceeds from the offering totaled approximately \$355 million, net of the underwriters' discount and other offering expenses, which will result in a third quarter 2006 pre-tax gain of approximately \$125 million on the sale of the units. Subsequent to the IPO, subsidiaries of Valero hold a 59.4% ownership interest in Valero GP Holdings, LLC. Valero intends to further reduce and ultimately sell all of its interest in the general partner. Valero intends to use funds from this offering for general corporate purposes, which may include acquisitions, stock purchases, and debt reduction.

VALUATION

Our continued positive view of Valero shares reflects our view that the Premcor transaction cements Valero's position as a bellwether for the U.S. refining industry and increases its strong leverage to U.S. refining margins and sweet/sour spreads. Additionally, the addition of Premcor's assets further enhances Valero's geographic diversity by strengthening its positions in the Northeast and the Midwest regions. And given management's track record of execution, we are confident of their ability to capture the targeted synergies. As such, we see upside in Valero shares from current levels and maintain our target price of \$65, which we determine using 2006 P/E and P/CF multiples of 6.9x and 5.3x, respectively.

INDUSTRY COMPARABLES					
	Pr Chg YTD %	Mkt Cap (\$ Billions)	P/E 06E	P/CF 06E	Div %
Valero (VLO)	8.0	34.7	5.9	4.5	0.57%
Industry Mean	23.2	N/A	7.8	5.7	0.82%
S&P 500	5.2	N/A	15.9	N/A	1.88%
Sunoco (SUN)	-9.1	9.3	8.5	5.3	1.40%
Tesoro (TSO)	3.2	4.3	6.1	3.9	0.63%
Frontier (FTO)	63.18	3.4	9.0	6.8	0.78%
Holly (HOC)	50.57	2.6	9.6	8.2	0.72%

RISKS

- The inherent volatility of the refining business reduces the accuracy and reliability of long-term earnings and revenue estimates.
- The near-term risk of a pullback in refining margins is very real, given the typically weak seasonal demand for gasoline in the winter months. A weakening margin outlook will impact the stock price.
- A narrowing of the sweet/sour crude spread will negatively impact Valero's results.
- Refiners are prone to unplanned shutdowns and outages.

INSIDER TRADING AND OWNERSHIP

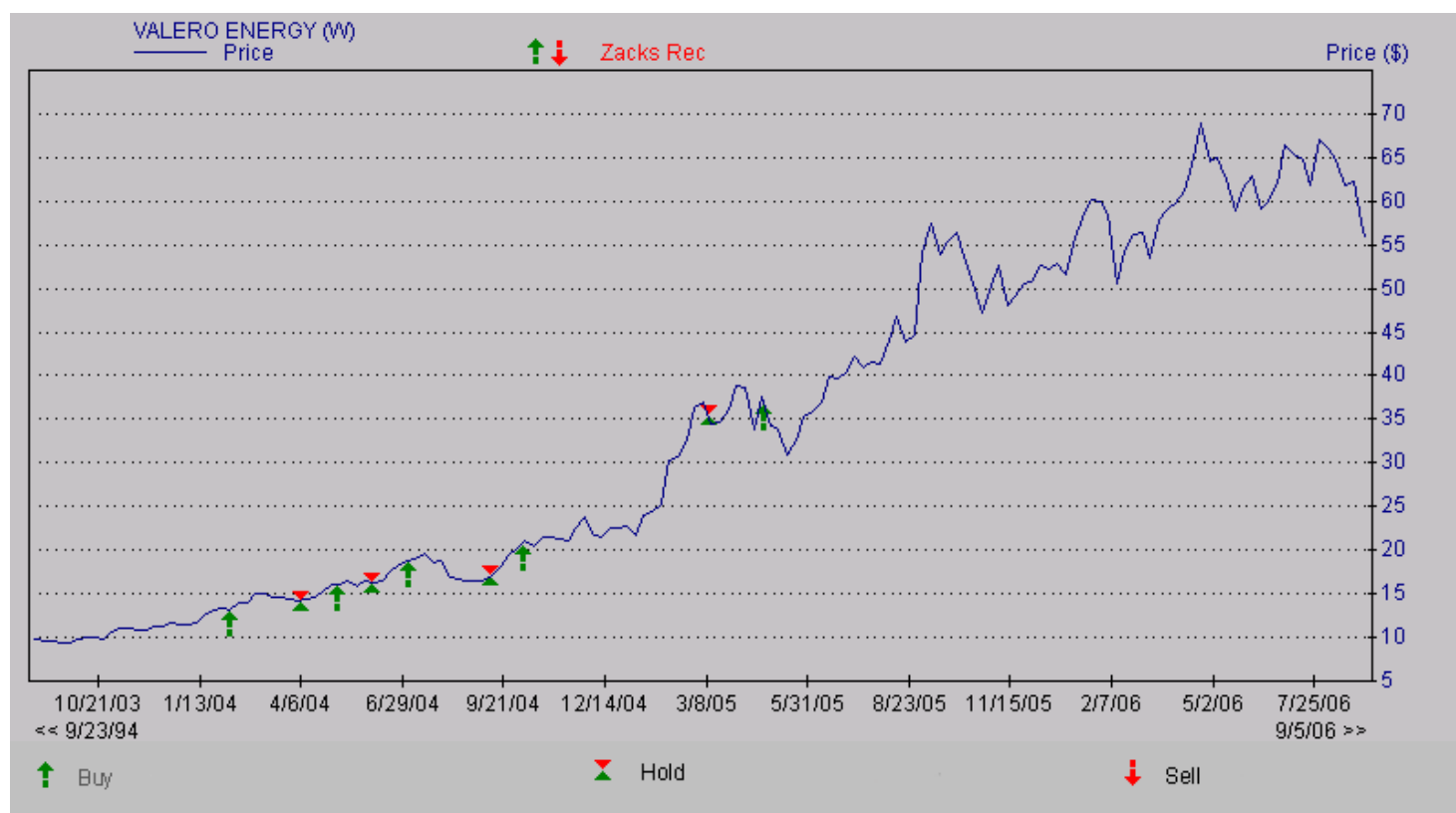
Institutional shareholders own roughly 73% of the company's outstanding shares. Major institutional shareholders are: Fidelity Management & Research (owns about 8.7% of the shares), Barclays Global Investors (6.6%), and State Street Global Advisors (3.4%). Institutional shareholders have been net sellers of the stock over the past quarter. Insiders own about 5% of Valero's stock and have been net sellers of the stock in modest amounts over the last six months. Short interest is slightly over one day, which is not significant.

PROJECTED INCOME STATEMENT & BALANCE SHEET

Valero Energy Corporation Income Statement and Balance Sheet (Dollars in millions, except EPS data)

	12/01	12/02	12/03	12/04	12/05	12/06E
Sales	14,988	26,976	37,969	54,619	82,162	100,522
Cost of Sales	13,684	23,793	33,587	47,797	71,673	85,233
SG&A	165	2,261	2,649	3,224	4,155	6,510
Other operating expenses	138	449	511	618	875	1,542
Interest and other	438	379	601	1,175	1,869	1,365
Zacks Adjusted Income before NRI	564	92	627	1,839	3,974	5,872
Net Income	564	92	622	1,804	3,590	5,872
Diluted EPS before NRI	2.21	0.21	1.30	3.33	6.68	9.44
Reported EPS	2.21	0.21	1.28	3.27	6.10	9.44
Cash & Marketable Securities	346	409	413	888	466	968
Current Assets	4,113	3,536	3,817	5,264	8,276	10,174
Current Liabilities	4,730	3,007	3,064	4,534	7,305	9,107
Long Term Debt	2,805	4,494	4,245	3,901	5,156	5,098
Shareholder's Equity	4,203	4,681	5,735	7,798	15,051	16,764

HISTORICAL ZACKS RECOMMENDATIONS



DISCLOSURES

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