MORGAN-DEMPSEY
CAPITAL MANAGEMENT, LLC

ExxonMobil: Increasing Weight 2.5% **September 2021**

The original thesis for the purchase of Exxon (pre-Covid) centered on a major counter-cyclical investment program emphasizing the development of upstream oil projects. This was derailed by the Covid pandemic that resulted in both extremely low oil prices negatively impacting upstream profitability and uncharacteristic weakness in the downstream chemical and refining businesses. The company took on additional debt, curtailed a significant amount of capital investment and sold less attractive assets to help maintain its dividend. We believe that a strategic shift catalyzed by both the stresses of the pandemic and the election of a slate of activist investors makes this an interesting time to add to the position.

The company has curtailed its aggressive capital investment program to grow reserves and is emphasizing upgrading its upstream and downstream assets while reducing the debt incurred to help support the dividend. This includes the sale of less attractive assets during this period of higher oil and chemical prices. The new board members are expected to aggressively address moving the company in a greener direction. At this point, Exxon is expected to focus more on molecules (carbon capture, hydrogen, and biofuels) than on green electricity production such as wind and solar.

Positives

- The election of a slate of three new directors proposed by hedge fund Engine No. 1 as well as the election of Jeff Ubben, an activist investor and ESG proponent, should provide a new perspective to what has historically been an insular board. They are expected to encourage greater spending discipline through a returns-focused capex strategy and to help the company gradually reposition itself to succeed in a decarbonizing world.
- XOM established a Low Carbon Solutions business this year to commercialize and deploy emissions-reduction technology. The company currently is #1 in the world for CO2 capture (in an admittedly small market) and is developing a hydrogen project in Rotterdam, Holland to demonstrate fuel cell technology.
- In the traditional energy space, XOM is focusing on higher margin Upstream projects such as Guyana, Brazil and the Permian as well as on chemical performance products such as lubricants.
- The company is adjusting its assets and investment portfolio with the expectation that it can generate $6 billion in structural efficiencies in 2023 vs. 2019. One goal is to be able to maintain the current dividend at $35 a barrel oil at 10 year average downstream and chemical margins.
- Capital allocation priorities remain the same:
    - Invest in advantaged projects to drive cash flow
    - Maintain balance sheet strength
    - Provide reliable dividend

Negatives

- The company remains economically sensitive and would be hurt by an economic slowdown or another round of Covid shutdowns. The downstream businesses were unable to compensate for the rapid decline of oil prices during the pandemic because of the collapse in demand for refined products, particularly jet fuel, and a lack of demand for its chemical products in the accompanying economic decline.
- It will be difficult for XOM to make money in some of its green endeavors, particularly carbon capture, without a carbon tax or carbon credits. This will require government involvement.
- Oil and gas stocks are highly unloved. Divestment by major institutional investors could continue to pressure shares in these companies.
- The company may be unable to develop and execute profitable low carbon strategies.
- XOM may be unable to obtain attractive prices for the assets that it is planning to sell and may not be able to reach its structural efficiency objectives.

Note:

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