Rating: Buy
S&P 500: 1115

Marathon Oil Corporation
Top Quartile Refiner with Production

Symbol	MRO	*Ebitda Next Twelve Months ending 3/31/05 (US$mm)*	3,600
Rating	Buy	*North American Natural Gas/Ebitda (%)*	25
Price (US$/sh)	33.67	*Natural Gas and Oil Production/Ebitda (%)*	74
Pricing Date	5/26/04	*Adjusted Reserves/Production NTM*	6.8
Shares (mm)	345	*EV/Ebitda*	4.9
Market Capitalization (US$mm)	11,600	*PV/Ebitda*	5.6
Debt (US$mm)	6,000	*Undeveloped Reserves (%)*	30
Enterprise Value (EV) (US$mm)	17,600	*Natural Gas and Oil Ebitda (US$/boe)*	20.40
Present Value (PV) (US$mm)	20,100	*Present Value Proven Reserves(US$/boe)*	14.22
Net Present Value (US$/share)	41	*Present Value Proven Reserves(US$/mcfe)*	2.37
Debt/Present Value	0.30	*Earnings Next Twelve Months (US$/sh)*	3.84
McDep Ratio - EV/PV	0.87	*Price/Earnings Next Twelve Months*	9
Dividend Yield (%/year)	3.0	*Indicated Annual Dividend (US$/sh)*	1.00

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

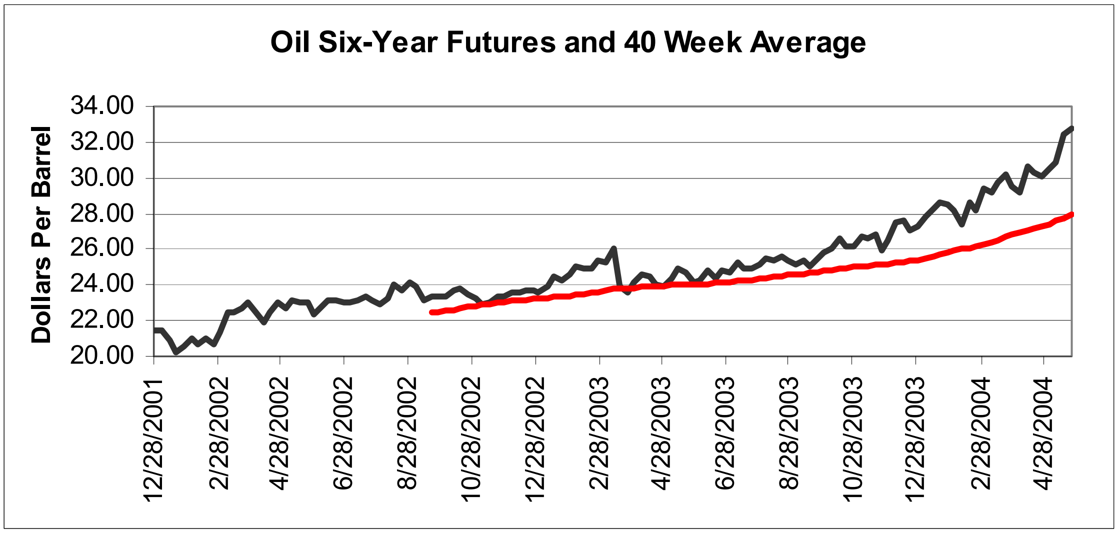
We restore a "Buy" rating on the common shares of **Marathon Oil (MRO)** on the basis of an improved industry outlook for refined products and for oil and gas production. The company has become a larger and better refiner/marketer while it has lost some strength as a producer. The stock appears undervalued relative to popular pipeline income partnerships that also move and store refined products, but not as undervalued as stronger producers. Refined products profitability is more volatile than producing profitability, but both businesses are vital for economic growth and security. We see about 22% appreciation potential to net present value of US$41 a share subject to the risk of a moderate debt level.

Oil Looks Up by the Charts, Fundamentals, Inflation and Security

Six-year futures describe the commodity price trends most relevant to estimating resource value. The longer time horizon better matches the period during which more of current resources will actually be produced. The longer term measure also smoothes the frantic near-month fluctuations and has the potential to keep climbing even if near-month quotes drop back temporarily.

The plots of weekly results since the beginning of 2002 trace a trend of six-year oil price rising 16% a year (see chart). We measure momentum with the 40-week moving average.
The charts look good as long as the current six-year quote remains above the trailing average.

Fundamental factors support the price trends. Oil demand is strong with world economic growth paced by developing countries, especially China. Supply is tight as the Middle East is showing maturity with the workhorse giant fields on the verge of peaking.



Monetary factors also favor oil investment as interest rates below inflation drive investors to real assets for protection against currency debasement. Compared to Treasury Inflation Protected Securities that we also favor, oil price is likely to rise more than the official government determined inflation measure.

There appears to be little of the cost of maintaining global security reflected in the price of oil. The U.S. military presence in the Middle East may be controversial today. Yet when the U.S. supported government in Iran fell at the end of the 1970s, the world experienced its highest energy prices ever.

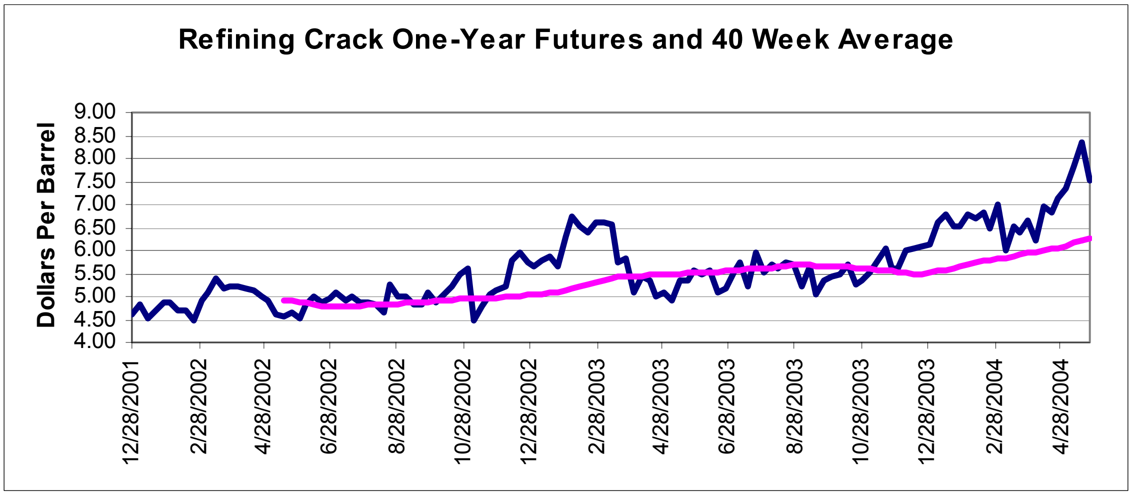
At some point oil price could be too strong and economic activity would be adversely affected. Six times in the past thirty years the annual gain in monthly price exceeded 70% briefly. July futures near $40 a barrel for Light, Sweet Crude Oil would have to exceed $52 a barrel to trigger a 70% warning.

Downstream Trends Also Strong

Industry people like to refer to the oil producing business as upstream and the oil refining/marketing business as downstream. Strong upstream business prospects captured in the rising trend of six-year futures are complemented by improving downstream prospects captured in the trend of one-year refining crack futures (see chart).

Compared to the two previous years, there has been no sign yet of a temporary peak in the trend. Perhaps there will be some falloff this year as in the past, but it would occur from a higher level.

The crack spread we measure is the price of two/thirds barrel of gasoline plus one/third barrel of heating oil minus a barrel of crude oil. While there are innumerable varieties of crude oil and products quoted around the world there is only one source of transparent, public quotes of futures prices for the next year, the New York Mercantile Exchange. As a result we use the Nymex quotes as an indicator of future downstream profitability globally, recognizing that markets are linked meaningfully, if not perfectly. Finally, the crack spread should be seasonally neutral because it always includes twelve months.



Volume, Price and Costs Translate to Attractive Cash Flow

Our process of estimating company-specific present value begins with an estimate of next twelve months cash flow. Current projections lead to a healthy level of unlevered cash flow, also known as Ebitda, short for earnings before interest, tax, depreciation and amortization (see table). We choose the next twelve months ending March 31, 2005 as the relevant time period.

For the next twelve months we project natural gas and oil volume near the first quarter 2004 level. That is sufficient for our valuation calculation. Management provides rich detail in conference calls, presentations and copious regulatory disclosures to put more color on a projection of growth for the rest of the decade.

We take the futures market at face value in projecting price for the next twelve months. Henry Hub quotes guide our projection of natural gas revenue. Light Sweet Crude quotes guide our projections of oil revenue. The refinery crack futures guide our projections of downstream cash flow. Because futures are constantly changing, our projection is adjusted accordingly. As a result, the specific amounts we project today may not be the amounts realized when the company next reports.

Assess Present Value Multiple Depending on Reserve Life

The important variables in the valuation of future production are captured in base year cash flow and a multiple of that cash flow that depends on reserve life. Indeed investors do differentiate on that basis as reflected in a high correlation of unlevered cash flow multiple with adjusted reserve life. We convert the market relationship to a formula that produces an anticipatory value with somewhat more sensitivity to reserve life.

Marathon Oil Corporation
Next Twelve Months Operating and Financial Estimates

	Q1 3/31/04	*Q2E 6/30/04*	*Q3E 9/30/04*	*Q4E 12/31/04*	***Year 2004E***	*Q1E 3/31/05*	***Next Twelve Months 3/31/05***
Volume							
Natural Gas (mmcfd)							
U.S. (or North America)	701	687	673	660	**682**	660	**670**
Overseas (or Int'l)	435	376	369	411	**399**	411	**392**
Total	1,136	1,063	1,042	1,071	**1,081**	1,071	**1,062**
Oil (mbd)	184	180	177	177	**179**	177	**178**
Total gas & oil (bcf)	204	195	193	196	**789**	192	**777**
Total gas & oil (mbd))	373	358	350	355	**360**	355	**355**
Price							
Natural gas ($/mcf)							
Henry Hub ($/mmbtu)	5.64	6.22	6.78	6.93	**6.39**	7.11	**6.76**
U.S. (or North America)	4.71	5.19	5.66	5.79	**5.33**	5.94	**5.64**
Overseas (or Int'l)	3.46	3.88	4.05	3.87	**3.80**	3.70	**3.87**
Total	4.23	4.73	5.09	5.05	**4.77**	5.08	**4.99**
Oil ($/bbl)							
WTI Cushing	35.23	39.51	41.20	39.42	**38.84**	37.67	**39.45**
Worldwide	28.98	32.51	33.89	32.43	**31.93**	30.99	**32.46**
Total gas & oil ($/mcf)	4.53	5.08	5.37	5.23	**5.04**	5.12	**5.20**
NY Harbor 3-2-1 ($/bbl)	6.98	12.29	9.34	5.82	**8.61**	5.82	**8.32**
Revenue ($mm)							
Natural Gas							
U.S. (or North America)	300	325	350	351	**1,327**	353	**1,379**
Overseas (or Int'l)	137	133	137	147	**554**	137	**554**
Total	437	457	488	498	**1,880**	490	**1,933**
Oil	485	533	551	527	**2,097**	493	**2,105**
Other	9,770	9,770	9,770	9,770	**39,081**	9,770	**39,081**
Total	10,693	10,761	10,809	10,795	**43,059**	10,753	**43,119**
Expense							
Fixed	166	166	166	166	**665**	166	**665**
Variable	166	179	187	185	**717**	177	**728**
Other	9,599	9,420	9,505	9,605	**38,129**	9,609	**38,139**
Ebitda ($mm)							
Exploration and Production	590	646	685	674	**2,595**	639	**2,644**
Other	171	350	266	166	**953**	161	**943**
Total Ebitda	761	996	951	840	**3,548**	800	**3,587**
Exploration	25	25	25	25	**100**	40	**115**
Deprec., Deplet., & Amort.	302	320	320	320	**1,262**	320	**1,280**
Ebit	434	651	606	495	**2,186**	440	**2,192**
Interest	38	38	38	38	**152**	38	**152**
Ebt	396	613	568	457	**2,034**	402	**2,040**
Income Tax	139	215	199	160	**712**	141	**714**
Net Income ($mm)							
Exploration and Production	478						
Other	64						
Unallocated	(285)						
Total	257	398	369	297	**1,322**	261	**1,326**
Shares (millions)	310	345	345	345	**338**	345	**345**
Per share ($)	0.83	1.15	1.07	0.86	**3.91**	0.76	**3.84**
Ebitda Margin (E&P)	64%	65%	66%	66%	**65%**	65%	**65%**
Tax Rate	35%	35%	35%	35%	**35%**	35%	**35%**

The adjusted reserve life index is the sum of developed and half undeveloped reserves divided by next twelve months production. When we last did an industry-wide upward revaluation on March 23, we estimated cash flow multiple equal to 2.5 plus 0.5 times reserve life. That approximates present value assuming constant commodity price near the one-year quotes at that time, about $35 a barrel for crude oil. Higher commodity prices since then imply higher cash flow and lower multiple by about 10%. Estimated present value provides a measure of appreciation potential should the market move toward that level as we expect.

Sale of the Yates Oil Field a Telling Event

The original "hook" that got us interested in Marathon in 1973, before the Arab Oil Embargo, was the company's 50% ownership in a great oil field in West Texas. That was the company's most valuable asset that carried investor's enthusiasm until U.S. Steel acquired the Ohio-based company in 1981. In recent years, after Marathon became an independent company again, Yates production declined to less significant levels. When the company sold the field late last year it left a void in the reported reserves. The company's reserve life index declined enough to cause us to scale back our estimate of present value even though the proceeds of the sale were reflected in a new balance sheet.

While the company's reserve life over the years has declined from longer than average to shorter than average, production still accounts for the majority of value in the stock. Production cash flow of 74% of total cash flow points to a similar split in value.

Acquisition of Minority Interest Expands Downstream Exposure

Along the way, Marathon has continually invested in maintaining and improving its Midwest refining/marketing business. A joint venture with former competitor, Ashland Oil, contributed to more market dominance and greater efficiency. Two months ago Marathon announced an agreement to acquire its partner's 38% interest by year end. The company subsequently sold a billion dollars of new shares to be ready to finance the deal.

Most of the cash flow from the whole venture has already been in our projections because Marathon accounted for the operation on a consolidated basis. While we did not attempt to revise our estimates to reflect a proportional consolidation, we recognized the difference in judging the market cash flow multiple and in assessing a present value multiple. When the deal is done some common shares will be issued to the seller and a minority interest deduction will no longer offset a portion of the reported profits that reach the bottom line for the whole company.

Kurt H. Wulff, CFA

Research Methodology/Ratings Description: McDep Associates is an independent research originator focused on oil and gas stocks exclusively. The firm applies the thirty years of experience of its analyst to estimate a present value of the oil and gas resources and other businesses of covered companies. That value is compared with a company's stock market capitalization and debt. Stocks with low market cap and debt relative to present value tend to outperform stocks with high market cap and debt relative to present value. Buy recommendations are expected to deliver a total return better than 7% per year above inflation. Hold recommendations assume the attributes of the underlying business are more than fully reflected in the current price of the stock. Sell recommendations are expected to deliver a negative total return less than 7% per year including the effects of inflation.

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