

Rating: Buy  
S&P 500: 1131

## **Marathon Oil Corporation**

### **Lower Net Present Value to \$40 a Share**

<i>Symbol</i>	MRO	<i>Ebitda Next Twelve Months ending 9/30/05 (US\$mm)</i>	3,900
<i>Rating</i>	Buy	<i>North American Natural Gas/Ebitda (%)</i>	23
<i>Price (US\$/sh)</i>	37.05	<i>Natural Gas and Oil Production/Ebitda (%)</i>	66
<i>Pricing Date</i>	11/2/04	<i>Adjusted Reserves/Production NTM</i>	7.7
<i>Shares (mm)</i>	347	<i>EV/Ebitda</i>	4.9
<i>Market Capitalization (US\$mm)</i>	12,900	<i>PV/Ebitda</i>	5.2
<i>Debt (US\$mm)</i>	6,100	<i>Undeveloped Reserves (%)</i>	30
<i>Enterprise Value (EV) (US\$mm)</i>	19,000	<i>Natural Gas and Oil Ebitda (US\$/boe)</i>	22.40
<i>Present Value (PV) (US\$mm)</i>	20,000	<i>Present Value Proven Reserves(US\$/boe)</i>	12.70
<i>Net Present Value (US\$/share)</i>	40	<i>Present Value Proven Reserves(US\$/mcf)</i>	2.12
<i>Debt/Present Value</i>	0.31	<i>Earnings Next Twelve Months (US\$/sh)</i>	4.30
<i>McDep Ratio - EV/PV</i>	0.95	<i>Price/Earnings Next Twelve Months</i>	9
<i>Dividend Yield (%/year)</i>	3.0	<i>Indicated Annual Dividend (US\$/sh)</i>	1.12

Note: Estimated cash flow and earnings tied to one-year futures prices for oil and natural gas.

Reported results may vary widely from estimates. Estimated present value per share revised only infrequently.

### **Summary and Recommendation**

We continue a Buy rating on the common shares of **Marathon Oil (MRO)** as we lower our estimate of net present value to \$40 a share from \$43 on the basis of projected cash flow and a multiple in line with producer/refiner peers. Partly for temporary reasons, recently reported earnings from production were below normal for the second quarter in a row considering industry conditions. Meanwhile the timing appears to have slipped to 2005 for the company to buy out its 38% partner in a U.S. Midwest refining/marketing business well positioned to handle increasing heavy oil imports from Canada. In our opinion, our present value estimate can be justified by a constant real crude oil price of \$35 a barrel compared to current six-year futures of \$41 a barrel. A continued favorable industry outlook supports our current buy rating possibly up to a McDep Ratio of 1.2 that, in turn, relates to a stock price of \$51 a share.

### **Oil Price Move Possibly Just Starting**

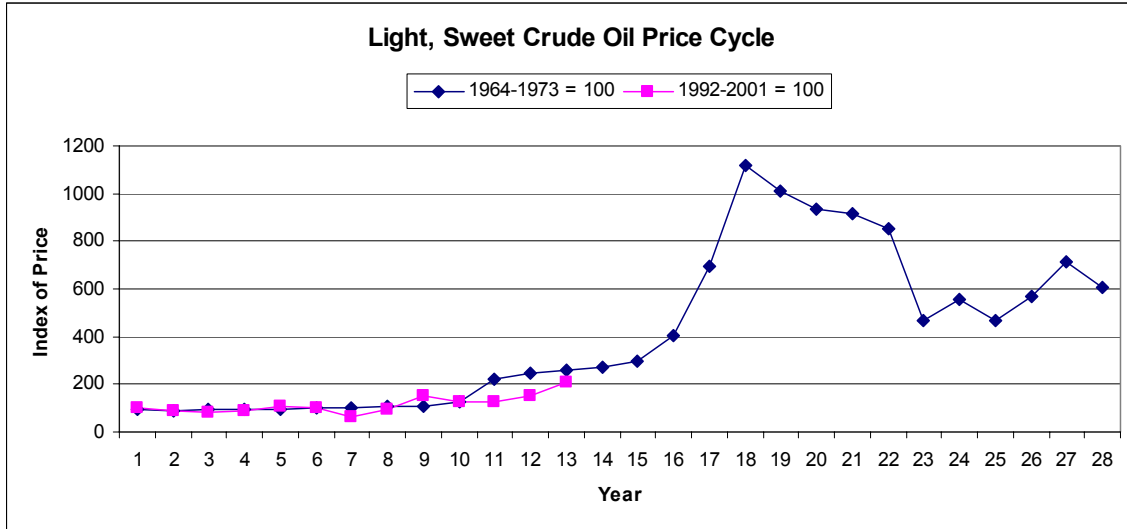
To offset any inclination to underestimate further potential for oil and gas price, we compare the relatively stable price period from 1992 to 2001 to the period from 1964 to 1973. Each was a ten year period that immediately preceded a sharply lower stock market in 2002 and in 1974. After quiescence, oil price started moving up in each case. We may be in the early stages of a new historic move (see chart [Light, Sweet Crude Oil Price Cycle](#)).

Frankly, few investors would give much weight to the likelihood of continued oil price strength. Contrast that with the growing chorus for a weaker dollar. It may just be that oil price is not high, but the real value of the dollar is low. That, too, is a parallel to historical experience.

Let us imagine how the cycle might unfold. By the way we chose to draw the chart Year 13 corresponds to 1976 and 2004. Once the move got going in the previous cycle, the annual average oil price did not decline until Year 19 (1982). The annual peak of 1100, or 11 times the first ten year average, was too high to be sustained. It might be less disruptive economically if

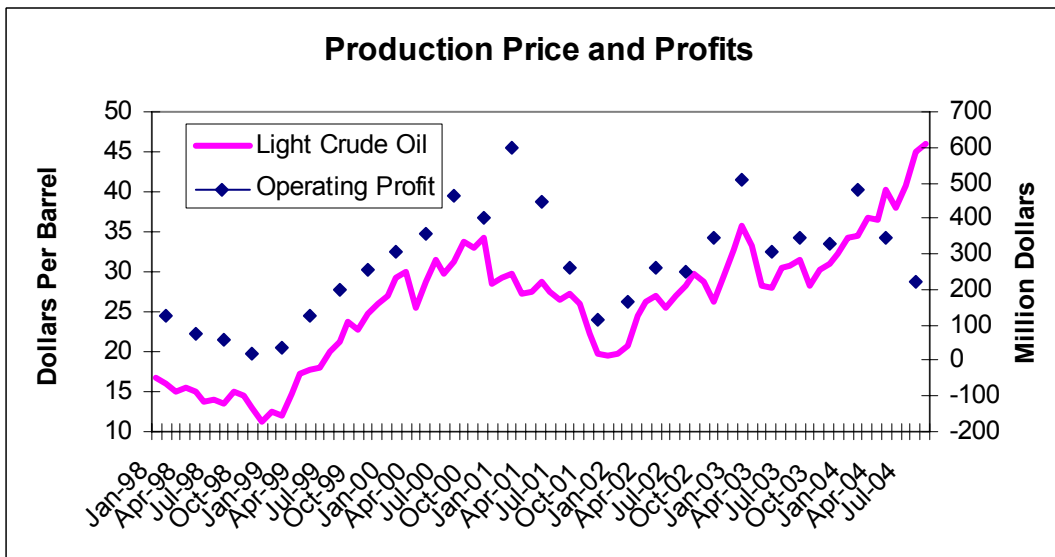
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the peak ahead of us were lower and the decline shallower. The end point in Year 28 at 600 implies a tripling over the next 15 years. If higher oil price unfolded gradually it would give everyone time to adjust.



**Production Earnings Deviate from Commodity Price**

While oil price has climbed, Marathon’s operating profit from production has dropped (see chart Production Price and Profits). It is not supposed to work that way. Apparently part of the decline is due to a natural gas contract involving North Sea production. Marathon seems to have committed to a low price contract that accounting rules require to be “marked to market”. Magnified potential future losses are booked when indicated. Presumably if futures prices remained constant there would be no further losses and reported production earnings would snap back into line.



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### Value MRO as Four Businesses

The producer/refiner has its value concentrated on oil production, perhaps to no surprise (see table Functional Cash Flow and Present Value). Of course that value is directly sensitive to oil price.

#### Marathon Oil Corporation Functional Cash Flow and Present Value

	<i>NTM</i> <i>Ebitda</i>	<i>Adjusted</i> <i>R/P</i>	<i>PV/</i> <i>Ebitda</i>	<i>Present</i> <i>Value</i>	
North American Natural Gas	870	6.4	4.6	4,000	
Overseas Natural Gas	260	7.8	5.2	1,400	
Oil	1,420	8.6	5.6	8,000	
Downstream	1,300		5.1	6,580	
	3,850	7.7	5.2	19,980	
Debt					6,100
Net Present Value (\$mm)					13,880
Shares					347
Net Present Value (\$/sh)					40

The downstream refining/marketing business is a natural hedge. When oil price is low and economic activity strong, the downstream business does well. When oil price is too high (not yet), and economic activity is weak the downstream might not do well. A plus for MRO's refining business is its location to receive growing supply of heavy oil from Canada. Canadian producers who have not made other arrangements to upgrade their resource may offer an attractive proposition to Marathon such as a discounted price or a joint venture.

The two natural gas businesses have distinct characteristics. North American natural gas is the premium energy business where competition is limited and the quality of the product high.

The overseas natural gas business is growing faster than oil and has contractual pricing that responds only slowly to change. The company has plans to liquefy natural gas in Africa and sell it in North America or Europe.

### Track Quarterly Cash Flow and Project It

Quarterly reports are interesting to us not for the bottom line earnings number, but for the operating and cost details that give us a basis for anticipating future performance (see table Next Twelve Months Operating and Financial Estimates). Marathon's trend has deviated from expectations. We have added back a hundred million dollars in each of the past two quarters to make the base more realistic. After a struggle we can see continued value in the company, though less than in most of our buy-rated and buy-recommended stocks.

Kurt H. Wulff, CFA

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**Marathon Oil Corporation**  
**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>3/31/04</i>	<i>6/30/04</i>	<i>9/30/04</i>	<i>12/31/04</i>	<i>2004E</i>	<i>3/31/05</i>	<i>6/30/05</i>	<i>9/30/05</i>	<i>9/30/05</i>
<b>Volume</b>									
Natural Gas (mmcf)									
U.S. (or North America)	701	641	598	590	<b>634</b>	590	578	567	<b>581</b>
Overseas (or Int'l)	435	324	303	400	<b>366</b>	400	342	335	<b>369</b>
Total	1,136	965	901	990	<b>1,000</b>	990	920	902	<b>950</b>
Oil (mbd)	184	178	157	157	<b>169</b>	157	154	151	<b>155</b>
Total gas & oil (bcf)	204	185	170	178	<b>736</b>	174	168	166	<b>686</b>
Total gas & oil (mbd)	373	339	307	322	<b>336</b>	322	307	301	<b>313</b>
<b>Price</b>									
Natural gas (\$/mcf)									
Henry Hub (\$/mmbtu)	5.64	6.10	5.49	7.49	<b>6.18</b>	8.62	7.16	7.20	<b>7.62</b>
U.S. (or North America)	4.71	5.02	4.76	6.49	<b>5.22</b>	7.47	6.21	6.24	<b>6.61</b>
Overseas (or Int'l)	3.46	3.07	2.79	3.28	<b>3.19</b>	3.16	3.07	2.98	<b>3.13</b>
Total	4.23	4.37	4.10	5.19	<b>4.47</b>	5.73	5.04	5.03	<b>5.26</b>
Oil (\$/bbl)									
WTI Cushing	35.23	38.34	43.89	51.67	<b>42.28</b>	49.68	48.36	46.96	<b>49.17</b>
Worldwide	28.98	29.48	36.29	42.72	<b>34.03</b>	41.07	39.98	38.83	<b>40.67</b>
Total gas & oil (\$/mcf)	4.53	4.65	5.09	6.13	<b>5.08</b>	6.27	5.86	5.75	<b>6.01</b>
NY Harbor 3-2-1 (\$/bbl)	6.98	12.73	7.83	5.70	<b>8.31</b>	6.57	8.70	8.70	<b>7.42</b>
<b>Revenue (\$mm)</b>									
Natural Gas									
U.S. (or North America)	300	293	262	352	<b>1,207</b>	397	327	325	<b>1,401</b>
Overseas (or Int'l)	137	91	78	121	<b>426</b>	114	96	92	<b>422</b>
Total	437	383	340	473	<b>1,633</b>	511	422	417	<b>1,823</b>
Oil	485	478	524	617	<b>2,104</b>	580	560	539	<b>2,296</b>
Other	9,770	11,731	11,452	11,452	<b>44,406</b>	11,452	11,452	11,452	<b>45,809</b>
Total	10,693	12,592	12,316	12,542	<b>48,143</b>	12,543	12,434	12,408	<b>49,928</b>
<b>Expense</b>									
Fixed	166	130	182	182	<b>661</b>	182	182	152	<b>698</b>
Variable	166	130	182	230	<b>708</b>	230	207	201	<b>867</b>
Other	9,599	11,217	11,016	11,135	<b>42,967</b>	11,168	11,101	11,101	<b>44,504</b>
<b>Ebitda (\$mm)</b>									
Exploration and Production	590	600	500	679	<b>2,369</b>	679	593	603	<b>2,554</b>
Other	171	514	436	317	<b>1,439</b>	284	351	351	<b>1,305</b>
Total Ebitda	761	1,114	936	996	<b>3,807</b>	964	945	954	<b>3,859</b>
Exploration	25	27	43	43	<b>138</b>	40	40	40	<b>163</b>
Deprec., Deplet., & Amort.	302	308	299	299	<b>1,208</b>	299	320	320	<b>1,238</b>
Other non cash		100	100		<b>200</b>				<b>-</b>
<b>Ebit</b>	434	679	494	654	<b>2,261</b>	625	585	594	<b>2,458</b>
Interest	38	51	40	40	<b>169</b>	40	40	40	<b>160</b>
<b>Ebt</b>	396	628	454	614	<b>2,092</b>	585	545	554	<b>2,298</b>
Income Tax	139	220	159	215	<b>732</b>	205	191	194	<b>804</b>
<b>Net Income (\$mm)</b>									
Exploration and Production	478	343	244						
Other	64	357	261						
Unallocated	(285)	(292)	(210)						
Total	257	408	295	399	<b>1,360</b>	380	354	360	<b>1,494</b>
<b>Shares (millions)</b>	310	346	347	347	<b>339</b>	347	347	347	<b>347</b>
Per share (\$)	0.83	1.18	0.85	1.15	<b>4.01</b>	1.10	1.02	1.04	<b>4.30</b>
Ebitda Margin (E&P)	64%	70%	58%	62%	<b>63%</b>	62%	60%	63%	<b>62%</b>
Tax Rate	35%	35%	35%	35%	<b>35%</b>	35%	35%	35%	<b>35%</b>

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