

Cautionary Comments on Total

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The March 19 issue of *Barron's* includes an article devoted to commentary on Total (TOT). The stock pays a generous dividend (5.4%) and *Barron's* argues that it has favorable prospects for capital appreciation. However, cautionary comments are in order.

The article states "Total's beauty isn't unblemished. Critics contend the company has lower-quality assets and higher finding costs than peers. Also, Total prospects in some of the world's dicier regions. But such drawbacks arguably are reflected in its shares. The ADRs currently fetch 7.8 times this year's expected earnings, at the low end of the industry's range."

Several years ago, the current CEO of Total was much in the news because he had publicly embraced the concept of "peak oil." He then believed that, in the future, recoverable petroleum resources would become increasingly scarce and expensive. He directed Total's reserve discovery and development strategy accordingly, seeking new prospects in locations that present significant difficulties, both physically and politically. He expressed the belief that dealing with such adversity was necessary to secure the company's future prospects.

But, new recovery technologies such as hydraulic fracturing (fracking) and horizontal drilling have significantly altered that outlook since Total embarked on their expensive high-risk strategy. These technologies are vastly increasing recoverable reserves of both oil and natural gas. Peak oil has been pushed off into the indefinite future.

One other cautionary consideration is worthy of mention. In the financial sector, book value is often used as a figure of merit in arriving at stock valuations. In the oil business an important figure of merit is **return on invested capital**.

Exxon Mobil (XOM) has long been the outstanding industry leader using this measure of performance. By this metric, Exxon Mobil has a return on invested capital that is approximately 50% greater than that of Total. This is a measure of success at risk management and capital allocation, two important criteria in petroleum exploration and production.

Finally, the French government has a strong influence over the management of Total. The company has long wanted to close three unprofitable refineries located in France. The French government has prohibited this action because it would result in laying off workers.

On the other hand, Total may be a strong candidate for improvement on the basis of its low P/E valuation and low return-on-capital. It may be a French poodle to compete with the Dogs of the Dow. Caveat emptor. (3/18/2012)