Valuation of Oil Companies

-The Use of Financial Indicators [i]

by

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Abstract

Investment banks and financial analysts make use of financial indicators in valuating companies. We review the most common financial indicators used in the oil industry, and link them with financial theory. Thereafter we use accounting and market panel data to test the actual causality between different sets of financial indicators and market capitalisation.

The most common financial indicators and valuation benchmarks in the oil industry are Return on Capital Employed (ROCE), cost relative to industry benchmarks, production growth, reserve replacement rate, and average tax rates. These indicators can be perceived as an implicit, balanced incentive scheme presented to the oil firms by the market. Responding to these incentives, the companies need to strike a balance between short-term goals of rentability and medium- to long-term goals of reserve replacement.

In presentation of their valuation techniques, investment banks often present the relationship between market capitalisation (or EV/DACF) and a single financial indicator - like ROCE - in a diagram. They typically show this relationship for different companies at a given point of time. We explore these causalities in a more detailed econometric analysis, using multiple (simultaneous) explanatory factors and panel data set. Thereafter, we compare our findings with the common analyst perceptions. Finally, suggestions for improving valuation techniques are put forward.

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