ACORN RESEARCH

RESEARCH REPORT

September 7, 2010

Valero Energy Corporation
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San Antonio, TX 78249

www.Valero.com

Phone: 210.345.2000

VLO: BUY

SYMBOL:	VLO
CURRENT PRICE: (09.7.2010)	$16.92
TARGET:	$25.8
SHARES OUTSTANDING:	566.26 M
MARKET CAP:	9.59 B
52-WEEK RANGE HIGH:	$21.78
52-WEEK RANGE LOW:	$15.49
AVG. VOL. (50 DAYS):	10,106,800

HIGHLIGHTS

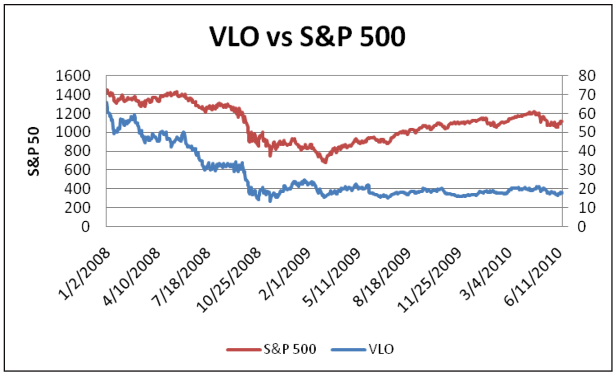
- Valero Energy is the largest refiner in North America
- In the second quarter of FY2010, the company has acheived EPS of $0.93 from its continuing operation.

OVERVIEW

Valero Energy Corporation, based in San Antonio, Texas, is North America's largest independent petroleum refiner and marketer. It was incorporated in 1981. At present the company has around 21,000 employees. Its revenue comes from three segments; Refinery, Retail and Ethanol Plants with refinery being the major contributor. The company has 15 refineries in the US, Canada and the Caribbean Island's with production capacity of around 2.8 million barrels per day. The company markets branded and unbranded refined products through a network of around 5,800 retail outlets in the United States and Canada. It also owns ten ethanol plants with a combined ethanol production capacity of about 1.1 billion gallons per year. .

In FY2009 Valero Energy had achieved revenue of US$ 68.14 billion with a net loss of $1.98 billion. Over the last couple of years, the company encountered very tough business conditions due to the economic recession leading to a thin refining margin to operate with. However with the global economy about to be out of recession, refining margin has already been showing signs of improvement. The company has the ability to produce high-value, clean fuels from a wide variety of crude feedstock.

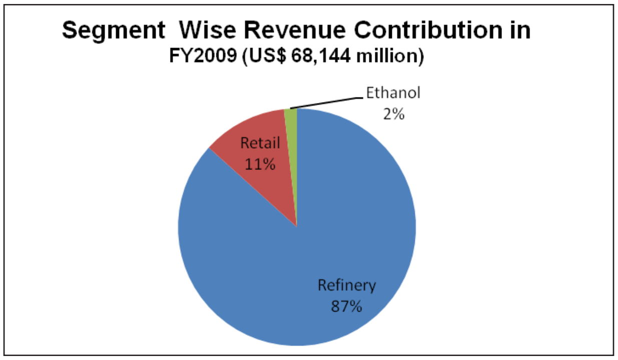
The Refinery segment contributes more than 85% of company's revenue and the improvement in refining margin is vital to the profitability of the company. During the first half of current year, the company has already witnessed improvement in the operating margin. We believe Valero Energy holds good prospect in the long term once the economy becomes stable. By virtue of its huge refining capacity, improvement in refining margins will substantially improve the profitability of the company. It has a strong balance sheet and significant unutilized assets. As the economy starts growing, demand for oil in US will again grow and so the refining margins will improve. VLO seems a good buy with a target price of $25.80.



Source: Yahoo Finance

VALERO ENERGY BUSINESS OVERVIEW

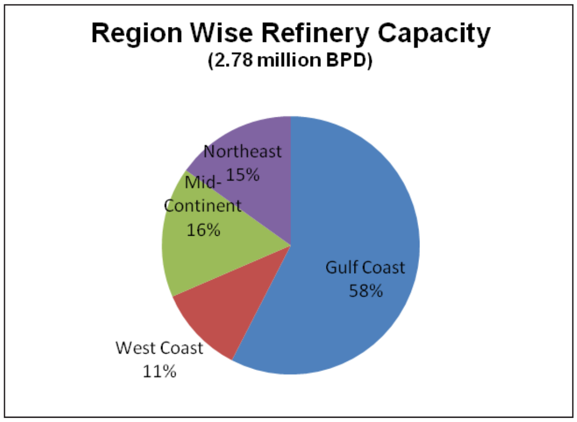
Valero Energy Corporation is North America's largest oil refiner. However its revenue comes from three business segments; Refining, Retail and Ethanol Production. Refining is the major segment contributing around 90% of the revenue. It has 15 refineries in the US, Canada and the Caribbean Island's with production capacity of more than 2.8 million barrels per day. The company also markets branded and unbranded refined products in the US and Canada. In FY2009, the retail segment revenue was close to $8



Source: Annual Report

billion. Valero Energy owns ten ethanol plants with a combined production capacity of about 1.1 billion gallons per year.

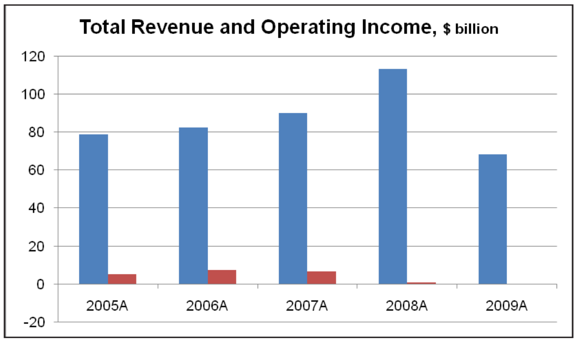
As the largest refiner in North America, the company has the ability to process a variety of lower cost feedstock and produce higher value products. The refineries are geographically diversified among four regions; Gulf of Mexico, West Coast, Mid-continent, and North East.



Source: Annual Report

GLOBAL REFINERY BUSINESS

Global oil refining spare capacity has been increasing steadily since 2006 and this has impacted the refinery margins. This has adversely affected Valero Energy with its bottom line plummeting from a profit of $5.2 billion in 2007 to a loss of around $2 billion in 2009.

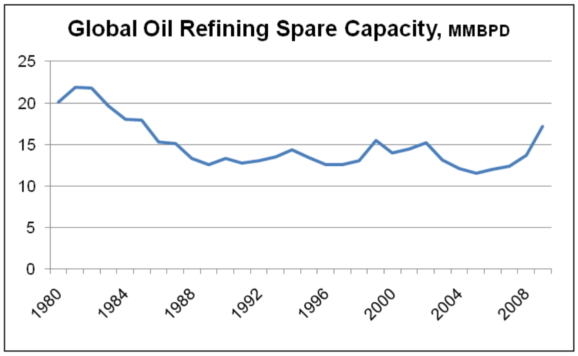


Source: Annual Report

REFINING MARGIN WILL BE UNDER PRESSURE AND IMPROVEMENT WILL BE SLOW

The period between 2004 and 2007 is considered the golden age for the refinery industry with historically the highest refining margins. However, since then, due to the slowdown in global economy, this industry has been experiencing very tough situation with margins under tremendous pressure. Global spare refining capacity has been rising.

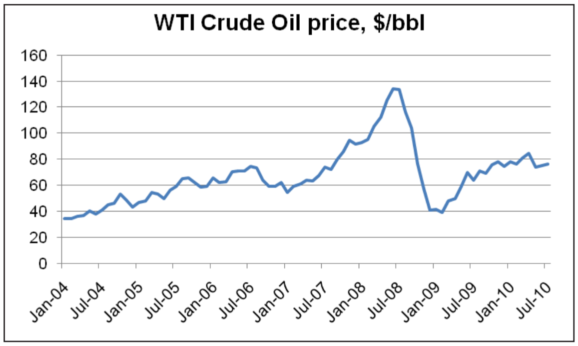
The over capacity and lower demand for oil have resulted in refining margins plummeting to unsustainable levels. Since 2007, refineries of approximately 1.5 million BPD capacity globally have faced closures or shutdowns. We believe this tough period will bring rationalization to the industry and bigger players will emerge stronger.



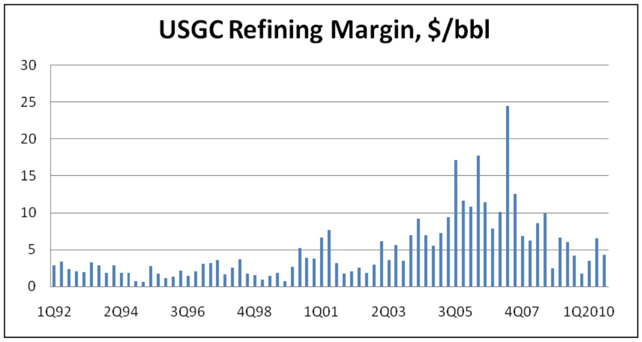
Source: BP

Beginning of the current year, there has been encouraging signs for the refining industry. Oil prices have been steady in the range of $75 to $85 per barrel. Demand growth for oil is slowly getting back in track with growth in GDP, industrial production, trade and jobs.

With the shutdown of refining capacity and no fresh capital coming for new capacity addition, we will witness gradual reduction in spare capacity and thus improvement in refining margins. However as it is expected that the recovery of US economy will be slow, we also feel recovery in refining margins will also be slow and gradual.



Source: EIA



Source: EIA

REFINERY SEGMENT WILL BE TE MAJOR GROWTH DRIVER

The Refinery segment is the major business for Valero energy, contributing more than 85% of revenue. Currently the company utilizes around 84% of its existing refining capacity. So it offers the company to increase production once demand for oil in the US starts growing. We expect in the long term, refinery business will be the major contributor to the revenue. Similarly this segment will be the major contributor to the bottom line of the company with improvements in refining margins globally. We expect the other two segment s, retail and ethanol to operate at the current margins.

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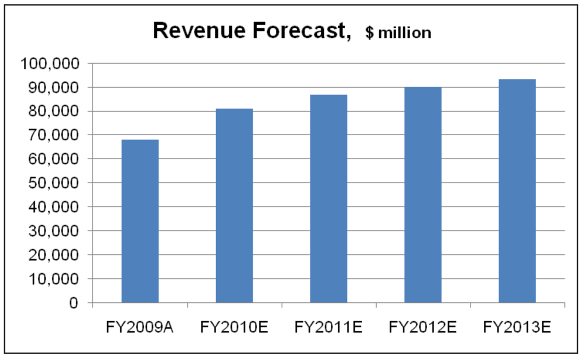
REVENUE TO WITNESS AROUND 20% GROWTH THIS YEAR

The Global economy is on its path to recovery and so we expect Valero Energy to again show growth in its revenue. We expect the revenue to be around $80 billion in 2010 with the highest percentage of growth coming from the Ethanol segment.

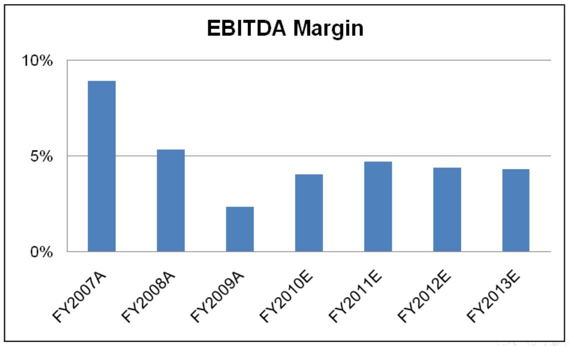
Beyond 2010, we expect a steady growth in revenue, although it depends a lot on commodity prices fluctuations.



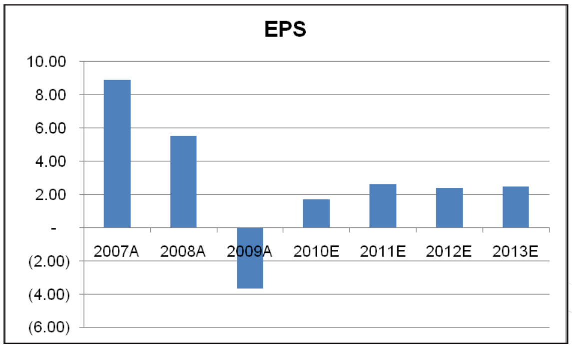
Source: Own Analysis

WE EXPECT EBITDA MARGIN TO IMPROVE IN 2010 AND REMAIN AT THAT LEVEL

Valero Energy's operating margins depend a lot on the crack spread. However the company has the ability to use a variety of feedstock that is cheap and has higher price differential to the WTI. The company has also significantly reduced refinery operating expenses. With the crack spread in US gradually improving, we expect Valero Energy to improve its EBITDA margin in 2010 and stay at that level for next few years.



Source: Annual Report & Own Analysis



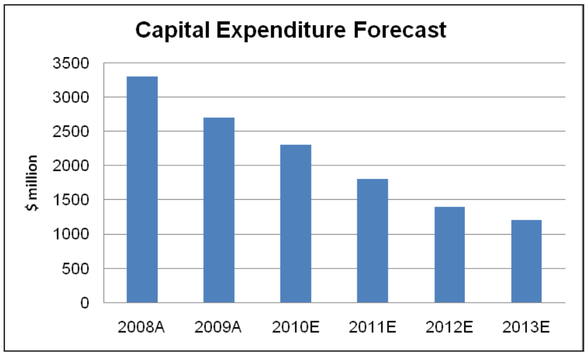
Source: Annual Report & Own Analysis

With increase in revenue and marginal improvement in EBITDA, we expect Earnings per share of the company to reach $2.44 in year 2013.

(Note: FY2008 EPS calculation excludes goodwill Impairment)

CAPITAL EXPENDITURE WILL GRADUALLY REDUCE

Valero Energy has spent around $6 billion in FY2008 and FY2009. It expects to spend $2.3 billion in 2010. However with no capacity addition in refinery envisaged, we expect significant reduction in capex after year 2010.



Source: Annual Report & Own Analysis

VALUATION

The stock is being currently traded at $16.94

We have used a DCF method to value the stock. We expect the company to spend around $1.5 billion every year in capital expenditures over the next few years.

We followed a CAPM method to calculate the Weighted Average Cost of Capital (WACC). We considered a 30:70 debt equity ratio. Risk free rate is taken as the current yield from 10 years T-Note. Beta is calculated as a time varying beta between S&P 500 index and the stock. We got the beta to be 1.42. We finally got the optimum WACC as 10.29% with expected tax rate of 35%. We are assuming a terminal value till year 2050 for our valuation.

RISKS

1. The company is susceptible to global refinery margin and global economic activity. Most of its revenue comes from the refining business and reduction in refinery margins significantly affects the bottom line of the company.

2. Compliance with and changes in environmental laws, including proposed climate change laws and regulations, could adversely affect the performance of the company.

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CONCLUSION

Valero Energy Corporation is North America's largest independent petroleum refiner and marketer. Due to the recent global economic crisis and thus reduction in refining margins, the company's bottom line has shown a steep fall. However we expect this phase to be an opportunity for bigger players to emerge stronger. To face the challenge Valero Energy has also reduced the refinery operating expense significantly. With price differential of its input cost with respect to WTI showing increase, we expect the company to improve its EBITDA margin to around 4% in FY2010 compared to 2.4% in FY2009. With Earnings per Share expected to be more than $2 per share in year 2011, we expect the company to be an outperformer and put a target price of around $25.80 per share.

VALUATION MATRIX

Risk Free Rate	2.75%
Risk Premium	6.75%
Beta	1.42
COE	12.34%
Cost of Debt	8.50%
Debt equity ratio	30:70
Tax rate	35%
WACC	10.29%
Terminal Grow th Rate	2.70%

RATIOS

	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016	FY 2017	FY 2018
Standard ratios											
Sales grow th (%)	26%	-40%	19%	7%	3%	4%	4%	4%	4%	4%	4%
EBITDA grow th (%)	-25%	-73%	103%	25%	-4%	1%	1%	1%	1%	1%	1%
EBT grow th (%)	-92%	-185%	425%	54%	-8%	2%	2%	2%	2%	1%	1%
EPS grow th (%)	-124%	70%	146%	54%	-8%	2%	2%	2%	2%	1%	1%
EBITDA margin (%)	5%	2%	4%	5%	4%	4%	4%	4%	4%	4%	4%
EBT margin (%)	0%	-1%	2%	3%	2%	2%	2%	2%	2%	2%	2%
Net profit margin (%)	-1%	-3%	1%	2%	2%	1%	1%	1%	1%	1%	1%
Return on avg assets (%)	-3%	-6%	3%	4%	4%	4%	4%	3%	3%	3%	3%
Return on avg equity (%)	-7%	-13%	6%	9%	8%	8%	7%	7%	7%	7%	6%
ROIC (%)	-4%	-7%	3%	5%	4%	4%	4%	4%	4%	4%	4%
ROIC - WACC (%)	-14%	-17%	-7%	-5%	-6%	-6%	-6%	-6%	-6%	-6%	-6%

COMPANY FINANCIALS FISCAL YEAR ENDING 31-DECEMBER

	FY 2009 A	FY 2010 E	FY 2011 E	FY 2012 E	FY 2013 E	FY 2014 E
Income Statement Analysis (US$ million)						
Net Sales	68,144	81,132	86,904	89,901	93,140	96,560
Other Income	17	0	0	0	0	0
Total Revenue	68,161	81,132	86,904	89,901	93,140	96,560
EBITDA	1,617	3,278	4,105	3,952	4,004	4,052
Profit before tax	-449	1,461	2,246	2,075	2,126	2,175
Net Income	-1,982	949	1,460	1,349	1,382	1,414
EBITDA Margin (%)	2%	4%	5%	4%	4%	4%
Net Margin (%)	-3%	1%	2%	2%	1%	1%
Balance Sheet & Other Fin. Data (US$ million)						
Current Assets	10,923	9,588	9,638	9,647	9,658	9,671
Total Assets	35,629	36,476	37,855	38,877	39,928	41,007
Current Liability	7,798	7,838	7,976	8,054	8,138	8,226
Long Trem Debt	7,163	7,163	7,163	7,163	7,163	7,163
Shareholder funds	14,725	15,532	16,773	17,717	18,685	19,674
Capital Expenditure	2,700	2,300	1,800	1,400	1,200	1,300
Return on average Assets (%)	-6%	3%	4%	4%	4%	4%
Return on average Equity (%)	-13%	3%	10%	18%	22%	22%
Per share data (US$)						
Tangible Book Value	12	13	14	15	17	19
EPS	-3.67	1.68	2.58	2.38	2.44	2.50

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- BUY — The stock appears attractively valued and we feel the stock's total return will exceed that of the market over the next 12 months.
- HOLD — The stock appears appropriately valued and we believe the stock's total return will be inline with the market over the next 12 months.
- SELL — The stock appears over valued and we believe the stock's total return will be below the market over the next 12 months.

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