Case study: gulf oil corporation

Business

Evaluate the economics of Gulfs exploration and development program in net present value terms. How do Gulf's outlay for exploration and development compare to cash returns Gulf generates from these actively. If we evaluate the performance of Gulf's management for the period from 1976 to 1983, we will find out that the management basically did not run the company properly. Many indicators prove the fact the management's efforts in spending huge amount of money in exploration and development activities did not yield their unifies.

The analysis will cover numerous set of financial Indicators In order to present the full picture of Gulf's management's performance.

For the period of 7 years, the management spent $15. 1 Billion in exploration activities. By right, the amount spent should have resulted in an increase in the company's performance represented in an increase in shareholder's wealth. That was not the case with Gulf. The management of Gulf was spending huge amount of money without proper analysis, In a nutshell, they were showing careless attitude In managing assets of the company.

This was reflected In huge market undervaluation of company's stock, which will be demonstrated later.

Coming back to the expenditure on exploration activities, we will find out that on per share basis, it cost shareholders $91 . The amount is derived as per below: Per share exploration expenditure= Total exploration expenditure/ Number of sharers Per share exploration expenditure= $15. 1 Billion/ 0. 165 Billion=$91 Now, let us look how much the price of the company increased for the period of 7 years. Referring to the exhibit 6, we

will see that the company's share Increased from 29 to $43, which mean $14 Increase in share prices.

14 increase in price for $91 expenditure per share clearly shows the fact that the management of Gulf headed by Mr.. Lee did a very poor job. And it happened in the environment, when the crude prices increased from $5. 76 in 1976 to $22. 42 in 1983.

But this is only one angle of the analysis. Let's cover other aspects. If we refer to exhibit 3, we will see that the company was heavily depleting its reserves. Its reserve replacement ratio on average of 7 year was 0. 85, which is not a good indicator.

Ration below 1 means that the company produces more that It develops reserves.

If Gulf continued operating In this manner, Its estimated reserve life would be 8 years. Estimated Reserve Life (1983) = Accumulated Reserves/ Production= Estimated Reserve Life (1983) = toner Inhalators, sun as return on assets Ana equally, wanly we can aerial Trot exhibit 7, show that the company performs below the industry average. So that average return on assets for Gulf for the period of 7 years was 6% compared to 7. 2%.

Similarly, average return on equity was 12. % compared to industry average of 16. 8%. All this indicators proves the point why the market so drastically undervalued Gulf's stocks.

If we calculate ANTA per share basis, we will find out that it is $112.

9, compared to $43. It's not a surprising fact looking at the poor asset management. Net Total Assets per share= (Total Assets-Long term debt)/ Number of shares ANTA per share= ($21 Billion- 2. 3 Billion)/ 0. 165=$112. 9 Despite of such a poor performance, management of Gulf showed a practice of paying high dividends to shareholders.

This tactics is usually done by the management to portray its good performance in the eyes of shareholders. 2. How Gulf shares became so valuable within a short period of time?

How Pickers could benefit from Royalty trust concept, why was he offering such a big premium? The share prices of Gulf became so valuable mainly due to speculative activities; it had nothing to do with the performance of the company. Just to highlight one interesting fact, one week before Picking's partial tender offer, a trading volume of Gulf shares increased almost two times. Why investors wanted to acquire shares of Gulf? One of the reasons might be the royalty trust concept, which Pickers wanted to implement in Gulf.

Pickers was a clear corporate raider, who was mainly benefiting by acquiring shares of companies and selling them at the premium thus getting capital gains. The concept of royalty trust would results in a huge increase in PEPS since the concept of royalty trust enabled the company to enjoy tax benefits. In general, the basic advantage of setting up a trust to distribute oil and gas income is that the trust revenues are not subject to corporate taxation before any dividends are strutted, even though the owners enjoy the benefit of limited liability.

Generally, once the corporate tax has been paid, firms can retain their earnings and/or distribute them to their stockholders as dividends. Corporate dividends paid to individuals are subject immediately to the personal income tax at a rate.

To the extent that the market value of stock is enhanced through retained earnings, the increased value is taxed as capital gains when stockholders sell their shares. So should Pickers have implemented this concept in Gulf, the prices of royalty trust hares would have been around $134, which is derived as per below: PIE Gulf Shares (1983) -P $43/ PEPS $5. = 7. 8 As a result of corporate tax exemption, new INAPT would be $2. 85 Billion. New PEPS= $2.

85 Billion/ 0. 165=$17. 23 New pence= New That was the reason why Pickers was ready to offer $65 and why there were so many individual investors willing to acquire the shares of Gulf on the eve of Picking's offer. Pickers net capital gains on share basis from the sale of Gulf shares after implementing the royalty trust concept would have been $34. 5 After tax capital gains per share= ($134-$65)*0. =$34.

5 3. How much should Keller of Social offer for Gulf shares?

In contrast to Pickers, Keller of Social wanted to acquire Gulf to run it. That was one of the reasons why management of Gulf was more eager to be acquired by Social rather than by Pickers of Mesa, who wanted to liquidate the company and enjoy huge capital gains from the sale of royalty trust shares. Since Gulf Management did not want to accept any offer below $70, Keller should bid $80 for Gulf shares. Social was in the position to offer $80,

since many banks are willing to offer loans because of low gearing ration of the company.