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RESEARCH NOTES

JUNE 3, 2010

INTERIM UPDATE: BP PLC-ADR

MANDATE: SPECIAL SITUATION **PRICE: $38** **FAIR VALUE: $55 (MAINTAIN)**

RATING: *BUY UP TO $50*

Investment Conclusion:

Obviously, the nature of an investment in BP has changed dramatically in light of the enormity of the calamitous oil spill in the Gulf. Portfolios in which BP was originally held as a high-quality, defensive position might now consider realizing losses and reinvesting in any of our other attractive energy sector ideas – most of them *also* oversold given the recent strength in the dollar and attendant weakness in the commodities, as well as over concern about collateral regulatory and political fallout in reaction to developments in the BP disaster.

However, *in appropriate portfolios*, we believe BP may offer wide total return potential from its current price and indicated dividend yield - recognizing the possibility BP reduces or temporarily suspends dividend payments to mollify interests bent on vilifying the company and its management purely for the sake of political expediency. We think the market is grossly overreacting to the combined uncertainties of the costs of cleanup and damages, and the growing threat of wanton, politically-motivated penalties, yet-to-be-formulated.

We are maintaining our "spill-adjusted" fair value of **$55** - which reduces our $60 fair value by the full amount of a *$15 billion* all-in, present value estimated cost of cleanup, fines and damages. Other guesstimates of this liability run to $37 billion. Since the accident, BP has lost **$60 billion** of total market capitalization which, no matter what number one uses to guesstimate the total cost of this disaster, would seem to discount the worst-case outcome for BP – *including* an enormous opportunity cost of projects postponed or foregone and/or the possible distressed sale of certain assets for the sake of meeting all of its accident-related liabilities (which we don't think will be necessary).

Discussion

"Uncertainty" surrounding possibly significant outcomes often gets inappropriately discounted in market prices - sometimes to the point of being plain illogical. Instances where we see this kind of market behavior might include class-action suits against pharmaceutical companies, episodes of regulatory scrutiny in any industry, or, perhaps a better parallel to the BP situation given the high emotions, the prosecution of Philip Morris. During the bleakest moments of these episodes we typically see large-scale capitulation in the related stocks which, much more often than not, represent exceptional buying opportunities.

This is a huge mess; and it's impossible not to be touched by the human and environmental impact of this disaster. It is emotional. But, in our capacity as financial analysts and portfolio managers, it's important we do not let emotions color our analyses, no matter how difficult that may be in this instance.

From a purely financial perspective, then, we believe BP *will* survive this - last year it had virtually the same throughput as Exxon; and BP is among the world's largest corporations with enormous financial resources. Without BP among the handful of corporations sure to be named as codefendants in any sort of legal action, what entity would be there to bear the liability for this disaster on the scale the market seems to be anticipating? The plaintiffs will *need* BP to survive.

The fact is that BP has the cash flows and financial resources to meet any imaginable liability. This is not to say that BP will not be significantly impacted financially by these events, but we see it as unlikely that they will have to rationalize any reserve assets, nor do we expect these events to affect their cash flow from continuing operations, though it might raise their cost of capital somewhat (today BP received downgrades from two debt rating agencies, leaving the company with still strong investment-grade ratings). They will continue to have willing customers to buy all the oil and gas they can produce. And, although it could be viewed as provocative to many politicians who want to make it an issue, BP could, and very well might, declare its regular dividend at the end of July despite calls for the company to suspend payments.

True, there is significant "headline risk" which will surely buffet the stock. In particular, the Obama administration is overcompensating in the press for the criticism it has received from all sides that they did not take early or decisive action to deploy resources towards the containment of the spill. In his press conference announcing a criminal probe into the affair, Atty. Gen. Holder talked a tough game - but his delivery and body language was not convincing that he believes he has a prayer of successfully assigning criminal culpability to anyone.

There is no overstating the enormity of this tragedy on many fronts. However, at the end of the day it was an accident, not a conspiracy. Cleanup, damages and fines will surely add up to many billions of dollars - but nowhere near the $60 billion of market value that BP shareholders have lost.

Credit default swaps on BP debt have widened dramatically, which appears to us a particularly visceral reaction given the implications. And, the large trading volume in the stock suggests there are many agents who just do not want to explain to their clients why they own BP shares. The buyers on the other side of this volume must be able to take the longer view and recognize the opportunity this market over-reaction presents for investors who can withstand volatility and uncertainty for the sake of high returns.

If you have questions or comments regarding this or any other Research Note, click here to contact the H.M. Payson & Co. Research Department.