Royal Dutch Shell

ANCHOR CAPITAL

RESEARCH

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July 2017

With the weakness in the oil price, let us revisit the investment case for Royal Dutch Shell. There are three things to consider:

- Why choose Shell ahead of the other oil companies?
- Outlook for the oil price?
- Valuation of Shell?

We like Shell ahead of the other major oil companies primarily because of the potential for efficiency improvements.

		2013 – 2015 average	2019 – 2021 average
CREATE A WORLD CLASS INVESTMENT CASE	ROACE	8%	-10%
	Organic free cash flow	$5 billion p.a	$20-25 billion p.a
	Brent	-$90	-$60

Source: Shell

Historically Shell was known as a great innovator but it was also a very bureaucratic company (the former UK and Dutch corporate structure played a part). It did very exciting things in energy exploration but financial returns were not as important. This is now changing because of new leadership under Ben van Beurden, who became CEO in January 2014. He has an absolute focus on creating a world class investment case for Shell. We are beginning to see the fruits of this.

We do not try to forecast the oil price – it is too difficult to do, as it is for many other global commodities. We do note however when oil prices are considered to be expensive or cheap, based on profitability levels at the independent oil majors and the national oil companies. Industry profitability is currently depressed indicating a cheap oil environment plagued by excess above-ground oil stocks (in storage tanks, oil tankers etc). And OPEC is trying hard, through production cutbacks, to reduce these above-ground oil stocks to the 5 year average.

This has proven to be more difficult to achieve than expected, because of the resilience of US shale production in the Permian Basin and the return of strife affected oil supplies from Nigeria and Libya. We do not know how long this rebalancing of oil stocks will take but low industry profitability should ultimately lead to higher oil prices. If not, an oil supply shortfall is likely in the medium term (in 3-5 years).

Shell is not very profitable in this cheap oil environment, only achieving a return on equity (ROE) of 3.8% in 2016. In prior years, however, when oil was expensive they did far better and achieved ROE’s of >20%. The current share price of 2100p is factoring in some improvement in profitability but certainly not a return to expensive oil. We believe that if Ben van Beurden is successful (as we expect) in improving efficiency at Shell, and the oil price rises because of declining above-ground oil stocks, the share price has scope to rise by 25% or more. This implies an increase in the price/book ratio from 1.2x to 1.5x. The good news is you also receive a dividend yield of 7% per annum. This reflects a dividend of say $1.88 per share in 2017 (in line with 2016). If oil prices continue to languish in 2018 (at $45 per barrel or even lower), then the company may be forced to lower the dividend slightly in that year. In summary, Shell represents an attractive investment opportunity.