

Alpha shares analysis

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Shell – the future is green? Not green enough

As a leading oil and gas company, Shell has benefited from turbulence in energy supply markets leading to upgrades in near-term profit forecasts that are two-thirds higher than before Russia invaded Ukraine. The ratio of share price to earnings per share (PE) is low, even by Shell's standards, but this is not a cheap stock. Neither is it a value trap; but good long-run returns depend on its management of the energy transition.

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Shell share price



Source: FactSet

At the start of writing this report there was a choice between which of the UK's two large integrated oil and gas companies to cover: **Shell (SHEL)** or **BP (BP)**. Today, this is a pretty tough call as there is hardly a hair's breadth between them in terms of key drivers, focus, financial health and valuation. As the chart below shows, £1,000 invested in Shell 10 years ago would today (25 October) be worth £1,352.60, whereas the same invested in

BP would be worth £1,356.10. The chart also shows that throughout this period the stocks were, in effect, a proxy for one another. However, I picked Shell.

So why pick Shell over BP other than perhaps by tossing a coin? As the title suggests, my initial thought was that Shell is more invested in providing a greener future. Also, when I was a cub analyst way back in the 1980s, there was a well-established adage of 'never sell Shell' – always go with what you think you know. So was this the right choice? Shell is a complex beast so I have chosen to focus on just the scope for greener credentials and income.

Total returns Shell and BP – inseparable



Source: FactSet

Pariah turned gamekeeper

Oil companies have long been in the pariah category along with the likes of tobacco and coal mining as they produce the raw materials for making greenhouse gases. That is certainly true as there is around 425kg of CO₂ released into the atmosphere from every 42 gallon barrel of crude oil refined. Annual oil production is around 90 million barrels per day, so the industry contributes to almost 14 billion tonnes of CO₂ released every year. It is the same story for natural gas with around 675 billion cubic metres produced annually and with 2.2kg of CO₂ per cubic metre, gas pumps another 1.5 billion tonnes of CO₂ into the atmosphere.

Shell is a major producer of both with output of 579 million barrels of oil and 70 billion cubic metres of natural gas in 2021. This means that it has only around 2½ per cent market share in oil, but is much larger in natural gas, with just over 10 per cent. So Shell is clearly part of the problem, but it does have a stated aim increasingly to be part of the solution.

Its oil production is being deliberately lowered year on year and so far in 2022 upstream production is down 13 per cent over 2021, although the withdrawal from Russia is a material part of this. Even before the Ukraine war, production was falling from a peak in 2019 of 627 million and the target reduction is 1-2 per cent each year. Gas production is also down in 2022 by around 6 per cent, but this is likely a blip due to Russia's war as gas production is planned to increase.

However, this shaving production of oil is just tinkering and to really become part of the solution the oil companies need to invest, and invest heavily, in renewable energy. Shell has begun its journey and is expected to accelerate, thanks in no small part to the decision to appoint the former head of the renewables division, Rael Sawan, as the new group CEO.

Shell already has interests in offshore wind, solar and hydrogen (for fuel cells) and is looking to help facilitate a 10-fold increase in the number of electric vehicle (EV) charging points in the UK but most positions are still fledgling. Its investment in all aspects of becoming greener is around 6 per cent of free cash flow, but this is still only one-third what is put into oil and gas.

Shell's challenge is to convince observers it wants to become a major part of the solution, and isn't just trying to make itself come across better. It has a three pronged strategy for 'energy transition': avoid, reduce and mitigate. However, most of what it seems to be doing is in the latter two, whereas the environment really needs a lot of the former. It is targeting offset schemes (carbon capture plants and planting forests), stabilising production emissions, growing gas to replace oil in its output, expanding the production of lower carbon auto and aircraft hydrocarbons. This leaves its own carbon footprint pretty large.

Given the sheer scale of free cash flow available for investment that Shell has (especially now that debt has been sharply lowered) and compared with the very limited budgets and access to new capital that the truly green businesses have, Shell does have the opportunity to turbocharge fully green solutions but does seem to be pulling its punches.

Oil and gas are going through a purple patch right now, but long-term volatility in commodity prices leading to gyrating profit and cash flow still await investors and too much still rests here in unknowns to ever allow for a meaningful, and lasting, re-rating of the sector. The case to be made is that can only really come from a serious push to make things greener and cleaner.

Windfall risk

The UK is looking somewhat out of step with its European counterparts in not seeking to tax excess profits being made by energy companies (although that may change with the chancellor Jeremy Hunt's eagerly awaited fiscal plan). Where external factors sharply change, and deliver far more profit than anyone had been expecting, the political response is often to place a surtax on the excess (although the scale of excess can be hard to assess).

The UK government has committed itself to a large and potentially open-ended support package for domestic energy costs (though the scheme has been reduced to six months) where the pain felt by consumers is the opposite side of the same coin driving supernormal profits for the energy sector. Socially it has to be right to tax excess profits because history tells us that if the money does not go into the public purse, it will very likely be paid out to shareholders in capital returns. Although this can be seen as indirectly being paid to consumers by boosting pension fund performance, that is a very long game and not the way that the public perceives matters.

So will new prime minister Rishi Sunak's government impose a windfall tax on Shell and the other energy sector beneficiaries? The recent financial maelstrom indicates that the markets would take kindly to such a move and politically it should mean that any austerity measures can be less aggressive. Oil companies' long-term investment plans are likely to be unaffected as they were based on 'normal' profits and cash flows: if excess profits were even to be taxed very heavily, energy businesses would not suffer any real harm. Rishi Sunak also has some 'previous' on this issue with the 'temporary, targeted levy' introduced in May this year.

Equity markets are likely to have priced in a windfall tax, so when looking at Shell's valuation, the potential imposition of one is a risk that can be largely ignored.

The long outlook for oil and gas

If one looks at a chart for the expected shift in the nature of automotive engines from internal combustion to electric and given that around 45 per cent of each barrel of oil produced turns into fuel for transport, the outlook for oil might appear weak. However, while the rate of growth in the demand for oil is set to slow, forecasts by OPEC (pinch of

salt perhaps needed for an organisation talking up its own book) suggest that by 2045 global demand for oil will be higher than today.

In 2020, global demand was 90.6 million barrels per day; OPEC estimates 108 million barrels a day in 25 years' time. That is annual growth of just 0.7 per cent so a steady drop in real terms (versus GDP) and against that demand profile Shell already has in hand a programme to reduce its oil production long term by 1-2 per cent per annum. Shell does have the luxury of other large income sources and the capability to supplant oil sales, which some less integrated oil companies lack.

Where is the growth coming from? The largest part of the increase is still transportation with a fairly equal contribution from road and aviation fuels. Petrochemicals is the next largest increase with demand for the likes of paint, synthetics, car tyres and fertilisers rising despite producers investing heavily in alternatives. The only expected drop is in power generation and even this is forecast only to drop by 1 million barrels. Oil is a minority fuel in power generation with even the largest user, Brazil, only generating around 4 per cent of its annual electricity consumption from oil-fired power plants.

There is a similar but stronger outlook for natural gas. McKinsey reckons that through to 2035 demand will rise by around 3.5 per cent per annum. The drivers are global population growth, urbanisation, slow transitions in power generation, a long tail in domestic use (heating & cooking) but with the main use of gas globally (60 per cent) being to make so-called 'grey' hydrogen and thence ammonia for fertilisers: this is likely to prove hard to substitute. After 2035, the forecasts indicate that gas demand begins to match oil with absolute demand growing at only 0.5 per cent so again falling in real terms.

While demand is more stable and predictable, the last two years have shown us that the price of both oil and natural gas are anything but. Oil, pre-Covid, was trading at \$60/barrel, but slumped to below \$20, being momentarily negative and recently breaching \$120 before dropping back to below \$80. Gas price volatility is well documented, but even here prices recently flicked briefly into the negative through a combination of high imports to Europe and a delayed and subdued start to the heating season.

A great long-term store of value

The old adage about never selling Shell and viewing it as a long-term store of value and a stable returning investment is certainly borne out in practice. This was, or was very close to being, a bond proxy. Any length of investment in the last 30 years and the total shareholder return (TSR) is positive and ahead of the FTSE All-Share Index. The two-year return is an outlier, as it is a Covid rebound, but the remainder tells a very positive story.

Periodic TSR for Shell in £

Period	Annual TSR
30 years	9.09%
20 years	8.18%
15 years	6.30%
10 years	6.85%
5 years	5.22%
3 years	4.77%
2 years	61.86%

Source: FactSet

While other stocks may have made better returns at various times and for shorter periods, this record is pretty impressive. One might think that a major commodities cyclical stock would tend only to track GDP (plus a little bit) over the long term, but these returns show that management has been able to create value consistently.

Will this continue? Why not? Demand for oil and gas may be in shallow relative decline but there are other global trends to consider. Most nations are targeting carbon zero only by 2050 (or 2070 in some cases such as India), so core demand is set to remain robust well beyond any reasonable investment time horizons. Plus Shell has the will, the time and, in spades, the resources to roll with the big changes in global energy.

Outlook

Volatile but generally drifting downwards would be the best summary of the outlook for Shell. While the very recent Q3 figures beat market forecasts, underlying profits were still down against both Q2 (this is not an especially seasonal business), but were substantially higher than the same quarter last year. There should be sufficient momentum and improvement over 2021 to see Shell posting record profits for 2022 with earnings before interest, tax, depreciation and amortisation (Ebitda) in the upper end of the \$70bn-\$80bn bracket: last year Shell reported \$41bn. It is notable that before the start of hostilities in Ukraine, the consensus forecast was for just \$47bn.

However, 2022 is likely to be the high watermark (never say never, however, in this unstable climate) and after reporting Ebitda at the thick end of the \$70bn-\$80bn range this year, 2023 is expected to deliver something in the mid \$60bn-\$70bn range, then the high \$50bn-\$60bn range and finally closer to \$50bn by 2025.

Earnings, capital investment, debt reduction and share buy-backs are harder to predict because of potential changes in taxation (primarily the risk of a UK windfall tax) or repricing of the energy contract with suppliers that could reduce profits if something like

the margin ceiling in the water industry was to be introduced. Also, with Shell's planned production cuts in oil progressing, there are likely to be higher exceptional charges for closures.

The core dividend, however, feels safe. Against current profit levels, Shell is under-distributing with a payout ratio this year likely to be less than 20 per cent of post-tax profits. As profits are set to sink by a third, this is the right policy and the shorter-term policy, of capital returns via buy-backs, which is a far better way to deal with excess profits and the consequent build up of capital than boosted core or special dividends. The dividend is growing, and while the Q3 increase was only 1¢ (to 25¢) the total for the first nine months of 2022 is 15 per cent higher than for 2021, and that same increase is guided for the final/Q4 payment. This means a total 2022 dividend of 104¢ against the current consensus 100¢.

Dividend growth has been forecast to run steadily against the flow of profits through to 2025 with analysts (before the recent Q3 figures) pencilling in 100¢ followed by 107¢, 113¢ and then 117¢: we can probably bump each of these up by at least 2½ per cent. Another interesting dimension for UK investors is that the dividend is paid in US dollars so the weak pound actually boosts the sterling value of the income. Last year's 88¢ was worth about 65p but (at today's £/\$ rate) the forecast 104¢ will be worth 90p, an increase of 39 per cent. Although, of course, currency markets fluctuate.

That leaves the stock with a current yield of 3¾ per cent. One slight fly in the ointment here, however, is that the increase in the \$ dividend could be blunted by any recovery in sterling - although the case for expecting any major rebound is still to be proven by Messrs Sunak and Hunt. Assuming no great surprises on the exchange rate, the yield has potential to rise to 5 per cent by 2025.

Not cheap nor a value trap

Shell is trading on a pretty low PE ratio of 5½x on December 2023 earnings projections; this is after a sizable pickup thanks to the recent share price rally and a month ago the rating was closer to 4½x. This does look low by historical standards with the long run PE for Shell standing typically either side of 10x depending on where we are in the commodity cycle.

This low rating isn't indicating a gap in the valuation: but neither is it a value trap. For that to be the case, forecasts in the market need to be wrong by being too high but we are looking at sharp reversals in expected profits meaning that the PE trends up towards 7x or 8x by 2025.

So, in reality, Shell is trading at close to its norms and with the oil and gas markets hopefully normalising before 2025, that suggests that the shares are actually standing close to fair value (perhaps up to 10 per cent below) rather than being exceptionally cheap. There are positives here: a new CEO with a different bias, a helpful rejig of the domicile (from Holland to the UK), the end of the dual Dutch and UK share listing, a simplified internal structure, a very affordable dividend and a boost for UK holders in the sterling value of their income. Those are all very nice, but this is still a stock with a large presence in pariah categories and that will remain a millstone around the neck of the rating. Accelerate the green conversion and the valuation could be transformed: don't hold your breath on that one, but do hold (and keep holding) the stock, as you can still be pretty confident of good total returns being delivered across the long term.

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