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No shell game

Evan Lorenz writes:

If America skirts a recession, Mr. Market can say he told you so. The S&P 500 has logged an 19% gain this year in the teeth of two consecutive quarters of weakening corporate earnings. The three months through June will make a third such period, if, as expected, it registers a decline (9% is the consensus forecast) in S&P earnings per share.

Wanted, therefore, is an inexpensive investment with sufficient balance-sheet strength to survive a bust but with enough growth potential to shine in a boom. In preview, *Grant's* is bullish on Shell plc (SHEL in London and New York, SHELL in Amsterdam). It's the very company—"Delivering more value with less emissions" is its motto—that the Archbishop of Canterbury has been selling.

Volatility comes with the energy-investing territory, needless to say. The price of West Texas Intermediate crude plunged to negative $37.63 per barrel on April 20, 2020, as traders begged someone—anyone, please?—to cart away the oil that locked-down Americans couldn't consume. Two years later, other traders—maybe even the same ones—were paying $123.70 for the identical barrel.

A pair of Canadian gas drillers illustrate what can happen in oil and gas investing. Tourmaline Oil Corp. (*Grant's*, March 18, 2022) has generated a 48.6% total return since it featured in these pages on March 18, 2022. Paramount Resources Ltd., which made its *Grant's* appearance just two weeks later, in the issue dated April 1, has generated a 2.9% loss (each recorded in U.S. dollar returns and including reinvested dividends).

A worldwide economic slowdown, though discounted on Wall Street, remains a very real risk for companies like Shell. "If you look at global liquids-demand growth back to 1975 and all the way through 2022, inclusive of both end years," Colin Fenton, head of commodities at 22V Research Group, LLC, tells me, "you'll find that demand contracted in 9 of those 48 years and that the median decline was 1.2%. If you apply that to where we've been, you're talking on the order of magnitude of a 1.2 million barrels per day hit to demand. . . . The duration of a contraction lasts upwards of 18–24 months. So, it is possible that a hard-landing scenario would be associated with something like 2.5 mmbpd of lost demand."

And now that the planet, the lawyers and the politicians are hotting up together, hard landings in the energy business come in many forms. Thus, last month, Multnomah County, Ore., which encompasses Portland, filed a $1.5 billion-plus lawsuit against Shell, BP plc and Exxon Mobil Corp., among other fossil-fuel offenders, over a 2021 heatwave. This adds to a growing docket of cases filed by states and cities over climate change and extreme-weather events. Last year, the U.K. and the eurozone levied a windfall profits tax ("solidarity contribution") on fossil-fuel producers.

Crude prices have sagged under a disappointing reopening of China's economy and a warm winter in the Northern Hemisphere. Sales from the U.S. Strategic Petroleum Reserve have flooded commercial inventories, and domestic shale-oil production has shown surprising strength, a sharp decline in the domestic rig count notwithstanding. In April, on a year-over-year basis, U.S. crude production jumped by 0.95 mmbpd, an amount greater than Venezuela's total output, to 12.6 mmbpd.

But the supply-demand balance may be tightening. Since bottoming at $71.84 on June 12, the price of a barrel of Brent has rallied to $83.57. In a July update, the International Energy Agency predicts that oil demand will outstrip supply for the balance of this year.

As to the world's migration away from fossil-fuel-powered transportation to the electric alternative, the operative word is "slow." In an April 13 Bernstein Research report, a team of analysts led by Oswald Clint project that electric vehicles will make up 81% of the global fleet by 2040. Even so, Bernstein foresees oil demand falling to only 105.3 mmbpd in 2038 from a peak of 109.2 mmbpd in 2029 and an estimated 101.6 mmbpd this year.

"We've run a lot of really long-run projections on what might happen for liquids consumption and demand in the year 2050," Fenton relates. "One just absolutely mind-boggling fact that comes out of that is if you were to assume that all liquids consumption in all OECD countries went to zero, literally zero, at trend growth for people and capital, the emerging world would replace all the lost barrels. You would have a bigger market in the year 2050 than you do today."

DUCs, short for "drilled but uncompleted" wells, also help to explain the paradox of spurting production and slowing drilling activity; the number of such holes in the ground declined by 300 to 4,804 between November last year and June, compared with a 2020 high of 8,809. "What we think will happen now is, we're going to see production sort of follow the rig count with a lag," Tom Loughrey, president of FLOW Partners, LLC, analysts of geologic and production data, tells me.

Since last Thanksgiving, the domestic-rig count has tumbled to 647 from 764 for the simple reason, according to the July 18 edition of *The Wall Street Journal*, that the operators (for the most part, private ones) "have drilled up many of their best remaining wells."

That fact is related to a concern we raised in the June 30 issue of *Grant's* courtesy of our friends at Goehring & Rozencwajg Associates, LLC. To wit: Production at the highly prolific Permian Basin that straddles New Mexico and West Texas may be topping out.

What happens in Texas doesn't stay in Texas—the Permian accounted for 74% of the 7.3 mmbpd increase in worldwide production between 2015 and 2022. "The largest wells in the Delaware Basin [a part of the Permian], the top-10 percentile of wells, are becoming smaller," says Loughrey. That's significant, he continues, because the output of even the basin's most productive wells is weakening. You have heard—oil executives have said—that drilling in the Permian is a little like slicing a layer cake. The removal of one slice won't disturb the structure of neighboring slices, they have proposed, so one may carve and eat the figurative confection slice by profitable slice.

However, counters Loughrey, "a well in one zone, in many cases, is going to deplete product from another zone." Confronting this problem, the drill operator may a) bunch his drill sites close together, which maximizes production over the long term while sacrificing a high rate of output in the short term or b) space drill sites farther apart than usual, thereby maximizing short-term production though at some cost to long-run output.

The first option, favored, for instance, by Exxon, is known as "optimizing."

What does this mean for Permian production? "If we're optimizing," Loughrey continues, "we're in the mid-innings. From here, if we don't optimize, we're somewhere in the later innings, the seventh or eighth. What that leads to is the need for secondary assets. We're going to have to bring more tier-two assets into the equation faster than people think." Of course, energy companies will need higher oil prices to drill wells with weaker economics.

Shell plc at a glance

all figures in $ millions except per share data

	TTM*	2022	2021	2020	2019
revenue	$388,956	$386,201	$272,657	$183,195	$352,106
operating income	72,028	67,996	33,436	(22,878)	30,175
net income	43,902	42,309	20,101	(21,680)	15,842
earnings per share	6.03	5.71	2.57	(2.78)	1.95
shares outstanding	7,281	7,411	7,807	7,796	8,113
cash	42,074	40,246	36,970	31,830	18,055
debt	85,142	83,795	89,086	108,014	96,424
total assets	429,154	443,024	404,379	379,268	404,336

* For the 12 months ended March 31, 2023.

source: company reports

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Shell came into the world in 1907 through the merger of the Royal Dutch Petroleum Co. and Shell Transport and Trading Co. (The predecessor Shell began in 1833 when British businessman Marcus Samuel created a shipping business to import seashells from Asia before pivoting to the more-profitable transportation of crude oil.) The combined company grew to become the largest producer of crude by 1920 and racked up many industry milestones, including the first commercial sea transportation of liquefied natural gas in 1964.

The corporate marital partners slept in separate beds. Holders of the Amsterdam-listed line continued to own stock in Royal Dutch, which, in turn, held 60% of the combined group; British shareholders owned stakes in Shell T&T, which, in their turn, owned the remainder of the group. Shell maintained two headquarters, and its hundreds of separate business units sometimes competed against one another. "At one point in 1993," according to a Barclays plc report last month, "there were 244 operating companies in over 100 countries."

A lack of central oversight contributed to a 2004 reserves scandal, in which Shell revised down its estimates for recoverable hydrocarbons by 4.5 billion barrels of oil and gas equivalents. The following year, the century-old partnership between Royal Dutch and Shell T&T was dissolved and the company was unified under a central corporate office. Various restructuring and simplification programs followed, culminating in the 2021 announcement to move the headquarters to London, drop "Royal Dutch" from the name and abandon the dual-share class structure entirely.

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Shell's operations fall into five broad areas. First, the upstream division, which explores for, and extracts, natural gas and oil and generated $42 billion in Ebitda in the 12 months ended March 31. Shell last year traded 66 million tons of LNG, or around one-fifth of the world's total. Second, the integrated gas unit, which houses the LNG operations and chipped in $27.7 billion in trailing Ebitda. Third, chemicals and products ($9.6 billion), which transforms natural gas and crude feedstocks into products such as ethylene, styrene, gasoline and diesel. Fourth, the marketing unit ($5.6 billion), which spans Shell's 46,000 branded retail service stations, lubricants (brands like Jiffy Lube and Pennzoil) and green fuels. Fifth, the renewables and energy-solutions division ($2.6 billion), which includes wind and solar farms, the trading of pipeline gas and electricity and the production of green hydrogen.

Shell's commanding position in the LNG market confers more than just bragging rights. The largest fleet of LNG ships in the world bestows on its owner the best market intelligence about the global natural-gas supply and demand situation. Thus informed, Shell can route hydrocarbons to the locations that maximize prices. Such dexterity, management contends, increases the returns on capital employed in the integrated gas division by 2–4 percentage points.

Leaning into the green movement, Shell cut its Scope 1 and 2 emissions, i.e., carbon dioxide produced directly or indirectly from company actions, by 30% between 2016 and 2022. From that 2016 baseline level, the front office targets a 50% reduction in emissions by the end of the decade and a 100% reduction by 2050.

Shell trades at 7.4 times estimated 2023 earnings, a slight premium to European majors like BP and TotalEnergies S.E., which average 6.3 times, but a big discount to U.S. megaproducers like Exxon and Chevron Corp., which command an average 12.1 multiple.

Wael Sawan, age 49, took over as CEO on Jan. 1 and has set a target to close the valuation gap with his American peers. Having joined the company in 1997, Sawan is well-versed in Shell's strengths and weaknesses. He previously served as a director of the integrated gas and renewables and energy-solutions units.

At Shell's "capital markets day" on June 14, Sawan laid out his plan to boost the company's share price. Management, he said, will trim annual capital expenditures to $22 billion–$25 billion per year through 2025 (down from previous plans of $23 billion–$27 billion), cut $2 billion–$3 billion in operating expenses by 2025 and boost buybacks and dividends to 30%–40% of cash flow from operations (up from the prior target of 20%–30%). This, Sawan believes, assuming a $65 per barrel oil price, will contribute to growth in free cash flow per share by 10% per year through 2030. Oil prices as low as $40 a barrel can cover the 3.9% dividend yield, he adds.

To meet these objectives, the company is jettisoning top-down production goals, rather favoring "value over volume" and a "ruthless" approach to capital-investment decisions. The old management regime was wedded to numerical targets, for instance, by directing that the number of Shell gas stations be raised to 55,000 by 2025 from 46,000 currently. Such directives have had mixed results. In the case of the gas-station edict, it led to the marketing unit acquiring or building new outlets even if they dragged down overall profitability. Under Sawan, Shell will sell off gas stations in regions, like Pakistan, where the returns don't pencil out. Management is reviewing its entire portfolio with an eye to dispose of less-profitable assets and to invest in such green projects that promise high returns, and no others. In March, for example, Shell cancelled plans to build a biofuel plant in Singapore because, as Sawan explained on the May 4 earnings call, "the economics were simply not robust enough."

"[I]t's a fundamental change around newfound accountability," a June 15 Bernstein report summarizes. "Jobs are now on the line, those who don't like [it] will leave, 100-year-old country footprints are not reasons to stay, hidden rules such as 'we need chemicals and will never touch it' are being torn up. We spent a one-hour breakout with the new CFO [Sinead Gorman] and were almost scared by her ruthlessness. Senior EVPs are having their budgets checked with a fine-tooth comb—which just doesn't happen. She wants the CEO to be known as a Chief Executive Officer and not a 'Chief Explanation Officer' apologizing for missed targets."

Shell has identified new wells that will allow the maintenance of flat oil and liquids production, at around 1.4 mmbpd, through 2030. This contrasts with prior plans to let production annually decline by low single digits. "Oil and gas will continue to play a crucial role in the energy system for a long time to come with demand reducing only gradually over time," Sawan declared last month. "Continued investment in oil and gas is critical to ensure a balanced energy transition."

The message did not win Shell many friends in ecclesiastical circles. On June 22, the Church of England announced plans to divest its stake in "Shell plc and other oil and gas companies which are failing to show sufficient ambition to decarbonize."

It's the disinvestment call to arms that creates the countervailing investment opportunity. Shares are cheap on current earnings and cheaper still if Sawan can deliver on his promises. Shell is trading at around the same share price it did in 2014, despite a 74% boost in earnings per share from that year through the 12 months ended March 31.

Shell has spent billions of dollars in the past two decades building up a renewable portfolio with nameplate capacity of 6.4 gigawatts in wind and solar farms worldwide. American majors have invested much less. As Shell trades at a 39% discount to American peers like Exxon and Chevron, the market is valuing these businesses at zero. On July 13, Bloomberg reported that Shell has hired advisors to find ways to get the

The archbishop's a seller

source: The Bloomberg

market to notice the green portfolio. Options include the sale of a stake in the renewables business to outside investors.

While Shell commands solid investment-grade ratings credentials—Aa2/single-A-plus, for now—management aspires to pure double-A. As of March 31, the balance sheet showed net debt of $43.1 billion, a sum equal to 63% of this year's guesstimate for Ebitda. In the first quarter, operating income covered interest expense by 13.3 times.

Of the 25 analysts on the case, 20 say buy and none says sell. Insiders logged exactly one open-market purchase, of 8,235 shares worth $257,323, in the past 12 months; they sold none.

With its dividend and buyback goals, Shell is on a path to return a double-digit percentage of its market cap to shareholders every year through 2030, observes Alex McColl, who rates the stock a buy for Bernstein Research; this compares to payouts of between 5% and 8% for Exxon and Chevron. "Fundamentally, if you are an investor and you can get your money back within 10 years and you have a free call option on all of these new businesses within Shell, we think that's a really attractive investment proposition," McColl tells me. "It's definitely a no-brainer for us."

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