KILLIK & Co

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Large Cap

.COMPANY:	EPIC:	MARKET CAP:	RECOMMENDATION:	RISK RATING:	PRICE:
Royal Dutch Shell	RDSB.L	£144.9bn	Buy Initiating Coverage	5 CATEGORY: UNRESTRICTED (see bottom of note for risk categories)	2,313p

Royal Dutch Shell is a global energy company, with activities in oil and natural gas, refining and marketing, chemicals, power generation and renewable resources.

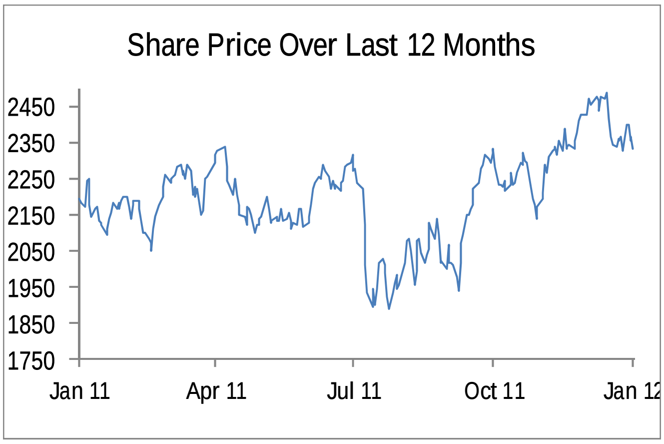
Investment Case

- The stock provides exposure to the oil price, which we believe will continue to be supported by a combination of increased emerging market demand and constraints over supply.
- The group's industry-leading LNG portfolio has an Asian bias and is well placed to meet the growing need for gas imports to ensure security of energy supply.
- Strong cash generation and a robust balance sheet, combined with improved operational efficiency, leave the group with the flexibility to invest for growth.
- At a time of economic uncertainty, the stock provides defensive attributes and an attractive dividend stream.

The defensive attraction of the business meant that the shares rose by 11% last year, compared to a 6% decline in the FTSE 100. The stock currently trades on 7.7x 2013 consensus earnings, below the global peer group on 8.1x. In terms of dividend yield, the shares offer 5.0%, well ahead of the peer group (4.0%).

52 Week High	2,499p
52 Week Low	1,768p
Price to Book Value	1.5x
Dividend Yield	4.6%
Free Cash Flow Yield	17.8%
Dividend Cover	2.5x
Net Debt	$20.1bn
Interest Cover	26.3x
Emerging markets sales	42%
Next announcement	2 February 2012

Source: Company Data and Bloomberg Consensus



Year End	Sales ($m)	PBT ($m)	EPS (c)	PE (x)	DPS (c)	Yield (%)
Dec 2010	368,056	35,344	328.0	11.1	168.0	4.6
Dec 2011	477,012	45,010	420.8	8.6	168.0	4.6
Dec 2012	451,098	44,635	450.7	8.1	176.0	4.8
Dec 2013	459,235	47,535	476.8	7.6	184.0	5.1

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Royal Dutch Shell is a global energy company, with activities in oil and natural gas, refining and marketing, chemicals, power generation and renewable resources. The group operates an integrated model, which encompasses exploration, production, refining, transporting and retailing. The group also owns a number of equity interests: Woodside (34%); Showa Shell (35%); and Comgas (18%)

Shell has strong relationships with host governments and a legacy position in innovative technology in areas such as deep water, gas and unconventional hydrocarbons. In particular, the group has the world's largest portfolio of LNG assets. Most of the gas is delivered under long-term supply contracts, mainly in Asia and the Middle East, with demand driven by the growing need for gas imports. The group is currently benefiting from the huge price premium of Asian gas over US gas, driven in part by the impact of the Japanese earthquake.

A broad geographic spread – Asia (29% of 2010 production), Europe (28%), Americas (22%), Africa (15%) and Oceania (6%) – helps to insulate the group against disruption or fiscal changes in an individual country. Shell reports in dollars, and is therefore exposed to currency movements.

We remain positive on the long-term outlook for the oil price, which we believe will continue to be supported by a combination of increased emerging market demand and constraints over supply. Meanwhile, one of the legacies of the Arab Spring is that Saudi Arabia needs an oil price of at least $95/barrel to break even on its budget, while continued uncertainty surrounding Iran is likely to provide further near-term support. Although the integrated operators, such as Shell, provide exposure to the oil price, we appreciate that there are more highly-geared ways of playing this theme, and we would highlight our Buy recommendation on Tullow Oil* (TLW.L, 1,381p, Buy).

Upstream (77% of estimated 2011 earnings)

At present, around two-thirds of the group's capital is employed in the "upstream" business, where the focus is on exploration for new oil and gas reserves, the development of major projects, and the production of those reserves. The group operates hundreds of fields worldwide, with the main oil operations in Nigeria, the Gulf of Mexico, Oman, the UK and the Emirates. The main gas operations are in the Netherlands, Norway and the UK. The production split between oil and gas is fairly balanced, with oil accounting for 52% in the first nine months of 2011.

At the end of 2010, the group's proven oil and gas reserves amounted to 14.2 billion boe (barrel of oil equivalent), with a reserve life – or the number of years it would take to exhaust reserves at the current level of production – of 11.5 years. The reserve replacement ratio for the five years 2005-2010 averaged 134%, among the highest in the peer group.

In order to replace reserves that undergo a process of natural decline, the group has to undertake ongoing reinvestment in the business. Shell is planning to spend over $100bn on net capital investment between 2011 and 2014 on one of the most ambitious programmes in the industry. The focus (at least 80% of spend) is the upstream business – where returns are higher – and where Shell is renowned for taking a generational approach.

Shell currently has 20 projects that have recently started up or are under construction, with a combined resource potential of 11 billion boe that the group believes can support growth out to 2020. Across a portfolio of high-quality assets, there is a relatively large exposure to oil sands, deep water and integrated gas projects. Deutsche Bank estimates that the average portfolio breakeven is $54 per barrel. Notable assets include:

- Athabasca Oil Sands Project (Canada) – The group extracts bitumen from the oil sands and synthesises crude oil from it. The Expansion 1 project is intended to increase production capacity by 100 thousand barrels of oil equivalent per day (kboepd) to 250 kboepd.
- Gbaran-Ubie (Nigeria) – The project is one of Nigeria's largest oil and gas developments, and is helping to meeting the domestic government's target to reduce the flaring of gas. Production is expected to peak at 250 kboepd.
- Qatargas 4 LNG – The JV project with Qatar Petroleum is designed to convert natural gas into liquefied natural gas and natural gas liquids. The huge investment sustains the group's global leadership in LNG, and is expected to achieve peak production of 280 kboepd.

- Pearl Gas-to-Liquids (Qatar) – This is the world's largest GTL plant, and makes use of pioneering gas technology. Trains 1 and 2 started up in 2011. In the first phase, cash flow will be used to recover the group's $18bn investment in the project. Shell believes that the total cash flow from Pearl (and Qatargas 4) at $70 oil will be $4bn. This compares to $3bn of cash flow in the $50 oil environment at the time of the agreement.
- Gorgon LNG (Australia) – The project involves the development of the largest gas discoveries to date in Australia and the world's largest foundation LNG project. Completion is expected in 2015.
- Other Assets – Final investment decisions have also been taken on the Clare Phase 2 development in the UK and the Wheatstone LNG project in Australia.

Group production is expected to average 3.5m barrels per day (b/d) in 2012 (6% above 2010 levels). For 2014, the group is targeting 3.7m b/d (12% above 2010 levels, based on $80 oil), making it the fastest growing of the oil majors.

Shell also has a substantial exploration portfolio and a competitive track record on exploration finding costs: less than $2 per barrel. The group claims to have around 30 projects on the drawing board with at least 10bn boe resource potential. The group is exposed to many of the world's largest basins, including the Gulf of Mexico, North American tight gas and Australian LNG. Shell is the operator (and 45% stakeholder) on Zaedyus, the recent discovery in French Guiana, and has signed a MoU with Tullow Oil covering the entire Atlantic Basin.

Downstream (23% of estimated 2011 earnings)

Downstream, the group is involved in refining, shipping, marketing, and chemicals. The business also encompasses the group's interests in alternative energy, where Shell is one of the world's leading distributors of bio-fuels. The division accounts for just under one-third of the group's capital employed.

Shell has interests in around 30 refining sites worldwide, with 40% of the capacity in Europe and Africa, 30% in the Americas and 30% in Asia Pacific. Around four million barrels of crude per day are processed into a range of products including petrol, diesel, aviation fuel, marine fuel and lubricants. The chemicals business produces and markets petrochemicals for industrial customers, including the raw materials for plastics, coatings and detergents.

The outlook for the refining industry is weak. In its *Energy Outlook 2030*, BP estimates that if China achieves its aim of being self-sufficient, the net increase in refinery runs will be curtailed because of the growth of liquids that do not need refining. Against this background, ownership of cost-advantaged assets is essential, and Shell is focusing on its most profitable units in order to improve returns. These tend to be larger, integrated sites with increased sophistication. Between 2002 and the end of 2012, the group expects to have reduced its capacity by 30%, with the average refinery size increasing from 130 kbpd to 195 kbpd. Although the group is adding new refining capacity in the US at Port Arthur, the focus is increasingly on growth markets, such as Brazil, Asia Pacific and the Middle East.

In contrast with most of its peers, Shell's downstream activities are more heavily skewed towards marketing, where the group continues to enhance the quality of its portfolio by reducing its global footprint, while focusing on high growth markets, such as Germany or China. In Chemicals, further steps are being taken to improve the business by focusing on integrating assets with refining at super-sites.

At the time of its 2011 Strategy Update, the group announced a new target for a further $1bn of cost savings for 2011-12. The aim is to generate returns above the cost of capital at the bottom of the cycle. The bulk of the asset sales programme has been completed.

Current Trading

The next time we hear from the company will be on 2 February with the release of the Q4 2011 results. In the third quarter, the group generated a 42% increase in net income, to $7.0bn, on a current cost of supply basis – which strips out the impact of gains or losses on commodity inventories – ahead of market expectations of $6.6bn. The performance was driven by increased energy prices (liquids

+48%; natural gas +31%) and a strong downstream performance (+25%). Return on average capital employed on a net income basis was 16.4% during the quarter.

The fourth quarter is expected to have been more subdued. Although upstream income will have been boosted by the 26% rise in the oil price, the benefit will have been offset to some extent by higher exploration costs and the impact of the warm weather in Europe on gas volumes. The mid-single digit decline in production reflects the impact of asset sales and higher levels of maintenance. The downstream business is expected to have made a loss due to weaker refining margins and lower levels of capacity utilisation.

Financial Considerations

Following the disclosure of an overstatement of reserves in 2004, Shell embarked upon a programme of business simplification and operational improvement. There has been a focus on asset sales, portfolio upgrading and cash flow generation. The group has sold assets worth more than $30bn, and further disposals of non-core businesses will continue – probably at a rate of $2bn-$3bn per year – as the group seeks to improve its competitive position and capital efficiency. The group's underlying costs declined by c. $2bn in 2010, and have fallen by more than $4bn since 2008.

One of the main attractions of Shell is its financial strength and strong cash flow generation. In the first nine months of 2011, the group generated cash flow from operating activities of $30.3bn. As at 30 September 2011, financial gearing stood at 10.8% – towards the lower end of the group's through-the-cycle range of 0%-30%.

In 2012, Shell expects to generate a 50% increase in cash flow (from $24bn to $36bn) relative to 2009 assuming a $60 per barrel oil price and an improved environment for downstream margins and natural gas prices. In an $80 per barrel environment, 2012 cash flow is expected to be 80% higher (i.e $43bn) than 2009 levels. The oil price is currently trading well above this scenario ($110 per barrel for Brent), with the potential for short-term spikes driven by additional turmoil in the Middle East. However, the benefit of the strong oil price has been diluted to some extent by the depressed US natural gas price, which at $2.60/mmbtu (million British thermal units) is currently well below the $4.00/mmbtu-$8.00/mmbtu the group uses in its models. However, North America only accounts for 20% of Shell's gas sales.

The strong balance sheet provides the flexibility to invest for growth and return cash to shareholders. During the third quarter, the group took advantage of weak equity markets and bought back $0.8bn of shares. Given the record low cost of debt, we believe further buybacks are possible. However, dividends remain the preferred way of returning cash to shareholders. At the beginning of 2010, the group shifted its dividend policy from one based on growing the US dollar payout at least in line with inflation to one targeting growth in line with the group's view of its underlying business earnings and cash flow. The Q3 2011 dividend was maintained at 42c, and we expect the full-year 2011 payout to remain level with 2010, at 168c. There is a chance of a return to growth – for the first time since 2009 – in 2012. An increase would provide a positive signal of management's confidence in the business, and according to current consensus expectations would be well covered by free cash flow over the next three years. At current exchange rates, a maintained 2011 dividend would equate to a yield of 4.6% for a sterling-based shareholder, well above the yield on the group's 5-year debt (1.95%).

There are two classes of ordinary shares – A and B – both of which have identical rights, except related to the dividend access mechanism, which applies only to the B shares. Here, dividends paid will have a UK source for Dutch and UK tax purposes, and there will be no UK or Dutch withholding tax on such dividends. The dividend is declared in dollars and then paid to the A holders in euros and the B holders in sterling. Traditionally, the A shares have traded at a slight premium to the B shares. At present, however, the B shares are trading at a 3.5% premium. The gap is driven by a number of factors: Dutch withholding tax may make it more attractive for some investors to hold B shares; currency may have a positive impact on the dividend payment; and the buyback is targeted at the B shares. We would recommend holding the B shares.

The defensive attraction of the business meant that the shares rose by 11% last year, compared to a 6% decline in the FTSE 100. The stock currently trades on 7.7x 2013 consensus earnings, below the global peer group of 8.1x. In terms of dividend yield, the shares offer 5.0%, well ahead of the peer group (4.0%).

	PE			Dividend Yield			EV / EBITDA		
	2011	2012	2013	2011	2012	2013	2011	2012	2013
Royal Dutch Shell B	8.7x	8.1x	7.7x	4.6%	5.0%	5.2%	4.1x	3.9x	3.5x
BP	6.5x	6.5x	6.2x	3.8%	4.2%	4.7%	3.7x	3.6x	3.3x
Total	7.8x	7.6x	7.2x	5.7%	5.8%	6.0%	3.5x	3.4x	3.3x
ExxonMobil	10.3x	10.4x	9.6x	2.1%	2.2%	2.4%	4.9x	4.9x	4.8x
Chevron	7.9x	8.2x	7.8x	2.9%	3.1%	3.2%	3.5x	3.5x	3.4x

Risks with this recommendation

- A slowdown in global economic growth would have a negative impact on the price of oil and gas, and on refining margins.
- A weak dollar would impact the level of dividend payments for sterling-based shareholders.
- An increase in resource nationalism or changes in fiscal rates would have an impact on the business.
- The group may fail to execute the projects due onstream over the next few years.

KILLIK & Co RESEARCH RECOMMENDATIONS					
Equity Research			Fund Research		
Large Cap	Mid Cap	Global	Absolute Return	Income	Growth
Investment ideas in the FTSE 100 which we believe will generate returns ahead of the All-Share index.	*Investment ideas in the FTSE 250 which we believe will generate returns ahead of the All-Share index.*	*Global investment ideas which we believe will generate returns ahead of the FTSE World (ex UK) index over the long term.*	*Funds that aim to generate an absolute return over the medium to long term, i.e. a positive return irrespective of equity or bond market direction.*	*Income producing funds, which are attractive in the context of the yield available from cash, gilts and UK equities.*	*Funds which we believe have the potential to generate a high level of capital growth over the long term.*

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Daily Note	ETFs Bulletin	Thematic
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