OCTOBER 2020

ATLANTIC CAPITAL MARKETS

BP plc Vs Royal Dutch Shell

01872 229 000
www.atlanticmarkets.co.uk

BP Plc

A Brief History

BP is a British multinational oil and gas company headquartered in London. It is one of the world's oil and gas supermajors.

- 1908. The founding of the Anglo-Persian Oil Company, established as a subsidiary of Burmah Oil Company to take advantage of oil discoveries in Iran.
- 1935. It became the Anglo-Iranian Oil Company
- 1954. Adopted the name British Petroleum.
- 1959. The company expanded beyond the Middle East to Alaska and it was one of the first companies to strike oil in the North Sea.
- 1978. British Petroleum acquired majority control of Standard Oil of Ohio. Formerly majority state-owned.
- 1979–1987. The British government privatised the company in stages between.
- 1998. British Petroleum merged with Amoco, becoming BP Amoco plc,
- 2000-2001. Acquired ARCO and Burmah Castrol, becoming BP plc.
- 2003–2013. BP was a partner in the TNK-BP joint venture in Russia.

Positioning

BP is a "vertically integrated" company, meaning it's involved in the whole supply chain – from discovering oil, producing it, refining it, shipping it, trading it and selling it at the petrol pump. BP has operations in nearly 80 countries worldwide, produced around 3.7 million barrels per day (590,000 m3/d) of oil equivalent, and had total proven reserves of 19.945 billion barrels (3.1710×109 m3) of oil equivalent. The company has around 18,700 service stations worldwide. Its largest division is BP America. In Russia, BP also own a 19.75% stake in Rosneft, the world's largest publicly traded oil and gas company by hydrocarbon reserves and production. BP has a primary listing on the London Stock Exchange and is a constituent of the FTSE 100 Index. It has secondary listings on the Frankfurt Stock Exchange and the New York Stock Exchange.

Key Fundamentals

	31.12.15($m)	31.12.16($m)	31.12.17($m)	31.12.18($m)	31.12.19($m)
PE Ratio	-	1,027.55	40.4	13.51	31.38
PEG	-	-	0.01	0.08	-0.54
Earnings per Share Growth	-	-	2727.40%	173.14%	-57.77%

Dividend Cover	-0.88	0.02	0.43	1.16	0.48
Revenue Per Share	1,229.65¢	986.77¢	1,235.85¢	1,518.67¢	1,392.28¢
Pre-Tax Profit per Share	-52.23¢	-12.21¢	36.46¢	83.74¢	40.20¢
Operating Margin	-3.81%	-0.84%	3.40%	6.24%	4.08%
Return on Capital Employed	-5.46%	-1.02%	5.24%	11.57%	6.95%
Dividend Yield	7.63%	6.38%	5.76%	6.38%	6.59%
Dividend per Share Growth	1.92%	-0.48%	0.27%	1.26%	1.24%
Net Asset Value per Share (exc. Intangibles)	364.57¢	339.02¢	346.18¢	347.95¢	350.73¢
Net Gearing	27.55%	36.54%	38.22%	43.57%	45.98%

Chart

The BP that we see and know now is certainly a shadow of its former self. BP used to be a powerhouse in the UK Index and a major global player, but it has since dwindled to be a relatively minor player on the global stage. For example, its market capitalisation is now 'only' just over £43bn and trading around £2.20, against 20-year highs of over £7.00. Naturally BP has a broad correlation with Brent Crude prices, although many readers may be surprised to see that the relationship is not as close as you might naturally think. Brent crude has rallied from the April lows and is currently only down around 29% from the 2018 highs, while BP is down 55% in the same period.

Electric vehicle makers have seen waves of fresh investors over the past few years, with the likes of Tesla now having a market capitalisation of £298bn. Major freight operators are increasingly planning for electric futures, with talk growing about electric powered container ships, trucks and even air freight in the coming years. California has announced that by 2035 all vehicles sold must be emission free, If California was a country it would be in the G7. It is quite clear then that BP is selling a 20th century product, rather like tobacco. This undeniable fact has been a long term drag on the share price, and without a serious pivot from the firm it is hard to imagine how this long-term outlook will change. As a result, the best outlook for the oil stocks is bargain hunting on the belief that the understandable selling pressure has been overdone. Due to the short-term breakdown in the correlation between BP and Brent you can start to make this argument.

Royal Dutch Shell

Ticker: RDSa/RDsb

A Brief History

Royal Dutch Shell PLC or as its more commonly known "Shell", is an Anglo-Dutch oil and gas company headquartered in the Netherlands and incorporated in the UK. They are also one of the worlds supermajors and the third-largest company in the world measured by 2018 revenues and the largest based in Europe.

- 1907 - Shell was formed through the amalgamation of the Royal Dutch Petroleum Company of the Netherlands and the "Shell" Transport and Trading Company of the United Kingdom.
- 2005 – The firm unified and operated as a dual-listed company, whereby the British and Dutch companies maintained their legal existence but operated as a single-unit partnership for business purposes.
- 2016 - Shell acquired BG Group making it the world's largest producer of liquefied natural gas.

Positioning

Shell is vertically integrated, similarly to BP and is active in every area of the oil and gas industry, including exploration and production, refining, transport, distribution and marketing, petrochemicals, power generation and trading. It also has renewable energy activities, including biofuels, wind, energy-kite systems and hydrogen. Shell has operations in over 70 countries, produces around 3.7 Mn barrels of oil equivalent per day and has 44,000 service stations worldwide. Shell Oil Company, its principal subsidiary in the United States, is one of its largest businesses. Shell holds 50% of Raízen, a joint venture with Cosan, which is the third-largest Brazil-based energy company by revenues and a major producer of ethanol. Shell has a primary listing on the London Stock Exchange and is a constituent of the FTSE 100 Index. It had a market capitalisation of £216bn. They are the largest of any company listed on the London Stock Exchange. It has secondary listings on Euronext Amsterdam and the New York Stock Exchange.

Key Fundamentals

	31.12.15($m)	31.12.16($m)	31.12.17($m)	31.12.18($m)	31.12.19($m)
PE Ratio	73.67	49.92	21.09	10.62	15.01
PEG	-0.85	0.58	0.12	0.14	-0.5
Earnings per Share Growth	-86.86%	86.59%	173.16%	78.48%	-30.14%
Dividend Cover	0.16	0.31	0.84	1.5	1.05
Revenue Per Share	4,306.06¢	3,055.74¢	3,792.47¢	4,787.70¢	4,369.48¢
Pre-Tax Profit per Share	32.39¢	71.37¢	220.47¢	430.06¢	316.26¢
Operating Margin	1.45%	3.67%	7.11%	9.93%	8.57%
Return on Capital Employed	1.79%	3.51%	7.93%	14.17%	11.33%
Dividend Yield	8.23%	6.49%	5.64%	6.28%	6.36%
Dividend per Share Growth	1.08%	-0.27%	0.27%	-	-
Net Asset Value per Share (exc. Intangibles)	2,447.71¢	1,997.20¢	2,047.17¢	2,130.36¢	2,074.38¢
Net Gearing	16.35%	39.30%	33.63%	25.21%	28.31%

Chart

Royal Dutch Shell is understandably a very similar situation to BP. Shell had been trading above £27.00 in 2018, and now languishes under £10.00. Shell has had its fair share of problems, but the company's strategic moves in April give reason to believe the worst could be behind it. Shell is trying to embrace renewable energy. Unlike some of its European competitors that could turn into renewable energy stocks, Shell is targeting a modest amount of renewable investment while also focusing on making the oil and gas industry cleaner. Shell's move into CCS, carbon-neutral LNG, and reduced flaring of natural gas are all admirable, but they aren't helping Shell get through the current downturn. The big help is Shell lowering the quarterly dividend obligation.

These changes mean that there's less reason to buy Shell for the short-term, but they could end up benefiting Shell over the long-term. And with the stock already selling off quite heavily the market may have already priced in short-term headwinds.

While Shell's environmental efforts are admirable, the company hasn't figured out a way to monetize CCS or carbon-neutral LNG. For now, these efforts do little more than improve public perception of Shell. Still, they are worth keeping track of in the event Shell gains a competitive advantage in a green technology that can deliver bottom-line results. If Shell can prove that it can generate solid operating cash flow even with reduced spending, then it could emerge as one of the better oil majors from this downturn. In the meantime, Shell yields 4.5%, which isn't chump change.

How Do They Compare

BP has more cost-efficient upstream operations than Shell

- BP's operations are more environmentally friendly when compared to Shell.
- BP's upstream faces threats from Shell's aggressive capital expenditure plans over the next five year.
- Shell has a clear competitive advantage in the near future.

Who is better placed to absorb an oil price crash?

BP's higher focus on upstream and lower offset from downstream makes their profitability more sensitive to oil price changes than Shell.
When oil prices crashed between 2014 and 2016, Shell's profits were less affected and recovered quicker than BP. The oil price slump during this period had a very similar impact on revenues at both the companies, but the overall profit decline was much higher for BP at 261%, compared to Shell, which saw just an 85% decline.

During all the three years of rapid oil price fall in 2014 to 2016, BP's net profit fell at a much higher rate compared to Shell exposing its extreme sensitivity to oil price crashes. During the recovery, BP returned to profits recording a 101% growth in profits in 2016 with a 17.89% revenue decline while Shell's revenues declined at a lower rate of 11.84% and profit grew at a higher rate of 117%.

Overall, it is safe to say that BP's profitability is more sensitive to oil price crashes than Shell's.

2020 Earnings so Far

Recent figures from both the UK super majors has shown exploration and production activities reduced significantly whilst they grapple with the coronavirus-induced low commodity prices. The pandemic has hammered global energy demand which in turn has hit all global oil stocks. Strict social-distancing measures to combat the spread of the virus have drastically reduced demand for fuel, which in turn has resulted in serious pressure on the oil price throughout 2020.

The weakness in oil prices is definitely bad news for the European energy majors since the balance sheets of both BP and Royal Dutch Shell are significantly more leveraged than their US counterparts such as Exxon Mobil and Chevron. This makes any reliance on their balance sheet strength to keep investing in business and return cash to shareholders far more vulnerable, especially in the present challenging environment.

Both companies reported huge and historic drops in profitability. BP reported a £5.1bn adjusted loss in the second quarter compared with a £2.1bn profit in the same period a year prior. Shell, on the other hand, produced an adjusted profit of £462mn, down from £2.7bn a year ago.

Share price performance

By first looking at the BP share price in absolute terms, it is evident that BP has outperformed Shell in 2020. That being said both shares prices move very closely, and both have hugely under performed the index even after the initial crashes. Trying to suggest that one is ultimately better than the other based on this year's performance is really splitting hairs and the reality is both have underperformed the broader index.

This deviation was certainly more noticeable in the performance of the shares on the respective days of their announcements, providing a truer gauge of investor sentiment to the underlying performance of the businesses. BP shares rallied, whilst Shell shares dropped. BP shares bounced despite a cut in their dividend, suggesting the market had largely priced in a reduction in pay-outs and were more concerned with the underlying profitability and management of the companies.

Dividends

Both firms have taken the move this year to reduce dividends, As BP released their figures, they also made the decision to cut dividends by 50% . Shell took the decision to cut their dividend in the previous quarter, cutting by 66%. Working on the income from the two business' BP would still seem more attractive to income seekers with their higher yield, but this approach is too simplistic to fully evaluate the relative value of each company's equity. It must also be noted the earnings coverage of these dividend is non-existent in the case of BP and negligible in the case of Shell so attention must be paid to the cash position of each company.

Cash Position

BP's cash position has improved from the end of 2019 as the company hit the bond market for cash to the tune of £8.48bn. The bond issue, coupled with £19.26bn of impairments and writes offs helped offset BP's £15.41bn pre-tax loss, meaning BP's cash rose to £26.6bn from £13.87bn in the first quarter of 2020. With BP dividends also reducing, the amount of cash would at first seem sufficient to support dividends and provide resources for the shifting strategy towards a low carbon energy producer. However, it is never quite so straight forward and the £15.41bn pre-tax loss should be a concern for investors as a similar loss in the coming quarters would put the cash position under considerable pressure, highlighted by BP's lack of Free Cash Flow. Measured by deducting investing cash from operational cash flow, BP's Free Cash Flow amounts to a £209.6mn deficit. Shell, conversely, produced Free Cash Flow of £9.25bn, suggesting Shell has greater scope to invest in the next chapter of their shift towards greener fuels and the next big growth area for energy companies.

Shell's Edge Over BP

In April, Royal Dutch Shell cut its dividend by 66%, mostly to survive the pandemic. Importantly, the move has made it possible for the integrated energy major to lower annual dividend payments by a massive £7.7bn, thereby creating additional financial flexibility. The sizable manoeuvre will make Royal Dutch Shell more resilient to weak oil. The company will also be able to sustain and grow its value, thereby securing more cashflows for shareholders.

BP also has significant debt load and its balance sheet is considerably more levered than most peers, thereby limiting its financial flexibility. Notably, BP's gearing of 36.2%, as of the March quarter of 2020, compares with Royal Dutch Shell's 28.9%. We can say that BP is more vulnerable to energy market downturns. Investors should know that BP's balance sheet has piled up huge debt balance owing to the Gulf of Mexico oil spill incident on Apr 20, 2010, and the 2018 acquisition of U.S. unconventional onshore resources.

Shift to Renewables

With the considerable reduction of oil demand and associated fall in oil prices, the focus on renewables has increased for both BP and Shell. Both companies have strategies to increase the proportion of clean power they produce, and when assessing the relative value of each over the long term, this must be central to any valuation thesis. However, with revenue from renewables limited in both companies, the judgement of their low carbon activities falls to natural gas. In this respect, Shell has a far larger exposure to natural gas and would be judged to be ahead of BP in becoming a greener energy producer

About Atlantic Capital Markets

We are a multi-Asset brokers offering clients the ability to buy the shares either in a traditional fashion with standard shares or taking advantage of leverage and purchase via a CFD.

Call us on 01872 229 000.