

Royal Dutch Shell (RDSA LN)

Erratum: Lots of Moving Parts

Key Takeaway

Shell generated \$11.6b in CFFO ex working capital and initiated its \$25b share repurchase program, but these positive developments could not overcome a large earnings miss driven amongst other things by disappointing production.

Erratum: RDSA LN rating mistakenly moved to Hold in original note.

CFFO delivers, more or less. In a mirror image of 1Q, Shell CFFO of \$11.6b (ex. WC of -\$2.1b) was in line with our estimate of \$11.7b, but adjusted earnings of \$4.7b were 18% below our est. & 21% below cons. In 1Q, earnings were in line but cash flow missed our est. by \$2b. The market reaction was the same: RDS took a drubbing after both sets of results. We are encouraged that cash generation met our expectations as in our view delivering cash targets is the key for RDS performance. However, we had also included a \$0.8b headwind (in line with the actual result) in our 2Q CFFO estimate for yet another margin call related to Shell's dubious LNG hedging strategy and those that did not may have been disappointed in the result.

Still, Shell generated \$5.5b of free cash flow ex. WC on the quarter after interest payments or \$22b annualized. Its target for free cash flow in 2019-2021 is \$25b-30b in a \$65 Brent environment (or \$60 Brent on 2016 real terms), so 2Q18 annualized is \$8b short of target after adjusting for \$74 Brent (\$6b CFFO/\$10 in Brent). \$5b of this shortfall can be made up by the ramp of new MCPs in high-margin locations like Brazil and the Gulf of Mexico. The remaining \$3b shortfall will need to come from further cost reductions, better operating efficiency (refinery availability 87% in 2Q) and perhaps different hedging counterparties.

Major catalyst from buyback gets lost. Shell launched its \$25b buyback program, with an initial tranche of \$2b expected to be utilized in the next three months via an irrevocable, non-discretionary arrangement to repurchase both A and B class shares. The full program is subject to oil prices and further progress on debt reduction, but we view this step as a strong endorsement by the Board of the company's financial condition

Production a big miss. 2Q production of 3,442 missed our estimate by 6% with the largest variances in Europe and Africa. Further, Shell guided for 3Q production to decline sequentially by 40-70 kbde in Integrated Gas and by 210-240 kbde in Upstream due to maintenance, divestitures and field decline. We lower production estimates by 5% in 2018 and 2019 (and prospectively) to account for the various issues affecting production, and resulting lower cash flows reduce our DCF-derived PT to 3250p from 3350p. We now expect a production CAGR of 2% in 2017-2020, down from 3%.

USD	Prev.	2017A	Prev.	2018E	Prev.	2019E	Prev.	2020E
Production	--	3,665	3,781	3,603	3,972	3,791	4,132	3,945
Net Profit Adjusted	--	15,764.0	25,554.0	23,878.0	30,525.0	29,420.0	28,532.0	27,467.0
TEV/DACF	--	7.6x	6.8x	7.2x	5.7x	6.2x	5.6x	6.1x
Div Yield	--	6.70%	--	5.40%	--	5.80%	--	5.90%

EPS Adjusted

FY Dec	--	1.90	3.05	2.87	3.64	3.55	--	3.41
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TEV/DACF	--	7.6x	6.8x	7.2x	5.7x	6.2x	5.6x	6.1x
Div Yield	--	6.70%	5.40%	5.50%	--	5.80%	5.90%	6.00%
FY Dec	--	3.80	6.10	5.73	7.29	7.09	--	6.81

BUY

Price target 3,250.00p

(from 3,350.00p)

Price 2,576.00p^

Price target \$87.00

(from \$88.60)

Price \$67.76^

Bloomberg LSE: RDSA LN

Bloomberg NYSE: RDS/A

Financial Summary

Book Value (MM):	\$197,331.0
Book Value/Share:	\$23.56
Net Debt (MM):	\$65,353.0
Net Debt/Capital:	24.7%
Long-Term Debt (MM):	\$73,630.0
Dividend Yield:	5.5%
Cash & ST Invest. (MM):	\$21,927.0

Market Data

52 Week Range:	2,755.00p - 2,078.50p
Total Entprs. Value (MM):	\$340,653.4
Market Cap. (MM):	\$275,300.4
Institutional Ownership:	35.0%
Shares Out. (MM):	8,155.0
Float (MM):	4,596.9
Avg. Daily Vol.:	5,637,926

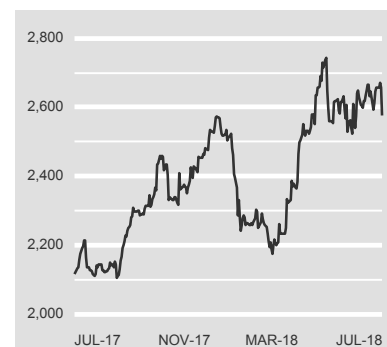
Jason Gammel *

Equity Analyst

+44 (0) 20 7029 8709 jason.gammel@jefferies.com

* Jefferies International Limited

Price Performance



^Prior trading day's closing price unless otherwise noted.

Lots of Moving Parts

Shell launched its \$2.5b buyback program today, with an initial tranche of \$2b

2Q18 RDS divestments were \$5.7b and total divestitures are at the target of \$30bn

Completed the sale of the Bongkot field in Thailand (\$750m) and its interest in the Malaysia Tiga LNG venture (\$640m)

Announced the sale of Norwegian upstream assets (\$556m) and its Argentinean downstream business (\$950m)

Total divestitures since 2016 have now reached Shell's target \$30b

Achieved first production at its Nanhai, China 1.2 mtpa ethylene cracker and at the 40 kbd (peak) Kaikias field in the deep water Gulf of Mexico

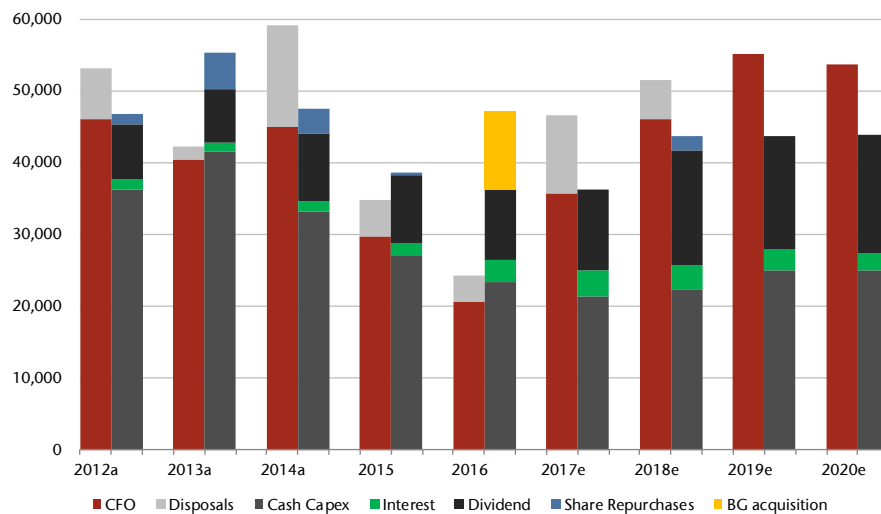
Announced a significant discovery at the Dover well in the Norphlet trend in the deep water Gulf of Mexico, near the Appomattox field.

Net debt/capitalization down to 23.6% vs 24.7% in 1Q18

Net debt decreased \$5.1bn to \$61.0bn

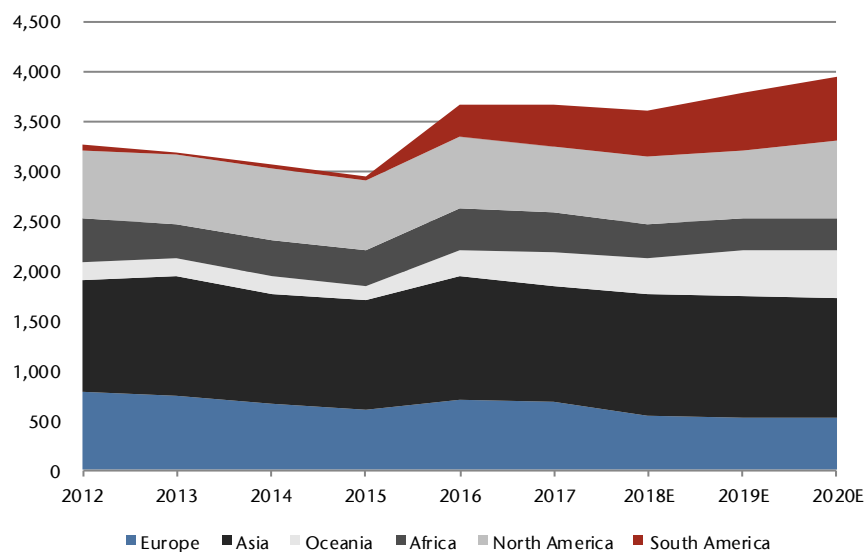
We estimate the company could reach 20% gearing by the end of the year

Exhibit 1: Summary cash cycle (\$m)



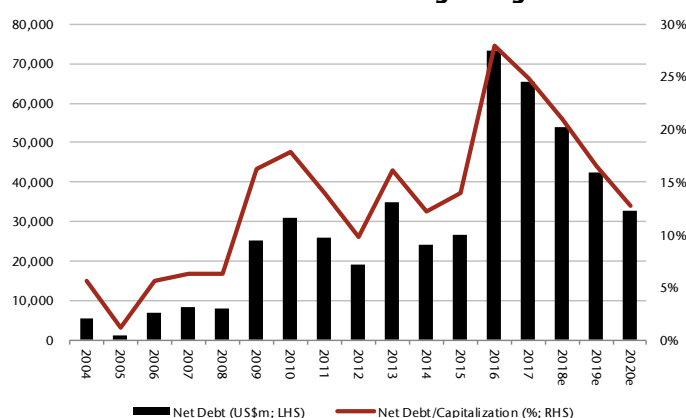
Source: Jefferies estimates, company data

Exhibit 2: RDS production profile (kbde)



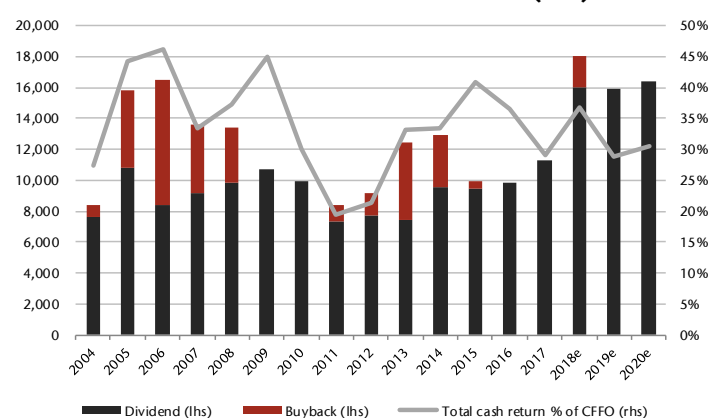
Source: Jefferies estimates, company data

Exhibit 3: RDS net debt and financial gearing



Source: Jefferies estimates, company data

Exhibit 4: RDS return of cash to shareholders (\$m)



Source: Jefferies estimates, company data

[2Q18: Strong CFO and Buyback Override Earnings Miss](#)

RDS adjusted net income of \$4,691m was a 21% miss to consensus of \$5,967m and an 18% miss of our estimate of \$5,731m.

Exhibit 5: Summary financials

RDS Summary P&L (\$m)	2Q18a	2Q17a	YoY	1Q18a	QoQ	2Q18e	Δ	Cons. (Vara)	Δ
Upstream	1,457	339	330%	1,551	-6%	2,285	-36%	2,009	-27%
Integrated Gas	2,305	1,169	97%	2,439	-6%	2,047	13%	2,366	-3%
Oil Products	1,102	1,905	-42%	1,081	2%	1,418	-22%	1,481	-26%
Chemicals	558	624	-11%	685	-19%	532	5%	596	-6%
CCS adj. earnings	5,421	4,037	34%	5,756	-6%	6,282	-14%	6,408	-15%
Corporate	(610)	(323)		(234)		(425)		(328)	
Minorities	(120)	(110)		(121)		(126)		(112)	
Underlying CCS net income	4,691	3,604	30%	5,401	-13%	5,731	-18%	5,967	-21%
Identified items	535	(1,684)		302					
CCS Downstream adjustment	(798)	375		(196)					
Reported net income	6,024	1,545	290%	5,899	2%	5,731	5%		
Adjusted EPS (US\$/sh)	0.56	0.43	29%	0.64	-13%	0.68	-18%	0.71	-21%
Reported DPS (US\$/sh)	0.47	0.47	0%	0.47	0%	0.47	0%	0.47	0%
Production (kbde)									
Liquids	1,730	1,814	-5%	1,785	-3%	1,833	-6%		
Gas	9,930	9,747	2%	11,912	-17%	10,520	-6%		
Total	3,442	3,495	-2%	3,839	-10%	3,647	-6%		

Source: Jefferies estimates, company data

Earnings miss. CCS adjusted net income of \$4,691m was a 21% miss relative to consensus of \$5,967m and 18% below our estimate of \$5,731m. Foreign exchange losses were \$0.5b on the quarter due to the large devaluation in Brazil, Argentina, et al:

- Upstream earnings of \$1,457m missed the cons. of \$2,009m by 27% and JefE of \$2,285m by 36%. Total production was 3,442 kbde, 6% below our estimate (Nigeria and Europe the key variances).
- Integrated gas earnings were \$2,305m, 3% below the cons. of \$2,366m and 13% above JefE of \$2,047m.
- Oil Products earnings of \$1,102m were 26% below the cons. of \$1,481m and 22% below JefE of \$1,418m, due in part to lower trading profitability. ■ Chemicals earnings of \$558m were 6% below the cons. of \$596m but 5% above JefE of \$532m

Exhibit 6: RDS production profile (kbde)

2016	Total Consideration \$m	Net Debt Reduction \$m
Upstream		
Brutus/Glider	425	425
Canadian Gundy/Deep Basin acreage	1,033	758
Other	620	620
Subtotal - Upstream/IG 2016	2,078	1,803
Downstream/Other		
Maui natural gas pipeline (New Zealand)	200	200
Mahanagas Gas Ltd IPO (India)	77	77
Showa Shell	1,400	1,400
Philippines downstream IPO	289	289
SHLX equity issuances	819	819
Other	121	121
Subtotal - Downstream/Other 2016	2,906	2,906
Total 2016 divestitures	4,984	4,709
2017		
Upstream/Integrated Gas		
UK North Sea	3,000	2,465
Canadian oil sands	8,129	8,600
Gabon	913	913
Woodside	2,635	2,635
Comgas	380	146
Other	215	215
Subtotal - Upstream/IG 2017	15,272	14,974
Downstream/Other		
Motiva dissolution proceeds	2,288	862
SADAF equity	820	820
Africa marketing (Vivo Energy)	250	250
Australia aviation	250	250
SHLX equity issuances	275	275
Hong Kong LPG	150	150
Other	114	114
Subtotal - Downstream/Other 2017	4,147	2,721
Total 2017 divestitures	19,420	17,695
2018		
Upstream		
Bongkot, Thailand	750	750
Corrib	947	947
New Zealand	578	578
Norway (Draugen/Gjoa)	556	437
West Qurna 1, Iraq	550	550
MLNG Tiga 15% equity stake	750	640
Other	72	72
Subtotal - Upstream/IG 2018	4,203	3,974
Downstream/Other		
SHLX equity issuance	673	673
Argentina downstream	950	950
Other	48	48
Subtotal - Upstream 2018	1,671	1,671
Total 2018 divestitures	5,874	5,645
Total cumulative divestitures	30,278	28,050
Announced divestitures not closed	3,225	3,225

Motiva total consideration includes \$1,426 of non-consolidated debt assumed by Aramco that is not classified as divestitures in RDS disclosures

Oil sands net debt reduction includes gain on CNQ shares

Italicised transactions have not closed as of last reporting date

Source: Jefferies estimates, company data

Exhibit 7: RDS Summary financials

RDS								UK TP:	32.50
								ADR TP:	87.0
Key Inputs	2014a	2015a	2016a	2017e	2018e	2019e	2020e	'17-20e CAGR	
Brent (US\$/bbl)	99.1	52.5	43.7	54.2	76.6	75.0	70.0	9%	
Henry Hub (US\$/mmbtu)	4.44	2.66	2.46	3.11	2.84	2.80	3.00	-1%	
USD/GBP	1.65	1.53	1.36	1.29	1.34	1.30	1.30	0%	
Liquids Production (kbd)	1,484	1,509	1,838	1,826	1,747	1,895	2,016	3%	
Gas Production (mcf/d)	9,259	8,380	10,613	10,669	10,764	10,998	11,185	2%	
Total Production (kbde)	3,080	2,954	3,668	3,665	3,603	3,791	3,945	2%	
Production growth	-4%	-4%	24%	0%	-2%	5%	4%		
Profit & Loss (\$m)									
Upstream adj. net income	6,754	(2,255)	(2,704)	3,091	8,272	10,036	9,152		
Integrated Gas adj. net income	10,332	5,057	3,700	5,268	9,756	11,909	10,167		
Oil Products adj. net income	4,889	8,062	5,560	6,460	5,378	6,090	6,168		
Chemicals adj. net income	1,376	1,686	1,683	2,622	2,548	2,755	2,894		
Segment adj. net income	23,351	12,550	8,239	17,441	25,954	30,791	28,381	18%	
Corporate Items	(245)	(788)	(784)	(1,259)	(1,540)	(755)	(347)		
Non-controlling Interests	(55)	(316)	(270)	(418)	(537)	(616)	(568)		
Underlying CCS Net Income	23,051	11,446	7,185	15,764	23,878	29,420	27,467	20%	
Earnings growth	15%	-50%	-37%	119%	51%	23%	-7%		
Shares (m)	6,312	6,394	7,892	8,299	8,338	8,298	8,298		
Underlying CCS EPS (US\$/sh)	3.65	1.79	0.91	1.90	2.87	3.55	3.31	20%	
EPS growth	15%	-51%	-49%	109%	51%	24%	-7%		
Underlying CCS EPADR (US\$/sh)	7.30	3.58	1.82	3.80	5.73	7.09	6.62		
DPS (US\$/sh)	1.88	1.88	1.88	1.88	1.88	1.94	1.99	2%	
DPS growth	4%	0%	0%	0%	0%	3%	3%		
Payout ratio	51%	105%	207%	99%	66%	55%	60%		
DPS ADR (US\$/sh)	3.76	3.76	3.76	3.76	3.76	3.87	3.99		
Cash Flow (\$m)									
Net Income	14,730	2,200	4,777	13,435	26,004	29,420	27,467		
D,D&A	24,499	26,714	24,993	26,223	21,900	23,360	24,080		
Other	(590)	(4,625)	(2,866)	(850)	1,235	2,409	2,188		
Source of Funds	38,639	24,289	26,904	38,808	49,139	55,190	53,735		
Working Capital	6,405	5,521	(6,289)	(3,158)	(3,032)	-	-		
Cash Flow from Operations	45,044	29,810	20,615	35,650	46,107	55,190	53,735	15%	
Capital Expenditure (cash)	(31,676)	(26,131)	(22,116)	(20,845)	(21,714)	(25,100)	(25,100)		
Proceeds from Disposals	14,036	4,996	3,637	10,985	5,384	-	-		
Acquisitions	-	-	(11,421)	-	-	-	-		
Other	(2,017)	(1,272)	(1,063)	1,831	3,491	-	-		
Cash Flow from Investing	(19,657)	(22,407)	(30,963)	(8,029)	(12,839)	(25,100)	(25,100)	46%	
Dividends Paid	(9,560)	(9,487)	(9,857)	(11,283)	(16,046)	(15,952)	(16,431)		
Interest Paid	(1,480)	(1,742)	(2,938)	(3,550)	(3,377)	(2,750)	(2,341)		
Increase/(Decrease) in Debt	357	14,891	11,074	(11,829)	(4,869)	-	-		
Issue/(Repurchase) of Stock	(3,328)	(409)	-	-	(2,000)	-	-		
Other	1,221	559	950	(424)	(412)	-	-		
Cash Flow from Financing	(12,790)	3,812	(771)	(27,086)	(26,704)	(18,702)	(18,772)		
Balance Sheet (\$m)									
Cash	21,607	31,752	19,130	20,312	19,468	19,468	19,468		
Total Debt	45,540	58,379	92,476	85,665	73,340	61,952	52,090		
Net Debt	23,933	26,627	73,346	65,353	53,872	42,484	32,622	-21%	
Shareholder Equity	172,786	164,121	188,511	197,812	203,595	214,314	223,008		
Net Debt/Capitalization	12%	14%	28%	25%	21%	17%	13%		
Net Debt/Equity	14%	16%	39%	33%	26%	20%	15%		
ROACE (%)	12%	7%	4%	7%	10%	13%	12%		
Valuation									
P/E (x)	12.8	15.8	26.9	14.8	12.0	9.4	10.1		
EV/DACF (x)	8.1	7.2	9.1	7.6	7.2	6.2	6.1		
Dividend Yield (%)	4.0%	6.6%	7.6%	6.7%	5.5%	5.8%	6.0%		
FCF Yield (%)	3.6%	0.6%	-2.9%	4.6%	7.1%	9.8%	9.5%		
P/BV (x)	1.7	1.1	1.0	1.2	1.4	1.3	1.2		

Source: Jefferies estimates, company data

Exhibit 8: Summary financials

Forecasts	FY18E New	FY18E Old	% Chg	FY19E New	FY19E Old	% Chg
CFO (\$m)	46,107	50,808	-9%	55,190	59,380	-7%
EPS (\$/sh)	2.87	3.05	-6%	3.55	3.64	-3%
Production (kbde)	3,603	3,781	-5%	3,791	3,972	-5%

Drivers of Change

1Q18 actual results

Source: Jefferies estimates, company data

Company Description

Royal Dutch Shell

Royal Dutch Shell is an integrated oil company with operations in Upstream, Refining & Marketing and Chemicals across the globe. After tax earnings in 2016 were US\$7.2bn and in 2016 Shell employed c.92,000 people. In 2016, Shell produced 3.7mbde and had proven reserves of 13.0b boe. Shell closed the US\$54bn acquisition of BG in 1Q16.

Company Valuation/Risks

Royal Dutch Shell

Our price target is derived from a Discounted Cash Flow (DCF) model. In addition to oil/natural gas commodity price and refining margin risks, we view the incremental debt and dividend burden from the BG acquisition as the primary risk to the stock.

Analyst Certification:

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Investment Recommendation Record

(Article 3(1)e and Article 7 of MAR)

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Recommendation Recalled	, 02:54 ET. July 27, 2018
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Recalled Recommendation Distributed	, 03:41 ET. July 27, 2018

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Within the past twelve months, Royal Dutch Shell plc has been a client of Jefferies LLC and investment banking services are being or have been provided.

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Underperform - Describes securities that we expect to provide a total return (price appreciation plus yield) of minus 10% or less within a 12-month period.

The expected total return (price appreciation plus yield) for Buy rated securities with an average security price consistently below \$10 is 20% or more within a 12-month period as these companies are typically more volatile than the overall stock market. For Hold rated securities with an average security price consistently below \$10, the expected total return (price appreciation plus yield) is plus or minus 20% within a 12-month period. For Underperform rated securities with an average security price consistently below \$10, the expected total return (price appreciation plus yield) is minus 20% or less within a 12-month period.

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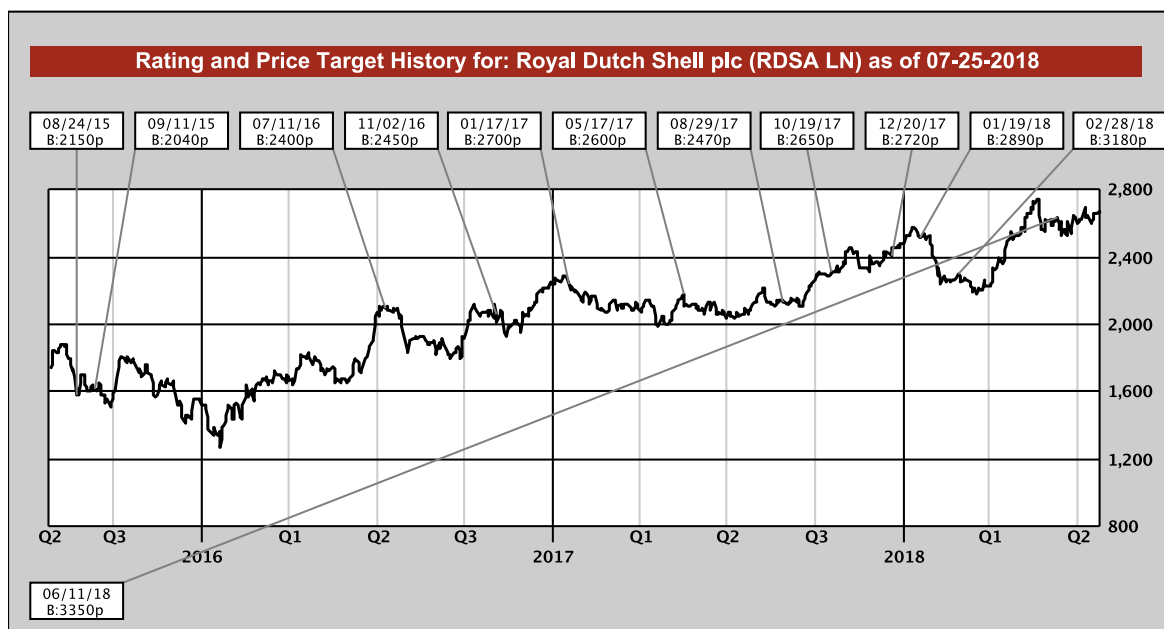
P/FCF, premium (discount)/average group EV/EBITDA, premium (discount)/average group P/E, sum of the parts, net asset value, dividend returns, and return on equity (ROE) over the next 12 months.

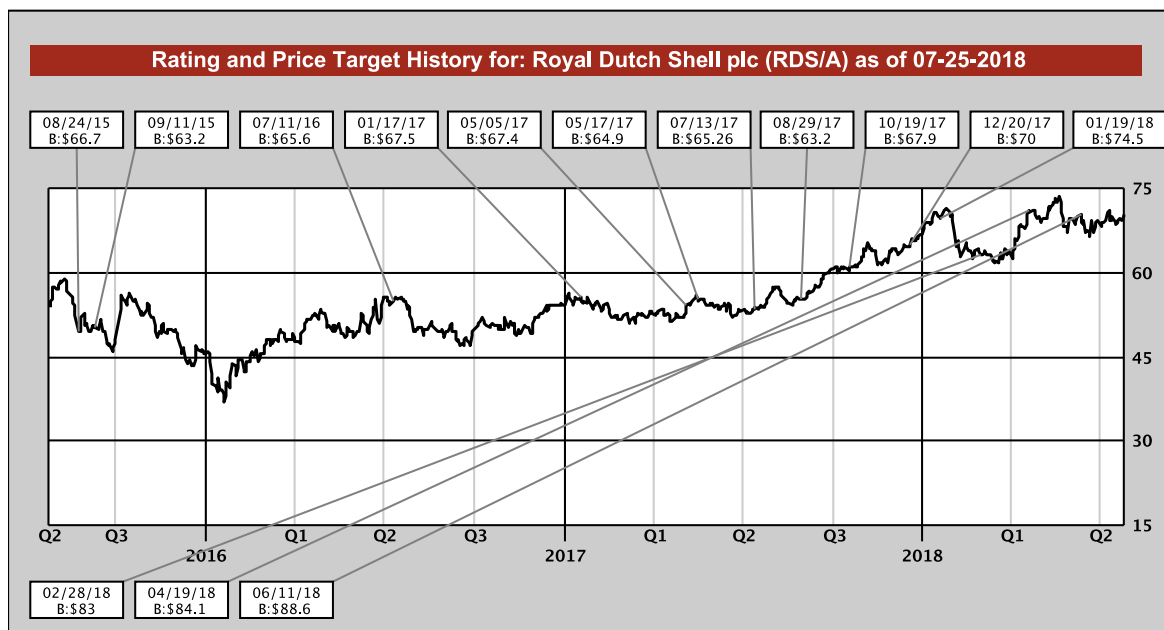
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Notes: Each box in the Rating and Price Target History chart above represents actions over the past three years in which an analyst initiated on a company, made a change to a rating or price target of a company or discontinued coverage of a company.

Legend:

I: Initiating Coverage

D: Dropped Coverage

B: Buy

H: Hold

UP: Underperform

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			Count	Percent	Count	Percent
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