ROYAL DUTCH SHELL PLC

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PORTLAND INVESTMENT COUNSEL™

Business Description:

Royal Dutch Shell plc is one of the world's largest independent oil and gas companies in terms of market capitalization, operating cash flow and production. Its diversified portfolio consists of some of the world's most innovative energy projects, from the deepest offshore oil and gas field on earth to the largest floating liquefied natural gas production facility. Since its establishment in 1907, the company's business expanded on the continued growth and success of its premium quality brands and products, and has been recognized as a market leader with daily production of 3.1 million barrels of oil equivalent. As of December 2015, Shell operates in over 70 countries and territories and generates sales of more than $264 billion per annum. The company is headquartered in The Hague, the Netherlands, and incorporated in England and Wales with approximately 94,000 employees.

Overview and Investment Thesis:

- **Robust portfolio with global scale.** For over 100 years, its yellow-and-red emblem, the Pecten, has stood for the pioneering spirit, which guided Royal Dutch Shell to establish leading positions in the oil and gas industry. The success of Shell was maintained through owning some of the world's most valuable assets. From its upstream business, the company produces 3.1 million barrels of oil equivalent per day, which represent more than 3% of the oil supply worldwide. From its downstream business, it has interests in 24 refineries around the world with the capacity to process a total of over 3.1 million barrels of crude oil per day. It owns and operates seven tank farms across the United States and transports more than 1.5 billion barrels of crude oil and refined products a year via 3,800 miles of pipelines connecting the Gulf of Mexico and the United States. In over 70 countries, millions of people buy its fuels, lubricants and other goods and services at its global network of more than 43,000 Shell service stations. Shell fuels more than 7,000 aircrafts each day at approximately 800 airports worldwide, which implies that one airplane is fueled by Shell every 12 seconds.
- **Innovation drives competitive advantage.** The pioneering spirit has always been vital for Shell to continue operating as a company of firsts: from sailing the first oil tanker through the Suez Canal in 1892, to designing and building the first floating liquefied natural gas facility today. Innovation has been the lifeblood of Shell, as the company spends over $1 billion a year on research and development, more than any other international oil company. Shell holds more than 15,000 active patents, making it one of the world's most inventive energy companies. Its technical and engineering community comprises more than 45,000 members located in 16 research centers throughout Asia, Europe and North America. In 2015, approximately two-thirds of Shell's R&D budget is invested in improving its asset base and projects, with the remainder devoted to research aimed at securing its long-term competitive position.
- **Value creation through acquisition.** In April, 2015, Shell agreed to merge with BG Group PLC in a cash and stock swap transaction, which we believe will provide a strong platform to refocus the company's core competency, therefore, to create a simpler and more completive Shell.

  BG Group acquisition provides Shell with:

  - **Ability to reshape unveils hidden synergy.** The combination accelerates the strategy to improve financial performance, enhance capital efficiency and ensure strong project delivery, by providing an enhanced set of positions in the so-called three pillars: upstream and downstream cash engines, deep water and liquefied natural gas (LNG). Those three pillars together will play as a springboard to reshape Shell, resulting in a simpler and more focused group. Shell believes it has a strong and complementary portfolio and country fit with the BG Group, providing synergy opportunities to be realized in number of areas. Management has identified that pre-tax synergies are expected to be $3.5 billion in 2018, which comprises $2 billion of operating cost saving and a $1.5 billion reduction in exploration expenditures.
  - **A leading player in liquefied natural gas (LNG).** Shell's existing competitive position in integrated gas was represented by its broad-based and growing portfolio. The underlying earnings of $10.4 billion in 2014 indicated a nearly 5 fold increase since 2009. The combination with BG Group will further enhance Shell's leadership in LNG as the management expects the combined group's equity LNG capacity to be 44 metric tons per annum (mtpa) by 2018, which will be almost twice the capacity of its next biggest competitor. We believe the merged group will realize immediate benefits from their complementary LNG production operations.
  - **Acceleration of deep water strategy.** As a well established leader in deep water, approximately 10% of Shell's total production comes from deep water fields. In 2013, Shell has entered the Libra pre-salt discovery in Brazil, which may turn out to be the world's largest pre-salt find in the basin. On the other hand, BG Group's deep water Brazil acreage offers near-term growth and options in the Santos Basin, complementing Shell's existing production, and longer-term growth potential from the Libra project. The merger will enhance Shell's leading position as a major reserves holder and investor in Brazil, as the production is expected to increase from 48,000 barrels of oil equivalent per day (boepd) in 2014 to an estimated 550,000 boepd for the merged entity by the end of the decade. The upside potential with Libra from Shell's side, together with BG Group's complementary deep water position, provides Shell with a high level of confidence to unlock profitability and growth potential.
  - **Enhanced cash flow.** The combined entity is expected to make substantial disposals following completion of the combination, as its management team plans asset sales of approximately $30 billion between 2016 and 2018. Exploration spending and capital investment for the merged group will also be restructured, where management expects a reduction of the capital investment program to around $33 billion in 2016, with options to further reduce the spending level given favorable conditions. Some sources of those cost reductions include structural operating cost reduction, staff and contractor reduction, efficiency improvements, activity level reduction and project deferrals and re-scoping. As a result, cash flow from operations is expected to be 15% higher to almost $52 billion which is well above the other majors. Notwithstanding the much lower energy price subsequent to the proposed acquisition, most large shareholders are still believed to be in favor of this transformational deal, since its assurance that fuel cost cutting will be possible in the lower energy priced environment. Based on the assumptions on synergies and capital expenditures, the deal is net present value break-even in the "low $60s". With room for further operational synergies and capital expenditure cuts post the closing of the deal, we believe the break-even price will move down over time.
  - **Improved balance sheet and greater potential on shareholder return.** As Shell becoming more focused, resilient and competitive, management aims to balance cash inflows and cash outflows over the business cycle to finance competitive investment programs and shareholder distributions. Following completion of the merger, Shell has three major priorities for its cash: debt reduction, dividends and shares buybacks and capital investment. Shell plans to pay down debt from 2016 to maintain a strong balance sheet and credit rating to underpin its business model. In addition, Shell plans to pay a dividend of no less than $1.88 per share in 2016, while replacing the Scrip Dividend Program (i.e. a program allows shareholders to increase their shareholding by choosing to receive new shares instead of cash dividends) in 2017 with a share

buyback program of at least $25 billion in the period between 2017 and 2020. Shell expects the buyback program to offset the shares issued under the Scrip Dividend Program and to significantly reduce the equity issued to complete the merger.

- **Experienced management team.** Shell's management team is lead by industry experts who have in-depth knowledge about the company. Ben Van Beurden, the Chief Executive Officer (CEO) as of 2014, joined Shell in 1983, he served under various key roles within the organization prior to his appointment as the CEO. Other core executives, such as Chief Financial Officer Simon Henry, Director John Abbott and Technology Director Harry Brekelmans, all have over 25 years of experience with the firm.

Industry Growth Drivers/Trends:

- **Underlying global energy demand.** According to an analysis conducted by Shell, there will be 9 billion people on the planet by 2050, 2 billion more than today's population. Consequently, the 2 billion extra population will transfer to approximately 1.2 billion more vehicles. This implies that the demand for energy is expected to double in the first half of this century as hundreds of millions will begin to use computers, drive cars, and fly for the first time.
- **Brand reputation.** In oil and gas industry, brand image continues to serve as one of the most significant factors in consuming and transporting of oil, natural gas, lubricant and petrochemicals. This is particularly true in developing markets where the guarantee of environment protection and product safety is limited. Through centuries of operations in Asia, Middle East and Africa, Shell has already established a highly reputable image via trust worthy brands including Shell V-Power and Shell FuelSave. In particular, Shell V-Power grew out of the long-standing technical partnership with the Ferrari Formula 1 team, which has demonstrated its high level of fuel efficiency and product safety.
- **Rising market in LNG.** In a recent annually published World Energy Outlook, the International Energy Agency (IEA) forecast a growing role for natural gas in the world's energy mix, with natural gas being the only fossil fuel whose share will rise. The estimated global demand for natural gas has been growing at approximately 2.7% per annum since 2000. In comparison, the global demand for LNG has risen by an estimated 7.6% per year over the same period, nearly three times faster than the growth of natural gas. As a result, LNG demand is expected to be even stronger, particularly through 2020. According to Earnest and Young, global LNG demand by 2030 could be almost double the level that has been estimated in 2012.
- **Rising industry standards.** In order to improve safety, environmental and social performance throughout the energy sector, many industry trade associations and professional bodies have raised the practice standards. To achieve those higher standards, Shell has responded by initiating many approaches including the "Goal Zero" ambition, which pertains to obtaining no harm and no leaks across all operations. The "Goal Zero" approach has helped in preventing and mitigating major events. For instance, the number of safety incidents in Shell has dropped to almost half of the level in 2012, while the volume of spillage has also dropped dramatically over the past few years.
- **Emerging market opportunities.** Opportunities in emerging markets are largely due to their rapid economic expansions in the past few decades. Consumer purchase power in developing nations such as India and China has been growing at a high pace, as the nations' annual GDP per capita growth rose gradually. Revenue streams contributed by emerging market at Shell accounts for over one third of the company's total revenue, and continue to follow a rising trend. We believe Shell is well positioned to take advantage of the high growth offered by those markets and benefit from the shift of consumption to those economies.

Competitive Advantages:

- **Development and application of technology:** Since 2007, Shell has spent more to research and develop innovative technology than any other international oil and gas company. The technology development includes seismic processing and visualization software that reveal previously unnoticed geological details; drilling rig equipment that delivers wells more quickly and more safely; oil recovery methods that increase production from fields and processes that refine crude oil and liquefy natural gas more efficiently.
- **Project management:** Shell has one of the best project delivery track records, as it developed 75 material project start-ups since 2011. It has won the Project Management Company of the Year award from the Association for Project Management in 2014.
- **Integrated value chains:** Shell explores for oil and gas worldwide, both from conventional fields and from sources such as tight rock, shale and coal formations. Its portfolio of refineries and chemical plants enables it to capture value from the oil and gas that it produces. The company has a strong retail and lubricants position not only in major developed countries, but also in emerging economies.

Competitors:

- **Supermajors:** ExxonMobile Corporation, Chevron Corporation, BP plc, Total SA, Eni SpA and ConocoPhillips.
- **Other project competitors:** PetroChina Company Limited, Occidental Petroleum Corporation, Phillips 66 and Statoil ASA.

Customers:

- Over the past few decades, Shell's international operating platform demonstrated its ability to deliver products to a diversified customer base. Given the breadth and depth of the company's diversified portfolios of businesses, there is no other significant exposure to a single customer.

Barriers to Entry:

- **Economies of scale:** In order to compete in the capital-intensive oil and gas industry, a start-up firm would need to spend significant amount of up-front outlays. A long established track record in project delivery, technology development and capital spending is likely to help larger companies to achieve economies of scale, where it would be much more difficult for a new firm to duplicate.
- **Ownership of licenses:** Licenses for exploring oil and gas onshore and offshore are finite, especially for the ones that offer high potential rates of return.
- **Innovation expertise:** A new firm without the existing capability to innovate will find itself struggling to breakeven given the so-called technological learning curve. On the other hand, companies with the ability to innovate will enjoy lower production costs, higher efficiency in production and less safety issues.

Officers and Directors:

- Non-Executive Chairman of the Board, Charles Holliday; Chief Executive Officer, Ben van Beurden; Chief Financial Officer, Simon Henry; Downstream Director, John Abbott; Projects and Technology Director, Harry Brekelmans; Upstream Director, Andrew Brown.

Corporate Governance:

- **13 member board** – of which 10 are considered independent directors, while three currently serve at the management level.
- Shell works to manage carbon dioxide emissions in the global battle against climate change. It focuses on producing more natural gas, which generates half as much carbon dioxide as coal when burnt for power.
- Shell utilizes new technologies and recycling processes to reduce

dependence on fresh water. In British Colombia, Canada, its Groundbirch natural gas project has built a waste-water treatment plant with the local authority. This reclaims enough waste water to supply its need.

- Shell's "Goal Zero" ambition highlighted its desire to achieve zero harm and zero leaks across all of its operations. The initiatives have shown considerable improvements, as the company managed to significantly reduce injuries, spills and number of incidents.
- Each year Shell spends many billions of dollars on goods and services from companies in countries with lower incomes. In Canada, it has spent more than $1 billion on contracts with companies run by aboriginal people. In United States, Shell's Motiva refinery spent over $1 billion in six years with firms owned by locals, women and those from ethnic minorities.
- Shell's key management personnel remuneration is equivalent to 0.2% of the company's operating income.

Ownership:

- Franklin Resources Inc. 2.3%, T. Rowe Price Associates, Inc. 1.2%, Vanguard Group Inc. 0.7%, FMR LLC 0.6% and Capital Group Companies Inc. 0.6%.

Capital Allocation/Uses:

- Shell has shown continuing commitment to shareholder returns, as it distributed $12 billion to shareholders in form of dividends and spent $3 billion on share repurchases in 2014. In 2015, the company distributed $12 billion in dividends. Shell plans to pay a dividend of no less than $1.88 per share in 2016, while replacing the Scrip Dividend Program in 2017 with a share buyback program of at least 25 billion in the period between 2017 and 2020.
- Shell currently has a corporate rating of AA from Fitch and AA- from Standard &Poor's. In addition, it plans to utilize the proceeds generated from sale of noncore assets to pay down debt to maintain a strong balance sheet and credit rating to underpin its business model.
- During its fiscal year 2015, Shell's net cash from operating activities was $30 billion, a decrease from $45 billion in 2014. Shell's net cash in investing activities was $22.4 billion in 2015, an increase from $19.7 billion in 2014. The increase was mainly the result of lower proceeds from sale of assets, which more than offset a reduction in capital expenditure.
- Shell's net cash from financing activities in 2015 was an inflow of $3.8 billion, compared to cash outflows of $12.8 billion in 2014 and $9 billion from 2013. This included net debt issued of $14.9 billion, partly offset by payment of dividends to Royal Dutch Shell plc shareholders of $9.4 billion and interest paid of $1.7 billion.
- In 2015, the company used $26.1 billion of capital expenditure to support innovation and cost savings. The spending figure declined by $5.5 billion compared to prior year.
- Total proceeds from divestiture of assets and the initial public offering in Shell Midstream Partners, L.P. were $15 billion in 2014 and 2015. Divestments of non-strategic assets in 2014-15 totaled over $20 billion, successfully completing its divestment program for that period.

Financial Statement Summary (US$ MM except per share items which is in US$, years ended December 31):

	2010	2011	2012	2013	2014	2015
Income Statement						
Total Revenue	368,056	470,171	467,153	451,235	421,105	264,960
EBITDA	41,981	55,820	52,501	48,461	44,390	23,496
Earnings per Share (Diluted)	3.28	4.95	4.26	2.60	2.36	0.30
Dividend per Share	1.68	1.68	1.72	1.80	1.88	1.88
Balance Sheet						
Total Debt	44,332	37,175	37,754	44,562	45,540	58,379
Total Equity	148,013	158,480	174,749	180,047	171,966	162,876
Total Debt: Total Equity	29.95%	23.46%	21.60%	24.75%	26.48%	35.84%
Cash Flow Statement						
Operating Cash Flow	27,350	36,771	46,140	40,440	45,044	29,810

Key Ratios and Figures:

Y/E Decmber 31	2010	2011	2012	2013	2014	2015
EBITDA Margin	11.40%	11.90%	11.20%	10.70%	10.50%	8.90%
Current Ratio	1.12	1.17	1.18	1.11	1.16	1.32
Return on Invested Capital	9.60%	13.70%	11.10%	6.40%	5.60%	0.80%
Fixed Asset Turnover	2.68	3.19	2.88	2.48	2.19	1.41

Business Segments (Years ended December 31):

	Revenue (%)			Capital Investment (%)		
Business Sectors Mix	2015	2014	2013	2015	2014	2013
Upstream	10.75%	10.74%	10.49%	81.52%	83.81%	87.54%
Downstream	89.21%	89.23%	89.47%	17.74%	15.83%	12.01%
Corporate	0.04%	0.03%	0.03%	0.74%	0.36%	0.46%

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Geographic Segments (Years ended December 31):						
	Revenue (%)			Capital Investment (%)		
Geographic Mix	2015	2014	2013	2015	2014	2013
Europe	35.94%	36.74%	38.91%	15.25%	15.24%	15.56%
Asia, Oceania, Africa	36.19%	35.59%	34.94%	47.86%	45.53%	43.74%
USA	19.12%	16.82%	16.08%	23.38%	22.12%	22.36%
Other Americas	8.75%	10.86%	10.07%	13.51%	17.11%	18.34%

Sourced from Thomson Reuters and Company Reports

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