Shell's stealth dividend

"Arbitrage" is a fancy word which is often used in the finance industry. Essentially it means taking advantage of price differentials in the same asset, across markets, in order to make a quick buck. It's what keeps markets efficient. By way of example, if you could buy a share in Microsoft on the New York Stock Exchange and simultaneously sell it at a higher price on the Nasdaq, then you'd lock in a (risk-free) profit. Though the "cost-of-living crisis" has us concerned about whether we should be buying our trifle at Marks & Spencer ("M&S") or Aldi, we do not have to worry about which exchange to use when buying US shares, fortunately. There are hordes of arbitrageurs which contribute to keeping price differentials efficient.

Foodies might point out that comparing the trifle offered by M&S versus Aldi is unfair. That concept is "fungibility" - which means that, in order to be "arbitrage-able", the product must be identical, replaceable and mutually exchangeable. Microsoft shares are clearly fungible. However, don't try returning an Aldi trifle to M&S!

To the extent that there is not fungibility, material divergences in valuations are possible – even in the same asset. By way of example, Rio Tinto is listed both in Australia and in the UK. The shares carry equal voting rights and receive exactly the same dividend, yet they trade at different prices. At the time of writing, the discount of the UK share to the Aussie line was more than 13%. The reason for the persistent discount has to do with Australian tax laws which allow personal tax ("franking") credits on imputed dividends, whereas this is not the case in the UK. Hence Rio's dividend is more valuable to Australians than Brits.

"Relative value" is another term often touted by investors. It is the idea that one can achieve superior returns by buying the cheaper version of otherwise similar assets. Using the above example, the price disparity between Rio's Aussie and UK listings should persist so long as the tax divergence continues to exist (possibly ad infinitum), and global investors can thus pick up approximately 1.2% of extra dividend yield annually by holding the UK listing rather than the Aussie one. Moreover, there is always a possibility that Rio could merge their UK and Australian listings (as BHP did last year), in which case UK holders would be "quids in" (i.e. the discount would close).

Shell is one of our largest positions and has long traded at a material discount to US listed peers (Chevron, Exxon), even prior to the Covid-19 pandemic, notwithstanding a comparable track record of profitability. Historically, there were many plausible reasons for the discount: ESG has been more of a concern this side of the pond, thus Shell's shares became increasingly verboten. Also, we drown in energy opportunities in the UK, at least relatively speaking, with the sector comprising approximately 12.6% of the FTSE 100 as compared to 5.3% of the S&P 500. That said, Shell has always had a fan base, being much prized by UK dividend income funds, thanks to a high single digit yield and a pedigree of consistent paying. Recall that Shell was able to hold their dividend during both the 2008/9 global financial crisis as well as the shale gas glut of 2015 (when oil dropped to as low as $40/barrel).

Post the pandemic, Shell's discount to US listed peers has almost doubled. Even though their earnings growth from pre to post pandemic levels has actually been comparable, Shell's shares today languish at approximately the same price level as at the start of 2020. US peers on the other hand now trade at prices some 50% to 60% higher. ▶▶

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Though the headlines of "windfall taxes" in the UK have hurt sentiment, the reality is that all of the "big oil" companies are global businesses, with comparable exposures. We believe the primary reason for the doubling of the discount was Shell being forced to halve their hitherto ironclad dividend during the 2020 lockdown during which oil prices went negative temporarily. For income fund managers, this heinous act would've gone down like a lead balloon. Put simply, Shell lost some of their biggest shareholder base. In contrast, US peers were able to hold their dividends, only because their pay-out ratio was roughly half of Shell's. They also halted share repurchases quietly.

Today, Shell is a veritable free cash flow "gusher" (in oilman speak). They have imitated their US peers' capital returns policy: keeping their dividend at the (post covid) rebased level, whilst simultaneously initiating massive share buybacks for the first time.

This policy change seems to be underappreciated in the UK market, where share buybacks are a rarity (compared to the US). In other words, were Shell to hike their dividend (but reduce their buyback to the same extent), we believe the share price would appreciate significantly, notwithstanding the fact that they would be returning the same capital, only in a different way. To the extent they do not, we'll benefit from reduced share count (annually) which gives us an ever-bigger slice of the same pie - a kind of "stealth dividend". For example, last year, Shell reduced their share count by an astonishing 9%, whilst paying their dividend and reducing debt materially. Shell today presents the kind of asymmetric risk reward we seek. Heads you win, tails you don't lose. ■

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