Activist Investor Third Point urges for Breakup of Shell

Introduction

As of Q2 2021, Third Point began amassing a $750m position in the Anglo-Dutch oil giant Shell to capitalize on impending corporate change. With Shell facing increased pressures to both decarbonize as well as increase their current scanty annualized returns from governments and investors alike, Third Point has proposed the following solution: splitting Shell into two separate companies to firstly satisfy ESG and returns oriented investors with aggressive decarbonization and secondly, prioritize returns for shareholders through reductions in CapEx and offloading assets. This move is comparable to the hedge fund Engine No. 1 and their investment in ExxonMobil, highlighting a movement of ESG-focused active investing in companies that aren't already environmentally clean to impart the highest amount of positive change possible in an industry with a fast approaching and mandated clean future.

About Shell

Royal Dutch Shell Plc. (Shell) is an Anglo-Dutch independent multinational oil and gas corporation incorporated in the United Kingdom but headquartered in The Hague. Shell is a part of the "supermajors", ranking fourth out of the six largest oil & gas companies by market capitalization while being the second largest non-United States based company. It operates in 70 different countries with ~86,000 employees, primarily working within the fully vertically integrated oil & gas business segment, including but not limited to production, refining, transportation, power generation and trading. Despite this, Shell has made strides towards clean energy, with their "Integrated Gas" segment housing their New Energies portfolio and liquified natural gas (LNG) activities making up 7% more of yearly revenue over the past 3 years even with their average 3% returns year over year for the past 2 decades.

While Shell's upstream and downstream oil & gas activities have been the driving factor in its revenues for decades, its oil output has peaked in 2019 and it is estimated a 1-2 per cent production decline to transition spending to "New Energies" such as renewables and Liquid Natural Gas, with the goal of net zero emissions by 2050 or sooner. However, this is arguably not enough for stakeholders, some of which are unsatisfied with the low annualized returns that Shell has been yielding over the past few decades, and others, such as governments, believe that Shell should speed up their decarbonization timeline. The latter materialized in May 2021 with a Dutch court ruling Shell must cut emissions 45% by 2030. This paired with a ~66% dividend cut from 47 cents to 16 cents per share in Q1 2020 are some factors that motivated Third Points new activist investment.

About Third Point

Third Point, LLC (Third Point) is a Wall Street activist investment advisory firm helmed by Daniel Loeb yielding average returns of 15.7% since 1996. Third Point manages approximately $17b in assets, employing an "event-driven investment strategy" targeting companies approaching a catalyst such as intense corporate change, restructuring or impending bankruptcy.

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Concerning Shell, Third Point has amassed a $750m position starting from Q2 2021 to motivate Shell to accelerate its decarbonization efforts and increase investor returns. Third Point has taken a passive approach through meetings and interactions with Shell, showing the long-term engagement that Third Point adapts with the vast majority of the companies they invest in, in contrast to other hedge funds such as Engine No. 1, which aggressively won board seats when it acquired a stake of Exxon. Third Points recommendations are often implemented, with the two most recent examples being Prudential Plc which spun off its US business following Third Points recommendation to do so in Q1 2020, and Intel, which named a new CEO shortly after Third Points Q1 2021 investment.

Analysis of Third Point's letter to investors

Third Point has recently addressed in their latest letter to investors, on October 27th, the "incoherent" strategy of Shell. Third Point's approach echoes the playbook used with other companies where Third Point pushed for changes, including Chip maker Intel Corp, which named a new CEO in January 2021 after the hedge fund's investment became public a month earlier, and British insurer Prudential Plc, which announced in January that it would spin off its U.S. business, less than a year after Third Point pushed for this move in early 2020.

Third Point's move recalled the successful six-month proxy campaign waged this spring by Engine No. 1, an upstart fund manager, which nominated and elected three directors on the board of Exxon Mobil with the goal of pushing it to reduce its carbon footprint, arguing that the Company's plans to increase oil and gas production posed an "existential risk" to it. Third Point, which has built a large stake of $750m starting from Q2 2021, pressured the oil supermajor Shell to split itself up into multiple standalone companies, due to the ineffectiveness of incoherent strategies pushed by different competing stakeholders. In fact, some shareholders want Shell to invest aggressively in renewable energy, others want it to prioritize return on capital and its legacy oil and gas business. Moreover, Third Point's letter comes less than six months after a court in The Hague ordered the Anglo-Dutch company to speed up its plans to cut CO2 emissions, and a day before the CEOs of the Big Oil companies were expected to testify in Congress about the alleged misleading of the public over the relevance of fossil fuels in climate change. In addition to that, the International Energy Agency announced in May that investments in new oil and gas facilities must stop in order to reach net-zero carbon emissions by 2050. Nowadays, most of the energy companies which relied on mineral fuels are investing in clean energy, urging the need for a similar transition at Shell: Eni and Repsol made plans to spin off parts of their renewables businesses to help finance their transition to less carbon intensive products.

Shell, which stated its oil output peaked in 2019, plans to allow production to decline by 1-2% a year, while investing in renewable energy and other low-carbon technologies such as hydrogen. As a signal of this shift, the company last month sold for $9.5bn its share in Permian, a core area of its oil business. The company also announced it was open for dialogue with all shareholders, including Third Point, but remarked that it would have followed the energy transition strategy it published in April, which had received the approval of 89 percent of shareholders. Third Point sees this approach as an attempt to "do it all", which fails to satisfy any of its stakeholders, arguing that Shell made, at the same time, shareholders and society unsatisfied, not doing enough for both returns and the environment. The hedge fund has suggested both improving Shell's corporate structure to diminish the cost of capital, so that it

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can invest in decarbonization, and adapting Shell's business units to the unique shareholders' factions allowing the company to react better and faster to market and environmental policy developments.

This strategy, as previously stated, would involve splitting the company in multiple independent businesses: a Shell's legacy business for upstream, refining and chemicals, which could further diminish capex, sell assets, and prioritize return of cash to shareholders to reallocate it into low-carbon areas of the economy, and a new separate entity which would focus on cleaner energy, such as LNG/Renewables/Marketing, in order to reinvest cash returns with aggressive investment in renewables and carbon reduction technologies. This strategy would result in a reduction in CO2 emissions, as well as a significant increase in returns for shareholders, a win for all stakeholders.

Third Point added in the letter that Big Oil companies are one of the biggest ESG opportunities, especially Royal Dutch Shell, making clear how it believes that the company has a strong potential for growth: Shell indeed generated a large percentage of its cash flow and earnings from stable businesses that have a major role in the energy transition. For example, the liquified natural gas ("LNG") business is expected, by Third Point, to generate EBITDA of over $25bn, sustaining capex of only $5 billion in 2022, which could easily sustain Shell's entire enterprise value if they were a standalone company. Its stock is also trading at under 4x next year's EBITDA and ~8x earnings at "strip" prices, with a ~35% discount on most metrics to competitors, despite Shell's higher quality and more sustainable business mix. Due to the divestitures in assets that are not aligned with a low-carbon future, its massive dividend cut, and other asset sales (like Permian), Shell also has now an under-levered balance sheet with year-end 2021 net debt to EBITDA of well below 1x, which allows it to return capital earlier and more aggressively than peers. However, according to Third Point, Shell will not be able to exploit the competitive advantage granted by a low debt level and a unique LNG business, unless it will solve its internal contrasting interests, which deems it necessary for the company to split up its business.

Market reaction

As of November 5th, more than one week after Third Point's letter to investors, Shell's share price has decreased by 5.85% to €19.75 per share. It is yet to understand whether Shell, which stated its openness to dialogue, will implement the suggestions made by Third Point, as other companies previously did when prompted by the hedge fund.

Jessica Uhl, Shell's CFO, admitted that Shell's board haven't done enough of a good job in explaining Shell's strategy for shifting to cleaner energy, adding that she didn't have much more information regarding Third Point's intentions, other than that contained in the letter. Mr. van Beurden, Shell's CEO, pointed out that if they were to exclude the revenues from Shell's legacy business, the transition to new energy sources wouldn't go as fast due to the lack of funds. Moreover, the current shortfalls of natural gas in Europe and resulting record prices were in his opinion an example of what would happen if investments in fossil fuels are stalled before enough is done to reduce its demand. Andrew Mackenzie, appointed Shell's chair in May, has had experience in dealing with active investors during his experience as CEO at BHP, the world's biggest miner, when Elliott Management launched an aggressive campaign to push the company to divest its oil business and consolidate into a single listed group, which Mackenzie resisted, questioning whether Third Point's attempt will end in the same way. Additionally, Mark van Baal, head of an activist shareholder group Follow This, which holds a small stake in Shell, expressed doubts on whether breaking

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up the company would help the fight against climate change, since using cash generated by fossil fuels to invest it in renewables still seems more efficient as there is no substantial renewables division of Shell yet to invest in.

Even if Shell's board is divided and may want to resist the idea of a breakup, the pressure from Third Point is likely to have an impact: Abrdn, one of Shell's largest shareholders, agreed with Third Point that there's "hidden value," but suggested that Shell's integrated operations would make a split difficult. Despite the mixed reactions, the letter of Third Point signals that investors may not see value in keeping all these businesses in house, having realized the inefficiency of this corporate structure and its obsolescence with respect to the energetic transition, which could prompt Shell's board to eventually implement the suggested solution.

TAGS: activism, third point, shell, engine no.1, oil and gas, petrol, renewables

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