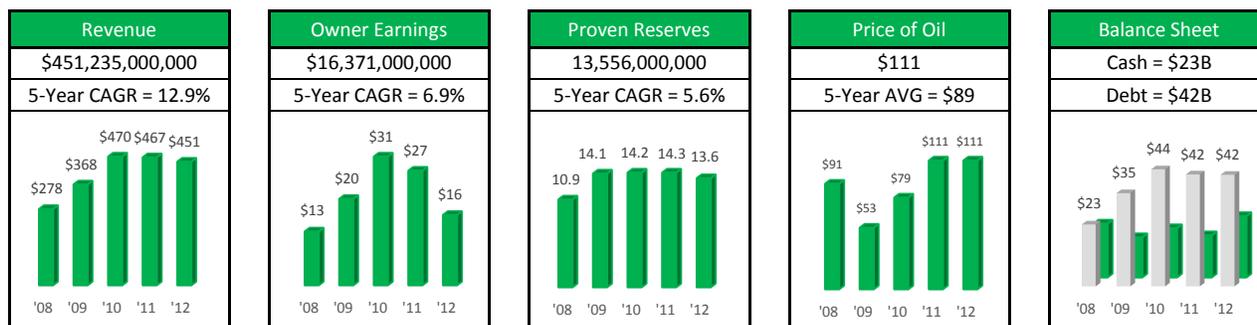




Royal Dutch Shell  
April 17, 2013

## General Overview

Royal Dutch Shell (RDS.B) is one of the world's largest oil and gas companies. The company focuses on oil and gas exploration, oil and gas refining, chemical production, and biofuel production. The company is divided into two divisions: Upstream activities and Downstream activities. The upstream activities include all projects related to oil and gas exploration as well as the transportation of raw product. The downstream activities include the refining of fossil fuels and production of chemical products.



## Purchase Logic

RDS.B was founded more than 100 years ago and has grown to be one of the most profitable businesses on the planet. In 2012 the business earned more than \$16 billion dollars. As a company the earning power is relatively volatile due to price fluctuations in the price of oil and natural gas, but over long periods of time profits tend to accumulate for the business owners. We purchased Royal Dutch Shell at a 52-week low and roughly 9 times earnings. We bought the Class B shares to avoid the withholding of taxes associated with the Class A shares. At the time of purchase we had a substantial cash position, in excess of 40%, and believed that over long periods of time RDS.B would prove to be a safe and reliable investment that was superior to cash. At our purchase price the dividend yield was 5.5%. It is our intention to hold onto this position until the price rises modestly or a superior investment opportunity is available.

## Key Metrics

The key metrics for RDS.B are Revenue, Owner Earnings, the Price of Oil, Proven Reserves, and the Balance Sheet. The business factors that drive each of these metrics are described in detail below.

### Revenue

The majority of revenue is generated at RDS.B by extracting oil and gas from the ground, transporting it to a refining facility for production into useable products (such as gasoline), and then sold in the market. In addition to this vertically integrated revenue source the company also refines oil and gas for other exploration companies and produces chemicals and biofuels that are closely correlated with the oil and gas industry.

### Owner Earnings

The owner earnings for RDS.B represent the funds that owners could freely extract from the business, through dividends or share repurchases, without impacting the competitive position of the business. This number is calculated by taking the reported earnings plus depreciation and amortization minus the average amount of capital expenditures required to maintain the company's competitive position and unit production of oil. This is the ultimate driver of business value for RDS.B and the source of cash flow for us as business owners.

### Price of Oil

The price of oil is a macro-economic factor largely outside of RDS.B control. This value is the average price of crude oil throughout the year. In years when the price of oil is higher RDS.B posts larger profits and when prices are lower the opposite is true.

### Proven Reserves

Proven reserves represent the total estimated barrels of oil equivalent that could be recovered with reasonable certainty. This value is derived from the total land owned or leased by RDS.B and the corresponding estimate of fossil fuels tied to the mineral rights of this land. The proven reserves are important because oil and gas companies are constantly depleting their existing oil reserves and need to discover new reserves annually to ensure future profitability.

### Balance Sheet

The balance sheet for RDS.B is extremely important and will be carefully monitored moving forward. Oil and gas companies typically have reasonable levels of debt to help pay for capital intensive projects and earn adequate returns on equity due to the leverage involved. However, we strongly prefer companies with little or no debt and RDS.B must maintain reasonable debt levels to adequately cover interest payments moving forward.

### **Historical Performance of Key Metrics**

Year	'08	'09	'10	'11	'12
Total Revenue	\$278,188,000,000	\$368,056,000,000	\$470,171,000,000	\$467,153,000,000	\$451,235,000,000
<i>Gross Profit</i>	\$49,812,000,000	\$60,422,000,000	\$73,574,000,000	\$71,213,000,000	\$69,650,000,000
Owner Earnings	\$12,518,000,000	\$20,127,000,000	\$30,826,000,000	\$26,712,000,000	\$16,371,000,000
Price of Oil	\$91	\$53	\$79	\$111	\$111
Proven Reserve	10,903,000,000	14,132,000,000	14,249,000,000	14,250,000,000	13,556,000,000
Cash	\$20,209,000,000	\$15,075,000,000	\$18,483,000,000	\$15,813,000,000	\$23,020,000,000
Debt	\$23,269,000,000	\$35,033,000,000	\$44,332,000,000	\$42,096,000,000	\$41,929,000,000

### Revenue

In the last 5 years the revenues for RDS.B have grown at a pace of 12.9%. This growth was largely due to the low base year that occurred in 2008 during the financial recession. RDS.B is a very mature company in a very mature industry and we anticipate growth of only 3% moving forward. As a global producer of a valuable commodity we anticipate RDS.B to fluctuate with the price of oil, but over long periods of time anticipate a reasonable return on investment.

### Owner Earnings

The owner earnings for the business have fluctuated between \$12 billion and \$30 billion with a 5 year average of \$21 billion. The average annual dividend payment in the last 5 years was \$9.1 billion indicating that RDS.B has plenty of earning power to cover the 5% dividend yield at our time of purchase. We anticipate owner earnings to fluctuate dramatically with the price of oil, but to average approximately \$21 billion over the next 10 years.

### Price of Oil

The price of oil has largely recovered from the 2008-2009 historical lows. We believe that it is not possible to accurately predict the price of any commodity over time, however, we do believe that oil is vital resource to the global economy and historically has provided owners of large oil conglomerates with stable income. We anticipate volatility in the price of oil over the years, but expect to collect the 5% dividend under most economic conditions and view this investment as superior to cash.

### Proven Reserves

In the last 5 years the proven reserves have grown by almost 30% from 10 billion barrels of equivalent (boe) to more than 13 billion boe. At an annual production rate of ~3.1 million boe per day RDS.B has roughly 10 years of proven reserves available. It is our expectation that this number remains stable as RDS.B discovers new reserves to offset the current production.

### Balance Sheet

In the last 5 years the debt to equity ratio of RDS.B has fluctuated between 20% and 30%. We believe that a reasonable level of debt for RDS.B would be less than 30%. In the event that the debt to equity ratio climbs significantly above 30% we would sell our position in the business.

#### Summary of Key Metrics

<b>Metric</b>	<b>Expectations</b>
Revenue	Relatively volatile with large changes year-over-year 10-year average growth of approximately 3%
Owner Earnings	Relatively volatile with large changes year-over-year 10-year average > \$21 billion
Price of Oil	We anticipate fluctuations that we cannot predict. We believe that oil is vital to the global economy and will remain so.
Proven Reserves	Stable at 13 billion boe Discoveries offsetting depletion
Balance Sheet	Debt to Equity Ratio between 20% and 30% Would exit the position if Debt / Equity >> 30%

### **The Moat Around The Metrics**

In order to make money in the oil and gas exploration industry companies must have rights to land, either purchased or leased. Without these rights businesses cannot extract the fossil fuels located beneath the earth's surface. This requirement establishes excellent barriers of entry in the oil and gas industry. New companies that want to compete against massive oil conglomerates have to grow their business one acre at a time – a very long and capital intensive process. It takes several decades to accumulate a land empire comparable to RDS.B. The business currently has mineral rights, purchased or leased, for more than 140 million acres globally. An energy portfolio this size has a wide economic moat due to the difficulty in replicating the capital reinvestment that went into the building RDS.B. We expect the natural economics of the oil and gas industry to allow the major oil conglomerates to earn reasonable returns on capital over time.

## Risks

As a large multi-national with land rights in countries all across the globe RDS.B is subject to risk from a wide array of sources. Below summarizes the short-term and long-term risks we face as owners for RDS.B.

### Short-Term Risks

- Fluctuation in oil and gas prices. The price of oil has historically fluctuated across a wide spectrum of prices. In the short-term a sharp decline in oil prices would have a material impact on RDS.B earnings, but we believe that oil is vital to the global economy and over long periods of time, meaning 10 years or more, the oil industry will earn appropriate returns on capital invested. We would not be inclined to sell during a downturn in the market for the price of oil and view the subsequent recovery as a near certainty.
  - Low Risk
- Political turmoil. RDS.B operates in several countries with hostile political regimes. There is a probability that certain of RDS.B's projects could be seized by a foreign government without compensation. While seizure of damage to a large RDS.B infrastructure project would be detrimental to the business and impact short-term results we believe that RDS.B energy portfolio is sufficiently diverse across nations that the business would fully recover over time.
  - Low Risk
- Regulatory changes. The oil and gas industry is highly regulated. Events, such as the Deepwater Horizon disaster, create additional regulatory pressure on how oil and gas industry conducts business. While this is a real risk, typically when political changes occur that increases the price of oil production those prices are passed on to consumers and adequate returns on capital are maintained.
  - Low Risk
- Self-insurance. RDS.B self-insures the majority of projects globally. In the event that one of these projects experiences a disaster or is seized RDS.B will be liable for all damages. While this is a significant risk it is extremely difficult for RDS.B to economically insure its projects globally and assuming these project risks makes is a sound decision.
  - Moderate Risk

### Long-Term Risks

- Renewable energy sources. In the long term it is likely that the global energy supply will become less dependent on fossil fuels as alternative energy sources emerge. While this development is a near certainty in the long run – it will be many decades before the oil and gas industry experiences significant pressure from these alternative sources. We believe that as owners of RDS.B we will receive a sufficient level of income during the interim period to justify a safe investment decision.
  - Low Risk
- Electric cars. Rapid adoption of electric cars would have a material impact on the global demand for gasoline. While we believe that the long-term future of automobiles is electric it will take many decades for this transition to occur globally. The developing world will continue to increase its energy dependence on fossil fuels for the foreseeable future which would likely offset the adoption of electric cars over time in the developed nations.
  - Low Risk

## **Conclusion**

RDS.B was founded more than 100 years ago and has grown to be one the most profitable oil and gas companies in the world. We purchased Royal Dutch Shell at a 52-week low and 9 times earnings with the expectation of collecting a stable 5.5% dividend while we wait for superior investment opportunities. The company earned \$21 billion dollars on average over the last 5 years and covers the dividend payment by more than a factor of two. While the oil and gas industry is volatile based on the price of a barrel of oil we believe that over long periods of time RDS.B will earn adequate returns on invested capital for shareholders and pay substantial dividends. The earning power of RDS.B is largely protected by the time and money required to build a land empire of equivalent size – now totaling 140 million acres and 13 billion boe in proven reserves. It is our expectation that we will earn a reasonable return on our investment over time.

## **Works Cited**

- 1) *RDS.B Annual Report - SEC Filing 20-F*. EDGAR, 2012.

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