HSBC Global Research

22 July 2021

# Global integrated oils

## How long are you willing to wait?

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- Any sector re-rating may continue to prove elusive despite much better results and signs of higher cash distributions
- It may not come for a long time, as critical mass in low-carbon is still years away, and climate pressures are intensifying
- Downgrade Chevron, ENI and Shell from Buy to Hold. TotalEnergies is now our only Buy-rated stock

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We are taking a fundamentally more pessimistic view of the integrated oil sector. It's tempting to view the oil majors as severely undervalued at current levels, but we think the sector's complete lack of response to a range of positive catalysts leaves historic valuations looking increasingly irrelevant, and attests to pervasive market concerns over the sector's long-term outlook. These concerns will only be addressed as the companies transform over many years – in the meantime, we think any significant valuation upside could well prove elusive.

**Climate headwinds aren't going away:** The major headwinds for valuations are ESG/investability constraints and market scepticism of what the energy transition means for the viability of companies' financial frameworks. As we examine in detail in this report, we think concerns on low-carbon returns and financial frameworks are overdone, but these are unlikely to be addressed for some years given a lack of disclosure or critical mass. With low-carbon assets set to contribute only 10-15% of earnings by 2030e, it is far too early for many investors to consider them plays on the transition theme: our analysis shows that the oil majors lag at least a decade behind utilities and autos on relative exposure to clean energy. In addition, pressure on company climate strategies may well continue to intensify, given the recent momentum behind the need for net zero 2050 climate pathways.

**Strong financials aren't moving valuations**: 2Q results will likely confirm that the sector is firmly back in a free-cash-generative position. In recent months we've had strongly positive news on crude prices, dividends and buybacks, and hugely positive earnings momentum – all of which have failed to generate any sector outperformance. We are increasingly unconvinced that further positive news flow on the same lines will do so either, other than in the much longer term as climate issues are addressed.

**Lowering target prices, rating downgrades**: We have updated our estimates but cut our target prices by an average of 13%, reflecting a much more cautious view of how much re-rating could be achievable on a 6-12 month view. We now have only 6% average upside to our target prices and, a result, we have downgraded our ratings on Chevron, ENI and Shell from Buy to Hold. Our only Buy rating is on TotalEnergies, reflecting its high dividend yield, good near-term growth and strong progress on growing its low-carbon businesses.

**Integrated oils: Summary of ratings and valuations**

| Company / Ticker | Currency | Current Price | New TP | Old TP | Rating | Up/downside | 21e Div yield | 21e PE | 21e EV/CF | 21e FC yield |
|---|---|---|---|---|---|---|---|---|---|---|
| BP (BP/ LN) | GBp | 296.1 | 315 | 360 | Hold | 6.4% | 5.1% | 8.5 | 5.9 | 14.7% |
| Chevron (CVX US) | USD | 101.3 | 112.0 | 127.0 | Hold (vs Buy) | 10.6% | 5.3% | 17.8 | 8.5 | 8.6% |
| ExxonMobil (XOM US) | USD | 59.0 | 57.0 | 65.0 | Hold | -3.3% | 5.9% | 15.3 | 8.6 | 8.9% |
| Shell A (RDSA LN) | GBp | 1,407 | 1,540 | 1,800 | Hold (vs Buy) | 9.4% | 3.6% | 7.3 | 4.8 | 13.9% |
| Shell B (RDSB LN) | GBp | 1,377 | 1,500 | 1,715 | Hold (vs Buy) | 8.9% | 3.6% | 7.2 | 4.7 | 13.6% |
| TotalEnergies (TTE FP) | EUR | 36.65 | 41.90 | 49.00 | Buy | 14.3% | 7.2% | 8.7 | 6.8 | 10.2% |
| ENI (ENI IM) | EUR | 9.91 | 10.90 | 12.50 | Hold (vs Buy) | 10.0% | 6.6% | 15.2 | 5.6 | 7.5% |
| Repsol (REP SQ) | EUR | 9.33 | 9.70 | 11.70 | Hold | 4.0% | 6.2% | 7.0 | 5.0 | 13.7% |
| Equinor (EQNR.NO) | NOK | 174.7 | 171.0 | 188.0 | Hold | -2.1% | 3.5% | 7.0 | 3.8 | 18.4% |

Source: Refinitiv Eikon, HSBC estimates. Priced at close 15 July 2021


**Disclosures & Disclaimer**
This report must be read with the disclosures and the analyst certifications in the Disclosure appendix, and with the Disclaimer, which forms part of it.

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# As good as it gets?

- Any sector re-rating is proving elusive despite much better results and signs of much higher cash distributions
- It may not come for some time, as critical mass in low-carbon is still years away, and climate pressures are intensifying
- Downgrade Chevron, ENI and Shell from Buy to Hold. TotalEnergies is now our only Buy-rated stock

## Boom times aren't doing anything for the shares

So far in 2021, we have seen a steadily improving macroeconomic backdrop for the integrated oils, following the severe pressure they were under in 2020.

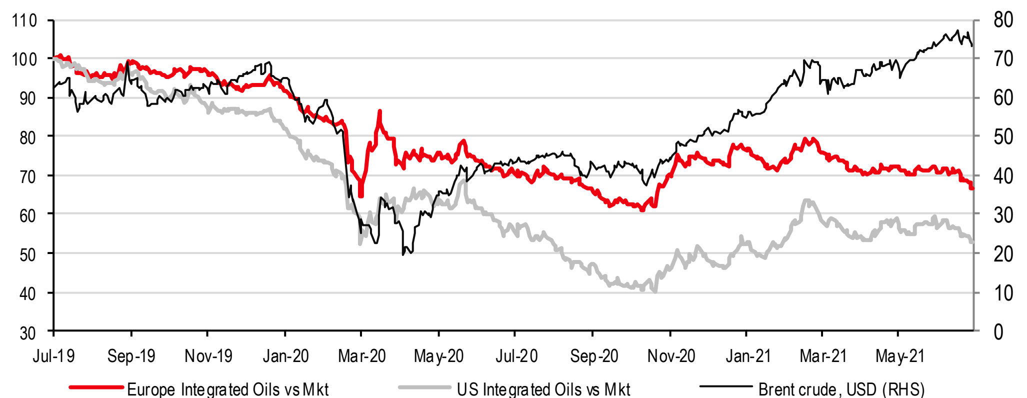
**A strongly free cash positive sector once more**

1Q sector results represented a watershed for the group, with a return of the sector to significant positive free cash flow. This has been reflected in positive news flow on balance sheet gearing and on cash distributions – both in the form of higher dividends and share buybacks. The momentum of consensus estimates has been strongly positive, and growth momentum (from a very depressed 2020 base) has exceeded that of most other sectors.

**A complete lack of outperformance since last November**

So far, all of this good news has singularly failed to result in any sector outperformance apart from a short, sharp rally last November as Brent moved up towards USD50/b. On balance the stocks have done nothing relative to market (in fact they've fallen) through the last ~USD20/b (35-40%) or so rise in Brent.

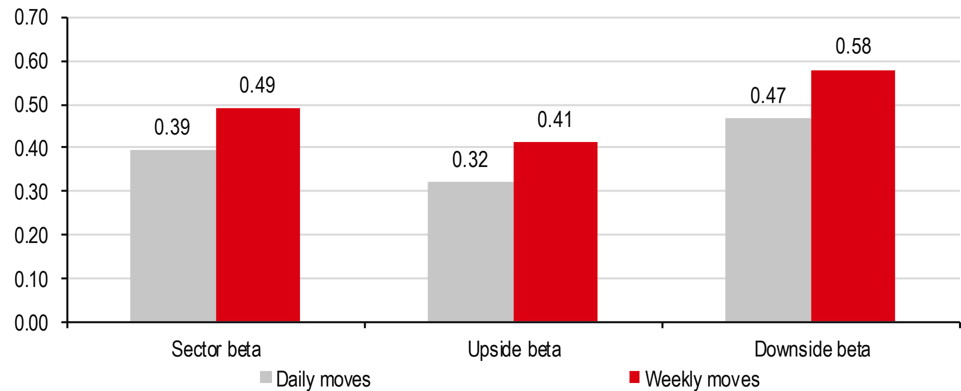
**European and US Integrated Oils: performance vs domestic market, past two years**




Source: Bloomberg

For some while the shares of the integrated oils have demonstrated a skewed relationship with movements in the Brent crude price. The sector beta to daily or weekly *increases* in Brent price rises is considerably lower than its beta to price *falls*. The graph below shows that oil majors' shares tend to rise by 0.3-0.4% for every 1% move up in Brent prices (two middle columns: "upside beta"), making them a poor proxy for the underlying commodity.

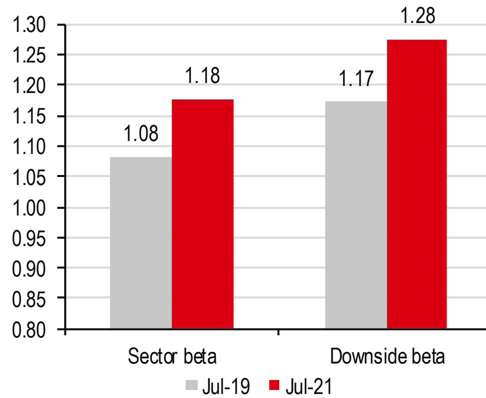
**European integrated oils vs Brent – long-term average 3m beta**




Source: Refinitiv Eikon

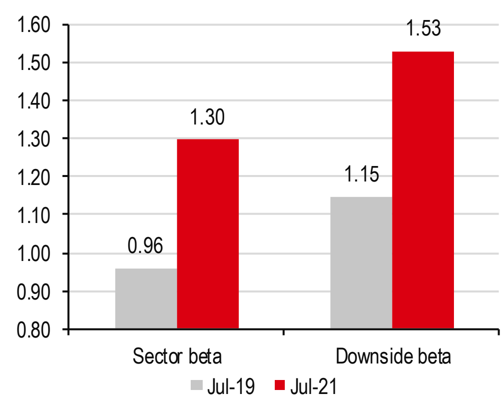
Our analysis of the European and US oil majors' upside and downside betas demonstrates that the stocks have more downside sensitivity than upside sensitivity. Put simply, the stocks are currently likely to underperform the market both ways: the oil majors fall more than the market when market indices are down, and rise less when the market is up. This share price behaviour emerged around mid-2019, and if anything the companies' downside betas have increased over the last two years.

**European integrated oils vs market – 6-month beta, daily moves**




Source: HSBC estimates. NB: Indices used to calculate betas: STOXX Europe 600 and STOXX Europe 600 Oil and Gas

**US integrated oils vs market – 6-month beta, weekly moves**




Source: HSBC estimates. NB: Indices used to calculate betas: S&P 500 and S&P 500 Integrated Oil & Gas

**Strong 2Q results unlikely to do the trick**

**2Q results will likely be strong, but that's largely expected, so we may not see any "catalysts"**

The companies start reporting 2Q21 results in the last week of July, and we discuss these in more detail later in this report. During the quarter we saw a solid improvement in macroeconomic conditions almost across the board, and this should be reflected in a broadly strong set of results.

However, this is largely expected, and we aren't convinced that we will see enough in the way of "catalysts" that will actually work to generate sector outperformance. Ahead of the results, we have already seen Shell comment that it will be close enough to its target debt level to start buybacks in the second half, and BP's CEO comment on the likelihood of "material" buybacks if crude prices stay at current levels. Neither stock rose on either of these announcements. Equinor's shares actually fell on the day the company announced a new buyback programme at its June capital markets day.

So why should things change now? We have had so many "catalysts" on the financial front so far this year, to no effect relative to market, and we are increasingly unconvinced that a continuation of the strong underlying trends will do much more to finally drive outperformance.

There are clearly other factors going on here, and we'd summarise them as follows:

- The post-pandemic economic recovery that's behind the demand-side of the improvement in crude prices is perceived by the market as having at least as strong an effect on the prospects of many other sectors, limiting the oils' ability to outperform.
- We believe most market participants are "looking through" the companies' strong results this year, explaining why short-term earnings upgrades aren't pushing shares higher.
- Market views on crude prices are, as always, divided. While there are some who believe prices could spike higher, there are others who feel that the bias of risks is further to the downside.

**Market concerns over the energy transition remain a significant headwind for the shares**

- We would not underestimate the importance of sentiment over the energy transition as a headwind for the shares. If better financial performance cannot drive outperformance in the sector from here, it is likely that risks around the energy transition will continue to impede valuations.

The last point is crucial in understanding the outlook for the sector. In this report we look in some detail at the companies' ability to transition their businesses, and what it means for their longer-term structure. Our broad conclusions are as follows:

- All of the European IOCs now have some form of net zero long-term emissions target. The companies' strategies look broadly consistent with meeting their intermediate emissions goals
- The strength of the IOCs' balance sheets and the scale of their redeployment of capital into low-carbon businesses makes the companies important agents for transforming the global energy system in our view. However, they will remain primarily hydrocarbon-based for many years to come – we estimate that low-carbon assets will still only contribute around 9-12% of group cash flow in 2030. For this reason, we think they are still a long way off from being viewed as "transition plays" by the majority of the market in the way that – say – some of the utilities companies have become in the past 1-2 years
- With low-carbon assets still well below critical mass and set to remain so for some while, disclosure is likely to remain an issue. Market concern over low returns on low-carbon assets – and resultant uncertainty over future financial frameworks – is a critical factor driving sentiment. In practice, we think these concerns are overdone. However, it will most likely take many years for the companies to be able to demonstrate this

**There is a real risk that pressure over climate ambitions continues to intensify**

- In the meanwhile, there are real risks that investor expectations over emissions targets continue to tighten. The recent IEA Net Zero 2050 scenario and similar approaches appear to be gaining momentum as templates for the scale of global transformation needed. In particular, there seems to be an increasing focus on the need for absolute emissions targets rather than the intensity-based ones which are widespread across the IOCs. Sizeable cuts to absolute emissions – such as that mandated in the recent Dutch court ruling against Shell on its climate strategy – necessitate a significant shrinkage of hydrocarbon sales over time, in contrast to the plans for most IOCs to reduce intensity in large part through a rapid growth of low-carbon energy sales during this decade.

Sector valuations have de-rated substantially since 2018 and the widespread question in the market is now how much the stocks could re-rate. However, we are increasingly questioning how relevant the valuation history of the sector is at all, given how radically the companies and the market are changing.

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