

Rating: Buy
 S&P 500: 1189

Royal Dutch Petroleum Transformation Approaching

<i>Symbol</i>	RD	<i>Ebitda Next Twelve Months ending 3/31/06 (US\$mm)</i>	32,500
<i>Rating</i>	Buy	<i>North American Natural Gas/Ebitda (%)</i>	4
<i>Price (US\$/sh)</i>	62.03	<i>Natural Gas and Oil Production/Ebitda (%)</i>	64
<i>Pricing Date (intraday)</i>	3/18/05	<i>Adjusted Reserves/Production NTM</i>	7.6
<i>Shares (mm)</i>	2016	<i>EV/Ebitda</i>	4.6
<i>Market Capitalization (US\$mm)</i>	125,100	<i>PV/Ebitda</i>	4.9
<i>Debt (US\$mm)</i>	25,400	<i>Undeveloped Reserves (%)</i>	41
<i>Enterprise Value (EV) (US\$mm)</i>	150,500	<i>Natural Gas and Oil Ebitda (US\$/boe)</i>	26.10
<i>Present Value (PV) (US\$mm)</i>	158,500	<i>Present Value Proven Reserves(US\$/boe)</i>	13.30
<i>Net Present Value (US\$/share)</i>	66	<i>Present Value Proven Reserves(US\$/mcf)</i>	2.22
<i>Debt/Present Value</i>	0.16	<i>Earnings Next Twelve Months (US\$/sh)</i>	6.95
<i>McDep Ratio - EV/PV</i>	0.95	<i>Price/Earnings Next Twelve Months</i>	9
<i>Dividend Yield (%/year)</i>	3.9	<i>Indicated Annual Dividend (US\$/sh)</i>	2.39

Note: Estimated cash flow and earnings tied to one-year futures prices for oil and natural gas.

Reported results may vary widely from estimates. Estimated present value per share revised only infrequently.

Summary and Recommendation

We continue to recommend current purchase of **Royal Dutch Petroleum (RD)** that will be combined with **Shell Transport and Trading (SC)** in a few more months to become Royal Dutch Shell plc. We raised our estimate of net present value on January 26, 2005 when we revised our estimate of long-term oil price to \$40 a barrel constant real from \$35. Net present value can be a moving target as six-year oil price marches steadily upward surpassing \$51 a barrel. Meanwhile, the historic transformation concentrates ownership in a single company with one chief executive and one board of directors. The earlier controversy over reporting of oil and gas reserves has been turned into the opportunity to improve the company. Even mighty mega cap competitors, **ExxonMobil (XOM)** and **BP plc (BP)**, have been humbled into admitting that reported reserves did not fully meet Securities and Exchange Commission standards. Dividends to be paid quarterly rather than semi-annually are expected to beat inflation for a real return in excess of dividend yield.

Cash Flow Grows

Our current estimate for RD/SC's cash flow is some \$54 billion for the next twelve months (see table [Next Twelve Months Operating and Financial Estimates](#))s. Only late last year that estimate was \$44 billion (see *Stock Idea: [Royal Dutch](#)*, December 22, 2004 and *Stock Idea: [Shell Transport](#)*, December 22, 2004).

Crude oil price drives the gains in cash flow from production. The steeper discount for harder-to-refine oil drives higher margins for downstream. We project refining/marketing margins at a constant level equivalent to the average of the last half of 2004.

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Royal Dutch/Shell
Next Twelve Months Operating and Financial Estimates

	Q3	Q4	Year	Q1E	Q2E	Q3E	Q4E	Year	Q1E	Next Twelve Months
	9/30/04	12/31/04	2004	3/31/05	6/30/05	9/30/05	12/31/05	2005E	3/31/06	3/31/06
Volume										
Natural Gas (mmcf)										
U.S. (or North America)	1,294	1,302	1,335	1,302	1,302	1,302	1,302	1,302	1,302	1,302
Overseas (or Int'l)	6,412	8,408	7,528	9,034	6,625	6,023	8,432	7,523	9,027	7,521
Total	7,706	9,710	8,864	10,336	7,927	7,325	9,734	8,825	10,329	8,823
Oil (mmb)										
Oil (mmb)	210	199	825	195	197	199	199	789	195	789
Oil (mbd)	2,279	2,163	2,261	2,163	2,163	2,163	2,163	2,163	2,163	2,163
Total gas & oil (mmb)	328	348	1,365	350	317	311	348	1,326	350	1,326
Price										
Natural gas (\$/mcf)										
Henry Hub (\$/mmbtu)	5.75	7.10	6.15	6.27	7.35	7.59	7.95	7.29	8.41	7.82
U.S. (or North America)	6.18	7.27	6.33	6.20	7.28	7.52	7.87	7.22	8.32	7.74
Overseas (or Int'l)	2.96	3.32	3.08	4.14	4.73	4.81	4.77	4.58	4.69	4.74
Total	3.50	3.85	3.57	4.40	5.15	5.29	5.19	4.97	5.15	5.19
Oil (\$/bbl)										
WTI Cushing	43.89	48.30	41.44	49.78	56.88	57.78	57.37	55.45	56.36	57.10
Worldwide	38.23	40.17	35.56	41.41	47.31	48.06	47.71	46.15	46.88	47.49
Total gas & oil (\$/bbl)	32.02	32.86	29.98	34.76	41.09	42.17	40.60	39.54	39.79	40.87
NY Harbor 3-2-1 (\$/bbl)	7.83	5.66	8.43	5.98	9.47	8.79	7.61	7.96	4.63	7.63
Revenue (\$mm)										
Natural Gas										
U.S. (or North America)	736	871	3,084	727	862	900	942	3,432	975	3,680
Overseas (or Int'l)	1,746	2,568	8,471	3,367	2,852	2,663	3,701	12,583	3,808	13,025
Total	2,481	3,439	11,555	4,094	3,715	3,563	4,644	16,015	4,784	16,705
Oil	8,016	7,994	29,357	8,061	9,313	9,564	9,495	36,432	9,126	37,497
Other	60,495	64,991	227,152	64,991	64,991	64,991	64,991	259,964	64,991	259,964
Total	70,992	76,424	268,064	77,145	78,018	78,118	79,130	312,412	78,900	314,167
Expense (\$mm)										
Production	4,669	4,466	15,888	4,611	4,785	4,805	5,007	19,208	4,962	19,559
Other	56,224	59,488	209,644	60,104	60,104	60,104	60,104	240,416	60,104	240,416
Ebitda (\$mm)										
Exploration and Production	5,828	6,967	25,024	7,544	8,242	8,322	9,131	33,239	8,948	34,643
Other	4,271	5,503	17,508	4,887	4,887	4,887	4,887	19,549	4,887	19,549
Total Ebitda	10,098	12,470	42,532	12,431	13,129	13,209	14,018	52,788	13,835	54,192
Exploration	304	519	1,828	519	519	519	600	2,157	600	2,238
Deprec., Deplet., & Amort.	2,605	3,545	11,897	3,545	3,545	3,545	3,545	14,180	3,545	14,180
Other non cash	97	161	554	161	161	161	100	583	100	522
Ebit	7,092	8,245	28,253	8,206	8,904	8,984	9,773	35,868	9,590	37,252
Interest	304	336	1,259	336	336	336	336	1,344	336	1,344
Ebt	6,788	7,909	26,994	7,870	8,568	8,648	9,437	34,524	9,254	35,908
Income Tax	2,376	2,768	9,448	2,754	2,999	3,027	3,303	12,083	3,239	12,568
Net Income (\$mm)										
Exploration and Production	2,405	2,578	9,664							
Other	2,367	3,036	9,436							
Unallocated	(359)	(473)	(1,554)							
Total	4,413	5,141	17,546	5,115	5,569	5,621	6,134	22,440	6,015	23,340
Shares (millions) - RD	2,021	2,016	2,025	2,016	2,016	2,016	2,016	2,016	2,016	2,016
Per share (\$) - RD	1.31	1.53	5.20	1.52	1.66	1.67	1.83	6.68	1.79	6.95
Shares (millions) - SC	1,578	1,575	1,581	1,575	1,575	1,575	1,575	1,575	1,575	1,575
Per share (\$) - SC	1.12	1.30	4.44	1.30	1.41	1.43	1.56	5.70	1.53	5.93
Ebitda Margin (E&P)	56%	61%	61%	62%	63%	63%	65%	63%	64%	64%
Tax Rate	35%	35%	35%	35%	35%	35%	35%	35%	35%	35%

Diversified Strength in Downstream

While RD/SC shares in the improved outlook for natural gas and oil production profits along with its peers, the group has more relative exposure than its peers to the downstream businesses of refining and marketing of oil products and chemicals. That line of business accounts for some 45% of present value compared to about a third for peers by our current estimates (see table Present Value by Line of Business).

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Present Value by Line of Business

	<i>North Amer. Natural Gas (%)</i>	<i>Over- seas Natural Gas (%)</i>	<i>Oil Prod'n (%)</i>	<i>Down- stream (%)</i>	<i>Total (US\$m)</i>
Exxon Mobil Corporation	10	18	37	34	412,000
Royal Dutch/Shell	3	17	35	45	264,000
BP plc	10	12	46	32	263,000
ChevronTexaco Corporation	6	8	52	34	178,000
Total S.A.	-	22	43	35	175,000

Though producing governments are taking most of the profit on production for the largest exporters, crude oil still has to be refined before it is useful. At the same time the declining quality of incremental oil supply requires even more intensive refining. As a result, refining/marketing continues to be a vital role for mega cap companies. RD/SC's downstream system appears well-positioned to exploit the long-term trend to heavy, sour crude oil as light, sweet becomes less available.

We estimate present value for downstream businesses near six times next twelve months cash flow (see table Functional Cash Flow and Present Value). Uncertainty around that estimate could account for some of the difference in McDep Ratios for mega cap integrated companies compared to independent producers.

**Royal Dutch/Shell
 Functional Cash Flow and Present Value**

	<i>NTM Ebitda (US\$m)</i>	<i>Adjusted R/P</i>	<i>PV/ Ebitda</i>	<i>Present Value (US\$m)</i>	
North American Natural Gas	2,350	4.9	3.8	9,000	3%
Overseas Natural Gas	8,320	10.4	5.3	44,000	17%
Oil	23,970	6.3	3.9	93,000	35%
Downstream	19,550		6.0	118,000	45%
	54,190	7.6	4.9	264,000	100%

Reserves Restatement Turned into Opportunity

There are further implications beyond the simplified RD/SC structure. It may be that new management is wiping the slate clean for a fresh start. Reserves may now be stated more conservatively than for competitors. We know that Securities and Exchange Commission standards understate likely ultimate production especially when rigidly applied. The typical oil field would probably not be developed if the capital program had to be justified by SEC reserves.

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As a result from a more conservative base, RD/SC may be able to report performance that looks better than would otherwise be the case.

At the other extreme, the Shell experience calls attention to other potential overstatements. The Middle Eastern producing countries come to mind. Fully a third of the “reserves” of Saudi Arabia would likely be considered as “probable” in the SEC classification. Of the proven reserves a large portion would be considered undeveloped. There is little doubt that the oil is there as in Shell’s case, it is just a matter of investment and timing.

Obviously there is still a lot of oil in the Middle East and Russia. That has always been the case. What is different now is that there is no known spare capacity of light oil. The pace of investment needed to expand capacity is likely to lag market requirements just as capital spending is inherently cyclical. The question is more how rapidly will consumers have access to growing volumes. For the next several years it looks like a seller’s market. The producers must spend large sums. Inevitably there are delays and some producing countries may not see the situation as urgently.

Management Did the Right Thing

The historic development combines the 60% owner and the 40% owner of Royal Dutch/Shell Group as a single company. The transformation is a constructive and worthwhile outcome to the unfavorable publicity the group received earlier in 2004 on disclosure of reserves. A change of management at the top resulted in Mr. Jeroen van der Veer becoming the new chief executive. Mr. van der Veer communicated his ideas for Structure and Governance as “Effectiveness + accountability + transparency + simplicity”. The concepts have been turned into bold action that no predecessor has been able to achieve for a hundred years.

Royal Dutch shares are to be converted to Royal Dutch Shell A shares and Shell Transport shares to Royal Dutch Shell B shares. The remaining distinction is that the dividend on the A shares will be sourced in the Netherlands for tax purposes and the equal pre-tax dividend on the B shares will be sourced in the U.K. The relatively higher McDep Ratio of SC as compared to RD may reflect differences in after-tax dividend yield for some shareholders.

Buy Oil and Gas Producers at Mid Decade

Three to five-fold gain potential for oil and gas price over the next 5 to 13 years justifies investment in recommended oil and gas producers including RD/SC, in our opinion. Supporting improving prospects, the average futures prices of oil and gas for continuous delivery over the next six years are in a multi-year uptrend defined by the current quotes above the 40-week average. The current benchmark oil average futures price for the next six years is almost \$52 a barrel. That is higher than the \$40 a barrel reflected in our current estimates of present value.

Valuation of RD/SC appears close to that of peers (see table [Rank by McDep Ratio](#)). Our estimate of present value currently appears conservative relative to peers by a few percent. The historic transformation should improve investor perceptions and we think the company has the capability to deliver positive surprises.

Rank by McDep Ratio: Market Cap and Debt to Present Value

	Symbol/ Rating		Price (\$/sh) 18-Mar 2005	Shares (mm)	Market Cap (\$mm)	Net Present Value (\$/sh)	Debt/ Present Value	McDep Ratio
Mega Cap								
	XOM	B	62.22	6,461	402,000	60.00	0.06	1.03
	BP	B	64.92	3,601	234,000	64.00	0.12	1.01
	TOT	B	120.98	1,218	147,000	120.00	0.17	1.01
	SC	B	55.94	1,587	89,000	55.90	0.16	1.00
	RD	B	62.03	2,016	125,000	66.00	0.16	0.95
	CVX	B	60.01	2,123	127,000	76.00	0.10	0.81
	<i>Total or Median</i>				1,124,000		0.14	1.00

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