Big Oil, small short

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As oil majors have successfully monetized Russia's invasion of Ukraine, their stock prices have been on a relentless rise. But even with efforts to channel idiosyncratic cashflows to shareholders, dividend yields have in many cases fallen dramatically, illustrated in Figure 1 for Exxon Mobil (XOM US). Simultaneously, short-end rates have gone up significantly and oil bond spreads have remained stable. This has resulted in dividend yields that are far inside short-dated corporate bond rate yields, see Figure 2. Framing such capital structure dislocations can be interesting from a climate impact exposure angle.[1] Consider the following illustration, where an equity short is "funded" by a partial long in the corporate bonds:

- Short (-100% risk) XOM US @119.17, **indicative dividend yield of 3.05%.**
- Long (+63%+discretionary excess X% risk) XOM 2.992% 03/25s @96.323, **yield of 4.856%**.
- Use X%-based excess carry from bond position to fund name-specific climate change mitigation engagement.

If we set X=0, then this combination would have net zero carry (expected dividend yield - bond yield) and a net short capital exposure to XOM: the net capital provided is (-100%)+63% =-37% of notional.[2] Setting X>0 generates positive carry that can be used for engagement efforts. Key financial risk in this set-up is a further appreciation of the stock price from current all time-highs.

Figure 1. Exxon equity returns (blue, LHS), and dividend yield (red, RHS). Source: Bloomberg.

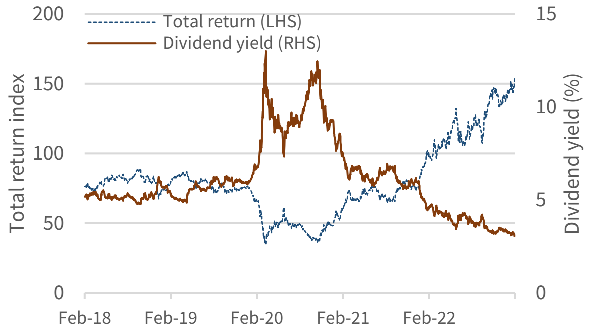
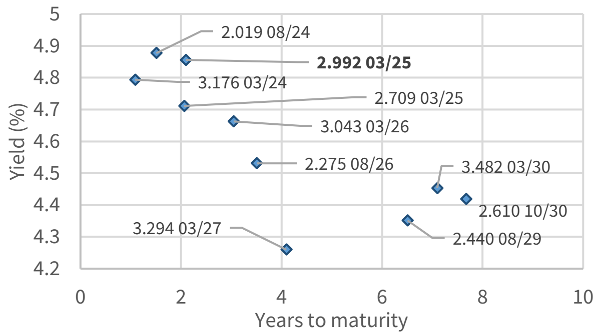


Figure 2. Exxon USD benchmark bonds, front-end. Note the inversion. Source: Bloomberg.



[1] AFII covered the reverse situation in "Exxon cap structure arbitrage/impact", AFII, 21 May 2021, suggesting a short debt, engage in equity approach at a 15 by 1 ratio (Short 1500% credit, long 100% equity, active engagement for increased debt to pay dividends and reduce capex). At the time, XOM US equity was marked at 58.84 and XOM 5y CDS at 38bps.

[2] In terms of ESG impact, this number likely underestimates the actual climate footprint, as a larger portion of the ESG footprint should be allocated to the equity/longer duration part of the capital structure. For a further discussion on accounting of short positions, refer to "Carbon negative leveraged investment strategies", AFII, 12 Aug 2021.For completeness sake, the concept of short positions having impact is controversial, also refer to "ESG Reporting in Long-Short Portfolios", MSCI, 19 Apr 2022; "Accounting for ESG factors, What to do with short positions?", AIMA, June 2022.

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