Sector Update

Oil and Gas

Oil and Gas sector outlook

UNDERWEIGHT▼

The race for storage

- **Oil market faces significant oil demand loss from measures to contain the Covid-19 pandemic. We view that no production cut is sufficient to balance the market in the near term.**
- **We lower our 2020 average Brent forecast to USD30/bbl (from USD65/bbl) in view of global recession compounded by higher supply amidst oil war.**
- **Within our coverage, potential key beneficiary from lower crude prices is Lotte Chemical Titan (BUY TP: RM2.00) while Hibiscus Petroleum would likely be affected the most as its revenue is highly correlated with oil.**

Unprecedented oil surplus environment

Oil market could be facing an unprecedented oil surplus in coming weeks with weakening demand due to Covid-19 pandemic. The oil demand is expected to decline as more countries announcing strict measures including travel restriction and lockdown to combat the contagious Covid-19 virus. At its peak, Vitol – an oil trading house – expects that oil demand could drop by c.20m bpd yoy, while IHS Markit sees 2Q20 oil demand to decline by 14m bpd yoy.

While oil demand is falling, the oil war causes another shock to the supply side. Russia's rejection to OPEC's proposal to make additional production cut of 1.5mbpd has led to the end of OPEC production curb agreement. It is now expected that there will be an additional oil supply of c.3-4m bpd swamping the market in April 2020, contributed by higher production from Saudi, UAE and Russia.

We expect geopolitical tension to continue dictating the market direction in future. We think Russia – who aims to gain market share from US shale – will never turn to Saudi again considering massive capex cut announced by US shale in the past few weeks. The US Texas Oil authority will meet OPEC next June to cooperate on production cut but we think that it still not sufficient to balance the market as the expected decline in oil demand has far surpassed what everyone could possibly cut.

Our view of Brent for 2020

As oil price is currently hovering below USD30/bbl, we think there is further downside risk to Brent crude oil price in view of looming global recession in coming quarters, compounded by increasing supply. In totality, we expect c.15m bpd of oil surplus in 2Q20 which translates into approx. 1.3bn barrels of oil surplus, which may fill up nearly all available onshore oil storage estimated at c.1.5-2bn barrels globally.

Overall, we lower our 2020 average Brent forecast to USD30/bbl (from USD65, YTD: USD51/bbl). We think the global recovery from Covid-19 pandemic will be the key factor for oil price to recover.

Potential winners and losers of low crude oil

With crude oil entering a bear market, we note only one potential beneficiary within our coverage; Lotte Chemical Titan (BUY TP: RM2.00) which benefits from cheaper feedstock cost. On the flipside, we think Hibiscus (TP and recommendation under review) is at risk of having negative cash flows in coming quarters as its cash cost is c.USD30/bbl. Our top pick remains Yinson (BUY, TP RM7.70) owing to its long term earnings visibility. The impact of low crude oil to the stocks under our coverage is summarised in Table 1 as below.

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Table 1: Summary of winners and losers of low crude oil

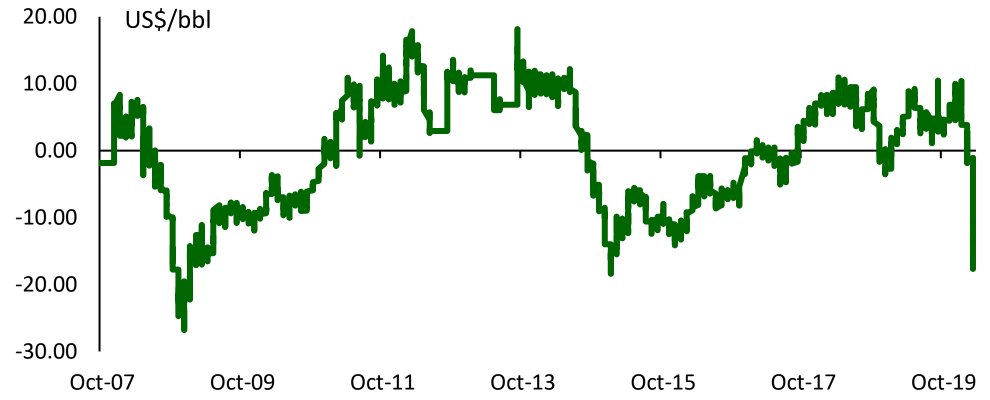
Company	Impact	Comment/Views
Lotte Chemicals Titan	Positive	• LCT is the key winner of low crude oil price as it consumes naphtha (produced mainly from crude oil) as its main feedstock for its production. • Naphtha accounts for 50-70% of its total operating costs. • Naphtha price is now at c.USD200/mt, more than 60% lower than 4Q19 average price of USD535/mt. Usually there is lag impact of 6 months for low naphtha prices to be reflected in its income statement. • Assuming ASP and naphtha prices correlates at +0.8 (ie. ASP drops by USD8/mt for every USD10/mt decline in naphtha price), we estimate LCT could gain 1.5% in gross profits or c.RM20m for every USD10/mt drop in naphtha prices.
Yinson	Neutral	• Yinson is least affected as it is an upstream services company with exposure to the development and production segment. Its FPSO assets, a substitute to fixed offshore platform, are on long-term lease and rates are fixed. Thus, the exposure to oil price volatility is limited to future development projects only. • Yinson's future projects will revolve mainly in Brazil after it secured its maiden job from Petrobras for the FPSO Marlim 2. We expect Petrobras will continue with its future development projects given its low cash lifting cost of below USD10/bbl. • For existing projects, we believe Yinson is fairly protected against early termination due to robust contract terms and further supported by strong credit rating clients.
MMHE	Slight negative	• MMHE is more vulnerable to oil price volatility as compared to Yinson with exposure to the development segment only. Sharp decline in oil price will likely see IOCs cutting capex to preserve cash. • We see no immediate impact to its earnings as Petronas is likely to proceed with sanctioned projects, however there could be fewer projects for 2021 onwards. • MMHE has secured orderbook worth RM2.7bn including Kasawari CPP development projects which could maintain its revenue visibility until FY23-24F. • We think its sizable orderbook and net cash position amounted to RM493m or RM0.31/share could provide stability while awaiting market recovery.
Velesto Energy	Slight negative	• Velesto is more vulnerable to oil price volatility as compared to Yinson given its exposure to the exploration and development segment and the generic nature of jack-up rigs. • We see no immediate impact to its earnings as Petronas is likely to proceed with sanctioned projects, however there is risk of lower utilisation and charter rate for 2021 onwards
Petronas Chemicals	Slight negative	• PCG would be impacted as most of its products are positively correlated with crude oil prices; margins are likely to be under pressure. We note that price correlation of commoditised chemicals (such as ethylene, propylene, benzene, toluene, styrene, methanol, butadiene) with crude oil is at +0.945 over 1993-2017 period. • Despite a challenging near term outlook, it has a huge net cash position of RM10.7bn or RM1.37/share to pursue inorganic growth in specialty chemicals.
Petronas Dagangan	Negative	• PDB will likely face inventory losses in 1H20 as inventory is marked-to-market. Sales volume may also decline due to lower jet fuel and gasoline demand due to restricted travel and lockdown imposed by the government. • Nonetheless, we think it can withstand current market turmoil with its strong balance sheet and net cash position amounted to RM3bn or RM3.10/share.
Hibiscus Petroleum	Negative	• We are of the view that Hibiscus is the biggest loser as it does not hedge its crude oil production. Its cash production cost is c.USD30/bbl which risks negative cash flows in coming quarters.

Source: BIMB Securities

Potential downside risk to oil price

We believe there is further downside risk to crude oil price from current level. During previous global recession in 2008, we observed that the futures curve structure shifted to deep contango *(*near month futures contract is cheaper than far month*)* where 2-year calendar spread fell to as low as USD25/bbl vis-à-vis current spread of c.USD17/bbl (Chart 1). We believe the unprecedented surplus in oil inventory will be the main driver for oil to be heading lower in coming weeks/months.

Chart 1: Historical Brent 2-year calendar spread



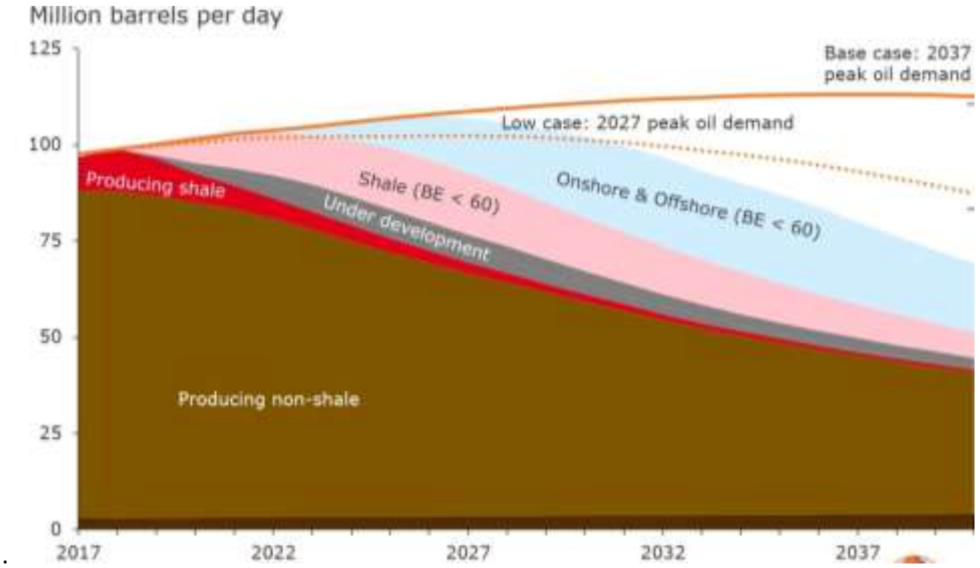
Source: BIMB Securities, Bloomberg

Long term view on oil price

We view that most oil producers are likely to proceed with projects when oil price sustains above USD40/bbl. At current level, we saw many independent oil companies (IOCs) announced capex cut to preserve cash. Only projects with low cash lifting costs and short payback period are likely to proceed.

We do believe that oil price of below USD40/bbl is not sustainable over the long-term. Assuming the world will recover from Covid-19 pandemic by the end of 2020 and oil demand returns, we expect these project delays and cancellations will take its toll on the industry's ability to meet future demand growth. According to Rystad Energy, while it projects that oil demand will continue to grow and peak somewhere in late 2020s, the industry needs all projects with break-even below USD60/bbl to be sanctioned to meet all future demand (Chart 2).

Chart 2: Peak oil demand scenario



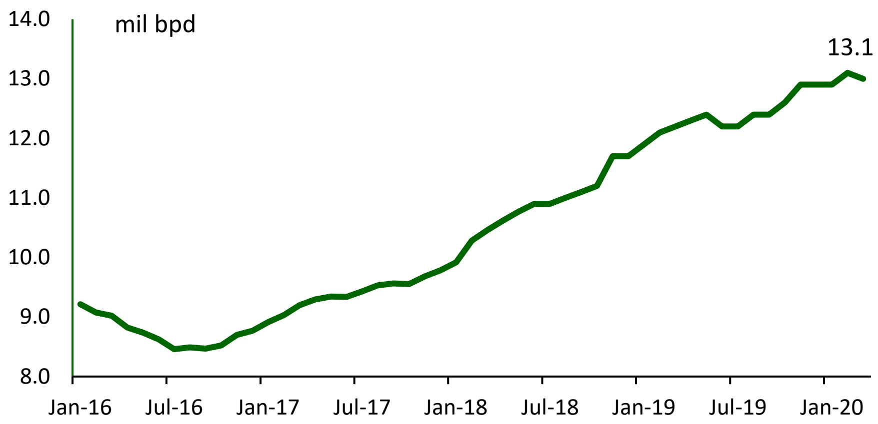
Source: BIMB Securities, Rystad Energy

Peak US shale is the turning point

The growth in US shale production in recent years has helped to meet global oil demand growth. The US remains the world's largest oil producer with record high oil production rate of 13.1m bpd in Feb 2020 (Chart 3). This is aided by oil price stability due to concerted effort by OPEC+. However, aggressive capex cut announced by US shale producers in past few weeks could lead to lower oil production in coming months.

According to EIA's Short Term Energy Outlook published on 10th Mar 2020, US Oil production should peak at 13.2m bpd in April before it begins to decline and falling to 12.6m in 2021.

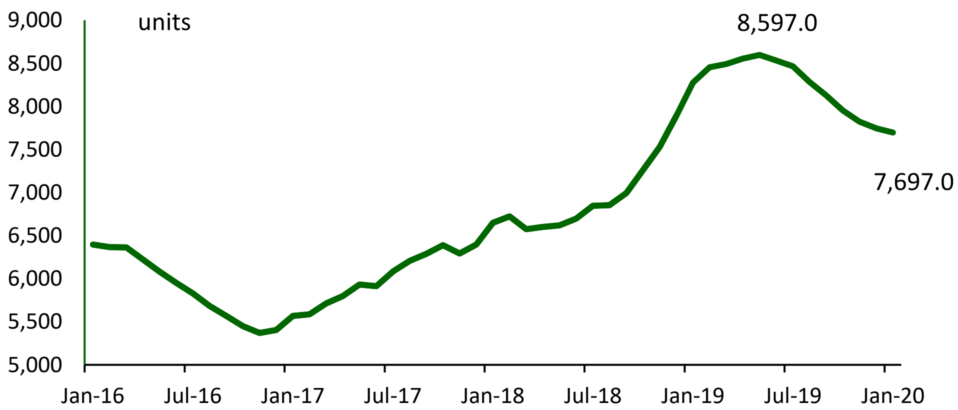
Chart 3: US crude oil production



Source: BIMB Securities, Bloomberg

It is the consensus view that the peak in US shale production – where it no more can play the role as swing producer to meet higher global demand – will be a major turning point for oil price to boom in the next upcycle, assuming the world will recover from Covid-19 pandemic and oil demand returns. Subsequently, the world will then shift towards conventional oil for new supply to meet higher global demand.

Chart 4: US drilled but uncompleted wells



Source: BIMB Securities, Bloomberg

The decline in drilled but uncompleted wells (DUCs) is the precursor of the peak of US oil production. The DUC reached its peak at 8,597 wells in May 2019 (Chart 4) before gradually declining due to the combination of (i) lesser new wells were drilled as remaining areas are relatively more expensive to be drilled; and (ii) more DUC wells were completed and brought online. In Mar 2020, there are 7,697 DUC wells outstanding.

Downgrade Oil and gas to UNDERWEIGHT

We downgrade our recommendation on Oil and Gas sector to UNDERWEIGHT (from OVERWEIGHT) due to unattractive outlook in near term. As the market faces double shocks – both supply and demand at the same time – it appears both upstream and downstream segments will be affected.

We think the main beneficiary of this market condition is midstream segment. We think companies such as Dialog is well-positioned to benefit from rising demand for its storage tanks amidst supply glut while MISC, to a certain extent, could also benefit from higher charter rate for its petroleum tankers as these tankers are likely in high demand as an alternative for offshore oil storage.

For companies under our coverage, our top pick is Yinson (BUY, TP RM7.70). We think it is least affected from current market turmoil as its FPSOs are leased on long term charter at fixed rates, which provides long term earnings visibility. It is also protected against early contract termination due to robust contract terms supported by strong credit rating clients. We remain optimistic with its growth potential coming from future FPSO projects in Brazil where Petrobras is likely to continue with new development projects due to low cash lifting costs of below USD10/bbl.

We wish to highlight that 5 out of 7 companies under our coverage – Petronas Chemicals, Petronas Dagangan, LC Titan, MMHE and Hibiscus – possess strong balance sheet with net cash positions. Save for Hibiscus who is at risk of having negative cash flows in coming quarters, we believe these companies will be able to withstand this market rout. As such, it may be appropriate to buy these stocks for medium-to-long term investment.

DEFINITION OF RATINGS

BIMB Securities uses the following rating system:

STOCK RECOMMENDATION

BUY	Total return (price appreciation plus dividend yield) is expected to exceed 10% in the next 12 months.
TRADING BUY	Share price may exceed 15% over the next 3 months, however longer-term outlook remains uncertain.
HOLD	Share price may fall within the range of +/- 10% over the next 12 months
TAKE PROFIT	Target price has been attained. Fundamentals remain intact. Look to accumulate at lower levels.
TRADING SELL	Share price may fall by more than 15% in the next 3 months.
SELL	Share price may fall by more than 10% over the next 12 months.
NOT RATED	Stock is not within regular research coverage.

SECTOR RECOMMENDATION

OVERWEIGHT	The Industry as defined by the analyst's coverage universe, is expected to outperform the relevant primary market index over the next 12 months
NEUTRAL	The Industry as defined by the analyst's coverage universe, is expected to perform in line with the relevant primary market index over the next 12 months
UNDERWEIGHT	The Industry as defined by the analyst's coverage universe, is expected to underperform the relevant primary market index over the next 12 months

Applicability of ratings

The respective analyst maintains a coverage universe of stocks, the list of which may be adjusted according to needs. Investment ratings are only applicable to the stocks which form part of the coverage universe. Reports on companies which are not part of the coverage do not carry investment ratings as we do not actively follow developments in these companies.

Printed and published by

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