

25 July 2017 | Sector Update

Oil and Gas Sector

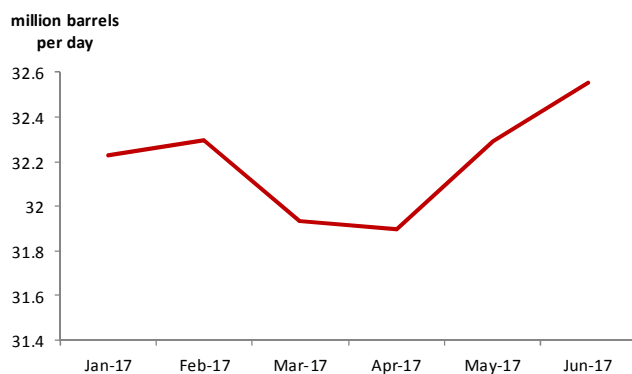
Negative (for upstream)
Positive (for downstream)

Heavy offshore asset owners; Sink or swim?

- Global crude oil prices expected to hover at around USD50pb for foreseeable term
- OPEC increasing crude oil production whereas Malaysia decreasing crude oil production rates
- Bursa-listed heavy offshore asset owners trading below book value as opposed to downstream counterparts which are all trading at multiple times its book value
- Offshore vessels and rigs charter rates remain depressed; meaningful recovery not yet seen
- Rock bottom valuation for offshore service providers could prolong
- Recommend exposure into oil and gas downstream and utilities related companies

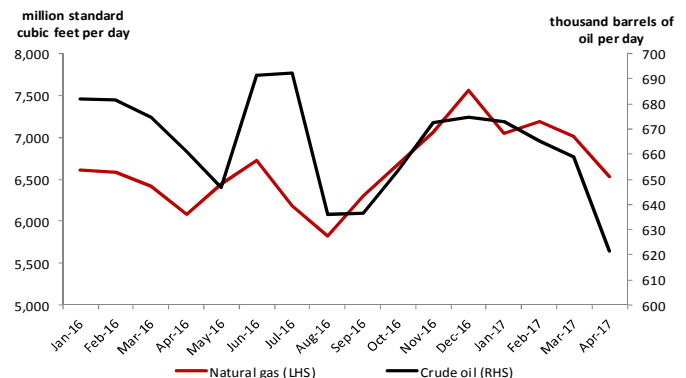
Oil price movements. Since the start of 2017, global Brent crude oil prices have retreated by -15.6%ytd to USD47pb, reaching a year high of USD57pb to a year low of USD44pb. The current year-to-date average is approximately USD52pb. Crude oil prices have been hovering below the USD50pb level for nearly three months due to increased production levels from OPEC countries (refer to Chart 1), volatile U.S. inventory movements and the continuous supply threat from continental U.S. shale oil producers. Locally, offshore activity levels have been less-than-exciting as production sharing partners are still on a continuous effort to drive costs down due to depressed global crude oil prices. In addition, Malaysia's crude oil and natural gas production are on a decline (refer Chart 2) as Malaysia has pledged to reduce crude oil production by 20,000 barrels a day in-line with OPEC's decision to reduce production until 1QFY18.

Chart 1: OPEC monthly production level for 2017



Source: Bloomberg, MIDFR

Chart 2: Malaysia crude oil and natural gas production

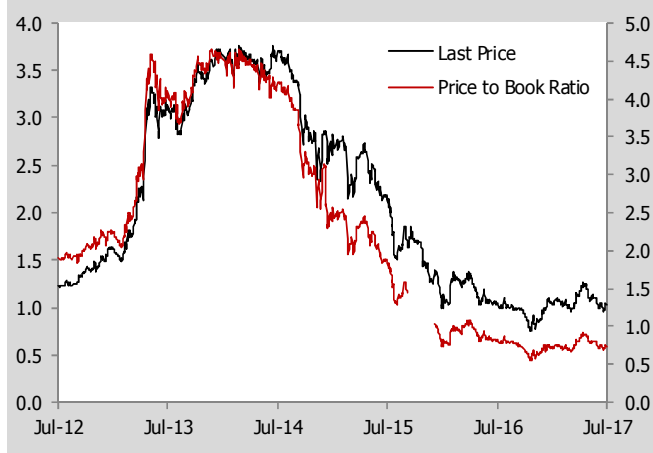


Source: Bloomberg, MIDFR

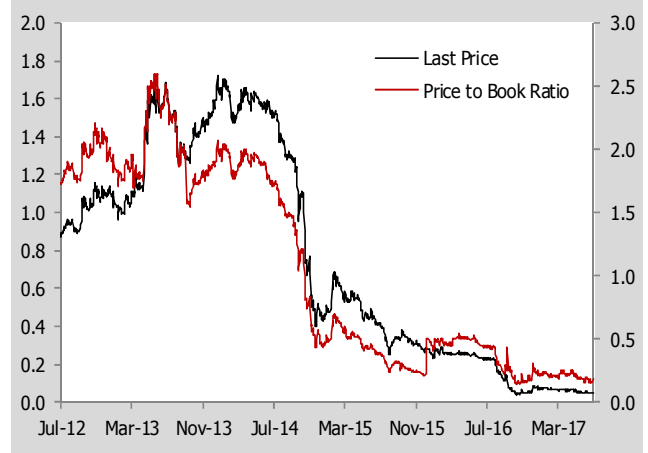
Bursa listed heavy offshore asset owners. Almost the entire Bursa-listed heavy offshore asset owners are currently trading at a discount below its book value (below 1x price-to-book multiple) compared to a premium before the crude oil price slump mid-2014. This is largely due to receding profit margins, declining profitability, low offshore activity levels, low charter rates and overall slump in exploration and production activities. Unlike its downstream counterparts however, downstream and utilities related oil and gas stocks have been trading at multiple times its book value, further supported by its stable and robust earnings base.

Charts 3: Price-to-book multiples for heavy offshore asset owners and service providers

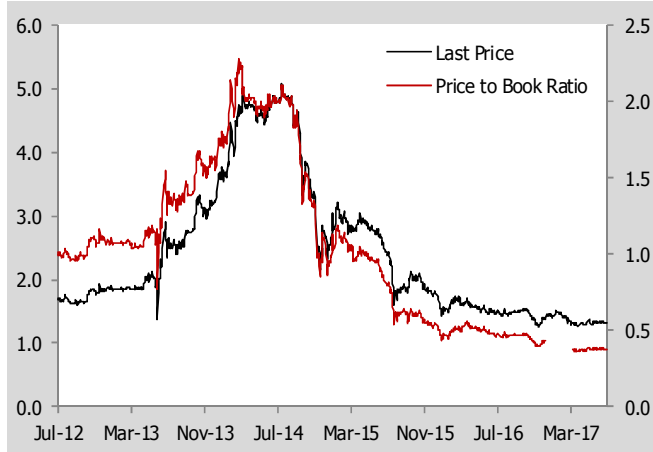
Dayang Enterprise Holdings Berhad



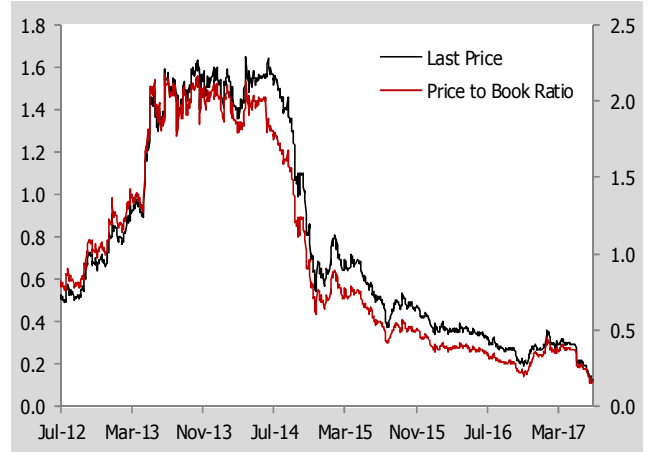
Perisai Petroleum Teknologi Berhad



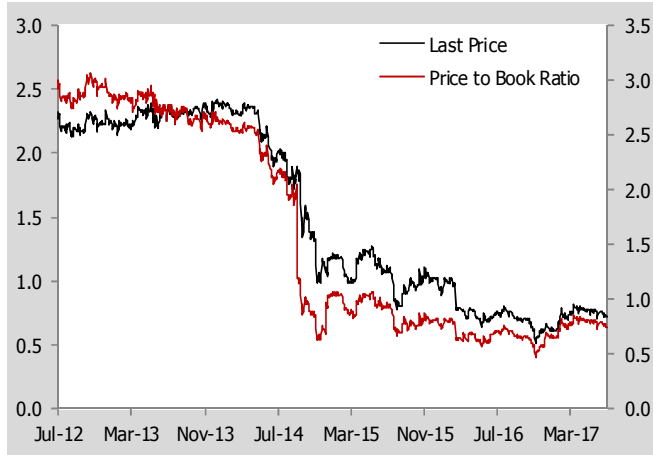
Coastal Contracts Berhad



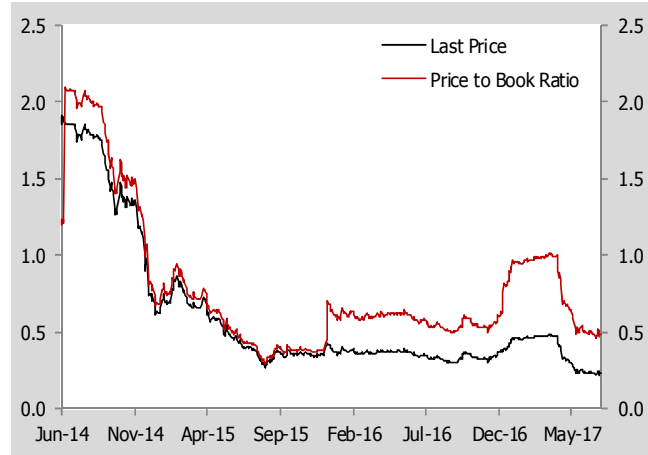
Alam Maritim Berhad



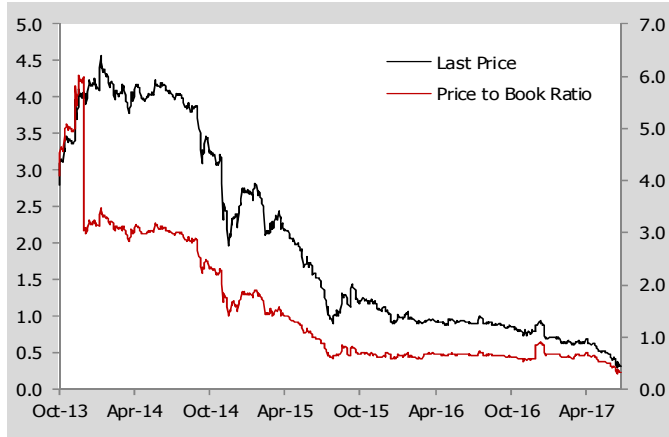
Bumi Armada Berhad



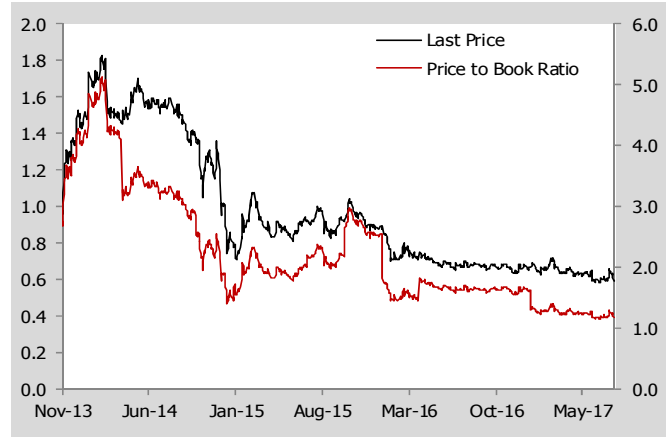
Icon Offshore Berhad



UMW Oil and Gas Berhad



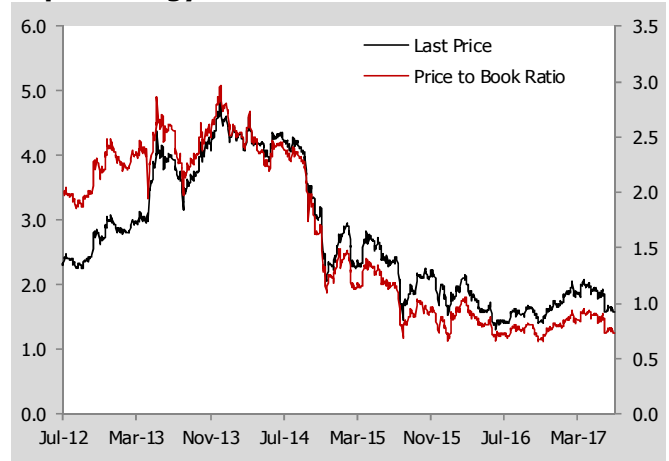
Barakah Offshore Berhad



Petra Energy Berhad

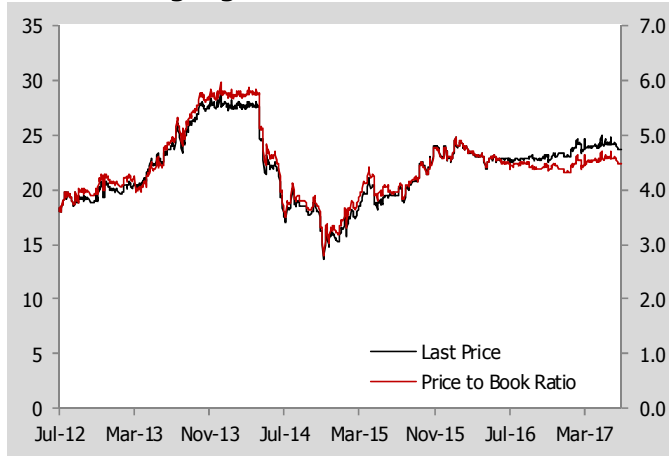


SapuraEnergy Berhad

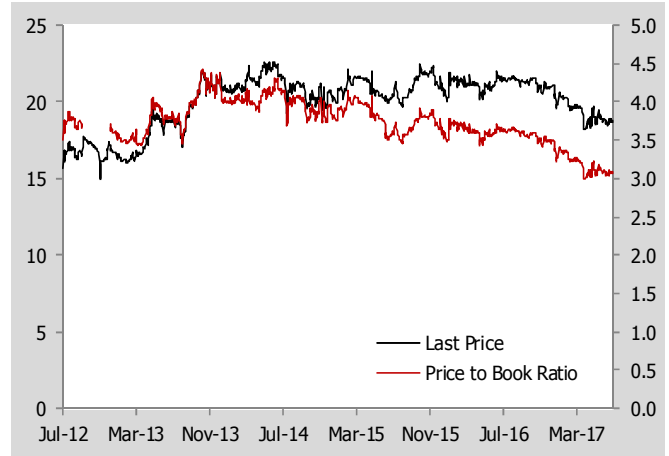


Charts 4: Price-to-book multiple for oil and gas downstream and utilities stocks

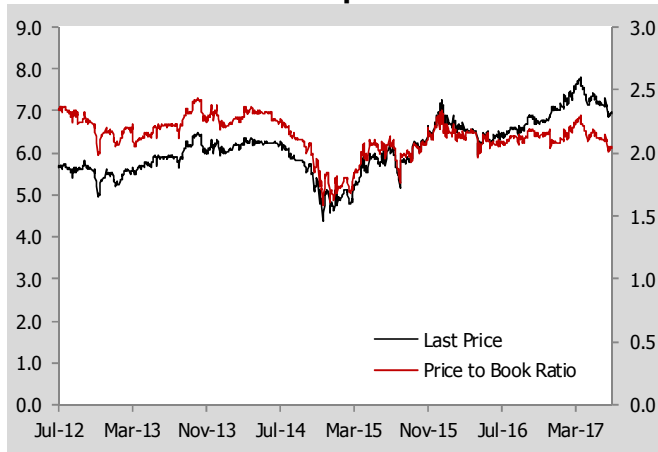
Petronas Dagangan Berhad



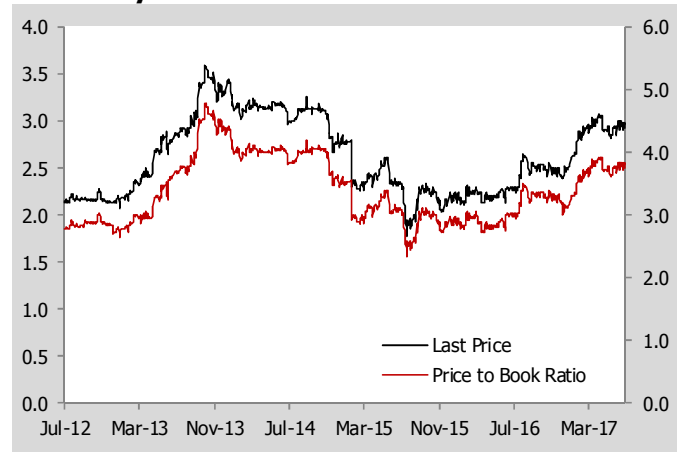
Petronas Gas Berhad



Petronas Chemicals Group Berhad

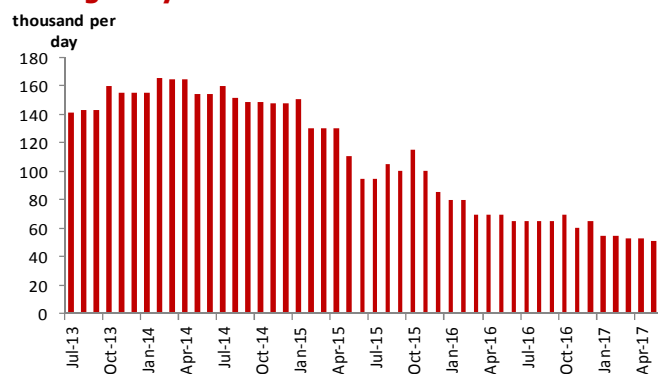


Gas Malaysia Berhad



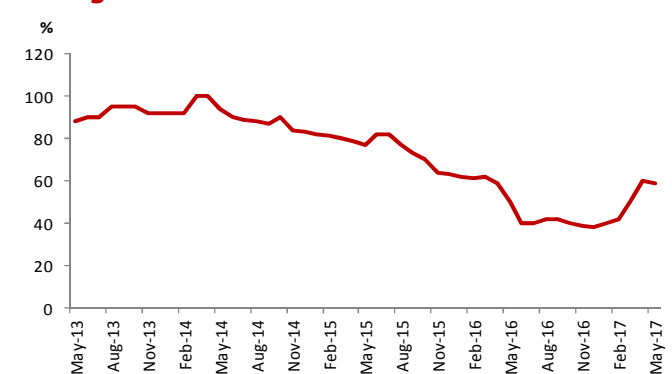
Rates unlikely to post meaningful recovery and demand for offshore assets to remain depressed. Large offshore asset utilisation rates and charter rates are still expected to remain depressed throughout 2017, if not lower. Currently, as of 4MFY17, the global utilisation rate (UR) for global rigs is at 68% compared with 73% a year earlier. The situation is slightly bleaker in South East Asia where the average UR for large offshore assets including jackups, drillships, semisubs and tenders is at only 65.7%. Charter rates for jackups in SEA remains depressed at approximately USD50-60k per day. Current charter rates for offshore support vessels (OSV) in SEA are depressing even further to a current low of USD0.70 per brake horsepower per day (for the common 5,000bhp anchor handling tug and supply). We reiterate our view that UR and charters rates will not be staging meaningful improvements throughout 2017.

Chart 5: Southeast Asia Jackup 361-400IC Average Day Rates



Source: Bloomberg, MIDFR

Chart 6: Southeast Asia Jackup 361-400IC Average Utilisation Rates

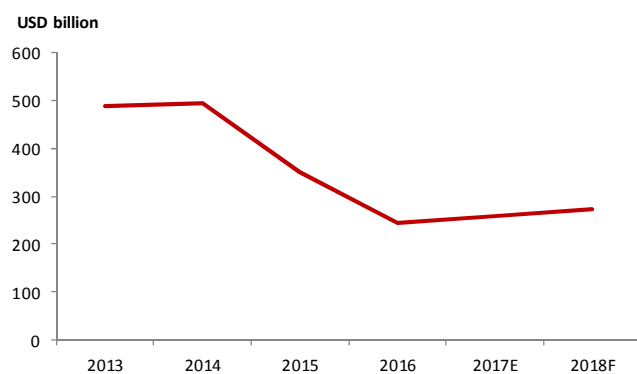


Source: Bloomberg, MIDFR

Rock bottom valuation for offshore service providers could prolong. Due to the limited upside potential of global crude oil prices, relatively low expected capex from oil majors for 2017 and 2018 and also PETRONAS' downstream focus for capex allocation, we are of the opinion that the rock bottom valuation for offshore service providers could prolong and that these offshore service providers could continue to trade at a steep discount compared with its downstream counterparts.

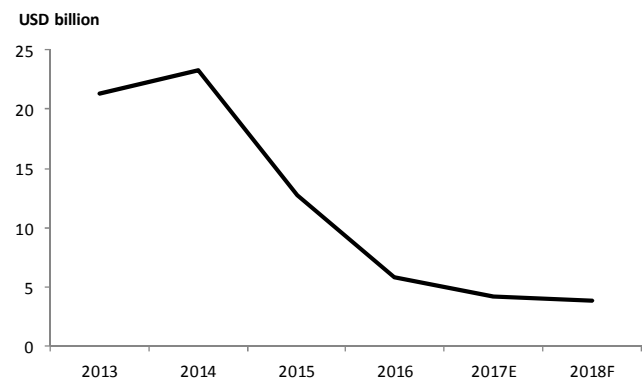
Charts 7 and 8 below show that the expected capital expenditure allocations for offshore activities are unlikely to make any meaningful recovery in 2017 and in 2018. Moreover, consensus is expecting capex for drilling and offshore support to further decline in 2018 compared with 2017.

Chart 7: Capital expenditure by integrated and independent exploration and production companies, drilling companies and oilfield service providers



Source: Bloomberg

Chart 8: Capital expenditure by drilling and support companies including offshore, land and drilling support



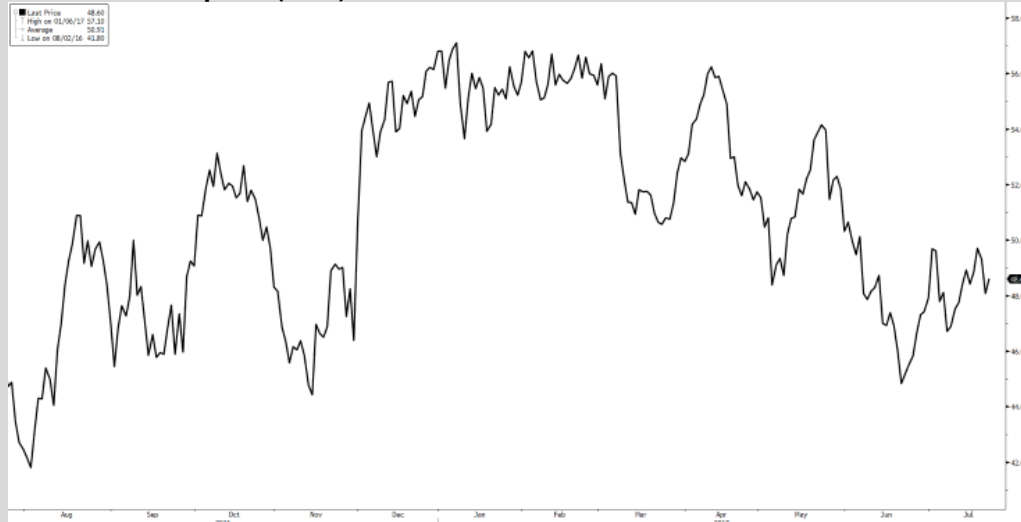
Source: Bloomberg

Recommend exposure into downstream oil and gas companies. Due to the persistent struggle in global crude oil prices to make meaningful upside recovery, relatively low upstream activities and charter rates stress on offshore heavy assets, we are maintaining our **Negative** stance on the upstream oil and gas sub-segment. We are however reiterating our **Positive** stance on the downstream sub-segment as we see continuous growth in this sub-segment from Petronas' committed capital expenditure plan focusing on downstream oil and gas segment. We are recommending safe exposures into **Gas Malaysia Berhad (BUY; TP: RM3.50)** and **Petronas Dagangan Berhad (BUY; TP: RM28.00)**. We opine that the downstream utility and retail fuel segment will continue to register commendable year-over-year earnings growth, offer above risk-free rate dividend yields and acceptable capital upside.



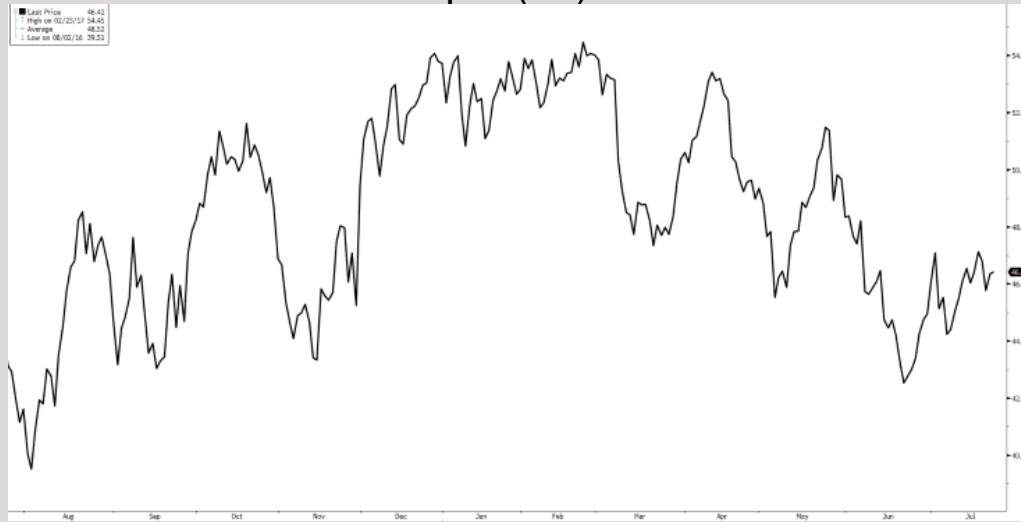
DAILY PRICE CHART

Brent crude oil price (CO1)



Source: Bloomberg, MIDFR

West Texas Intermediate crude oil price (CL1)



Source: Bloomberg, MIDFR

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STOCK RECOMMENDATIONS

BUY	Total return is expected to be >15% over the next 12 months.
TRADING BUY	Stock price is expected to <i>rise</i> by >15% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -15% and +15% over the next 12 months.
SELL	Total return is expected to be <-15% over the next 12 months.
TRADING SELL	Stock price is expected to <i>fall</i> by >15% within 3-months after a Trading Sell rating has been assigned due to negative newsflow.

SECTOR RECOMMENDATIONS

POSITIVE	The sector is expected to outperform the overall market over the next 12 months.
NEUTRAL	The sector is to perform in line with the overall market over the next 12 months.
NEGATIVE	The sector is expected to underperform the overall market over the next 12 months.