

08 June 2016 | Sector Update

Oil and Gas sector

The quest to reduce operating costs

Negative (*for upstream*)

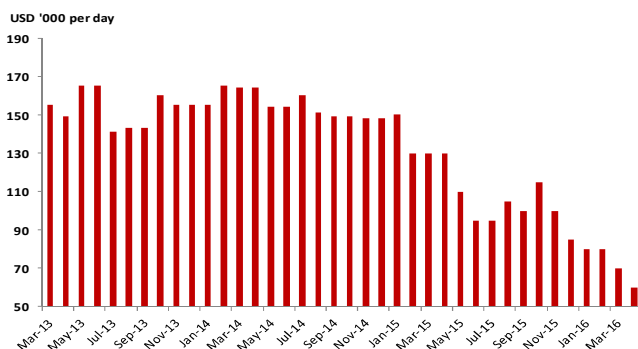
Positive (*for downstream*)

- The quest to reduce operating cost and increasing operating efficiency is an ongoing initiative by local oil and gas service providers
- However, not all companies are able to meaningfully reduce operating costs in light of declining revenue
- Companies which show improvement in managing operating costs in the midst of declining revenue are SapuraKencana Petroleum, Gas Malaysia, Petronas Gas, Deleum and KNM Group
- Maintain **POSITIVE** on downstream and **NEGATIVE** on upstream with revised 2016 average Brent crude oil price assumption of USD45pb (*previously USD40pb*)

Crude oil price review. Brent crude oil price has staged a significant rebound of approximately >+41%ytd to reach a 2016 high of USD51.44pb. The average Brent price year-to-date currently stands at USD39pb. In view of the steeper than expected rise in Brent crude price, we are revising our 2016 average Brent price forecast upwards to USD45pb from USD40pb previously.

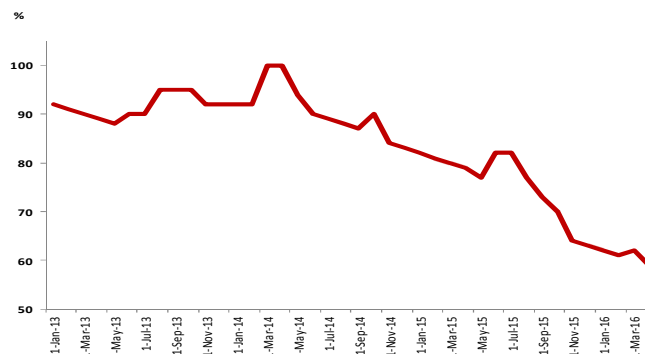
New norm in contract values. Despite the steep increase in crude oil price, we do not believe that offshore activity contract values, charter rates or fabrication rates will reach that of 2011-2014 levels when crude oil prices were hovering above USD100pb. Even if oil prices were to sustain at current levels and possibly trade beyond USD50pb for a prolonged period, it is likely that the value of new projects, contracts and charter rates would see a significant decline in terms of value compared with the glory days of 100-dollar oil. As such, oil and gas service providers would need to adjust their respective cost structures to be in-line with the new norm in revenue in order to preserve profit margins and remain profitable.

Chart 1: Average Southeast Asia Jackup 361-400 IC Day Rates



Source: MIDFR, IHS

Chart 2: Average Southeast Asia Jackup 361-400 IC Utilisation rates




Source: MIDFR, IHS

Major oil major on mission to reduce costs. In a bid to reduce overall operating costs, oil majors such as Petroliam Nasional Berhad (Petronas) has been aggressively reducing operating costs both internally and externally via its vendors. Dubbed Coral 2.0, Petronas is focused on reducing cost via three value levers namely (i) Proactive Demand Management; (ii) Spend Consolidation; and (iii) Driving Innovation. Petronas targets to achieve an annual cost savings of between RM4.0-7.5b to be achieved before or by the end of the next five years. The effects from this cost savings campaign have been felt across the local oil and gas service providers. This is evident from reducing revenue for most offshore service providers for the past many quarters.

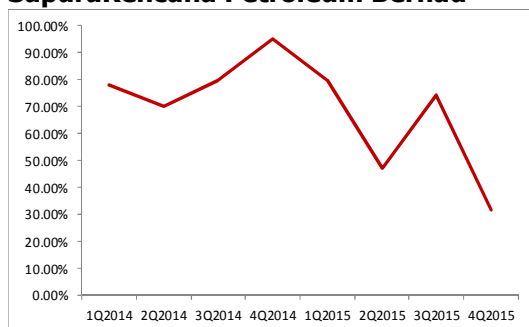
Efficiency ratio as a measure of operating effectiveness. In tandem with the decline in revenue, oil and gas service providers would need to reduce its operating cost to maximise the overall efficiency in maintaining its profit margin and sustaining profitability. The efficiency ratio or operating cost-to-revenue ratio measures how much was spent to earn a Ringgit. Hence, the lower the ratio the better – or the more stable the ratio in relation with declining revenue the better. Should oil prices be able to breach higher sustainable levels in the future, we opine that companies which were able to efficiently manage cost in a low oil price environment could benefit the most.

Increasing operating efficiency. Referring to the charts below, we measured the operating efficiency of a selected number of oil and gas service providers listed on Bursa. In times of declining revenue, companies such as SapuraKencana Petroleum, Gas Malaysia, Petronas Chemicals, Petronas Gas, Destini, Deleum and KNM Group have displayed the ability to maintain or decrease its operating cost in relations with declining revenue. Incidentally, SapuraKencana, Gas Malaysia and KNM Group remain as our top **Buy**s for the sector. These companies have displayed competent managerial skills in reducing overhead costs, reducing redundancies (both personnel as well as operations), reducing wastages and have displayed efficient capital and working asset management.

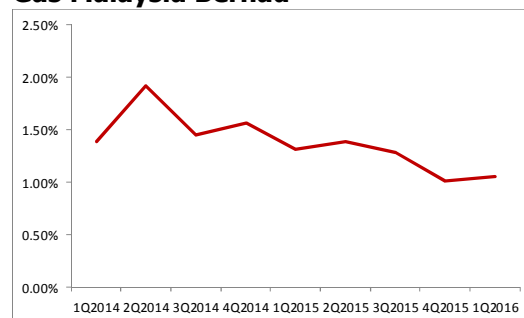
Recommendation. Based on the effectiveness of company management to synchronise and rationalise operating cost in tandem with revenue, we maintain our **BUY** recommendations on *SapuraKencana Petroleum (BUY; RM2.72)*, *Gas Malaysia Berhad (BUY; TP: RM2.92)* and *KNM Group Berhad (BUY; TP: RM0.59)*. As we are positive on **Downstream** segment of the oil and gas value chain, we prefer stocks with Petronas refinery and petrochemical integrated development project (RAPID) exposure. We are recommending downstream specialty companies such as **KNM Group Berhad** and **Muhibbah Engineering Berhad (BUY; TP: RM3.05)**. In addition, our **Buy** recommendation on **Gas Malaysia Berhad** is premised on our positive view that the adoption of the Incentive-Based Regulation (IBR) regime will provide better earnings visibility and predictability. 

Operating Cost-to-revenue (efficiency ratio) of various Bursa-listed oil and gas service providers

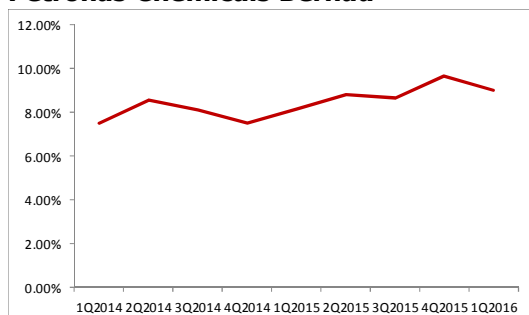
SapuraKencana Petroleum Berhad*



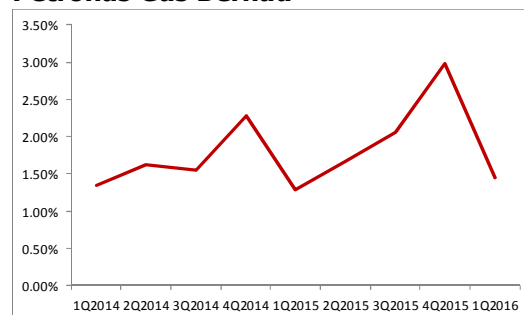
Gas Malaysia Berhad*



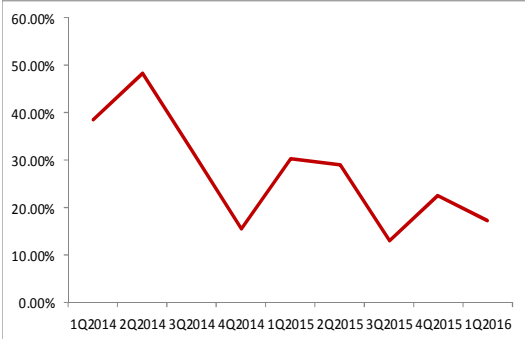
Petronas Chemicals Berhad



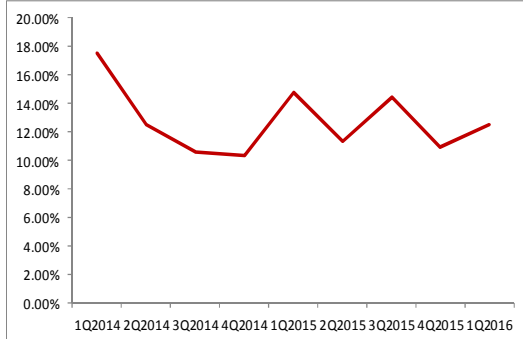
Petronas Gas Berhad



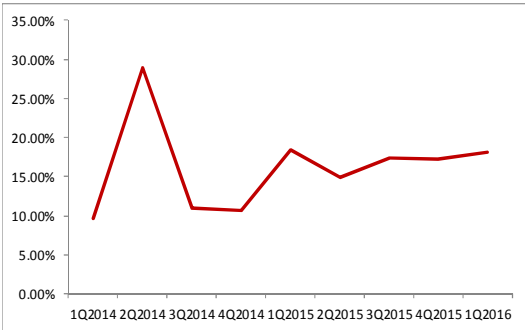
Destini Berhad



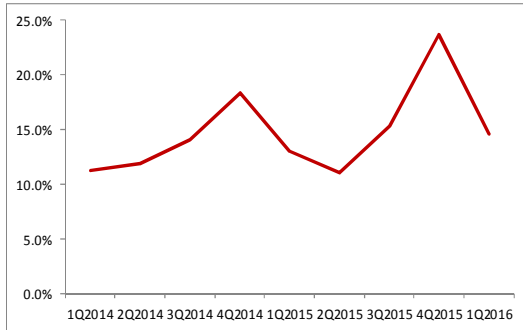
Deleum Berhad



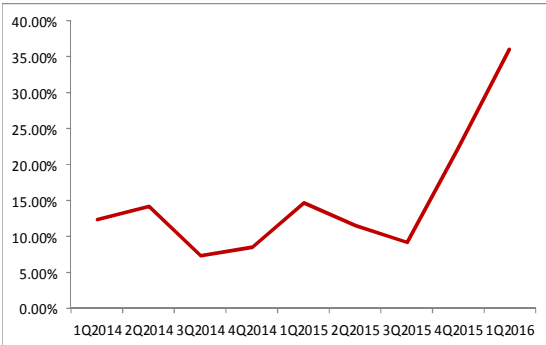
Icon Offshore Berhad



Uzma Berhad



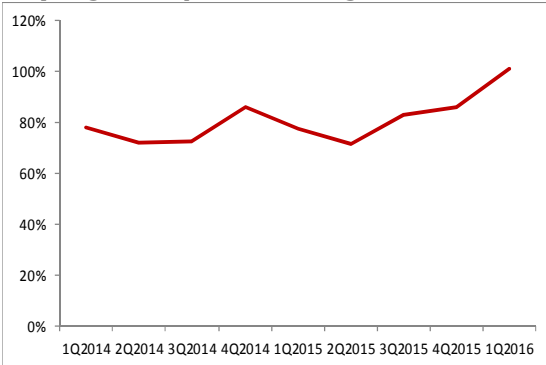
Alam Maritim Resources Berhad*



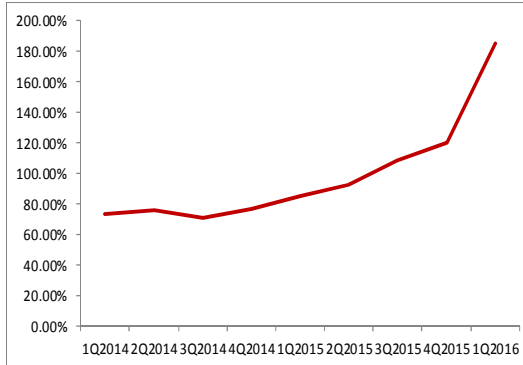
Dialog Group Berhad



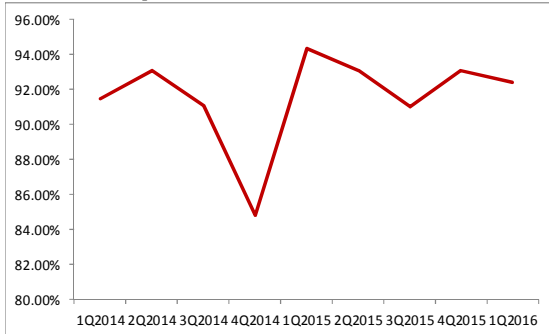
Dayang Enterprise Holdings Berhad*



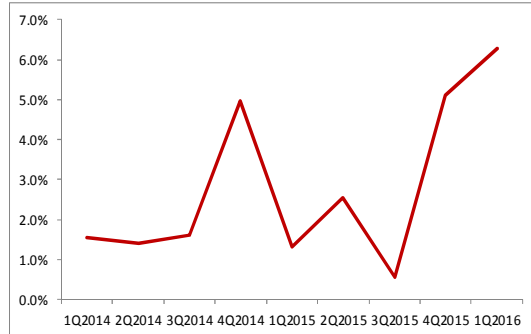
UMW Oil and Gas Berhad*



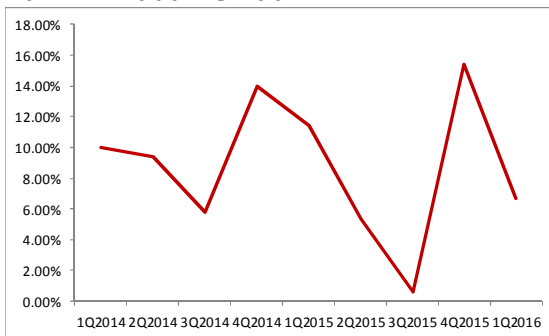
KNM Group Berhad



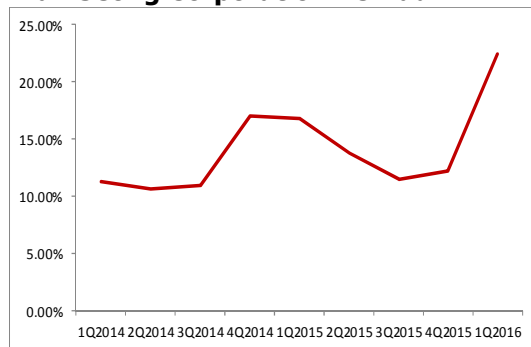
Coastal Contracts Berhad



Bumi Armada Berhad



Wah Seong Corporation Berhad*



Source: MIDFR, Company financials

* Administrative and Operating expenses net of one-off/exceptional cost ie. impairments, out-of-the-ordinary forex charges

DAILY PRICE CHART

Brent crude oil price (CO1)



Source: Bloomberg, MIDFR

West Texas Intermediate crude oil price (CL1)



Source: Bloomberg, MIDFR

Aaron Tan Wei Min
aaron.tan@midf.com.my
03-2772 1650

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MIDF AMANAH INVESTMENT BANK : GUIDE TO RECOMMENDATIONS

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.