21 December 2015 | Sector Update

Oil and Gas sector

Looking towards the downstream segment

***Maintain* POSITIVE**

- **Moving into 2016, we are anticipating continued headwinds for the upstream oil and gas segment based on both relatively low crude oil prices and generally negative investor sentiment shrouding the broader industry**
- **However, we remain POSITIVE on the sector based on our house anticipation of (i) bottoming crude oil price in 2016 around an average of USD50pb, and (ii) further action in the downstream RAPID project**
- **We remain sanguine on companies involved in the oil and gas downstream value chain**
- **Our average 2016 Brent crude oil price forecast remains at USD50pb**

Wrap-up of 2015. The year 2015 has indeed been marred with negativity surrounding the oil and gas sector. Both the WTI and Brent crude oil prices have slumped by -33.8% and -34.9% respectively since the start of the year. Apart from crude oil prices, our local oil and gas scene has also experience a shortfall in contracts awarded. Back in 2013, approximately RM40.4b worth of contracts were awarded to local service providers. However, in 2014, which saw oil prices slumped towards the second half, total contracts awarded for the year declined in tandem to only approximately RM24.7b. In 2015, the total contracts awarded still managed to achieve a commendable figure of approximately RM10-12b, taking into consideration massive cutbacks in spending and capital expenditure.

Corporate earnings in 2015. Apart from the lacklustre key industry indicators, the corporate earnings under our oil and gas universe of coverage have also suffered from strings of asset impairments and lack in offshore activities. 1Q15 cumulative results fell by an average of -11.9%yoy while 2Q15 and 3Q15 results slumped by -13.7%yoy and -14.0%yoy respectively. However, drilling deeper into the individual stocks within our universe of coverage, we realise that the bulk of the decline stemmed from the upstream service providers. Earnings for the downstream companies such as Petronas Dagangan, Petronas Chemicals, Petronas Gas, Gas Malaysia and KNM Group have fared relatively well - albeit admittedly, the fundamental valuations for the larger capitalisation stocks have remained lofty.

Oil price outlook. Global crude oil prices have remained relatively weak throughout 2015. The average Brent Crude and WTI Crude oil prices for 2015 are down by -25.4%yoy and -28.1%yoy respectively. Moving into 2016, we are expecting Brent crude oil price to possibly trade within an average of USD50pb – our view largely rest on a better second half of the year. Our assumption is based on the global asset breakeven prices and average fiscal breakeven prices for global oil producing countries. Despite contradicting views in the media from various OPEC members regarding oil price expectations and also production levels, we are of the opinion that the low oil price climate will negatively affect all of the OPEC members which could cause the cartel to eventually scale-down on production. In addition, the low oil price climate is not conducive for exploration ventures and production enhancement projects. Without these projects, future production faces the risks of a decline which will affect output in the future. The key risk to our view is a longer-than-projected ability to withstand the low oil price climate.

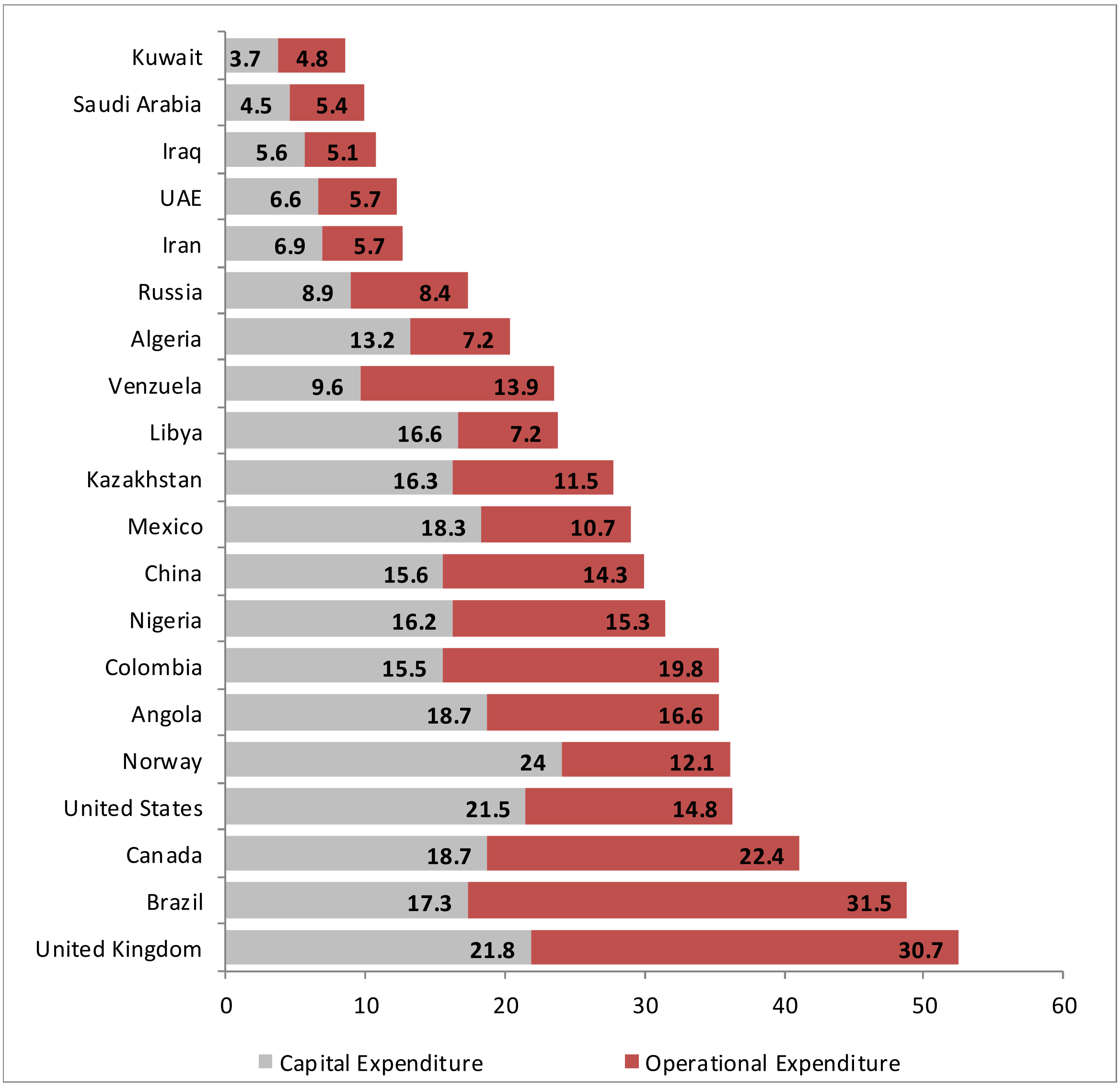
U.S. bans 40-year export ban on crude oil. Last Friday, the U.S. Congress has voted to repeal the ban on U.S. crude oil exports. Along with the vote to lift the ban was an additional five-year extension of tax breaks to boost renewable energy. This historic decision to lift the ban will send mixed signals to the oil mart as oil prices are trading at multi-year lows. As U.S. oils were not exported for the past 40 years, the move to lift the ban could now allow the

West Texas Intermediate (WTI) to trade almost equally alongside the Brent Crude oil benchmark. This move could also see the discount on WTI with Brent to narrow – we do not discount the possibility that WTI could trade higher than the Brent benchmark as the discount is only at +USD2.60pb currently. The lowest spread was USD1pb achieved in December 2015. On a broader note, the decision to allow U.S. crude exports could also provide better energy security to Europe which were previously highly reliant on OPEC and Russia; The European Union imports roughly 28.9% and 33.6% of crude oil from Russia and OPEC members respectively. Subsequently, should U.S. exports be able to suppress the crude supply dominance of the OPEC members, we could see the OPEC scaling down on oil supply production which could lead to higher crude oil prices – the crude oil surplus could taper. However, all in we do not believe that the U.S. will 'flood' global oil supply for the foreseeable future as such actions will only drive oil prices even lower. Flooding the oil mart will be counterproductive for all oil producing countries. We believe that the U.S. crude supply could enter the global market in a minute way, only to steadily pick up pace in the next few years.

Focus on downstream. Although the upstream sub-segment of the oil and gas value chain remains depressed as exploration and production (E&P) capex are being reduced by many, if not all major oil producers, Malaysia's downstream sub-segment industry is expected to remain robust. Moving into 2016 and into 2017, works and activity levels at the RM90b Refinery and Petrochemical Integrated Development (RAPID) Project within the Pengerang Integrated Petroleum Complex (PIPC) are expected to be at its peak. As such, key beneficiaries are oil and gas companies which have downstream specialties such as KNM Group Berhad and **Muhibbah Engineering Berhad (BUY; TP: RM2.95)**. Channel checks indicate that there could be a possibility of reallocation of staff by Petronas towards its downstream segments to prepare for the commencement of RAPID in Pengerang by 2019.

Recommendations. Given the volatile and relatively negative sentiment shrouding the oil and gas industry, we are recommending investors to cherry-pick stocks which are specific to the downstream segment of the oil and gas industry. For exposure into Pengerang, we are recommending **KNM Group Berhad (BUY; TP: RM0.62)** as PETRONAS, via **Petronas Chemicals Berhad (NEUTRAL; TP: RM5.49)**, has announced three petrochemical projects within PIPC and that KNM Group stands to be a beneficiary for the supply of specialized process equipments. For investors seeking exposure in a more predictable downstream company offering stable earnings, we are recommending **Gas Malaysia Berhad (Buy; TP: RM2.87)** as the adoption of the Incentive-Based Regulation (IBR) regime will provide better earnings visibility and predictability.

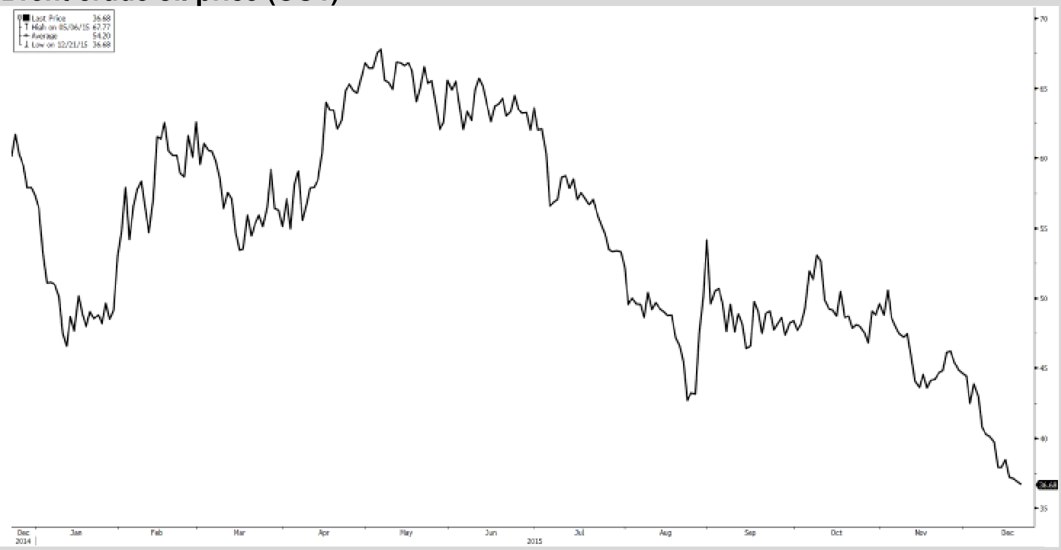
Average production cost per barrel (USD per barrel) of 20 largest oil producing countries



Source: Rystad Energy, MIDFR

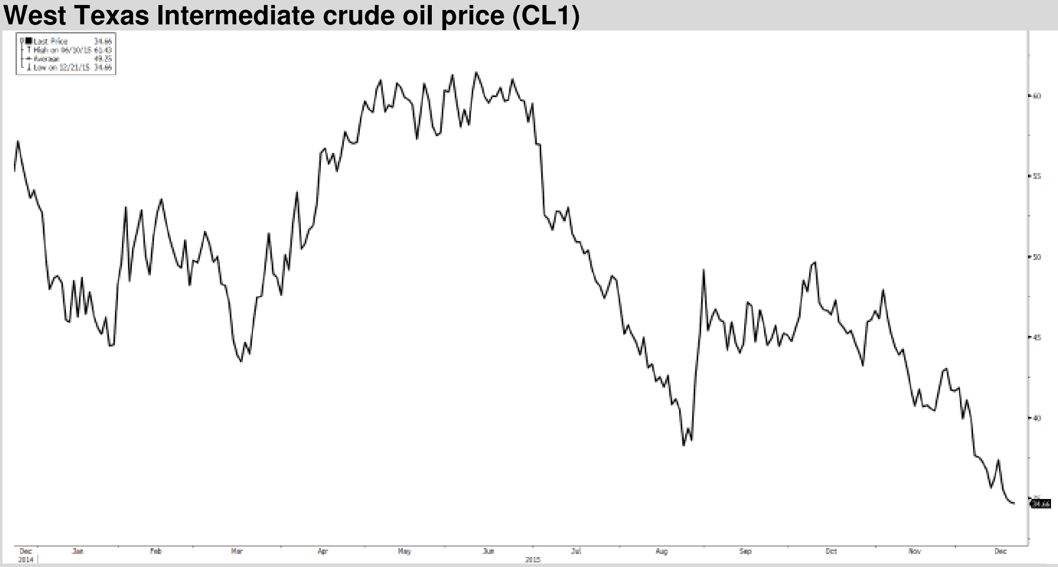
DAILY PRICE CHART

Brent crude oil price (CO1)



Source: Bloomberg, MIDFR

West Texas Intermediate crude oil price (CL1)



Source: Bloomberg, MIDFR

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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 *rise* 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 *fall* 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.