**09 March 2015 | Sector update**

# Oil & Gas sector

***Reiterate* POSITIVE**

## Expect sector to be more operationally efficient

- **Oil price continues to remain stable at around USD60pb**
- **MIDF Research expects Brent crude to average USD60-70pb in 2015 as indicated previously**
- **Cost rationalisation seen among production sharing contract operators in Malaysia**
- **Sector expected to operate more efficiently through better asset utilisation rates**
- **Maintain POSITIVE on sector**

**Oil price remains steady in 2015.** The Brent crude oil price is on a slight upward trajectory in 2015 after experiencing a steep slump towards end 2014. Year-to-date, Brent crude price has appreciated by approximately +6.3% to levels surpassing USD60pb. Going forward, we are of the view that Brent crude price will trade range-bound between USD60-70pb in 2015. As such, we continue to be optimistic that prices will stay lifted based on average global oil demand growth of 1.03mbpd for 2015 and 1.01mbpd for 2016.

**Cost rationalisation in Malaysian waters**. Most, if not all, global oil and gas producers including Petronas have reiterated that there will be significant cost rationalisation in 2015 and beyond. Petronas was quoted in the media indicating that it will be reducing capital expenditures by -10% and operating expenditures by approximately -25% to -30%. The effects are already felt in the industry, and in the equity markets, as selected oil and gas service providers were asked to relook and to renegotiate existing contracts. Our channel checks indicated that some offshore support vessel (OSV) operators were asked to readjust downwards charter rates for existing and new contracts, whereas some operators experienced vessel cancellations in favour of maximising the utilisation of fewer vessels.

**Sector to be more efficient.** The positive side of cost rationalisation within the industry is with regard to operating efficiency. During times of subdued oil prices, operators and service providers can expect fewer job orders but at more competitive rates. As such, companies would need to review its own operating costs (reduce staffing costs and material costs) in order to submit competitive bids without compromising on its own profit margin. This view is corroborated by local OSV operators. In addition, during times of comparatively low vessel charter rates, certain OSV operators would prefer spot charters (short term) as opposed to long-term charters as they are not willing to risk locking in a vessel at a low rate for a prolonged period.

**Possible knock-on effects of softening operating expenditure**. At this point in time, we have only one OSV operator under our coverage, i.e. Perdana Petroleum Berhad (NEUTRAL; TP: RM1.26). Despite still remaining positive on the overall oil and gas sector, we are cautious on Perdana as we have downgraded the stock to NEUTRAL in our FY14 Results Review report dated 24 February 2015. We are aware that as the production sharing contract (PSC) operators are embarking on the cost rationalisation drive, charter rates will face downward pressure and the charter of vessels will be at risk. There could also be knock-on effects from the other sub-segments of the industry onto the OSV industry. For example, in an event that hook-up and commissioning (HUC) contractors such as Dayang Enterprise Holdings Bhd (BUY; TP: RM3.82) were to experience rescheduling in job orders, the knock-on effect could be felt on Perdana as Dayang charters the vessels for its HUC activities from Perdana.

**Oil and gas stocks under MIDF Research coverage outpaced broader market gains.** On average, the oil and gas stocks under our coverage have appreciated by +3.4% year-to-date, in-line with the appreciation in Brent crude price. Stocks under our **BUY** recommendation however, have appreciated by +15.7%ytd, far outpacing the broader market FBMKLCI gain of only +2.7%ytd.

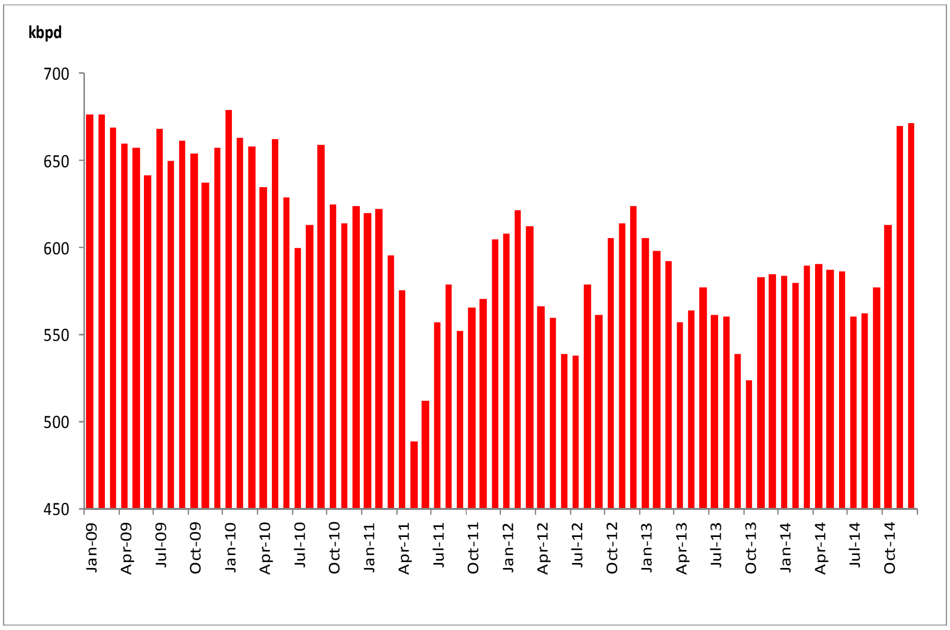
**Maintain POSITIVE.** We reiterate our **Positive** stance on the oil and gas sector, pinning our optimism on supported global crude oil prices, sustained local oil output and sustained activity levels to support oil output levels. Despite the lacklustre sentiments reverberating throughout the sector, contracts continue to flow from Petronas. For instance in 1Q15, Petronas awarded Alam Maritim Resources (unrated) and Icon Offshore (unrated) with OSV umbrella contracts. Engineering and maintenance works were also awarded to Barakah Offshore Petroleum (unrated) by Petronas in 1Q15. In addition to the award of contracts, activity levels remain robust in Malaysian waters as can be seen from the huge increase in national crude oil production. For 9M14, the average production rate was approximately 580kbpd but in 4Q14, the production rate was boosted by more than +15% exceeding 670kbpd.

**Table 1: Oil & Gas stocks under coverage**

| Company | Market cap (RM m) | Target price (RM) | Last price (RM) | Call | Earnings per share (sen) | | Price-earnings ratio (x) | | Price-book ratio (x) | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | FY14 | FY15F | FY14 | FY15F | FY14 | FY15F |
| Sapurakencana Petroleum | 14,501.0 | 3.7 | 2.41 | Buy | 18.1 | 22.1 | 14.8 | 10.9 | 1.6 | 1.4 |
| Dayang Enterprise Holdings | 2,402.4 | 3.82 | 2.75 | Buy | 21.3 | 23.9 | 13.6 | 11.5 | 2.6 | 2.5 |
| KNM Group | 1,219.9 | 1.15 | 0.76 | Buy | 2.9 | 7.2 | 16.9 | 10.4 | 0.4 | 0.6 |
| Wah Seong Corp | 1,048.0 | 1.88 | 1.36 | Buy | 16.3 | 15.7 | 7.4 | 8.7 | 0.7 | 0.8 |
| Favelle Favco | 674.7 | 4.51 | 3.09 | Buy | 40.6 | 41 | 6.8 | 7.6 | 1.3 | 1.5 |
| Petronas Gas | 45,313.0 | 19.09 | 22.86 | Neutral | 93.2 | 90.1 | 23.8 | 25.4 | 4.1 | 4.3 |
| Petronas Chem | 43,120.0 | 5.01 | 5.38 | Neutral | 31 | 35.8 | 17.6 | 15.0 | 1.8 | 1.8 |
| Dialog Group | 7,739.7 | 1.57 | 1.60 | Neutral | 4.6 | 4.6 | 40.9 | 34.8 | 5.8 | 4.9 |
| Bumi Armada | 6,335.6 | 1.12 | 1.08 | Neutral | 4.3 | 7 | 25.3 | 15.4 | 1.0 | 0.9 |
| Gas Malaysia | 3,222.8 | 3.4 | 2.52 | Neutral | 13.1 | 14.2 | 24.6 | 17.7 | 4.1 | 3.2 |
| Perdana Petroleum | 886.5 | 1.26 | 1.16 | Neutral | 12 | 12.6 | 9.3 | 9.2 | 1.3 | 1.3 |
| Malaysia Marine & Heavy Engineering | 2,048.0 | 1.19 | 1.28 | Sell | 8.1 | 8.5 | 22.0 | 15.1 | 1.1 | 0.8 |

*Source: MIDF Research, Company, Bloomberg*

**Chart 1: Malaysia crude oil production**

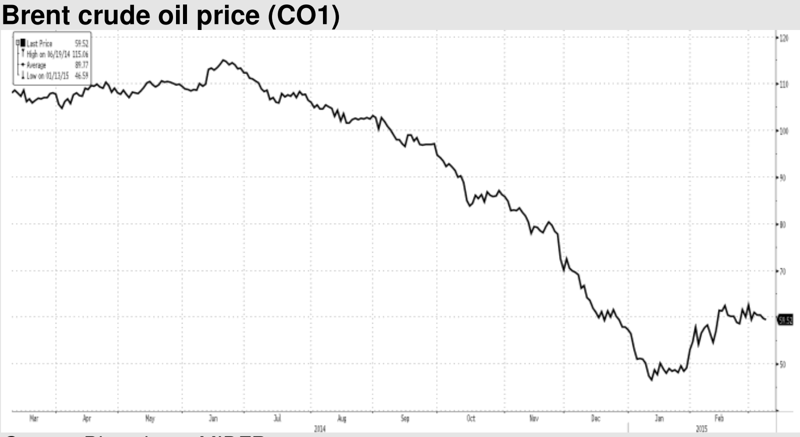



*Source: MIDF Research, Bank Negara Malaysia*

Crude oil production level surpassed 600kbpd level in 4Q14 as new output came on-stream from Gumusut-Kakap field

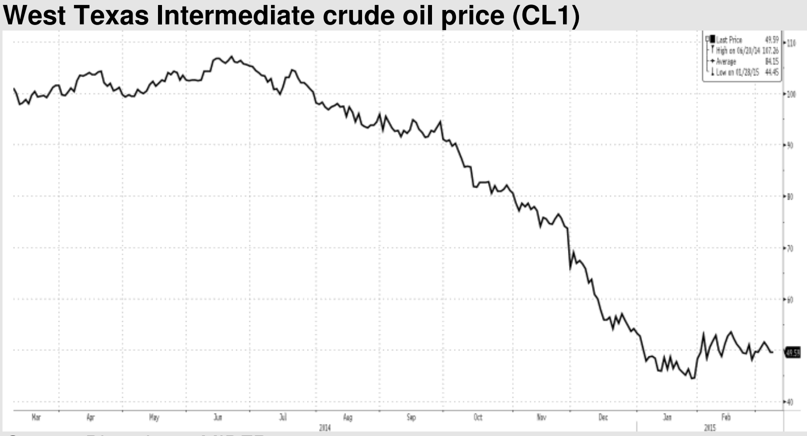
## DAILY PRICE CHART

**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 *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. |