Sector Update | Tuesday, 10 March 2020

Oil & Gas

Maintain **NEUTRAL on Upstream**
Maintain **POSITIVE on Downstream**

Another oil crash in the making?

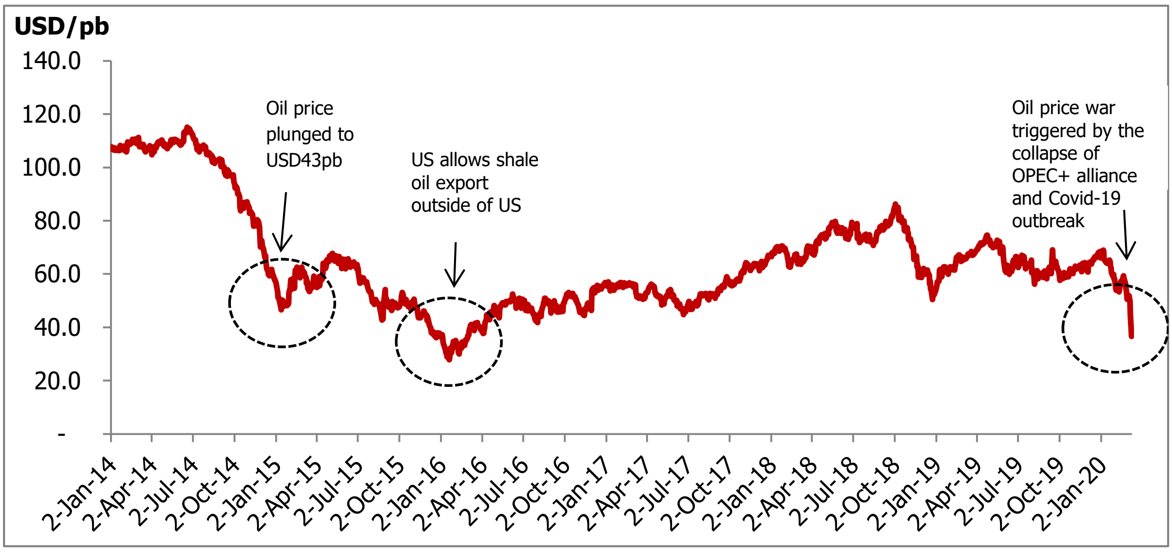
KEY INVESTMENT HIGHLIGHTS

- **OPEC+ alliance meeting ended in acrimony resulting in the worse oil price plunge since 2016**
- **Oil price plunge reignites the fear of another oil crash similar to that of 2014**
- **Saudi retaliation against Russia unlikely to prolong; limiting pressure on production costs**
- **Covid-19 outbreak expected to gradually subside in 2QFY20 with infected and mortality cases trend growing at a slower rate**
- **Brent crude oil price target revised to an average of USD51pb**
- **Impact on local oil and gas stocks generally negative**
- **Maintain NEUTRAL on Upstream, Maintain POSITIVE on Downstream**

A four-year alliance that ended in acrimony. An OPEC+ alliance meeting with Russia to discuss deeper production cuts for the year, of an additional 1.5mbpd from the current 2.1mbpd in view of the declining demand following the outbreak of the novel coronavirus (Covid-19), has sent the world into a sudden supply-demand shock. It seems that the OPEC+ alliance which was established back in 2016 as a platform to stabilise oil production and oil prices following the entry of unconventional oil (shale) into the market has prematurely ended in acrimony. The alliance which is due to expire at the end of this month came to an abrupt end which terminated the four-year pact between the 14 OPEC countries and Russia. This has resulted in more than 20% plunge in both oil price benchmark Brent and WTI to USD36pb and USD32pb respectively yesterday. The plunge was the worse since 2016 when OPEC+ alliance was formed when oil price was at USD39.6pb.

What happened? The OPEC+ alliance meeting which was held last Friday, March 6th in Vienna, saw Russia refusing to conform to a deeper production cut despite the slowing demand due to the Covid-19 outbreak. Russia was said to have wanted to start producing oil without limits imposed on them and this had caused Saudi Arabia to retaliate by removing its own production limit and cutting the official selling prices (OSPs) of its products to all regions in the world. Following this, sources familiar to the matter stated that the Saudis will now be increasing their production output from April onwards to 11.0mbpd and would not hesitate to pump up to 12.0mbpd from its current 9.5-9.7mbpd production output limit. Additionally, aside from ramping up its production output the Saudis are also cutting its OSPs and are offering discounts of between USD6-8pb across all regions to oil refiners for its Arabian light crude which effectively meant roughly a USD10pb discount to the Brent crude benchmark.

Figure 1: Brent crude oil price



Source: Bloomberg, MIDFR

Another oil crash in the making? Following this new development, the crude oil benchmark Brent has plunged over 20% yesterday to USD36pb, reigniting the fear of another potential oil price crash - similar to that of 2014. Recall that, back in 2014 the sharp decline in oil price from USD116pb to USD43pb was primarily driven by the: (i) contraction in emerging economies' demand and; (ii) unconventional oil production in Northern America. Subsequently, the oil price plunged further to an unprecedented level of USD27.88pb in early 2016 after the US allowed its shale oil to be exported outside of the country; contributing to the sharp rise in the world's oil supply during the period.

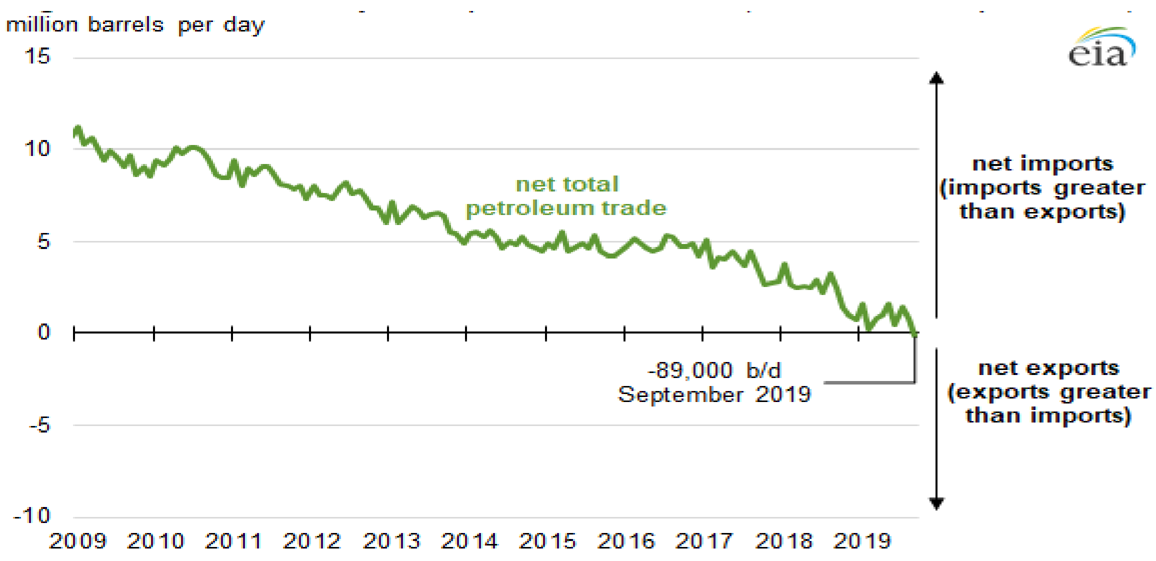
Despite the fear of another oil crash in the making, we opine that the current low oil price environment which resulted from Saudi's retaliation against Russia's decision to opt out of production cuts will not prolong. This is due to the fact that a persistently low oil price environment will put pressure on oil-related revenue arising from higher cost of production for most oil producers. On average, cost of production within OPEC is currently at about USD30pb, slightly below than the current crude oil price whilst other cost of productions outside of OPEC could reach up to USD40pb. Furthermore, we believe that the low oil price environment is expected to lure Russia back to the negotiating table and potentially put in force a new set of production cut for 2020. Currently, only Saudi Arabia has the capability to withstand low oil price environment given that its world's biggest oil reserve and is believed to have the lowest cost of production in the world.

Impending US shale producers' debt maturity to drive potential voluntary production cut. According to Moody's Investor Service, an estimated USD200b worth of debt raked up by the North American oil and gas companies since 2015 is expected to mature within the next four years. The first tranche of debt worth USD40b is due in 2020. Average daily crude production has risen 34% since November 2014 as US companies continued to drill new wells reaching about 12.5mbpd in September 2019. The specter of debt maturities will prompt companies to reduce drilling of new wells. Evidently, number of rigs currently in the US went down by -25% at the end of 2019 to 805 from 2018.

Furthermore, according to the US Energy Information Administration (EIA) expects the US crude oil production to reach 13.2mbpd in 2020, an increase of 0.9mbpd from its 2019 level. Though the growth in 2020 is expected to be lower when compared against the 2019 growth of 1.3mbpd and 2018 growth of 1.6mbpd which mainly attributable to the decline in number of rigs operating in US; the EIA forecasts production will continue to grow as rig efficiency and well-level productivity level rises as companies chase the deadline of their respective debt maturity. This is evident by the increase in net exports of US crude petroleum recorded back in September 2019.

In this respect, we opine that it is not in the US shale producers' interest to allow the low oil price environment to persist as they require production to continue and price to be at favourable levels to repay the maturing debts. Hence, we believe that should the condition prolongs, there could potentially be a voluntary production cut by the US shale producers in their attempt to cushion the low price environment.

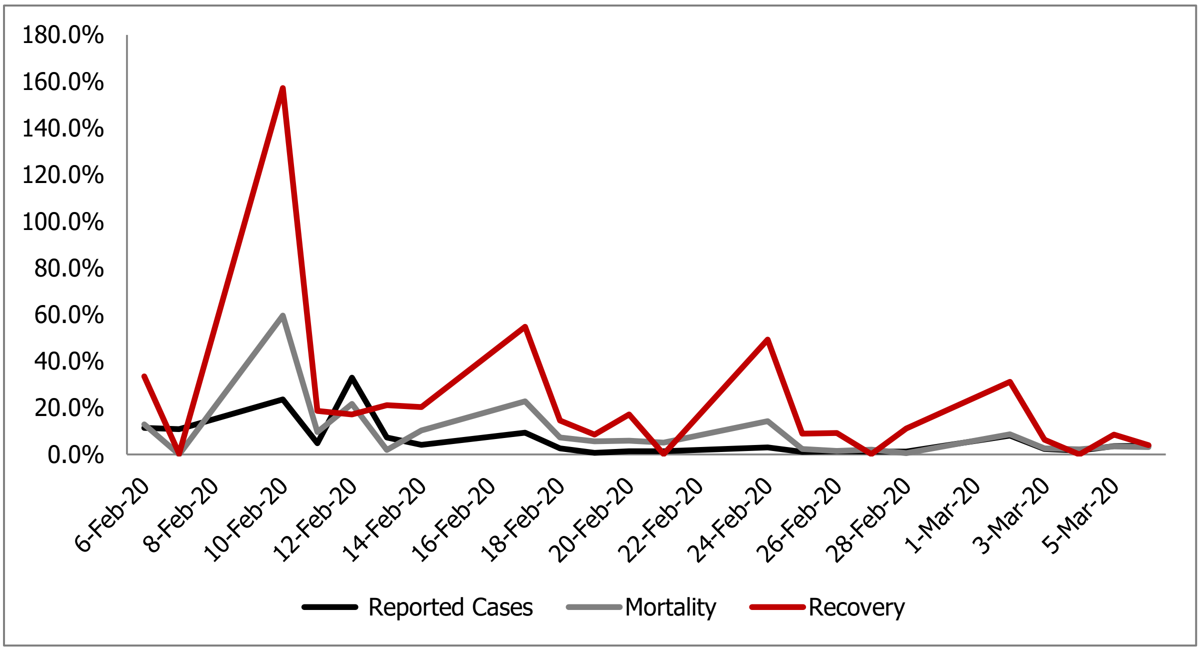
Figure 2: US monthly total petroleum trade (crude oil and products)



Source: The US Energy Information Administration (EIA)

Recovery in Covid-19 outbreak to cushion demand. Further to that, we opine that the Covid-19 outbreak will subside gradually into 2QFY20 which will help to alleviate demand for crude oil in the near term. This is based on the our daily tracking of the Covid-19 outbreak which shows both reported infected and mortality cases growth are slower when compared against the peak of the outbreak back in mid-February. Refer to Figure 3 and 4 below.

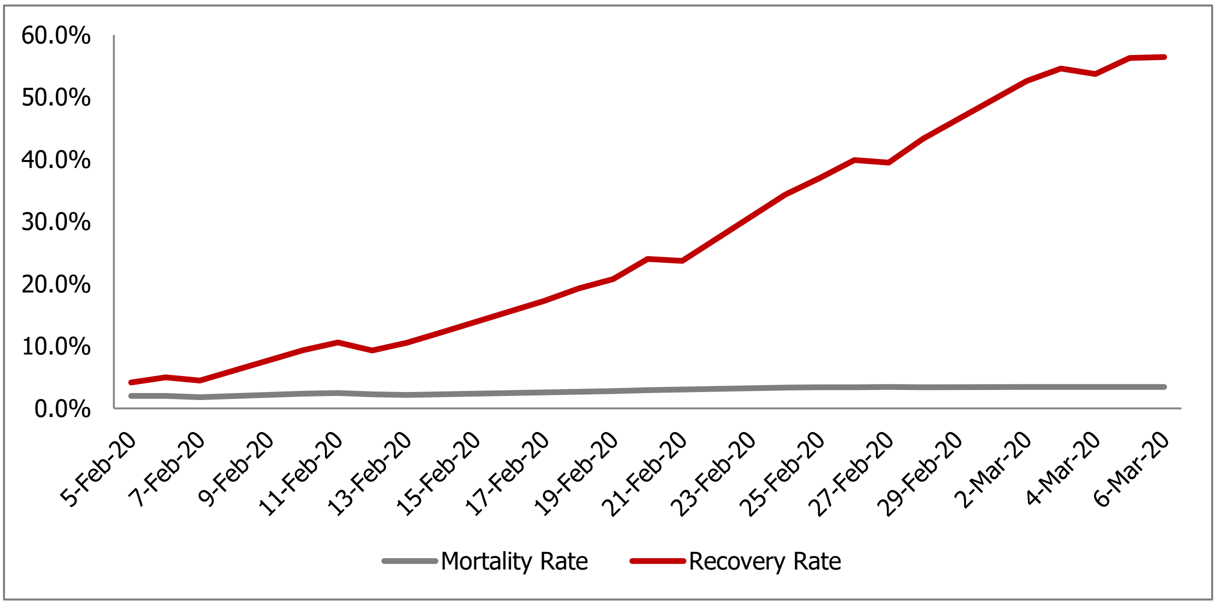
Figure 3: Covid-19 cases daily growth rates (as of March 6th 2020)



Source: Bloomberg, MIDFR

While we note that the Covid-19 outbreak has spread to the North America and European continents, we opine that given the growth rate for both reported cases and mortality cases are slowing down; global demand especially from China will gradually pick up in-line with the increase in recovery rate. We foresee that the infected cases coming from these two continents will eventually taper off as per the Chinese experience by end-2QFY20 and travel bans imposed in various countries to be lift-off accordingly. This, in return is expected to drive massive federal and consumer spending especially coming from China given the two consecutive quarters of suppressed spending due to the Covid-19 outbreak. It will assist in lifting the demand for crude oil across the globe.

Figure 4: Covid-19 mortality and recovery rates (as of March 6th 2020)



Source: Bloomberg, MIDFR

Brent crude average oil price target for 2020 revised to USD51pb. After taking into account the impact from: (i) the potential oil price war between Saudi et al; (ii) Covid-19 outbreak and; (iii) the upcoming US Presidential Election in November; we are revising our 2020 average Brent crude oil price target to **USD51pb** (from USD65pb previously). Our new target has not only taken into account the abovementioned events but we have also factored in the oil price movement trend from 2014-2016 into our calculation. Our newly revised quarterly Brent crude oil price target are as follows:

Figure 5: MIDF's quarterly and annual brent crude oil price forecasts

Quarter	Brent crude oil price forecast (USD)
1QFY20	51.23
2QFY20	50.59
1HFY20	**50.90**
3QFY20	53.13
4QFY20	48.24
2HFY20	**50.70**
FY20	**51.00**

Source: MIDFR

That said, though we anticipate the recovery in demand for crude oil in the coming quarters; we believe that it will not be strong enough to overcome the effect of the ongoing US-China trade war which has taken a back seat post-outbreak of the Covid-19.

Impact on local oil and gas players, generally negative. The sharp plunge in oil price will definitely hit the upstream exploration and production (E&P) players the most given that the oil productions are directly correlated to the oil price. In a prolonged oil price war environment, globally, we anticipate oil majors to cut or delay some portion of their planned capital expenditures (CAPEX) for 2020 which in turn, could potentially result in delayed contract awards for the oil and gas service providers. Therefore, the low oil price environment is negative for the oil and gas players.

Similarly, on the local front, we opine that there will be a negative impact in general on the oil and gas players. Should the current environment prolong, listed E&P players such as **Hibiscus Petroleum (NR)**, **Reach Energy (NR)** and **Sapura Energy Berhad (NEUTRAL, TP: RM0.28)** are the likely candidates to be in a disadvantaged position in the oil price war. Notwithstanding other factors; for Sapura Energy specifically; due to 50% of its E&P arm sold to OMV AG, its exposure to the sharp drop in oil price is limited. However, it might further delay the recovery of its drilling segment which remains at a loss-making position.

As for the local oil and gas support services players, in the event of a prolonged low oil price environment; we are favourable towards companies that are involved in maintenance, construction and modification (MCM) services. This is due to the fact that Malaysia is an oil exporting nation and revenue from oil-related income constitutes 30.9% of the total Government revenue in 2019. To ensure stable revenue and cash flow, oil production must be sustained. Hence, MCM services will be carried out regardless of the oil price environment. Therefore, we believe that national oil company Petroliam Nasional Berhad (PETRONAS) will remain committed to its maintenance spending in 2020. Nevertheless, the low oil price environment could also mean compressed margins for the players.

Hence, our Top Pick for the sector is **Dialog Group (BUY, TP: RM3.83)** specifically due to its stable recurring income from its tank farm business and due to it being one of the main beneficiary of the soon-to-be operational Pengerang Integrated Complex (PIC) MCM contract awards and; **Dayang Enterprise Berhad (NEUTRAL; TP: RM2.69)** as the company can expect to benefit from its synergy with Perdana Petroleum in providing vessels to E&P players and sustained offshore maintenance works.

As for the downstream subsector of the O&G industry, we favour **Gas Malaysia Berhad (BUY; TP: RM3.11)** as the decline in oil price has a neutral impact on its cost due to the offtake arrangement it has with Petronas Gas. On the other hand, things are not looking too rosy for **Petronas Chemicals Berhad (BUY, TP: RM6.75)** and **Petronas Dagangan Berhad (BUY, TP: RM24.58).** For PChem, even though the low oil price environment is favourable in terms of feedstock price, the low price will also result in low average selling prices (ASPs) of its products which will reduce its margin spread. Coupled with the persistent weak selling price outlook partially due to Covid-19, earnings are expected to be weak in 1QFY20. As for PetDag, the sudden drop in oil price could mean another round of inventory lagged losses similar to what it has experienced back in 4QFY18 when oil price suddenly took a plunge in late November through December. The inventory lagged loss is expected to impact its 1QFY20 earnings.

Analyst(s)
Noor **ATHILA** Mohd Razali
noor.athila @midf.com.my
03-2772 1679

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MIDF AMANAH INVESTMENT BANK : GUIDE TO RECOMMENDATIONS	
STOCK RECOMMENDATIONS	
BUY	Total return is expected to be >10% over the next 12 months.
TRADING BUY	Stock price is expected to *rise* by >10% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -10% and +10% over the next 12 months.
SELL	Total return is expected to be <10% over the next 12 months.
TRADING SELL	Stock price is expected to *fall* by >10% 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.