OIL & GAS

***Maintain* NEUTRAL**

Soft Offshore Activities As Demand Inches Up Gradually

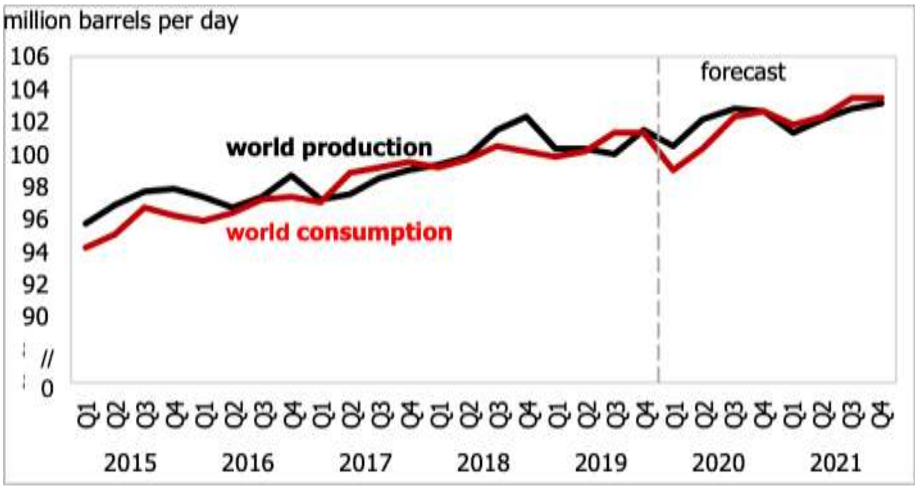
KEY INVESTMENT HIGHLIGHTS

- **Crude oil priced to remain swayed by Covid19 developments**
- **E&P capex cut to support soft crude oil price**
- **Stable rigs and drillships average day rates and utilisations a positive sign**
- **Low oil price and Covid-19 pandemic to threaten OSV charter recovery**
- **Oil price to continue trading sideways as it remains trapped between negative Covid19 news and slow demand recovery**
- **Maintain NEUTRAL stance on the sector, 2020 Brent target unchanged at USD41pb**

Crude oil price to remain swayed by Covid19 developments. We reiterate our view that the oil price will continue to be susceptible to all the major socio and geopolitical developments in the world throughout the year which will cause oil price to remain volatile. That said, we are positive on the recent development in the market where: (i) OPEC and its allies have decided to ease the production cut from August onwards to 7.7mbpd; (ii) the easing of Covid19-related measures by countries worldwide which will restore demand and; (iii) voluntary production cut by the non-OPEC countries especially the US shale producers. We opine that these developments will provide some stability in the oil price movement for the remainder of the year.

Additionally, the US Energy Information Administration (EIA) recently reported that crude inventory in the US has dropped by 7.2mb during the last week of June. We expect the continued decline in worldwide crude inventory will assist in lifting oil price going forward. Hence, we opine that, crude inventory will gradually decline until 3Q20 before the demand finally catches up in 4Q20 after two quarters of suppressed consumption and the production cut by US shale producers. Note that production output often lags by six-months from the change in oil price resulting in the full-impact of production cut to be felt only towards the end of 2H20. These are, however, remains subjected to the latest development in the fight against Covid19 where currently there is a fear on the arrival of a "second wave" which could result in a prolonged pull-back in demand that could stunt the recovery of the industry.

Figure 1: World oil production and consumption forecasts for 2020-2021



Source: US Energy Information Administration (EIA), MIDFR

COMPANY IN FOCUS

Dialog Group Berhad
Maintain BUY | Unchanged target price: **RM3.83**
Price @ 20th July 2020: RM3.84

- Beneficiary of low oil price environment as low oil price results in surge in demand for storage
- Earnings to be cushioned by resilient maintenance services and a frontliner to win more maintenance contracts in Pengerang
- Limited exposure to upstream sub-segment limits downside for both revenue and earnings

Share price chart

Serba Dinamik Holdings Bhd
Not Rated | Fair Value: **RM3.88**
Price @ 20th July 2020: RM1.65

- Revenue stream is well-diversified and geographically-wide exposure to international oil and gas industry
- Revenue and earnings in FY20 to be supported by stable O&M segment which has seen no interruption despite Covid19 & low oil price
- Remains committed to a 30% dividend payout in FY20

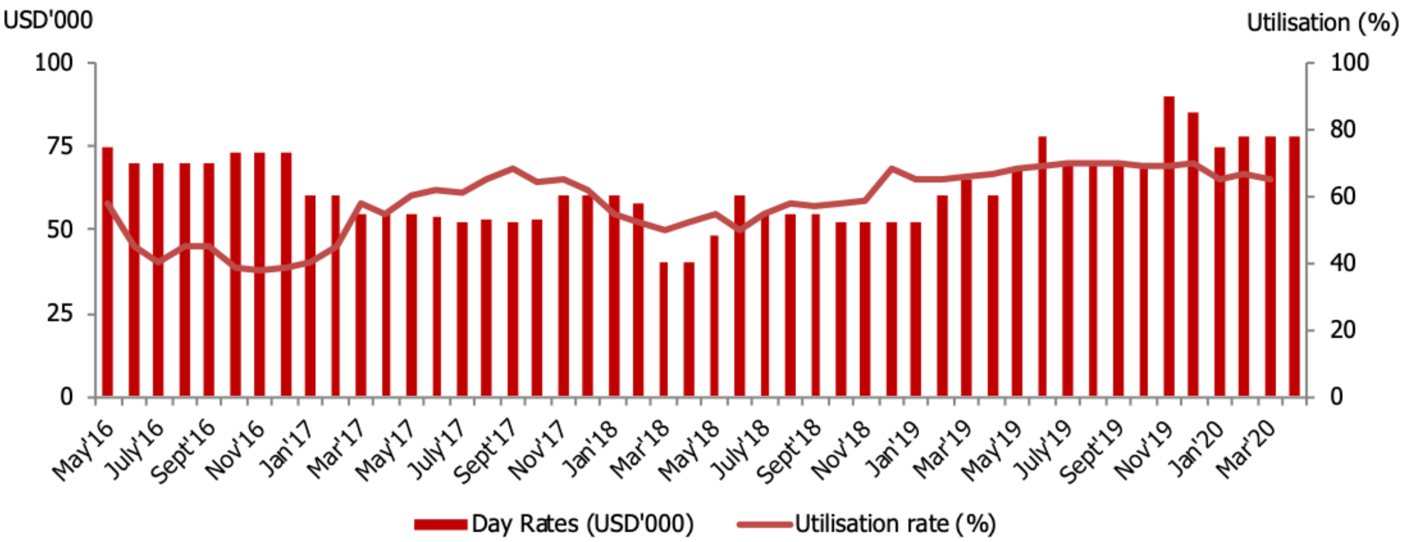
Share price chart

ANALYST
Noor **ATHILA** Mohd Razali
noor.athila@midf.com.my
03 -2173 1679

E&P capex cut to support soft crude oil price. We note that spending for the upstream exploration and production (E&P) by oil majors consisting global integrated oils and independent E&P companies for 2020 have been slashed by 20-30% in order to deliberately reduce production output and to assist in the recovery of the oil. This is in view of the slow-down in demand attributed to the Covid-19 pandemic which has shrunk China's demand for crude oil by 20% year-to-date and plunged the world into perpetual uncertainty. China's demand alone account for 80% of global oil demand growth in 2019. On average, approximately 30-40% of E&P capex is allocated for drilling and completion while around 15-20% for subsea production. Meanwhile, on the local front; PETRONAS has announced that it will be cutting back on its CAPEX by 21% to RM39.0b (from RM50.0b previously) to account for the current low oil price environment and expected slowdown in offshore activities. Further to that, it has also announced a cut in its OPEX spending this year by 12% this year which is estimated to be about RM2.0b. This in turn would lead to potential termination of soon-to-be-renewed contracts and margin compression for oil and gas service providers which are dependent on PETRONAS-related contracts.

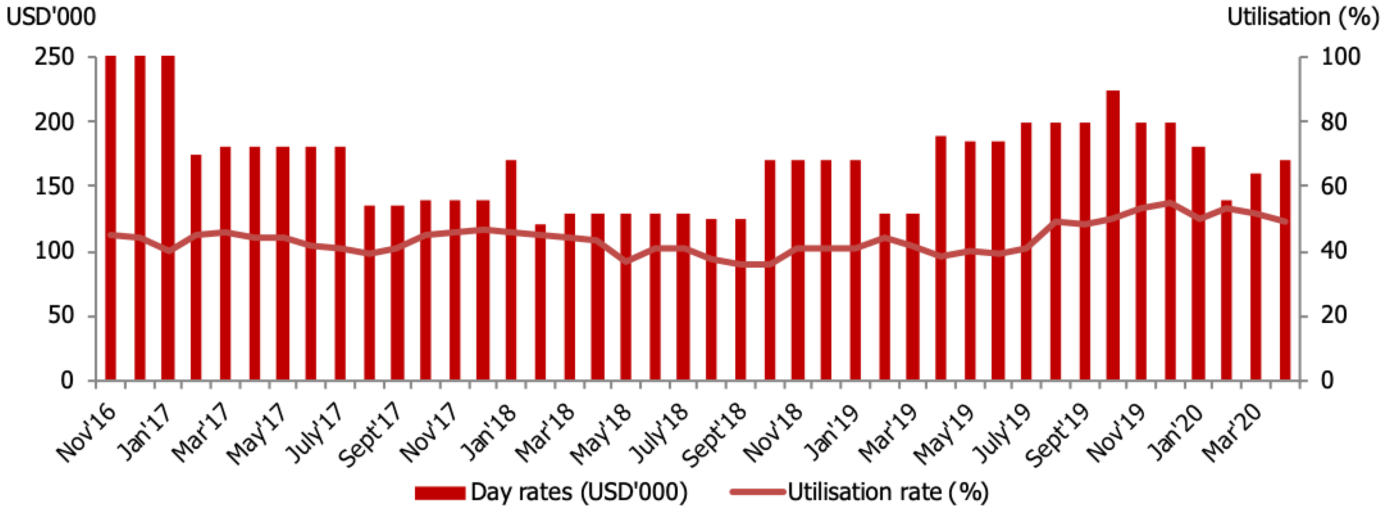
Stable rigs and drillships average day rates and utilisations a positive sign. Overall offshore and onshore E&P activities are expected to improve into 2H20 with average day rates and contracted utilisation rates for worldwide semisubmersibles, drillships and Southeast Asian jack-up rigs have not shown much sign of decline despite the current low oil price environment and weak demand. Utilisation rates and average day rates for worldwide semisubmersibles in particular, have remained rather stable in the 1Q of 2020 into the 2Q of 2020. Jackup rigs utilisation rates remains in excess of 60% with stable average day rates. That said, industry players do see further signs of recovery with increased drilling activities particularly in Southeast Asia with new contracts awarded back in 2HCY19 by regional players which is expected to drive the utilisation rates for the rigs. Furthermore, demand particularly in Southeast Asia is expected to continue its upward trajectory with an average demand of about 40.5 units of rigs in 2020, up from the 34.7 units in 2019.

Figure 2: Southeast Asia jackup rigs 361-400 IC average day rates and utilisation rates



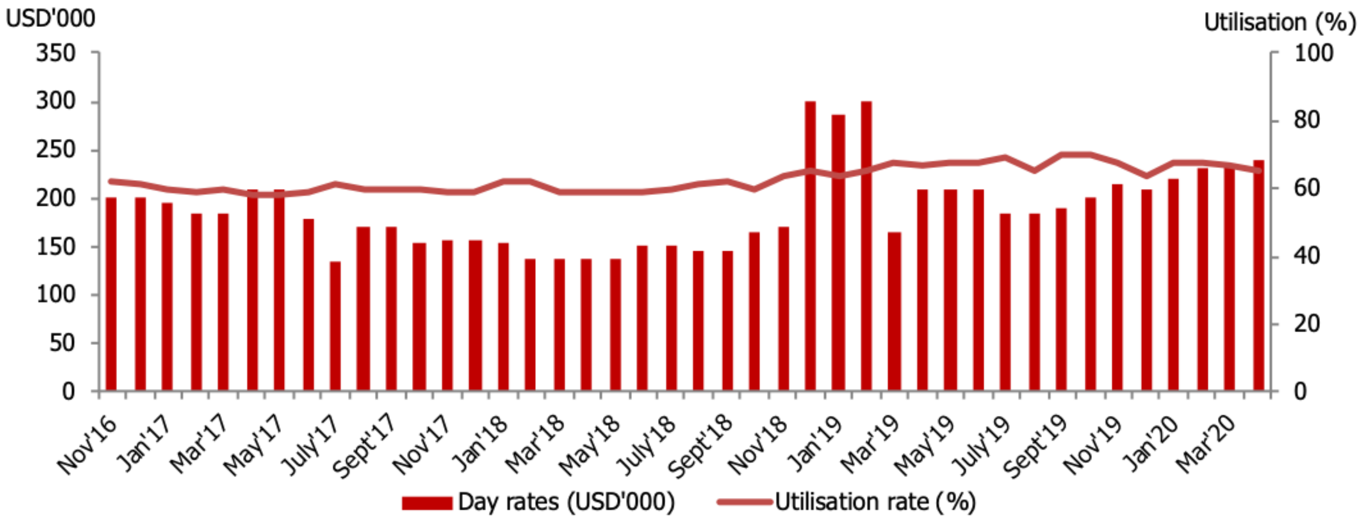
Source: IHS Markit, MIDFR

Figure 3: Worldwide semisubmersibles >7,500 ft average day rates and utilisation rates



Source: IHS Markit, MIDFR

Figure 4: Worldwide drillships >7,500 ft average day rates and utilisation rates



Source: IHS Markit, MIDFR

Low oil price and Covid-19 pandemic to threaten OSV charter recovery. Demand and charter rates for offshore support vessels (OSV) which has been staging recovery since 2HFY19 is now threatened by the recent OPEC+ alliance fallout and Covid-19 pandemic outbreak. The outbreak of Covid-19 pandemic is preventing the movement of goods and services in the market which is driving the decline in crude oil demand and giving a big blow to demand for transport fuels. The Covid-19 and oil price war between Saudi-Russia has insofar pressured the oil price down and weigh on the demand for OSVs and its rates coupled with the cut in E&P spending just as it is about to see firmer recovery this year. This is especially so in the Southeast Asia region which has shown promising recovery signs with a couple of players returning to the black in 2019 after two-three consecutive loss-making years.

PETRONAS in its activity outlook for 2020-2022 stated that it will need in total, 134 vessels in 2020 to support its production operations and 256 vessels to support its drilling operations. We opine that Petronas might revise these requirements following its decision to reduce its CAPEX and OPEX spending to reflect the current market condition accordingly which could mean lesser number of charters coupled with lower charter rates for 2020.

Figure 5: Petronas three-year outlook demand for vessels in Malaysia to support production

Type	2020	2021	2022
Utility vessel	7	7	7
Landing craft	26	26	26
Standby support vessel	17	17	17
Fast crew boat	43	43	43
PSV	14	16	16
AHTS vessel (<100t BHP)	27	29	29

Source: Petronas Activity Outlook 2020-2022, MIDFR

Figure 6: Petronas three-year outlook demand for vessels in Malaysia to support drilling

Type	2020	2021	2022
Utility vessel	1	1	1
Landing craft	4	4	4
Standby support vessel	2	2	2
Fast crew boat	27	27	27
PSV	42	42	42
AHTS vessel (<100t BHP)	36	36	36
AHTS vessel (>100k BHP)	86	86	86

Source: Petronas Activity Outlook 2020-2022, MIDFR

Brent crude average oil price target for 2020 maintained at USD41pb. The crude oil price so far has averaged at USD42.10 in the 1H20 however; we are maintaining our 2020 oil price assumption at USD41pb. We opine that the oil price will continue to trade sideways for the next couple of months towards the end of 2020 as the oil price remains trapped between the negative coronavirus news and slow demand recovery. The negative development on the Covid19 front continues to plague the oil price given that new cases remains elevated in 16 countries that accounts for 70% of the global crude consumption.

Additionally, the decline in oil price following the decision to ease the production cut by OPEC and its allies is expected to be arrested by the declining crude inventories worldwide coupled with the recovery in demand. According to the latest statistics presented by EIA, global crude consumption was up by 10.0mbpd in June from April levels as economies globally began to emerge from lockdowns. It is estimated by the EIA that global crude inventories will continue to decline at the rate of 1.8mbpd through to the end of 2021.

Figure 7: MIDF's quarterly and annual brent crude oil price forecasts

Quarter	Brent crude oil price forecast (USD)
1QFY20 (A)	50.80
2QFY20 (A)	33.39
1HFY20 (A)	**42.10**
3QFY20 (E)	36.00
4QFY20 (E)	45.10
2HFY20 (E)	**40.55**
FY20	**41.33**

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.

Maintain NEUTRAL on both Upstream sub-segment and Downstream sub-segment. Due to the various events impacting the oil price's stability going forward, reduction in offshore E&P capex and; gradual demand recovery for oil-related products globally, we are maintaining our stance on the upstream sub-segment of the oil and gas industry at **NEUTRAL**. We are also maintaining our **NEUTRAL** stance on the downstream sub-segment of the oil and gas industry. This is also in-line with our crude oil assumption for 2020 at USD41pb.

Challenging operating environment ahead for oil and gas players. The sharp plunge in oil price back in March are definitely impacting the upstream exploration and production (E&P) players the most given that the oil productions are directly correlated to the oil price. Globally, we have witnessed oil majors reducing or delaying some portion of their planned capital expenditures (CAPEX) for 2020 which in turn, have resulted in delayed contract awards for the oil and gas service providers. Therefore, the current 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 (TRADING BUY, TP: RM0.113)** 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 current low oil price environment; we remain 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; **Serba Dinamik Holdings Berhad (NR)** as the company has a well-diversified revenue stream and has geographically-wide exposure to the global oil and gas network. It is worth noting that both companies are involved in MCM services for oil and gas industry which has seen minimal interruption from the current Covid19 pandemic and low oil price environment.

Meanwhile, 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, outlook remains lacklustre for **Petronas Chemicals Berhad (NEUTRAL, TP: RM5.85)** and **Petronas Dagangan Berhad (NEUTRAL, TP: RM21.39).** 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 FY20. As for PetDag, the lower sales of petrol due to MCO in April and May are expected to impact its 2QFY20 earnings as movements remains restricted during the quarter. We opine that this will also continue into 2HCY20 as consumers remains wary of excessive movement post-MCO. That said, as oil price has remained rather stable for the past one month, this will assist in reducing the downside risk for both PChem and PetDag going into the 2H of 2020. This is as the stability in oil price will provide some room for recovery in revenue and earnings as volatility in terms of product pricing has been significantly reduced.

MIDF RESEARCH is part of MIDF Amanah Investment Bank Berhad (197501002077(23878-X)).
(Bank Pelaburan)
(A Participating Organisation of Bursa Malaysia Securities Berhad)

DISCLOSURES AND DISCLAIMER

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.