Oil & Gas

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

US-Iran crisis escalation, unlikely

KEY INVESTMENT HIGHLIGHTS

- **Current US-Iran crisis was years in the making**
- **Escalation of crisis could lead to targets placed on US-related asset and oil-related assets**
- **Stand-off expected to stabilize the oil price moving forward**
- **US companies' debt maturity and high crude stockpile to weigh on crude oil price**
- **Market reacted favorably to the stand-off between US-Iran with Wall Street closing generally higher on Thursday**
- **Maintain NEUTRAL on Upstream, Maintain POSITIVE on Downstream**

A crisis years in the making…The geo-political development involving the US and Iran has finally escalated to a new level this week. Recall that, US President Donald Trump ordered an attack on an airport in Baghdad, Iraq that killed Iran's top military commander Qassem Soleimani and a veteran Iraqi military officer Abu Mahdi al-Muhandis in the early hours of Friday last week. The attack followed the death of an American contractor at an Iraqi military base, possibly caused by Iranian-backed militias as well as string of political and economic pressure on Iran imposed by the US which began with the US pulling out of the 2015 nuclear deal back in 2018. Since then, multiple threats of further sanctions on Iran has been uttered by the President Trump despite President Trump's insistence on multiple occasions that he is flexible and willing to negotiate with Iran's top leader Hassan Rouhani where the latest of such insistence being back in September 2019.

The attack by the US which led to the death of Qassem Soleimani has resulted in Iran vowing retaliation and more than a dozen ballistic missiles raining on two Iraqi military bases (Al-Asad airbase and Erbil) hosting the US soldiers on Wednesday; hours following the funeral of Soleimani. The US announced that no casualties were reported from the attack and it will not be responding to the attack. Similarly, Iran has also announced that it will be standing down and has concluded proportionate measures in self-defense.

Figure 1: Iran's attack on two US bases in Iraq

Source: NBC News

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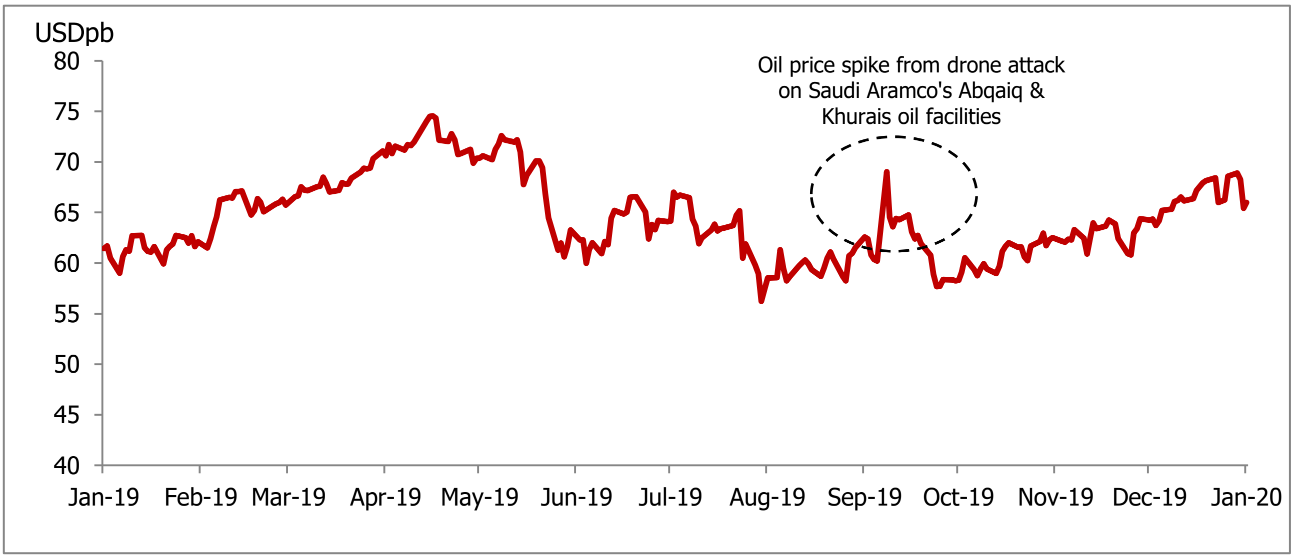
…further escalation will potentially result in attack on US-related assets. While both the US and Iran seemed to have come to a stand-off following the US drone attack in Iraq and counter-attack by Iran; many are unconvinced that the crisis will end there. This is following multiple contradicting media statements released by both the US and Iran on the state of the crisis. This signals that while the contradicting statements may ease the escalating tensions between the two countries in the near term; the situation could immediately turn south for both very quickly. While we do not believe that at this juncture further escalation will take place however; we opine that should any escalation resulting from the attacks or rise in internal pressure happens; it will potentially result in a target placed on US-related assets and oil-related assets. This, in return could lead to a temporary disruption in oil supply and rise in oil price.

We believe there will be a temporary knee-jerk reaction towards the oil price - should there be an escalation of attack. It will be similar to that of the recent attack on Saudi Aramco's oil facilities – the Abqaiq and Khurais oil facilities, back in September 2019 which wiped out 5.7mbpd of crude supply from the market. The attack is also followed by a series of explosions and sabotage attempts against ships in the Persian Gulf of which the US has blamed Iran for. Following the drone attack, we saw the oil price rising by +14.0% to USD69 from USD60 before the attack.

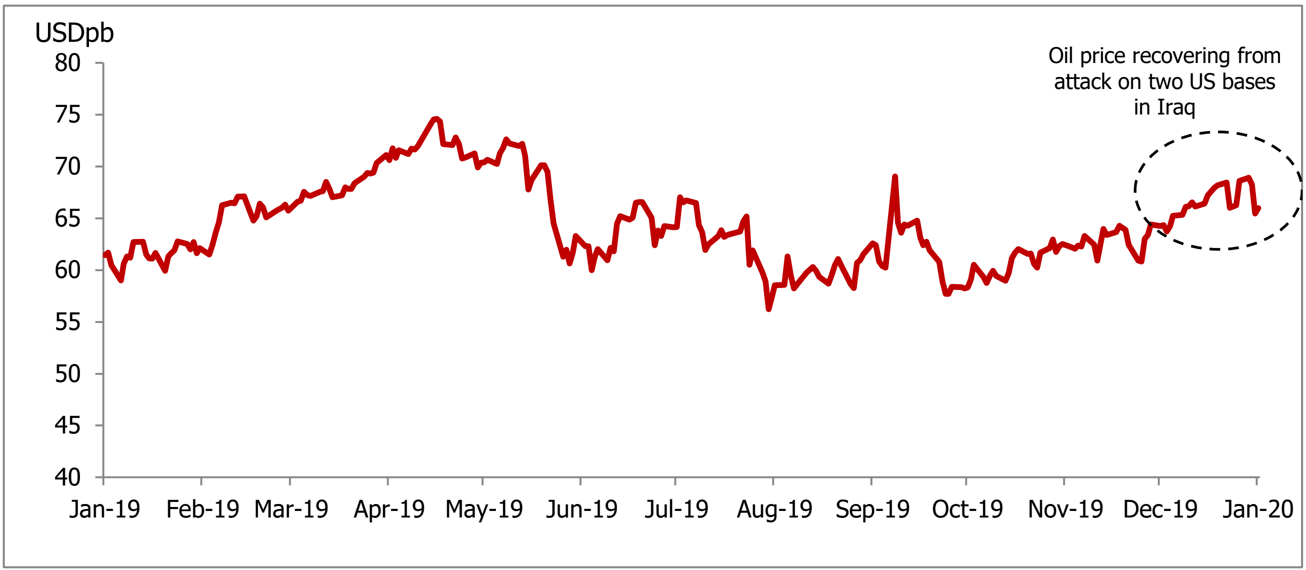
Figure 2: Oil price movement pre and post attack on Saudi Aramco's oil facilities



Source: Bloomberg, MIDFR

De-escalation of situation to stabilize oil price. On the other hand, should the current stand-off between the US and Iran remains; we opine that it will lead to a more sustainable oil price movement and a more stable outlook for the oil and gas industry. Some 20% of the world's oil supply originates from the Middle East. Therefore, any tensions surrounding the region and Strait of Hormuz will disrupt world trade and oil supply. Members of the Organization of Petroleum Exporting Countries (OPEC) in recent interviews with various news agencies stated that they are vulnerable to regional conflicts and unable to cope should there be an attack by Iran on their oil facilities. As recent experience has shown; the drone attack on two of Saudi Arabia's oil facilities effectively wiped out half of the Kingdom's oil production.

Figure 3: Oil price movement pre and post-attack on US base in Iraq



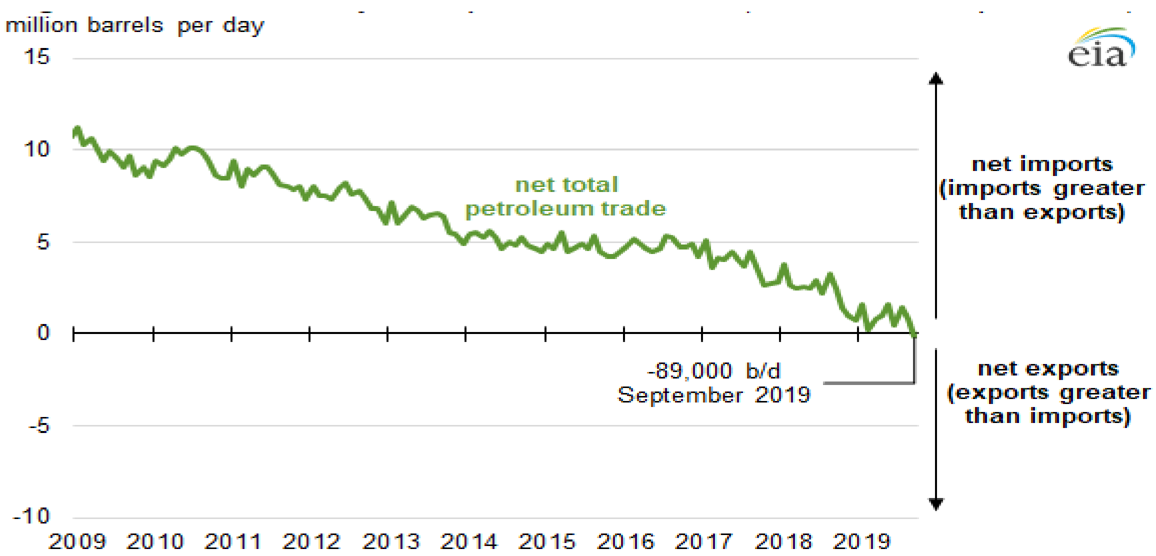
Source: Bloomberg, MIDFR

Due to this, we reiterate our view that the situation is unlikely to escalate further at this juncture and we expect oil price to trade between the USD60-65pb range and to average at USD65pb in 2020. Furthermore, various measures have been taken by fellow OPEC countries to reduce the impact of the regional tensions some of the measures include: (i) re-routing oil tankers away from the Strait of Hormuz; (ii) adding armed security guards on oil tankers; (iii) reviewing evacuation plans and; (iv) orchestrating orderly shutdowns of offshore facilities should the need come. Additionally, the deeper production cuts – from 1.2mbpd to 1.7mbpd, agreed in the recent OPEC meeting on 6th December 2019 will assist in mitigating the volatility of the oil price going price.

Impending US oil and gas companies debt maturity…to continue pressuring oil price downward with optimization of existing drilling wells. 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.

Figure 4: US monthly total petroleum trade (crude oil and products)



Source: The US Energy Information Administration (EIA)

Stable and sustainable oil price is the way forward. While in general a higher crude oil price is favourable to encourage the continued spending of oil and gas exploration and production (E&P) producers, we opine that a stable and sustainable oil price will be even more favourable to the oil and gas companies in the current operating climate. It is to enable a proper planning for future capital expenditure (CAPEX) to be conducted using predictable parameters rather than projecting numbers in an extreme environment. That said, we understand that most E&P producers are comfortable at the current USD60-70pb oil price level as current production costs ranges from USD30-40pb for offshore production whilst for onshore productions; the cost is even lower which will ensure the current upbeat offshore and onshore activities momentum will be sustained.

Hence, looking at the current operating climate we reiterate our view that local oil and gas services companies that are involved in drilling, fabrication and; vessel providers (i.e FPSO and OSVs) will continue to benefit from the upbeat offshore activities going into 2020. For the upstream services segment, we remain bullish on **Dayang Enterprise Berhad (BUY; TP: RM2.69)** as the company can expect to benefit from its synergy with Perdana Petroleum in providing vessels to E&P players and more active offshore maintenance works. We also like **Bumi Armada (BUY, TP: RM0.56)** due to its improving operational conditions as well as; its position as the largest FPSO provider in Malaysia. We are also favourable towards **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).

For the downstream subsector of the O&G industry, we remain positive on **Petronas Chemicals Group Berhad (BUY; TP: RM8.77), Petronas Dagangan Berhad (BUY; TP: RM27.75)** and **Gas Malaysia Berhad (BUY; TP: RM3.11)** as despite industry-specific challenges, we opine that demand for downstream products remains robust and that the external disruptions are temporary in nature which will not halt the respective companies' growth going forward.

MARKET REACTION

The equity market sentiment in the US is buoyant hence investors have the tendency to look at the glass half full.

Thus, even in the aftermath of Iran's ballistic missiles attack on US military bases in Iraq, a conceivably 'dovish' statement (i.e. Iran "appears to be standing down" after it attacks US bases in Iraq) by US President Trump was enough to appease the market.

On the Iranian side, its Foreign Minister issued a statement declaring that it had "concluded" its retaliatory, self-defense attacks, and added that "we do not seek escalation or war, but will defend ourselves" against any further aggression.

The DJIA recouped early losses on Wednesday (the missiles attack took place after the closing bell on Tuesday) to close more than 160 points higher.

Asian equity markets reacted favorably to the overnight performance on Wall Street and closed generally higher on Thursday.

At this juncture, we do not expect further escalation to this crisis as both sides seem unwilling.

We reiterate our FBM KLCI 2020 baseline target at 1,680 points.

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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.