Oil & Gas

At The Turning Point?

NEUTRAL

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Earlier in the week, OPEC+ had agreed to extend its production cuts by another 9 months to March 2020. We view this positively, with it being imperative to sustaining oil prices at current levels, although near-term negatives could still arise as some market observers may have expected a widened production cut to mitigate recent demand-side concerns. Nonetheless, data shows that OPEC-11 has been fairly consistent in meeting production cut compliance throughout the year, with Russia also having reached full compliance since May 2019 onwards. We feel current Brent crude prices at USD60-70/barrel to be "sensible", with oil majors more than comfortable producing at these levels, and as such, we maintained our 2019-2020 Brent crude average price assumption at USD65/barrel. Meanwhile, local contract flows have seen an uptick for the past 3-4 quarters. While we are still far from a "contract bonanza", signals of improvements such as these could mean that the sector is currently at a turning point, although we feel that an upcycle could be long and gradual. In tandem with Petronas' activity outlook guidance, recent contracts mainly came from the marine vessels, drilling and maintenance space. Nonetheless, we feel that many names within the sector would still need to undergo restructuring and/or balance sheet recapitalisation in order to regain competitiveness to fully benefit from the increased jobs flow. Currently, we posit that names with great international exposure and a relatively healthy balance sheet (e.g. SAPNRG, SERBADK, YINSON) still remain the likeliest to benefit from a long-term recovery. We maintain NEUTRAL on the sector, given limited upside on Petronas-related counters, although with increased sanguinity. Earnings delivery and balance sheet strength still remain as our key selection criteria, and hence, we continue to favour names such as SERBADK and YINSON, although we have also highlighted PANTECH and SAPNRG as tactical plays.

OPEC+ agrees to extend production cuts. Earlier in the week, OPEC+ had agreed to extend its production cuts by another 9 months to March 2020. This would follow-through from its previous output limitation agreement, which was set to expire June-2019, and continue production cuts of 1.2m barrels per day from its Oct-2018 benchmark all the way until 1Q20. While we view this positively, with the extended production cuts being imperative for oil prices to sustain at current levels, some near-term negatives could still arise as market observers might have expected a widened cut to mitigate some recent concerns over slowing of demand growth. Data has shown that OPEC-11 has been fairly consistent towards its compliance on the production cuts, with Russia having also reached full compliance since May-2019 onwards. Overall, we feel the current trading range of Brent crude oil and prices between USD60-70/barrel to be "sensible", with oil majors more than comfortable producing at these levels given favourable and very feasible oil economics. Overall, we keep our 2019-2020 average Brent price assumption of USD65/barrel unchanged.

Early uptick in contract flows. Contract flow started to show signs of a gradual pick-up for the past 3-4 quarters, although there is still some distance to matching the peaks seen in 2013-2015. While this is still far from being considered as a "contract bonanza", the improved contract flow is, nonetheless, a positive sign coming on the back of recent stabilising oil prices, and as a result of (i) under investments in the yesteryears, coupled with (ii) increased local activities, as guided by Petronas' latest activity outlook and increased upstream spending. In fact, in tandem with Petronas' latest activity outlook, we observed that recent contracts have mostly come from the (i) marine and subsea vessels, (ii) drilling rigs, and (iii) HUC & MCM space.

At an inflection point? While contract flows have started to show signs of improvement, an upcoming upcycle may still be long and gradual, instead of an instant "boom". We note that many of the contracts, especially from the marine vessel chartering space, are still relatively small in value as compared to the larger fabrication/engineering or multi-year maintenance jobs. With margins much more competitive than ever given the current cost optimisation landscape, we feel that there is still a need for companies to undergo some form of restructuring and/or balance sheet recapitalisation before they can regain competitiveness and fully benefit from the increased job flow and deliver on jobs execution. With that said, we still find a large sum of the local oil and gas service and equipment providers to be heavily reliant on local job flows. As such, we believe names with great international exposure and a relatively healthy balance sheet (e.g. SERBADK, SAPNRG, YINSON) may be the likeliest to benefit from the gradual long-term recovery of the oil and gas sector.

Maintain NEUTRAL, given limited upsides to big-cap Petronas counters, although we are starting to increase our sanguinity on the sector given its early signs of a gradual recovery. From here, earnings delivery and balance-sheet restructuring, especially from the smaller less-established names, would provide another added catalyst towards the sector. Nonetheless, we still remain resilient with our stock picks at this juncture, favouring names with (i) visible strong earnings growth, (ii) track record of good earnings delivery, and (iii) healthy balance sheet. As such, our preferred picks from the sector are **SERBADK (OP, TP: RM4.80)** and **YINSON (OP, TP: RM7.75)**, although we have also highlighted **PANTECH (OP, TP: RM0.69)** and **SAPNRG (OP, TP: RM0.43)** as tactical plays for this quarter.

List of preferred picks

Top Picks	Comments
SERBADK (OP, TP: RM4.80)	SERBADK has one of the best ROEs within the sector, coupled with its spotless track record of earnings growth recovery. Forward earnings are underpinned by its current order-book of RM8.7b, and we expect more contract wins to continue as management targets to hit RM10b order-book by year-end. Current TP is derived from 15x PER on FY20E.
YINSON (OP, TP: RM7.75)	YINSON is expected to show a significant jump in its FY21E earnings (+56% based on current assumptions) on the back of the commencement of two FPSOs – Helang and Abigail-Joseph. Further contract wins are expected from its overseas bids in Brazil and Ghana, with our SoP-valuation having already priced-in 2 additional new wins. Our TP implies 22x PER on FY21E.
PANTECH (OP; TP:0.69)	Potential "dark-horse"-play within the oil and gas sector, premised on a restoration of earnings visibility and dividend pay-outs, given its recently-announced uplift of its U.S. shipment suspension. As such, expect strong 2H results. PANTECH could also potentially benefit from the increase in local offshore fabrication works. Our TP is derived from 0.9x PBV on FY20E – implying PER of 12-13x.
SAPNRG (OP; TP: RM0.43)	Tactical play with limited downside, capitalising on an anticipated turnaround in the 2H of this year post-recapitalisation exercises, underpinned by: (i) finance costs savings from borrowings repayments, (ii) depreciation savings from impairments last year, and (iii) profit recognition from 2-year's high order-book of RM17.3b, with projects load-out mostly occurring in the 2Q-3QCY19. TP is derived from 0.5x PBV on FY21E.

Appendix

Brent Crude Oil Price Chart

Source: Bloomberg, Kenanga Research

Commentary: *Brent oil prices have been trading between the USD60-70/barrel range for most of YTD-2019 (2019-YTD average of USD66/barrel versus USD71/barrel in 2018)*

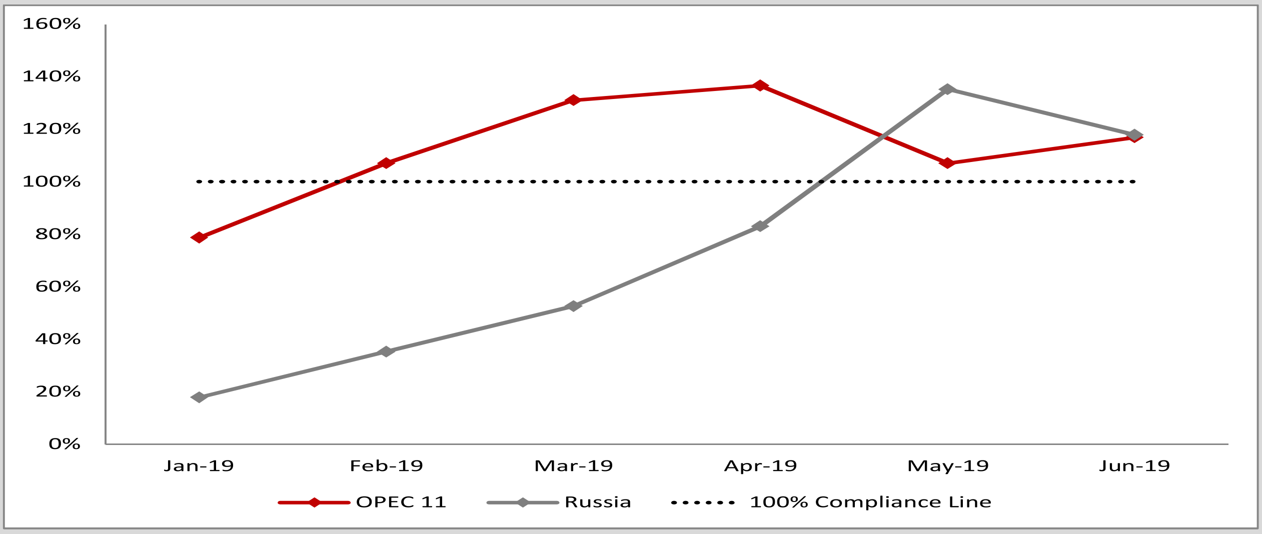
OPEC's and Russia's Oil Cut Compliance Levels (for June 2019)

Production ('000 b/d)	Oct 2018 Benchmark	Pledged Cut	Output Target	Jun-19	June 2019 Cut From Benchmark	Compliance	Compliance (Yes/No)
Algeria	1,057	-32	1,025	1,010	-47	147%	Yes
Angola	1,528	-47	1,481	1,440	-88	187%	Yes
Ecuador	524	-16	508	530	6	-38%	No
Equatorial Guinea	127	-4	123	110	-17	425%	Yes
Gabon	187	-6	181	200	13	-217%	No
Iraq	4,653	-141	4,512	4,750	97	-69%	No
Kuwait	2,809	-85	2,724	2,730	-79	93%	No
Nigeria	1,738	-53	1,685	1,890	152	-287%	No
Republic of Congo	325	-10	315	350	25	-250%	No
Saudi Arabia	10,633	-322	10,311	9,730	-903	280%	Yes
U.A.E	3,168	-96	3,072	3,060	-108	113%	Yes
OPEC 11	**26,749**	**-812**	**25,937**	**25,800**	**-949**	**117%**	**Yes**
Russia	**11,421**	**-230**	**11,191**	**11,110**	**-271**	**118%**	**Yes**
OPEC 11 + Russia	**38,170**	**-1,042**	**37,128**	**36,930**	**-1,220**	**117%**	**Yes**

Source: Bloomberg, Kenanga Research

Commentary: *Note that OPEC 11 does not include Iran, Libya and Venezuela as they were excluded from the production cut deal. Other non-OPEC members (aside from Russia) that have pledged an output cut that are not included in the table above includes Azerbaijan, Bahrain, Brunei, Kazakhstan, Malaysia, Mexico, Oman, South Sudan and Sudan, totalling to 1.2m barrels of crude oil per day of production cut from the Oct-2018 benchmark.*

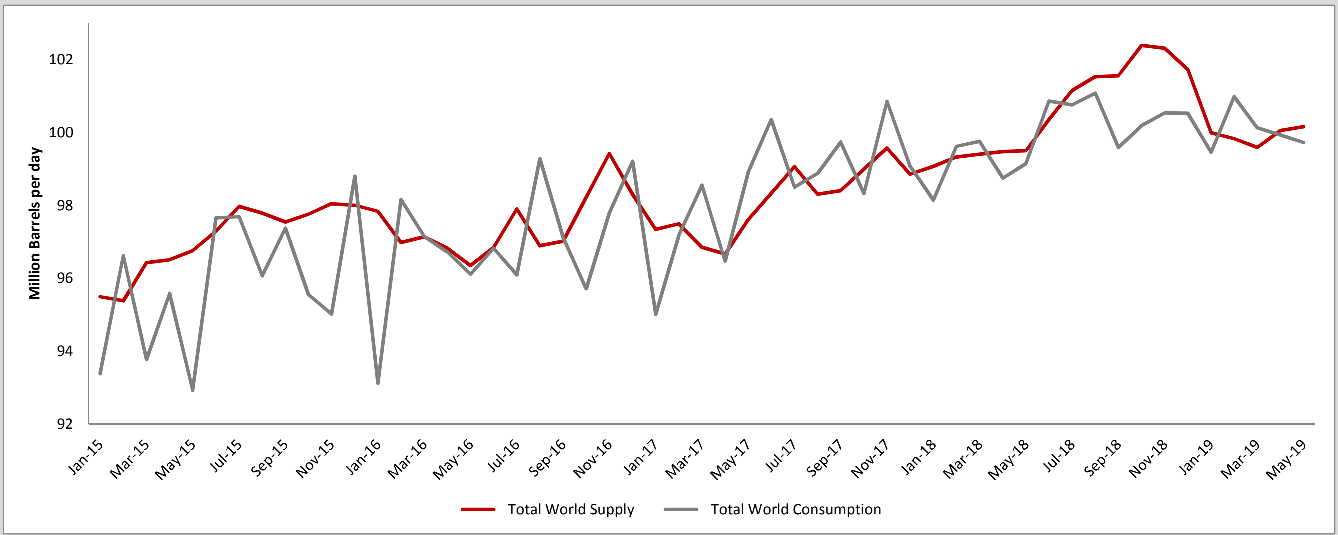
OPEC 11 and Russia's Production Cut Compliance in 2019



Source: Bloomberg, Kenanga Research

Commentary: *OPEC 11 had shown track record of compliance, having achieved >100% compliance since Feb-2019. Russia's compliance had been gradually increasing, reaching >100% in May-2019.*

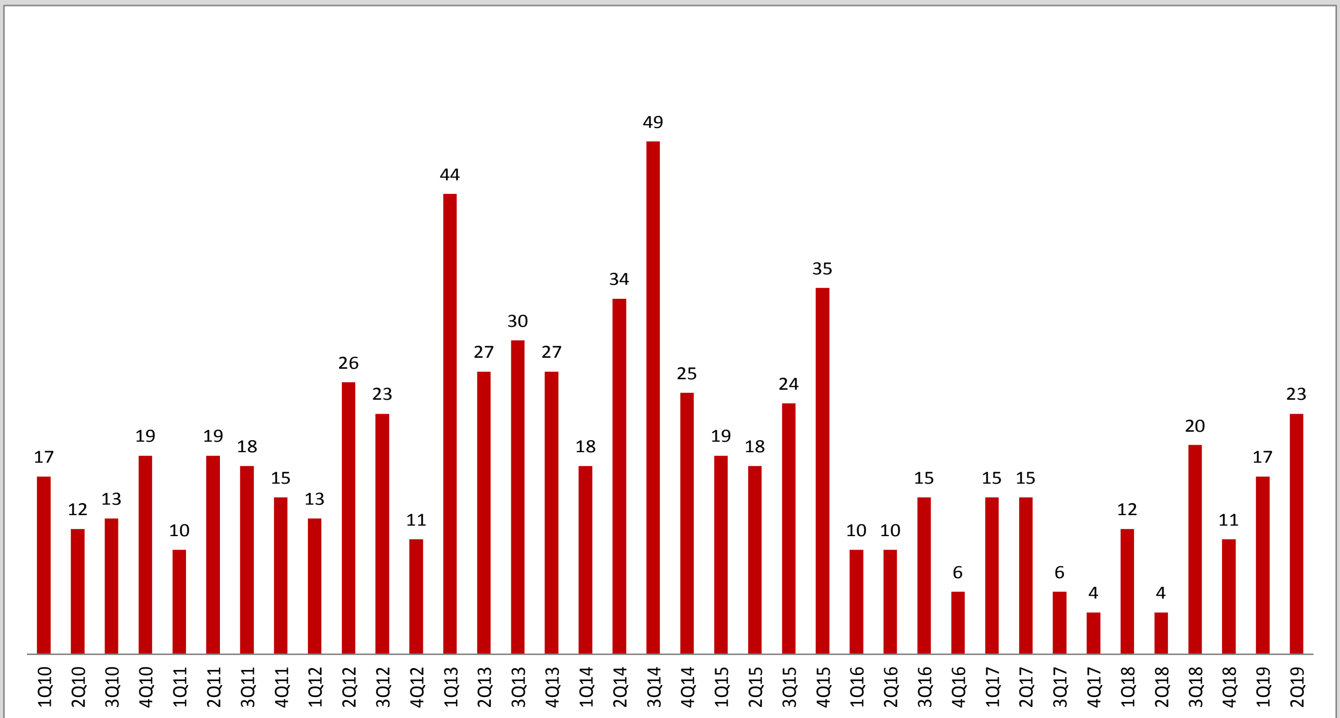
Global Crude Oil Supply vs Demand Trend



Source: EIA, Kenanga Research

Commentary: *As at May-2019, global crude oil demand stands at a slight oversupply.*

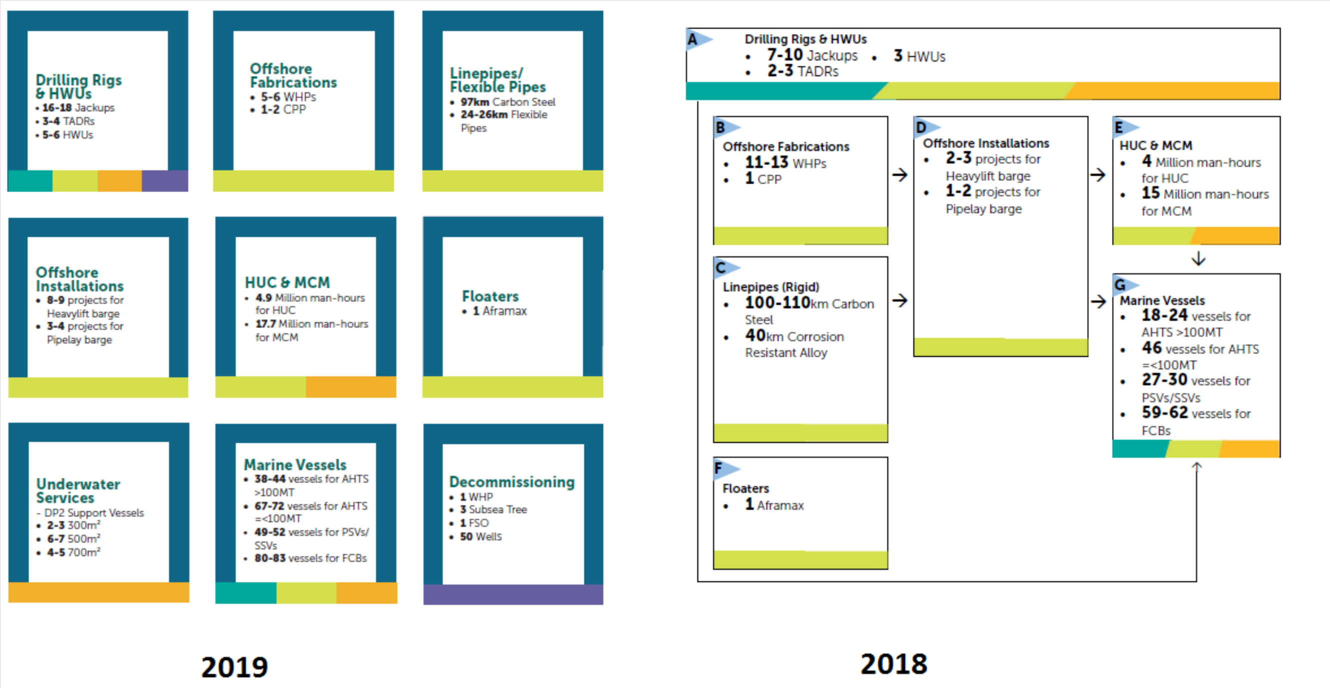
Number of Oil and Gas Contracts Announcements by Quarter



Source: Kenanga Research, Bursa Malaysia

Commentary: *Contract flows have started to pick up in the past several quarters, although have yet to repeat their highs as seen in 2013-2014.*

Petronas Activity Outlook 2019 vs 2018

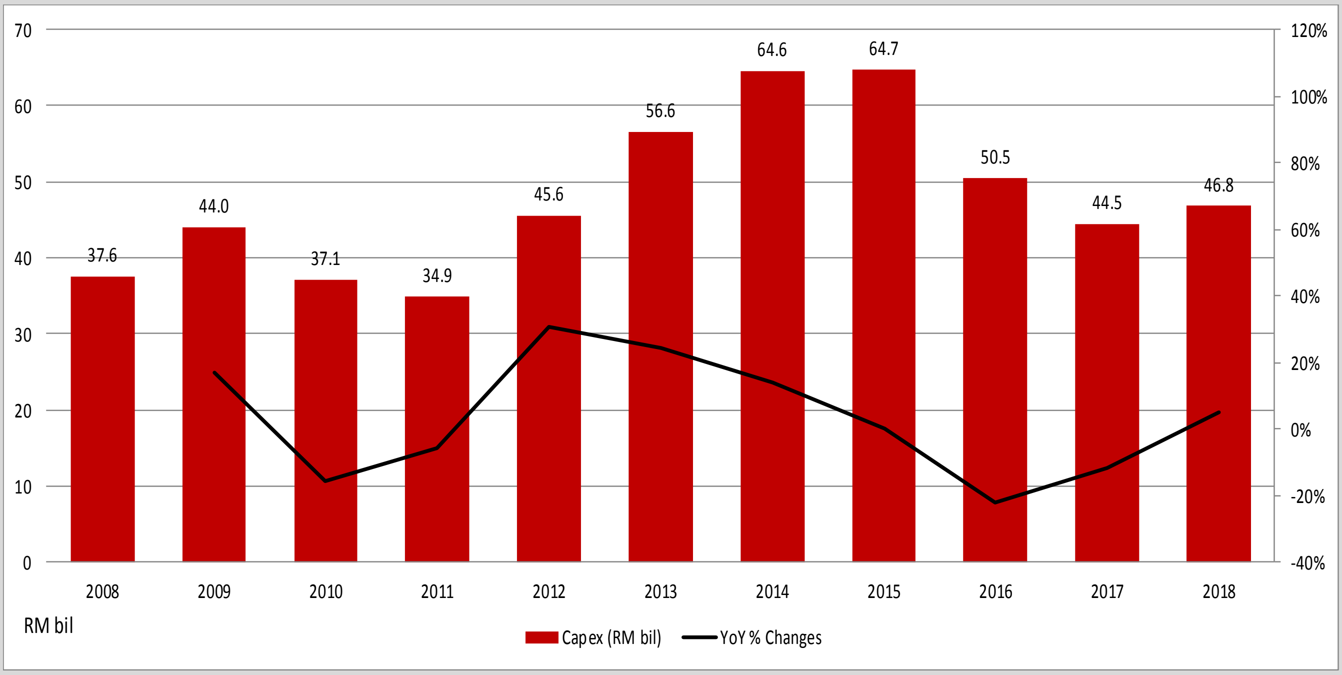


Source: Petronas

Notable points:

1. *Increased activities in (i) drilling, benefiting players like VELESTO, (ii) marine vessels and offshore installations, benefiting players such as ALAM, PERDANA, ICON, (iii) HUC & MCM, benefiting maintenance players such as DAYANG, (iiv) new decommissioning activities, benefiting players such as UZMA.*
2. *Possible decrease in offshore fabrications, affecting players such as SAPNRG and MHB.*

Petronas Yearly Capex Spend



Source: Petronas, Kenanga Research

Commentary*: Petronas expected to increase 2019 capex to >RM50b, of which ~RM30b will be for upstream.*

Peer Comparison

Name	Price	Market Cap	Shariah	Current	Revenue Growth		Core Earnings Growth		PER (x) - Core Earnings			PBV (x)		ROE (%)	Net Div.Yld. (%)	Target	Rating
	(RM)	(RM'm)	Compliant	FYE	1-Yr. Fwd.	2-Yr. Fwd.	1-Yr. Fwd.	2-Yr. Fwd.	Hist.	1-Yr. Fwd.	2-Yr. Fwd.	Hist.	1-Yr. Fwd.	1-Yr. Fwd.	1-Yr. Fwd.	Price (RM)	
BUMI ARMADA BERHAD	0.205	1,204.7	N	12/2019	14.3%	-19.8%	38.4%	2.2%	5.3	3.9	3.8	0.4	0.4	9.3%	0.0%	0.180	UP
DAYANG ENTERPRISE HLDGS BHD	1.18	1,138.5	Y	12/2019	22.2%	4.4%	-33.9%	9.1%	6.9	10.5	9.6	1.0	1.0	9.5%	0.0%	1.35	MP
DIALOG GROUP BHD	3.24	18,268.1	Y	06/2019	-22.9%	14.8%	10.1%	13.5%	42.6	38.7	34.1	5.2	5.0	13.2%	1.0%	3.80	OP
MALAYSIA MARINE AND HEAVY EN	0.700	1,120.0	Y	12/2019	-10.1%	-25.6%	845.5%	123.4%	N.A.	77.2	34.6	0.4	0.5	0.6%	0.0%	0.770	MP
MISC BHD	7.20	32,139.0	Y	12/2019	0.8%	-2.9%	21.2%	10.1%	24.3	20.1	18.2	0.9	0.9	4.6%	4.2%	6.65	MP
PANTECH GROUP HOLDINGS BHD	0.555	415.9	Y	02/2020	1.3%	5.9%	1.3%	6.4%	9.5	9.4	8.8	0.8	0.7	7.6%	2.9%	0.690	OP
PETRONAS CHEMICALS GROUP BHD	8.56	68,480.0	Y	12/2019	-9.8%	7.7%	-15.9%	17.0%	13.8	16.4	14.0	2.2	2.1	13.2%	3.1%	8.75	MP
PETRONAS DAGANGAN BHD	25.46	25,293.3	Y	12/2019	-5.6%	2.0%	33.0%	2.2%	30.2	22.7	22.2	4.3	4.1	18.4%	3.1%	24.95	MP
SAPURA ENERGY BHD	0.305	4,861.5	Y	01/2020	5.9%	20.7%	1875.6%	258.5%	N.A.	100.7	28.1	0.4	0.4	0.4%	0.0%	0.430	OP
SERBA DINAMIK HOLDINGS	4.08	5,991.5	Y	12/2019	18.6%	9.7%	12.2%	8.0%	15.6	13.9	12.9	2.9	2.5	19.4%	2.2%	4.80	OP
UZMA BHD	0.710	227.2	Y	06/2019	-24.3%	-0.1%	-86.0%	193.1%	4.4	31.6	10.8	0.5	0.4	1.5%	0.0%	0.760	MP
WAH SEONG CORP BHD	0.700	539.3	Y	12/2019	-47.7%	-7.7%	-18.8%	-18.1%	8.6	10.6	12.9	0.6	0.6	5.4%	0.0%	0.620	UP
YINSON HOLDINGS BHD	6.06	6,546.2	Y	01/2020	0.1%	70.2%	-7.1%	55.9%	24.9	26.8	17.2	3.8	3.4	13.5%	1.0%	7.75	OP

Source: Bloomberg, Kenanga Research

Note: Prices are based on our strategy cut-off date of 21 June 2019

Stock Ratings are defined as follows:

Stock Recommendations

OUTPERFORM	: A particular stock's Expected Total Return is MORE than 10%
MARKET PERFORM	: A particular stock's Expected Total Return is WITHIN the range of -5% to 10%
UNDERPERFORM	: A particular stock's Expected Total Return is LESS than -5%

Sector Recommendations***

OVERWEIGHT	: A particular sector's Expected Total Return is MORE than 10%
NEUTRAL	: A particular sector's Expected Total Return is WITHIN the range of -5% to 10%
UNDERWEIGHT	: A particular sector's Expected Total Return is LESS than -5%

******Sector recommendations are defined based on market capitalisation weighted average expected total return for stocks under our coverage.***

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