Regional Sector Update

4 July 2022

Energy & Petrochemicals | Regional Oil & Gas

Regional Oil & Gas

Overweight (Maintained)

Tight Supply To Stay; Keep OVERWEIGHT

Stocks Covered	16
Rating (Buy/Neutral/Sell):	12 / 3 / 1
Last 12m Earnings Revision Trend:	Positive

- **Maintain OVERWEIGHT; Top Picks: Petronas Chemicals, Bumi Armada, Yinson, PTT Exploration and Production and Bangchak.** Near-term oil prices should be supported by the continuously tight supply in the market. However, we maintain a conservative outlook, with a relatively lower YoY projection in 2023-2024, due to the higher possibility of economic slowdowns in that period.
- **We increase our 2022F Brent crude oil price to USD108/bbl from USD104/bbl, while keeping 2023-2024 projections at USD85/bbl and USD75/bbl.** We expect oil prices to average at USD110/bbl in 3Q22 and moderate to USD105/bbl in 4Q22. The higher adjustment reflects the continuously tight supply market in the near term, evidenced by low inventory levels and OPEC+ not meeting the production quota. At the recent 30^{th} OPEC and non-OPEC Ministerial Meeting, OPEC+ reconfirmed its pledge to raise production by 0.648mbpd in August, as what had been agreed upon in the previous meeting. Overall, OPEC's decision is likely to stay intact but supply should remain tight in 2H22 – as OPEC+ struggles to meet its production quota, casting doubt over the readiness of its spare capacity. Nigeria's output ramp-up plan could be offset by a gradual decline in Russia's production. With that, the Organisation for Economic Co-operation and Development (OECD) stock levels is likely to hover at current levels in the near terms, which is not far off from 2010-2014 averages.
- **Be aware of a global slowdown.** According to OPEC, global oil demand growth is still estimated at 3.4mbpd YoY to a total demand of 100.3mbpd for 2022F, premised on a global GDP growth of 3.5%. While we believe global oil demand is likely to strengthen QoQ as China relaxes its restrictions, crude oil prices could be dragged by increasing concern over global recession risks. For the time being, we think that the balance of risks is skewed towards a plain vanilla US recession, accompanied by a slow-down in global growth in 2023, but with limited risks of an economic or financial crisis environment arising in 2022-2023.
- **US production to accelerate in 2023.** Despite the strong rig count numbers, US production has only grown by 0.2mbpd to 11.9mbpd in the past six months. The slow ramp-up is widely explained by overall capital spending discipline amidst workforce and equipment bottlenecks, and the continuous decline in drilled but uncompleted (DUC) wells. This trend may change as the Energy Information Administration (EIA) expects US crude production to accelerate to 12.4mbpd in 4Q22 and grow by another 0.9mbpd to all-time high of 13.33mbpd in 4Q23.
- **Maintain OVERWEIGHT.** We believe that upstream service providers (drillers, maintenance-related) should benefit from a ramp-up in activities and increased domestic capex allocations, coupled with better service rates ahead. Exploration and production, selective refineries and petrochemical companies should continue to enjoy strong earnings, while riding on stronger product prices. Downside risks to our sector call: Weaker-than-expected crude oil and product prices, lower capex spending, and a slowdown in global economic growth.

Company Name	Rating	Target	% Upside (Downside)	P/E (x) Dec-23F	P/B (x) Dec-23F	ROAE (%) Dec-23F	Yield (%) Dec-23F
Bangchak Corp	Buy	THB39.00	24.8	7.8	0.8	11.2	5.3
Bumi Armada	Buy	MYR0.58	52.4	3.5	0.5	14.3	-
Dialog	Buy	MYR2.96	39.6	22.6	2.5	11.2	2.0
IRPC	Buy	THB4.50	39.8	10.0	0.7	7.6	6.2
Malaysia Marine & Heavy Engineering	Neutral	MYR0.42	9.1	26.1	0.4	1.4	-
MISC	Neutral	MYR7.79	9.4	16.0	0.9	5.8	4.6
Petronas Chemicals	Buy	MYR12.21	34.4	12.0	1.8	15.2	4.2
Petronas Dagangan	Neutral	MYR20.05	(4.3)	26.4	3.5	13.6	3.0
PTT	Buy	THB51.00	47.8	8.9	1.0	11.1	5.4
PTT Exploration & Production	Buy	THB165.00	3.8	12.9	1.4	11.2	3.1
PTT Global Chemical	Buy	THB73.00	60.4	8.1	0.6	7.5	5.5
PTT Oil and Retail Business	Buy	THB35.00	37.3	21.6	2.6	12.7	1.4
Sapura Energy	Sell	MYR0.02	(55.6)	na	na	63.0	-
Star Petroleum Refining	Buy	THB11.70	(3.3)	8.0	1.1	14.7	3.1
Thai Oil	Buy	THB68.00	30.1	9.3	0.8	8.9	4.8
Yinson	Buy	MYR2.83	44.4	4.8	0.7	15.7	3.1

Source: Company data, RHB

Top Picks	Target Price
Bangchak Corp (BCP TB) – BUY	THB39.00
PTT Exploration and Production (PTTEP TB) – BUY	THB165.00
Bumi Armada (BAB MK) – BUY	MYR0.58
Petronas Chemicals (PCHEM MK) – BUY	MYR12.21
Yinson (YNS MK) – BUY	MYR2.83

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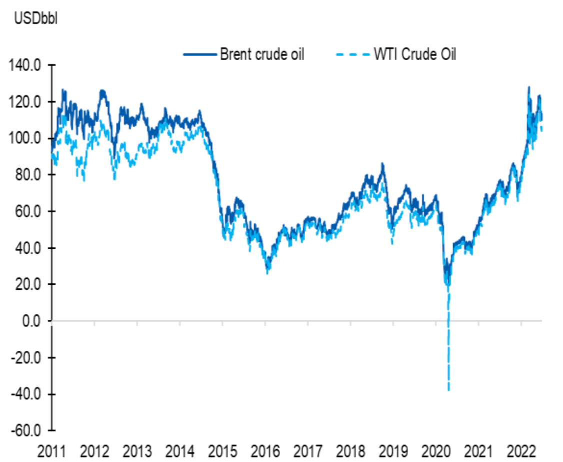
Brent and WTI prices



Source: Bloomberg

Crude Oil Price Forecasts

We increase our Brent crude oil price forecast for 2022 to USD108 per bbl from USD104 per bbl, while keeping 2023-2024 projections at USD85 per bbl and USD75.00 per bbl. 2Q22 QTD crude prices have averaged at USD114 per bbl, bringing the 1H22 average to USD107 per bbl. This is rather in line with our 2Q22 projection of USD115 per bbl. We expect oil prices to average at USD110 per bbl in 3Q22 and moderate to USD105 per bbl in 4Q22. The higher adjustment reflects the continuous tight supply in the near term, as evident by low inventory levels and OPEC+ not meeting the production quota. That said, we would like to stay conservative, with a relatively lower YoY projection in 2023 and 2024 at USD85 per bbl and USD75 per bbl. This is largely premised on a gradual increase in global supply and the higher possibility of an economic slowdown.

Our main assumptions are:

i. Global oil demand is projected to grow by 3.4mbpd to 100.3mbpd in 2022;

ii. The supply disruption from Russia continues in 3Q22-4Q22, but still higher than production guidance by its Finance Minister. With that, non-OPEC production is expected to improve by 1.8mbpd YoY to 70.6mbpd in 2022;

iii. While OPEC+ continues on its production ramp-up plan, we assume the production shortfall to gradually narrow to c.500kbpd from 1mbpd (currently) by 4Q22, following Nigeria's commitment to increase production. As such, OPEC production could increase from 28.3mbpd in 1Q22 to 29.1mbpd in 4Q22F, and average 28.7mbpd in 2022F. Such production levels are below than the pre-pandemic level of 29.4mbpd in 2019.

With the assumptions highlighted above, the theoretical deficit is estimated at 0.9mbpd in 2022. The struggle of OPEC+ ramping up production also casts doubt over the readiness of its spare capacity.

Figure 1: Demand and supply, and crude oil prices and forecasts

	2018	2019	2020	2021	1Q22	2Q22	3Q22F	4Q22F	2022F
Crude oil price (USD/bbl)									
Brent, RHB (new)	71	64	43	71	99	114	110	105	108
Brent, RHB (old)	71	64	43	71	99	114	100	100	104
Change					0	0	10	5	4
World oil demand and supply balance (mbpd)									
Total demand	99.1	100.3	91.0	96.9	99.3	98.2	100.9	102.8	100.3
YoY change	1.5	0.9	-9.1	5.7	5.2	2.6	3.2	2.5	3.4
Total non-OPEC	63.4	65.6	63.0	63.6	65.4	64.8	64.8	66.0	65.2
OPEC NGLs	5.3	5.2	5.1	5.3	5.3	5.4	5.4	5.4	5.4
Total non-OPEC +OPEC NGLs	68.7	70.8	68.0	68.9	70.7	70.2	70.2	71.4	70.6
YoY change	3.1	2.1	-2.7	0.7	2.9	1.6	1.3	1.3	1.8
OPEC	31.3	29.4	25.7	26.4	28.3	28.4	29.0	29.1	28.7
Total production	100.1	100.1	93.7	95.2	99.0	98.6	99.2	100.6	99.3
Balance	0.9	0.1	2.7	1.7	0.3	-0.4	1.7	2.2	0.9

Source: OPEC (as at June), RHB

Upside for crude oil prices rising above and beyond our revised forecasts could come from:

i. OPEC+ being unable to increase production on time;

ii. Global oil demand turning higher than expected;

iii. Unexpected geopolitical events heightening the risk premium.

Further downside to our crude oil price assumptions could stem from:

i. Weaker-than-expected crude oil demand if there is a full-scale lockdown in China;

ii. Higher-than-expected production from the US;

iii. Weaker-than-expected compliance from OPEC+;

iv. Slowdown in the global economy.

Global oil demand projection remains healthy

In OPEC's monthly report for Jun 2022, oil demand this year remains unchanged from last month. Global oil demand growth is still estimated at 3.4mbpd YoY to a total demand of 100.3mbpd for 2022, premised on a global GDP growth of 3.5%. OECD region is projected to have higher growth, at 1.8mbpd, than non-OECD regions' 1.6mbpd in 2022. Diesel and gasoline are expected lead the recovery among the petroleum products, driven by increasing mobility and robust industrial activities. Meanwhile, the demand for jet kerosene will also make a stronger comeback, on the back of increased global air travel activities. Meanwhile, the International Energy Agency's (IEA) June Oil Market Report showed a relatively lower growth projection of 1.8 mbpd in 2022 for global oil demand. However, IEA expects global oil demand to grow at a faster 101.6mbpd (or up 2.2mbpd) in 2023, surpassing pre-pandemic levels on the back of the recovery in demand from China, masking a weaker economic outlook.

Be aware of a global slowdown

In OPEC's monthly report for Jun 2022, OPEC still maintained its global economic growth forecast at 3.5% YoY. While we believe global oil demand is likely to strengthen QoQ as China relaxes its restrictions, there are increasing concerns over prolonged inflation leading to demand destruction in the longer run, and that the US economy could result in a hard landing. Indeed US recession risks in the next 6-12 months are being priced in by markets, and the potential spillover to the rest of the world. Going forward, it is inevitable that crude prices will also remain volatile, and sentiment could turn negative in response to that. For the time being, we lean towards the notion that the balance of risks is skewed towards a plain vanilla US recession, accompanied by a slowdown in global economic growth in 2023, but with limited risks of an economic or financial crisis environment arising in 2022 and 2023.

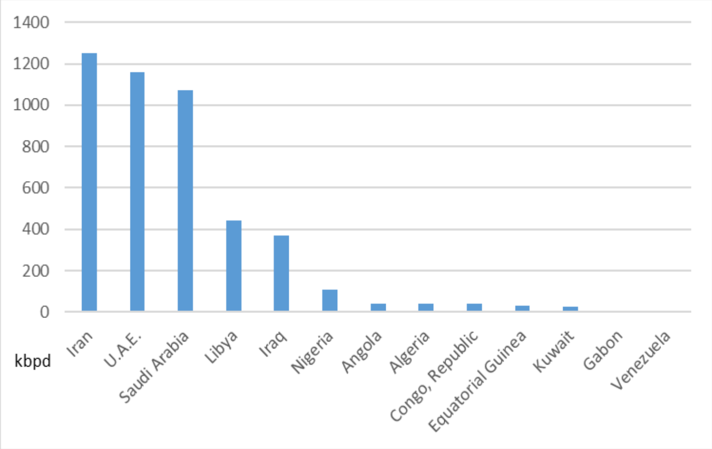
EU ban on Russian oil may be partially cushioned

The EU will ban seaborne imports of Russian crude oil starting December this year, and ban petroleum product imports by Feb 2023. We believe that the impact could be partially cushioned by stronger take-up rates from China and India leveraging on the discounted prices. It was reported that China ramped up crude oil imports from Russia by 55% YoY to 8.4 tonnes (equivalent to 1.98mbpd) in May, while Indian refiners bought 25m bbls (c.840kbpd) of Russian oil in the same month. Such a trend is expected to continue, and we do not discount the possibility of Russian oil being re-routed to Europe via India. Despite Russia oil production staying strong in May at 10.5mbpd, its Finance Minister Anton Siluanov projected that Russian oil output could decline by 17% to about 9.1mbpd in 2022, the lowest since 2004 due to this year.

OPEC+ struggles to meet its production quota

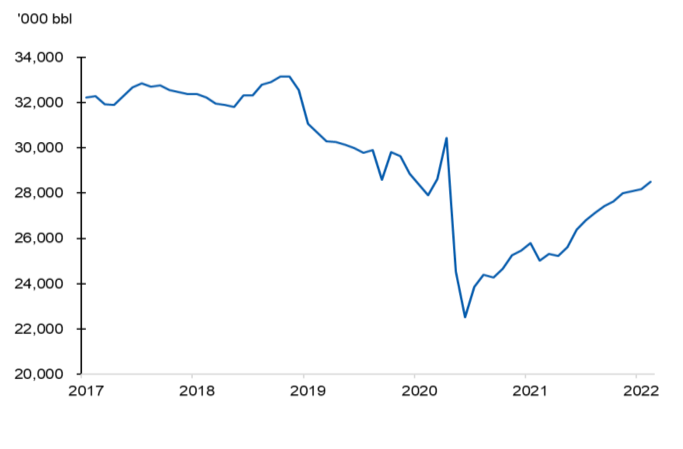
In early June, OPEC+ decided to accelerate the July and August production ramp-up quota to 0.648mbpd, by redistributing September's planned production adjustments equally over these two months. In the recently concluded 30th OPEC and non-OPEC Ministerial Meeting, OPEC+ reconfirmed that it will raise production levels by 0.648mbpd in August, as what had been agreed on, in the previous meeting. Overall, we believe OPEC is likely to stay intact but supply market is likely to stay tight as evident by the widening gap between OPEC+ output and its target levels to 2.7mbpd in May. OPEC-10's total production stood at 24.5mbpd in May, or 1.05mbpd lower than the production quota. Such a shortfall was mainly attributable to Saudi Arabia, Angola and Nigeria. Moving forward, Nigeria is trying to close the gap by increasing 500kbpd in the next two months, as stated by its oil minister, Timipre Sylva. The country is working with oil majors – including Shell, Chevron and ExxonMobil – to bring back production facilities online at the Niger Delta region. According to Bloomberg, OPEC's spare capacity stood at 4.6mbpd, with the United Arab Emirates and Saudi Arabia having the highest spare capacity among OPEC-10, at 1.2mbpd and 1.1mbpd.

Figure 2: OPEC's spare capacity



Source: Bloomberg

Figure 3: OPEC – crude oil production



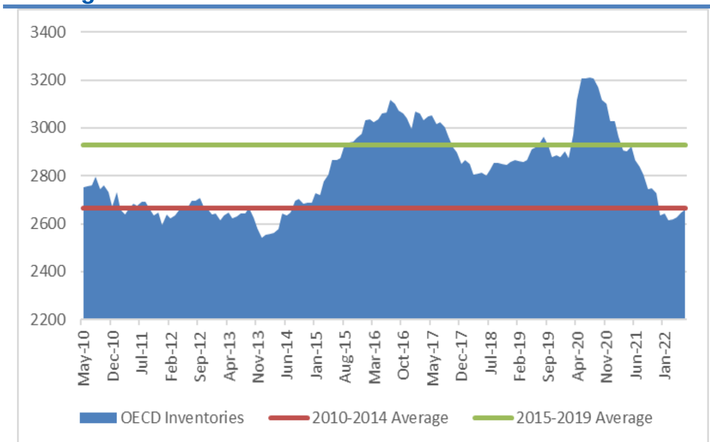
Source: Bloomberg

OECD inventories level are slightly above 2010-2014 levels

The IEA's June Oil Market Report highlighted that OECD industry oil stocks have increased by 77m bbl to 2.67bn bbl in April, or 290.3m bbl below its 5-year average. Preliminary data indicated that total OECD stocks grew by a further 6m bbl in May. Do note that the current levels have slightly surpassed the average inventory level in 2010-2014 level, in which oil prices are at average of USD102.00 per bbl.

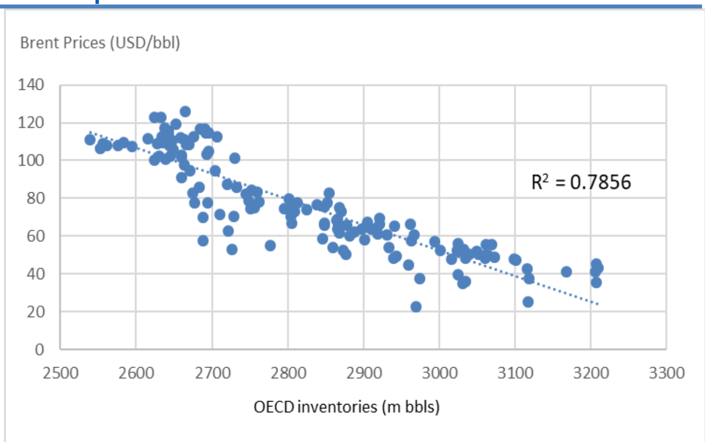
We find it difficult to ascertain OECD inventory levels in 2023, as there are multiple significant variables that could swing the outcome. On demand, a weak economic outlook – or, in the worst case, a recession – would bring down global demand significantly. On the other hand, Russia's production has been guided to decline in 2023, keeping supply tight. If we do not see OECD inventory levels to recover meaningfully in 2023, we may see further upside in our oil price projection. It is also then very much dependent on how strong US oil production can grow next year.

Figure 4: OECD inventories are slightly above the 2010-2014 averages



Source: Bloomberg

Figure 5: OECD inventory levels are strongly correlated with oil prices



Source: Bloomberg

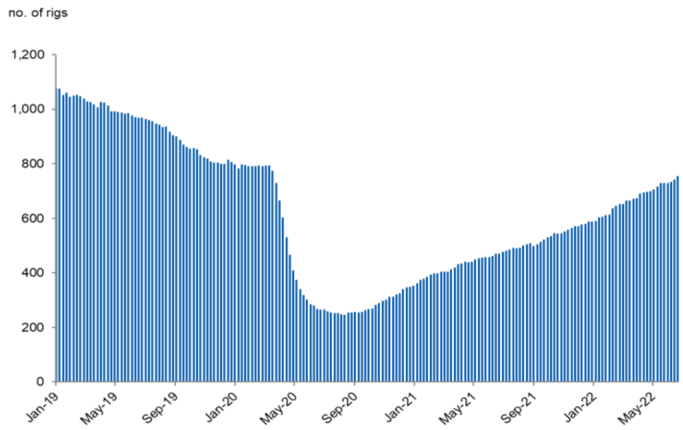
US production to pick up in 2023

The EIA expects US crude production to improve by 0.7mbpd YoY to 11.9mbpd in 2022, and continue to grow by c.1.1mbpd in 2023 – surpassing the previous average annual high of 12.3mbpd in 2019 to 13mbpd. This would make the US the producer that delivers the strongest output growth outside OPEC+ in 2022. In response to the high oil prices, the US rig count is still growing – it stood at 753 in mid-March, about 60% up from a year ago but is still a gap from the 900-1000 levels recorded in 2018-2019.

Despite the strong rig count numbers, US production increased by just 0.2mbpd on average, in 1H22. It was widely reported by the press that US shale oil producers are capping their capital spending to reward shareholders with only a single-digit production growth plan this year. Meanwhile, shale oil producers are also facing workforce and equipment bottlenecks in the near term even though oil prices have surged beyond USD100 per bbl. Recently, Reuters reported that re-fracking activities on existing shale wells have been picking up, to boost production without incurring huge capex in new wells (40% lesser than drilling wells). Re-fracking can be useful on those deposits where the shale produces low yields, as it may expand their productivity and extend their lifespan. However, we find this a short-term measure, and these low-hanging fruits could be reaped very soon.

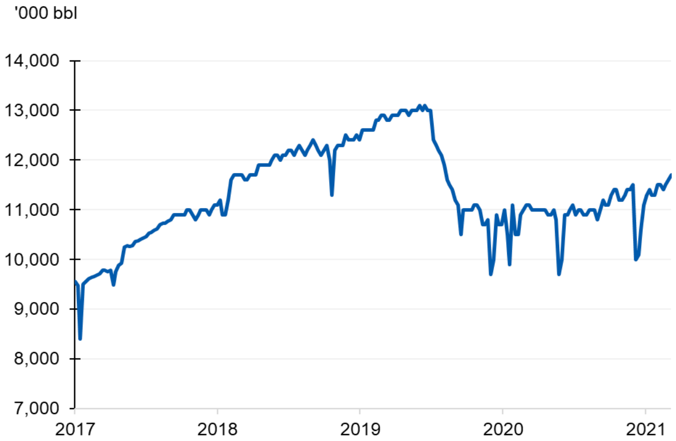
After all, we should be able to see overall US oil production growing at a faster pace next year, if the drilling momentum continues. Based on the EIA's latest Drilling Productivity Report, total DUC wells in US were still declining (-1% MoM), to a multi-year low of 4,249 in May this year. This means fracking is still picking up faster than drilling activities. However, the magnitude of decline has moderated – indicating that the DUC count could have bottomed in the near term.

Figure 6: US rig count



Source: Bloomberg

Figure 7: US crude oil production



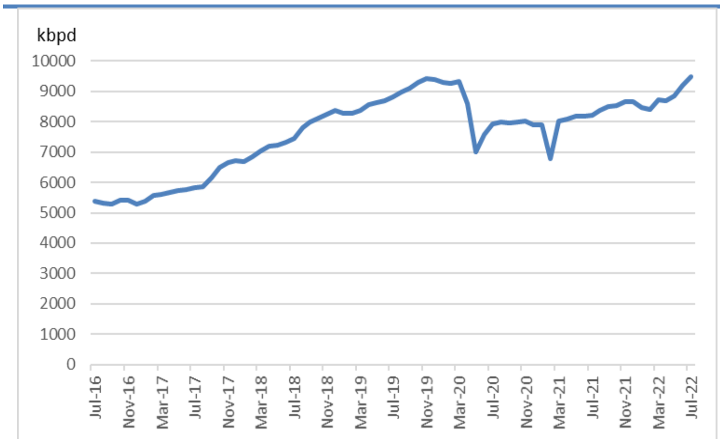
Source: Bloomberg

Figure 8: US annual oil production to accelerate in 2023

(mbpd)	2016	2017	2018	2019	2020	2021	2022	2023
US crude oil production	8.84	9.35	10.99	12.29	11.28	11.19	11.92	12.97
US crude oil production growth	-0.6	0.51	1.64	1.3	-1.01	-0.09	0.73	1.05

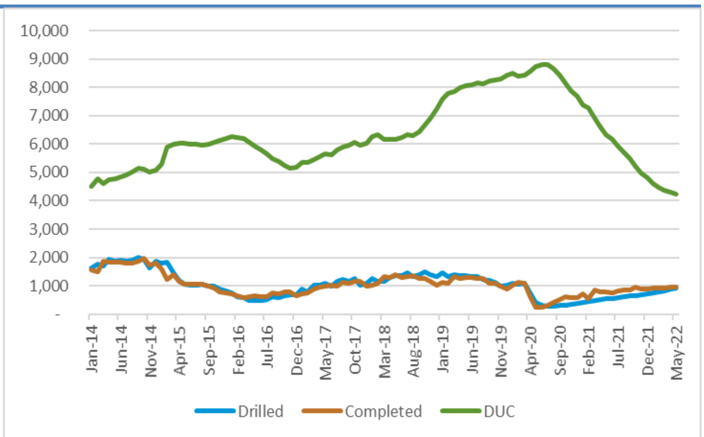
Source: EIA, RHB

Figure 9: US shale production



Source: Bloomberg

Figure 10: Newly drilled, completed wells and DUCs in the US



Source: Bloomberg

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