UOBKayHian

SECTOR UPDATE

Oil & Gas – Malaysia

Petronas 2022: Capex Still Needs To Play Catch-up; Opex Is A Risk

OVERWEIGHT

(Maintained)

Petronas' 2022 capex still fell short of the target by RM10b, partly due to the expensive energy transition capex allocation. Overall this implies >RM40b of O&G upstream/ maintenance capex gap to catch up. We remain bullish on the sector outlook, as Petronas' 2023 capex may exceed the RM60b target. However, sector valuations have priced in this expectation, but not the risk of rising opex. We suggest a narrower trading range, or invest in stocks with strong execution/earnings catalysts.

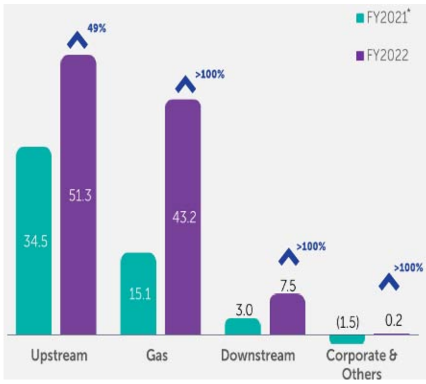
WHAT'S NEW

- **Petronas: 2022 FCF nearly doubled yoy to RM85b (2021: RM48b).** Petronas reported profits of RM102b (2021: RM51b), and a 51% surge in revenue to RM375b. This was mainly on the back of a 43% rise in average O&G prices (2022: US$101/bbl), while entitled O&G volumes and LNG sales rose yoy by 5-7%. The strong free cash flow (FCF) can support the RM50b dividend payment, while for 2023 the dividend expectation is RM40b.
- **2022 capex grew by 65% yoy to RM50.1b, still below 2022 guidance of RM60b.** Petronas said domestic capex increased by 24% yoy, which implies local capex of RM19b (2021: RM15b). Although Petronas' local upstream capex was not revealed, it said the industry local upstream capex surged to RM15b (2021: RM10.9b; out of this Petronas' share was RM8b). The surge in 4Q22 capex was expected, though this factored in a lumpy RM11.1b incurred on Petronas Chemical's (PCHEM) acquisition on Perstop (on EV basis). The capex rollout in our view remains disappointing, especially given our persistent sector theme that maintenance/production capex needs to be critically enhanced to ensure sustainable production. Petronas' CEO Tengku Taufik commented publicly a year ago that the ecosystem needed to catch up from the RM30b yearly capex level during the COVID-19 periods.
- **2023-27 capex p.a. at RM60b, including energy transition (2022: RM12.5b).** For 2020-1H22, there were very few new O&G discoveries, and part of the reason was Petronas' capex allocation needed to consider energy transition and expensive carbon capture technologies. Today, the asset transfers to the East Malaysian states are ongoing. Hence, 2023 is the year for Petronas to play catch up, and we reckon this is the key reason behind Petronas' revelation during the Malaysia Bid Round 2023 - that upstream capex for 2023 will be at around US$12.5b (~RM50b). If this guidance is met, 2023 upstream capex may almost double yoy, even though the overseas/local upstream capex mix is unknown.

ACTION

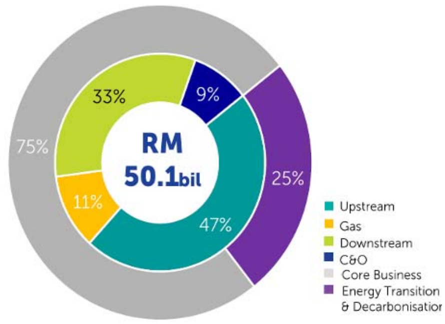
- **Retain sector OVERWEIGHT, but suggest accumulation at lower levels, or to invest in companies with clear earnings catalysts.** We still opine that OPEC+ coalition will manage a sustainable oil price level (consensus' 2023 view: US$87/bbl), and if any, there will be times when the sector's sentiment may benefit from rising O&G price movements (from ytd low of <US$80/bbl). We are still bullish on the sectors' outlook, but we also acknowledge that valuations had appreciated materially in the past few months, likely pricing in a pent-up/ higher levels of upstream maintenance activities. Earnings risk is still prevalent for some players: a) 1Q23 activity is slow, b) major contracts renewals, and c) whether the sector's margins have (or have yet to) adequately factor in full industry cost inflation (please see the next page).

PETRONAS: PAT BY SEGMENT (RM BILLION)



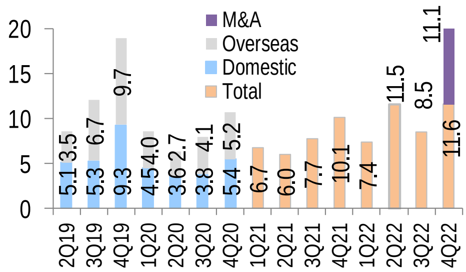
Source: Petronas

DETAILED BREAKDOWN OF 2022 CAPEX



Source: Petronas *Note: Acquisition of Perstop : RM11.1b

PETRONAS' CAPEX (RM BILLION)



Source: Petronas *No domestic/ overseas disclosure since 1Q21

ANALYST(S)

Kong Ho Meng
+603 2147 1987
homeng@uobkayhian.com

PEER COMPARISON

Company	Ticker	Rec	Share Price 10 Mar 23 (RM)	Target Price (RM)	Market Cap (RMm)	PE 2023F (x)	PE 2024F (x)	P/B 2023F (x)	P/B 2024F (x)	Interest Cover 2023F (x)	Interest Cover 2024F (x)	Net Debt to Equity 2023F (%)	Net Debt to Equity 2024F (%)	ROE 2023F (%)	ROE 2024F (%)
Bumi Armada	BAB MK	BUY	0.66	0.75	3,905.9	4.9	4.3	0.7	0.6	4.3	5.4	57.3	29.7	14.6	14.7
Dialog Group	DLG MK	BUY	2.38	3.00	13,429.3	28.2	23.8	2.8	2.6	14.9	17.0	8.6	9.7	10.3	11.2
Deleum	DLUM MK	SELL	0.98	0.82	393.5	12.1	10.4	1.0	0.9	110.1	76.6	n.a	n.a	8.2	9.1
MISC	MISC MK	BUY	7.25	8.60	32,362.2	14.9	14.9	0.8	0.8	7.1	7.4	34.1	33.1	5.7	5.6
MMHE	MMHE MK	BUY	0.69	0.80	1,104.0	17.0	24.8	0.6	0.6	15.0	12.3	n.a	n.a	3.6	2.5
Petronas Dagangan	PETD MK	HOLD	20.68	20.80	20,544.6	25.4	22.3	3.6	3.5	138.4	128.6	n.a	n.a	14.1	15.9
Sapura Energy	SAPE MK	HOLD	0.05	0.05	719.1	(3.0)	5.8	(2.6)	(4.8)	0.9	1.2	n.a	n.a	n.a	(58.3)
Uzma	UZMA MK	BUY	0.70	0.82	246.4	10.0	8.8	0.5	0.5	4.1	4.4	58.8	66.3	4.3	5.3
Velesto Energy	VEB MK	SELL	0.22	0.16	1,766.4	19.4	21.3	0.9	0.9	14.5	14.1	13.5	2.5	5.0	4.3
Yinson Holdings	YNS MK	BUY	2.57	4.45	7,469.7	12.2	9.7	2.3	2.1	4.6	5.6	110.0	101.8	13.1	15.4

Source: Bloomberg

- **Top Pick: Yinson (BUY/Target: RM4.45) is still a favoured long-term BUY** for the best execution, ESG goals, and highest future growth. We also nominate stocks with strong earnings support angle and contract catalysts, such as MISC Berhad (to benefit on more LNG newbuilds, and crude tanker rates remain strong ytd), Malaysia Marine & Heavy Engineering (MMHE) (strong new contract win prospects on the back of sustainable marine repair earnings), and Dialog (new storage terminals prospects, on the back of peak cycle spot storage fundamentals). We also like non-rated stocks like Dayang and T7 Global.

ESSENTIALS

- **Consensus oil price view at US$86/bbl to US$87/bbl for 2023-24**. Despite the Russian oil price cap, China's economic reopening had been lacklustre (please see paragraph below), and hence consensus is still expecting a mild global crude inventory buildup, ie world crude production (driven by non-OPEC supply increases) is forecasted to be slightly above world crude demand. We still believe OPEC+ supply management will reduce the price downside volatility, or keep oil prices above US$80/bbl. The recent oil price weakness was induced by increasing pressures of the Fed's rate hike. A higher breakeven oil price is necessary now in an environment of higher interest rates, and factoring in the expensive emission reduction investments for capital budgeting, to incentivise long-term O&G investments.

- **China's reopening did not give the expected impact of a big surge in demand.** Although jet fuel usage has surged given the recovery in tourism and global travel, the global petrochemical industry saw its fortunes reversing by end-22. According to ChemOrbis, China itself is set to welcome about >8MTPA of new polypropylene (PP) capacities for 2023, and 18% of which had come online in Feb 23. This gives rise to the issue of how China can manage massive capacity additions amid weak economic growth forecasts at only 5%. China's demand recovery sentiment was short-lived following the end of the zero-COVID policies in early-Jan 23, and polymer prices in the regions reverse the upward trajectory after the Chinese New Year holidays to a decline, barring any new developments of economic stimulus

  Another major chemical consultant (ICIS) believes the global chemical oversupply may hit 218m tonnes in 2023, which will be the highest oversupply since the 1990s. This is mainly due to massive China and Middle East expansion, as the cost-per-tonne economics may not be the sole major factor for such mega project approvals done in the past 10 years, if they can include value added manufacturing factors and transition the nations from a middle income trap. Sentiment for chemical players like PCHEM and Lotte Chemical Titan may be subdued in the near term. But also, this is a key risk that may affect oil price sentiment, as chemicals form a major part of oil demand forecasts.

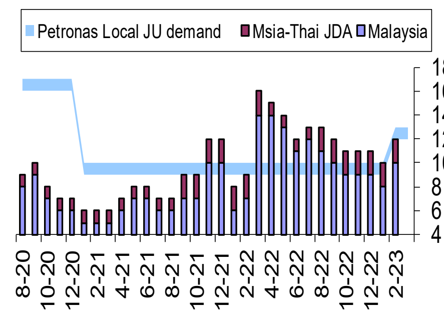
- **Petronas' 4Q22 EBITDA is lower qoq, at RM41b vs RM47b.** Even though the revenues were higher qoq, Petronas' downstream segment fell to a loss of RM1.9b in 4Q22 (3Q22: RM1b profit), as the chemical industry was seeing strains in price movements. More noticeably, three of Petronas' segments saw lower profit qoq. Other than the downstream segment, we were surprised to see lower profits qoq for upstream (4Q22: RM12b; 3Q22: RM16b) and corporate segments (4Q22: RM1.8b loss; 3Q22: RM2.2b). The corporate segment, which included MISC (Petronas's transportation arm), reported results that were entirely the opposite trend of the MISC (its 4Q22 EBITDA and profit beat consensus and our expectations). Higher opex was cited as the key reason for all three segments.

- **Opex increase is another uncertainty.** Petronas' group costs increased by 38% yoy to RM281b in 2022, but the industry opex increased by only 10% yoy to RM19b, and this is still within the usual RM17b-20b local upstream maintenance opex cited by Tengku Taufik (88% of the opex-related contracts are awarded to local players). The local upstream industry opex increase seems to merely match the production increase in 2022. This suggests that even though Petronas reported supernormal profits, it remains tight on opex management, and had been slow in renegotiating for higher service rates with its 4000 vendors. Petronas' capex commitment remains heavy for energy transition (ie Gentari), and overseas projects (ie the proposed US$10b Argentina LNG terminal). Many of the upstream maintenance long-term contracts are up for renewal in the 2023-24 horizon. However, we fear that as long as the service rates increase lag behind opex, the sector's margins have yet to adequately price in industry cost inflation (ie inventory and offshore manpower wages). If true, this may be an emerging earnings risk in the upcoming 2023 quarterly results

ENTITLED VOLUME GROWTH

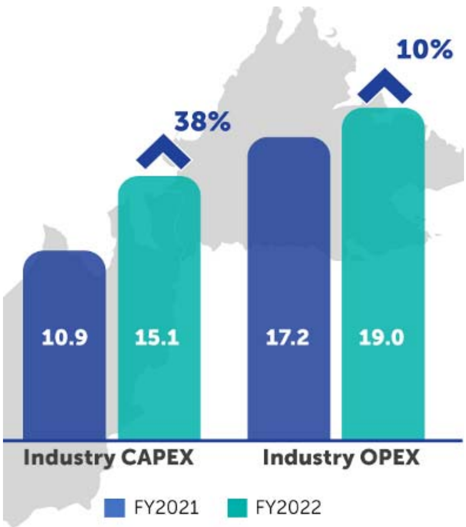
*Source: Petronas *Purple bar: Crude oil; Green bar: Gas*

MALAYSIA JACKUP (JU) RIG COUNT



Source: Westwood Global

UPSTREAM INDUSTRY COST CHANGES



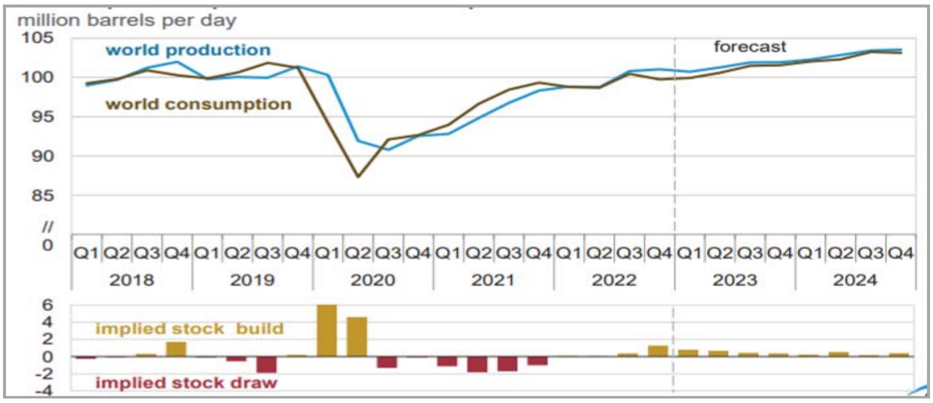
*Source: Petronas *Note: in RM Billion*

SOME OF MAJOR CONTRACTS UP FOR RENEWAL IN 2023

	Stocks
Pan Malaysia slickline	Deleum
Pan Malaysia Drill Bits and Hole Enlargement	Deleum
Pan Malaysia Drilling Fluids	Deleum
Pan Malaysia Integrated Well Services	Uzma, Velesto, T7 Global
Gas Lift Valves, Strings	Deleum
Jackup rigs, call-out	Velesto
Pan Malaysia Hook Up and Commissioning	Dayang, Carimin, Petra,
Integrated Turnaround for Mechanical Static	Dialog, Serba
Individual Maintenance, Construction and Modification	Deleum, Dayang, Carimin, Petra

Source: Petronas Activity Outlook 2023-25

WORLD CRUDE SUPPLY-DEMAND



Source: US Energy Information Administration (EIA) Short Term Energy Outlook, Mar 23 Edition

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