SECTOR UPDATE

Oil & Gas – Malaysia

Petronas Shows Signs Of Cost Increases And Structural Capex Shifts In 1Q23

Petronas' 1Q23 results show two key takeaways that reiterate our sector theme. It is increasingly focusing on scrutinising cost inflation (despite lower product costs). Secondly, its five-year forward local O&G capex reflects its decreasing local capex mix over time vs East Malaysian oil majors, and necessitates overseas expansion. Overall, we see higher activity levels, along with higher earnings volatility amid the structural changes. Retain OVERWEIGHT with selective investments.

WHAT'S NEW

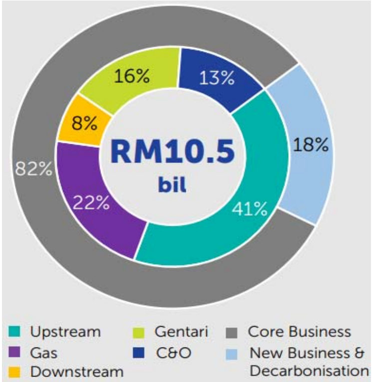
- **Petronas 1Q23 results: Margin compression due to cost increase.** It reported RM23.8b profit in 1Q23 (+1% yoy), on entitled production growth of 6%. Its lower EBITDA (-6% yoy to RM39b) and free cash flow (FCF) (-24% yoy to RM15b) are a direct result of the downtrend O&G prices since end-22, especially the downstream business. It highlighted in particular that group costs surged by 23% yoy to RM69b (domestic group costs: +35% yoy). This is across opex and repair and maintenance costs in anticipation of rising activities, under the operating environment of rising inflationary pressures and supply chain disruptions.
- **1Q23 capex review.** While the RM10.5b capex appears to show a high 42% yoy growth, note that 18% of the capex is for non-O&G/energy transition, which also includes Gentari's acquisition of the solar company Wirsol that likely costs RM1.5b. The actual upstream capex (for domestic and overseas) for 1Q23 of RM4.2b, is similar to 1Q22 levels, even though total domestic capex rose by 44% yoy "to foster local ecosystem".
- **Petronas' five-year local capex direction reflects its declining mix vs East Malaysian majors.** The most alarming information of all is that the forward 2023-27 domestic capex of RM113b (average: RM23b) appears to be lacklustre, against 2018-22 levels of RM101b (average: RM20b, but was RM25b p.a before the COVID-19 pandemic). Moreover, the plan is far lower vs Petronas' 2013-17 local capex of RM183b (average: RM37b). Petronas said the capex is to ensure energy security, but we are not surprised by this trend, as this reflects the inevitable transfer of Petronas' business in East Malaysia to majors like Petros and Sabah Maju Jaya, as dictated in the commercial settlement agreements.

ACTION

- **Retain sector OVERWEIGHT, but suggest a narrower trading strategy.** While activity levels will grow, overall, we also see increasing risks of earnings volatility among service players with heavy local contract exposure, arising from renegotiations of service rates vs costs inflation and structural changes in the local O&G industry. But we still see trading upside in the sector as oil price sentiment is expected to be stronger towards end-23 (Brent expectation: US$90/bbl). By balancing sentiment against risks, we suggest accumulation on bargain on stocks that have proven execution, or with specific earnings catalysts as below:

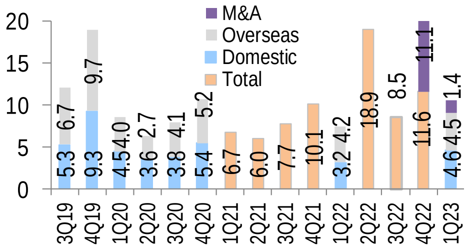
OVERWEIGHT
(Maintained)

DETAILED BREAKDOWN OF 1Q23 CAPEX



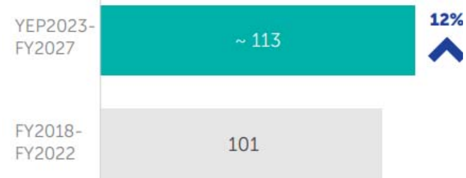
Source: Petronas

PETRONAS' CAPEX (RM BILLION)



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

PETRONAS: FIVE-YEAR DOMESTIC CAPEX



*Note: 2013-2017: RM183b
**Additional notes: Petros near-term capex is RM2b
Source: Petronas

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PEER COMPARISON

Company	Ticker	Rec	Share Price 6 June 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	SELL	0.49	0.40	2,870.3	5.1	4.7	0.5	0.5	4.3	5.4	59.6	36.0	10.6	10.6
Dialog Group	DLG MK	BUY	2.09	3.00	11,793.0	24.8	20.9	2.4	2.3	14.9	17.0	8.6	9.7	10.3	11.2
Deleum	DLUM MK	SELL	0.90	0.82	361.4	11.1	9.5	0.9	0.9	110.1	76.6	n.a	n.a	8.2	9.1
MISC	MISC MK	BUY	7.20	8.60	32,139.0	14.8	14.8	0.8	0.8	7.1	7.4	34.1	33.1	5.7	5.6
MMHE	MMHE MK	BUY	0.52	0.80	824.0	12.7	18.5	0.5	0.5	15.0	12.3	n.a	n.a	3.6	2.5
Petronas Dagangan	PETD MK	HOLD	21.36	24.70	21,220.2	19.9	19.0	3.6	3.5	138.4	128.6	n.a	n.a	18.3	18.8
Sapura Energy	SAPE MK	HOLD	0.04	0.05	639.2	(3.6)	(2.3)	(0.7)	(1.0)	0.9	1.2	(681.2)	(665.2)	n.a	n.a
Uzma	UZMA MK	HOLD	0.66	0.68	232.3	8.7	9.5	0.5	0.5	4.1	4.4	57.3	100.3	5.2	5.1
Velesto Energy	VEB MK	HOLD	0.23	0.21	1,848.5	20.3	22.3	1.0	0.9	14.5	14.1	13.5	2.5	5.0	4.3
Yinson Holdings	YNS MK	BUY	2.55	4.05	7,411.9	11.4	9.7	2.0	1.8	4.6	5.6	144.1	155.9	12.6	13.9

Source: Bloomberg

- **Top Pick: Yinson (BUY/Target: RM4.05) is still a favoured long-term BUY** for the best execution, ESG goals, and highest future growth. For near-term trading picks, we also like MISC (to benefit on more LNG newbuilds, and strong crude tanker earnings), MMHE (strong new contract win prospects and sustainable marine repair earnings), and Dialog (new storage terminals prospects, on the back of peak cycle spot storage fundamentals). Other non-rated stocks that appear to have better execution ability or catalysts, include T7 Global (benefitting from new demand of mobile offshore production platforms) and Dayang Enterprise (Sarawak's largest maintenance O&G player).
- **Bumi Armada remains as a SELL.** Given the lack of immediate updates especially from Enquest, the client of Kraken, we assume the FPSO shut-in will be prolonged. We cut our target price further by RM0.10/share to assume additional costs that cannot be recouped.

ESSENTIALS

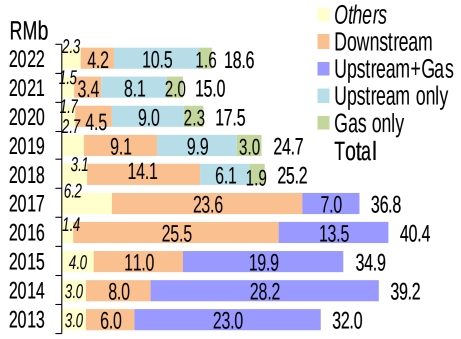
- **OPEC+ policy appears to be effective to meet its main goal of limiting price volatility,** which is also crucial to protect the security of its energy supply to customers. Consensus oil price view is still stable at US$86/bbl and US$85/bbl for 2023-24, vs about US$87/bbl three months ago. Oil price is expected to increase from current levels to US$90/bbl by end-23, implying that global crude inventories should be tightening towards end-23, but it is unlikely to surge beyond US$100/bbl given the ongoing weakness in the global economy. Hence the OPEC+ coalition surprised the market again recently, as Saudi Arabia added on to its 0.5m bpd voluntary production cuts, with another 1m bpd for July, but these cuts can be extended later if required. This brings total OPEC+ curbs to 4.7m bpd for July, close to 5% of world supply.
- **The "Saudi lollipop" is a direct message of OPEC's reassurance to its customers**. The Saudi Energy Minister dubbed this decision as a "Saudi lollipop". Platts reported that the major Asian refiners do not expect their term crude allocations from Saudi to be cut. The refiners observed that the surge in US crude exports, and resilient Russia crude flows in recent months were mainly absorbed by India and China. This means the refiners generally viewed that the Saudi's extra 1m bpd of cuts simply reflected its weaker sales to China and India. Hence, this also goes to show the extremes OPEC+ will go to be more reactive to dynamic market situations, and ultimately listen to its refinery customers to "do whatever it can to stabilise the market". This is especially because refiners like HengYuan had in the past suffered huge losses due to mismatch in hedging its feedstock costs especially in highly volatile periods.
- **Our sector theme on the key risks (rising opex levels) is reiterated by Petronas' message.** While Petronas said the costs increase is in anticipation of higher activities, do note that that pent-up activity level was also a key driver in 2022 (post-pandemic-peak period). But at that time product and material costs surged due to the Russia crisis, yet the local upstream industry's opex grew by only 10% yoy to RM19b in 2022. For 1Q23, we observed that product costs, classified by Petronas as "strategic actionable costs", had eased from 2022's high, but "operational actionable costs" ie costs related to procurement and manpower, had surged. Hence, this suggests that for 2023, Petronas will intensify its recalibration of opex base, especially since there is a strong need from its vendors to renegotiate upwards the service rates, which are already lagging behind market rates.
- **Petronas revealed several pieces of important information on its five-year forward capex**. The forward 2023-27 domestic capex of RM113b (average: RM23b) appears to be lacklustre, against 2018-22 levels of RM101b (average: RM20b, but was RM25b p.a in 2018-19, ie before the COVID-19 pandemic). Moreover, the plan is far lower vs Petronas' 2013-17 local capex of RM183b (average: RM37b). This new information may alarm investors, but we are not surprised by this trend, as this reflects the inevitable transfer of Petronas' business in East Malaysia to majors like Petros and Sabah Maju Jaya, as dictated in the commercial settlement agreements.
- **Part of its 3-Pronged Growth (3PG) Strategy,** this is also aligned to our sector theme that Petronas will inevitably be more focused on channelling overseas capex (as there was a huge boost in 2022 overseas upstream capex), and ultimately boost its long-term LNG market share from the current 32 MTPA capacity to 55 MTPA capacity. At the same time, Petronas

PETRONAS UPSTREAM AND GAS CAPEX

	2016	2017	2021	2022
Total	22.3	14.8	21.8	28.2
Total upstream	*22.3*	*12.1*	*14.7*	*22.7*
Domestic	13.5	7.5	10.1	12.1
- Upstream	Na	5.5	8.1	10.5
- Gas	Na	2.0	2.0	1.6
Overseas	8.8	7.3	11.7	17.1
- Upstream	Na	6.6	6.6	13.2
- Gas	Na	0.7	5.1	2.9

Source: Petronas Integrated/ Annual Reports

PETRONAS LOCAL CAPEX *



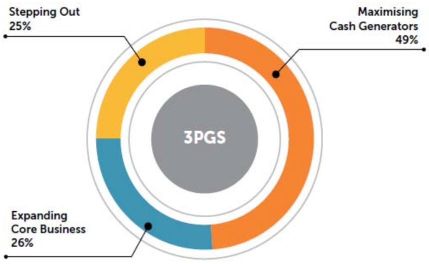
**Note: Gas became standalone segment eff 2018 accounts*
Source: Petronas Integrated/ Annual Reports

PETRONAS COSTS ANALYSIS

	1Q23	2022	2021	2020
Total	68.6	280.7	202.0	204.2
- % of revenue	*76%*	*75%*	*81%*	*114%*
Strategic	*52.1*	*226.9*	*158.5*	*163.2*
- Product costs	31.6	123.0	81.9	63.6
- Tax, SST, duty	11.6	56.2	33.6	33.5
- Non price sensitive (D&A)	8.9	50.7	43.0	78.6
Operational	*16.4*	*53.8*	*43.5*	*41.0*
- Procurement	8.9	24.9	20.5	23.9
- Other opex	7.5	28.9	23.0	17.1

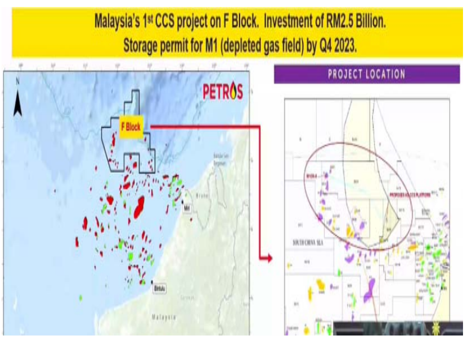
Source: Petronas Integrated/ Annual Reports

PETRONAS 3PG STRATEGY



Source: Petronas Integrated Report 2022

KASAWARI CARBON CAPTURE

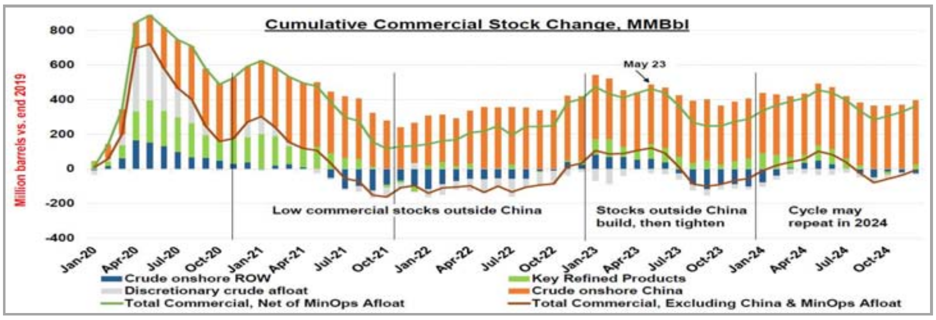


Source: Petros

also envisions its long-term capex to have 25% allocation towards non-O&G and transition, which is higher than the previously guided 20%. Hence, assuming most of the Malaysian businesses can be viewed as business-as-usual projects under the 49% allocation in its 3PG strategy, the traditional local O&G service contracts will also fall over time, and it will be increasingly crucial for service players to adapt to the new capex direction to remain relevant.

- **For example, Petros recently revealed a RM2b capex commitment**. This is mainly for the investment of a new gas power plant in Miri as part of the Sarawak Gas Roadmap ambitions, targeted for 4Q23 sanction. Petros also quoted a figure of RM2.5b capex for the first offshore carbon capture project (Kasawari) along with the depleted M1 gas field (for carbon storage). Though we are unsure if this capex is part of the RM4.5b value of the platform currently being fabricated by Malaysia Marine and Heavy Engineering (MMHE).

WORLD CRUDE INVENTORY MOVEMENTS WILL LIKELY HAVE REDUCED VOLATILITY



Source: Platts

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