GOOD TIMES FOR OIL AND GAS FIRMS

Rising fuel prices will lead to more tenders and contracts.

By Ishak Ahmad

WHEN Petroliam Nasional Bhd (Petronas)'s financial year-end results were announced last month, its President and Chief Executive Officer Tan Sri Mohamed Hassan Marican relayed concerns that rising costs in the oil and gas sector could dent the state-owned company's future earnings.

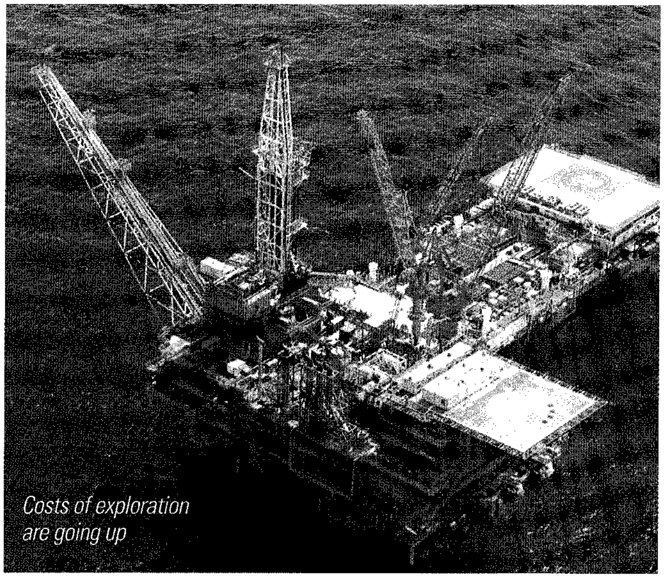
According to him, the cost for oil and gas services has skyrocketed by between 50% and 80% due to the rising cost of materials and human capital.

He added that this has caused delays in some projects and made others economically unviable. The crux of the matter, he argued, was that the cost of doing business in the oil and gas industry is definitely on an upswing.

But he failed to tell the other part of the argument. The record profits oil majors like Petronas are handsomely enjoying are because crude oil prices are hitting their all-time highs, hovering over US$ 70 (about RM252) per barrel, which is more than twice what it used to fetch a few years ago.

This compares to an average of producing crude oil of between US$ 10 and US$ 25 per barrel which translates to a huge profit margin for oil majors, say industry players.

'The breakeven price of production to the oil majors are well below current price levels of above US$ 70 per barrel. Depending on the location of the production field, prices need only to be above the range of between US$ 10 and US$ 25 per barrel for profits to be made by the oil majors - US$ 70 is still a long way ahead to make the economics unattractive for production,' an industry player says on the condition of anonymity.


Costs of exploration are going up

He adds that the pace of exploration and production (E&P) activities undertaken by oil majors worldwide has placed constraints on infrastructure and yard capacity and premiums on services, wages, materials and other input costs of production in the sector.

Industry players say price increases of steel, wages and services have translated to higher costs of production to the oil majors.

Nevertheless, they stress these factors have not inhibited the growth of E&P activities. This is due to speculative activities by oil dealers and traders, which provide a forward looking scenario of price levels as well as introducing further uncertainty to prices, thus placing further premiums on these traded benchmark products such as Brent and Tapis.

New technologies, designs and techniques used in E&P, they add, would further reduce risks and cost of finding oil and push E&P activities to greater heights, especially in areas deemed non-economical, difficult or too risky.

Another is the strong demand side factors, including developed countries' consumption, growth in China and India as well as stockpiling by the major economies. These will continue to ensure a permanent regime of high oil prices seen today and may even push price levels towards US$ 100 per barrel in the not too distant future, they speculate.

It is not suprising that the oil and gas sector has been very robust in the past few years ever since the price of crude oil skyrocketed.

Billion-ringgit projects from upstream and downstream activities changed hands in the sector in this period. Much more is expected in the coming years.

However, industry players say service providers have one big problem in this rising cost environment.

As pricing for projects is fixed during tender bids and not priced over time, they say players sometimes get caught when they price too low for projects due to inaccurate costing.

'Sometimes, these players purposely bid lower to win tenders for projects and would carelessly misjudge future cost increases in material costs.' This, coupled with the inadequate hedging for material increases, is a recipe for disaster and will result in losses rather than profits for the players if they are not careful,' says an executive from a local oil and gas concern.

Overall, industry players, analysts and investors alike are abuzz on the outlook for the sector, despite the escalating costs on the back of sustained high crude oil prices.

This will ensure hefty profits for oil majors

HOW OIL AND GAS STOCKS STACK UP AGAINST ONE ANOTHER

Company	FV (RM)	PE (x) FY05	PE (x) FY06	EPS Growth (%) FY05	EPS Growth (%) FY06	Price/NTA (x)	MarketCap (RM Mil)
KNM	6.40	20.5	16.0	171.0	28.0	5.4	856.5
TGOFFS	2.81	13.3	16.1	(16.0)	(17.0)	3.0	235.5
SAMUDRA	1.47	n.m	9.3	(175.7)	265.8	1.4	96.8
PERISAI	1.38	15.1	12.9	264.4	16.9	9.0	260.0
PETGAS	9.60	21.3	17.4	28.2	22.3	2.6	17,511.5
DIALOG	0.57	22.3	18.7	-13.1	19.3	2.5	730.7
EPIC	1.66	118.9	20.0	-90.6	494.6	0.9	262.4

Source: OSK Research

and service providers in the years to come.

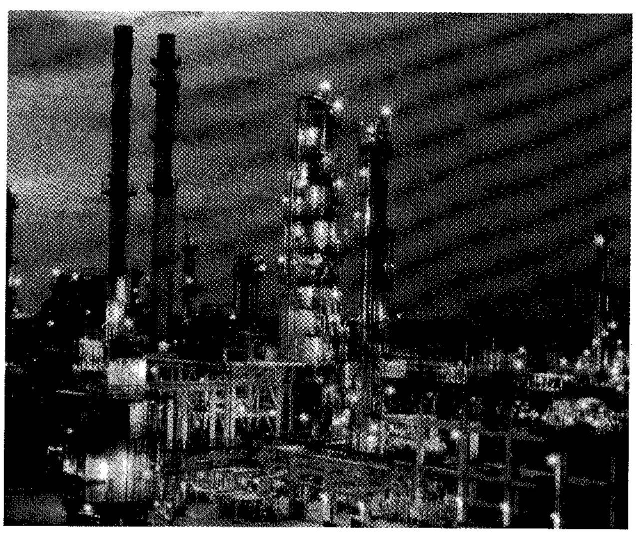
OSK Securities' analyst Chris Eng Poh Yoon says the rising cost is actually good for the local oil and gas players, who are mainly service providers, in terms of being able to charge higher prices for their products and services due to strong demand.

He estimates this will lead to increased profit margins for local players by at least 5% to 10%, depending on the cost structure of individual players.

Eng favours KNM Group Bhd for its strong international exposure and good branding. He adds KNM has always been able to exceed profit forecasts with demand for its services remaining strong.

As for Tanjong Offshore Bhd, he says the company is well run and has a lot of growth potential. Another company that he is overweight on is Dialog Group Bhd that continues to garner strong demand for its oil exploration services like oil drilling.

Eng sees the share prices of these companies appreciating as more contracts for the sector are expected to roll in the near future.



'Generally I am very positive on the sector due to its robust growth prospects backed by the high price of crude oil. Local players who have established good networking internationally will be the better ones,' he adds.

OSK Securities is overweight on the sector. In its latest report, it says among the beneficiaries from an expanded drilling programme will be Scomi Group Bhd, which supplies drilling mud, and Dialog which acts as an agent for the base oil for the drilling mud.

SapuraCrest Petroleum Bhd will also benefit from more platform hook-ups and commissioning contracts for new platforms, as well as more demand for its drilling rigs.

Kejuruteraan Samudra Timur Bhd will benefit from more demand for its services related to downhole fishing and tubular services.

As for the marine players, Scomi Marine Bhd, Petra Perdana Bhd and Tanjong Offshore will benefit from more demand for their marine vessels.

On the downstream side, it says KNM will benefit from the need for refineries to refurbish their equipment to meet the greater demand for lighter products.

According to the report, the era of cheap oil is over, with good times in store for Malaysian oil and gas companies. As the country seeks to develop its deepwater fields to maintain its current production levels, increased services will be required from Malaysian oil and gas companies.

It says companies involved in refineries stand to gain as refineries seek to upgrade their equipment to handle the increased complexity required, and so more equipment and services will be required.

'Overseas forays by national oil companies will continue and companies like Petronas will continue to break into the territories originally held by international oil companies. For the service providers, who can leverage upon this geographic expansion successfully, the rewards will be there,' the report says. mb