KGI CHINA DEVELOPMENT FINANCIAL

Oil & Gas Sector

CNOOC (883 HK)

Bottom fishing for cyclical stocks: Part 1

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"A cyclical is a company whose sales and profits rise and fall in regular if not completely predictable fashion...in a cyclical industry it expands and contracts, then expands and contracts again…Coming out of a recession and into a vigorous economy, the cyclicals flourish, and their stock prices tend to rise much faster than the prices of the stalwarts." ——Peter Lynch, "One Up on Wall Street: How to Use What You Already Know to Make Money In"

- CNOOC (883 HK) is our top pick among the big oil companies. We expect it to recover to its 5-year P/B average of 1.0x, implying a fair value of HK10.04. This represents a total potential upside of 21%, comprising of 17% capital gains and a 3.5% forecasted dividend yield in FY2020F.

We are in the gutter

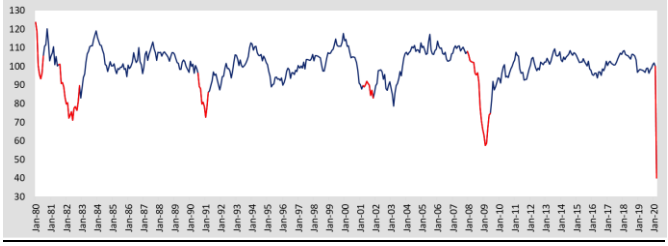
Not only is the US the top GDP contributor, dominating the global economy (15.1% as of 2019), but the country also imposes substantial impact on the world's order with its internal and external policies in the fields of finance, military, and diplomacy. Therefore, we take the US economy and market as the benchmark for analysis.

Before parking their capital into the market, investors should have a big picture on where the economy's current position is in. The COVID-19 pandemic has resulted in a worldwide recession since March 2020, and the ripple of its disruptive impact is still unmeasurable and uncertain at the moment. The macroeconomic data in March, such as GDP growth, non-farm payroll, PCE, and PMI have indicated the start of a deteriorating economic condition in the US.

According to the CEIC leading indicator* (US) which provides early signals to the turning point of the economic cycle, the US is clearly in a recession. The implication for investors after going through the rapid and sharp indiscriminate sell-off in March and the hefty recovery in April is that we are nowhere near the end of the down-cycle, but just embracing its unexpected arrival which shocked most professionals and amateur market participants who had gotten used to the prolonged bull cycle after the GFC in 2008.

Based on the record of the past five US recessions, a recession generally ends two months after the index forms a bottom. Except for the S&P 500 Index which has established a bottom, the rest of the components that were published were worse off than the March level. Therefore, the seeming market bottom in March is way too ahead of the economic bottom. In other words, we have not passed the cyclical trough.

Figure 1: CEIC Leading Indicator index for US



100 is the neutral level; Red line: US economic recession

Source: CEIC, KGI Research

**The components of the leading indicator are shown below:*

1.	Housing Market Index
2.	Consumer Confidence Index
3.	S&P 500
4.	PMI
5.	Federal Funds Rate
6.	Motor Vehicle Sales
7.	Initial Jobless Claims
8.	Average Hours Worked
9.	Capacity Utilization
10.	Building Permits
11.	Inventories to Shipments Ratio
12.	New Orders

The nature of the economy and businesses is driven primarily by supply and demand. Measures being taken such as the lockdown of cities, restriction of traffic, and implementation of social distancing have significantly reduced the demand for non-essential goods and services. Hence, almost every industry is impacted by this global public health crisis. However, there is one sector that was impacted the most due to the deliberate dislocation of the law of supply and demand; boosting supply even when demand was plunging. And that industry is oil!

Reaching the trough of the oil cycle

Less than month after Saudi Arabia started the price war in early March, oil prices (WTI) created a new record in history by falling to negative territory. The oil glut has never been this high before. According to the International Energy Agency, the global demand for oil is estimated to have plunged by almost 29mn bbl/d in April and by 23mn bbl/d (-23% YoY) in 2Q20 while the supply of oil only dropped by 10.7mn bbl/d in April. The gap (supply over demand) could reach more than 12mn bbl/d in 2Q20. Another institute, the US Energy Information Administration also shares the same view regarding the current oil market dynamics.

April's excessive supply (15mn bbl/d) tripled from the level back in January 2016 when oil prices dropped below US$30/bbl (the last time oil price traded below this level was in October 2003). Oil market has been maintaining a

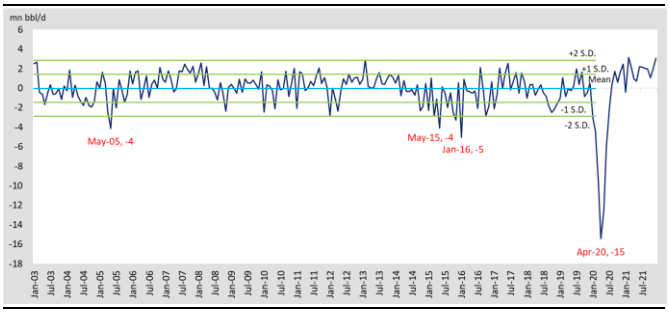
statistically normal range of supply-demand dynamics until March 2020. April 2020 or the full year of 2020 could be the outlier of cycles when the imbalance is unprecedentedly huge.

The message we are trying to deliver is that the downswing of the economic cycle could have pushed oil to the trough. Negative oil price was a phenomenal event, and this sent a vital signal to every participant in the oil market. If the parties with vested interest such as oil producers, trading houses, and storage and transportation providers deem the glut sustainable, their dominant positions in the market will be damaged sooner rather than later.

As the whole industry operates with high leverage and deals with massive amount of oil, the sensitivity to oil price movement is the highest when the price level is hovering around the breakeven levels of the business. The zero-sum game that the major oil exporters are in turns into everyone's losing game. There is no doubt why OPEC+ reunited to come up with a new round of an output cut deal in April, a stark comparison to a month ago when they were trying to flood the market with more oil.

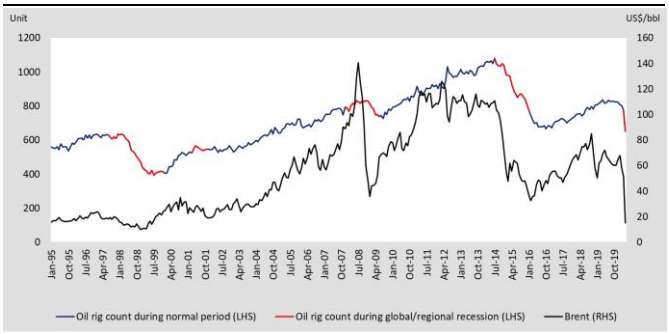
EIA projects that the oil market will return to balance in 3Q20 and the glut to be reversed in 2021. Therefore, oil prices will be better off from April onwards. The US oil rig count, a coincident indicator, dropped by 50% in less than two months to below the level in early 2016. Such a sharp jump in the amount of idled rig portends a significant decline in oil production which helps the restoration of imbalance in the near term.

Figure 2: World total liquids net withdrawal



Source: EIA, KGI Research

Figure 3: International oil rig count



Source: Baker Hughes, KGI Research

Conservative strategy: park capital with oil majors

Given that most investors are more comfortable with the familiar names for investment and trading, we recommend the big oil companies as stock picks for the oil cycle play.

Firstly, these conglomerates are geographically well-diversified, with footprints from the upstream segment (E.g. exploration and production) to downstream segment (E.g. refining of petroleum). Operating the whole supply chain provides a buffer to limit the impact better than standing on just a single business. Secondly, the big oil companies, either state-owned or privately-owned, have near monopoly positions that are considered a moat. Lastly, they are "too big to fail" as these conglomerates are among the highest tax contributors to the economies where they operate. In addition, these oil companies hold hundreds of billion debt, thus making them highly likely to eb be bailed out by the government if they run into problems.

The next question arises of which ones investors put capital in since the investable scope is narrow, down to less than ten names.

The higher the oil beta, the better the return once oil prices recover

Oil beta measures the extent of how sensitive the stock price is to oil prices. We derive the oil beta from regressing the monthly return of the stock against the corresponding return of the Brent price dated from the early 2000s to the current period. In the 20-year timeframe, CNOOC (883 HK), ConocoPhillips (COP US), PetroChina (857 HK) and Shell (RDS/A or RDS/B US) show a relatively high synchronised movement with oil prices.

Figure 4: Oil beta of major oil companies

Name	Stock ticker	Oil beta
BP PLC	BP US	0.39
China National Offshore Oil Corporation	883 HK	0.56
China Petroleum & Chemical Corporation	386 HK	0.33
Chevron Corporation	CVX US	0.32
ConocoPhillips	COP US	0.52
Exxon Mobil Corporation	XOM US	0.27
PetroChina Company Limited	857 HK	0.47
Royal Dutch Shell PLC	RDS/A or RDS/B US	0.46
Total S.A.	TOT US	0.33

Source: KGI research

Compare big oil players using value stock metrics

In terms of the investment styles, there are two (or three) classifications: value, growth, and (momentum). The oil majors are value stocks given that the oil industry is mature and well-established, and the growth of demand for oil aligns with the low single digit world GDP growth. During the downturn of the economy, the focus should not be on the Big Oils' profitability, which is expected to decline substantially, but rather on the financial strength that will enable them to get through the down cycle.

Firstly, though these oil majors are unlikely to hit problems with critical solvency issues that would result as a "going concern", the decline in solvency ratios like interest coverage

ratio could result in the downgrade of their bonds, deterring the recovery of equity price because some institutional investors have mandates to reduce positions of the companies whose bonds are downgraded. As shown in the table below, CNOOC, Chevron, and BP have the highest buffer for to meet liquidity requirements before the oil market crashed in March. CNOOC, especially, is able to cover its interest expenses longer that the rest can if the downturn extends.

Figure 5: EBIT/Interest expense

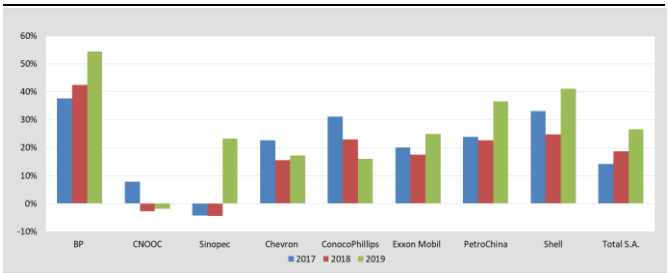
	1Q19	2Q19	3Q19	4Q19	1Q20
BP	6.5x	5.2x	4.4x	NM	NM
CNOOC	NA	33.8x	NA	21.9x	NA
Sinopec	5.8x	5.3x	4.4x	7.8x	NM
Chevron	14.1x	18.2x	14.8x	4.5x	15.5x
ConocoPhillips	9.6x	12.1x	8.7x	9.2x	3.1x
Exxon Mobil	13.8x	15x	14.3x	12.8x	NA
PetroChina	3.8x	5.4x	3.3x	4.9x	NM
Shell	7.5x	3.9x	5.7x	1.0x	1.4x
Total S.A.	7.8x	7x	7.2x	9.3x	3.0x

NA: Not available, NM: Not Meaningful due to a negative EBIT
Source: Capital IQ, KGI Research

Secondly, the companies that can sustain dividends during recessions can prevent rounds of sell-off in their share price, provided dividends are funded by cash flows from its business. Oil market had a small up-cycle in 2017 and 2018 after the rout in 2014/2015. Even though their share price performances have not fully recovered back to during the heydays, some of the big oil companies adopted unsustainably aggressive dividend policies (mainly by issue debt to pay dividends). Even though central banks have implemented zero-interest-rate policies, that does not mean these oil majors have zero debt burden. The incremental increase in debt is more than the reduction in interest rate, resulting in rising financing costs. Only CNOOC stands out due to its net cash position as of December 2019 and its rational and stable dividend policy.

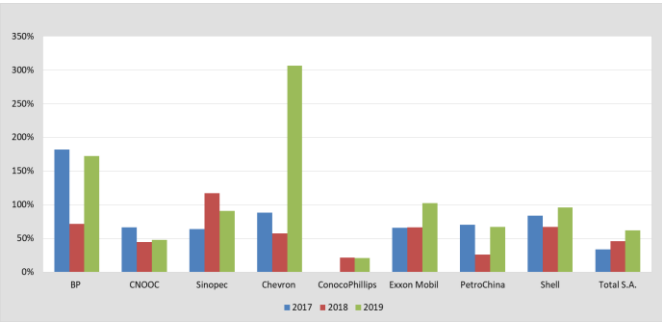
Shell announced that it will slash dividend by 66% this year. BP and Total S.A. did not comment on their dividends this year. Chevron and Exxon Mobile reaffirmed their dividend payout this year. According to Bloomberg, most of the oil majors are expected to trim dividends this year. However, we believe the longer-term sustainability of dividend matters. Given the low net gearing CNOOC is expected to have, CNOOC could be a better choice in terms of future dividend payout.

Figure 6: Net debt/equity



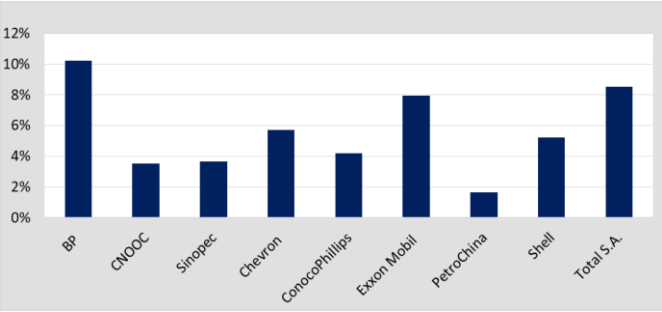
Source: Capital IQ, KGI Research

Figure 7: Dividend payout ratio



ConocoPhillips: DPS of $1.06 vs EPS of -$0.7 in 2017
Source: Capital IQ, KGI Research

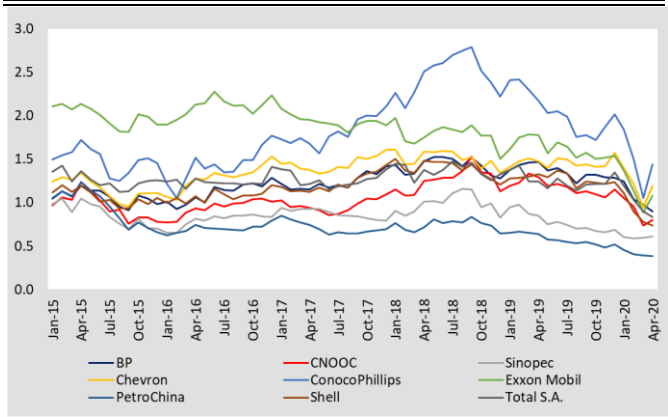
Figure 8: Estimated dividend yield in 2020



Source: Bloomberg, KGI Research

Lastly, we assume that oil price will recover to the pre-COVID-19 level by the end of this year. Accordingly, we recommend CNOOC as our stock pick given its higher correlation to oil price, strong balance sheet position, and relatively rational dividend policy. Based on the P/B valuation, our target price for CNOOC is the book value per share of HK$10.04, implying an upside of 19%.

Figure 9: P/B ratio



Source: Bloomberg, KGI Research

Figure 10: Potential upside

	Last P/B	Upside to 5-year average level	Upside to pre-COVID-19 level
BP	0.90	36%	15%
CNOOC	0.80	31%	19%
Sinopec	0.61	39%	-3%
Chevron	1.19	14%	2%
ConocoPh	1.44	26%	4%
Exxon Mo	1.08	70%	5%
PetroChin	0.38	86%	5%
Shell	0.74	61%	22%
Total S.A.	0.83	51%	24%

Source: Bloomberg, KGI Research

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