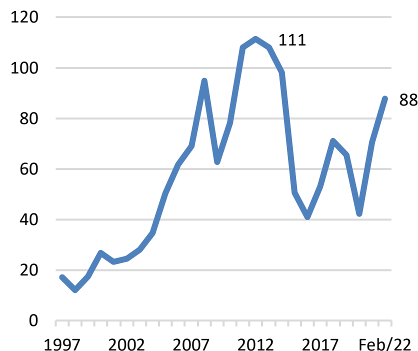
Daybreak

Monday, 14 February 2022

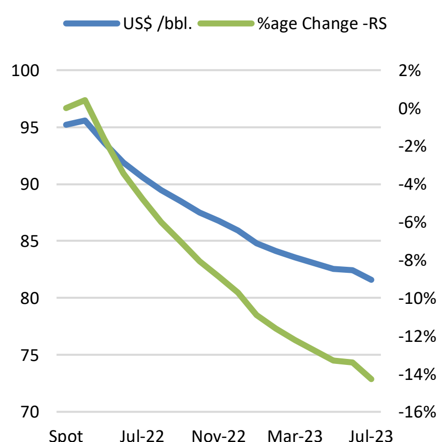
IGI Securities

Economy

Oil prices back in the 90s



Brent oil prices in backwardation



Analyst

Saad Khan
Saad.Khan@igi.com.pk
Tel: +92 21 111 234 234 Ext: 810

Abdullah Farhan
Abdullah.Farhan@igi.com.pk
Tel: +92 21 111 234 234 Ext: 912

Aariz Raza
Aariz.raza@igi.com.pk
Tel: +92 21 111 234 234 Ext: 916

Economy

Oil back in the 90s

- Oil prices have surged by nearly ~30% since FY22 start, crossing US$ 90bbl mark by Jan-22 to current US$ 97/bbl, after a nearly 8years (Sep-2014).
- We view crude oil prices are likely to fall as production continues to increase faster than consumption and inventories build. However, this production catching up with demand won't be anytime sooner.
- In near-term we expect oil price fall to range of US$ 75-85/bbl. Beyond, 2022 into 2023 we expect oil prices to further contract averaging in the range of USD 65-70/bbl

Oil prices at almost 8-year peak

Oil prices have surged by nearly ~30% since FY22 start, crossing US$ 90bbl mark by Jan-22 to current US$ 97/bbl, after a nearly 8years (Sep-2014). This rise in oil prices is certainly fogging country's key economic indicators including inflation and current account balances.

Brewing tensions between Russia and Ukraine could potentially send prices to peak US$ 120

The recent hike in global oil prices can be traced to the brewing tensions between Russia and Ukraine and the imbalance it will create on global oil demand/supply. Analysts have warned of a possible full-scale military confrontation as they considered the Russian military moves in the region. Moreover US National Security Adviser Jake Sullivan, in an interview cited "Russia invasion could begin any day" (link). In an event of full-scale military confrontation analysts suggest this could send oil prices to peak US$ 120/bbl. Whether the current bout between Russia and Ukraine and the USA, settles the outcome remains uncertain.

…however, oil prices remain in backwardation suggesting a downward trend

Having said that, Brent oil futures remain in the state of backwardation, suggesting the market anticipation of a decline in spot prices over the next few months. 3 & 6 month forward contract prices of May / August 2022, are trading at US$ 93.63 and US$ 89.45/bbl (down 2-6%). Moreover, this downward sloping-curve seems also validate fundamental supply-demand situation going forward. In our note, baring the current geopolitical situation, we have assessed what we think will be direction of prices going forward.

2014 last time prices hovered in the region of US$ 90s

Our latest memory of oil price trading above US$ 90s is from 2011 till about the end of 2014. With the start of 2015, emerging supply glut, led by US shale production boom, leading to a ~50% contraction in prices from average price of US$ 98/bbl in 2014 to US$ 51/bbl. And since thereon oil prices have

averaged US$ 55/bbl till roughly the end of 2019 (4years) albeit experiencing episode of lows and highs of US$ 21-to-86/bbl.

The supply/demand disruption phase: COVID-19
With the advent of COVID19 starting Jan-2020 and the lockdown that followed (Mar-2020); halted global demand and worsen up supply situation. As a result of this temporary closure of demand along with continuous production of oil; prices took a hammering, with oil prices touching a low of US$ 13/bbl by April of 2020 while WTI briefly traded in negative region.

However, since then as globally lockdown have gradually lifted and oil demand rebounded much more aggressively than anticipated, and so does the price of oil. In response to keep up with the demand, we saw multiple reversion of OPEC+'s production supply increases, but the opening of economies and the demand that followed simply outpaced the supply. Hence, on obvious grounds oil prices by the end of 2020 rose to a high of US$ 73/bbl from a low of US$ 13/bbl in 2020; that's almost 4.5x growth. And since then it has been on a forward march, reaching US$ 97/bbl by February of 2022.

Putting the current crude oil price into perspective
Although there are multitude of factors in play determining oil prices, including OPEC led cartel, geopolitical environment etc. But foremost it all comes down global demand which barring 2020 is rather inelastic and supply.

Demand factors
Looking at the demand factors, global oil consumption rebounded in 2021 by 5.5%y/y from 2020 levels. However, this demand is still 3% lower from pre-pandemic levels in 2019. The rise in demand during 2021 was primarily led y opening of global economies and resumption of economic activity after ease in COVID-19 let restriction / lockdowns and roll-out of Covid-19 vaccinations

For instance, US one of the largest oil consumers saw its oil consumption dropped to 18.12mnbpd on average in 2020 from 19.5mnbpd reported consumption in Dec-2019; that's almost 7% drop in a year. As of latest in 2021, this consumption stands close to 19.7mnbpd that's roughly +9% growth, outpacing oil supply leading to such substantial rise in global oil prices.

Supply factors
Looking at the supply factors, production although increased by 1.7%y/y in 2021 to stand at 95.5mnbpd compared to 93.9mnbpd in 2020, but this increase was lower than the global demand surge in 2021 which stood at 96.6mnbpd (as per OPEC), creating a supply deficit of nearly 1.6mnbpd one of the highest seen in past decade. This supply deficit was mainly caused by OPEC+ led supply curtailment, on-going geopolitical tensions, supply disruption in Libya and drop in US oil production. On top that, oil inventories

also witnessed a decline of 1.4mnbpd in 2021 after increasing by 2.1mnbpd in 2020.

Historical perspective

Globally oil demand and supply has remained volatile over the past 10-15 years, leading to volatile prices. Looking back, oil prices have generally traded in their 80s and 90s as when there were periods of high demand outpacing supply or when supply nearly matched total consumption. For instance it happened back in 2013/14 when the total demand exceeded supply by 0.5mnbpd (OPEC). For 2021, oil demand as aforementioned exceeded supply by nearly 1.6mnbpd (OPEC) which pushed prices above US$ 90/bbl. s

Exhibit: Global Crude oil Supply/Demand (as per OPEC)

mnbpd	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022E
Total Supply	90.2	92.6	95.5	95.5	96.8	100.0	100.1	93.7	95.1	100.7
OPEC	31.2	30.5	31.9	32.2	31.5	31.4	29.4	25.7	26.3	28.8
Non-OPEC	59.0	62.1	63.6	63.3	65.3	68.7	70.8	68.0	68.8	71.9
Total Demand	90.7	92.0	94.2	95.7	97.5	99.1	100.1	91.0	96.6	100.8
Difference (Supply-Demand)	(0.5)	0.6	1.3	(0.2)	(0.7)	0.9	0.0	2.7	(1.6)	(0.1)

Source: OPEC, IGI Research

Production to increase in near-term

As global demand continues to rise from 2020, OPEC in its recently held meeting agreed to increase it's per day production by 0.4mnbpd (link) in line with previous decision to phase out the output cuts it decided earlier during the slump in global demand.

Exhibit: Global Crude oil Supply/Demand (as per EIA)

mnbpd	2020	2021	2022E	2023F
Total Supply	88.8	90.2	95.5	97.3
OPEC	25.6	26.3	28.8	28.9
Non-OPEC	63.2	63.9	66.8	68.4
Total Demand	91.9	96.9	100.5	102.3
Difference (Supply-Demand)	(3.0)	(6.7)	(5.0)	(4.9)

Source: EIA, IGI Research

In all, earlier in Nov-21 EIA (Energy Information Administration) estimated global supply to reach 101.05mnbpd, owing to surplus capacity of OPEC and US projected oil production of 11.85mnbpd in 2022. Along with this EIA projected demand size of 100.5mnbpd, which will create a supply surplus of 0.5-0.6mnbpd, raising the crucial oil inventory level.

Oil prices likely to come down

Hence we view crude oil prices are likely to fall as production continues to increase faster than consumption and inventories build. However, this

production catching up with demand won't be anytime sooner. A significant sustainable oil price direction is in our view is likely to develop from 2HFY22, but we expect in near-term range of US$ 75-80/bbl. Beyond, 2022 into 2023 we expect oil prices to average in the range of USD 65-70/bbl based on buildup in inventories, stable production from OPEC+ and Libya.

Risks remain plenty

Having said that, significant risks lies and uncertainty regarding supply and demand both are detrimental for oil prices outlook. Mainly these include,

Unplanned OPEC+ supply cuts: OPEC+ failing to utilize surplus capacity to meet rising demand.

Geopolitical Tensions: Tension between Russia and Ukraine aggravate leading to supply disruption to Europe and US. Economic risks to impact production from countries such as Libya. Moreover, US-Iran talks are underway and if materialized supply from Iran could potentially see further drop in global oil prices. For our estimates we have not incorporated any development on this front in to our assumption of global oil production.

COVID-19 Omicron and other variant flare-ups: Further lockdowns and restriction in air travel on emergence of potential new variants to hurt demand.

US oil production: Substantial rise in production from US as rig count as doubled since Aug-20 and response of shale industry to higher oil prices.

Economy adjusting to oil prices

On economy side of things higher oil prices bring its own set of complications. The foremost being inflation. The link between domestic and international oil prices is pretty much straightforward; higher oil prices leads to higher domestic inflation.

Oil prices impact on inflation is positive but is short-lived

As per latest studies; domestic POL prices have a positive correlation of 0.6 (weak) to domestic inflation. One direct impact can be gauged by the total weightage of motor fuel which is about 2.7%, meaning for every 10% change in domestic oil prices we can expect a monthly impact of 0.27% on national headline inflation.

However, it raises the cost of production in Medium & Long-term

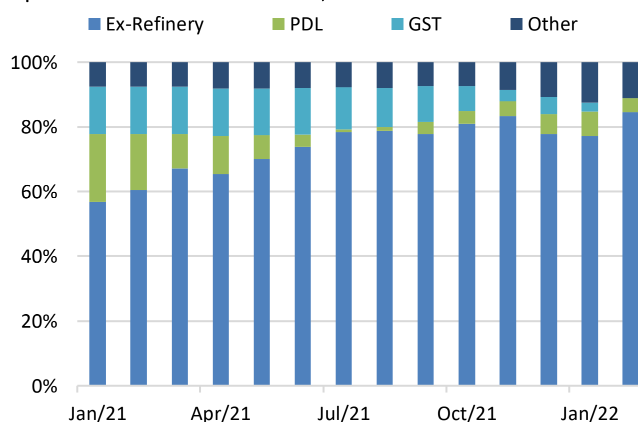
And then there are other related commodities which have a lagged impact of 1-2 months on inflation. Energy cost particularly under fuel price adjustment charges, and energy related charges are revised on monthly basis, but takes roughly a month or two to reflect on headline inflation. Take FPA, which normally occurs on a monthly basis with its adjustments are normally done a month ahead basis.

But that's not all, oil is raw commodity in many goods including petrochemicals, plastics, cosmetics footwear, and the biggest usage of oil is in transport sector including transport services and logistics cost etc. In fact changes in oil prices; changes raw material cost and subsequently production costs. Hence, the impact on consumer inflation may not be as pronounced in the short-lived but higher oil prices ramp up overall producers cost which in the medium to long term are downward sticky. Hence shifting the inflation bar higher in the medium to long term.

In Pakistan POL prices are subsidised. Reduction in Petroleum Development Levy (PDL) and sales tax (GST) has been talk of the IMF and authorities in the recently held 6th review of extended Fund Facility (EFF).

Exhibit: PDL & GST % age weight in Domestic POL retail price

PDL and GST has been constantly revised, to pass on minimum oil price increase. From Jan-22, GST is almost non-existent.



Among the seven peer economies, Pakistan is the cheapest retail seller of fuel that is US$ 0.84/ltr equivalent to PKR 146.1/ltr, while India ranks on top in the group and sells at US$ 1.38 /ltr or PKR 241.2 ltr. One of the reasons for keeping oil prices low is Pakistan's low per capita income and higher per capita consumption of oil. Pakistan's per capita fuel expenditure stands at 11% of total GDP per capita, while 13% is in India (highest among peers), and 2% in Bangladesh (lowest among peers).

Exhibit: Pakistan POL prices compared to region and peers

Country	US$ / Ltr	PKR / Ltr	Oil Consumption / per capita (ltr)	% of annual GDP Per capita
Pakistan	0.84	146.1	159	11%
India	1.38	241.2	195	13%
Bangladesh	1.04	180.9	42	2%
Sri Lanka	1.02	178.2	351	10%
Turkey	1.06	185.6	685	8%
Kenya	1.16	202.5	135	7%
Nepal	1.16	203.2	92	9%

Expecting wider trade imbalances

Second is the impact on country trade balance. During the 1HFy22, total c/a deficit reached US$ 9.0bn. Of this, total goods import bill accounted for US$ 36.4bn. Pakistan imports roughly ~70% of its oil requirement. Historically speaking Crude Petroleum and Petroleum Products imports generally accounted for ~30% of the total imports but due to lower oil prices and COVID-19 in this dropped to ~18%. However, in the past 6months of FY22, petroleum crude and products imports alone amounted to US$ 6.9bn compared to US$ 6.7 and US$ 7.8bn in Fy20 and Fy21, taking its share imports 19% - highest was back in 2012 at 36%.

As of 6months FY22 average price of crude oil import is US$ 75/bbl. Even taking this base number current import trajectory Pakistan is likely to end up with an import bill over US$ 73bn (last high US$ 56bn in 2018). Nevertheless, for every US$ 10/bbl increase in oil prices overall petroleum based import bill goes up by US$ 170mn every month or US$ 1.0bn in 6month.

Market performance could come under the current spell of rising oil prices

From market standpoint, higher oil prices have negative implication on manufacturing sector due to rise in energy prices, and subsequent reduction in margins. However, market heavy sector E&Ps and Banks could potentially negate the overall market performance, but given current economic times, that performance seems unlikely to come-by.

Betting on E&Ps sector

Take E&P sector for instance. The sector benefits directly from higher oil price as revenues are derived from sale of oil to refineries and gas to utility companies (SSGC & SNGP). As gas prices are derived from oil prices, rise in wellhead gas prices has not been translated in to consumer prices.
Thus, despite increase in profitability, E&P sector has been marred with substantial rise in receivables due to expanding differential between wellhead and consumer gas prices. As a result, cash tied in circular debt has eroded cash based earnings for E&P sector.

Furthermore, E&P sector has not encountered any substantial discoveries in last few years, mainly due to lack of new blocks on offer in wildcat areas and lack of investment on the back of cash constraints. This has brought forth risk of reserve replacement via natural depletion whereby major oil and gas fields are about to deplete completely in the next few years with no major additions to reserve base.

Consequently, E&P sector is currently trading at historic low P/E; 3.7x (3.1x ex MAR & POL) as cash crunch looms, compared to average P/E's during period of higher oil prices, despite bull-run in oil prices.

Exhibit: Oil prices and P/E have had a negative relation
Before 2014 (2011-2014) when oil prices averaged over US$ 90/bbl market P/E averaged 7.3x

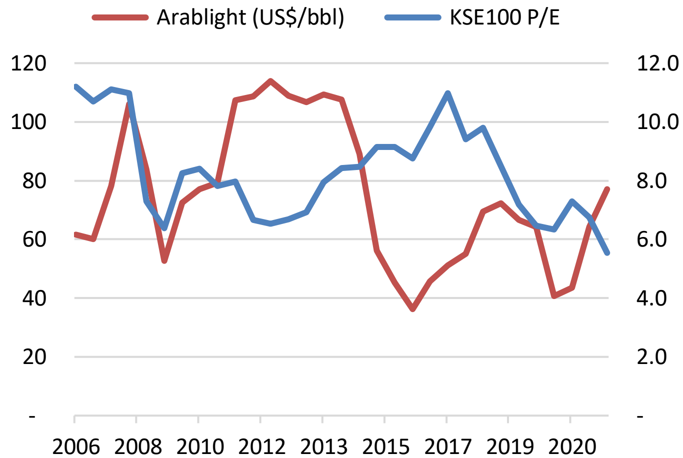
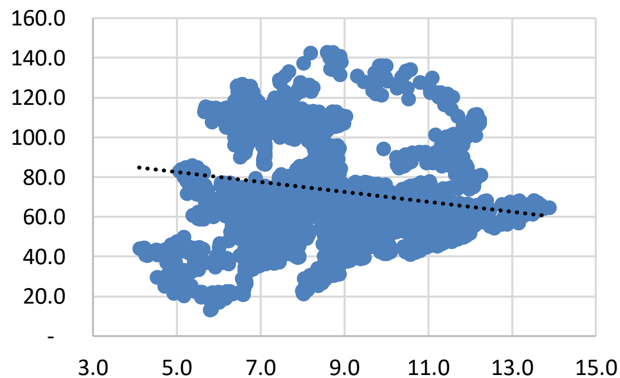


Exhibit: Arab light US$/bbl (y-axis) and KSE100 P/E (x-axis) plotting
Downward liner relationship, higher oil prices lead to downward P/E rating. Although the relationship has weekend over the years



Important Disclaimer and Disclosures

Research Analyst(s) Certification: The Research Analyst(s) hereby certify that the views about the company/companies and the security/ securities discussed in this report accurately reflect his or her or their personal views and that he/she has not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report. The analyst(s) is principally responsible for the preparation of this research report and that he/she or his/her close family/relative does not own 1% or more of a class of common equity securities of the following company/companies covered in this report.

Disclaimer: The information and opinions contained herein are prepared by IGI Finex Securities Limited and is for information purposes only. Whilst every effort has been made to ensure that all the information (including any recommendations or opinions expressed) contained in this document (the information) is not misleading or unreliable, IGI Finex Securities Limited makes no representation as to the accuracy or completeness of the information. Neither, IGI Finex Securities Limited nor any director, officer or employee of IGI Finex Securities Limited shall in any manner be liable or responsible for any loss that may be occasioned as consequence of a party relying on the information. This document takes no account of the investment objectives, financial situation and particular needs of investors, who shall seek further professional advice before making any investment decision. The subject Company (ies) is a client of the IGI Finex Securities Limited and IGI Finex Securities offers brokerage services to Subject Company (ies) on a regular basis, in line with industry practice. This document and the information may not be reproduced, distributed or published by any recipient for any purpose. This report is not directed or intended for distribution to, or use by any person or entity not a client of IGI Finex Securities Limited, else directed for distribution.

Rating system: IGI Finex Securities employs three tier ratings system, depending upon expected total return (return is defined as capital gain exclusive of tax) of the security in stated time period, as follows:

Recommendation Rating System
Buy if target price on aforementioned security (ies) is more than 10%, from its last closing price(s)
Hold if target price on aforementioned security (ies) is in between -10% and 10%, from its last closing price(s)
Sell if target price on aforementioned security (ies) is less than -10%, from its last closing price(s)

Risk: Investment in securities are subject to economic risk, market risk, interest rate risks, currency risks, and credit risks, political and geopolitical risks. The performance of company (ies) covered herein might unfavorably be affected by multiple factors including, business, economic, and political conditions. Hence, there is no assurance or guarantee that estimates, recommendation, opinion, etc. given about the security (ies)/company (ies) in the report will be achieved.

Basic Definitions and Terminologies used: Target Price: A price target is the projected price level of a financial security stated by an investment analyst or advisor. It represents a security's price that, if achieved, results in a trader recognizing the best possible outcome for his investment, **Last Closing:** Latest closing price, **Market Cap.:** Market capitalization is calculated by multiplying a company's shares outstanding by current trading price. **EPS:** Earnings per Share. **DPS:** Dividend per Share. **ROE:** Return on equity is the amount of net income returned as a percentage of shareholders' equity. **P/E:** Price to Earnings ratio of a company's share price to its per-share earnings. **P/B:** Price to Book ratio used to compare a stock's market value to its book value. **DY:** The dividend yield is dividend per share, divided by the price per share.

IGI Finex Securities Limited
Research Analyst(s)
Research Identity Number: BRP009
© Copyright 2022 IGI Finex Securities Limited

Contact Details

Equity Sales

Faisal Jawed Khan	Head of Equities	Tel: (+92-21) 35301779	faisal.jawed@igi.com.pk
Zaeem Haider Khan	Regional Head (North)	Tel: (+92-42) 38303559-68	zaeem.haider@igi.com.pk
Muhammad Naveed	Regional Manager (Islamabad & Upper North)	Tel: (+92-51) 2604861-62	muhammad.naveed@igi.com.pk
Syeda Mahrukh Hameed	Branch Manager (Lahore)	Tel: (+92-42) 38303564	mahrukh.hameed@igi.com.pk
Shakeel Ahmad	Branch Manager (Faisalabad)	Tel: (+92-41) 2540843-45	shakeel.ahmad1@igi.com.pk
Zaid Farook	Branch Manager (Stock Exchange) Karachi	Tel: (+92-21) 32462651-52	zaid.farook@igi.com.pk
Asif Saleem	Equity Sales (RY Khan)	Tel: (+92-68) 5871652-56	asif.saleem@igi.com.pk
Mehtab Ali	Equity Sales (Multan)	Tel: (+92-61) 4512003	mahtab.ali@igi.com.pk

Research Team

Saad Khan	Head of Research	Tel: (+92-21) 111-234-234 Ext: 810	saad.khan@igi.com.pk
Abdullah Farhan	Senior Analyst	Tel: (+92-21) 111-234-234 Ext: 912	abdullah.farhan@igi.com.pk
Aariz Raza	Analyst	Tel: (+92-21) 111-234-234 Ext: 810	Aariz.raza@igi.com.pk
Ajay Kumar	Analyst	Tel: (+92-21) 111-234-234 Ext: 912	ajay.kumar@igi.com.pk
Huzaifa Yaseen	Analyst	Tel: (+92-21) 111-234-234 Ext: 912	huzaifa.yaseen@igi.com.pk

IGI Finex Securities Limited
Trading Rights Entitlement Certificate (TREC) Holder of Pakistan Stock Exchange Limited |
Corporate member of Pakistan Mercantile Exchange Limited
Website: www.igisecurities.com.pk

Head Office
Suite No 701-713, 7th Floor, The Forum, G-20,
Khayaban-e-Jami Block-09, Clifton, Karachi-75600
UAN: (+92-21) 111-444-001 | (+92-21) 111-234-234
Fax: (+92-21) 35309169, 35301780

Stock Exchange Office
Room # 134, 3rd Floor, Stock Exchange Building,
Stock Exchange Road, Karachi.
Tel: (+92-21) 32429613-4, 32462651-2
Fax: (+92-21) 32429607

Lahore Office
Shop # G-009, Ground Floor,
Packages Mall
Tel: (+92-42) 38303560-69
Fax: (+92-42) 38303559

Islamabad Office
Mezzanine Floor, Office 5, 6 & 7, Kashmir Plaza,
Block- B, Jinnah Avenue, Blue Area
Tel: (+92-51) 2604861-2, 2604864, 2273439
Fax: (+92-51) 2273861

Faisalabad Office
Room #: 515-516, 5th Floor, State Life
Building, 2- Liaqat Road
Tel: (+92-41) 2540843-45
Fax: (+92-41) 2540815

Rahim Yar Khan Office
Plot # 12, Basement of Khalid Market,
Model Town, Town Hall Road
Tel: (+92-68) 5871652-3
Fax: (+92-68) 5871651

Multan Office
Mezzanine Floor, Abdali Tower,
Abdali Road
Tel: (92-61) 4512003, 4571183

IGI Finex Securities Limited
Research Analyst(s)
Research Identity Number: BRP009
© Copyright 2022 IGI Finex Securities Limited