

# Industry Focus

# Flash Note

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DBS Group Research . Equity

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## Regional Energy

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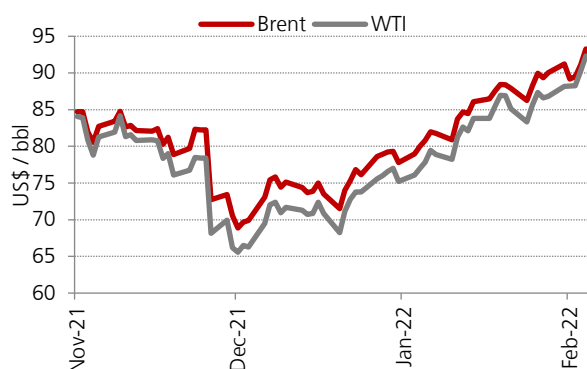
### Oil prices cross US\$90/bbl as tensions escalate in Ukraine

- Standoff between Russia and US/NATO allies shows no immediate sign of cooling off
- In the unfortunate event of war, we predict Brent crude oil prices could breach US\$100/bbl and even US\$110/bbl, as supplies could be disrupted
- We revise up our 2022 average forecasts for Brent to account for the prevailing risk premium, but our medium-term theses of high energy prices and increases in oil & gas capex continue to hold, even without the current volatility
- We remain constructive on the oil price proxies; our top pick is [CNOOC](#)

### What's New

Oil prices spike as US-Russia standoff over Ukraine escalates. Brent crude oil prices have crossed US\$90/bbl this week, as the geopolitical risk premium makes a strong comeback.

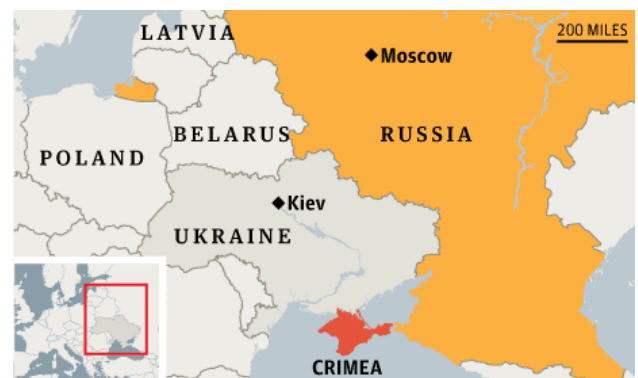
### Oil price trends (3-month)



Source: Bloomberg Finance L.P., DBS Bank

**What is happening in Ukraine?** Russia has been building up a heavy military presence along Ukraine's border in recent days, prompting fears of a potential direct ground invasion by Russia. In response, NATO allies have started sending troops and military equipment to Ukraine and the US has put some 8,500 troops on alert.

### Understanding Ukraine's position on the map



Source: Press reports, DBS Bank

**What is Russia's stand?** Russia believes the current actions are necessary for its domestic security and is blaming NATO for worsening the security situation in the region. Ukraine has, for long, wanted to become a member of the NATO alliance, and Russia considers this a danger signal, as it could mean NATO members would get a military footing in Ukraine, close to Russian borders, too close for comfort. Thus, Russia's key demand is that Ukraine does not join the NATO. It wants NATO to deny membership to any ex-Soviet countries and roll back deployment of troops and weapons in eastern Europe and stop militant drills in the region. Russia had sent these proposals to the US and its NATO allies in December 2021 amid their troop buildup near Ukraine.



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What are the origins of this conflict?

### A brief timeline of events

Pre 1991	Ukraine was part of the Russian Empire and then became a Soviet republic, part of the erstwhile USSR
1991	USSR breaks up and Ukraine becomes an independent country
Post 1991	Ukraine increasingly looks towards the West as allies and tries to shun its Russian antecedents
2014	Ukrainian President Viktor Yanukovych, considered pro-Russia, rejects an agreement to move closer to the European Union (EU) and is removed from office after protests break out in the country
2014	Russia annexed the Crimean Peninsula, which was part of Ukraine, and allegedly supported separatist movements in eastern regions of Ukraine, Luhansk, and Donetsk, where fighting continues to this day
2021	Ukraine aspires to join the NATO – while it is considered a partner of the alliance, it is not a NATO member currently
2022	Russia intensifies pressure on Ukraine by assembling troops near the border

Source: DBS Bank

**Where do the US and its allies stand?** Russia's ultimatums to withdraw forces from Eastern Europe and stop drills have been generally ignored by NATO members in the past. But recent strong statements from Russian President Vladimir Putin have brought US and NATO members to the discussion table. However, so far, Russia's main demands – Ukraine being banned from NATO and a legal guarantee that NATO won't expand further into the east – have been turned down. The NATO Secretary General had, in December, turned down Russia's demands of rescinding an earlier commitment to Ukraine that it would eventually become a NATO member.

**What are the chances of war?** Russia has reportedly amassed close to 145,000 troops on the Ukrainian border and there are apprehensions that it is ready to invade. However, Russia so far denies it has any plans to invade Ukraine. Meanwhile, the Pentagon has put troops on standby, as mentioned earlier, and some NATO members have sent defence equipment to Ukraine,

which has further escalated tensions between Russia and the West. Will Russia attack? The situation remains fluid at the moment and may depend on the progress of talks between Russia, the US, and NATO.

Given its military superiority vis-à-vis Ukraine, Russia could indeed claim a swift victory and put a stop to increasing NATO influence in its vicinity by pushing Ukraine to admit that it has more to lose by allying with the West than with Russia, if NATO allies are unable to sufficiently protect Ukraine from an attack. So, the chances of war cannot be ruled out completely, especially if both sides remain belligerent for a while. In a precautionary measure, the US has pulled out families of Ukraine embassy staff, which indicates that the chances of war are not negligible.

**Can the West respond? How?** It is unlikely that NATO will directly support Ukraine in a war with Russia. There could be indirect assistance in the form of weapons, equipment, medical facilities, and nearby NATO members could deploy troops to ensure the war would not spread beyond Ukraine. More likely, there could be some form of sanctions imposed on Russia and its leaders including Putin. This could include sanctions on exports to Russia, sanctions on banking systems, or blocking access to the US dollar. But, given that Russia is a major exporter of energy, including both oil and gas, and Europe is already reeling from an energy crisis, such moves would need to be carefully weighed to prevent it from boomeranging and damaging their own economies.

**What happens to the oil & gas market if the conflict aggravates?** Russia is currently the world's second largest oil and natural gas producer and any sanctions or supply chain impacts arising from the conflict would have a significant impact on oil & gas prices. Russia exports about 4.5mmbpd of oil currently, and while China is the single largest importer, at 1/3rd share, EU countries combined account for close to 50% of Russia's oil exports (around 15% of EU oil demand). On the other hand, Europe imports c.40% of its gas requirements from Russia, mainly through pipelines. The gas market is already very tight in Europe this winter and any further impact to gas pipelines or imports would result in even higher gas and LNG prices and have an indirect impact on oil as well.

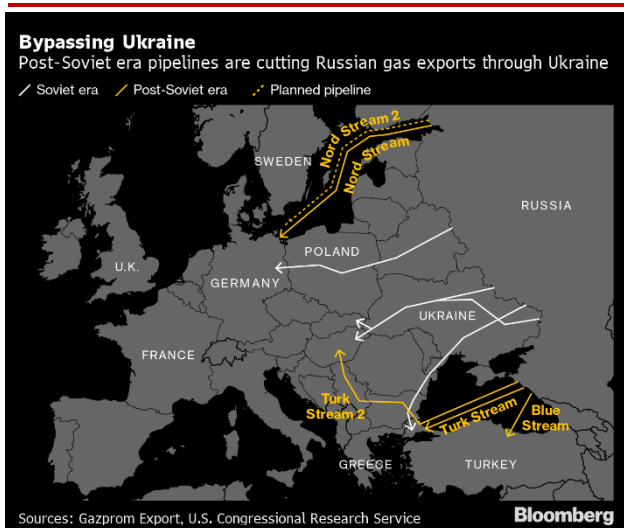
**The role of gas pipelines in the Ukraine conflict.** Around a quarter of the gas exports from Russia into Europe go via Ukraine, and Ukraine receives hefty fees amounting to US\$2-3bn annually (2% of GDP) from this arrangement. The rest goes through Polish pipelines and the Nord

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Stream I pipeline that cuts through the Baltic Sea directly into Germany. The gas pipeline in Ukraine gives the country some degree of leverage over Russia, as Russia needs uninterrupted gas sales revenue for its own coffers.

However, Russia has been looking to reduce its dependency by building the Nord Stream II pipeline to Europe – parallel to Nord Stream I – which has been caught in political wrangling over permissions, especially in Germany. If Russia chooses to invade Ukraine, the approvals for Nord Stream II could come under possible sanctions by the EU. On the other hand, if Russia cuts off gas exports through Ukraine, it could force Germany to sign off on the controversial Nord Stream II pipeline. It is unlikely that Germany and the EU would be able to source this gas from elsewhere overnight, so Russia seems to have the upper hand in this game as of now.

### How Russian gas gets to the EU



Source: Bloomberg Finance L.P.

**Our oil view at this point does not change markedly, though we need to factor in high prices in 1Q22.**

Fundamentally, oil prices do look overheated to us at current levels, so we believe there is a fair bit of geopolitical risk premium being factored into oil prices right now (about US\$8-10/bbl, in our view). However, over the next few weeks, as the conflict unfolds, we expect oil prices to stay elevated around current levels or even higher, and in case there is a full-blown conflict, oil prices

could easily breach the US\$100/bbl barrier and beyond, to US\$110+/bbl, as even a 1-2mmbpd impact on oil exports from the region (some of Russia's key oil exporting ports are near Estonia, a NATO member) could have a sharp impact on the oil market, which is reasonably tight on the inventory front.

If talks do materialise and once the conflict deescalates, we believe oil prices could retreat to the US\$80-85/bbl levels. Overall, we need to revise up our oil price forecasts for 1Q22 by around US\$7/bbl to account for the current oil price bullishness, assuming the risks blow over in a few weeks. Our average Brent crude oil forecast for 2022 is thus revised up to US\$77-82/bbl, compared to our current average forecast range of US\$75-80/bbl. No change to our 2023 forecasts.

**How should investors position?** Given the expected extreme volatility in the near term, it may not be advisable to increase exposure to oil & gas proxies and play on US\$100 oil, as market dynamics could change very rapidly. From a more medium-term perspective, and given our expectations of Brent crude oil prices at US\$80/bbl in 2022 and even higher in 2023, we still remain positive on oil proxies, with or without the current conflict-related volatility. Our top picks include CNOOC and PTTEP.

**Share prices have lagged oil price performance even before the Ukraine news flow, especially CNOOC.** Oil prices staged a strong rally since early 2021, with the consensus' forward estimates steadily climbing towards US\$80/bbl, 30% higher than the expectations of US\$60-65/bbl pre COVID. Oil majors are mostly delivering profit that is higher than 2019 levels as well. In spite of the favourable macro backdrop, stock prices continue to be significantly below 2020 highs, especially that of CNOOC, and have not fairly reflected the strong oil rebound, as illustrated in the bottom table on the following page. CNOOC is currently trading at -1SD below mean at 0.8x PB, which, we believe, presents an attractive entry point for investors in view of the positive catalysts in place: (1) Favourable production outlook in 2022 backed by healthy realised oil prices, (2) special dividend for FY21 and lucrative dividend yield of 10-11% in the next three years, and an (3) A-Share listing. A share buyback exercise would also lend support to CNOOC's share price.

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### Oil price forecast by quarter (2021/22)

(US\$ per barrel)	1Q22F	2Q22F	3Q22F	4Q22F	1Q23F	2Q23F	3Q23F	4Q23F
Average Brent crude oil price	83.0	77.5	78.5	81.0	83.0	85.0	89.5	92.5
Average WTI crude oil price	80.0	74.5	75.5	78.0	80.0	82.0	86.5	89.5

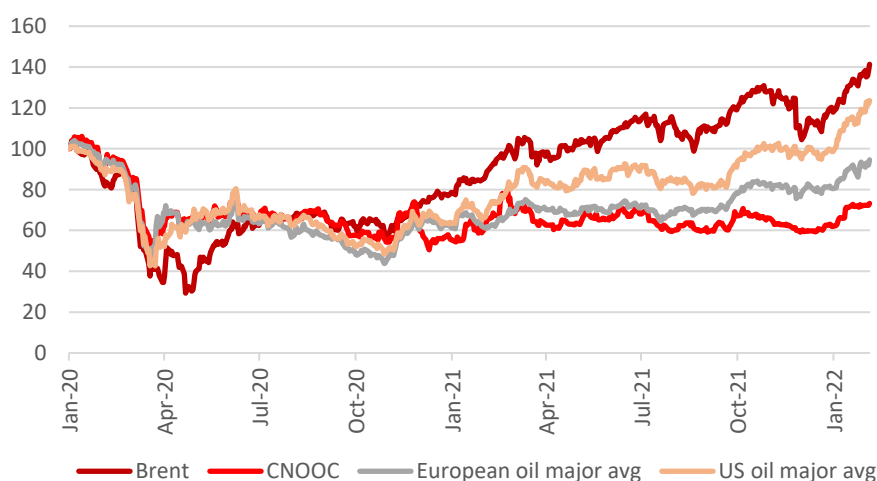
Source: Bloomberg Finance L.P., DBS Bank (forecasts)

### Chinese oil majors underperformed regional and global upstream peers

Company	Share price (LC)			P/Bv			Current share price vs:	
	2020 High	2020 Low	Current	2020 High	2020 Low	Current	2020 High	2020 Low
Date	Pre COVID	Post COVID	Feb-22	Pre COVID	Post COVID	Feb-22		
<b>Regional Peers</b>								
CNOOC	13.74	6.40	9.53	1.2	0.6	0.8	-31%	49%
Petrochina	4.20	2.16	3.97	0.6	0.3	0.5	-5%	84%
Sinopec	4.80	2.97	4.13	0.7	0.4	0.5	-14%	39%
Medco	775	264	550	1	0.3	0.9	-29%	108%
PTT	47.25	25.75	39.25	1.5	0.8	1.1	-17%	52%
PTTEP	134	55	129	1.5	0.6	1.3	-4%	135%
<b>Global Peers</b>								
Chevron	135.41	54.22	134.2	1.6	0.7	1.9	-1%	148%
Shell	2309	900	2020.5	1.3	0.5	1.2	-12%	125%
Total	50.44	21.975	49.71	1.4	0.6	1.4	-1%	126%
BP	504.1	193.44	392.4	1.4	0.6	1.5	-22%	103%
Exxon	70.9	31.45	79.68	1.6	0.7	1.6	12%	153%
Conoco	66.48	22.67	90.87	2.1	0.7	2.6	37%	301%
Eni	14.32	5.885	13.288	1.1	0.5	1.2	-7%	126%
ONGC	128.5	60	169.9	0.7	0.3	1.0	32%	183%

Source: Bloomberg Finance L.P., DBS Bank

### CNOOC lagging far behind oil prices and US and European oil majors since 2020



Source: Bloomberg Finance L.P., DBS Bank

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**BUY** (>15% total return over the next 12 months for small caps, >10% for large caps)

**HOLD** (-10% to +15% total return over the next 12 months for small caps, -10% to +10% for large caps)

**FULLY VALUED** (negative total return, i.e., > -10% over the next 12 months)

**SELL** (negative total return of > -20% over the next 3 months, with identifiable share price catalysts within this time frame)

\*Share price appreciation + dividends

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