Winning in a changing world
Malaysia economic outlook

Issue 1
December 2015

Foreword

Valued Clients,

I am pleased to present to you issue 1 of Deloitte Malaysia's quarterly Economic Outlook.

This new publication demonstrates our continued support and committed endeavor to deliver valuable insights on the economic landscape in which we all do business; combining both a retrospective angle to see what we can learn from recent activity as well as providing detailed outlooks, projections, trends and market conditions. While the focus is very much on Malaysia, we are mindful of the impact of the ASEAN region and the global economy and so we keep one eye on developments overseas too. We hope that this overview will be of benefit to you as you consider your business strategy in the challenging business environment we find ourselves in.

Looking back, 2015 global growth – currently projected at 3.3 percent – was marginally lower than in 2014, following a setback in activity in the first quarter of 2015 which resulted in a small downward revision across the year.

According to the IMF, the underlying drivers for a gradual acceleration in economic activity in advanced economies – easy financial conditions, more neutral fiscal policy in the Euro area, lower fuel prices, and improving confidence and labor market conditions – remain intact. The continued growth slowdown in emerging market economies reflects several factors, including lower commodity prices and tighter external financial conditions, structural bottlenecks, rebalancing in China, and economic distress related to geopolitical factors. A rebound in activity in a number of distressed economies is expected to result in a pickup in growth in 2016.

Overall, with growth expected to strengthen to 3.8 percent in 2016, the global economy is poised for growth comparable to recent years, but "with a somewhat different texture", as termed by Forbes: European countries will do a little better, Asian countries a little worse, and natural resource-based economies much worse. However, many economists view Asia as a 'wild-card' in the outlook and so the coming year will be an interesting one for us all.

I hope that you will find this first issue of our Economic Outlook interesting – I welcome your feedback on how we can improve for future editions.

Thank you again for partnering with Deloitte in 2015, and we look forward to supporting you in greater depth in 2016.

Best Regards,

Country Managing Partner

Global economic outlook and trends

Key Issues:

- **Values of major currencies**
- **Weak commodity prices**
- **Slowing Chinese economy**
- **Expectations about monetary policy in the United States**

Global economic outlook and trends

The global economy registered a growth of 2.9 percent in H1 2015, and is projected to grow at 3.1 percent in 2015 (0.3 percentage point lower than in 2014), before picking up to 3.6 percent in 2016.

- The recovery in advanced economies is expected to pick up slightly (particularly in the Euro area, supported by the decline in oil prices and accommodative monetary policy). On the other hand, growth in emerging markets and developing economies is projected to slow, due to declining commodity prices, reduced capital flows to emerging markets, pressure on currencies, a slowdown in China with less reliance on import-intensive investment, and adjustment in the aftermath of credit and investment boom.

World Economic Outlook Projections

	2014 (%)	2015 (%)	2016 (%)
World Output	**3.4**	**3.1**	**3.6**
Advanced Economies	**1.8**	**2**	**2.2**
• US	2.4	2.6	2.8
• Euro Area	0.9	1.5	1.6
• Japan	-0.1	0.6	1
• UK	3	2.5	2.2
Emerging Markets and Developing Countries	**4.6**	**4**	**4.5**
• CIS	1	-2.7	0.5
Emerging and Developed Asia	**6.8**	**6.5**	**6.4**
• China	7.3	6.8	6.3
• India	7.3	7.3	7.5
• ASEAN 5	4.6	4.6	4.9

Source: World Economic Outlook - Adjusting to Lower Commodity Prices, IMF, October 2015

A further decline in oil prices, as well as in prices of other commodities, should support demand in the majority of advanced economies that are net commodity importers, but the slowdown in emerging markets will imply weaker exports. Lower oil and other commodity prices could provide some upside to demand in commodity importers, but complicate the outlook for commodity exporters.

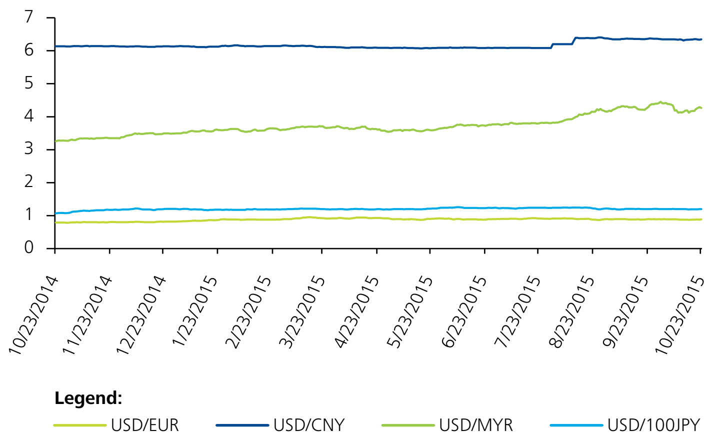
Major trends to look out for:

1. Values of major currencies:

Currencies of major emerging economies have depreciated in real effective terms, reflecting weaker fundamentals, i.e., weakening growth prospects and worsening terms of trade. In real effective terms, the euro appreciated by 3.7 percent and the U.S. dollar by 2.3 percent between March and August 2015, while the yen weakened slightly.

Following the depreciation of the Yuan in August 2015, financial markets have become more volatile. This led to an increase in global risk aversion, weakening currencies for many emerging markets, and a sharp correction in equity prices worldwide.

Major Currencies against USD (Oct 14 - Oct 15) *



Source: Oanda.com (accessed on 23rd Oct, 2015)

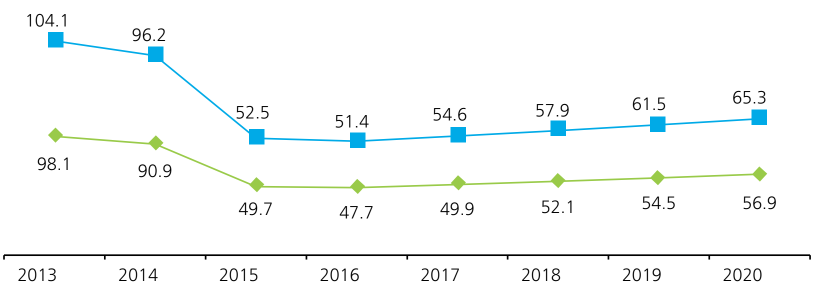
While commodity exporters have seen sharp depreciations of their currencies, a general trend of reduced financial inflows to emerging markets has resulted in more generalized depreciation against the U.S. dollar, Euro, and Yen. Countries with weakening growth prospects and worsening terms of trade are facing currency depreciation pressures as part of global adjustment.

2. Weak commodity prices:

After remaining broadly stable during the second quarter of 2015, a sharp drop in sectoral investments has led to decline in oil prices. This was supported by a strong supply from members of the Organization of the Petroleum Exporting Countries (OPEC), the prospects of higher future output following the nuclear deal with Iran, and weaker global demand. Following excess supply and weaker demand, oil prices are forecast to remain below projected levels through 2020. The IMF suggests average annual prices of $51.62 a barrel in 2015, $50.36 in 2016, and $55.42 in 2017.

- Lower oil prices have supported demand for importers. Income gains from lower oil prices have supported increases in private consumption in advanced economies, (except in the United States (harsh winter) and Japan (low levels of consumption due to delayed pass-through and wage moderation).

World Bank: Average Spot Price (Brent, Dubai, and WTI) $/Barrel



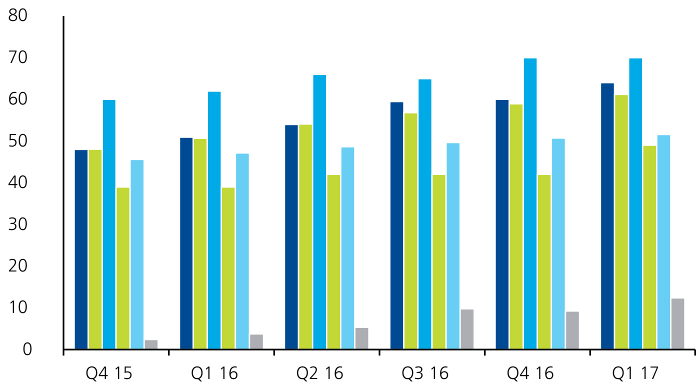
Legend:

Real 2010 USD   Nominal USD

Source: World Bank, Average spot prices (Oct, 2015)

More resilient supply, including in North America, and weaker global activity remain the key factors behind the downward pressure on prices. The adjustment for excess supply conditions is expected to take longer, and prices are projected to remain below the projected levels.

Spot crude oil prices - Forecsast ($/Barrel)



Legend:

- Median
- Low
- Mean
- Current Fwd
- High
- Diff (Median - Curr)

Source: Bloomberg (Accessed on Oct 23rd, 2015)

3. Slowing Chinese economy:

The slowdown in China is, so far, in line with forecasts (expected to grow 6.8 percent in 2015 and 6.3 percent in 2016), but its cross-border repercussions appear greater than previously envisaged.

- This is reflected in weakening commodity prices (especially for metals) and reduced exports to China (East Asian economies). Investment growth slowed compared with last year and imports contracted, but consumption growth remained steady. While exports were also weaker than expected, they declined less than imports, and net exports contributed positively to growth.
- If China registers further slow growth, the effects would be felt in the rest of the region, especially in countries linked to China through trade, investment, and tourism.

4. Expectations about monetary policy in the United States:

With the first increase in U.S. policy rates (0.25 percent since 2009 and is expected to increase to 0.5% by Q4 2015) approaching and contracting the global outlook, emerging markets will see tightened financial conditions. Dollar bond spreads and long-term local-currency bond yields have increased by 50 to 60 basis points on average, and stock prices are weaker, while exchange rates have depreciated.

- While the increase in U.S. interest has been anticipated and is likely to be orderly, markets could react sharply, causing currencies to depreciate, bond spreads to rise, capital inflows to fall, and liquidity to tighten.

Capital flows to emerging markets have slowed recently, and increased U.S. policy rates are likely to be associated with some tightening of external financial conditions.

Malaysia economic outlook

Key Issues:

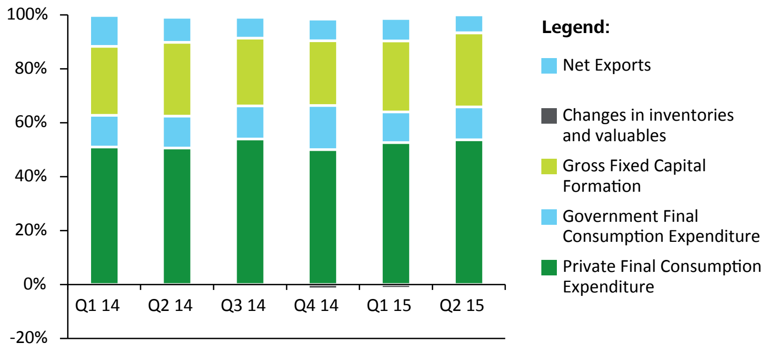
- **Foreign direct investments**
- **Short term economic outlook for Malaysia**
- **Policy frameworks and government initiatives**
- **Risks factors for moderating growth**

Malaysia's economy has performed strongly in H1-2015 (overall 5.3% (5.6% in Q1 and 4.9% in Q2)) owing to improved domestic demand (private consumption increased from surge in retail spending ahead of introduction of 6% GST in April 2015), offset by weakening exports. But the economy is moving towards moderation in output growth (4.7 percent in 2015), caused by deterioration in the external balances, which has weighed on the currency.

- Malaysia's trade surplus was significantly impacted by weaker export revenues, which has narrowed the country's overall current account surplus to 2.7% of GDP in Q2 2015, as against 3.6% in Q1 2015 and 4.4% in 2014.
- The ringgit has also depreciated by 20.6% against the US dollar and 8.9% in real trade-weighted terms (January – August 2015).

GDP growth is moderating, weighed down by net exports and, in Q2, lower domestic demand growth

% contribution to GDP by expenditure



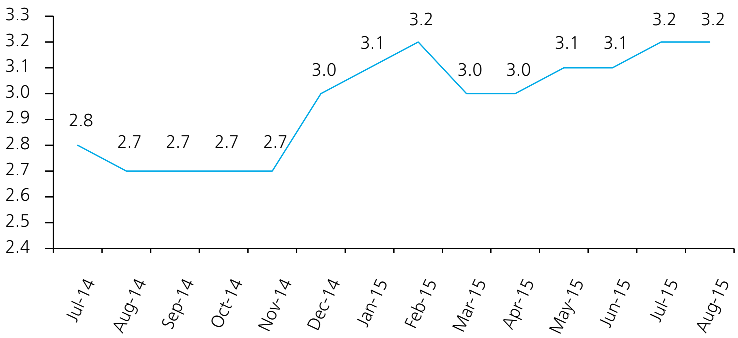
Source: Department of Statistics, Malaysia

The government maintained growth in its consumption expenditure at 5.5% in the first 6 months, but its fixed investment declined by 3.7%, partly due to completion of projects by state-owned enterprises. Private sector fixed investment continued to decelerate but still grew by 7.5%. Fixed investment overall increased by 4% in H1 2015, compared to 6.8% during H1 2014.

Private consumption to moderate in short-term: Private consumption generated most of the growth in GDP and expanded by 7.6% in H1 2015, compared to H1 2014. Consumer spending was boosted by wage rises and government cash transfers, including flood relief payments in early 2015. *Domestic demand will be constrained through the second half due to lower earnings from oil and other commodities, and due to falling consumer and business confidence. A number of factors point to more muted growth in private consumption: slowing growth in credit to households, high household debt (87.9% of GDP), signs of softening in the labor market, and implementation of GST*, among others.

In the recent budget, the government has increased minimum wage from RM 900/month to RM 1,000/month that could have an impact on private consumption but increasing unemployment could be a concern. Although, the unemployment rate is low (3.2%), the number of unemployed rose by 16.6% in the 12 months to June 2015. Companies are facing heat due to slowing economy and have taken retrenchment initiatives to cut cost.

Unemployment Rate (%)



Source: Department of Statistics, Malaysia

Exports are facing heat: Trade and current account surpluses narrowed in H1 2015. Merchandise exports fell by 13.7% to US$89.7 billion. This was due to decline in exports of commodities, resource-based manufactured products such as refined petroleum, and slow growth registered by electrical products. Demand in major markets was weak and prices dropped for oil, liquefied natural gas, and some agricultural commodities. As for export destinations, the steepest falls were recorded in shipments to Japan, the Republic of Korea, Taipei, and China. Imports of intermediate and capital goods declined, reflecting the export and investment results, but buoyant private consumption drove imports of consumer goods. This resulted in 21.9% narrowing of the trade surplus to US$14 billion. This, and a much wider deficit in services, due partly to a decline in tourist arrivals, reduced the current account surplus by more than half to US$4.8 billion, equal to 3.1% of GDP. The financial account posted net outflows of US$7.6 billion (outward portfolio investment), leaving the balance of payments in deficit by US$2 billion, equivalent to 1.3% of GDP.

Export income has been considerably weaker than anticipated. Some improvements were noted during June and July (2015) for exports of electrical and electronic products, palm oil, and rubber, but export income for crude oil, refined petroleum products, and liquefied natural gas dropped. Exports are seen to be picking up in 2016, though imports will also rise in line with a projected better performance in investment. Better outlook for export will help current account surpluses to reach 2.7% of GDP in 2015 and 3.2% in 2016.

Exports forecast to rebound 1.4% in 2016 after a 0.7% fall in 2015.

Import and Exports (RM Billion)

Source: Department of Statistics, Malaysia; and Malaysian Industrial Development Finance Berhad (Trade Balance Remains Sizable, November 2015)

Major Exports (RM Million)			
	2014	Jan - Aug 2014	Jan - Aug 2015
Electrical and Electronic Products	256,145	165,492	177,665
Palm Oil and Palm Oil-Based Products	66,073	43,504	40,568
Liquefied Natural Gas	63,750	42,184	31,305
Crude Petroleum	32,723	22,175	16,314
Petroleum Products	60,415	42,055	26,655

Source: Department of Statistics, Malaysia; and Malaysian Industrial Development Finance Berhad (Trade Balance Remains Sizable, November 2015)

Further, the economic slowdown in China, which accounts for over 9% of total Malaysian exports, may have a negative impact on the Malaysian economy, if the economy continues to contract. The spillovers of economic slowdown in China would be relatively significant for economies that trade intensively with China. Malaysia is particularly exposed, as measured by the Chinese market share of its total output. China's growth moderation and rebalancing has already exerted a significant negative impact on international commodity prices, and hence, on the terms of trade, exports, and growth in major commodity producers including Malaysia.

Within control Inflation: In Malaysia, retail prices rose following the introduction of the General Sales Tax in April 2015. Inflation was unexpectedly low at an average of 1.7% y-o-y during January-July 2015, even as the new tax on goods and services and the ringgit's depreciation put some upward pressure on prices in Q2 2015. Headline inflation, after dipping below 1% y-o-y in March 2015, increased to 3.3% y-o-y in July 2015. Rising vegetable prices caused by bad weather contributed to higher inflation in July. The producer price index fell by 6% over the first half owing to lower global prices for oil and other commodities. *Firmer domestic demand, higher oil prices, and the ringgit's depreciation will put moderate upward pressure on the inflation rate in 2016, offset to some degree by the fading impact of the goods and services tax next year.*

Year	2012	2013	2014	2015	2016
Inflation	1.7%	2.1%	3.1%	3.2%	2.9%

Source: Department of Statistics, Malaysia

Debt to increase: Malaysia's external debt as a percentage of GDP rose to 53.8% in Q2 2015 from 51.4% a year earlier (June 2014 – June 2015). Most of the debt is categorized as medium-long term and is to be serviced by Malaysian currency. Government debt limit is expected to remain at 54% in 2015 and 55% in 2016, as against 52.7% in 2014.

(RM Million)	1Q 2014	2Q 2014	3Q 2014	4Q2014	2014	1Q 2015	2Q 2015
Central Government Debt	560.6	568.9	569.3	582.8	582.8	596.8	627.5
% of GDP	50.7	51.4	51.4	52.7	52.7	51.2	53.8
Domestic Debt	398.4	397	397.2	414.7	414.7	418.9	429.2
% of GDP	36	35.9	35.9	37.5	37.5	35.9	36.8
External Debt	162.1	171.9	172.1	168.2	168.2	177.9	198.3
% of GDP	14.7	15.5	15.6	15.2	15.2	15.3	17

Source: Malaysian Investment Development Authority

Currency in pressure: The exchange rate for ringgit fell below symbolic thresholds against the U.S. dollar (4 Malaysian ringgit/ U.S. dollar). From the start of this year to early September, the ringgit depreciated by 16.5% against the U.S. dollar. However, the U.S. dollar has strengthened on a global basis since mid-2014, amidst continued quantitative easing in the Euro area and Japan. In mid-August, the adjustment in China's system of exchange-rate fixing also caused a 2% depreciation. The depreciation of the ringgit will have a limited direct impact on the ability of the government to service its debt, since only 3% of Malaysian government debt is denominated in foreign currency. *MYR crossed the "psychological threshold" of RM3.80/USD on 6 July 2015, and touched its lowest external value in the last 17 years at RM4.4725/USD on 29 September 2015.*

Significant decline in current account:

Malaysia's balance of payments has some cushion against weaker capital inflows. Reflecting its well-diversified economy and competitive manufacturing sector, the current account remains in surplus. But this surplus has declined significantly from above 10% of GDP in 2011 to a forecast 3.5% of GDP in 2015. Notwithstanding the current account surplus, the ringgit has depreciated by more than 18% this year, while gross foreign currency reserves dropped to US$94.5 billion by mid-August from US$116.0 billion at end 2014. The current account balance of Malaysia has been eroded by the decline in global commodity prices and demand since 2011. Malaysia's current account surplus has narrowed dramatically in recent years, and continued to fall in the second quarter of 2015; imports compressed, in line with a moderation in domestic demand, but export revenues, including for hydrocarbons, weakened even further.

The recent budget highlights decline in current account surplus to RM 11.3 billion in 2016, from RM 23.4 billion in 2015, and RM 47.3 billion in 2014.

(RM Million)	1Q 2014	2Q 2014	3Q 2014	4Q 2014	2014	1Q 2015	2Q 2015	2015 (F)
Current Account Balance	19,518	14,986	7,148	5,666	47,317	9,968	7,582	49,049

Source: BNM

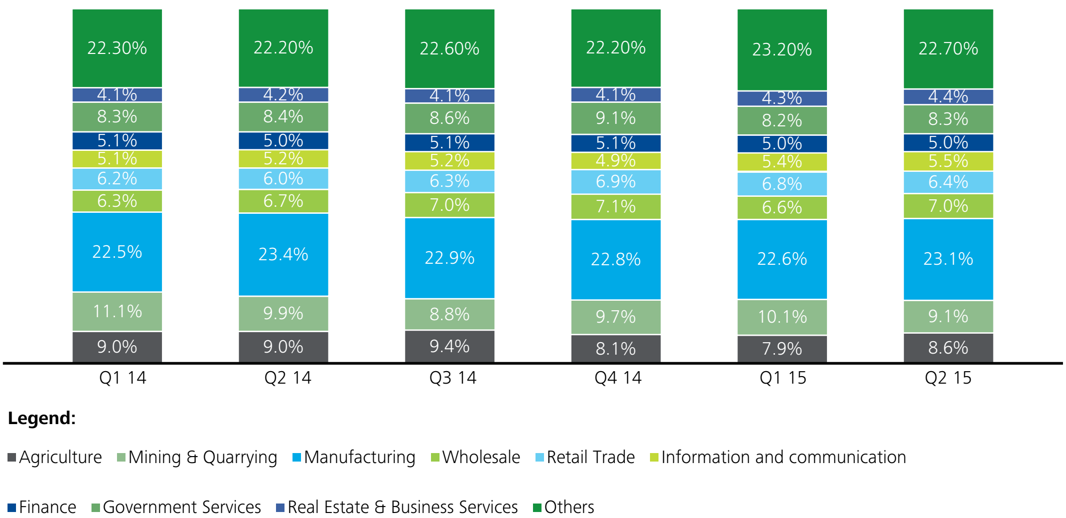
Declining reserves: International reserves fell by 18.3% to US$94.7 billion through August from the start of 2015, still enough to cover 7.4 months of imports, and equal to short-term external debt. The fall in reserves reflected efforts by the central bank to support the ringgit as it came under downward pressure largely from the slide in exports and capital outflows. Investor concerns about the finances of the government-owned investment company 1Malaysia Development Berhad intensified pressure on the ringgit in August.

(USD Billion)	1Q 2014	2Q 2014	3Q 2014	4Q 2014	2014	1Q 2015	2Q 2015	3Q 2015 (Oct)
International Reserves	134.9	130.2	131.8	127.3	116	105.1	105.5	94.1
Months of Retained Imports	9.2	9	8.7	8.4	8.4	8.1	7.8	7.4

Source: BNM

Moderating industry growth: Growth in manufacturing slowed to 4.9%. Electronics output, which rebounded in the first half of 2014, fell in the 6 months to June this year. Construction also decelerated from a year earlier, though it still recorded robust expansion of 7.7%. Output from mining/oil & gas quickened to 7.8%, driven partly by a new oilfield offshore of Sabah state. Agricultural production was flat in the first half of 2015. Small increases in the production of food and natural rubber were offset by lower production of palm oil caused by floods.

% contribution to GDP by economic activity



Source: Department of Statistics, Malaysia

FDI – Maintaining net inflow:

During 2015, the inflow of foreign direct investments (FDI) stood at RM9.88 billion in Q1 and RM12.48 billion in Q2.

In 2014, FDI flows recorded a net inflow of RM35.3 billion (2013: RM38.2 billion) to attain position at RM467.5 billion at the end of 2014 (2013: RM446.4 billion). The net inflow was generated from equity & investment fund shares of RM30.3 billion (2013: RM31.3 billion) or 85.8%, and debt instruments posted RM5.0 billion (2013: RM6.8 billion) or 14.2%.

The top five investing countries for inflows in 2014 were: Singapore, Netherlands, Hong Kong, Cayman Islands, and Bermuda. These countries recorded a total of RM22.4 billion (63.4%) of the total inflows in Malaysia. With regard to position as at end 2014, FDI investment was mainly originated from Singapore, Japan, Netherlands, United States, and Norway, which amounted to RM257.7 billion (55.1%) of total position in Malaysia. In terms of income, United States, Singapore, Netherlands, Japan and Bermuda were the top earners in 2014. Together, these countries accounted for a total of RM39.0 billion (62.3%) of the total income in Malaysia. In terms of flows, the services sector was the largest recipient of FDI 46.6% in 2014, followed by the mining & quarrying (36%) and the manufacturing sector (13.2%).

Outlook:

As a major producer and exporter of crude oil, natural gas, and palm oil, Malaysia is bound to be affected by the decline in demand and prices for hydrocarbons and other commodities. Net external demand dragged down GDP growth in the first half of 2015, and this is expected to continue in the second half.

Malaysia's growth is also expected to ease during 2015-2016 amid intensifying downside risks from a potential slowdown in China's economy, the impending U.S. interest rate hike, weak commodity prices, and moderating domestic demand.

Again, private consumption faces headwinds from lagging consumer confidence, the new tax on goods and services, slowing growth in credit to households, and signs of softening in the labor market. Business sentiment has been hurt by dampening prospects for exports, a sharp depreciation of the ringgit, slide in stock prices, and spare manufacturing capacity. Capital expenditure in the oil and gas sector, a key driver of strong investment growth in the past three years, will be delayed by lower oil prices.

Overall, growth is expected to slow to 4.7% for 2015 and 2016, before picking up mildly toward 5% in 2017, helped by strengthening exports. The current account balance is projected to hold at approximately its recent level (2.5% of GDP in 2015). The ongoing moderation in domestic demand and global commodity prices should help to cap inflation below 3% in 2015. In 2016, investment is projected to strengthen on prospects for improved economic growth in the major industrial economies and some improvement in demand for oil and commodities.

Policy frameworks:

Alongside the flexible approach to the currency, the authorities have also smoothed volatility and drawn down reserves, which fell by US$20.3 billion (January – August 2015). BNM has maintained its overnight policy rate at 3.25% since July 2014. Growth in loans outstanding to households moderated to 8.7% year on year in June 2015, though loans to businesses picked up to increase by the same 8.7%. Concerns about high household debt and capital outflows could weigh against easing interest rates.

Diversifying public revenue: Since oil-linked revenue accounts for approx. 30% of government's revenue, the drop in global oil prices has posed a major fiscal challenge. The government has scrapped fuel subsidies in 2014 (yielding budgeted savings for 2015 of RM10.7 billion (US$2.6 billion) and narrowed fiscal deficit to 2.8% of GDP in H1 2015 from 3.5% in H1 2014), and introduced the new GST that has helped to maintain fiscal stability.

Government stimulus: The government has established a Fiscal Policy Committee, besides adopting a medium-term fiscal framework to strengthen public finance management and ensure fiscal sustainability. The government is constrained from offering substantial new fiscal stimulus by its pledge to shrink the fiscal deficit, in order to narrow the gap to 3.2% of GDP in 2015 and cut public debt by 2020.

Eleventh five-year plan (2016 – 2020): The plan unveiled in May 2015 targets annual average GDP growth of 5–6% (5.3% in previous plan). Inflation is targeted at below 3%. The plan aims to raise gross national income per capita from the US$10,200 expected this year to US$15,690 in 2020. The strategy emphasizes boosting productivity by building infrastructure and broadband networks, investing in skills development, and fostering small and mid-sized enterprises. Private investment is targeted to rise by an average of 9.4% per year in real terms through 2020, and public investment by 2.7%.

Risks:

The Malaysian economy faces a challenging environment due to a continued plunge in commodity export prices, foreign exchange market turbulence – commodity-currency shocks, slowing Chinese economy, and to an extent normalization of interest rates in the US. On the domestic front, increasing net outflows of portfolio investment; the depreciation of the ringgit; rising cost of living; increased federal government and household debts; rising probability of default; and increasing likelihood of downgrading of ratings for Malaysian Government debt also present a cloudy economic outlook.

A focus on Malaysia's Oil & Gas sector

Key Issues:

- **Investments and projects**
- **The strategic focus of Petronas**
- **Global industry challenges**

As the world's second-largest exporter of LNG and the second-largest producer of oil and natural gas in Southeast Asia (fourth-largest reserves in Asia), Malaysia's economy is, to a great extent, dependent on oil and gas industry. The oil, gas, and energy industry contributes over 20% to Malaysia's GDP, a prominent sector to define future growth of the country.

The current state of Malaysia's oil and gas industry

Malaysia has witnessed a marginal growth in oil production and reserves, while gas production continues to trend upward (accounted for 10.2% of global LNG exports in 2014).

- Declines in production at Malaysia's major producing oil fields (Tapis, Seligi, Guntong, Semangkok, Tebu, and Palas) have prompted government efforts to encourage investment in enhanced oil recovery, and development of marginal and deep water fields (through risk-sharing agreements). Future hydrocarbon production will be increasingly reliant on deep water offshore fields requiring higher investment.
- Malaysia strategically exports its premium crude oil and imports low-grade oil to refine in its downstream facilities. Further, the country is increasing refining capacity to become a net oil product exporter. The Pengerang Integrated Petroleum Complex (PIPC) in Johor, and Sipitang Oil & Gas Industrial Park (SOGIP) in Sabah will almost double the refining capacity nationwide from 588,000bbl/d to 1,158,000bbl/day.
- Although Malaysia is expanding its LNG facilities (3.6mt of capacity due to come on stream in early 2016), the country is expected to lose market share to other LNG-exporting countries such as Australia, where output is growing rapidly. Malaysia's LNG exports are expected to remain under pressure during 2015-2021, declining from 28 bcm in 2015 to 27.0bcm in 2021.

PETRONAS' Group Petroleum Resources

(Billion barrels of oil equivalent)		1 January 2015	+/-	1 January 2014	Share of Global Reserves (%)	R/P Ratio
Crude Oil & Condensates	Reserves (2P)	4.2	-6.70%	4.5	0.20%	15.4
	Contingent Resources (2C)	3.3	6.50%	3.1		
Natural Gas	Reserves (2P)	8.1	3.80%	7.8	0.60%	16.2
	Contingent Resources (2C)	12.1	-0.80%	12.2		
Unconventional	Reserves (2P)	2.4	60.00%	1.5		
	Contingent Resources (2C)	3.1	-16.20%	3.7		
Total Discovered		33.2	1.20%	32.8		
PETRONAS Entitlement		11.3	11.90%	10.1		
ORRR (3 Years Rolling Avg.)		3.12x		3.09x		

Source: PETRONAS Annual Report 2014

Oil	[Thousand barrel/day]	2010	2011	2012	2013	2014	Share of global
	Production	718	653	671	645	666	0.70%
	Consumption	689	718	759	800	815	0.80%

Gas	[Billion Cubic Meters]	2010	2011	2012	2013	2014	Share of global
	Production	62.6	62.2	61.6	67.2	66.4	1.90%
	Consumption	34.5	34.8	35.5	40.3	41	1.20%

Source: BP Statistical Review of World Energy June 2015

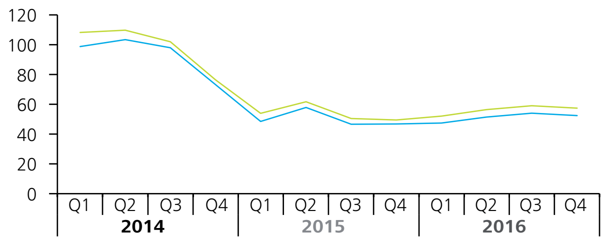
Key trends to watch:

Deep water exploration to slow down: Malaysia's deep water assets hold over 7 billion barrel of oil equivalent (boe), of which only 50% has been identified, while extraction activities are limited to only 26% of these assets. As these projects are capital intensive, an environment of lower oil prices may raise sustainability issues for companies. Marginal field (over 120 fields in Malaysia with potential oil reserves of 600 million barrel of oil equivalent) development (under risk-sharing contract with Petroliam Nasional Berhad (PETRONAS)) will also see a decline due to low oil prices.

Enhanced oil recovery (EOR) for increased production: Malaysian oil fields have an oil recovery factor of 35-37% of oil-initially in place (OIIP). PETRONAS has prioritized this method, given that over 40% of the country's producing oil fields have potential for EOR, which could increase OIIP by 5-10%. PETRONAS also plans to spend over RM1 billion towards R&D for EOR studies.

Mid-term oil and gas price outlook:
Shale oil development is creating a structural change, leading OPEC to give up its market manager role and create price volatility. Oil price is expected to touch level of US$40-70/bbl in the mid-term, wherein shale oil will play a 'price ceiling' role.

Average crude oil price (US$/barrel)

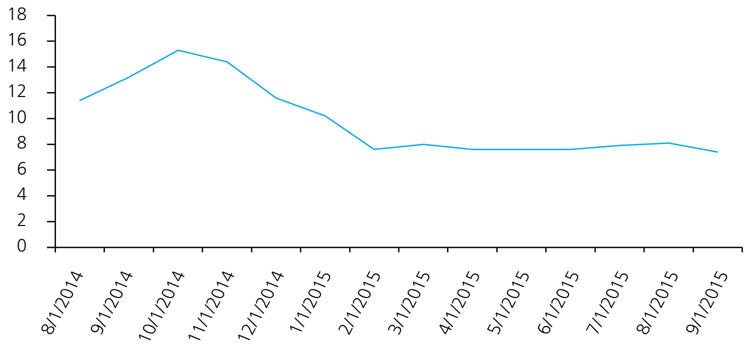


Legend:

WTI Spot Average   Brent Spot Average

Source: EIA

LNG spot price (US$/mmBTU)



Source: EIA

In September 2015, S&P revised its crude oil and natural gas prices. The new price assumptions are US$50 per barrel (bbl) for Brent (down US$5 from the previous price assumption) and US$45/bbl for WTI (down US$5), while Henry Hub will remain US$2.75 per million Btu for the remainder of 2015. For 2016, price assumptions are US$55/bbl for Brent, US$50 for WTI, and US$3 per million Btu for Henry Hub.

Investment and projects: Low oil and gas price has raised concerns for energy companies, particularly in the upstream space, to revisit and reassess their investments. Major players in the industry have reduced their capital expenditure.

Investment in Petroleum Products (Including Petrochemicals) - US$ Million				
Time Period	**Number of Projects**	**Domestic**	**Foreign**	**Total Investments**
Jan - June 2015	3	6,619.24	74.28	6,693.52
2014	19	3,215.79	1,350.44	4,566.24

Source: Malaysia Investment Development Authority

As part of Malaysia's Economic Transformation Programme, two new oil and gas industrial projects are underway to support Malaysia's industrial growth and develop the country as a regional energy hub:

- **Pengerang Integrated Petroleum Complex (PIPC):** This project comprises Pengerang Independent Deepwater Petroleum Terminal (PIDPT), and Pengerang Industrial complex. The 20,000- acre industrial project houses refining and petrochemical facilities, storage facilities, import terminals, and an LNG liquefaction terminal. The first phase of PIDPT, with a storage capacity of 8 million bbd, has been completed. The second phase aims to increase the storage capacity to five million cubic metres by 2020.
- **Pengerang Integrated Complex**: PETRONAS started (April 2014) the $16-billion, Refinery and Petrochemical Integrated Development project (RAPID). The project (a 300,000 bbl/d refinery to be operational by 2019) is a cornerstone of the Pengerang Integrated Petroleum Complex, which will help establish Malaysia as a regional oil storage and trading centre by 2020.
- **Sipitang Oil and Gas Industrial Park (SOGIP):** A 4,000-acre industrial park, SOGIP is targeted for completion in 2015. This is expected to serve as a new focal point for oil and gas investment within the Sabah, Brunei, and Labuan economic regions.
- Other notable projects include: PETRONAS LNG Train 9 in Bintulu (to be operational by Q4 2015); PETRONAS Floating LNG (Q4 2015); ROTAN LNG (2018); and two PETRONAS Floating LNG projects being executed in Korea. Pacific North West Integrated LNG project in Canada is stuck at the conditional final investment decision (FID) stage.

Overall outlook for oil and gas industry in Malaysia:

- The impact of falling oil prices could be seen in terms of reduced investments and slower production rates in Malaysia. The effect has been highlighted by mature oil fields and high cost of exploration (long term) for potential deep water assets (EOR and marginal fields), which have a high breakeven point. Falling oil prices may not adequately support these capital-intensive projects.
- Although new refining projects (Sabah and Johar) will significantly increase Malaysia's refining capabilities (in line with its development agenda to become a regional oil and gas hub by 2020), falling oil prices, consolidation in the industry, and subdued domestic consumption (due to removal of subsidies and moderate economic outlook for Malaysia) may have a negative impact.
- New production from 'Greenfields' 1st hydrocarbon (11 year-to-date, 5 in Q3 2015), new discoveries (12 in 2015 with overall resource replenishment ratio of 1.5x and reserve replacement ratio of 1.9x), and new production (Azerbaijan and commencement of production from Gladstone LNG project in Australia) will help PETRONAS sustain production levels and ease pressure on maturing fields. Additionally, Malaysia's first deep-water development, the Gumusut-Kakap field, has commenced production (October 2014). Once operating at full capacity, the floating platform is expected to reach a yearly peak oil production of about 135,000 barrels/day. The Bertam field also commenced production in April 2015, and is expected to reach 15,000 barrels/day by the end of 2015.

Impact of moderate outlook of oil and gas industry: PETRONAS is Malaysia's National Petroleum Corporation [and the regulator], wholly owned by the Malaysian Government.

- **Contribution to Malaysian government revenue**: PETRONAS is a major revenue contributor for the government of Malaysia. Slow growth and subdued oil prices are negatively impacting performance of PETRONAS and, in turn, dividends, for the government of Malaysia. As part of its Q3 2015 results disclosure, PETRONAS announced a lower dividend to the government, with an agreed RM16 billion (excludes taxes - estimated at RM9.33 billion) to be paid in 2016, as compared to RM26 billion being paid for this year. This would be PETRONAS' lowest dividend payment to the government since 2007. The impact of lower dividend, however, is expected to be partially offset by the removal of subsidies on fuel. The government of Malaysia is diversifying its revenue base to reduce reliance on the oil and gas sector.
- **Impact on Malaysian economy:** The government's budget is premised on the average price of Brent crude oil at US$55 a barrel, and right now, the average for the year is close to that. With Brent trading below that number, the budget deficit for Malaysia will go up. Again, the collapse of crude oil price will have a major effect on companies, employment, and the economy. A number of companies have had to make write-offs on their ongoing businesses, and the weak price of crude oil will mean that exploration and production activity will slow down.

Strategic focus of PETRONAS: Despite the bearish outlook, PETRONAS is keen to expand its portfolio with quality assets (acquisition of remaining interests in Malaka refinery complex from Philip66) and other opportunities (production-sharing contracts). Projects that have already reached FID, such as RAPID and Pacific North West Integrated LNG project in Canada (conditional FID), are expected to progress on schedule. The company's main focus remains on internal cost-containment measures to improve bottom-line margins and increase the utilization rate of its E&P assets by 5% in terms of well production volume. The company's Cost Reduction Alliance initiative (Coral 2.0) realized actual savings of RM1.5 billion as at September 2015.

- The industry is expected to foresee consolidation in the near future to tackle a pervasive low oil price environment in the short to medium term.

Challenges for the global oil and gas industry:

- **Uncertain global economic scenario**: Although advanced economies are picking up growth, growth in developing and emerging markets is expected to moderate. As developing economies constitute a major portion of hydrocarbon consumption, a decline in economic and industrial activity in these economies will have a negative impact on oil and gas exporters.
- **Currency volatility**: Most of the currencies are trading weaker against the US dollar. The volatile currency environment favors net importers of commodities but will have a negative impact on net exporters. Malaysia exports a significant volume of sweet crude oil & LNG (net exporter), and could be affected by the low exchange rate of ringgit against the US dollar.
- **Low commodity prices**: The low oil and gas price scenario is not expected to recover in the short to medium term, and the prices are expected to remain well below the threshold of US$70/barrel till 2017-18. This will have a negative impact on investment in the sector and companies will be reluctant to take up capital-intensive projects, putting more pressure on conventional E&P projects. Moreover, the global oil & gas industry is expected to cut over 200,000 jobs in the near future.
- **China factor:** China's economic growth has slowed and the economy is expected to moderate further in the short term. The country is moving towards less reliance on import-intensive investment, which will impact its trading partners. Also, being a major consumption destination of natural resources (hydrocarbons and minerals), China will exert downside pressure on commodity prices, if demand falls further.
- **Increase in costs of doing business**: Most producing fields in Malaysia are moving towards maturity and production levels are expected to decline. Malaysia's deep-water assets have potential for E&P activities, but the current low-price scenario may not create a feasible environment to undertake these high-cost activities. Also, an increase in minimum wages in Malaysia will increase the overall cost of operations for oil & gas companies.

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The Malaysian economy faces a challenging environment due to a continued plunge in commodity export prices, foreign exchange market turbulence – commodity-currency shocks, and a slowing Chinese economy. On the domestic front, the depreciation of the ringgit, increased federal government and household debts, and rising probability of default present a cloudy economic outlook.