Industry Note

October 17, 2019

# Refining/Chemical

OVERWEIGHT

**Refining/Chemical/Utility**

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## VLCC rate hike to benefit Korean refiners

### Major issues and conclusions

- Concerns that the recent VLCC spot price hike will add to Korean refiners' cost burdens overblown
- Chinese refiners, mostly working with Chinese shippers, likely to be forced to lower utilizations, benefitting Korean refiners
- Despite the recent hike of complex margins, Chinese teapot refineries' utilizations fell due to a sharp decline in simple refining margins caused by the collapse in the price of bunker C oil; teapot refineries' profitability to continue narrowing going forward

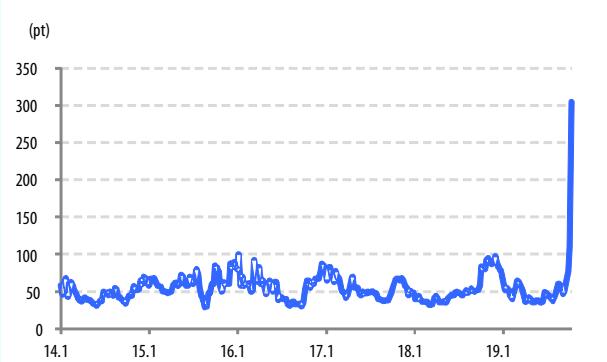
### Industry and stock outlook

- Refining shares reflect excessive cost concerns of late, instead of pricing in refining margin strength
- Corrections offer a good entry point; we continue to present S-Oil (010950.KS, BUY) as our top pick and SK Innovation (096770.KS, BUY) as a stock of interest

### VLCC rate hike put Korean refiners in an advantageous position vs. Chinese peers

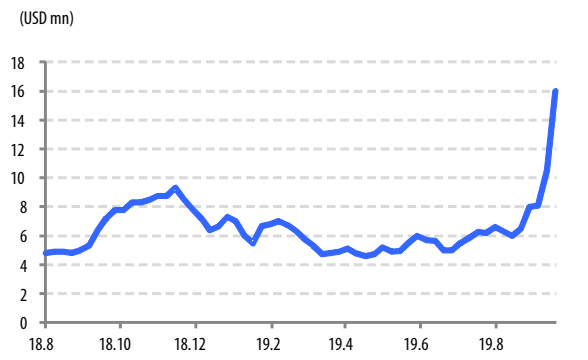
There are concerns that the recent VLCC freight rate hike could burden Korean refiners. In our view, these worries are overblown, because Korean refiners' VLCC contracts are mostly long term. However, for Chinese refiners, it is indeed burdensome. Reuters reported that Sinopec, China's biggest refiner, decided to reduce its crude imports in December and was considering lowering the utilization of its refining facilities. Chinese refiners use Chinese ships and their contracts are mostly spot contracts. Accordingly, they will be directly impacted by the rising VLCC spot freight rates. Their cost burdens could increase considerably, assuming VLCC freight rates increase on an average of USD7/bbl. Korean refiners, relatively less affected by the freight rate hike, stand to benefit in the tightening petrochemicals market. As supply tightens further toward the end of the year, refining margins should improve too.

**Fig 1. VLCC spot rate: Middle East-Ulsan (WS)**




Source: Clarksons, Hyundai Motor Securities

**Fig 2. VLCC spot rate: Middle East-Ningbo (lump sum)**




Source: Clarksons, Hyundai Motor Securities

### VLCC spot rate hike has a limited impact on long-term shipping contracts

The recent spike in VLCC freight rates is the result of tight supply stemming from the US sanctions on oil tankers owned by China's COSCO Shipping Tanker and heightening tensions in the Middle East which worked to raise risk premiums and insurance premiums. COSCO Shipping Tanker is one of the world's biggest VLCC operators with some 50 VLCCs. The refiners that used to use COSCO's ships are switching to other companies' ships in order to dodge US sanctions, which caused a sharp increase in spot freight rates. It is believed that about 300 VLCCs have stopped operating as the result of the sanctions.

Even if the VLCC spot rates increase, it does not affect long-term contracts. Long-term contract prices are determined when newbuilding orders are awarded according to the agreements between freight owners and charterers/ship owners, taking into account newbuilding prices and other financial costs. Possible increases in variable costs and insurance premiums afterward may be recognized by freight owners but these cost increases are only a small portion of freight rates. Korean refiners have 70-80% of their contracts long term, thus current spot rate hikes are not completely reflected into their freight rates. We note that recent sharp increases in the BDI have not significantly boosted the profitability of STX Pan Ocean or Korea Line Corp (005880.KS, not rated).

**Fig 3. Asia's biggest refiner Sinopec to cut refining utilizations on freight rate burden**

REUTERS

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China's Sinopec weighs output cuts due to freight rate surge: sources

Florence Tan, Nidhi Verma, Julia Payne

2 MIN READ



Source: Reuters, Hyundai Motor Securities

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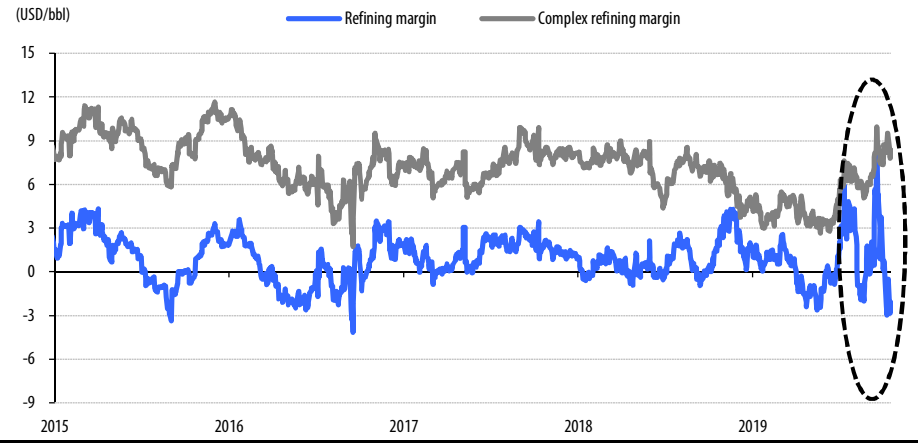
### Decoupling of simple refining margins and complex refining margins under way

As the bunker C oil margin recently fell below –USD10/bbl, simple refining margins have entered negative territory, even though complex refining margins saw a sharp increase on the back of strong gasoline and naphtha margins. This suggests the deepening decoupling of the two margins. We believe the decoupling could further decrease the utilization rates of teapot refineries which do simpler refining work. The decoupling could accelerate further from 2020 because of IMO 2020. We note that, despite the recent strength of complex refining margins, teapot refiners' utilizations fell for a second consecutive month. We expect complex refining margins to remain strong going forward.

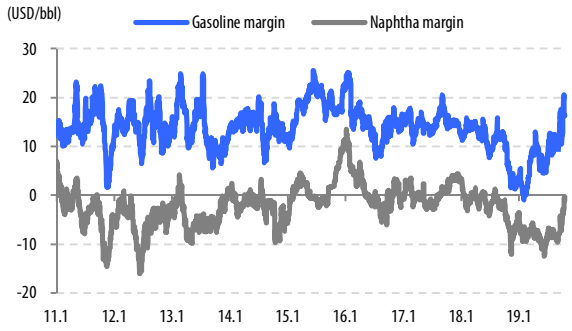
Meanwhile, the gasoline and bunker C oil spread has increased to USD30/bbl on the back of solid gasoline margins and the steep decline in the bunker C oil margin. The gasoline-bunker C oil spread is a key earnings indicator of S-Oil's RUC/ODC facilities. As such, we expect S-Oil to outperform peers from 4Q19 in terms of profitability, the reason that we need to pay close attention to the company.

**Fig 4. Decoupling of simple and complex refining margins**



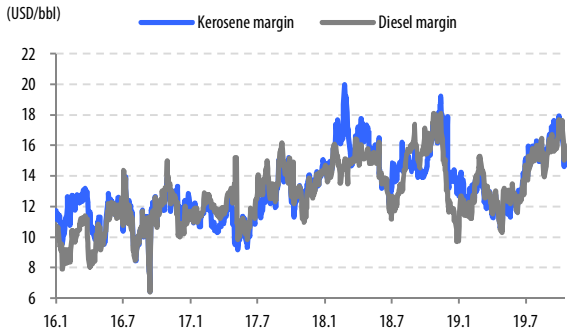

Source: Petronet, Hyundai Motor Securities

**Fig 5. Gasoline and naphtha margins widening sharply**




Source: Petronet, Hyundai Motor Securities

**Fig 6. Kerosene, diesel margins solid**

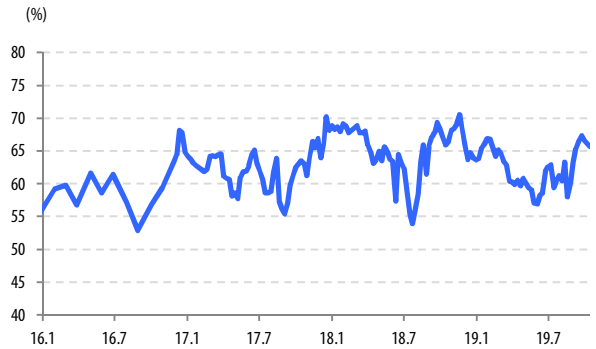



Source: Petronet, Hyundai Motor Securities

**Fig 7. Bunker C oil margin plummets**

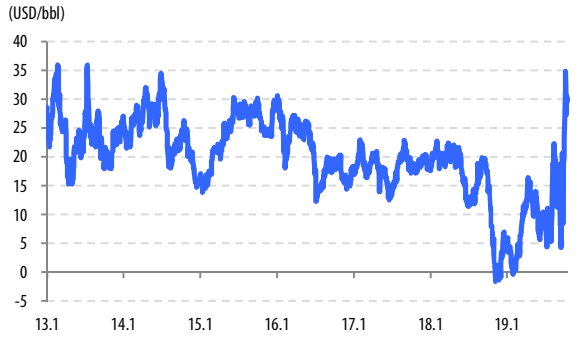
Source: Petronet, Hyundai Motor Securities

**Fig 8. Utilization rate of Chinese teapot refineries**



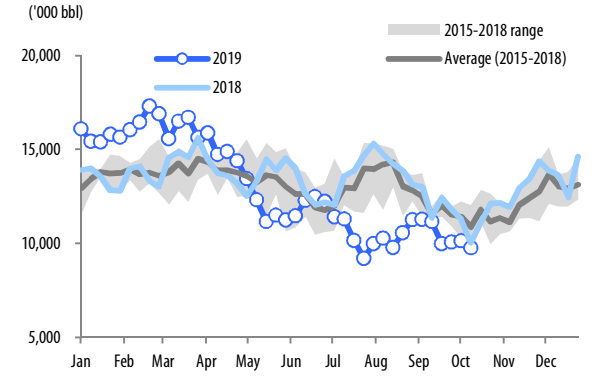

Source: Bloomberg, Hyundai Motor Securities

**Fig 9. RUC/ODC profitability indicator**



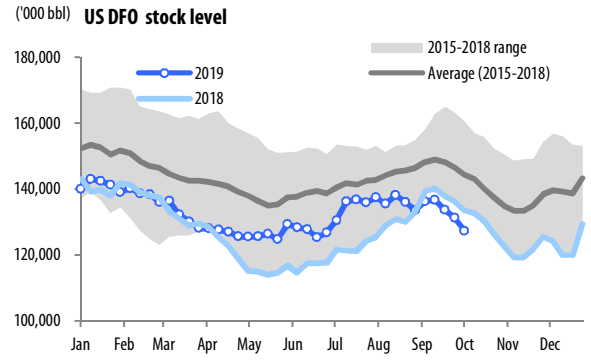

Source: Petronet, Hyundai Motor Securities

**Fig 10. Singapore light distillate inventory at a record low**



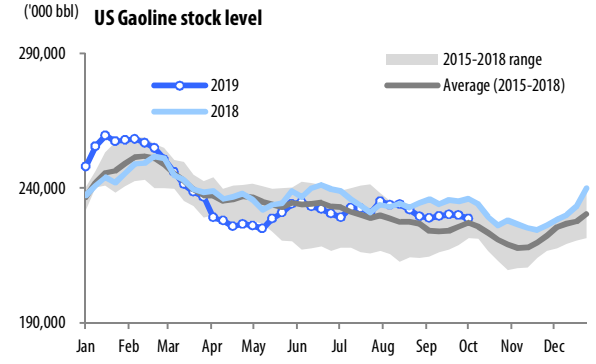

Source: Bloomberg, Hyundai Motor Securities

**Fig 11. US DFO inventory tight**




Source: Bloomberg, Hyundai Motor Securities

**Fig 12. US gasoline inventory burden low**

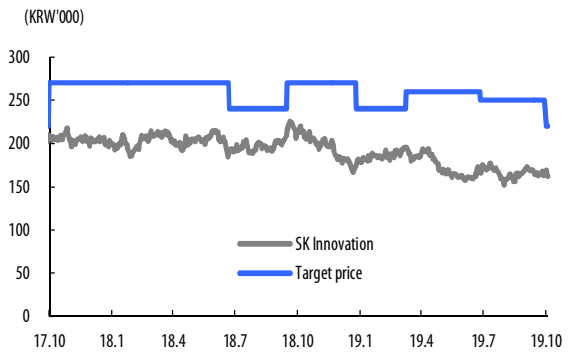



Source: Bloomberg, Hyundai Motor Securities

## Investment rating and target price history

| Date | Rating | TP | Difference (%) | |
|---|---|---|---|---|
| | | | Average | High/Low |
| 19/02/01 | BUY | 240,000 | -22.7 | -20.0 |
| 19/03/06 | BUY | 240,000 | -21.7 | -18.5 |
| 19/03/22 | BUY | 260,000 | -28.2 | -25.6 |
| 19/04/22 | BUY | 260,000 | -28.0 | -25.6 |
| 19/04/24 | BUY | 260,000 | -27.9 | -25.6 |
| 19/04/26 | BUY | 260,000 | -30.9 | -25.6 |
| 19/05/31 | BUY | 260,000 | -33.3 | -25.6 |
| 19/07/09 | BUY | 250,000 | -31.1 | -29.2 |
| 19/07/29 | BUY | 250,000 | -31.2 | -29.2 |
| 19/07/30 | BUY | 250,000 | -34.7 | -31.4 |
| 19/08/16 | BUY | 250,000 | -34.3 | -30.8 |
| 19/09/24 | BUY | 250,000 | -34.0 | -30.8 |
| 19/10/15 | BUY | 220,000 | --22.7 | --25.6 |
| 19/10/17 | BUY | 220,000 | - | - |

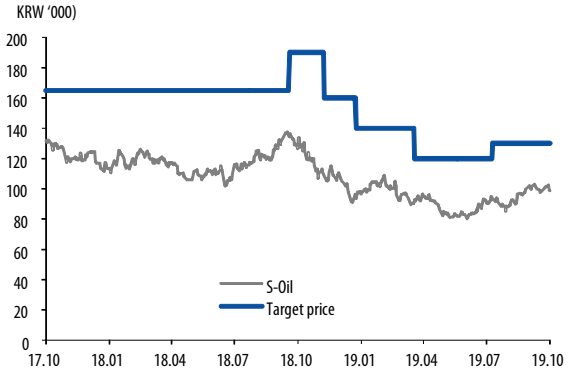
## Two-year price chart




## Investment rating and target price history

| Date | Rating | TP | Difference (%) | |
|---|---|---|---|---|
| | | | Average | High/Low |
| 19/01/29 | BUY | 140,000 | -26.0 | -25.0 |
| 19/02/15 | BUY | 140,000 | -26.3 | -22.1 |
| 19/03/06 | BUY | 140,000 | -29.2 | -22.1 |
| 19/04/03 | BUY | 120,000 | -21.8 | -19.5 |
| 19/04/24 | BUY | 120,000 | -21.7 | -19.5 |
| 19/04/25 | BUY | 120,000 | -25.8 | -19.5 |
| 19/05/31 | BUY | 120,000 | -27.6 | -19.5 |
| 19/07/03 | BUY | 120,000 | -27.5 | -19.5 |
| 19/07/09 | BUY | 120,000 | -26.9 | -19.5 |
| 19/07/25 | BUY | 130,000 | -30.6 | -27.6 |
| 19/08/16 | BUY | 130,000 | -30.0 | -25.3 |
| 19/09/03 | BUY | 130,000 | -27.9 | -21.2 |
| 19/09/24 | BUY | 130,000 | -26.6 | -20.8 |
| 19/10/17 | BUY | 130,000 | - | - |

## Two-year price chart



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## Stock ratings distribution (October 1, 2018-September 30, 2019)

| Rating | Count | % of rating category |
|---|---|---|
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| MARKETPERFORM | 20 | 12.27 |
| SELL | 0 | 0.0 |


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