

Economic Research

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Country Outlook: South Korea



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the last page of this report*

In a nutshell

- The South Korean economy remained strong, having rebounded sharply by 6.1% in 2010 following the dismal performance in 2009 when gross domestic product (GDP) barely grew 0.2%. Policy stimuli (both fiscal and monetary) have proven to be effective as the country managed to sustain positive growth during the global recession in 2009. Going forward, GDP growth is expected to return to its trend level of 4.8%, in line with the Bank of Korea's (BOK) December 2010 projection of 4.5% growth in 2011 and 4.7% in 2012.
- In 4Q2010, sources of growth appeared to have stemmed from the external sector, with real exports registering a 15.7% increase against 11.6% in the preceding quarter. Domestically, consumption expenditure looked to be the main driving force, with private consumption growth holding steady at 2.9% in 4Q2010. Improved labour market conditions, as evidenced by the rise in total employment, would result in sustained private consumption growth going forward. In March 2011, for instance, total employment increased by 469,000 from a year earlier, causing the employment rate to inch up to 58.3% from 57.8% in March 2010.
- Inflationary pressure has started to build up since the second half of 2010, driven by prices of commodities such as agricultural products and fuel. The consumer price index (CPI) continued to climb, with March's reading clocking in at 4.7% compared with 4.1% and 4.3% recorded in January and February respectively as commodity prices continued their ascent. Apart from the cost factor, demand-led inflation is also taking hold in the economy, although it has eased somewhat in recent months. The production capacity index and average operation ratio have improved from their respective troughs of 1.9% year-on-year (y-o-y) in May 2009 and 62.8% in January 2009 to 7.0% and 84.8% in January 2011. Going forward, we foresee international commodity prices continuing to compound inflationary pressure in the economy, given that the country has limited natural resources such as oil.
- The BOK has entered its normalisation cycle as economic activities have picked up pace and prices are now hovering at elevated levels. Thus far, the policy rate has been raised by a total of 100 basis points, bringing the rate to 3.00% currently. The Ministry of Strategy and Finance opined that the industrial output as a whole remains on a recovery track considering favourable conditions for domestic demand and exports. As such, demand-driven inflation is expected to persist, adding upward pressure on the CPI in the near term. Despite the possible headwinds stemming from the external sector, the BOK believes that the Korean economy will maintain its underlying trend, implying that further rate hikes are likely to happen in 2011.
- The country continued to register a healthy balance of payments, with its current account recording a surplus of USD28.2 billion during 2010 (2009: USD32.8 billion), while its capital and financial account reported a deficit of USD25.3 billion (2009: -USD34.7 billion). Similarly, South Korea's reserve assets rose to USD291.6 billion, representing an increase of 8.0% over the previous year's level, sufficient to cover more than seven times its total imports (international standard: three times), indicating that the country has enough buffer if volatility in capital flows become apparent.
- Based on the five-year performance of macro matrices, South Korea's economy continues to possess favourable characteristics: its fiscal position is relatively better than other countries in the region as it lies within the group that has lower government debt and small fiscal deficits (same as Indonesia and China). In terms of growth and consumer prices, the economy appears to be growing at a sustainable path, given the relatively low inflation rate in the past several years. We believe such a growth dynamic is important to promote stability in the country's sociopolitical scene, and is crucial for the crafting of good, efficient and effective policies. As for competitiveness measures, South Korea's position was also favourable as it lies within the top percentile of the Control of Corruption indicator, one of the six dimensions of the World Governance Indicators (WGI).
- On the external front, however, South Korea's position lies in the least-favourable quadrant in light of its relatively low current account balance compared with other countries in the region. This is despite the recent improvement in its current account position. There are also concerns about the country's position in the "per capita GDP and population matrix" due to its low population growth that could potentially weaken the country's future growth prospects, especially when the population is dominated by the older generation.

Introduction

South Korea, one of the world's most renowned industrial nations, is located in Eastern Asia, along the Korea Strait, with the Sea of Japan and the Yellow Sea as its natural borders. It is the 108th largest country in the world at 99,720 square kilometres, and, as part of a peninsula, has a vast coastline of 2,413 kilometres. However, as the country comprises mostly hills and mountains with wide coastal plains in the west and south, only about 16.58% of the land is arable.

Chart 1: The map of South Korea



Source: CIA – The World Factbook

After existing as an independent country since its initial unification in the seventh century, Korea was declared a protectorate of Japan in 1905 following the Russo-Japanese war and subsequently annexed as a Japanese colony in 1910. Korea regained its independence at the end of World War II after Japan surrendered to the United States in 1945. After World War II, the Republic of Korea (ROK) was established in the southern section of the Korean Peninsula with President Syngman Rhee as the first president, while a Communist-style government was formed in the north under Kim Ji Sung. During the ensuing Korean War (1950-1953), troops from the United States and United Nations joined forces to defend the ROK from attacks from North Korea, which was supported by China and the Soviet Union. An armistice was eventually signed in 1953 that separated the peninsula along a demilitarised zone at about the 38th parallel, and to this day, the war has not officially ended.

In the years following the armistice, South Korea underwent a period of political turmoil under autocratic leadership. President Syngman Rhee was forced to resign in April 1960 following a student-led uprising. The Second Republic, under the leadership of Chang Myon, was ended by a military coup led by Major General Park Chung-hee after only a year in power. Park's subsequent rule, which saw significant economic growth and development but curtailed political freedom, ended when he was assassinated in 1979. Subsequently, a strong group of military officers, led by Lieutenant General Chun Doo-hwan, declared martial law and wrested power.

The Park and Chun regimes saw a growing movement against authoritarian rule which peaked after Chun's military coup in 1979. Pro-democracy activities intensified, leaving the authorities no choice but to undertake political concessions in 1987 that included the restoration of direct presidential elections.

In 1987, Roh Tae-woo, a former general, was elected president; further democratic advances during his tenure led to the 1992 election of long-time pro-democracy activist Kim Young-sam, who became Korea's first civilian-elected president in over three decades. The 1997 presidential election and peaceful transition of power was a notable milestone in Korea's democratisation when Kim Dae-jung, a lifelong democracy and human-rights activist, was elected from a major opposition party. In 2002, self-educated human-rights lawyer Roh Moo-hyun won the presidential election on a "participatory government" platform, furthering the nation's transition to an open, democratic system. In December 2007, South Koreans elected former business executive and Seoul Mayor Lee Myung-bak as president.

South Korea has a population of 48,636,068 people as at July 2010, making it the 26th largest nation in the world. The 15-64 years age group makes up 72.3% of the population, and 97.9% of the population aged 15 and over can read and write. Korean is the national language, as the population is homogeneous (except for about 20,000 Chinese), while English is widely taught in junior high and high school.

Serious tensions with North Korea have strained inter-Korean relations in recent years. In 2010 alone, there were two hostile incidents where the North allegedly sank the South Korean warship Cheonan in March, and launched an artillery attack on South Korean soldiers and citizens in November.

The government and legal system

Although South Korea is a republic with powers shared among the president, the legislature, and the courts, the locus of power is traditionally centred in the presidency. The president is chief of state and is elected for a single term of five years, while the 299 members of the National Assembly are elected for four-year terms. South Korea's judicial system comprises a Supreme Court, appellate courts, and a Constitutional Court, and the system's independence has been enshrined in the constitution, which was last revised in 1987.

The country has nine provinces and seven administratively distinct cities: the capital of Seoul, Busan, Daegu, Daejeon, Gwangju, Incheon and Ulsan. Political parties include the Grand National Party (GNP), Democratic Party (DP), Liberty Forward Party (LFP), New Progressive Party (NPP), Pro-Park Alliance (PPA), and Renewal Korea Party (RKP). The current President is Lee Myung-bak, while Kim Hwang-sik holds the post of Prime Minister, functioning as head of the government.

Economic background and structure

South Korea's remarkable development over the past few decades has enabled it to rise from the economic shambles following the Korean war to become a member of the Organisation for Economic Cooperation and Development (OECD). Today, South Korea is the seventh-largest trading partner of the United States and is also the 15th-largest economy in the world, no mean feat for a country with such humble roots.

In the early 1960s, the Park Chung-hee administration initiated sweeping economic policy changes that placed emphasis on exports and labour-intensive light industries, leading to rapid debt-financed industrial expansion. The government also instituted currency reform, strengthened financial institutions and introduced flexible economic planning. In the 1970s, the nation began directing fiscal and financial policies toward promoting heavy and chemical industries, consumer electronics and automobiles. As such, manufacturing grew rapidly into the 1980s and early 1990s.

After the Asian Financial Crisis reared its ugly head in 1997/98, South Korea sought assistance from the International Monetary Fund (IMF) and quickly recovered from the crisis, with its recovery stemming primarily from the extensive financial reforms that helped restore stability to markets. Indeed, growth rates were remarkable in subsequent years - 10% in 1999 and 9% in 2000. The global economy weakened in 2001 after the September 11 terrorist attacks in the United States, causing South Korean exports growth to slow to 3.3%. This prompted the government to introduce stimulus measures that brought about a 7.0% growth in the following year. However, overspending by consumers and the consequent rising household debt, along with other external factors, put a dampener on growth in 2003. Economic performance in the year after improved to a healthy 4.6% due to an expansion in exports, and remained at or above 4% until the onset of the global financial and economic crisis, when annual GDP growth slowed to 2.3% in 2008 and just 0.2% in 2009.

The economy's strong point is its diversity: as of 2008, the economy is comprised of agriculture, forestry and fishing (1.7%), mining and quarrying (0.1%), manufacturing (48.8%), electricity, gas and water supply, and construction (9.0%), services (38.4%) and others (1.9%). The presence of an educated workforce and an export-oriented manufacturing enabled the South Korean secondary sector to grow into a high-income, advanced economy with a developed market.

South Korean companies have grown in stature to become reputable global brands. In 2011, South Korean shipyards are expected to be at the pole position in the global shipbuilding industry due to competitive design skill, abundant skilled labour and technological advancements. Indeed, shipping is a major cornerstone of the South Korean economy, with four main shipyards leading the way: Hyundai Heavy Industries, Samsung Heavy Industries, Daewoo Shipbuilding and Marine Engineering, and the newest in line, STX Shipbuilding. The largest and most successful of the shipyards, Hyundai Heavy Industries, is also the largest shipbuilder in the world, building a full 10 percent of all ships manufactured in the world as at October 2010. Hyundai-Kia, the country's automobile manufacturer, also owns the distinction of being fourth-largest in the world, while the country is home to three of the world's largest oil refineries. In the sphere of consumer technology, the country is the largest manufacturer of television displays, and Samsung and LG are among the world's top three television and mobile-phone manufacturers.

However, the country's rapidly ageing population and structural problems such as the rigidity of labour regulations, the need for more constructive relations between management and workers, the country's underdeveloped financial markets, and a general lack of regulatory transparency are presently threatening to detract from the nation's growth potential.

The economy in detail

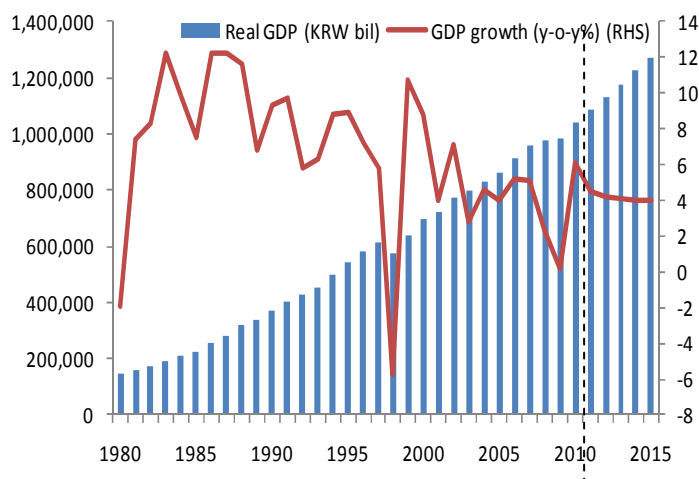
Economic activities are firming up

The latest release of 4Q2010 GDP numbers showed that the Korean economy continued to grow steadily at 4.8% y-o-y from the 4.4% expansion recorded in the preceding quarter. Sources of growth appear to stem from the external sector, with real exports registering a 14.9% increase against 11.1% in the preceding quarter. Domestically, consumption expenditure appears to be the main driving force, with private consumption growth holding steady at 3.2% in 4Q2010 (3Q2010: 3.3%). Improved labour market conditions, as evidenced by the rise in total employment, would result in sustained private consumption growth going forward. In March 2011, for instance, total employment increased by 469,000 from a year earlier, causing the employment rate to inch up to 58.3% from 57.8% in March 2010.

Investment activities, on the other hand, were sharply lower at 2.2% in the quarter under review, compared with 6.6% in the preceding period, due to the fall in construction investment which declined by 4.7%, the third back-to-back contraction thus far as building construction and civil engineering works decreased following weak sentiment. Consequently, construction output growth fell 3.9% in 4Q2010 as opposed to the 1.0% increase previously. In the same vein, facilities investment expanded, albeit at a moderate pace of 16.0% in 4Q2010 from 24.3% previously, caused by the slowdown in semiconductor and transportation equipment investment.

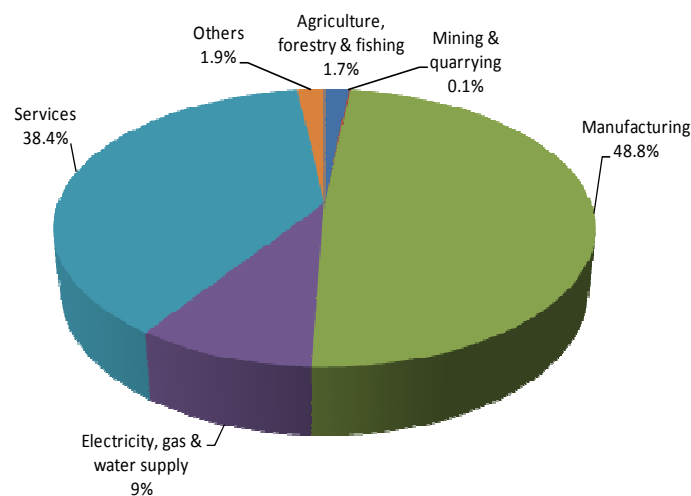
In 2010, the economy rebounded sharply to 6.1% after a dismal performance of 0.2% in the year 2009 following the outbreak of the global financial crisis in 2007 and 2008. Policy stimuli (both fiscal and monetary) have proven to be effective as the country managed to sustain positive growth during the global recession in 2009. Going forward, GDP growth is expected to return to its trend level of 4.8%. The BOK in December 2010 projected GDP to grow by 4.5% in 2011 and 4.7% in 2012.

Chart 2: Real GDP growth (y-o-y%)



Source: IMF World Economic Outlook
 Note: 2010-15 GDP figures are forecast figures

Chart 3: South Korean economic structure



Sources: Bank of Korea

Table 1: GDP growth (y-o-y%)

	1Q 09	2Q 09	3Q 09	4Q 09	1Q 10	2Q 10	3Q 10	4Q 10
Gross Domestic Product	-4.3	-2.2	1	6	8.1	7.2	4.4	4.8
By expenditure								
Final consumption expenditure (Private)	-2	0.7	1.7	4.7	5.7	3.6	3.2	3.3
(Government)	-4.4	-1	0.7	5.8	6.3	3.7	3.3	3.2
Gross fixed capital formation (Facilities investment)	7.2	6.7	5.3	1.1	3.8	3.2	2.8	3.9
(Construction)	-7.4	-2.3	0.4	7.1	11.4	6.4	6.6	2.1
Exports of goods & services	-23.1	-17.3	-7	13.3	29.9	30.2	24.3	16
(Construction)	2.8	5.1	4.4	5	2.3	-2.9	-2.3	-4.7
Imports of goods & services	-10.7	-3.4	1	9.8	16.6	14.1	11.1	14.9
(Imports of goods & services)	-18.8	-13.3	-7.7	8.7	21	19.3	14.7	14.6
By industry								
Agriculture, forestry & fishing	1.5	-1.3	3.3	2.8	-1.9	-2.2	-7.5	-6.6
Manufacturing	-13.6	-7.2	1.7	13	20.7	18	10.1	11.2
Electricity, gas & water supply	6.1	4	7.5	1.4	5	6.2	3.6	6.5
Construction	0	3.2	0.3	3.3	1.5	-0.5	1	-3.9
Services	-0.4	0.3	0.9	3	4.4	3.6	2.7	3.2

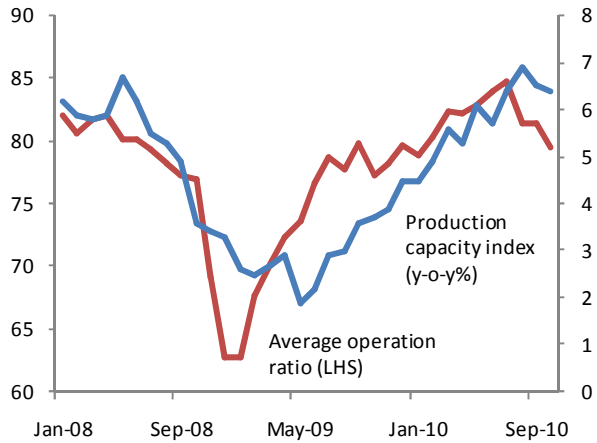
Source: Bank of Korea (BOK)

Inflation dynamics

Inflationary pressure started to build up in the second half of 2010, driven by commodity prices such as agricultural products and fuel. The CPI rose to a high of 4.1% in October 2010, underpinned by commodity sub-indices which rose by 7.2% during the month. In the first three months of 2011, the CPI continued to climb, with March's reading clocking in at 4.7% compared with 4.1% and 4.3% recorded in January and February respectively as prices of commodities continued their ascent. Going forward, we foresee the economy to remain vulnerable to gyrations in international commodity prices, given that the country has limited natural resources such as oil which the country imports in vast quantities to meet its energy needs.

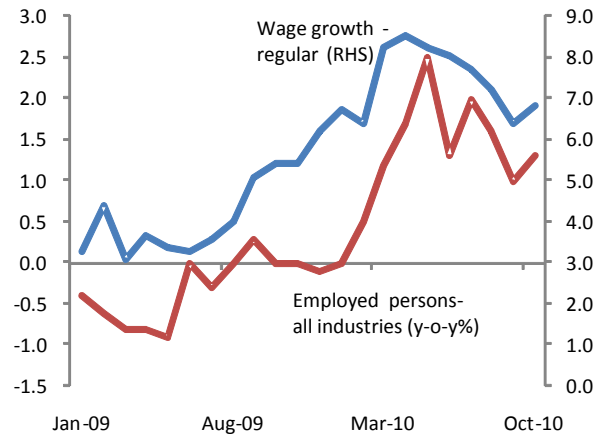
Apart from the cost factor, demand-led inflation is also taking hold in the economy, although it has eased somewhat in recent months. The production capacity index and average operation ratio have improved from their respective troughs of 1.9% y-o-y in May 2009 and 62.8% in January 2009 to 7.0% and 84.8% in January 2011, signalling that production activity has picked up pace after experiencing a slowdown in 2009 following the global recession. Similarly, wage and employment growth have increased to 3.3% and 1.4% in January 2011 after the dismal expansion in early 2009.

Chart 4: Average operation ratio and production capacity growth (y-o-y%)



Source: Ministry of Strategy and Finance (MOSF)

Chart 5: Employed persons – all industries (y-o-y%) and wage growth (y-o-y%)



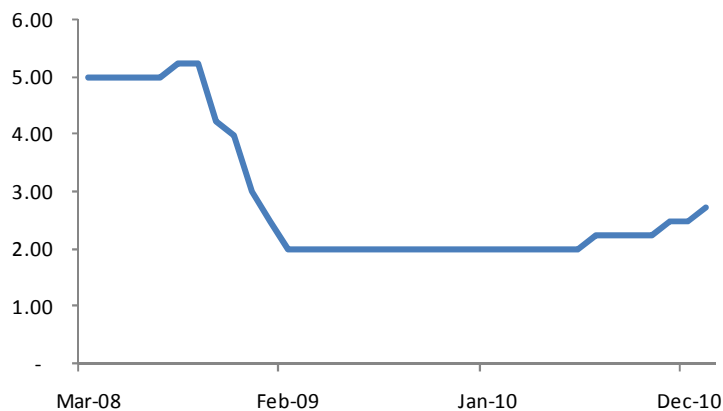
Source: MOSF

Monetary policy – normalisation mode

The BOK has entered its normalisation cycle as economic activities have picked up pace and prices are now hovering at elevated levels. Thus far, the policy rate has been raised by a total of 100 basis points, which brings the bank rate to 3.00% currently. During the monetary policy committee (MPC) meeting in the early part of this year, the BOK was of the view that emerging economies have performed favourably, whilst the advanced economies continue to grow, albeit at moderate speeds.

In the same vein, the domestic economy showed its resilience with the ongoing improvement in the labour market led by the private sector. Despite the possible headwinds stemming from the external sector, the BOK believes that the Korean economy will maintain its underlying trend, implying that further rate hikes are likely to happen in 2011. Although February’s industrial production showed a 2.3% month-on-month decline, the Ministry of Strategy and Finance considered it as a one-off event due to seasonal factors, though analysts have voiced concerns of slowing growth. The Ministry opined that the industrial output as a whole remains on a recovery track considering favorable conditions for domestic demand and exports. As such, the demand-driven inflation is expected to persist, justifying the need to increase the policy rate further.

Chart 6: BOK’s policy rate



Source: Bloomberg

Balance of payments and reserve assets

The country continued to register a healthy balance of payments, with its current account recording a surplus balance of USD28.2 billion during 2010 (2009: USD32.8 billion), while its capital and financial account reported a deficit of USD25.3 billion (2009: -USD34.7 billion). Similarly, South Korea's reserve assets rose to USD291.6 billion, representing an increase of 8.0% over the previous year's level. The reserve level is estimated to be more than seven times its total imports (international standard: three times), indicating that the country has enough buffer should volatility in capital flows become apparent.

Thus far, the trend of the Korean won (KRW) against major currencies has been favourable with no extreme volatility recorded after the economy recovered from its slump in the middle of 2009. Despite that, the authority has been proactive in managing potential stress stemming from capital flows following very loose monetary policies adopted by advanced economies. The imposition of a withholding tax on foreign investments in government securities and a levy on non-deposit foreign liabilities reflect the government's commitment to preempt any instability arising from sudden capital outflows. The levy will be imposed in August 2011, and will include lower rates for longer-term debt to reduce banks' dependence on short-term borrowings and their subsequent vulnerability in times of market instability.

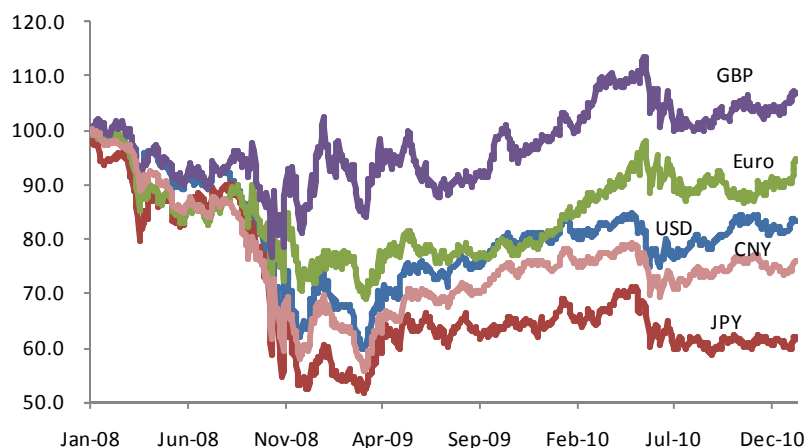
Notwithstanding this, based on a five-year average performance, the country's external sector lies in the least favourable quadrant in light of its relatively low current account balance (chart 8). This could explain why the authorities take the risk of capital flight very seriously.

Table 2: Balance of payments

USD Million	2005	2006	2007	2008	2009	2010p
Current account	18,607	14,083	21,770	3,198	32,791	28,214
Goods	32,857	31,433	37,129	5,170	37,866	41,904
Services	- 9,952	- 13,332	- 11,967	- 5,734	- 6,641	- 11,229
Primary income	- 1,817	75	135	4,435	2,277	768
Secondary income	- 2,482	- 4,093	- 3,527	- 674	- 712	- 3,229
Capital & financial account	- 19,529	- 14,151	- 23,877	- 1,154	- 34,651	- 25,332
Capital account	- 2,340	- 3,126	- 2,388	109	290	174
Financial account	- 17,189	- 11,025	- 21,489	- 1,263	- 34,941	- 25,157
Net errors & omission	922.9	68.2	2,106.9	-2,043.5	1,860.7	-2,882.1

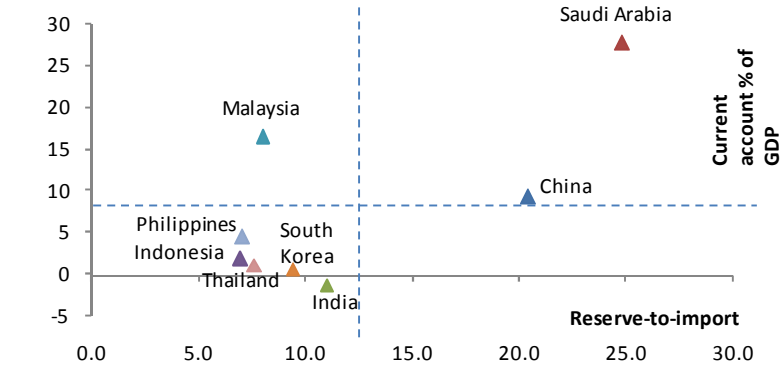
Source: Bank of Korea

Chart 7: Currency movements (Jan 2008 = 100)



Sources: CEIC & MARC Economic Research

Chart 8: Reserves-to-imports (x-axis) and current account % of GDP (y-axis) - 5-year median



Sources: CEIC & MARC Economic Research
 ----- represents the average of 5-year median

Fiscal Policy

In December 2010, the National Assembly approved the Budget 2011 total expenditure of KRW309.1 trillion, while total revenue is expected to reach KRW314.4 trillion, resulting in an overall balance deficit of KRW25.0 trillion, or 2.0% of GDP (2010: -KRW30.1 trillion, or -2.7% of GDP). Given the lower deficit level, government debt is expected to improve from 36.1% of GDP to 35.1% in 2011. Government finances are also on the right track as fiscal stimuli are gradually being removed in an environment of improving economic growth. As such, the risks of structural deficits are rather low at this juncture, given the government's commitment to achieve a balanced budget by 2013 or 2014.

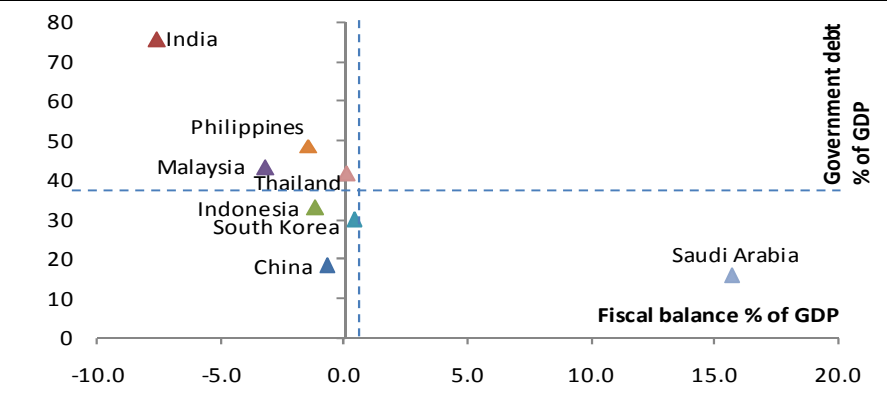
Table 3: Central government finances

KRW trillion	2007	2008	2009	2010	2011
Total revenue	243.6	250.7	255.3	290.8	314.4
Total expenditure & lending	209.8	238.8	272.9	292.8	309.1
Overall balance	33.8	11.9	-17.6	-30.1	-25.0
Overall balance (% of GDP)	3.5%	1.2%	-1.7%	-2.70%	-2.0%
Government debt (% of GDP)	29.7%	29.0%	32.6%	36.10%	35.1%

Sources: MOSF & CEIC

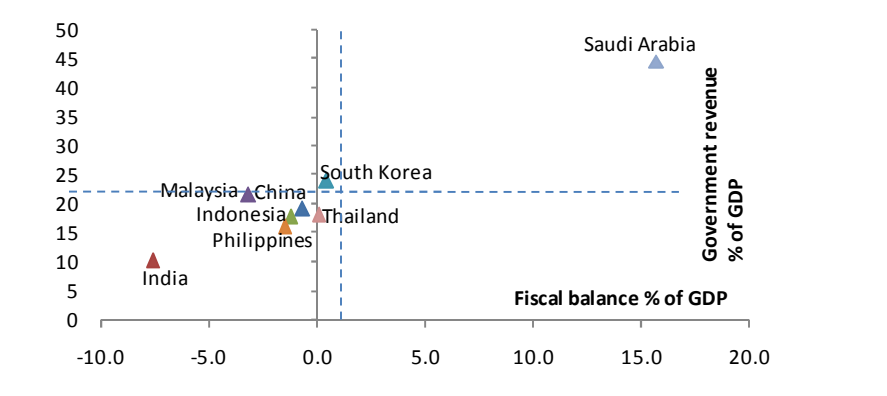
In comparison with its regional peers, South Korea's fiscal position is relatively better, although it may not be in the best quadrant. Based on Chart 9, South Korea is within the group that has lower government debt and small fiscal deficits (same group as Indonesia and China). This is in stark contrast with Saudi Arabia, which lies in the most favourable quadrant as natural resources such as crude oil appear to be the backbone of its government finances. The same can be seen in Chart 10, where the country falls behind Saudi Arabia in terms of the size of government revenue to the economy's value. Overall, South Korean fiscal performance should be commended, as the country is able to exhibit prudent financial management even in the absence of key natural resources.

Chart 9: Fiscal balance (x-axis) and government debt % of GDP (y-axis) - 5-year median



Source: MARC Economic Research
 ----- represents the average of 5-year median

Chart 10: Fiscal balance (x-axis) and government revenue % of GDP (y-axis) - 5-year median



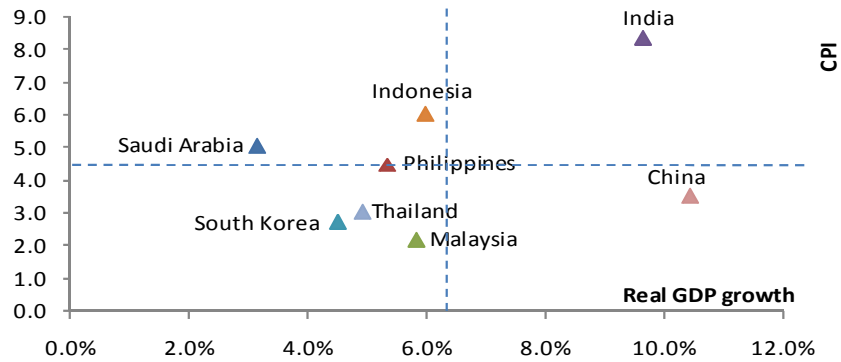
Source: MARC Economic Research
 ----- represents the average of 5-year median

Other macro matrices

i) Real GDP growth, inflation and competitiveness

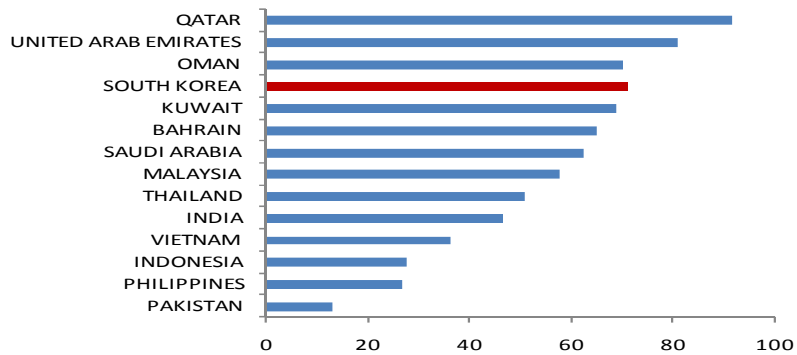
The South Korean economy appears to be growing at a sustainable path, given the relatively low inflation rate. We believe such a growth dynamic is important to promote stability in the country's sociopolitical scene, and is crucial for the crafting of good, efficient and effective policies. This is reflected in the WGI, where South Korea was within the top percentile of Control of Corruption, one of the six dimensions of the WGI (see Chart 12). Generally speaking, a country that has poor economic conditions such as high incidence of poverty and structural unemployment are prone to social problems, including corruption, and can hinder the economy from growing at its maximum potential.

Chart 11: Real GDP growth (x-axis) and CPI (y-axis) – 5-yr median



Source: MARC Economic Research
 ----- represents the average of 5-year median

Chart 12: Control of corruption

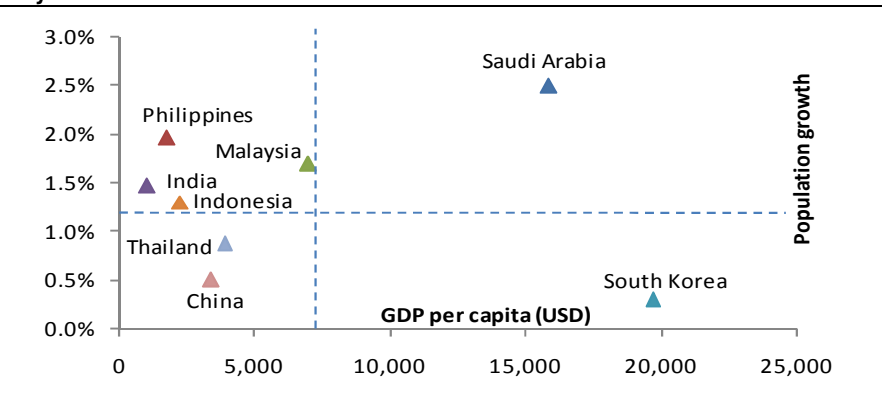


Source: World Governance Indicators (WGI), World Bank

ii) GDP per capita and population growth

Although per capita GDP was on the high side, the lower population growth could potentially weaken the country's growth prospects in the future. This is especially true when the population is dominated by the older generation. Worryingly, the IMF, in its Article IV report dated August 2010, said that the country is facing a rapidly growing ageing population, with the national social security fund projected to be depleted by 2050 – 2060 should there be no reform of discretionary spending.

Chart 13: GDP per capita (x-axis) and population growth (y-axis) – 5-yr median



Source: MARC Economic Research
 ----- represents the average of 5-year median

Table 4: Summary of Macro Matrices

Matrix	Explanation
Reserve-to-import ratio and current account balance	South Korea lies in the least-favourable quadrant due to relatively lower current account balance as a percentage of GDP when compared with other countries
Fiscal balance and government debt	South Korea lies in a neutral quadrant but is certainly better positioned than India, Thailand, the Philippines and Malaysia
Fiscal balance and government revenue	South Korea is located in the second-best quadrant and is more favourable than countries such as India, Indonesia, China, Malaysia and the Philippines
Real GDP growth and CPI	South Korea is located in the best quadrant, with growth dynamics appearing to be on a sustainable path with relatively low inflation
Control of corruption	South Korea ranked favourably due to good control of corruption
GDP per capita and population growth	Although South Korea has high GDP per capita, population growth is too low and can be a source of fiscal instability in the future

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