MALAYSIAN RATING CORPORATION BERHAD (364803 V)

A modest retreat in credit fundamentals ahead?

The year 2008 had started out as rather picture perfect despite slowing global growth and turbulence in international markets. Indicators such as retail sales growth, auto sales, home sales and consumer credit growth exhibited strength, and the economy showed good momentum. As the second half of 2008 commences, MARC expects the same indicators which exhibited strength earlier to soften through the remaining months of the year in light of the recently announced higher-than-expected fuel hike, higher electricity tariffs effective July 1, as well as the authorities' revisions of forecast inflation rate and gross domestic product (GDP) growth. Although the economy is now expected to advance more slowly but surely still, our view is that downside risks to forecast numbers have increased and could have meaningful implications for much of our rating universe. Notwithstanding, MARC does not anticipate any 'free fall' in its credit ratings in the near term stemming from the recent developments.

In this article, we discuss the possible credit implications of the recent announcements on selected industry sectors.

Financial Institutions and Consumer Receivables Backed Issuances

The recent announcements will affect households in lower income brackets the most notwithstanding certain counter measures put in place to alleviate possible financial hardship to this income group. Households in the lower income brackets will be most susceptible to deterioration in loan repayment capacity. Also, recent increases in consumer debt also suggest less headroom for households to incur more debt, particularly those with already stretched balance sheets. Easier access to consumer credit, especially credit cards and personal loans by households in recent years has resulted in an increase in the exposure of banks to deterioration in this segment's debt servicing capacity. The sustainability of the credit quality of households is ultimately a function of the level of indebtedness as well as personal disposable income trends.

We believe the recent developments will cool down household credit growth, and put a damper on loan growth. At the same time, asset quality pressures could arise in the SME and corporate loan exposures on account of rising inflation and slower economic growth. Higher inflation will exert upward pressure on interest rates, which if raised, will most certainly intensify consumer credit pressures. Higher delinquencies and non-performing loans may then result. There is also a possibility that banks may tighten their lending criteria to counter asset quality pressures. Notwithstanding an unchanged Overnight Policy Rate (OPR) at this juncture, bond yields are rising and prices are falling. This scenario is likely to result not only in declining trading income in respect of fixed income securities but also lower underwriting and advisory income from bond issuance where investment banks are concerned with fewer issuers tapping bond market funding. Despite our concerns as to what could be a potential turning point in the credit cycle, MARC believes that given the robust capitalization and current low levels of non-performing loans of most domestic banks, these institutions possess the capacity to weather the more challenging environment ahead.

In respect of the consumer receivables backed issuances rated by MARC, we are of the view that consumer receivables originated by cooperatives could be susceptible to higher default rates as given the typically stretched balance sheets of its members. Nevertheless, the risk of default is moderated by the direct salary deduction scheme the cooperatives have with Angkatan Koperasi Kebangsaan Malaysia (ANGKASA) and an imposed salary deduction cap of not more than 60% of the borrower's gross salary.

Construction Sector

In the recent quarters, private construction demand has held up well and should be sustained through the second half of 2008. The pace of public construction activity has been slower than anticipated and focused mostly on small scale projects. The government seems likely to maintain an austere approach to the implementation of the projects in the months ahead as implied by the tone of its recent announcements. The combination of further inflation-driven increases in construction material costs, coupled with already low construction operating margins and a likely moderation of construction activity in 2009 will create a more challenging environment for domestic construction players. Margins on existing fixed price contracts would be susceptible to further erosion as steelmakers and cement manufacturers seek to pass on their production cost increases. Construction players that are highly dependent on construction earnings and are purely domestic in their operations would be more vulnerable to these risk factors as compared to those which have diverse revenue streams including infrastructure concessions and/or property development.

Property Sector

Prior to the announcements, measures by the government to stimulate the housing market including permitted monthly withdrawals by Employee Provident Fund contributors and the removal of Real Property Gains Tax, had contributed an improvement in overall market sentiment and an upturn in project launches. However, the outlook for sustained recovery in the low to medium residential property has become more uncertain as result of the negative consumer sentiment which is likely to develop following the recent announcements. Consumer confidence, which underlies demand for residential properties, is likely to take a beating as inflationary pressures persist and with greater moderation in the domestic economic growth rate. High-cost projects will be least affected by an erosion in the purchasing power of their target buyers, the higher income bracket households. Prospective homebuyers may delay purchasing decisions whilst existing homeowners will be more reluctant to trade up. Location would play a more important role in the buying decision than previously on account of rising transportation costs. Vacant stock could rise further. This would pose further challenges to developers who are already seeing a contraction in development margins due to the rising cost of construction materials. In a scenario of weaker demand, developers will find it harder to compensate for their lower margins through volume sales. Slower turnover of inventory may result. Developers that are relying on a limited number of projects will likely be more vulnerable. MARC expects operating margins for property developers to remain under pressure through 2008 and 2009. Debt protection measures are likely to weaken from 2007 levels.

Where property investment is concerned, MARC expects the office and retail leasing market segments to remain fairly resilient. Absent a mismatch between supply and demand for office and retail space in prime locations as is currently observed, rental rates are likely to hold up through 2008. Demand for office space in the Golden Triangle and the Central Business District remains strong as reflected in low office vacancy rates. The retail leasing segment has been benefiting from continued growth in visitor arrivals in addition to favourable household income trends. We believe that this segment will be affected somewhat by weaker demand from local consumers. The three-year lease structures that the market generally operates on may expose property owners to lease non-renewal risk and downward rental revisions. Overall tenant diversification and the credit quality of tenants remain important determinants in the performance of investment properties. MARC expects most of its office and retail property backed transactions to perform within expectations and assigned ratings.

Steel Sector

Given current industry fundamentals, MARC expects steelmakers to maintain favourable operating momentum in the near-term notwithstanding the cost pressures posed by the hike in fuel price and higher electricity tariffs come July 1. Capacity utilization rates of steelmakers rated by MARC have showed an uptrend since (2007) in tandem with increased steel demand locally and abroad. This has allowed steelmakers to implement price increases to recover higher input costs, particularly for scrap and iron ore. Effective May 12, 2008, the domestic ceiling price for steel bars and billets has been removed and importers have been exempted from import licensing and paying import duty. Against the backdrop of sustained steel demand, the prospects for passing on increases in the electricity, natural gas as well as transportation costs to steel purchasers remains favourable. Energy costs account for no more than 5% of the production costs of MARC’s rated steelmakers. The rational production discipline of the world's leading steelmakers and industry consolidation as well as China's elimination of outdated steel production capacity have provided support for an apparent shift of pricing power from steel consumers to steelmakers. This will also continue to temper steel price volatility which has historically characterized the steel sector.

In the intermediate term, falls in domestic demand on account of slower domestic construction activity may be cushioned by increasing regional steel exports. The strength of regional steel importing economies such as Thailand, Indonesia and Vietnam will be an important driver for growing and sustained levels of steel exports from Malaysia. China’s consumption trends after the Beijing 2008 Olympic Games, and rebuilding efforts after the Sichuan earthquake will likely have a bearing on the global demand-supply scenario and prices. The financial profiles of steelmakers rated by MARC mostly showed improvement in 2007, and as such are unlikely to face negative rating action should a modest weakening of industry fundamentals unfold.

Industrial Products Sector

Among rated entities in this sector, the rubber glove manufacturers are identified as most affected by the increase in gas prices. Industrial customers consuming less than two mmscfd (million standard cubic feet per day) will encounter a hike in gas price from RM9.40 per mmBtu to RM24.54 per mmBtu while industrial customers consuming more than two mmscfd will have to pay RM32.56 per mmBtu (previously RM11.32 per mmBtu). The significant increase in gas costs is expected to have immediate earnings impact. MARC believes that the bargaining power of our rated glove manufactures will position them favourably to pass on cost increases eventually. There is no immediate downward pressure on the existing ratings of the rubber glove players rated by MARC.

Automotive/Auto Part Makers

As consumers adjust to higher living costs following the petrol price hike and impending increase in electricity tariffs, we believe that possible outcomes in relation to vehicle ownership decisions include deferring expenditure on big ticket items such as cars and a shift in vehicle preference towards smaller and more fuel-efficient cars. Vehicle sales are likely to trend lower in the following months and this is likely to affect all domestic carmakers but with varying degree. Local car manufacturers (Proton and Perodua) should fare relatively better in the months ahead given the majority of models produced by both carmakers fall within the sub-1,600 cc segment. MARC also foresees an increase in demand for Natural Gas Vehicle (NGV) conversion systems in light of the huge differential in the price of petrol relative to natural gas. Meanwhile, the annual cash rebate of RM625 for owners of private vehicles with engine capacity of up to 2,000 cc provides little cushion against expected rising costs of other necessities such as food and energy. The industry's performance also remains sensitive to the level of interest rates, lending criteria, repayment period and used car prices which may become less supportive of new vehicle sales should banks start tightening their lending criteria.

While total industry volume for 2008 is expected to moderate in tandem with the weaker consumer sentiment, MARC foresees the impact on ratings of autoparts and components manufacturers will be uneven. As highlighted in MARC's 2008 Sectoral Outlook, companies with good earnings diversity will be in a better position to withstand the impact of lower vehicle sales.

Plantation Sector

The imposition of windfall tax to replace the existing Cooking Oil Stabilization Scheme (COSS) cess levy is anticipated to have a minimal impact on the future net earnings of plantation companies.

Under the COSS, plantation companies are required to pay 2% on the amount for every tonne of FFB sold, if CPO price exceeds the RM1,500 per metric tonne threshold. Meanwhile, the new tax levy is structured with higher threshold price of RM2,000 but will be computed based on the amount of CPO production. The new tax structure also imposes higher tax bracket of 15% on plantations in Peninsular Malaysia as they are not burdened by the Federal palm oil cess of 7.5% levied on their counterparts in East Malaysia. This means that planters in the Peninsular would only enjoy cost saving if the CPO price fall below RM3,000 per tonne while those in East Malaysia would continue to enjoy marginal cost saving should the CPO price increases further. Hence, plantation companies with more estates in East Malaysia will be less affected than those owning more estates in the Peninsular Malaysia.

Plantation companies are experiencing a surge in operating costs due to escalating fertilizer price and higher labour costs. Nevertheless, with CPO price prevailing around RM3,500 per tonne and the locking-in of sales via longer forward contracts, we anticipate continued robust operating cash flow through 2008. MARC does not foresee any downward pressure on ratings of its plantation entities, the majority of which are represented by pure plantation/integrated companies with estates located mainly in East Malaysia. In the case of our plantation-backed transactions, the differential between current CPO prices and MARC's long term CPO price assumptions and the loan to value ratios applied at respective rating levels provide sufficient cushion to absorb the impact of the windfall tax and cost pressures.

Toll Roads

MARC believes that the traffic growth on toll roads will be indirectly impacted by consumers' reduced spending power. We expect changes in traveling patterns as consumers cut back on expenses for leisure and recreation activities. Traffic flow will also be affected by lower motor vehicle sales. Nevertheless, our view is that commuter and commercial traffic will be less sensitive to negative traffic growth trends as motorists and commercial vehicle operators are likely to still use toll roads to save time. Hence, our belief that toll roads in the Klang Valley will be less affected than inter-state toll roads. In 2006, when the fuel price was increased by 19% (i.e. by 30 sen to RM1.92), the traffic flow on toll roads took between 6-9 months to stabilize. MARC envisages that this time around, traffic flows may take a little longer to adjust to the higher quantum increase compared to 2006.

Power Sector

Whilst the tariff adjustment will allow Tenaga Nasional Berhad (TNB) to pass on the higher gas tariff to consumers, the average 23.3% gas tariff adjustment will not be sufficient to absorb full impact of the fuel bill with the rising cost of coal.

In line with the government's sustainable energy policy, Petronas will progressively remove its gas subsidies to the electricity sector over a 15-year period, and over an 11-year period for the industrial sector, to pave the way for its gas prices to gradually increase to market based levels. We believe this move signals willingness on the part of the government to raise TNB's electricity tariffs in corresponding manner, going forward.

Negative pressures which could develop on Tenaga's ratings include a steep contraction in electricity demand as a result of the impending July 1, 2008 tariff hike, and its exposure to the surge in coal price arising from unhedged coal costs.

The independent power producers (IPPs) continue to operate under a highly protective pricing regime that provides them with significant income and cash flow certainty in addition to full cost recovery. The imposition of a 30% windfall tax on audited return on assets (ROA) in excess of 9% is not expected to affect IPPs under MARC's rating coverage given their present ROAs which are well below the 9% threshold.

Retail Sector

Soaring petrol prices and higher energy costs will affect consumer sentiment. Expectations of a more mediocre economic showing and more subdued job creation, going forward, will likely impact consumer confidence and keep retail spending in check. The continued influx of inbound tourists will help to counter negative momentum in retail sales caused by the recent announcements. Recent increases in consumer debt also suggest lower spending in the months ahead given the already stretched household balance sheets. In addition, expenditure on transportation, electricity and food will now consume a greater proportion of household income, leaving less for durables and less essential items. This will likely induce households in the low and middle income brackets to trade down to cheaper-price substitutes. Sales of consumer electronics, household electrical appliances, clothing, toys, housewares, watches and clocks are likely to be most affected. Retailers of luxury goods and high-end jewellers, however, are expected to remain resilient as their prime customers are high-income earners whose shopping habits are less influenced by energy costs and higher inflation. This is evidenced by the ability of high-end jewellers to pass the rising costs of precious metals and stones to their customers as opposed to mass market jewellers which are more reliant on the spending appetite of the middle class consumer, as observed in recent years.

The more challenging market backdrop with ongoing pressure on commodity and energy costs and weaker consumer confidence going forward will have a bigger impact on small players in the sector. Larger players will likely see a deceleration in sales growth and increased margin pressure along with smaller players but fare relatively better. The larger players which notably include hypermarkets will be more resilient on account of their ability to simulate store traffic and sales through promotions and discounts, and tight focus on operational efficiency. Retailers will also face greater challenges in managing costs with the upward pressure on labour, energy and transportation costs.

MARC expects slower growth in inflation-adjusted retail sales through the next six months in the absence of meaningful wage gains. Notwithstanding, the business profiles of rated entities in this sector are expected to remain stable.

Oil Services Sector

The majority of MARC-rated entities in the Oil Services Sector are not affected by the recent announcements. Strong oil and gas prices continue to support healthy margins and cashflow generation for the oil and gas industry as well as the oil services sector. Oilfield services companies have benefited from a more robust earnings environment and the strong growth in spending on exploration and production (E&P). Higher costs for oilfield services, equipment and labour are reflected in the continuing trend of annual increases in E&P spending budgets. In recent quarters, tighter capacity in this segment has enabled the oil services players to pass on cost increases to oil production companies with ease and implement more favourable billing terms.

Conclusion

Notwithstanding the likely retreat in credit fundamentals for a meaningful cross section of our rated entities, MARC is of the view that the entities that successfully overcome challenges posed by slower demand growth as well as cost and margin pressures will eventually develop stronger fundamentals. The current adversities will provide the catalyst for cost structure and operational efficiency improvements. The fuel hike and impending increase in electricity tariffs provides continuing evidence of the government's commitment to a 'user pays' philosophy, which should contribute to stronger foundations for the utilities sector and a lower fiscal burden for the Government of Malaysia, going forward. Ultimately, a competitive economy is fundamental to the country's long term resilience and the basis of a strong sovereign rating. An unintended consequence of the recent announcements may be the demise of weak corporates but the 'fit' will most certainly survive to contribute to the making of a more competitive economy.

Posted Date : 10 Jun 2008