MALAYSIAN RATING CORPORATION BERHAD (364803 V)

MARC views stimulus package as critical buffer against sharp slowdown in Malaysian economy

The second stimulus package unveiled by the Deputy Prime Minister, Datuk Seri Najib, is a bold effort by the government to boost domestic growth in the wake of rapidly deteriorating global economic conditions.

Malaysian Rating Corporation Berhad (MARC) views the RM60 billion stimulus package, which represents 9% of Malaysia's GDP and nine times the size of the first package, as essential to soften the impact from the fallout of sharply declining world trade activities since the last quarter of 2008 that has continued to weigh heavily on Malaysia's macroeconomic performance.

The estimated budget deficit by the government is in line with MARC's projection and the rating agency is of the view that the stimulus package may result in an increase in government debt to 46% of GDP in 2009 from an estimated 41% of GDP in 2008. Funding however, will not be an issue as the government can tap domestic bond market which is now the second biggest in Asia Pacific excluding Japan.

MARC opines that the second stimulus package is comprehensive in that it does not only focus on expanding development expenditure but also cuts across a wider scope of the economy by creating employment opportunities and establishing working capital guarantee schemes to small-and-medium enterprises (SMEs).

Furthermore, efforts to relieve the burden on rakyat through a 63,000 employment creation in the government sector, additional training and re-training programs via joint collaboration between government and private sector as well as higher food subsidy to avert price increases of necessities will provide a critical buffer against a steep drop in consumer spending, which has been a major force behind Malaysia's strong economic expansion, contributing an annual average of 3.7-percentage points to growth since the new millennium, the rating agency said.

Measures to alleviate burden on businesses such as double taxation for employers who recruit retrenched workers will help ease the pressure in the labour market which in January this year recorded a threefold increase in retrenchment to 4,325, from January 2008.

Notwithstanding the positive effects of the stimulus package, the extent of external negative forces that have rippled through the domestic economy would lead to economic activity to decelerate at a pace sharply faster than anticipated. Combined with the fact that cash outlays for direct fiscal injection and tax incentives is smaller than expected, MARC expects the Malaysian economy to experience a contraction of 1.5% in 2009 in its base case scenario.

With the rapidly slowing economy and notwithstanding the Second Stimulus Package, MARC expects a rise in corporate defaults through 2009, resulting from a combination of factors including aggressively leveraged capital structures, downbeat earnings prospects, and burdensome debt repayment schedules as well as limited access to equity and debt funding. The withdrawal of credit facilities by banks and reluctance to extend new credit could also exacerbate liquidity strains for these corporates. The continuing deterioration in the revenues and earnings of some issuers will undermine their ability to generate sufficient cashflow from operations and restore creditworthiness, and has caused already nominal liquidity to weaken quarter-on-quarter in some instances. Some issuers have also indicated that they will be relying on asset divestitures to fund a significant part of their debt repayments. Against this backdrop, we expect the corporate default rate for our rated universe to exceed its long-run average of 2.1%, reaching 4.1% in our base case scenario.

MARC expects corporate defaults, nonetheless, to be largely confined to borderline investment and speculative grade issuers. The stressed financial profiles of these issuers suggest that prevailing negative pressures will outweigh benefits arising from the short-term boost to the economy provided by the Second Stimulus Package. We also foresee increased potential for defaults on other non-rated debt to trigger cross-defaults in rated outstanding debt. Incidences of financial covenant breaches have increased in recent months as highlighted in a number of our MARCWatch Negative placements and rating downgrades. Some weaker issuers have been compelled to seek waivers on bond covenants while others are already in negotiations with lenders to restructure their debt with a view to avoiding payment default.

Issuers in the property and construction, auto and steel sectors which have been more severely impacted than other sectors of the economy have experienced revisions to their ratings outlook. The Second Stimulus Package targets two of these sectors, namely property and auto, and offers some respite for players in both sectors but is unlikely to restore demand to previous levels. The announced tax relief for interest paid on housing loans should improve house buyer sentiments, and benefit property developers and retail mortgage lenders. Similarly, it remains to be seen, nonetheless, whether the announced measures to support the automotive sector by way of an RM200 million additional allocation to the Automotive Development Fund as well as financing assistance for the auto-scrapping scheme for PROTON and PERODUA can effectively offer a lifeline for the domestic automotive sector and restore financially distressed autopart makers to a semblance of health. Still, every little bit counts in this time of economic challenge.

MARC had earlier projected corporate bond issuance to decline to between RM25 billion to RM30 billion in 2009 on account of reduced supply of high investment grade bonds as well as reduced demand for issues rated ‘A’ and lower. The establishment of a financial guarantee institution to provide credit enhancement is viewed by MARC as timely given the increased risk aversion among fixed income investors towards lower rated issuance amid increased economic uncertainty. It will give the bond market a needed lift and address the longstanding issue of debt market funding access for lower rated corporates.

MARC notes the ongoing efforts being galvanized by Bank Negara Malaysia and the government to rehabilitate economic activity. An aggressive monetary easing by the central bank, evidenced by a 125 basis point reduction in the benchmark overnight policy rate (OPR) since late January and a 250 basis point cut in statutory reserve requirement (SRR) underscored the central bank’s commitment to prevent dislocations in the financial market and to buffer the economy against a significant slowdown. Similarly, the government’s comprehensive stimulus package will likely prevent the current global economic calamity to affect the Malaysian economy to the extent of 1998.

Contacts :
Nor Zahidi Alias 03-2090 2277/ zahidi@marc.com.my ;
Milly Leong 03-2090 2288/ milly@marc.com.my

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