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MALAYSIAN RATING CORPORATION BERHAD
(364803 V)

Fixed Income Research

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2H2011 Corporate Bond Market Outlook

July 7, 2011

Limited upside on earnings but credit quality should remain intact…

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- Corporate earnings are not expected to pick up much in the second half of the year as the soft patch currently experienced by developed economies is likely to take its toll. Rising input costs, largely driven by continued high oil prices, may also affect earnings.

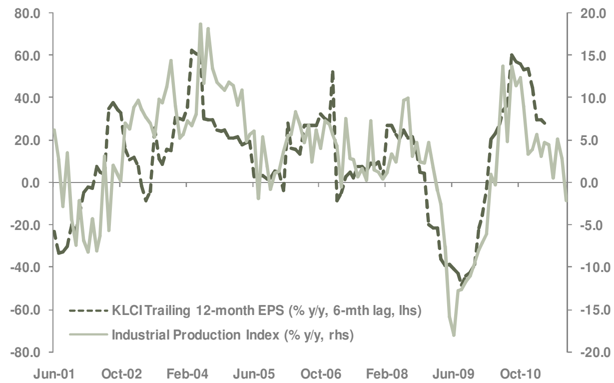
- A relatively flat earnings trend is not a worrying sign for the corporate bond market given the fairly healthy build-up in cash balances subsequent to the global financial crisis and we have not witnessed any shareholder-friendly activity that could have serious repercussions on corporate credit quality.

- Going into 2H2011, any issuer downgrade is likely to be driven by specific issuer problems and is only expected to come from the distressed pool. We do not foresee a general decline in credit quality, assuming that the current soft patch in the US economy does not have serious repercussions on this region.

- We are maintaining our initial forecast of corporate bond issuance for the full year of 2011 at MYR50 billion, and the figure could be higher if we include non-rated quasi sovereign securities.

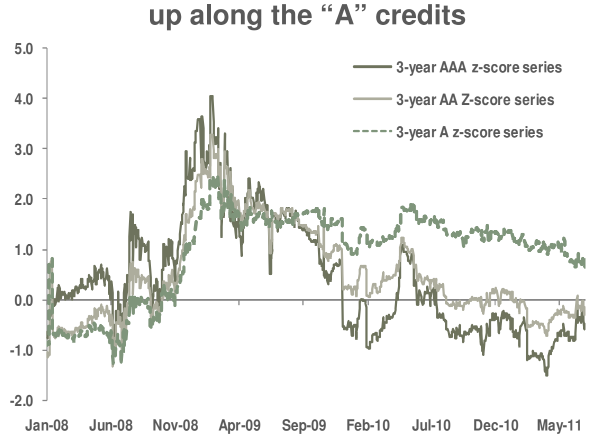
- At the beginning of the year, the 3-year credit spread for "A" credits hovered around 1.4 standard deviations above its long-run mean as implied by our z-score estimates but has narrowed since then to 0.8 standard deviations at the time of writing. The z-scores for the AAA and AA credits, on the other hand, stand at -0.5 and -0.1 standard deviations below their respective long-run means.

The IPI has been a good indicator of EPS growth and is now pointing to slower earnings in the next six months



Source: Bloomberg, MARC Fixed Income Research

Normalized 3-year Corporate Spreads show that AAA and AA remained in expensive territory, but there is still a rich spread pick-up along the "A" credits



Source: Bloomberg, MARC Fixed Income Research

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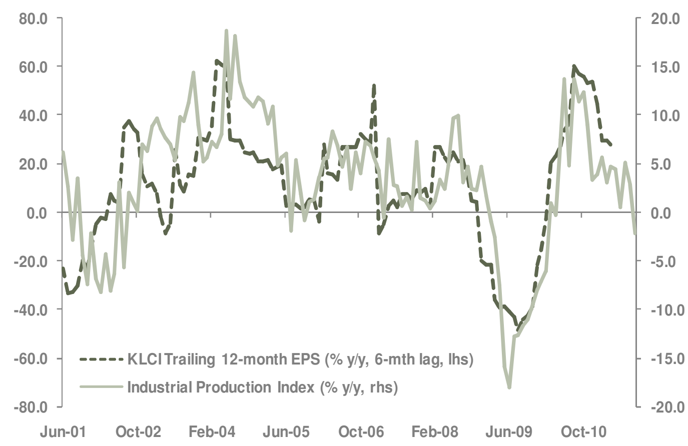
Limited upside on earnings but credit quality should remain intact…

Flat trend in corporate earnings ahead. Corporate earnings are not expected to pick up much in the second half of the year as the soft patch in the developed economies is likely to take its toll. Rising input costs, largely driven by continued high oil prices, may also affect earnings. In addition, lackluster export demand as implied by weakening ISM orders will test export-oriented corporations.

However, we do not expect to see a serious deterioration in earnings fundamentals as we do not foresee a severe global slowdown in our base case scenario in the second half of the year. Additionally, a stronger ringgit would also help to lower the import prices of inputs. The industrial production index has always been a reliable gauge of earnings potential, and, using a 6-month lag, earnings are expected to grow at a much more moderate pace. (See Exhibit 1).

This is also not a worrying sign for the corporate bond market as the post-global financial crisis build-up in cash balances has been quite healthy and we have not witnessed any shareholder-friendly activity that could have serious repercussions on corporate credit quality. Although earnings are expected to be relatively lower, anticipated earnings growth is still well above the targeted GDP growth.

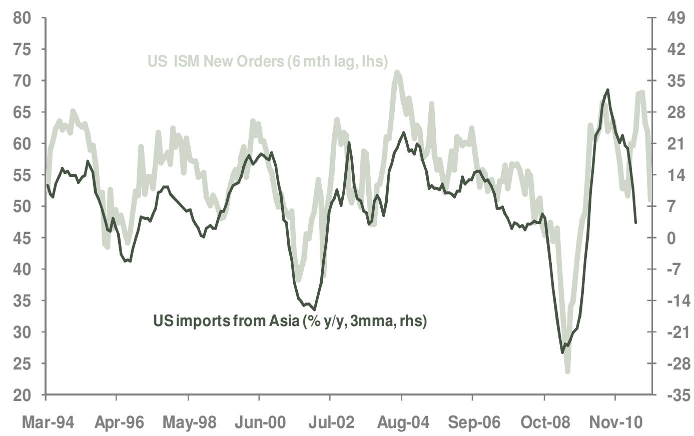
Exhibit 1: The IPI has been a good indicator of EPS growth, and is now pointing to slower earnings in the next six months



Source: Bloomberg, MARC Fixed Income Research

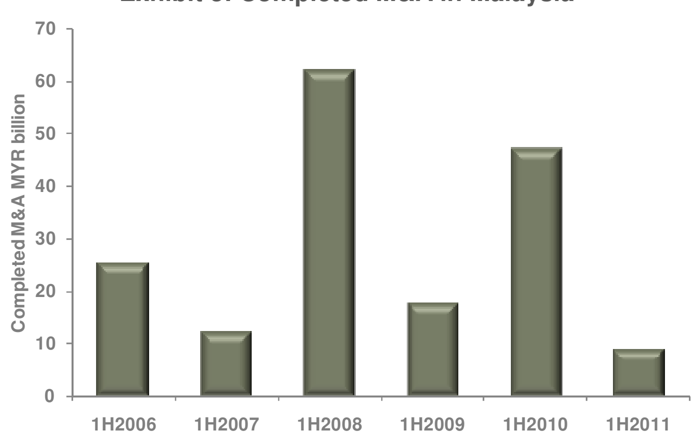
No serious repercussions on credit quality. In general, a continuing benign corporate operating environment will limit the likelihood of any major setbacks in business and consumer confidence over this period. We did not see any evidence of increased shareholder-friendly activity in the first half of 2011, with the M&A volume declining from almost MYR50 billion in 1H2010 to less than MYR10 billion this year. The build-up in cash is seen as a positive credit factor; cash-to-total debt ratio has improved notably even exceeding the 50% mark. Although there was no significant improvement in cash from operation-to-debt coverage, the sustained cash flow coverage metrics suggest that the likelihood of a pronounced deterioration in the debt servicing capacity of Malaysian corporates should be low.

Exhibit 2: Slowing ISM New Orders is not a positive sign for the exports



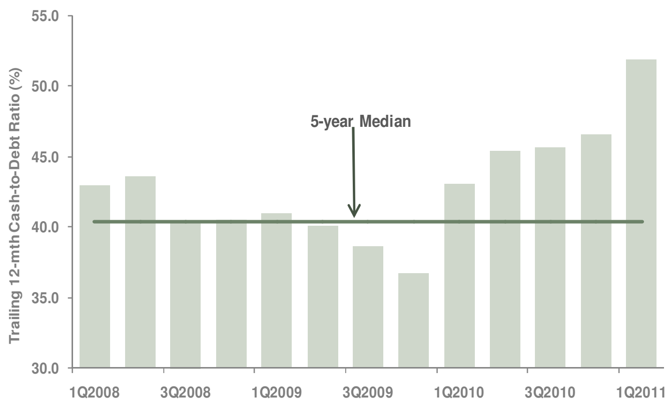
Source: Bloomberg, MARC Fixed Income Research

Exhibit 3: Completed M&A in Malaysia



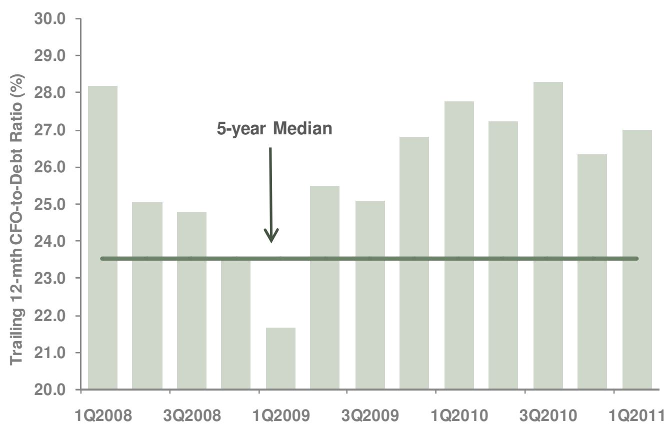
Source: Bloomberg, MARC Fixed Income Research

Exhibit 4: Healthy build-up in cash balances*



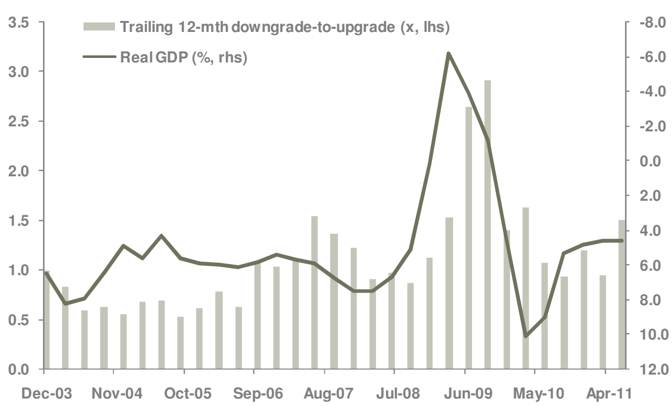
Source: Bloomberg, MARC Fixed Income Research

Exhibit 5: No deterioration in operating cash flow*



Source: Bloomberg, MARC Fixed Income Research
***Data used in Exhibits 4 & 5 are estimated using the non-financial corporates listed on Bursa Malaysia.*

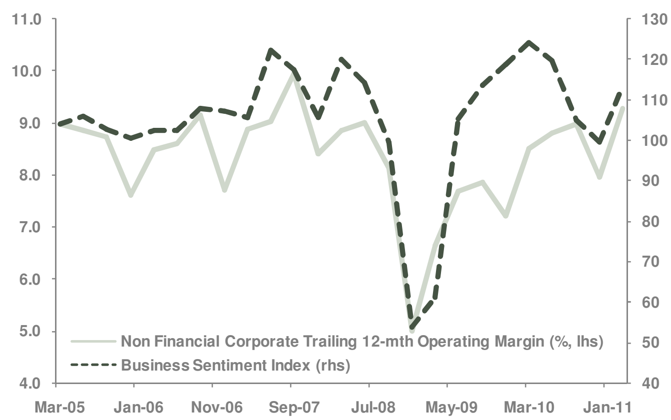
Exhibit 6: GDP vs. downgrade-to-upgrade ratio*



Source: Bloomberg, MARC Fixed Income Research
** Using migration data for Malaysian corporate as per Bloomberg compilation*

Negative rating actions if any, should only be driven by specific issuer problems and not because of any deterioration in economic fundamentals. Apart from the Selangor water-related downgrades, credit quality as measured by the trailing 12-month downgrade-to-upgrade ratio continued to show an encouraging trend, which is not surprising as the economy is now on a growth trajectory. The spike in the downgrade-to-upgrade ratio in 2Q2011 was due to the downgrades of Selangor water-related issuers, but the level is nowhere near the crisis level. Going into 2H2011, any issuer downgrade is likely to be driven by specific issuer problems and is only expected to come from the distressed pool. We do not foresee a general decline in credit quality, assuming that the current soft patch in the US economy does not have serious repercussions on this region. This in turn is likely to sustain the favourable business sentiment, which supports the positive operating environment.

Exhibit 7: Operating environment is strongly supported by business sentiments

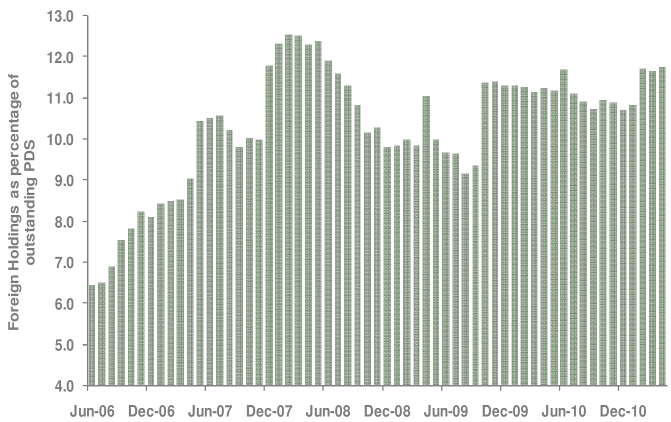


Source: Bloomberg, MARC Fixed Income Research

Corporate bonds are not an avenue for foreign funds. We mentioned in our government bond outlook that currency play has thus far been dominating that market and that this trend is likely to persist going forward as we do not see any strong catalysts for the USD to strengthen. Nevertheless, the effect of foreign funds in the domestic corporate bond market is minimal and there is no reason to believe that this will change.

As mentioned earlier, foreign funds are coming in on strengthening currency so they need to hold on to liquid asset classes. Despite performing handsomely since early this year, emerging currencies will continue to remain fragile (i.e. they tend to sell off faster whenever risk appetites are falling, which is the reason why foreigners will only hold liquid assets).

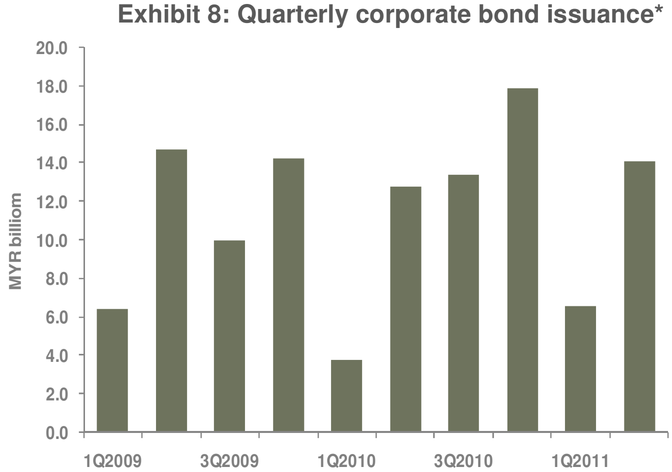
Exhibit 7: Different trend in foreign holdings of PDS compared to MGS



Source: Bloomberg, MARC Fixed Income Research

We maintain our issuance forecast of MYR50 billion for the whole of 2011. In the first half of the year, a total of MYR21.0 billion worth of corporate bonds was raised compared to MYR16.7 billion seen over the corresponding period in 2010. Including the non-rated quasi sovereign universe, the amount raised via the bond market was significantly higher at MYR32.4 billion (MYR20.3 billion in 2010). By major sector, the infrastructure and utility sectors seem to have dominated the pie with MYR11.5 billion issued, of which MYR9.5 billion was issued by Pengurusan Air SPV Berhad.

Exhibit 8: Quarterly corporate bond issuance*



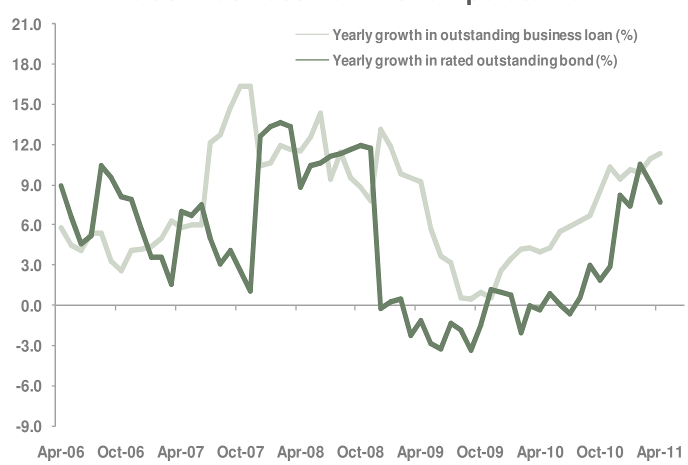
Source: BPAM, MARC Fixed Income Research
** Data includes long term rated and non-rated corporate & cagamas only. All other quasi sovereigns are excluded.*

We maintain our initial corporate bond issuance forecast for the full year of 2011 at MYR50 billion, and the figure could be higher if we include the non-rated quasi sovereign securities. The driving factors for corporate bond issuance are the capital expenditure by corporations amidst the economic recovery and the Public Private Partnership (PPP) programme.

According to the recent progress update on Pemandu's website, the cumulative amount of projects implemented stands at MYR170.3 billion. From a technical point of view, we observed a seasonal effect over the last 10 quarters where there appeared to be slower primary market activity in the first quarter followed by a pick-up in the following three quarters.

We would like to highlight here that funding via bank loans among businesses has continued to gain traction and could create a potential substitutional effect in the corporate bond market. The yearly growth in outstanding business loans has been outpacing the growth rate of corporate bonds (rated portion) by an average of 4.0% since April 2010. Nevertheless, we do not consider this a structural slowdown in the bond market in general considering that projects with long-term cash flow would still be better matched via bond funding.

Exhibit 9: Business Loan vs. Corporate Bond

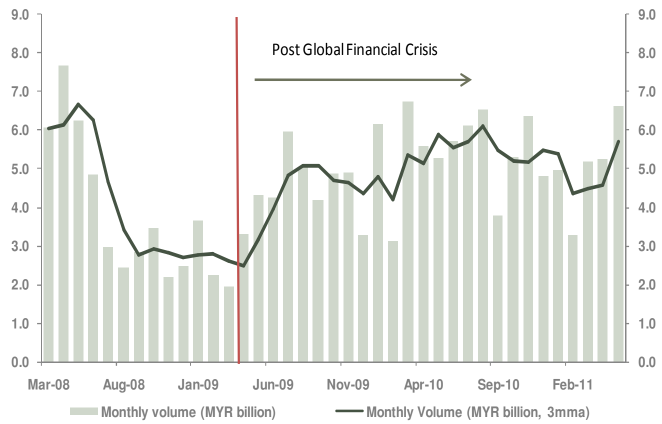


Source: BNM, MARC Fixed Income Research

The question now is whether it will be traditional straightforward corporate bond funding or a government-backed programme. If it is the latter, it could be a challenge for issuers with standalone credit strength to tap corporate bond market, although it is too premature to tell if this will be the case at this point of time.

Secondary trading activity has recovered to pre-crisis levels but unlike before, concentrations along the AA and AAA credits are even higher now. Based on the current information flow, there are no strong catalysts to change this trend, but it is worth noting here that persistence of this trend makes the price discovery process for lower rated credits even more challenging.

Exhibit 10: Corporate bond secondary trading



Source: BPAM, MARC Fixed Income Research

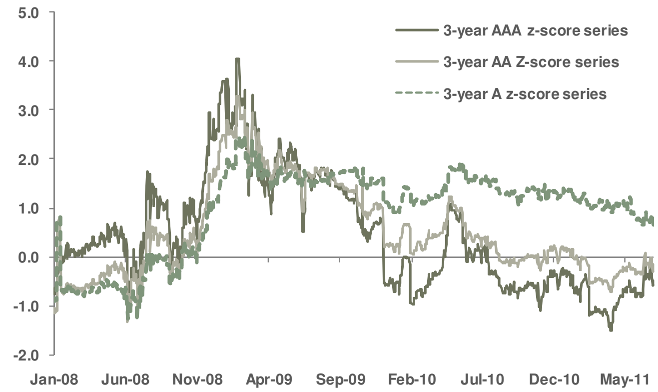
Same story with corporate spreads, but an adjustment seems to have taken place along the "A" credit. The story with corporate spreads has not changed much, with the AAA & AA spread level remaining below their respective averages. In the current scenario where investors are mainly focusing on this part of the credit curve, it is unlikely that we will see a widening scenario in the near future, although they are actually in the expensive territory by historical standards.

On the other hand, the 3-year A spread continued to point to an attractive valuation, but the level has somehow narrowed from 380 bps spotted earlier this year. It is important to highlight here that this narrowing was not solely driven by yield compression in govvies but the 3-year "A" yield itself declined by almost 30 bps. Despite that, it still offers rich valuation to investors, unlike the AAA and AA.

We highlighted the ongoing yields and spread dislocations along the lower end of the investment grade credit curve in our corporate bond outlook published earlier this year. There have been some interesting developments over the last five months on this part of the credit curve where the "A" indicative yields across the 3-, 5- and 10-year maturities have declined. We are not that surprised as such dislocations have been present for some time and cannot be adequately explained by economic or corporate fundamentals.

At the beginning of the year, the 3-year "A" credit spread hovered around 1.4 standard deviations above its long-run mean as implied by our z-score estimates, but it has narrowed since then to 0.8 standard deviations at the time of writing. The z-scores for the AAA and AA credits, on the other hand, stand at -0.5 and -0.1 standard deviations below their long-run means respectively. Against this backdrop, we maintain our view on the rich valuation on the "A" credits.

Exhibit 11: Normalized 3-year Corporate Spreads



Source: Bloomberg, MARC Fixed Income Research

The counter-argument is that the "A" credits are less liquid so such dislocations could have been driven by liquidity premiums on the part of investors. However, we would like to point out two important points pertaining to this issue. Firstly, during the pre-crisis period, even when the economy grew below its potential level, the risk premiums were much lower than they are now, and the liquidity status was not much better. Given that the corporate operating environment has returned to the pre-crisis standard, there are no fundamental explanations for the continued wide spread.

Secondly, judging from the turnover ratio in the secondary trading of the corporate bond market, most investors are adopting a buy-and-hold strategy. On that note, the association of current spread dislocation on this part of the curve with liquidity premiums is at least arguable in our view. That said, we are not implying that investors should rush to buy everything under the sun. We would like to reiterate that the corporate "A" credits certainly offer attractive valuations but that should also be balanced by proper assessments on the credit metrics of specific issuers.

Exhibit 12: Indicative "A" yields started to fall

Source: Bloomberg, MARC Fixed Income Research

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