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The best offence is a good defence

In a market on a downturn in the wake of bad news worldwide, some sectors and stocks will withstand the damage better and some will come out of it faster.

THE deepening financial crisis over the past two months has wiped out a huge portion of investors' wealth. And despite concerted efforts by governments and central banks worldwide to cut interest rates and inject massive liquidity into the stock market, the global credit crisis has yet to show any sign of abating.

Some countries have already been dragged into a recession because of the global crisis, while others, including Malaysia, may be heading towards a slower economic growth.



Malaysian Institute of Economic Research executive director Mohamad Ariff had two weeks ago warned of a possible recession if the US economy were to continue to deteriorate. Already, the private think tank has slashed its forecast of economic growth for next year to 3.4% from to its earlier forecast of 5%.

The worsening economic outlook for the country does not help our stock market, which has lost 40% year-to-date. The Kuala Lumpur Composite Index on Thursday closed at 853.56 points.

In the days ahead, the stock market is expected to remain volatile with a downside bias. A head of research from a local house says the majority of stocks listed on Bursa Malaysia would not be able to buck the trend, even though many of them have strong business fundamentals.

“However, the so-called more defensive ones would not be as badly affected as the rest,” he says, adding that the defensive players would most likely see their earnings remaining intact, albeit with a slower growth.

OSK’s head of research Chris Eng concurs, saying that the defensive sectors may not experience much growth, “but at least, they won’t shrink”. He expects these players to report flattish to slightly positive earnings growth in the tough environment ahead.

Among the sectors considered more resilient to recession include rubber-glove manufacturing, selective consumer products such as tobacco, breweries and F&B, gaming and utility such as telecommunications, toll, power and water, because demand for their goods and services is inelastic, and some are a necessity to every household.

Furthermore, the country’s population growth would generate new demand for their goods and services, says an analyst.

Besides their recurring income and low-risk nature, the fact that most of these defensive sectors offer good dividends is an appealing factor to investors. Nevertheless, some defensive players could still fall out of investors’ favour due to several factors such as high gearing or regulatory changes.

For instance, the possibility of a renegotiation of the power purchase agreements looming on the horizon may hold back investors’ interest in independent power producers and result in a down-rating by analysts.

Cash-rich companies: Selected companies with net cash positions (latest available date)

Companies	Call	Target Price (RM)	Net Cash (RM mil)
Malaysia Airlines Bhd	Withheld	Withheld	4,220.20
Resorts World Bhd	Hold	3.70	4,155.60
Genting Bhd	Hold	5.70	2,163.70
Petronas Gas bhd	Hold	10.50	1,532.90
Sime Darby Bhd	Fully Valued	5.20	1,165.20
Proton Holdings Bhd	Hold	2.25	1,144.40
Bursa Malaysia Bhd	Sell	5.10	1,303.80
Malaysia Airport Holdings Bhd	Withheld	Withheld	766.80
UMW Holdings Bhd	Buy	5.40	745.80
Bintulu Port Holdings Bhd	Buy	6.70	488.80
Star Publications (Malaysia) Bhd	Hold	3.12	457.40
DiGi.Com Bhd	Hold	20.80	312.30
Asiatic Development Bhd	Buy	3.20	279.70
Amway (M) Bhd	Hold	7.00	244.20
Carlsberg Brewery Malaysia Bhd	Hold	4.40	222.10
JT International Bhd	Hold	4.65	213.10

Source: Aseambankers

Stretch-ability

In times of a recession, the rubber glove industry probably stands as the best and safest bet because demand for its products – a necessity for healthcare, food and laboratory industries – is sustainable and keeps growing each year. What's more, the world is its market.

According to the Malaysia Rubber Glove Manufacturers' Association (Margma), global consumption of rubber gloves was 120 billion pieces last year; and this global consumption is expected to grow at a compounded annual rate of 10% to 12%. This means global consumption of rubber gloves by the end of this year will be at least 132 billion pieces and 145 billion next year.

MOST DEFENSIVE LIQUID LARGE-CAP STOCKS

Company	Foreign Portfolio Ownership	PE (FY09 earnings)	Dividend yield (%)	Cash per share	Comments
British American Tobacco (M) Bhd	17%	14.6	3.6	1.80	Resilient earnings, generous dividend policy
Berjaya Sports Toto Bhd	20%	12.0	8.4	0.13	Generous dividend policy
PLUS Expressways Bhd	9%	12.2	4.9	1.55	Steady stream of cash flow from toll collection
Resorts World Bhd	36%	10.7	3.8	0.71	Capital management, M&A
Telekom Malaysia Bhd	19%	13.4	8.2	0.11	Stable earnings and committed 2008 dividend

Source: Aseambankers

There are several factors contributing to the sustainable and growing demand for rubber gloves. One of which is the emergence of deadly diseases, such as SARS and bird flu, as well as the growing threat of bioterrorism that require the use of rubber gloves for protection.

On top of that, the mandatory use of rubber gloves in hospitals and food outlets in the US and the European Union, as well as the rising standards of living in the developing world, is increasing the demand for rubber.

According to Margma, Malaysia satisfies 60% of the world's consumption of rubber gloves, with its main export markets being North America (46%), Europe (21%) and South America (23%). India and China are huge markets that provide future growth opportunities for the Malaysian rubber glove industry, which is led by listed players such as Top Glove Corp Bhd, Supermax Corp Bhd, Hartalega Holdings Bhd, Kossan Rubber Industries Bhd and Adventa Bhd.

As most of these companies' goods are exported and traded in US dollars, the recent strengthening of the currency is a boon to their earnings in the coming quarter.

No doubt, there is increasing competition from Thailand, but Malaysia-produced rubber gloves are generally preferred by importing countries for its superior quality and reliability. The glove-making industry is mainly concentrated in the Southeast Asian region because it is the main producer of latex, which makes raw material easily accessible to local manufacturers. (Malaysia, Thailand and Indonesia collectively produce more than 70% of total natural rubber in the world.)

The recent softening of latex prices, in tandem with other commodity prices, is expected to improve the margin of rubber glove manufacturers significantly, as the raw material constitutes more than 50% of their cost structure. Over the week, latex prices fell under the RM4.50 per kg mark, the lowest in three years.

With efforts of latex-producing countries to stem the continuous fall of the commodity's price by reducing production, Ikmal Hafizi of TA Research says he expects latex prices to stabilise within the range of RM5.60 to RM6.00 per kg next year. This compares with its year-high of RM7.20 per kg in July. On Thursday, latex last traded at RM4.38 per kg.

Ikmal says even if rubber-glove prices were to increase in the event of rising raw material costs, manufacturers should not face much trouble in passing the cost to their customers. This is because rubber gloves are rather inexpensive, and users are usually tolerant of any price hikes, especially considering the wide usage and importance of the product. For instance, compare the cost of rubber gloves with the total cost of treating a patient in a hospital, the former is almost negligible.

Top Glove, the largest producer of gloves in the world for the last 10 years, recently reported a 23% year-on-year increase in net profit to RM110.1mil for its financial year (FY) ended Aug 31, 2008, with total dividend payout at 11 sen per share. Affin Research expects the earnings momentum of the company to accelerate by 27% in FY2009, underpinned by continued firm demand that is relatively "immunized" to the economic slowdown and favourable latex prices.

Analysts say other rubber glove manufacturers are expected to do well in spite of the current global uncertainties because their earnings risk is relatively low compared to other companies.

Guilty pleasures

Some habits are just hard to give up, as they say. Generally, consumers are still willing to spend on guilty pleasures such as smoking and drinking regardless of the country's economic condition.

In view of the inelastic demand for their products, tobacco manufacturers and brewery companies are expected to do relatively well even when the country's economy is not. The nature of these businesses is one of the least cyclical because of the relatively stable demand from consumers.

Malaysia's tobacco industry is mainly controlled by the Big-3, namely British American Tobacco (M) Bhd (BAT), JT International Bhd (JTI), and Philip Morris (M) Sdn Bhd. But the listed players – BAT and JTI – have a stronger market presence, thanks to their product-differentiation strategies.

BAT, whose key brands are Dunhill, Kent and Pall Mall, controls some 61% of the duty-paid cigarette market in Malaysia, while JTI controls about 19%. The latter has a portfolio of six brands, namely Winston, Mild Seven, Camel, More, Salem and Mi-Ne.

Going forward, analysts say operating conditions for these cigarette manufacturers will continue to be tough, particularly with the Government raising excise duty every year, hence forcing the players to raise their selling prices. In Budget 2009, the Government raised the excise duty for cigarettes by 20%, or three sen, to 18 sen per stick.

The rising prices of duty-paid cigarettes have promoted illicit trade, which according to TA Research analyst Farhana, currently stands at 30% of the total tobacco sales in the country, compared to 24.9% in June. BAT and JTI also face some competition from extremely low-priced (ELP) cigarettes, which currently accounts for almost 8% of total sales volume. On top of that, the Government is also increasing its efforts to discourage people from smoking.

While there is a risk of BAT and JTI's growth being capped by these challenges, both the companies are expected to be able to weather through the storm, with their improved cost efficiencies and promotion of their value-for-money brands. Besides, the country's population growth has introduced a group of new tobacco consumers to the market.

For investors who are increasingly risk-averse, given the current global financial turmoil, BAT and JTI's high dividend payouts and resilient performances will be an appealing factor.

According to Aseambankers, the recent introduction of a minimum price of RM6 per pack of 20 cigarettes, which will take effect by the end of the year, is a boost to BAT and JTI counters. It says the floor pricing would reduce the price difference between their products and those of ELPs.

Aseambankers adds that the Government's implementation of pictorial warnings from Jan 1, 2009, instead of the expected Dec 1, 2008, is another small boost to the industry as it gives the players more time to phase out existing stocks to comply with the new requirements.

Even though the removal of "light", "low tar", "ultra light" and "mild" terms from the cigarette packaging is to take immediate effect, Aseambankers is of the opinion that the new developments will still leave a net positive effect for BAT and JTI. It says, so long as affordability of cigarette in real terms remains within the reach of the masses, it would maintain its neutral to positive outlook for tobacco manufacturers.

As for the brewery sector, the absence of excise duty hikes in Budget 2009 is a positive factor for Guinness Anchor Bhd and Carlsberg Brewery Malaysia Bhd. Although these companies still face competition from lower priced and illegal products, their strong brand presence will help them remain defensive in a tough environment.

In the quarters ahead, the brewery sector will see more headwinds as consumer sentiments have been dampened by high inflation. Analysts believe consumption will decline as consumers are also anticipating an economic slowdown. But the ability of the players to procure raw materials at lower prices, following the end of their forward-buying contracts soon, will help improve their profit margins.

Over the week, Carlsberg reported a net profit of RM66.5mil for the nine quarters ended Sept 30, 2008, which represents a 23.4% year-on-year increase. This is above consensus expectation and that of OSK Research, but is short of Aseambankers and Affin Research's expectations.

The luck factor

Prospects for the gaming sector remains buoyant when the economy takes a turn for the worse. This is particularly so for the relatively more superstitious Asian community who believe in the luck factor.

In Malaysia, analysts believe an increasing number of consumers would indulge in numbers-forecast activities and casino games in the hope of winning high money prizes when times are bad.

This bodes well for numbers forecast operators (NFOs), namely Berjaya Sports Toto Bhd (BToto), Tanjong plc and Magnum Corp Bhd, as they can expect better ticket sales, while casino operator Resorts World Bhd and its parent company, Genting Bhd, can expect a steady stream of visitors. Hence, earnings of these gaming companies are expected to remain intact even in a recession.

"It is the luck factor that pulls consumers to their businesses," says OSK's Eng.

In addition, the absence of higher gaming tax and casino duties in Budget 2009 is expected to add strength to the performances of the gaming companies. BToto, Tanjong plc and Resorts World are listed on the main board of Bursa Malaysia, while Magnum was privatised last year.

Analysts are in favour of BToto and Resorts World as reliable investments in uncertain times, given their large cash reserves and attractive dividend yields. For instance, AmResearch in its report says BToto's expected dividend yield of 8% for FY2009 will be supported by its stable operating cash flow of between RM450mil and RM470mil annually.

Affin Research's Chong Lee Len, on the other hand, says BToto is expected to outperform the other NFOs, given the fact that it is the largest player in the country. Besides, the company's Mega 6/52 "jackpot money" variant game is gaining momentum among punters.

The research house says there are early indications that BToto's coming quarterly earnings may surprise on the upside, given its normalising prize payouts to the 62% levels, compared to 70% in the final quarter of last year. The house has conservatively assumed the average prize payout to be between 63% and 64% for FY2009 to FY2011.

On top of that, the intensity in BToto's Mega 6/52 jackpot game is expected to support the company's revenue growth of more than 5% year-on-year (on per draw basis) for the coming quarter.

As for Resorts World, analysts say the risk to its earnings remains relatively low because the bulk of its business (estimated at 70%) is driven by domestic visitors; and most of these visitors are day-trippers from the Klang Valley.

The VIP segment, which constitutes around 30% of Resorts World's business, consists mainly of foreigners. Although this segment will be slightly impacted in an economic downturn, analysts say Resorts World would still be able to generate income growth, albeit at a modest pace.

AmResearch states Resorts World's expected turnover growth rate for next year would be a modest 4% to RM4.9bil, compared with 10% for FY2008. It adds that the company's growing cash pile, estimated at RM5.3bil for FY2009, would give it the advantage when bidding for casino projects overseas and enable it to secure financing without much difficulty should the need arise.

Meanwhile, Genting, which has more international exposure, could face a risk reporting lower-than-expected earnings in the coming quarters due to losses in its British operations and possible cost overruns from its integrated resort project in Singapore. But in general, the company remains resilient in a recession.

Stable ride on the road

Given that most of the toll roads in Malaysia are already in the semi-mature and mature stages, and have achieved a base traffic volume, toll concessionaires are assured of a steady flow of income even when the country's economic growth slows. In addition, this is a cash-cow industry as all business transactions with consumers are conducted in cash.

According to an analyst, generating profits in tough times is not a difficult feat for the industry because most commuters would still use toll roads for efficient travels between towns and within the Klang Valley.

“It is just a matter of whether there is any growth in their profits,” he says.

PLUS Expressway Bhd and Lingkaran Trans Kota Holdings Bhd (Litrak) are the main toll operators in Malaysia. The former operates most of the toll roads in country, including the North-South Expressway and North Klang Valley Expressway, while the latter operates toll roads in the greater Kuala Lumpur area such as the popular Lebuhraya Damansara-Puchong, or LDP.

Following the downward revision in petrol and diesel pump prices over the past two months as a result of lower crude oil prices, analysts say there will be more upside potential for the toll concessionaires in terms of the traffic volume and earnings forecast. What more, there is a high possibility of a further reduction in local pump prices ahead, in view of the lower crude oil prices, hence improving the prospects for toll concessionaires, according to a TA analyst.

(Crude oil prices have cooled off from its record high of US\$147 per barrel in mid-July to below the US\$70 per barrel level currently due to fears of a global recession.)

Thanks to the improving outlook for the industry and the beaten-down share prices of PLUS and Litrak, Aseambankers have recently rated the sector as overweight. The research house says the recent compensation for toll rate cuts for buses, and the scrapping of windfall profit levies on IPPs are positive indicators that the Government would not embark on any more “unfriendly” measures that could further destroy values for the toll concessionaires.

Attractive net dividend yields offered by PLUS (4.7%) and Litrak (9%) also make both counters a good buy for investors.

Nevertheless, it is important for investors to bear in mind that the sector is not entirely free of risk. For instance, there is always a possibility that the Government’s policy for toll concessions could turn unfavourable to the players, while the mounting political uncertainties remain a key market risk.