

Only the Strong Will Survive

As the government shifts from a controlled price environment to a market price one in a bid to increase the country's competitiveness, structural price changes are bound to happen and along with it winners and losers. A look. ■ By James S

IN THE Sept 16, 2006 issue of *Malaysian Business*, a feature story on the Kondratieff wave or more commonly known as 'K-Wave', a 60-year economic cycle theory, suggested that Malaysia may be going through some of the main characteristics of a late autumn or early winter period under the cycle. Under this theory, in the period of winter, there will be:

- (a) changes in price structure,
- (b) a period of relatively flat economic growth and mild prosperity,
- (c) selective industry growth,
- (d) termination in the feeling of euphoria,
- (e) economic growth mainly derived from consumption, and thus
- (f) a rapid increase in debt.

Recall that some observers are already suggesting that some of the events unfolding in the country currently fit into the criteria of the winter period highlighted above. These include:

- (i) price wars in industries such as banking, the inability to pass down rises in operating costs, and hence a margin squeeze,
- (ii) a two-tier equity market, where only the blue chips perform while the performance of the lower liners are disappointing,
- (iii) organic growth is seen only in selective sectors such as oil and gas, and
- (iv) vertical and horizontal mergers and acquisitions (M&As) to maintain profitability and growth.

It is not surprising, thus, that analysts are

increasingly focused on theme plays in the market that closely mirror that of the above developments. For example, the market has seen at least five big theme plays this year. Four of the theme plays (capital allocation and dividend play, Ninth Malaysia Plan (9MP) and demand play, government-linked companies restructuring theme play and global Malaysia niches theme play) clearly are underpinned by the characteristics of (ii), (iii) and (iv) above. Interestingly, foreign research house Macquarie Research has also in a recent strategy report touched on the theme of structural price changes, which is the characteristic of (i) above.

In this article, we look at this latest theme play which is unfolding in the market and the likely stocks that will turn out to be the winners and losers of this theme ahead.

Pricing not only for growth but also defensiveness

While pricing power will boost growth, it is also important as a defensive mechanism to maintain growth in a soft market. AMS Research in a previous report on the

pricing power (*see Table 1*) of Malaysian companies, says that in an environment of rising interest rates, which would hurt consumer spending, stocks that still have the ability to raise the prices of their goods and services without worrying too much about the higher prices adversely affecting the demand for their goods, make good investment choices.

Such stocks could also be perceived as 'defensive stocks', given their ability to weather softer demand better than others, it notes. The

■ Table 1: Industries with Typical Pricing Power

Table 1: Who has and who does not have pricing power?		
Pricing Power?		
Yes	No	Neutral
Food & Beverage	Airlines	Banks
Media	Construction	Casinos
Tobacco	Insurance	Latex Glove
	Logistics	Motor
	Numbers Forecast	
	Pharmaceutical	
	Plantations	
	Power	
	Property	
	Retail	
	Shipping	
	Steel Products	
	Telecommunication	

Source: AMS Research

Table 2: Selected List of Controlled Goods and Their Market Price

	Current price (RM)	Est market price (RM)	Difference (%)
Retail fuel (per litre/kg)			
Gasoline RON97	1.92	2.70	(28.9)
Gasoline RON92	1.88	2.60	(27.7)
Diesel	1.58	2.70	(41.5)
LPG	1.75		
Mild steel round bar (10mm/ton)	1,635	2,034	(19.6)
Mild steel round bar (12mm/ton)	1,598	2,034	(21.4)
Mild steel round bar (16mm/ton)	1,531	2,034	(24.7)
Mild steel round bar (25mm/ton)	1,531	2,034	(24.7)
Cement (ex-Kuala Lumpur, 50 kg bag)	9.90	10	(1.0)
Wheat (not prepacked, 1kg)	1.20		
Refined white sugar (not prepacked, 1 kg)	1.40	2.00	(30.0)
Condensed milk - full cream (397g)	1.75	2.40	(27.1)
Condensed milk - filled (397g)	1.60	2.40	(33.3)
Bread (standard loaf 200g)	0.80		
Chicken ex-farm alive (maximum price, 1kg)	4.00		
Chicken wholesale alive (maximum price, 1kg)	4.50		
Chicken wholesale clean (maximum price, 1kg)	5.40		
Chicken retail alive (maximum price, 1kg)	5.00		
Chicken retail clean (maximum price, 1kg)	6.00		

Source: Macquarie Research, Industry

research house believes that generally, companies command pricing power if they possess one (or a combination of more than one) of the following four sources or factors:

- (1) the demand for their products and/or services is relatively inelastic,
- (2) the company has strong branding power,
- (3) the products or services provided by the company are essential products or services, and
- (4) the company is in a monopolistic or oligopolistic industry structure.

Restriction in practice in controlled industries

However, in practice, suppliers or providers of essential goods and services, or companies with monopolistic structures, generally find themselves lacking pricing power because of the government's insistence on controlling the prices of such goods and services (presumably in the name of consumer protection).

Examples of these are that of the power and water utilities sector, airlines, postal services, financial services and land transport service providers. Even then, AMS Research notes that some of these providers of essential

services, despite not having the freedom to raise their prices (because of government controls), still enjoy inelastic demand for their services. And a number of them, such as Malaysia Airports, Malaysian Airline System Bhd (MAS), Pos Malaysia Bhd and Tenaga Nasional Bhd, are expected or have already gotten their tariff or price increases from the government this year.

Are structural price changes taking place now?

According to Macquarie Research, prices are frequently a key driver of return on equity (ROE), but unfortunately, it also tends to be cyclical. This probably explains why stock plays on price changes such as a spike caused by sudden demand or supply factors tend to be temporary. For example, new products launched by a manufacturer, a new fad in the market place or new innovative products that don't last long enough.

Structural price changes, however, are very powerful in boosting long-term ROE and go beyond the product or company's inherent characteristics. The research house believes that this scenario is now unfolding in Malaysia mainly as a result of three factors:

(i) First, there has been a shift in government preferences from controlled prices to market prices and this will impact a broad range of sectors.

(ii) Secondly, emerging technology such as biodiesel will raise crude palm oil (CPO) prices structurally, as opposed to cyclically, and

(iii) Thirdly, Macquarie Research sees pricing power being exercised in selected sectors for the long term following new product launches and/or industry consolidation.

Shift in government stand and philosophy?

Macquarie Research is convinced that there has been a very important shift in government philosophy between the previous administration and the current one. Specifically, it believes that there has been an apparent shift in preferences from controlled prices to market prices. As in any structural shift in pricing, the impact on prices – and therefore margins – will continue to play out

over the next few years and stocks that are prime beneficiaries of this structural change will also be key winners ahead.

Indeed, many analysts say that the shift in government preferences is being driven by a desire to change the subsidy culture in the country as in the longer term, Malaysia cannot afford to fund inefficiencies as globalisation and liberalisation take place. Pricing driven by a true functional market is likely to take precedence over government-controlled pricing mechanism and is likely to be the trend ahead in a global economy.

To be sure, the government has indeed been taking steps to reduce subsidies or relax industry-controlled pricing in the last one or two years under the new administration. For one, domestic fuel subsidies have been cut dramatically. According to Macquarie Research, as recently as 2004, retail gasoline prices were at RM1.35/L, while the tax neutral price would have been closer to RM2.05/L. The government has gradually raised prices, with the last increase at end February 2006 bringing gasoline prices to RM1.92/L

Meanwhile, the national airline, MAS, has been allowed to choose which routes to fly, full fare flexibility, and the ability to rightsize its

■ **Table 3: Regional Utility Tariffs**

	Power (commercial) (US\$/kWh)	Water (urban home) (US\$/cu. m.)	Sewerage (urban home) (US\$/cu. m.)	Water + Sewerage (US\$/cu. m.)
Malaysia	8.4	0.20	0.53	0.78
Japan (Tokyo)	15.7	2.86	0.20	3.06
Philippines (Manila)	14.1	0.22	0.11	0.33
Hong Kong	12.9	0.53	0.18	0.68
Korea (Seoul)	10.7	0.40	0.11	0.51
Singapore	9.8	1.10	0.16	1.25
China (Beijing)	9.5	0.35	0.11	0.46
Thailand	9.2	0.27	0.58	0.85
Taiwan	8.4	0.30	0.12	0.42
Indonesia	7.6	0.60	0.04	0.64

Source: Macquarie Research

organisation. Note that certain routes of MAS were previously heavily subsidised because of its obligation to serve the rural areas, fares were fixed by tariffs which did not allow optimal yield management, and the company was also severely overstaffed.

Another case is the national car manufacturer, Proton Holdings Bhd (Proton), which has seen some of its tariff protection reduced. Part of this was driven by Malaysia's obligations to international agreements like that of the Asean Free Trade Area (Afta) and the World Trade Organisation (WTO), but more subsidies may be unravelled in the future to prepare the company to stand on its own against foreign challenges.

Macquarie Research also believes that the shift in thinking is also underscored by the 9MP announced by the government, which was not only significant for its sheer scale (RM200 billion worth of development expenditure over 2006-2010), but also because for the first time, measures were put into place to reduce cost overruns and delays in payments.

More structural and price relaxation to come?

Going forward, the research house believes that the government will continue its present track record of re-examining subsidies and striving to reduce or eliminate them where possible in order to improve the country's competitiveness. Some of the more conspicuous types of price distortions currently include direct price controls on goods, tariffs for utilities and indirect price controls.

According to its report, the previous government has maintained a number of centrally controlled prices, from sugar and chicken to gasoline and diesel, and cement and steel (*see Table 2*). These have in general

lagged world prices and caused market distortions and even foreign exchange leakages, such as the rampant smuggling of diesel from Malaysia into Thailand.

Interestingly, the research house believes that retail fuel prices, sugar and milk are likely to see revised pricing within the next twelve months as they have lagged world price movements, which are not good news for consumers but will nonetheless benefit companies involved in those products.

Utility prices due for a rise?

Tariffs for various utilities in the country are currently fully regulated, for example power, water, sewage, etc. Many analysts believe that these tariffs are due for a rise as they have not been raised for some time and are lagging that of other countries in the region. For example, Malaysia's power tariffs – despite the recent increase – remain apparently among the lowest in Asia (*see Table 3*).

According to Macquarie Research, Malaysia is also the cheapest provider of

■ **Table 4: Selected List of Indirect Price-Controlled Industries**

Sector	Selected controls
Airlines	Previously, domestic air fares and selected routes were controlled
Banks	(1) Floor on retail fixed deposit rates (2) Ceiling on car finance, credit card lending rates
Cars	(1) Import and excise duties (2) AP's are being phased out
REITS	Maximum gearing, tax rates
Telecommunications (mobile)	No minimum contract periods

Source: Macquarie Research

■ **Table 5: Key Sector Plays**

Sector	Key event	Longs	Shorts
Plantations	Biodiesel	KLK, IOI, PBOB, AALI, Carotech	Are you kidding?
Power	IPP industry restructuring	Tenaga	IPPs
Media	Pricing power returning	Astro, Media Prima	Star, NST, Nexnews
FB & T (Food)	Higher global pricing	Tradewinds, PPB Group, F&N, Etika, Nestle	
FB & T (Tobacco)	Tax maximisation by slowing tax increases	BAT	
Water	Tariff increase	Puncak	
Telcos	Mobile number portability	Telekom	Maxis
Banks	Ongoing repricing of loans predicated on a further 25 bps rate hike by end 2006	Public, BCB	Maybank

Source: Macquarie Research

Table 6: Potential Winners and Losers of Structural Price Changes Theme

Sector	Potential price event with highest impact in each sector	Likelihood	Timeframe	Rationale	Winners	Losers
Energy - REEM	Govt could reduce and eventually remove petrol and diesel subsidies	High	>24 months	Reduce budget deficit	Pet Dagang	
Materials - Construction	Govt could raise price ceiling on steel	Low	>24 months	The decision will depend on movements in steel prices globally	Kinsteel, Lion, Southern	Contractors, high rise property developers. Impact muted as some costs are passed on
	Govt could raise price ceiling on cement	Medium	>12 months	Last price increase in 1996. Production cost has increased more than 30% since. Recent electricity tariff increase will impact profitability. Khazanah may want to restructure CIMA	LMC (44% mkt share), YTL Cement (24%), CIMA (16%), Tasek (13%)	Low-end residential developers with land bank
Transportation - Airlines	Govt has liberalised domestic air fares	Happened	n/a	Restructuring MAS, removing state subsidy from domestic air travel	MAS	Air Asia
Consumer -Autos	Govt is abolishing AP's in 2010	Scheduled	>24 months	Compliance with WTO, AFTA	UMW, DRB, Tan Chong, Sime	
	Govt could gradually reduce protection for domestic industry	Medium	>24 months	Compliance with WTO, AFTA	UMW, DRB, Tan Chong, Sime	Proton
Consumer - Media	Industry has consolidated- should lead to reduced irrational discounts on TV ad rates	Happening	<12 months	Profit maximisation	Media Prima	NST, Star, Nexnews
Consumer -F&B	Biodiesel technology could raise demand for CPO	High	<12 months			Plantations
	Govt could raise price ceiling on sugar	High	<12 months	Last price increase in Feb 98 from RM1.20 to RM1.45, then cut to RM1.40 in Mar 02	PPB Group, Tradewinds	
	Govt could raise price ceiling on milk	High	<12 months	Last price increase in Feb 98 by 10 sen per 397g can	F&N, Etika, Nestle	
Financials - Banks	Govt appears to be slowing price hikes on tobacco	High	<12 months	Tax maximisation	BAT, JTI	
	BNM has allowed IBOR to rise above FD	Happened	n/a	Return to normal market conditions	CAHB, Public	Foreign banks, AMMB
	BNM could liberalise FD rates	High	<12 months	Part of Financial Sector Master Plan	CAHB, Public	Foreign banks, AMMB
Property - REITs	Relaxation of tax rates for local investors and withholding tax for foreign investors	Happened	n/a	To develop the REIT industry in Malaysia	Starhill, Axis, Landmarks	
Telecoms	Mobile number portability	High	<12 months	Further deregulation	Telekom, Digi	Maxis
Utilities - Power	IPP Industry restructuring	High	<12 months	Raising energy efficiency	Tenaga	YTL, Tanjung, Malakoff
Utilities - Water	Tariff increase	High	<12 months	Needed to partly fund water infrastructure spending	Puncak, PBA	

Source: Macquarie Research

water, although it is the second most expensive provider of sewerage. While Tenaga Nasional (Tenaga) finally received its tariff increase earlier this year, there are currently talks to restructure the industry to include the pricing structure of the independent power producers (IPPs). Water tariffs have not been raised as yet although analysts expect this to be a matter of when and not if, due to the need to build new infrastructure such as water pipes.

Other indirect price-controlled industries could be next

The government's drive to reduce subsidies and revert to market pricing mechanism could also result in structural price changes in a number of other indirect price-controlled industries (see Table 4). For example, in the airline sector, MAS has targeted a return to profitability after losing some RM500 million, now that it has the ability to choose which routes to fly, and full flexibility to set its fares.

In the telecommunications sector, Macquarie Research notes that despite having among the lowest mobile tariffs in the world, the inability of operators to lock in consumers into minimum contract periods means that incentives are low, and as a result, profit margin for telco players in the country are among the fattest in the world. This also makes the incumbents very secure in their earnings. However, the research house believes that with mobile number portability (MNP) likely to be introduced by 2007, a maximum of 12 months will likely be stipulated for the minimum contract period, and this could usher in higher industry spending on incentives.

In short, changes in structural pricing for these industries are likely to have a wide impact on the profitability of companies involved in the sectors involved.

Other structural price changes to come

Apart from changes in government-controlled companies and industries, other developments are also driving structural price changes in many other industries. Macquarie Research says that although the new preference for market pricing will drive the more regulated industries, there are also other specific industries where structural price changes are occurring, notably in plantations, where the advent of biodiesel conversion technologies are providing an additional

source of demand for CPO.

Meanwhile, another driver of pricing will apparently be the good old market forces. The research house says that where there is capacity expansion and the ability to offer new products (for example satellite TV), or where industry consolidation has taken place and pricing is returning to more sensible levels (free to air TV), structural price changes could also be seen occurring.

The key sectors and stocks affected

According to Macquarie Research, the key sectors which could see a material change in pricing and/or margin within the next 12 months under the structural price theme include plantations, power, media, food, beverage and tobacco (see Table 5).

The potential events and their frameworks that could shape these sectors and the likely winner and losers in each sector are shown in Table 6.

Conclusion

Structural price changes are likely to occur in a number of industries ahead, from government-regulated ones to those which

are seeing new market forces and events such as that of the plantation industry. The changes could be also a reaction to a likely more challenging economic environment ahead even as foreign players are coming aggressively into the country amidst the trend of globalisation and liberalisation in key industries such as banking and automobile.

While price rises in certain industries such as water cannot be avoided, consumers will likely hope that these are offset by improved efficiencies and services in these sectors. On the other hand, price wars in certain industries such as banking and telecommunications could benefit consumers in the form of lower prices and more innovative products being introduced.

As for investors, the structural price changes theme is likely to be a key theme ahead as the government shifts its thinking from a regulated stance to a more liberalised market pricing stance. There will be winners and losers as always, and in a structural change environment, the winners normally win big while those who cannot adapt face a real challenge to grow or even survive. **mb**