Strategy - Malaysia

Crackdown On Illegals Heightens Risks To Growth

Stocks Covered: 144
Ratings (Buy/Neutral/Sell): 61 / 67 / 16
Last 12m Earnings Revision Trend: Negative

The ongoing crackdown on illegal foreign workers in Malaysia is a worry for its negative impact on economic growth and corporate earnings while adding another negative factor to further dull investor sentiment. However, the ensuing labour shortages comes at an inconvenient time for the economy and financial markets given the nascent uptick in GDP growth and expected rebound in corporate profitability. The fragility of earnings arising from cost pressures has been a recurring theme in recent years and the clampdown would heighten the risks to growth, requiring close monitoring. However, past experience has shown that the initiatives to weed out illegals only last for a few months. The current crackdown is also likely to be offset by stronger export growth. We make no change to our +4.8% GDP growth forecast for the time being.

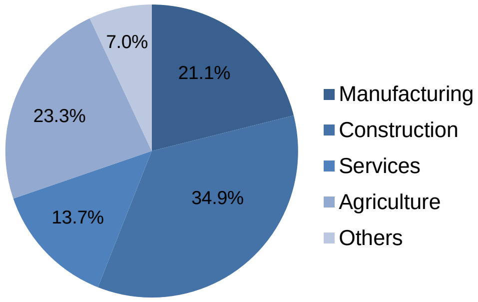
Construction and plantations sectors employ the highest number of foreign workers. The ongoing initiative by the Immigration Department of Malaysia comes after the expiry of the 30 Jun deadline for illegals to obtain an enforcement card (E-card) pending legalisation. The construction and plantation sectors remain the most dependent of foreign workers due to challenges to automate the processes. Other labour-intensive industries and sectors with direct and direct dependence include property, timber, rubber gloves, consumer (F&B), technology and telecommunications (mobile operators). While the larger companies are likely to only employ only legal workers, it may not necessarily be true for smaller businesses and SMEs, given the onerous processes and costs to employ legal workers. The SME sector is estimated to contribute 37% to GDP. The larger businesses may also be indirectly affected by the resulting labour shortage if its sub-contractors or suppliers are unable to deliver. Anecdotal evidence also suggests that both legal and illegal workers have been caught up in immigration dragnets on worker settlements, requiring time and effort to process and release the legal workers. The cost to hire legal workers would also likely spike higher during this time.

How many foreign workers in Malaysia? There are about 1.9m legal foreign workers in Malaysia and we estimate that there are a similar number of illegal foreign workers. Clampdowns on illegal workers happen from time to time, most recently in 2013-2014, lasting for a few months. While labour shortages are here to stay, it could help to spur the adoption of automation and other advances such as IBS in the construction industry.

Impact on GDP to be manageable. We envisage that the downside risk to growth from the crackdown on illegal workers would likely be mitigated by a stronger-than-expected growth in exports. As such, we are inclined to maintain our real GDP forecast at 4.8% for 2017 (+4.2% in 2016) even though our projection appears to be on the conservative side currently.

Accumulate on weakness. We reiterate our underlying positive stance on the equity market. The improved risk appetite and upturn in growth prospects suggest that investors should focus on cyclical sectors, exporter, liquid blue chips, high growth mid-caps and high-yielding stocks.

Foreign workers by sector



Note: As of 2015
Source: Ministry of Home Affairs

Company Name	Rating	Price	Target	% Upside (Downside)	P/E (x) Dec-18F	P/B (x) Dec-18F	Yield (%) Dec-18F
AEON Co M	BUY	MYR2.22	MYR2.97	33.6	24.8	1.6	1.8
BIMB Holdings	BUY	MYR4.29	MYR5.20	21.2	11.1	1.5	3.2
Datasonic Group	BUY	MYR1.20	MYR2.07	72.2	14.5	4.8	4.3
Gadang Holdings	BUY	MYR1.30	MYR1.55	19.2	7.4	1.1	2.4
IOI Properties Group	BUY	MYR2.17	MYR2.57	18.4	13.3	0.7	4.4
Kerjaya Prospek Group	BUY	MYR3.54	MYR3.62	2.2	12.5	1.9	2.4
Kimlun Corporation	BUY	MYR2.25	MYR2.57	14.4	7.9	1.0	3.2
Malayan Banking	BUY	MYR9.61	MYR10.40	8.2	13.1	1.3	5.8
Malaysian Pacific Industries	BUY	MYR13.54	MYR14.80	9.3	13.7	2.2	2.3
POS Malaysia Bhd	BUY	MYR5.17	MYR6.30	21.9	25.4	2.0	2.6
Press Metal	BUY	MYR2.68	MYR3.66	36.5	12.5	3.1	2.4
Public Bank	BUY	MYR20.36	MYR22.00	8.1	14.4	2.0	3.0
Serba Dinamik Holdings	BUY	MYR1.92	MYR2.78	44.9	8.4	1.6	3.6
Yinson Holdings	BUY	MYR3.50	MYR4.01	14.5	12.9	1.5	0.7

Source: Company data, RHB

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Crackdown On Illegals Heightens Risks To Growth

Our 2017F real GDP forecast stays at 4.8%

Following the expiry of the application for E-cards on 30 Jun, the Government has launched a crackdown on illegal immigrants. In our view, the recent crackdown on illegal foreign workers would not take a major toll on large companies, as they mostly hire legal workers, with little or no difficulty in registering the foreign workers, in terms of cost and licensing.

The Malaysian Employers Foundation (MEF) said "the bigger businesses are usually the fully-licensed ones, and they do not indulge in hiring illegal foreign workers". Instead, the impact would most likely be felt by small and medium enterprises (SMEs). Indeed, SME Association of Malaysia said that 70-80% of SMEs have illegal workers because it is too expensive not to do so and there is no guarantee they will be supplied with legal workers.

As of 2016, SMEs contribute 37% to overall GDP, 65% to employment and nearly 18% exports. As it stands, companies that hire most of the illegal foreign workers are in the manufacturing, agriculture and construction sectors.

In the past, similar episodes of crackdown on illegal foreign workers were seen through the first phase 6P programme in Jul 2012, where 330,000 immigrant workers were repatriated back to their respective countries.

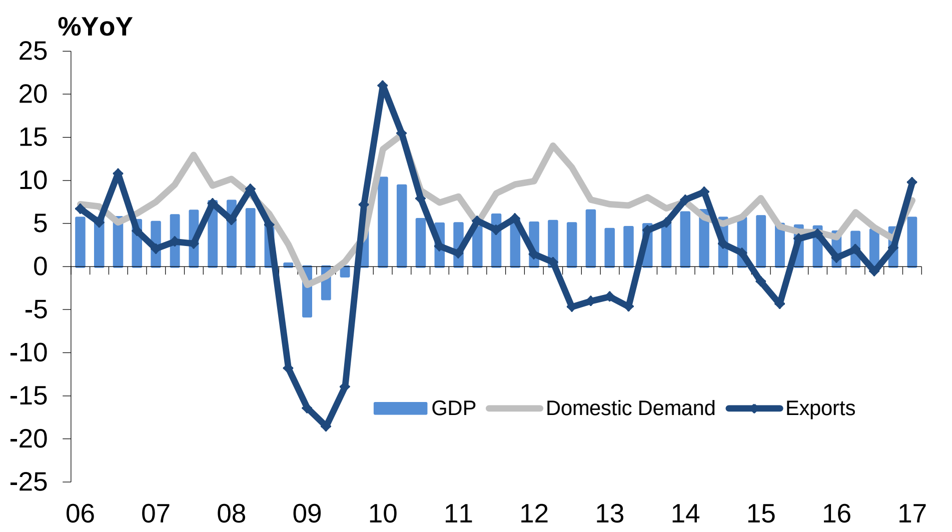
In 3Q12, growth of the manufacturing and construction sector output decelerated slightly to 2.8% and 18.1% YoY, from 5.3% and 21% respectively in the previous quarter. The manufacturing sector bounced back in 4Q12, while growth in construction continued to slow during the quarter. It seems the crackdown might have caused the slowdown – but a slowdown in exports and public spending during the period might have contributed more to it, in our opinion.

Meanwhile, the second phase of the 6P programme was implemented in Jan 2014. On the flipside, GDP growth picked up significantly to 6.3% YoY during this quarter, from +5% in 4Q13, with all major sectors registering stronger growth. The pick-up in real GDP growth was in part driven by a recovery in exports and suggesting that there was limited impact from the crackdown of foreign workers, as businesses would be able to adjust to the new requirement.

Overall, we believe the impact from the recent clampdown would be limited to Malaysia's overall GDP growth, as we don't expect the crackdown to be too prolonged and we believe businesses would be able to adjust to the requirement after a transition period.

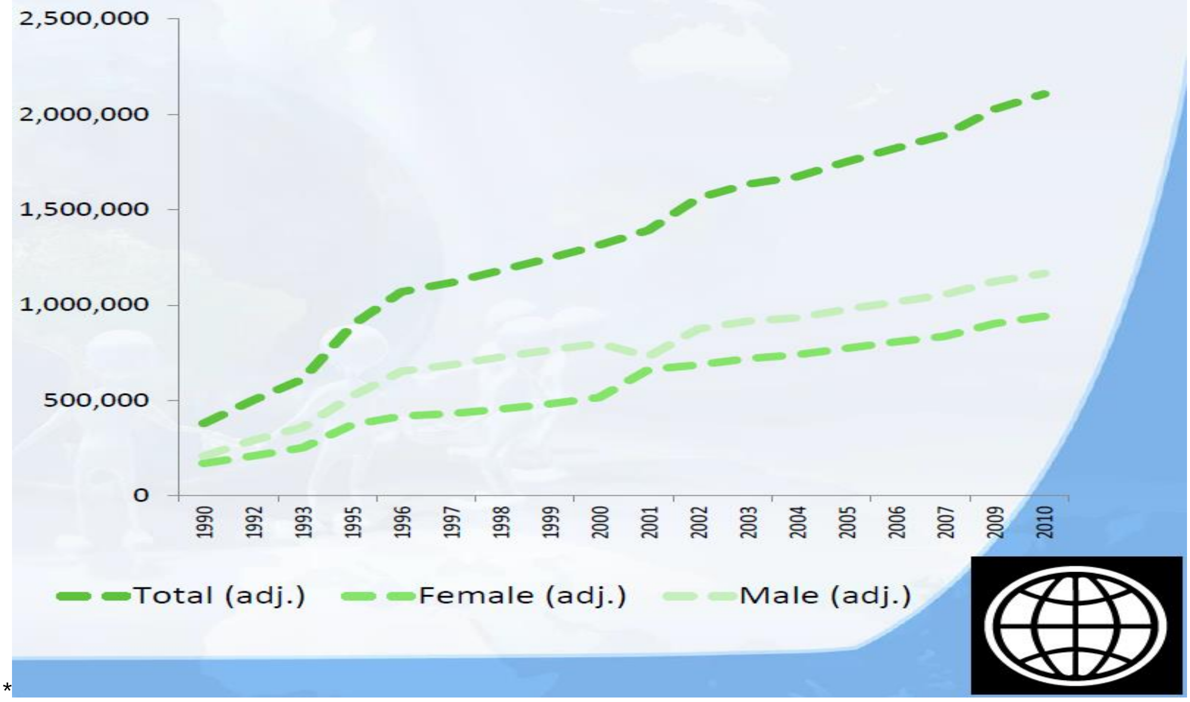
We envisage that the downside risk to growth from this crackdown would likely be mitigated by a stronger-than-expected growth in exports. As such, we are inclined to maintain our real GDP forecast at 4.8% for 2017 (+4.2% in 2016) – even though our projection appears to be on the conservative side currently.

Figure 1: Malaysia's GDP, domestic demand and external demand



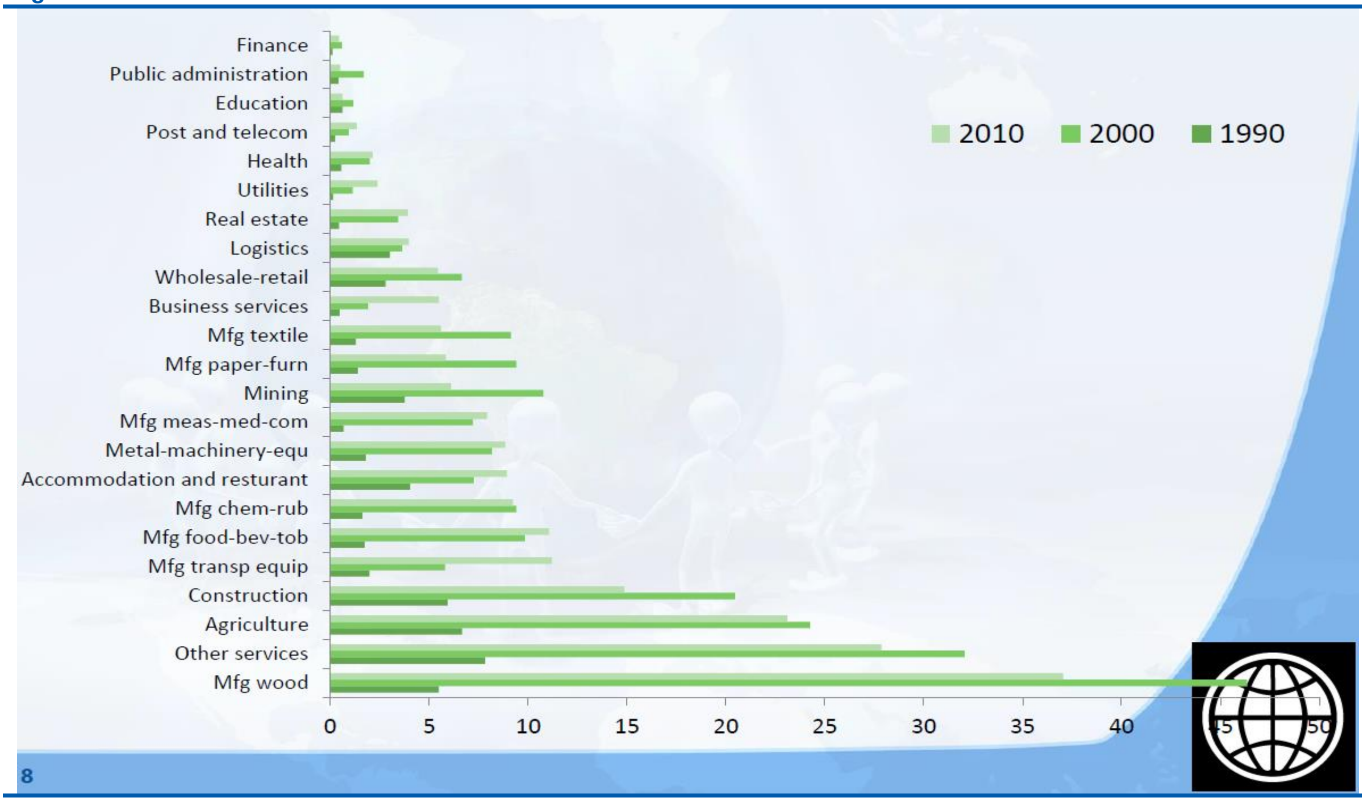
Source: RHB, Department of Statistics

Figure 2: Foreign workers in Malaysia (1990-2010)



Source: World Bank

Figure 3: Foreign workers make up the largest share of the labour force in wood products, other services and agriculture sectors



Source: World Bank

Sector Review

Construction — OVERWEIGHT

The construction companies that handle government projects under our coverage were largely unaffected as labour requirements are approved by Ministry of Home Affairs (KDN). However, construction players which are more involved in the private projects were affected as they were experienced reduced availability of manpower. There is nothing much these companies can do at the moment and if the situation is prolonged, the progress of construction projects might be delayed.

The recurring labour issues might encourage construction companies and their customers (project awarder) to be more inclined to opt for the Industrialised Building System (IBS) in future projects, which is less dependent on human labour as compared to the conventional construction system.

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Consumer — NEUTRAL

F&B, paper manufacturers and electronic manufacturing services (EMS) providers under our coverage were largely unaffected, as all of their labour force is legal and some of the companies had pre-emptively prepared for the clampdown by getting the permit/documentation ready for verification.

Breweries were affected, to a certain extent, as traditional on-trade channels, the coffee shops and hawker centres had to cut short the operating hours due to the shortage in labour. However, the actual impact could not be quantified. Meanwhile, production in breweries was unaffected.

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Logistics — OVERWEIGHT

We see minimal direct impact of the ongoing illegal labour clampdown on the logistics sector. This is so, as all commercial vehicles have to be registered with the Road Transport Department and Land Public Transport Department.

Under the Government's ruling, only Malaysians can obtain the goods driving licence to operate a commercial vehicle. We understand from Westports (WPRTS MK, NEUTRAL, TP: MYR3.80) that the company currently only has three foreign workers under its employment as it has a policy to hire locals. The impact, we believe, would mainly affect third-party service providers/sub-contractors – especially in warehousing operations where most of the foreign workers are employed. We expect productivity issues to arise in the logistics supply chain if the illegal labour clampdown exercise by the Government is prolonged.

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Plantations — UNDERWEIGHT

Labour shortages in the plantation industry in Malaysia are still very common. Most planters are still not operating at optimal efficiency due to the labour shortage which is still at 10-20% for most planters. While the impact would be hard to quantify, it is possible that increasing the number of labourers would increase FFB yields by at least 0.25-0.5t/ha, particularly for those planters facing a more severe shortage.

The shortage of labourers would impact the industry more during the peak production period, when more harvesters are needed. Given that this is an industry-wide phenomenon, the labour shortage affects all planters more or less equally.

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Property — NEUTRAL

Based on our checks with a few developers under our coverage, the illegal labour clampdown has not significantly affected the real estate industry. Most developers have not heard of any complaints from their contractors. However, if the clampdown gets more widespread, contractors would need to be liable for the late delivery of projects, and the liquidated and ascertained damages (LAD) charges. Impact to developers would be minimal.

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Rubber products — NEUTRAL

We believe the recent clampdown of illegal labour would have no impact on the rubber products sector. Even though they are players in a labour-intensive industry, we believe the rubber product companies under our coverage only hire legal foreign workers.

On the supply chain, all of the rubber players have a strong global network. If any of the local suppliers are affected by the on-going enforcement, there would be no issue for the glove players to switch to another supplier overseas.

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Technology — OVERWEIGHT

With respect to the manufacturing-based technology players under our coverage, we believe all of them are currently in full compliance with the local policy on hiring of foreign labour.

In particular, Unisem and Inari Amertron employ approximately 3,000 and 2,000 foreign workers respectively, or estimated 40%/28-31% of their respective headcounts. Globetronics is currently has 1,300-1,400 foreign employees (total workforce: 2,100).

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Telecommunications — NEUTRAL

The telcos would continue to be impacted by weaker consumer sentiment and the on-going repatriation of foreign workers, who are avid prepaid users. The rising headwinds for the overseas foreign workers (OFW) segment have impacted Digi the most, which reportedly has the lion share of the OFW market. Digi's prepaid revenue fell 13.5% in 1H17, dragged down by the decline in the price-sensitive IDD segment, the contraction in prepaid base and prepaid to postpaid conversion.

We expect industry prepaid revenues to remain under pressure, with the telcos focusing on wallet share and mobile internet customers to drive profitable growth. For 2017, we expect industry mobile service revenue to be moribund, with flattish growth at best.

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Timber — NEUTRAL

The ongoing illegal labour clampdown is nothing new. A few of the timber players that we spoke to guided that estate managers are working hard to deal with the labour shortage. As a rule of thumb, there is currently a 1:10 ratio of workers per ha in the timber estates.

While most timber players are moving towards mechanising production, particularly in the plywood segment, we understand that the labour force is not directly inter-changeable. The plywood division, for example, has more female workers while plantation estates require more male manpower. By increasing the number of labourers, we see room for FFB yields to increase in the plantation segment, while the impact on the logging segment would be milder due to the tight harvesting regulations that were put in place by the Sarawak State Government.

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