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Reversal of Fortune

It is exhilarating to see the country experiencing a reversal of fortune. About this time last year, we were beset with rapidly rising world oil prices that were made more burdensome by an uncomfortable peso-dollar rate (which went to as high as P56). Alongside these, consumers were jittery with the impending expansion of the VAT coverage, forcing them to be cautious with their spending patters.

Today, the peso is hitting new highs versus the US dollar and compounds the benefit of declining world crude prices. Inflation is coming off (hitting a 27-month low of 5.7% in September) which should help perk up consumption expenditure and consequently sustain further economic growth.

Against this backdrop, we have been getting inquiries on what to expect as far as the stock market is concerned. In our February 20, 2006 article entitled "It pays to track the peso," we outlined how exchange rates play an important role in stock investment decisions and how listed companies are affected by forex volatilities. In today's column, we take a step further to identify the sectors which we think are likely to benefit the most from the confluence of strong peso, declining oil prices and inflation, and rising consumption expenditure.

Sectors on a roll

The obvious conclusion is that a strong peso is bad for exporters and those whose revenues are denominated in foreign currencies. But this is no longer a straightforward rule. It is equally important to consider the cost structures of these companies, as well as factors affecting demand or consumption patterns. With these as benchmarks, we identify the following sectors which should benefit the most from the prevailing circumstances:

1. **Telecommunications**: In the early 1990s, it was almost a rule of thumb among investors to sell telecom stocks when the peso strengthens and buy when the peso weakens vs. the dollar. This was logical because a good portion of the telecom revenues (particularly overseas call or IDD tolls) were dollar-linked. The basic monthly service fees (MSF) are automatically raised or cut through the currency exchange rate adjustment (CERA). Then, the MSF and IDD revenues accounted for as much as 85% of a telecom company's (telcos) revenues. Today, the advent of mobile phone and data services has significantly diversified telco revenues such that only about 35% of total revenues are dollar-linked.

Another reason that a strong peso is net positive for most telcos is that these companies have accumulated large amounts of foreign debt to finance their massive capital expenditures during the past decade. Thus, a strong peso will result in lower translation of their interest expenses thereby boosting the bottomline. Furthermore, these companies also book forex gains in cases of a stronger local currency and vice versa. We have seen this happen in the first quarter this year when telcos' profits got a considerable boost from forex gains due to a strong peso. The opposite happened in the second quarter when local currency weakened sometime in May and June this year when there was a flight to the dollar amid expectations for US interest rates to go up.

The subsequent recovery of the peso and expectations of its continued strength onto next year should be a boon to these companies. In the case of PLDT, the benefit is considerable. We have seen market estimates that show PLDT's net income increasing by at least P500 million for every P1 appreciation versus the US dollar.

2. Utilities. While the benefit from a peso appreciation is not as significant in other utilities as it is for the telcos, power generators and distributors as well as water utilities should still be able to book forex gains on account of their considerable forex-denominated debts. But more importantly, these companies will tend to benefit from higher consumption given the impact of declining pump prices on inflation. Lower inflation should theoretically provide a boost to purchasing power of consumers. Furthermore, the declining oil prices should mean lower cost of production for power generators and distributors which could (theoretically) be passed on to consumers and could stimulate further usage. Any rate hike that the regulators will grant for cost recovery by utilities would be a bonus.

3. Consumer. These pertain to companies in the food and beverage sector, covering both the manufacturers and restaurants and fastfood chain operators. Among the top listed companies from this sector are San Miguel Corporation, Jollibee Food Corp, and Universal Robina Corporation.

Lower inflation and higher income are expected to perk up consumption and thereby underpin the prospects of these companies. Demand should get a further boost from next year's election spending and the potential multiplier effect on employment of the planned massive infrastructure spending by government. In terms of costs, these companies can look forward to lower transportation/distribution and freight costs that should come along with declining oil prices.

Philippine multinationals

In terms of the impact of a strong peso on income, San Miguel and URC are more vulnerable given the sizeable (and growing) proportion of revenues derived abroad. However, this is likely to be mitigated by rising consumer demand given gains they have made in strengthening their brands in markets where they are present. In the case of URC, it has established market leadership in certain segments of branded consumer food in countries like Thailand, Malaysia, Indonesia and Vietnam – countries which are exhibiting similarly good economic trends as the Philippines.

In the case of Jollibee, revenues derived abroad, albeit growing, account for just 11% of total revenues. Thus, the peso appreciation should not be that detrimental to its profitability. To the contrary, this should even be net positive for the company given that up to 15% of its costs are on imported materials while most of its equipments are also bought in dollars.

4. Property sector. We have expounded in the past that low interest rates are a boon to property companies as this tend to spur demand. Simply put, low financing costs make it more affordable for buyers to acquire properties. Given the prevailing peso strength and tame inflation, there is little justification for monetary authorities to raise interest rates. We can also factor in the boost to purchasing power derived from the continued strong inflow of OFW remittances. Taken together, these factors will likely extend the boom currently being experienced by the property sector.

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Erratum: In last week's column, we mistakenly mentioned that UCPB was under receivership when in fact it was only under rehabilitation. UCPB EVP and CFO Cesar Rubio, my classmate and friend, emailed to clarify that the bank continues to operate normally as a regular commercial bank. UCPB is on track as far as its business plans are concerned and ranked 14th in terms of total assets as of June 2006. We apologize for the inadvertent oversight.

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