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OSK

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Consumer Spending Boost

Malaysia's Prime Minister announced yesterday that civil servants deserve a pay rise and the Public Service Department is in the midst of making a final recommendation to the Government. Our analysis shows the new salary scheme could boost consumer spending growth by 0.5ppt and 1ppt respectively in 2007 and 2008, resulting in higher GDP growth of 0.2ppt and 0.5ppt respectively. The salary revision will represent a broad-based boost for most sectors, including consumer products, properties, banking, telco and media. Amongst the consumer stocks under our coverage, we reiterate our buy recommendation on AEON, Dutch Lady, Hai-O, KFC, QL and Tek Seng, with the view that the salary revision will have direct positive impact on the earnings of these companies.

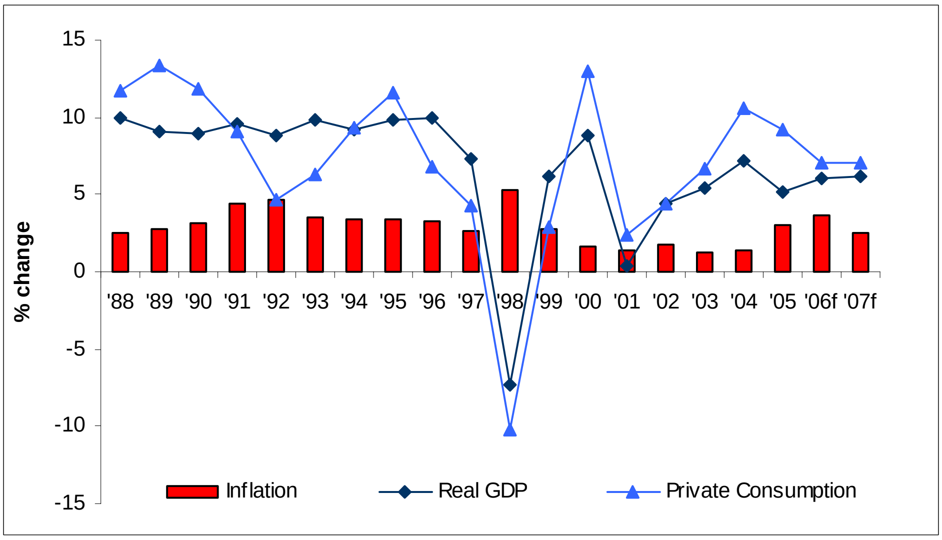
Long-waited salary revision. Prime Minister Datuk Seri Ahmad Badawi commented yesterday that civil servants in the country "deserve a pay rise". The PM also said that the Public Service Department (PSD) is in the midst of studying the salary revision proposed by the Congress of Unions of Employees in the Public and Civil Services (Cuepacs) and is making its final recommendation to the Federal Government. To re-cap, the Cuepacs has requested for a comprehensive revision on the salary scheme since beginning of this year. The Cuepacs cited that cost of living has risen significantly and the employees' work performance has also improved whilst the last "meaningful" salary revision was done 25 years ago in 1992.

Cuepacs's big request. According to various sources, the Cuepacs has submitted a proposal containing several requests. Some of the major appeals include **(i)** extending the retirement age to 60, **(ii)** revamping the pension scheme; and **(iii)** salary revision. Cuepacs also proposed a remuneration system based on years of service instead of the current performance review through the Efficiency Level Assessment. Collectively, the Cuepacs has said that the proposals would cost the Government an additional RM5bn per annum.

Government the largest single employer. It has been mentioned that there are about 900,000 civil servants whom are directly under the Government's payroll at the moment. Besides, there are about another 300,000 workers indirectly affiliated with the Government through state and local governments as well as various agencies and statutory bodies. The number of retirees currently stands at about 500,000. All in all, approximately 1.7m people in the country could potentially benefit from this massive pay hike exercise.

Big boost to consumption. The salary revision will elevate disposable income of civil servants which in turn will boost consumer spending and its contribution to GDP growth. Reflecting the rising cost of living and higher interest rates, Malaysia's private consumption growth has moderated from a peak of 10.4% y-o-y in 3Q '05 and has normalised to 6.4% y-o-y in 4Q06. Historically, growth in private consumption tends to outpace GDP growth by about 1ppt. In addition, we also see the lapse of monetary transmission effect given that the last rate hike was already more than one year ago (25 Apr 2006). Consequently, we believe consumer spending has already normalised enough and it is time for this segment to become an important driver of Malaysia's overall economic growth.

Figure 1: Real GDP, Private Consumption & Inflation



Source: Bloomberg, BNM & OSK Research

But proposal may not be accepted wholesale. To recap, the Cuepacs had proposed a broad-based salary revision consisting of the following:

(i) 40% increase for Support Group II (Grades 1 to 16), the lowest category of public employees;
(ii) 30% increase for Support Group I (Grades 17 to 26 and Grades 27 to 40);
(iii) 20% increase for the Management and Professional Group (Grades 41 to 54); and
(iv) 10% increase for the Premier Grade of the Public Sector (Jusa).

The total package (RM5bn per annum) represents approximately 19.4% of the existing Federal Government's emolument expenses (2007f: RM25.8bn) or 4.4% of the total operating expenditure (2007f: RM113bn). Given the financial constraint with a RM20bn budget deficit expected in 2007, **our view is that the Government may not approve the proposal wholesale**. Instead, we see partial approval to the Cuepacs's recommendation amounting to RM4bn, but opine that the approved scheme will benefit those in the lower income bracket. Moreover, the claim by Cuepacs that there was no pay hike since 1992 was not entirely true as civil servants enjoyed approximately 10% salary adjustments in 1996, 2000 and 2002 respectively. The Government has also started to pay Cost of Living Allowance or COLA to civil servants since 2005.

Possibility of implementation by 2H this year. Given that the Prime Minster had already announced the imminent salary revision, it will not be surprising to see the implementation of the new proposal beginning 1st July this year. We may see staggered implementation of the revised salary scheme (i.e. back-dating the revision in lump sum payments) but the actual impact could begin to filter through the economy as soon as the actual declaration date due to "announcement effect" (i.e. households factoring in higher future income).

Quick Impact Analysis:

Using the Marginal Propensity to Consume (MPC) ratio 0.45 in 2006 and an import leakage assumption of 10%, the salary revision could generate an additional RM2.7bn of consumer spending per annum. The additional consumption could lift private consumption growth by 0.5ppt and 1ppt respectively in 2007 and 2008. After applying the respective deflators, **the entire salary revision scheme will contribute an additional 0.2ppt and 0.5ppt respectively to real GDP growth in 2007 and 2008!**

Figure 2: Impact of the Salary Revision on the Malaysian Economy

Sector	Baseline				After Salary Revision			
	2007f		2008f		2007f		2008f	
	RM bn	%chg	RM bn	%chg	%chg	% Diff	%chg	% Diff
Private Consumption (nominal)	262.3	9.7	287.2	9.5	10.2	+0.5	10.5	+1.0
Private Consumption (real)	150.3	7.0	161.5	7.5	7.5	+0.5	8.5	+1.0
REAL GDP	**294.9**	**6.2**	**313.5**	**6.3**	**6.4**	**+0.2**	**6.8**	**+0.5**

Source: BNM & OSK Reserach

Impact could be even higher. The above calculation only factors in an “average” scenario based on the average MPC for all Malaysians. As proposed by the Cuepacs, the lower rank officers will get the higher pay hike in percentage terms. As such, the impact on the economy could be even bigger as lower income group tend to have higher MPC and may spend most of the pay rise to upgrade their living standards. At this juncture, we prefer to wait for details of the salary revision before imputing the impact into our forecast model.

Reinforcing the feel good factors. The salary revision should reinforce the current “feel good factors” in the system (i.e. stock market rally, higher commodity prices and 9MP implementation) to generate further impetus of growth to sustain the economic momentum. In the absence of external shocks, the Malaysian economy should be able to expand its near-term potential output growth of 6.3% as reported by BNM.

Potential re-rating of the consumer sector? With the potential implementation of a revised salary scheme, we envisage a broad-based boost for most sectors of the stock market, including consumer products, properties, banking, telco and media. **Among the consumer stocks under our normal coverage, we reiterate our buy recommendation on AEON, Dutch Lady, Hai-O, KFC, QL and Tek Seng, with the view that the salary revision will have direct positive impact on the earnings of these companies.** A thorough upgrade to their earnings will only be carried out once details of the salary revision become available.

Figure 3: OSK’s BUY Recommendation – Consumer Sector

Company	Current Price (RM)	Target price (RM)	Potential Upside (%)	Recommendation
AEON	9.45	10.30	9.0	BUY
Dutch Lady	11.70	13.10	12.0	BUY
Hai-O	2.25	2.86	27.1	BUY
KFC	6.65	7.50	12.8	BUY
Tek Seng	0.49	0.63	28.6	BUY
QL	3.08	3.73	21.1	BUY

Source: OSK Research

OSK Research Guide to Investment Ratings

Buy: Share price may exceed 10% over the next 12 months

Trading Buy: Share price may exceed 15% over the next 3 months, however longer-term outlook remains uncertain

Neutral: Share price may fall within the range of +/- 10% over the next 12 months

Take Profit: Target price has been attained. Look to accumulate at lower levels

Sell: Share price may fall by more than 10% over the next 12 months

Not Rated: Stock is not within regular research coverage

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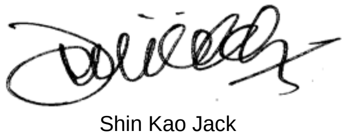

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