Philippines

SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS September 29, 2016

Analyst: Rolf Danielsen. Tel : +46 8 763 83 92. E-mail : rolf.danielsen@seb.se

The economy has continued strengthening based on solid macro-economic fundamentals accompanied with structural reforms to gradually improve the business climate. Recent general elections were calm and ended in a landslide victory to Mr. Duterte much due to his popular signature policy to kill drug dealers with scant respect for due process.

Country Risk Analysis

Solid growth is set to accelerate: Growth in 2016 started on a strong note and is set to reach 6.6% for the whole year, an improvement by 0,7pp over 2015, propelled by investments and private consumption. Net exports, by contrast, could prove a drag as quickened economic activity is drawing in rising amounts of imports. That keeps a lid on domestic economic pressures as reflected in a declining unemployment rate. Supported by low energy prices, a stable exchange rate and confidence building monetary policy, the inflation rate has nevertheless dropped to about 2% and is expected to remain well within the target rate of 3%±1% pa.

Fiscal policies in 2016 are set to weaken slightly with the deficit rising to 1,3% of GDP, still low compared with many peers, though. Unlike last year when the government had problems in executing its investment program, this year started by speeding up infrastructure projects. Despite the higher deficit, general government debt is set to decline further to 40% of GDP. This is still moderate and further underpinned by low contingent liabilities from the banking system which most observers now characterize as solid and healthy with strong capitalization and a low level of bad loans.

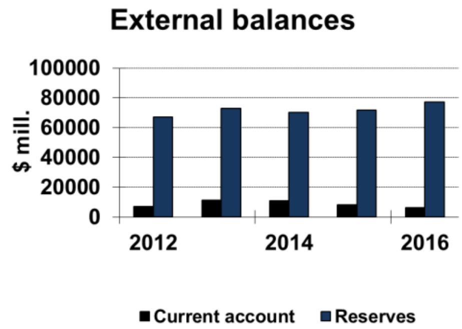
The general elections of last May ended with a landslide victory for an “outsider” -- the previous mayor of the southern city of Davao. He won on a ticket fighting the country’s rapidly growing drug mafia with vigilante methods and extra-judicial killings. Some observers have raised concerns that such methods may threaten the integrity of the country’s weak institutions including the judiciary. Investors, by contrast, remained reassured as he appointed a reform and growth friendly cabinet.

With the recent upgrade to one notch above lowest investment grade the Philippines have seen further drop in the country’s sovereign risk premium. This also benefits country risk, which, however, could be hurt by a sharper downturn in China than expected at the moment.

Recent economic developments

Stronger growth: From a slightly weaker performance in 2015, when economic growth fell back to 5,9% partly in response slowing regional economies led by the downturn in China, growth for the current year is expected to pick up. The year started on a strong note with activity accelerating to 7% expansion in the second quarter largely propelled by government spending on delayed infrastructure projects. For the whole year expectations are for the economy to expand at a rate of 6,6% as activity moderates somewhat toward year-end. In addition accelerated construction of infrastructure projects rising growth will be driven by services including business services now exported world-wide. Also private investments in manufacturing and other industries will play in.

Investment in the driver's seat: In stark contrast to the country's past, investments are becoming the main driver of economic growth. In the second quarter of the current year they rose by an exceptional 28% yoy (year-on-year), while private consumption, the traditional mainstay of the economy, still continued strong but at a more moderate pace of 7%. Strong investment demand was much underpinned by government initiated project but also rising investor sentiment as political calm prevailed during the election campaigns without the violence that has often accompanied them in the past. Only net exports exerted a drag on the economy as imports responded to the strong investment demand boosting deliveries from abroad of associated equipment.



Price pressure remains well contained: In the first half of the current year consumer prices continued subsiding to the 1-2% range in part due to falling energy prices but also underpinned by lower and now quite well anchored inflation expectations. That occurred despite some tightening of the labor market with unemployment falling below 6% as job creation accelerated. However, measures of unemployment in a developing country like the Philippines should be seen against a background of high underemployment in rural districts at almost 20% according to the central bank.[1]

Weaker current account surplus: With a well-established current account surplus since 2003, reaching almost 3%/GDP last year, the Philippines enjoy external strength normally accorded to countries in much stronger rating classes. In the current year that surplus is likely to fall to about 2%/GDP, as imports have started to grow faster while exports have fallen back. In the second quarter, the trade deficit widened to $9bn. as imports soared 24% yoy while exports of goods declined 7% including to China and Hong Kong which account for 22% of the total. However, exports of business services have continued on a solid note and been accompanied by rising revenues from tourism helping to limit the decrease of the current account surplus.

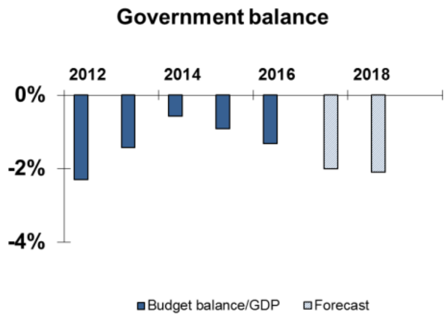
While the capital account remains strong: The capital account of the total balance of payments have continued at a decent pace in the current year supporting a strong level of foreign reserves in the hands of the central bank at almost 80bn. Net inflows

[1] Bangko Sentral ng Pilipinas, Economic and Financial Developments, Second quarter 2016.

of direct investments have so far in the current year shot up reaching 1bn already in the second quarter -- more than half of the projected whole year target of 1.5bn. That is sharply up from last year's paltry 0.1bn result. Estimated loan repayments at a total of $9bn. have so far mainly been rolled over or covered by other capital inflows. These flows and the current account surplus should enable the central bank to build reserves further to maintain a healthy coverage of about 10 months of imports or enough to cover the total external debt of the country also estimated at around $80bn equivalent to 26%/GDP of which a sixth is on short terms of less than a year.

Policies:

Ramping up fiscal spending: Coming from a fiscal deficit of 0,9%/GDP in the previous year, improved budget execution is bound to raise the deficit to 1,3%/GDP in the current year. The outgoing government sped up disbursement for infrastructure projects and social services in the last quarters before the general elections in May. Also, at 17% total revenues as share of GDP in the first half of the year recorded declining growth compared with the same period of 2015 when the ratio reached 18.5% but still outpaced nominal GDP growth, a legacy of the previous administration's effort to strengthen collection and run after evaders. Although strengthened, the government's tax take is still weak due to lingering inefficiencies in collection and a narrow tax base.



Moderate government debt: Due to more than a decade of prudent fiscal management, the government's debt burden has come down to less than a third relative to GDP since the crisis of the early 2000s. It is projected to decline to only 40%/GDP by the end of the current year of which about one half is owed foreign investors mostly on longer terms. Successful debt management has lengthened maturity to 13 years from 7 years in 2009. This has reduced annual gross borrowing requirements to an annual average of $6bn which the government has been able to refinance at stronger market terms in comparison with many peers. Moreover, unlike many peers the government does not face a major contingent liability from its banking system. This is well capitalized and unlikely to be in need of government bail-out at least in a medium term scenario.

Strengthened monetary policies: From a past of high and volatile inflation, the central bank – Bangko Sentral ng Pilipinas – has been able to instill confidence with markets. It appears also to have succeeded in anchoring inflation expectations within its target of 3% consumer price growth per annum with a margin of one percentage point on either side. Last year and into the first half of the current, it was also much helped by the unexpected decline of global prices of crude oil and other commodities which damped the actual inflation outcome to around 2%. However, from now on that is support to inflation fight is likely to unravel and for the whole year 2016 price pressure should recover slightly to 1.8% thus keeping any fear of deflation at bay. Having achieved this, the central bank recently changed its monetary policy framework in terms of day-today operations by introducing an interest rate "corridor" with a width of 2 percentage points of central bank lending and deposits rates for the country's commercial banks. The apparent objective was to improve competition in the interbank market and ultimately the transmission mechanism of monetary policy.

Sound banking sector: Like many peers and also developed countries, the financial system in the Philippines is dominated by banks. The banking system itself, however, is fairly fragmented largely reflecting the geography of the archipelago and the still low level of internet penetration in particular outside the few metropolitan areas. Notwithstanding this underutilization of economies of scale, the whole system is regarded as healthy. Moody's, the statistical rating agency, describes it as "stable and resilient". Over several years the level of bad loans – non-performing loans (NPL) – has declined to a low average level of 2% of banks' loan book. Capital buffers are close to 20% with a high ratio for Tier1 capital. Liquidity is strong as seen in interbank rates often undercutting short term policy rates. Last year loan growth slowed to 14% from 19% the year before as the central bank acted to reduce the potential build-up of risks. Including a cap of 60% on property lending helped limit the growth of loans to construction and real estate sectors.

New soaring loan growth: However, loan growth has picked up again so far in 2016 to an annualized 17%, twice the underlying nominal growth rate of the economy. That may not be alarming for an investment driven growth scenario but would need continued monitoring.

Reform policies: Over the years the Philippines has carried out important reforms, although as a whole the economy is still held back by many restrictions including on foreign ownership of companies and real estate. More important than new reforms, however, is rather implementation. In the fiscal sector, tax compliance has improved thereby expanding the fiscal room for much wanted infrastructure spending. But it is not clear that new attitudes have deep roots and that a relapse cannot be excluded. While corruption also has tended lower over the last couple of years according to anecdotal evidence, such improvements depend much on the political climate and respect for institutions. With the election of a president expressively advocating unconventional methods to deal with societal ills, some observers express concerns that courts and other public institutions could be weakened in the wake of such vigilante activism.

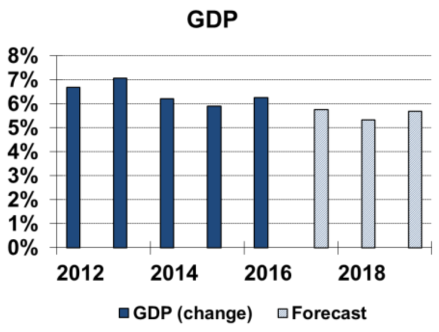
Politics

Mr. Duterte as president: Last May the Philippines elected Mr. Duterte as president with 39% of the votes. The constitution does not allow for reelections but the term is long, 6 years. The long standing mayor of Davao, the thirds largest city of the country, Mr Duterte has attained fame for strong-man policies. Over two decades he fought drug abuse and other vices within his constituency with apparent success with little regard for human rights and respect for the law. He was elected on a ticket of bringing such policies to the whole nation. This has caused strong objections from human rights groups and consternations in the foreign diplomacy not least for Mr. Duterte's use of colorful and vulgar expression when characterizing dignitaries including of the Catholic Pope or the US president.

The China factor: As President, Mr. Duterte has also signaled a path back to the foreign policy preceding his predecessor, i.e. a more neutral stance between the US and China. However, times are no longer the same as at the beginning of the century and the strong popularity of the US among 90% of Filipinos — according to Pew surveys – means that new president may have to take care where he is heading in foreign policy.

Outlook:

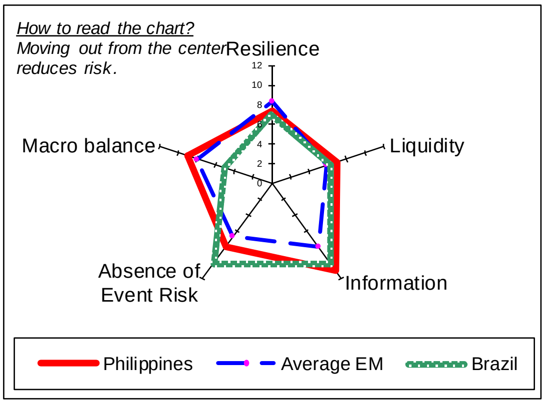
Medium term slow down: Our main scenario for the Philippines is continued strong growth but with some medium term softening. The forces that have mitigated price pressure since late 2014 are fading and may prompt the central bank to take a harder look at financial sector stability and external balances resulting in some monetary tightening. That said, however, growth in the range of 5-6% should also continue support social stability and sustainability of economic and financial balances.



Potential for continued healthy long term growth: Beyond the slowing expected over the medium term growth could strengthen again. That is provided the infrastructure program continues at the new and higher level while investor sentiment remain elevated and is not hit by fallback to past forms in terms of poor governance and endemic corruption. Barring a return of populism and unstable politics economic performance could also strengthen on favorable demographics provided matching job-creation. The country has a huge underutilized mining potential with a PDV worth five times annual GDP crying out for better infrastructure now hopefully on its way.

Risks to the medium term scenario: On the upside, stronger growth in the US may present an impetus through greater exports and stronger investor sentiment. On the downside there are risks related to regional security and trade while the domestic banking sector could still be in need of central bank vigilance and monitoring.

Key ratios	2016
Population (mill.)	98
GDP/capita ($)	2979
GDP (change)	6.3%
Inflation	1.8%
Curr.Acc. Balance/GDP	2.1%
Reserves/imports (months)	13.0
Budget balance/GDP	-1.3%
Government debt/GDP	40%



External ratings:
Fitch: BBB- /pos.
S&P: BBB
Moody's: Baa2

Peers:
India
Indonesia
Mexico

Graph: The pentagon shows the soft areas of the Philippines' creditworthiness compared with the average of emerging markets being mainly resilience. It is stronger on liquidity, macrobalance, information and event risk.

Key data:	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
GDP (mill.US$)	250	272	285	292	305	327	355
GDP/capita (US$)	2602	2778	2867	2896	2979	3141	3363
GDP (change)	6.7%	7.1%	6.2%	5.9%	6.3%	5.8%	5.3%
Investments/GDP	20%	21%	21%	23%	25%	25%	25%
Budget balance/GDP	-2.3%	-1.4%	-0.6%	-0.9%	-1.3%	-2.0%	-2.1%
Govt debt/GDP(*)	49%	48%	45%	44%	40%	39%	38%
CPI inflation (%)	3.2%	2.9%	4.2%	1.4%	1.8%	3.1%	3.7%
Money demand (%)	7%	24%	21%	9%	12%	10%	10%
Stock prices	96238	97788	99344	100892			
Interest rates	4.0%	2.4%	2.2%	2.5%	2.6%	3.6%	4.7%
Exch. Rate ($)	42.2	42.4	44.4	45.5	47.0	47.6	47.7
Trade/GDP (%)	45%	39%	41%	37%	37%	36%	36%
Oil price (Brent)	$112	$109	$99	$52	$44	$50	$52
Millions US $							
Export of goods	46 386	44 512	49 824	43 277	42 632	45 658	49 201
Imports of goods	65 310	62 175	67 154	64 976	69 556	72 913	77 806
Other:	25 875	29 047	28 086	30 096	33 243	35 006	37 219
Current account	**6 951**	**11 384**	**10 756**	**8 397**	**6 319**	**7 751**	**8 614**
(% of GDP)	2.8%	4.2%	3.8%	2.9%	2.1%	2.4%	2.4%
FDI (net)	-959	89	-1 014	123	1 408	1 513	1 621
Loan repayments	-2 725	-2 918	-3 047	-5 789	-8 976	-11 222	-12 798
Net other capital flows	1 729	-3 003	-9 342	-1 073	6 656	6 849	7 971
Balance of payments	**4 996**	**5 552**	**-2 647**	**1 658**	**5 407**	**4 891**	**5 408**
Reserves	67 262	72 814	70 167	71 825	77 232	82 123	87 531
Total debt	68 565	67 997	73 613	76 816	78 563	80 379	82 245
o/w short term debt	14 801	16 737	16 496	16 514	16 926	17 287	17 626

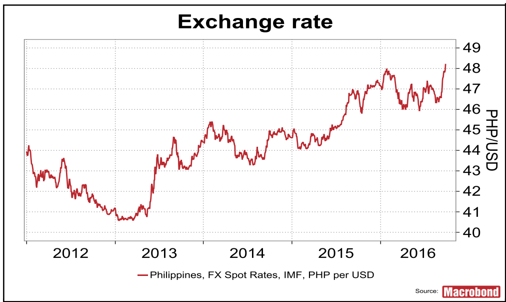
Source: OEF (Oxford Economic Forecasting) and SEB estimates.

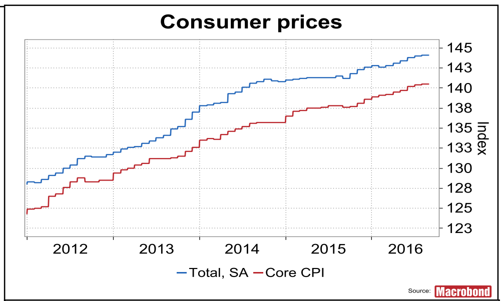
(*) Ecluding public enterprises

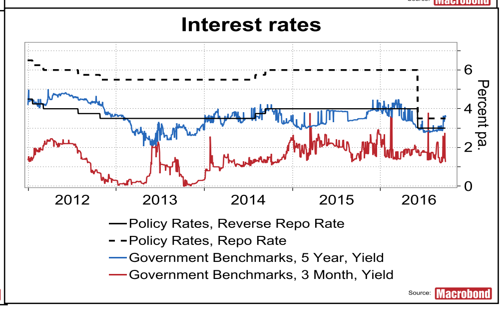
Rating history				
Fitch (eoy)	BB+	BB+	BBB-	BBB-
Moodys	Ba2	Ba1	Baa2	Baa2

Type of government:

Next elections	2022 General
Other:	
Latest PC deal	1994 (active)
Latest IMF programs	1998 Stand-By







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