market insight

MAY 2013

CROSSING THE THRESHOLD OF A DEVELOPED ECONOMY

Picture this scenario: a month after Fitch Ratings upgraded the Philippines' investment rating, Standard & Poor's (S&P) raised the Philippines' credit rating to BBB- from BB+ as the country entered the month of May. While this occurrence may have been a "ludicrous" dream in the past, the current situation seems to make a Moody's Investors Service (the last of the big three) upgrade something to be expected within the year, if not in the next few months.

External observers, as well as local experts are in unison in citing the reasons for such upgrades: continued improvement of the economy resulting to stable consumer prices, significant reduction in total debt stock, better government finances, and strong buffer against external shocks. Fuelling the economy is the strong combination of the steady supply of overseas remittances and continued increase in receipts from business process outsourcing. Such inputs have resulted to healthy international reserves, enabling the country to pay for its imports and settle its foreign debt, even in the face of external shocks.

For its part, the government is now managing its finances better than any other time in the past. It has boosted its spending where the country needs it most ---- infrastructures. So, after under-spending last year, the much delayed roll-out of PPP projects has finally got its momentum. Such projects are now creating ripple-effects in most of the sectors of the economy.

What's happening is actually not borne out something radical or even miraculous, but rather, adherence to sound economic fundamentals. At its current state, the economy is able to keep inflation to manageable levels, stave off price escalations and stabilize peso appreciation. Consequently, you have a strong bank presence and companies (i.e. investors and developers) operating at relatively low debt levels. Now, stability and sustainability are no longer a subject for speculation.

END OF A CARNIVAL RIDE

The Philippine economy has experienced so many roller-coaster rides in the past that imprinted a stigma of doubt whenever its performance followed a steep upward trend. In fact, such highs and lows occurred too often that, not a few believed that 2012 was just part of the old cycle waiting to happen. To the surprise of many, the Philippines did not just survive the challenges of 2012. It capitalized on the powerful jump start and rode on its strong momentum, crossing 2013 with steady and consistent growth not looking back at the ghosts of past years.

Even prior to completing its sterling performance in 2012, a number of experts, mostly from the global perspective gave positive outlooks for the country in years to come:

1. Ranked 16th biggest economy in 2050 (HSBC)
2. RP classified as a Creditor Country (IMF)
3. Investment-grade Ratings (Fitch and S&P)

Amidst the continued growth and positive performance of the local economy, a number of sectors rose above the rest, indicating glimpses of strong growth within the next 2 to 3 years:

Business Process Outsourcing (BPO) – Employment contribution of this Sector registered 750,000 jobs, over-shooting its target of 710,000. This is still expected to grow beyond the 900,000 mark this year and over 1.3 million within the next 3 years. As it is, tremendous potential can be expected not only in terms of employment, but also for office space demand under the construction and real estate industries, and the much needed receipts in cash flows predominantly from foreign contracts.

Equity and Bond Markets – A low interest rate regime would always attract investments in the equities market. More specifically, upgrades in investment ratings will trigger influx of foreign capital, initially benefitting the stock market but eventually being translated into larger assets that would translate to long-term gains for the country. Although such sector is subjected to strict regulatory requirements intended to limit drastic increases in interest rates that could be driven by significant acquisition of Philippine stocks by foreign players, nonetheless, wider participation even among conservative or mid-sized investors would enable steady and sustainable performance within the next 2 to 3 years.

Industrial Sector – After exploring the short-term stock market, foreign direct investment are coming into the country from foreign investors mostly through the development of industrial facilities to meet long-term objectives. For this particular period, however, not all products are favourably performing. Strong growth is only expected in consumer goods such as food, beverage, and personal care items which are driven by high domestic demand. During the first half of 2013, inquiries for expansion and relocation sites abound, both from incoming investors and existing/currently operating entities seeking for bigger or better facilities in view of increased or diversified production.

Ironically, the country still benefits from weak global performance in this sector, serving as a "lifeboat" for US & European economies and investments. On the other hand, the recent flooding in Thailand and the tensions between Japan, Taiwan and China due to longstanding territorial disputes have given the Japanese enough reason to consider moving their manufacturing plants to the Philippines. While the power rates and labor costs remain relatively high, the incentives provided by the government help compensate for such drawbacks and make investing in the Philippines cost-effective vis-à-vis other countries.

Retail Industry – With the Filipinos' propensity to spend, and after planting the "malling experience" firmly into the Filipino lifestyle, the retail sector will always be a major industry of the economy. Formally known in the business and statistical reports as Domestic Consumption, it accounts for about 70% of the economy. Whether the Filipino is an Overseas Filipino Worker (OFW) or a BPO employee, or even a self-employed or small businessman, disposable incomes continue to rise over time. Its cyclical nature gives the much needed dynamism in the economy: circulating and distributing liquidity while at the same time, increasing its expenditure volume as the improved economy warrants its expansion, which is clearly a self-sustaining process.

Tourism – The number of visitor arrivals in the country in 2012 increased by more than 9%, from 3.9 million the previous year to 4.3 million. After the first quarter, tourists entering the Philippines reached 1.2 million, higher than the 1.148 million recorded the same period last year, per Department of Tourism (DOT). At this rate, by the end of 2013 visitor arrivals are expected to reach 5.54 million.

From the perspective of a different industry, the 2013 target of 5.4 million visitors would require Airline seats (currently at 6 million) to increase more than double in order to match the 10 million target within the next three years.

The reason for such impact on the airline business is the evolution of the industry itself. From the traditional tourists coming in to stay at varying resorts for vacation, tourists are now looking into the prospects of investing and owning part of a favourite destination. Before, tourists were either belonged to the high-end bracket (going to boutique, island resorts) or economy level visitors (backpackers) who take the buses and boats to reach small, family-owned resorts, or hopping from one destination to the next without staying permanently in one location.

The onset of luxury residential destinations, (i.e. facilities with hotels developed in tandem with residential condominiums), brought forth the tourist/investors. The tourists visit the country at specific periods in a year and rent out their units (enroll their unit to the hotel pool) to generate income across the year. Given such additional income, these tourists visit other destinations for extended rest and recreation. Such “sub-sector” has evolved to the point of being a separate consideration in the real estate sector.

On the other hand, exponential increases in number of retirees coming into the country over from 2010 to 2011, thence to 2012, at 42% and 62%, respectively, make retirement and medical tourism another attractive “sub-sector” to consider. To date, the Philippines is already ranked 15th most preferred destination for medical tourism and retirement.

The Gaming Sector is yet another sector that caters to a different cross-section of tourists. The government has clearly given its support to this sector, priming up the country to become the alternative casino destination in the region. The Philippine Amusement and Gaming Corporation (PAGCOR) expects to lure high rollers from China, Macau, Singapore. PAGCOR is developing the Parańaque lot into a Las Vegas-like gaming complex in the reclamation area. Four major players have joined the fray: Solaire Resort and Casino (owned by Ricky Razon’s Bloomberry Resorts Corp.), Balle Grande Manila Bay (owned by Belle Resources), Resorts World Manila Bay (partnership between Resorts World, Star Cruises and Megaworld Properties), and Universal manila bay Resort (owned by Kazuo Okada in partnership with Robinsons Land)

Banking Sector – This sector is a direct beneficiary of the steady and consistent flow of OFW remittances. High levels of liquidity, however, is not the factor that drives the lending rates downward, but rather, stronger business confidence which minimizes the risk indices normally padded on to the base lending rates. As the banking sector clearly supplements the other fund-intensive sectors such as the construction and real estate sectors, it can also be observed that most if not all of the upcoming projects are being developed by the major players in the industry (i.e. the Ayala’s, the Sy’s, etc.) which have already established their own banking institutions if only to capture this side of the business, but more importantly, to put some stability in the process of development, as the fund-sourcing phase (during pre-development) and fund-management (during pre-selling and actual sales) are imbedded into the entire loop.

Construction/Real estate – Previously, the construction sector has been heavily dependent on real estate development, primarily buildings and subdivisions. However, the government’s push towards Public Private Partnerships (PPP) projects is expected to give the sector a significant boost in expanding its contributions to the economy.

The real estate sector, on the other hand, affirms its dominant role in the economy as the widespread developments, brought forth by the improved economic performance, translate into significant contributions in employment, trading (construction materials), local development (as real estate developments move outwards to growing localities), tourism (development of rest and recreation facilities), housing, and the business sector (office/commercial/retail establishments).

MARKET DRIVERS

The following factors will continue to drive the economy positively and ensure consistent performance:

1. Population base (largest proportion belong to the 20-24 age bracket)
2. Continued increase OFW Remittances
3. Exponential growth in tourist arrivals beyond 10%
4. Improved governance and business confidence
5. Low inflation rate (2.6% in April 2013, lowest over a 13 month span)
6. Low lending rate (below 6%)

OFFICE MARKET

There is still a strong demand for office spaces in Metro Manila, with occupancy rates ranging from 94% to 98% in the different business districts. The BPOs' continued expansion constitute majority of the demand. Developers are moving at an accelerated pace to be able to capture the demand. Rents are moving upward due to supply considerations. While Ortigas, Taguig and Quezon City offer alternative sites, Makati CBD and BGC remain as preferred office locations. With new buildings coming up as developers race to finish their respective projects ahead of their competition, pre-leasing has regained popularity among incoming locators.

The Makati Business District remains as the preferred location for headquarters of major companies and global businesses. The limited space has opened the doors for developers and investors looking old buildings that can be renovated or re-developed, to be re-introduced to the market. There are still other companies that look for existing buildings that can be converted for their own use and occupancy. While rental rates are increasing due to space limitations, these are still within tolerable limits.

The frantic pace to acquire lots in Fort Bonifacio Global City has driven the prices to surprisingly high levels. The cross section at BGC, however, does not directly compete with Makati CBD. As buildings (green and all) are being constructed left and right, these mainly cater to BPOs and Call Centers with global operations and magnitude. This is actually good as both CBDs stand to compliment each within reasonable distance. This makes it more attractive to foreign locators with integrated operations. Moreover, the peripheral areas of BGC are also being developed and can serve to further provide complimentary development that would make the location autonomous and self-sustaining. These include the 5-hectare Forbestown Center, 50 hectare McKinley Hill, 15-hectare Uptown Bonifacio, and McKinley West, a 34.5 hectare mixed-use project near Manila Polo Club.

LAST NOTE

By and large, the Philippines have not yet approached the tail-end of this fairy tale story of recovery. Certain areas can still be addressed to further improve the already sterling performance: questions of income levels and income distribution remains, regulatory measures still have much room for improvement, and dominance of some players in certain sectors must be evaluated accordingly. Yet, there are more good things ahead to look forward to in the near and not-so-near future. The stability attained and proven in the last 6 months can be used as a springboard in most of the sectors discussed above. Tourism can still be considered a sunrise industry while foreign investments in the industrial sector can be maximized to add further stability while some of the sectors and sub-sectors are slowly ascending to make their respective contributions. With that a closer look at the worthy and highly promising industries would be in order.

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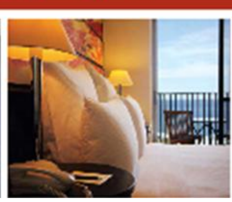

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