CreditSights

Asia Credit: Inflation Winners and Losers

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Executive Summary

- **How does higher inflation shape our outlook for Asia credit?** Asian $ bond issuers are grappling not only with the impact of inflation on their home markets, but also with the repercussions of rising US inflation and US interest rates.
- **While every country we follow is facing some degree of inflationary pressure, China may be an outlier.** Weak consumer demand and the government's ability to introduce swift regulatory measures could rein in price increases before they spiral out of control. Indeed, the key concern for China's policymakers at present seems to be sustaining economic growth rather than curbing inflation.
- **Within the Asia ex-Japan $ credit universe, we believe banks, upstream oil and gas producers, consumer staples and telecoms are the most resilient sectors to high inflation.**
- **The most vulnerable sectors include energy refiners, power producers, airport operators and China property developers, in our view.**

Relative Value

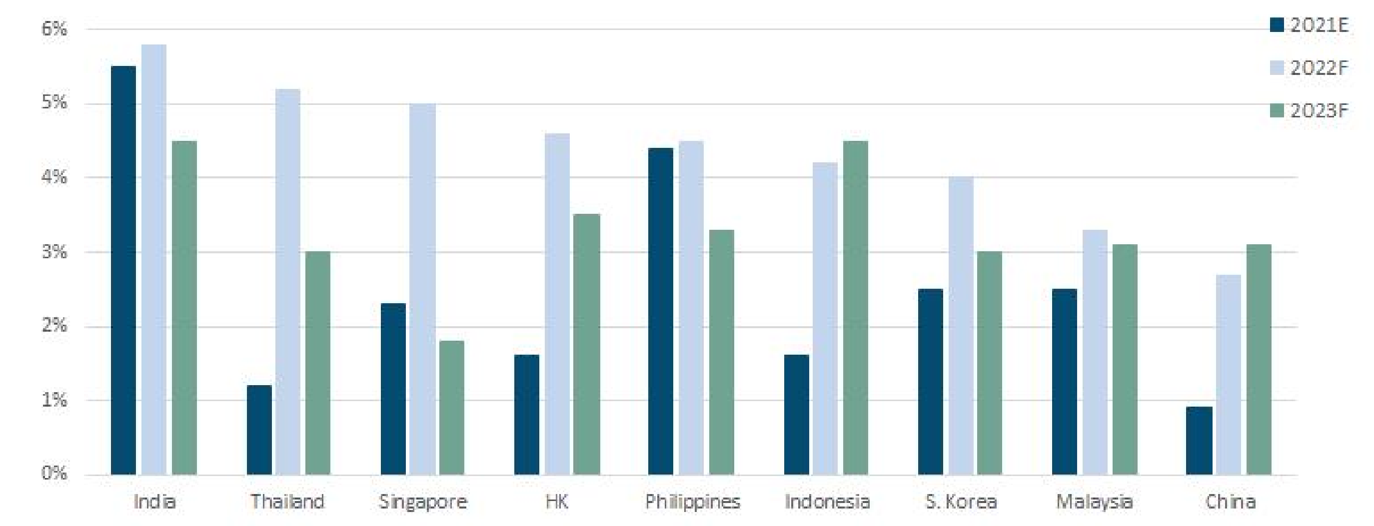
See **Asia Credit Recommendations: May 2022** and **APAC Financials Relative Value: February 2022**

How does higher inflation across the world shape our outlook for Asia credit? Asian $ bond issuers are not only grappling with the impact of inflation in their domestic markets, but also with the second-order effects of rising US inflation. Broadly speaking, higher US interest rates and a stronger US$ do not bode well for emerging markets, making it harder for weaker sovereigns to repay and service their debts, as well as spurring investor fund flows out of emerging markets. Earlier this month, for instance, **Sri Lanka** announced it would temporarily suspend all payments on foreign debt, but that was a situation of the current government's own making ever since it cut taxes in November 19, when it came to power.

Within the Asia ex-Japan $ bond universe, every country we follow is facing some degree of inflationary pressure at present. The Reserve Bank of India unexpectedly raised the country's repo rate by 40 bp to 4.4% earlier this month in an attempt to curb inflation. Indonesia's consumer price index (CPI) rose by 3.47% YoY in April, with food, energy and air transport fares the largest contributors, while Philippine's April CPI rose to 4.9% YoY, driven by food, energy and water utilities. China’s producer price index (PPI) rose by 8% year-on-year in April 2022 and CPI rose by 2.1%, according to data from the National Bureau of Statistics. Inflationary pressure has come from COVID-19-related supply disruptions, as well as rising prices of imported oil and gas and metal ores, exacerbated by **RMB depreciation**. That said, China may be an outlier in Asia, given weak consumer demand, as well as the government's ability to quickly introduce regulatory measures to curb inflation. For example, the authorities could impose price caps on certain commodities or increase production volumes to boost supply.

Asia ex-Japan Inflation

CPI % growth, year-on-year average



Source: Fitch Solutions. Note: E=estimate, F= forecast

With this in mind, we polled our analyst team for the sectors or credits they believe will fare well or badly in this environment.

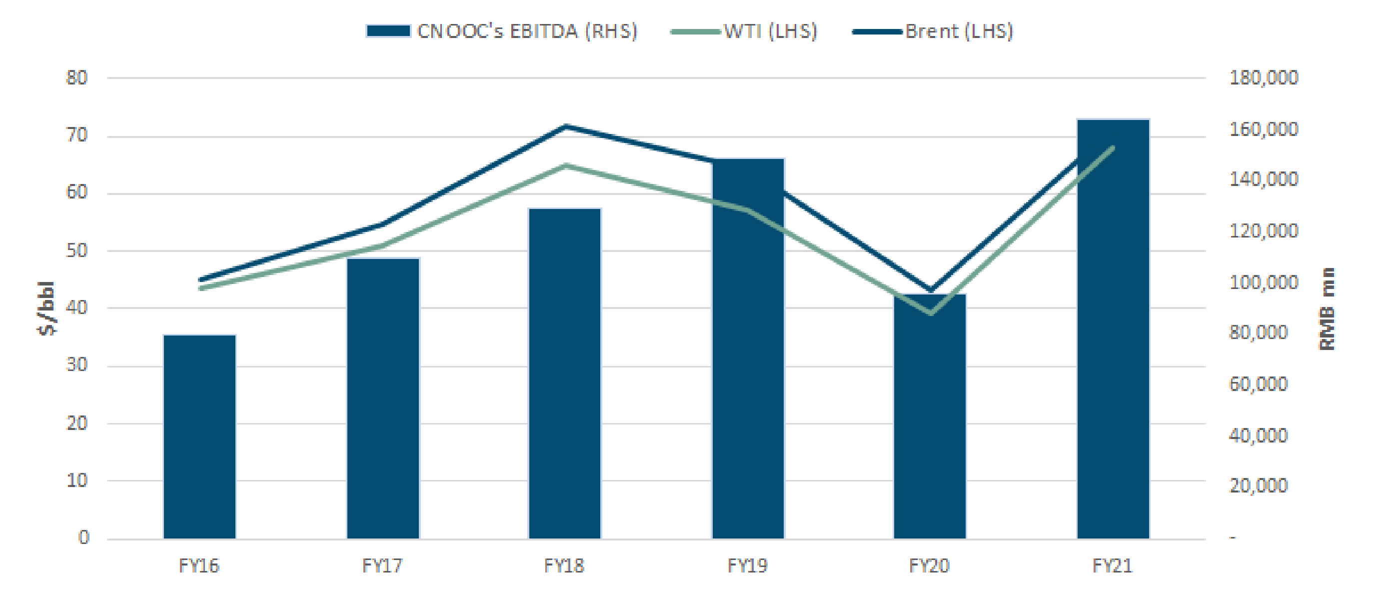
Winners

Banks. Inflation is helpful for financials if it leads to higher interest rates which are better for net interest margins; the increased margins typically provide more buffer for the asset quality issues that follow, especially for banks that have a larger SME book. Banks that have a greater proportion of CASA (current account / savings account) deposits (an indication of a better funding franchise) will also benefit more as they can capture more spread than those that don't, as CASA rates move up slower than lending rates. However, as funding conditions tighten, CASA deposits should also moderate at banks; time deposits at banks have increased generally in Q1 as banks move to lock in funding costs before they rise further and depositors too see better value in time deposits. Banks' margin sensitivity to interest rates will also depend on the size of their fixed-rate loan book and how soon they can reprice those loans. Finally, if loan growth is slow then some of the margin benefit of higher rates can get whittled away by increased competition. But on balance the trajectory is up. Banks from Hong Kong, Japan, South Korea, Singapore, Australia and India should benefit from improved net interest margins in the coming months.

Upstream energy producers. Rising oil and gas prices are benefiting exploration & production companies. In the Asia ex-Japan $ credit universe, these include state-owned producers such as **CNOOC**, **Sinopec**, **CNPC**, **Pertamina** and **Petronas** (all Market perform), as well as the privately-owned Indonesian energy firm **Medco** (Outperform).

CNOOC EBITDA vs. Crude Oil Prices

Like other upstream energy producers, CNOOC's EBITDA follows oil price trends

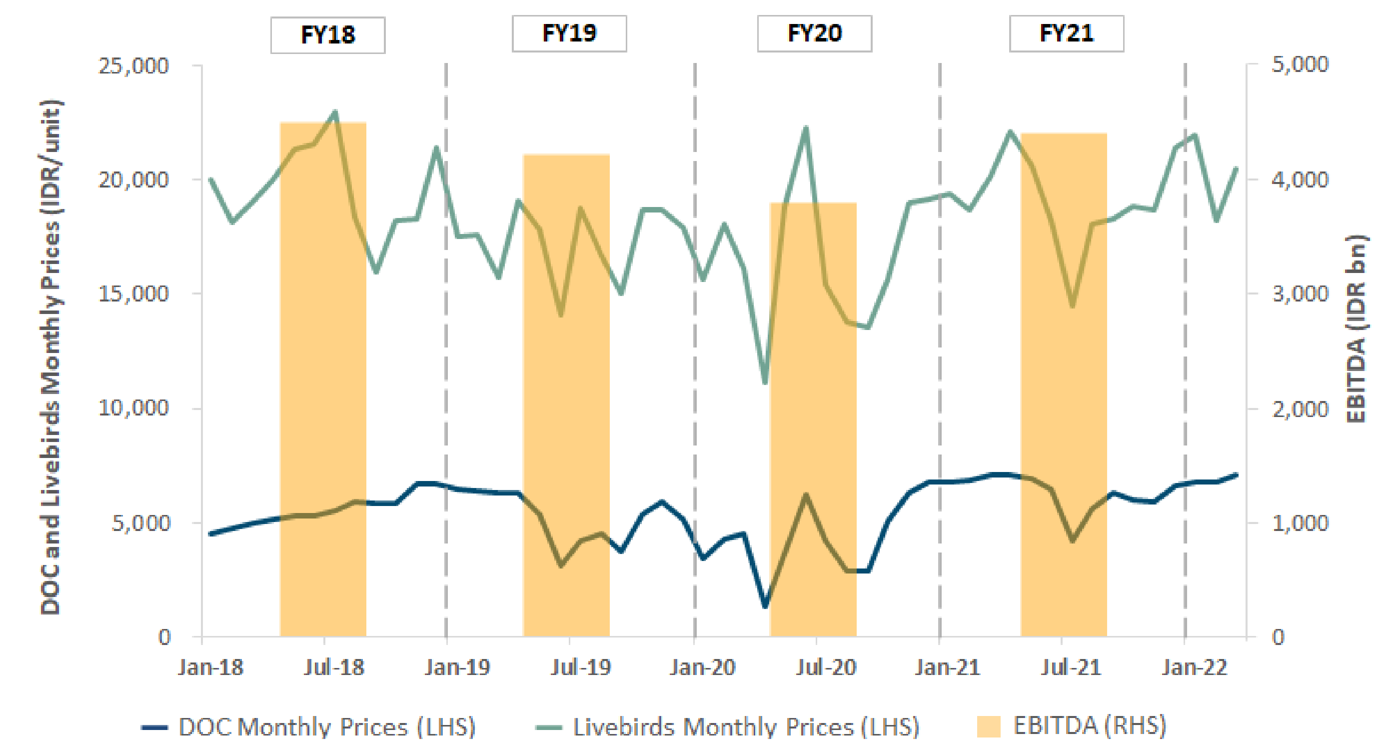


Source: Bloomberg, CreditSights.

Consumer staples. Consumers are suffering from higher food prices but given the essential nature of these purchases, we expect the credit profiles of food producers to remain relatively resilient. Indonesian poultry producer **Japfa Comfeed** (Market perform) is one example, which has managed to maintain steady EBITDA generation amid fluctuating chick and bird prices.

Japfa Comfeed: Poultry Monthly Prices and EBITDA

The Indonesian poultry producer's EBITDA has remained resilient amid rising poultry prices

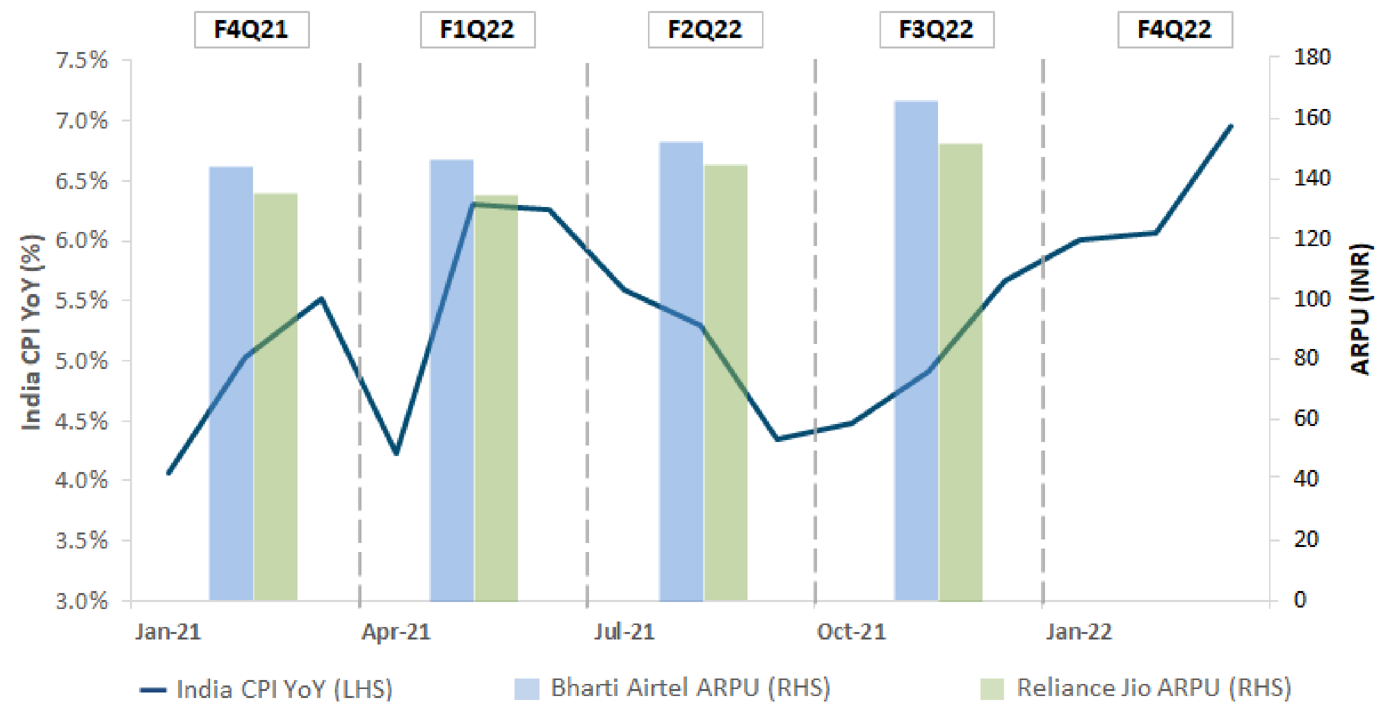


Note: (i) DOC = Day Old Chick. (ii) Data is from 1 January 2018 to 31 March 2022. Source: Company data, CreditSights.

Telecoms. Telecoms are a relatively defensive industry amid rising inflation. Within our coverage universe, Indian operators **Bharti Airtel** and **Reliance Industries** (Market perform) offer exposure to the sector: both companies have managed to raise their tariffs steadily in recent quarters (see the chart below).

Indian Telecoms: Average Revenue Per User (ARPU) vs. India Consumer Price Index

Bharti Airtel and Reliance Jio have remained resilient in an inflationary environment owing to periodic tariff hikes



Note: data is from 1 January 2019 to 31 March 2022. Source: Company data, CreditSights.

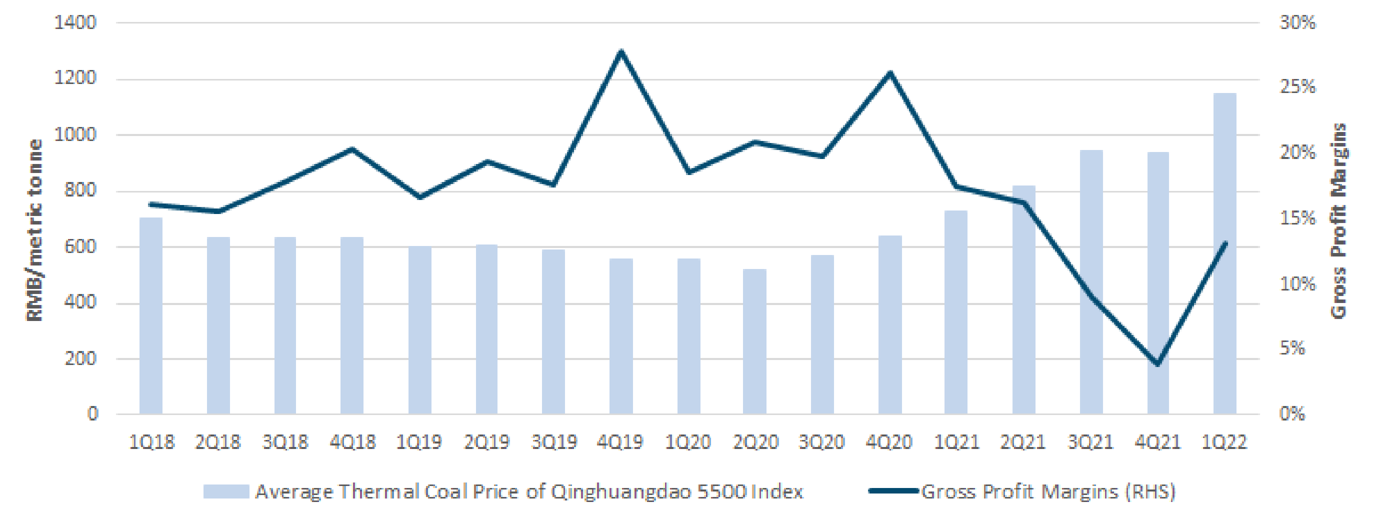
Losers

Energy refiners. Downstream energy firms such as **Bharat Petroleum** (BPCL, Underperform) and **Indian Oil Corporation** (Market perform) could find their profitability squeezed by **rising input costs**.

Power producers. Similar to downstream energy firms, utilities companies could also see their profitability squeezed by higher prices of input commodities, such as coal. This could be mitigated by regulatory measures in some countries: for instance, during China's **power crisis** last October, the government quickly boosted coal production, relaxed the electricity pricing regime and cracked down on speculative trading, temporarily sending coal prices plummeting (see chart below).

China Huaneng Power: Gross Profit Margin vs. Qinghuangdao Coal Price

Profitability has plunged since 3Q21 due to high coal prices



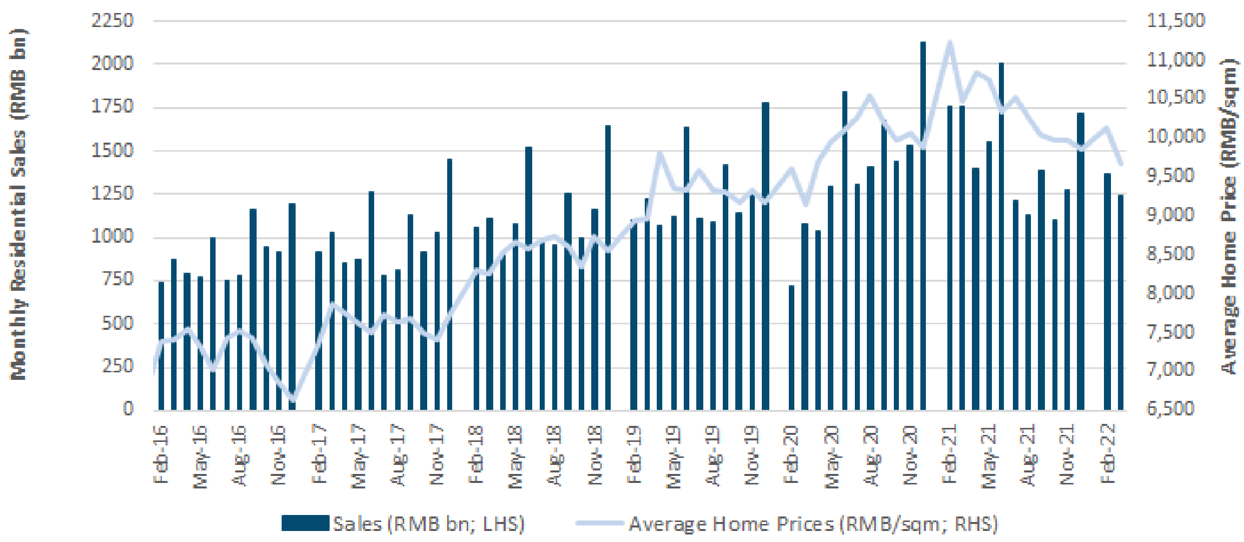
Source: China Coal Resource, Bloomberg, Company filings, CreditSights.

Airport operators. Airport operators such as **Delhi International Airport** (DIAL, Market perform) could face second-order impacts from inflation, for example in the event that higher oil prices prompt airlines to cut the number of flights or result in lower passenger volumes (e.g. if airlines raise ticket prices to pass through higher fuel costs). DIAL's revenues are linked to the number of flights scheduled by the airlines operating at its airports, so a decline in air traffic could hurt their revenue stream.

China property. While property is traditionally viewed by homebuyers as a hedge against inflation, the prolonged **slump** in China's property market and the uncertainty over whether certain developers will continue to survive (and deliver the properties they have promised to build) have deterred many from buying homes. We expect property demand to remain weak unless there is more widespread policy support. Rising material cost such as that of steel, copper and cement could also further crimp the already narrow gross profit and EBITDA margins in the coming years.

China: Monthly Residential Sales & Average Home Prices

Total residential sales fell by 29.1% YoY, and the average home price declined by 7.7% YoY in March



Note: No data for every January. February column for first 2 months of the year.
Source: Wind Info, National Bureau of Statistics of China.

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RELATED COMPANIES

M/P Bharti Airtel	U/P BPCL	M/P CNOOC
M/P Delhi International Airport	M/P IOC	M/P Japfa Comfeed Indonesia
M/P Reliance Industries		

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