

The King and I - Reflections on Thailand

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Amongst the coverage of Hurricane Gustav, the Democrat and Republican Party Conventions and trouble in the Caucasus, Rexiter's clients may have seen that political events in Thailand have taken another turn for the worse, but they would be forgiven if they find the picture rather hard to interpret. Having just returned from a series of company visits in Bangkok and therefore having gained a sense of what has been going on first hand, here are some impressions about the stand-off between the People's Alliance for Democracy (PAD) – currently encamped outside Government House – and coalition government led by the People's Power Party (PPP).

At the heart of the problem is a long-standing struggle for control of the Thai economy between the bureaucratic establishment, the military and the monarchy on the one hand, and the rural masses North of Bangkok on the other. The tension in this struggle has increased in recent years because King Bhumibol, who has reigned over the country for over 60 years and represents its strongest force for stability, is getting old and because the strength of the monarchy's "societal glue" will certainly be diluted under his successor. Worse, the previous prime-minister, Thaksin Shinawatra, has demonstrated that it is possible to threaten the establishment's pre-eminence through the adoption of populist policies designed to appeal to rural Thais.

In addition to being reviled by the establishment for the political threat he posed, Thaksin personally is less popular than he was because he is now seen to have been both corrupt and to have over-reached himself – concentrating too much power in his own hands and, if you like, in a highly "disrespectful" way, setting himself above the hugely popular King. However, although Thaksin was ejected by the coup of 2006 and his Thai Rak Thai (TRT) party was banned for electoral fraud, in the subsequent general election, the promise that his populist policies would continue meant that the TRT's successor party (the PPP) retained its rural support and was able to lead the current government.

There are therefore two leading threads behind the current stand-off; a personal one (anti-Thaksin and his cronies) and an attempt by the establishment to reassert control. The fact that PM Samak, who is seen by many as Thaksin's stooge, is also thought to have handled the economy, as well as a recent border dispute with Cambodia, poorly, does not help his cause.

The leader of the PAD, a media businessman, seems to be steering the PAD towards an overtly conservative, monarchist stance, though it also seems likely that many of his supporters are more simply concerned with killing off Thaksin's influence. The stated objectives of the protest are (a) to force the resignation of the Samak government and (b) to steer Thailand away from democracy and towards a government which would be predominantly appointed by "the great and the good". The PAD's leadership seems to fear that, were another democratic election to be held, the rural population cannot be relied upon to not re-elect the PPP or its successor party.

If things get to this point, a key question therefore, is whether the rural majority would be willing to tolerate being disenfranchised in exchange for greater economic "stability" promised by the PAD. PM Samak, understandably, is arguing that his government was elected with popular support only at the turn of the year and that it is undemocratic for it to be forced out by a minority protest in this way. He is also pointing out that the PAD is not a political party; why should he give into the protest of a group of people who are unwilling to run the electoral gauntlet themselves?

The PAD, conscious of the awkwardness of their stance and also of Thai precedent, seems to be trying to provoke the army into staging another coup, thus achieving their objectives by other means. PM Samak's response has been to put the army, rather than the police, in charge of controlling the PAD protest – this helps to obviate the risk of the PAD picking a fight with the police and forcing the military's hand. Thus far, the military – stung by the failure of its last coup in 2006 – has refused to rise to the bait, although the risk is that, if the protests turn violent (one person was killed on the night of Monday 1st September), they will no longer be able to resist the temptation.

In the meantime, the Commission overseeing the 2006 election has found one of the executive members of the PPP guilty of vote buying. Their findings have been forwarded to the Constitutional Court, which will probably choose, in a few months, to force the dissolution of the PPP and ban its leaders from politics.

This at least is the overt background to the stand-off. It is possible that there is another layer to the story – in effect, that the establishment is using the PAD to distract the government from its attempts (a) to reverse the constitutional changes made by the previous coup's leaders to dilute the executive powers of the prime minister and (b) to pass a populist budget before calling an election. On this interpretation, the Electoral Commission's verdict sets a timeline for such support. You could argue that, were the powers that be to tell the PAD to stop their protest, they would do so and settle for an election.

Pursuing this line of argument further (this being Thailand), some of the PPP's allies in the coalition will, in the meantime, be induced financially to leave the government – helped by the knowledge that four of the coalition's seven junior parties themselves face the threat of being banned for vote buying in the last election. The expectation is that they would then join the Democrats, the party that dominates in Bangkok and the South and to which the establishment will lend its support. Assuming Thaksin's recent antics (including skipping the country again) have cost him some popularity and that the PPP's performance in government has also cost it some of the vote, it would not take many defections to leave the Democrats in a strong position to win the next election.

On this view, provided violence can be avoided, the establishment already has the upper hand and a peaceful way can be seen to a resolution of the current impasse. (A counter-argument would be that the establishment, having failed to secure the result it wanted in the last election, will eventually feel itself obliged to use tougher tactics this time around). The less palatable alternative is that the impasse is unresolved, tempers boil over and the army is forced to intervene. All these outcomes are clearly possible – my guess is that the verdict of the Electoral Commission makes the first the more likely. I would hope a settlement can be reached sooner rather than later.

One question is where Thai business fits into all of this. If the eventual outcome is to be an establishment-led government, will Thai business be able to prosper in the same way that it has hitherto? Would the bureaucrats be sufficiently reactionary to prioritise stability over growth as a means of re-establishing control, until it is persuaded that the rural majority has accommodated itself to the new/old order? I think the answer is that Thailand would probably not become excessively introverted and that business (and certain businesses in particular) will continue to prosper, but I know these are questions being aired by many investment professionals.

Another question is how much damage all this political noise is doing to the economy and the risk premium that investors will demand for Thai equities.

On the first point, the evidence of my trip is that the economy, at least today, is doing reasonably well. Arguably, Thais are used to the political infighting and have been quietly going about their business irrespective. Undoubtedly, the recent rise in food prices has been helping the rural economy. This is admittedly a short-term cyclical factor, but a longer term trend has been that Japanese-led investment in manufacturing on the Eastern Seaboard has continued unabated (FDI in 2007 was USD 7.8bn – 3% of GDP – matching the performance of the previous 2 years). The evidence of the recent export numbers (average monthly growth in the year to June of 23% YoY) and of the current account surplus (slightly short of 2% of GDP on an annualized basis) is that Thailand has been doing rather better than much of Asia ex Japan this

year - and this despite the rise in oil imports. Arguably, Vietnam's current troubles work to Thailand's advantage in terms of export competitiveness.

It is safe to assume that the second half will see slower growth than the first, and the current troubles certainly risk denting consumer confidence, as well as tourism. Successively weak governments have led to shortfalls in infrastructure investment and although capacity utilization in industry is high, the energy sector apart, companies appear disinclined to increase capex by much. Headline inflation has peaked, helped by administered tariff cuts in areas such as transport, and core inflation (2.7% in August) is within the BOT's target band, but interest rates probably have a little further to rise. However, in a regional context, the picture does not look that bad.

At the company level, the better banks (Siam Commercial Bank and Kasikorn Bank) seem set for a reasonable year; credit risks seem well controlled (there have been few excesses in previous years), there is substantial potential in consumer finance and fee income and they should be able to garner further market share from their less nimble competitors. Loan growth in the sector in the first half was inflated in some cases by working capital loans in an environment of rising raw material prices. Allowing for this however, valuations still seem quite reasonable.

Visits to Advanced Information Services and DTAC in the telecom sector suggested that there is a little more pricing discipline than before, and that there are faint signs of pricing power emerging. Arguably, also, the regulatory picture (always cloudy) is becoming a little less so, though whether the sector can be relied upon to take the best advantage of its opportunities is likely to remain something of a moot point. Absent regulatory upsets, the downside should be limited.

CP All, Thailand's leading convenience store operator, and BEC World, a leading TV station, both suggested that consumer demand is reasonably resilient and that the prospects for growth are robust. Again, valuations seem quite reasonable, although allowance has to be made for lower liquidity and corporate governance issues on the first (a consensus buy) need to be watched.

On consensus expectations, the market today is trading 9.5x 2008 PER, assuming 11.5% EPS growth this year, and 8.9x 2009 PER, assuming 9% growth next. This compares with an Asia ex Japan average multiple of 12.9x for this year (1% EPS growth) and 11x for 2009 (14% growth). The trailing yield is 4%, RoE is expected to average 16.8% in the years 2007-09 (Asia ex Japan average 14.3%) and the market trades on a 2008 P/BV multiple of 1.7x (Asia ex Japan 1.8x). There is downside risk to earnings assumptions, but it is not immediately obvious that this is greater than elsewhere.

Certainly allowances have to be made for political risk and the relatively high share of the index represented by the energy complex, refiners and chemicals (40%+) but, even after adjusting for the risks, we would argue it is possible to find decent companies at reasonable valuations.

As the market represents only a little over 2% of MSCI Asia ex Japan (a little over 1% of MSCI GEM), this is a market that many investors will arguably be willing to ignore. That is Thailand's risk – the competition for capital is something not to be ignored - but assuming a peaceful solution can be found to the current impasse, today's depressed sentiment seems to be offering selected buying opportunities.

However, even if this is achieved, the key challenges facing the country – the establishment's determination to retain the levers of power in the face of democratic forces and the development of the body politic following the death of the King – are not about to go away.

The next bulletin emerging from SE Asia is likely to take a look at the changing political scene in Malaysia.