Thailand Update: Economic Growth Accelerates As Capital Returns

Thailand's Expansion Aided by Flood Recovery, Tax Incentives, Favorable Investment Environment.

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How things change. A year ago, Thailand was hemorrhaging capital. Wracked by civil unrest and violence, Thailand saw global investors pulling 14 billion baht worth of investment out of the country, and dragging asset prices down sharply in their wake, throughout the country.

But in July of 2011, after months of discord, pain and loss, the populist Puea Thai Party finally obtained a clear electoral mandate to form a government. The previous ruling party stepped aside and gracefully congratulated the victors. The wrenching violence of the Red Shirt Revolution receded, at last, and the Thai central government finally enjoyed legitimacy in the eyes of its people that it had not possessed for some time.

Almost on cue, Thailand's capital outflows reversed: by years' end the Thai economy had managed to recapture some 9 billion of the 14 billion baht it had lost in the first six months of the year. Thai stocks have taken off in the 1st quarter of 2012, returning more than 18 percent through March 27, as measured by the SET index of publicly-traded stocks in the Thai Stock Exchange.

The reversal in fund flows has made its mark for investors in the Thai Capital fund, a closed-end, actively-managed growth stock fund with just under $43 million under management. Thai Capital's managers have been successful in narrowing their discounts to NAV - closing the discount from an average of over 12 percent over the last six months down to less than 4 percent today - which has been a boon to current shareholders.

And it's no wonder: the funds' managers have managed to best the MSCI Ex-Japan Index over the trailing 10-year, 5-year, 3-year, 1-year and year-to-date time periods - often by a wide margin, on an NAV basis.

How? Obviously, this fund isn't a closet index fund. The Thai Capital management team, led by Suchai Sutapak, was able to blunt the impact of the outflows by boosting its cash position, moving back to close to fully invested as overall Thai market conditions improved. So there has been an element of successful market timing.

Additionally, the fund's managers also employ a sector rotation strategy - boosting allocations to specific segments of the Thai economy as they appear to be more compellingly valued. Again, this has helped the fund pull ahead of the pack.

As of early April 2012, the fund has staked out a value-oriented position: The fund's stock portfolio has an average P/E of just under 10 times earnings - well below the 11.8 percent fund average for the category.

Managers have substantially overweighted the portfolio's allocation to energy - in advance of concerns of an energy shortage sparked by conflict in the Persian Gulf. Looking at the last publicly-released portfolio information from September 2011, the fund is also overweight in basic material stocks, while substantially underweight, compared to the Asia Ex-Japan benchmark, in technology and industrials.

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A Bright Spot

A recent International Monetary Fund report projects that Thailand's economy will continue to grow robustly over the short-to-medium term, with 5 percent growth expected 2012 and as much as 7.5 percent in 2013. The 2013 GDP boost is partly due to expected positive financial reforms including opening the country more to foreign investment; an expansionary monetary policy; and the point-blank stimulative effect of domestic spending as Thailand rebuilds following the late 2011 floods. This growth rate is slightly better than projections for the rest of the Asia ex-Japan market, and is much better than the 2.5 to 2.9 percent projected GDP growth in the United States over the same period.

Meanwhile, Thai stocks are still reasonably valued by global standards with a trailing price-to -earnings ratio of 12x - cheaper than stocks in the U.S., although they are priced slightly greater than the roughly 11.5x average multiple currently found across the rest of the Asia ex-Japan market. The resulting PEG ratio of just over 2 is an order of magnitude better than that available in the West.

Valuations

Although the Thai economy is expected to grow in the mid-single digits, Sutapak is projecting earnings growth in the mid-teens for the companies in the Thai stock market. Their valuation, based on a 14.8 percent projected earnings growth scenario, suggests that the Thai stock market is trading on price-to-earnings for 2012 of 10.7x, price-to-book value of 1.87 times earnings, with a dividend yield of 4.0%.

Domestic Initiatives

The Thai government has enacted a full court press to attract investment, targeting four specific industries: manufacturing, technology, alternative energy, and medicine. Specifically, the government is luring capital and fostering economic growth through a series of tax incentives for industries to locate anywhere in the country other than Bangkok:

- Exemption from duties on imported machinery;
- Double the deduction for transportation, electricity and water supply costs for ten years - beginning from the date companies first begin deriving income, not the project start date;
- Eight-year exemption from the corporate income tax, with no earnings cap;
- Fifty percent reduction of corporate income tax on net profit for five years after expiry of tax holiday.

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This accommodative tax policy, combined with wages that are still globally competitive, makes for a compelling scenario for manufacturers.

Financial Reforms

Thailand's financial institutions are still smarting from the Asian crisis of 1997, and Thailand's authorities have been relentlessly shoring up their financial institutions since that traumatic time. Between 2004 and 2008, Thailand completed phase I of its Financial Sector Master Plan-a multi-year, ongoing effort culminating in the full implementation of the Basel III standards in 2013.Basel III promises to bring substantial improvements to the Thai financial sector's risk management, liquidity and resiliency and go a long way to helping to prevent a repeat of the 1997 scenario.

Even more than that, the Thai economy as a whole is much less leveraged than we are accustomed to in the West and in much better shape than it was in the 90s. Thailand has made good use of the time bought for it by the Asian boom by strengthening its financial institutions.

External Factors

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trading partner, China, announced a broad loosening of monetary standards, which should help boost economic activity throughout the region. Despite some rumblings in the Chinese urban real estate market in recent months, Chinese bankers seem to have successfully engineered a soft landing - and its monetary measures bode well for Thai exports overall. The ASEAN market continues to expand, and the U.S. market appears to be recovering, albeit slowly.

Risks

At this point, investors in Thailand should be prepared to deal with two primary risks: The first risk is that the Chinese economy should falter, and the soft-landing that the Chinese Central Bank has thus far seems to have organized should fail. In practical terms, this would be the case if the Chinese growth rate should fall below about 5 percent - the Chinese economy need not fall into an actual contraction for Thai stocks to take a potential hit.

The second major risk is the potential for unrest in the Persian Gulf to disrupt the global supply of oil. Thailand, like other economies in the Asian region, is highly-dependent on oil imports, and an unexpected spike in oil prices would hurt Thai prospects for growth.

The Road Ahead

Thailand has a lot going for it in terms of future growth prospects. It has a great deal of room to expand its middle class - especially outside of Bangkok - and authorities are actively working to route capital to the provinces. As investment and economic activity flows throughout Thailand, so will an emerging middle class - which bodes extremely well for domestic demand. Manufacturing will beget a local demand for retail, electronics, media, and health care.

Thailand also enjoys a very educated, literate work force in most areas of the country, compared to other emerging markets. It has been successful in developing a first-rate commercial infrastructure close to Bangkok, and its government has responsibly built out that infrastructure without taking on unreasonable debt levels.

Thailand's increasingly sophisticated workers and educational system is also helping to build a world-class system of hospitals and technology, which has, in turn, enabled the country to become a destination of choice for medical tourism. These benefits tend to trickle down to workers, though it may take some time for their full effects to be felt throughout the provinces. But the aggressive courtship of capital, combined with a productive and competitively-priced workforce and a solid technology, communications and transportation infrastructure mean that Thailand's prospects are more than just a cyclical story. There is yet untapped power in that economy. ■