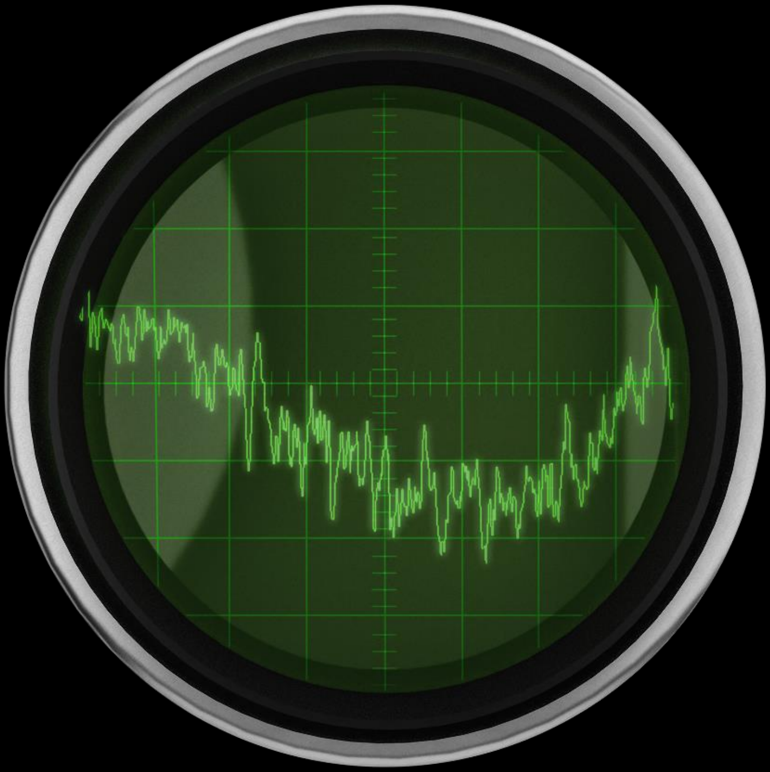


The Big Squeeze

Inflation and Interest Rates

Turnaround & Restructuring Insights

Southeast Asia | Q1-2023

MAKING AN IMPACT THAT MATTERS since 1845

The Big Squeeze

Emerging from the disruptions of the pandemic, economies in Southeast Asia and around the world are experiencing levels of inflation not seen since the period prior to the 2008 global financial crisis. Central banks have responded with a sharp tightening of monetary policy and further rate rises are projected in 2023. Debt and capital markets are tightening.

What do the inflationary and interest rate pressures mean for business? In this edition of Deloitte Turnaround & Restructuring Insights, we explore how "The Big Squeeze" is impacting the profitability and debt capacity of companies across Southeast Asia.

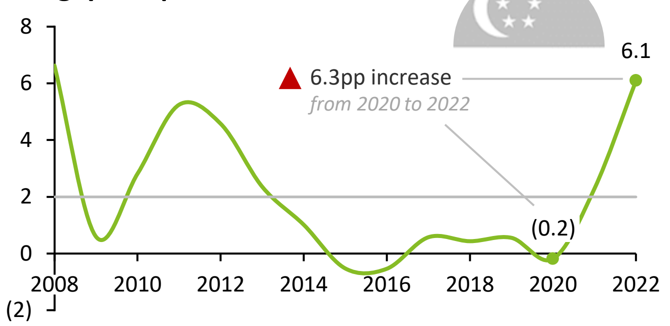
Report Contents	Page

The **Inflation** Acceleration

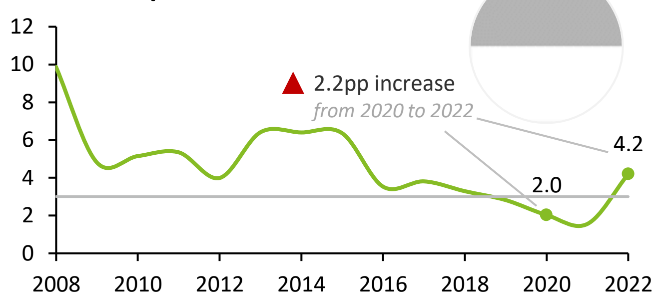
Emerging from the disruptions of the pandemic, economies in Southeast Asia and around the world are experiencing levels of inflation not seen since the period prior to the 2008 global financial crisis

Key: Actual Target Inflation

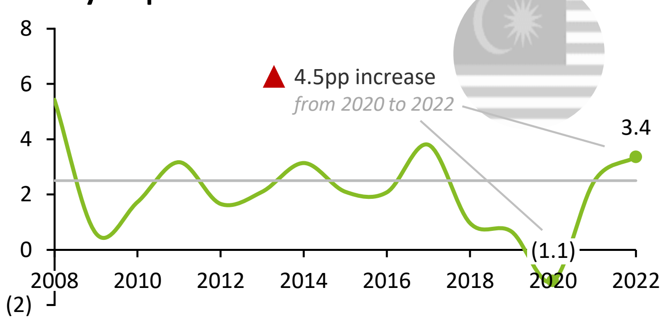
Singapore | Headline Inflation %



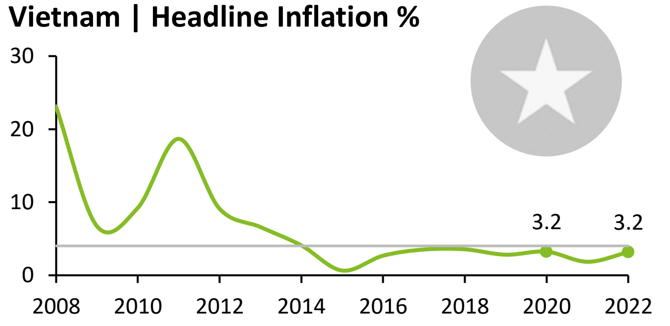
Indonesia | Headline Inflation %



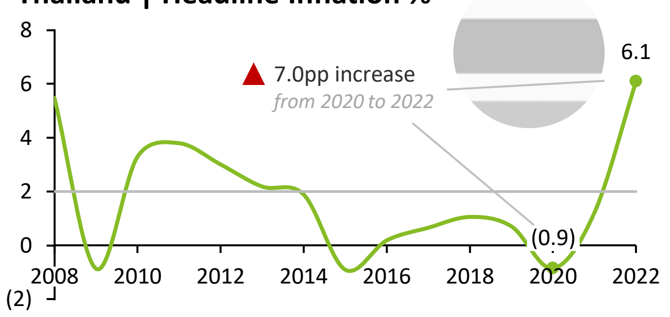
Malaysia | Headline Inflation %



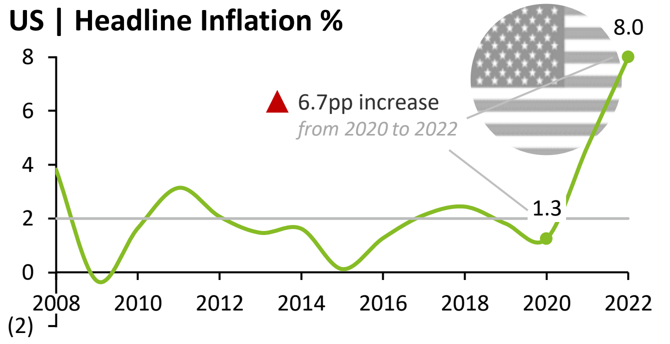
Vietnam | Headline Inflation %



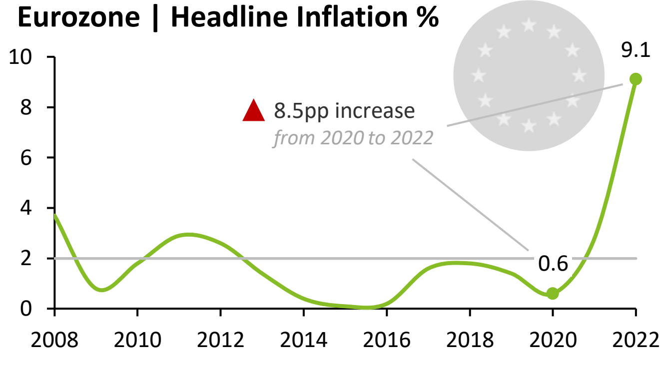
Thailand | Headline Inflation %



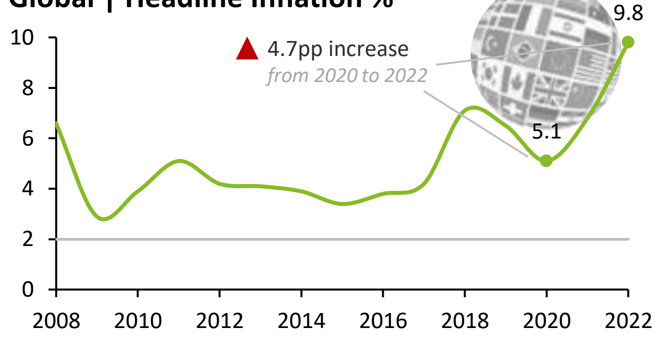
US | Headline Inflation %



Eurozone | Headline Inflation %



Global | Headline Inflation %



Sources: EIU, World Bank, Monetary Authority of Singapore, Bank of Indonesia, Bank Negara Malaysia, State Bank of Vietnam, Bank of Thailand, US Federal Reserve, European Central Bank ("ECB")

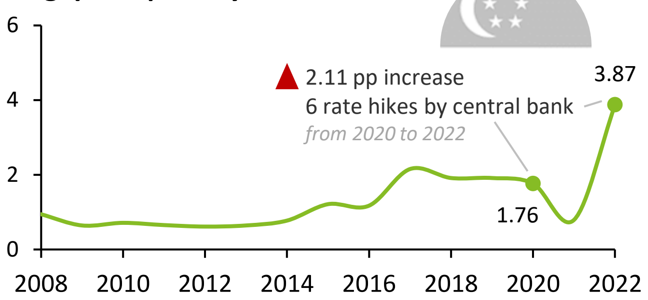
Notes: The latest central bank target inflation is charted above. Where a central bank has set a target *range*, the mid-point is charted. A 2% inflation target is assumed at a global level

The **Interest Rate** Handbrake

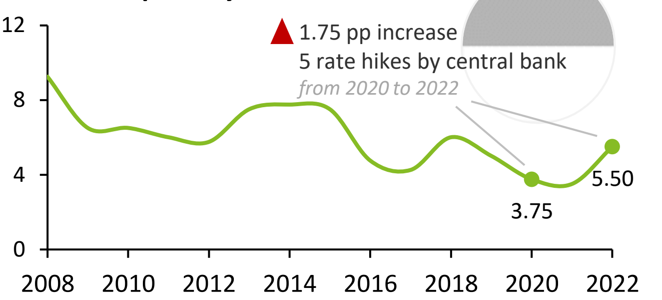
Central banks have responded with a sharp tightening of monetary policy and further rate rises are projected in 2023. Debt and capital markets are tightening

Key: Interest Rates

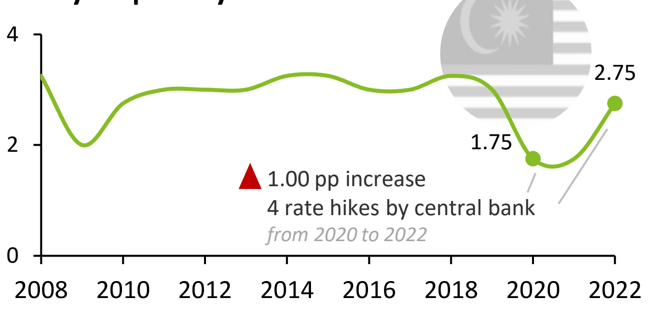
Singapore | Policy Interest Rate %



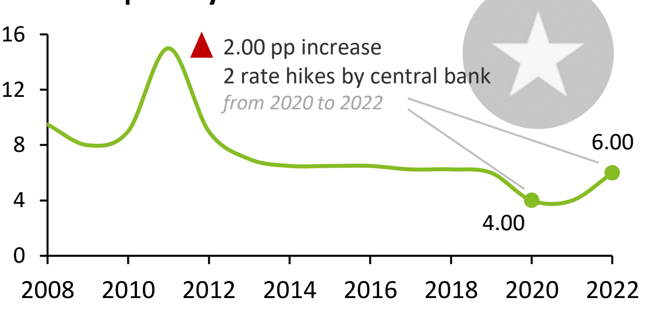
Indonesia | Policy Interest Rate %



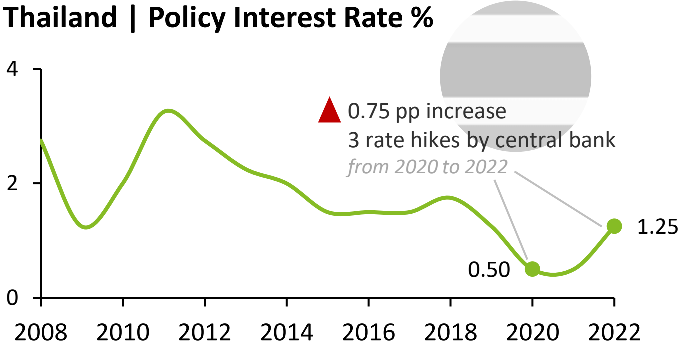
Malaysia | Policy Interest Rate %



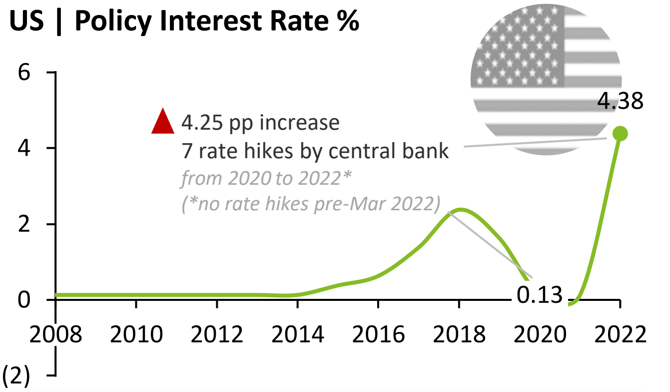
Vietnam | Policy Interest Rate %



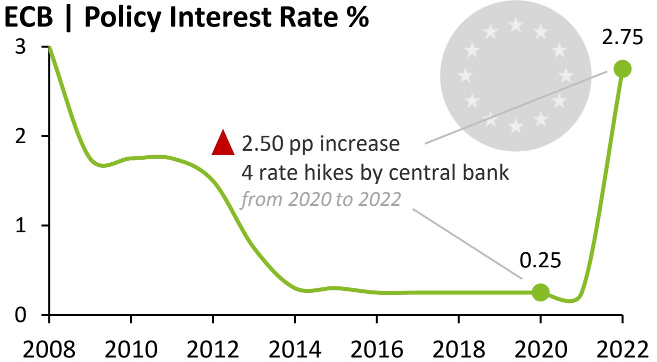
Thailand | Policy Interest Rate %



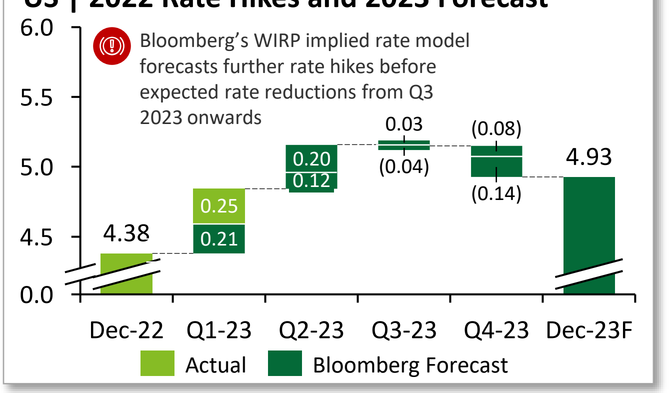
US | Policy Interest Rate %



ECB | Policy Interest Rate %



US | 2022 Rate Hikes and 2023 Forecast



Sources: EIU, Monetary Authority of Singapore, Bank of Indonesia, Bank Negara Malaysia, State Bank of Vietnam, Bank of Thailand, US Federal Reserve, ECB, Bloomberg

Notes: Calendar year average policy rates are charted, except for ECB policy rates which are expressed at year-end

The “Squeeze” Scenario

What do the inflationary and interest rate pressures mean for business?

The Squeeze Scenario

We have run three basic sensitivities on the 2022 financials reported by 654 public companies across Southeast Asia assuming:

(a) 50% of the input cost increases (see point (b) below) can be recouped through increased sales prices;

(b) costs follow the rate of inflation in each market; and

(c) debt servicing costs, assumed to be variable, follow interest rates in each market.

…together these sensitivities comprise the “Squeeze Scenario”.

“Company A” *(illustration only)*

USD’k	Base Case	Squeeze Scenario	*Variance*
Revenue	50,000	51,220	*1,220*
Cost of Sales	(40,000)	(42,440)	*(2,440)*
Gross Profit	**10,000**	**8,780**	***(1,220)***
Overheads	(3,800)	(4,032)	*(232)*
EBITDA	**6,200**	**4,748**	***(1,452)***
Depreciation & Amortisation	(500)	(500)	-
Interest	(875)	(1,475)	*(600)*
NPBT	**4,825**	**2,773**	***(2,052)***
Tax	(820)	(471)	*349*
NPAT	**4,005**	**2,302**	***(1,703)***
Profitability			
GM%	20.0%	17.1%	*(2.9)pp*
EBITDA%	12.4%	9.3%	*(3.1)pp*
NPAT%	8.0%	4.5%	*(3.5)pp*
Debt Metrics			
Debt	20,000	20,000	-
Leverage	3.2x	4.2x	*+1.0x*
ICR	7.1x	3.2x	*(3.9)x*
Effective Rate	4.38%	7.38%	*+3.0pp*

Squeeze Scenario Assumptions
(Sensitivities applied against the Base Case)

- **50% of the increase** in cost of sales is **passed on to customers** through increased prices
- Assume **cost of sales increase** by **6.1%** (i.e. 2022 Singapore inflation rate)
- Assume **overheads increase** by **6.1%** (i.e. 2022 Singapore inflation rate)
- Assuming no change in Debt, **interest expense increases** by **3%** of debt (assume variable rate)

Important Note The “Squeeze Scenario”, whilst intended to mirror real world trends, is a ceteris-paribus hypothetical illustration only. These dynamics will <u>not</u> apply to all companies equally. Factors such as price elasticity, the intensity of competition and flexibility in the cost base will be important considerations when assessing specific companies.

Sources: Deloitte Analysis | “Company A” is a hypothetical Singapore company

Profits Under Pressure

High inflation and interest rates have the potential to profits under pressure

Southeast Asia Public Company Profitability

Industry	No. of Companies (in sample)	Base Case (2022 reported)		The Squeeze Scenario		
		Total NPAT (USD'm)	Average NPAT (USD'm)	Total NPAT (USD'm)	Average NPAT (USD'm)	Profit Erosion (USD'm)
Agriculture	15	77	5	32	2	**(45)**
Construction	43	238	6	(109)	(3)	**(347)**
Manufacturing	337	6,398 *Not to scale*	19	2,477 *Not to scale*	7	**(3,921)**
Real Estate	94	2,587 *Not to scale*	28	170	2	**(2,416)**
Retail	24	330	14	144	6	**(187)**
Services	77	527	7	200	3	**(327)**
Telecom. and Public Utilities	18	844	47	41	2	**(803)**
Transportation and Logistics	35	577	16	(176)	(5)	**(753)**
Others	11	2	0.2	(126)	(11)	**(129)**

Sources: Capital IQ, Deloitte Research and Analysis

Impact on Debt Capacity

Reducing profitability may materially impact debt servicing capacity

Southeast Asia Public Company Debt Capacity

Excludes outliers (including companies with negative or above 100x leverage / ICR)

Key: 2022 **Base Case** Average | The **Squeeze Scenario** Average

Industry	Industry Leverage (Debt to EBITDA)		Industry ICR (EBITDA to Interest Expense)	
	2022 Base Case Average	The Squeeze Scenario Average	2022 Base Case Average	The Squeeze Scenario Average
Agriculture	2.4x	14.0x	15.4x	7.0x
Construction	8.6x	10.2x	12.1x	5.2x
Manufacturing	3.7x	6.5x	19.4x	8.1x
Real Estate	11.5x	13.5x	7.1x	3.0x
Retail	5.6x	12.4x	17.5x	6.4x
Services	4.7x	6.8x	17.4x	9.0x
Telecom. and Public Utilities	3.2x	4.4x	17.9x	10.5x
Transportation and Logistics	7.2x	10.0x	14.6x	8.0x
Other	4.9x	7.5x	16.0x	5.5x

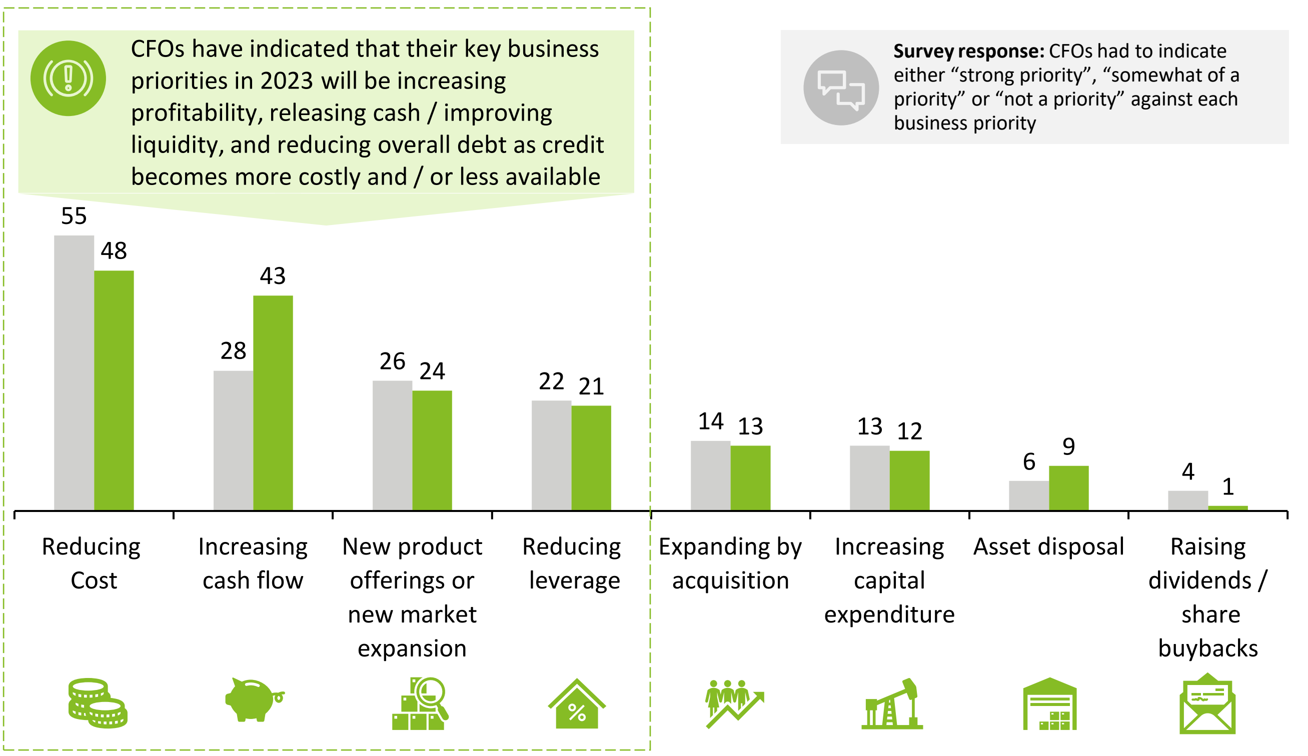
Sources: Capital IQ, Deloitte Research and Analysis

Business Sentiment

CFOs are prioritising defensive strategies, such as cost reduction, cash flow management and deleveraging, to mitigate against an uncertain economic environment, although they also recognise that the growth prospects in Asia may present opportunities

CFO Priorities | Q4 2022 Deloitte Survey Results

% of CFOs who rate each of the following as a strong priority for their business in the next 12 months



2023 GDP Outlook (% Change in Real GDP on Prior Year)

Sources: Deloitte CFO Survey Q4 2022, EIU

Countermoves (…not exhaustive)

Smart businesses are making countermoves now to mitigate against “The Big Squeeze”

	Challenges	Impact	Countermoves
Inflationary Pressures	• Record-high inflation in 2022 has resulted in increased input and overhead costs	• Margins are getting squeezed, and more cash is required to sustain business operations	• Review pricing strategy and test elasticity in line with market and competitive advantage • Optimise portfolio • Consolidate or seek alternate sources of supply
Increased Borrowing Costs	• Central banks are raising interest rates to counter inflationary pressures	• Increasing debt servicing costs will decrease consumer spending and capital expansion and drag on (leveraged) business cash flows	• Optimise capital structure • Identify and implement deleveraging strategies • If in doubt, engage lenders early and reschedule servicing to match cash flows
Labour Challenges	• The “great resignation” and increasing salary demands have led to labour market challenges	• Employers in certain sectors have struggled to fill positions or have had to implement retention strategies such as out of cycle pay reviews	• Flatten organisational structures, optimise rosters, incentivise staff • Assess productivity, eliminate inefficient work and automate processes
Working Capital	• Margin erosion reducing working capital growth • Receivables becoming stretched in some sectors	• If unaddressed this may lead to short-term cash flow challenges	• Identify opportunities for ‘quick win’ cash release • Setup a working capital PMO • Include working capital cost in project / customer financial assessments
Portfolio Assessment	• The pandemic and geo-political tensions have caused financial and operational stress across many industries and value chains	• There is an opportunity for businesses to re-evaluate their business portfolio / non-core assets or look for distressed M&A opportunities	• Accelerate ‘fix, sell or close’ decisions and act fast to resolve underperformance and release liquidity • Scan for under pressure targets with potential synergies
Supply Chain Disruptions	• Global supply chain pressures have contributed to inflation, but these pressures were easing in 2022	• In some cases, disruptions resulted in increased input prices or a complete halt in production due to shortages	• Seek visibility over suppliers and activate alternate sources of supply • Map out supply chains, ascertain ability of suppliers to fulfil orders

Finally… Some Predictions for 2023

NOT investment advice! The views of the author are his own

Advanced western economies will enter or narrowly miss recession while **growth in Asia will continue albeit lower and slower**

Less IPO activity / more public-to-private transactions amidst **tightening capital markets** and increasingly volatile equities markets

More corporate carve-outs as business leaders seek **to unlock cash on the balance sheet**

Asset price dislocation will widen: driven by the **higher cost of funds** and pressure will become more acute in leveraged businesses

Increasing **investment in ESG oriented propositions** in the **pursuit of 'net zero' and the 'circular economy'** (driven by regulators, financiers, customers)

Governments will **(re-)prioritise infrastructure agendas** (likely through more public-private-partnerships due to fiscal limitations) **to ease supply constraints and in the pursuit of growth**

Material and **increasing private sector investment in cyber security and artificial-intelligence** (…could an AI service replace online search as we know it?)

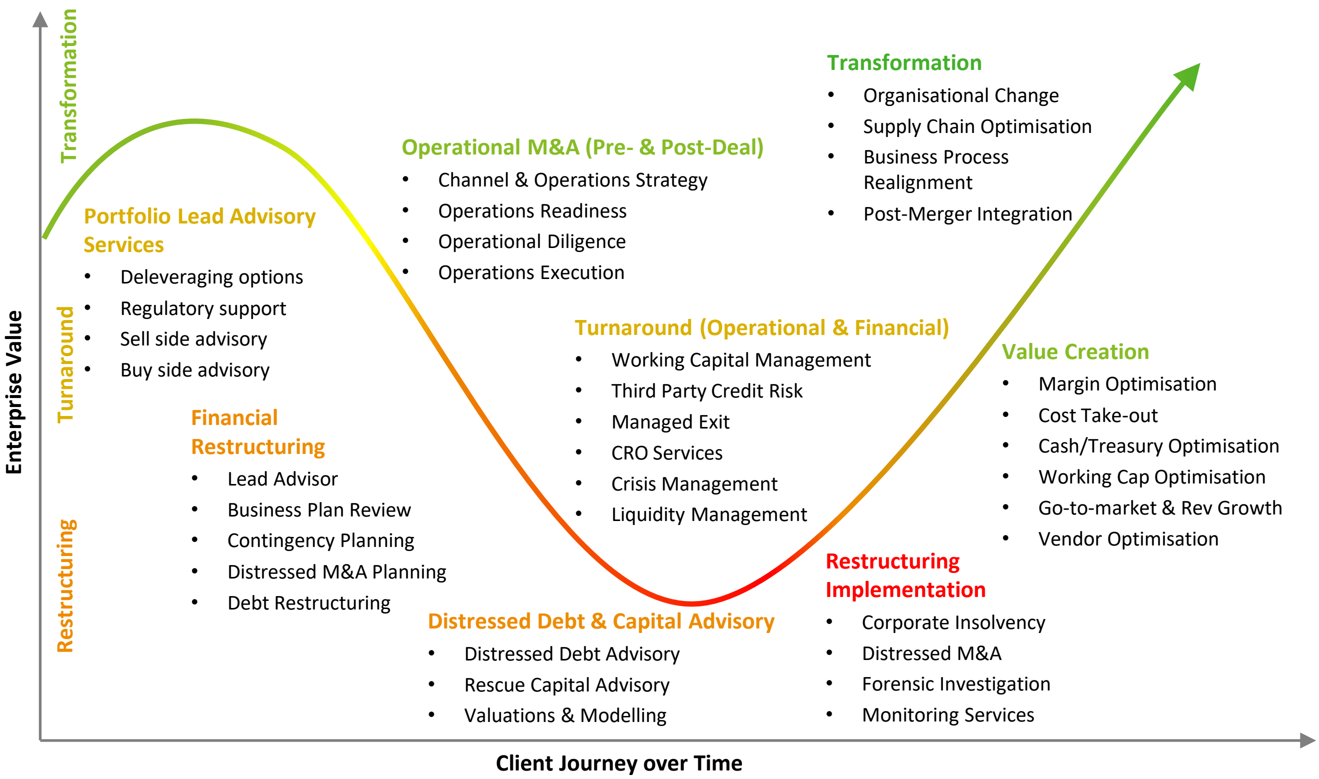
Increasing **portfolio diversification** towards **fixed income** and **the alternative asset classes** seeking to build in 'recession-resilience'

The **major 'Black Swan' risk in 2023** is **geopolitical not structural**

About Deloitte Turnaround & Restructuring

We work with clients to improve outcomes across the stress spectrum ranging from companies seeking to turnaround short term underperformance to those in deep financial distress requiring crisis management. We are actively assisting businesses across Southeast Asia and globally to turnaround, restructure and grow

Deloitte Turnaround & Restructuring



Turnaround & Restructuring Insights

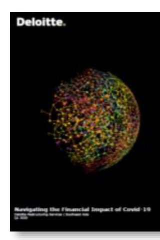
Click on the Report to learn more

"Hot Commodities" (2022)

The commodities "Super-cycle"

Electrifying Singapore (2021)

Singapore Electricity Generation

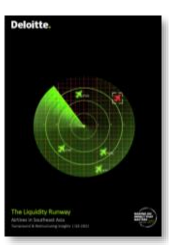


Critical Moves (2020)

Navigating the Financial Impact of Covid-19

"Checking Out" Retail (2022)

SEA Retail sector outlook



The Liquidity Runway (2021)

A review of the SEA Airline sector

Preparing for the End of Stimulus (2020)

What it means for business

https://www2.deloitte.com/sg/en/pages/financial-advisory/articles/turnaround-restructuring-insights.html

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Notes