APAC Equity Strategy

Commodity crunch: the key client question

Equity Strategy

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How soon will lower commodities lift earnings?

We've been highlighting lower commodity prices as a key support for Asian earnings, but the key question from clients is how quickly will this feed into better margins, and how soon will companies erode these gains through price cuts? To help answer this question we sought expertise from current and former industry experts consisting of CEOs, other C-suite executives, senior managers and procurement managers, totalling 39 responses across five key sectors.

We asked the experts – it should start feeding through within three months

The transport sector is expected to benefit quickest with margins forecast to improve within 3 months. The benefit for autos and construction/engineering may take time to feed through, but autos are expected to start to pass on some of the gains to consumers almost instantly, whereas construction/engineering should hold on to their better margins for longer. Figure 1 summarises the margin "sweet spot" for each of the five sectors – i.e. the best period for margin expansion before the benefits begin to fade from price cuts (although some margin uplift is likely to still remain).

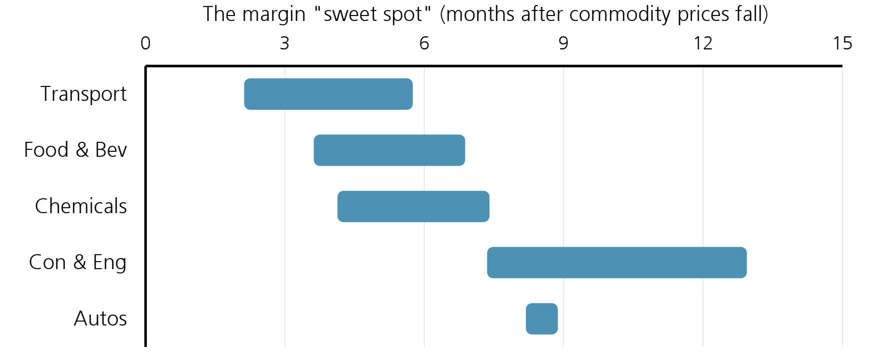
From super-cycle to profit cycle

As we've been saying all year, lower commodity prices should underpin margins and help drive c.10% earnings growth both this year and next. In our previous report: Commodity Crunch: Asia's earnings beneficiaries we identified the sector and stock implications of lower commodity prices, and summarised the key commodity exposures and potential impact to earnings for almost 300 companies in the region.

Key beneficiaries

We update our list of stocks that should benefit on page 5. These are UBS Buy rated stocks that have either good earnings momentum or attractive valuations. Stocks include: Cathay Pacific, Hyundai E&C, Tingyi Cayman Islands, Toray and Toyota Motor.

Figure 1: Margin "sweet spots" - how quickly lower commodity prices feed into better margins vs. how quickly price cuts start to erode those margin gains



Note: Based on rough averages from survey respondents. Blue bars represent the time period between margins starting to benefit from lower commodity prices and the point at which price cuts start to erode margins.
Source: UBS estimates based on a survey of industry experts

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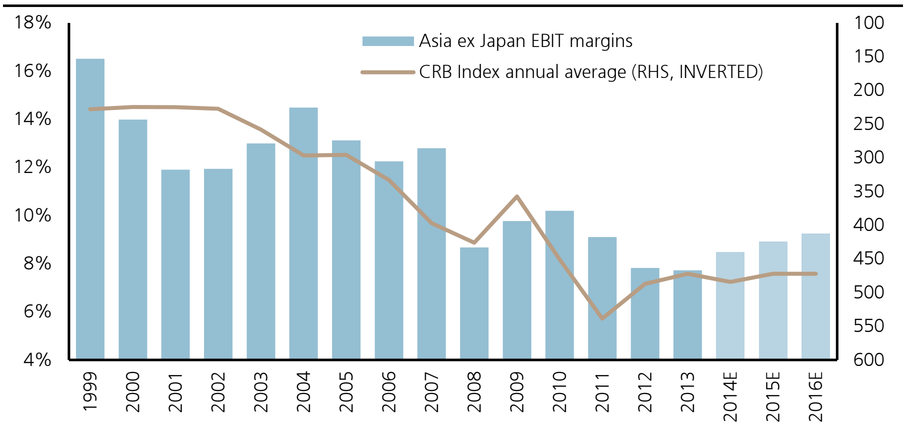
Falling commodity prices will be a major support for corporate profits in Asia. We estimate that commodities are around 30% of the cost base for companies in this region from energy and raw materials inputs, and therefore more significant than wages. Last month we published a detailed analysis of how lower commodity prices should feed through to operating profits for almost 300 companies with the help of our analysts – click here to see the full publication.

Figure 2: Asia ex Jp EBIT margins vs CRB index (inverted)



Source: Worldscope, IBES, Thomson Datastream, UBS estimates

But the key question is just how quickly will lower commodity prices feed into better margins, and how quickly will companies start to erode these gains through price cuts? To answer this, we've sought the experts and have conducted a survey of current and former industry executives consisting of CEOs, other C-suite executives, senior managers and procurement managers. In total we have analysed 39 responses across five key industries that should benefit from lower commodity prices: autos, chemicals, construction & engineering, food & beverage producers and transport.

So what do the experts say?

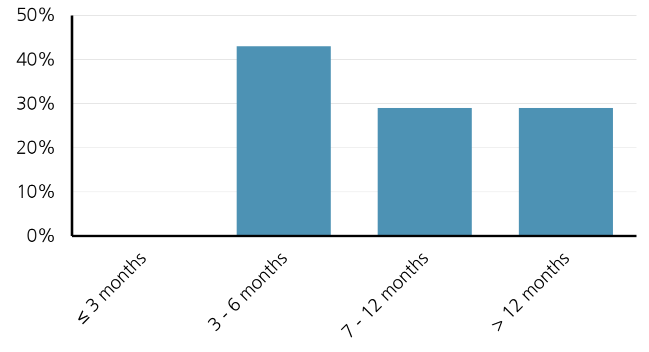
Key takeaways:

- Transport likely to benefit quickest – margins should improve within 3 months.
- Autos and construction & engineering will benefit with a lag – it may take at least 6 months for lower prices to start to feed into better operating profits.
- Benefits for autos are expected to start to be eroded very rapidly, with price cuts starting almost as soon as the benefits are felt.
- Construction & engineering is expected to hold on to its gains longest, despite the long wait for the benefits to be seen.

It's important to note that we ask when margins start to be eroded, so it is likely that companies will be able to maintain some of the benefits and should therefore continue to see some margin uplift beyond this period.

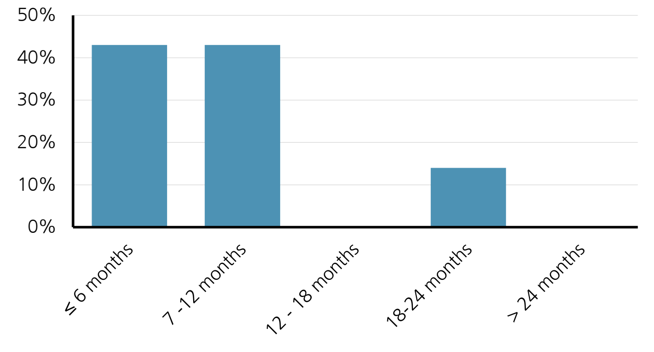
Autos: Lower input costs (e.g. steel and aluminium) could take at least six months to feed into better margins for the auto manufacturers, with the lower cost of parts/components taking time to work through the manufacturing chain. Interestingly though, they may not hold on to all of these gains for long with price cuts likely to follow pretty quickly, according to our experts.

Figure 3: Autos: How long will it take for lower commodity prices to feed into better profit margins?



Source: UBS. Survey responses of 7 industry experts.

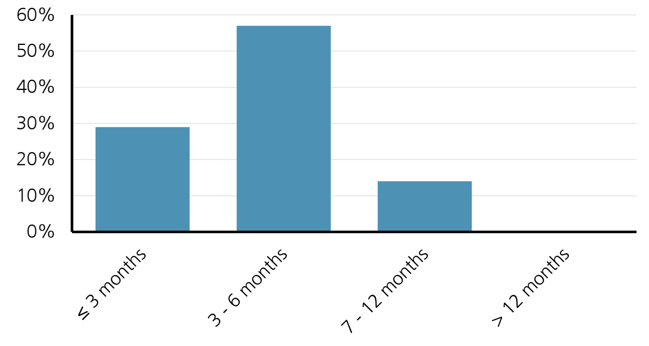
Figure 4: Autos: how long before the competitive environment starts to erode these margin gains?



Source: UBS. Survey responses of 7 industry experts.

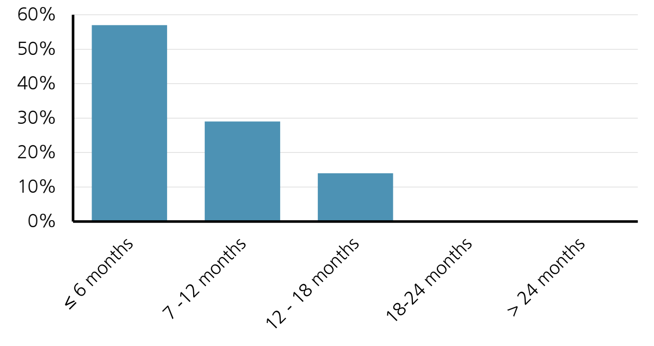
Chemicals: Lower input costs, principally oil, could very quickly feed into better margins – 6 of the 7 responses indicate within six months. Price cuts should come through with a small lag, but likely within a year.

Figure 5: Chemicals: How long will it take for lower commodity prices to feed into better profit margins?



Source: UBS. Survey responses of 7 industry experts.

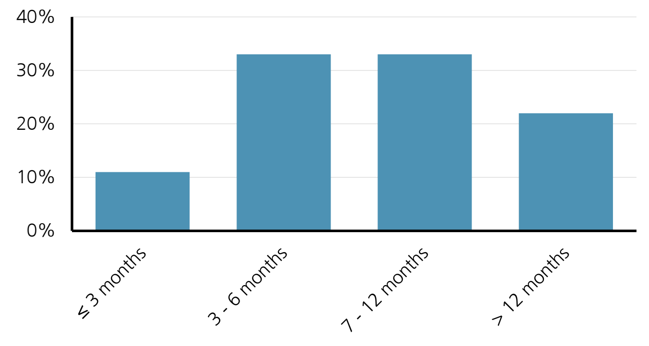
Figure 6: Chemicals: how long before the competitive environment starts to erode these margin gains?



Source: UBS. Survey responses of 7 industry experts.

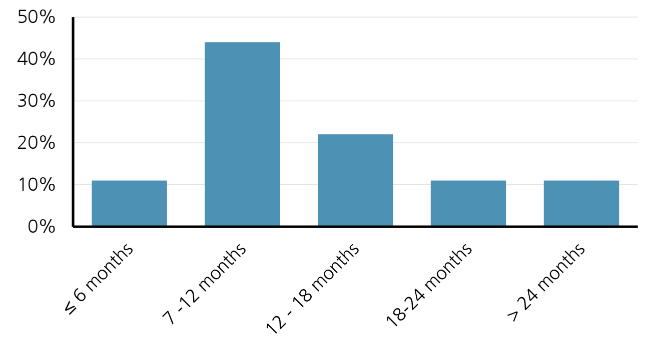
Construction & Engineering: Lower fuel and material costs are likely to take time to feed into construction & engineering margins, but equally there is a long lag time on these margins being eroded, with price cuts likely to take a year or so to come through.

Figure 7: Con & Eng: How long will it take for lower commodity prices to feed into better profit margins?



Source: UBS. Survey responses of 9 industry experts.

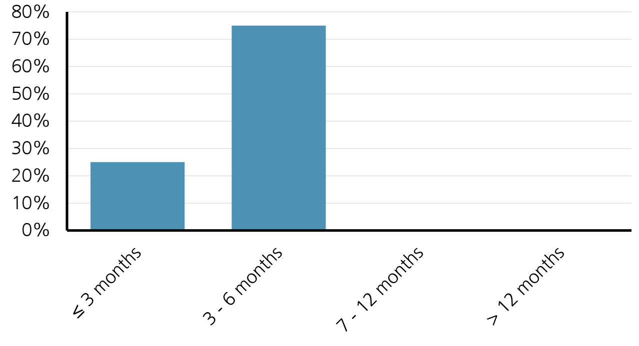
Figure 8: Con & Eng: how long before the competitive environment starts to erode these margin gains?



Source: UBS. Survey responses of 9 industry experts.

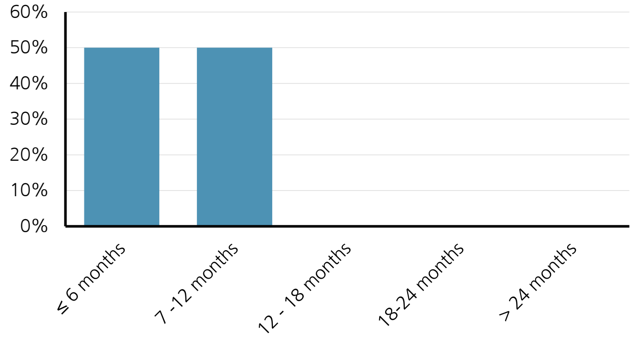
Food & Beverage producers: Margins should quickly benefit from falling food input prices, with all respondents estimating margins benefiting within six months. Any benefit may be relatively short lived with prices likely to reflect lower costs within a year.

Figure 9: Food & Bev: How long will it take for lower commodity prices to feed into better profit margins?



Source: UBS. Survey responses of 8 industry experts.

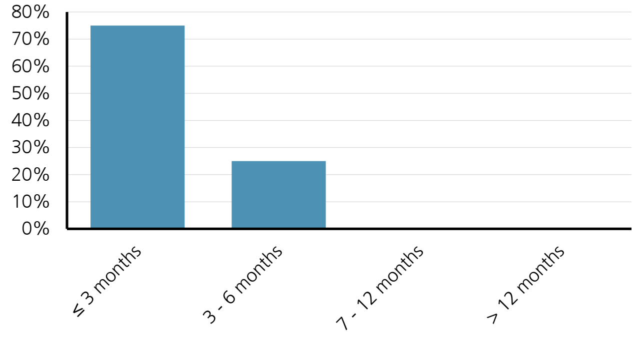
Figure 10: Food & Bev: how long before the competitive environment starts to erode these margin gains?



Source: UBS. Survey responses of 8 industry experts.

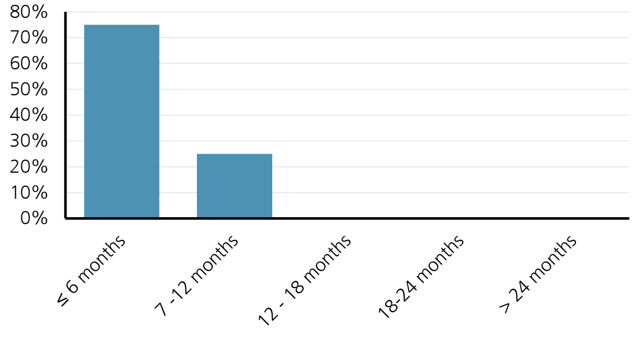
Transport: The sector is likely to feel the benefit fastest of all sectors with the majority of respondents estimating better margins within three months. As we highlighted in our previous publication, many transport stocks can be extremely sensitive to small changes in the oil price given low operating profits. But gains may quickly start to fade with our experts anticipating price cuts within six months.

Figure 11: Transport: How long will it take for lower commodity prices to feed into better profit margins?



Source: UBS. Survey responses of 8 industry experts.

Figure 12: Transport: how long before the competitive environment starts to erode these margin gains?



Source: UBS. Survey responses of 8 industry experts.

Who are the main beneficiaries?

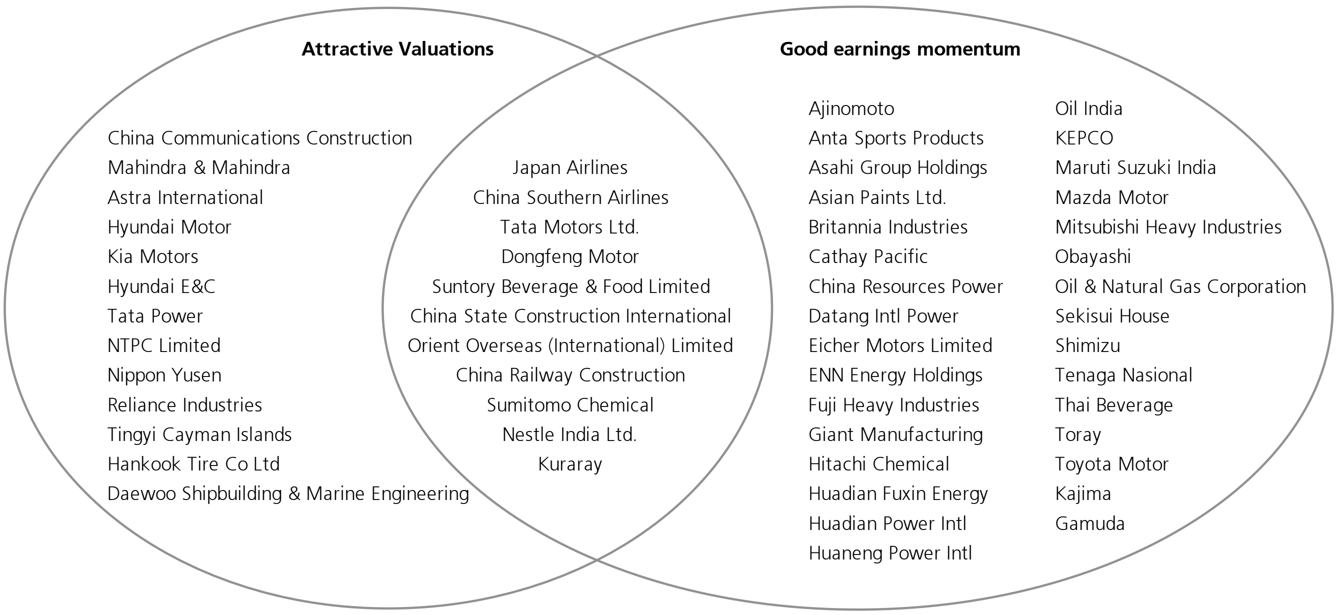
This publication focusses on just five key sectors that should benefit from structurally lower commodity prices. We wrote more on this subject in our recent report: "Commodity crunch: Asia's earnings beneficiaries" where we outlined which sub-sectors should benefit or suffer from the commodity crunch. With the help of our analysts we estimated the potential impact for almost 300 stocks in Asia. Figure 13 below highlights a selection of stocks that should benefit and are favoured by our analysts (Buy rated). In addition these companies are also seeing earnings upgrades and/or have attractive valuations relative to the market compared to history.

Transport stocks are likely to be the earliest beneficiaries and are very sensitive to moves in the oil price given low operating margins. Our transport analyst, Eric Lin, see **Cathay Pacific** as a quality cyclical that should benefit from the oil price given that c.40% of operating cost is fuel. Oil should also support some of the chemicals names, like **Toray** given Naphtha is a key material for them which is derived from refining oil.

Among the consumer names, we continue to like **Tingyi Cayman Islands**, a UBS Key Call. Our analyst Christine Peng sees a 2014 margin turnaround and believes that a 10% fall in all major raw materials (mainly PET resin which is used for packaging, but also palm, flour and sugar which is used in production) would likely see operating profits rise 40%.

Among the sectors that should benefit later, we like **Hyundai E&C**. Our analyst Yong-Suk Son estimates that steel is 29% of the raw material used and a 10% decline in its price would likely increase operating profits by 17-21%. In the autos sector we would highlight **Toyota Motor** which should be a major beneficiary amongst the Japanese autos stocks given 65% of its production is overseas and it should therefore see a greater impact from lower material prices in the current weak Yen environment.

Figure 13: A selection of UBS Buy rated stocks that should benefit from lower commodity prices



Source: UBS estimates

Figure 14: Sector winners (✓) and losers (✗) of falling commodity prices

	Oil & Gas	Coal	Steel / Iron Ore	Copper	Aluminium	Rubber	Wheat	Corn	Cotton
Utilities	✓	✓		✓					
Machinery & Equipment manufacturers			✓	✓	✓				
Automobile manufacturers	✓		✓		✓				
Tire manufacturers	✓					✓			
Food & Beverage producers	✓				✓		✓	✓	
Footwear manufacturers	✓					✓			✓
Homebuilders			✓						
Construction & Engineering	✓		✓	✓					
Energy intensive industries	✓	✓							
Transport	✓								
Cement producers	✓	✓							
Electrical Equipment			✓	✓	✓				
Shipbuilding			✓						
Apparel retailers									✓
Steelmakers	✓	✓	✗✓						
Agricultural Chemicals	✓						✗	✗	✗
Chemicals and refining	✓✗					✗			✗
Agricultural machinery			✓		✓		✗	✗	
Oil & Gas companies	✗								
Oil drilling equipment suppliers	✗		✓						
Mining equipment suppliers		✗	✓✗	✗	✗				
Miners	✓	✗	✗	✗	✗				

Source: UBS estimates

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Buy	FSR is > 6% above the MRA.	47%	34%
Neutral	FSR is between -6% and 6% of the MRA.	42%	28%
Sell	FSR is > 6% below the MRA.	11%	21%
Short-Term Rating	**Definition**	**Coverage[3]**	**IB Services[4]**
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%

Source: UBS. Rating allocations are as of 30 September 2014.
1:Percentage of companies under coverage globally within the 12-month rating category. 2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.
3:Percentage of companies under coverage globally within the Short-Term rating category. 4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

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UBS AG Hong Kong Branch: Niall MacLeod; Matthew Gilman; Yuka Murata.

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Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Ajinomoto[5]	2802.T	Buy	N/A	¥2,302.5	21 Nov 2014
Anta Sports Products	2020.HK	Buy	N/A	HK$15.58	24 Nov 2014
Asahi Group Holdings	2502.T	Buy	N/A	¥3,651.0	21 Nov 2014
Asian Paints Ltd.	ASPN.BO	Buy	N/A	Rs689.75	24 Nov 2014
Astra International	ASII.JK	Buy	N/A	Rp7,100	24 Nov 2014
Britannia Industries	BRIT.BO	Buy	N/A	Rs1,656.60	24 Nov 2014
Cathay Pacific	0293.HK	Buy	N/A	HK$15.80	24 Nov 2014
China Communications Construction[4, 5, 16a]	1800.HK	Buy	N/A	HK$7.76	24 Nov 2014
China Railway Construction[2, 4]	1186.HK	Buy	N/A	HK$8.78	24 Nov 2014
China Resources Power	0836.HK	Buy	N/A	HK$21.55	24 Nov 2014
China Southern Airlines[16b]	1055.HK	Buy	N/A	HK$3.25	24 Nov 2014
China State Construction International	3311.HK	Buy	N/A	HK$11.30	24 Nov 2014
Daewoo Shipbuilding & Marine Engineering	042660.KS	Buy	N/A	Won22,500	24 Nov 2014
Datang International Power	0991.HK	Buy	N/A	HK$4.44	24 Nov 2014
Dongfeng Motor	0489.HK	Buy	N/A	HK$11.62	24 Nov 2014
Eicher Motors Limited	EICH.BO	Buy	N/A	Rs14,615.20	24 Nov 2014
ENN Energy Holdings[2, 3, 4, 5]	2688.HK	Buy	N/A	HK$47.50	24 Nov 2014
Fuji Heavy Industries	7270.T	Buy	N/A	¥4,247.5	21 Nov 2014
Gamuda	GAMU.KL	Buy	N/A	RM5.21	24 Nov 2014
Giant Manufacturing	9921.TW	Buy	N/A	NT$269.50	24 Nov 2014
Hankook Tire Co Ltd	161390.KS	Buy	N/A	Won52,700	24 Nov 2014
Hitachi Chemical	4217.T	Buy	N/A	¥2,187	21 Nov 2014
Huadian Fuxin Energy Corporation[2, 4, 5]	0816.HK	Buy	N/A	HK$4.33	24 Nov 2014
Huadian Power International[2, 4, 5]	1071.HK	Buy	N/A	HK$6.60	24 Nov 2014
Huaneng Power International[16b]	0902.HK	Buy	N/A	HK$9.00	24 Nov 2014
Hyundai E&C[5]	000720.KS	Buy	N/A	Won48,350	24 Nov 2014
Hyundai Motor[2]	005380.KS	Buy	N/A	Won171,500	24 Nov 2014
Japan Airlines[5]	9201.T	Buy	N/A	¥3,320	21 Nov 2014
Kajima	1812.T	Buy	N/A	¥469	21 Nov 2014
KEPCO[5, 16b]	015760.KS	Buy	N/A	Won43,800	24 Nov 2014
Kia Motors	000270.KS	Buy	N/A	Won55,900	24 Nov 2014
Kuraray	3405.T	Buy	N/A	¥1,396	21 Nov 2014
Mahindra & Mahindra	MAHM.BO	Buy	N/A	Rs1,249.75	24 Nov 2014
Maruti Suzuki India	MRTI.BO	Buy	N/A	Rs3,346.05	24 Nov 2014
Mazda Motor	7261.T	Buy	N/A	¥2,961.0	21 Nov 2014
Mitsubishi Heavy Industries	7011.T	Buy	N/A	¥675.6	21 Nov 2014
Nestle India Ltd.[22]	NEST.BO	Buy	N/A	Rs6,297.05	24 Nov 2014
Nippon Yusen	9101.T	Buy	N/A	¥314	21 Nov 2014
NTPC Limited	NTPC.BO	Buy	N/A	Rs142.80	24 Nov 2014
Obayashi	1802.T	Buy	N/A	¥761	21 Nov 2014
Oil & Natural Gas Corporation[1, 5]	ONGC.BO	Buy	N/A	Rs380.70	24 Nov 2014

Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
Oil India	OILI.BO	Buy	N/A	Rs595.20	24 Nov 2014
Orient Overseas (International) Limited	0316.HK	Buy	N/A	HK$45.90	24 Nov 2014
Reliance Industries[4, 5]	RELI.BO	Buy	N/A	Rs984.60	24 Nov 2014
Sekisui House	1928.T	Buy	N/A	¥1,580.0	21 Nov 2014
Shimizu	1803.T	Buy	N/A	¥813	21 Nov 2014
Sumitomo Chemical	4005.T	Buy	N/A	¥424	21 Nov 2014
Suntory Beverage & Food Limited	2587.T	Buy	N/A	¥4,210	21 Nov 2014
Tata Motors Ltd.[16b]	TAMO.BO	Buy	N/A	Rs526.60	24 Nov 2014
Tata Power	TTPW.BO	Buy	N/A	Rs91.75	24 Nov 2014
Tenaga Nasional	TENA.KL	Buy	N/A	RM14.46	24 Nov 2014
Thai Beverage[5]	TBEV.SI	Buy	N/A	S$0.70	24 Nov 2014
Tingyi Cayman Islands	0322.HK	Buy	N/A	HK$18.50	24 Nov 2014
Toray	3402.T	Buy	N/A	¥920.5	21 Nov 2014
Toyota Motor[16b]	7203.T	Buy	N/A	¥7,089	21 Nov 2014

Source: UBS. All prices as of local market close.
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