OCBC Bank

Malaysia Outlook

Navigating the Fiscal Road Ahead

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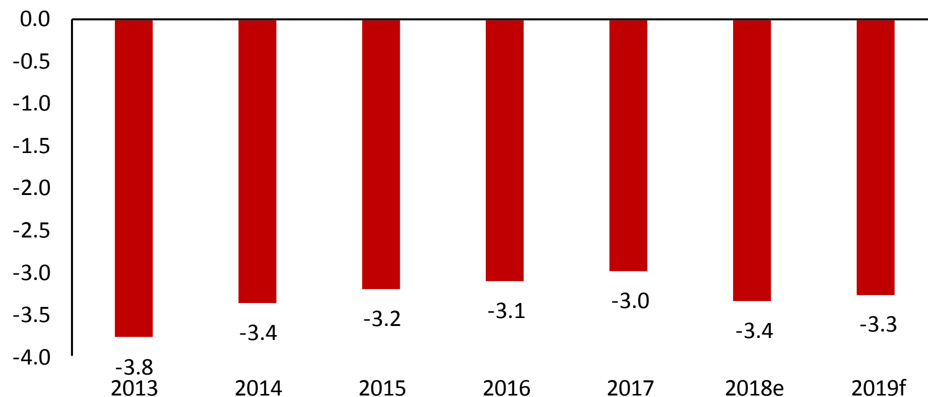
Treasury Research
Tel: 6530-8384

The 2019 budget is still very much anybody's guess but we are going to go with the government hitting a fiscal deficit of 3.3% in 2019, following a likely overshoot of the initial target of 2.8% under the old administration to around a revised 3.4% in 2018 (see chart 1). The new government is managing multiple challenges of reducing the burden of the people and inducing growth whilst at the same time addressing legacy government finance issues such as the GST, income tax and real property gain tax refund. The government though is targeting to try to achieve a fiscal deficit target of 3.0% by 2020 as stated in the mid-term review of the 11th Malaysia Plan.

Chart 1: Fiscal deficit, % of GDP



Source: CEIC and OCBC

We foresee that revenue will decline as a percentage of GDP from our estimate of 16.3% in 2018 to 16.0% in 2019 mainly due to the replacement of GST with SST although Petronas and the government linked companies could possibly ramp up their contributions to help shore up the government's financial situation. Petroleum revenue could also possibly continue to remain elevated (assuming the government takes the ICE Brent to average US$75 in 2019). Our budget forecasts though have not factored in potential new taxes that the new government could introduce or existing taxes they could raise. Some of these measures that we would talk more about later include possibly introducing a digital tax and raising income tax. At this point though, we think that the government would not be able to significantly adjust the tax system in the short term as new taxes would need time to implement whilst the timing may not also be right to raise existing taxes.

Alan Lau
Tel: 6530-5949
AlanLau@ocbc.com

On the cost side, we see that overall expenditure would decline from our estimate of 19.7% of GDP in 2018 to 19.2% of GDP in 2019. Operating expenditure may particularly be hit by an increased need to hold fuel prices such as RON95 at RM2.20 per liter as we see it more likely that the government would still have to introduce a blanket subsidy in 2019 given that they may need more time to implement a targeted subsidy program. At the same time, the government will continued to be weighed down by rising emoluments and pensions expenses, which we foresee being at 43% of operating expenditure in 2019 given that the Finance Minister Lim Guan Eng had earlier announced that they will not be rationalizing staff. However, expenses related to supplies and services, grants & transfers and other expenses could decline by as much as 10% as the government works to optimize expenditure. As a note, we have included the GST, income tax and real property gains tax refunds under operating expenditure that would therefore weigh down on the operating expenditure. We believe development expenditure will likely fall by about 8.0% or RM3.5bn in 2019 from the preceding year mainly due to rationalization of expenses at the Prime Minister’s Department and cost reductions for megaprojects.

Table 1: Malaysia budget 2016 – 2019f, RM bn

	2016	2017	2018e	2019f
Overall Revenue	212.4	220.4	236.8	242.4
% of GDP	17.3	16.2	16.3	16.0
Tax	169.3	177.7	182.3	180.8
Direct Tax	109.6	116.0	135.4	139.5
Income Tax	99.6	105.2	127.2	131.4
Companies	63.6	64.4	72.5	75.2
Petroleum	8.4	11.8	19.2	18.9
Individuals	27.6	28.9	32.2	34.1
Stamp Duty	5.7	5.7	6.5	6.5
Others	4.3	5.2	5.1	5.0
Indirect Tax	59.7	61.6	46.9	41.3
Export Duties	1.0	1.4	1.4	1.3
Import Duties	2.9	2.8	3.0	3.1
Excise Duties	11.7	10.1	12.3	12.4
GST	41.2	44.3	22.8	-
SST	0.2	-	4.0	21.0
Others	2.7	3.0	3.3	3.5
Non Tax	40.0	39.5	51.1	58.2
License & Permits	8.6	8.4	9.5	9.9
Petroleum Royalty	3.7	4.4	4.8	4.8
Investment Interest & Returns	21.4	21.6	30	36.5
Others	6.3	5.1	6.8	7.0
Non Revenue Receipts	3.0	3.2	3.4	3.4
Total Expenditure	250.8	261.9	285.8	292.0
% of GDP	20.4	19.3	19.7	19.2
Operating Expenditure	210.2	217.7	242.9	252.7
% of GDP	17.1	16.0	16.8	16.6
Emoluments	73.1	77.0	79.9	82.8
Pensions & Gratuities	21.0	22.8	24.6	26.7
Debt Service Charge	26.5	27.9	30.9	33.0
Supplies & Services	30.0	34.7	31.6	30.1
Subsidies	24.7	22.4	30.7	34.9
Asset Acquisition	0.7	0.5	0.6	0.5
Grants & Transfers	33.2	31.3	38.9	35.0
Others	0.9	1.0	0.9	0.8
Tax refund	-	-	4.9	8.9
Net Development Expenditure	40.7	44.2	42.9	39.4
% of GDP	3.3	3.3	3.0	2.6
Development Expenditure	42.0	44.9	43.5	40.0
Loan Recoveries	1.3	0.6	0.6	0.6
Overall Surplus/Deficit	-38.4	-41.5	-49.0	-49.6
% of GDP	-3.1	-3.0	-3.4	-3.3

Source: CEIC and OCBC

Note: 1) We forecast GDP growth to be at 4.8% yoy for both 2018 and 2019

2) Numbers may not add up due to rounding errors.

Where costs will emerge and where savings could happen?

Repayment of income tax, real property gains tax and GST refunds

This amounts to a whopping RM19.4bn for GST refunds and RM16.046bn for income tax and real property gains tax refunds but the government will most likely gradually pay out these refunds. The Ministry of Finance has already mentioned that they will be paying out the GST refunds starting from 2019 onwards in phases. Meanwhile, for the income tax and real property gains tax refunds, Finance Minister Lim Guan Eng has said that those with outstanding tax refunds from the tax authorities can "off-set" this against tax payable in 2018. He also said that "the remaining tax refunds will be carried out based on the ability of the government depending on its fiscal position". We therefore assume that the income tax and real property gain tax refunds could be paid out in equal proportions over four years starting from 2018 onwards. As for GST refunds, we assume the government will pay out also over four years starting from 2019 onwards.

Table 2: Schedule of GST refunds owed over the years

Year	Amount (RMbn)
2018	9.2
2017	6.8
2016	2.8
2015	0.6
Total	19.4

Source: Various online sources

Table 3: Schedule of income and real property gains tax refunds owed over the years

Year	Amount (RMbn)
One year back	1.789
Two to three years back	6.125
Four to five years back	3.539
Over 6 years back	4.593
Total	16.046

Source: Various online sources

Fuel subsidies – targeted or blanket?

At this point, despite the government's intention to implement a targeted fuel subsidy scheme, we believe that they are still likely to implement a blanket scheme in 2019. This is because of the time needed to address the challenges related to rolling out a targeted subsidy scheme. A targeted scheme may involve the introduction of a fuel card where measures also have to be put in a place to prevent misuse so that non-targeted groups are not able to illegally benefit from it. Deputy Minister of Finance Datuk Amiruddin Hamzah has said that such a scheme would be announced next year. He had also said such a scheme would target motorcycles with engines below 125cc and cars with engines below 1300cc and each recipient would only be given a monthly quota at an appropriate rate. We estimate a blanket subsidy would cost RM7.1bn for 2019 whilst a scheme targeted at

the bottom 40% lowest income households (B40) only would cost RM2.5bn. This assumes an ICE Brent price of US$75 per barrel, RON95 to be fixed at RM2.20 whilst petrol consumption would be at 15,505 ktoe and that the B40 would consume 35% of total fuel. As a comparison, total blanket fuel subsidies cost the government RM9.6bn in 2010 when ICE Brent daily price averaged about US$80 per barrel.

Housewife Employees Provident Fund Scheme or the Suri Incentive Programme

The government had announced the launch of this program back in August with an allocation of RM20m for the first phase and therefore based on this, we are assuming that they will allocate RM60m for 2019. The program is overall split into a first, second and third phases. The first phase will involve the government co-contributing RM40 per month starting from August 15th. The second phase will involve the government co-contributing RM50 per month starting in early 2019 whilst the third phase will begin in early 2020.

Bantuan Rakyat 1Malaysia (BR1M) or some other hand-out?

We don't see it likely that the government would abolish BR1M or rename the program in the interim as Prime Minister Mahathir Mohamad had earlier mentioned that it will instead be gradually phased out. Therefore, for our budget forecast, we are assuming that the government will scale down the pay outs to each group (see tables 4 and 5).

Table 4: BR1M pay out 2017

2017				
Group	**Monthly Income**	**Total Recipients**	**BR1M Hand Out (RM)**	**Total Hand Out (RM)**
Household	**≤RM3,000**	**3,242,048**	**1200**	**3,890,457,600**
Household	**RM3,001 – RM4,000**	**291,918**	**900**	**262,726,200**
Single	**<RM2,000**	**2,786,803**	**450**	**1,254,061,350**
Total		**6,320,769**		**5,407,245,150**

Source: Various online sources and OCBC

Table 5: BR1M pay out 2019

2019 (estimation)				
Group	**Monthly Income**	**Total Recipients**	**BR1M Hand Out (RM)**	**Total Hand Out (RM)**
Household	**≤RM3,000**	**3,334,678**	**1100**	**3,668,145,737**
Household	**RM3,001 – RM4,000**	**300,259**	**800**	**240,206,811**
Single	**<RM2,000**	**2,866,426**	**400**	**1,146,570,377**
Total		**6,501,362**		**5,054,922,925**

Source: OCBC calculations

Assumptions:

1) Total recipients of the BR1M in 2019 are assumed to be at 90% of total targeted group of 7.2m people (as mentioned by the government). This assumption is made because it is believed that only about 90% of the targeted recipients received the BR1M payment in 2017 (6,320,769 out of a reported target group of 7,000,000 as claimed by the government).
2) It is assumed that the percentage composition of the recipients for each group will stay the same in 2019 as it was in 2017.
3) It is also assumed that the government will reduce the BR1M hand out for <RM3,000 by RM100, for the RM3,001 – RM4,000 by RM100 and for the <RM2,000 by RM50 for 2019.

B40 Healthcare Scheme or "Skim Peduli Sihat"

The government has announced that a national healthcare financing scheme for the bottom 40% lowest income households (B40) would be introduced in 2019 with our estimation that it could cost RM1.5bn. The manifesto had indicated that such a scheme would pay out RM500 per year for families in the B40 group. At the end of 2016, there were 7.59m households with 40% of households therefore totaling 3.04m. For 2019, we assume that the B40 households would total 3.10m for the calculation of our estimated cost of the initiative.

Improving cost management for supplies and services and grants and transfers

We believe supplies and services and grants and transfers could fall by about 10% as the government works to optimize spending. In particular, the mid-term review of the 11th Malaysia plan had already talked about enhancing procurement management though reforms such as abolishing selective tenders and replacing them by open tenders, making detailed information on government procurement planning available on the MyProcurement portal or reviewing exceptions for direct negotiations to be in line with international standards and best practices. Special Officer to the Minister of Finance Tony Pua has also already said that the government will be implementing a zero-based budgeting for procurement processes. Furthermore, the ministry of finance for a number of years now has been looking at driving the implementation of outcome based budgeting.

Renegotiating or cancelling contracts of major projects

The government has also been working hard since their election to manage costs related to major projects. Some notable clear cost reductions that have occurred include:

- **LRT3:** The government has claimed that they have reduced the cost of the project by 47% or RM15.02bn. The ministry has explained that some of the measures undertaken to lower cost include reducing train sizes, shelving the construction of five stations and cancelling the construction of a 2km tunnel among various other changes.

- **MRT Line 2:** Finance Minister Lim Guan Eng has said that the cost of the project has been reduced by RM8.82bn or 22.4% from RM39.95bn to RM30.53bn after negotiations with MMC-Gamuda.

Meanwhile, notable reviews that appear to be ongoing or where cost savings are not yet clear include:

- **Multi-Product Pipeline (MPP) and Trans-Sabah Gas Pipeline (TSGP):** The Ministry of Finance has reportedly confirmed that these projects have been scrapped. The projects would reportedly cost US$2.8bn. However, the total cancellation fees incurred are still not clear at the moment as Finance Minister Lim Guan Eng said that lawyers were still handling the matter.

- **East Coast Rail Link:** According to the government, this project would have cost RM81bn if it is fully realized. At the moment, the government is still reviewing the project whilst concerns related to any cancellation would be the level of the penalty incurred. The government claims that RM19.68bn has been paid out as advance and progressive payments up to 15th February 2018. However, Finance Minister Lim Guan Eng has said that “in the worst case scenario, the government can get back RM10bn out of the RM19.68bn that was paid”.

There also a number of other potential expenses that the government could incur:

1) Abolish unnecessary debts that have been imposed on FELDA settlers.

2) Introducing alternatives measures to address tolls.

3) Introduce RM100 monthly public transport card when using any public transport in the Klang Valley and in all the cities in Malaysia.

4) Share the cost difference of the increase in the minimum wages.

5) Postpone the repayment of student loans for graduates whose salaries are below RM4,000 per month and abolish the blacklisting policy.

6) Introducing marriage incentive of RM500 for young couple below 35 years of age for their first marriage.

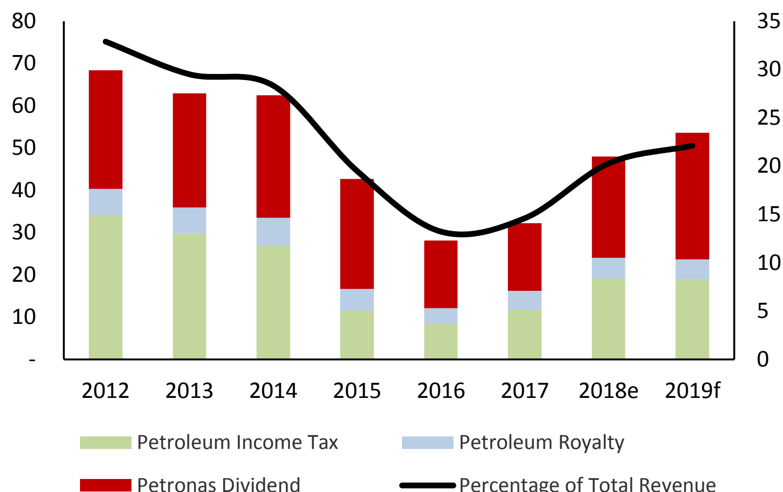
7) Increase the number of public buses by 10,000 nationwide to improve public transport connectivity.

Where will revenue be sourced?

Oil's contribution to revenue

With higher oil prices (assuming the government takes that ICE Brent will average at US$75 per barrel) and the abolishment of GST, the government will not surprisingly come to find itself increasingly reliant on oil related revenue again (see chart 2). This reverses a trend seen in the previous years (Note: for the Malaysian government, the three major oil related revenue components are direct petroleum income tax, petroleum royalty and Petronas dividends). Petroleum income tax would most likely stand at 1.2% of GDP in 2019, much unchanged from our estimate of 1.3% of GDP in 2018 whilst petroleum royalty would also be stable at 0.3% of GDP for both 2018 and 2019. We believe that Petronas dividends would most likely increase their dividend pay out to the government to RM30bn in 2019 from RM24bn in 2018 to assist the government in shoring up their financial situation.

Chart 2: Value of Oil Related Components (LHS), RMbn and Share of Total Revenue (RHS), %



Source: CEIC and OCBC

So what taxes could they potentially introduce?

Digital tax

The mid-term review of the 11th Malaysia Plan already made mention that "the government will explore imposing tax on these online transactions". However, Deputy Minister of Finance Amiruddin Hamzah has said, "We are looking at the matter but I'm not sure if can quickly incorporate it in the budget presentation." This strongly hints that there may still not be any digital tax introduced in the 2019 budget or rather.

Based on the World Bank report titled - "Malaysia's Digital Economy: A New Driver of Development" published in September 2018, there still appears to be challenges and issues domestically and globally that need to be addressed before the digital economy can be effectively taxed. The report mentioned that "the ability to secure tax revenue is conditional on identifying who owes the tax and having an effective domestic tax charge to apply to that enterprise or individual". It said that digital supply chains are more convoluted than normal with it being often the case that the government can normally not tax a non-resident supplier who has no permanent establishment in the country. Suppliers in the digital economy usually do not have a permanent establishment in many countries except a storage or delivery facilities, which would not constitute a permanent establishment. Legislation may have to be amended but the government would have to ensure that there are no contradictions with the rest of the tax system. The report also made note that often only the final consumer and the digital intermediary can be easily identified and directly regulated by the tax authorities.

The report itself had a few suggestions regarding taxes which were:

- **Introduce a freestanding tax on foreign suppliers of digital service that is explicitly not part of the income tax code.** However, this can it states risk challenges under the WTO rules,

- **Ratify the multilateral instrument (MLI) that currently comprises two-thirds of the world's population and GDP.** The report notes that Malaysia has signed it but not yet ratified it. This can help bring Malaysia immediately together with multiple countries already to help address the issue. MLI also presents an opportunity to introduce new rules related to permanent establishments. However, it should be noted that Brazil and the USA have not signed the MLI.

- **Ensure that indirect taxes (particularly SST) require foreign suppliers to account for digital transactions.** This though it mentioned would need an effective compliance strategy, especially requiring foreign suppliers to register with the government. A change to legislation would also be needed.

- **Extend the existing withholding tax to include payments for digital goods and services.** The report highlighted this could be limited by Malaysia's double taxation agreements with other nations if the agreements had clauses which contradict Malaysia's attempt to tax the digital economy. For example, an agreement with Singapore, allocates to Malaysia the taxing rights over technical services only if they are performed inside the country.

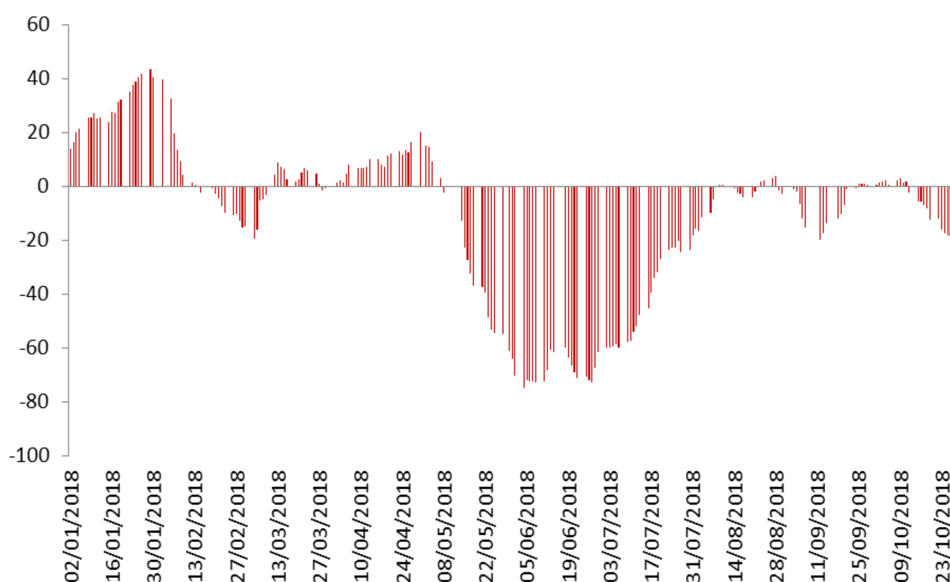
Capital gains tax

We believe that a capital gains tax for equities is unlikely to come in for 2019. The Malaysian stock market has already lost -5.6% ytd of its value (as of 26th October 2018) and net outflows were at US$2.5bn ytd according to Bloomberg (as of 26th October 2018). The Malaysian market like many of its ASEAN peers is already feeling increasing external pressure from global uncertainties. Capital gains tax though, are not new in Malaysia per se as they already exist in the form of real property gains tax.

Chart 3: FBM KLCI value

Source: Bloomberg and OCBC

Chart 4: Rolling 20-day average of net equity inflow/outflow for equities in 2018, US$m



Source: Bloomberg and OCBC

Increase in personal income tax rates

Finance Minister Lim Guan Eng has stated that the government "is not planning to raise" the individual income tax and therefore, we believe it is likely that individual income tax would not be raised in 2019. At this point in time, the government will probably work to plug any leakages or gaps related to income tax. However, we don't rule out the possibility that they may roll back on tax deductions.

Table 6: Individual income tax brackets for 2016 - 2017

Chargeable Income (RM)	Rate (%)
0 – 5,000	0
5,001 – 20,000	1
20,001 – 35,000	5
35,001 – 50,000	10
50,001 – 70,000	16
70,001 – 100,000	21
100,001 – 250,000	24
250,001 – 400,000	24.5
400,001 – 600,000	25
600,001 – 1,000,000	26
>1,000,000	29

Source: Inland Revenue Board of Malaysia

Raising corporate tax rates

Corporate tax is unlikely to be raised especially given the commitment from Finance Minister Lim Guan Eng that the government "is not planning to raise corporate tax rates". Raising corporate tax at this point in time doesn't immediately appear ideal to the government given it may be received negatively by the business community? The Malaysian economy is also already facing uncertainty at the moment due to its exposure to global growth which is at risk of slowing. At the same time, the government would probably be keen to leverage on the opportunity that interest in investing in Malaysia is likely to rise amid the continued trade war between China and the US. Relative to other key ASEAN peers, Malaysia's corporate tax rate is only lower than Indonesia and the Philippines but higher than Thailand, Vietnam and Singapore (see table 7). The government has also said in its manifesto, "Pakatan Harapan will review the national taxation system holistically, with the goal of making the rate of our income tax, corporate tax, and other taxes competitive compared to other ASEAN countries."

However, it can't be ruled out that the government may quietly work to streamline tax incentives throughout the country although effects from this may not come in the short term. This isn't new and it has been talked about for a number of years already. Many of these incentives can risk actually eliminating any government tax collection revenue that could be generated from attracting investment into the country for many years. Take for example, the incentive for firms that qualify for pioneer status. Manufacturing companies that acquire such status will be given a partial exemption from the payment of income tax with them only being required to pay tax on 30% of its statutory income for five years. Examples of manufacturers that could qualify such an incentive include those who produce dry rubber products, palm oil products, chemicals and etc. In addition, there are

also other incentives available under the various corridor authorities such as the Iskandar Regional Development Authority (IRDA), Northern Corridor Economic Region (NCER), East Coast Economic Region (ECER), Sarawak Corridor of Renewable Energy (SCORE) and Sabah Development Corridor (SDC). Other ASEAN peers such as Singapore (Pioneer Certificate Incentive), Thailand and Indonesia have similar incentives although criteria and benefits differs from Malaysia.

Table 7: Corporate income tax across key ASEAN countries

Country	Corporate Tax Rate (National Rate)
Philippines	30%
Indonesia	25%
Malaysia	24%
Thailand	20%
Singapore	17%

Source: Deloitte

Soda tax

Prime Minister Mahathir Mohamad and Special Officer to the Minister of Finance Tony Pua have talked about such a tax but we think it is unlikely that it will be introduced. The justification for such a tax would lie in trying to reduce sugar consumption but it would most likely be the case that industry players and associations would probably work to reduce sugar content in drinks before the government introduces a tax. Other countries that have introduced such a tax include the United Kingdom and France.

Other taxes

A series of other measures the government could consider includes introducing an inheritance tax, imposing a higher stamp duty on foreign buyers of property or even increasing the rate of sin taxes. However, any changes to the tax system generally can risk giving out an unfavourable perception to foreign investors or encourage more tax evasion or tax avoidance from domestic stakeholders.

Offloading holdings of sovereign wealth funds or selling land?

Prime Minister Mahathir Mohamad has already said that the government may have to sell assets and "land is one of them" whilst Finance Minister Lim Guan Eng has said that they will "reduce the government's direct participation in the equity ownership of companies". One option that the government can consider is to possibly sell the stakes of Khazanah's holdings in public listed companies. Selling stakes in these firms can usually be done much quicker than disposing privately held assets. Based on Bloomberg data, Khazanah has ownership stakes in a total of 14 public listed companies to the value of RM73.5bn (see table 8). They are unlikely to offload strategic assets such as Tenaga Nasional Berhad and Telekom. Therefore, if they were to sell of 20% of the holdings in the remaining companies, they could generate RM9.8bn. However, selling all their holdings in the remaining 12 companies would generate RM49.1bn. The government also has the option to dispose of assets held under PNB. As for land, we do not have sufficient data on this. Overall, Khazanah has a realizable asset value of RM157.2bn (as at 31st December 2017) whilst PNB has RM279.2bn of assets under management (as at 2017).

Table 8: Value of known public listed companies of which Khazanah has shareholdings

Company	Value (RMbn)
Tenaga Nasional Bhd (TNB)	22.29
IHH Healthcare Bhd	15.87
CIMB Group Holdings Bhd	14.33
Axiata Group Bhd	11.65
Malaysia Airports Holdings Bhd	4.58
Telekom Malaysia Bhd	2.12
UEM Sunrise Bhd	1.96
Time dotcom Bhd	0.496
Ping An Healthcare and Technology Co Ltd	0.149
Bioalpha Holdings Bhd	0.026
Redt Energy PLC	0.022
Key Asic Bhd	0.011
Green & Smart Holdings PLC	0.007
DagangHalal PLC	0.004
Total	73.5
10% of Total Holdings excluding TNB and Telekom	9.8

Source: Bloomberg
Note: This data is as of 26th October 2018

How would the rating agencies react?

Moody's has already recently said, "the resultant increase in fiscal deficit is credit negative and marks a departure from the previous path of steady deficit reduction." This comes after the government announced in the mid-term review of the 11th Malaysian Plan that it would be aiming for a fiscal deficit of 3.0% in 2020 instead of a balanced budget as originally targeted. It may be a difficult situation but the government does have a number of options at hand to show that it can put the fiscal situation on a sustainably stable trajectory. As discussed, they can reduce the debt level through the disposal of assets such as land and the holdings under the sovereign wealth funds. On the budget side, they can continue to work to optimize spending through reducing the costs of large projects via negotiations or implementing stricter budgeting/procurement processes.

Table 9: Rating of Malaysian sovereigns by the rating agencies

Agency	Rating	Outlook
Standard & Poor's	A-	Stable
Moody's	A3	Stable
Fitch	A-	Stable

Source: Bloomberg

Conclusion

The government is definitely managing a challenging situation here as it tries to balance out inducing growth, reducing the people's burden and setting the finances on a sustainable trajectory. However, the cost savings they have achieved from reviewing the LRT3 and MRT2 shows they are serious in reducing expenses. The government will probably also continue to achieve cost savings in other areas except that it would probably take time. A similar situation exists with the revenue side where the government would probably be able to more significantly increase revenue but that they would need time to implement any new taxes or await the right time to raise the rates on existing taxes. Legacy financial issues such as the GST, income tax and real property gains tax refunds that amount to about RM35bn also worsens the situation. Hence, in the short-run, the fiscal situation may look less bright as the government may most likely overshoot its initial fiscal deficit target (2.8% of GDP) for 2018 at 3.4% of GDP whilst the 2019 fiscal deficit would most likely still be rather elevated at 3.3% of GDP. However, in the longer run, the fiscal situation should improve as the government gradually reforms the structure of the budget.

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