Construction industry outlook expected to remain stable

Analyst: Haryo Koconegoro

PEFINDO believes that the outlook for the construction sector will remain stable in the medium term, despite short-term macroeconomic challenges such as the weakening of the rupiah, a widening current account deficit, and an increased inflation rate stemming from the subsidized fuel price hike. Demand is expected to remain stable, partly due to the government's commitment to increase infrastructure spending and the relatively robust growth of the property sector, supported by high consumer confidence on the economy. However, stiff competition in the industry remains in place, with the construction sector highly fragmented with more than 100,000 companies. PEFINDO rates five construction companies, of which most are in the range of $_{id}$A- to $_{id}$A+. All have a 'Stable' outlook.

Exhibit 1: Published ratings of construction companies

Company	Rating	Outlook
PT Wijaya Karya (Persero) Tbk	idA+	Stable
PT Waskita Karya (Persero) Tbk	idA	Stable
PT Adhi Karya (Persero) Tbk	idA	Stable
PT Pembangunan Perumahan (Persero) Tbk	idA-	Stable
PT Hutama Karya (Persero)	idA-	Stable

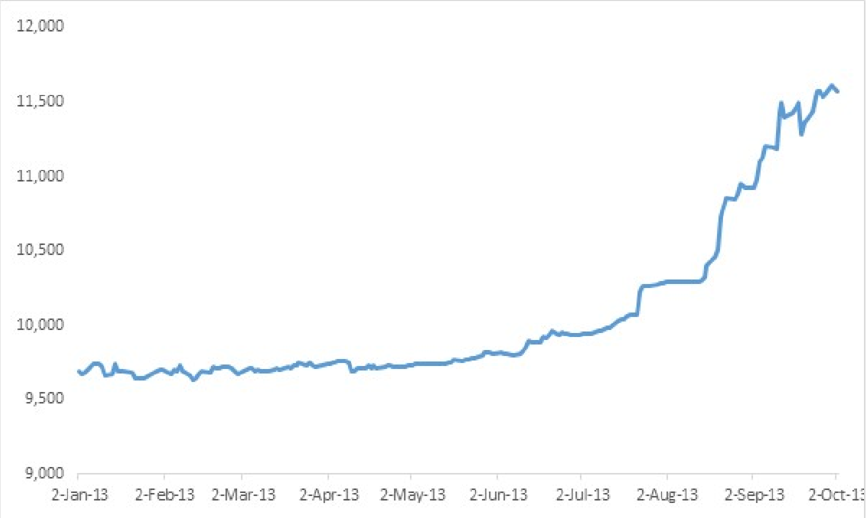
Source: PEFINDO database

These established companies, which are government owned, control less than 10% of the Indonesian construction market. As such, they have low margins due to high price competition. However, we believe that the major government owned companies should fare better than the industry as a whole as they have a stronger financial profile that enables them to handle larger scale projects, which are typically derived from the government or state-owned companies.

Limited impact from short-term macroeconomic challenges

Macroeconomic indicators have been less conducive since the beginning of 2013 due to the volatility of the rupiah, a widening current account deficit reaching 4.4% of GDP in 2Q13 from 2.6% of GDP in 1Q13, and increased inflation of 8.4% in September 2013 from 4.6% in January 2013. We believe, however, that the impact of these problems will be relatively short lived and macroeconomic conditions will gradually improve in the first semester of 2014, supported by the improving global economy and the effect of a slow-down of imports. Improving global economic conditions will help increase global commodity prices, and hence improve the value of exports, which are largely dominated by commodities. On the other hand, a weak rupiah should to some extent curtail imports, and as a result improve the current account deficit as the gap between export and import value will become narrower. Inflation is also expected to gradually stabilize, reaching high single digits by the end of the year.

Exhibit 2 :Year-to-date rupiah/USD (up to October 2, 2013)



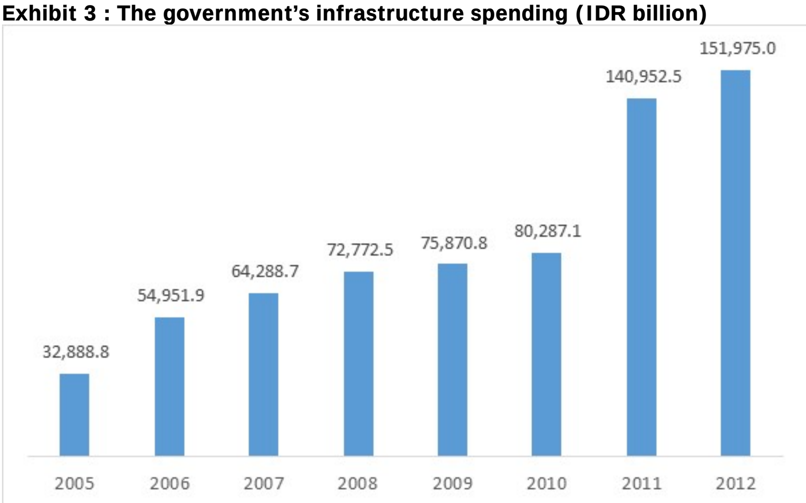
Source: Bank Indonesia

We do not see current macroeconomic developments as having an adverse impact on the cash flow of construction companies. The weakening rupiah will have a limited impact as most of the industry's raw material costs are in rupiah, unlike other industries such as pharmaceuticals or food and beverages. The spike in inflation was also driven by the increase in the subsidized fuel price and the supply and demand imbalances of staple food that generally occurs during the fasting month. We estimate the increase in raw material costs to be less than 10%, hence the impact will be manageable. Furthermore, a cost escalation clause is common in contracts relating to government projects, hence construction companies should be able to pass on increases in costs due to inflation to the project owner.

Intensifying government focus on infrastructure development favorable for industry

The Indonesian government has expedited infrastructure development, with a compound annual growth rate (CAGR) in infrastructure spending of around 24% in 2007–2012. All this is favorable for the construction industry. The government's Master Plan for Acceleration and Expansion of Indonesia Economic Development 2011–2025 (MP3EI), which was initiated in 2011, will reinforce the focus on increasing the speed of the country's economic growth to 8–9% annually in the medium to long term (from 6–6.5%) by developing major infrastructure projects (such as power plants, toll roads, and seaports). We believe that this strong trend in infrastructure spending will be successful provided that land clearing regulations can be implemented effectively.

Exhibit 3 : The government's infrastructure spending (IDR billion)

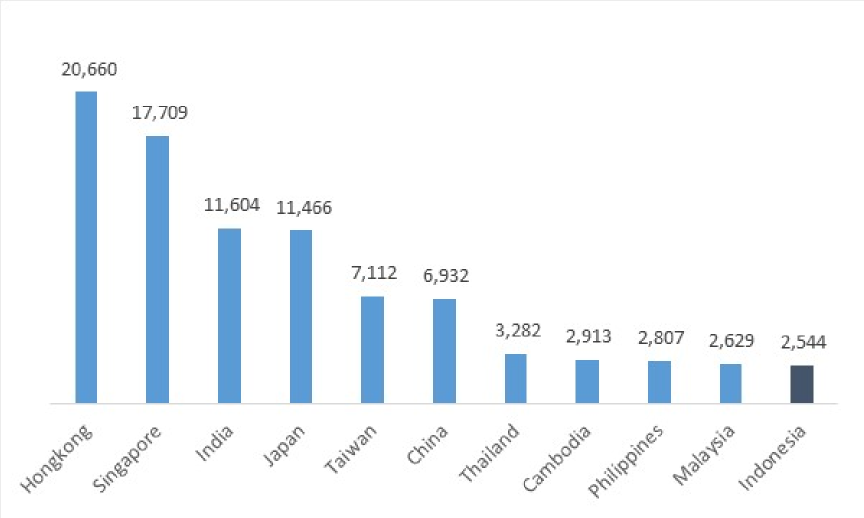


Source: Ministry of Finance

Developing property market should provide additional construction demand from private sector.

Low investment levels after the financial crisis in 1998, which dragged on until 2004/2005, curtailed demand and supply across the property segment and pushed the occupancy rate for Jakarta's central business district (CBD) office space and Greater Jakarta industrial estates. Furthermore, the lower price of property in Indonesia relative to the the region should continue to be a positive boost for property development here. As such, we believe that the relative undervalued price of Indonesian property on a regional basis should uphold a strong construction spending pattern going forward.

Exhibit 4:
Average per sqm in USD of 120-sqm apartments located in the center of the most important city of each country.

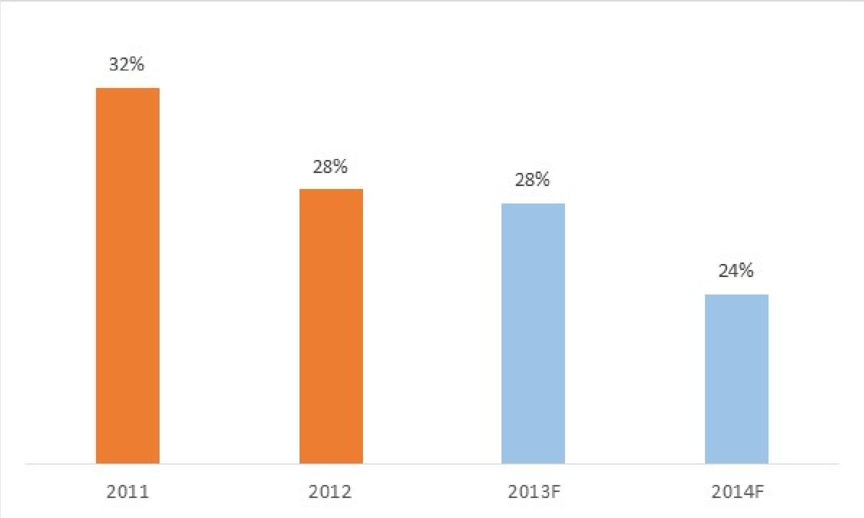


Source: globalpropertyguide.com

Major construction companies to record positive topline growth in 2013 and 2014.

We project the revenue of most construction companies under PEFINDO's rating portfolio to grow by around 28% in 2013 and 24% in 2014, supported by relatively resilient demand from the infrastructure and property sectors, thanks to the government's commitment to improve infrastructure conditions as well as the relatively undervalued price of Indonesian property on a regional basis.

Exhibit 5: Combined revenue growth of major construction companies



Source: PEFINDO database.

Cash flow indicators and liquidity position remain adequate

As per June 30, 2013 financial statements, we find that the cash flow protection indicators of the majority of the companies that we rated are in general relatively adequate, as reflected by average earnings before interest tax depreciation and amortization (EBITDA)/debt of 0.3x and an average EBITDA/Interest of 5.5x. Bearing in mind that the seasonality of construction work tends to cause cash flow indicators to be less favorable in the first two quarters of the year before improving in the last two quarters when most contract orders usually start to come in, we therefore expect that these ratios will improve or at least remain steady in the near term. The liquidity position is also relatively adequate with average cash of around IDR900 billion and average short term debt of around IDR1,066.2 billion. Most of these short-term debts are working capital loans that can usually be rolled over. The average current maturity of debts is only IDR66.5 billion, so we do not foresee any liquidity problems for these companies in the near term.

Risks pertaining to the industry remain

The construction industry, however, is a low-margin business where one miscalculation in costs for one mega project can deteriorate a construction company's profitability and cash flow. Rising costs, in the form of rising labor and material costs, if they persist, may further diminish the profitability of a company and could force it to halt construction to limit losses. Reduced government income on account of weak export values may cause the government to take budget tightening measures, such as postponing or canceling some infrastructure projects. This could lower the expected growth of companies that tend to significantly rely on projects coming from government and/or government related institutions. In addition, a prolonged weakness of the rupiah, higher interest rates, and government regulations to increase the downpayment to 50% for secondary buyers, could eventually affect consumer buying power and confidence, which in turn will hamper construction demand from the property sector.