Pawn industry after POJK 31

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PEFINDO foresees a stable outlook for the pawn industry in Indonesia in the near to medium term. We project a moderate industry growth of about 15% in the next 12-18 months, as we expect a soft economic growth of 5%-5.2%. This industry growth will be supported by market fundamentals: a large portion of Indonesia's population has limited access to formal financial services. The industry's target customers are generally insensitive to changes in interest rates, in our view, given the low amounts of financing involved and the short financing periods.

We expect to see increased competition in the industry due to the implementation of the Financial Services Authority's (OJK) *Peraturan Otoritas Jasa Keuangan* No.31/POJK.05/2016 (POJK 31), which regulates pawning activities. However, the stricter regulatory environment is seen to be positive for the market as a whole, as it will force all players to operate in line with the new regulation.

Key features of POJK 31

POJK 31 welcomes private pawnshops to the industry, allowing them to be established as limited liability companies (*perseroan terbatas*, PT) or as cooperatives. Pawn companies formed as limited liability companies can only be owned by the government of Indonesia, a regional government, Indonesian citizens, and/or an Indonesian legal entity. As cooperatives, they must follow the respective regulations. Direct or indirect foreign ownership is prohibited, unless through the stock exchange.

Their scope of business includes the distribution of financing with collateral under the pawn law, the distribution of financing with collateral under a fiduciary, a deposit service for valuable goods, and appraisal service. Pawn services can be offered under conventional or sharia principles. They are also allowed to engage in fee-based income business activities outside the pawn business, but they need to obtain prior approval from OJK.

The regulation requires pawn companies to have minimum paid-up capital of IDR500 million to conduct their business on a regency level and IDR2.5 billion on a provincial level. It also requires them to have at least one certified assessor in each outlet. Pawn companies must define valuation guidelines and set fair market prices for collaterals.

Pawn companies are obligated to submit periodic reports every three months, including a company profile, financial statements, and operational reports. Details regarding the form, structure, and procedure for these reports will be stipulated in a circular letter.

Companies have two years from the time the regulation is enacted to register with the regulator. Failure to do so can merit a written notification, suspension, or revocation of business license from OJK.

Improved regulatory environment to enhance industry discipline

We view the enactment of this regulation positively, as it increases oversight over pawn business activities in Indonesia. We are of the view that more stringent control will protect consumers against potential fraudulent pawnshops. The lack of financial literacy among low-income segments has resulted in the high numbers of loan sharks in Indonesia, although there is limited information on the actual size.

With the new regulation, it is expected that previously unlicensed pawnshops will comply and register to be allowed to operate. We also expect consolidation within the industry, since pawnshops that cannot meet the requirements will be closed down, thus reducing the number of potential players and improving OJK's supervision. With the new regulation, micro and small enterprises with limited access to banks will have alternatives for funding sources through legal pawn brokers.

We view the limitation on geographical coverage as a tool to drive the supply and demand of financing in rural areas, making distribution more even. The reporting requirement should also increase data transparency and reliability, and improve financial discipline among pawn players.

Impact on PT Pegadaian (Persero)

PT Pegadaian (Persero) (PPGD) is the only government-owned pawn brokerage company in Indonesia, and has been the dominant player in the business for over 100 years. We view the outlook of PPGD as stable in the near to medium term, and expect its business position to remain superior despite the increased competition from new pawn players as a result of POJK 31. However, given the coverage area limitation, these pawn companies will focus on their respective regencies and provinces. PPGD is the only pawn brokerage with the license to operate nationwide. In this regard, it has the competitive advantage given its considerable network and infrastructure. We are of the view that it would take time to replicate what PPGD has achieved over the years. In addition, with the new regulation, PPGD will no longer be accused of being a monopoly, which could improve its image among the general public.

PPGD also faces competition from sharia banks, albeit a limited one as they serve different markets. For sharia banks, the financing to value (FTV) ratio of pawned gold products is limited to 80%, as opposed to PPGD that has no regulatory restrictions. That gives it an advantage, as it is able to offer more competitive pricing to customers. As we expect the number of pawn players to increase sharply, we project interest rates and FTV ratios to become more competitive. Thus, we project PPGD's margin to narrow over the medium term, although it is unlikely to decrease significantly.

Another downside of this regulation to PPGD is that it has to establish new subsidiaries for activities outside its core business of pawn brokerage, which will increase its operational costs. Supporting businesses that are not in accordance with the regulation – gold trading, micro financing, auction houses, and property rental – would have to be conducted by subsidiaries that operate as non-pawn brokerage business units.

PPGD's credit profile

On April 5, 2017, PEFINDO raised the rating for PPGD and its outstanding bonds to "$_{id}$AAA" from "$_{id}$AA+". The upgrade reflects the proven results of improved underwriting methods in limiting the potential loss from gold price volatility, as reflected by non-performing loan containment and a track record of very little credit loss from collateral settlement. Amid the unfavorable macroeconomic environment and gold price volatility, it was able to maintain stable business growth, with loan disbursement increasing to IDR120.9 trillion at end-December 2016 (FY2016) from IDR112.8 trillion in FY2015 and IDR102.6 trillion in FY2014.

PEFINDO classifies PPGD as an important government-related entity, as it has a strategic function in providing pawning services to the low- to middle-income segments and loans to small businesses, which have limited access to banks. We are of the view that its failure could create economic disturbance for its customers and affect the government's reputation. PEFINDO is of the view that the government has an interest in maintaining its viability and would provide any necessary support if required. As of FY2016, it served over 6.9 million customers, with around 41.5 million accounts.

PPGD's superior business position is followed by a strong financial profile. It has very strong capitalization, more than sufficient to absorb potential business risks and support business expansion in the medium term. Its equity base will continuously grow due to its strong profit and its leverage can be kept low in the medium term, with its debt to equity ratio (DER) projected at no more than 2x. The lower dividends in the last two years of 26%-30% of net income, compared to the previous 45%-50%, should support further capital retention. Its equity base increased to IDR16.5 trillion in FY2016 from IDR12.5 trillion in FY2015, driven by another round of fixed asset revaluation and strong profit accumulation. Its DER was 1.7x in FY2016, slightly improved from 1.9x in FY2015 and much lower than the maximum regulatory limit of 10x.

In terms of liquidity, we view its position as strong and we expect it to be maintained over the medium term given its business model. Offering financing with short-term tenors of 15 days to four months keeps the Company's liquidity risk at a minimum. With strong liquidity, we expect it to have a strong capacity to meet future liabilities. It had a strong monthly internal cash flow of around IDR10.4 trillion and cash position of IDR412.6 billion at FY2016. PPGD has mostly kept its liquid asset ratio above 150% since 2013, and this ratio stabilized in the 140%-150% range at the end of 2016.

The constraining factor for PPGD is its exposure to gold price volatility. PEFINDO expects it will continue to be exposed to such risk as pawn brokerage will remain its dominant business focus, accounting for around 90% of revenue over the medium term. Its business growth and asset quality could still be affected by gold price volatility, particularly if a price decline persists over a long period. Though partly mitigated by strong underwriting criteria and robust risk management practices, which result in strong recovery of collaterals, the risk of price volatility has not been completely removed. In addition, its non-pawn businesses have not grown significantly to be able to act as a balancing factor for its revenue and asset quality performance.