The Airport Industry in Indonesia

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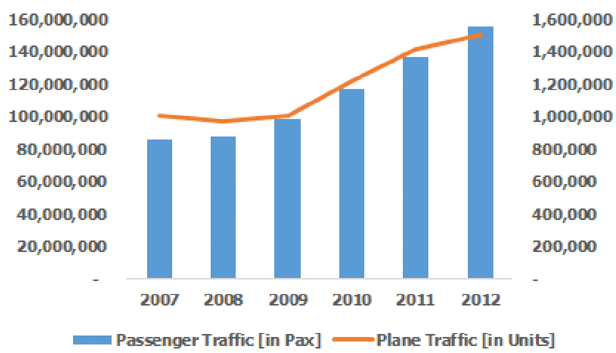
We view the outlook for the domestic airport industry as positive in the near to medium term as it is strongly linked with the aviation sector, which we also believe has good prospects despite its highly capital intensive nature. However, we believe that airports are more stable in the midst of an unstable airline industry. Our positive view on the airport industry is supported by the country's favorable economic growth over the past five years which led to the emerging middle-class income segment which has boosted passenger traffic, both domestic and international, which in turn prompted major airlines in Indonesia to expand their fleet profiles. However, we believe this surge in traffic and expansion has not been followed by significant improvements in the country's infrastructure. In addition, significant capital expenditure (capex) by airport operators to expand their current over-utilized terminals may also hamper their financial profiles, particularly capital structure and cash flow protection measures, in the near to medium term.

Demand for aviation inevitable due to archipelagic nature of Indonesia

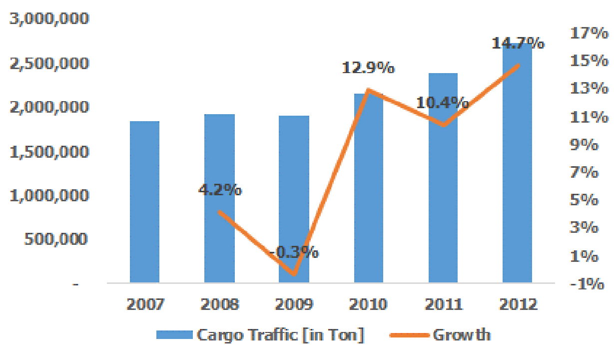
With a population of more than 240 million people (the world's fourth largest) spread across more than 17,000 islands and over 113,700 square miles, Indonesia is an aviation market that relies on aircraft to move its citizens more than most. The need for connectivity has become vital as the government looks to further connect its people, resources, and industries to maintain its gross domestic product (GDP) growth by about 5.8%-6.2% (6.3% in 2012, 6.5% in 2011) through its Master plan for Acceleration and Expansion of Indonesia Economic Development (MP3EI) program. We believe that such connectivity cannot be achieved by only relying on land and water transportation as they are constrained by distance, time and a lack of infrastructure. Therefore, demand for aviation, which offers faster and more efficient travel, is inevitable, especially with rapid economic development.

Figure 1. Passenger Traffic vs. Plane Traffic



Source: Ministry of Transportation, processed by PEFINDO

Figure 2. Cargo Traffic

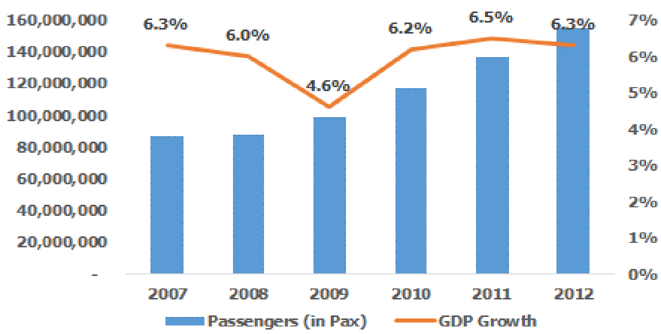


Source: Ministry of Transportation, processed by PEFINDO

Growing middle-class income a boost to aviation industry

The airport industry's good prospects are supported by the burgeoning middle-class, which brings high consumer demand for air travel. The aviation industry has been expanding routes and increasing flight frequencies to take advantage of this. Many airlines are moving into the low cost carrier (LCC) segment to further tap the growing market, including PT Lion Mentari Airlines, PT Wings Abadi Air, PT Garuda Indonesia Tbk (GIAA) through its Citi Link, and Tigerair Mandala (formerly known as Mandala Airlines). This growing market has also attracted oversees LCC players such as AirAsia Berhard from Malaysia. These factors led to a significant increase in passengers (departure and arrival) with a five-year compound annual growth rate (CAGR) of 15.4% during 2008-2012 to 155.2 million passengers. McKinsey & Co forecasts that around 40 million people could join the middle-class income segment by 2020 and 90 million by 2030 if Indonesia can maintain GDP growth of about 5%-6%. We believe that the growing middle class will become the key driver for the Indonesian market for both domestic and international flights, thus resulting in a more resilient aviation environment in the event of global economic downturns or geopolitical instability.

Figure 3. Passenger vs. GDP Growth 2007-2012

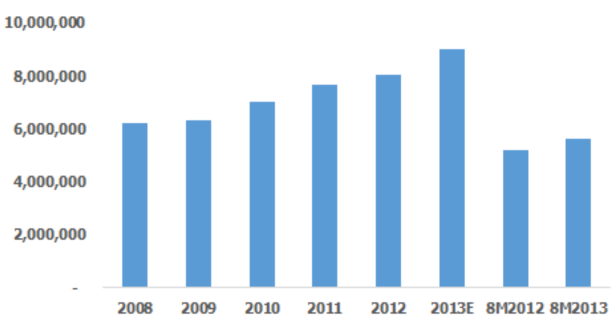


Source: Ministry of Transportation and The World Bank, processed by PEFINDO

We also view the increasing number of foreign visitors to Indonesia as a contributing factor. Supported by world-class tourist destinations and the current conducive geopolitical condition, the country saw an increase in foreign tourists of 8.3% year-on-year (YoY) to 5.6 million at August 2013 and 5.2% YoY to eight million in 2012. Around 60% entered Indonesia through the Soekarno-Hatta and Ngurah Rai airports, and direct flights from overseas proved to be an important factor boosting the number of tourists, as well as the government's tourism promotion campaign. The government expects foreign tourists to reach around nine million in 2013 and at least ten million in 2014, with the majority coming from the Asia-Pacific region.

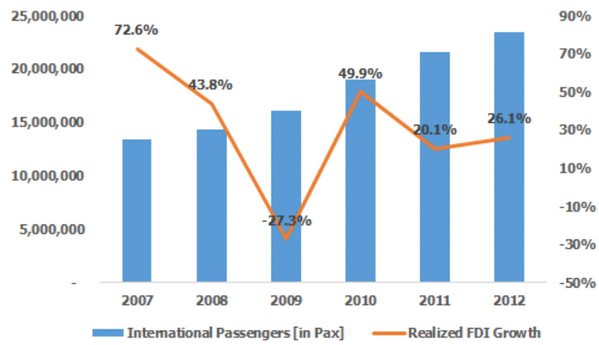
An increase in realized foreign direct investment (FDI), which grew with a five-year CAGR of 13.4% during 2008-2012 may also contribute to the rise in international passengers, in our view. Despite the recent fuel price hike and capital market volatility, Indonesia's sound economic growth over the past five years in the midst of the global economic slowdown, and the government's commitment to maintain its GDP growth of about 5%-6% in the near to medium term, have spurred international companies to expand their business in Indonesia, as well as local businesses looking for international partners. This is expected to result in a new business community and thus resulting in more frequent business travel in and out of the country.

Figure 4. Foreign Visitors 2008-2012



Source: Ministry of Tourism and Creative Economy

Figure 5. International Passengers vs. Realized FDI



Source: Ministry of Transportation and the Indonesian Investment Coordinating Board (BKPM), processed by PEFINDO

Investment by airline companies to anticipate surge in passengers

As mentioned earlier, the airport industry is strongly linked with the aviation sector, thus, any actions taken by major airlines could impact on the business operations of the airports. Leading local airlines, including GIAA, PT Lion Mentari Airlines, and PT Indonesia AirAsia, spent approximately IDR35.2 trillion to procure new planes in 2012 to anticipate a surge in passengers in the medium term. GIAA through its Quantum Leap program spent more than IDR20 trillion on 11 A330-300s and around IDR18 trillion on 18 Boeing planes with delivery expected through 2018, aiming to increase its number of aircraft to 154, and boost the number of passengers to around 35.2 million. PT Lion Mentari Airlines, Indonesia's largest privately run airline, recently signed a record-breaking contract with Airbus for 234 A320s worth USD23.6 billion, with delivery expected from 2015 to 2026. Early in 2011, it signed a contract worth USD21.7 billion for 230 Boeing 737s. In addition, Tigerair Mandala plans to increase its fleet profile to around 15-16 A320s by the end of 2014 from its nine aircraft currently, while Indonesia AirAsia plans to add 10 A320s per year for the next five years. Based on data from CAPA – Centre for aviation, there are more than 600 aircrafts on order from the local airlines with delivery expected until 2028.

Infrastructure challenges

Unfortunately, the rapid passenger growth and expansion carried out by airline companies has not been accompanied by an improvement in the country's infrastructure. The aviation industry is challenged by a lack of capacity, both in terms of terminal capacity and runways, as many airports are over-utilized. For that reason, the two most frequent visited airports in the country, Soekarno-Hatta and Bali's Ngurah Rai, are currently being redeveloped and expanded by their operators, PT Angkasa Pura II and PT Angkasa Pura I, respectively. On the other hand, current congested aircraft traffic, which grew at a five-year CAGR of 11.6% during 2008-2012, prompted the Ministry of Transportation to issue a moratorium limiting the number of new airlines, and this is expected to reduce the level of flight delays for both arrivals and departures. In addition, recently GIAA was forced to postpone its service to London, which was initially scheduled for November 2, 2013, due to the pavement classification number (PCN) of the runways and aprons at Soekarno-Hatta of 120 tons not meeting the required level of strength of 132 tons needed for the operation of a full capacity, heavy duty commercial plane such as the Boeing 777-300ER.

Another issue is airport access. The heavy traffic to Soekarno-Hatta provides uncertain travel times as the main access to the airport is through the Sedyatmo toll road. This is further aggravated by the lack of supporting facilities such as an integrated railway. In addition, the newly operated Kuala Namu, which is located about 29 km from Medan and intended to replace the over-capacity Polonia, can only be reached through a narrow road. The airport is the first in Indonesia to be supported with an integrated rail connection from Medan, however, its capacity can only accommodate about 20% of the airport's passengers. Limited space for parking is another issue faced by the industry.

In the near to medium term, we expect the financial profile of an airport operator, particularly its capital structure and cash flow protection measures, to weaken from its current conservative level considering the significant amount of capex required to carry out the expansion of its existing over-utilized terminals. The majority of the capex will likely be financed by external funds since operating income (EBITDA), mostly derived from aeronautical-related services, will not be sufficient enough to cover it. The renovation of Ngurah Rai cost PT Angkasa Pura I more than IDR3 trillion, while the expansion and revitalization of Soekarno-Hatta is expected to cost PT Angkasa Pura II more than IDR20 trillion.

Figure 6. Future Airport Projects Through PPP Schemes

Project Name	Location	Value [in USDmn]
Ready For Offer Projects:		
- Nil	-	-
Priority Projects:		
- South Banten	Pandeglang, Banten	214
Potential Projects:		
- Kertajati International Airport	Bandung, West Java	130
- Kulonprogo International Airport	DI Yogyakarta	500
- New Bali Airport	Bali	510
Total Investments		1,354

Source: the National Development Planning Board (BAPPENAS)

The Indonesian government is encouraging the role of public-private partnerships (PPPs) in the development of infrastructure including toll roads, railways, seaports, and airports. There are currently four airport projects worth USD1.4 billion in the pipeline, however, two remain in limbo due to a lack of interest from investors. In the near to medium term, we believe that the issues mentioned above will remain as the industry's major constraints as project completion is often hampered by prolonged and complex land acquisition, regulatory uncertainty, bureaucratic issues, project management, and financing issues.