Property Sector Stable Despite Slowdown

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PEFINDO is of the view that the outlook for the property sector will remain stable in the near to medium term, despite its slowdown during the first half of 2015 (1H2015). This is underpinned by the country's backlog of roughly 15 million units in 2014, its young demographics and the expanding middle class segment. These factors will continue to drive demand for residential properties, with first home buyers as the largest market. We expect growth in property development on the outskirts of Jakarta - Tangerang, Bekasi, Depok and Bogor - will continue given the urbanization trend and affordability. This is also expected to increase demand for retail and commercial properties. Our view is further supported by the government's infrastructure spending, including the development of new toll roads and transportation systems, to better connect cities to the capital. We also expect greater exposure from developers to secondary cities - Bandung, Surabaya, Medan, Balikpapan and Makassar - given the scarcity of residential land bank in Jakarta and the opportunities these cities will provide over the medium to long term.

Nevertheless, the slowing economy, rupiah depreciation against the US dollar, weakening purchasing power, and policy uncertainties weakened demand during 1H2015, with most of the sales of property developers lagging behind their targets. PEFINDO also notes that the Eid Al-Fitr festivities and school holidays, both in July, contributed to the weakening market as buyers delayed purchases amid the slowing economy. As a result, several developers have changed their strategies, adjusting their property portfolios, product price segmentation and unit size to meet market demand, rescheduling their property launches for the second half after July.

PEFINDO considers the following four factors will be key catalysts to a more favorable climate in the sector over the near to medium term: tax regulations imposed on property products are now set and clear; relaxation of the foreign ownership law over the next couple of months; relaxation of the loan-to-value (LTV) regulation; and government disbursement on infrastructure spending, which is expected to improve economic growth and purchasing power.

Table 1. 1H2015 marketing sales (IDR billion)

Company	1H2015	1H2014	% y-o-y change	% of 2015 target	2015 [E]	2014	2013	2012
PT Bumi Serpong Damai Tbk	3,600	2,750	30.9	48.0	7,500	6,508	7,348	4,280
PT Lippo Karawaci Tbk*	2,700	1,639	64.7	45.0	6,000	5,185	4,116	4,683
PT Ciputra Development Tbk*	4,300	3,360	28.0	41.3	10,640	8,631	8,941	7,298
PT Summarecon Agung Tbk	2,700	2,400	12.5	49.1	5,500	4,601	3,725	3,873
PT Agung Podomoro Land Tbk	1,583	2,466	-35.8	24.4	6,500	6,022	6,027	5,800
PT Alam Sutera Realty Tbk*	1,165	2,500	-53.4	20.1	5,800	4,256	3,814	3,648
PT Pakuwon Jati Tbk*	2,000	1,100	81.8	58.7	3,410	3,137	3,003	1,851
PT Modernland Realty Tbk	2,062	1,800	14.6	38.0	5,423	3,651	2,900	1,088
PT Intiland Development Tbk	497	1,181	-57.9	16.5	3,002	2,359	2,369	1,650
Aggregate	20,607	19,196	7.4	38.5	53,535	44,350	42,243	34,171

Source: PEFINDO database, company reports and news   ** not rated*

Set and clear property tax revisions

New tax regulation, No. 90/PMK.03/2015 released April 30, 2015 by the Ministry of Finance, and effective May 31, 2015, is the revision of regulation No. 253/PMK.03/2008 regarding super luxury income tax (PPh 22). The new regulation imposes a 5% tax on buyers of properties valued at more than IDR5 billion or with a size of at least 400 square meters (sqm) for houses and 150 sqm for apartments/condominiums. Previously, the super luxury tax threshold for property was IDR10 billion, and at least 500 sqm for houses and 400 sqm for apartments/condominiums. It is also clear that the IDR5 billion threshold should exclude the 10% VAT (PPN) and 20% luxury tax (PPnBM). The 5% super luxury tax on property purchases could be treated as a tax credit for the individual's total annual income tax (SPT PPh 21).

For the luxury tax itself, under new regulation No. 106/PMK.10/2015, released June 8, 2015 and effective July 8, 2015, it was finally agreed that the 20% tax imposed will still be based on property size and not pricing, which is at least 350 sqm for houses and 150 sqm for apartments/condominiums. Previously, it was said that the luxury tax would be imposed based on pricing, with the threshold believed to be IDR3 billion, given that the current super luxury tax threshold is IDR5 billion. However, recent news in the media suggests the government still plans to impose the luxury tax based on property value, with the threshold expected to start from IDR10 billion. If the regulation is to be imposed, we believe it will not significantly impact property players given their small exposure to properties valued above IDR10 billion. With property tax regulations now clearer, this allows the sector to settle in and recover in the medium term from the lingering uncertainties it suffered during the first half.

Table 2. Current tax structure for luxury property

Description	In %
Property base value	100%
VAT (PPN)	10%
Duty on the acquisition of land and building rights (BPHTB)	5%
Land and building transfer tax	5%
Luxury tax (PPnBM)	20%
Super luxury tax (PPh 22)	5%
Total price paid by customer	145%

Source: PEFINDO and Ministry of Finance

An additional 45% of transaction costs to acquire property in the primary market

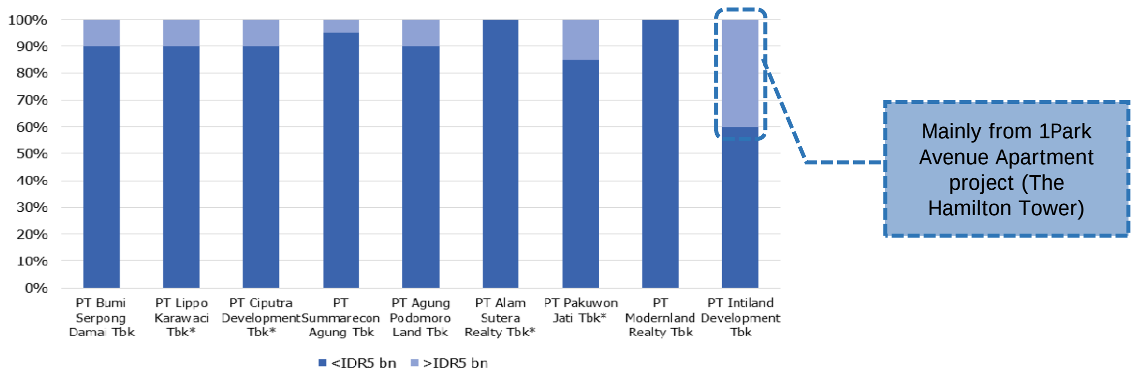
Foreign ownership on the horizon

According to the media, the government is expected to relax property ownership rule for foreigners over the next few months, indicating that it will revise the current regulation No. 41/1996 on housing or residential ownership for foreign citizens based in Indonesia. Media reports say the relaxation will allow foreigners with a presence in Indonesia to own luxury apartments in big cities with a minimum value of IDR5 billion. Under the current regulation, foreigners can only have a property holding a right of use certificate that will lapse in 25 years and can be extended twice for another 20 and 25 years. The new policy is expected to eliminate the period restriction and will allow foreigners to bequeath the property to their heirs or resell it. Still, they are not entitled to the right of ownership certificate or freehold. We emphasize that the IDR5 billion threshold is not yet confirmed, but we do expect there will be a minimum floor price to distinguish the foreign customer market from that of local buyers.

The relaxation on foreign ownership is also to accommodate the goals of regional economic integration set for the ASEAN Economic Community (AEC), which will commence at the end of the year. In comparison, Thailand has allowed foreigners to purchase apartment/condominium freeholds without restrictions, but only in a building where more than 51% of the total number of units are Thai owned, otherwise a foreigner can only buy a leasehold. In Malaysia, foreigners are allowed to buy freehold landed properties and high-rise condominiums in key areas, such as Johor, Penang, and Klang, and are subject to a minimum threshold, which varies in different states, while for leasehold titles, most are originally for 99 years and can be extended on paying a further sum. Malaysia has also encouraged foreigners to own property under the Malaysia My Second Home program since 2002. The program has several requirements, which include a minimum monthly income, minimum liquid assets, and a fixed deposit. Singapore, on the other hand, has no price threshold but requires government approval for the purchase of restricted properties, while for apartments/condominiums, foreigners can buy a leasehold for a period up to 90 years. Recently in Vietnam, the government eased the policy on foreign ownership of properties similar to that of Thailand. The new law, in place from July 1, 2015, allows foreigners with valid residence visas to buy up to 30% of the total number of units in an apartment building and up to 250 residential houses in a ward administrative unit. In addition, foreign individuals who are married to a Vietnamese are entitled to long term home ownership.

PEFINDO is of the view that the easing on foreign ownership of properties could broaden the customer base for premium apartments and help boost growth in the sector, though not significantly. The move is expected to benefit property developers with high exposure to premium apartments under our coverage, such as PT Intiland Development Tbk (idA/Stable) and PT Agung Podomoro Land Tbk (idA/Negative). Outside our rating coverage, PT Ciputra Development Tbk, PT Lippo Karawaci Tbk, and PT Pakuwon Jati Tbk are expected to be the main beneficiaries of the foreign ownership relaxation, in our view.

Figure 1. Proportion of property products priced above IDR5 billion



*Source: PEFINDO database, companies report, and news   * Not rated*

Relaxation of LTV to stimulate property growth in the medium term

The central bank (BI) has released regulation No.17/10/PBI/2015 regarding the relaxation of LTV for mortgages to revise circular No. 15/40/DKMP. First, second, and third mortgages are eased by 10% to 80%, 70%, and 60%, respectively. But, only banks with a non-performing loan (NPL) ratio of less than 5% are allowed to sell mortgages under the new ratio. The average NPL ratio of the banking industry as per July 2015 was 2.7%. BI did not change the mortgage disbursement terms from banks to developers. First mortgages are still disbursed on a percentage of completion basis, while second mortgages onwards are disbursed when construction is completed.

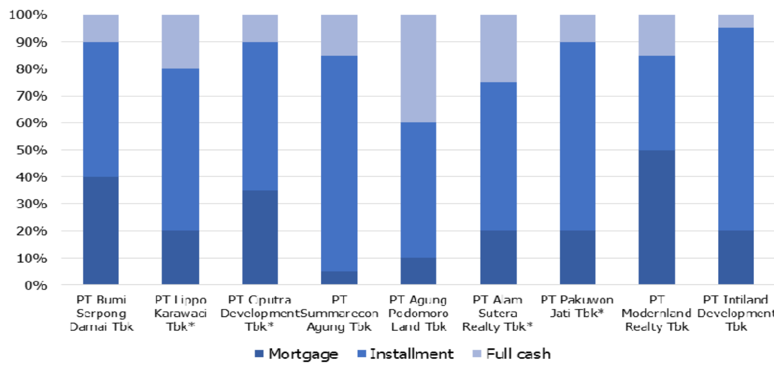
PEFINDO believes that the lower down payment requirements could stimulate growth, particularly in the middle class primary home market, which bodes well for the country's young demographic profile and expanding middle class segment. However, it is likely that the relaxation will not impact property sales straightaway, given the current slowing economy and more cautious consumer spending. We expect the impact to be felt in 4Q2015 or 1Q2016 at the latest, given our expectation of an improved economy and lower mortgage rates. In 2014, only 25% of developers' customer profiles were financed by mortgages. Within our coverage, PEFINDO notes that the lower LTV ratio is expected to benefit PT Bumi Serpong Damai Tbk (idAA-/Stable) and PT Modernland Realty Tbk (idA/Stable), as these two companies have the largest exposure to mortgage facilities relative to their peers.

Table 3. Current LTV policy (BI regulation No. 17/10/PBI/2015)

Property Type	1st Mortgage	2nd Mortgage	3rd Mortgage
Landed House			
>70 sqm	80%	70%	60%
22-70 sqm	n.a	80%	70%
<21 sqm	n.a	n.a	n.a
Apartment			
>70 sqm	80%	70%	60%
22-70 sqm	90%	80%	70%
<21 sqm	n.a	80%	70%
Shop houses	n.a	80%	70%

Source: Bank Indonesia

Figure 2. Payment method composition based on 2014 presales



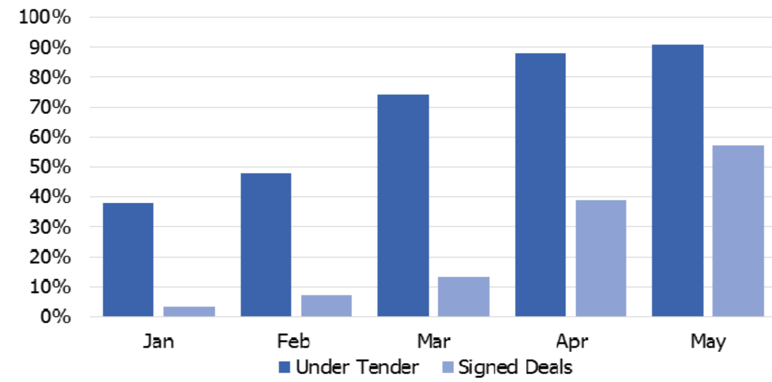
Source: PEFINDO database, companies report, and news ** Not rated*

Government disbursement on infrastructure spending

The government has allocated about IDR290 trillion (USD21 billion) for infrastructure spending based on the 2015 revised state budget, a 60% increase on 2014. However, up to June 30, 2015, its absorption rate was less than 10%. This was mainly due to severe bureaucratic issues, including land disputes, and political struggles between the ruling coalition and the opposition camp in the House of Representative. PEFINDO is of the view that government spending is key for economic improvement in the second half of 2015. The slower than expected economic growth in 1H2015 is expected to put pressure on the government to accelerate its infrastructure spending. In the past, a large portion of the state budget was spent during the fourth quarter or by year-end. Nevertheless, PEFINDO expects spending will likely come earlier than usual with the government's commitment to boost economic growth. The latest update is that the government plans to issue a presidential decree to speed up budget disbursements.

This, in our view, will improve economic growth to 5% during the second half of 2015 from 4.7% during 1H2015 (1H2014: 5.1%) as it will create a multiplier effect in the economy, and in turn improve purchasing power and domestic consumption over the medium term. It will eventually improve related industries, including the property sector. However, a downside scenario remains as a large shortfall in tax revenue could potentially lead to reduced spending. Tax revenue during 1H2015 reached IDR555.2 trillion, only 37.3% of the revised state budget.

Figure 3. Indonesian infrastructure projects (% of targeted projects)

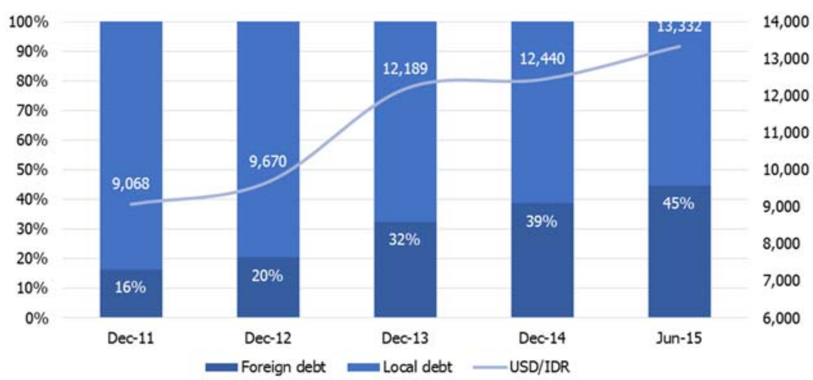


Source: Ministry of Public Works

Higher exposure to rupiah volatility

In recent years, more property developers entered the US dollar bond market to finance their expansion programs, given the lower interest rates, increasing the average proportion of foreign currency denominated debt to total debt to 45% as per June 2015, from 15% as of 2011. As all domestic transactions are currently banned from using foreign currency, Indonesian property players cannot generate foreign currency revenue for domestic transactions (existing USD contracts signed before July 1, 2015 will remain valid). This could hamper their capital structure and cash flow protection measures with exposure to US dollar denominated debt with no hedging activities when the rupiah depreciates against US dollar. To date, the rupiah has depreciated more than 15% against the dollar from the beginning of the year, and by nearly 60% over the past five years. PEFINDO expects this volatility will continue in the second half following a potential rate hike by the US Federal Reserve by end of year. We note that most players have partly hedged their bond principals to minimize foreign currency risks. But, interest was left unhedged, raising funding costs, thereby negatively affecting interest coverage.

Figure 4. Average foreign debt vs. local debt



Source: PEFINDO database

Conclusion

PEFINDO expects the majority of the credit ratings of property companies under our coverage to remain the same in the near term, backed by their relatively large sales backlog which provides sufficient revenue visibility for 2015-2016 and relatively stable EBITDA margins. However, we do expect revenue will grow at a slower pace in 2016-2018 compared to prior years due to deceleration in presales in 2014-1H2015 following a tighter mortgage policy issued by BI in September 2013, legislative and presidential elections in 2014, and a weakening economy and policy uncertainty in the beginning of 2015. Generally, revenue will be booked within 18-24 months of presales.

In addition, we anticipate there will be higher working capital needs following the new LTV ratio, with the proportion of customers using mortgages expected to increase in the medium term. Besides LTV relaxation, the new regulation also requires a guarantee from developers on top of the existing corporate guarantee for properties still under construction, in the form of fixed assets, moveable assets, bank guarantees, standby letters of credit (LC) and/or funds which are deposited and/or held in the bank lender's escrow account. This will pressurize developers' cash flow, thus testing their balance sheet capability as they need to finance the construction of the project upfront, internally or externally, as well as for collateral requirements. We also expect high capital spending for land acquisition to continue, particularly in secondary cities, given their rising prices and rapid economic development, with a large part expected to be financed by debt. Early land banking allows property players to ensure sufficient profitability levels for their future developments, in our view.

We anticipate a weakening in financial profiles, debt to EBITDA ratios in particular, in the near term, but do not expect this to breach our downgrade trigger of 4.0x. The average debt to EBITDA ratio of property companies under our coverage as of June 2015 was 3.0x. We project the average ratio at around 3.5x in 2015 and 3.0x in 2016.

Table 4. Rating comparison among peers (in IDR billion)

	PT Bumi Serpong Damai Tbk	PT Summarecon Agung Tbk	PT Agung Podomoro Land Tbk	PT Modernland Realty Tbk	PT Intiland Development Tbk	PT Duta Anggada Realty Tbk
for the period ended	*30-Jun-15*	*30-Jun-15*	*30-Jun-15*	*30-Jun-15*	*31-Mar-15*	*30-Jun-15*
Adjusted assets	34,600.4	17,172.4	24,050.4	9,844.2	9,026.9	5,324.5
Inventory	5,712.1	4,057.0	4,160.1	818.3	1,375.8	527.9
Real estate assets	8,330.6	5,284.3	4,299.8	4,343.3	3,245.3	329.0
Adjusted debt	7,460.6	4,953.2	6,457.0	3,797.8	2,304.4	1,516.8
Adjusted equity	21,249.7	6,856.1	8,403.5	4,040.0	4,589.0	3,384.7
Sales	3,367.1	2,596.7	2,775.7	1,413.6	603.3	561.3
EBITDA	1,798.3	963.9	930.3	551.9	163.9	231.3
Net income	1,415.3	529.3	351.1	215.3	120.7	141.2
GPM [%]	74.6	53.7	52.0	53.8	39.1	45.7
EBITDA margin [%]	53.4	37.1	33.5	39.0	27.2	41.2
Debt/EBITDA [x]	*2.1	*2.6	*3.5	*3.4	*3.5	*3.3
DER [x]	0.4	0.7	0.8	0.9	0.5	0.4
FFO/debt [%]	*40.7	*25.5	*17.8	*13.2	*14.0	*20.6
EBITDA/interest [x]	8.6	4.1	2.8	2.4	3.0	2.4
Rating	$_{id}$AA-/Stable	$_{id}$A+/Stable	$_{id}$A/Negative	$_{id}$A/Stable	$_{id}$A/Stable	$_{id}$A-/Stable

Source: PEFINDO database, 2015
FFO = EBITDA – IFCCI + gross interest income – current tax expense
EBITDA = operating profit + depreciation expense + amortization expense
IFCCI = gross interest expense + other financial charges + capitalized interest; (FX loss not included)
*MI = minority interest; * annualized*