

CONSTRUCTION

INDUSTRY

CONSTRUCTION INDUSTRY

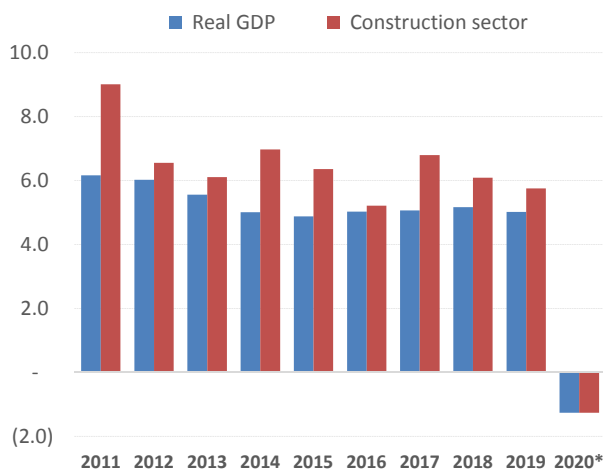
We view the outlook for construction industry will be challenging as growth prospects are weaker than we anticipated. The coronavirus (COVID-19) pandemic has resulted in reduced construction activities following the large-scale social restrictions (PSBB) imposed by the government to curb the outbreak, consequently delaying project deliveries. Demand is also expected to be weaker in the short term on the back of delays and postponement of several infrastructure projects and the economic fallout caused by COVID-19. Furthermore, the pandemic has also exposed the financial profiles of construction companies, especially small and medium contractors. Project delays can severely hinder their earnings and cash flows, making them vulnerable to non-performing. Meanwhile, from a competitive landscape, although the market consists of many players, state-owned contractors have a strategic position in the market, especially in government projects.

WEAKER GROWTH PROSPECTS IN SHORT TERM

We see a weaker outlook for the construction industry, with the real sector's contraction reducing demand for construction services. Project delays also weigh on growth prospects in the short term.

Growth in construction sector services is closely related to the real sector. Indonesia's economic growth contracted 5.32% YoY in 2Q2020 after a positive 2.97% YoY in 1Q2020, according to the Central Statistics Agency. Cumulatively, economic growth contracted 1.27% YoY in 1H2020, with the construction sector contracting by 1.26% YoY in the same period.

EXHIBIT 1. DOMESTIC ECONOMY AND CONSTRUCTION SECTOR GROWTH (% YOY)



*As of 1H2020
Source: Central Bureau of Statistics

EXHIBIT 2. BANK LOAN TO PROPERTY SECTOR BY TYPES OF USAGE (% YOY)



Source: Bank Indonesia

We expect construction demand from the property and real estate sector to remain weaker, as indicated by lending activities by banks. Bank Indonesia data shows that loans to the property sector grew by 4.0% YoY as of May 2020 to IDR1,025.6 trillion and the percentage of growth was significantly lower compared to the same period in the previous year (17.3% YoY).

Deteriorating economic conditions make buyers postpone spending decisions. Loan growth for residential property purchases slowed from 13.4% YoY in May 2019 to 2.7% YoY in May 2020 (to IDR501.4 trillion). With weaker demand, we are of the view that construction activities in the residential segment will be delayed.

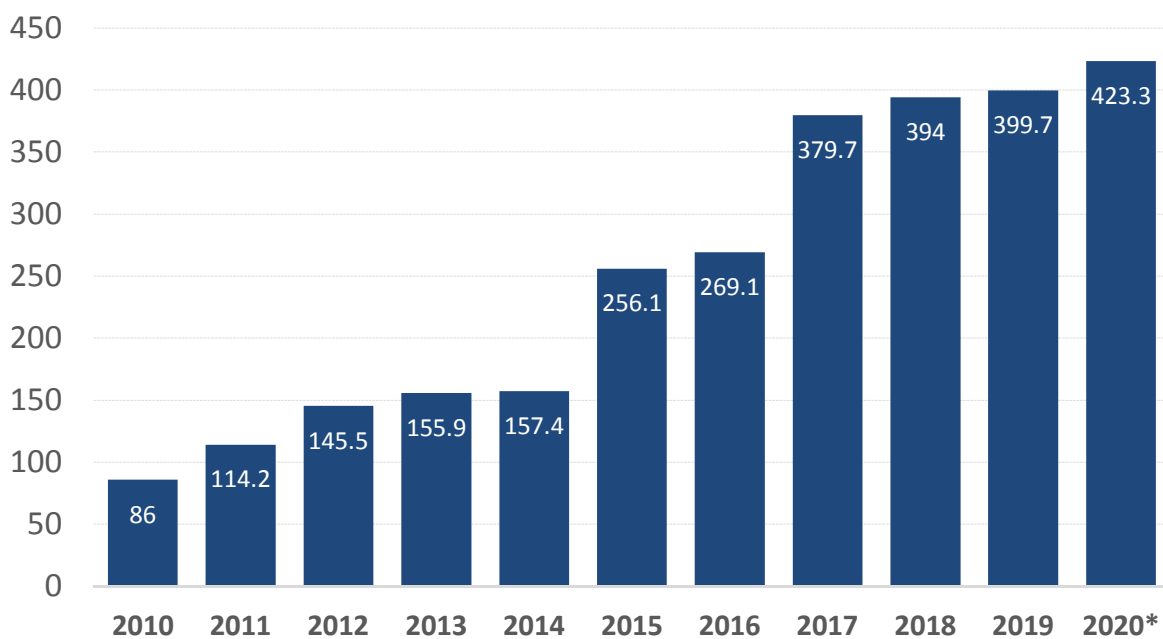


LARGE GOVERNMENT INFRASTRUCTURE SPENDING IS LIKELY TO BE DELAYED

Construction activity in the infrastructure sector is declining. To prevent the spread of COVID-19, the government imposed large-scale social restrictions, which included business closures and reduced operating hours for public transport. It also postponed the development of a number of infrastructure projects until 2021, such as the Sp Tohpati-Tjokroaminoto Bridge, the Baro Raya Irrigation Network in Aceh, and the Way Sekampung Dam. Phase 2 of the Jakarta Mass Rapid Transit System work (from the Hotel Indonesia Roundabout to the National Monument) was also delayed for three months.

The government has budgeted a large amount for infrastructure spending in 2020. Ministry of Finance data shows IDR423.3 trillion budgeted for infrastructure development in 2020, 5.9% higher than IDR399.7 trillion in 2019. However, we expect the realization to be much lower due to potential delays caused by government restrictions on outdoor activities due to COVID-19.

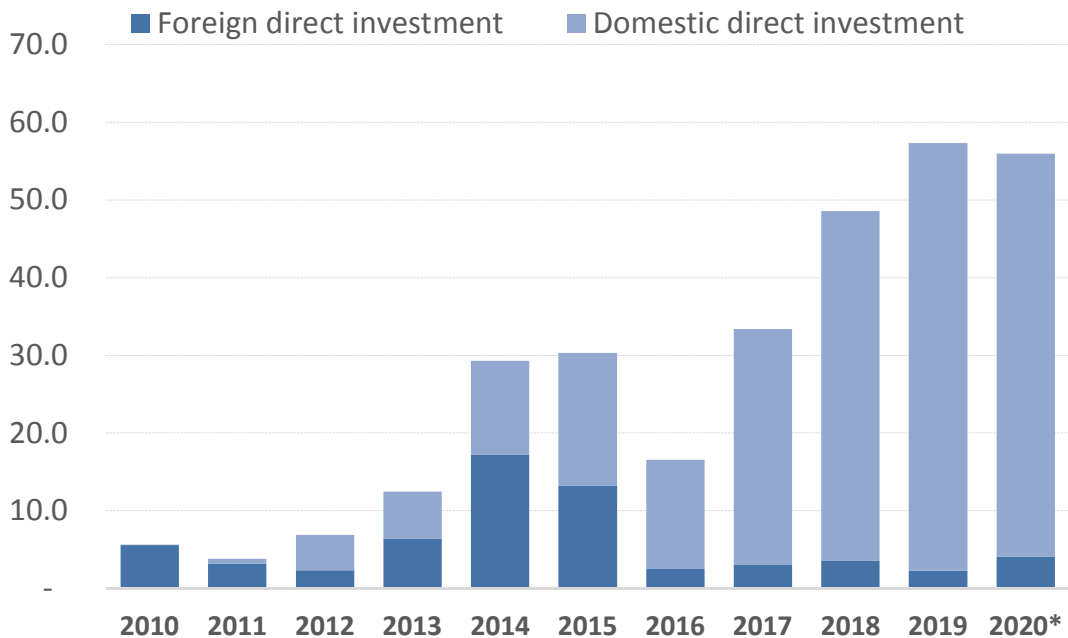
EXHIBIT 3. INFRASTRUCTURE BUDGET BY NATIONAL GOVERNMENT (IDR TRILLION)



Source: Ministry of Finance

Realized direct investment in the construction sector was IDR28.0 trillion in 1H2020, according to Investment Coordinating Board data. For the whole year, we estimate the realized value to be lower than the IDR57.3 trillion figure in 2019.

EXHIBIT 4. DIRECT INVESTMENT TO CONSTRUCTION SECTORS (IDR TRILLION)



**Annualized based on 1H2020 data
Source: Capital Investment Coordinating Board*

Of the total investment realization in 1H2020, IDR26.0 trillion or 92.7% of the total was domestic direct investment. Foreign direct investment accounted for the balance of IDR2.0 trillion.

Not only will this result in slower project completion, the social restriction policies can also cause delays in customer payment, which will have a negative impact on construction companies' profitability and cash flow.



POST COVID-19 DEVELOPMENT

Assuming COVID-19 ends, 2021 may be a monument to the growth of the construction industry. Infrastructure development projects delayed and postponed during the pandemic will be back on track. In its 2020-2024 medium-term development plan, the government prioritizes economic development with an estimated budget of IDR2,000 trillion. Among its targets are:

- Road connectivity along 2,500 km of toll roads, 3,000 km of national roads, 60,000 meters of bridges and 35,000 meters
- Construction of 60 dam units, 500,000 hectares of irrigated areas and 2,100 km of flood control
- Rehabilitation of 2.5 million hectares of irrigation networks
- Construction of 50,000 apartment units, 25,000 special housing units, 1.5 million independent houses and housing infrastructure, facilities and utilities for 500,000 units.

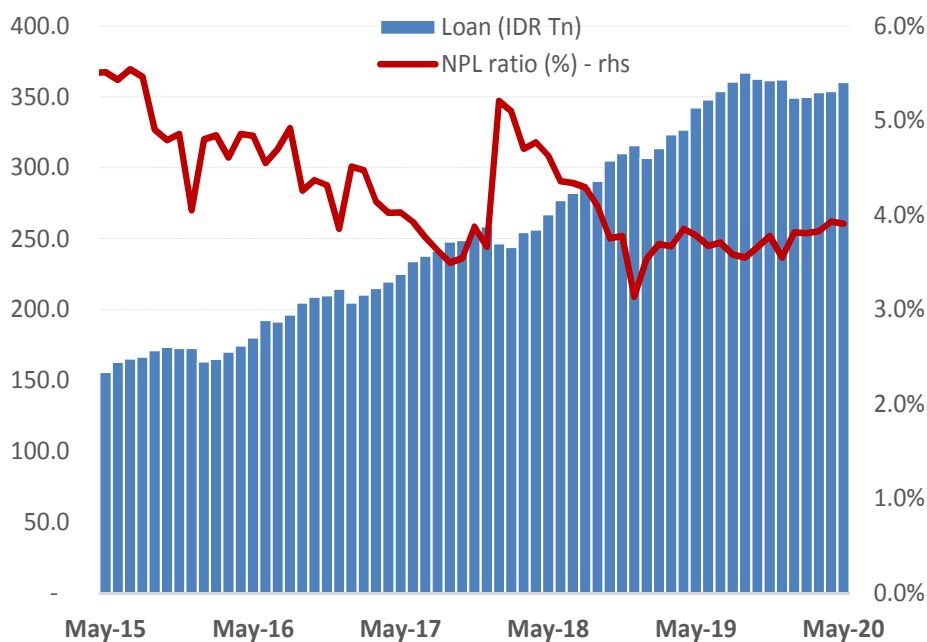
BAD LOAN IN THE CONSTRUCTION SECTOR

Commercial bank lending to the sector has slowed since October 2019. In May 2020, growth was only 5.2% YoY with an outstanding value of IDR360.5 trillion. This growth rate is much lower than the 28.1% YoY growth in May 2019 and the 2019 full year growth of 14.6% YoY.

Although cutting interest rates is usually a catalyst for increased lending, it is unlikely to have a major impact on new loan demand. Growth is likely to enter the negative territory in the next few quarters. Delays in construction and project auctions have slowed construction activities.

Cutting interest rates may be useful to reduce the level of leverage. Construction companies can raise funds to refinance overdue loans. But, if the pandemic prolongs, it could certainly disrupt contractor's cash flows and their ability to refinance, particularly for small- and medium-sized contractors.

EXHIBIT 5. COMMERCIAL BANK'S LOAN AND NON-PERFORMING LOAN TO CONSTRUCTION SECTORS



Source: Financial Services Authority

The risk of lending to the construction sector, as indicated by the non-performing loan (NPL) ratio, is relatively under control, because the pandemic has only lasted a few months so far. As of May 2020, the NPL ratio was 3.9%, up slightly from the 3.6% figure at the end of the previous year. However, a close examination based on the regional distribution of commercial loans shows that the NPL ratio of some areas has exceeded the national figure, especially in parts of Java where most of the loans are located. In Jakarta, which accounted for 66.8% of the outstanding construction loans nationwide, the NPL ratio increased from 1.8% at the end of 2019 to 2.1% in May 2020. The highest increase was in West Java, which rose from 6.6% to 9.3% in the same period.

EXHIBIT 6. COMMERCIAL LOAN TO CONSTRUCTION SECTOR BASED ON LOCATION

Province	Outstanding of commercial loan to construction sector (IDR billion)					NPL ratio (%)			
	2017	2018	2019	May-20	Share (%)*	2017	2018	2019	May-20
DKI Jakarta	158,501	200,370	234,344	240,902	66.8	2.2	2.1	1.8	2.1
East Java	16,939	21,887	23,107	22,230	6.2	4.5	3.2	4.4	4.8
West Java	20,116	22,024	24,140	22,159	6.1	3.9	2.7	6.6	9.3
Central Java	10,763	13,821	15,536	14,753	4.1	1.4	2.1	2.6	4.1
Banten	8,486	10,075	11,717	12,176	3.4	2.8	3.2	4.4	5.4
North Sumatra	8,206	9,511	9,851	9,137	2.5	5.2	4.3	5.9	6.7
East Kalimantan	3,689	4,364	7,250	7,132	2.0	10.3	8.2	14.0	13.8
South Sulawesi	6,805	6,047	6,390	5,325	1.5	20.6	18.7	19.0	9.7
South Sumatra	4,371	4,233	4,385	4,014	1.1	11.0	16.3	13.5	13.8
Riau	1,913	2,227	2,390	2,270	0.6	6.6	5.1	6.6	9.7
Bali	2,070	2,171	2,287	2,172	0.6	3.2	5.7	6.7	6.9
Papua	1,447	1,920	2,099	1,802	0.5	16.3	10.0	7.1	11.4
D.I Yogyakarta	1,092	1,372	1,554	1,609	0.4	1.6	1.1	7.2	7.7
North Sulawesi	1,114	1,405	1,695	1,589	0.4	6.8	5.9	4.5	5.4
South Kalimantan Total	1,378	1,687	1,492	1,473	0.4	4.6	4.3	9.2	10.4
Riau islands	1,545	1,659	1,590	1,462	0.4	4.7	3.3	5.5	5.9
Jambi	965	1,129	1,161	1,150	0.3	5.9	7.1	8.1	7.9
West Nusa Tenggara	820	893	1,087	981	0.3	1.2	3.5	4.5	7.2
West Kalimantan	1,421	1,262	1,186	971	0.3	3.7	6.8	11.1	15.8
Aceh	833	951	1,092	899	0.2	10.6	7.8	4.5	6.9
Lampung	1,259	1,103	1,033	866	0.2	2.6	2.5	5.1	7.8
Central Kalimantan	405	609	836	719	0.2	1.8	1.7	1.6	2.2
West Papua	594	776	777	707	0.2	3.5	2.3	4.3	3.7
East Nusa Tenggara	828	854	940	706	0.2	12.0	7.7	8.5	12.9
West Sumatra	668	658	732	622	0.2	3.1	2.3	7.5	9.9
Central Sulawesi	592	668	685	603	0.2	10.8	4.8	6.4	6.9
Southeast Sulawesi	524	589	539	554	0.2	10.4	6.8	8.5	9.7
Maluku	243	390	483	425	0.1	6.0	2.7	2.1	2.9
Others	226	372	920	283	0.1	1.2	0.8	-	0.1
Bangka Belitung	255	189	225	231	0.1	11.7	5.1	8.8	9.0
Bengkulu	269	344	258	220	0.1	3.1	7.2	10.0	17.4
North Maluku	341	278	212	148	0.0	5.5	8.0	7.6	8.7
Gorontalo	174	190	133	136	0.0	43.1	36.8	46.6	48.1
West Sulawesi	80	69	146	100	0.0	0.6	0.7	0.5	0.9

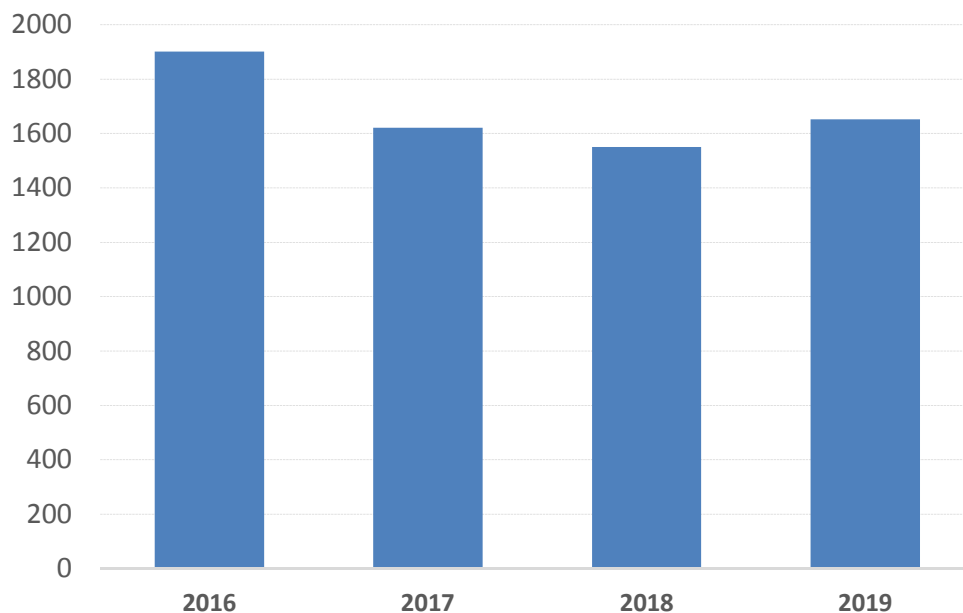
* Data is sorted based on outstanding May 2020.
Source: Financial Services Authority



COMPETITION LANDSCAPE

Indonesia's construction industry consists of so many companies. Many of them are small- and medium-sized contractors, which act as sub-contractors of large construction companies. Quoting data from the Central Statistics Agency, there were 1,653, 24,029, and 120,977 of large-, medium-, and small-sized construction companies as of 2019, respectively.

EXHIBIT 7. NUMBER OF LARGE CONSTRUCTION COMPANIES



Source: Central Bureau of Statistics

The state-owned construction companies have a strategic position on the competitive landscape. In recent years, they have benefited from the big-ticket size of infrastructure development by the government. Among the building construction companies that are listed in the stock exchange, state-contractors are among the top four based on their revenue in 2019, led by PT Waskita Karya Persero Tbk with revenues of IDR31.4 trillion, followed by PT Wijaya Karya Persero Tbk (IDR27.2 trillion), PT Pembangunan Perumahan Persero Tbk (IDR24.7 trillion), and PT Adhi Karya Persero Tbk (IDR15.3 trillion). Furthermore, apart from being resilient to economic downturns, government contracts carry a lower risk of payment, hence, it provides better financial visibility.

EXHIBIT 8. REVENUE BY LISTED BUILDING CONSTRUCTION COMPANIES* (IDR TRILLION)

Company	2018	2019	Share*
Waskita Karya (Persero) Tbk	48,789	31,387	20.6%
Wijaya Karya (Persero) Tbk	31,158	27,213	17.9%
PP (Persero) Tbk	25,120	24,660	16.2%
Hutama Karya (Persero)	36,748	26,391	17.4%
Adhi Karya (Persero) Tbk	15,655	15,308	10.1%
Jaya Konstruksi Manggala Pratama Tbk	5,157	5,471	3.6%
Wijaya Karya Bangunan Gedung Tbk	5,823	4,568	3.0%
Surya Semesta Internusa Tbk	3,682	4,006	2.6%
Acset Indonusa Tbk	3,725	3,947	2.6%
Nusa Raya Cipta Tbk	2,457	2,618	1.7%
Total Bangun Persada Tbk	2,783	2,475	1.6%
Indonesia Pondasi Raya Tbk	920	958	0.6%
Nusa Konstruksi Enjiniring Tbk	1,024	922	0.6%
Superkrane Mitra Utama Tbk	561	682	0.4%
Totalindo Eka Persada Tbk	1,458	681	0.4%
Paramita Bangun Sarana Tbk	359	608	0.4%
Cahayasakti Investindo Sukses Tbk	31	68	0.0%
Lancartama Sejati Tbk	57	41	0.0%
Total	185,507	152,004	100.0%

*As of 2019, both bond and stock issuers
Source: Company's Financial Statement

R REGULATION UPDATE

The Indonesian Financial Accounting Standards Board has released two financial accounting standard statements (PSAK), which, in our view, have a significant effect on financial reporting in the construction sector. This is part of the implementation of International Financial Reporting Standards (IFRS). The regulations have been in place since 2017, but implementation will only become mandatory in 2020. The two regulations are:

- PSAK 71 regarding financial instruments
- PSAK 72 regarding revenue from contracts with customers

Previously, companies were obliged to make provisions after a loss occurred. However, PSAK 71 mandates companies to provide provisions from the beginning of the receivable period. Because this has not yet occurred, companies must estimate the value based on future expected credit loss, where one of the considerations is future economic projections.

PSAK 71 also requires companies to reserve all categories of trade receivables, whether they are performing, underperforming or non-performing. With the pandemic, expectations of losses will likely be high amid the threat of an economic recession.

PSAK 72 changes the way contract revenue is recognized, from rules based to principles based. Construction companies will have to recognize revenue using the over time method or at the point of delivery (at a point in time).

The over time method can only be applied if it meets the more stringent requirements. If not, the company can only use the recognition method when handing over assets. With the latter, there is a possibility that revenue will accumulate at one point if the transfer of assets occurs at the same time.

