ICRA Indonesia Comment

April 2015

# Residential Estate: Sustained Demand and Tax Revision Challenge


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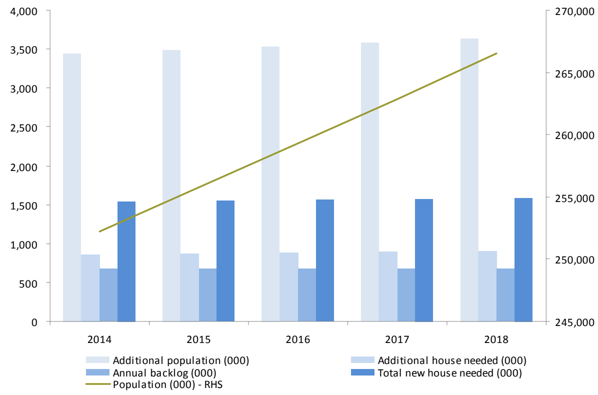
## Sustained demand for residential estate

Total Indonesia population stood at around 248.8 million in 2013, growing by 1.4% on average per annum in the last two years. It is projected that the population will increase by 3.4-3.6 million per annum during 2014-2018. Assuming a household consists of 4 people, there will be a demand for new houses of 860-910 thousand per annum. The development of new houses is critical as currently national backlog stands at about 13.6 million which is expected to be settled within 20 years, according to Ministry of Public Housing (MPH, 2012). At the Bottom line, it is predicted that Indonesia needs to develop 1.5-1.6 million new houses per annum until 2018 when the population is estimated to reach around 266.5 million.

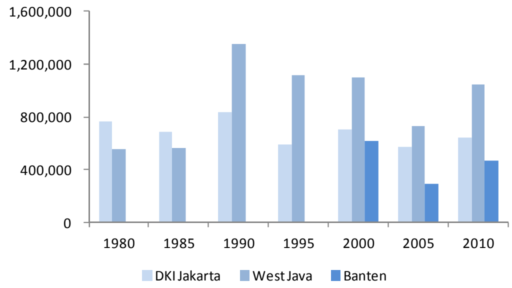
Exhibit 1 New housing need estimation




Source: BPS, ICRA Indonesia estimation

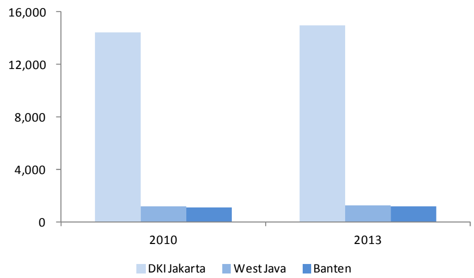
In addition, housing demand in big cities especially Jakarta and its surrounding areas is triggered by the uptrend in urbanization or people migration. In 2010, for instance, West Java province booked the highest migration level of 1,048,964 people (vs. 551,960 people in 1980) whilst Jakarta positioned as the second with a stable migration level of 643,959 people. Banten as a new province split from West Java also recorded a high migration level of 465,080 people. Meantime, given its limited land availability, Jakarta recorded the highest population density of around 15,015 people/sqkm (2013) followed by West Java (1,282 people/sqkm) and Banten (1,185 people/sqkm). High density will trigger demand for apartment in those cities due to limited land areas.

Exhibit 2a. Migration




Source: BPS

Exhibit 2b. Density

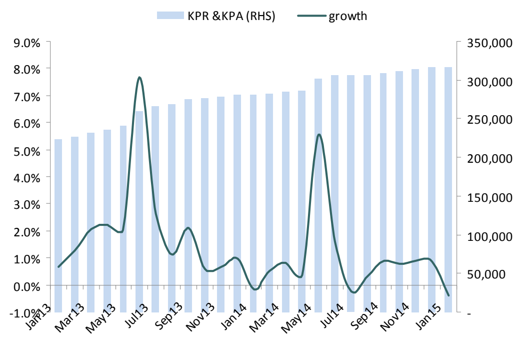



Source: BPS

Housing demand in the recent years has also been backed by accelerating mortgage loans provided by banks as seen in the Exhibit 3a below. However, as Bank Indonesia tightened Loan to Value (LTV) Ratio in September 2013, mortgage loan growth has since came down and only temporarily up during May-June 2014 following the positive sentiment over political situation post general election which spurred sales of residential properties.

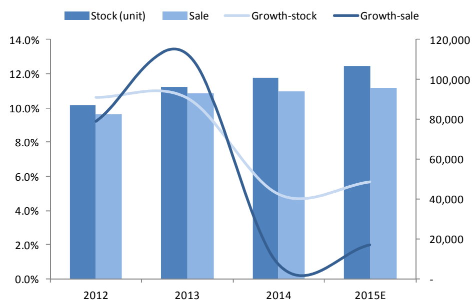
More specifically in the apartment segment, apartment for sale growth (in unit) for Jakarta, Bogor, Depok and Bekasi area (Jabodebek) of about 13.2% in 2013 was also backed by mortgage loans growth of 26.6%. As the loan expansion dipped to 12.8% in 2014, mainly due to the tighter LTV regulation, apartment for sale growth also weakened to only 0.9%. This is despite the players have introduced nil down payments, balloon payment or instalment with longer period as well as promotional strategies & incentives to attract buyers following the implementation of LTV ratio.

Exhibit 3a. Mortgage loan




Source: BI

Exhibit 3b. Demand & Supply (Apartment)

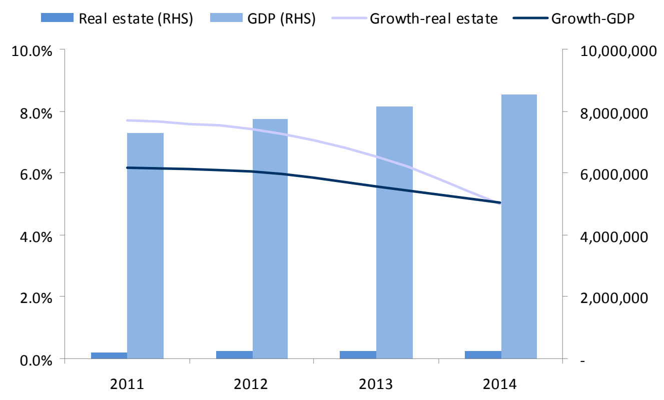



Source: BI survey, ICRA Ind's estimation

## Steady supply in tandem with the economy

The real estate sector moves in line with the economy as market is mostly driven by local economy with no foreigner is allowed to own apartment and landed house. As a component of GDP, normally, growth in the value of this sector is higher than GDP's as evident in 2011 (7.7% vs. 6.2%), 2012 (7.4% vs. 6.0%) and 2013 (6.5% vs. 5.6%). However in 2014, it only grew by 5.0%, broadly the same pace with GDP's owing to unfavorable market conditions including in liquidity, regulation and political events. Given the current steady economic growth estimate following the ongoing transition and reform by the new government, real sector growth is likely unchanged from last year. Aside from the above factors, the sector will likely be challenged by the upcoming tax revision on property transactions.

Exhibit 4 Real estate sector and GDP

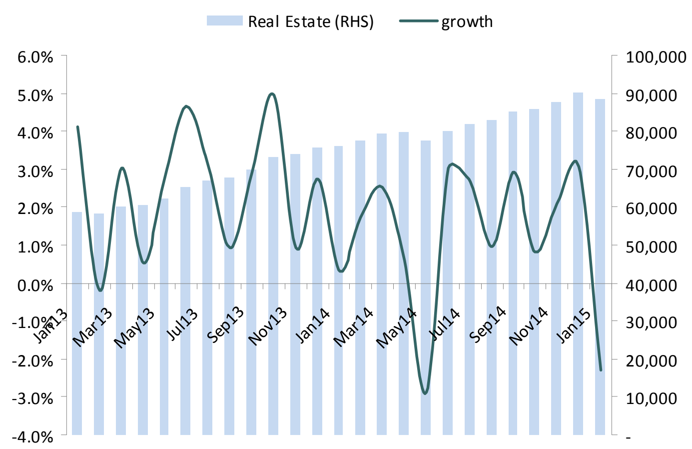



Source: BI

The supply of apartment for sale also grew by 5.0% in 2014 (Exhibit 3b) and ICRA Indonesia expects pretty much the same level of acceleration in 2015. In the Jabodebek area in particular, near-term supply of apartment will be backed by some new pipeline. Along the Jakarta area itself, total supply will be around 47,269 units in 2015-2016, contributed by Central Jakarta (21%), North Jakarta (20%), East Jakarta (19%), West Jakarta (18%), South Jakarta (17%), and CBD (5%) (Source: Colliers).

In tandem with the mortgage loan post implementation of the new LTV ratio, loans to real estate developers grew at a decelerating rate. The monthly growth was even worse during May 2014, as opposed to the mortgage loans, due to wait and see stance by the developers and the higher amount of down payments received from buyers. Likewise, the central bank reported that loan extended to this sector expanded at a slower pace of 19.1% in 2014 (vs. 34.8% a year earlier), which amounted to about IDR 90.4 trillion.

Exhibit 5 Real estate credit (mom)




Source: BI

## Regulatory framework will have an implication to the sector

*Non-tax regulations*

The current regulatory framework for real sector can be classified into non-tax- and tax-related. Along the non-tax-related, selected regulations affecting this industry are Minister of Public Housing Regulation No. 12 Year 2012 on balanced housing and residential area (development ratio) and BI's Circular Letter No. 15/40/DKMP Year 2013 on LTV ratio.

As per the requirement of development ratio regulation, the composition for low income unit, middle income unit and luxury unit is 3:2:1. Consequently, when a developer builds one luxury house, it has to build two houses for middle income, and three houses for low income. For commercial apartment (for sale) segment, developer is also obliged to develop at least 20% of total floor area for public or low income units. However, this regulation is likely difficult to be met by developers due mainly to price cap of low unit by MPH.

Meanwhile, the central bank reduced the LTV ratio for the purchase of a second property (landed properties and apartments > 70 sqm) to 60% and 50% for purchases beyond the second property. As mentioned previously, LTV ratio implementation has adversely impacted the mortgage loans which also resulted in slow down on bank credit for real estate.

Table 1 Non-tax Regulation

| Regulation | Remarks | Applied transaction | Implication |
|---|---|---|---|
| Minister of Public Housing (MPH) No. 10 Year 2012 | Balanced housing & residential areas | Primary | Difficult to build in the same area due to price cap of low unit income by MPH |
| | 1). Low :middle (income units) :luxury unit= 3:2:1 (residential) | | |
| | 2). 20% of total floor for low income unit (commercial apartment) | | |
| Circular Letter No. 15/40/DKMP | Loan to Value ratio | Primary & secondary | Declining mortgage loan growth |

Source: Various sources

*Tax regulations*

The above apart, the upcoming tax revision will likely be the main concern for developers to affect the primary market of residential sector. In brief, there are three areas of tax likely to be revised in the near future, namely PBB (land & building tax), PPH 22 (income tax), and PPNBM (luxury tax).

Implication of the revised land & building tax set by the government with a current property market value as a basis is expected to be neutral as it will reflect the current market value of property when sold, both in primary and secondary market.

Meanwhile, an income tax of 5% will be imposed to property transaction for landed house and apartment worth more than IDR 2 billion per unit (vs. IDR 10 billion for houses more than 500sqm or apartment larger than 400sqm previously). Furthermore, the government is also proposing to lower the price limit of the property transaction value for the imposition of luxury tax or PPNBM (20%) to IDR 2 billion per unit from IDR 10 billion for houses larger than 350sqm or apartment larger than 150sqm.

Table 2 Current and upcoming tax revision

| Regulation | Remarks | Applied transaction | Implication |
|---|---|---|---|
| Law No. 12 Year 1985 | Land & building tax (PBB), adjusted once every three years<br>0.5% times Nilai Jual Kena Pajak | | |
| *Revision plan* | Current property market value (prize zoning) | Primary & secondary | Neutral |
| Govt Regulation No. 48 Year 1994 | PPH 22 (income tax)<br>5% of total property value<br>(H: >IDR 10 billion & > 500sqm)<br>(A: >IDR 10 billion & > 400sqm) | | |
| *Revision plan* | 5% of total property value<br>(H: >IDR 2 billion)<br>(A: >IDR 2 billion) | Primary | Negative for players with main focus on high-end residentials & higher proportion of investment |
| PMK No. 103 Year 2009 | PPNBM (luxury tax)<br>20% of total property value<br>(H: > 350sqm)<br>(A: > 150sqm) | | |
| *Revision plan* | (H: >IDR 2 billion)<br>(A: >IDR 2 billion) | Primary | Negative for players with main focus on high-end residentials & higher proportion of investment |

Source: Various sources

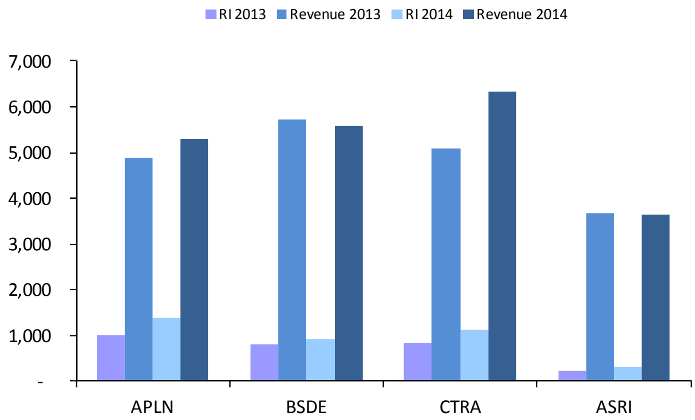
*Implications to this sector*

If these tax revisions are approved, purchases of properties that are in accordance with the revised regulations would be subjected to a total transaction tax of 40%. It consists of value added tax of 10%, an income tax of 5%, a luxury tax of 20% and a property transfer fee of 5%. Consequently, the price of landed house and apartment would increase as developers are likely to pass on the tax increments to the consumers. In ICRA Indonesia's view, the increase in prices may pressure the demand and supply of residential estates and can cause a slowdown in this sector going forward. However, the impacts will vary among the players within this industry. Due to the luxury tax, developers of luxury properties will be more affected compared to players focusing on non-luxury projects.

## Diversification to minimize concentration risks

ICRA Indonesia sees diversification as one of the key success factors in the industry as it can minimize any concentration risks. For residential companies, diversification could be done in many ways. In terms of product offerings, they can offer various types of property such as shopping mall, office building, mixed use building and industrial estate apart from landed house & apartment. However more importantly, they can lease their properties to receive recurring income which is critical especially when the economy is slowing down. On the latter, for instance, key listed players in the domestic real estate sector have shown various profiles as reflected in the Exhibit 6 below.

Exhibit 6 Recurring income & total revenue (billion)



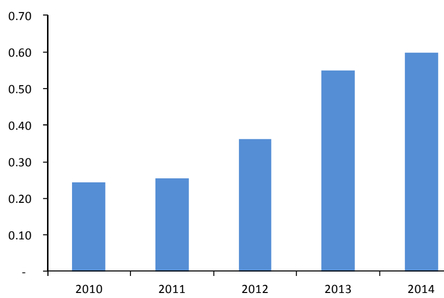

Source: Companies' FS

Further, they can lease it to both individuals and corporations. In addition to local people, they can also lease the property to expatriates who are not allowed to own property in Indonesia. Currently, there are about 97,645 expatriates working in Indonesia which can be a potential target market for property. Diversified locations (Java & non-Java) as well as consumer income profile (low, medium to high segment) would also position developers better to mitigate concentration and business risk.

## Performance snapshot of key players

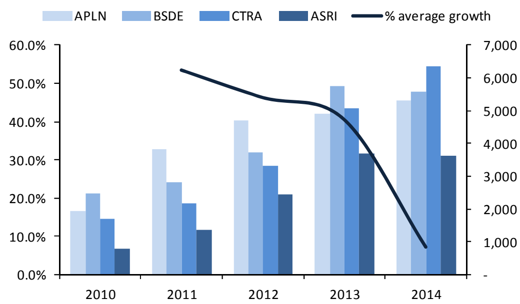
Rivalry in the real estate industry in general remains high as market is fragmented considering a large numbers of players including 45 listed developers. Overall, key developers booked a lower growth of revenue in 2014 at about 7.2% (vs. 40.5% in 2013) due to economic slowdown. Diversification to recurring income by key developers, however, has supported their revenue profile as shown in the previous chart. For 2015, ICRA Indonesia expects revenue of these key players to by grow about 7.0%, taking into account the impact of the revised tax regulations. On the other hand, developers are expected to increase their capital expenditure spending in the near-term given their new supply pipelines especially those located in Jakarta. Fortunately, this will be backed by a favourable debt to equity ratio (less than 1.0x) recorded in 2014.

Exhibit 7a. DER




Source: Companies' FS

Exhibit 7b. Revenue (billion)




Source: Companies' FS

## Summing up

Demand for residential estates is expected to sustain amidst increasing needs of new housing due to growing population, urbanization and current national backlog. For 2015, ICRA Indonesia expects the residential segment to expand by around 5%, taking into account the growth of overall real estate sector during 2014, the expected GDP growth for 2015 and challenges that will be faced by this sector, including the implication of the proposed revision in the tax regulations.