Sinarmas Sekuritas Investment Research

TOUGHER TIME AHEAD

Challenging Banking Outlook

Bank Indonesia announced Indonesia foreign exchange reserves fall to $98,1 bn. Inflation June hike to 5,9 %. BI has increased the BI Rate by another 50bps this month to control inflation and maintain Rupiah. There are two main reasons why BI should increase the reference rate: 1) to slow down the inflation, 2) to maintain the stability of Rupiah. BI also has tightened LTV regulation which due on September 2013

Funding. In the midst of rising inflation, most of the banks tend to increase their deposit rate in order to maintain the attractiveness of the funding side. The increasing deposit rate leads to an increase in their Cost of Fund (CoF), therefore it will also reduce their Net Interest Margin (NIM).

Lending. The rising funding rate will push Banks to increase their lending rate. On the other hand, the tightened LTV will pressure Banks even worse. Banks should be able to determine the suitable rate based on their type of loans, target market, and peer competition.

Which Banks are More Prepared during The Period of Tightening

We expect that Banks should have these several conditions to be able cope with this situation. The conditions are the followings :

- The low risk of Non-performing Loan (NPL)
- Banks focus more on improving their credit portfolio on Small Medium Enterprise (SME), including Micro
- The low Cost of Funding (CoF) coupled with efficient BOPO

Sector Update
Sector : Banking

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Challenging Banking Outlook

Our economy has been facing two unfavorable conditions. The first one is the increase in the price of fuel subsidy last month and the increasing demand for consumer goods during Ramadhan and Idul Fitri which will temporarily increase this month inflation rate. We expect the July inflation rate will jump to 7.2% year on year from 5.9% last month.

The second is our June Foreign Reserve data which came out unfavorable to the economy at US$ 98.1 bn, the lowest since February 2011. Bank Indonesia need to spend around US$ 7 mn in order to reduce capital outflow from Indonesia during period of June. Moreover, the pressure on our Balance of Payment need to be closely watched on. It has been declining to negative US$ 6.6 bn, the lowest since 2008. It put much pressure on our Indonesian Rupiah which has been depreciating around 3.1% since the beginning of this year to approximately Rp 9980 to Rp 10100.

Exhibit 1. USD/IDR Year to Date

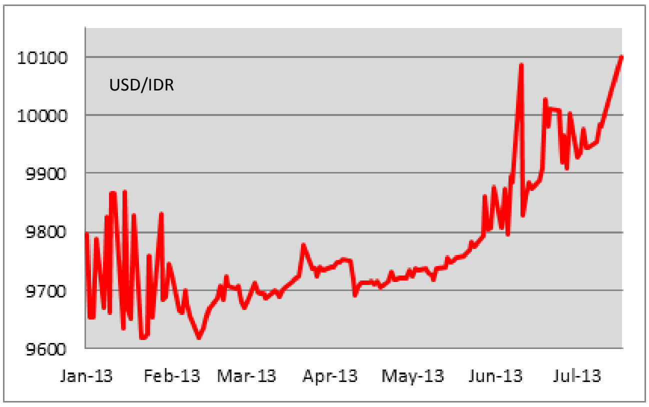
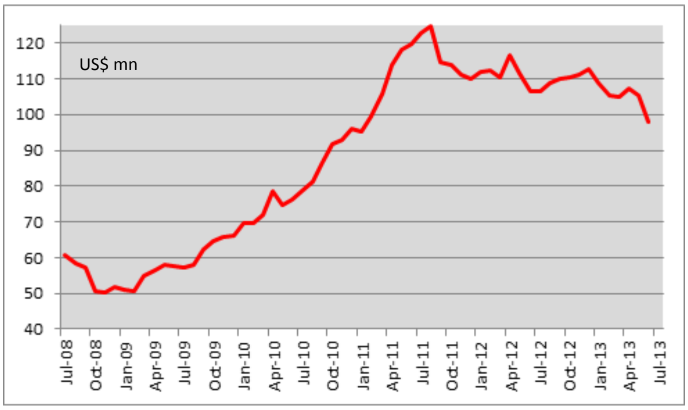


Exhibit 2. Indonesia Foreign Reserve



Source: Bloomberg, Sinarmas Sekuritas Research

Therefore, considering all those conditions, we see that BI has taken reasonable action to raise the BI rate by another 50 bps to 6.50%. The consequences of the increase will be having direct impact to the Financial sector, particularly Banking sector. We believe that Banks' funding and lending rate are the two main vulnerable components to the changing of it. In addition, BI has also tightened the Loan To Value (LTV) regulation in order to control the property prices. The regulation demands more down payment should be paid for second or third property sizes above $70m^2$. The down payment ranges from 30%-50% depending on the ownership. This will eventually pressure Banks' lending growth even worse.

Exhibit 3. Relation between Inflation Rate, BI rate, and Funding Rate

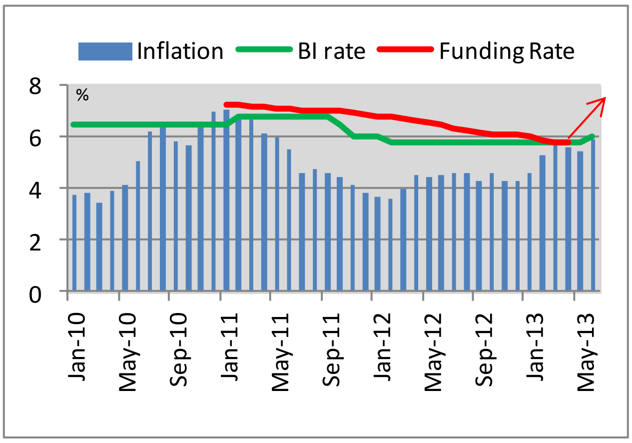
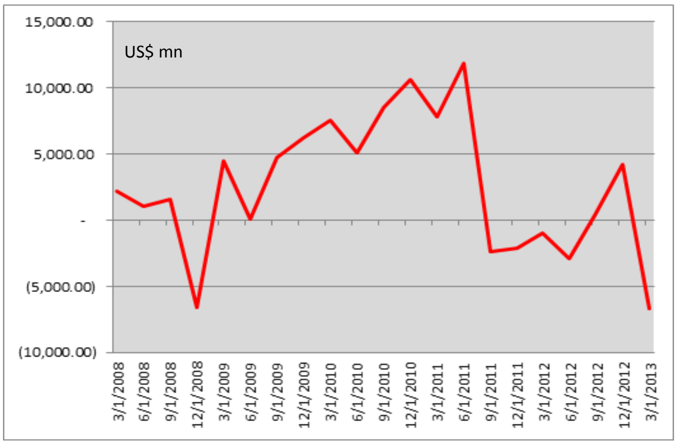


Exhibit 4. Indonesia Balance of Payment



Source: BI, Bloomberg, Sinarmas Sekuritas Research

Funding is Becoming More Competitive

Banks tend to raise both their funding and lending rate due to the reference rate increase. Doing so will cost banks on their liability side due to an increase in Cost of Funding (CoF). We see from Exhibit 3 that the Funding Rate is represented by average 12 Month Time Deposit (TD) Rate. It also shows that BI has been consistent with the BI rate since February 2012. The current increase of 75 bps to 6.50% would need to be considered by banks since there is a trend that Funding Cost is generally higher than BI rate due to competition.

The Funding Cost decreased from 7.23% in January 2011 to 5.79% in April 2013, just two months prior to the announcement of a surge of BI rate to 6%. We consider that it is the time for Banks to increase their Time Deposit rate.

Lending is Expected to Slow Due to Rising Rate

Even before BI started to raise the interest rate, the appetite to lend is already decreasing. It is because the increase in the Cost of Funds usually will be followed by the increase in the lending rate, otherwise it would put further pressure on their Net Interest Margin (NIM). Several Indonesian banks have already anticipated the period of high inflation shown by CIMB Niaga "working capital loan" rate has already increase by 12.09% yoy from 14.14% to 15,85% by 26 June 2013 just before the announcement of an increase in the price of fuel subsidy by the government (Kontan, June 28 2013). The increase in the lending rate would be a bad signal for creditors. Creditors would be more reluctant to take credit in a period of hiking credit rate. The hiking credit rate could heavily cost their ability of debt repayment.

The data compiled by BI support our argument. According to the BI survey, the new credit applications has been decreasing among all credit areas. Exhibit 5 reflects that all new credit appliance including working capital loan, investment loan and consumer loan declined quite significantly in 1Q13. For instance, the most significant decline shown by the demand for new consumer loan which reach 19% appliances in 1Q12 decreased by more than twice in 1Q13 to only 7% appliances. The effect of this increasing rate will reduce the volume of the Banks' Loan. If we look at Exhibit 6 shows the all three new loan group by debtors also shows a decreasing trend new loan application since the end of last year. However, comparing it year on year, the decrease is only applied on Non micro SME (Non UMKM) debtors which decrease from 47 new loan demand application in 1Q12 to only 26 of it in 1Q13. We conclude that both the increasing Cost of Funds and the decreasing volume of loan certainly are not conditions that banks want to be faced with.

Exhibit 5. Classification of Demand for New Loan Based on Usage

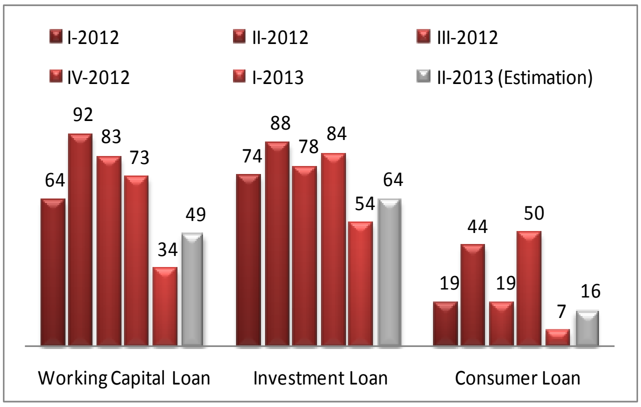
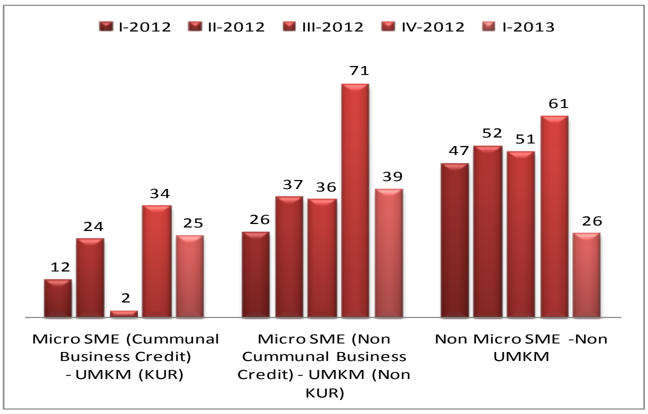


Exhibit 6. Classification of Demand for New Loan Group of debtors



Source: BI Survey Perbankan, Sinarmas Sekuritas

Which Banks are More Prepaid during The Period of Tightening

The Low Risk of Non Performing Loan (NPL). We prefer BBCA in this case.

According to sensitive global environment , banks NPL is one of the factors affect the health of banks. Banks with Low NPL show their ability to maintain low risks of uncollectable debt, even though credit segmentation is also other factor that will influence the level of NPL.

Mostly large banks have good track records in maintaining their low NPL below 2 (shows in exhibit 7). In this case, BCA are most benefited by keeping their NPL at the lowest level among others. Based on our ground survey on February 2013, we conclude that smaller banks are more lenient in approving loan compared to large banks. Historically, regional development banks have a higher risk of NPL due to their lack of supervision. Therefore, we prefer BCA due to their NPL achievement.

Exhibit 7. Indonesia Bank's NPL and NIM

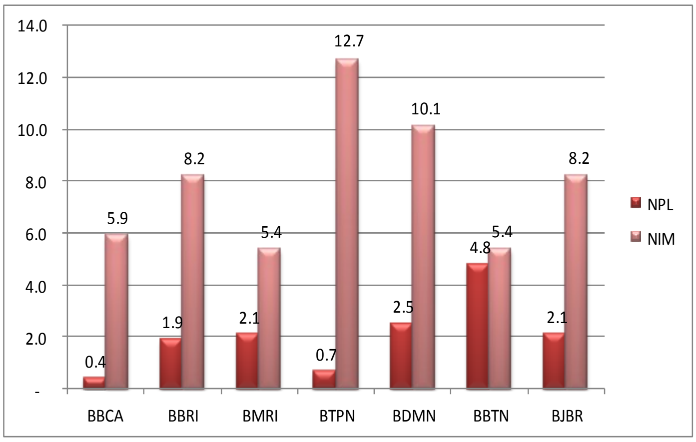
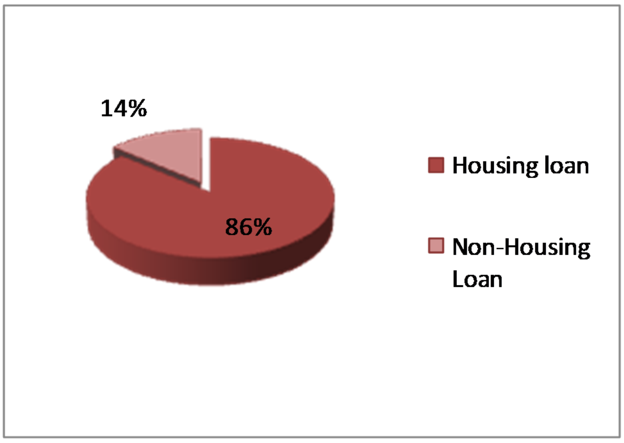


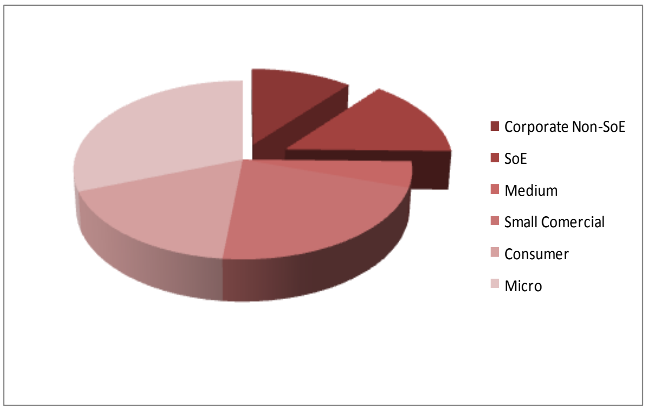
Exhibit 8. Loan Composition of Bank Tabungan Negara



Source: Company, Sinarmas Sekuritas Research

On the other side, we see that Bank Tabungan Negara (BTN) have the highest risk in their NPL among our data in Exhibit 7. Considering the further rising on lending rate and the tightened LTV regulation, BTN portfolio which is primarily dominated by housing loans by more than 80% will weaken the bank's balance sheet. Housing loans comprised of two different rates which are fixed and floating rate. Thus, when the fixed rate period is over, the lender will be facing with higher monthly floating debt repayment which could lead to higher risk of default.

Exhibit 9. Loan Composition of Bank Rakyat Indonesia



Source: Company, Sinarmas Sekuritas Research

Banks that are focus more on improving their credit portfolio on Small Medium Enterprise (SME), including Micro). That is why we are positive on BBRI.

Based on classification of credit by debtors, banks with credit segment focused more on SME and Micro will give additional advantages for the bank. Micro segment are rely more on volume rather than value which gives an ample room to enhance their fee based income. BRI has biggest number of customers (42mn) compare to two other biggest banks in Indonesia (BMRI :12mn and BCA : 11mn).

Sector Update

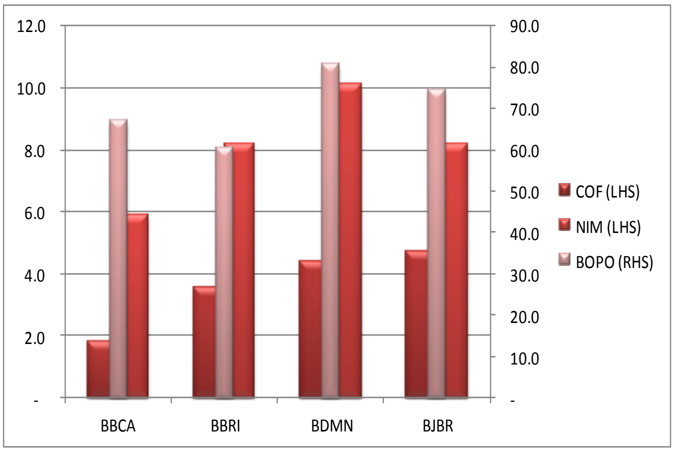
BANKING SECTOR

Micro segment usually are more familiar with the imposition of high interest rate. Slight increase of the rate would not bring significant impact to their ability to pay.

In addition, We believe that SME sectors are less susceptible during a global economic crisis because firstly, SME segment does not heavily depend on the credit from financial or banking sectors compare to big firms. Secondly, contribution of SME and Micro firms to our export/ import are less significant than large firms. Thus, they are less exposed to the exchange rate risk. Last but not least, most of them produce products of daily needs which are less demand sensitive even in a state of crisis. One example of Banks that well-known with their Micro and SME segment is shown in Exhibit 9. It reflects that BRI have more than 70% of their loan portfolio to the Micro and SME segment. Therefore, we conclude that we prefer due to their strength in Micro and SME segment.

The Low Cost of Funding (CoF) coupled with Efficient BOPO. Again, BBCA is a less risky bet for investors.

Exhibit 10. Banks Financial Ratio



Source: Company, Sinarmas Sekuritas Research

Having a good reputation and integrity will give a bank bargaining power to remain attractive for customers even if they give low funding rate. For example, BCA without spending a high interest expense is still able to collect large amount of funding. Indonesian people, particularly who are living in urban city, have been using BCA for their daily transactions since decades. That is why BCA have the lowest CoF compared to other banks.

One other thing, we can also see the ratio of operating expense to operating income (BOPO) in order to measure the level of Banks' effectiveness. Normally, smaller banks will have a higher BOPO ratio compared to larger banks.

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