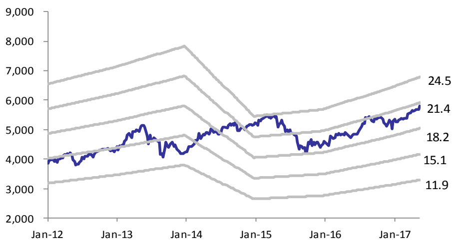
Monday, 22 May 2017

Market Outlook

Investment grade!

JCI Index **IDR5,791**

JCI PE Band



S&P finally upgraded Indonesia's sovereign rating to BBB-, investment grade. The impact is fundamentally positive for the equity market as it lowers the risk free rate and ultimately reduces the cost of debt shouldered by companies listed on the Indonesian Stock Exchange. While we are still assessing the impact on the risk free rate, we note that some sectors which are driven by debt financing will benefit from this upgrade. Property, construction, as well as the automotive and cement sectors should be the main beneficiaries.

S&P has upgraded Indonesia's sovereign rating to BBB- which automatically makes Indonesia an investment grade country. After a long wait of two years, the upgrade comes as a relief for the government and investors as it should lower the cost of funds. The yield on 10-year government bonds declined by 50bps from 7.3% in the morning to 6.8% following the upgrade. The impact on the equity market is less direct, in our view. The risk free rate, as a basis for making equity valuations should also be adjusted. However, we need to assess the impact further as the yield decline may also be affected by the market's over-reaction.

Some sectors stand to be the main beneficiaries. As the downward shift in the yield curve should reflect a lower cost of debt, companies in sectors whose growth is driven by the availability of affordable financing should benefit the most. We believe that the property, construction, automotive and cement sectors will be the main beneficiaries. By comparison, the banking sector - which profits from the interest rate spread - may not benefit that much from the upgrade, other than obtaining broader access to debt markets.

Cheaper mortgages translate into more affordable property. We also believe that the rating upgrade will positively impact the property sector since the mortgage rate may potentially decline. This, in turn, will make property more affordable. Among the property companies under our coverage, the proportion of properties sold to consumers using mortgages ranges from 5-60%. However, as marketing sales are a function of overall economic growth, in the absence of a considerable improvement in purchasing power, marketing sales are unlikely to see a significant improvement in our opinion.

Upgrade has been priced in. We believe that the run-up in Indonesian stock valuations over the last 4 years has been driven by the phenomenon of fund flows into Emerging Markets. As for the S&P upgrade, we believe that it is likely to have only a short-term impact as investors will ultimately judge companies by their earnings growth and quality. For FY17, we forecast 14% EPS growth coming off a low base in 2016 along with a visible recovery in line with the rebound in commodity prices. Nonetheless, the JCI is now trading at 20.9x 12 months fwd PE – all positive expectations have been priced in, our view.

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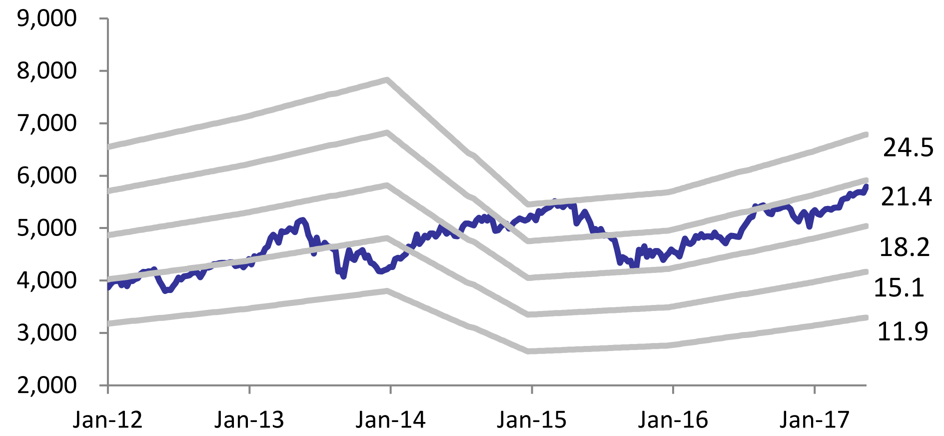
Exhibit 1. JCI PE bands



Source: Bloomberg, Danareksa Sekuritas

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