MIKE SELL
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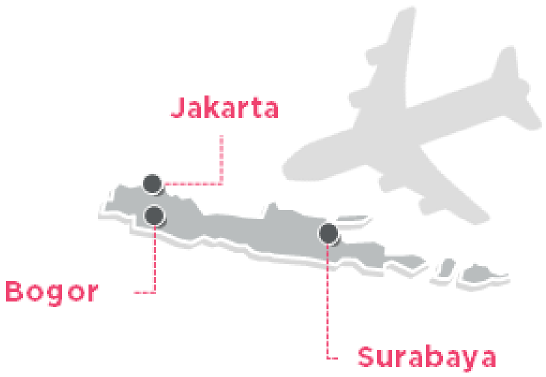
INDONESIA: OVERLOOKED AND UNLOVED



Mike Sell, Alquity's Head of Asian Investments, spent a week in Indonesia for his regular on-the-ground meetings with local companies. Mike had 16 meetings and 33 store visits in 3 cities with the goal of re-assessing the macroeconomic and business outlook ahead of Presidential elections in April, and to discover new potential ideas for the portfolios. As a result of the trip, followed by further desk-based analysis, we have already increased our weighting across our portfolios and expect to continue to do so.

INDONESIA FROM A BIRD'S EYE VIEW

Indonesia **has been largely ignored by investors** despite the country's sound inherent characteristics and its solid economic prospects. The country perfectly encapsulates our key investment themes of monetisable **structural growth opportunities**. Indonesia has a large population of about 264mn people, which is expected to steadily increase at a rate of 1.3% per annum. Indonesia's population is also very young with an average age of 31.2, whilst in countries such as the United Kingdom or Germany, the average age of the population is as high as 40.2 and 45.9, respectively. Meanwhile, the rate of urbanisation has been rising as well (from 42% in 2000 to 55% in 2017), which shows that there is an ongoing gradual shift from low-value added rural economic activities to high(er) value-added industries, which in turn translates into a sustained increase in the purchasing power of households. The trend of rising urbanisation will continue, and the rate is expected to hit 63% by 2030.

Furthermore, the political strength and popularity of President Joko "Jokowi" Widodo allowed for the initiation of **deep structural reforms** in 2014-15 that addressed some of the economy's deficiencies and will ease the constraints on GDP growth over time. The reasons to implement reforms were twofold:

1. to avoid the re-occurrence of excessive macroeconomic volatility vis-à-vis balance of payments vulnerabilities that torpedoed Indonesia's economic growth during the Asian crisis in the late 1990s
2. to improve the country's growth potential in an attempt to circumvent the "middle-income trap", i.e. the most common chronic disease of emerging economies that prevents them joining the league of developed markets

The ongoing reforms are based on three coherent pillars:

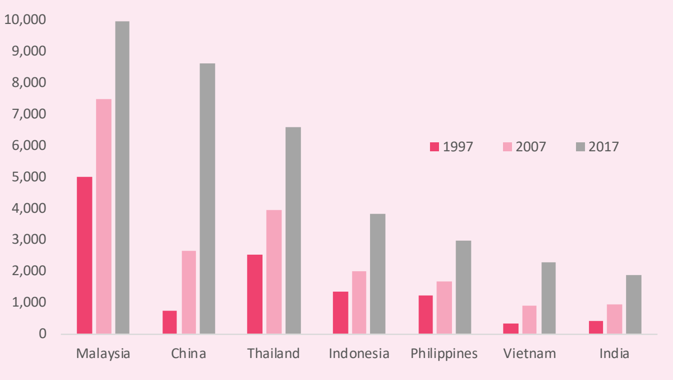
1. an infrastructure construction and development programme on an unprecedented scale to reduce transportation time and costs
2. the bureaucratic and administrative frameworks ("soft infrastructure") have been revisited and tweaked to create a more conducive business environment
3. attempts have been made to capture a greater portion of high(er) value-added industries to

substitute away from the export of raw and intermediate goods

We saw first-hand that some of the reforms have already had a meaningful impact– such as the improved infrastructure in the Greater Jakarta metropolitan area, the world's second largest urban agglomeration after Tokyo. Furthermore, there has been a **tangible improvement in the business environment**. According to the World Bank's Ease of Doing Business index, Indonesia was ranked between 120 and 130 (out of 190) before the Jokowi-led government took office in 2014. Since then, the country's ranking has significantly improved (ranked 73 in 2019) on the back of a streamlined state bureaucracy and tax administration. However, the progress in terms of capturing a greater portion of the high(er) value-added industries has been limited so far.

Overall, we believe that the total magnitude of the reforms is comparable to the demonetisation and the introduction of the goods and services tax in India, and will ultimately result in a structural shift. Furthermore, they will have a long-lasting boosting effect on economic activity through more robust domestic drivers (e.g. stronger purchasing power of households) and a more diverse export base with greater value-added. These favourable developments could lift Indonesia's potential GDP growth rate in the medium- to long-term, from the current 5-5.5% range, and drive GDP per capita towards countries such as Thailand and Malaysia (see graph below).

Graph 1: GDP per capita in USD (current prices)



Source: Oxford Economics

> ***Indonesia perfectly encapsulates our key investment themes of monetisable structural growth opportunities: young population, rising rates of urbanisation and roll-out of structural reforms.***

Whilst investors have recognised the magnitude of the Modi government's reforms in India, **asset prices have not yet benefitted from the same attention in Indonesia.** The fact that the Indonesian stock market does not enjoy the attention of capital market participants – which it deserves – is demonstrated by capital flows throughout 2018, when equity-type portfolio holdings were sharply sold off with a capital outflow of IDR 70.8tn (or USD 5bn; see graph below). Consequently, the country's JCI stock index is currently trading below its 5- and 10-year averages on a trailing price to earnings basis, and thus, provides an attractive entry point from a risk-reward aspect. We believe that the catalyst that will attract the attention of investors' and trigger capital flows into the country is **the upcoming election this April.** Of course, recent more accommodative Fed commentary will also be particularly supportive for Indonesia.

Graph 2: Net cumulated equity flow to Indonesia since 2010 (IDR bn)

Source: Bloomberg. Alquity calculations

INDONESIA

OVERLOOKED & UNLOVED

MACROECONOMIC STABILITY WITH A PINCH OF ASSET PRICE VOLATILITY

Indonesia has a long and tumultuous economic history, including the turbulent years of the late 1990s, when the country's economy and financial markets were turned upside-down due to the contagious effect of the Asian crisis. Although GDP growth was robust, fiscal accounts registered a surplus, the current account deficit was manageable and the import coverage ratio of FX reserves was at an adequate level, Indonesia still suffered a great deal, due to the extremely high exposure to USD-denominated external debt maturing in just a year's time – double the amount of the country's FX reserves in 1997. Due to the turbulence in markets, companies could not roll over their maturing short-term USD-debt. The adverse market sentiment was so extreme that it triggered an unstoppable vicious cycle of currency weakness leading to further defaults leading to further currency weakness. At the time, the IMF's bailout package played the role of a circuit breaker.

Since the Asian crisis, the country has recovered, re-entered the primary bond market and real GDP growth has stabilised at around a 5.5% average growth rate between 2000 and 2018. Meanwhile, **external financial vulnerabilities have been reduced** by accumulating FX reserves and reducing short-term external debt (below 37% of reserves; equating to 10-times import coverage at end-2017). Household debt, private non-financial corporate debt and gross public debt to GDP ratios were also at comfortably low levels at the end of 2017, namely approximately 17%, 40% and 34%, respectively. Although the country's external financial vulnerability has been mitigated to an enormous degree, financial imbalances are still present to a limited extent in the form of a twin deficit (less than 2% of GDP budget deficit and about 3% of GDP current account deficit in 2018) and a bond market, where non-resident investors have a dominant role (ca. 38% of government bonds were held by non-residents at end-2018).

Looking forward, **our expectation of sustained and stable GDP growth of above 5% was confirmed by the companies that we met, without exception.** However, we are conscious that Indonesian financial asset prices may not mimic the same degree of stability, due to their particular sensitivity to global market sentiment. In other words, when overseas investors' appetite for risk assets decrease, Indonesian assets tend to suffer, and vice versa, i.e. the openness of Indonesia's capital markets also imply that asset prices substantially benefit from an upbeat global sentiment. Our base case is that investors' appetite for risk will remain positive, due to the Fed's pause in its rate hike cycle.

PRESIDENT JOKOWI'S VICTORY COULD BE THE TRIGGER EVENT

President Jokowi's coalition of nine parties currently possesses 62% of Parliamentary seats, while there are five parties in opposition. The upcoming Presidential election in April will be a rematch of the fight seen in 2014, although probably not an exciting one, since the incumbent President and his government will probably secure over 50% of popular votes, according to recent opinion polls, whilst his opponent, Prabowo, attracts about 30% of votes. **We see Jokowi's victory as the catalyst for increasing capital inflows, both from domestic and foreign investors,** once the election related uncertainty is over.

HIGHLIGHTS FROM OUR ON-THE-GROUND MEETINGS

Our focus on this trip was on beneficiaries of structural growth, following on from our brief visit in November 2018. Given Jokowi's focus on infrastructure, we met with Indocement which operates 25mt capacity in Java, and is part of the Heidelberg Cement group. We know from our extensive meetings with their Indian sister company (where we are invested) that the Group standards on Environmental and Social issues meet our expectations. This was re-iterated in our meeting in Jakarta. **Our bespoke red flags are clearly met:**

- health and safety policy in place
- accident rates and water usage are published (and have declined over the last three years)
- reduced sulphur and nitrogen dioxide emissions by 39% since 2008 and dust by 42%

Cement consumption in **Indonesia is just 262kg per capita – similar to India at 244kg**, and a fraction of Thailand (458), Malaysia (763) or China (1648). This is an area that has previously generated good returns for shareholders. Industry utilisation reached 91% in 2012, before excess capacity was created (notably by the Chinese) resulting in a crash in utilisation to 61% in 2017. After a few difficult years and industry consolidation, the demand supply balance has begun to turn favourable. However, valuations already reflect the near-term potential and thus we will wait for a more attractive entry opportunity.

Following numerous management meetings and store visits in three cities, **our clear view is that the consumer sector is highly polarised**. Low-end retailers have been gaining customers from the unorganised sector, as Indonesia's poverty rate gradually decreases (still around 10% of the total population in 2017, i.e. ca. 26mn people). Previously, we repeatedly met with Ramayana which caters to exactly this low-end segment – and visited several of their stores to test our hypothesis on the ground on this trip. This remains a potential investment opportunity, as it does in India, Bangladesh, Philippines, Vietnam, etc.

Matahari Store

Ramayana Store

However, the mid- and high-end of the retail sector is facing increasing competition from e-commerce, such as Lazada, JD.com or Tokopedia. This has been much faster than expected. Low credit card penetration (about 1.6% of total population vs. 12.8% in Asia) and bank account penetration of only 36% of working age group vs. 90%+ in Malaysia, Thailand, India and China would initially suggest that the conditions required for e-payment and e-commerce transactions are not yet in place. However, **the underpenetrated credit card market has not proved to be a barrier**, because the Indonesian consumer has moved straight to digital wallet/mobile payment solutions. Thus, our search was for companies that possess a very strong sustainable competitive advantage, which allows them to withstand or benefit from the e-commerce onslaught. Indonesia is basically following the path of China in this regard.

Furthermore, the mid-end is being squeezed by changing desires. The Instagram generation is focusing more on aspirational products (e.g. travel) or electronic gadgets (for example Erajaya Swasembada, a mobile phone distributor, generated sales growth of over 50% in 2018). **Smartphone penetration is estimated to be 60-70% for Indonesia,** and 80-90% in Java – driven by Chinese brands. In addition, customers increasingly want more sophisticated handsets. As a result, an electronics retail environment dominated by mom and pop stores (with 50-60% market share) continues to offer a tremendous growth potential for the organised sector.

As well as being squeezed by differing tastes and e-commerce, the mid-high market is also suffering from the growth of high-end, aspiring retailers, such as Ranch (whose supermarkets would not look out of place in the UK) or lifestyle retailers, e.g. Ace, whose stores and product range are significantly better than older, tired brands (for example Hypermart). A more general, but consistent takeaway from all our meetings however is that despite Indonesia's perennial currency volatility, and government regulations designed to protect traditional retail, companies are adept at dealing with these challenges, and repeatedly highlighted that this is not a major issue for them.

Indonesia has a number of powerful home-grown consumer brands. Examples include Mayorah Indah (focuses on biscuits, coffee and sweets), who dominates the multinational competitors in terms of allocated space in stores, which we saw first-hand. Kino is a much less well-known company, with their beverage brands (for example Cap Panda) and personal care products (such as Ellips hair protection) prominently displayed in numerous retail formats. These companies are ideally positioned to benefit from Indonesia's structural growth potential, namely a young population and rising urbanisation levels. Their strong brands provide a sustainable competitive advantage that can benefit from the onslaught of e-commerce rather than be threatened by this seismic change.

Kino's product range

As part of our process, we undertake due-diligence / store visits to cross-check that managements' descriptions are validated (and over the years we have sometimes been very disappointed with the reality of the product positioning, such as with a Singaporean beverage company). In the case of Kino, we were (rarely) positively surprised. Their products occupy niche segments, focused on urban women, that are not saturated by multinationals like Unilever. This is an area where we will undertake further research, as these brands could become power brands across the region. Similarly, Nippon Indosari's – a company we own – 'Sari Roti' bread product is prominently displayed in every store type (and have a 65% share in the ubiquitous minimarkets). KKR have increased their stake in the company from 15% to 18%, which displays confidence in the outlook, and are supporting management on a day-to-day basis. A company such as **Nippon Indosari, which is benefiting from Indonesia's structural growth and dominates its product segment, but remains attractively valued, is hugely appealing.**

We also met with four companies from the financial sector, an area that we have been following for over 15 years. Despite the expectations for further interest rates hikes in 2019 after a cumulative 175bp policy rate increase in 2018, we saw no emerging signs of stress. This would be called into question if palm oil or coal prices were to collapse (and is also partly because banks have not passed on the full extent of the interest rate increase so as not to stress their clients). But neither we, nor the banks, have any concerns on the outlook for loan growth which is expected to be in low teens for 2019, with corporate customers requiring financing for capacity expansion for the first time in many years (a point re-iterated by Kino who could not keep up with demand for certain products). This sector was perhaps one of the highlights of the trip. Managements are again adept at navigating government restrictions (for example on ATM fees) and preparing aggressively for digital banking. Bank Mandiri, which is undergoing a transformation under the new CEO, grew net profit 20% in the first three quarters of 2018, despite the above. **We have initiated a position in the bank** due to attractive valuations (with the trailing price to book at a discount to the 5 year average) which do not reflect either the improving macro environment, the long term growth opportunity, nor the company-specific restructuring.

ESG FOCUS

Indonesia is a regional laggard in terms of Environmental, Social and Governance disclosures. Companies in frontier markets, who require capital are prodded in terms of ESG compliance by multilateral institutions, such as the IFC. Indian and Chinese companies are increasingly responding to the appalling pollution levels in their major cities. Developed countries such as Hong Kong are adopting ESG reporting, following best practice from the West. Indonesia is not part of any of those trends, and thus dialogue and education with companies are very important. Thailand and Malaysia would also fall into the same category, from our recent interactions there, albeit less so.

It is important to consider that countries are not the same, and a one size fits all approach to ESG does not work. There are typically minimal (or zero) independent directors in Indonesia, because the Board of Directors is 'internal'. Oversight is provided by the Board of Commissioners, where there are external members, but their independence is questionable in many cases. However, comfort is provided by the fact that the audit committee typically includes external accountants, who are neither Directors or Commissioners. Only Vietnam operates a similar system, and in any case is moving towards Western practice of an integrated board, but there is no sign of that in Indonesia. Thus, **we must be sure that companies are being run in the interests of minority shareholders and that the mindset of management and minorities is aligned. This can only be achieved by face to face meetings, rather than a tick box approach.**

It is also noteworthy that companies want to change. We had an in-depth conversation with one of the largest companies in Indonesia regarding the certification to local (not international) standards of their palm oil plantations as well as the increasing trend for investors to divest all coal related holdings. This apparently is not an area that most investors discuss with them, even now. Engagement is a key part of our process, as we believe we are on a shared journey with the companies that we invest in. Our focus and priorities in this regard are very much **on increasing levels of independent oversight in corporate structures, and a greater concentration on Environmental issues**. Some companies are beginning to produce detailed sustainability reports – which will be mandatory in a couple of years (as has happened already in Hong Kong). Banks are beginning to incorporate sustainability into their lending decisions, and whilst they admit they have a long way to go, this is very encouraging.

CONCLUSION

Indonesia has been largely ignored by investors despite the country's sound inherent characteristics and its solid economic prospects. ***The country perfectly encapsulates our key investment themes of monetisable structural growth opportunities thanks to its young and steadily rising population, ongoing urbanisation and the roll-out of structural reforms.*** *Reforms by President Jokowi's government have already improved the country's growth prospects. This has not been appreciated by markets, which is also proven by the fact that investors' aggregate exposure to Indonesia is at historical lows. The re-election of Jokowi should result in capital flows targeting Indonesia again.*

Consequently, we are of the view that the Indonesian market offers an attractive entry point from a risk-reward aspect, since there are some excellent companies, who sustainably benefit from the country's structural domestic growth momentum. Such stories can be found in industries such as cement, consumer or financials. We have already increased the weighting across our funds and expect to continue to do so.

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