October 2020

INDONESIA

THE MOST UNDERAPPRECIATED COUNTRY IN SOUTH EAST ASIA?

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Alquity

LIFE CHANGING INVESTMENTS

SUMMARY

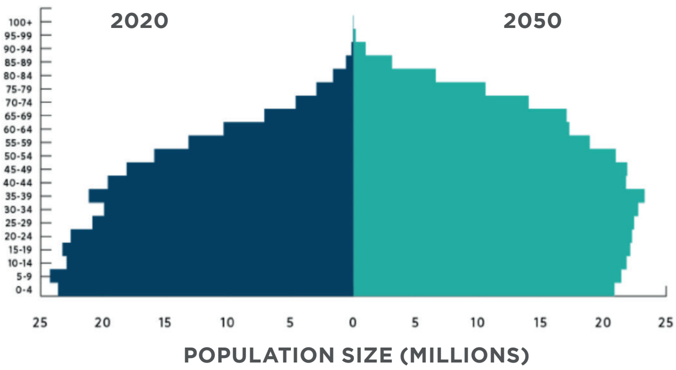
- Indonesia has exciting **long-term structural advantages**, which have been forgotten by investors
- We expect an **economic upturn due to both monetary and fiscal stimulus**, coupled with major structural reform which could be a powerful catalyst
- This is not reflected in market valuations, and thus **we can readily identify attractive well-run companies**
- **Indonesia is therefore one of our greatest differentiators** versus peers and indices

INTRODUCTION

Indonesia is the largest economy in Southeast Asia, both in terms of population and size of the economy. Indonesia's population is the 4th largest globally with over 270.6 million people and has grown by an average 1.3% p.a. over the last 10 years. The absolute size of Indonesia's economy amounted to US$1.12tn in 2019, which is the 16th globally. Within an ASEAN context, Indonesia's economy substantially exceeds the Thai (US$543.6bn), Philippine (US$376.8bn) and Vietnamese economies (US$261.9bn).

Most importantly, the favourable demographics of the country will boost economic growth in the next 30 years, according to UN population projections. Currently, the median age of Indonesia's population is just below 30, broadly matching India's estimated median age, which makes Indonesia one of the youngest nations on Earth. In comparison, the median age in China and the US is around 38, over 40 in the UK and around 44 in Western Europe. The UN projects Indonesia's median age to be 38.5 in 2050 (under a constant fertility rate assumption). The Indonesian population is young and will stay young in the next 30 years.

Figure 1: Indonesia's demographics remain favourable for the next 30 years



With a median age just below 30, Indonesia is one of the youngest nations on Earth.

Source: UN World Population Prospects (2019)

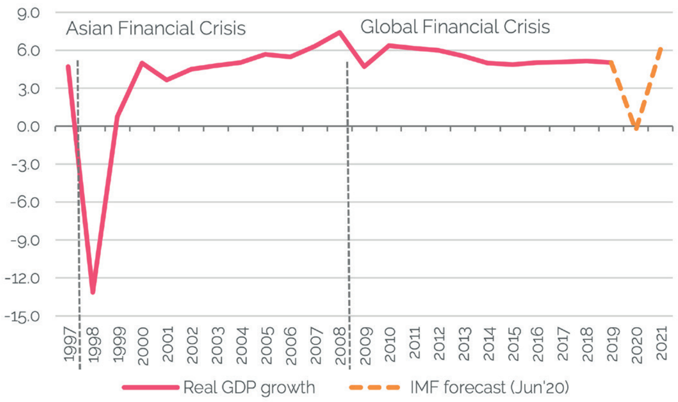
Furthermore, **the economy is also going to benefit from continued urbanisation**, an important structural growth driver in emerging economies. According to the World Bank, only 56% of Indonesia's population lives in urban areas, a markedly lower ratio than in developed countries, such as Japan (92%), the UK (84%), the US (82%) and Germany (77%).

Companies in our portfolio such as **Nippon Indosari** (bread), **Kino** (personal care) and **Ramayana** (retail) **are positioned to benefit from these long-term structural factors**.

FIRST RECESSION IN TWO DECADES

Indonesia has enjoyed two decades of sustained economic growth since the Asian Financial Crisis of 1997. Between 1999 and 2019, the average rate of GDP growth was 5.1% per annum. This long streak of consistent expansion, which was barely dented by the Global Financial Crisis, ended this year due to the coronavirus pandemic. Real GDP growth started to slow in the first quarter of 2020, to 3% YoY, as the initial negative impact of the coronavirus weighed on economic activity. Business conditions further worsened in the second quarter, with GDP contracting 5.3% YoY due to the containment measures. As a result of the social distancing and regional lockdowns, household spending and investment activity fell 5.5% YoY and 8.6% YoY, respectively.

Figure 2: Real GDP growth since 1997 and forecast

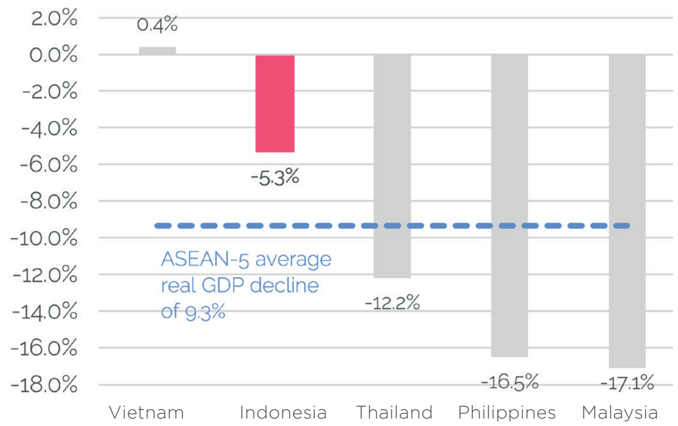


Indonesia managed to grow at an average 5.1% between 1999 and 2019.

Source: IMF (2020)

Within an ASEAN context, Indonesia was not impacted as severely as the Thai, Philippine, or Malay economies in the first half of the year. This is because the Indonesian government opted for a less stringent and decentralised approach, where local administrations had a say in the formulation of the Covid-related regulations. Thus, **there was no strict nationwide lockdown in place, but only local-level restrictions**, such as a ban on domestic travel during the Lebaran (Eid) holiday period. These local measures – outside of Jakarta – have been gradually eased. For example, factories were allowed to re-open after June, including those where staff had been found infected if special measures were implemented.

Figure 3: Annual real GDP change vs ASEAN-5 average in 2Q20

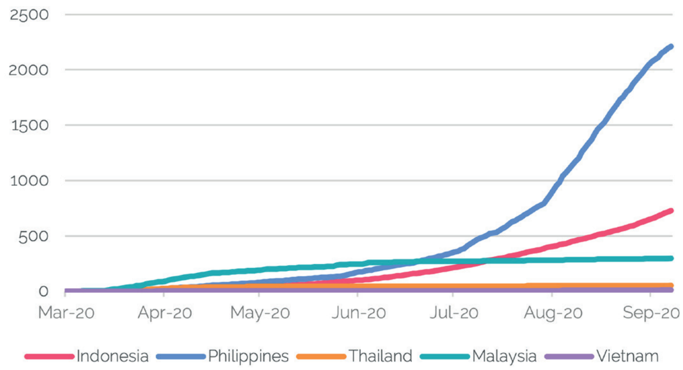


Indonesia has been less impacted than the Thai, Philippine and Malay economies.

Source: Bloomberg, Alquity calculations (June 2020)

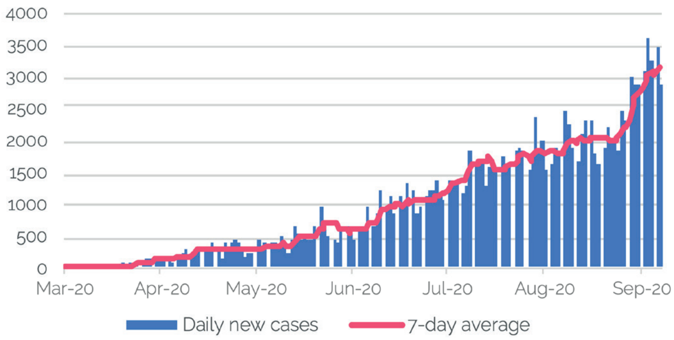
The benefit of the Indonesian government's more lax approach to social distancing and social mobility is the **smaller adverse impact on economic activity**. Government officials argued that the large-scale social restrictions allowed some economic activities to continue. On the other hand, **the drawback is the continued spread of the virus**. As a result, the total number of confirmed cases further rose and became the second highest in Southeast Asia with over 196,000 cases, after the Philippines, where the total number of cases exceeded 238,000 (as of the 7th September).

Figure 4: Number of cases per million people



Source: Bloomberg, Alquity calculations (September 2020)

Figure 5: Daily number of new cases in Indonesia



Source: Bloomberg, Alquity calculations (September 2020)

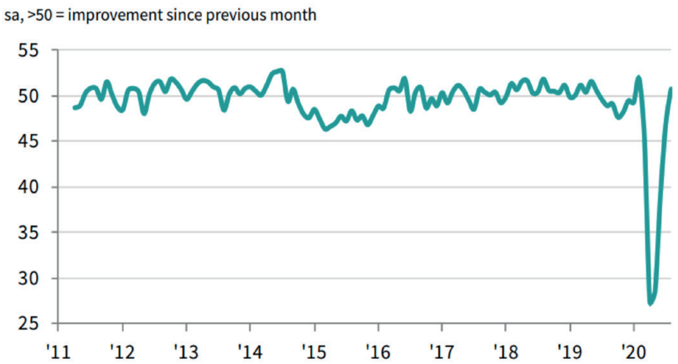
On the other hand, although the **mortality rate** came down from 7.8% in April to 4.2% in August, it **remains above the global average of 3.6%**. The higher-than-global average mortality rate is explained by the fact that Indonesia has not ramped up its testing capacity yet, despite the government's pledge to do so. **The suboptimal testing activity is also evidenced by the high positivity rate of 14% in August** - surpassing the WHO's 5% benchmark. The WHO recommends performing one test per 1,000 population per week, which would require Indonesia to conduct almost 270,000 tests per week. However, the number of tests conducted is only about 35% of the recommended amount.

COUNTER-CYCLICAL MACRO POLICIES BOOST THE RECOVERY

The Indonesian economy hit the bottom in 2Q20 after which mobility restrictions were eased. **As mobility data shows, a sustained recovery has begun, and activity was halfway back to its pre-crisis levels as of August**. We expect this favourable trend to persist.

Our thesis is supported by the latest manufacturing PMI print in August, which rose to 50.8 – returning to expansionary territory. The industrial sector was supported by the reopening fo factories, which are now allowed to operate again.

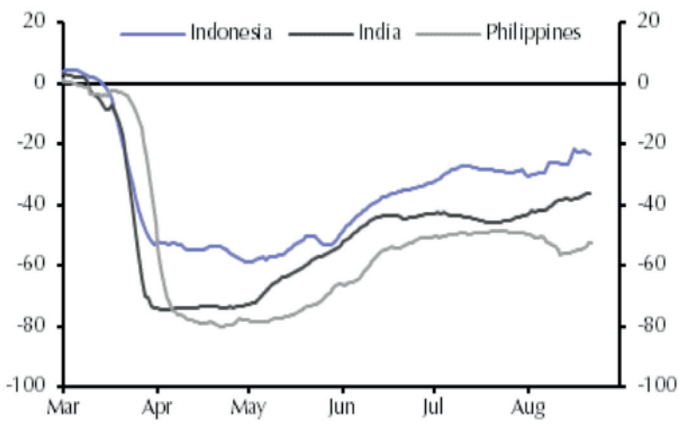
Figure 6: Indonesia's PMI



Recovery underway – Outperforming regional peers.

Source: IHS Markit (September 2020)

Figure 7: Difference from pre-crisis baseline



Mitigating the pandemic damage, as well as boosting the pace of the impending recovery.

Source: Capital Economics (September 2020)

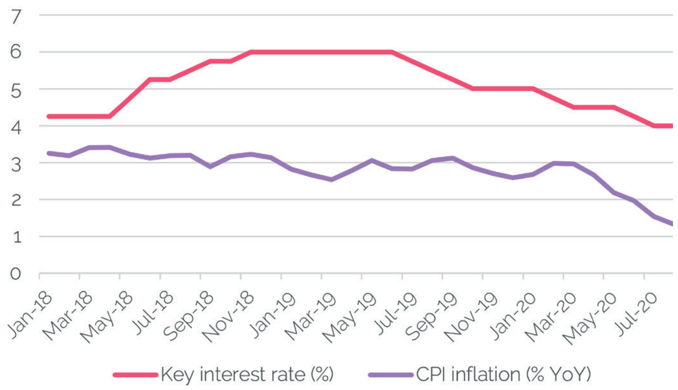
Jokowi presented an updated budget for 2020 and 2021, which is counter-cyclical in nature and provides a **fiscal cushion to the economy to mitigate the pandemic damage, as well as boosting the pace of the impending recovery**. The government's budget bill breaks away from the fiscally prudent track record (i.e. a budget balance between +0.4% and -2.6% of GDP since 1997), as the budget deficit is forecast to widen to 6.3% of GDP in 2020 and to 5.5% of GDP in the following year. The government's commitment to a swift cyclical recovery is also evidenced by the rapid removal of political and legal hurdles to temporarily bypass the statutory deficit limit.

Most importantly, **the budget will favour infrastructure development** in 2021, which will create new jobs on a large scale and improve geographical connectivity, such as the completion of the Trans Sumatra toll roads. Overall, infrastructure spending will be 15% of total budgetary outlays in 2021, which means that it will be 5.1% higher than in 2019. **Ramping up infrastructure development is positive for our holding Indocement.**

Counter-cyclical macro policies have been further boosted by the Central Bank. The key policy rate has been reduced by 100bp to 4% since the beginning of 2020, and the reserve requirement ratio has also been cut by 200bp to release fresh liquidity for the banking sector. Furthermore, the Central Bank has been purchasing government securities in the secondary market, to manage bond market liquidity during times of market stress when non-resident investors exit. The Central Bank has also started to directly purchase government bonds through the primary market (called the Debt Burden Sharing scheme) to support bond auctions as supply drastically increases to cover the budget's funding needs.

INDOCEMENT

Figure 8: Evolution of the key interest rate and inflation since 2018



Counter-cyclical macro policies have been further boosted by the Central Bank.

Source: Bloomberg (September 2020)

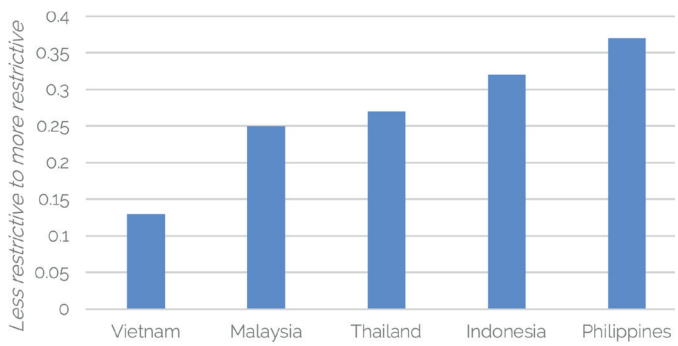
REFORMS

Although we expect an economic recovery to take place, **Indonesia needs reforms to enhance the medium-term GDP growth potential**, which is currently estimated to be around 5% p.a. **President Jokowi stated that the crisis provides 'an opportunity to make big leaps'**. The President has a strong track record when it comes to the execution of a reform agenda: in his first five years in office, Indonesia advanced on the World Bank's Ease of Doing Business ranking from the 120th place to 73rd. The so-called 'omnibus bills' could be President Jokowi's next milestone, which would replace and consolidate dozens of overlapping laws relating to investment, streamline tax regulations and relax labour laws.

The omnibus laws will also simplify permit processes for businesses covering 15 sectors including manufacturing, agriculture, energy and mining, and construction. The long-awaited amendments to regulations related to the business environment aims to simplify the regulatory framework, ease land acquisition, reduce the number of items on the negative investment list and ensure greater labour market flexibility. The rigidity of the jobs market, i.e. the difficulties and very high expenses related to hiring and replacing staff, stems from the current labour laws (passed in 2003), which include some of the most generous severance pay rules in the world. The omnibus bill is expected to reduce the maximum severance payment from 32 times monthly salary to 19 times. Furthermore, the corporate tax rate will be reduced from 25% to 20% by 2022. The government will further cut corporate income tax to 17% for 2022 for public companies with at least 40% shares traded in the stock market.

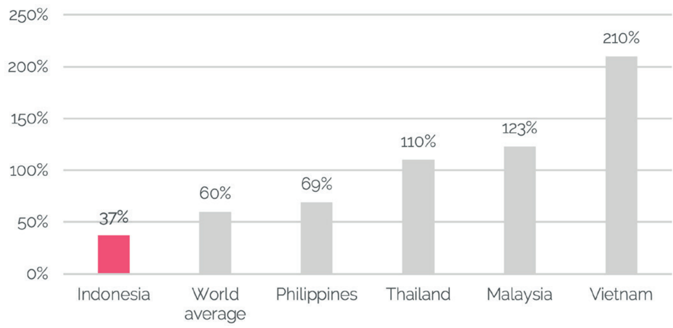
As the omnibus bills comes into force, **the country will become more attractive for FDI**. Currently, Indonesia's laws are a significant hindrance for foreign companies, with only the Philippines having laws which pose a greater constraint (according to the OECD) as shown in figure 9 and 10 below. Meanwhile, regulations in Thailand, Malaysia and especially in Vietnam are more streamlined and business friendly.

Figure 9: FDI restrictiveness



Source: OECD FDI restrictiveness measure (2019)

Figure 10: ASEAN-5 openness - total foreign trade in 2019



Source: World Bank (2019)

Ultimately, these steps would enhance the flexibility of the labour market and thus would attract fresh FDI inflows thereby boosting the country's potential GDP growth by 1-2pp to 6-7% p.a. over the medium term.

ESG IN INDONESIA

Indonesia is a clear laggard in terms of Environmental, Social and Governance disclosure and understanding within Asia. Unfortunately, even some of the largest companies are unaware of major issues such as coal mining related activities being a red flag for many investors, which is disappointing.

However, **we are able to find sufficient companies whose values are aligned with ours.** For example, **Bank Mandiri** operates a sustainable action plan, discloses information on training, staff turnover, and diversity. The bank also incorporates Environmental and Social considerations into their lending policy, and provides significant disclosure on their lending to palm oil plantations. We consider Bank Mandiri as 'A' for ESG in our rating methodology. **Indocement** is part of the Heidelberg Cement Group, and thus ESG standards are also in line with our standards and better than local peers, resulting in a 'C ' rating in line with Heidelberg Cement India.

Selected smaller companies also are beginning to become more aware of these issues, helped by our one-on-one engagement programme. Nippon Indosari, the leading bread manufacturer (rated 'C' for ESG) has started to track data such as emissions and accident rates, in anticipation of subsequent publication. Whilst Indonesia needs to do much more in this area, there are at least encouraging signs of progress.

VALUATIONS SUGGEST THE MARKET UNDERAPPRECIATES INDONESIA'S POTENTIAL

The Indonesian stock market has de-rated since 2014, despite the President's strong track record in delivering and executing reforms to improve the country's competitiveness. The market continues to ignore the favourable impact of the impending reform agenda, which has only temporarily been placed on the backburner until the spread of Covid-19 is contained.

Although the Jakarta Composite index's 12-month trailing price-to-book ratio has bounced from the March low (which was a low that last occurred during the Global Financial Crisis, i.e. two standard deviations below the 20 year average), the market still remains more than one standard deviation below its historical average in contrast to markets such as India and Taiwan. **We believe that this suggests that the country's short-term recovery prospects as well as its long-term GDP growth potential (enhanced by the impending reforms) remain underappreciated by the stock market**. This provides us with an investment opportunity.

Figure 11: Historical 12M trailing P/BV of the Jakarta Composite index (+/-2 standard deviations)

Source: Bloomberg, Alquity calculations (September 2020)

CONCLUSION

Indonesia is one of our largest active positions in the Alquity Asia Fund and the Alquity Future World Fund versus various indices and our peers. We believe that there is a mispriced opportunity here, as the country's favourable long-term structural drivers, upcoming cyclical recovery, high likelihood of reform and persistently attractive valuations are ignored by investors.

There are risks – such as a weakening of reform momentum due to political reasons (albeit unlikely as the next Presidential election is not until 2024 and Jokowi cannot stand for a third term in any case) or increased negative sentiment towards Emerging Markets, as well as any deterioration in the Covid situation. However, we believe that the risk-reward trade-off is highly favourable at these valuation levels.

We are also able to identify a number of well-run interesting small and large cap companies with sustainable competitive advantages – with robust business models, strong balance sheets and more than adequate ESG metrics – that benefit from our core themes, namely monetizable structural growth and favourable cyclical positioning. Hence, we conclude that in our analysis, Indonesia is the most underappreciated investment opportunity in South East Asia.

CONTACT INFORMATION

EUROPE	ASIA	UNITED KINGDOM	LATIN AMERICA	NORTH AMERICA
Benoit Ribaud	**Suresh Mistry**	**Alex Boggis**	**Cyn Cano**	**Renee Arnold**
+44(0) 7702 257 865	+44 (0) 7973 309687	+44(0) 7702 257866	+44(0) 207 5577 871	+1 215 350 9063
benoit.ribaud@alquity.com	suresh.mistry@alquity.com	alex.boggis@alquity.com	cyn.cano@alquity.com	renee.arnold@alquity.com

FOR MORE INFORMATION ON ALQUITY, PLEASE CONTACT:

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