Emerging Markets Equity Perspective

Southeast Asia is a key contributor to global growth, and Indonesia is a large market engine of the region. The size and incremental contribution of the Southeast Asian economies to global demand, and the corresponding investment opportunities, remain, we believe, largely underappreciated by global investors.

Indonesia fits in our ‘Four Macro Pillars’ that drive long term growth, with attractive demographics of a large and young population, per capita income levels well below $10,000, rising urbanization rates and relatively high savings and investment rates. We see compelling investment opportunities in Southeast Asia, and maintain our overweight allocation with a medium and long term horizon.

Four Macro Pillars that Drive Long Term Growth

- **DEMOGRAPHICS**
  - Steady (net) supply of a young population entering the workforce
  - Sustain high domestic demand and economic growth rates
  - Drives momentum in investment and consumption as well as competitive wages

- **INCOME**
  - Per capita income levels below 10k
  - Rapid increases in consumption
  - Higher likelihood for earning surprises

- **URBANIZATION**
  - Still low, but rising urbanization trend
  - Expected to lead to higher per capita incomes and productivity
  - Drives domestic consumption
  - Drives EPS growth and equity returns

- **SAVINGS AND INVESTMENT**
  - High and consistent domestic savings rates
  - Growth appears sustainable in the long term when investments are funded internally through high domestic savings rates

We spent the first full week of March in Indonesia meeting with policy makers, think tanks and senior management of Indonesian companies. Indonesian equities can provide a heavy exposure to commodities, and we wanted to assess the prospects of continued improvements in the fundamentals of the Indonesian commodity companies. We also wanted to better understand how the upcoming April 2019 General Elections may affect domestic consumption and government policy. We remain constructive on our Indonesian portfolio following our trip.

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Map of Indonesia

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Palembang
In addition to Jakarta, we visited Palembang, Indonesia’s ninth most populous city, the capital of South Sumatra province and home to 10.7mil people. Palembang’s economy is dependent on commodities, such as rubber, coal and palm oil, which makes it a good proxy for Indonesia’s economy. Palembang will also host the 2018 Asian Games in August.

Consumption: Better overall growth compared to 2017, with a recovery of mass market demand
Indonesia’s consumer spending growth diverged in 2017. Home improvement and mid-to-high end apparel sales grew, whereas mass market apparel sales declined. In 2017, mass market consumption was hit by the removal of electricity subsidies for 19 million out of 23 million low-income households. In 2018, mass market consumption is expected to recover as the government approved a 33% increase in Indonesia’s social assistance budget, and, in a partial reversal of 2017 policy, granted electricity subsidies to an additional 2.5 million households.

In Palembang, we saw mass market retailers offer 50-70% discounts to run down old inventory in preparation for the Lebaran holiday (a peak sales period in Indonesia) coming up in the second quarter of 2018. Year-to-date, the store we visited has reported 15% yoy sales growth.

Home improvement retailers are guiding for double-digit growth2 in 2018. In Palembang, local hardware stores are reporting 20% same-store sales growth with one-off construction and renovation boost from local venues involved in the Asian Games.

Residential Property: Strong demand for smaller units
Indonesia’s residential market has been lackluster since the commodities bust in 2014. The government’s tax amnesty program in 2016 led to a short-term liquidity shortage for entrepreneurs and wealthier home buyers.

Indonesian residential developers are guiding for 0-12% increase in 2018 sales3,4,5. While there is strong underlying demand for low-end homes, mid-to-high end property buyers appear to be waiting on the sidelines until after the General Elections are over. We visited the CitraGrand City Palembang project, which has houses ranging from IDR 400.0 million (US$29,080) to IDR 2.0 billion (US$145,000). Sales officers confirmed strong take-up for properties under IDR 800.0 million (US$ 58,160), while properties of IDR 2.0 billion accounted for less than 20% of sales.

Infrastructure: Ambitious growth
Indonesia’s lack of infrastructure has hampered growth in the past. Chart 1 shows that Indonesia’s public stock

50%+ retail discounts draw good traffic on a Thursday afternoon at Ramayana, a local department store
per capita is below other emerging markets. Public stock is the value of government-owned assets that are used to generate economic productivity, usually infrastructure such as roads, bridges and utilities distribution. President Jokowi’s National Medium Term Development Plan (RPJMN) seeks to raise public and private investment in infrastructure. Rising commodity prices will help to fund public spending in infrastructure. In 2016, 6.5% and 82.7% of the government’s revenues were directly or indirectly correlated to commodities prices.6

We witnessed part of the infrastructure construction boom as Palembang city rushed to build its Light Rail Transit (LRT) system that will connect the airport to Jakabaring Stadium for the Asian Games.

Key Takeaways

Indonesia’s economy continues to benefit from the recovery in global commodity prices and we are invested accordingly. Financial sector profits are rising after non-performing loan provisions related to the commodities down-cycle peaked in 2015-16. We are exposed to Indonesia’s infrastructure growth through investments in heavy equipment and building material. Rising discretionary incomes are trickling down to mass market consumers, which supports department stores and advertising. As incomes continue to rise, we see possibility for further pick-up in property demand. We are positive on the long-term prospects of Indonesia.

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