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Jokowi's Star Team— Why Indonesia Will Finally Get Inclusive Growth

With the outcome of the US presidential elections causing anxiety over emerging markets, Indonesia's stock market has suffered strong outflows of USD 527[1] mn as foreign investors took profits and reallocated to the US. We believe that pulling out of Indonesia is a mistake. Any direct trade-related fallout is limited by the fact that Indonesia is not a TPP signatory, and direct exports to the US is below 10%. Investors have not fully considered its largely insulated domestic consumption base, and the structural progress in Indonesia since President Joko Widodo, popularly known as Jokowi, took office in 2014. More improvements are on the way as Jokowi has managed to assemble a star team that has the capability, integrity, and tenacity to get things done. This team is currently focusing on delivering inclusive growth, which at its core, is about an Indonesian government that is competent and credible enough to spread prosperity to the bottom 40% of Indonesians. This inclusive agenda has important investment implications, given that Jokowi is likely to be re-elected[2] when he stands for presidential election in 2019, effectively shaping Indonesia's investment prospects for the next 8 years. Given the vastly improved chances of Indonesia accomplishing institutional and structural reforms, APS took the opportunity during the recent market weakness to deepen and broaden our exposure to infrastructure and consumption stocks, as we explain at the end of this paper.

What is inclusive growth in Indonesia's context?

Jokowi has been committed to improving the livelihood of the poorest in Indonesia since his days as mayor of Solo and governor of Jakarta. As President of Indonesia, he set[3] an explicit target of reducing the Gini coefficient in Indonesia from 0.40 in 2015 to 0.36 by 2019. Unlike other emerging markets, the Indonesian government has been consistent in rejecting the "growth at all costs" model, choosing instead to emphasize the twin pillars of growth and equality. The guiding principle in Indonesian fiscal policy is then to prioritize the type of spending that can best promote growth and spread prosperity.

Infrastructure spending and the ongoing tax amnesty initiative are key components of this coherent inclusive growth agenda, rather than piecemeal policy initiatives. Infrastructure spending benefits the poorest the most by granting basic access to water, electricity, and public transport, while the tax amnesty is fundamentally about mobilizing the financial resources necessary for the state to deliver public services. Consequently, it is not surprising that Indonesia will increase infrastructure spending by 22% YOY from USD 24 bn in FY2016 to USD 29 bn in FY2017 even as it cuts back on other social spending and priorities.

Central to the inclusive growth agenda is a commitment to build effective institutions that are competent, transparent, and accountable in order to achieve sustainable growth. This is a marked shift from previous administrations. Sri Mulyani Indrawati, the new finance minister, understands that good policies and politics alone are insufficient. Proper institutions are needed to implement them. She knows that the tax amnesty, while successful at collecting more than USD 7.6 bn of taxes thus far, is not a

[1] Weekly foreign net flows 7-18 Nov; IDX

[2] According to a recent CSIS survey, Jokowi's personal rating has improved from 51% in Oct 2015 to 67% in Aug 2016 as the public is increasingly satisfied with his economic and political achievements

[3] National Medium-Term Development Plan from 2014-2019; Bappendas 2014

structural remedy. Instead, Indonesia needs to raise its tax-to-GDP ratio. By doing so, Indonesia would get higher sovereign risk ratings, which would lower the cost of debt, which would in turn make Indonesia fiscally stronger and more resilient to capital outflows. Indonesia's tax amnesty in 2008 ("Sunset Policy") had limited success precisely because it did not meaningfully raise the tax-to-GDP ratio, hence necessitating the current tax amnesty exercise.

To address this, Jokowi has committed to raise the tax-to-GDP ratio from 10.4% today to 16% by 2019. To get there, institutional reforms are needed to improve tax collection and reduce leakage. With only 10 million out of more than 250 million Indonesians paying taxes today, the tax authority needs to be overhauled to enable its officers with the information, competence, and integrity to knock on doors and get people to pay taxes. Currently, only 27 million Indonesians have a tax identification code, and one key improvement is to pair the 186 million people with identification cards with a unique tax identification code. We understand that preparations are ongoing, and this would be a gamechanger when implemented in the coming years.

Another key institution to be reformed in the inclusive growth agenda would be the police force, seen by Indonesians to be the most corrupt public institution[4]. A popular saying in Indonesia goes,"*if you report a chicken missing, you are likely to lose your cow"*. Jokowi and Sri Mulyani understand that a credible inclusive growth agenda would have to include fighting corruption because corruption allows the rich to steal resources from the poor, increases business costs, and reduces the efficacy of both public and private investment. If enforcement mechanisms are lacking, tax information is useless to the state, and may in fact be dangerous to its citizens, if used by the police to demand bribery and exploit the poor. However, citizens are more willing to pay taxes if they trust the state to spend wisely and believe that the tax law will be enforced impartially on all without fear or favor. It is to that end that Jokowi appointed Tito Karnavian, with a reputation for being clean and capable, as the new police chief in July 2016. During the inauguration ceremony, Jokowi expressly enjoined Tito to reform the police force from "top to bottom" in order to restore public trust.

Once these institutional reforms are put in place, we believe that Sri Mulyani will then consider pro-growth tax reforms and rationalize the tax system. First, the VAT system could be replaced with a GST ranging from 6-8%. GST would reduce the scope for tax evasion and lower administrative and enforcement costs. Moreover, there is increasing acceptance globally of GST as a better alternative to VAT, with countries such as India and Malaysia introducing GST in recent years. To lay the groundwork for this, Indonesia is collecting more data by actively encouraging SMEs to take part in its tax amnesty program with an attractive penalty tax rate of just 0.5% for those declaring assets below USD 0.77bn, and 2% for those declaring assets above.

Second, a corporate tax cut could eventually come into effect. Jokowi has declared that he wishes to cut corporate tax rates from 25% to 18% to increase Indonesia's competitiveness. But we believe that it will be a while before this happens, because Sri Mulyani is likely to hold this off until most institutional reforms are in place. After all, what's the point of boosting growth via tax cuts if the revenues leak away? In a wide-ranging interview with the Jakarta Post[5], Sri Mulyani astutely pointed out that despite a commodity boom in Indonesia three to four years ago, state revenues did not grow as quickly as expected because of tax leakage. Moreover, Jokowi needs to keep some powder dry for infrastructure spending.

[4] Indonesia swears in new police chief after bitter feud; AFP; 17 Apr 2015
[5] Discourse: Sri Mulyani all about fair growth, reforms; Jakarta Post; 29 Sept 2016

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Why can inclusive growth be achieved this time?
Previous administrations had ambitions for reforms and inclusiveness but fell short. Jokowi has already proven that he is different with strong leadership and a star team of reform-minded technocrats. The president is able to leverage the patronage of his office to win support for his administration, growing his ruling coalition from 208 seats out of 560 seats in late 2014 to 386 seats in October 2016. Less talked about, but no less important, are the key members of his star team who are instrumental in implementing his inclusive growth agenda, namely Sri Mulyani who is in charge of economic affairs, Tito who is in charge of law and order, and Luhut Panjaitan who is in charge of political affairs.

Sri Mulyani is very well-respected both in Indonesia and internationally, with a strong reputation for competence and integrity. Known as the “Iron Lady”, she was the finance minister of Indonesia from 2005 to 2010 who successfully led Indonesia through the global financial crisis, fought corruption, and made many political enemies in the process. Her claim to fame was standing her ground against the rent-seeking demands of her Golkar enemies over the Bank Century bailout in 2009. Subsequently, she distinguished herself as a capable managing director at the World Bank for 6 years. Deeply committed to inclusive growth and institutional reforms, Jokowi had tried to convince her to return to Indonesia since the start of his administration. Her return to Indonesia only in Aug 2016 is testament to Jokowi’s personal charisma as well as a calculated assessment that the political climate is finally conducive enough for her to carry out her inclusive growth agenda. During the first stage of the tax amnesty drive, she had the gravitas and stature to warn Indonesian tycoons that tax amnesty was their last opportunity to have their “sins deleted” or face “hell” later. Evidently, based on the success of the tax amnesty thus far, many of them decided that it was unwise to challenge her and came clean. On the ground, many business owners and senior establishment figures that we spoke to also hold her in high regard, and we believe that she is well-placed to execute Jokowi’s inclusive growth agenda.

Tito Karnavian received a double promotion this year, and was first appointed as the chief of BNPT, a national counter-terrorism agency in March 2016, before being promoted to be the youngest police chief since Indonesia’s independence in July 2016. Known as the “warrior-philosopher,” Tito was the commander of Densus 88, the counter-terrorism unit that took out the Islamic militants behind the 2002 Bali bombings. In addition, Tito graduated top of his class at the Police Academy in 1987 and has a PhD in terrorism from the Rajaratnam School of International Studies (RSIS), at the Nanyang Technological University in Singapore. Pledging his political allegiance to no one but Jokowi who gave him his promotions, Tito has a long runway to help Jokowi weed out corruption, and deal with the social conflicts that arise as reforms clash with vested interests.

Luhut Panjaitan’s formal position in Jokowi’s cabinet is Coordinating Minister for Maritime Affairs in Indonesia. However, this belies his true influence. As Jokowi’s business partner for nearly a decade before his rise to power, Luhut played an instrumental role in supporting Jokowi’s rise from mayor to president by navigating Indonesia’s byzantine politics. Effectively the “hand of the king,” Luhut’s elite deal-making has helped Jokowi cut deals and seal alliances. As a Golkar politician, Luhut was credited with convincing the Golkar Party, the second-largest political party in Indonesia, to join Jokowi’s coalition. He also lobbied intensively for the passage of the tax amnesty law which is key to the inclusive growth agenda. Moreover, Luhut helps to maintain discipline within Jokowi’s cabinet, and has publicly communicated that ministries and state institutions cannot publicly contradict the president’s policy goals. Most importantly, Luhut is an ideal political affairs coordinator as he will never pose a political threat to Jokowi. As a Christian of Batak descent and not a Muslim-Javanese, it is near impossible for Luhut to get elected as president even if he had presidential ambitions.

APS' portfolio positioning—infrastructure and consumption

Since infrastructure spending is central to Jokowi's inclusive growth push, we have increased our exposure to new infrastructure stocks since our last update in April 2016. During the market slide in November 2016, we added to our positions in Wijaya Beton Precast (WTON) and Adhi Karya (ADHI).

We also initiated new infrastructure stocks such as Waskita Beton Precast (WBSP) which is a producer of precast concrete and ready-mixed concrete. It has a wide variety of precast products such as PCI girders, PC piles, and retaining walls to capture growing precast demand. Since its inception, it has grown rapidly, quadrupling its production capacity from 0.6 mn in 2013 to 2.3 mn tonnes today, and is now the second largest precast concrete producer in Indonesia. The investment thesis is that WBSP is a direct beneficiary of the Indonesian government's infrastructure spending in the next 3-5 years. As part of the Waskita group--one of the largest state-owned contractors in Indonesia--WBSP directly benefits from contracts awarded at the parent company level. We initiated WBSP during its IPO at an estimated 2017 PE of 19x which is a fair price for a good company with strong growth prospects going forward. We also added to our position when the market corrected in November 2016.

We believe that another key beneficiary of the inclusive growth agenda is Indopora (IDPR). It is the largest foundation contractor in Indonesia with close to 30% market share in Jakarta alone. With strong expertise in foundation construction, Indopora provides foundation construction services for various building and infrastructure projects. The investment thesis for IDPR is that it is a proxy to growing infrastructure and property development in Indonesia. As foundation work requires more complexity and expertise, IDPR has a gross margin of around 25%, which is higher compared to other Indonesian contractors whose gross margins are in the mid-teens. Moreover, foundation work is typically completed between 3 and 6 months, thus allowing IDPR to have more efficient working capital with lower project risk. With the success of the ongoing tax amnesty, IDPR is well-positioned to receive more foundation construction projects due to stronger infrastructure and property development in 2017. In the longer term, the Indonesian government is keen to provide affordable housing to the poorest and IDPR is a potential beneficiary of the policy aim to build 1 million low-cost housing units. On the back of these tailwinds, IDPR's order book is expected to grow strongly next year, and valuation is compelling at 2016 PE of just 13x.

The economic benefits of infrastructure spending would eventually facilitate job creation and raise the real income and consumption prospects of the bottom 40% of Indonesians. We have bought into Global Mediacom (BMTR) which is an indirect beneficiary of rising mass domestic consumption. Its crown jewel is MNCN which manages 4 national free-to-air TV stations which consistently commands around 45% share of prime-time viewers: RCTI, MNCTV, GlobalTV and and iNewsTV. TV advertising gets over 66% of all media ads. Mass advertising through these free-to-air TV stations is the most effective way for consumer companies to reach the millions of Indonesian consumers across the sprawling Indonesian archipelago. MNCN is also the largest producer of local content in Indonesia with a 270,000- hour content library, and reputable brands such as Unilever, P&G, and Indofood advertise through MNCN. The investment thesis for BMTR is that as inclusive growth increases mass consumption, BMTR will be a beneficiary of rising advertisement spending especially since Indonesia is coming from a low base with net advertisement spending as a percentage of GDP of just 0.2% (i.e. lower than the regional average of 0.38%). We have added to our positions as the market sharply sold off BMTR after the US elections. We like the undemanding valuation with a sum-of-parts discount of nearly 60%.

We have also taken advantage of the recent market weakness to increase our exposure to Multipolar (MLPL), which is a familiar consumption name to our long-time investors. MLPL holds valuable assets in retail and TMT which are strong beneficiaries of mass consumption. The fundamentals of MLPL have also improved as IMTV- a satellite tv provider - is expected to reach cash flow breakeven by the end of 2016, and unprofitable hypermarts and department stores in China have mostly been shuttered. We understand also that the USD 108 mn worth of properties on its books are trading at a sizeable discount to market, and MLPL is in the final stages of preparing to spin off these assets into a REIT. We are hopeful that this would be completed by 1H2017 which would allow MLPL to re-rate.

Lastly, the inclusive growth agenda will place Indonesia on a higher and more sustainable growth trajectory. With growing evidence of institutional reforms and the easing of logistical bottlenecks by higher infrastructure spending, foreign investors will gain confidence and increase their FDI into Indonesia. We have already identified Indonesian industrial estate companies, such as Bekasi Farjar (BEST), to be major beneficiaries, and we will buy into them when we think the price is right. In short, APS will closely monitor the progress of the inclusive growth agenda in Indonesia and buy stocks with strong prospects and sensible pricing to generate alpha for our clients.

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