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Phillip Securities Research Pte Ltd

29 March 2012

Jakarta Composite Index: 4080
MSCI Indonesia: 4956, 15.3x T4Q P/E, 13.6x Fwd4Q P/E

This report is the first in a series of Regional Strategy reports including Thailand, China & HK, US, and Singapore, covering markets of the PhillipCapital Group of Companies.

Indonesia enjoys the luxury of strong domestic drivers which come into play even in a slower growth world. Ironically, a high speed world may not be so good for Indonesia thru disproportionate effects on oil which can lead to a rate raising cycle – this killed the market in 2008. Given our view of a slower growth world, and our base case of only a single rate hike, we are Overweight on Indonesia. Risks to our Overweight would be a rate raising cycle. Global macro risk remains. Research Indonesia's top picks are: Adaro Energy and Bank Mandiri.

INDONESIA

- **Growth Outlook**: We expect real GDP growth to moderate to 6.3% in 2012 from 6.5% last year. Key risk to Indonesia's growth is high crude oil prices which will have a double drag effect on the economy – consumption and its net exports. For consumers, they face a 33% hike in fuel prices on 1st April, which threatens to raise the share of fuel from 6% of total expenditure to 8%. However, as nominal wages are posting 10% gains a year, our view is that consumption will be able to withstand the full 33% hike. For the external economy, Indonesia is a net exporter of non-crude commodities but a net importer of crude related. Unfortunately, price gains in crude oil have outpaced price gains in other commodities (Fig.1). Given that net exports contributes roughly 1%pt out of 6%pts of growth, this is a drag whichever way you look at it – in the event the global economy is strong, it is more likely crude will outpace non-crude prices even as both rise; if the global economy is weak, non-crude falls harder than crude, which will likely remain more buoyant on abundant liquidity from the Fed and ECB. Mitigating the external downside, is that Indonesia's bond yields have collapsed as bond prices soared on the back of improved credit ratings (Fig.2). This will be a boost on private investment as the cost of credit drops, and will also be a positive on public investment as government finances improves as it refinances at half the rate. Overall, we are positive that Indonesia will post about 6.3% growth, with 5.8% being the full downside case of deteriorating terms of trade. (Although deteriorating terms of trade may have little effect on GDP growth, high oil has a negative effect on the Indonesian equity market thru a Bank of Indonesia rate raising cycle, see paragraph on Market Strategy).

Fig.1 Crude diverges from the general Commodities Index, which is a negative for Indonesia given that it is a net importer of crude related and net exporter of non-crude

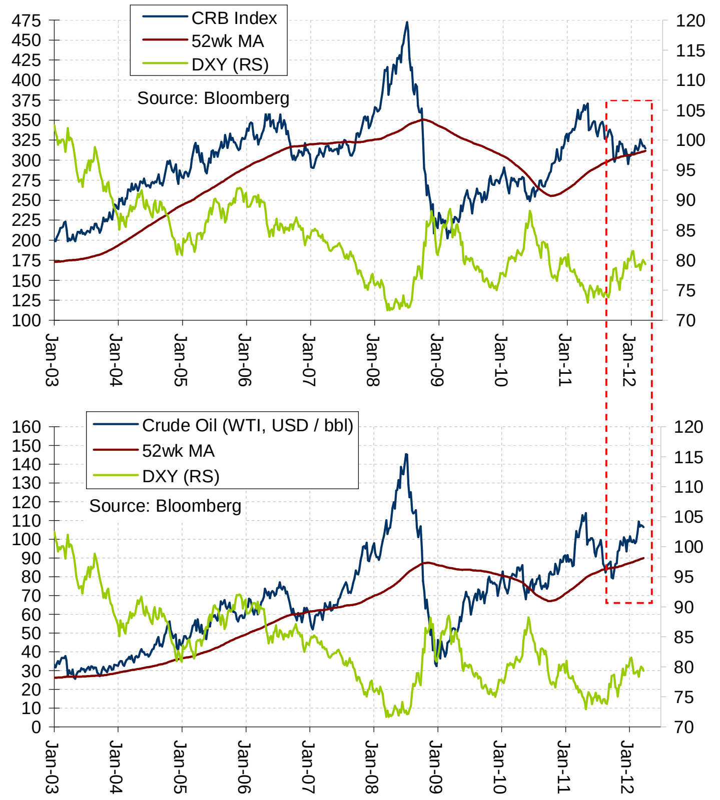
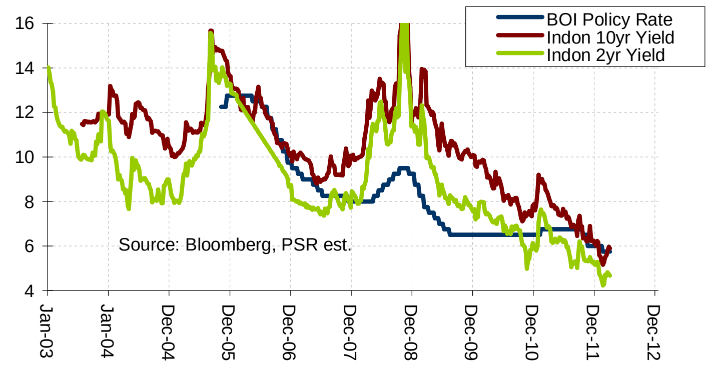
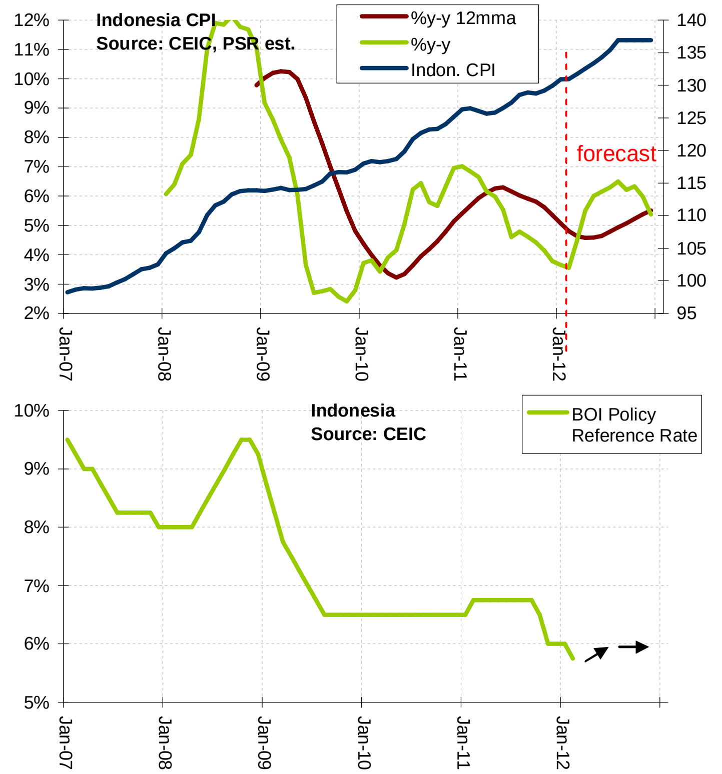


Fig.2 Indonesian credit costs continue to fall



- **Inflation & Monetary Policy Outlook: one hike, and then stand pat.** We expect full year inflation to average out around 5.8% (5.4% last year), taking into account trend inflation and the transitory nature of the fuel price hike. The Bank of Indonesia (BOI) has been on a rate cutting cycle, but we think this year is to give one hike by mid-2012 to 6% from the current 5.75% and then stand pat, in order to balance the external downside risks to growth with inflation risks present. Given that the fuel price hike transpired to be at the maximum end, full year inflation is likely to exceed the upper end of BOI's 4.5% plus or minus 1% initial target range for 2012 (i.e. 5.5%). Fig.3 shows that %y-y CPI changes will climb sharply to till mid-2012. As the %y-y CPI change starts to climb, there may be social pressure to raise rates (Fig.3), and we think there is a likelihood of the BOI doing a single rate hike, especially if it feels that it wants to pre-empt against unhinged inflation expectations. **As such, although our base case is for the BOI to do one hike and then to stand pat, we do not envisage a rate raising cycle**. In the worst case hawkish scenario, a persistent rise in oil could spark a rate raising cycle like it last did in 2008, which killed the stock market (see next para). Should oil surge again for whatever reason (geopolitical, QE3), we expect BOI to do the same.

Fig.3 Hopefully BOI will stand pat, but given the highly politicised nature of the fuel hike, we won't discount a single hike



- **Market Strategy: Broad market conditions are not the best as Asia ex-Japan makes its 3rd lower high (Fig.4 lower chart, red oval), but bucking the trend is Indonesia, which we are Overweight on resilient GDP and EPS growth – be mindful though of a rate raising cycle (in which case Underweight!).** The Indonesian market is not cheap compared with MSCI Far East ex-Japan (Fig.4), trading at 25% premium valuation of +15x T4Q p/e, +13x Fwd 4Q p/e (compare Fig.4b with Fig.4a). For its bull trend to not flatten out requires that expectations of 21% EPS growth be fulfilled, and that the market does not de-rate its p/e by the same percentage. Right now the base case is that EPS growth will materialize as >6% growth seems resilient from domestic drivers. Valuations, may seem high compared with the MSCI FExJ, but are actually "fair" in our view: (1) you get what you pay for, we note that the MSCI FExJ valuation is actually skewed strongly downward by China's extreme de-rating on hard landing fears – Indonesia, however, enjoys its domestic drivers front and centre; (2) valuations are actually at the lower end of the range post 2005 (red box Fig.4) – when the country began to emerge as a strong economy after 10 years of restructuring post Asian Financial Crisis.

- **Risks to our Overweight rating would be a rate raising cycle (we stress "cycle", not just one or two hikes) by the BOI if inflation expectations get out of hand.** Oil climbing aggressively toward US$140bbl would be a risk in point, in which case, Underweight. Ironically, we think Indonesia will fare better as an Overweight in a slow global growth scenario: from the 2008 experience, high global growth caused oil to spike (look back at Fig.1), which led to the BOI initiating a rate raising cycle (Fig.5), this caused the Indonesian market to start a bear cycle. Under current conditions of slow global growth, inflation has been less of a problem which has enabled the BOI to keep rates low, which is clearly market supportive from Fig.5, hence our title of "better in a slower world".

- **Global Macro Risk**: Further risks to being positive on Indonesia has nothing to do with the country: overall macro conditions are going to remain tough (see Strategy 15th Feb12) and the onus is on companies to realize their expected EPS growth in spite of these – 2013 remains a challenging prospect globally as the US and the Eurozone both face massive fiscal withdrawal to the tune of US$500b – US$1tr. No small amount.

Fig.4 Indonesia is not cheap compared with the region excluding Japan, but is an overweight on resilient GDP growth and 21% EPS growth.

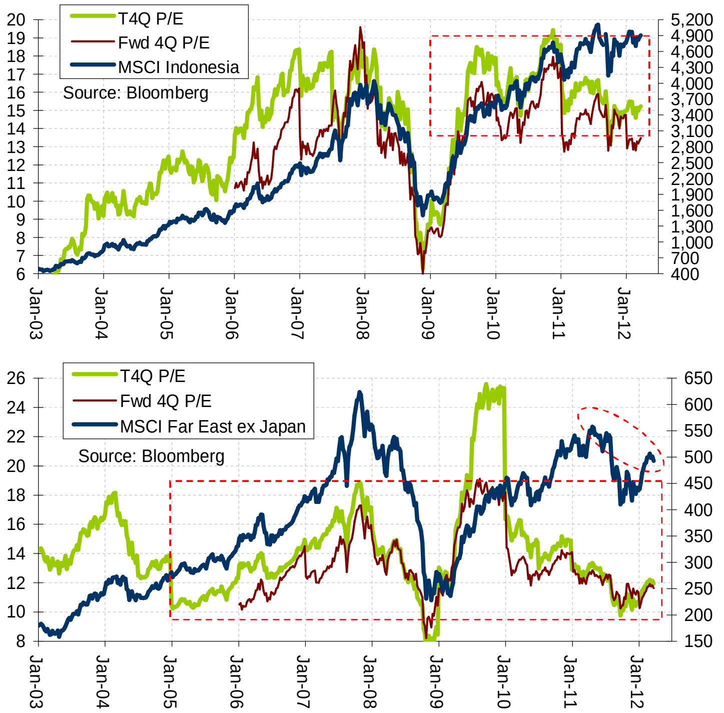
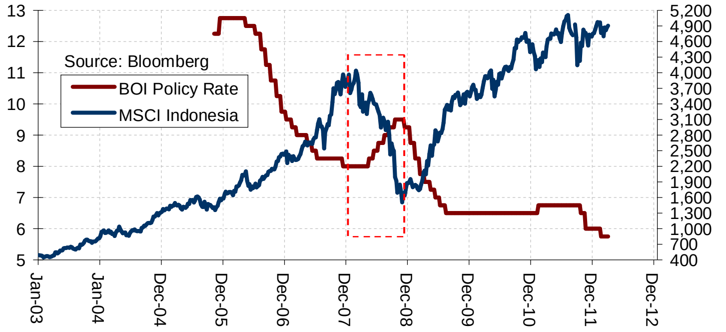


Fig.5 A rate raising cycle like back in 2008 would be a case for Underweight.



- **Head of Research Indonesia's top picks are: Adaro Energy and Bank Mandiri.**

  Adaro Energy:

  - IDR 1910 (Accumulate), IDR 2270 (12mth target price), Market Cap >US$6.5b,
  - Valuation: T4Q p/e 12.1x, Fwd 4Q p/e 10.4x is based on consensus 2012 EPS growth of 16%y-y (Fig.5).
  - Adaro is a coal mining giant with the single largest coal mining site in the southern hemisphere pit and one of the top 5 producers globally.
  - Production was 47.7m MT for 2011, expects 52.5m MT for 2012, +10%y-y (10yr CAGR is 11%).
  - Vertically integrated from pit to port, it is one of the lowest cost producers, with the 2nd highest EBITDA margin of 36% versus Indonesian industry range of 14%-37% (29.5% average)
  - Adaro sells its coal to Indonesia 25%, China & HK 19%, Japan 9%, India 8%.
  - Price of coal has strong underlying fundamentals: (1) as Indonesia prefers to export its LNG, coal is increasingly the energy source of choice, itself demanding ~67.5m tones in 2012, +11%y-y (2) Chinese demand to double over next 5yrs to 6b tones by 2016; (3) Japan will likely seek additional coal imports due to winding down of nuclear energy and to diversify coal dependence away from Australia; (4) India rising market.
  - Price of coal though, has softened 4q11-1q12 (Fig.6) due to soft economies of China and India, but our macro strategist expects the Chinese government to guard against a hard landing in China via a fiscal stimulus
  - Adaro's price may have 6.5% downside risk from here as the price of coal has cracked the 52 week MA (Fig.6), but we see strong support from underlying fundamentals at US$100/MT from US$107/MT now, as coal demand is expected to exceed supply from here till 2015 (Fig.7). We see the present price weakness as a bottoming out process, and a chance to accumulate Adaro.

Fig.5 Valuations are on the low side for trailing multiple, further upside will be expected EPS growth of 16%.

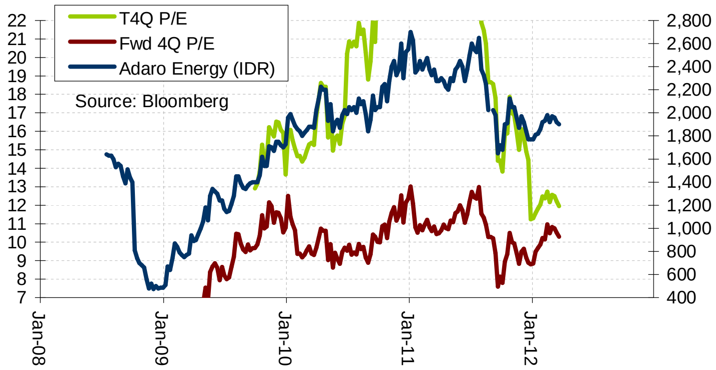


Fig.6 Price of Coal, support is at US$100/MT

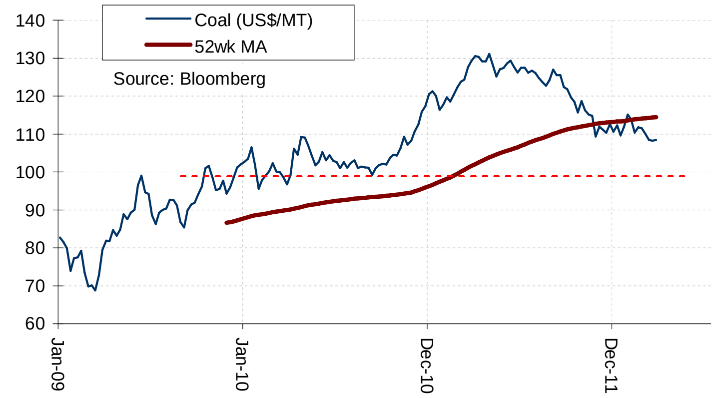
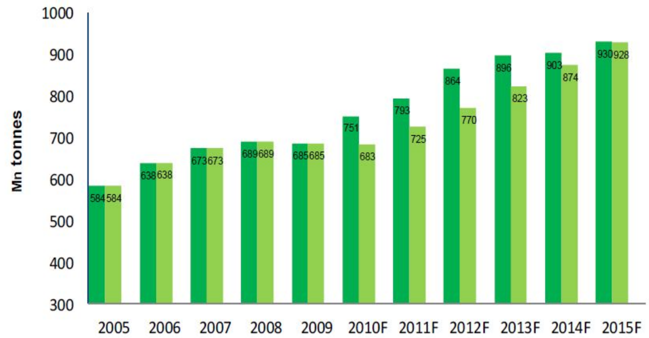


Fig.7 Demand (dark green) and Supply of Coal (Source: Adaro Energy, Australian Mineral Economics, Nomura)



Bank Mandiri:

- IDR 6700 (Accumulate), IDR 8000 (12mth target price), Market Cap >US$17b
- Valuation: T4Q p/e 13x is at the lower end of the trading range, Fwd 4Q p/e 11.8x, is based on consensus 2012 EPS growth of 10%y-y (Fig.7)

- Bank Mandiri is the largest bank in Indonesia in terms of assets and deposit base. It is well capitalised with a capital adequacy of 15.13%, and has superior returns of ROA 3.37%, ROE 25.57%.

- Established leader in Corporate-Wholesale Banking, and thus a key beneficiary of the investment upswing

- Current ambition to also lead in Retail banking has been a well executed strategy as its Retail-Micro (+28.4%y-y) and Consumer Finance (+20.7%y-y) lending continues to drive Net Interest Income (+11.7%y-y) (Fig.8)

- Net Interest Income (NII) as a proportion of total income falls from 68% to 61% as Bank Mandiri's JV with AXA gains traction from Net Premium Income growing by +228%y-y (Fig.8). The bank is seeking to diversify away from over-reliance on NII.

- Consensus estimates of 10%y-y EPS growth seem too pessimistic at the moment. It is very unlikely that the banks' profit growth will be below the mid-teens nominal rate of growth of GDP at this stage of development, the only time that happened in recent history was the Lehman crisis (see Fig.9). But chief reason is that Indonesia is severely under-banked, with loan-GDP and deposit-GDP ratios at 30% and 37%, compared with Thailand (89%, 71%) and Malaysia at (115%, 148%). Loan volume growth is thus on a secular trend despite cyclicality (Fig.10). A surprising fact has been that the economy has grown faster than deposits have grown, and the declining deposit-GDP ratio was only reversed in 2010, indicating that deposit gathering is only just getting started (Fig.11).

- Key-Risk: Sector will de-rate on a rate raising cycle as the market will be overly negative on NIM compression. This is because deposit rates track the policy rate rather tightly, more so than lending rates (compare Fig.7 price declines in 2005 and 2008 versus Fig.12 rate raising cycles in the same periods).

Fig.7 Bank Mandiri's trailing p/e is currently on the low side

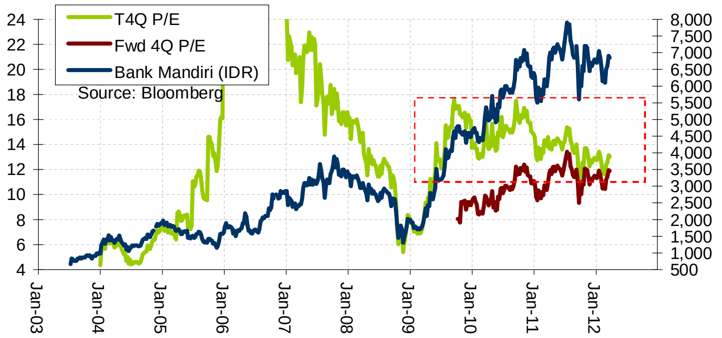


Fig.8 Bank Mandiri's Net Interest Income dynamics are healthy – more reliance on Retail-Micro-Consumer Loans, less reliance on Govt Securities to drive Net Interest Income (NII); Net Premium Income is a new growth driver, signifying a diversification away from NII as well.

Bank Mandiri

Net Interest Inc. (Rp Bn)	2010	% NII	2011	% NII	%y-y
Corporate-Insti	3,655	18.1%	4,011	17.8%	9.7%
Commercial	5,221	25.9%	5,513	24.5%	5.6%
Treasury	982	4.9%	1,075	4.8%	9.5%
Retail-Micro	5,479	27.2%	7,036	31.2%	28.4%
Consumer Finance	2,188	10.8%	2,640	11.7%	20.7%
Marketable & Govt Sec	2,645	13.1%	2,260	10.0%	-14.5%
Income:	**2010**	**%tot. Inc**	**2011**	**%tot. Inc**	**%y-y**
Total Net Interest Inc.	20,170	68%	22,535	61%	11.7%
Total Non-Interest Inc:-	9,494	32%	14,350	39%	51.1%
Net Premium Income	553	2%	1,815	5%	228.3%
Fee & Commission Inc.	5,237	18%	6,558	18%	25.2%
Fin. Asset Gains	3,704	12%	5,977	16%	61.4%
Total Income:	29,664	100%	36,885	100%	24.3%
Total Expenses:-	(15,927)	54%	(20,539)	56%	29.0%
Salary, General, Admin	(12,918)	44%	(17,129)	46%	32.6%
Fin. Asset Losses	(3,010)	10%	(3,410)	9%	13.3%
Operating Profit	13,737	46%	16,346	44%	19.0%
PATMI	9,218	31%	12,246	33%	32.8%

Source: Bank Mandiri

Fig.9 Bank Mandiri's earnings to grow slower than the Nominal Rate of GDP? Not likely!

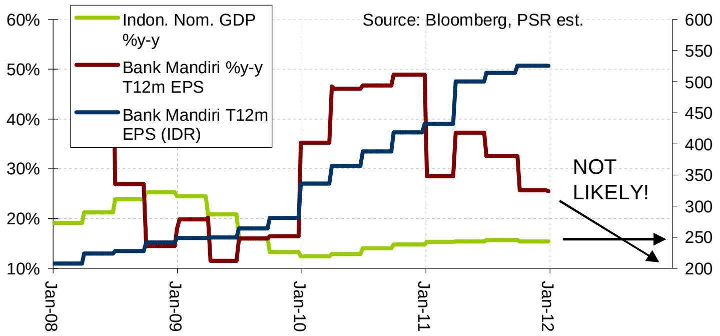


Fig.10 Loan growth on secular trend (12-34%y-y) despite cyclicality

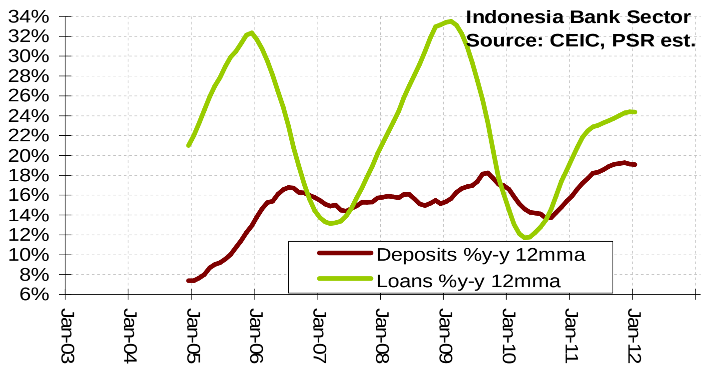


Fig.11 Deposits have only recently kept pace with Nom. GDP

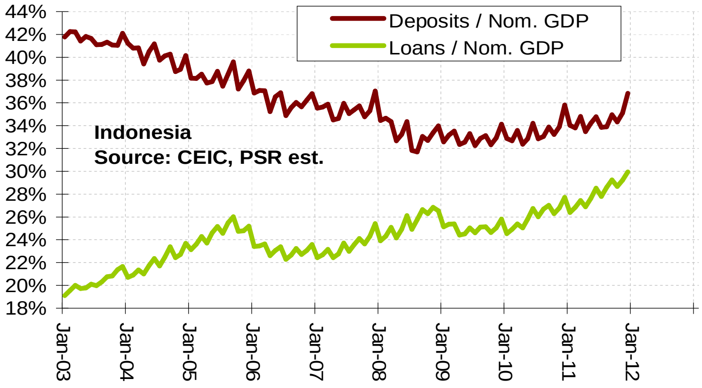
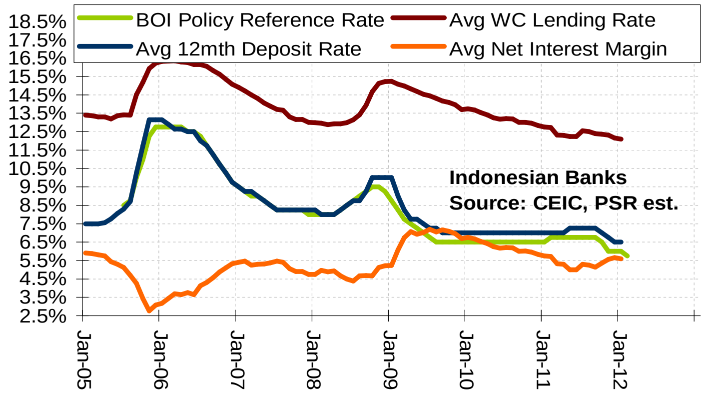


Fig.12 Rate raising cycles in 2005 and 2008 coincides with Bank Mandiri sell-offs (compare Fig.7).



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