Regional Strategy - Indonesia

Beware of weak Rupiah and policy hazards

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JCI: 4180.16 (9.4 %ytd)
MSCI Indonesia: 5003.89 (5.1%ytd)

2011 Real GDP / Inflation: 6.5% / 5.4%
2012(f) Real GDP / Inflation: 5.7% / 4.5%

- **Equities: Indonesia Sector Strategist's top picks are: Bank Mandiri and Bank Rakyat Indonesia.**
- **ETF: PhillipETF department recommends "DB X-TRACKERS MSCI INDONESIA TRN INDEX ETF" which proxies the MSCI INDONESIA TRN INDEX. (See risks for ETFs: www.phillipetf.com > ETF education > Risks for ETFs)**
- **Unit Trust: Indonesian funds that UT investors can consider include: Aberdeen Indonesia Equity Fund, Fidelity Indonesia A-USD Fund. UT investors please contact your FA for Portfolio matters.**

Macro Outlook:

The Indonesian Rupiah (IDR) is likely to remain weak on account of persistent current account deficit. Without intervention by Bank Indonesia, we suspect the IDR might be even weaker. While reserves remain adequate for now, import cover has been declining. The continued deterioration in external balances is likely to pose a challenge in monetary policy formulation for the central bank.

We expect Bank Indonesia to continue to stand pat (barring significant deterioration in the macro outlook). With inflation remaining within the target range and in view of elevated downside risks, odds are skewed towards a rate cut. However, in view of the deteriorating external balances, a rate cut would further exacerbate the weakness in the IDR.

Equities:

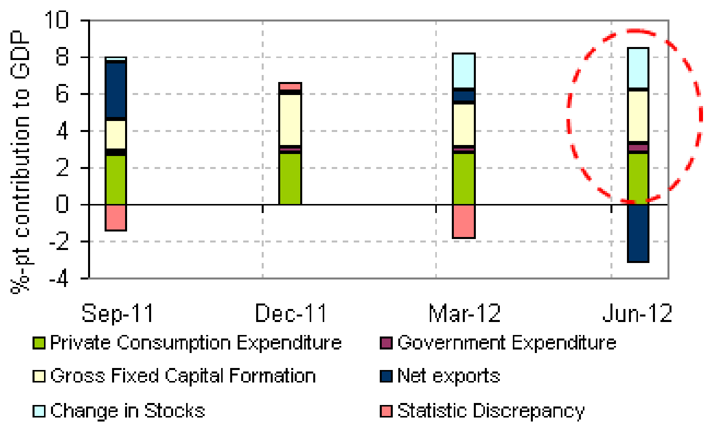
Indonesian equities have been recently buoyed by anticipation (as well as realisation) of monetary easing by G3 central banks (Fed's QE3, ECB's Outright Monetary Transactions as well as BoJ's expanded asset purchase program). But we opine improved economic fundamentals as well as corporate earnings are essential for further market gains.

The JCI and MSCI Indonesia have returned ~10% and ~5%YTD and are still on resilient uptrends. We would have maintained Overweight Indonesia on account of resilient domestic demand offsetting a weak global economy. However, we downgrade it to Marketweight in view of a weak rupiah as well as policy hazards given its "protectionist" stance of late.

GROWTH OUTLOOK:

- Amid a global slowdown, the Indonesia economy expanded by 6.4% y-y in 2Q12, almost similar to the pace of growth registered in the preceding quarter (6.3%). Growth was driven entirely by resilient domestic demand which mitigated the fallout from net exports. Specifically, fixed investment accelerated 12.3% and domestic consumption (household and government) remained firm, registering growth of 5.2%, adding 2.9%-pt and 3.3%-pts to headline GDP growth.

Fig 1. Robust domestic demand more than offset the weakness in external demand.



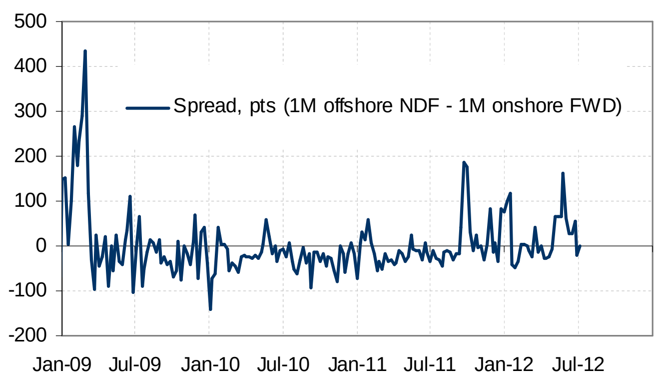
- Looking ahead, we expect fixed investment to remain robust on account of the following infrastructure investment related to the targets set out in the Masterplan for the Acceleration and Expansion of Economic Development of Indonesia (MP3EI) in 2011. Specifically, key elements of the MP3EI include developing the regional economic potential in six Indonesia Economic Corridors as well as strengthening connectivity- both of which require massive investments in infrastructure network.
- However, we note that the progress of such infrastructure investment has been hampered by legal hurdles as well as financing issues. Infrastructure investment tend to require loans of long maturities which Indonesian banks -as well as banks worldwide- have difficulty extending owing to Basel III requirements. While Islamic bonds or sukuk might help fill the gap, Indonesia -unlike Malaysia- has yet to set up the regulatory framework needed for Islamic finance.
- On the external front, we are concerned about the deteriorating balance of payments situation which continues to weigh on the Indonesia economy

(especially the Indonesia Rupiah). To recap, reasons for a weak rupiah (which we detailed In our Indonesia Regional Strategy report dtd 17 July 2012) include:

(i) shortage in onshore USD liquidity
(ii) deteriorating external balances (which continues to worsen),
(iii) accommodative monetary policy and low bond yields that possibly translate to outflows/ reduced capital inflows as investors embark on a search for higher yield elsewhere.
(iv) policy missteps when the official tone has turned increasingly protectionist

- The shortage in onshore USD liquidity has eased along with lower risk aversion, especially with the tail risk of a EZ breakup reduced in view of the ECB's recent Outright Monetary Transactions. Furthermore, to address this paucity in onshore USD liquidity, the Indonesian government has recently auctioned USD term deposits at attractive rates to onshore banks in a bid to attract USD deposits as well as accepted a broader range of USD denominated collateral for commercial banks. However, we caution that beneath a seemingly calm backdrop, there are lingering risks from the looming US fiscal cliff as well as unresolved issues on the EU sovereign debt crisis. If these risks materialise, it is likely that the shortage of onshore USD liquidity might once again resurface.

Fig 2. Shortage in USD liquidity has eased



- Going forth, we expect the IDR to remain weak on the back of worsening external balances. Specifically, Indonesia's current account deficit widened for third consecutive quarter in 2Q12. The deficit is expected to persist on account of (i) sluggish exports (owing to weak external demand) as well as (ii) healthy imports (on the back of resilient domestic demand).

Fig 3. External balances have deteriorated…

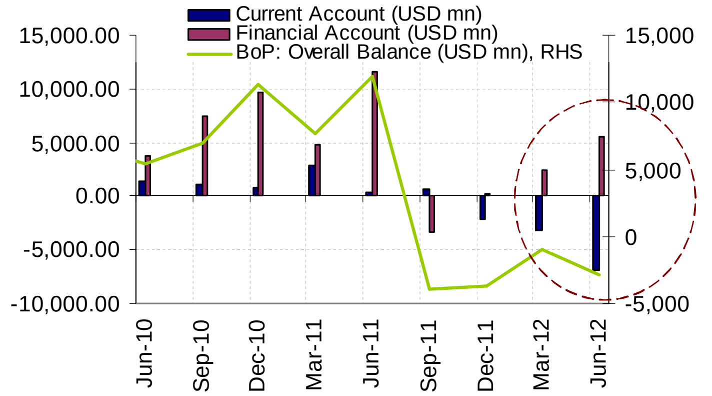
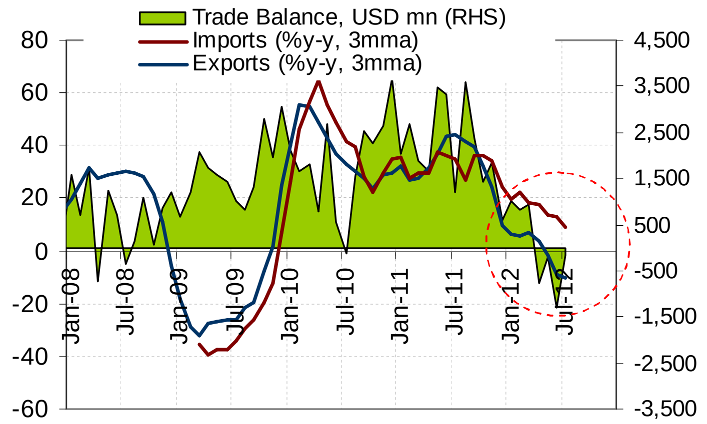


Fig 4. …largely due to widening current account deficit as exports slumped



- Without intervention by the Bank Indonesia, we suspect the IDR might be even weaker. While reserves remain adequate for now, import cover has been declining.

Fig 5. BI probably intervened to prop up the Rupiah - without which the IDR might have been even weaker.

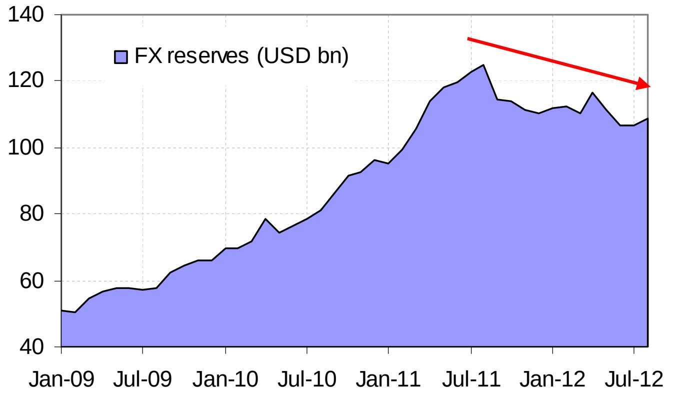
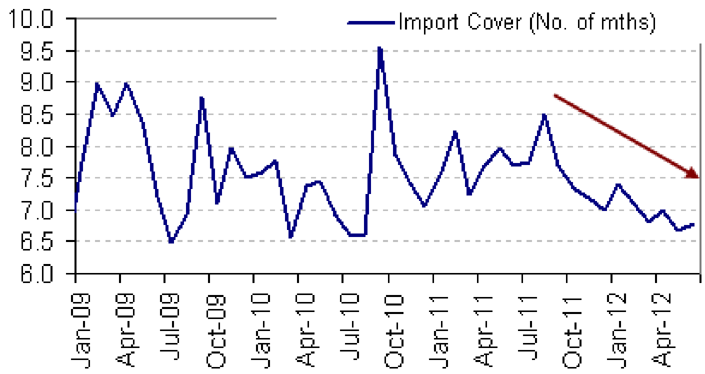


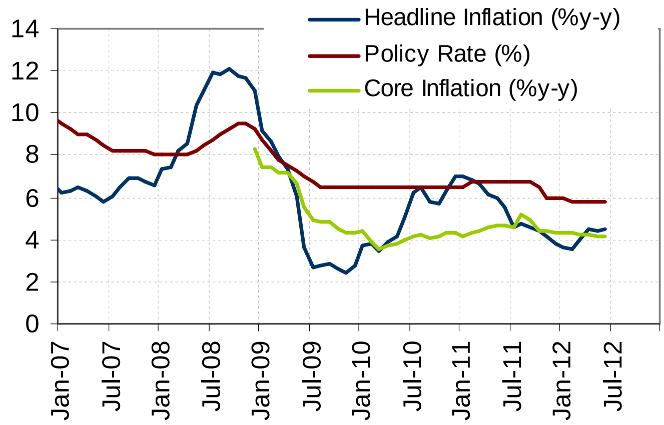
Fig 6. Import cover has been dwindling.



- The continued deterioration in external balances (as detailed above) is likely to pose a challenge in monetary policy formulation for the central bank (i.e. Bank Indonesia). Bank Indonesia stood pat at its September monetary policy meeting -maintaining the policy rate at 5.75% for the seventh consecutive meeting- on the back of resilient domestic demand which mitigated the sluggish external demand. CPI inflation rose 4.6% in August, similar to the pace registered in the preceding month.

- **Looking ahead, we expect Bank Indonesia to continue to stand pat (barring significant deterioration in the macro outlook). With inflation print (4.2% ytd) remaining within the target range (3.5 - 5.5%) and in view of elevated downside risks, odds are skewed towards a rate cut.** However, in view of the deteriorating external balances, a rate cut would further exacerbate the weakness in rupiah (IDR).

Fig 7. Inflation print within the target range; BI continued to stand pat.



CURRENCY:

- Currency weakness in the IDR remains a cause for concern for foreign investors. Ytd, the IDR has depreciated around 4% against the USD. Going forth, we expect the Indonesian rupiah (IDR) to weaken against safe havens such as the USD, JPY, and SGD. Specifically, (i) current account deficit is expected to deteriorate further. (ii) Furthermore, capital flight -in the event of risk aversion (US fiscal cliff, unresolved issues in the EZ)- will likely weigh on the financial account.

Fig 8. IDR has been on a secular depreciation path

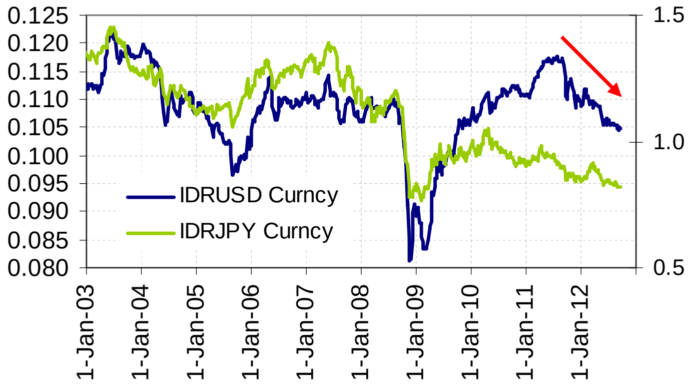
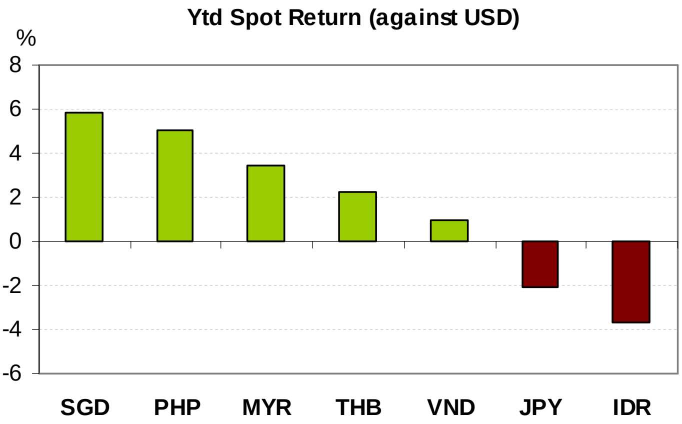


Fig 9. Amongst regional currencies, the IDR depreciated the most against the USD.



EQUITIES:

- **The JCI and MSCI Indonesia have returned around 10% and 5% ytd respectively. Compared to FExJ, Indonesia's uptrend still remains intact, owing to Indonesia's more domestically driven demand story offsetting external weakness**. MSCI Indonesia is currently trading at around 27% premium valuation of +16x T4Q P/E, +15x F4QP/E (compare Fig 12 with Fig 14). Not cheap you might say; but MSCI Indonesia's valuations are actually at the lower end of the range post 2007.

- **We would have remained Overweight Indonesia on account of the reasons above, but on a currency adjusted basis we downgrade Indonesia to Marketweight (Neutral). We caution that a weak rupiah as well as policy hazards in view of its "protectionist" stance of late are a cause for concern.**

Fig 10. MSCI Indonesia

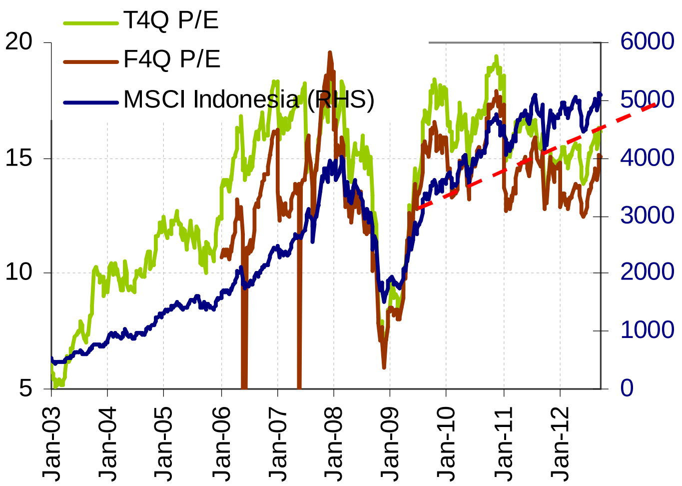
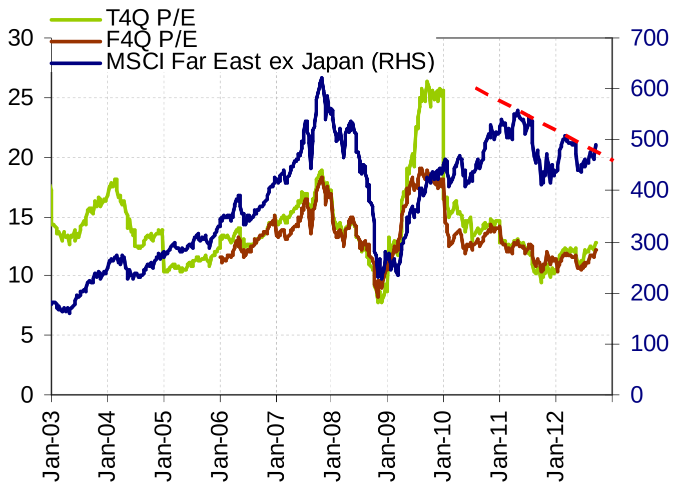


Fig 11. MSCI Far East ex Japan



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- ***Indonesia Sector Strategist's* Overweight top picks are: Bank Mandiri and Bank Rakyat Indonesia.**

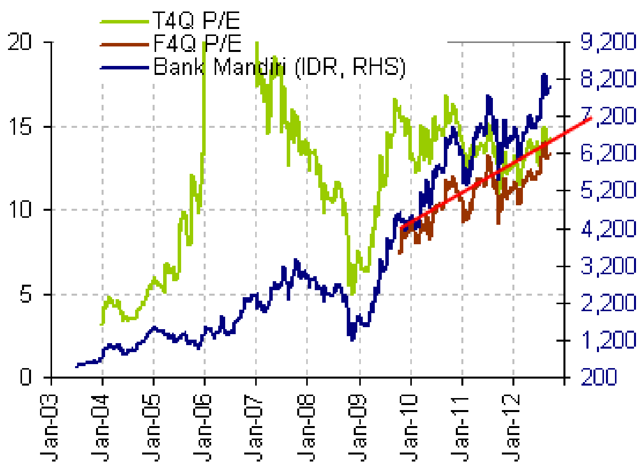
Top Picks:

Bank Mandiri

- IDR 8,200 (Accumulate), IDR 8,978 (12-mth target price), Market Cap > USD 18.6 bn. Currently, trading at T4Q p/e 14.2x, Fwd 4Q p/e 13.3x.

- Valuation: T4Q p/e 15.1x, Fwd 4Q p/e 12.9x is based 2012 EPS growth of 17.37% y-y.

Fig 12. Bank Mandiri



- BMRI is the largest bank in Indonesia in terms of assets, which reached IDR 571.7 trillion in the second quarter of 2012.

- As of the second quarter of 2012, 40.8% of the loan provided by BMRI was disbursed to corporate segment, 29.4% to commercial segment, 10.8% to small business segment, 14.8% to consumer segment, and 4.9% to micro business segment.

- Up to Jun 2012, BMRI has disbursed loan of more than IDR 125.2 trillion to corporate segment. In terms of funding, BMRI's time deposit grew 62.9% (y-y), followed by saving deposit 26.4%, and time deposit 15.3%.

- In 2Q12, BMRI posted the following ratios: CAR of 16.2%, LDR of 83.4%, NIM of 5.24%, Low cost fund ratio 62.3%, and net NPL of 0.55%.

- Bank Mandiri (BMRI)'s total revenue in Q2-2012 was IDR 20.22 trillion, or up 11.6% from the same quarter last year.

- As of the first quarter of 2012, BMRI owns 1,548 branches across Indonesia, and 7 overseas branches/representatives offices/subsidiaries. In addition, Bank Mandiri has a network of 99,765 Electronic data capture units as well as various and comprehensive electronic channels which include Mandiri Mobile, and Internet Banking.

- 27.8% of BMRI's fee-based income was generated from administration fee, 21.7% from its subsidiaries, and 14.17% from money transfer, retail transaction, and others.

- Viewed by sector, 14% of the loans provided by BMRI have been disbursed to the plantation industry, 13% to the manufacturing industry, and 10% to business services sector.

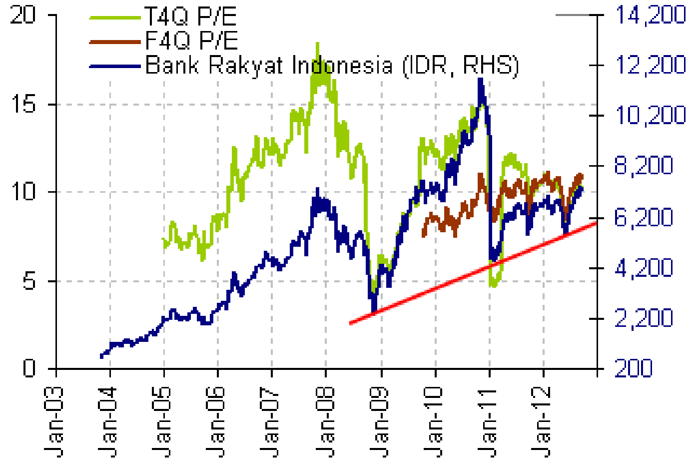
- As of March 2012, BMRI has the largest number of Automated Teller Machines (ATM) among bank rivals. The company owns 8,966 units of ATM across Indonesia. Its' close rivals, BCA (BBCA IJ), owns 8,836 units of ATM, BRI (BBRI IJ) operates 8,341 units, and BNI (BBNI IJ) owns 6,227 units.

Bank Rakyat Indonesia (BRI)

- IDR 7,350, IDR 7,909 (12-mth target price), Market Cap > USD 19 bn. Currently, trading at T4Q p/e 10.2x, Fwd 4Q p/e 10.8x.

    - Valuation: T4Q p/e 10.94x, Fwd 4Q p/e 9.5x is based 2012 EPS growth of 15% y-y.

Fig 13. Bank Rakyat Indonesia



- BRI is the second largest bank in terms of assets, which were IDR 456.5 trillion at the end of 2011, and the biggest in terms of outstanding loans, which were IDR 283.6 trillion at the end of 2011 and IDR 283.1 trillion as of the first quarter of 2012. The Government has 56.75% of total shareholder's equity in BRI. BRI is well-known for disbursing loans to micro businesses under the government program (KUR) as it's the biggest player by far in this segment.

- As of second quarter of 2012, the total credit BRI was disbursed 31.7% to micro, 18.9% to consumer, 20.7% to small business, 4.6% to medium business, 14.9% to state-owned enterprises, and 9.2% to corporate.

- As of June 2012, BRI disbursed micro loan of more than IDR 96.6 trillion.

- In terms of funding, BRI's CASA ratio is 62%, so the proportion of time deposits is as much as 38% of the third party deposits as of second quarter of 2012.

- In 2Q12, BRI has the following ratios: CAR of 16.00%, LDR of 82.13%, NIM of 8.49%, Op. expense to Op. income ratio of 61.81%, and gross NPL of 2.38%.

- As of second quarter of 2012, BRI owns 18 regional offices, 431 branches, 527 sub branches, 4,876 BRI units, and 1,621 teras BRI. As of second quarter of 2012, BRI's total employees are 44,211.

- Bank Rakyat Indonesia (BBRI)'s interest income in Q2 2012 was IDR 23.65 trillion or up 2.5% from previous second last year.

- BRI's fee based income has several sources: deposit administration fee (66.7%), loan administration fee (9.8%), ATM related fee (7.5%), and other (the rest).

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