October 2022

A Letter from Indonesia - Emerging Markets Research Trip

Our EM specialist investment partner, Northcape Capital, recently visited Indonesia – their second on-the-ground visit to one of their key markets since the pandemic. Indonesia is one of Northcape's "Most Preferred" EMs, with a substantial 9.5% weighting vs. the MSCI Emerging Markets Index (2.2%). Pleasingly, the trip reaffirmed the team's positive view on Indonesia from both a macro and company-specific perspective.

This information has been prepared by Northcape Capital, the underlying investment manager for the Warakirri Global Emerging Markets Fund.

Letter from Indonesia

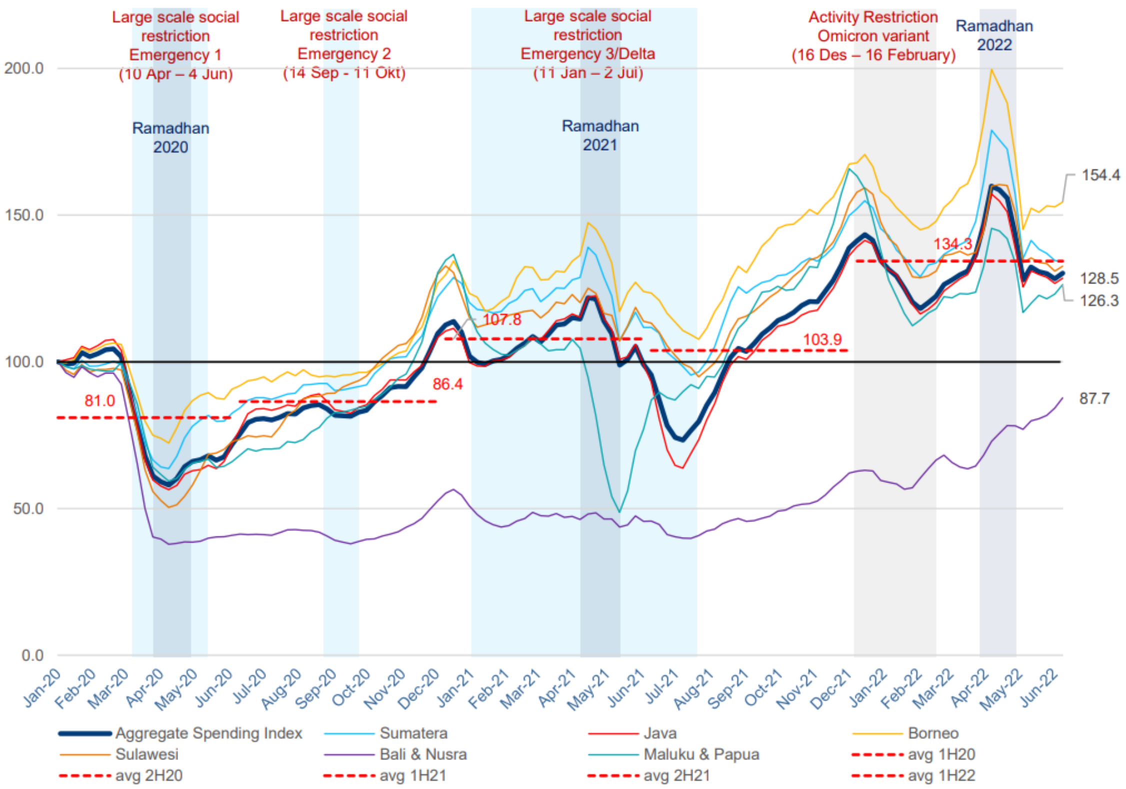
In September we visited Indonesia – our second on-the-ground visit to one of our key EMs since the pandemic. Indonesia is one of Northcape's "Most Preferred" EMs, and we have substantial 9.5% weighting vs. the MSCI EM index (2.2%). Pleasingly, our trip reaffirmed our positive view on Indonesia from both a macro and company-specific perspective.

The Indonesian market has performed solidly this year, flat in USD, well-ahead of the MSCI EM index, which has fallen -29%. The Indonesian Rupiah (IDR) has also been one of the more resilient EM currencies – down -6.4% vs. the USD.

A key factor underpinning Indonesia's outperformance has been the recovering economy which is growing around 6% at present – amongst the highest in EM. Buoyant commodity prices and positive real rates have also supported the IDR.

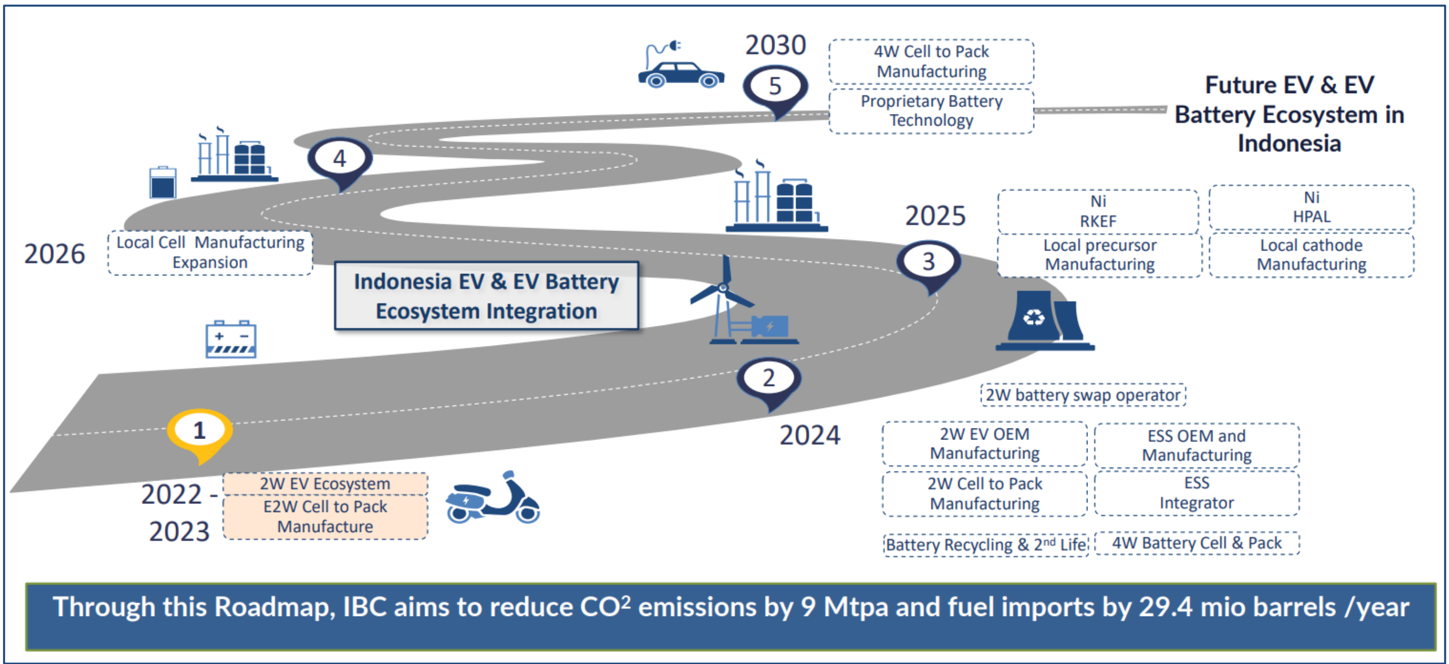
Indonesia's GDP is highly dependent on household consumption – it accounts for 54% of GDP, one of the highest in EM – well above China (38%) for instance. This means the economy took a big hit during Covid – as Indonesians were restricted from going out and about their daily business. But now that Covid restrictions have largely been lifted, activity has recovered swiftly. Indeed, economic activity indicators and surveys from leading banks such as Bank Central Asia (BCA) and Bank Mandiri indicate spending has returned to above pre-Covid levels **(see Exhibit 1).**

Exhibit 1: Mandiri Spending Index* by region – all regions ex-Bali are back above pre-Covid levels



Note: Mandiri Spending Index Tracks Bank Mandiri's Customer Spending Data Through Debit Cards, Credit Cards, Prepaid Cards, and Other Digital Transaction Channels

Exhibit 2: The Indonesia Battery Corp roadmap in EV and EV battery ecosystem development (Source: IBC)



The Indonesian economy has benefitted from strong commodity prices – notably palm oil, coal, nickel, although strength in these commodities is offset by the negative impact of the stronger crude oil price of which Indonesia is a net importer. Companies told us how buoyant prices for some of Indonesia's key commodities have translated into robust consumption in rural areas, especially in Kalimantan and Sulawesi. Indonesia's exports remain dependent on commodities – the annual export value of each of palm oil, coal and nickel individually is larger than the value of the country's manufacturing exports combined.

Indonesia's dependency on coal – both as an exporter and for its own electricity generation – does present challenges for the long run. That said, we were encouraged to hear about initiatives to decarbonise the Indonesian economy. Indonesia is targeting that 23% of its energy will come from renewable sources from 2025 (up from the current 17%), and most companies we spoke to were targeting the same. One leading coal company we met with says it plans to completely get out the coal business once its existing mine life ends, and in the meantime, it is embarking on green energy projects.

A major green energy initiative is the Indonesian Battery Corp, (IBC) who we met with. The IBC has so far raised $15bn and is backed by local mining, electricity and energy players, who have partnered with global battery leaders CATL and LG to try and develop Indonesia's EV battery ecosystem – from mining to recycling **(see Exhibit 2).** Ultimately Indonesia aims to manufacture its own electric bikes and cars.

Indonesia is naturally endowed with key metals and minerals that are crucial for EV and green energy supply chains, such as nickel, copper and bauxite, but typically these have been processed offshore, or by Chinese-owned smelters in Indonesia. Should the IBC, or other initiatives prove successful to onshore more of this downstream value chain, we see this as a positive for the Indonesian economy in the long run. EV penetration in Indonesia is still low – <1% of cars and bikes – but initiatives like the IBC should help boost this. Indeed, IBC management say they are targeting 14-20% 4W and 40-50% 2W EV penetration by 2035. GoTo – one of Indonesia's leading tech companies (see more below) – is looking to fully electrify the fleet of bikes used by its drivers which number more than 2.5mn **(see Exhibit 3).**

Exhibit 3: An electric bus, an MRT station under construction, Gojek drivers, and BCA's HQ (Northcape)

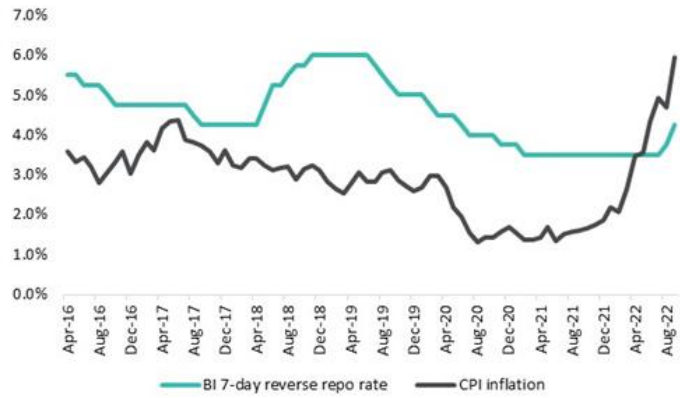
However, if Indonesia wants to become a bigger destination for global FDI – and thus reduce its reliance on commodity exports and lift its GDP growth rate – we think the country will need to accelerate its transition to renewable energy. Some global corporates are reluctant to manufacture in Indonesia given its energy mix is highly reliant on fossil fuels, and companies could face carbon border adjustment taxes if Indonesia does not lower its emissions. The country has proposed a carbon tax of just $2.02 per ton of CO_2 equivalent, and there is no firm date for its implementation.

Like other economies globally, inflation in Indonesia has been heading higher – jumping to 5.95% in September, and is expected to reach around 7% by year-end. Indonesia reduced its subsidies on fuel on 3 September (just before we arrived in the country), which saw the price of unleaded petrol jump by 30%. There were some minor protests around this announcement, but nothing too disruptive **(see Exhibit 4).** The move had been long anticipated, and had been suppressing Indonesia's reported CPI.

Exhibit 4: Barbed wire outside the National Monument to deter protestors (Source: Northcape Capital)

Companies and experts we spoke to think Indonesia's inflation will remain manageable, and indeed, the economy and consumers have been resilient to fuel price hikes in the past. Bank Indonesia has just put through a 50bps hike, and is expected to hike by another c. 75-100bps by mid-2023 **(see Exhibit 5).**

Exhibit 5: Positive real rates (until recently) have helped support the Rupiah (Source: Bloomberg Finance LP)



The combination of perky GDP growth and rising interest rates is positive for the Indonesia's banks, which is our largest sector exposure in the market. Several banks we spoke to indicated that they expected loan growth over the medium-term to average around 10% – in-line with nominal GDP, which is very healthy in the global context. The leading banks in Indonesia also have good leverage to higher interest rates with very low cost funding, high CASA (current and savings accounts – where higher rates are not typically passed on to customers), and a high proportion of variable loans (which reprice quickly with higher central bank policy rate). We think the leading banks are deliberately understating their NIM sensitivity to higher interest rates, which could result in a stronger-than-anticipated profit outlook over the next couple of years. Our key exposure in the sector is BCA, which has consistently been one of the very best performing banks in EM.

The digital economy in Indonesia is omnipresent – from e-commerce, ride-hailing, food delivery, and fintechs. Indonesian digital start-ups have attracted billions of dollars in funding, but none of the major ones are currently profitable. Take for example GoTo – which was formed by the merger of Tokopedia (Indonesia's leading e-commerce operator) and Gojek (leading on-demand player). In the last quarter GoTo generated revenues of $130mn, but incurred operating expenses of nearly $600mn – which mainly comprises promotions to its customers. The company is generating losses of around $500mn per quarter.

That the large Indonesian tech companies are still deeply loss making is concerning after we have just been through arguably the best conditions such businesses could hope for during the pandemic. Near-term potential headwinds include rising inflation which may crimp demand, and rising cost of funding for 'profitless tech' companies globally.

We will continue to monitor the space though, as the current market turmoil may lead to certain companies reaching attractive valuations, and result in the emergence of clear industry leaders.

There were initially concerns that fintech start-ups would come in and compete away the excellent profits enjoyed by the incumbent Indonesian banks. But this has not happened – in fact, the leading banks are enjoying above-sector growth in digital transactions, app usage, and are finding they are able to close some branches and ATMs which reduces costs. Their strong deposit franchises, which provides them with exceptionally low funding costs, has again proven to be an important competitive advantage. For instance, BCA pays around 1.9% on customers term deposits (and a mere 0-5bps on CASA) compared to Sea Ltd's SeaMoney which offers up to 7% on term deposits **(see Exhibit 6).**

Exhibit 6: BCA (top) vs. SeaBank (below) term deposit rates

Rupiah e-Deposito

Currency	Interest Rate (% p.a.) / Period (month)			
	1	3	6	12
IDR < 2Bn	1.90	1.90	1.90	1.90
IDR ≥ 2Bn - < 5Bn	1.90	1.90	1.90	1.90
IDR ≥ 5Bn - < 10Bn	1.90	1.90	1.90	1.90
IDR ≥ 10Bn - < 25Bn	1.90	1.90	1.90	1.90
IDR ≥ 25Bn - < 100Bn	1.90	1.90	1.90	1.90
IDR ≥ 100Bn	1.90	1.90	1.90	1.90

Effective from January 20, 2022

Note: amount in Rupiah (IDR)

Minimum Deposit

Rp8,000,000

Finishing up on politics, Joko Widodo ("Jokowi") has been President since October 2014. While his tenure hasn't been perfect, he has still been one of the better EM leaders over the past eight years, in our opinion. Jokowi has been known as the "Infrastructure President" and his achievements on this front will be clearly visible to those visiting Jakarta – from the updated terminal 3 at Soekarno-Hatta International Airport, to the MRT, new highways, and reduced traffic in the CBD.

Jokowi also promoted the Omnibus Law, with the aim of synchronising government regulations, cutting bureaucratic red tape, attracting investment, and generating jobs. The Law was last November ruled "conditionally unconstitutional" by the Constitutional Court, but if necessary changes can be made within two years, the Law would help improve Indonesia's ability to attract foreign direct investment – which has not quite meet expectations under Jokowi. Boosting its FDI remains critical for Indonesia if it is to escape the 'middle income trap', which would require GDP growth closer to 7% vs. the current 5-6%.

Attention is now turning towards the February 2024 elections. It is still too early to have a firm view on the frontrunners, and the candidates have not yet been announced. But the early favourite appears to be Ganjar Pranowo – the Governor of Central Java. Similar to Jokowi, he is seen as a "man of the people", and considered relatively moderate and centrist. Pranowo is arguably not quite as pro-business and does not have the same track record on infrastructure as Jokowi, but the initial indications are that if he were to be elected, this should result in continuity of Jokowi's major policy initiatives.

There has also been some talk that Jokowi himself may run as Vice President – there is no constitutional rule preventing him from doing so. The move would potentially help Jokowi see through his ambitious infrastructure agenda, which includes relocating the capital city to Kalimantan. Although critics point to the era of President Suharto, which saw him rule with an iron fist until his ouster in 1998 after which Indonesia embraced a freer democracy.

For more information, please contact us on 1300 927 254 or visit warakirri.com.au