Asia Special Report

GLOBAL ECONOMICS AND STRATEGY

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Indonesia: Building momentum

- With incremental reforms – our base case – the economy's building momentum should deliver 7% growth, on average, over the next five years. We identify 10 signposts of more substantial reforms which, if realised, could lift the growth rate above 8% by 2015.
- We expect an upgrade in the sovereign credit rating to investment grade next year, if not before. This is largely priced into government bonds, but we believe CDS still offers potential upside.
- Capital inflows should more than offset a narrowing current account surplus to support IDR/USD appreciation to 7,400 by end-2014.
- On the equity side, we favour natural resources stocks (such as Bukit Asam, Adaro, Bumi Resources and London Sumatra); stocks that benefit from discretionary consumption (Astra); infrastructure stocks (Jasa Marga and Semen Gresik); and stocks in the under-penetrated banking sector (micro-finance leader Bank Rakyat).

Principal Authors

Yougesh Khatri
+65 6433 6960
yougesh.khatri@nomura.com

Wilianto Ie
+62 21 2991 3341
wilianto.ie@nomura.com

Alastair Newton
+44 20 7102 3940
alastair.newton@nomura.com

See Disclosure Appendix A1 for the Analyst Certification and Other Important Disclosures

Foreword

We are pleased to present our inaugural special report on Indonesia, in which our economists, strategists, equity and political analysts assess the medium-term prospects for Indonesia, teasing out the key themes, opportunities and challenges over the next five years.

At Nomura, we pride ourselves in producing research of the highest standard. Historically, we have had a strong presence across Asia, and in recent years we have greatly increased our footprint in Europe and the United States to become Asia's leading global investment bank. We now have an Equity Research department of 400 analysts covering about 2,000 listed stocks globally and a Fixed Income Research team with some 190 client-facing analysts and over 30 economists worldwide.

Our roots in Asia allow us to see first-hand the breakneck speed at which the region's economies are emerging – and contributing over half of global GDP growth. China and India lead the world growth stakes, but Indonesia cannot be ignored. After more than a decade of reforms, the economy is now building momentum. The country boasts the world's fourth-largest population (which is also relatively young), an abundance of natural resources and finds itself in the tail winds of some of the world's most dynamic economies.

In this report – *Indonesia: Building momentum* – we identify six key investment opportunities and 10 milestones which, if realised, should lift Indonesia's real GDP growth above our base case of 7%, on average, over the next five years.

It is fitting that this report coincides with the build out of our equity business in Jakarta and this publication underscores Nomura's dedication to produce thematic, long-term studies, involving cross-region and cross-division collaboration among our research teams. We welcome your feedback as we continue our tradition of collaborative work to deliver unique investment insight and ideas to our clients.

Rob Subbaraman and **Simon Flint**
Co-heads of Fixed Income Research,
Asia ex-Japan

Stewart Callaghan
Head of Equity Research,
Asia ex-Japan

Acknowledgements

This study represents the combined efforts of many people.

Nomura has long seen the tremendous potential of Indonesia and against this backdrop was born the original idea of doing this special report by Alastair Newton, Senior Political Analyst and Rob Subbaraman, Chief Economist for Asia ex-Japan.

For their strong support in this project which spans many areas of research, we would like to especially thank Rob, Simon Flint (Global Head of FX Strategy), Stewart Callaghan (Head of Equity Research for Asia ex-Japan) and Jit Soon Lim (Head of ASEAN Equity Research).

A great many people provided input, insights and material we have drawn upon. We cannot thank everyone in this space, but below are at least some of the important contributors.

This report gets into some detail on issues relating to infrastructure, labour markets, natural resources, financial sector issues, fuel subsidies and other structural issues. The World Bank, Asia Development Bank and International Monetary Funds's research and publications in these areas have proven to be invaluable resources. Moreover, counterparts at these institutions have been extremely generous with their time and have provided deep insights during our various trips to Jakarta over the past 18 months.

A number of Indonesia's government and central bank officials have also been very generous in sharing their time and in articulating their objectives and priorities for the medium term, and of course their personal insights.

At Nomura's Asia Equity Forum in Singapore last June, presentations by our expert panellists in the Indonesia session – Sofyan Wanandi (Chairman of the Indonesia Employers Association, APINDO), James Castle (Founder of CastleAsia) and William Wallace (Senior Advisor, World Bank Jakarta) – and the subsequent Q&A with clients provided an ideal medium to draw out the most important opportunities and challenges on the minds of key stakeholders and international investors. We thank participants in the panel and investors and corporates in the audience of that session.

We have benefitted substantially from Kevin O'Rourke's (Founder of *Reformasi Weekly*) detailed knowledge and insights on Indonesia, both during our meetings with him and from his *Reformasi Weekly* – a valuable resource for key political and economic developments and analysis.

The authors are grateful to Sara Bazoobandi, University of Exeter, for her expert research into Indonesia's history and contemporary politics, which has been incorporated into our thinking in the preparation of this report.

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Despite our best efforts, there will be errors for which the authors accept full responsibility.

The cut-off date for information in this report is 1 June, 2011.

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Chapter 1: Introduction and conclusions

Yougesh Khatri
yougesh.khatri@nomura.com
+65 6433 6960

Wilianto Ie
wilianto.le@nomura.com
+62 21 2991 3341

Alastair Newton
alastair.newton@nomura.com
+44 20 710 23940

We identify six key investment opportunities and 10 signposts which, if realised, should lift Indonesia above our base case 7% average GDP growth over the next five years.

Indonesia is gaining its rightful place on the global stage, as evidenced by its membership in the G20. Its abundant natural gifts, including a large and young population, a stable liberal democracy, proximity in the world's fastest growing region, and an abundance of natural resources, underlie its tremendous – and now widely appreciated – potential. It has however taken one and a half decades since the Asian Crisis to regain the "darling of investors" status. The economy – averaging 5.7% growth over the past five years, compared with 4.7% over the five years preceding that – is building momentum, which is reflected in many metrics, including record-high FX reserves, increasing foreign direct investment and now a sovereign credit rating only one notch away from investment grade. Indeed, we see virtuous cycles kicking in (such as the growing middle class supporting consumption and FDI). In this sense, the "phoenix" metaphor might seem apt.

This study focuses on the medium-term outlook for Indonesia for the next five years. Despite the leaps of progress made recently, the remaining fundamental institutional reforms (of the electoral system and judiciary, amongst others) required to fully realize the economy's full potential are likely to be slow moving and dominated by imperatives for stability and consensus-building during the remainder of this administration. Those calling for faster progress should keep in mind that Indonesia remains a young democracy and a very diverse nation where a more evolutionary approach to reform, based on consensus building (particularly in the context of the prevailing Javanese culture), may be the more judicious and sustainable methodology with which to build on past gains.

In our view, the economic "momentum factors" such as demographic and income-growth sweet spots, in combination with the natural gifts stated above, should be enough to average 5.5-6.0% real GDP growth in the medium term (the "do nothing" scenario). However, our base case is that the current momentum will be augmented by incremental reforms and progress on infrastructure development, sufficient to deliver 7% GDP growth, on average, over the next five years. Within this base case, our fixed income and equity strategists and analysts have identified six main medium-term investment opportunities:

- **IDR/USD appreciation to 7,400 by end-2014** as supported by capital inflows.
- Much of the likely upgrade to a sovereign investment grade rating is already priced into the cash spreads, but we believe **CDS still offer potential upside**.
- **Natural resources:** We expect investment gains derived from increased global demand and the government's intention to promote downstream manufacturing and processing. Coal miners and palm oil plantations such as Bukit Asam, Adaro, Bumi Resources, and London Sumatra provide exposure to the sector.
- **Discretionary consumption:** we think Astra is the best proxy for capturing Indonesia's rapidly growing middle class, which, based on our estimates, will triple in size from 50mn people in 2009 to 150mn in 2014. Astra commands strong market leadership in cars, motorcycles and their supporting industries plus around one-third exposure to the commodity sector.

- **Infrastructure**: the government's 2010-14 development plan estimates that Indonesia requires US$220bn in overall infrastructure development. This should benefit market leaders in infrastructure such as Jasa Marga and the largest cement producer, Semen Gresik (which is expanding its capacity to support growth).
- **Financial:** banking is still under-penetrated and we favour Bank Rakyat, which dominates micro financing with strong brand equity and a high barrier to entry.

Our base case points to a bright outlook, but a key risk is complacency among policy makers as the reasonably high growth rate might stymie progress on reforms. Other risks include failure to kick-start infrastructure development, a global financial slowdown and collapse in commodity prices, sharply high commodity prices stoking inflation, and the political transition beyond President Yudhoyono. Natural disasters, with Indonesia on the "ring of fire", are always a background risk. Sectarianism and terrorism are headline grabbing but we think that environmental challenges pose the greater threat to Indonesia's economic and thus political stability.

The past five decades of relatively rapid growth and development – punctuated by the Asian Crisis – are instructive in that they have not been enough to sufficiently create quality jobs and reduce poverty, and fallen far short of the achievements made by neighbouring Malaysia and Thailand. Deeper institutional reforms aside, the development of physical and human capital would help boost growth potential (which we think could be closer to Indian than ASEAN growth rates). The government's medium-term development plan aims to do just that. Thus, we believe there is potential upside to our 7% growth base case scenario.

We identify 10 signposts which could indicate Indonesia was exceeding our base case, roughly ranked in order of importance:

1. Passage of the **Land Acquisition Bill** and its related regulations.
2. Realization of the planned step-up in **public infrastructure investment**.
3. Some **successful pilot public-private partnership projects** and a move to market pricing in the relevant sector (particularly power).
4. **Labour market reforms** – we look for a win-win simplification and reduction of severance pay together with more effective worker protections such as an unemployment benefits; re-establishing minimum wages as purely a safety net for low-wage earners; and an improved framework for skills development.
5. **The oil and gas sector** – further improvements in regulatory certainty and investment incentives and improved governance would likely boost much needed exploration and help stem the declining contribution of this sector.
6. **Removal of wasteful fiscal subsidies** on food and energy and reallocate the resources to productive human and physical capital investment.
7. **Financial sector development**, including a reduction in public ownership.
8. **Opening up the services sector** (particularly education and health) to domestic and international investment to boost quality, choice and productivity.
9. **Strong political backing for Indonesia's anti-corruption agency** (KPK) as a key indicator of the government's willingness to face down vested interests. Any erosion of the KPK's ability to deliver on its mandate would be seen as a negative by investors.
10. While past reforms will likely allow Indonesia to maintain momentum into the medium term, we look for **a pro-reform coalition to emerge from the 2014 elections** to allow Indonesia to maintain momentum into the latter part of this decade.

Chapter 2: A new-born nation

Alastair Newton
alastair.newton@nomura.com
+44 20 710 23940

Against the backdrop of the history of its first five decades since independence, Indonesia's achievements since 1998 outweigh the challenges with which it is still grappling.

Indonesia has only enjoyed post-colonial independence since 1945

Indonesia's fight for independence dates back to the early years of the Dutch colonial era. As the Second World War drew to a close in 1945, Indonesia's leaders formally declared independence. However, it was not until December 1949 that the Netherlands formally acknowledged Indonesia's independence – and not until 2005 that the government in The Hague accepted 17 August 1945 as Indonesia's official independence day.

At the outbreak of Second World War in 1939, the archipelago which comprises modern Indonesia had been under the colonial rule of the Netherlands since 1800. Invasion by Japan in 1942 effectively brought Dutch rule of the then Dutch East Indies to an end and allowed a previously suppressed independence movement to begin to grow. (For a more detailed chronology, please see Annex A.)

In March 1945, the independence movement established the Investigating Committee for Preparatory Work for Indonesian Independence (*Badan Penyelidik Usaha Persiapan Kemerdekaan Indonesia* or BPUPKI). The committee chose Soekarno as president (see Box 1). On 1 June 1945, Mr. Soekarno gave a speech to the BPUPKI outlining the first draft of the *Pancasila* (literally "five principles"), which remain (in principle at least) the official philosophical foundation of the Indonesian state (see Box 2).

Box 1: Soekarno (1901-1970)

Soekarno was born to a Javanese family from the lower aristocracy. He was educated in Surabaya (East Java), where he met many of Indonesia's future leaders, before studying civil engineering at the Technical Institute of Bandung. He founded the Indonesian Nationalist Party (PNI) in 1927. Between 1927 and 1931 he was imprisoned because of his nationalist activities and he was sent to exile from 1933 to 1938.

In 1945, he declared the Five Principles of the Indonesian nation (see Box 2), contributed to the drafting of the first Indonesian constitution and was central to the declaration of independence for the "Republic of the United States of Indonesia" (which in 1950 was changed to the Republic of Indonesia). He formally assumed the presidency on 27 December 1949 as Indonesia secured *de jure* independence from the Netherlands.

After the coup of 1965, he was pressured by the military to hand over power to General Soeharto, which he did finally in 1966. However, the figure and charismatic personality of President Soekarno have survived in popular memory through to the present, as the rise in popularity of Megawati Soekarnoputri, one of Mr. Soekarno's daughters and a leading political figure in her own right since the early 1990s, makes clear (see Box 4).

Mr. Soekarno's image in official history is somewhat tarnished by the corruption during the communist-dominated Guided Democracy era (1957-1965). However, he will perhaps live in the collective mind of the Indonesian nation as one of the rare country leaders who, in an extremely class-divided society, was close to the people, had an affinity to popular food and regularly sneaked out of the palace to mix with ordinary citizens.

As a nation, Indonesia remains geographically, ethnically and linguistically diverse

Mr. Soekarno declared the country's independence just two days after the end of the Second World War on 17 August 1945. However, there followed a four-year military and diplomatic struggle before the Dutch formally recognised Indonesia's independence on 27 December 1949, an event which saw the bringing together of over 17,500 islands, over 300 different ethnic groups and more than 250 distinct languages into a single nation state.[1]

[1] The Dutch territory of West New Guinea was an exception, only being transferred to Indonesia in the wake of the 1962 New York Agreement and formally incorporated in 1969.

Independence brings instability

Independence was followed by 15 years of instability and economic decline…

The first 15 years of Indonesia's history as an independent state were characterised by political instability and economic decline. As the Economist Intelligence Unit (EIU) puts it:

> *"The liberal democratic republic established in 1950 was characterised by frequent changes in cabinets, regional revolts and economic mismanagement. The situation deteriorated after 1959, when President Sukarno dissolved the elected House of Representatives and replaced it with a Provisional People's Consultative Assembly. This era of Guided Democracy was a period of political turmoil, during which economic prudence was often subordinated to revolutionary zeal in domestic policymaking."* [2]

Box 2: The *Pancasila*

In 1945, Mr. Soekarno and his advisers laid the basis for a national ideology intended to underpin the development of nationalism. The key was the doctrine of the Five Principles or *Pancasila*:

- Belief in the One and only God (*Ketuhanan Yang Maha Esa*);
- Just and civilised humanity (*Kemanusiaan Yang Adil dan Beradab*);
- National unity (*Persatuan Indonesia*);
- Democracy based on consensus flowing from deliberations among representatives (*Kerakyatan yang Dipimpin oleh Hikmat Kebijaksanaan dalam Permusyawaratan dan Perwakilan*); and,
- Social justice (*Keadilan Sosial bagi Seluruh Rakyat Indonesia*).

… which helped open up a major rift between the Communist-influenced president and the army

As a consequence, by 1957 the army was playing an increasingly active role in politics (and, indeed, in the economy, underlined by the military's seizure of Dutch companies in December of that year which it justified in the context of an ongoing dispute with the Netherlands over the future of West New Guinea – see footnote 1).

However, Mr. Soekarno's politics were increasingly seen as being influenced by the People's Republic of China, following his visit there in October 1956 and the consequent increasing influence of the Indonesian Communist Party (*Partai Komunis Indonesia* or PKI) not only rang alarm bells in Western capitals (especially Canberra, London and Washington) but was also instrumental in opening up a rift between the army and the president (which was ultimately to lead to Mr. Soekarno's downfall in 1965).[3]

In response, Mr. Soekarno moved closer to the PKI (and the Indonesian Air Force) in an effort to strengthen his position relative to the army, evolving his ideology into *Nasakom*, i.e. nationalism (a gesture to the army), religion (to woo the Islamists) and communism. His success at balancing opposing forces against one another during this period earned him the description in some quarters as the great *dalang* or "puppet master".

However, the army benefitted in popular opinion from its successes against various rebellions and by 1963 was being courted by both the Soviet Union (anxious to counter the increasing influence which China was wielding via the PKI (now reportedly two million-strong) and the United States. This led to a proposal from PKI leaders to establish a "fifth force", made up of armed peasants and workers, and the appointment of *Nasakom* advisors to the armed services, which was perceived as a direct threat to the army.[4]

[2] Indonesia Country Profile, Economist Intelligence Unit (2010).

[3] Mr. Soekarno laid out the basis of Guided Democracy – later known as *Manipol* (or political manifesto) – in his 17 August 1957 Independence Day address. It subsequently evolved into an ideology known as USDEK which incorporated the 1945 constitution, nationalism, socialism and a guided political and economic framework.

[4] "Fifth" relative to the army, navy, air force and police.

The downfall of Communism…

The demise of the Soekarno regime in the mid-1960s was a tumultuous period…

What followed was arguably the most tumultuous period in Indonesia's often troubled history.

On the night of 30 September/1 October 1965, six senior Indonesian army generals were assassinated by members of an army faction called the *Gerakan 30 September* (G30S). Confusion followed. But by the end of 1 October, what appeared to have been an attempted *coup d'état* had been stymied. The army blamed the PKI and launched a nationwide anti-communist purge in which, according to consensus, as many as half a million may have died as the PKI, which had officially been banned on 18 October, was effectively neutralised as a political force.[5]

In March 1966, as the purges drew to a close, a new cabinet was agreed upon by Mr. Soekarno and by Major-General Soeharto (see Box 3), who had been appointed chief-of-staff of the army the previous year in what was widely seen as a victory for the right wing of the military establishment. That cabinet was replaced in June by a five-man presidium chaired by General Soeharto. The political sparring which followed saw key personnel loyal to Mr. Soekarno quickly replaced by supporters of the General; Indonesia formally bury its differences with neighbouring Malaysia (the so-called *Konfrontasi*); and the country rejoin the IMF, the World Bank and the United Nations (from which it had stepped down at the height of Guided Democracy).

… up to the appointment of General Soeharto as acting president in March 1967

On 12 March 1967, a special session of the Provisional People's Consultative Assembly (MPRS) – as the supreme legislature had come to be called by then – agreed to strip President Soekarno of his powers and appoint General Soeharto as acting president.

… and the rise of the New Order

President Soeharto quickly established an authoritarian system of governance…

Just over a year later on 27 March 1968, General Soeharto was sworn in as Indonesia's second president, thereby marking the end of the transition to the "New Order" which was to dominate Indonesian politics for a further 30 years.[6]

As president, General Soeharto established an authoritarian system characterised by tight centralised control and long-term personal rule. At the top of the hierarchy was the president himself, making important policy decisions and carefully balancing competing interests in the country to maintain his power. Arrayed below him was a bureaucratic state in which the military played the central role. The military's dual political-social function was set up to be a permanent feature of Indonesian nationhood, in contrast to other Southeast Asian regimes like Thailand and Burma where military regimes promised an eventual transition to civilian rule.

… albeit one still based, in principle, on the *Pancasila…*

Shortly after Mr. Soeharto assumed the presidency he appointed Ali Murtopo, a senior army officer whom he had known since the 1950s, as a member of his *Aspri,* or group of special presidential assistants.[7] Mr. Murtopo recognised that a new device was needed to wean popular sentiment away from the charismatic former leader, Mr. Soekarno, and towards the new regime. This led directly to the Soeharto regime presenting itself as the "New Order", replacing a revolution based on the personality of Mr. Soekarno. That "order" was based

[5] The ban was actually announced on army-controlled radio stations and there was some doubt at the time over whether it applied to the country as a whole or only to Jakarta. However, it did provide a platform for the purge that followed.

[6] President Soeharto was re-elected for further five-year terms in 1973, 1978, 1983, 1988 and 1993. His re-election was, on each of these occasions, by Indonesia's legislature, not by universal franchise.

[7] The *Aspri* – or *Asisten Pribadi* – had no official power but in practice its members, especially Ali Murtopo and Sujono Humardhani, wielded significant influence over policy. This ultimately led to its disbandment in 1973/74 as it became a major focal point for critics of the regime.

on adherence to the *Pancasila*, an abstraction of higher value than the president, thus enshrining (in principle, at least) the *Pancasila* and the 1945 Constitution as the highest elements of the nation so that the new regime could claim to be one based on the rule of law.

… coupled with "functional groups" or Golkar

Besides formulating key elements of the Soeharto regime's ideology, Mr. Murtopo engineered mergers of existing political parties and reformulated Mr. Soekarno's Guided Democracy into a state based on "functional groups" called Golkar after the Indonesian abbreviation of their name, *Golongan Karya*.[8] His success in "*Golkari*-ising" the nation was shown in the first New Order parliamentary election of 1971 where Golkar received two-thirds of the vote.

Box 3: Soeharto (1921-2008)

Haji Muhammad Soeharto, usually referred to simply as Soeharto, became Indonesia's second president in 1967 and held that office until his resignation in 1998. He was a career soldier, rising to the rank of Major General after independence.

As president, Mr. Soeharto declared a total break with the past, purging communists from the system and launching new plans for an expanded education system and to raise living standards as key elements in establishing peace and stability. By the end of his first term the armed forces were firmly in control of the country and a system had been instituted which would publically affirm his leadership every five years. Western support for the regime was epitomised by its financial help with food imports.

Throughout his rule, Mr. Soeharto put a strong emphasis on the *Pancasila* (see Box 2) which he considered a statement of what bound Indonesians together. In 1975 political parties were required to incorporate the constitution and the *Pancasila* into their charters. National ideology and national history were introduced into the school system at every level to spread the message of essential unity of indigenous Indonesians.

The economic policies introduced by Mr. Soeharto were based on neo-liberal classical theories aimed at creating a comfortable middle class but, in practice, also bringing vast wealth to a small minority comprising family members and others closely connected to the government.

On 21 May 1998, Mr. Soeharto announced his resignation from the presidency amid mass protests over corruption and the human rights abuses. His recently appointed Vice President, B.J. Habibie (see Box 6), assumed the presidency. Mr. Soeharto did not stand trial (on health grounds) and lived quietly in Jakarta until his death in January 2008.

The resultant greater stability owed much to the power and loyalty of the military

Although opposition movements and popular unrest were not entirely eliminated, the government under Mr. Soeharto was astonishingly stable – and especially in comparison with the previous regime. This stability was firmly based on the military's extensive political and administrative powers and its absolute, or near-absolute, loyalty to the regime.

New Order, new discipline

Only two parties – one secular, one Islamic – were allowed to contest elections with Golkar

After the establishment of the New Order the political parties system was changed. In the period between 1967 and 1971 the surviving non-Islamic political parties were joined into an Indonesian Democratic Party (PDI). Likewise, the Islamic parties were brought together into a more neutrally named United Development Party (PPP). These two parties alone were allowed to contest elections with Golkar (but they were never allowed to get too large a proportion of vote). Golkar's guaranteed support from the military, public service and centrally controlled unions made it a highly effective political machine – although the Soeharto regime differentiated it from the PDI and PPP by insisting that it should not be referred to as a "political party" *per se*.

The end of the New Order…

By the 1980s Indonesia had entered an exceptional period in its history. The near monopoly on violence enjoyed by the government meant that it could maintain an image of quiescence which assured it of international support

[8] Civil servants and the military were the two main functional groups united into a single body answerable to the state.

(especially in the geopolitical context of the Cold War and the aftermath regionally of the Vietnam War). Western countries built up close relations with Indonesia, particularly with the military.

… but the fall of the Berlin Wall eroded that support as domestic pressure for democratisation rose

However, the country could not isolate itself from the geopolitical shifts which followed the fall of the Berlin Wall in 1989. By that time, NGOs were increasingly calling for democratisation and the government was pressured into an official policy of social liberalism called "Openness" (including support for previously suppressed Islam), as well as proclaiming a period of liberalisation of the economy. Furthermore, the post-Cold War boost to globalisation was to prove a two-edged sword. On the one hand, it stood to benefit Indonesia's economic prospects – at least up until the time of the 1997 Asian financial crisis and the global economic crisis of the following year (see below). On the other, for opponents of the regime it served as a way of showing that the government could not control all aspects of life. Notably, as Indonesia came increasingly under international scrutiny, the growth of new forms of media meant that filtering information was getting harder for the government. Furthermore, the collapse of the Soviet empire meant that Mr. Soeharto's Western supporters were much less inclined unquestioningly to support his regime now that the perceived global threat posed by communism had diminished.

The decline in domestic support for the regime was exacerbated by increasing corruption…

Inevitably, in our view, Mr. Soeharto started to lose popular support. In addition to the global context, there were two main domestic drivers. First, he was implicated in controversial steps which were taken by the government in 1996 to weaken Megawati Soekarnoputri (daughter of former President Soekarno and herself a leading politician by this time – see Box 4) and the PDI. Second, especially after the death of his wife in 1996, he appeared increasingly unable to control corruption, particularly the widespread rent-seeking business activities of his relatives and other associates; indeed, economic liberalisation had allowed the large conglomerates controlled by the Mr. Soeharto's children and key ethnic Chinese-Indonesians close to the president to increase their wealth and power.[9]

… and the Asian financial crisis

"The depth of the collapse in Indonesia, if not unparalleled, is among the largest peacetime contractions since at least 1960 (excluding the experience of the Transition economies)." [10]

… and the Asian crisis served to hasten President Soeharto's downfall…

The timing of the Asian financial crisis of 1997 was to prove instrumental in at least hastening the downfall of President Soeharto and, therefore, in spurring the start of a decade of rapid political and economic transition in Indonesia.

In the first half of 1996, rising domestic interest rates and falling inflation prompted a strong inflow of foreign capital and an appreciation of the rupiah. However, largely for political reasons, this trend rapidly changed. By early 1997 concerns about Indonesia's political stability were being reinforced by fears that the country's economy, while exhibiting considerably more healthy fundamentals than those of its neighbours, was heading to a point where its stability was at risk.

… by exposing critical weaknesses in governance

Despite the advantages of Mr. Soeharto's authoritarian rule in terms of capacity for action and the regime's aggressive response to economic challenges in the past, the events of 1997 exposed a number of critical weaknesses in Indonesia's governance. These included: the risk of arbitrary actions; a lack of transparency surrounding business-government relations; and the uncertainties

[9] On a symbolic level, observers of Javanese culture noted that the ideal ruler should have ruled in partnership with his spouse. On a practical level many imagined she had exercised a restraining hand on her family.

[10] "Economic Crises: Evidence and Insights from East Asia" by Jason Furman and Joseph Stiglitz – paper prepared for the Brookings Panel on Economic Activity, Washington DC, November 1998.

which surrounded political succession. Once Mr. Soeharto's grip on power was called into question, the challenges his regime faced became increasingly apparent and the credibility of the government started to decline.

Domestic political uncertainties put the rupiah at high risk of contagion from the currency crisis which had began in Thailand in mid-1997 and rapidly spread throughout southeast Asia. On 21 July 1997 alone, as the regional crisis deepened, the rupiah fell by 6% against the US dollar – the biggest one-day fall in five years. Faced with continued pressure on the currency, Bank Indonesia, the central bank, announced the application of a floating exchange rate policy, which led to further devaluation to the point where the rupiah lost almost 80% of its value against the US dollar.

Box 4: Megawati Soekarnoputri

"… Megawati came to power on the crest of a wave of youth rebellion. Those kids didn't really think about it; they didn't have any other figurehead, so they adopted her because she was Soekarno's daughter…"

Pramoedya Ananta Toer, *Time Magazine* (2001)

Ms. Megawati Soekarnoputri, the daughter of President Soekarno, was born two years after her father was appointed head of state and was 20 when his presidency ended. After her father's ouster, Ms. Megawati and other members of her family lived through difficult times as a result of their closeness to a figure viewed by the new regime as being responsible for the decline of the Republic of Indonesia.

She has been active in politics since 1987 and assumed the leadership of the Indonesian Democratic Party (PDI) in December 1993. In 1996, she became a symbol of resistance to the Soeharto regime following her attempted expulsion from the Democratic Party. In response, Ms. Megawati founded the Indonesian Democratic Party - Struggle (PDI-P), which won the 1999 parliamentary election on the back of huge popular support. However, she failed to gain a majority of the votes in the MPR in the subsequent presidential election and was obliged to settle for the role of vice-president to President Abdurrahman Wahid. Nevertheless, in July 2001 Mr. Wahid was removed from office by a unanimous vote at a special session of the MPR and Ms. Megawati become Indonesia's fifth president in a little over three years, serving as head of an uneasy coalition until October 2004.

Ms. Megawati ran for a second term in the October 2004 presidential election (Indonesia's first direct presidential election by universal suffrage); but she lost to Susilo Bambang Yudhoyono (see Box 7) in the second round. She nevertheless remains an important political figure in Indonesia as the leader of PDI-P and, despite a decline in her popularity, was widely seen as the main rival to Mr. Yudhoyono in the 2009 presidential election. Furthermore, some commentators think that she may stand in the 2014 presidential election – although others believe that her daughter, Puan Maharani who is now a senior member of PDI-P, may be the preferred candidate of her party.

Political turbulence also upset the inflow of foreign direct investment (FDI). In 1997, FDI inflows to Indonesia fell by around 9%, a downtrend which continued for several years.[11] This reached the point where, according to the World Bank, approximately $9bn net of foreign capital left the country in 2000. In addition, GDP growth slowed to 4.7% in 1997 and then GDP contracted by 13.2% in 1998, the worst performance since records began. Severe inflation – as high as 80% – also shook the economy in 1998 (see Chapter 4).

The increasing clamour for reform finally brought the Soeharto era to an end on 21 May 1998

By early 1998, in response to the deteriorating economic situation and mounting political pressures, Mr. Soeharto and those around him were trying to engineer mass violence against opposition forces. But the call for reform was now heard in all levels of society. After a dramatic few weeks of action by the reformists, Mr. Soeharto's position finally became untenable. He resigned on 21 May 1998 and handed power to B J Habibie (see Box 6), thereby marking the beginning of a new era in Indonesia's evolution.

[11] United Nation's World Investment Report.

Annex A: Independent Indonesia

A chronology

1945 Future President Soekarno sets out the Pancasila in a speech on 1 June

Soekarno and Mohammad Hatta (the first vice president) proclaim independence on 17 August, signalling the beginning of the Indonesian Revolution

1949 Indonesia achieves full independence on 27 December

1950 Federal states dissolve and Indonesia's first unitary cabinet meets on 6 September

1952 Army-organised demonstrations in Jakarta on 17 October demand the resignation of the legislature, leading to the appointment of a new cabinet (after lengthy negotiations) on 31 July 1953

1955 The start in March of regional rebellions in Sulawesi and Sumatra, which persist until 1961

Continuing disagreements with the army lead to another new cabinet being sworn in on 12 August

The parliamentary general election held on 29 September turns out to be the last free national election until 1999

1957 President Soekarno announces his "Conception" (Konsepsi) for Indonesia on 21 February, paving the way for "Guided Democracy"

Declaration of martial law and resignation of the cabinet on 14 March

Attempted assassination of President Soekarno in a grenade attack on 30 November

1959 With the support of the army, President Soekarno dissolves the Constituent Assembly on 5 July and announces a reversion to the 1945 constitution, thereby completing the introduction of "Guided Democracy"

1962 The New York Agreement transferring sovereignty over Western New Guinea to Indonesia from The Netherlands is signed at the UN

1963 President Soekarno is elected "President for life" by parliament on 18 May

President Soekarno leads the Konfrontasi campaign against newly independent Malaysia (until 1965)

1964 President Soekarno launches an anti-American campaign on 17 August

1965 Indonesia withdraws from membership of the UN on 7 January (rejoining on 28 September 1966)

Assassination of six senior generals by the so-called G30S army faction in an abortive coup attempt on 30 September/1 October triggers a nationwide anti-communist purge.

President Soekarno appoints Major General Soeharto as minister/ commander of the army

1966 President Soekarno signs the Supersemar delegating presidential power to General Soeharto on 11 March

1967 The Provisional People's Consultative Assembly (MPRS) strips President Soekarno of his remaining powers on 12 March and appoints General Soeharto acting president

1968 General Soeharto formally sworn in as president on 27 March

1970 Former President Soekarno passes away on 21 June

1971 Indonesia's second parliamentary election – and first under the "New Order" – held on 3 July results in a majority for Golkar

1973 A three-party system is established comprising Golkar, the Indonesian Democratic Party (PDI, bringing together nationalist and Christian parties) and the United Development Party (PPP, bringing together Muslim parties)

1975 East Timor declares independence from Portugal on 28 November and is occupied by Indonesia nine days later

1976 Indonesia formally annexes East Timor as its 27th province on 17 November – a move that is rejected by the UN General Assembly on 19 November

1978 The *Pancasila* is declared compulsory moral education for youth and government officials

1985 All Indonesian organisations are required to adopt the *Pancasila* as their sole philosophy

1989 The Free Aceh Movement (GAM), founded in 1976, re-emerges, spurring renewed conflict in the region

1997 A shift in El Niño in June leads to a protracted period of severe drought across much of the country, accompanied by forest fires

The Asian Crisis is triggered by the collapse of the Thai baht in July

1998 President Soeharto is unanimously elected by the MPR for a seventh term on 11 March as (initially largely peaceful) student demonstrations against the regime start to escalate, leading to violent riots by mid-May

President Soeharto resigns on 21 May and is succeeded by B.J. Habibie

1999 On 7 June Megawati Soekarnoputri's PDI-P wins a plurality in the first free and fair legislative elections since 1955

In a UN-sponsored referendum held on 30 August, almost 80% of East Timorese vote for independence

Abdurrahman Wahid is elected president by the MPR on 20 October

2001 Mr Wahid is ousted from the presidency and succeeded by his vice president, Ms Megawati Soekarnoputri, on 23 July

Susilo Bambag Yudhoyono establishes the Partai Demokrat (PD) in September

2002 East Timor becomes an internationally recognised independent state on 20 May

Suicide bombings in Bali kill 202 people on 12 October

The Indonesian government and the GAM sign a peace accord in December, but the agreement breaks down in 2003

2003 Jemaah Islamiyah bomb Jakarta's Marriott hotel on 5 August, killing 12

2004 A bomb attack outside the Australian embassy on 9 September kills 11 and injures around 100 people

Mr Yudhoyono wins the final round of Indonesia's first direct presidential ballot by universal suffrage, taking office on 20 October

Indian Ocean earthquake and tsunami kills an estimate 230,000 people in Aceh alone on 26 December

2005 A new peace agreement between the government and GAM leads to the withdrawal of the army from Aceh in December

Bombings in Bali on 1 October kill 20 people

2006 An earthquake on 27 May kills thousands of people in central Java

2008 Former President Soeharto passes away on 27 January

First G20 summit is held in Washington on 15 November

2009 Mr Yudhoyono secures a second term, scooping just over 60% of the vote in the first round of the presidential election on 8 July

Jakarta hotel bombings on 17 July kill nine people

Jemaah Islamiyah commander Noordin Muhammad Top, is shot and killed by security forces on 17 September

2011 Indonesia assumes the ASEAN presidency for the year

Chapter 3: The age of "Reformation"

Alastair Newton
alastair.newton@nomura.com
+44 20 710 23940

Stability and consensus building are likely to continue to take precedence over reform for the remainder of President Yudhoyono's second and final term.

The period since 1998 has been one of both revolution and reformation…

By any standards, the period between the collapse of the Soeharto regime and the present day has been one of remarkable change in Indonesia. However, although Indonesians continue to refer to the immediate aftermath of the demise of President Soeharto as an age of crisis, the leaders who followed him have encouraged people to see themselves in an age not of revolution but of *reformasi,* or reformation.

… during which Indonesia has gone through a remarkable transformation

We have some sympathy with both views. On the one hand, we firmly take the view that Indonesia has made remarkable progress, both politically and economically over the past decade or so. On the other hand, we also accept that a more evolutionary approach to reform based on consensus may well be the most judicious basis on which to build long-term stability – especially given Indonesia's history from independence to the collapse of the Soeharto regime (the key context, in our view, in which to see contemporary Indonesia), not to mention its diversity (see Box 5).

Box 5: Contemporary Indonesia – some basic facts and figures

Total area:	5,070,606 sq km
Land area:	1,904,443 sq km (divided among over 17,500 islands)
Sea area:	3,166,163 sq km (before deductions for sea area now under the control of Timor-Leste)
Population (2010):	237 million
Age structure:	0-14 years: 27.7% (1.04 male/female)
	15-64 years: 66.2% (1.01 male/female)
	65 years and over: 6.1% (0.79 male/female)
Median age:	28.2 years
Ethnic groups:	Javanese – 40.6%; Sundanese – 15%; Madurese – 3.3%; Minangkabau – 2.7%; Betawi – 2.4%; Bugis – 2.4%; Banten – 2%; Banjar – 1.7%; Other/unspecified – 29.9%
Languages:	Indonesian (Bahasa Indonesia), as well as some 250 other regional languages and dialects. English has replaced Dutch as the main second language and is widely spoken in government and business circles
Religions (2000):	Muslim – 86.1%; Protestant – 5.7%; Roman Catholic – 3%; Hindu – 1.8%; Other/unspecified – 3.4%

(Sources: CIA World Factbook, Economist Intelligence Unit, Nomura)

Reformasi

"The achievements of Indonesia's Reformasi era are important and lasting. But the country must move beyond changes to the formal set up of its institutions to undertake a substantive institutional transformation, and it must do so quickly to make the most of globalization and avoid the pitfalls of heavy dependence on natural resources and low-wage manufacturing."

Anthony Saich,
Director of the Rajawali Foundation Institute for Asia, 30 August 2010

In the four years which followed the downfall of Mr. Soeharto, Indonesia was to have four more presidents.

Mr. Soeharto's successor, B.J. Habibie, pursued reforms which undermined his popularity

In May 1998, B.J. Habibie became Indonesia's third president. His reforms involved some major economic changes in the light of the post-Asian crisis IMF support package and the application of "Washington Consensus" measures. The short-term consequences of these measures were, perhaps, to be the main factors underpinning the decline in Mr. Habibie's popularity which led to his withdrawal from the presidential election of 1999 (see Box 6).

Box 6: Bacharuddin Jusuf Habibie

Bacharuddin Jusuf Habibie, Indonesia's third president, was born in 1936 to a Javanese family which was to become close to (then) Colonel Soeharto in the 1950s. President Soeharto appointed him as a presidential advisor on technology in 1974 and then as minister for technology from 1978 to 1998. As a cabinet member, he was also a leading member of Golkar. He was elected vice president in March 1998 shortly after Mr. Soeharto had accepted the nomination for a seventh term as president.

By the time of Mr. Soeharto's resignation on 20 May 1998, Mr. Habibie had carefully positioned himself as the legitimate successor and was duly sworn in as president the following day.

Although Mr. Habibie was to occupy the presidency for just 17 months, he made a significant contribution to the democratisation process during a difficult transition period, both politically and economically. Notably, he oversaw the first free elections since 1955 and the East Timor independence referendum. His administration also appointed a group of investigators to expose the history of military abuses against separatists in the outlying regions of Indonesia. Furthermore, he succeeded in stabilising the economy, albeit at a time when (from November 1998 at least) financial markets had calmed considerably.

Nevertheless, in a country which had had over three decades of political suppression and which was struggling with separatist pressures (in addition to the consequences of the Asian financial crisis), Mr. Habibie inevitably found himself walking a tightrope between democracy and disintegration, the masses and the military. As such, he was, in our view, always likely to struggle to meet popular expectations. In particular, he was strongly criticised over the East Timor referendum; question marks persisted over his administration's pursuit of Mr. Soeharto over alleged corruption; and the reforms he brought in inevitably upset vested interests while failing to satisfy the pro-reform lobby.

In consequence, despite his determination to continue as president, his chances of winning the 1999 presidential election declined sharply even though he was nominated as the Golkar candidate. The legislative elections held on 7 June 1999 saw Golkar (120 seats out of a total of 462 contested) defeated by PDI-P (153 seats), adding to the pressure on Mr. Habibie. The crunch came in October when Mr. Habibie delivered his accountability speech to the general session of the MPR only to see it rejected in the subsequent ballot when pro-reform members of Golkar broke ranks. In the wake of this defeat, Mr. Habibie withdrew his nomination for the presidency.

Since retiring from frontline politics, Mr. Habibie has continued to work for democratisation through the Habibie Centre and has recently been an adviser to President Yudhoyono.

His successor, Abdurrahman Wahid, clashed with the military…

Mr. Habibie was succeeded by Abdurrahman Wahid (colloquially known as Gus Dur), an East Javanese preacher who had long been a leader of the Islamist group *Nahdlatul Ulama* (NU). In 1998, he had been persuaded by his supporters to form a new political party, the National Awakening Party (*Partai Kebangkitan Bangsa*, PKB) which, although dominated by NU members, promoted itself as sectarian.

PKB won 12% of the vote in the following year's legislative elections, which saw Megawati Sukanoputri's PDI-P emerge with a clear plurality of 33% of the vote. Initially, PKB formed a loose alliance with PDI-P; but this was to prove short-lived as the former realigned itself with the Central Axis, a coalition of Muslim parties formed by Amien Rais. This partnership was pivotal in the election of Mr. Amien to the chair of the People's Consultative Assembly (*Majelis Permusyawaratan Rakyat*, MPR) in October 1999 and to the MPR's election of Mr. Wahid to the presidency later that month.[12] The backlash which followed on the streets as Ms. Megawati's supporters registered their displeasure at this outcome led to her rapid installation as vice president.

… which was instrumental in his ouster in favour of Megawati Soekarnoputri in July 2001…

Although Mr. Wahid's government struggled from the outset in the face of a series of economic and political crises, the main cause of his downfall in 2001 was almost certainly his clashes with the military, including by challenging their control over key resources and their interference in politics.

… bringing Susilo Bambang Yudhoyono to the presidency in a time of increasing stability

Box 7: Susilo Bambang Yudhoyono

Susilo Bambang Yudhoyono (often referred to simply as "SBY"), Indonesia's first president to be directly elected by universal suffrage (taking office on 20 October 2004), was born in East Java in 1949.

In 1973, Second Lieutenant Yudhoyono graduated top of his year from Indonesia's military academy (AKABRI). By May 1998, he had risen to the rank of general and was a member of a group of reformist officers which was instrumental in pressuring President Soeharto to resign. He was noted thereafter as one of the main proponents of reforming the military.

In 1999, he was appointed minister for mines and energy in the Wahid administration, moving to the political and security affairs portfolio in 2000. He broke ranks with the increasingly unpopular President Wahid in mid-2001 and was dismissed from the cabinet, but was reappointed to his former cabinet post after the MPR impeached Mr. Wahid and elected Megawati Soekarnoputri as president.

In September 2001, Mr. Yudhoyono established the Democratic Party (*Partai Demokrat*), which was and remains ideologically based on the *Pancasila*.

In March 2004, Mr. Yudhoyono resigned from the cabinet and announced his willingness to run in that year's presidential race. Public disagreements with Ms. Megawati boosted his popularity and that of his party which won 7.5% of the vote in the April 2004 legislative elections – critically, a sufficient share to nominate a presidential candidate.

Together with his running mate, Golkar's Jusuf Kalla, Mr. Yudhoyono came first in the first round of the presidential election held on 5 July 2004, with 33% of the vote. He went on to win the run-off against Ms. Megawati with over 60% of the vote.

During their term, differences emerged between Mr. Yudhoyono and Mr. Kalla which contributed to the latter's decision to run for president in the 2009 election as the Golkar candidate. Mr. Yudhoyono selected as his running mate then central bank governor Boediono and duly won re-election in the first round on 8 July 2009, again scooping just over 60% of the vote.

Presidents are limited to two terms, so Mr. Yudhoyono is therefore due to step down in October 2014.

The coalition of Soeharto regime politicians and military hardliners who brought down Mr. Wahid backed Ms. Megawati as his replacement and she was duly elected president by the MPR on 23 July 2001. However, she too was to enjoy a relatively short period in the presidency, being defeated in Indonesia's first direct presidential ballot by universal suffrage in October 2004 by Susilo Bambang Yudhoyono.

Democracy brings greater stability

The good news is that even before Mr. Yudhoyono was first elected president in 2004, political reform was bringing greater stability to the country. As a result the *Economist Intelligence Unit* now rates Indonesia on its Band B for "political stability risk" (where "E" is the most risky), i.e. on a par with the likes of Brazil, India and Malaysia and better than Asian neighbours (Figure 1).

In 2004, Ms. Megawati was defeated in the first presidential election by universal suffrage

[12] As we explain in more detail later in this chapter, the MPR is the bicameral legislative branch of Indonesia's political system.

Furthermore – and as Figure 1 also shows – Indonesia is rated Band B for “macroeconomic risk”, putting it on a par with, inter alia, three of the BRIC countries, i.e. Brazil, China and India. As *The Economist* noted in October 2010:

“…Indonesia’s global stature is rising. The public finances are sound and the economy has sailed through the financial crisis. Among G20 economies, only China and India grew faster than the 4.5% Indonesia achieved [in 2009]…. That would have seemed almost unimaginable [in 1998], when the economy collapsed and Indonesia’s longstanding dictator, Soeharto, fell.”[13]

Diversity and demographics

Under Mr. Yudhoyono, ethnic and other inclusiveness remains a major factor in policy evolution

As we have already suggested, Indonesia’s ethnic diversity is a major factor in determining policy evolution. Figure 1 sets out key “macro” data on Indonesia’s demographics, while Box 5 includes data on age structure and a broad breakdown by ethnic group of the total population of 237 million (forecast by the UN to rise to 254 million by 2020 and 288 million by 2050), of which close to 130 million live in Java, one of the world’s most densely populated areas.[14] In Chapter 4 we look in more detail at Indonesia’s demographics and consider related economic and investor implications.

State structures…

Significant constitutional reforms since 1998 have remained faithful to the *Pancasila*

The four presidents which Indonesia has had since 1999 are matched by four significant revisions to the constitution over the same period; all of which have brought about substantial changes to governance and the balance of power but remained faithful throughout to the *Pancasila* (see Box 2 above).

Today’s constitution provides for six principal organs of state as follows:

The presidency remains the dominant organ of state despite additional checks and balances

- **The Presidency:** in Indonesia’s presidential system of government, the president – who has been directly elected under universal suffrage since 2004 and who is now limited to two five-year terms – is head of the Executive. The president appoints the cabinet, members of which do not have to be elected members of the legislature. Although the presidency remains Indonesia’s dominant political office, the past 13 years have seen the introduction of significant parliamentary checks and balances on its powers.[15]

President Yudhoyono’s current government includes representatives of his Democratic Party (*Partai Demokrat,* PD), Golkar, the National Awakening Party (*Partai Kebangkitan Bangsa,* PKB), the National Mandate Party (*Partai Amanat Nasional,* PAN), the Prosperous Justice Party (*Partai Keadilan Sejahtera,* PKS) and the United Development Party (*Partai Persatuan Pembangunan,* PPP).[16]

[13] “SBY’s feet of clay”, *The Economist*, 23 October 2010.

[14] By way of comparison, Java has approximately the same land area as Greece which has a population of just 11.3 million.

[15] Since 2004, the vice president has similarly been elected by a direct popular plebiscite.

[16] PD and Golkar are nationalist secular parties – as is the main opposition PDI-P. PAN, PKB, PKS and PPP all have an Islamist orientation.

Figure 1: Some key data (relative to the BRICs and selected Southeast Asian economies)

	Indonesia	Brazil	China	India	Malaysia	Philippines	Russia	Thailand	Vietnam
Population	**237mn**	193mn	1,313mn	1,210mn	29mn	102mn	139mn	67mn	91m
Population growth	**1.07%**	1.10%	0.60%	1.34%	1.58%	1.90%	-0.47%	0.57%	1.08%
Gender ratio (m/f)	**1.00**	0.98	1.06	1.08	1.01	1	0.85	0.98	0.99
Median age (yrs)	**28.2**	29.3	35.5	26.2	26.8	22.9	38.7	34.2	27.8
Life expectancy at birth (yrs)	**71.3**	72.5	74.7	66.8	73.8	71.7	66.3	73.6	74.9
Urban population	**52%**	87%	47%	30%	72%	49%	73%	34%	30%
Literacy	**90.4%**	88.6%	91.6%	61.0%	88.7%	92.6%	99.4%	92.6%	90.3%
GDP 2010 (mkt exchange rate)	**$707bn**	$2,088bn	$5,878bn	$1,653bn	$238bn	$189bn	$1,465bn	$319bn	$104bn
GDP per capita 2010 (mkt exchange rate)	**$2,908**	$10,804	$4,480	$1,400	$8,418	$1,889	$10,337	$4,720	$1,181
GDP per capita 2010 (PPP)	**$4,254**	$11,283	$7,740	$3,560	$14,724	$3,530	$15,746	$8,730	$3,161
Ave real GDP growth 2006-10	**5.7%**	4.4%	11.2%	6.5%	4.4%	4.9%	3.4%	3.6%	7.0%
Ave inflation 2006-10	**7.8%**	4.7%	3.9%	7.4%	2.7%	5.0%	10.2%	2.9%	10.8%
Ave FDI inflows 2006-10 (% of GDP)	**1.5%**	2.2%	2.8%	2.3%	2.7%	1.5%	3.5%	3.3%	8.2%
TI Corruption Perceptions Index 2010*	**2.8**	3.7	3.5	3.3	4.4	2.4	2.1	3.5	2.7
World Bank ease of doing business ranking 2011**	**121st**	127th	79th	134th	21st	148th	123rd	19th	78th
EIU overall risk rating***	**C55**	C41	C47	C53	B32	C51	C54	C52	C56
EIU security risk	**C57**	B39	B32	C46	B29	E82	C54	C57	A18
EIU political stability risk	**B35**	B25	C55	B25	B30	C55	C55	D65	C55
EIU legal & regulatory risk	**D72**	C42	C60	C60	B40	C58	D70	C58	C58
EIU macroeconomic risk	**B35**	B30	B25	B35	A20	B40	B35	B40	C50

Note: * A higher score means less perceived corruption. ** Economies are ranked 1-183 on their ease of doing business. *** E = most risky; 100 = most risky. Sources: CIA World Factbook, Economist Intelligence Unit, Transparency International, World Bank, Nomura

- **The People's Consultative Assembly (*Majelis Permusyawaratan Rakyat*, MPR):** the MPR is the highest organ of state and comprises a joint sitting of the **DPR** and the **DPD** (see below), in normal circumstances being convened at least once every five years. Its responsibilities include overseeing amendments to the constitution and the inauguration and possible dismissal of the president.

As the highest organ of state, the MPR has the power to dismiss the president

- **The People's Representative Council (*Dewan Perwakilan Rakyat*, DPR) and Regional Representatives Council (*Dewan Perwakilan Daerah*, DPD):** elections for the two chambers of Indonesia legislature are held every five years under a complicated system of proportional representation:

The bicameral parliament is subject to elections every five years under a complex PR system

  - The DPR, comprising 560 seats, is the main legislative chamber and all legislation put forward by the Executive requires its approval. Parties represented in the current government currently hold seats in the DPR as follows:

PD:	148
Golkar:	106
PKS:	57
PAN:	46
PPP:	38
PKB:	28

In principle, this should afford the government a hefty majority of 423 seats, capable of passing legislation at will. But some commentators aver that: "Rather than use his party's

The politics of consensus has a strong tradition and is consistent with nation building

parliamentary numbers to push through reform, Mr. Yudhoyono has stuck with a consensus-based style, building a bigger, weaker, six-party coalition than he needs".[17] For our part, we note that the politics of consensus is a strong tradition in Javanese culture and that the continuing process of building a genuine nation state in as young and geographically and ethnically diverse a country as Indonesia presents a strong case in favour of what is sometimes referred to as "big tent" politics.

- o The DPD, which comprises 132 members directly elected from the country's 33 provinces (see below), has more limited powers principally related to the governance of the regions. Notably, it cannot veto legislation but it does have powers to monitor implementation.

Elections for both chambers are next due to take place in April 2014 – probably, we judge, under the present electoral rules as efforts to raise the threshold required for seats in the legislature from 2.5% to 5% of the total vote appear to have stalled.

- **The Supreme Court (*Mahkamah Agung Republik Indonesia,* MARI):** the independent judicial arm of state whose members are nominated by the Judicial Commission for approval by the DPR and confirmation by the president.[18] It has oversight of high and district courts and is the final court of appeal. Up to 60 members may be appointed.
- **The Supreme Audit Institution (*Badan Pemeriksa Keuangan*, BPK):** the independent body responsible for auditing financial management by central government, Bank Indonesia, SOEs and so on. Its members are appointed by the DPR in consultation with the DPD.

… and the regions

The period since 2001 has seen a major devolution of power to the regions…

Matching the shift in the balance of power from the presidency to the legislature has been the major devolution of power to the regions since 2001. Central government retains authority over defence and foreign policy, fiscal policy, justice and religious matters; but most other decision-making and, importantly, spending authority, is devolved to local districts (*kabupaten*) and metropolitan areas. Direct elections are now held in all of Indonesia's 33 provinces, over 500 districts and 91 cities.[19]

… which has helped defuse separatist tendencies…

Supporters of devolution claim that: "'unity in diversity' is a reality. True, tensions remain between Jakarta and Papua… But places like East Kalimantan are now proudly local and proudly Indonesian".[20] We consider separatist tendencies in more detail in Box 8.

Politics and corruption

… but which may have encouraged corruption

While acknowledging some success stories (particularly in Java), critics of devolution claim that "local electoral politics has become mired in corruption… According to the [central] government, up to the end of last year 158 district and provincial leaders had been charged with corruption, about a quarter of the total… Most of the guilty have been defrauding budgets and marking up the value of government contracts".[21]

[17] "SBY's feet of clay", *The Economist*, 23 October 2010.

[18] The Judicial Commission was established in 2001 and comprises seven members appointed by the president subject to the agreement of the DPR.

[19] Devolution has brought with it a proliferation of local authorities – ie in 1999 there were just 26 provinces and 292 districts.

[20] "Power to the people! No, wait…", *The Economist*, 19 March 2011.

[21] Ibid.

Furthermore, intimidation as well as bribery seems to be increasingly common to secure electoral support, to judge from a recent report by the International Crisis Group (ICG).[22]

Central government is now weighing options for trimming local autonomy. However, we judge that it will be politically very difficult to reverse what has been one of the more popular trends of the past decade or so – and especially when the popular perception appears to be that corruption is far from being limited to local officials. Based on in-country surveys, Transparency International's (TI) 2010 Corruption Perceptions Index scores Indonesia at 2.8 (on a scale from 1 to 10 where a higher score means less perceived corruption).[23]

Indonesia's tough anti-corruption agency has run into some political headwinds…

It is, in our view, to Indonesia's credit that its anti-corruption agency (*Komisi Pemberantasan Korups*, KPK), which began operations in late 2003, has established a reputation for having real teeth – to the point where individuals in the attorney-general's office and the police were found last year to have fabricated evidence in an effort to discredit some of its key personnel.[24] In 2009, TI reported that its:

> *"… Global Corruption Barometer shows increasing public confidence in the KPK's… ability to handle corruption. More than 70% of respondents feel the government has been effective in addressing corruption."*[25]

Recent moves by both the government and the DPR to revise anti-corruption legislation have raised question marks over the authorities' determination to take on powerful vested interests despite the popularity of the anti-corruption drive – with possible electoral consequences downstream. As TI also noted in 2009:

> *"Despite their undeniable achievements and widespread public support, the KPK and the special court for corruption crimes (Tipikor) have been under incessant attacks by parliament, the attorney general's office and the police, among others… Failure by the government to shield the KPK and the Tipikor court, will not only hinder all efforts to eradicate corruption, but will certainly impact on the political and economic credibility of Indonesia. Most importantly, it will dent Indonesians' belief that their government is serious about establishing and maintaining solid mechanisms to hold the corrupt to account."*[26]

… but Mr. Yudhoyono has recently publicly reaffirmed his determination to fight corruption

However, it is, in our view, encouraging that on 11 May 2011 Mr. Yudhoyono, returning to Jakarta from an international conference on corruption in Bali, underlined to journalists his personal commitment to fighting corruption, including over allegations revolving around members of his own party in the so-called "Sea Games" case, and stressed that KPK would continue to operate "without political considerations".

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22) See "Indonesia: Preventing Violence in Local Elections", International Crisis Group Asia Report No 197, 8 December 2010 – available at http://www.crisisgroup.org/en/regions/asia/south-east-asia/indonesia/197-indonesia-preventing-violence-in-local-elections.aspx.

23) TI notes that: "The 2010 CPI draws on different assessments and business opinion surveys carried out by independent and reputable institutions. It captures information about the administrative and political aspects of corruption. Broadly speaking, the surveys and assessments used to compile the index include questions relating to bribery of public officials, kickbacks in public procurement, embezzlement of public funds, and questions that probe the strength and effectiveness of public sector anti-corruption efforts."
See http://www.transparency.org/policy_research/surveys_indices/cpi/2010/in_detail#3.
We acknowledge criticism of TI's methodologies, especially insofar as they are of questionable value for year-on-year and inter-country comparisons. But we also note that TI continues to work with the authorities in Indonesia as part of the latter's anti-corruption drive.

24) See, e.g., "The gecko bites back", *The Economist*, 5 November 2009.

25) "Indonesian government must ensure anti-corruption is not undermined", Transparency International, 27 July 2009.

26) Ibid.

Politics, reform and doing business

The World Bank rates Indonesia higher than three BRIC countries for "ease of doing business"…

In its report *Doing Business 2011*, the World Bank currently ranks Indonesia overall 121 out of 183 countries for "ease of doing business" (Figure 2).[27] On this basis, as Figure 1 shows, Indonesia rates as a better place to do business than three of the four BRIC economies (Brazil, India and Russia) but is less well placed relative to regional competitors, notably Thailand and Malaysia (let alone Singapore, which ranks first globally). Furthermore, the World Bank scores Indonesia relatively highly in the context of southeast Asia for cumulative improvement of its business regulation over the period 2006-11; the EIU forecasts that Indonesia's score in its business environment rankings will continue to rise over the period 2011-15.[28]

… but there remains room for improvement, including relative to regional competitors

However, although the EIU also forecasts a slight improvement in Indonesia's global ranking for the decade from 2006 to 2015 (from 61 to 59 out of 82 countries), it also foresees Indonesia's ranking *per se* standing still in the regional context at 13 out of 17 economies.[29] While acknowledging improved prospects for political and macroeconomic stability as well as an improving tax regime and healthy banking sector, the EIU goes on as follows:

> *"… there are signs that the efforts of the president… to improve the business environment are faltering in the face of resistance from vested interests. The resignation of Sri Mulyani Indrawati as finance minister in May 2010 has deprived the government of its most respected minister and has raised doubts about the president's commitment to reform. Despite the appointment of a strong successor… in Agus Martowardojo… the influence of vested interests could grow during the forecast period. Other reformist ministers will have learnt from the circumstances of Ms. Mulyani's departure that they cannot count on the support of the president if they encounter opposition."*[30]

We expect politics to weigh against rapid economic reforms until after the 2014 elections

We therefore expect Indonesia's politics to continue to mitigate against rapid progress with market-oriented reform, at least until the 2014 elections; indeed, one area – the procedures governing land acquisitions – which had looked promising and which the state development agency *Bappenas* sees as central to over $100bn investment in key infrastructure projects may now also be running into headwinds, this time from the NGO community.

[27] *Doing Business 2011: Indonesia*, The World Bank, 2011

[28] "Indonesia: Business environment ranking summary", Economist Intelligence Unit, 14 April 2011.

[29] The other 16 economies are: Australia, Bangladesh, China, Hong Kong, India, Japan, Malaysia, New Zealand, Pakistan, Philippines, Singapore, South Korea, Sri Lanka, Taiwan, Thailand and Vietnam.

[30] "Indonesia's business environment ranking remains unchanged", Economist Intelligence Unit, 22 June 2010.

Box 8: Separatism in decline

Historically, Indonesia's ethnic complexity has often been the context for political tensions which have degenerated into separatist movements and violence. Three areas of Indonesia in particular were centres for ethnically driven tension and violence between separatist movements and Indonesian military forces since the New Order – Aceh in northern Sumatra, East Timor (now, formally, the Democratic Republic of Timor-Leste) and Papua/Irian Jaya (Indonesia's largest and most easterly province).

During the Soeharto era, separatist tendencies were not only fuelled but also repressed by authoritarian government. Consequently, the speed with which the Soeharto regime collapsed in 1998, coupled with the weakness of national institutions at that time, exposed a fragile and bitterly divided country. The spark for a consequent wave of separatist sentiment – in not only Aceh and Papua but also Ambon, Kalimantan, Riau and even Bali, causing politicians in Jakarta to warn of "Balkanisation" of the country – was East Timor.

On 28 November 1975, **East Timor** had declared independence from Portugal, only to be occupied by Indonesian forces nine days later and incorporated into Indonesia as the country's 27th province. Between 1976 and 1999, over 100,000 people are believed to have died as a result of the struggle between separatists and the Indonesian military. Over 80% of the population converted to Christianity (from traditional religions) to comply with the then state requirement for monotheistic faith.

Immediately post-Soeharto, the transitional government of President Habibie came under considerable domestic and international pressure over East Timor, leading to a UN-supervised referendum on 30 August 1999 in which almost 80% of East Timorese voted for independence. The Indonesian army reacted by sending in militias, precipitating violent clashes – in which 1,400 are thought to have died – until Australian peacekeepers arrived on 20 September. On 20 May 2002, East Timor/Timor-Leste was internationally recognised as an independent state.

International attention then switched to **Aceh** where the Free Aceh Movement (Gerakan Aceh Merdeka, GAM) had been struggling for independence since the mid-1970s. However, the 2004 tsunami disaster, which is believed to have killed approximately 230,000 Acehnese, triggered a peace agreement between the government and the GAM. Under the subsequent 2005 agreement, government troops were withdrawn, GAM disarmed and Aceh has a significant degree of autonomy in its affairs.

While separatist tendencies elsewhere in Indonesia have largely abated, according to the International Crisis Group (IGC), tensions in **Papua** persist despite "special autonomy". In "Asia Briefing 108" published on 3 August 2010, the ICG suggested that a significant degree of mutual misunderstanding between the authorities in Jakarta and the Papuan People's Council (Majelis Rakyat Papua, MRP) lies at the heart of this, calling for political dialogue to try to bridge the divide. We note too that there are issues over religion between the largely Christian Melanesian Papuans and non-Papuan Indonesian immigrants, which may be deepened by wider sectarian tensions discussed later in this chapter. However, Papua is recognised as part of Indonesia by the international community and we believe that any separatist tendencies there may be are therefore likely to be kept in check.

Figure 2: Indonesia's Ranking In "Doing Business 2011"

Rank	Doing Business 2011
Ease of doing business	121
Starting a business	155
Dealing with construction permits	60
Registering property	98
Getting credit	116
Protecting investors	44
Paying taxes	130
Trading across borders	47
Enforcing contracts	154
Closing a business	142

Source: IBRD/IFC (ranking out of 183 economies)

Continued reform of the bureaucracy and the judiciary remains a business priority

In the wider realm of governance, we note that Finance Minister Martowardojo has adopted the "carrot and stick" approach of his predecessor to pursue reform of the civil service (one of Mr. Yudhoyono's stated priorities for his second term), i.e. increasing the budget of ministries which meet their spending target and reducing the budget of those which overspend. Especially against the backdrop of the high "legal and regulatory risk" rating of "D" which the EIU gives Indonesia in both absolute terms and relative to other economies in the region (Figure 1), we see continued progress with reform of both the civil service and the judiciary as a priority for business and investors. That the same group of parliamentarians who were instrumental in the resignation of Ms Mulyani is now attacking her successor over the finance ministry's purchase of the final seven percent stake in a copper and gold mine is therefore likely to be of some concern to investors.

Independent experts confirm that further reforms would help on the "path of prosperity"

Overall in the context of this and the previous three sections of this chapter, we note the conclusions of a recent major report on Indonesia's "prospects for growth, equity and democratic governance" authored by the Rajawali Foundation Institute for Asia at Harvard University's John F. Kennedy School of Government – to which the quote from Institute Director Anthony Saichs at the start of this chapter relates.[31] The report recommends five areas in particular for reform which its authors believe "could set Indonesia back on the right course toward a path of prosperity", as follows:

- **Electoral reform:** to reduce "[electoral] complexities and thus curb some corruption, incentivizing politicians to act more in the public interest";
- **Adopting international standards:** "following China's example… [to] make a stronger commitment to international rules and halt business-as-usual practices influenced solely by domestic interests";
- **Reforming decentralisation:** "to improve efforts in overseeing and coordinating decentralisation…[to] provide much needed consistency and accountability of functions";
- **Legal and judicial reform:** to channel "public dissatisfaction with corruption… into larger NGO watchdog groups, which would… give people more of a stake in their democracy's ongoing stability";
- **Finding the "missing middle":** lifting people away from poverty by, *inter alia*, "expanding access to public education and removing paralyzing labour laws and restrictions that prevent the growth of stable employment".[32]

In Chapter 5 we consider priorities and prospects for reform over the next five years in more detail from an investor perspective.

The role of the military

Despite reform since 1998, the military remains heavily involved in business

Despite the reforms which have taken place since 1998 in particular – a process in which, as previously noted, Mr. Yudhoyono has been very much to the fore – Indonesia's armed forces (*Tentara Nasional Indonesia*, TNI, formerly *Angkatan Bersenjata Republik Indonesia*, ABRI) remain among the country's principal "owners" of vested interest, including in business. (Indeed, irritation over the loss of business opportunities to the president's "cronies" is widely considered to be one of the main reasons for the erosion of the military leadership's support for Mr. Soeharto in the 1990s.) Indicative of the military's business interests is the fact that just 70% of defence funding currently comes from the budget; this despite long-standing plans to make the armed forces fully budget-funded, not least as encouragement to the military to divest its commercial interests.

[31] "From *Reformasi* to Institutional Transformation: A Strategic Assessment of Indonesia's Prospects for Growth, Equity and Democratic Governance", Rajawali Foundation Institute for Asia, August 2010 – available at http://ash.harvard.edu/extension/ash/docs/indonesia.pdf.

[32] "New Report on Indonesia Recommends Key Areas to Enhance Progress", The Ash Center on Democratic Governance and Innovation", 30 August 2010 – available at http://www.hks.harvard.edu/news-events/news/articles/ash-indonesia-report-aug10.

After some years of decline, regional factors have triggered an increase in defence spending

In fact, according to the Stockholm International Peace Research Institute (SIPRI), both as a proportion of GDP and in constant US dollar terms, military expenditure had been in decline (to less than 1% of GDP) since the middle of the last decade. However, principally, we believe, thanks to increases in defence expenditure elsewhere in the region, that trend has recently reversed with military expenditure in 2010 rising by over 20% in constant US dollar terms from the previous year to over US$6bn.[33]

Overall, the influence of the military in governance has declined

Although reforms passed in the 1990s have yet to be fully implemented, the former – and officially recognised under President Soeharto – "dual function" of the military and its deep integration into most aspects of policymaking have been significantly diminished over the past decade (e.g. through the annulment of the military's reserved seats in the DPR). However, the military's territorial command structure, which shadows civilian administration down to the village level, is still in place, giving it significant potential influence in local government decisions, including business-related ones. Nevertheless, its continuing importance notwithstanding, it is a mark of how much less central to Indonesia's governance the military is today relative to even a decade ago that this report devotes only three short paragraphs specifically to it.

Sectarianism, security and terrorism

There has been significant progress with counter-terrorism over the past decade…

Since the October 2002 suicide bomb attacks in Bali which killed 202 people, Indonesia has suffered four further major terrorist attacks – most recently the July 2009 hotel bombings in Jakarta which killed nine and injured more than 50 others. However, the police authorities have made major strides countering terrorism since the Bali incident, including killing or capturing the leaders of *Jemaah Islamiyah* (JI, an organisation believed by intelligence agencies to have links with *al Qa'ida*), the group which was responsible for the attacks.[34]

… but sectarian violence remains a concern…

Nevertheless, the persistence of religious extremism appears to have been highlighted by a series of parcel bomb attacks in March 2011 on religious minorities and moderate Islamists and a suicide bombing inside a police station mosque the following month. These attacks followed two major incidents of sectarian violence in February – a fatal attack on three members of a small Islamic sect, the Ahmadiyah, by members of the Islamic Defenders Front (*Front Pembela Islam*, FPI) and attacks by mobs on Catholic and Protestant churches and a Catholic orphanage over the outcome of a blasphemy trial, both in Java.

In a recent report the ICG noted that:

> *"Violent extremism in Indonesia increasingly is taking the form of small groups acting independently of large jihadi organisations but sometimes encouraged by them. This is in part a response to effective law enforcement… But it is also the result of ideological shifts that favour…low-cost, small-scale targeted killings over mass-casualty attacks that inadvertently kill Muslims… [If] the ultimate goal is to build an Islamic state, then it is imperative to build public support. Rather than engage in violence, groups like JI… are focused for the moment on building up a mass base, by finding issues that resonate with their target audience. Increasingly this means a greater focus on local rather than foreign "enemies", with officials who are seen as oppressors,*

[33] The TNI is made up of the army, navy (including the marine corps) and airforce, totalling around 432,000 personnel of which approximately three-quarters are army. The TNI does not include law enforcement and paramilitary agencies such as the police (POLRI – 540,000 personnel) and the police mobile brigade (BRIMOB – 39,000).

[34] The alleged spiritual leader of *Jemaah Islamiah*, Abu Bakar Bashir, is currently standing trial in Jakarta, charged with funding terrorism, having been found not guilty in trials held in 2003 and 2005 of direct involvement in bomb attacks.

particularly the police; Christians; and members of the Ahmadiyah sect topping the list." [35]

… albeit one which is unlikely to unsettle investors in the short term

Although a rise in sectarian-based violence is worrying in itself, we doubt that the threat it poses is likely to be of much immediate concern to investors; after all, markets bounced back very quickly after the most recent successful large-scale terrorist attack in July 2009. Furthermore, we note Indonesians' long-established tradition of tolerance, including religious tolerance, which has been underlined by recent statements from Muslim leaders supporting religious freedom and which should act as something of a counterweight to the extremists. However, as the EIU has argued in two recent articles, any perceived failure by the government and security forces to tackle this sort of extremism would potentially serve, longer-term, to tarnish Indonesia's positive image in the eyes of investors.[36]

Environmental challenges

Environmental challenges pose a greater threat than terrorism to stability

Headline grabbing though terrorism and sectarian violence tend to be, we are firmly of the view that environmental challenges pose a much greater potential threat to Indonesia's continuing economic – and, therefore, political – stability and development.

Despite rapid urbanisation, approximately two-thirds of Indonesians live in essentially rural areas and are directly or indirectly dependent on communal land, coastal and environmental resources which are being depleted rapidly. The other third is affected by environmental conditions, such as water and air pollution, flooding, congestion and noise. Ensuring adequate environmental management is, therefore, likely to remain a challenge.

Environmental policy is strong, but authorities are struggling with implementation

For the past decade or so, the government institutions concerned with environmental management have benefited from good national level leadership and also from an active network of civil society organisations focused on environmental issues. However, despite the support for policy and capacity development both from within the government and from international donors, the country's administrative and regulatory frameworks are, in our view, struggling to meet the demands of sustainable development. One important example supporting this is the fact that, according to a report published by Chatham House last year, although illegal logging in Indonesia has declined by an impressive 75% since 2000, around 40% of the timber harvested in 2010 was still illegal.[37]

The cost of environmental degradation could be as high as 5% of GDP per annum

According to the World Bank, the total cost of environmental degradation in Indonesia, was over 5% of GDP in 2009 – a figure which the World Bank believes is likely to increase over the next few years under current policies. [38]

Major environmental challenges identified by the World Bank include:

- **Climate change** resulting in reduced crop production, rising sea levels endangering lowland coastal areas and greater risks of flooding, with a projected economic cost of up to 7.0% of GDP by 2010;
- **Coastal zone and marine degradation** eroding a rich marine biodiversity with negative implications not only for food supply but also for the tourist industry;
- **Deforestation** which – in addition to climate change-related issues – risks undermining a major economic resource unless more sustainable practices are pursued;

[35] "Indonesian Jihadism: Small Groups, Big Plans", International Crisis Group Asia Report No 204, 19 April 2011.

[36] See: "Sectarian tensions" and "Extremist threat", both published by the Economist Intelligence Unit on, respectively, 15 February 2011 and 24 March 2011.

[37] "Illegal Logging and Related Trade: Indicators of the Global Response – Country Report Cards" by Sam Lawson and Larry MacFaul, Chatham House, July 2010

[38] "Investing in a more sustainable Indonesia", World Bank Report No.50762 (2009)

- **Land degradation** resulting mainly from water-induced erosion in uplands and from salinisation and water logging of irrigated areas;
- **Air pollution**, the health impact of which is estimated to be about 1.3% of GDP (2007);
- **Water sanitation and hygiene:** the health, water, tourism and other welfare costs associated with poor sanitation have been estimated to amount to more than 2% of GDP (2005).

Indonesia's increasing international importance

"We have China, we have India, we have Japan, and we have [ASEAN]. What we need is a stable region. It means we need a kind of dynamic equilibrium not in the sense of balance of power that was practiced several decades ago, but with this equilibrium I believe that this stability and order can be maintained here in the region while we can also contribute to the global economy."

President Susilo Bambang Yudhoyono (April 2011)

Indonesia is playing a key role internationally in environmental and other forums…

Given its environmental challenges, it is entirely understandable that Indonesia has also begun to play an important international role on sustainability issues. But it is also the case that Indonesia's international prominence has grown significantly in recent years in a number of non-environment forums.

… including the G20 and ASEAN

Topping the list, in our view, is the **G20** which has risen significantly in importance since the demise of Lehman Brothers in 2008. Regionally, Indonesia holds the chair of the Association of Southeast Asian Nations (**ASEAN**) for 2011 and has thus far won general approval for its efforts, including in trying to resolve peacefully the Cambodia/Thailand border dispute.

Bilaterally, Indonesia remains committed to non-alignment

Bilaterally, Indonesia is committed to the principle of non-alignment which should, in our view, help it to continue to build closer relations with both the **United States** (encouraged in part by US President Barack Obama's personal ties with Indonesia) and **China** (a major foreign investor, and second-largest export market after the **European Union**). Consistent with that approach, in an extensive TV interview in the United States in April 2011, President Yudhoyono called for dialogue with China to defuse tensions over maritime border disputes in the South China Sea while acknowledging the need for the US "to participate and play active roles".

Relations with China stand to be increasingly important, both economically and politically

However, just a few days after that interview, unease in Indonesia over China, which has been evident since the Sino-ASEAN free trade agreement came into effect at the start of 2010, resurfaced despite the announcement by Chinese Premier Wen Jiabao while visiting Jakarta of soft loans of about $4bn for infrastructure projects. Complaints from business and political leaders in Jakarta range from the impact on indigenous manufacturing of a surge in imports from China over the past 18 months to China's alleged advantage in determining the purchase price for commodities – summed up recently in the words of Airlangga Hartarto, a member of the legislature and chairman of the commission on trade to the effect that: "We send bauxite to China and they make aluminium and cars based on that aluminium, they undercut Indonesian manufacturing. The value added is not in Indonesia."[39] With Indonesia's trade deficit with China almost doubling to $4.7bn in 2010 we expect to see continuing potential for trade frictions to escalate.

Japan will remain a major economic partner despite the 11 March 2011 disaster

Strong economic ties with **Japan** stand to be adversely affected near-term by the 11 March 2011 earthquake and tsunami. According to Bank Indonesia (BI), Japan accounted for 12.5% of Indonesia's non-oil and gas exports in 2010 and

[39] "Indonesia uneasy about links with China" by Anthony Deutsch and Henny Sender, *Financial Times*, 30 April/1 May 2011.

was Indonesia's second-biggest supplier of imports. Disruption could hit a wide range of sectors. That said, in the longer term, post-tsunami reconstruction should create fresh demand for Indonesian goods, services and labour; and a reassessment of energy policy in Japan could boost demand for Indonesian coal and LNG.[40]

The impact on Japanese FDI and grant aid flows to Indonesia remains to be seen but could also be significant. Again according to BI, Japan was the largest foreign direct investor in Indonesia in 2010 ($3.7bn); and Japanese capital of up to $50bn is particularly important for infrastructure projects including coal extraction, power generation and Jakarta's proposed mass transit system.

Periodic frictions with Malaysia and Singapore are likely

Among Indonesia's immediate neighbours, periodic frictions remain likely with both **Malaysia** and **Singapore** over a range of long-standing issues, but relations with **Australia** have improved considerably over the past few years (not least because of the effectiveness of Indonesia's counter-terrorism efforts) as was underlined by the success of Mr. Yudhoyono's state visit to Australia in March 2010.

After 2014

Mr. Yudhoyono, due to step down in 2014, is expected to endorse a possible successor

Even though Mr. Yudhoyono still has around three years of his second and final term to serve, there is already much talk over his possible successor.

Speaking during a television interview in the United States in April 2011, Mr. Yudhoyono confirmed that, nearer to the time of the next presidential election due in 2014, he hoped to find a "strong candidate" to endorse but added that he had yet to identify that individual. This has been seen by some analysts as consistent with their view that Mr. Yudhoyono may try to model his succession on the recent Lula/Rousseff succession in Brazil, possibly with the hope of remaining influential behind the scenes. Possible candidates include **Anas Urbaningrum** who was elected as chairman of DP in 2009; and some analysts believe that Mr. Yudhoyono's wife **Kristiani Herawati** (aka Ani Bambang Yudhoyono), a former vice chair of DP, may be looking to make a comeback into frontline politics.

His endorsement would be a boost to any contender…

Given Mr. Yudhoyono's sweeping victory in the 2009 election, any candidate receiving his endorsement would, in our view, be a strong contender despite some recent criticism of his consensual style in the local and international press. However, nothing, in our view, can be taken for granted this far ahead of elections and much may hinge on the performance of the economy – which we consider in Chapters 4 and 5 – and, as we have previously indicated, on the government's ability to continue its efforts on issues such as corruption.

Possible non-DP candidates, in our assessment (and in alphabetical order), include:

- leading businessman **Aburizal Bakrie** (Golkar);
- former Vice President (in Mr. Yudhoyono's first term) **Jusuf Kalla** (Golkar), who was a defeated presidential candidate in 2009;
- former President **Megawati Sukanoputri** (PDI-P), who was also a defeated presidential candidate in 2009;
- **Prabowo Subianto**, who stood for vice president – as Ms. Megawati's running mate – in 2009;
- Ms. Megawati's daughter **Puan Maharani** (PDI-P);

[40] In an article published on 8 April 2011, the EIU also noted that the disaster in Japan had reopened the debate on the wisdom of nuclear power in Indonesia where the government is proposing to construct the country's first ever plant by 2019, despite strong local opposition to the proposed site.

- Mr. Kalla's running mate in the 2009 election, **Wiranto.**

We doubt that either the current vice president, the technocratic **Boediono**, or former finance minister (now with the World Bank) **Sri Mulyani Indrawati**, who is a firm favourite with financial markets, is likely to stand for president, although Ms. Mulyani is seen by some as a potential candidate for the vice presidency.

… but it remains far too soon, in our view, to fully assess possible successors

All that being said – and although speculation over possible successors is likely to continue – we believe that it is too soon to seriously consider likely candidates at this stage and propose revisiting this issue much closer to the 2014 elections.

Chapter 4: A robust economic outlook

Yougesh Khatri
yougesh.khatri@nomura.com
+65 6433 6960

Euben Paracuelles
euben.paracuelles@nomura.com
+65 6433 6956

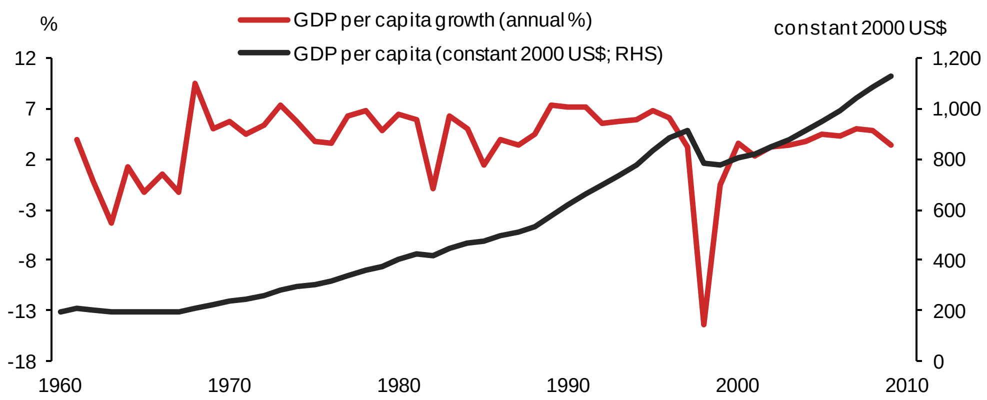
Indonesia's medium-term outlook is supported by favourable demographics, a growing middle class and natural resources.

Doing very little on the reform front, Indonesia's real GDP should still grow by 5.5-6.0% in the medium term given strong economic development "momentum" factors. Some progress on infrastructure development and continued incremental reform (our base case) would likely deliver an estimated 7% growth, while we believe 8% or more could be achieved if there are more concerted reforms and bottlenecks to growth are removed. In the "do nothing" scenario and even in our base case, GDP growth may seem relatively high even by emerging market standards, but the opportunity cost in terms of foregone output and income relative to the best-case scenario quickly accumulates over time. For example, continued growth of 8% rather than 6% would imply GDP per capita would be a third higher by 2025. In this chapter and the next, we assess Indonesia's likely growth in the medium term (2011-15), the constraints to achieving its full potential and what key metrics to watch for in determining whether Indonesia will float or fly.

Indonesia's impressive growth and development record has accompanied a shift from agriculture to industry

Indonesia has a fairly impressive growth and development record (Figure 3) and has weathered global financial crises well. Growth has been accompanied by fundamental change, with the share of manufacturing increasing from 15% of GDP to around 41% and agriculture declining from over 50% to 13% since 1960. Additionally, more than half the population is now urbanized.

Figure 3: Real GDP growth and per capita GDP growth, 1960-2010



Source: World Bank World Development Indicators; Nomura Global Economics.

The Asian crisis resulted in massive economic and social dislocation…

The 1997-98 Asian crisis seemed to put an end to the southeast Asian "miracle". What unfolded in Indonesia was massive economic and social dislocation, including: a huge decline in GDP (by over 13%); a freefall of the rupiah; inflation that peaked in excess of 80% y-o-y; a dramatic increase in government debt to over 100% of GDP (with the effective bankruptcy and nationalization of the banking system); poverty and unemployment rising sharply; and the collapse of the Soeharto regime.

… but the period since has been transformational

The past decade or so, however, has been transformational, with democratization and decentralization (see Chapters 2 and 3), and substantial improvements in economic fundamentals. Indonesia's corporate and bank balance sheets are now significantly healthier; public and external debt has more than halved since 2004; the rupiah is largely market-determined, providing an additional conduit for economic adjustment; FX reserves have increased to over US$118bn; and Indonesia is on the cusp of an investment grade credit rating (see Chapter 6). The "phoenix" metaphor may not seem too extreme if we consider that Indonesia has become a politically stable and economically strong middle-income country, with elevated global standing as a G20 member.

Growth and development have nevertheless fallen short by some measures

Unfortunately, this economic performance and robustness in the face of crises has not been enough. In per capita income terms, and according to a number of development metrics, Indonesia still substantially lags its neighbours. GDP per capita (in real 2000 US$) grew at an average 3.8% per year over the last decade, at which speed it would require decades to attain 2010 per capita GDP levels in Thailand and Malaysia. Economic expansion has not absorbed all the unemployed or underemployed, nor has it reduced poverty as much as desired. As such, some have characterized Indonesia's history of economic development as one of "missed opportunities" (ADB 2010a, p.6), given its abundant natural and human resources.

Five decades of economic development

Indonesia achieved long periods of relatively high growth by global standards…

Following the relatively stagnant years at the end of the Soekarno regime (see Chapter 2), Indonesia achieved around three decades of development based on real GDP growth averaging 6.6% per annum during 1967-1997. With the stability and reconstruction under Soeharto, and the assistance of high oil prices, growth in terms of per capita real GDP averaged 5.5% between 1968 and 1980. After another relatively stagnant period through 1986, structural and financial sector reforms in the mid/late 1980s delivered a similar per capita real GDP growth for the decade preceding the 1997-98 Asian crisis. The aftermath of the crisis saw a dramatic period of economic reforms which set Indonesia up to grow robustly again, but only after a long post-crisis recovery period. Indeed, real GDP only exceeded the pre-crisis peak in 2002; and in per capita terms it took until 2004.

… but lagged its neighbours until recently

Indonesia's real per capita GDP growth has been high by global standards (IMF 2005). During 1960-2000, average growth of global real per capita GDP (in PPP terms) was about 1.8% per annum, with the 2.7% growth in industrial countries' real per capital GDP nearly double the 1.4% growth in developing countries. East Asia however stood out over this period with per capita GDP growth of nearly 3.5% (Box 9 reviews Asia's rapid growth experience and the key drivers). While Indonesia was close to that average, it still lagged most of its neighbours. It has, however, done better during last decade.

Growth from the production side

Industry and services have contributed most to growth

Looking at the sources of growth from the production side, industry and services have contributed the vast majority, around 90%, over 1960-2010 (Figure 4). Indonesia's economy was initially dominated by the agricultural sector which accounted for over half of GDP after independence in 1945; agriculture remained important through to the mid-1960s in the pursuit of agricultural self-sufficiency.

Figure 4: Growth by major production sector, 1960-2010

(%)	Real GDP growth (%)	Agriculture growth rate (%)	Agriculture growth contrib. (pp)	Industry growth rate (%)	Industry growth contrib. (pp)	Services growth rate (%)	Services growth contrib. (pp)
1960-69	3.7	2.6	1.0	6.7	1.6	3.2	1.2
1970-79	7.8	4.4	1.3	11.0	3.6	8.6	2.8
1980-89	6.4	4.1	0.9	7.5	2.8	6.9	2.7
1990-99	4.8	2.0	0.4	6.2	2.6	5.1	1.9
2000-10	5.2	3.3	0.5	4.2	1.9	6.2	2.8
1960-10	5.6	3.3	0.8	7.1	2.5	6.0	2.3

Source: World Bank WDI; Nomura Global Economics.

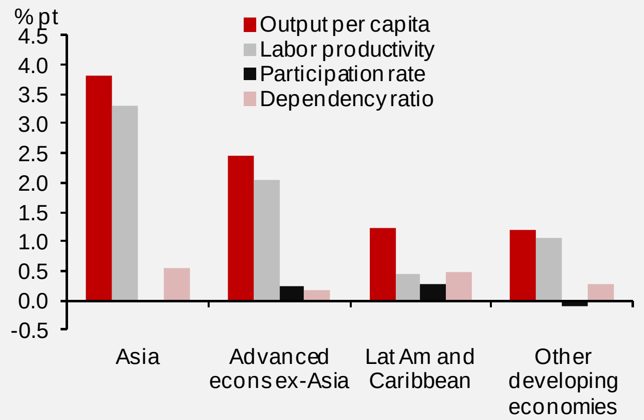
Box 9: Lessons from rapid economic development in Asia

Growth experiences in Japan, the "newly industrialized countries" (NIEs) and more recently China and India, offer important lessons for the rest of Asia aspiring to converge on advanced economy income levels. A comprehensive study by the IMF (2006) found that underlying Asia's striking growth performance has been rapid accumulation of physical capital, strong total factor productivity growth, as well as an accumulation of human capital (workforce size and education). These in turn were supported by policy and institutional structures:

- During 1970-2005, growth differences between regions and within Asia were driven by differences in labour productivity (Figure 1), since respective "take-offs" in labour productivity were mainly boosted by capital accumulation and total factor productivity growth. In ASEAN-4, capital accumulation has been the main driver, followed by labour force growth (Figure 2).
- Asia has benefitted from the shift from agriculture to other sectors. For the world overall, labour productivity is typically about three times higher in the non-agricultural sector than in agriculture but in Asia the productivity differential is even higher. Industry has also maintained faster productivity growth than agriculture or services (Figure 3). Thus the shift from agriculture to industry and services has boosted overall productivity in Asia.
- In Asia and in many advanced economies, productivity in industry is persistently higher than in services. This likely reflects the sheltered nature of service sectors in many cases and points to potential for further productivity gains from liberalizing services.
- Empirical evidence suggests higher productivity growth is closely related to variables which are proxies for the strength of institutions, level of financial system development, the investment climate, quality of infrastructure, openness to trade and education levels (Figure 4).

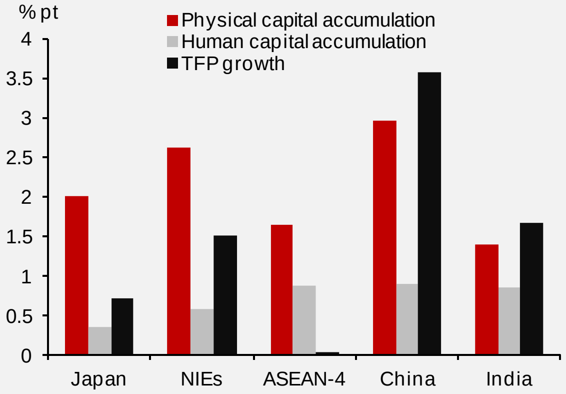
These experiences suggest that if Indonesia further improves its policies and institutions, it could continue to boost sectoral productivity and gain from the shift away from agriculture into the more productive industries and services, and thus support higher overall productivity and growth.

Figure 1. Sources of per capita output growth, 1975-2005



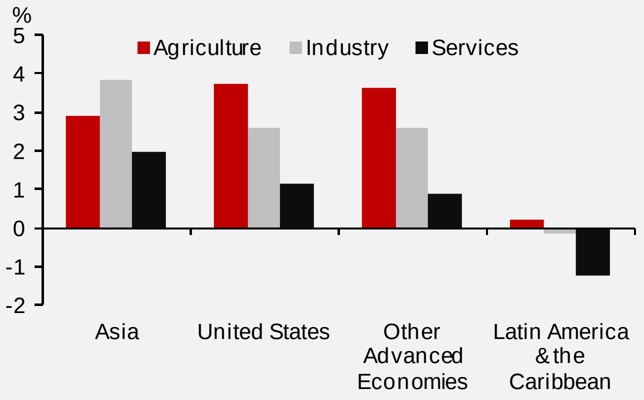
Source: IMF (2006); Nomura Global Economics.

Figure 2. Sources of labour productivity growth *



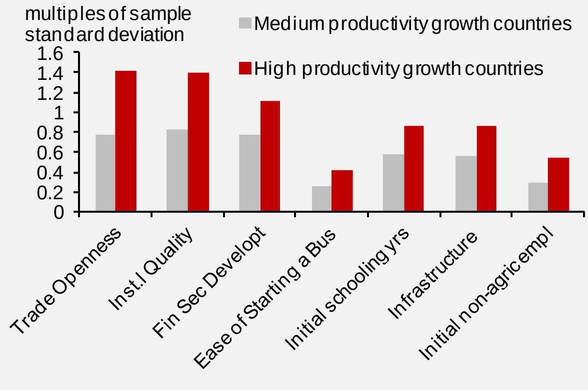
Source: IMF (2006); Nomura Global Economics.

Figure 3. Productivity growth by sector, 1980-2004



Source: IMF (2006); Nomura Global Economics.

Figure 4. Determinants of productivity growth 1965-05



Source: IMF (2006); Nomura Global Economics.

*Since the "growth takeoff" defined as occurring in 1955 for Japan, 1967 for the NIEs, 1973 for the ASEAN-4 (Indonesia, Malaysia, the Philippines and Thailand), 1979 for China and 1982 for India. Each decade corresponds to 10-year periods following the takeoff years stated above.

The GDP share of industry has gained while that of agriculture has declined…

The agricultural sector has grown by over 3% per annum since 1960 but the industrial and service sectors have grown by around 7% and 6%, respectively (thus the share and contributions to growth of these sectors have dominated).

The share of agriculture declined to around 13% of GDP in 2010. It is worth noting that the spike in the share of the agriculture sector in 1998 reflects the sector acting as a “safety net” during the Asian crisis, absorbing the workforce displaced from other sectors due to the crisis.

… helped by a booming oil sector in the 1970s and early 1980s

With industrialization a pursuit of the Soeharto government from 1967, the industrial sector grew strongly in the 1970s and into the early 1980s; industry’s share of GDP increased from 15% to 40% between 1960 and 1980, although this owes much to a booming oil and thus mining subsector. The share of the services sector has only gradually moved higher. Indonesia’s sector shares are broadly in line with other large Asian economies although “low to middle income” countries typically have a larger services share and lower agriculture share which will likely be the case for Indonesia with continued economic development.

Growth from the expenditure side

Figure 5: Growth by major expenditure components, 1960-2010

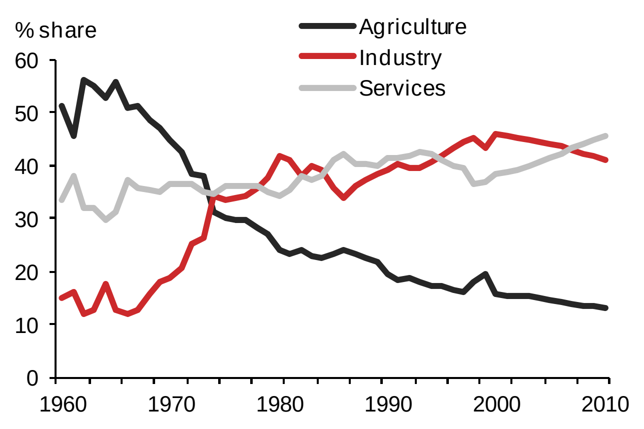
%	Private consumption Growth Rate	Private consumption Share	Government consumption Growth Rate	Government consumption Share	Investment Growth Rate	Investment Share	Exports Growth Rate	Exports Share	Imports Growth Rate	Imports Share	Real GDP Growth Rate	Real GDP Share
1961–1970	3.9	82.6	2.6	8.4	10.6	9.1	5.0	12.9	7.0	13.1	3.9	100
1971–1980	7.9	75.2	12.4	10.9	15.1	20.7	8.7	17.8	17.4	24.5	7.9	100
1981–1990	5.6	62.2	5.2	10.9	8.7	25.4	3.0	23.0	6.9	25.0	5.5	100
1991–2000	5.4	62.1	1.1	8.2	3.4	27.0	8.0	28.4	7.1	26.6	4.1	100
2001–2010	4.3	59.1	8.1	7.9	7.3	22.0	6.8	43.6	7.6	34.0	5.2	100

Source: CEIC; Nomura Global Economics.

Private consumption has been the main expenditure-side growth driver

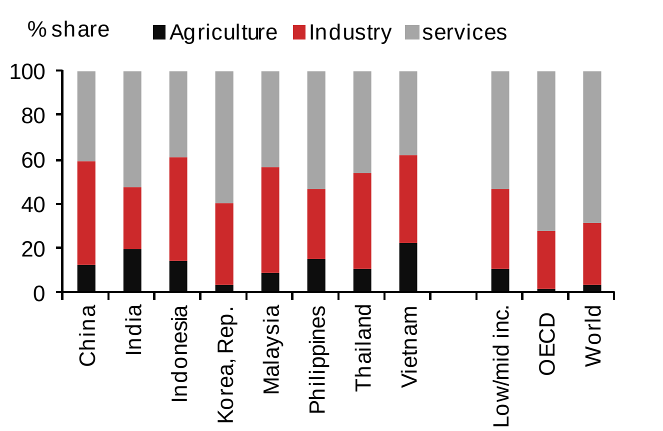
Private consumption has been the main driver of growth from the expenditure side during the last half century, with a share of GDP of around 60% for most of that time (Figure 5). Government consumption has hovered between 5-10% of GDP. The investment share of GDP increased from less than 10% in the 1960s, to around 20% of GDP in the 1970s with the industrialization push and mining (particularly oil) sector development, and increased to nearly 30% of GDP between 1980 and 2000 (see discussion of the capital accumulation driven growth during this period). Following the Asian crisis in the late 1990s, the

Figure 6: Historical sector shares



Source: World Bank; CEIC; and Nomura Global Economics

Figure 7: Sector shares in real GDP, 1960-2010



Source: World Bank; Nomura Global Economics.

investment to GDP ratio fell, as it did elsewhere in Asia, but in Indonesia it has recovered somewhat more in recent years (see the discussion below and Box 9 on the central role of capital accumulation in Asia's experience of rapid growth and development). Relative to neighbouring countries, Indonesia is less reliant on net exports and government consumption. Only the Philippines has a higher consumption share of GDP (supported by remittances).

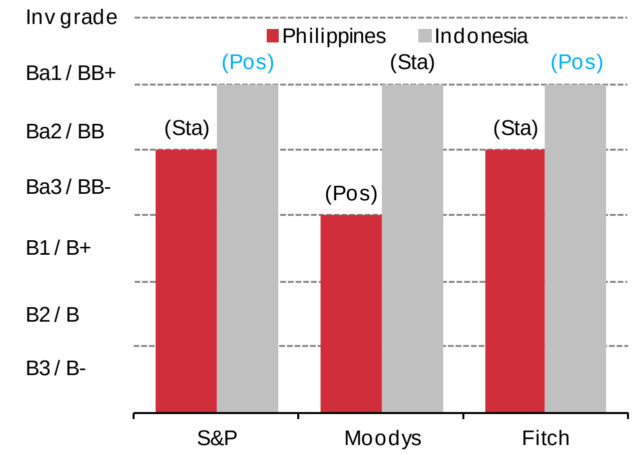
Growth by main islands/regions

Economic activity is concentrated in Java

Despite Indonesia's rich geographic and cultural diversity, its economic activity is concentrated in Java and Bali (mainly Java) which account for over 60% of national GDP and 65 percentage points of GDP growth. Sumatra accounts for around one-fifth of GDP while resource-rich Kalimantan, Maluku, Nusa Tenggara, Papua and Sulawesi combined, account for less than Sumatra.

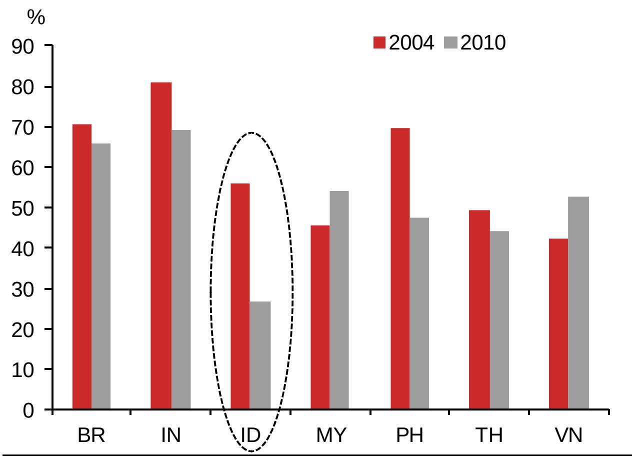
A picture book on Indonesia's fundamentals

Figure 8. One notch to IG after a series of upgrades



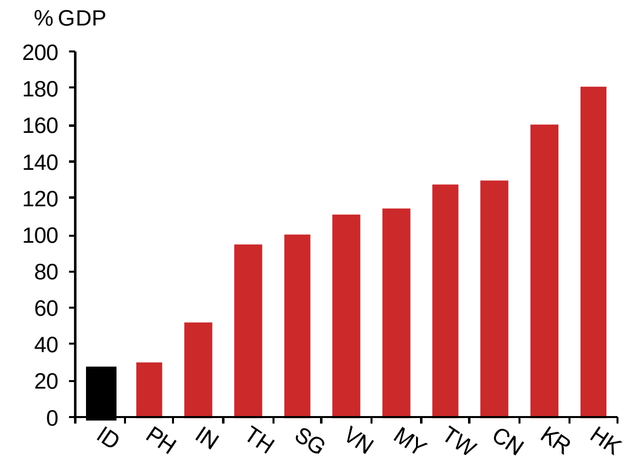
Source: CEIC; and Nomura Global Economics.

Figure 9. Govt debt declined by 60% since 2004



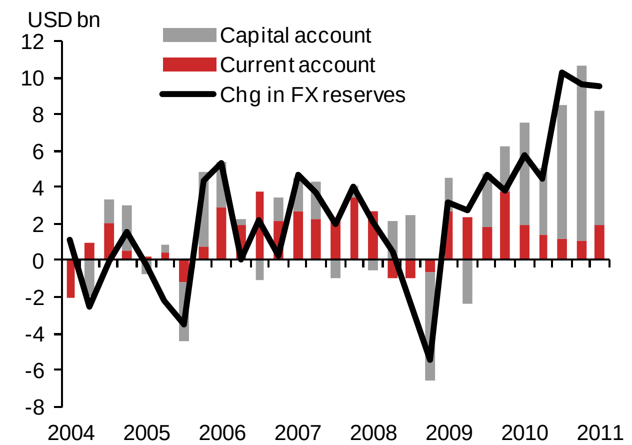
Source: IMF; and Nomura Global Economics.

Figure 10. Domestic credit is relatively low (2010)



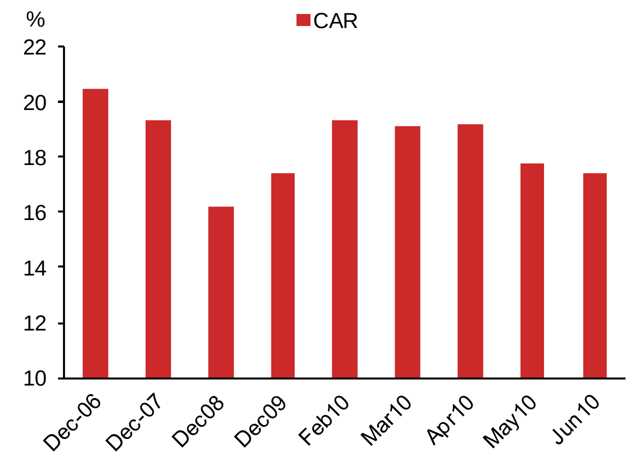
Source: CEIC; and Nomura Global Economics.

Figure 11. Strong FX reserves accumulation



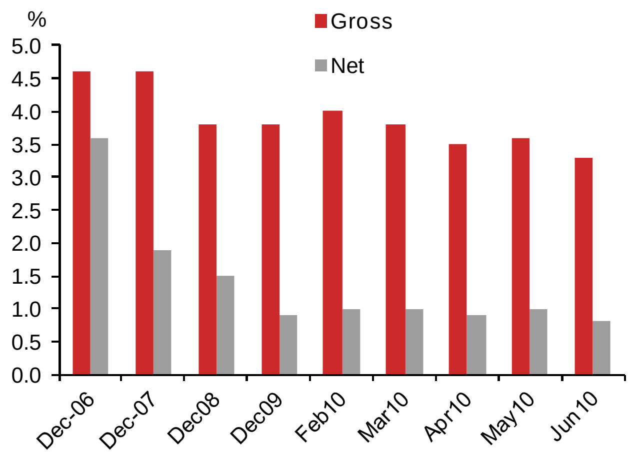
Source: CEIC; and Nomura Global Economics.

Figure 12. The banking system is well capitalized



Source: CEIC; and Nomura Global Economics.

Figure 13. Non-performing loan ratios are relatively low



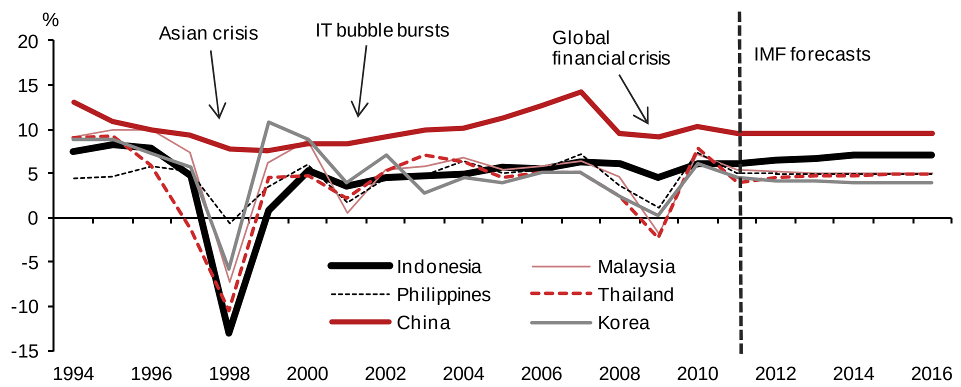
Source: CEIC; and Nomura Global Economics.

Improved fundamentals are delivering…

Improved fundamentals lead to a more robust economy…

While Indonesia was the hardest hit economy during the Asia financial crisis (Figure 14), structural reforms (see Annex B), improved macroeconomic policy frameworks (including a more flexible exchange rate), and deleveraging following the Asia crisis have helped improve Indonesia's fundamentals (see picture book above) and build resilience. Indeed, during the 2001 downturn, following the bursting of the IT bubble, Indonesia was less affected than its neighbours, partly because it is less export- and IT-dependent than its ASEAN neighbours, but also because of its improved economic fundamentals. With the onset of the global financial crisis, Indonesia's growth rate in 2009 declined only around 1pp below the previous five-year average to 4.6%. With sound macroeconomic fundamentals, supportive monetary and fiscal policies were likely more effective than in most affected developed countries. Thus, domestic and international confidence rebounded quickly, supporting a domestic demand-driven recovery.

Figure 14: Real GDP growth in Asia during various crises and medium-term forecasts



Source: IMF; Nomura Global Economics.

… and faster growth prospects relative to ASEAN neighbours

This resilience, relatively less reliance than other Asian countries on external demand, and the economic development momentum factors described below have allowed Indonesia to grow more quickly than most of its neighbours over the last decade and its growth prospects look better than others. For example, the April 2011 IMF forecasts put Indonesia's trend GDP growth at 7% per year in the medium term (2016), compared with Malaysia, Philippines and Thailand at 5% and Singapore and Korea at around 4% (only Vietnam, India and China are expected to grow more quickly). Indonesia's resilience during recent downturns/crises has also started to change international investor perceptions (manifesting as an increasing trend in FDI inflows and declining trend in CDS and bond spreads). All three major rating agencies have Indonesia at one notch below investment grade, but S&P and Fitch both have Positive Outlooks. Another upgrade is within reach, which would take Indonesia to investment grade, reducing financing costs and increasing portfolio inflows (see Chapter 6).

… but not enough

Growth has however fallen short of delivering enough good jobs…

However, growth has not generated enough good jobs – the majority of Indonesia's more than 105mn working-age population are concentrated in the agricultural and informal sector, with little protection. The average growth rate of 5.2% over the last decade has been just enough to absorb additions to the labour force and unemployment stands out as being relatively high compared with other countries in the region (see Chapter 5). Indeed, if we consider that 1) the faster job creation might have spurred higher participation rates; 2) by some estimates around one-third of the labour force is underemployed; and 3) youth unemployment is around 30%, then the job creation record looks poor.

Box 10: Improving macroeconomic policy frameworks

Inflation-related policies

Indonesia's **monetary policy framework and operations** have gone through significant changes over the past decade and continue to evolve in a direction that, in our view, favours improved inflation outturns. The Bank Indonesia (BI) Law passed on 17 May 1999 endowed BI with independence to pursue its objective of maintaining rupiah stability (meaning both stability of its value against goods and services as well as against other currencies). BI formally adopted an inflation-targeting framework in July 2005 and shifted from using quantitative base money targets to using the BI policy rate as the main instrument for achieving monetary policy objectives.

With a large aggregate liquidity overhang, BI faces high open market operation and sterilization costs. This raises concerns that monetary policy may become compromised by the threat of BI hitting a recapitalization threshold (recapitalization of BI by government would be a politically sensitive issue). Under an MOU with the Ministry of Finance (MoF) on sharing the post-Asia crisis cost associated with bank bailouts (known as the "BLBI agreement") **the recapitalization threshold** was set at 3% of BI's capital base. However, in the BI Law, the threshold is stated as IDR2trn. Recent progress on clarifying the threshold as that in the BI Law (the IDR2trn is well below 3% of capital and is less likely to be hit) should ease concerns about BI's balance sheet constraining monetary policy. Furthermore, conversion of some of the non-tradable long-maturity government bonds on BI's balance sheet into tradable assets may be forthcoming. These government bonds could be used for monetary operations. Finally, the liquidity overhang is declining over time with rapid credit growth and banks' declining holdings (relative to total bank assets) of SBI and government bonds.

Improvements in food self-sufficiency and recent **government measures to reduce food price volatility** have helped to reduce the contribution of food prices to headline inflation in recent months and could provide a framework for dealing with food price volatility going forward. These measures include scrapping import duties on 57 products and various other measures to boost supply (e.g., increased rice imports, plans to build large food estates, and stopping the conversion of farmland to other industrial uses).

BI Governor Darmin Nasution is an MoF insider which suggests scope for **improved monetary, fiscal and financial policy coordination**. Indeed, the supply-side measures undertaken by the government in conjunction with measures by BI to address inflation (the first policy rate hike in February and allowing the IDR to appreciate) point to improved policy coordination between the government and BI.

The **increasing foreign ownership of government bonds** (over 30% of total holdings in recent months) brings benefits such as likely lower yields. But this high level of foreign ownership might also increase pressure on policymakers to keep inflation in check. This can be evidenced by the January 2011 bond market pressures and subsequent actions taken by BI and the government to bring down headline inflation.

Finally, **progress with infrastructure** should: 1) boost the supply potential of the economy; 2) reduce transportation costs, and 3) improve overall logistics and thus help to structurally reduce price pressures.

Improving fiscal policy frameworks

The State Finance Law and Government Regulation 23/2003 limits **consolidated national and local government budget deficits to 3% of GDP** in any given year and the overall central and local government debt-to-GDP ratio is capped at 60% of GDP. Much of the previous off-budget fiscal activity has been brought on-budget and various government accounts rationalised.

Progress has also been made on establishing **a stronger technical basis for fiscal policy** through the now fully functional Fiscal Policy Office in the MoF; improving technical capacity in the DPR (including by increasing the number of qualified staff); and a medium-term development framework with fiscal targets.

On the revenue side, the **new tax laws** adopted in July 2007 improved the balance between efficiency of the tax enforcement by the tax office and taxpayer rights while measures have been taken to improve the **conduct of tax officials** (including the introduction of a new code of conduct and boosting the capacity for internal investigations). **Tax administration reforms** (such as the Large Taxpayers' Unit and risk-based audits) during the last decade have delivered notable revenue gains although the revenue base still remains narrow.

Overall, Indonesia has retained its **conservative fiscal policy history** which has delivered substantial consolidation, with government debt-to-GDP declining by over 60% since 2004.

… or improvements in social indicators compared with the region

Using a broader set of social indicators as a metric for what the past 50 years of growth has accomplished, we again find great progress, but results still fall short of regional achievements (see picture book on social indicators). Life expectancy at birth in Indonesia increased from 41 years in 1960 (the lowest in the sample of countries) to just over 71 years by 2009. This is above the middle-income average of 68.8 but still below life expectancy in China, Malaysia, the Philippines, Vietnam, and the East Asia and Pacific average of 73.4 years. The literacy rate in Indonesia is only a little behind neighbouring countries, but the infant mortality rate (per 1000 live births) is around 30, compared with 5.7 in Malaysia, 12 in Thailand and 20.4 for the East Asia and Pacific region.

The opportunity cost of sub-potential performance accumulates rapidly

Various recent estimates put Indonesia's medium-term potential growth rate in a 6-8% range (Figure 15). While Indonesia has fared relatively well during the most recent crisis, it has not achieved its full potential in our opinion, and this "performance gap" accumulates rapidly creating a chasm of lost opportunity. For example, if Indonesia had achieved Indian growth rates since 2002, its GDP level would have been a quarter higher than the actual end-2010 GDP (Figure 16).

Assessing Indonesia's economic potential

We use a production function approach to assess Indonesia's potential growth

In assessing Indonesia's growth outlook, we consider the supply-side potential and drivers of demand growth. In assessing the supply potential of the economy we use a standard "production function" approach (Box 11). On the demand side, we consider a number of developments, including demographics, growth of the middle class and terms-of-trade improvements as mutually reinforcing underlying trends that are likely to ensure robust aggregate demand growth, and in our base case, supply potential is what constrains growth.

We believe conditions for a virtuous cycle exist

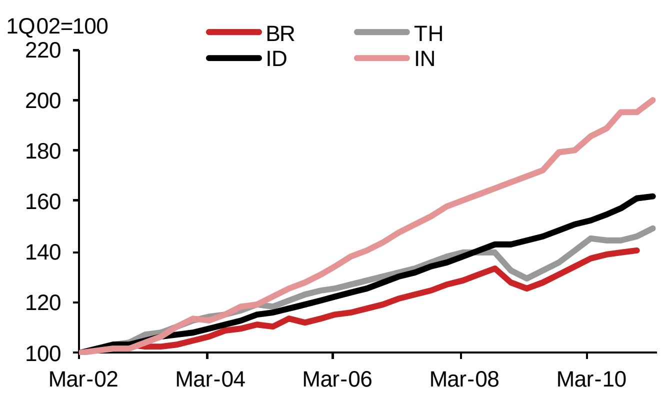
Of course, the demand and supply developments are interrelated where investment and consumption growth and public and private physical and social investment can create a virtuous cycle. Conditions under which such positive self-reinforcing dynamics can kick in include when: 1) critical income per capita thresholds are reached (e.g., Indonesia's rapid middle-class growth driving demand for consumer durables supporting investment and growth in manufacturing); 2) more open economies with deeper capital markets ease constraints on investment and market size, boosting technology and know-how and allowing the country to capitalize on its comparative advantage; and 3) growth and improvements in economic fundamentals boosts investor confidence and investment.

Figure 15: Recent estimates of Indonesia's growth potential

Study	Method	Estimation Period	Potential growth (%)
IMF (2010)	Not stated	2011-15	7.0
Indonesia's MT development plan (RPJM)	Not stated	2014	7.0-7.7
World Bank (2010b)	Prod function	2014	7.4 base (6-7.4 scenario-based range)
Nomura (2010)	Prod function	2004-08	5.9
		2011-20	5.9 base (4.2-7.9 scenario-based range)

Source: IMF; World Bank; Government of Indonesia; Nomura

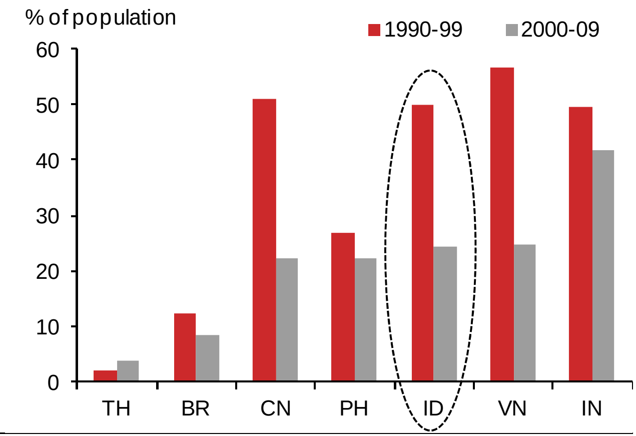
Figure 16: Output trajectories, March 2002=100



Source: CEIC; Nomura Global Economics.

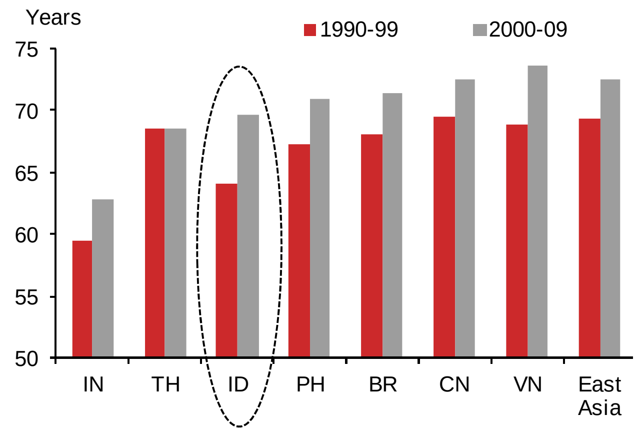
A picture book on social indicators

Figure 17. Poverty headcount ratio at $1.25 a day



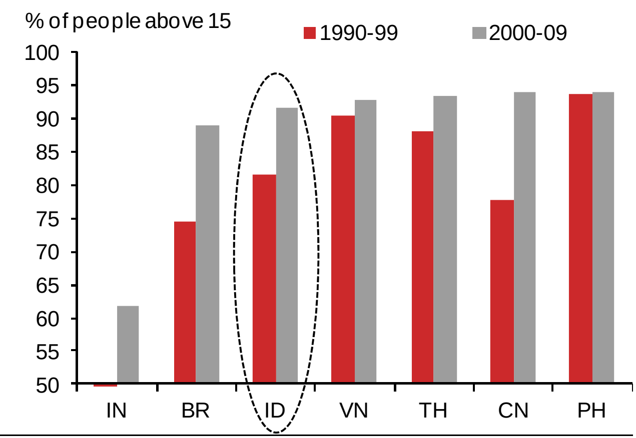
Source: World Bank; Nomura Global Economics.

Figure 18. Life expectancy at birth



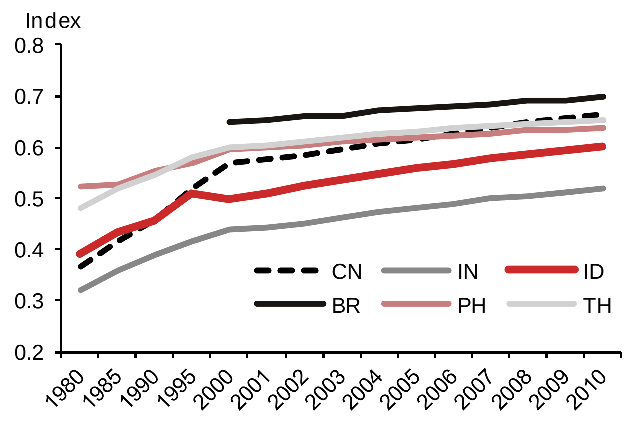
Source: World Bank; Nomura Global Economics.

Figure 19. Adult literacy rate



Source: World Bank; Nomura Global Economics.

Figure 20. UN Human Development Index



Source: UNDP; Nomura Global Economics.

Potential output and potential growth

An assessment of potential growth…

Potential output is generally taken to be the highest output level at which an economy can operate without stoking inflationary pressures. Correspondingly, potential growth can be defined as the growth in potential output (productive capacity) consistent with stable inflation; the output gap is the difference between actual output and potential output.

… is important for policy setting and for assessing prospects for asset prices

An accurate assessment of Indonesia's potential output (and growth) is important. In the near term, it is important for setting monetary and fiscal policies (i.e. avoiding pro-cyclical policy). In the long run, it is key to assessing the present discounted value of long-run investment projects, forecasting future company profits and hence the prospects for asset prices. A breakdown of the drivers of potential growth is particularly important for understanding where the policy focus needs to be in order to raise growth potential. The usual challenges to measuring the essentially unobservable potential output are exacerbated for Indonesia given ongoing structural change, uncertainty about the outlook for infrastructure and reforms, and data limitations. Mismeasurement of potential growth could result in costly policy mistakes.

Box 11: The production function approach to potential growth estimates

In economic theory, the aggregate production function (Figure 1) demarks the maximum output (Y) that an economy can produce for a given set of inputs (X), such as labour and capital, existing technology, managerial knowledge, and institutional and geographic backdrop (which defines the production relationship Y=F(X)).

Thus output can be increased by (i) increasing inputs (i.e., moving along the production function from say point A to B by increasing the capital stock or labour input, but with diminishing marginal output gains); or (ii) moving towards the production frontier (if operating below the frontier) e.g., improving productive efficiency by reallocating resources away from badly targeted subsidies and towards social and infrastructure investment; or (iii) by shifting the frontier – moving from say B to C – through improvements in quality of labour (education) or capital, innovation, or institutional changes and structural reforms.

We use a production function approach and related "growth accounting" to decompose past growth into contributions from changes in inputs versus the residual catch-all total factor productivity (TFP), that – among other things - measures a combination of changes in efficiency in the use inputs and changes in technology. This approach is extensively used by industrial countries for estimating growth potential and decomposing the sources of change in productivity growth and cross-country comparisons; and is the chosen approach of the US Congressional Budget Office, the European Commission, and the OECD. While widely used, this approach is still often criticized. We adopt the pragmatic approach of Hulten (2001) in treating the production function approach and growth accounting as "a simple and internally consistent intellectual framework for organizing data… For all its flaws, real and imagined, many researchers have used it to gain valuable insights into the process of economic growth."

The pros and cons of the alternative methods – including simple statistical smoothing methods (such as the extensively-used Hodrick-Prescott filter) or structural VARs – of potential output estimation are well documented. The key advantage of the production function approach is that it allows us to allocate output changes to inputs and the unexplained residual measure of total factor productivity; while the main disadvantage is it requires more data such as a capital stock measure.

A brief encapsulation of the production function and growth accounting approach is as follows. Starting with the aggregate production function:

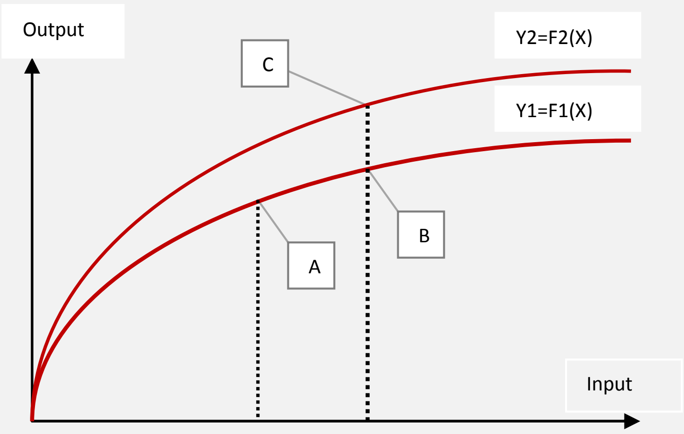
$$Y=A\,F(K,L) \qquad (1)$$

While there are various way to specify the production function F(.) the mostly commonly used form is a constant returns-to-scale Cobb-Douglas production function (given some very convenient simplifying properties). This gives us:

$$Y=A\,K^{\alpha}L^{(1-\alpha)} \qquad (2)$$

Where Y, F, K, L, and A are respectively total output, the production function, capital stock, labour input, and total factor productivity. Given the assumption of constant-returns-to-scale and assuming markets are competitive such that factors are paid their marginal product, then α can be interpreted as the share of capital in output and (1-α) the share of labour. Differentiating (2) and some simple rearranging gives us the workhorse of the growth accounting approach:

Figure 1: The aggregate production function



Source: Nomura Global Economics

Figure 2: Historical decomposition of growth

	Growth (%)	Contributions (pp) Capital stock	Labour growth	TFP growth
1970-79	7.2	1.6	1.6	4.0
1980-89	5.8	3.1	1.2	1.5
1990-99	4.3	3.4	1.5	-0.6
2000-10	5.2	1.5	1.2	2.5

Source: World Bank; CEIC; Nomura Global Economics

$$g(Y)= g(A) + \alpha*g(K) + (1-\alpha)*g(L) \quad (3)$$

where g(.) denotes growth rates. The output growth is the weighted share of growth in capital stock, labour and growth in total factor productivity and the residual measure of total factor productivity can be backed out for a given assumption or estimates of α (the output share of capital).

Decomposing past growth

In order to decompose past contributions to growth in this framework into contributions from labour, capital and total factor productivity (TFP) we need estimates for the capital stock (K), labour input (L) and the share of capital in output (α). We use the capital stock series for Indonesia constructed by Van Der Eng (2008) for the period 1960-2007 and we extend that series using the same perpetual inventory method. The labour series we use is the official series on labour force and employment numbers (ideally this should be hours worked if that data were available). We assume the share of capital in output is around one-third (α=0.35%) based on estimates of Sarel (1997) and this is similar to assumptions by the World Bank and OECD studies.

We find that capital accumulation and employment growth were both important contributors to growth between 1980 and 1999 (Figure 2). Following the Asia crisis and the decline in the investment to GDP ratio, the contribution of capital accumulation, not surprisingly, declined. The contribution of growth in employment had steadily declined over the past three decades with the slower growth rate in the working age population. Note Figure 2 is the decomposition of actual growth, not necessarily a breakdown of potential growth and its drivers. If we assume actual growth averaged over a decade approximates trend or potential growth over the same decade then these provide a reasonable guide to past potential growth (for advanced countries we would typically want to adjust for unemployment relative to non-inflation-accelerating rate of unemployment or NAIRU).

Estimating Indonesia's medium-term potential growth

In order to estimate potential output using this framework, we need to make a few assumptions: 1) the investment growth rate (and thus the rate of capital accumulation); 2) the rate of labour force growth (for which we use growth in the working age population based on UN forecasts); 3) the rate of employment growth; and 4) total factor productivity (TFP) growth. We consider three scenarios with our assumptions for each scenario summarized in Figure 21.

We need to make various assumptions to generate future potential growth estimates

- In our ***baseline scenario***, the growth rate of investment (which drives the rate of capital accumulation) is assumed to be 11%, which is higher than the historical rate of growth but less than the investment growth rate consistent with the infrastructure spending the authorities deem necessary. The unemployment rate is assumed to come down to 5.5%, consistent with the government's Medium Term Development Plan (RPJMN, see Annex D), and TFP is assumed to increase moderately from the 2.5% average over the previous decade to 3%. This baseline

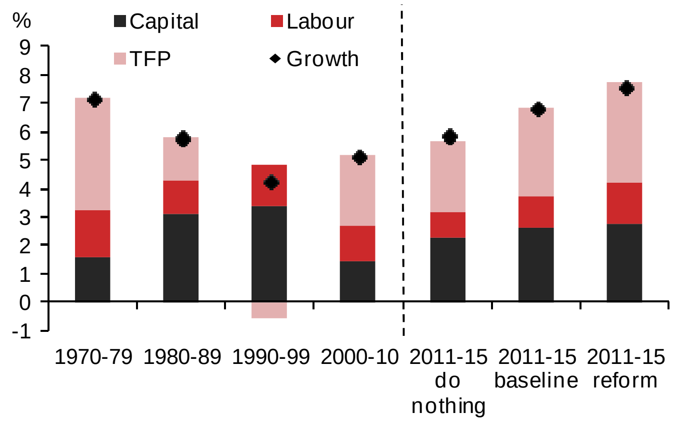
In our baseline, higher investment, employment and TFP can deliver 7% growth…

Figure 21: Assumptions underlying the 3 scenarios

(%)	"Do nothing"	Base case	Reform	RPJMN*
Inv growth 2015	8.0	11.0	12.5	11.7-12.1
Unemployment rate by 2015	7.0	5.5	4.0	5.0-6.0
TFP growth	2.5	3.0	3.5	2.2
Potential Growth	5.8	7.0	8.1	7.0-7.7

* RPJMN = government's medium-term development plan (see Annex D)
Source: World Bank; CEIC; and Nomura Global Economics

Figure 22: Composition of growth under the 3 scenarios



Source: World Bank; CEIC; Nomura Global Economics.
Note: RPJMN for 2014 and TFP as reported by the World Bank.

set of assumptions delivers potential growth of around 7%, with the investment to GDP ratio increasing from 24% in 2010 to 29% in 2015, and labour and capital contributing respectively 1.1pp and 2.9pp to growth (Figure 22).

- In our "***do nothing***" scenario (where the authorities do nothing on the structural reform front and make little progress with infrastructure) we take roughly the historical averages for investment and TFP and assume the unemployment rate stabilizes at around 7% (despite the demographic premium discussed below). This delivers growth of around 5.8% (roughly in line with the past trend), with the investment to GDP ratio rising slightly to 26.6% in 2015 and the respective growth contributions of labour and capital of 0.9pp and 2.4pp.

… but even unambitious assumptions deliver 5.5-6% growth…

- In our "***reform***" scenario, much of the infrastructure spending required is achieved and drives investment growth up to 14% and together with reforms, delivers higher TFP (3.5%) and lower unemployment (4%). Potential growth in this scenario would exceed 8% by 2015, with an investment to GDP ratio of 30% and growth contributions from labour and capital of respectively 1.5pp and 3.3pp.

… while the upside is potentially closer to India or even China growth rates

The reform scenarios and even the baseline scenario might sound optimistic based on historical growth levels and the contribution of TFP. However, we reiterate the potential from positive self-reinforcing dynamics discussed above. The baseline can also be thought of as returning to a more "normal" trend after a period of transition and recovery from the Asian crisis.

The baseline is not much above growth achieved in the past

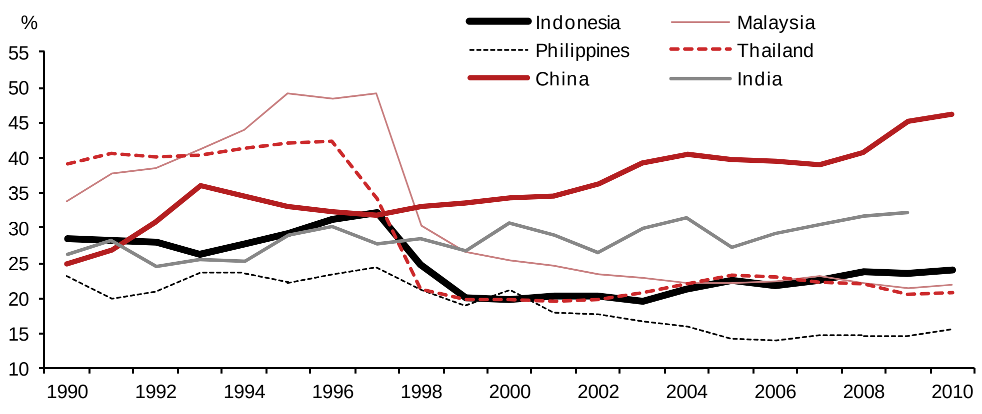
There are indeed downside risks to the baseline – namely that reforms do not gain momentum in the remainder of President Yudhoyono's term (Chapter 3), or that the constraints to land acquisition persist (e.g., the Land Acquisition Bill does not get passed). There are also upside risks. For example, labour force participation rates would increase (on top of declining unemployment) with growing opportunities; a bigger than assumed increase in private and foreign investment on improved growth prospects and in conjunction with greater public infrastructure spending ("crowding in"); and lower interest rate spreads from an improved credit rating and structurally lower inflation (with improved infrastructure); greater social expenditure (the 2004 commitment to providing universal health insurance); and faster productivity growth with a growing middle class affording/demanding better education and skilled workers being attracted to Indonesia.

There are both upside and downside risks to our baseline

It is clear from Asia's own experience (Box 9) and the results above that stronger investment growth and higher TFP will be needed to boost potential growth. Capital accumulation has been a particularly important driver of ASEAN growth in the past. Indonesia's investment-to-GDP ratio declined

Investment spending is key…

Figure 23: Investment to GDP ratios compared



Source: CEIC; Nomura Global Economics.

following the Asian crisis but not as dramatically as in Malaysia or Thailand (Figure 23). While this ratio has not recovered to its previous highs, encouragingly it is on an increasing trend (in contrast to the ratios for Malaysia and the Philippines) and particularly so in recent quarters. Growth achieved by China and India may now be a more appropriate comparison for Indonesia than ASEAN, and their investment ratios suggest Indonesia would need to boost its rate of capital accumulation significantly to achieve a step up in growth. This in turn points to a need to step up reforms such as improving the investment climate and reducing barriers to entry, including barriers to foreign investment in key sectors. Policies that enhance employment growth and labour force participation would also help boost potential growth.

… which in turn points to reform measures needed to boost investment

There are also likely sizable gains to be had from reforms that allow the existing factors of production to be utilized more effectively. For example, problems with land acquisition constrain the use of land for more productive uses (such as infrastructure). Labour market regulations and skills shortages constrain the full and more productive use of Indonesia's key natural resource – its people. Medium-term reform priorities addressing these issues are addressed in the next chapter.

"Momentum" factors favouring strong domestic demand

"Momentum" factors will likely ensure strong demand growth

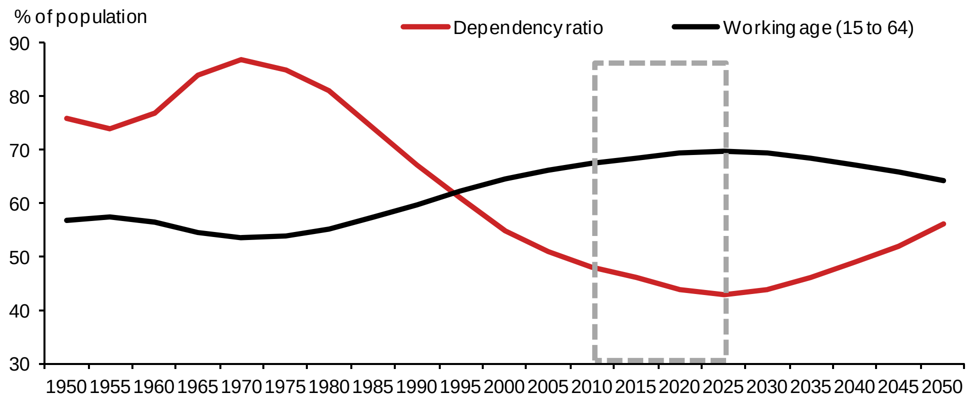
Indonesia's robust growth outlook (even in the "do nothing" scenario) is supported by favourable demographics, a growing middle-class and buoyant commodity demand improving the terms of trade (boosting rural incomes and investment). These "momentum" factors suggest a robust outlook and if the supply-side bottlenecks can be addressed then the future looks even brighter, and inflation and overheating are likely to be less of a problem. Below we briefly consider these momentum factors and tie in our baseline for potential growth into a medium-term macroeconomic framework.

Demographics

Working age population growth has added 1.2pp to growth in the last decade…

Indonesia has the fourth-largest population (and thus domestic market) in the world at 237.6mn people, and still favourable demographics, with a median age of 28. Growth of the working-age population has averaged 1.6% during the last decade – outpacing many neighbouring countries and UN projections suggest Indonesia's population growth will continue to outpace neighbouring countries. With the growing population has come a growing workforce (which we estimate has contributed 1.2pp to GDP growth during the past decade). The UN forecasts the working-age population to grow by 1.3% during the next decade and thus the contribution of labour growth to GDP growth may decline (unless participation rates increase and unemployment decreases).

Figure 24: An increasing working age population and declining dependency ratio



Source: UN; Nomura Global Economics.

… but the demographic sweet spot is likely still ahead

Indonesia has enjoyed a demographic premium since the 1970s as the dependency ratio has declined (from 0.8 in 1970 to 0.5 in 2009). The demographic sweet spot, however, is still likely to be in the next decade as the working-age population is projected to start peaking and the dependency ratio bottoms out (Figure 24). This demographic profile is only a "premium" if enough jobs can be created to productively absorb the additions to the workforce. Also, Indonesia needs to plan ahead for when the demographic profile becomes less favourable: the share of elderly is expected to increase notably between 2020 and 2030.

Rapid middlization

Rising average incomes is boosting the "middle class" numbers nonlinearly…

"Middlization of Asia" is the term used by Nomura economist Tomo Kinoshita in his leading work on the rapid growth of the middle classes in Asia. This is particularly pronounced in Indonesia as the average income approaches the middle-class threshold, adding nonlinearly to those falling in the middle classes (Figure 25). There are various ways to classify "middle class" (see extensive discussions in ADB (2010b) and World Bank (2011a)), hence the various measures of the size of the middle class. We use the simple criteria of households with annual disposable income of US$3,000 (but other criteria provide broadly the same picture).

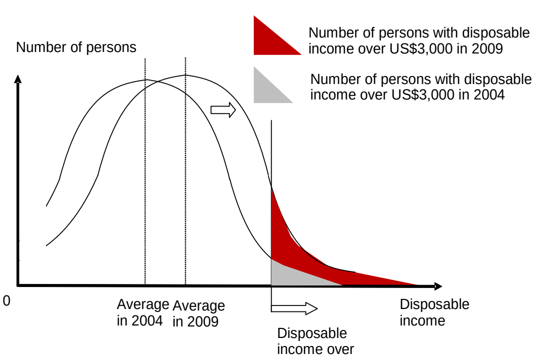
… supporting robust consumption growth…

By our criteria, the number of people in middle class households in Indonesia increased from around 1.6mn in 2004 to over 50mn in 2009 and we project the number could reach 150mn by 2014 (Figure 26). This middlization is a key driver of changes in consumption patterns of individuals and aggregate consumption growth. Work by our strategy team suggests that as per capita incomes increase past key thresholds (US$3,000), the elasticity of demand for goods and services increase. As household incomes increase, consumption moves beyond the basics (food, shelter and clothing) and expands into consumer durables, electronics, healthcare, education services and financial services. Indeed, sales of white goods, televisions, mobile phones and automobiles have grown significantly throughout Asia.

… but also economic development and political stability

There are benefits to middlization beyond the simple consumption story. The ADB (2010b) notes that a bigger middle class has generally translated into greater public sector transparency and accountability; it points to a virtuous cycle where a growing middle class supports economic development and political stability. The middle class can also help drive the supply-side of the economy, e.g., through their contribution to the deepening of financial markets, accumulation of savings which can be channeled to productive uses, and their likely influence in changing the type and quality of healthcare and education services available.

Figure 25: Rapidly growing middle class as income rises



Source: Nomura Global Economics

Figure 26: Number of "middle class" by US$3,000 criteria

(millions)		2004	2009	2014F
India	urban		26	147.7
	rural			82.1
China	urban	43.9	307.9	504.9
	rural		0.4	108.8
Indonesia		**1.6**	**50.4**	**149.7**
Thailand		21	32.9	39.9
Malaysia		14.7	21.3	27
Philippines		3	20.3	47.7
Singapore		3.7	3.9	4.3
Vietnam			1.8	28.4

Source: Country household surveys; CEIC; World Bank; and Nomura Global Economics.

Bringing this all together in a medium-term macro framework

Our baseline is medium-term growth of 7%...

Figure 27 summarizes our medium-term projection (2011-15) for key macro variables. Our baseline for average real GDP growth of 7% per year is drawn from our production function estimates above. Some key features of the medium-term framework on the expenditure side include the following:

… driven mainly by consumption…

- *Private consumption* will likely continue to be the main growth driver supported by the trends discussed above (demographics, middlization and terms of trade supporting rural demand). In our baseline, these factors combine to boost consumption growth by 1.5pp above the past decade average to around 6% (contributing over 3pp to growth) in the medium term.

… with government consumption and investment likely to pick up…

- *Government consumption and investment* could have substantial upside if fuel subsidies are eventually rationalized and resources are freed up for more productive social and infrastructure expenditure (which can be expected to also contribute to efficiency improvements showing up in TFP). Indonesia's public education and health spending to GDP is low relative to the region and have upside potential. In 2004, with the passage that year of the National Social Security System Act, Indonesia committed to achieving universal coverage of health insurance. Given more than half the population currently has no health insurance, this will certainly be challenging and points to higher public spending on health. The government also needs to maintain education spending at 20% or more of government expenditure.

… and private investment playing a greater role

- *Private investment* is expected to play a greater role with the government's commitment to developing infrastructure (both through budgetary allocation and by improving the framework for private infrastructure investment; see Chapter 5). Buoyant commodity prices are expected to persist into the medium term for structural reasons (see *The coming surge in food prices*, 8 September 2010) which supports domestic and foreign investment in Indonesia's agriculture and natural resource sectors. Indonesia's market size, growth potential and political stability are also likely driving a sustained pick-up in FDI.

Export growth is expected to remain buoyant…

- *Exports* of natural resources (oil and gas; coal and CPO) make up around 50% of Indonesia's exports and have been key drivers of growth. While

Figure 27: Medium-term forecast at a glance

% y-o-y growth unless otherwise stated	2007	2008	2009	2010	2011	2012	2013	2014	2015
Real GDP	**6.3**	**6.0**	**4.6**	**6.1**	6.5	7.0	7.0	7.0	7.0
Private consumption	**5.0**	**5.3**	**4.9**	**4.6**	4.9	5.3	5.7	6.0	6.1
Government consumption	**3.9**	**10.4**	**15.7**	**0.3**	3.9	4.9	10.0	10.0	10.0
Gross fixed capital formation	**9.3**	**11.9**	**3.3**	**8.5**	9.7	11.9	11.0	11.0	11.0
Exports (goods & services)	**8.5**	**9.5**	**-9.7**	**14.9**	11.3	11.3	11.5	11.8	11.9
Imports (goods & services)	**9.1**	**10.0**	**-15.0**	**17.3**	12.9	12.6	14.4	14.8	14.9
Contributions to GDP (% points):									
Domestic final sales	**5.3**	**6.6**	**4.8**	**4.7**	5.5	6.3	6.8	7.1	7.2
Inventories	**-1.6**	**0.1**	**-0.2**	**0.4**	0.1	0.0	0.0	0.0	0.0
Net trade (goods & services)	**0.6**	**0.7**	**1.2**	**0.8**	0.6	0.7	0.0	-0.1	-0.3
Consumer prices index	**6.4**	**9.8**	**4.8**	**5.1**	5.8	6.3	5.5	5.0	4.5
Exports	**14.0**	**18.3**	**-14.3**	**32.1**	20.9	12.8	18.0	18.3	18.4
Imports	**15.4**	**36.9**	**-24.0**	**43.7**	25.0	15.1	22.4	22.8	22.9
Merchandise trade balance (US$bn)	**32.8**	**22.9**	**30.9**	**30.6**	31.7	32.1	29.8	25.3	17.7
Current account balance (% of GDP)	**2.4**	**0.0**	**2.0**	**0.8**	0.6	0.5	0.1	-0.3	-0.8
Fiscal Balance (% of GDP)	**-1.3**	**-0.1**	**-1.6**	**-0.6**	-1.7	-1.6	-1.4	-1.2	-1.0
Bank Indonesia rate (%)	**8.00**	**9.25**	**6.50**	**6.50**	7.25	7.50	6.50	6.50	5.50
Exchange rate (IDR/USD)	**9419**	**10950**	**9400**	**8996**	8200	7800	7500	7400	7400

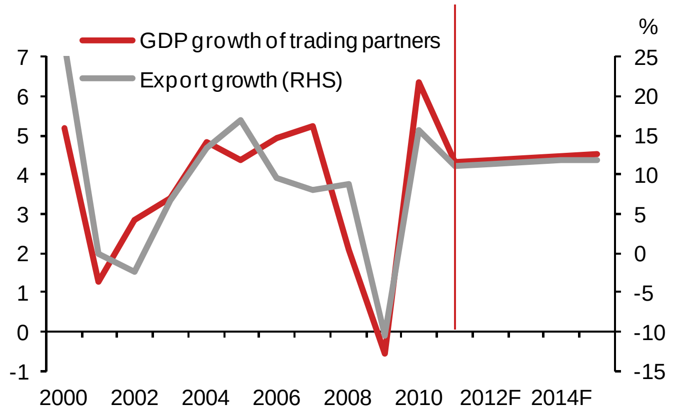
Notes: Numbers in bold are actual values; others forecast. Interest rate and currency forecasts are end of period; other measures are period average. All forecasts are modal forecasts (i.e., the single most likely outcome). Table reflects data available as of 1 June, 2011.
Source: CEIC; and Nomura Global Economics.

net oil exports have long turned negative, net oil, gas, and coal exports are still positive and high energy prices favour Indonesia's trade balance. With the share of total exports to fast-growing emerging markets (particularly China – see Annex C) increasing and demand for commodities likely sustained, export growth is likely to remain buoyant. With relatively cheap labour (and a complementary large and growing domestic market), we have seen an increase in manufacturing output and exports (see picture book on Indonesia's external competitiveness). Our forecast for export growth is based on the export-share weighted real GDP growth of Indonesia's main trading partners (Figure 28).

… but imports may grow even faster with higher domestic demand

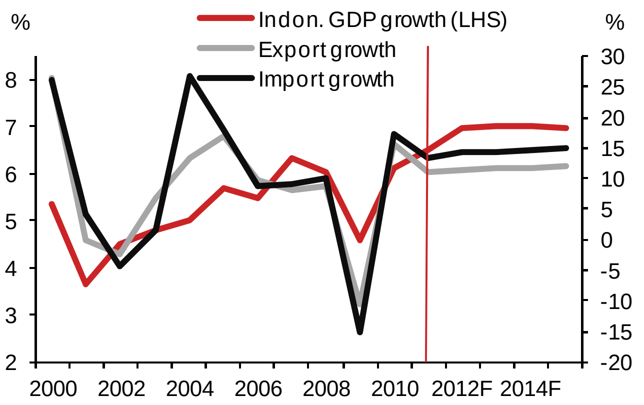
- On the other hand, *imports* are also expected to surge with infrastructure development, strong domestic demand growth and continued appreciation of the IDR in real effective terms. So net exports are expected to diminish and, with higher net income outflows (the counterpart to large portfolio inflows) we expect the current account to eventually move into deficit in the medium term. Our import growth estimates are based on Indonesia's real GDP growth and export growth (Figure 29).

Figure 28: Export growth and trading partner GDP growth



Source: CEIC and Nomura Global Economics.

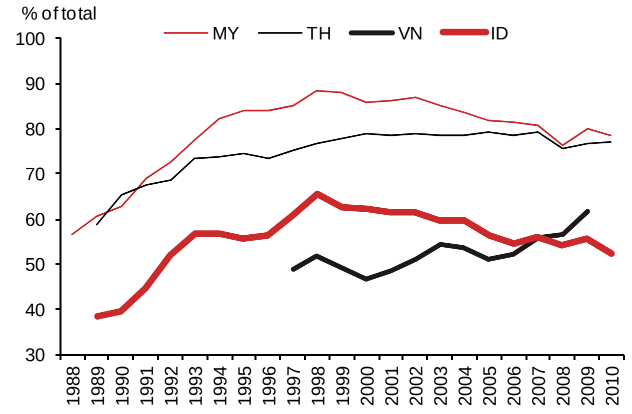
Figure 29: Import growth, export growth and GDP



Source: CEIC and Nomura Global Economics.

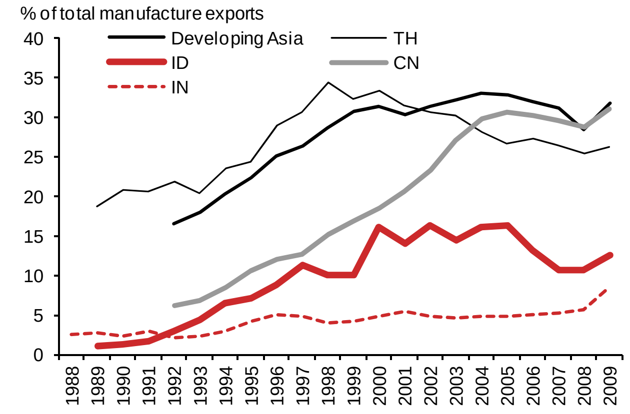
A picture book on external competitiveness

Figure 30. Share of exports of manufactures



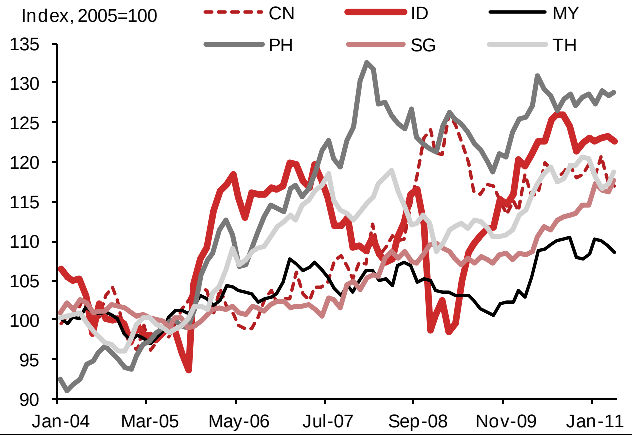
Source: UN COMTRADE; Nomura Global Economics.

Figure 31. High-technology exports



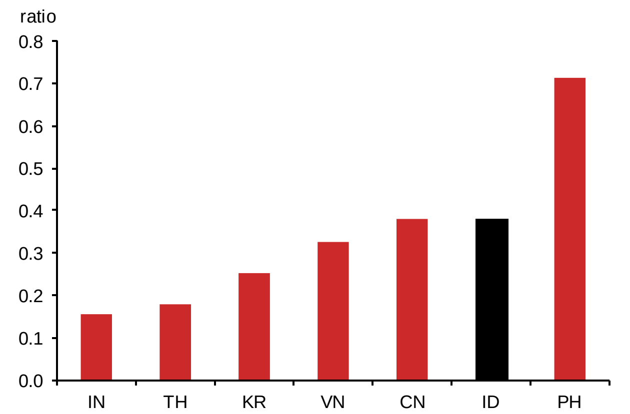
Source: World Bank; Nomura Global Economics.

Figure 32. Real effective exchange rates



Source: BIS; Nomura Global Economics.

Figure 33. Min. wage to value-added per worker (2008)



Source: World Bank; Nomura Global Economics.

Annex B: Structural reforms

Sector	Year	Law / Policy
Energy		***Changes in Subsidy Policy***
	2005	• Govt. undertook 2 large fuel hikes: prices of diesel fuel doubled, kerosene nearly tripled; and subsidies were eliminated for industrial users • To mitigate the impact on the poor, govt. introduced unconditional cash transfer system to 19 million low-income individuals
	2007	• The kerosene-to-LPG conversion program was initiated to reduce kerosene subsidy
	2008 (May) (July) (Dec)	• Govt. ceased subsidizing larger industrial electricity consumers and increased gasoline and diesel prices by nearly 30% and LPG prices by 23% • Compensation Program (in form of cash transfers) introduced • Following the drop in world oil prices, Govt. reduced the retail prices of gasoline and diesel
	2010	• Govt. announced plan to phase out sale of subsidized fuel to private cars and restricted it to public transport providers and motorcycles, starting in 2011. The plan seems to have been postponed indefinitely. • Electricity tariffs were hiked mainly for industrial users
		Changes in energy law
	2001	**Oil and Gas Law No. 22/2001**: • State owned oil and gas company, PERTAMINA's monopoly on: ➢ upstream oil development removed ➢ distribution of petroleum products terminated (since 2005) • Liberalization of downstream sector, distribution and retail opportunities for private investors
Mining	2009	**Mining Law No. 4/2009** • Contract of Work system replaced with a more equitable licensing/permit system. • Concessions given for 20 years and renewable for another 10 years with a maximum of two extensions • Companies required to pay additional 10% of net profits to local and central governments and prohibited them from exporting unprocessed ore
Electricity	2002	**Electricity Law No. 20/2002** • Establishing competitive electricity market by: ➢ restructuring and unbundling PLN ➢ mechanism for adjusting electricity tariff ➢ rationalizing mechanism for power purchases for private sector ➢ establishing regulatory mechanism for the sector **Ministerial Decree No. 1122/K/30/MEM on Small-Scale Power Purchase Agreement** • requires PLN to purchase electricity generated from renewable energy sources by non-PLN producers for projects of up to 1MW capacity. Institutions eligible to participate are cooperatives, and private and govt. companies • sets purchase tariffs at 80% for medium voltage and 60% for low voltage of PLN's announced "Electricity Base Price"
	2005	**Electricity Law No. 3/2005** • amended Electricity Law No. 20/2002, allowing private sector participation in the form of partnership with the state-run electricity firm
	2009	**Electricity Law No. 30/2009** • PLN will no longer have monopoly on supplying and distributing to end customers. IPPs will be allowed to do this as well, particularly in the regions, however, subject to a 'right of first priority' provided to PLN
Infrastructure		***Cross-Sector Policy, Legal, and Institutional Framework***
		• Established framework for public-private partnerships: ➢ **Presidential Regulation 67/2005** on Cooperation Between Govt. and Business Entities in infrastructure Provision (replacement of PR 7/1998) ➢ **CMEA regulation 3/2006** on readiness criteria for project prioritization and **4/2006** on procedures for evaluating projects requiring Govt. support • Improved coordination among govt. institutions and consultation with external stakeholders:

- **PR 42/2005** for strengthening KKPPI (National Committee for the Acceleration of Infrastructure Provision) mandate
- **Minister of Transportation decree 270/2006** and **Minister of Energy and Mineral Resources decree 2541/2006** on the establishment of the PPP nodes in their ministries
- Establishment of the Consolidated Indonesia Infrastructure Forum (CIIF) for consultations with investors and other stakeholders

- Established risk management framework:
  - **MOF regulation 38/2006** on risk management policy, outlining the criteria (legality, project quality, fiscal prudence, and transparency) and procedures for the provision of Government support for PPP projects.
- Established financing mechanism:
  - **Government Regulation 66/2007** issued on a proposal for the establishment of the Indonesian Infrastructure Fund to finance the private sector portion of PPP projects
  - Establishment and operationalization of IIFF (Indonesia Infrastructure Finance Facility Ltd. Liability Co.) to provide long-term local currency debt for PPP projects
- Established land acquisition framework:
  - **Presidential regulations 36/2005** and **65/2006** on land acquisition outlining the rules and procedures for infrastructure projects serving public purpose
  - **BPN** (National Land Agency) **Regulation 3/2007** on land acquisition guidelines
- Adopted legal framework:
  - **Government regulation 38/2007** on the assignment of functions among central, provincial, and regional and/or municipal governments
- Revised national policy and legal reform
  - **Government regulation 54/2005** on Regional Government Borrowing; **Government regulation 55/2005** on On-Lending; and **Government regulation 57/2005** on On-Granting
  - **Government regulation 2/2006** on Foreign Loans and Grants

Sector Reform

- ***Land Transportation:*** **Law 22/2009** on Road Traffic and Transportation
  - Revised legal framework to reflect decentralization (eliminated of SOE monopoly was regulated under Road Law no. 38/2004)
- ***Railways:*** **Law 23/2007**
  - Revised legal framework to reflect decentralization and eliminated KAI monopoly
- ***Sea Transportation:*** **Presidential Instruction 5/2005**
  - Revised legal framework to reflect decentralization and eliminated PELINDO monopoly
  - Promoting the separation of the regulatory and operator functions in ports and allowing more than one terminal operator
- ***Air Transportation:*** **Law on Aviation 1/2009**
  - Revised legal framework to reflect decentralization and eliminated Angkasa Pura monopoly
- ***Roads:*** **Road Law No. 38/2004**
  - Opened the toll road industry to the private sector
  - Revised legal framework to reflect decentralization and eliminated Jasa Marga monopoly
  - Adopted land acquisition mechanism
  - **MOF Regulation 791/2006** and **MPW Decree 171/2007** on the establishment of a revolving fund for land acquisition
- ***Telecommunication:*** **Telecommunication Law No. 36/1999**
  - phased out the exclusive rights of PT Indosat and Satelindo for international calling services and PT Telkom for domestic long-distance and local fixed-line services
  - The Government divested portions of its stakes in PT Indosat and Satelindo and raised telephone rates to conform to market levels and encourage private investment.

Labour	2000	**Trade Union Law No. 21/2000** ➢ Defines the role of unions and sets rules for their formation ➢ Unions have three roles: voice worker interests, draft collective agreements and resolve disputes including organizing strikes
	2003	**Labour Law No. 21/2003** ➢ Aimed at improving worker protection, tightening hiring and firing regulations and increases severance rates for workers ➢ Established a comprehensive framework for setting minimum wages
	2004	**Industrial Relations Dispute Settlement Law No. 2/2004** ➢ Governs termination of employment ➢ Creates an independent industrial relations court falling under the judicial branch
	2004	**Social Security Law No. 41/2004** ➢ merge existing social insurance schemes under a new national social security agency (DJSN) ➢ extend mandatory social insurance to informal sector workers
Education	1999	**Regional Autonomy Act No. 22/1999** for education: District-based education planning, management and quality assurances
	2003	**Indonesian National Education System Act (INESA 2003)** Emphasized religious and moral values, intellectual competencies, and democratic values
	2004	**Competency-Based Curriculum (KBK)** implemented Emphasized standardised competencies for students to achieve and increased authority for school stakeholders to participate in development of the curriculum
Investment	2003	**Presidential Instruction No. 5/2003** ➢ Main goals: ❖ to maintain Macro Economic Stability, ❖ to continue restructuring & reforming of financial sector, ❖ to promote investment, export and employment. **Presidential Decree No. 87/2003** ➢ National Team for Industrial Development & Investment Promotion was set up: ❖ To formulate policy on export and investment; ❖ To set up strategic steps to boost economic export and investment; ❖ To review and give recommendations in boosting export and promoting investment.
	2007	**Investment Law No. 25/2007** ➢ Equal treatment of foreign and domestic investors, streamlining procedures for starting business ➢ Investor protection such as non-discriminatory treatment, protection against expropriation, and recourse to international arbitration in disputes against the government ➢ Expanded the number of sectors in the 'negative list' in which foreign investment is restricted and increased foreign equity restrictions in telecoms, pharmaceutical, film and creative industries, and construction
	2009	**Presidential Regulation 27/2009** ➢ One-Stop Shop system (PTSP) - aimed to cut bureaucrat red-tape and allow investors to process business license faster ➢ Enacted to implement Article 26(3) of Law No. 25 of 2007 Regarding Capital Investment ("Law 25"), which requires the issuance of a Presidential Regulation for further implementation of the "one gate policy in investment services".

Sources: World Bank, US Embassy Jakarta, ADB, Indonesia Ministry of Finance, Bank Indonesia.

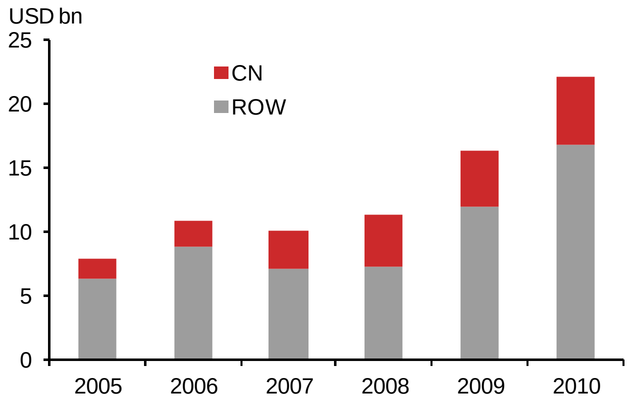
Annex C: The China connection

As an increasingly important engine of global trade, China has been viewed by other Asian countries as both presenting a huge opportunity and posing the key threat. We think Indonesia will likely be more of a net beneficiary of China's rise than most countries in the region:

- China is an increasingly important destination for Indonesian commodity exports, accounting for nearly a third of Indonesia's commodity trade surplus (including petroleum, coal and non-ferrous metals). This share has expanded from about 24% just five years ago (Figure 1). There is also an indirect but potentially large impact via China's demand pushing up global commodity prices, thus boosting Indonesia's overall terms of trade.
- Indonesia's ability to leverage China's strong demand for commodities remains encouraging. Indonesia's comparative advantage still lies primarily in natural resource exports, particularly of palm oil, natural gas, coal, wood products, rubber and metals (Figure 2).
- Outside the commodity space, Indonesia does not seem to be competing with China head on. One way to gauge this is by calculating an export similarity index to show the extent of competition in similar products (the index takes on a value of between 0% and 100%; the closer to 100% the higher the competition). The result is that among peers in ASEAN, Indonesia has one of the lowest levels of export similarity with China, at around 43%. This has fallen significantly from 50% in 2005. In contrast, Thailand has an index value of around 55%, down only marginally from 58% in 2005 (Figure 3).
- Apart from trade, financial linkages have also intensified between Indonesia and China. Foreign direct investment from China into Southeast Asia has soared since 2005, but especially so in resource-rich Indonesia (Figure 4). By 2009, Indonesia was a recipient of around USD230m in Chinese FDI, more than twice that of Vietnam and five times that of Thailand and Malaysia.
- Finally, as China's labour costs increase, Indonesia would be well placed to take over labour-intensive manufactured exports (suggesting even larger potential payoffs from labour market reforms discussed in Chapter 5).

There are, however, some longer-term issues. First, Indonesia became a net oil importer in 2004 and even the oil and gas trade surplus has been declining, so

Figure 1: Indonesia's commodity* trade surplus



Note: *These include oil, gas, coal and non-ferrous metals; Source: CEIC and Nomura Global Economics

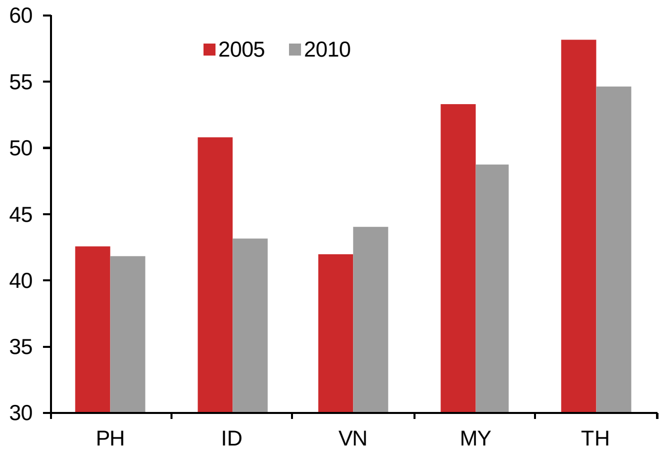
Figure 2: Revealed comparative advantage in exports

	ID	VN	TH	MY
Vegetable fats and oil, refined	14.2	0.5	0.3	13.1
Cork and wood manufacture, excl furniture	7.6	-0.4	-0.2	2
Gas, natural and manufactured	7.4	-0.1	0.3	3.2
Crude rubber	7.4	13.8	18	5.1
Coal, coke and briquettes	5.6	-1.3	-3.3	-3.3
Metalliferous ores and metal scrap	4.5	0.2	0.2	0.0

Note: The RCAs are relative to China, i.e. country RCA minus China's RCA of a product. Positive numbers imply higher RCA relative to China. Source: CEIC and Nomura Global Economics.

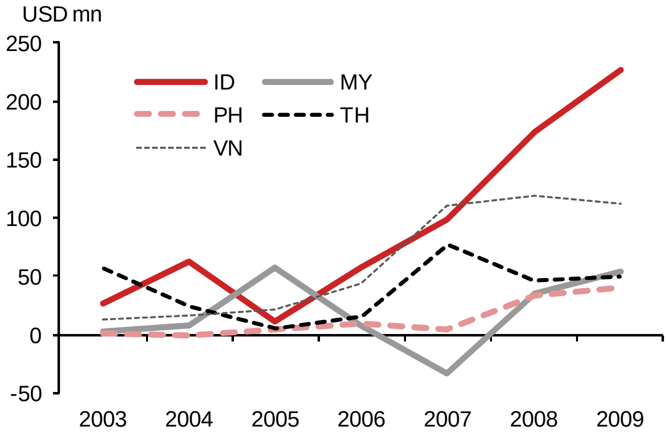
high commodity prices may not always remain a positive. Second, the heavy reliance on commodity exports raises the potential of a "Dutch Disease" problem, where a commodity boom causes a real exchange rate appreciation (and raises wages in the non-tradable sector) which then reduces competitiveness of other labour-intensive industries. This may already be reflected in the comparatively lower share of Indonesia's exports of manufacturers and high-technology products in the region (Figures 30 and 31 in the external competitiveness picture book). Yet these sectors tend to have more technological spillovers and a higher income elasticity of demand. Third, the IMF's April 2011 Regional Economic Outlook for Asia and the Pacific provided evidence of an increasingly elaborate supply chain involving China to which Indonesia has not participated as much as its regional peers, supplying mostly raw materials to China rather than intermediate goods. For Indonesia to take advantage of this trend, reforms to enhance competitiveness are necessary.

Figure 3: Export similarity index with China



Source: CEIC; Nomura Global Economics

Figure 4: FDI from China



Source: CEIC; Nomura Global Economics.

Chapter 5: Unleashing Indonesia's potential

Yougesh Khatri
yougesh.khatri@nomura.com
+65 6433 6960

Euben Paracuelles
euben.paracuelles@nomura.com
+65 6433 6956

Appropriate frameworks for developing physical and human capital are needed to achieve sustainable higher growth.

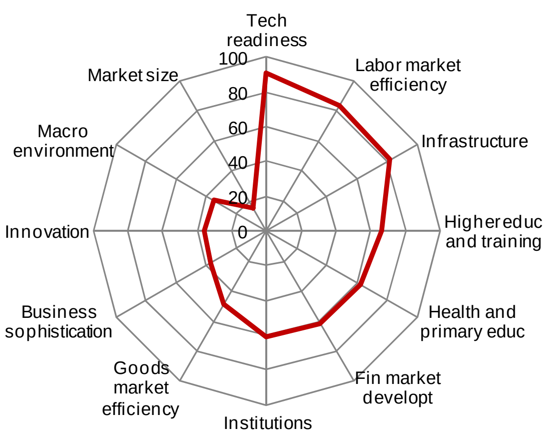
For Indonesia to achieve its full economic potential and eventually "developed economy" status, it needs to undergo more fundamental institutional reforms to address the key impediments to higher investment, employment and total factor productivity (TFP) growth. "Institutions" – including the government, political parties, the legal framework and administration – determine the "rules of the game" and thus incentives for (and returns on) firms' investment and innovation. As we have argued in Chapters 3 and 4, the existing institutional framework has under-delivered, with underinvestment in physical and human capital. We also noted we expected stability and consensus building to win out over a reform push in the remainder of this administration; and acknowledged that a more evolutionary approach may, within the cultural context, be the most appropriate approach.

More feasible medium-term structural reforms could deliver growth

Here we focus on feasible medium term structural reforms with a view to their implications for growth and markets within the next five years. Specifically, we consider prospects for debottlenecking infrastructure; getting a larger portion of the labour force working; leveraging greater benefits from natural resources and removing wasteful government subsidies; deepening the financial sector; and promoting the services sector. The World Economic Forum (WEF) competitiveness indicators flag similar priorities (Figures 34 and 35).

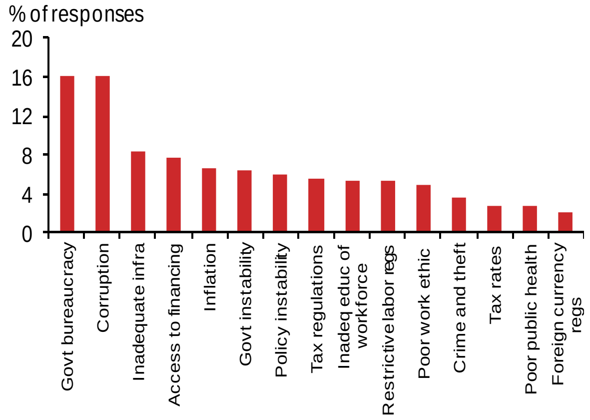
Markers for progress in these areas include: less rigid laws on land acquisition; a step-up in public infrastructure spending; some successful public-private partnership (PPP) projects; appropriate pricing policies; a simplification and reduction of severance pay, together with more effective protection of workers; minimum wages purely as a safety net for low-wage earners; improved skills development; improving irrigation, land management and titling; improvements in incentives and governance in the oil and gas sector; a removal of subsidies on fuel and a reallocation of resources for more productive spending; financial sector and capital market development; and further liberalization of the service sector to improve quality and productivity, particularly in education and health.

Figure 34: Global Competitiveness rankings, 2010-11



Source: World Economic Forum; Nomura Global Economics.
Note: country rankings by the 12 "pillars" out of 139 countries (1=best).

Figure 35: The most problematic factors for doing business



Source: World Economic Forum; Nomura Global Economics
Note: Respondents asked to select the 5 most problematic factors for doing business and rank them between 1 (most problematic) and 5. The higher the bars (responses weighted by rankings) the greater the perceived problem.

Infrastructure constraints and recent initiatives

Indonesia's physical infrastructure has been widely cited as a key constraint to growth and competiveness. The infrastructure problem in part reflects underinvestment since the 1997 Asian crisis. Prior to the Asian crisis, total public and private infrastructure spending reached 7% of GDP but declined to 2.5% in 2000. It has only partially increased since, to around 3.8% in 2008 (the most recent aggregate data) – still less than spending on fiscal subsidies and well below the 10% of GDP spent on infrastructure by China or Vietnam. Since decentralization of the public sector, which began in 1999, sub-national government infrastructure spending has played a larger role, accounting for 57% of public spending in 2009.

Infrastructure is widely viewed as a bottleneck…

Perhaps the most visible consequences of underinvestment in infrastructure have been road congestion in major cities, blackouts, floods and health issues relating to a lack of clean water and sanitation – all of which ultimately leads to slower growth, lower competitiveness and higher prices.

… obvious from some of the negative consequences…

Indonesia's global ranking in infrastructure development was 62 in 2005, ranking behind Vietnam, according to the Asian Development Bank Institute (Figure 36). In the latest WEF Global Competitiveness Index (2010-11), Indonesia ranks 44 overall (up from 54 in 2009) but specifically on infrastructure, its ranking of 82 is almost twice as bad. The most serious bottlenecks relate to ports (96), electricity supply (97) and roads (84).

… and in global rankings of infrastructure quality and adequacy

Figure 36: Ranking according to the level of infrastructure development

	1991		2000		2005	
Country	**Index**	**Rank**	**Index**	**Rank**	**Index**	**Rank**
US	25.96	1	22.95	1	20.66	1
Japan	16.28	5	18.65	4	18.58	2
Singapore	15.73	6	20.11	2	17.66	3
Malaysia	5.1	37	8.65	27	9.21	29
Thailand	4.17	43	5.48	38	5.89	42
Vietnam	0.91	92	1.85	75	3.27	61
Indonesia	**2.23**	**69**	**2.74**	**63**	**3.21**	**62**

Index = Research and Information System for Developing Countries Infrastructure Index (RII) where RIIit = RII of the i-th country (104 countries) in t-th time (namely, 1991, 2000, 2005), Wjt = weight of the j-th aspect of infrastructure in t-th time, and Xjit = value of the j-th aspect of infrastructure for the i-th country in the –th time point. Each of the infrastructure variables is normalised for the size of the economy so that it is not affected by the scale. The Wjt are estimated with the help of principal component analysis (PCA). The aspects of infrastructure covered in the construction of the composite index are transport infrastructure, ICT infrastructure, energy infrastructure and financial infrastructure.
Source: Asian Development Bank Institute (May 2009); Nomura Global Economics.

Transportation

Public investment in transport infrastructure fell from over 2% of GDP in 1994 to around 0.5% in 2000 and has only partially recovered since (to 1.5% by 2009, which accounted for 80% of total public infrastructure spending). Given rapidly growing demand, this level of investment is woefully insufficient.

Investment in transport infrastructure fell during the Asian crisis and only partially recovered since

Roads**:** are the dominant mode of transport in Indonesia, accounting for around 70% of freight and 82% of passenger traffic. The stock of vehicles has roughly doubled over the past five years and is expected to continue increasing rapidly. Despite progress on toll road legislation, actual implementation of public-private partnership projects has been poor. Indonesia's first toll road was built in 1978, covering approximately 50km; less than 700km has been added in the 30 years since (Figure 37), compared with more than 1,500km of toll roads in Malaysia. The main constraint to progress appears to have been strict land acquisition laws. The government has recently focused on road maintenance but the quality of roads has probably not yet returned to the pre-Asia crisis level (in 2000, 87% of national roads were in "good or fair conditions" compared to 83.3% in 2008, according to the World Bank).

Sea transportation and ports need to be developed to meet growing demand

Sea transportation and ports: are essential in a nation of more than 17,000 islands, spanning an archipelago of nearly 5,000km. Indeed, these are also key to Indonesia realizing its huge maritime development potential. Inter-island shipping is at the core of Indonesia's logistics system, accounting for 60% of total seaborne cargo. Indonesia has over 2,130 ports – 111 operated by state-owned Pelindos – and two of these (Tanjung Priok in Jakarta and Tanjung Perak in Surabaya) have potential to become international hubs, but their current capacity falls far short of international trans-shipment ports. Congestion has increased in Indonesia's main ports as container traffic has increased although port capacity has not.

Energy sector

The electrification rate is low, with insufficient investment…

The electrification rate – at 64% in 2008 – is the lowest among the main ASEAN economies (Figure 38). A large number of Indonesians do not have access to electricity, 80% of which live in rural areas. Those that do have access to power still face disruptions and the sector is already likely constraining efficiency if not growth (industry often uses more expensive private generation). To achieve the government's electrification target of 90% by 2020 would require the state-owned power company, PLN, to connect around two million new subscribers annually, which is roughly double the rate of the last few years.

… because of the lack of an appropriate legal and regulatory framework…

Key constraints to private investment in the sector are the lack of a legal and regulatory framework and uncertainty caused by the December 2004 repeal of the 2002 Electricity Law, which was to encourage more private competition, the unbundling of PLN and the establishment a regulatory agency.[1] The legal framework for the sector reverted to the 1985 Electricity Law designed for a vertically integrated monopoly. There have been few independent power producers (IPPs) entering the sector. PLN accounts for around 85% of installed capacity and IPPs the rest (including around 10,000 industrial and manufacturing units generating their own power, where PLN supplies are either unavailable or unreliable). In September 2009 the Electricity Law of 2009 was

Figure 37: Length of Indonesia's roads (kms)

Road by Status	2004	2007	2009
National	26,271	34,629	34,629
Provincial	38,914	50,044	48,681
District	222,981	245,253	264,326
Urban	21,863	23,469	23,469
Other (incl.Toll Roads)	460	773	688
Total	**310,489**	**354,168**	**371,793**

Source: World Economic Forum; Nomura Global Economics

Figure 38: Electrification rates in Southeast Asia, 2008

Country	Electrification rate in 2008(%)	Population without Electricity (in mn)
Indonesia	64	81.1
Malaysia	99.4	0.2
Philippines	86	12.5
Singapore	100	-
Thailand	99.3	0.4

Source: IEA 2008; Nomura Global Economics.

[1] The Constitutional Court ruled that the 2002 law violated the Constitution: Article 33 states that "sectors of production which are important for the country and affect the lives of the people shall be controlled by the state".

passed. While not as ambitious as the 2002 proposal, PLN will no longer have a monopoly on supply and distribution to end-customers. However, opposing forces may yet defer or water down the intent of the bill coming into force.

… and below-cost pricing

The most binding constraint to private sector investment in this sector is pricing. Electricity tariffs are among the lowest in ASEAN, at below-cost recovery levels. This limits PLN's capacity to invest and provides a strong disincentive for IPPs to enter the sector in a commercial capacity. Moreover, as capacity is expanded to meet rapidly growing demand, the cost of the government's electricity subsidy will also grow unless tariffs are adjusted.

While politically difficult, tariff increases seem inevitable

The future of the power sector is closely linked to the politically difficult issues of reducing electricity subsidies and establishing an appropriate regulatory framework. To avert a power crisis, tariff increases (subsidy reductions) seem inevitable; and reallocating the fiscal savings could go a long way to meeting the huge financing required to build additional capacity. Electricity tariffs were hiked in 2010 – the first time in a numbers of years, but admittedly only for industrial users – and in our view, additional hikes in the near future are feasible (motivated by both fiscal and power-supply concerns).

Government policies to boost infrastructure development

The infrastructure problem has been well recognized

The infrastructure problem has been well recognised by successive governments, but there has still been little tangible progress. After winning in November 2004, President Yudhoyono set goals to improve the investment climate and remove the infrastructure bottleneck in 2005-09. A high-profile infrastructure summit in January 2005 launched 91 projects worth over US$22.5bn (mainly toll roads, power and gas pipelines) and created high expectations for progress. Unfortunately very few of these projects seem to have reached the construction or operation phases, while there has been only 135km of toll roads added nationally since 2005.

Land acquisition, funding, price and policy uncertainty, governance, and lack of coordination are some constraints

Against this backdrop of disappointing progress, there is a healthy dose of skepticism among investors about the outlook for infrastructure. The key factors in our view that are limiting progress are the poor legal and institutional frameworks for land acquisition; insufficient public funding and guarantees; policy uncertainty; poor governance; a lack of coordination and capacity among key stakeholders, a proper framework for PPPs, and administered price setting.

This time might be different given starting conditions…

However, there is reason to believe conditions are perhaps sufficiently different this time around, including improved macroeconomic and fiscal conditions (see Chapter 4) and funding conditions (see Chapter 6). Developing infrastructure is a central part of Indonesia's medium-term development plan (see Annex D) and recent infrastructure policy reforms are targeting the key constraints noted above:

… and a Land Acquisition Bill expected to be passed this year…

- **The Land Acquisition Bill:** was submitted to parliament in December 2010 and we expect it to be passed this year. Once in force, it will ease the land acquisition-related impediment to infrastructure development. Its key features (see *Indonesia Infrastructure*; 2 May 2011, page 13) include the following: land title/rights within the public infrastructure corridor will be automatically cancelled; public infrastructure is defined to include roads, airports, ports, power plants, the power transmission grid, flood canals and other projects deemed important by the president. Compensation to land owners is to be decided through appraisal by an independent committee, including third-party appraisers, local governments, representatives of the local community and the Ministry of Public Works (MoPW). Under the draft bill, land owners will be able to take disagreements on the purchase price to court, with the court given 30 days to rule, with no further appeal allowed; land title/rights will be cancelled immediately and the infrastructure project is cleared to proceed. Cross-party support and incentives for pushing ahead with the bill seem well aligned, although NGOs have expressed concern recently (as noted in Chapter 3) that the statement "…and other infrastructure projects deemed important by the president", gives too much discretion to the president on defining public infrastructure.

… greater budgetary allocation for capital expenditures…

- **Public funds for infrastructure stepped up:** In line with improving fiscal finances, the share of the Ministry of Public Works' expenditure (a large part of total public infrastructure spending) in overall government expenditure has been trending higher, from 2.5% of budget expenditure in 2005 to more than 4.5% for 2011 (Figure 39). The 2011 allocation represents an increase of around 60% on 2010 (admittedly from a relatively low base).[2] Increased public infrastructure investment can in turn spur greater private and foreign investment, including through public-partnerships. Furthermore, any progress made on subsidy reductions will create more fiscal room for infrastructure spending, while an improved investment grade credit rating would reduce the cost of long-term debt financing.

… an improved framework for public-private partnership…

- **A stronger framework for public-private partnerships:** a risk management unit was established in the MoF which provides a framework for the government to take on (or share) some types of political, project performance and demand risks which should help nurture public-private partnerships. The unit provides criteria for government support and monitors and reports on the evolution of project risks. Financial support and guarantees are also available in the form of: 1) a land-capping fund (limiting uncertainty about land acquisition costs); 2) a revolving fund for land acquisition (for toll roads, with the fund being reimbursed by investors once the land is acquired); and 3) guarantee agencies such as the Infrastructure Guarantee Fund (IGF) (see *Indonesia Infrastructure*; 2 May 2011, Figure 16).

… and focus on policy coordination and capacity

- **Improved ministerial capacity and coordination:** the Policy Committee for Accelerating the Provision of Infrastructure (KKPPI) is an inter-ministerial committee, established to improve coordination among government institutions and improve capacity of government agencies for preparation of projects. The KKPPI's main tasks are to formulate strategies for coordination to accelerate infrastructure provision; coordinate and monitor the implementation of infrastructure provisions across various ministries and local government; and solve problems relating to infrastructure provision as they arise.

The government also now has a detailed plan on infrastructure needs

In February 2011 the government detailed a long-term infrastructure development plan under its Master Plan for Economic Development. The plan provides a detailed mapping of planned infrastructure spending by sector, project targets and potential impacts on the regional economy. Government estimates of total infrastructure development required through 2030 is US$932bn (Figure 40), with much of the funding expected to come from the private sector. The first stage, ending 2014, is expected to require US$76bn in "priority" infrastructure spending, with key emphasis on railways, roads and power (Figure 40).[3]

We thus expect improved progress with infrastructure but still not all that is needed or planned

We expect progress in our medium-term horizon (compared to the last five years), although not the full realization of the estimated investment needed given a combination of factors including: funding constraints; only a gradual movement to market pricing in energy, and lagging private participation; still-limited coordination and implementation capacity; and persistent governance issues. The government's assumptions on private participation are likely too

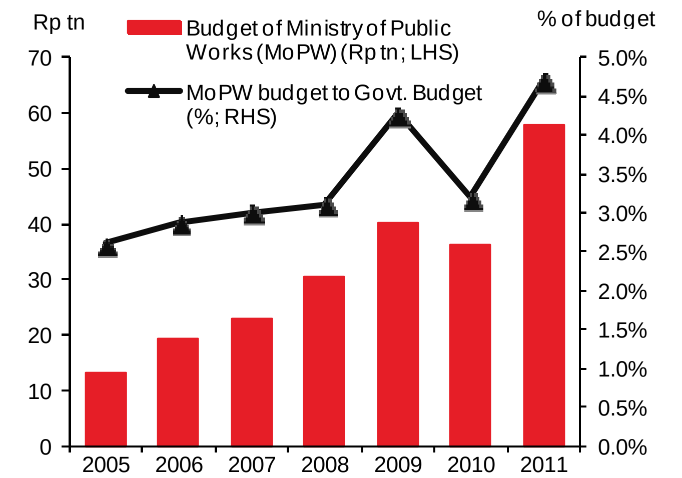
2) Other key ministries – Transportation, Energy and Mineral Resources, Communication and Information Technology, and Housing – are budgeted to spend another IDR42.6trn (US$4.6bn) for infrastructure-related development.

3) Note the RPJMN estimated an overall infrastructure need during 2010-14 of around US$220bn of which 70% – around US$150bn – would be non-government funded. As we understand it, the US$76bn represents just the priority need and is a subset of the overall US$220bn in the RPJMN.

ambitious, in our view – even in the best cases the majority of infrastructure investment is still public. We see four key signposts for infrastructure development:

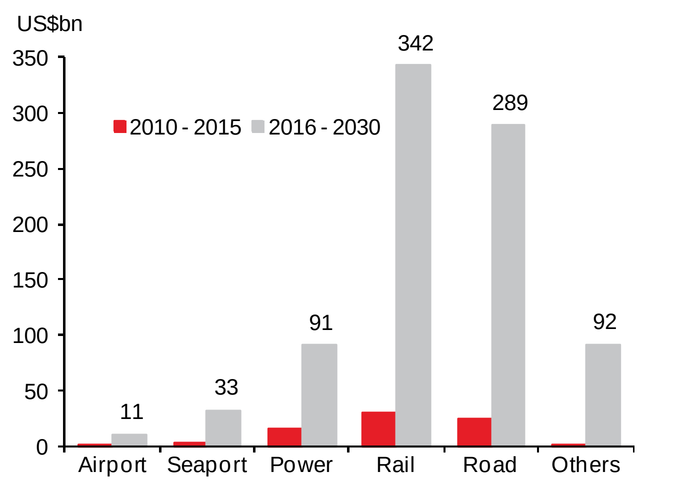
1. **Passage of the Land Acquisition Bill and associated regulations** and demonstrations of the benefits of the bill in action.
2. **A step-up in total public-sector infrastructure spending** (and greater expenditure realisation versus targets) through expenditure reprioritisation, notable by reducing badly targeted government subsidies.
3. **Successful public-private partnership projects** completed using the various financial support and guarantee frameworks to create a demonstration effect.
4. **A move to market pricing of natural resources** and a commitment to retain market pricing, particularly in the power sector. This would likely need to be in concert with increases in targeted transfers to the most vulnerable families.

Figure 39: Increasing share of budget for public works



Source: Office of Coordinating Ministry for Economy; Nomura Equity Research.

Figure 40: Official projections of infrastructure requirements



Source: Government; Nomura Global Economics.

Labour market issues

Indonesia's unemployment rate has only trended down in recent years from its post-Asian crisis peak of 11.2% in 2005 to a still-high 6.8% in February 2011. Over this period job creation has been led by non-public services (29% of total employment) as well as the mining, manufacturing and construction sectors (19%) (Figure 41). The agriculture sector remains the big employer, but has seen a gradual decline in share of total employment, from 42.0% in 2006 to 38.3% in 2010.

Unemployment has trended down in recent years…

The recent decline in unemployment rates followed a period of "jobless growth" in 1999-2005 when a relatively rapid economic recovery was not accompanied by rising employment (Figure 42).[4] The causes of this jobless growth have likely been rigidities in the labour market and large increases in real wages, which in turn tend to inhibit investment and formal sector employment.

… following a period of a "jobless recovery"…

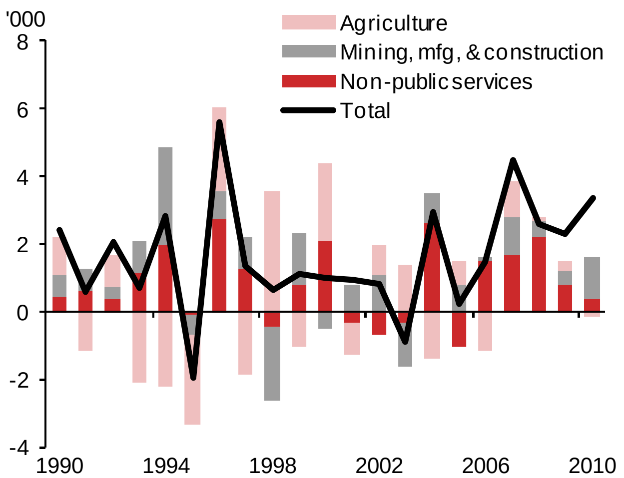
The Manpower Law of 2003 – and its numerous implementing regulations – regulates the labour market. The law focuses on improving workers' protection but increased substantially the rigidity of Indonesia's labour regulation (Box 12). It increased severance rates, added a 15% gratuity payment and introduced further restrictions on outsourcing and the use of fixed-term contracts. It also introduced a new framework for setting the minimum-wage and dispute resolution.

The Manpower Law (2003) increased protection for workers but added rigidity in the labour market

There have been attempts to revise the law to make it more business-friendly, but these have been unsuccessful, reflecting the difficult political realities the government has had to contend with. In 2006 the government withdrew proposed revisions to severance pay regulation following mass protests and, more recently, parliament removed the proposals from the priority legislative agenda this year. The government appears to be choosing its battles – for example, focusing on infrastructure development where there is broader consensus and understanding. Indeed, debottlenecking growth could help improve employment opportunities further. Progress with growth and lower employment suggest this might be a reasonable strategy.

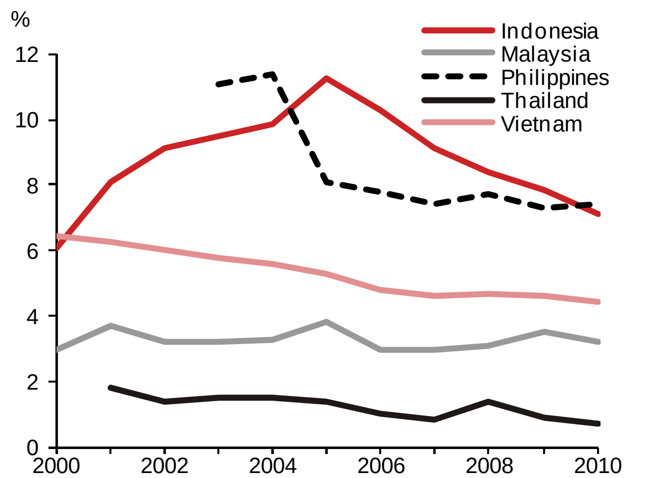
Recent attempts to make labour markets more business friendly have been stopped

Figure 41: Job creation per year



Source: CEIC; Nomura Global Economics.

Figure 42: Unemployment rates in the region



Source: CEIC; Nomura Global Economics.

4) The elasticity of employment to growth has been low relative to the region, according to the World Bank (see Table 2.1 in *Indonesia Jobs Report*, World Bank, September 2010, from which this section draws extensively). Unemployment rates rose sharply, reaching 10-11% in 2004-05 despite GDP growth averaging 4.8% over the period.

But there are likely sizeable gains in employment from improving labour regulations

However, while the trend decline in the unemployment rate in the last few years is encouraging, it remains an open question as to whether this can be sustained without meaningful labour market reforms contributing to a more positive investment climate. Also, at 6.8%, Indonesia's unemployment rate (measurement issues aside) is still one of the highest in the region. The counterfactual could have been more and better-quality job creation. For example, Feldmann's (2008) findings in a study of 74 countries, suggest that if Indonesia maximised its labour flexibility, the unemployment rate would fall by 2.1 percentage points (pp) and youth unemployment by 5.8pp.

Box 12: Regulatory rigidities in the labour market

Indonesia's labour regulations are among the most rigid in the world: in the World Bank's *2009 Doing Business* survey, looking at flexibility of labour markets across countries, Indonesia ranked 157 out of 181 countries and 23 out of 24 in Asia Pacific. There are three main sources of rigidities: high severance pay, restrictions on outsourcing and the use of temporary fixed-term contracts, and minimum wages.

Severance pay. The average cost of dismissing a worker for redundancy is about 35 weeks' salary, the highest in the region and nearly twice the regional average. This can be thought of as a hiring tax (and an uncertain one for the employer) which the World Bank estimates as equivalent to one-third of annual wages of workers and which ultimately reduces labour demand. Severance pay rate increases have been legislated three times in the last 15 years (1996, 2000 and 2003), with the more significant increases happening in the post-Soeharto era as trade unions became more organized and demanded stricter compliance of labour laws. In addition to already high severance rates, the 2003 Manpower Law has a complicated set of rules to determine the severance package (severance plus long-service pay) and who is entitled to it, adding to the difficulty and uncertainty faced by firms in trying to account for total labour costs.

Outsourcing and fixed-term contracts (FTCs). Under the law, labour outsourcing is limited to non-core activities. However, defining "non-core" is subject to negotiation between employees and employers. In most cases, according to labour unions, this gives employers the ability to outsource more production activities in order to avoid severance payments and circumvent other regulations. This leaves vulnerable employees with little job security. The negative sentiment towards outsourcing adds another constraint to firms being able to flexibly use this provision. Meanwhile, the duration of FTCs was reduced in the Manpower Law to a maximum of three years (without the possibility of renewals) from five years previously and limited its application to temporary, seasonal or experimental work. This is one of the most restrictive FTC regulations in Asia – by contrast Malaysia has no limits on the duration of contracts, while Thailand has no restrictions on the type of activity and the regulation covers all companies with at least 20 employees.

Minimum wages. In absolute terms, nominal minimum wages in Indonesia are still comparatively low, but as a ratio of value-added per worker, they are twice the regional average. In effect, unit labour costs are still fairly high in Indonesia with low worker productivity, and this would be higher if we take into account severance pay requirements. Since 2000 the minimum wage-setting process had been decentralised and the Manpower Law expands this with a more comprehensive process that allows provinces and districts to annually set minimum wages on the recommendation of local wage councils. Employers, however, argue that prices of basic commodities that are used to determine minimum wage increases are overestimated and importantly, minimum wages seem to be perceived as a wage-setting mechanism (which sets a floor to actual wages) rather than as a safety net for low-wage earners. As such, these are determined based on wages paid by large firms which are already high and does not allow for differentiations to reflect differences in worker productivity. As a result, firms find it difficult to provide performance-based wages to encourage higher productivity.

A "lose-lose situation"

The current labour regulations represent a "lose-lose situation"

The regulations mandated in the Manpower Law of 2003 have resulted in what the World Bank aptly describes as a "lose-lose situation", where employees and employers alike are disadvantaged. Labour market rigidities raise business costs, hampering investment spending and hence the prospects of faster job creation. They discourage foreign investment and hurt competitiveness, particularly for export-oriented industries. Given the costs, firms have an incentive to foster non-compliance of labour laws, putting them at risk of facing labour disputes at a time when the number of labour unions has grown rapidly.

Employee protection is relevant only to formal sector workers (<10% of the labour force)

From an employee's perspective, employee protection has only been afforded to the formal sector. The majority of the workforce (92.1%), however, is still either in the informal sector or employed without contracts – for these the Manpower Law is largely irrelevant in terms of protection, but rather more likely a barrier to entry into the formal or contracted workforce (Figure 44). Even among the formal sector workers who are entitled to severance, a large majority do not receive what they are legally entitled to: according to a government survey in 2008, 66% of those eligible did not receive severance pay after losing their jobs (as reported by terminated employees) and 27% received less than the entitled amount.

Figure 43: Components of hiring and firing difficulty index

	Regional average	ID	MY	PH	TH	KR	IN	VN
Min. wage for a 19-year old worker or an apprentice (US$/month)	153.4	105.9	0.0	173.2	78.9	579.9	24.1	40.7
Ratio of min. wage to avg. value added per worker	0.2	0.4	0.0	0.7	0.2	0.3	0.2	0.3
Paid annual leave (in working days)*	11.1	12.0	13.3	5.0	6.0	17.0	15.0	13.0
Severance pay for redundancy dismissal (in salary weeks)*	18.9	34.7	17.2	23.1	31.7	23.1	11.4	23.1

Note: *Average for workers with 1, 5 and 10 years of tenure.

Source: World Bank; Nomura Global Economics.

This situation is also complicated by increasingly unfavourable demand-supply dynamics for better-educated workers and concerns around a skills mismatch. The high wage premiums for better-educated workers are symptomatic of rising demand for these types of workers outstripping their supply. In a 2008 skills survey, firms in the services sector, which have seen increasingly higher skill requirements in the previous two years, pay a wage premium of 73.6% for more-educated workers. In contrast, this premium was only 32.4% and 44.1% in the agriculture and industrial sectors. Part of the problem is the mismatch of skills, which according to another recent study, Alisjahbana (2008), is prevalent even among tertiary degree holders. The mismatch for vocational graduates has been on a decline, but remains high relative to that of tertiary graduates (Figure 45).

Labour market reform – priorities and prospects

The need to accelerate labour market reforms in our view is compelling. However, we also acknowledge how politically difficult this will be, as evidenced by two failed attempts already. For progress, we would highlight three markers:

1. **Simplifying and reducing severance pay rates while boosting effective protection for employees.** Some form of unemployment benefit safety net would be important, financed by monthly

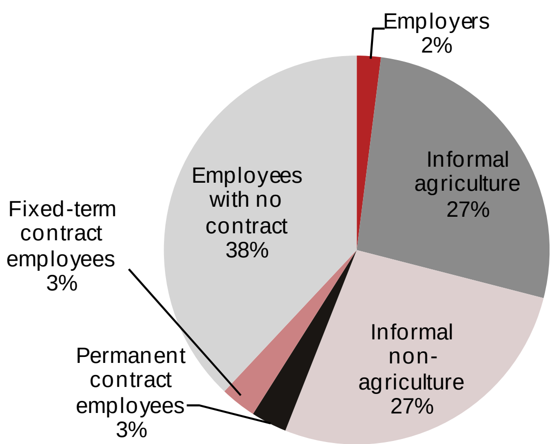
contributions from firms to a severance fund, integrated into a future social security system as in other middle-income countries.

2. **Minimum wages should be set purely as a safety net for low-wage workers and benchmarked against CPI inflation**. The setting of actual wages should ideally be via negotiations between employers and employees, and not based on minimum wages set at the provincial or district level.
3. **A targeted national skills training program**, particularly for those in the informal sector and those that do not have access to public education, and a more market-driven approach to determining the appropriate mix of enrollments in vocational versus general schools.

An improved labour market could boost FDI, start-ups, jobs and skills formation

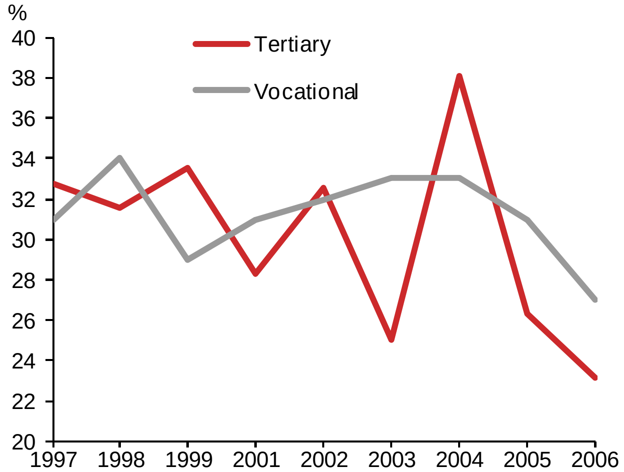
In our view, reduced labour market rigidities could significantly boost FDI, start-ups, formal sector employment and skill formation – and thus growth and productivity. The government has again shown an inclination to take on revisions to the law by assigning the Institute of Sciences in late 2010 to conduct a comprehensive review of the regulatory environment. However, there is some skepticism about whether the review can be completed within the two-year timeframe assigned, given the need to consider inputs of various stakeholders and study the different policy options. Whether the findings will translate into actual reforms remains to be seen as the political cycle could become a bigger factor as we draw closer to the 2014 presidential election. Meanwhile, reforms on skills training and education may be less political in nature but it may take time before the skills gap can be narrowed considerably.

Figure 44: Employment distribution by status



Source: Sakernas, World Bank, Nomura Global Economics.

Figure 45: Skills mismatch by type of graduates



Source: World Bank, Nomura Global Economics.

Resource-based sectors

Agriculture

Agriculture still plays an important role and there is scope to increase growth / productivity in this sector

Agriculture plays an important role in the Indonesian economy (see Chapter 4), still accounting for around 40% of employment. However, during the last couple of decades the sector has been marked by relatively low productivity amid declining public and private investment. We expect commodity and food prices to trend higher for structural reasons (see *The coming surge in commodity prices,* 8 September 2010) and thus this sector potentially offers better future returns (indeed, crude palm oil has been an important contributor to export growth). The key measures needed in this sector to boost productivity include: 1) improving irrigation systems; 2) assistance for small farmers to move towards high-value crops; and 3) establishing land titling which could boost investment by reducing uncertainty and increasing access to credit (with the land used as collateral). Fertilizer subsidies account for over half the Ministry of Agriculture's budget – phasing out input subsidies could create much room for rural infrastructure, irrigation, R&D and extension (training and capacity building).

Oil and gas

Oil and gas are important but steadily declining contributors to the economy

Oil and gas are also important contributors to the economy, with production in 2009 ranking 22- and 17-largest in the world, respectively. The contribution of the sector to the economy has, however, declined steadily over time. In 2000, the sector comprised more than 12% of GDP, 23% of export revenues and over 40% of government revenues. By 2010, these percentages had fallen to below 8%, 18% and 18.5%, respectively, despite high global oil prices. Indonesia's oil output has been trending lower, from a peak of 1.6 million barrels a day (mbd) in 1991 to less than 1mbd in 2010, while consumption increased strongly with subsidized fuel prices. Indonesia became a net oil importer in 2004 and ceased to be an OPEC member in 2009. The decline in oil production partly reflects the existence of distortionary fuel subsidies (see next section), structural factors (such as aging fields) and insufficient investment against a backdrop of regulatory changes/uncertainty (including with respect to cost recovery capping and taxes on import of equipment for exploration), domestic market obligations and governance problems.

State-owned Pertamina was entrusted with all oil&gas related matters until 2001

Prior to 2001, all oil and gas related matters were entrusted to state-owned PT Pertamina. In October 2001, the new oil and gas law separated the policy, licensing and regulatory functions from Pertamina and assigned them to different institutions.[5] However, implementation of the associated regulations to fully implement the new law was delayed in the initial years. In the recent past, there has been a flurry of regulations affecting the sector such as regulation number 35/2004 on upstream business activities, Ministry of Energy and Mineral Resources (MEMR) decree No.35/2008 concerning stipulation and offering of oil and gas working acreages, and MEMR decree No.36/2008, concerning the coalbed methane business. We believe these have brought much needed clarity and policy impetus to the sector.

Conditions have been more favourable for oil contractors…

Indonesia's production sharing contracts – contracts of cooperation between the upstream regulator BP Migas and a private investor – have become more generous over time. A few years ago, the contractor share was typically 15% for oil and 30% for gas whereas currently the standard share for a contractor is 20-35% for oil and 30-40% for gas. Moreover, the government has relaxed some norms for expenditures that can be included in the cost recovery list

5) A Directorate General of Oil and Gas (DGO&G) was established under the MEMR; an upstream regulator (BP Migas) assumed the upstream functions of Pertamina; while a downstream regulatory body (BPH Migas) was also established.

(investments which are deductable before arriving at the share to be split under a PSC).

… but uncertainty remains about domestic market obligation…

One policy issue around which there remains considerable uncertainty is the Domestic Market Obligation (DMO). The DMO was introduced in the 2001 Oil and Gas Law which stipulates that 25% of production be made available to the domestic market. Though the first five years of production are exempt from the DMO, uncertainty hinges around the price that companies receive under the DMO (typically, domestic oil and gas prices are below international prices).

… and some point to a need for more consistency in rules and regulations

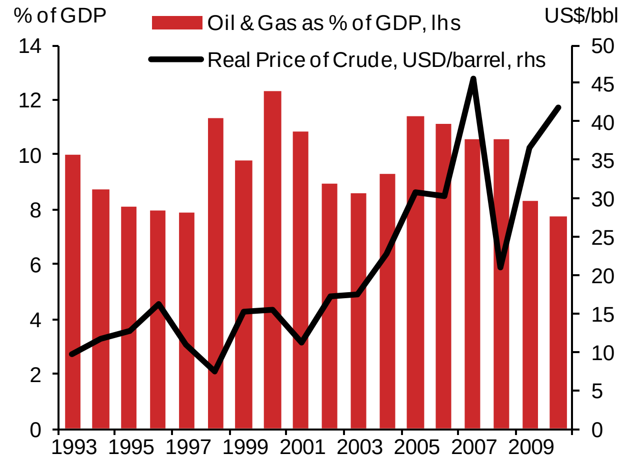
Also, some key industry figures – such as Abdul Hamid Batubara, Chevron Pacific Indonesia's president director (*The Jakarta Globe*, 28 December 2010) – point to a need for consistency in PSC rules and reduced confusion over land acquisition issues and environmental regulations in order to boost upstream investment. In terms of progress with reducing regulatory uncertainty, the new "cabotage" (transport of goods or passengers between two points) rules for shipping basically exempt oil and gas companies, to the seeming satisfaction of the industry; cost recovery caps were not imposed and tax exemptions on imports of equipment by oil companies at the exploration stage were made permanent. The government also announced plans last year to revise some regulations in this sector and a review of the 2001 law by parliament this year.

Prospects for oil prices and Indonesia's need to boost production point to possibilities in the sector

Indonesia's large oil and gas reserves (see picture book below) and a high crude oil price environment should make Indonesia an attractive destination for global oil and gas investors, in our view. The government's imperative to boost production is clear and it has taken many steps in the right direction. However, it needs to continue to improve regulatory certainty while providing better incentives and improved governance to boost exploration investment and stem the declining contribution of the sector to the economy.

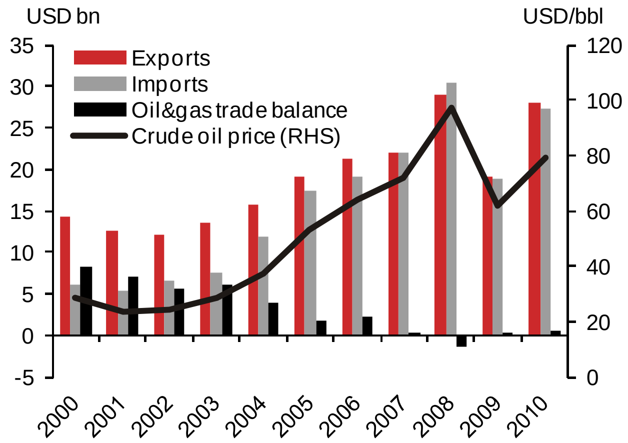
A picture book on the oil and gas sector

Figure 46. Share of oil and gas in GDP



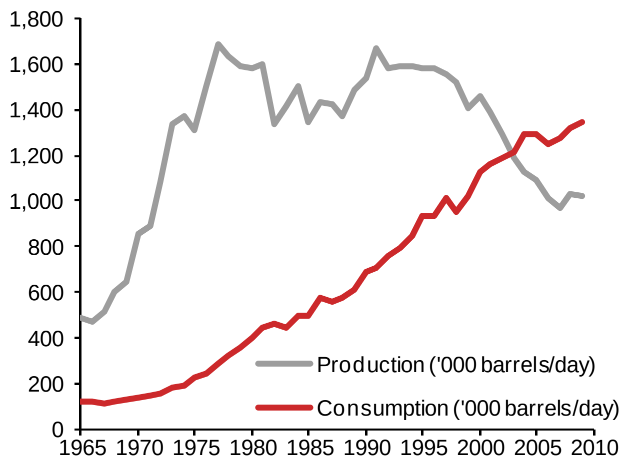
Source: CEIC; Bloomberg; Nomura Global Economics.

Figure 47. Oil and gas exports and imports



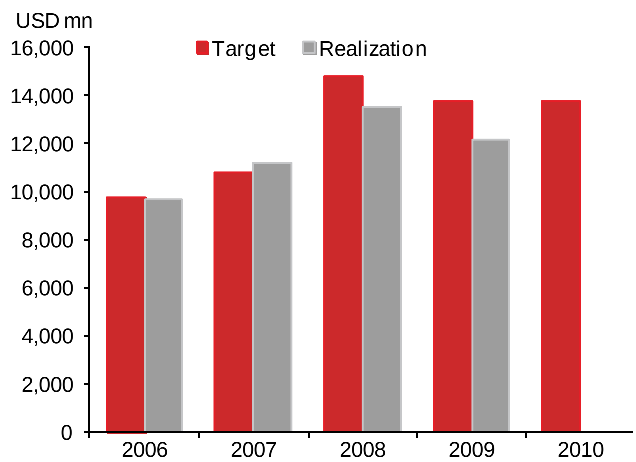
Source: CEIC; Nomura Global Economics.

Figure 48. Oil production and consumption



Source: BP Statistical Review of Energy, June 2010; Nomura.

Figure 49. Oil and gas investment



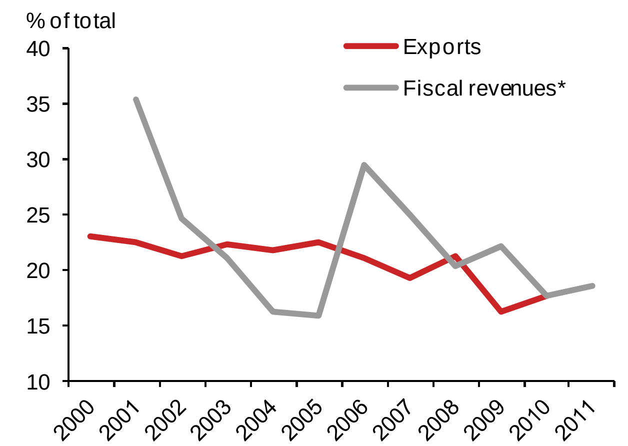
Source: DJMIGAS; Nomura Global Economics.

Figure 50. Oil and gas reserves (as of January 2009)

	Oil Reserves (MM barrel)	Gas Reserve (TSCF)
Proven	4303	107.34
Potential	3695.4	52.29
Total	7998.4	159.63

Source: DG Oil and Gas; Nomura Global Economics.

Figure 51. Contribution to export and govt revenues



Source: CEIC; Nomura Global Economics.
Note: * based on the budget

Subsidies – a pot of gold

Subsidies account for a large fraction of budget expenditures…

Indonesia's overall on-budget subsidies in 2010 amounted to IDR214trn (US$25bn) – around 3.3% of GDP and 20% of total government expenditures (Figure 52). Fuel subsidies alone (at over IDR82trn) exceeded overall central government capital expenditure (IDR77trn) and were more than three times the amount spent on social safety net programs. The 2011 budget allocates IDR96trn (11% of expenditure) to fuel subsidies and with oil prices and consumption likely well above budget assumptions (US$80/bbl and 38.6 million kiloliters), fuel subsidies will again overshoot the budget allocation.

… but the general government balance is roughly neutral to oil price changes

Given Indonesia is an exporter of oil, gas, coal, and crude palm oil (CPO), its trade balance and fiscal balance benefits from higher oil prices (the non-oil commodities having a fairly high correlation with oil prices). Higher oil prices mean that government oil and gas revenues (tax and non-tax) increase by more than the increase in fuel subsidies. However, the requirement that education expenditure should be 20% of overall expenditures means the higher fuel subsidy (and thus total) expenditure triggers further allocations for education and higher transfers to sub-national governments, so the impact on the *central* government deficit is almost neutral. What matters more is the huge opportunity cost in terms of forgone infrastructure and social investment flagged above.

Subsidies are problematic as…

Beyond the huge opportunity cost of subsidies, they are problematic because:

… they distort prices and thus consumption and resource allocation...

- **Subsidies are highly distortionary**: they deter investment in the sector while spurring over-consumption and the negative associated effects ("externalities"), like traffic and pollution (these externalities are the usual rationale for imposing fuel taxes rather than subsidies), However, they also promote longer-term misallocation of resources and inefficiency by distorting price signals (resulting in, for example, more dispersed cities and less investment in public transport).

… they create fiscal uncertainty and risks...

- **Create fiscal uncertainty**: as the ultimate size of the subsidy (a large fraction of overall spending) is uncertain, the fiscal position and financing needs are also uncertain. There is some evidence that bond yields in Indonesia move with oil prices; as the gap between market and subsidized prices increases, speculation about an administered fuel price hike (which creates a stepped increase in inflation) hits bond yields (World Bank, March 2011).

… and are highly regressive

- **Fuel subsidies are highly regressive**: household surveys suggest commercial users gain the most from subsidies, followed by higher income households. A breakdown of consumption by income levels shows the top 50% of households (by income) account for over 80% of consumption (with the top decile accounting for almost 40% and the bottom less than 1%). This is a very poor use of public funds, in our view.

There were some bold and well managed reductions in fuel subsidies since 2005…

Some reform progress has been made. In 2005, after a sustained rise in global oil prices, the government took the bold step of almost doubling administered fuel prices and eliminating subsidies for industrial users. At the same time, it introduced a temporary conditional transfer program (lauded as highly successful) and fiscal savings were also used to increase social spending. Subsequently, the government has taken a number of other initiatives such as the conversion from kerosene to LPG as the primary household fuel, achieved by actively distributing LPG connections and phasing out kerosene supply, and temporary fuel price hikes in 2008 (and more targeted transfers) as global oil prices peaked.

… and while the government abandoned the measures for this year...

Citing the high opportunity costs and poor targeting, the current administration has continued to signal its intent to reform subsidies. However, after much debate in 2010 and so far in 2011, the last reform plan (to ban private cars from purchasing subsidized fuel) was taken off the table against a background of elevated inflation concerns and questions about the feasibility/efficacy of the plan.

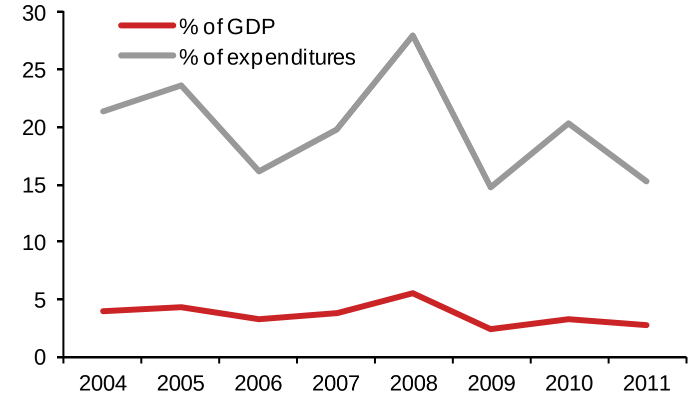
… we expect progress along the lines of past adjustments

We expect the government to eventually adopt the approach that has been successful in the past – namely, hikes in administered prices together with transfers to compensate the poor (our baseline scenario factors in some price adjustments from 2012).

We think progress should be possible, if properly sold

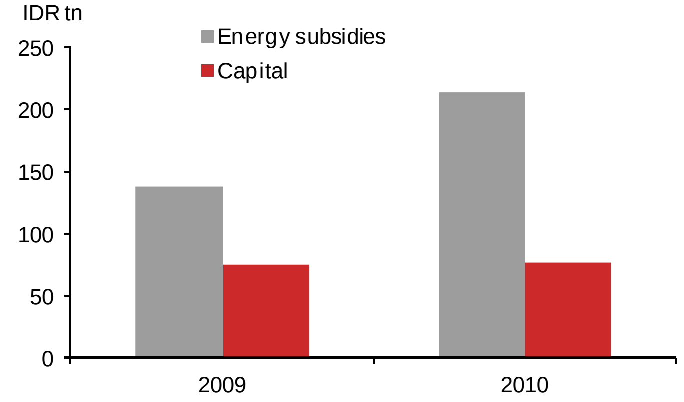
Subsidy reform is politically difficult, but with up to 3% of GDP at stake to reallocate more productively, it offers huge potential medium-term benefits. Indonesia has demonstrated it is possible, even in hard times with: 1) an appropriate "socialisation" strategy (highlighting that subsidies mostly benefit the relatively well-off and that the impact on CPI is likely to be largely a one-off rather than persistent); 2) conditional transfers to protect vulnerable households; and 3) a commitment by government to use the savings to boost physical and social infrastructure spending.

Figure 52: Subsidies, % of GDP and expenditure



Source: CEIC, Nomura Global Economics.

Figure 53: Subsidies versus capital expenditure



Source: CEIC, Nomura Global Economics.

Financial sector development

Financial development is necessary for economic development

An efficient and stable financial sector and broad access to financial services are necessary foundations for future growth and development aspirations (see Box 9). The financial sector is now in relatively good shape, but is still underdeveloped and rather inefficient. The real cost of borrowing has been higher than in neighbouring countries (Figure 54), and the spread between lending and deposit rates – one measure of efficiency or competitiveness – suggests Indonesia's banking system is less efficient than its neighbours (Figure 55).

Domestic credit to GDP remains low

Despite relatively rapid domestic credit growth over the last decade, Indonesia's domestic credit-to-GDP ratio remains very low by regional standards (see Chapter 4; Figure 10) and has been on a downtrend. This likely reflects a combination of relatively high real borrowing costs and the increasing reliance of the corporate sector on bond and equity markets for financing. Indonesia's improving credit ratings (see Chapter 6) and efforts by Bank Indonesia to improve financial intermediation may help to lower the cost of financing, while scope for a higher domestic credit-to-GDP ratio supports a step-up in growth.

Limited long-term fixed-rate lending

There is also limited long-term fixed-rate lending. This may partly reflect the relatively short maturity structure of banks' funding bases – mostly deposits with maturities of less than 1 month. While there are 5-year and longer floating-rate loans available, fixed-rate loans of more than five years are not commonly available. The development of longer-term fixed-rate lending would make it easier to finance large infrastructure investments.

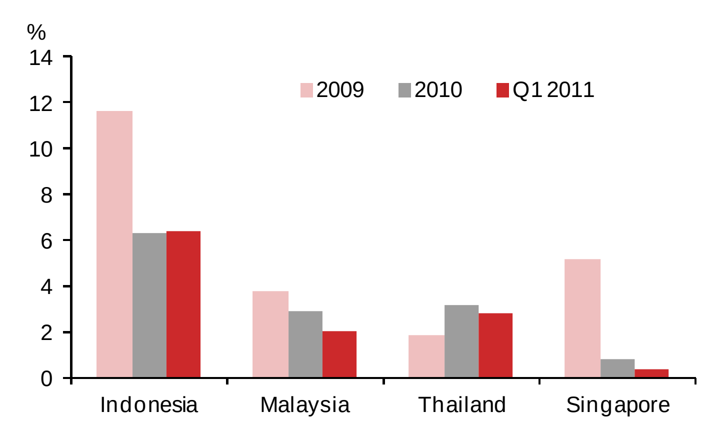
The financial sector is bank-dominated, relatively small, and concentrated

Financial sector structure: Indonesia's financial sector is relatively small, bank-dominated and concentrated. In 2009, Korea, Malaysia and China had financial sector assets well above 225% of GDP, compared to only 50-60% for Indonesia. In 2010, the banking sector's asset accounted for around 80% of the financial system (and 50% of GDP). Despite the relatively large number of banks (122 commercial banks), the top 15 banks account for 70% of the sector and deposit base. Most of these have large branch networks and enjoy a level of brand recognition that provides relatively easy access to low-cost deposits. The top three state-owned commercial banks account for one-third of the banking sector and deposit base; they dominate government-related transactional banking, micro and rural finance and mortgage lending.

Banks are well capitalized with relatively low NPLs

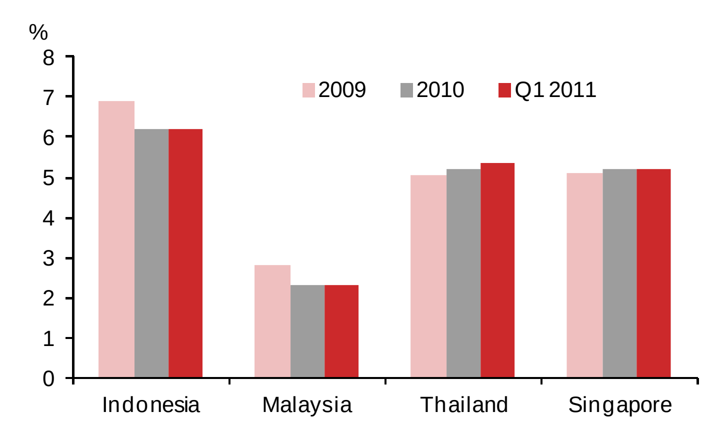
Soundness of the banking sector: has increased through improved bank regulation and supervision, provisioning and loan clarification and stricter governance and macro-prudential measures. Banks' non-performing loans (NPL) are relatively low and capital ratios are relatively high (see "Picture on

Figure 54: Real lending rates compared



Source: CEIC; Nomura Global Economics.

Figure 55: lending – deposit rate spreads



Source: Bloomberg; Nomura Global Economics.

improved fundamentals" in Chapter 4). The IMF-World Bank joint assessment of the banking sector (*Indonesia: Financial System Stability Assessment*, September 2010) found ample capital buffers and liquidity, and offered a positive outlook for bank profitability as growth picks up.

The key recommendations of the assessment were in line with our views:

- A sound legal framework for crisis management (through adoption of the revised Financial System Safety Net Law);
- When the revised financial regulatory framework is eventually adopted (plans to establish a consolidated supervisory body, or "OJK", were pushed out from end-2010 with no clear timeline as far as we can tell), the appropriate coordination of micro- and macro-prudential supervision should be ensured.
- To diversify funding sources, capital market development is needed, which could be supported by SOEs listing and further development of the pension industry. A deepening of the capital market would also increase Indonesia's ability to absorb large-scale capital inflows.

Services sector reform

Boosting service sector productivity is key to boosting growth potential

With Indonesia's service sector accounting for around 45% of GDP, boosting productivity in this increasingly important sector is key to lifting potential growth. Allowing for greater competition and removing barriers to entry, for both foreign and domestic investment, would help boost productivity and investment in services. Important steps in this direction were the 2007 Investment Law, which provided for equal treatment of foreign and domestic investors and the subsequent Presidential Regulation (No.76/2007) which defined which business areas are open and closed to investment. The regulation essentially moved to a more transparent "negative list" – such that all sectors were open for investment (albeit some with conditions) other than those on the negative list. In 2007 the list was revised to make some sectors more restrictive, but was revised again in 2010 (Law No. 36/2010) to make it more open.

In the medical services sector, for example, the ceiling on foreign ownership in hospital services was raised from 65% (and initially, only in the cities of Medan and Surabaya) to 67% across the country. Down the line, where physicians with foreign qualifications are currently only allowed to supervise and perform procedures in the context of educating Indonesian doctors, under the ASEAN Economic Community (targeted to be established by 2015), doctors from ASEAN member countries will be able to practice in Indonesia. Elsewhere, in the power sector foreign investors can now own up to 95% of joint ventures in power plants with capacity of more than 10MW. While these changes are undoubtedly positive, the new investment law is not a panacea – for example, the negative list does not exclude education, although the Education Ministry has its own rules which may constrain private and foreign investment in that area, and thus need to be altered as well.

There is tremendous potential from private and foreign participation in the provision of health and education services (other services such as financial and telecoms are discussed above and in Chapter 8). There is a serious lack of skilled labour and plenty of anecdotal evidence of poaching of skilled staff in Indonesia. As skilled worker wages rise over time, there will be greater demand for relevant training and it is important that the private sector be allowed to help meet this demand (within appropriate quality assurance mechanisms) to complement public sector initiatives.

Annex D: Medium-term development plan

The plan targets annual growth of at least 7% and annual inflation in the range 3.5-5.5% by 2014.

Indonesia's Medium-Term Development Plan (RPJMN) 2010-2014 – stipulated through Presidential Decree No. 5/2010 – is the second phase of implementation of the 2005-2025 National Long-Term Development Plan (RPJPN 2005-2025) promulgated through Law 17/2007.

The RPJMN guides Indonesia's development for the next five years, providing a strategy, policy direction, and national priorities. It also guides the ministries and agencies in formulating their strategic plans and the regional governments with their respective regional development plans to support national development targets (Figure 1).

The RPJMN consists of three books, which outline national and sectoral priorities and regional development strategies (as summarized by World Bank, March 2010):

Book I: Contains the strategy, general policies and macroeconomic framework, which reflect the vision, mission and 11 national development priorities of the RPJMN.

Book II: Contains sectoral development plans based on the National Long-Term Development Plan with the theme "to strengthen the synergy across development sectors" in order to accomplish the national development vision in Book I.

Book III: Contains the regional development plan by island, with the theme "strengthen the synergy between central and regional and inter-regional governments" to accomplish national development vision in Book I.

Figure 1: Selected key development targets of the RPJMN 2010-2014

Development		Target
Economic growth rate		Average 6.3-6.8% pa/ growth of 7% before 2014
Inflation rate		Average of 4-6% pa
Open unemployment rate		5-6% at end-2014
Poverty rate		8-10% at end -2014
Development target	**Initial status**	**Target in 2014**
Education and Health	**(2008/2009)**	
Increasing GER for senior secondary education (%)	64.28	85
Increasing GER for tertiary education (age 19-23, %)	21.26	30
Improving life expectancy (year)	70.7	72
Reducing infant mortality per 1,000 deliveries	34	24
Infrastructure		
Construct 19,370 km of highway		Completed
Increase electricity generation capacity		Add 3000 MW/year

Source: RPJMN (2010); Nomura Global Economics.

The 11 national priorities listed in Book I consist of new and existing development programs and reform initiatives. They are: 1) Bureaucracy and governance reform, 2) Education, 3) Health, 4) Poverty reduction, 5) Food security, 6) Infrastructure, 7) Investment and business sector, 8) Energy, 9) Environment and disaster management, 10) least developed, frontier, outer, and post conflict areas, and 11) Culture, creativity and technological innovation.

Some of the programs in the education, health and poverty reduction priorities are an extension or expansion of current programs. The new programs include construction of almost 20,000km of roads across seven islands, construction of integrated transportation infrastructure networks in accordance with the Multimode Transportation Blueprint of the national transportation system, increasing the electricity generation capacity by 3000MW per year and introduction of the single identity number and card this year (Figure 2).

The 'Education' priority's main objective is to increase the quality of and access to education. It plans to accomplish this by increasing enrollment rate at the primary, high school and university levels, providing scholarships, reforming the school curricula, increasing the quality of teachers, improving the teacher-student ratio and achieving a national education standard by 2013.

Through the 'Reducing Poverty' priority, the government aims to reduce poverty from 14.1% in 2009 to 8-10% in 2014. The government also aims to reduce the open unemployment rate from 7.9% in 2009 to 5-6% by 2014.

The government has allocated IDR 1,288 trillion (around US$150bn) over the next five years to implement these 11 national priorities. Two-thirds of this budget has been allocated to education, infrastructure and poverty reduction.

The government targets annual growth averaging 6.3-6.8% during 2010-2014, and at least 7% by 2014. Private consumption is expected to remain the main contributor to growth, expanding by 5.3-5.4% per year. Investment growth is projected to increase to 9.1-10.8% and exports by 10.7-11.6% per year.

A gradual fiscal consolidation is to be accomplished by conservatively targeting a budget deficit averaging 1.5% of GDP. As a result total public debt to GDP ratio is expected to decline to 24% of GDP in 2014. The tax to GDP ratio is projected to gradually increase from 12.4% of GDP in 2010 to 14.2% of GDP in 2014, with annual growth in tax receipts of 16.8%. With strong capital inflows in recent quarters, the target for FX reserves of US$101.4-105.5bn by 2014 has already been exceeded.

Figure 2: The RPJMN 2010-2014 macroeconomic framework

	Medium Term Projection				
	2010	2011	2012	2013	2014
Economic Growth and Stability					
Economic Growth	5.5-5.6	6.0-6.3	6.4-6.9	6.7-7.4	7.0-7.7
Inflation Rate CPI %	40-60	4.0-6.0	4.0-6.0	3.5-5.5	3.5-5.5
Nominal exchange rate (IDR/USD)	9750-10250	9250-9750	9250-9750	9250-9850	9250-9850
3 months SBI interest rate (%)	6.0-7.5	6.0-7.5	6.0-7.5	5.5-6.5	5.5-6.5
Balance of Payments					
Non oil and gas export growth (%)	7.0-8.0	11.0-12.0	12.5-13.5	13.5-14.5	14.5-16.5
Non oil and gas import growth (%)	8.0-9.0	14.0-15.6-	16.0-17.5	17.0-18.3	18.0-19.0
Reserves (US$ billions)	74.7-75.6	82.4-84.1	89.6-92.0	96.1-99.2	101.4-105.5
State Budget					
Budget deficit (% of GDP)	-1.6	-1.9	-1.6	-1.4	-1.2
Tax Revenues/GDP (%)	12.4	12.6	13	13.6	14.2
Government Debt/GDP	29	28	27	25	24

Source: World Bank (March 2010); RPJMN (2010); Nomura Global Economics.

Chapter 6: On the cusp of investment grade

Pradeep Mohinani
pradeep.mohinani@nomura.com
+852 2536 7030

Well placed for a rating upgrade, much is already priced into cash sovereign spreads, but CDS may offer some upside.

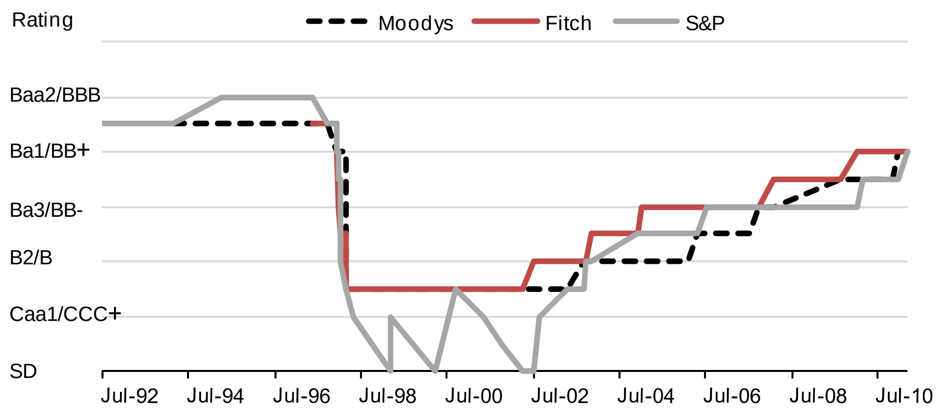
Indonesia's fundamentals have improved markedly since the Asian crisis…

Indonesia has certainly come a long way from the abyss of the Asian crisis. With favourable demographics and a growing middle class, Indonesia now has a well established domestic demand-led growth model which is likely to deliver at least 6% GDP growth. The growth outlook can be further boosted through higher fiscal expenditure aimed at infrastructure spending. Land-acquisition reforms could reduce (if not remove) a key bottleneck to infrastructure development – and thus growth – in 2011 and beyond. Among the near-term risks are rising oil prices that would result in higher subsidies. The rapid build-up in non-resident portfolio holdings is also a threat to the external balance sheet should capital flows reverse, although we do not believe this is likely. Indonesia is also a prime candidate to impose further capital control measures given the high costs associated with the sterilization of FX intervention. While presidential elections are not due until 2014, potential candidates can be expected to keep up a public discourse well ahead of the election itself.

… which is showing up in ratings upgrades and outlooks

The positive trajectory that Indonesia has set itself has resulted in Moody's, S&P and Fitch now maintaining Ba1/BB+/BB+ ratings, with S&P and Fitch offering Positive outlooks to Moody's Stable outlook – Indonesia's highest ratings since the Asian crisis, putting it on the cusp of an investment grade (IG) rating. For Indonesia to reach that milestone, all three agencies are focused on: 1) a deepening of domestic bond capital markets to allow the government to reduce its reliance on external financing; 2) higher levels of stable foreign capital funding, namely foreign direct investment (FDI), which is more supportive of the external balance of payments; and 3) continued discipline to push through fiscal, administrative and structural reforms. We believe that Fitch is likely to be the first to upgrade the Indonesian sovereign to investment grade, which it could do by H1 2012, with S&P next and Moody's completing the set.

Figure 56: Indonesia's sovereign rating history

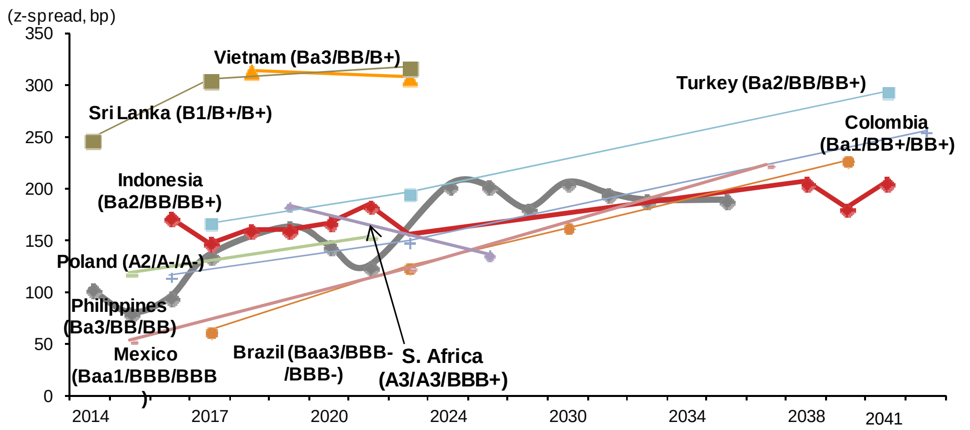


Source: Ratings agencies; Nomura.

Cash credit spreads seem to have already priced in an eventual upgrade to investment grade

With the rating upgrade to IG expected in due course, sovereign bonds and CDS have long priced in the upgrade. This is as a result of the strong inflows that emerging markets as an asset class have experienced through the post-Lehman financial crisis. We believe the tight trading levels are likely to be maintained and do not depend on the upgrade. Instead, a risk reversal in the macro environment and/or changes in US Treasury yields are likely to have a bigger impact on the performance of Indonesian sovereign bonds. With the sovereign having recently raised US$2.5 billion in 10-year bonds, we believe much of its foreign financing needs for 2011 have been taken care of, with the balance expected to come from overseas development assistance. The result is that any near-term supply pressure on the sovereign bond performance has been eliminated. From a relative value perspective, we have and continue to hold the view that much of the spread contraction is likely to come from the long-end of the sovereign curve, where the spread pick-up is about 40-50bp wider on a z-spread basis for the INDON 2035 and 2038 relative to a flat curve from the 2014 to 2021, at an average z-spread of 150-160bp.

Figure 57: The Indonesia sovereign spread curve relative to its regional peers

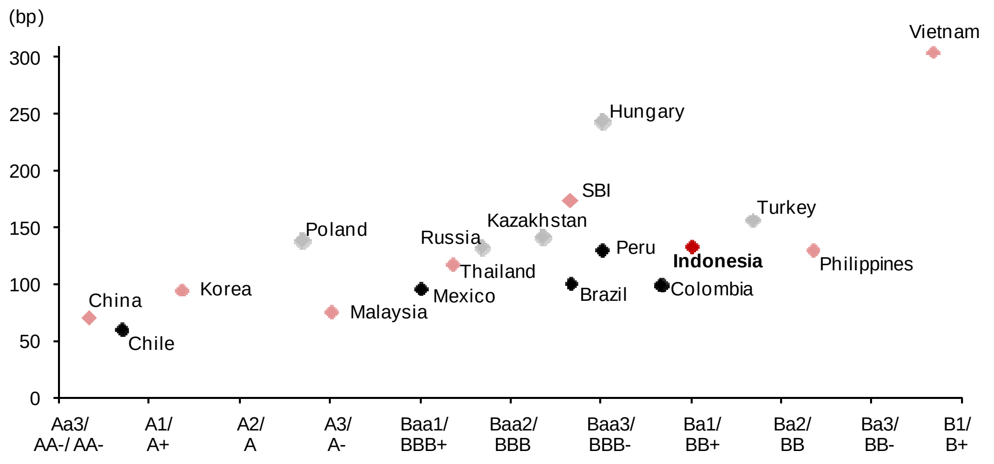


Source: Nomura.

CDS spreads could tighten further given spreads relative to the Philippines. A caveat is that it is also likely to remain more volatile

Similar to the cash curve, 5-year CDS also trades tight and marginally wider than peers such as Thailand, but tighter than State Bank of India (SBI), the proxy for the India sovereign. Despite the tight trading level, we believe Indonesia CDS could tighten further, particularly in relation to where it trades relative to the Philippines CDS.

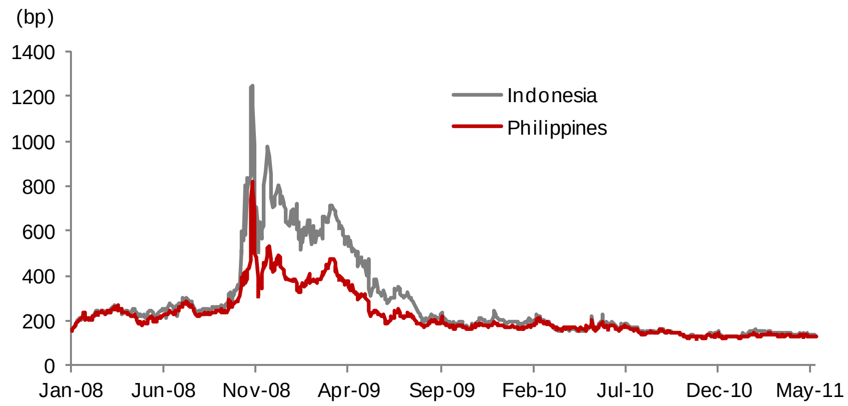
Figure 58: Indonesia 5-year CDS relative to its EM peers



Source: Nomura.

While Indonesia's economic fundamentals have witnessed a greater improvement in recent years relative to the Philippines, as reflected in the higher sovereign ratings, the CDS has typically traded wider to flat in recent months. The reason for the wider levels is due to Indonesia's relative external vulnerability as reflected during the crisis in 2008-09 where concerns were running high in relation to the size of foreign reserves against short-term external debt – Indonesia had one of the highest ratios in the region, after Korea. The doubling in Indonesia's FX reserves since then has resulted in an outperformance of its CDS. We believe this outperformance is likely to continue assuming the government does deepen its domestic bond market, thus reducing its reliance on external funding. This is in addition to a targeted improvement in the stickiness of inflows from portfolios to FDI. The result is that we could conceivably see Indonesia CDS trading 15-20bp tighter than Philippines over the next 6-12 months, from historically trading wider.

Figure 59: Indonesia vs Philippines historical 5-year CDS



Source: Bloomberg; Nomura.

This chapter was prepared by Nomura Sales or Trading desk personnel. It is not a product of the Fixed Income Research Department. For important conflicts regarding sales or trading desk personnel, please see the disclosures and disclaimer in Appendix A1 of this report.

Chapter 7: The medium-term IDR outlook

Craig Chan
craig.chan@nomura.com
+65 6433 6106

Prashant Pande
prashant.pande@nomura.com
+65 6433 6198

Wee Choon Teo
weechoon.teo@nomura.com
+65 6433 6107

Prateek Gupta
prateek.gupta@nomura.com
+65 6433 6197

We expect the rupiah to strengthen against the US dollar through to 2014, though the pace of appreciation is likely to slow from H2 2011 onwards. From a forecast of USD/IDR at 8,200 at end-2011 (9.1% annual appreciation), we expect IDR to progressively strengthen to 7,800 by end-2012 and to 7,400 by end-2014.

Our view is based on:

- Our medium-term FX valuation framework through our flow equilibrium exchange rate model (FEER);
- A relatively favourable balance of payments outlook, supported by strong capital inflows;
- Economic development being similar to previous periods when there were shifts to an FX appreciation bias and;
- Continued concerns over Bank Indonesia's (BI) balance sheet from high sterilization costs and its ability to continue to actively intervene.

That said, there are some caveats to our FX forecasts, including the risk of delayed monetary policy responses to future upside inflation pressures and a continued pick-up in macro-prudential controls. In addition, ahead of the 2014 presidential election the retirement of President Susilo Bambang Yudhoyono could raise some concerns about Indonesia's political and economic outlook.

Modelling fair value of IDR through our FEER model

We gauge the fair value of IDR through our flow equilibrium exchange rate (FEER) model.[6] This approach derives the adjustment of the IDR real effective trade-weighted exchange rate (REER) needed to align the equilibrium current account with the structural current account. The structural current account balance is the actual current account adjusted for the state of the economic cycle. Using income and price elasticities for imports and exports of goods and services to Indonesia's and the global output gaps, we calculate the exchange rate level that closes the gap between the structural and equilibrium current account.

FEER analysis shows IDR is around 4.3% undervalued so USD/IDR 8,150 would be fair value

Our latest estimates for June 2011 highlight that Indonesia's exchange rate was 4.3% undervalued on a REER basis, narrowing from around 19.0% undervaluation in March 2009 (Figure 60). This reduction in FX undervaluation is a result of the 28.7% IDR REER appreciation from March 2009 to end-May 2011 after weakening by 18.1% in the previous two years to March 2009. But despite the sharp IDR REER appreciation, IDR remains undervalued because of the rise in the basic balance surplus (at US$4.9bn in Q1 2011 against an average of US$3.7bn over the previous two years). With IDR remaining 4.3% undervalued on a trade-weighted basis, a fall in USD/IDR immediately to 8,150 would place IDR at fair value, by our estimates. Indeed, using Nomura's economic forecasts for end-2011 and end-2012, and extracting the USD/IDR rate that would bring IDR to fair value, we note USD/IDR could fall to 7950 and 7350 respectively (Figure 61).

That said, we view an immediate fall to 8,150 as extremely unlikely given the expected pick-up in BI's FX intervention. In fact, we expect USD/IDR to only move towards 8,150 in Q1 2012 as BI will likely view a sharp move as disruptive to domestic industries. Even with USD/IDR at 8,150 by Q1 2012, this does not imply IDR would be at fair value at that point because the FEER model is static, with feedback from changes in FX to macro factors such as inflation, the current account balance and FDI not accounted for. Nomura Economics also expects Indonesia's total factor productivity growth to rise to

6) See *FX Insights: A little look at EM FX fair value*, 22 January 2009.

3% over 2011-15 from the 2.5% average for the past decade, which supports our IDR appreciation view.

Figure 60. Nomura's IDR FEER model

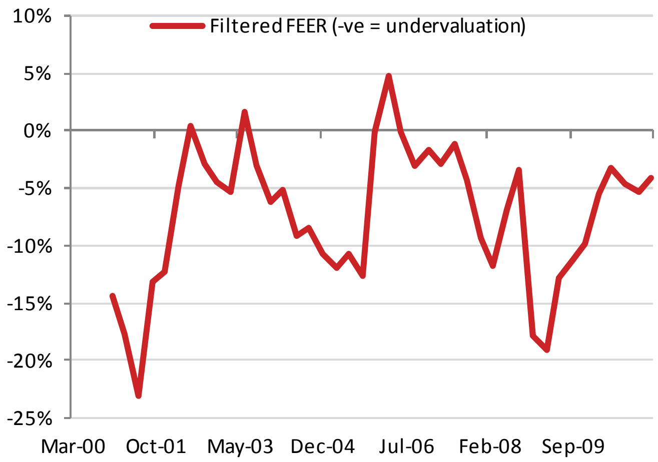


Figure 61: USD/IDR levels for fair value, FEER based, on our inflation and FX projections.

Forecasts to close filtered FEER valuation gap					
	USD/IDR	EUR/USD	USD/JPY	USD/SGD	USD/CNY
Jun-11	***8150***	1.43	82.5	1.23	6.40
Dec-11	***7950***	1.45	87.5	1.21	6.22
Dec-12	***7350***	1.45	92.5	1.16	5.90

Source: Bloomberg, Nomura.

Capital inflows to help counter the deterioration in the current account

Capital inflows to peak this year but remain strong over the medium term

As highlighted in Chapter 4, Nomura's medium-term projection for Indonesia's current account is that the surplus will continue to narrow as a percentage of GDP and fall into deficit in 2014 (at -0.3% of GDP). The rationale is that imports are expected to surge and outpace exports because of infrastructure development, strong domestic demand growth and continued IDR appreciation in real effective terms.

Although the current account moving into deficit will pose some headwinds to IDR appreciation over the medium term, the small deficit (forecast to widen to -0.8% of GDP in 2015 from a surplus of 0.6% of GDP in 2011) should not be enough to shift the overall balance of payments into deficit based on our assumption of 15% annual net FDI growth and our model of portfolio flows (both debt and equity securities). In our regression model of portfolio flows – including GDP growth, short-end rate differentials with the US and USD/IDR returns[7] – we attained an R-squared of 63%, with coefficients directionally intuitive and statistically significant (see Annex E). Indeed, the coefficients for short-end rate spreads and IDR returns are relatively large, which is in line with the intuition that yield and IDR appreciation are the main factors for capital inflows.

Based on our forecasts of solid real GDP growth (averaging around 6.9% over 2011-15), an assumption that the spread between short-end US and Indonesia rates will narrow only in 2013 (through to 2015), and IDR appreciation (vs. USD) to slow through to 2015, we expect net portfolio inflows to peak at US$11.2bn in 2011 and slow to US$5bn by 2015. Combine this with an assumed 15% annual increase in net FDI (US$12.3bn in 2011, rising to US$21.6bn by 2015) and we expect capital inflows to remain sufficient to offset the deteriorating current account balance. Indeed, we expect capital inflows from portfolio investment, the current account and net FDI to peak at 3.0% of GDP in 2011, falling to 0.9% of GDP by 2015. This supports our view that the pace of IDR appreciation will slow over the medium term (see Figures 63 and 64).

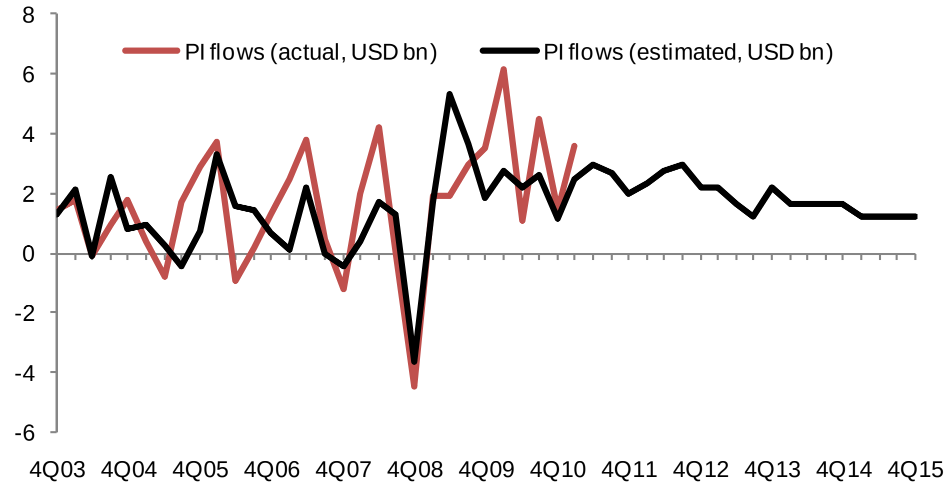
7) We use the overnight rate spread (JIBOR vs. LIBOR) to highlight the relative yield attractiveness of Indonesia, while positive USD/IDR returns (3-month) should be an additional important component for FX expectations and capital inflows.

Figure 62: Estimates of capital flows to Indonesia

	Estimated Real GDP growth		Overnight rates (begining of quarter in consideration)			USDIDR		PI forecast	CA forecast	FDI forecast	Capital Flows (expected)	
	%Δ YoY	%Δ QoQ	Indonesia	US	Rate diff	Levels	%Δ QoQ	(USD bn)	(USD bn)	(USD bn)	(USD bn)	(As % of GDP)
1Q11	6.5	1.5	6.75	0.25	6.50	8708	-3.20	3.6	1.9	3.0	8	4.2
2Q11	6.0	2.4	6.75	0.25	6.50	8400	-3.54	3.0	1.9	2.6	8	3.6
3Q11	6.4	3.8	6.75	0.25	6.50	8300	-1.19	2.7	1.5	1.9	6	2.7
4Q11	7.1	-0.8	7.00	0.25	6.75	8200	-1.20	2.0	-0.4	4.9	6	2.8
1Q12	6.5	1.0	7.25	0.25	7.00	8100	-1.22	2.3	1.9	3.4	8	3.2
2Q12	6.9	2.8	7.50	0.25	7.25	8000	-1.23	2.7	1.8	3.0	8	3.0
3Q12	7.0	3.9	7.50	0.25	7.25	7900	-1.25	2.9	1.5	2.1	7	2.4
4Q12	7.5	-0.3	7.50	0.25	7.25	7800	-1.27	2.2	-0.4	5.6	7	2.7
2011	6.5	NA	6.75 to 7.00	0.25	6.63	8200	-8.85	11.2	3.0	12.3	27	3.0
2012	7.0	NA	7.25 to 7.50	0.25	7.13	7800	-4.88	10.0	4.9	14.2	29	2.7
2013	7.0	NA	7.50 to 6.50	0.25 to 1.50	6.13	7500	-3.85	8.8	1.9	16.3	27	2.1
2014	7.0	NA	6.50	1.50 to 2.00	4.75	7400	-1.33	6.7	-3.3	18.8	22	1.5
2015	7.0	NA	6.50 to 5.50	2.00 to 3.00	3.50	7400	0.00	5.0	-11.8	21.6	15	0.9

Note: As estimates of LIBOR and JIBOR are not available, we take estimates of policy rates.
Source: Nomura Global Economics and FX strategy.

Figure 63: Estimates of portfolio investments



Source: Bloomberg; Nomura.

FX regime shift to IDR appreciation may continue towards end-2011

Bank Indonesia's shift in monetary policy to tightening may continue through H2 2011 and provide significant support to IDR appreciation. In late January we noted that a shift in monetary policy focus to inflation over growth was likely, with Indonesia viewed as relatively competitive.[8] This regime shift has continued since February, following BI's 25bp rate hike (to 6.75% on 11 February) and IDR appreciating by 5.5% against USD (1 February to 1 June 2011). With a lack of pushback on IDR strength from exporters, solid external sector performance and with BI still likely to be perceived by markets as having some control over inflation into H2 2011, we believe BI is likely to be able to maintain its current policy stance through the latter part of the year[9] (a preference for IDR strength and limited rate hikes).

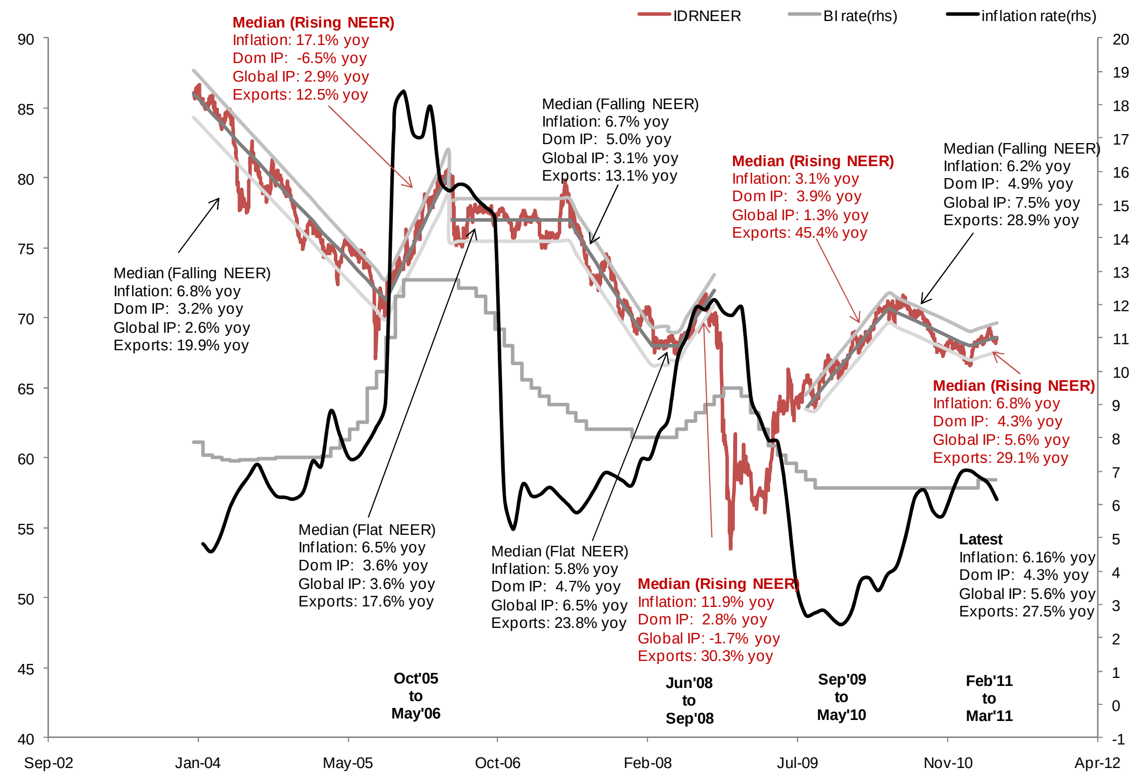
BI's policy stance is IDR-positive given macroeconomic backdrop is also supportive of IDR strength

This FX appreciation bias is also supported by comparing recent macroeconomic developments with previous periods of IDR NEER appreciation. Since February 2011, the median for CPI inflation has been 6.8% y-o-y; for Indonesian industrial production, 4.3% y-o-y; for global industrial production, 5.6% y-o-y; and exports for 29.1% y-o-y. Although inflation is not at levels experienced during the FX regime shifts in October 2005 and September 2009 (led mainly by subsidy adjustments), CPI is still uncomfortably high (BI's 2011 CPI target range is 4-6%). Exports are also at similar levels to previous periods of IDR NEER appreciation, while domestic and global IP are broadly stronger.

8) See *Asia FX Insights: Indonesia – Policy approaching a crossroad*, 28 January 2011.
9) See *FX Insights: Indonesia - Remain short USD/IDR*, 3 May 2011.

Historically, excluding the June-September 2008 period[10], the duration of IDR NEER appreciation has been roughly seven to eight months, while at the start of periods of IDR appreciation (similar to February 2011), BI's policy statements have been indicative of a shift[11] (Figure 64).

Figure 64: IDR NEER analysis



Source: Bloomberg; Nomura.
Note: Grey periods denote periods of IDR NEER appreciation.

Concerns over BI's balance sheet may be an overhang in the medium term

We estimate that BI's capital base has shrunk due to increased sterilization costs

Concerns from the IMF on BI's sterilization cost and the need to improve monetary management[12] is likely to remain a focus of the market given the risk to BI's balance sheet. This highlights a perceived risk that BI could at some point step back from its USD/IDR buying if balance sheet constraints materialize. There may be some relief that BI is no longer constrained by having to maintain a minimum capital adequacy ratio (CAR) of 3% (under a memo of understanding with the MoF) and especially with our estimates of BI's April CAR already close to those levels (the official CAR at end-2009 (most recent figure) was 8.88%)[13]. This has been led mainly by the increase in BI's monetary liabilities and from both monetary operations and government demand deposits (Figure 65). However, there is still some concern as it remains BI's legal mandate (under the Central Bank Act) to keep its capital above IDR2trn. While BI's capital is estimated to be around IDR34trn as of

10) IDR NEER appreciation over June-September 2008 was halted by the onset of the US financial crisis.

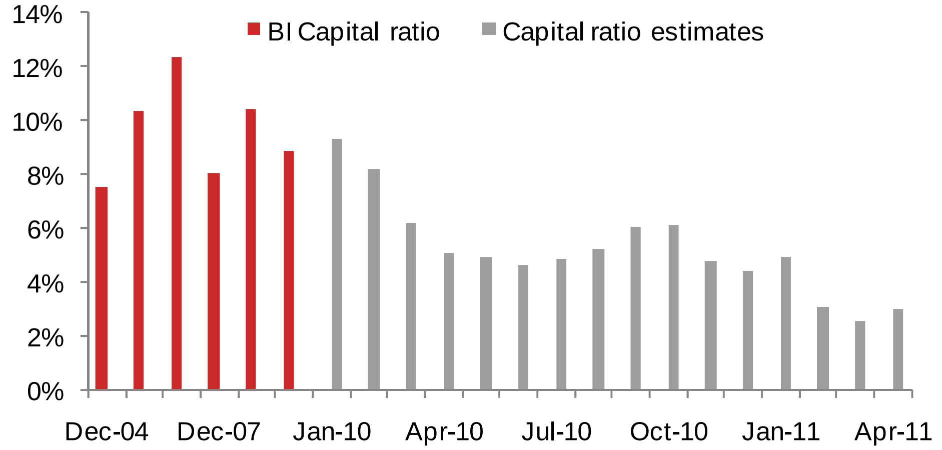
11) "In the view of Bank Indonesia, mounting expectations of inflation and depreciation in the exchange rate could put macroeconomic stability at greater risk. Policy actions aimed at maintaining macro-economic stability are necessary to ensure sustainable economic growth in the long term" (4 Oct 2005 BI monetary policy statement); "Capital inflows in Indonesia are supported by optimism for global and domestic economic recovery, attractive yields on rupiah instruments and improving perceptions of risk... rupiah appreciation remains at a level supportive of the competitiveness of Indonesian exports in comparison to other Asian economies" (10 Sep 2009, BI monetary policy statement).

12) See *IMF 2010 Indonesia Article IV Consultation – Staff Report*, September 2010.

13) Shares and other equity (retained earnings, general and special reserves, SDR allocations, valuation adjustments and funds contributed) less statutory reserves over Monetary Liabilities (currency in circulation, government demand deposits, bank demand deposits, international demand deposits, BI certificates).

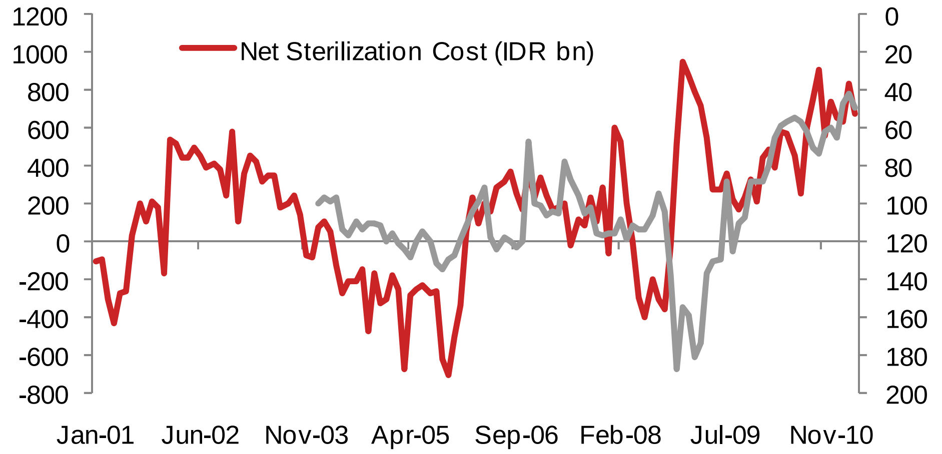
April – significantly above the minimum requirement – the main concern is the pace of deterioration given increased sterilization costs. Over the past 12 months, BI's capital base is estimated to have shrunk by 30%, with the majority of this from an estimated[14] sterilization cost of IDR19.9trn (US$856m) (Figure 66). While we expect overall capital inflows to remain strong over the medium term, posing challenges to BI, capital inflows are likely to peak in 2011 and slow more markedly from 2014 given our forecast current account deficit. That said, aside from further local and foreign currency reserve requirement hikes over the medium term, there are also ongoing talks with the government on the conversion of BI's non-tradable government bonds to tradable (IDR268trn, or 23.8% of total government bonds), which would help BI's monetary management.

Figure 65: Bank Indonesia – capital adequacy ratio



Source: Bank Indonesia, Nomura

Figure 66: Bank Indonesia – sterilization costs



Source: Bank Indonesia; CEIC; Bloomberg

Macro-prudential control risk to rise

Further macro-prudential measures are a risk to our view

With our projection of relatively strong capital inflows, we believe a step-up in macro-prudential controls is highly likely because even the latest measures taken – such as the suspension of SBI auctions for tenors less than nine months (February) and the extension of SBI holding periods (from one to six months, in April) – have done little to slow capital inflows. As of April, foreign

14) The difference between the interest expense on SBI and term deposits and interest income on reserves.

holdings of bonds and SBI s rose to a record high of USD36bn (or 33.9% of total outstanding – also a record).

Although there is potential for a further step-up of existing controls, other possible measures include the reduction of banks' short-term external debt (possibly from 30% of capital to 10%, applicable to external borrowings, without real underlying demand). As of December 2010, banks' gross external short-term debt was US$11.1bn, and so assuming a large 25% of short-term external borrowing is without underlying (primarily foreign banks) and that banks are currently at the 30% threshold, this would imply gross external borrowing falling by about US$1.8bn (around 16.7%). This looks relatively large, but pales in comparison to the current account surplus and foreign inflows into the bond market of US$16bn in the last 12 months. In addition, the impact will also depend on several other factors, including the time-frame that banks will have to meet new limits, the possibility that capital bases will be increased and whether banks are even at the 30% threshold (Figure 67).

Figure 67: Macro-prudential controls for Indonesia

	Drivers in the direction of controls
1	Pre-emptive measures given experiences from Asian financial crisis
2	The foreign holdings of government bonds & SBIs has reached a historical high of USD36bn
	Measures so far
10-Jun	Imposed a one-month holding period on SBI; introduced a one-month term deposit facility (and a two-month term deposit facility in October)
10-Nov	BI introduced three-month term deposits (available to only domestic banks) and suspended 3M SBI auctions
10-Dec	BI announced a package of more than 20 policy measures intended to "strengthen the stability of the monetary and financial system," including raising the reserve requirement ratio for FX deposits from 1% to 5% by March 2011 and to 8% by June 2011, the reintroduction of the FX borrowing cap for banks at 30% of capital, and the introduction of a disclosure requirement on prime lending rates for banks effective March 2011
11-Feb	BI suspends SBI auctions of maturities of less than nine months (9M) after introducing 9M SBIs and longer term deposits
11-Apr	BI announced that it would extend the holding period on its bonds (SBI) from one to six months, effective 13 May 2011
	Possible controls
1	Tenure of term loans increasing and replacing SBIs.
2	Taxes/penalties for short term investors.
3	Reduction of banks short-term external debt borrowing

Source: Nomura

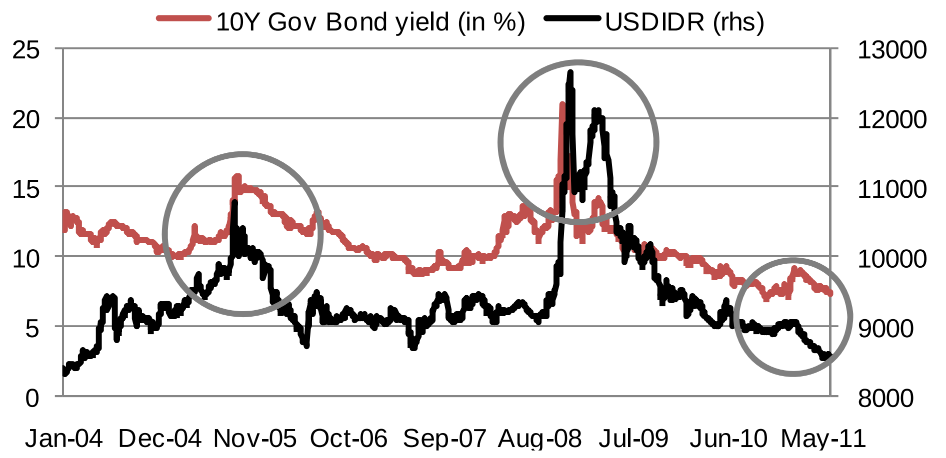
Reactive rather than proactive monetary policy

BI has historically been slow to react to inflation pressures

A risk to IDR over the medium term is that the authorities remain reactive rather than proactive against upward inflation risk. From H2 2010 and into January 2011, BI held the view that inflationary pressure 'from fundamentals was relatively mild' and 'core inflation was subdued.' But as inflation and price expectations continued to rise (with headline inflation hitting a high of 7.0% y-o-y in January), fixed income markets (namely bonds) sold off on the perception that BI was falling behind the curve[15] (Figure 68). It was only when BI hiked interest rates on 11 February and was explicitly supportive of a stronger IDR to counter inflation that the market followed through. However, the risk ahead (possibly over the next 6-12 months) is similar to the subsidy-led price hikes in 2005 and in 2008, where authorities may be pressured to reduce subsidies (namely on fuel). In the 2005 and 2008 inflation spikes, fuel price adjustments contributed to a significant increase in inflation volatility, which then required BI to act through both rate hikes and allowing IDR appreciation.

15) Indonesia's 20yr bond yield rose from a low of around 9% in November 2010 to a high of around 11% in January 2011, while spot USD/IDR rose from a low of around 8880 in November 2010 to a high of 9090 in January 2011.

Figure 68: USD/IDR vs 10yr government bonds yields



Source: Bloomberg

At least into Q3 2011, we expect BI to maintain (and be able to maintain) its current stance of preferring IDR appreciation, with limited rate hikes as headline inflation should remain relatively stable. This could lead USD/IDR lower through what we think is a misperceived support level of 8500 towards 8300 over the next few months. However, while there is some risk to inflation rising in Q3 2011 because of the end of Idul Fitri (the Festival that runs from 29 August to 2 September), the main risks are rising oil prices and the possibility of energy subsidy cuts (in oil, fuel and electricity).

Historically, adjustments have emerged when the energy subsidy bill has risen above certain thresholds. This was the case in 2005 and 2008[16] when the energy subsidy bill as a share of central government expenditure (CGE) and GDP averaged 30% and 4.1%[17] respectively. Indonesia's 2011 state budget last assumed that the subsidy bill would account for around 22.4% of CGE or 2.6% of GDP (Figure 69). However, given that this subsidy is in part based on an average 2011 oil price of US$80/bbl and USD/IDR at 9,250, the risk is a significant overshoot. Assuming oil prices remain at US$110.7/bbl (the average year to date) through 2011 and utilising our 2011 average USD/IDR rate of 8,400, the total subsidy bill rises to 24.6% of CGE and 2.9% of GDP. We also believe this is a conservative estimate as we assume no changes in electricity and non-energy subsidies[18] (accounting for around 27% of total subsidies) – (see Annex F). Although the government may still be able to hold off reducing subsidies if oil prices average US$110/bbl this year, or even marginally higher, an adjustment could still emerge as authorities view this as unproductive spending.

16) Gasoline, kerosene and diesel prices were hiked twice, by amounts totalling at least 150%. In May 2008, fuel prices were increased by more than 25%.

17) Energy subsidies (oil, gas and electricity) accounted for 28% of spending and 3.7% of GDP in 2005. In 2008, these levels were 32% of expenditure and 4.5% of GDP.

18) Non-energy subsidies include fertilizers.

Figure 69: Government subsidies

Year	Subsidy (IDR bn)	Expenditure (IDR bn)	GDP (IDR bn)	Subsidy (as % of Exp)	Subsidy (as % of GDP)
2004	91,529	297,464	2,295,826	31%	3.99%
2005	120,765	361,155	2,774,281	33%	4.35%
2006	107,432	440,032	3,339,217	24%	3.22%
2007	150,214	504,623	3,950,893	30%	3.80%
2008	275,291	693,356	4,948,688	40%	5.56%
2009	138,082	628,812	5,603,871	22%	2.46%
2010	201,263	781,534	6,422,918	26%	3.13%
2011	187,624	836,578	7,251,475	22%	2.59%

Note: Nominal GDP for 2011 calculated from forecasts of real GDP and CPI from Nomura Global Economics. Source: Statistics Indonesia, CEIC, Nomura, Reuters

Concerns over the presidential election and new cabinet in 2014

Presidential elections in 2014 could raise investor jitters over SBY's successor

As highlighted in Chapter 3, although President Susilo Bambang Yudhoyono still has around three years of his second (and final) term left, a medium to longer term concern is who will succeed him. Within the DP, our political analyst highlights that Anas Urbaningrum (elected party chairman in 2009) and perhaps Mr Yudhoyono's wife, Kristiani Herawati,[19] may run for president. From the opposition, potential candidates include Golkar's Aburizal Bakrie and Vice President Jusuf Kalla, while the PDI-P's former President Megawati Soekarnoputri may also run. Although the candidates may well change nearer the 2014 election, the current candidates may raise some concern over a change in the push for economic reform and fighting corruption. The increased confidence of investors since President Yudhoyono took office in 2004 is reflected in World Bank and Transparency International studies. The World Bank Governance Indicators[20] – which include Control of Corruption, Rule of Law, Regulatory Quality, Government Effectiveness, Political Stability, and Voice and Accountability criteria – have all improved significantly from 2004 through to 2009 (Figure 70). The Transparency International Corruption Perceptions Index from 2010[21] shows Indonesia's ranking improving to 110 in 2010 from 133 in 2004.

Figure 70: Worldwide Governance Indicators (2010)

Parameters for measuring governance effectiveness	2004*	2009*
Voice and Accountability (VA)	38	48
Political Stability and Absence of Violence/Terrorism(PV)	6	24
Government Effectiveness (GE)	45	47
Regulatory Quality (RQ)	27	43
Rule of Law (RL)	28	34
Control of Corruption (CC)	20	28

* Numbers indicate percentile rank
Source: World Bank

19) President Yudhoyono recently said that his wife would not run, but it still remains a possibility.
20) Worldwide Governance Indicators, The World Bank Group.
21) Transparency International 2010 survey.

Annex E

Modeling capital flows for Indonesia

A regression model was built to show the relationship between portfolio investment and various economic parameters. This included Indonesia's real GDP growth
(q-o-q), overnight LIBOR/JIBOR spreads and 3M USD/IDR returns (Figure 1).

With 30 data points (from Q4 2003 to Q1 2011) we attained directionally intuitive coefficients that were statistically significant.

*Portfolio Investments = 170 * (Real GDP q-o-q growth of Indonesia)*
*+ 273.63 * (Diff in overnight JIBOR (for IDR)and LIBOR (for USD)rates)*
*- 221.48 * (USD/IDR q-o-q returns)*

Figure 1: Regression statistics for Model

Regression Statistics	
Multiple R	79%
R Square	63%
Adjusted R Square	57%
Observations	30

	Coefficients	Standard Error	t Stat	P-value
GDP growth	170.65	127.20	1.34	0.1909
ON Rates	273.63	66.48	4.12	0.0003
USDIDR returns	-221.48	59.70	-3.71	0.0009

Source: Nomura, Bloomberg, CEIC

Annex F

Indonesia fuel subsidy: scenario analysis

Indonesia's 2011 planned subsidies (IDR bn)

1. Subsidy (total) : 187,624
2. Subsidy (fuel) : 95,914
3. Expenditure (planned) : 836,578

Assumptions:

1. Average exchange rate in 2011: USD/IDR 9250
2. Average oil price in 2011: $80/bbl

Our estimates on the impact on subsidies include the following assumptions:

- Gas prices and oil prices are highly correlated
- The government does not cut the volume of oil provided
- The subsidy is evenly spread throughout 2011
- There is no change in electricity or non-energy subsidies

The average oil price to date in 2011 has been $110.7/bbl and we have used our average USD/IDR forecast of 8400 for 2011. If this average holds for the entire year, the annual expected subsidy would be IDR125,991bn. Up to May 2011, IDR52,496bn of this would have been incurred (Figure 1). We also did the analysis for a scenario where oil is US$130/bbl and USD/IDR at 8400 (Figure 2).

Figure 1: Projections for scenario (Oil prices at US$110.7 per barrel, USDIDR at 8400)

Projections	
Energy subsidy (projected)	161213 IDR bn
Energy Subsidy (approved)	136614 IDR bn
Increase in expenses	24599 IDR bn
Subsidy (approved)	187624 IDR bn
add: increase in expenses	212223 IDR bn

	Total	% of Total expenditure	% of GDP
Energy Subsidy	161	19.3%	2.22%
Subsidy (Total)	212	24.6%	2.93%

Figure 2: Projections for scenario (Oil prices at US$130 per barrel, USDIDR at 8400)

Projections	
Energy subsidy (projected)	182238 IDR bn
Energy Subsidy (approved)	136614 IDR bn
Increase in expenses	45624 IDR bn
Subsidy (approved)	187624 IDR bn
add: increase in expenses	233248 IDR bn

	Total	% of Total expenditure	% of GDP
Energy Subsidy	182	21.8%	2.51%
Subsidy (Total)	233	26.4%	3.22%

Source: CEIC; Reuters; Statistics Indonesia, Nomura.

Figure 3 shows the summary of our fuel subsidy scenario analysis for different average values of USD/IDR and oil prices in 2011.

Figure 3: Scenario analysis for fuel subsidies

		Avg USDIDR							
	In IDR trn	8800	8700	8600	8500	8400	8300	8200	8100
Avg Oil Price	100	114	113	111	110	109	108	106	105
	110	125	124	123	121	120	118	117	115
	120	137	135	134	132	131	129	128	126
	130	148	147	145	143	142	140	138	136
	140	160	158	156	154	152	151	149	147

Source: CEIC; Reuters; Statistics Indonesia, Nomura.

Asia Special Report

Equity Strategy

NOMURA
EQUITY RESEARCH

Special report

Indonesia rising

June 7, 2011

Action: Pick the winners

Indonesia is the 18th largest economy in the world. It has a growing middle class, a young population, financial discipline, rich natural resources, and a working democracy that will support strong earnings growth and carry Indonesia forward into investment grade, in our view. Indonesia is reaping the benefits of structural changes in the past one-and-half decades that we believe will set a strong base for accelerated growth over the next five years. Our top picks for the next five years are companies with strong growth potential, strong market leadership (to benefit from rising middle income) or comparative cost advantage (to benefit from rising global demand for resources).

Catalysts: Key structural drivers

- Indonesia is moving to a structurally lower interest rate environment vs. its own historical inflation and its historical inflation gap to world inflation.
- We see lower currency volatility due to prudent financial management, both in the public as well as the private sector.
- Indonesia, we believe, will enter a period of accelerating GDP growth – from 4-6% in the past 5 years to 6-8% in the next 5 years.
- Its rich natural resources make Indonesia one of the countries that should benefit from high demand for resources/commodities.
- The government's intention to promote downstream manufacturing and value-added processing should promote further investment and job creation in the commodity sector.
- The political platform is shaping up for political stability and this young democracy should continue to prevail despite any noise of disruption.

Risk to advancement

The biggest risk to the market is a global economic meltdown *a la* 2008, that leads to a collapse in most asset prices, including equities and commodities. A political risk, while still relatively small, cannot be ruled out in the 2014 elections as there is still no clear frontrunner candidate for the President (the current president, SBY will end his second term in office in 2014 and is not allowed a third term as per Indonesian election laws).

Portfolio positioning for a rising Indonesia

Our top picks are Astra International, Bank Rakyat, Bukit Asam, Bumi Resources, Adaro, London Sumatra, Semen Gresik, and Jasa Marga. This reflects our view that Indonesia will survive an inflationary world and economic growth will boost the size of the middle class in Indonesia from 50mn in 2009 to 150mn in 2014F (according to Nomura's economist Tomo Kinoshita). The key structural drivers above will allow JCI to sustain its forward P/E valuation of 15x, based on 1x PE/Growth ratio, in line with the PE/Growth of MSCI AP and its own historical PE/Growth.

Rating: *See report end for details of Nomura's rating system.*

Anchor themes

We take a five-year view and look for structural drivers instead of short-term momentum trades. Also fleshed out are the risks on a five-year horizon. While Indonesia is facing growing pains, we see things paying off longer term.

Research analysts

Indonesia Strategy

Wilianto Ie - PTNI
wilianto.ie@nomura.com
+62 21 2991 3341

Contributing analysts

Anand Pathmakanthan, CFA - NSL
anand.pathmakanthan@nomura.com
+65 6433 6986

Andy Lesmana, CFA - PTNI
andy.lesmana@nomura.com
+62 21 2991 3344

Daniel Raats - NIHK
daniel.raats@nomura.com
+852 2252 2197

Isnaputra Iskandar, CFA - PTNI
isnaputra.iskandar@nomura.com
+62 21 2991 3346

Ken Arieff Wong - NSM
kenarieff.wong@nomura.com
+60 3 2027 6895

Sachin Gupta, CFA - NSL
sachin.gupta@nomura.com
+65 6433 6968

Indonesia rising

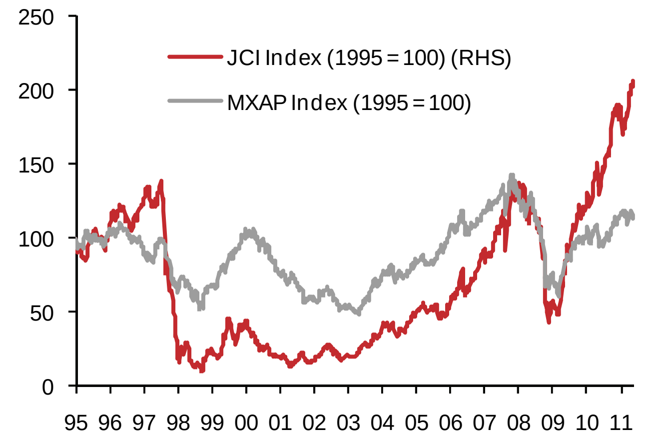
Indonesia is currently witnessing a rapid increase in its middle-class, with GDP per capita approaching US$3,000. This is being largely aided by higher commodity prices that boost rural income and redistribute wealth to the mass population. This, in turn, will lead to strong domestic consumption and trajectory demand for discretionary consumption over the next five years, in our view, which will greatly benefit producers of discretionary products and their value chain. Investors should look to build positions in infrastructure, commodity, automotive/discretionary consumer, and select banks to tap into the potential of a rising Indonesia.

It takes more than a decade to regain investor confidence

Indonesia was a darling to investors prior to the Asian financial crisis of 1997, with the Jakarta Composite Index (JCI) trading at P/E multiples of as high as 25x in 1994 (average P/E January 1993 – June 1997: 18.6x). However, the Asian financial crisis, was followed by social unrest, collapse of the rupiah, and the fall of Soeharto, which sent the index to its lowest P/E multiple of 6x in 2001.

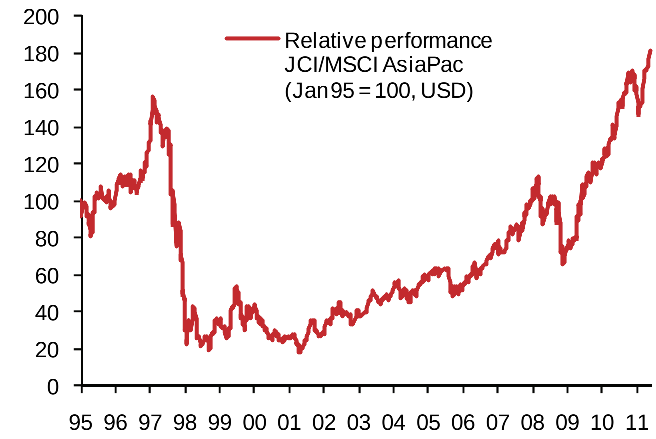
Since then, there have been structural reforms, balance sheet leverage has declined significantly and the economy emerged from the crisis stronger than before after having swallowed the bitter pill of restructuring. Yet, it took more than a decade to recapture the losses and be back at par with the MSCI Asia Pacific. The strong fund flows and rerating in recent years reflect a return of investor confidence that Indonesia is heading in the right direction, a view that we also share.

Fig. 1: JCI vs. MSCI Asiapac (in US$)



Source: Bloomberg, Nomura Research

Fig. 2: Relative performance (JCI/MSCI Asia Pac)



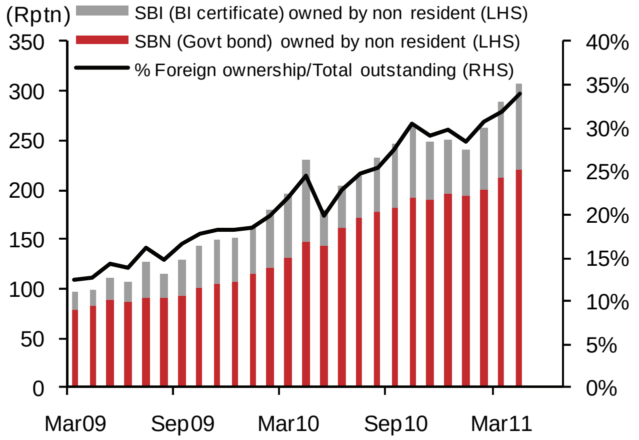
Source: Bloomberg, Nomura Research

Fund flows remain strong

Indonesia has attracted strong fund capital inflows since 2005. So far, there is no sign of a slowdown. Fundamental outlook to attract fund inflow in the next five years remain positive as earnings growth of Indonesia corporate will remain above global average, macro stability and financial discipline remain in place, and risk premium will continue to decline, in our view.

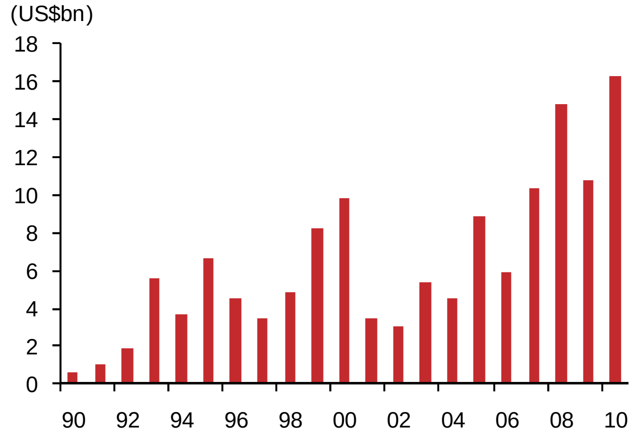
Indeed, the vote of confidence concerning Indonesia's economic stability is evident from the strong capital flow to chase higher yield, as shown by record-high foreign ownership of government bonds (SBN) and certificates from the Bank Indonesia (SBI). This has forced the central bank to enforce some soft capital control to mitigate the risk of sudden reversal of outflows (such as lengthen the holding period of SBI from one month to six months for foreign investors). Yet this has not deterred the fund flows to Indonesia as shown by the record foreign ownership of tradable government bond (SBN) and certificate of Bank Indonesia (SBI) in April 2011. The strong capital inflow provides a near-perfect opportunity for Indonesia to attract funding for infrastructure projects and divert some of the capital flows from debt market to equity market as (1) falling interest rate will make the equity market looks more attractive and (2) the yield gap of sovereign paper and IRR of infrastructure projects is widening as government offers IRR on infrastructure projects of around 15%.

Fig. 3: Foreign ownership of SBI and Government bonds



Source: Ministry of Finance

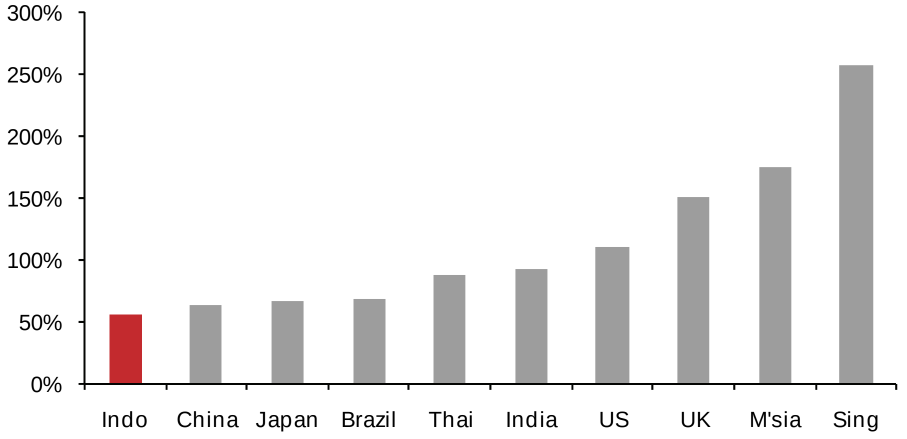
Fig. 4: Foreign direct investment



Source: Indonesia Investment Planning Board, Bank Indonesia

Indonesian companies have not fully tapped into the capital markets for funding, which is reflected in the relatively low May 2011 market cap to GDP ratio of 56%. This implies strong future potential in equity markets, as accelerating economic growth will encourage corporates to raise capital in the equity markets to support growth.

Fig. 5: Ratio of market capitalization to GDP (2010)

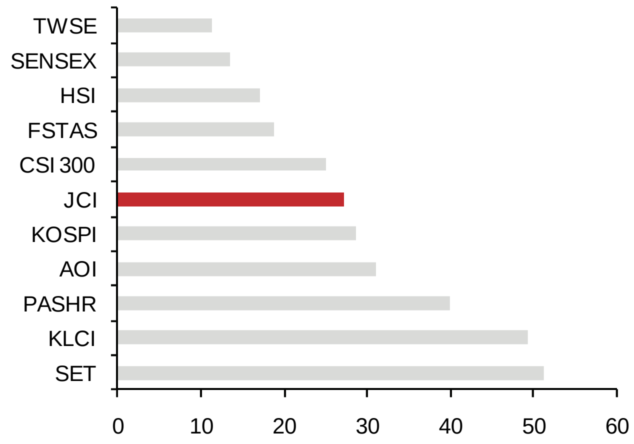


Source: IMF, Bloomberg

The lack of external funding is also reflected in the debt market, where the corporate debt to equity ratio remains relatively low. The bitter experience from the 1997 Asian financial crisis remains fresh in the memory of Indonesian companies that have been deleveraging their balance sheets, and before the memory faded, it was refreshed again by the 2008 global financial crisis (Indonesian companies escaped the 2008 financial crisis relatively unscathed due to the conservative attitude since the 1997 crisis).

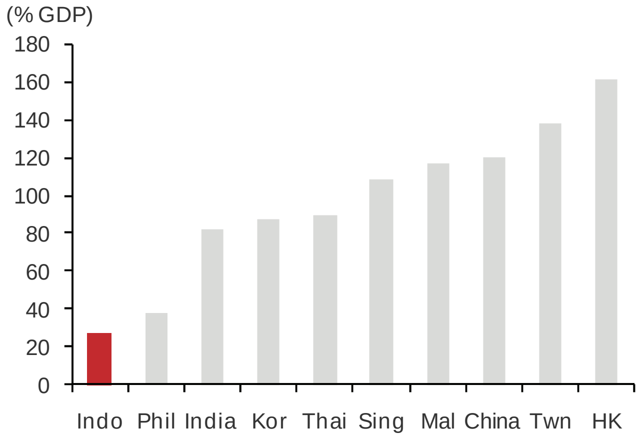
Growth over the past decade has been largely funded by internal cash flow, as reflected in the low debt to equity ratio of Indonesia-listed corporates as well as the nation's low debt to GDP compared to some developing countries.

Fig. 6: Net debt to equity ratio (2010)



Source: Thomas Reuters Datastream, I/B/E/S, Nomura International (HK) Ltd- Equity Quantitative Strategies

Fig. 7: Debt to GDP ratio (2010)



Source: CEIC

Banks are increasingly eager to expand their loan portfolios into consumer financing, small and medium enterprise loans, mortgages, and micro financing. This has been partly driven by efforts to mitigate downward pressure in net interest margin on corporate lending as well as the vast potential in consumer financing. The availability of consumer financing will boost domestic consumption further and eventually lead to rapid industrial capacity expansion to fulfill demand, in our view.

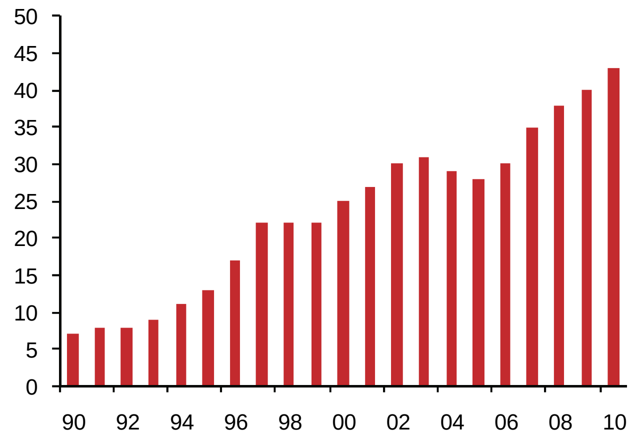
We expect companies to gradually leverage up their balance sheets or tap into capital markets to finance future growth. This trend is evidenced in the commodity sector, where Indonesia has vast natural resources, but a lot of capital is needed to exploit them. Many resources companies are raising funds in equity market for their expansion instead of aggressively leveraging their balance sheets, as debt is still perceived to have higher risk (of losing control) despite the theoretical lower cost of debt vs. the cost of equity.

The recent upward rerating of the Indonesian equity market has also helped to bring companies public, as owners of those businesses could capitalize on the goodwill. The rerating of the Indonesian market from a deep discount to par with its regional peers (over the past decade) and a better regulatory environment (including a more transparent corporate tax and lower tax for listed companies with 40% or more free float) should continue to attract more businesses to be listed, providing liquidity to the market and thus allowing more investors to participate.

Fig. 8: Commodities sector weighting in JCI

Source: Bloomberg, Nomura Research

Fig. 9: Number of commodity companies in JCI

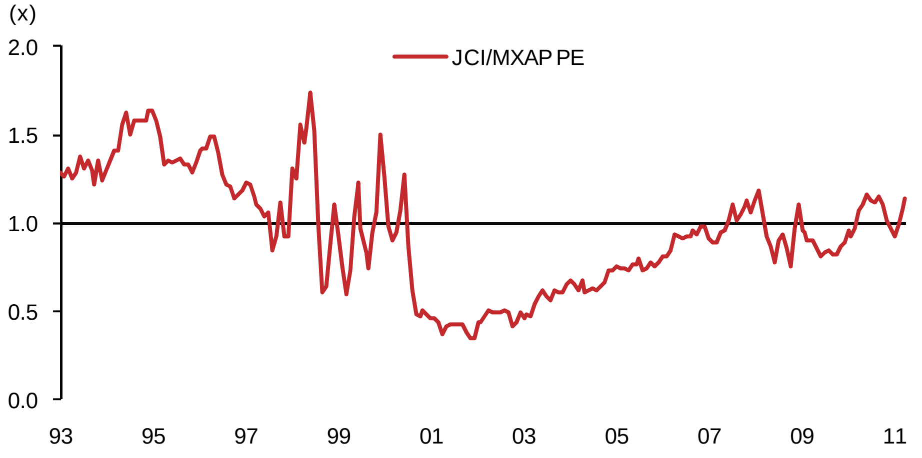


Source: Bloomberg, Nomura Research

Does Indonesia deserve to trade at premium to MSCI Asia Pac?

Indonesia trading at a premium to Asia Pacific had been an unthinkable investment proposal for most investors since the 1997 Asian financial crisis until recently. Some still reject the idea today, but we foresee an increasing chance for JCI to command a premium given Indonesia is currently in the sweet spot of strong earnings growth, runs solid financial discipline, and holds the potential for strong economic advancement in the next decade. This is despite our baseline assumption of JCI trading at par with MSCI Asia Pacific.

Fig. 10: P/E discount/Premium of Indonesia JCI vs. MSCI Asia Pacific



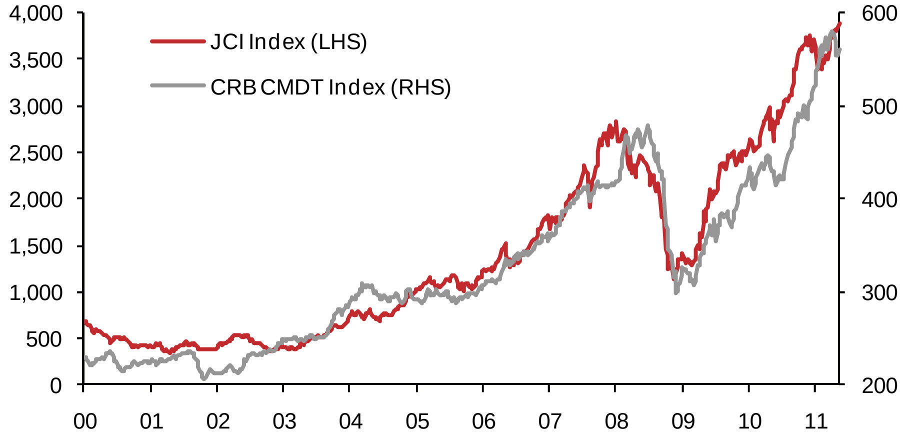
Source: Nomura Research, Thomas Reuters Datastream, I/B/E/S, Nomura International (HK) Ltd- Equity Quantitative Strategies

The nation's vast natural resources, relatively open/liberal economy, strengthening foundation of democracy, and stronger earnings growth, we believe, will earn Indonesia its place in investors' minds. Indonesia is relatively sheltered from the inflationary impacts of rising commodity prices. Indonesia is self sufficient in many agricultural products. We are self sufficient in rice production, largest producer and exporter of palm oil, 2nd largest producer of natural rubber, big exporter of cocoa, tea, vanilla, coffee, and many other agricultural products. The recent strengthening exchange rate (rupiah) and administered prices on some fuel, power, and some food also help to smooth the volatility of rising commodity price to Indonesian consumer.

Indeed, Indonesia benefits from rising commodity prices. Although Indonesia has become a net oil importer, it remains an energy exporter (gas and coal) and soft commodity exporter. Overall, high commodity prices favour Indonesia's balance of payments.

We also note that the correlation of the CRB commodity index with the JCI index is high (R2 = 0.93), which although not necessarily representing an argument for high correlation in the future, at least proves that high commodity prices do not deter economic growth and market performance.

Fig. 11: CRB CMDT index and JCI index



Source: Bloomberg, Nomura Research

This is explained by the fact that more than 80% of the farmland in Indonesia belongs to small holders, and thus higher commodity prices create wealth among the rural population. The snowball impact of this wealth creation is significant. Thus, Indonesia is well positioned in this inflationary environment over the medium to long term despite potential short-term inflation concerns.

Aside from the blessings from nature that provide Indonesia with an advantage in this period of rising demand for resources, the country itself is getting its act together to improve its competitiveness – it is currently ranked 44th (of 139) in the Global Competitiveness Index report by World Economic Forum in 2010/2011, up from 55/134 rank in 2007/2008. We see the improvement as upside potential or downside protection given Indonesia was still able to deliver 6.1% GDP growth in 2010 and survived the 2008 global crisis with 4.5% GDP growth despite the challenges.

The speed of progress and reform might not be as fast as many wish for, but the country is certainly moving in the right direction. Key structural drivers of the equity market are, among others:

- Acceleration of infrastructure projects (finally) to facilitate a more efficient economy (see our report, *Building blocks in place*, 2 May 2011, by Andy Lesmana & Wilianto Ie).
- Moving up the value chain from commodity to value-added downstream.
- Moving to structurally low-inflation economy (relative to its own historical inflation as well as to historical inflation gap with world inflation).
- Stepping up GDP growth from the 4-6% band to the 6-8% band.
- Reduced currency volatility and thus risk profile.
- Growing pains of democracy paying off.

A more efficient economy through debottlenecking infrastructure

The acceleration of infrastructure projects, facilitated by a land acquisition law that is expected to be passed this year, should help to reduce high economic costs caused by infrastructure and logistic bottlenecks.

The proposed land acquisition bill will help to accelerate infrastructure projects, in our view, as it will allow speedy land acquisition. Under the proposed bill, land rights in the public infrastructure corridor will be cancelled, owners will be compensated and any dispute (on compensation) will be taken to court and ruled on within 30 days. This will be a big help to infrastructure projects, as land acquisition has been difficult.

Currently, it takes two to three years (and often longer) to clear land, and less than two years to build roads, with land owners that refuse to sell able to hold back a project. The proposed bill will remove this problem and thus allow infrastructure projects to start at an accelerated pace.

Infrastructure to help employment

The acceleration of infrastructure projects will immediately help to create jobs, as infrastructure projects in Indonesia are still largely labour intensive. The construction sector workforce only grew at a 4% CAGR between 2005 and 2010 (vs a 10.8% CAGR in 1990-1996, when infrastructure development was strong). If infrastructure projects will help to bring the labour growth rate in the construction sector to 10.8%, it will absorb 600,000 new workers per annum (total workforce in the construction sector was 5.6mn in 2010 based on data from Statistics Indonesia), by our estimates. In our view, this will be one of the factors that will help to reduce unemployment rate from 7.1% in 2010 to our expectation of 5.5% in 2015.

The economic impact will likely also spread across the infrastructure corridors as workers settle within the vicinity of the projects and regional economies improve as a result of better access and the snowball effect of projects. It is common to find new plantations, new housing estates and new businesses/villages develop along infrastructure corridors, which all create new jobs and support consumption in the regions.

Job creation in the infrastructure projects will mainly involve the lower-end to middle segments, thus benefiting companies that sell mass consumption products such as cigarettes, basic personal care, telecom services and motorcycles, as well as mass market retailers.

Fig. 12: Some companies to benefit from jobs creation

Price	Company	Rating	PER 11F (x)	PER 12F (x)	Earnings growth 11F (%)	Earnings growth 12F (%)	PB 11F (x)	ROE 11F (%)	EV/Ebitda 11F (x)	Ticker
59,100	Astra International	Buy	14.8	12.9	12.2	14.7	4.2	30.4	9.2	ASII IJ
6,150	Bank Danamon Indonesia	Neutral	14.7	12.3	21.7	19.2	2.5	18.0	0.0	BDMN IJ
6,250	Bank Rakyat Indonesia	Buy	11.9	9.9	13.2	19.8	3.3	30.9	0.0	BBRI IJ
5,250	Indosat	Buy	18.6	13.5	20.7	37.8	1.5	6.2	4.9	ISAT IJ
5,850	PT XL AXIATA	Neutral	13.4	11.7	22.8	15.3	3.4	28.2	5.6	EXCL IJ
7,750	Telekomunikasi Indo	Buy	12.6	11.6	5.3	9.5	2.4	20.2	4.1	TLKM IJ
44,500	Gudang Garam*	Not Rated	17.1	15.0	21.8	14.2	3.5	20.7	11.5	GGRM IJ
14,800	Unilever Indonesia*	Not Rated	28.9	25.7	9.3	12.5	25.0	90.8	20.5	UNVR IJ
5,200	Indofood Consumer*	Not Rated	16.1	14.3	12.2	12.4	3.0	20.4	8.6	ICBP IJ
12,950	Mayora Indah*	Not Rated	17.9	13.8	21.2	30.1	4.2	24.0	10.0	MYOR IJ
810	Ramayana*	Not Rated	13.1	11.3	15.6	16.1	2.0	16.1	7.1	RALS IJ

Note: Price as per 1 June 2011 close. Based on market consensus

Source: Nomura Research, * Bloomberg

Improvements in logistics

We also believe that the infrastructure projects will help consumer companies to reduce logistics costs and create additional demand in the medium term. It will, however, also open the door to competition in the longer run, as improvements in logistics should lower the entry barrier into traditional markets (in contrast with modern trade) that still account for more than 60% of Indonesian FMCG.

Logistics are a big challenge for consumer companies, especially those new to the Indonesian market. Despite its rapid growth, modern trade still accounts for only 30-35% of retail trade in Indonesia, up from 25% a decade ago. Logistics is a major barrier for modern retailers to penetrate deep into smaller towns, given that the modern trade business model relies on fast inventory turnover.

It still takes 10-12 days for Ramayana to ship products from Jakarta to its stores in North Sumatra and East Kalimantan, which forces it to carry an extra three weeks' inventory (including goods in transit) for its stores outside Java (vs. normal inventory in Java of two months for clothing and one month for supermarket items).

Companies that try to penetrate the Indonesian market often have to rely on third-party distribution, which is often dominated by existing companies that are "exclusive distributors" to leading companies and usually have non-compete agreements (either on a legal or ethical basis). Building a new distribution network takes time and costs a lot of money, particularly given the archipelago nature of Indonesia's geography.

We believe that rapid acceleration of infrastructure projects will help to reduce logistics costs, improve the movement of goods, and thus help to ease inflationary pressure in the long run. It will likely also introduce competition in the regions currently dominated by strong consumer companies with deep distribution networks such as Unilever Indonesia, Indofood consumer, and major cigarette companies. We estimate logistics costs currently account for around 5% of costs at motorcycle makers and 2% of the total costs at retailer Ramayana.

Fig. 13: Some companies with comparative advantage on distribution network and brand equity

Price	Company	Rating	PER 11F (x)	PER 12F (x)	Earnings growth 11F (%)	Earnings growth 12F (%)	PB 11F (x)	ROE 11F (%)	EV/Ebitda 11F (x)	Ticker
59,100	Astra International	Buy	14.8	12.9	12.2	14.7	4.2	30.4	9.2	ASII IJ
7,750	Telekomunikasi Indo	Buy	12.6	11.6	5.3	9.5	2.4	20.2	4.1	TLKM IJ
6,250	Bank Rakyat Indonesia	Buy	11.9	9.9	13.2	19.8	3.3	30.9	0.0	BBRI IJ
9,650	Semen Gresik	Buy	14.7	13.0	7.3	13.2	4.0	29.8	10.1	SMGR IJ
2,225	Holcim Indonesia	Buy	19.0	17.6	8.1	8.2	2.3	12.5	8.5	SMCB IJ
16,800	Indocement Tunggal Perkas	Neutral	17.6	16.8	9.0	4.9	4.0	24.6	10.8	INTP IJ
44,500	Gudang Garam*	Not Rated	17.1	15.0	21.8	14.2	3.5	20.7	11.5	GGRM IJ
14,800	Unilever Indonesia*	Not Rated	28.9	25.7	9.3	12.5	25.0	91	20.5	UNVR IJ
5,200	Indofood Consumer*	Not Rated	16.1	14.3	12.2	12.4	3.0	20.4	8.6	ICBP IJ

Note: Price as per 1 June 2011 close. *) Based on market consensus

Source: Nomura Research, * Bloomberg

Moving up the value chain: from upstream to downstream

Indonesia is a major commodity producer and thus benefits from rising commodity prices. Loose monetary policy globally and rising demand from emerging economies bodes well for resources-rich Indonesia, in our view. Going forward, we expect government to put effort in encouraging investment in value added processing from commodities produced in Indonesia.

Commodity producers in Indonesia have invested heavily over the past five years to increase production so as to benefit from rising commodity prices. This is leading to rapid growth in key sectors, such as coal and palm oil. Coal production grew from 145mn tons in 2005 to 263mn tons in 2010, while palm oil production grew from 11.9mn tons in 2005 to 19.8m tons in 2010 (data from Association of Indonesian Coal Mining Companies and Directorate General of Estate). We expect Indonesian production of coal to increase to 445m tons and palm oil production to increase to 32mn tons in 2015F.

Indonesia is trying to capture as many value-added processes as possible from commodities produced in Indonesia, in our view. As part of the effort to induce midstream or downstream investment in Indonesia, the government has introduced either tax incentives or export bans for unprocessed raw materials. This effort is likely to boost investment, create jobs, and increase the bargaining power of Indonesia.

The intention is to move Indonesia from being solely a commodity exporter into an exporter of mid-stream products (and hopefully end-product) exporter. Indeed, even without tax incentives or an export ban, Indonesia should naturally attract downstream investment as the investment climate improves.

The ability of Indonesia to be a supplier of downstream products instead of simply exporting upstream commodities is demonstrated by the fact that Unilever Indonesia is able to capture the opportunity to supply tea to Unilever Australia, plus soap to Asean countries and the Middle East. Indonesian tyre producers also export to the global market. Indonesia has attracted major tyre producers such as Michelin, Goodyear, Dunlop and Bridgestone, to relocate, expand, or set up manufacturing plants or secure off-take agreements in Indonesia, according to the company.

Another example is the government's intentions to boost investment in the downstream palm oil industry and at the same time protect domestic consumers from rising global prices. The government has imposed a step up export tax structure that goes as high as 25% if the CPO price hits US$1,250/t or higher. It initially was aimed at protecting domestic consumers from rising international prices, but now serves as an attraction to downstream industry. The export tax allows downstream producers in Indonesia to purchase input material (CPO) at a lower rate than the global price, providing cost advantages.

Examples of regulation and potential investment in downstream business:

- Bakrie Sumatera Plantations (UNSP IJ – Not Rated) has acquired oleochemical plants for Rp1.1tn (US$125mn) and will invest an additional Rp1.1tn to complete the fatty alcohol plant that will have 145k tons per annum fatty alcohol capacity that will make it among the largest fatty alcohol producers in the world, according to management.
- Wilmar (WIL SP – Neutral) has proposed to relocate six of its downstream palm oil factories from China and Malaysia to Indonesia, with total investment of around US$900mn based on statements of Minister of Industry MS Hidayat to kompas.com in February 2011.
- Coal companies will be encouraged to invest in coal upgrading technology (Bayan Resources and White Energy are working on coal upgrading technology) as the government has announced its plan to ban the export of low-calorific-value coal in 2014.
- Metal producers will have to invest in smelters, as the government/parliament has passed a law that bans the export of all metal ores starting in 2014.
- Indonesia has banned log exports since 2002.

Fig. 14: Some companies to benefit from rising investment in downstream processing (of commodities)

Price	Company	Rec	PER 11F (x)	PER 12F (x)	Earnings growth 11F (%)	Earnings growth 12F (%)	PB 11F (x)	ROE 11F (%)	EV/Ebitda 11F (x)	Ticker
2,425	Adaro Energy	Buy	18.9	8.8	72.6	114.4	3.5	20	8.1	ADRO IJ
3,350	Bumi Resources	Buy	25.6	8.4	-2.9	205.9	4.2	17.4	6.0	BUMI IJ
700	Bumi Resources Minerals	Buy	21.0	18.5	11.4	13.7	1.0	5.0	12.6	BRMS IJ
21,400	Tambang Batubara Bukit As	Buy	16.8	9.7	45.4	74.0	5.9	40	11.6	PTBA IJ
46,950	Indo Tambangraya Megah	Buy	13.0	6.7	122.6	92.8	5.6	51.2	7.5	ITMG IJ
9,200	Harum Energy	Buy	13.7	6.4	117.8	114.1	6.3	58.6	7.8	HRUM IJ
2,400	PP London Sumatra	Buy	12.0	11.2	32.1	6.9	3.1	27.7	7.8	LSIP IJ
23,650	Astra Agro Lestari	Buy	13.3	11.7	55.9	13.4	4.7	37.6	8.7	AALI IJ
1,210	BW Plantation*	Not Rated	15.4	12.4	42.8	23.7	3.5	25.0	10.6	BWPT IJ
3,450	Sampoerna Agro*	Not Rated	11.9	11.5	43.5	4.2	2.6	22.5	7.1	SGRO IJ
380	Gozco Plantations*	Not Rated	9.8	9.0	26.8	9.1	1.4	19.0	9.0	GZCO IJ
460	Bakrie Plantations*	Not Rated	12.6	11.0	68.9	13.9	0.7	6.5	9.4	UNSP IJ

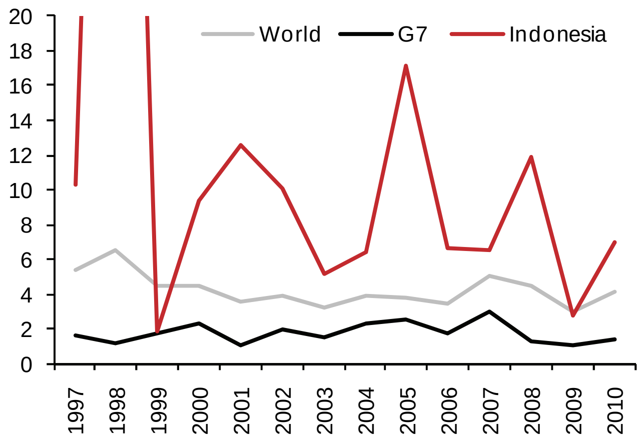
Note: Price as per 1June 2011 close. *) Based on market consensus

Source: Nomura Research, * Bloomberg

Moving to structurally lower inflation environment

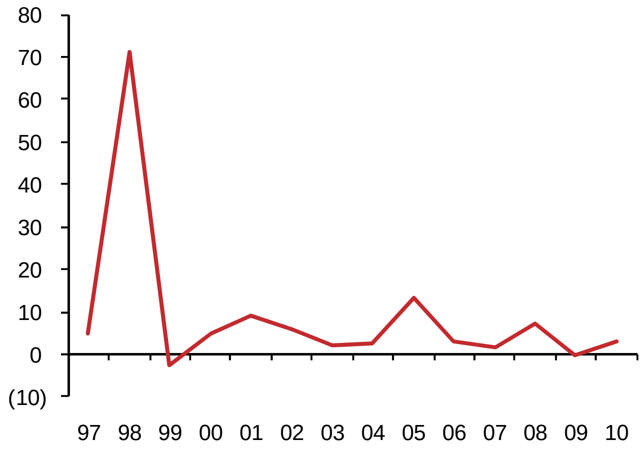
We believe Indonesia is moving to a structurally lower inflation environment versus its historical inflation and versus its historical inflation gap to world inflation. The current inflation rate of around 6% is still at the lower end of Indonesia's historical inflation range post independence in 1945. The move to a low inflation environment likely prompted a market re-rating, allowing the JCI to trade at par with regional peers (if not at a premium due to a higher growth profile).

Fig. 15: Inflation: Indonesia vs. the world



Source: IMF

Fig. 16: Inflation differential (Indonesia – world)



Source: IMF

Indonesia has seen inflation spike from a pre-Asian financial crisis of 9-10% to as high as 57.6% during the height of the Asian financial crisis in 1998. Inflation remained volatile over the decade preceding 1998 as Indonesia removed distortions in its economy, reduced import tariffs, reduced trade barriers and opened up foreign ownership in many sectors (eg, banks, foreign ownership limit in listed companies). During this period, state price control over nine basic commodities through Bulog (National Logistic Agency) was abolished, regional pricing control on cement was removed, and efforts to remove or reduce fuel subsidies were launched (industry is now paying market prices for fuel).

We think a stable currency also plays a significant role in reducing inflation pressure, as the Indonesian economy tends to be “dollarised”. A stable currency allows businesses to better manage costs and budgeting, thus reducing the need of a “cushion” against cost volatility. This enhances working capital efficiency and thus lowers production and distribution costs in general.

Step up GDP growth from 4-6% to 6-8%

Indonesian GDP growth will step up from 4-6% in the past five years to a new band of 6-8% in the next five years, we believe. This will likely be largely driven by higher commodity prices, rising domestic consumption, and faster investment growth. Our baseline growth assumption is 7.0% in 2011-2015, with potential upside risk of over 8% and downside risk of 5.8% (see “Estimating medium term growth,” p. 11).

We think the step up in GDP growth will be translated into domestic consumption growth and rising asset value, as rising GDP per capita will likely lead to higher consumption, especially in big-ticket and discretionary items such as cars, property, branded products, personal care products, smartphones, high-end TVs, and other lifestyle products. Even cement sales tend to grow at 1.5x GDP and have grown at a 7.5% CAGR over the past decade, based on data from the Indonesian Cement Association, versus 5.2% GDP growth during the same period.

In the early stage of a step-up in GDP growth, strong trajectory growth in discretionary consumption and rapid modernisation of trade and lifestyles are among the main features, especially when GDP per capita approaches US$3,000 per capita. This trend is seen in China, Korea, and Japan in the past, as pointed out by Nomura economist Tomo Kinoshita in his work on the “Middlization” of Asia (*Asian Economies*, December 2010).

Fig. 17: Some companies to benefit from rising middle income and stronger GDP growth

Price	Company	Rating	PER 11F (x)	PER 12F (x)	Earnings growth 11F (%)	Earnings growth 12F (%)	PB 11F (x)	ROE 11F (%)	EV/Ebitda 11F (x)	Ticker
59,100	Astra International	Buy	14.8	12.9	12.2	14.7	4.2	30.4	9.2	ASII IJ
5,250	Indosat	Buy	18.6	13.5	20.7	37.8	1.5	6.2	4.9	ISAT IJ
5,850	PT XL AXIATA	Neutral	13.4	11.7	22.8	15.3	3.4	28.2	5.6	EXCL IJ
7,750	Telekomunikasi Indo	Buy	12.6	11.6	5.3	9.5	2.4	20.2	4.1	TLKM IJ
7,100	Bank Central Asia	Neutral	18.8	16.8	14.0	12.1	4.5	26.0	0.0	BBCA IJ
6,150	Bank Danamon Indonesia	Neutral	14.7	12.3	21.7	19.2	2.5	18.0	0.0	BDMN IJ
7,150	Bank Mandiri	Buy	15.9	14.2	10.8	11.7	2.8	21.1	0.0	BMRI IJ
3,825	Bank Negara Indonesia	Buy	14.8	12.1	2.3	21.8	1.9	16.0	0.0	BBNI IJ
6,250	Bank Rakyat Indonesia	Buy	11.9	9.9	13.2	19.8	3.3	30.9	0.0	BBRI IJ
4,050	Perusahaan Gas Negara	Buy	14.7	13.5	-3.1	9.1	5.7	45.6	8.6	PGAS IJ
3,500	Jasa Marga	Buy	12.1	9.7	-1.7	24.6	2.8	14.3	11.1	JSMR IJ
1,130	Krakatau Steel	Neutral	11.9	9.0	40.6	32.3	1.7	15.1	9.1	KRAS IJ
680	Wijaya Karya	Neutral	11.5	11.6	24.5	-0.9	2.0	18.3	5.1	WIKA IJ
9,650	Semen Gresik	Buy	14.7	13.0	7.3	13.2	4.0	29.8	10.1	SMGR IJ
2,225	Holcim Indonesia	Buy	19.0	17.6	8.1	8.2	2.3	12.5	8.5	SMCB IJ
16,800	Indocement Tunggal Perkas	Neutral	17.6	16.8	9.0	4.9	4.0	24.6	10.8	INTP IJ
680	Lippo Karawaci*	Not Rated	23.8	19.6	9.1	21.8	1.8	7.8	16.2	LPKR IJ
910	Bumi Serpong Damai*	Not Rated	21.7	17.1	34.1	27.1	2.5	11.9	14.5	BSDE IJ
420	Ciputra Development*	Not Rated	24.1	17.0	29.6	41.2	1.2	5.0	13.2	CTRA IJ
1,150	Summarecon Agung*	Not Rated	24.1	18.0	35.5	34.2	3.3	14.6	13.5	SMRA IJ
165	Bakrieland*	Not Rated	37.6	35.2	11.2	6.7	0.9	2.0	24.9	ELTY IJ
335	Alam Sutera*	Not Rated	11.9	9.1	79.6	30.0	2.2	20	10.0	ASRI IJ
355	Agung Podomoro*	Not Rated	13.6	10.2	79.5	33.4	1.7	13.9	11.5	APLN IJ

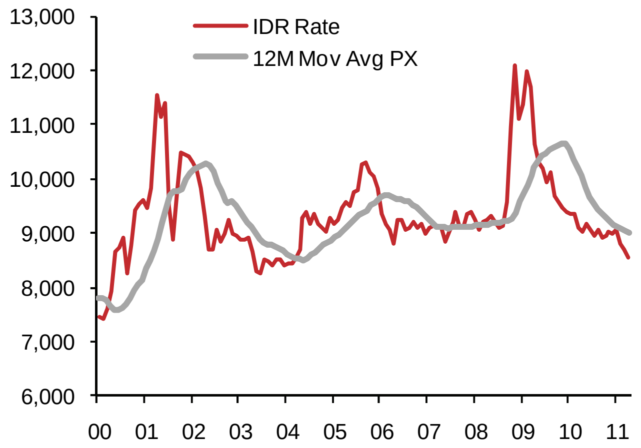
Note: Price as per 1 June 2011 close.*) Based on market consensus

Source: Nomura Research, * Bloomberg

Reduced currency volatility

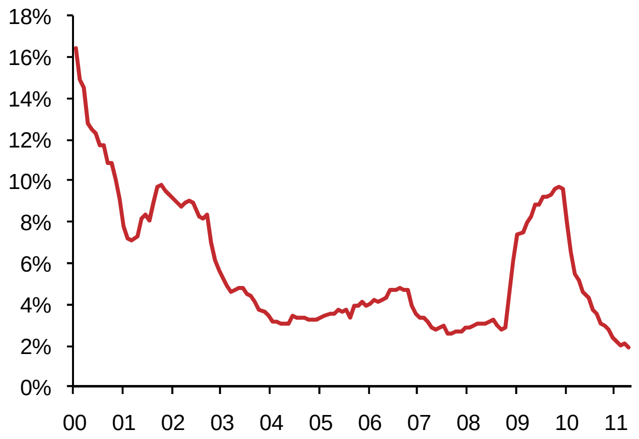
Currency (rupiah/US$) volatility has decreased in the past years, and the speed of the rupiah's recovery from the sharp depreciation during the 2008/2009 global financial crisis has enhanced confidence in the currency. Lower currency volatility technically reduces the perceived risk profile of Indonesia, allowing higher valuation multiples, in our view.

Fig. 18: Rupiah/US$ Exchange rate 2000-2011



Source: Bank Indonesia, Bloomberg

Fig. 19: Rupiah/US$ monthly volatility (high/low-1)



Source: Bank Indonesia, Bloomberg

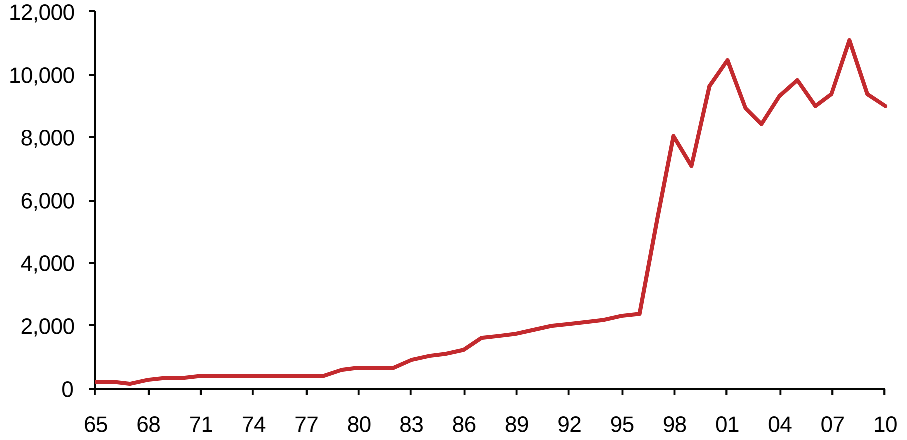
Since independence in 1945, the rupiah has depreciated from time to time and been a poor store of value. The wealth of people holding rupiah has been taken away by currency depreciation, and thus people's confidence in the rupiah was low. Low confidence and a fully convertible currency arguably made the rupiah one of the worst-hit currencies during the Asian financial crisis, which saw the Rp/US$ rate move from Rp2,375/US$ in January1997 to a peak of Rp16,950/US$ in June1998. Approximately US$9bn net of foreign capital left the country in 2000 (versus US$28bn in foreign currency reserves in January 2000), according to the World Bank.

Since then, steps have been taken successfully by Bank Indonesia and the government to reduce speculation and volatility:

- Bank Indonesia/the government announced that it is illegal to trade/transact rupiah outside Indonesia (2001).
- The government requires investors or individuals to have an underlying transaction to buy foreign currency (2005).
- Individuals or institutions that buy a large amount of rupiah (above US$100,000 per month) are required to complete a notification form for the underlying transaction and provide a tax number, which psychologically reduces the appetite to buy/speculate in a foreign currency during a crisis (introduced in 2005).

Yet the rupiah is fully convertible.

Fig. 20: Rupiah/US$ -- it has been a losing game to hold rupiah



Source: Bank Indonesia

The lack of confidence in the rupiah has started to change post the 2008/2009 financial crisis, when the rupiah fell from Rp9,000/US$ to Rp12,000/US$ in four months. Despite the rapid depreciation and the extent of the global financial crisis, Indonesians did not panic. We did not see any sign of corporations or individuals hoarding US$ cash and there was no rush to hedge debt or US$ cost exposure in 2008/2009. Total FX deposits in the banking system did not spike and was recorded at US$26.8bn in March 2009, only up 11.6% from US$24.0bn in December 2007 (Source: Bank Indonesia).

The financial discipline put in place since the 1997 Asian financial crisis will likely continue to support a re-rating of Indonesia. Low leverage is seen at both the country level (25% total debt/GDP ratio) as well as the corporate level (30% debt to equity ratio for the 50 largest listed companies ex-financial, as at December 2010). Although this may gradually change overtime as stronger GDP growth and capital intensive infrastructure projects might push corporate to tap into the debt market to finance growth, the tendency to rely on rupiah debt (supported by a falling cost of borrowing in rupiah) will continue to reduce the perceived currency risk profile of Indonesia, in our view.

Democracy: growing pains

The reform era that started after the fall of President Soeharto in 1998 has seen Indonesia go through the growing pains of becoming a democracy. The revamp of the political system, decentralisation of government, and media freedom are now being rebalanced towards moderation (see the political section of this report for more details).

The reform era post 1998 opened up the political system and allowed 48 political parties to be formed and contest the election in 1999. This resulted in a fragmented house of parliament (DPR) that made it harder for the elected president to form a coalition.

Fig. 21: Indonesian election since 1955

Election Year	# of parties/individuals participated in election	# of parties represented in parliaments	# of parties failing to win seats
1955	172	28	144
1971	10	8	2
1977	3	3	0
1982	3	3	0
1987	3	3	0
1992	3	3	0
1997	3	3	0
1999	48	21	27
2004	24	16	8
2009	34	9	25

Source: Commission of General Election, National Development Planning Board

This swing back to the middle came amid the Commission of General Election (KPU) setting a threshold of 2.5% to be represented in parliament in the 2009 election. The threshold is planned to be raised to 5% for the 2014 election, to force further consolidation among political parties (although it will be very hard to gain approval, see political section by Alastair Newton). The president has been selected through direct election since 2004 and can serve for a maximum of two five-year terms.

The consolidation of political parties plus the maturing democratic system in Indonesia will likely underpin greater social and political stability, and ensure a smoother coalition and law enactment to support government programs.

Risks to our view

The risks to our “Indonesia rising” scenario potentially come from domestic politics, global economics, a spike in basic commodity prices, currency volatility, failure in infrastructure development, and natural disasters. Most of the risks are general country risk and similar to those of other countries.

Political risk: The risk in domestic politics lies in the fact that there is no clear leading candidate to take over from current president Susilo Bambang Yudohono once his term ends in 2014. This will be seen as uncertainty by investors in the run-up to 2014 until an acceptable candidate appears to be leading. However, we are less concerned, as the political system is well in place for a fair election. The 2004 and 2009 elections show that Indonesia understands the need for reform and good leadership.

The 2009 election saw more than 70% of the previous parliament members voted out and the percentage of young (under 50 years old) representatives increased to 62% versus 49% in the 2004 election. The number of parliament members with post graduate degrees is also slightly higher at 38% versus 34% previously. We believe that in some areas, the top candidate from some parties received less votes compared with younger/new candidates from the same parties or were even voted out, implying people want reform and are willing to execute this through official/legal channels.

Risk of slowing global economic growth: A slowdown in global economic growth, including China, is a risk. A collapse in commodity prices, while unlikely in our view, would pare rural incomes and potentially hurt domestic consumption. Thus, if the world returns to a prolonged recession, Indonesia would also be hurt.

Liquidity and fund flow risk: Indonesia is prone to liquidity risk and a reversal of fund flow given the relatively small size of the market. A reversal of fund flow could pressure both the currency and funding availability to support economic growth. Cost of funding would rise and thus valuation multiples and earnings would fall.

The sharp fall in the JCI during the global financial crisis in 2008/2009 has shown that Indonesia will likely not decouple from the world in the worst time, and any rush to the exit could trigger a sharper than necessary fall in share prices (which in hindsight can provide a buying opportunity).

Risk from a sharp rise in commodity price: An orderly and gradual increase in commodity prices could be positive for Indonesia, given its vast natural resources and the nation's position as a leading commodity exporter. However, a sharp rise in basic commodity prices such as for oil, rice, and other basic food items could lead to a spike in inflation and pressure on urban population that might create discontent in the short term. Ability to manage the short-term discontent of the urban population will carry Indonesia forward, but the best case for Indonesia remains a gradual increase in commodity prices that will make it easier for Indonesia to pass on and digest, in our view.

Currency volatility: Currency volatility could lead to uncertainty in cost management as well as difficulties in pricing strategy, thus increasing risk. It could also have wider implications for general inflation, as domestic prices have a high correlation with international prices x Rp/US$ rate.

Failure in infrastructure development: Failure to kick-start infrastructure projects could hamper Indonesia's ability to grow faster. The infrastructure is stretched, with limited spare capacity for electricity, congested ports, and congested roads. Infrastructure development is needed to sustain a step-up in GDP growth from 4-6% to 6-8%.

Natural disaster: Natural disasters are unpredictable and vary in damage caused. Indonesia is in the "ring of fire," so has a high risk to earthquakes, volcano eruptions and other natural disasters.

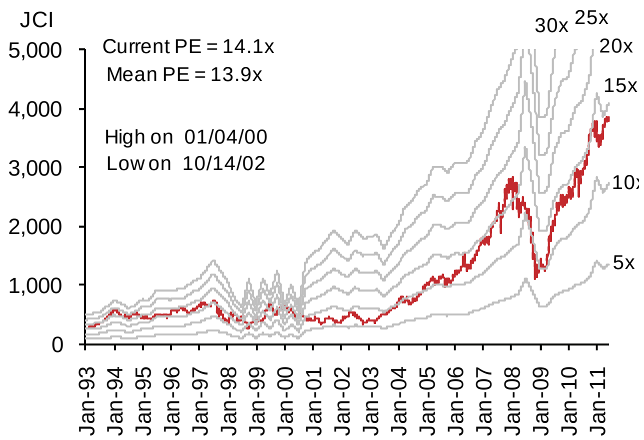
Positioning for rising Indonesia

On a five-year horizon, we position our portfolio in favour of discretionary consumption, natural resources, infrastructure/property, and selected banks to capture the medium-term potential of Indonesia.

Our base-line scenario is that the JCI will trade at its average valuation of 15x forward P/E, implying a target JCI index of 4500 in December 2012 and 6800 in December 2015. This is based on an assumption that aggregate earnings will continue to grow at 15% pa post the forecast period of 2013. Our target valuation will put JCI at a target PE/Growth ratio of 1.0x. The 1.0x target PE/Growth is in line with the current PE/Growth of the MSCI Asia Pacific and the average PE/Growth of JCI in the past five years.

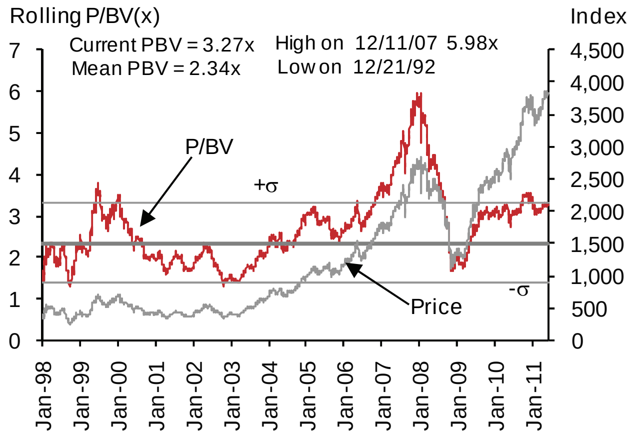
The valuation risks remain on the upside relative to MSCI Asia Pacific given a stronger earnings growth profile supported by high ROE and low balance sheet leverage, in our view.

Fig. 22: Historical PE ratio of JCI



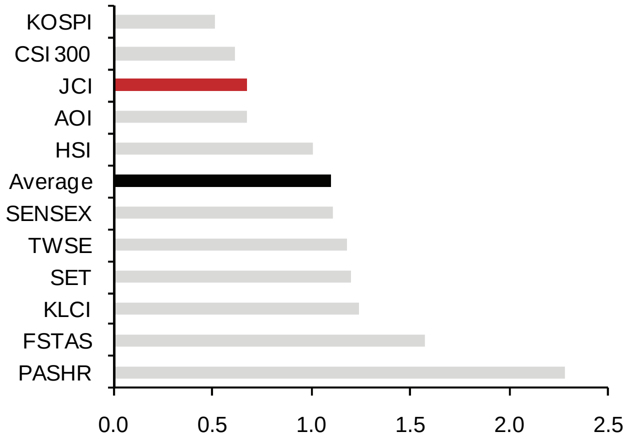
Source: Thomson Reuters Datastream, Nomura International (Hong Kong) — Quantitative Strategies

Fig. 23: Historical PB ratio of JCI



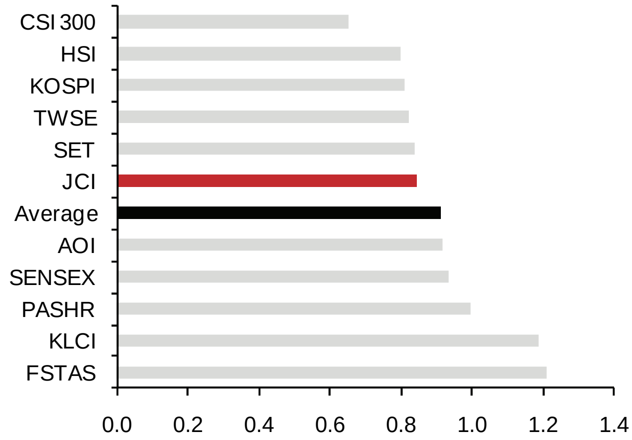
Source: Thomson Reuters Datastream, Nomura International (Hong Kong) — Quantitative Strategies

Fig. 24: PE2010/Growth2011



Source: Thomas Reuters Datastream, I/B/E/S, Nomura International (HK) Ltd- Equity Quantitative Strategies

Fig. 25: PE2011/Growth20 2



Source: Thomas Reuters Datastream, I/B/E/S, Nomura International (HK) Ltd- Equity Quantitative Strategies

Indentifying winners in the next five years will be challenging, as accelerating growth and improvement in infrastructure will likely intensify competition compared with the past decade. We like companies with strong brand equity, command comparative cost advantages, and are well positioned in the right sectors. With our base case of a rising middle class, sustainable high commodity prices, and accelerating infrastructure development in the next five years, **our top picks in Indonesia's equity market are Astra International, Bank Rakyat, Semen Gresik, Jasa Marga, Adaro, PTBA, Bumi Resources, and London Sumatera.**

Fig. 26: ROE of JCI (%)

Source: Nomura Research

Fig. 27: Valuation Table

Price	Company	Rating	PER 11F (x)	PER 12F (x)	Earnings growth 11F (%)	Earnings growth 12F (%)	PB 11F (x)	ROE 11F (%)	EV/EBITDA 11F (x)	Ticker
2,425	Adaro Energy	Buy	18.9	8.8	72.6	114.4	3.5	20.1	8.1	ADRO IJ
23,650	Astra Agro Lestari	Buy	13.3	11.7	55.9	13.4	4.7	37.6	8.7	AALI IJ
59,100	Astra International	Buy	14.8	12.9	12.2	14.7	4.2	30.4	9.2	ASII IJ
7,100	Bank Central Asia	Neutral	18.8	16.8	14.0	12.1	4.5	26.0	0.0	BBCA IJ
6,150	Bank Danamon Indonesia	Neutral	14.7	12.3	21.7	19.2	2.5	18.0	0.0	BDMN IJ
7,150	Bank Mandiri	Buy	15.9	14.2	10.8	11.7	2.8	21.1	0.0	BMRI IJ
3,825	Bank Negara Indonesia	Buy	14.8	12.1	2.3	21.8	1.9	16.0	0.0	BBNI IJ
6,250	Bank Rakyat Indonesia	Buy	11.9	9.9	13.2	19.8	3.3	30.9	0.0	BBRI IJ
3,350	Bumi Resources	Buy	25.6	8.4	-2.9	205.9	4.2	17.4	6.0	BUMI IJ
700	Bumi Resources Minerals	Buy	21.0	18.5	11.4	13.7	1.0	5.0	12.6	BRMS IJ
9,200	Harum Energy	Buy	13.7	6.4	117.8	114.1	6.3	58.6	7.8	HRUM IJ
2,225	Holcim Indonesia	Buy	19.0	17.6	8.1	8.2	2.3	12.5	8.5	SMCB IJ
46,950	Indo Tambangraya Megah	Buy	13.0	6.7	122.6	92.8	5.6	51.2	7.5	ITMG IJ
16,800	Indocement Tunggal Perkas	Neutral	17.6	16.8	9.0	4.9	4.0	24.6	10.8	INTP IJ
5,250	Indosat	Buy	18.6	13.5	20.7	37.8	1.5	6.2	4.9	ISAT IJ
3,500	Jasa Marga	Buy	12.1	9.7	-1.7	24.6	2.8	14.3	11.1	JSMR IJ
1,130	Krakatau Steel	Neutral	11.9	9.0	40.6	32.3	1.7	15.1	9.1	KRAS IJ
4,050	Perusahaan Gas Negara	Buy	14.7	13.5	-3.1	9.1	5.7	45.6	8.6	PGAS IJ
2,400	PP London Sumatra	Buy	12.0	11.2	32.1	6.9	3.1	27.7	7.8	LSIP IJ
5,850	PT XL AXIATA	Neutral	13.4	11.7	22.8	15.3	3.4	28.2	5.6	EXCL IJ
9,650	Semen Gresik	Buy	14.7	13.0	7.3	13.2	4.0	29.8	10.1	SMGR IJ
21,400	Tambang Batubara Bukit As	Buy	16.8	9.7	45.4	74.0	5.9	40	11.6	PTBA IJ
7,750	Telekomunikasi Indo	Buy	12.6	11.6	5.3	9.5	2.4	20.2	4.1	TLKM IJ
680	Wijaya Karya	Neutral	11.5	11.6	24.5	-0.9	2.0	18.3	5.1	WIKA IJ
	Simple average		15.5	12.0	27.6	37.0	3.5	25.6	6.6	
	Aggregate		15.2	11.8	18.5	28.3	3.3	21.6		

Note: Market capitalisation of stocks under our coverage accounts for 51% of total market capitalisation. Price as per 1 June 2011 close.

Source: Nomura Research

Infrastructure sector – Building blocks in place

Andy Lesmana & Wilianto Ie (+62 21) 2991 3344 andy.lesmana@nomura.com

A robust macro story, coupled with fiscal budget deployment, looks set to propel infrastructure spending and unlock pent-up growth. The government plans to pass a land acquisition law by 2H11, enhancing the investor-friendly stance. Demand for cement and bulk cement rose sharply in 1Q11, signaling accelerating demand from infrastructure projects even before the land acquisition law is passed. We highlight supportive macro news and the possibility of a credit rating upgrade. We are Bullish on the infrastructure sector, with a preference for Semen Gresik and Jasa Marga.

Background

Progress on infrastructure development in Indonesia has lagged expectations, since the government launched the infrastructure development program in 2005. Yet Indonesia has seen some minor progress in infrastructure development, adding some 135km (15%) of toll road length since 2005. We believe conditions have changed for the better since 2005:

- **Significantly improved macro story**: economic growth has accelerated from 5.5% in 2005 to 6.1% in 2010 and will continue to accelerate to 6-8% band, in our view. This will require support from infrastructure projects, a big push for infrastructure growth.
- **Indonesia's credit rating has improved** three notches from B+ in 2005 to BB+ in 2010 (S&P); and the long-term US-dollar government bond yield has declined from an average 12.5% in 2005 to 7.5-8% in 2011. Lower cost of funds has increased the feasibility and attractiveness of infrastructure projects.
- **Stronger fiscal position**: the revenue budget has more than doubled from Rp495tn or US$50bn in 2005 to Rp1,100tn or US$120bn in 2011, allowing the government to increase fund allocation for infrastructure spending.
- **Sufficient regulatory framework in place**: the regulatory framework now includes a law that ensures implementation of toll tariff increases, the establishment of a toll road authority laws, investment rules and protectionism, financial regulation, and subsidies — where progress and benefits are feasible in the near to medium term.

We expect Indonesia's infrastructure development to accelerate as the government gears up spending (the Ministry of Public Works budget is up 60% y-o-y and capital spending is up 43% y-o-y in 2011) and sets favourable policies for investors (e.g, land acquisition bill and funding support).

The key catalyst could be new land legislation. Government and parliament target to pass the bill by 2H11. With all the commercial funding support mechanisms well in place, the much-expected Land Acquisition Bill is the last remaining stumbling block for infrastructure development to take off in a major way, in our view. It will help to provide a legal base for the government to enforce land acquisition for infrastructure development.

Fig. 28: Companies in infrastructure sector

Price	Company	Rating	PER 11F (x)	PER 12F (x)	Earnings growth 11F (%)	Earnings growth 12F (%)	PB 11F (x)	ROE 11F (%)	EV/EBITDA 11F (x)	Ticker
2,225	Holcim Indonesia	Buy	19.0	17.6	8.1	8.2	2.3	12.5	8.5	SMCB IJ
16,800	Indocement Tunggal Perkasa	Neutral	17.6	16.8	9.0	4.9	4.0	24.6	10.8	INTP IJ
9,650	Semen Gresik	Buy	14.7	13.0	7.3	13.2	4.0	29.8	10.1	SMGR IJ
3,500	Jasa Marga	Buy	12.1	9.7	-1.7	24.6	2.8	14.3	11.1	JSMR IJ
1,130	Krakatau Steel	Neutral	11.9	9.0	40.6	32.3	1.7	15.1	9.1	KRAS IJ
680	Wijaya Karya	Neutral	11.5	11.6	24.5	-0.9	2.0	18.3	5.1	WIKA IJ

Note: Price as per 1 June 2011 close. Source: Nomura Research

Infrastructure sector in the equity market

Within the equity market, we generally maintain a bullish view on the infrastructure sector, particularly in the cement and transport (toll road) sectors. Toll road operators and cement, steel and construction companies are likely to be the key beneficiaries of any increase in infrastructure spending. We expect these companies to see business volume and profitability expand on average at a CAGR of 16% over the next three years. However, we expect rising production costs as a result of increasing commodity prices to remain key risks.

Semen Gresik (largest cement player, with 20% y-y capacity expansion in 2012) and Jasa Marga (main toll road company, key beneficiary of land acquisition law) are our top picks. We also like Holcim (third-largest cement player, strong in bulk cement).

Cement: prefer Gresik

We see the cement sector as a beneficiary of Indonesia's infrastructure story. Its use in a wide range of development should see the sector benefit from infrastructure spending itself, as well as the multiplied effect it brings for the economy. Our key investment thesis on the sector is volume growth, driven by capacity expansion over the next five years, and near-term selling price increases.

Volume growth on capacity expansion of 23% over next three years: The three listed cement companies should increase capacity by a combined 23% from the current capacity of 46mn tonnes to slightly more than 57mn tonnes. Semen Gresik has the most aggressive expansion plan, aiming to increase capacity by almost 20% from the current 20mn tpa to 25mn tpa in 2012, with commercial operations to start in the early part of the year. Holcim Indonesia is constructing its plant expansion in East Java that will see its operating capacity increase by 20% from 9mn tpa to 11mn tpa in 2013.

Some near-term price increase, albeit minimal: We expect the cement companies to increase selling prices by about 5% this year after no price adjustments in 2010, which will likely allow the cement producers to catch up with rising energy prices.

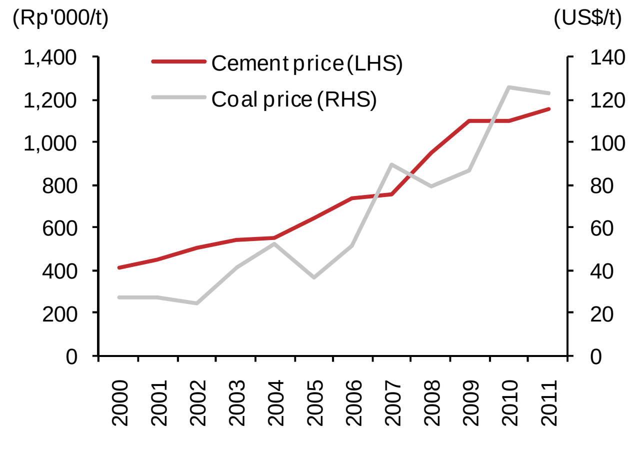
Bullish on toll road operators

Toll roads are the key focus of the government for infrastructure development, and will be the key beneficiary of the new land acquisition law when it is passed by parliament. We think the benefit of being able to build more toll roads with the implementation of this law for the toll road operators and investors are threefold:

- It will allow an acceleration in toll road development, adding project portfolios that will contribute traffic and cashflow (rather than just paper concessions), and potentially further re-investments in other toll roads by toll road operators.
- More toll road development will also helped to unlock accelerated traffic growth potential that has been hurt by capacity constraints. In the past 10 years, car sales growth hit an average 11% CAGR (source: Gaikindo), while Jasa Marga's traffic volume recorded an average CAGR of 5%. We believe that the 5% CAGR is below the potential that Jasa Marga can achieve owing to the toll road capacity constraints (cars are avoiding some toll roads which are more jammed than normal roads), as such more toll roads should boost traffic growth.
- We expect that accelerating toll road development will increase toll road connections and thus lead to further traffic volume growth.

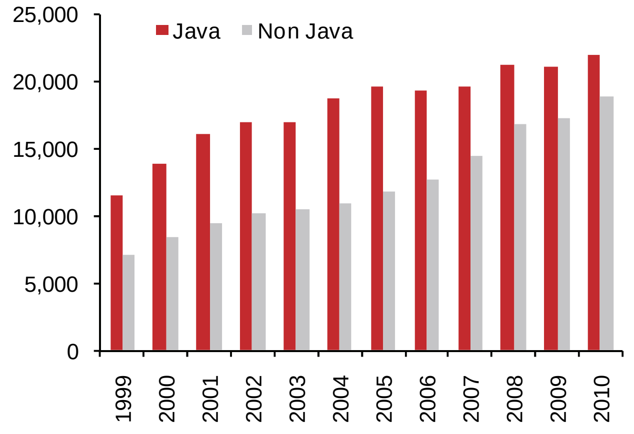
Infrastructure sector: Infrastructure chart book

Fig. 29: Pricing power of cement companies



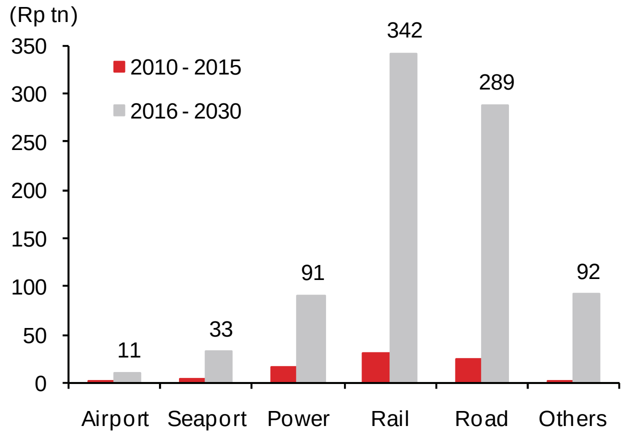
Source: Indonesian Cement Association (ASI), Company data, Bloomberg

Fig. 30: Cement demand ex-Java has been strong



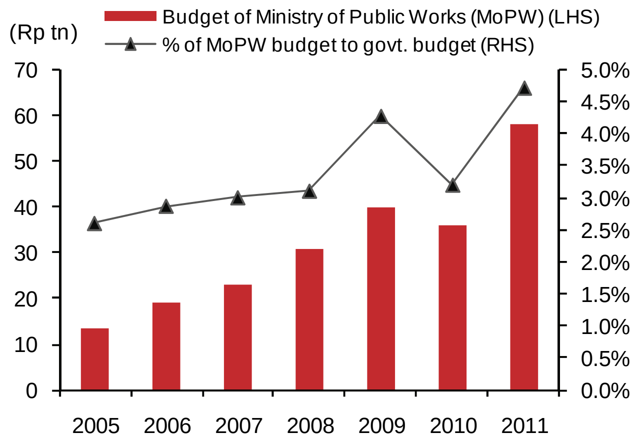
Source: Indonesian Cement Association (ASI)

Fig. 31: Infrastructure s ending requirement by sector



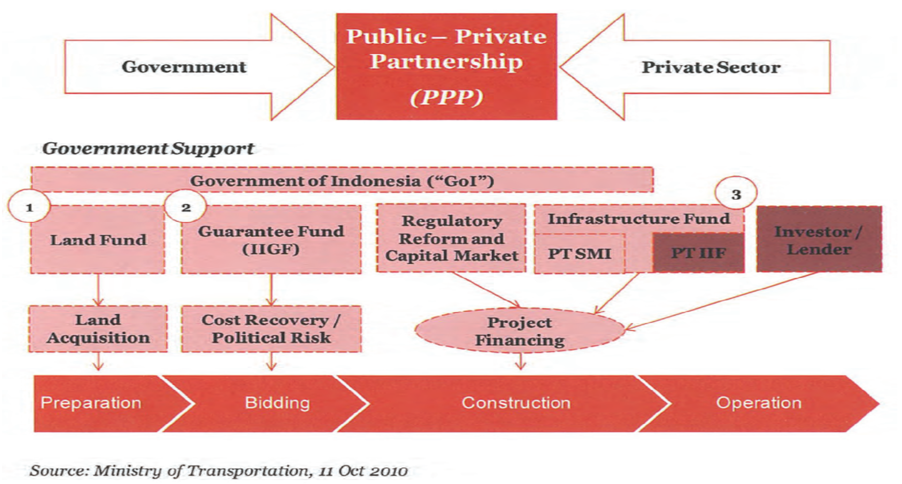
Source: Office of Coordinating Ministry for Economy

Fig. 32: Increasing budget on public work spending



Source: Ministry of Finance

Fig. 33: Structure of PPP in infrastructure development



Source: PT Nusantara Infrastructure

Mining sector – Bullish on coal

Isnaputra Iskandar (+62 21) 2991 3346 isnaputra.iskandar@nomura.com

We are bullish on coal prices, given that we expect demand from China and India to remain structurally strong, and Australia and South Africa to continue to face capacity constraints. In addition, Indonesia's strong domestic coal demand may put more pressure on global coal supply. Nomura is one of the more bullish houses on the Street on our coal price assumption as of June 2011. We forecast the coal price will rise to USD170/ton in 2012F from the current level of ~USD120/ton, and to stay at USD90/ton in the long term.

Strong domestic demand

Robust demand from the power sector in 2010-15F should continue to drive double-digit growth (13% CAGR) in domestic coal demand. We see minimal risk of negative impact for the industry, in view of our assumption of sufficient coal supplies from capacity expansion plus a market-friendly domestic pricing mechanism.

Strong earnings recovery and selective higher dividend story

We expect a combination of better/normalised weather (vs. high rain falls in 2010 that lower mine productivity) and strong coal prices, will turn around the profitability of Indonesian coal companies starting in 2011F. With stronger cashflows fortifying balance sheets, we see a selective dividend payout scenario in three to four years' time, ie, after major non-M&A capex is completed in 2011-13F. ITMG and PTBA are most likely to surprise on the upside with dividends, in our view, given relatively strong financials and lower capex.

Adaro and PTBA are top picks

Bumi Resources and PTBA are our top picks on a five-year view. Both have sizeable reserves to support long-term growth, are domestically strong, and have good exposure to the seaborne market, in our view.

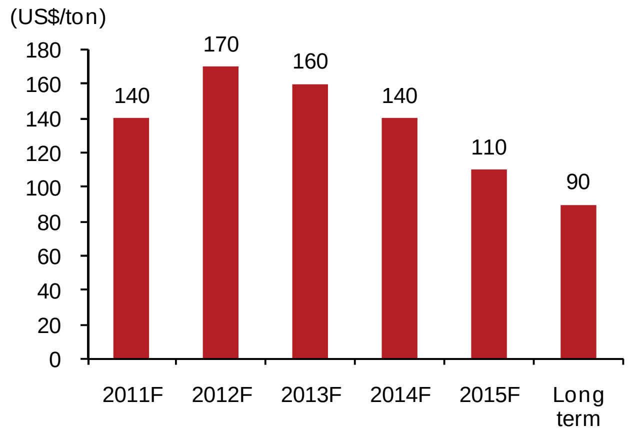
Fig. 34: Mining companies

Price	Company	Rating	PER 11F (x)	PER 12F (x)	Earnings growth 11F (%)	Earnings growth 12F (%)	PB 11F (x)	ROE 11F (%)	EV/Ebitda 11F (x)	Ticker
2,425	Adaro Energy	Buy	18.9	8.8	72.6	114.4	3.5	20.1	8.1	ADRO IJ
3,350	Bumi Resources	Buy	25.6	8.4	-2.9	205.9	4.2	17.4	6.0	BUMI IJ
700	Bumi Resources Minerals	Buy	21.0	18.5	11.4	13.7	1.0	5.0	12.6	BRMS IJ
9,200	Harum Energy	Buy	13.7	6.4	117.8	114.1	6.3	58.6	7.8	HRUM IJ
46,950	Indo Tambangraya Megah	Buy	13.0	6.7	122.6	92.8	5.6	51.2	7.5	ITMG IJ
21,400	Tambang Batubara Bukit As	Buy	16.8	9.7	45.4	74.0	5.9	40.0	11.6	PTBA IJ

Note: Price as per 1 June 2011 close
Source: Nomura Research

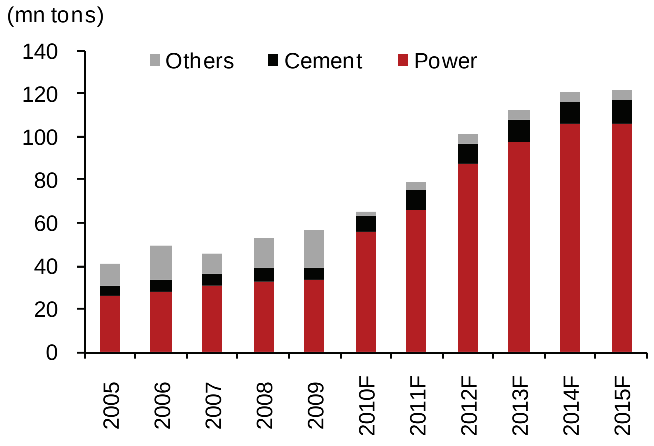
Interesting charts in mining sector

Fig. 35: Strong coal price remains in the future



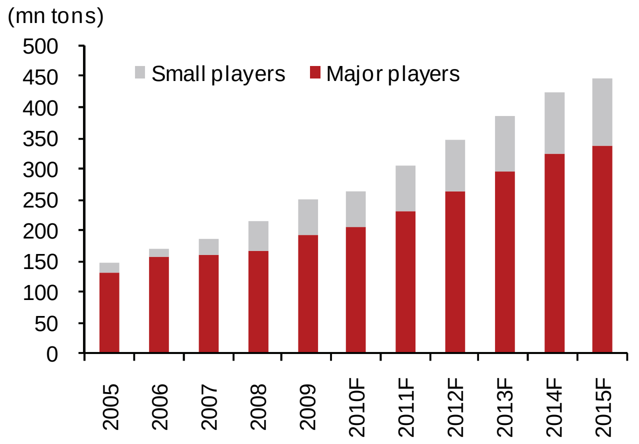
Source: Nomura estimates

Fig. 36: Power sector to drive domestic demand



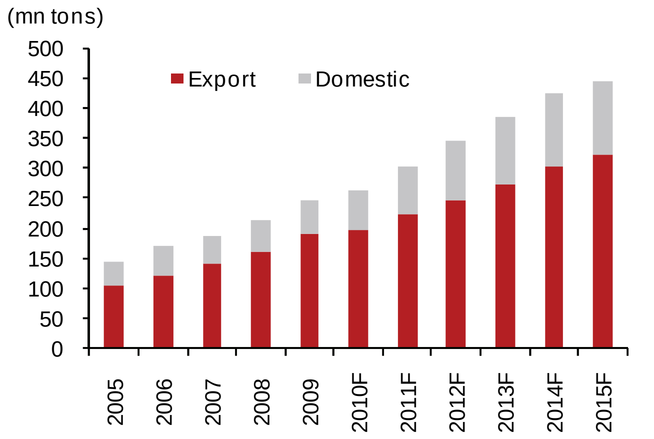
Source: Indonesia Coal Association, Nomura estimates

Fig. 37: Expansion by Indonesian coal companies



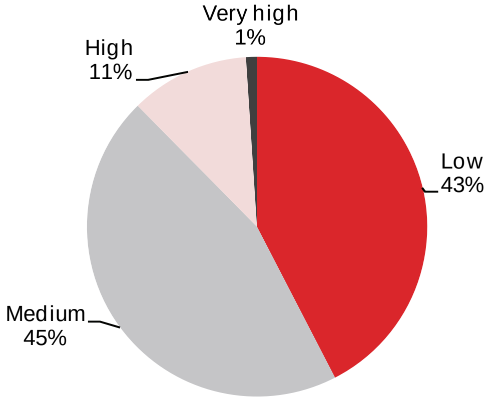
Source: Indonesia Coal Association, Nomura estimates

Fig. 38: Exports will still dominate production



Source: Indonesia Coal Association, Nomura estimates

Fig. 39: Most Indonesian coal is of low and medium quality, which is suitable for power consumption



Source: Ministry of Energy and Mineral Resources, Nomura estimates

Banking sector – At full throttle

Anand Pathmakanthan (+65) 6433 6986 anand.pathmakanthan@nomura.com

Indonesian banks are positioned to experience a sustained period of supernormal growth within a hugely under-penetrated market, underpinned by the mutually reinforcing supports of political stability, pro-growth government and regulatory policy, and a more settled interest rate and FX outlook. The downward pressure on net interest margin will be mitigated by strong loan growth, in our view. Our top pick in the sector is Bank Rakyat that has strong market leadership in micro lending and operates in a segment that is harder for new competitors to penetrate.

Roaring back from the (near) dead

The Indonesian banking sector has come a long way since the 1997-98 Asian financial crisis (AFC), during which the system practically collapsed under the weight of surging NPLs and chronic illiquidity brought about by massive capital flight. This has taken a dramatic turn, as Indonesia banks are now among the most profitable in the world.

Double-digit sector loan growth over the last few years, with only modest deceleration during the global credit crisis (GCC), has been supported by the convergence of resilient GDP momentum, robust banking sector fundamentals (ie, ready and willing to lend) and strong, broad demand for credit from across the economic spectrum.

Years of system retrenchment and restructuring post-Asian financial crisis in 1997 has left Indonesia's banking penetration (as measured by bank loans as a percentage of GDP) among the lowest in the region. We estimate that just to reach an India-comparable loan-to-GDP ratio of around 50%, the Indonesian banking system can sustain an average loan growth of 20% annually for the next decade, assuming underlying nominal GDP growth of 9% annually.

The Indonesian banking system effectively has a two-pronged approach to satisfying this deep latent demand for credit within the broad economy. The first and main avenue is via the expansion of mainstream commercial banking services across the vast country. The second avenue is the "bottom-up" provision of credit via microfinance in outlying rural areas. Scope for growth is massive – World Bank surveys indicate that less than 50% of households in Indonesia's rural areas have access to banking services while less than 40% have basic savings accounts.

The next five years will see Indonesian banking system reshaping with key characteristic of declining net interest margin, rapid loan growth, with deeper and wider penetration. Within the Indonesian banking sector, we continue to prefer Bank Rakyat for its strong position in micro financing, Bank Mandiri for its strong execution capability and strong liquidity, and Bank Negara Indonesia for the restructuring upside potential.

Fig. 40: Valuation comparison banks under our coverage

Price	Company	Rating	PER 11F (x)	PER 12F (x)	Earnings growth 11F (%)	Earnings growth 12F (%)	PB 11F (x)	ROE 11F (%)	EV/Ebitda 11F (x)	Ticker
7,100	Bank Central Asia	Neutral	18.8	16.8	14.0	12.1	4.5	26.0	0.0	BBCA IJ
6,150	Bank Danamon Indonesia	Neutral	14.7	12.3	21.7	19.2	2.5	18.0	0.0	BDMN IJ
7,150	Bank Mandiri	Buy	15.9	14.2	10.8	11.7	2.8	21.1	0.0	BMRI IJ
3,825	Bank Negara Indonesia	Buy	14.8	12.1	2.3	21.8	1.9	16.0	0.0	BBNI IJ
6,250	Bank Rakyat Indonesia	Buy	11.9	9.9	13.2	19.8	3.3	30.9	0.0	BBRI IJ

Note: Price as per 1 June 2011 close .

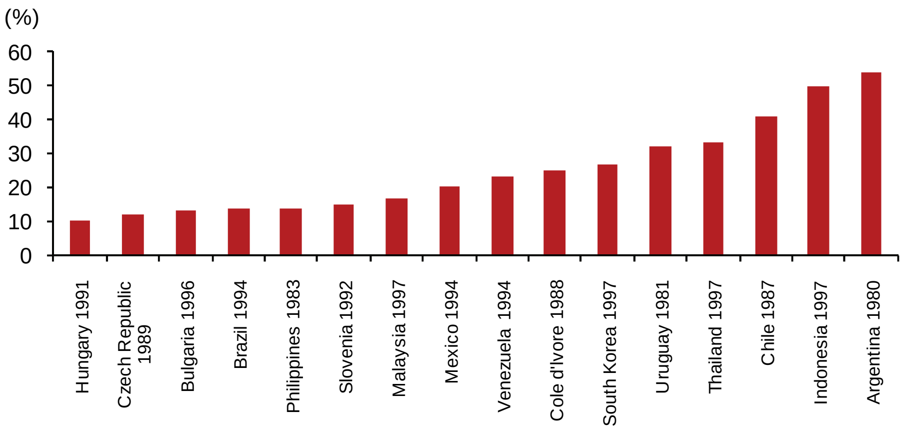
Source: Nomura Research

The historical perspective

The Indonesian banking system collapsed during the 1997 Asian financial crisis, burdened with heavy non performing loans, capital outflow, the risk of a bank run and sharp economic contraction. Sweeping government intervention was required, not just in terms of liquidity support to cope with bank runs but also to fund a broad recapitalisation via agencies, such as the Indonesian Bank Restructuring Agency (IBRA). It was followed by policy measures that allowed foreign investors to purchase Indonesian banking groups (the 1998 Banking Act raised the maximum limit of foreign ownership in domestic banks from 51% to 99%).

The final cost of recapitalizing (the government issued an estimated US$46bn of recapitalization bonds that were swapped for bank loans) and restructuring the Indonesian financial sector has been estimated at around 50% of GDP, ranking it as one of the costliest financial crises in the world.

Fig. 41: Cost of banking crisis (% of GDP)



Source: World Bank

More than a decade on, IBRA has been effectively wound up, a much more solid regulatory framework and oversight by Bank Indonesia is in place, and there has been significant industry consolidation with the number of commercial banks falling from almost 250 at the time of the AFC to just over 120 currently. With a good balance of government, private and foreign ownership (the latter estimated at around 40% of total banking assets, from less than 10% in 1996), the overhauled banking sector, which accounts for more than 80% of Indonesian financial system assets, now boasts a positive combination of respected governance, robust capital, sustained credit expansion and record profitability.

Fig. 42: Indonesian banks: size, capitalization and ownership

Country name	Bank name	Total assets (Local currency mn)	Total Loans (Local currency mn)	Portion of total domestic system loans (%)	Total deposits (Local currency mn)	Tier 1 Ratio (%)	CAR (%)	Major shareholders
Indonesia	PT Bank Mandiri	449,774,550	248,776,160	14.0	362,212,150	10.5	13.4	Government (60%)
	PT Bank Rakyat Indonesia	404,285,600	247,698,580	13.9	333,652,580	12.0	13.8	Government (57%)
	PT Bank Central Asia	324,419,070	156,901,270	8.8	277,530,640	12.6	13.5	Hartono family and associates (45%)
	PT Bank Negara Indonesia	248,580,530	137,223,420	7.7	194,374,680	18.6	18.6	Government (60%)
	PT Bank CIMB Niaga	143,652,580	104,801,490	5.9	117,833,230	11.1	14.5	CIMB (96%)
	PT Bank Danamon Indonesia	118,206,570	82,637,650	4.7	79,642,800	15.1	16.0	Temasek (68%)
	PT Pan Indonesia Bank	108,947,960	60,165,400	3.4	75,279,720	16.3	18.4	Panin (45%), ANZ (39%)
	PT Bank Interasional Indonesia	75,130,430	55,877,740	3.1	59,901,960	12.0	12.7	A prominent Malaysian Bank(95%)
	PT Bank Tabungun Negara	68,385,540	51,549,500	2.9	47,546,050	15.6	16.7	Government (73%)
	PT Bank Permata	73,813,440	52,839,990	3.0	59,385,310	10.7	14.1	PT Astra International (45%); Standard Chartered (45%)

Source: Company data, Bank Indonesia, Bloomberg

The Indonesian banking system effectively has a two-pronged approach to satisfying this deep latent demand for credit within the broad economy. The first and main avenue is via the expansion of mainstream commercial banking services across the vast country – aggressive branch expansion across urban and suburban population centers by all major banking groups is sustained as is establishment of e-banking infrastructure in the form of ATMs and web-enabled services.

Besides making credit more accessible to a widening geography and demographic, urban banking is also developing the fledgling fee product base. Where once fee income drivers were largely restricted to administrative fees for deposit accounts, loan-related charges and remittances/foreign exchange (underpinned by Indonesia's 5mn-strong migrant workforce), new revenue drivers such as credit cards, wealth management and bancassurance are growing rapidly in parallel with loan growth.

Complementing the aforementioned "top down" provision of banking services in urban areas is the second avenue, namely the "bottom-up" provision of credit via microfinance in outlying rural areas. Scope for growth is massive – World Bank surveys indicate that less than 50% of households in Indonesia's rural areas have access to banking services while less than 40% have basic savings accounts.

Unlike microfinance operations in other jurisdictions such as India which have to constantly combat charges of profiteering and restrictive regulations, Indonesia's microfinance industry is broadly viewed as a key means of getting credit to the estimated 50mn micro-businesses in both urban and rural areas which employ over 80mn people in the country.

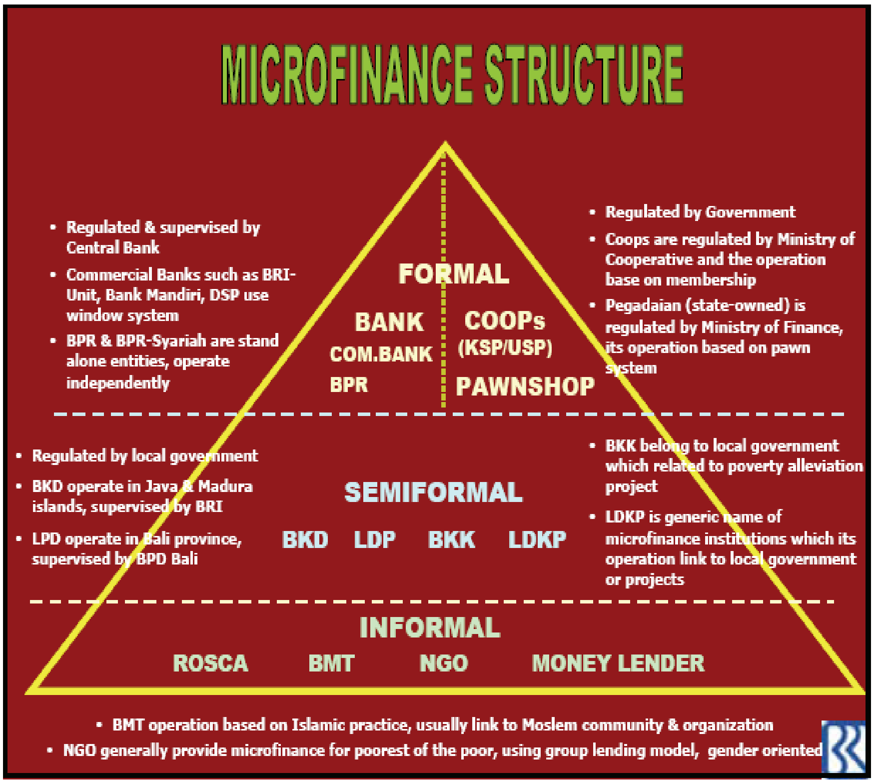
We think the three key reasons why microfinance has been a success in Indonesia and will continue to be so are:

i) regulated financial institutions provide the bulk of the microfinance services with NGOs/small MFIs (microfinance institutions) forming only a small part of the industry;

ii) commercial banks already have the lion's share of the microfinance market – large, microfinance-focused banking groups like Rakyat (rural microfinance) and Danamon (urban microfinance) have the resources and scale to provide a cost-effective, efficient service; and

iii) the government is an active participant in nurturing the industry, both via its direct ownership of banks like Rakyat as well as via providing a supportive regulatory environment that is built upon continuous engagement with microfinance providers.

Fig. 43: Indonesia: microfinance industry structure



Source: Bank Rakyat Indonesia

On the regulatory front, Bank Indonesia's (BI) improved supervision and oversight of the sector since the AFC has meant that, except for a brief liquidity squeeze at the onset, the Indonesian banks were largely unscathed by the GCC. The one high-profile casualty, namely Bank Century in 4Q08, was in fact a victim of fraud and effectively contained by BI to prevent systemic issues from arising (though not without political cost).

In 2010, Darmin Nasution was appointed as BI's governor (a position vacant since 2008 when ex-governor Boediono resigned to run as Yudhoyono's vice-presidential running mate). His expected focus on banking supervision and institution building (especially crucial at this juncture given the current confusion with the establishment of the OJK, which is meant to take supervision of the banking system off the hands of BI) appears to be broadly welcomed following the reputation gained from his success in cleaning up and reforming the corruption-ridden tax office.

With Indonesian banks already in the process of adopting the third and final stage of BASEL II over 1H11, focus should shift to advancing other aspects of the Indonesian Banking Architecture (IBA). Launched in 2004 and fine-tuned over the years, the IBA is a joint-effort between BI, the Capital Market Supervisory Agency (BAPEPAM) and the Ministry of Finance.

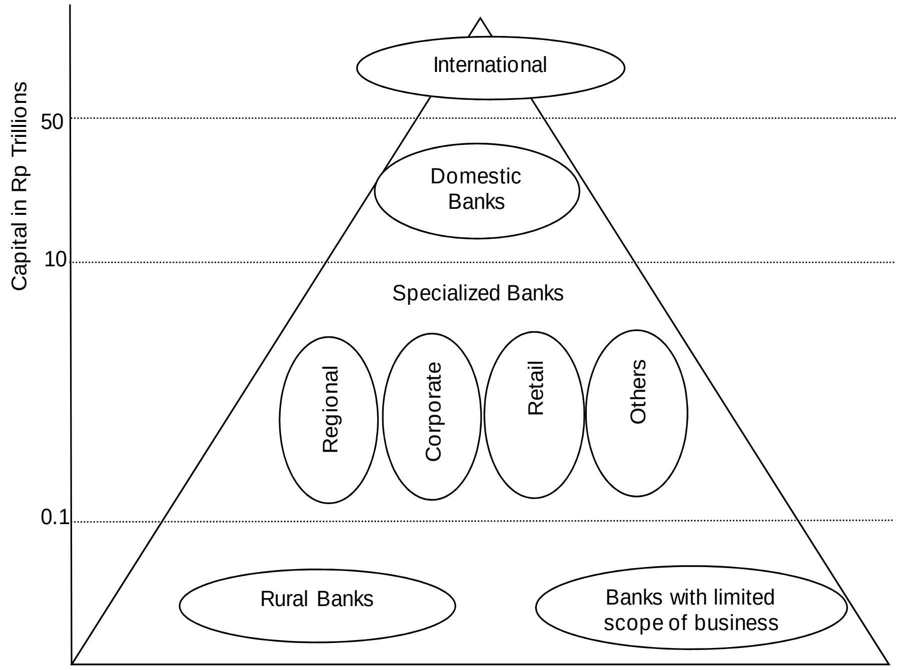
A cornerstone programme of the IBA is the structural reinforcement of the national banking system, which is aimed at building stronger capitalisation into commercial banks so as to underpin expansion of business scale and accelerate the required consolidation process among Indonesia's 120+ banks.

Against this backdrop, the programme for improvement of overall capitalisation of commercial banks is expected to produce a more optimum structure for the banking system over the next 10-15 years, established along the following lines:

- 2-3 banks with potential to emerge as international banks, possessing the capacity and ability to operate with an international presence and having total capital exceeding IDR50tn;
- 3-5 national banks, having a broad business scope and operating nationwide with total capital of between IDR10tn and IDR50tn;

- 30-50 banks operating as focused players, operating in particular business segments according to the capability and competence of each bank. These banks will have capital of IDR100bn to IDR10tn; and
- Rural banks (BPRs) and banks with limited scope of business, having capital of less than IDR100bn.

Fig. 44: Indonesian banking system – targeted IBA structure



Source: Bank Indonesia

Hence, with the political, macro, micro and regulatory picture showing a collective brightening, the prima facie growth and profitability outlook for Indonesian banking is strong into the medium term, in our view. However, the next few years will not be without challenges, key issues potentially being:

Regulatory uncertainty: New Bank Indonesia governor Darmin Nasution is adopting a much more proactive stance than his predecessor in advancing BI's overarching goal of increasing the provision of reasonably-priced credit to the economy.

While there have been no direct efforts against the banks in this respect (for example, there have been no setting of loan quotas or pricing caps), the sector is feeling the pressure in more indirect ways, eg, establishment of LDR-linked reserve requirements, mandatory publishing of the Prime Lending Rate and audits by both BI and the competition agency to verify credit pricing is "fair".

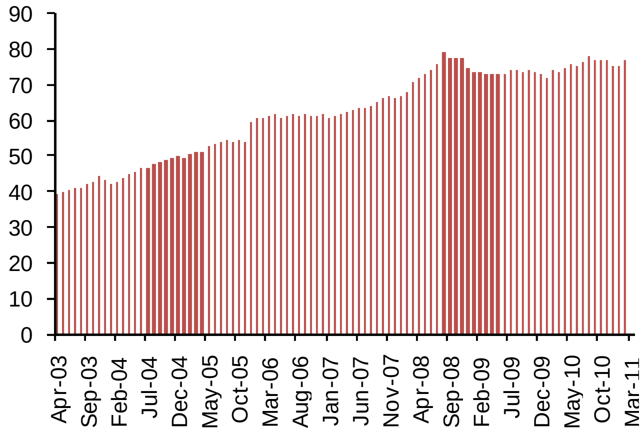
This regulatory "noise" injects a measure of uncertainty into what has been a highly laissez-faire attitude towards the operational decisions of the banking sector.

Liquidity imbalance: While the Indonesian banking sector as a whole is relatively liquid (1Q11 sector LDR at 77%), the dispersion of deposit liquidity among the banks is imbalanced. Due to branding/distribution advantages and limited deposit guarantee coverage (IDR2bn max), liquidity is concentrated among the largest banking groups, leaving the mid-size and smaller banks struggling.

While the positive corollary is a heightened urgency for smaller banks to consolidate, the imbalance poses potential systemic risk during times of macro stress when liquidity may dry up, causing smaller banks to fail. Bank Indonesia stands ready as a liquidity provider of last resort, but in the wake of the controversial and politically charged Bank Century bail-out, the system cannot count on a seamless intervention by BI should a similar systemic issue arise in the future.

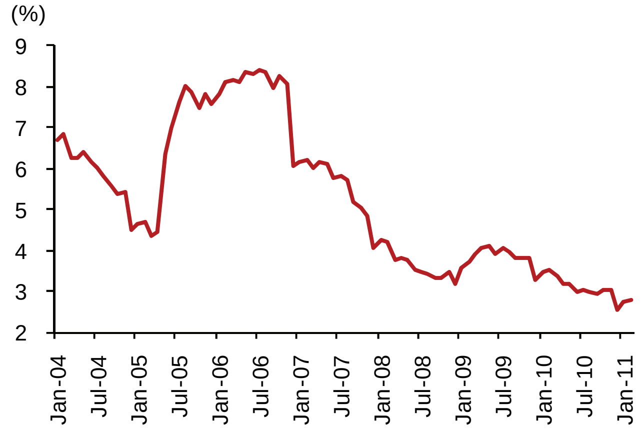
Key banking sector charts

Fig. 45: Indonesia banks: LDR



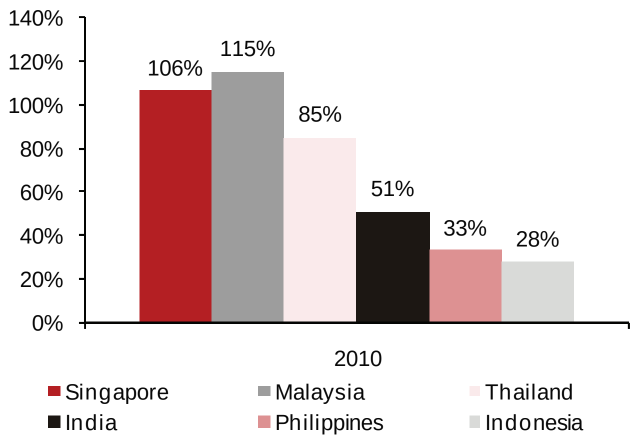
Source: Bank Indonesia

Fig. 46: Indonesia banks: gross NPL trend



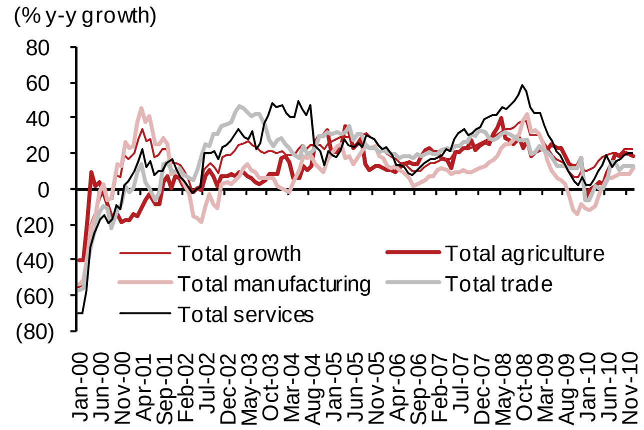
Source: Bank Indonesia

Fig. 47: Regional comparison: bank loans as a % of GDP



Source: Thomson Reuters Datastream, Bloomberg

Fig. 48: Indonesia: loan growth by key categories



Source: Bank Indonesia

Consumer sector – Alluring demographic structure

Janni Asman (+62 21) 2991 3345 janni.asman@nomura.com

Wilianto Ie (+62 21) 2991 3341 wilianto.ie@nomura.com

Last year, the country GDP hit USD3,000 per capita, a psychological limit that marks a similar achievement made by China in 2008. Indonesia's economic expansion is also characterised by the rise of the middle class, which we see sustaining growth in the consumer discretionary sector. Further, the relatively young population is a major boost factor for lifestyle consumption in Indonesia.

Demographics

With more than a quarter of the population (27.3%) aged 14 or below, and a fertility rate at 2.25 or around the replacement level, Indonesia's demographics are in top form to support economic expansion. On one hand, the population structure gives the country sufficient supply of workforce to maintain growth, and on the other hand, the population size is also likely to provide volume for consumer spending. This bodes particularly well for lifestyle consumption, which appeals most to the younger cohort.

Wage increment

The people's welfare has improved with job creation and increases in wages. Currently, disposable income in Indonesia makes up only around 10% of the minimum wage employee's income. With the wage increment moving above inflation, we expect consumer purchasing power to experience significant growth going forward.

Rise of middle class

The rise in income levels creating a bigger middle class in Indonesia and narrowing the wealth gap. We believe this will benefit Indonesia as it will push the society towards social stability. A more conducive environment should in turn increase awareness for improved healthcare, education, and eventually standards of living.

Top pick: Astra International

We believe Astra is the best proxy to capture Indonesia's growth story over the next five years, given that the company is well diversified in what we believe are the right sectors. Generally in the past three years, Astra generated around half of its consolidated earnings from domestic consumption (car sales), followed by key commodities at 35-40% (coal and palm oil), and financial services at 15%.

Fig. 49: Consumer sector valuation summary

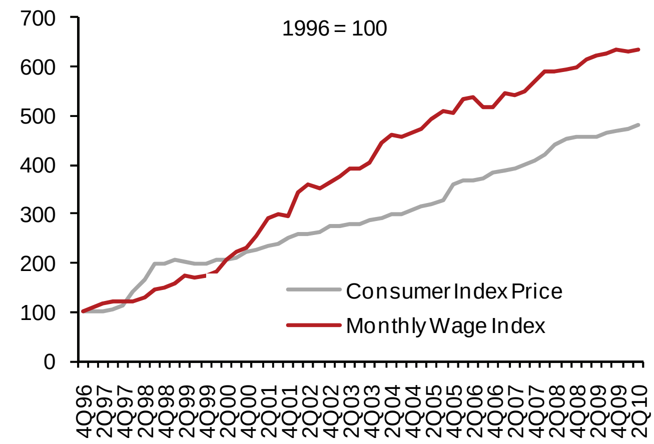
Price	Company	Rating	PER 11F (x)	PER 12F (x)	Earnings growth 11F (%)	Earnings growth 12F (%)	PB 11F (x)	ROE 11F (%)	EV/Ebitda 11F (x)	Ticker
59,100	Astra International	Buy	14.8	12.9	12.2	14.7	4.2	30.4	9.2	ASII IJ
44,500	Gudang Garam*	Not Rated	17.1	15.0	21.8	14.2	3.5	20.7	11.5	GGRM IJ
14,800	Unilever Indonesia*	Not Rated	28.9	25.7	9.3	12.5	25.0	90.8	20.5	UNVR IJ
5,200	Indofood Consumer*	Not Rated	16.1	14.3	12.2	12.4	3.0	20.4	8.6	ICBP IJ
12,950	Mayora Indah*	Not Rated	17.9	13.8	21.2	30.1	4.2	24.0	10.0	MYOR IJ
810	Ramayana*	Not Rated	13.1	11.3	15.6	16.1	2.0	16.1	7.1	RALS IJ
5,450	Indofood*	Not Rated	14.4	12.8	18.8	12.2	2.8	20.1	6.8	INDF IJ
1,350	Matahari*	Not Rated	9.7	N/A	N/A	N/A	1.0	6.3	N/A	MPPA IJ
3,400	Mitra Adiperkasa*	Not Rated	18.9	14.7	44.6	28.1	3.2	18.0	7.9	MAPI IJ

Note: pricing as of 1 June, 2011, *) based on market consensus

Source: Nomura Research, Bloomberg

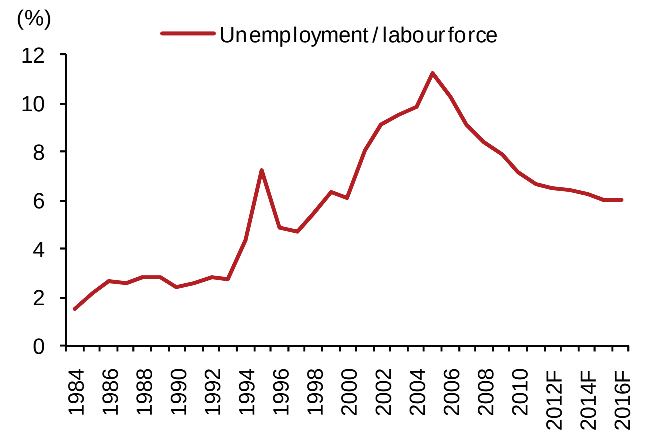
Interesting consumer sector charts

Fig. 50: Indonesia: Wage Index vs. CPI



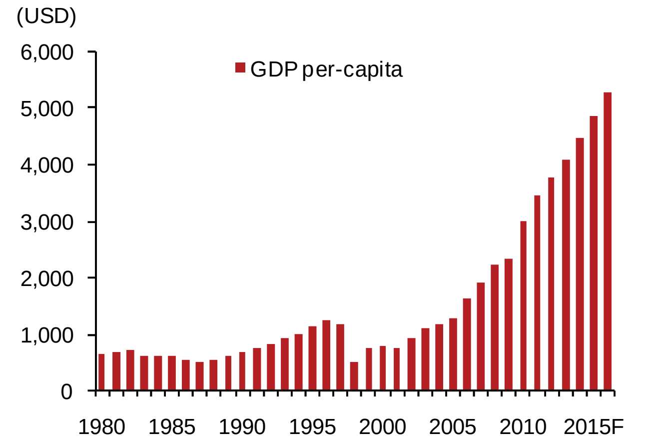
Source: Indonesian Statistic

Fig. 51: Indonesia: unemployment 1984 – 2016F



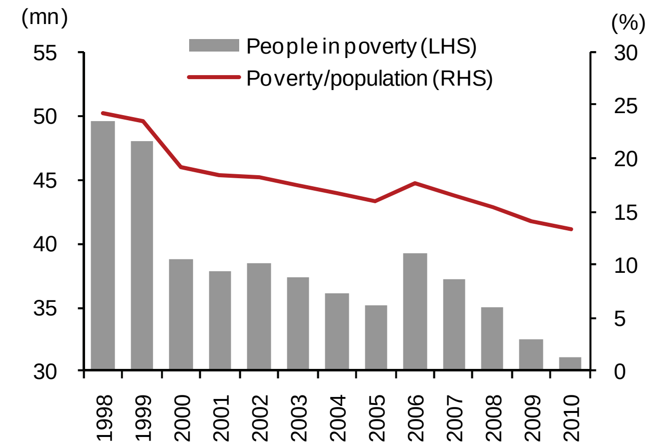
Source: International Monetary Fund

Fig. 52: Indonesia: GDP 1984 – 2016F



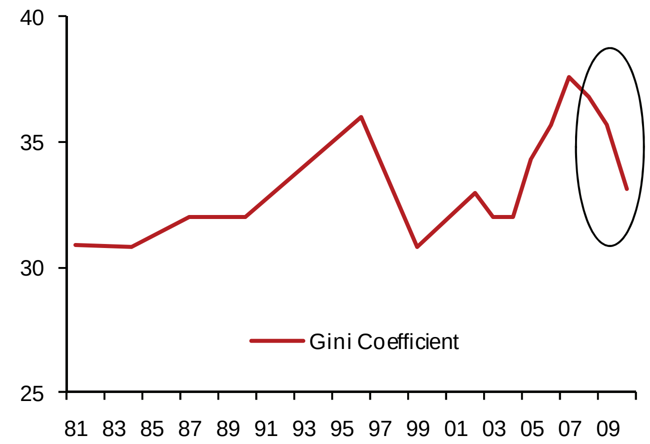
Source: International Monetary Fund

Fig. 53: Indonesia: poverty in recent years



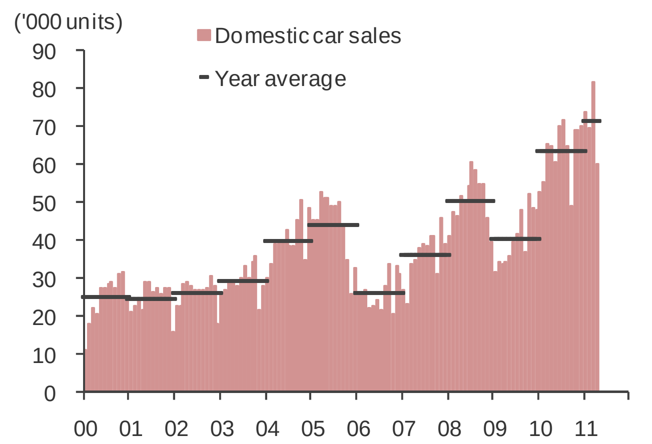
Source: Indonesia Statistics, World Bank, National Census

Fig. 54: Indonesia: income gap is narrowing after 2005



Source: National Socio - Economic Survey, Indonesia Statistics

Fig. 55: Indonesia: car sales



Source: The Association of Indonesia Automotive Industries

Telecom sector – Better execution for higher returns?

Sachin Gupta (+65) 6433 6968 sachin.gupta@nomura.com

We are relatively bullish on Indonesia's telecom sector compared to regional telecoms, but less so in the Indonesian stock market context given the subdued growth profile and lower incremental returns. Upside could come from potential growth in data revenues, while downside protection comes from dividend yield and low valuations. Telkom is our preference in the sector given its market leadership, extensive network, strong position outside Java and attractive valuation.

Structurally positive

In a regional context, we are relatively bullish on the Indonesian telecom sector given:

i) Benign competitive dynamics – the top-three players command 90% revenue share and this is unlikely to change materially over the next few years;

ii) Limited regulatory risks;

iii) Untapped data market potential, coupled with further voice growth, suggests upside revenue risks to our current 6-8% pa growth forecast over the next few years; and

iv) Reasonable valuations of 12-14x FY12-14F P/E. FCF outlook is also strong and rising with average FCF yields of 6-10%, which bodes well for dividends, too.

Inconsistencies remain

However, with inconsistent execution, along with fixed and wireless networks which aren't ubiquitous, we believe the revenue and earnings growth trajectories will be volatile and inconsistent amongst the operators.

Moreover, given the topographic challenges in Indonesia, incremental returns will likely be lower. We also note that EBITDA margins of 50-60% in Indonesia are one of the highest globally; hence, there is limited room for further operational efficiencies.

Expect solid growth in data revenue

As Indonesian operators try to expand their shares of the industry's revenues, they are increasingly looking at the data segment to substitute voice revenue growth which has become sluggish. Some of the key initiatives to drive data revenue growth include:

i) Proliferation of low-end smartphones;

ii) Selling customised devices for quick access to social networking sites; and

iii) Venturing into mCommerce and media portals.

Some of these initiatives appear to be working – data (ex-SMS) now contributes 13% to total revenues for the top-three players (versus less than 5% two years back) and we expect this to rise to 25% over the following two years.

Fig. 56: Indonesia telecoms: valuation summary

Price	Company	Rating	PER 11F (x)	PER 12F (x)	Earnings growth 11F (%)	Earnings growth 12F (%)	PB 11F (x)	ROE 11F (%)	EV/Ebitda 11F (x)	Ticker
5,250	Indosat	Buy	18.6	13.5	20.7	37.8	1.5	6.2	4.9	ISAT IJ
5,850	PT XL AXIATA	Neutral	13.4	11.7	22.8	15.3	3.4	28.2	5.6	EXCL IJ
7,750	Telekomunikasi Indo	Buy	12.6	11.6	5.3	9.5	2.4	20.2	4.1	TLKM IJ

Note: pricing as of 1 June, 2011

Source: Nomura Research

Fig. 57: Indonesia: key drivers of data growth

Drivers for operators	Drivers for subscribers
• To compensate slowing voice growth because of (i) rise in cellular penetration (ii) competition	• Overall rise in purchasing power
• Availability of reasonable spectrum	• Data enabled phones turning more affordable
• Increasing reach of mobile phones is simpler than increasing reach of PCs	• More mobility in work/personal life
• Government remains focussed to promote ICT services	• Attractive data applications, such as social networking

Source: Company data, Nomura research

Smartphone surge

Smartphones in Indonesia are now available for less than IDR1mn, or USD100–120, with some devices for as low as USD50 (with limited functionality). Even XL in a recent presentation flagged around a 15-20% drop in smartphone prices in the coming two years.

We expect an even bigger price fall, with recent mid- to low-end Android devices manufactured by Chinese suppliers gaining traction in key markets like India and China, and selling below the USD100 mark. This could alter the overall composition of the handset mix in Indonesia. Again, as per XL, the percentage of 3G+ handsets (including wireless broadband modem) could double by 2014, which amounts to an increase of 47mn devices to reach a total of 83mn.

Tariffs in Indonesia remain low – less than 5% of subscribers pay more than USD11 per month. Nevertheless, these tariffs have led to a rapid increase in mobile penetration, which has almost doubled over the past three years. This underpins our view that smartphones, if available at low prices, would see high levels of adoption. Overall, this bodes well for data growth in the country.

Social networking leading the Indonesian cyberspace

Social networking is gaining strong momentum in Indonesia:

- Indonesia has the second-largest Facebook population in the world of 37mn (second to the US);
- Mig33 recorded 43mn users worldwide in January 2011, out of which 23mn are in Indonesia (source: 'Indonesia Dominates Mig33 Online Social Networking', *Indonesia Finance Today*, 25 February, 2011);
- Indonesia ranks amongst top-10 'largest populations of Twitter users' in the world (source: 'Indonesia-Malaysia Twitter War: Size Does Matter', *Jakarta Globe*, 28 December, 2010).

But this is happening on the back of the following set of metrics, which are clearly lukewarm:

- Internet penetration of 12%;
- Broadband penetration of 4%; and
- PC penetration of 5%.

These factors highlight that while Indonesians have a strong tilt towards social networking, they are not being provided with the requisite number and variety of avenues/ media for these services. Nevertheless, this issue should be alleviated to some extent over the next few years – we expect more widespread Internet access, driven by broadband growth and higher adoption of data phones. As a result, we expect social networking to ride on rising Internet penetration, and gain significantly higher levels of traction over the next few years.

Opportunities in ex–Java region

We estimate that the Java region is running at high mobile penetration of >100%. Driven by such high saturation levels, we expect operators to try to capture higher shares of the market in the ex-Java region. Telkomsel remains quite strong in the ex-Java region, and so far it has been able to defend its position (interconnect rates have also worked in its favour). Its networks remain extensive, and its distribution structure is also ahead of peers, hence we think it is likely to maintain its lead. Nevertheless, ex-Java being a key revenue growth driver, other operators are increasingly focusing on expanding coverage or sharing networks to narrow the gap with the incumbent.

Telkomsel – will maintain lead at a higher cost

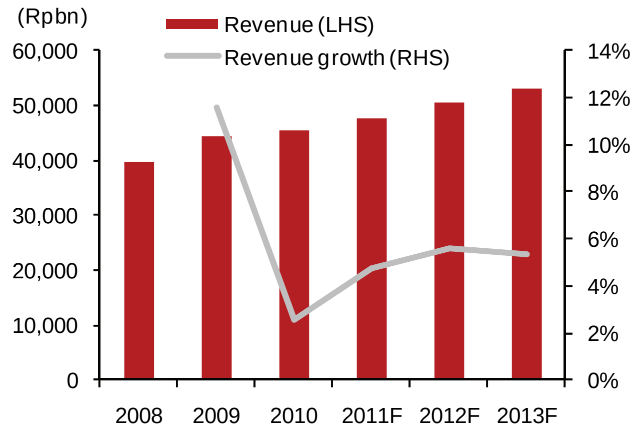
Telkomsel has lost 5% revenue share and 9% EBITDA in the past three years. XL is the main beneficiary. While we expect further revenue share declines, they are unlikely to be of the same magnitude. Importantly, most of the incremental growth will likely come from areas outside of Java, where Telkomsel commands a solid 60-80% share, and it also has the most extensive networks. Recent revision in interconnect rates – by a mere 3% to IDR250 – makes winning customers outright even more challenging for competitors.

Telkom now has a commanding market position with the following customer mix:

- 100mn wireless subs (GSM/3G);
- 19mn CDMA subs;
- 2mn fixed broadband customers (“Speedy”);
- 4mn wireless broadband subs (“Flash”); and
- 8mn fixed line subs, which is 99% share of the total market.

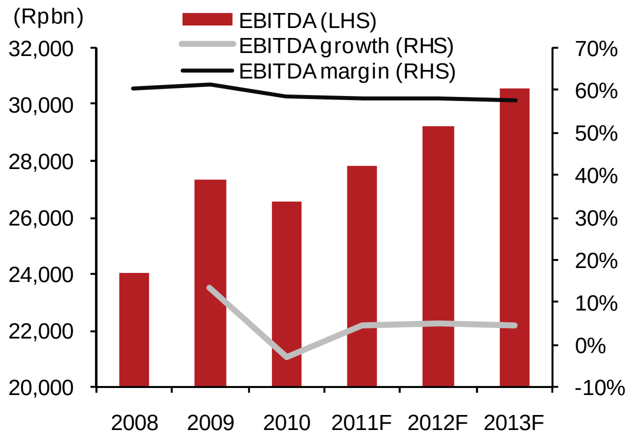
Telkom remains in a strong cash generative cycle – we forecast FCF growth of 51% over the next three years. The company is open to expanding offshore, but we don't see many large acquisitions on the horizon. Otherwise, we think the company will continue to return surplus cash to shareholders either via specials or share buy-backs. It recently announced a IDR3tn buyback for this year – the fourth buyback in the past six years.

Fig. 58: Telkomsel – revenue trends



Source: Company data, Nomura estimates

Fig. 59: Telkomsel – EBITDA trends



Source: Company data, Nomura estimates

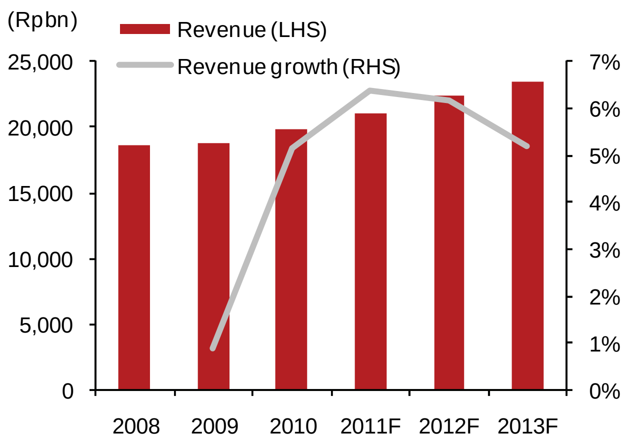
Indosat – the wildcard

There is tremendous potential in the market for Indosat; however, execution remains inconsistent. Plus, Indosat is up against two strong and credible operators, neither of whom are likely to cede share easily. The market is such that there aren’t enough inefficiencies left to be exploited for incumbent operators. Hence, the focus is very much on delivering on branding, distribution, networks – all of which should ensure Indosat can win and retain customers. We think its focus will remain on:

- Growing its revenue and EBITDA shares which are currently at 24% and 21%, respectively;
- Improving its network quality in existing areas and expanding its non-Java presence – we understand currently 35-40% of Indosat's total mobile subscribers are outside of Java, and there is significant scope to increase this further.
- Further growing the 3G and enterprise segment; and
- Optimising asset allocation and improving asset turnover – Indosat's ROIC last year was 5.4%, down from 10.7% in FY07, and this remains below the cost of capital (11.5%). Within this, asset turnover was 0.6x, well below Telkom's 1.1x.

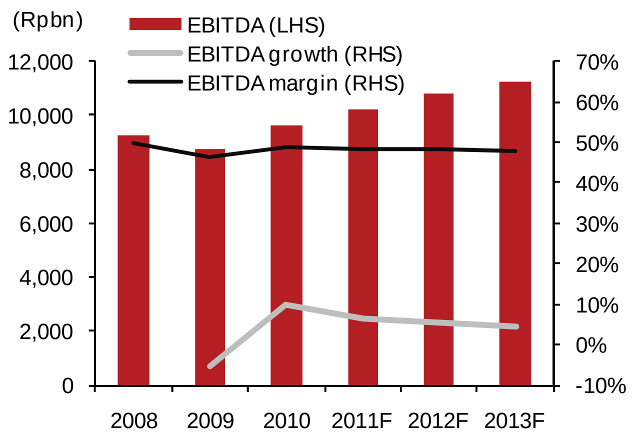
Some of Indosat's cost-management initiatives appear to be working well, as evidenced by its IDR972bn increase in total revenue in 2010, with only IDR121bn in additional costs – generating an incremental margin of 88%, which was higher than peers.

Fig. 60: Indosat – revenue trends



Source: Company data, Nomura estimates

Fig. 61: Indosat – EBITDA trends



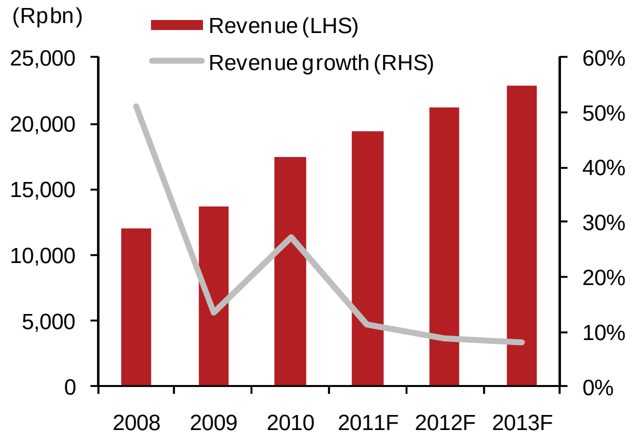
Source: Company data, Nomura estimates

XL – exemplary ROIC improvement

In the past 12 months, XL has increased its revenue and EBITDA shares by 1-2%. It has also improved its ROIC from a low 8% in FY08 to 18% currently – and we think it is likely to maintain these at current levels. It remains a very cost-focused company – in the past 12 months, it has improved its EBITDA margins to 52–53%.

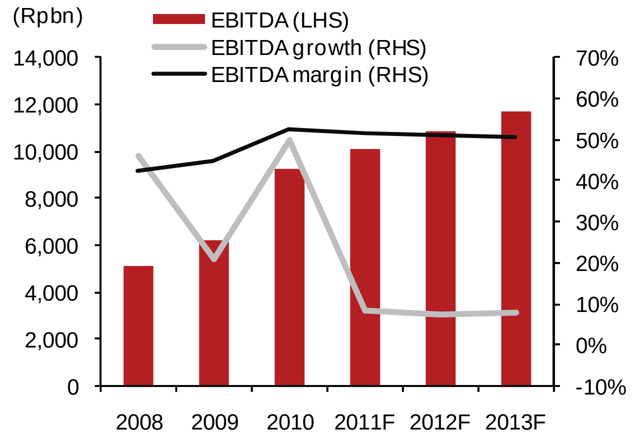
We believe Indonesia will remain a volatile market, and no doubt that XL can't win every quarter. Incremental share gains will come at a cost, and we expect margins to trend down from here onwards. We expect the company to focus on: 1) driving incremental operational efficiencies (better ROIC), as opposed to aggressively seeking market share gains; 2) further growth in data (contributed 41% of FY10 revenue) on higher investments and availability of cheaper handsets with Internet browsing facilities (XL also intends to continue pushing its per-minute Internet usage plans introduced in 4Q); and 3) using excess cash for dividends and deleveraging the balance sheet.

Fig. 62: XL – revenue trends



Source: Company data, Nomura estimates

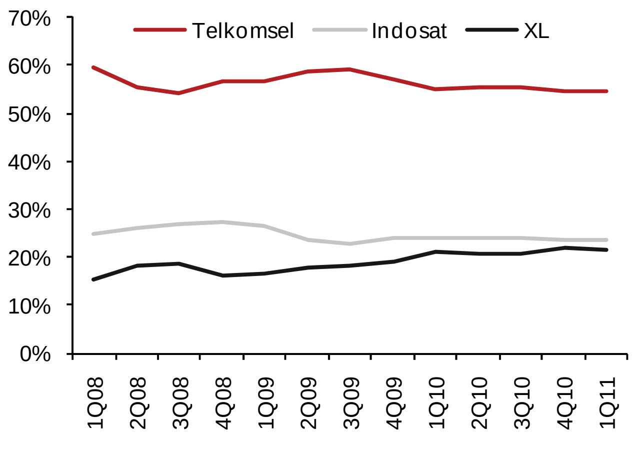
Fig. 63: XL – EBITDA trends



Source: Company data, Nomura estimates

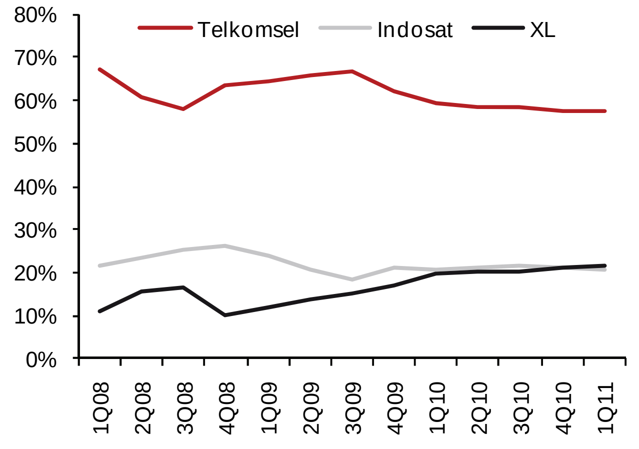
Interesting telecom sector charts

Fig. 64: Revenue share



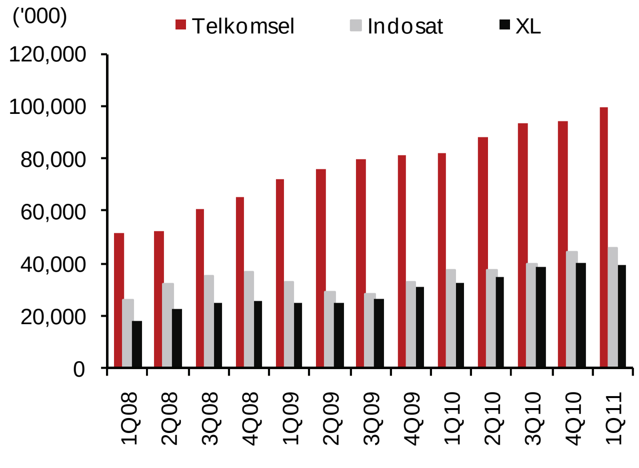
Source: Company data, Nomura Research

Fig. 65: EBITDA share



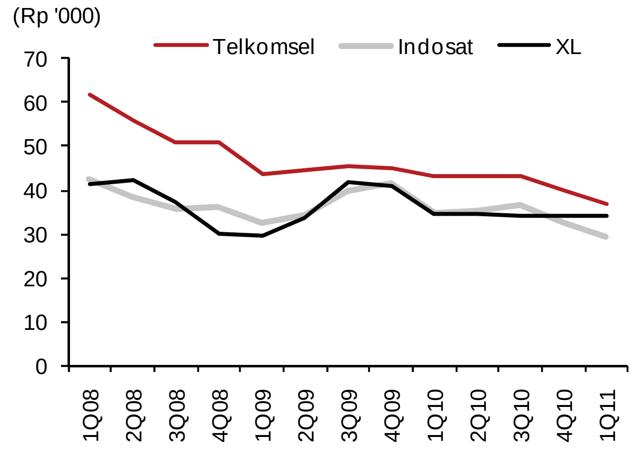
Source: Company data, Nomura Research

Fig. 66: Subscriber trends



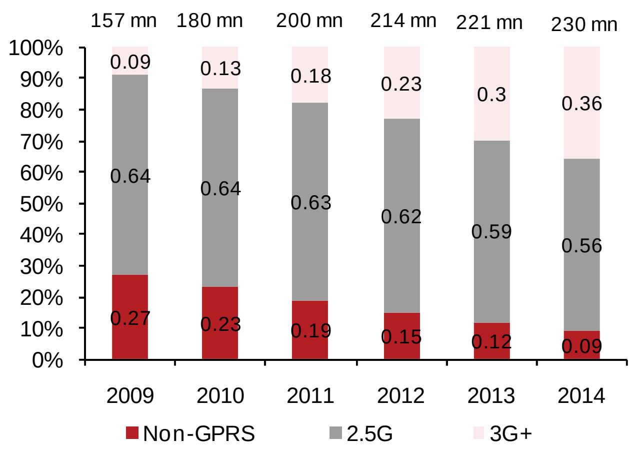
Source: Company data, Nomura Research

Fig. 67: ARPU trends



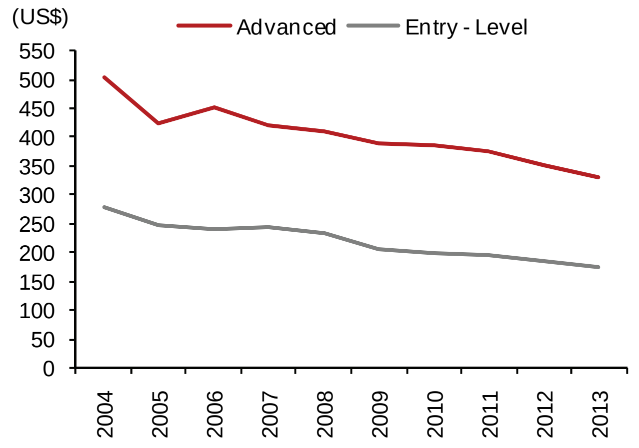
Source: Company data, Nomura Research

Fig. 68: Composition of handsets



Source: XL 1Q11 presentation

Fig. 69: Average price of entry-level vs enhanced smartphones



Source: XL 1Q11 presentation

Plantation sector – The key to global edible oil production growth

Ken Arieff Wong (+60 3) 2027 6895 kenarieff.wong@nomura.com

Indonesia is the largest producer of palm oil, supplying the world with more than 40% of total global supply. Palm oil is already the most consumed vegetable oil in the world and is likely to see the strongest growth in the coming years. Having a century-long history in large-scale agriculture, Indonesia is poised to benefit from this given: i) its ample suitable landbank; ii) sufficient human resources; and iii) continuously improving infrastructure. Corporate Indonesia recognizes this, with investments into the space growing rapidly in the past 10-years and showing no signs of slowing.

Positive medium-term outlook

Regionally, we continue to have a Bullish view on the palm oil sector, and the Indonesian market remains a top pick for the sector, especially given the positive growth prospects. We think that CPO prices are likely to remain above the long-term average in the next few years, supported by a continued tight supply scenario for global vegetable oils, sustained strong demand, relatively difficult outlook for any form of strong growth in other vegetable oils, as well as the relatively strong crude oil prices (offering downside support). Further, Indonesia's rapidly growing middle class should offer added support for local demand.

On the production front, steady expansion in planted hectarage, we think, will continue to support growth in the industry over the coming years. We get the sense that planters echo this upbeat view, with strong plans for expansion – although they cite increasingly tough competition to acquire landbank as a key concern. Stronger production growth and a positive outlook for prices will underpin an encouraging outlook for palm oil sector in the near to medium term, we believe.

Areas that would provide positive catalysts if improved

- Improvement of regulatory issues – including quicker land approvals and soothing environmental pushback would support the growth that planters desire to maintain.
- Review of the punitive export tax regime (with export tax as high as 25%) which has disadvantaged Indonesian planters relative to other planters (eg, Malaysian-based planters) by lowering revenue.
- Liquidity remains a concern for many investors, with the most liquid stock only doing US$3.5-4.8mn of Average Daily Trading Value a day (vs US$10-50 in Singapore and Malaysia). This we think will improve over time, eg, with the listing of PT Salim Ivomas Pratama.
- Further strong support for the Biofuels space (eg, increasing bio-diesel blending mandates) should underpin palm oil demand.

Liquid large-caps to ride CPO price strength, small-caps for growth

Within our large-cap coverage, London Sumatra is our top pick given compelling valuations (P/E only near its mean valuation, even with CPO prices at +1SD) and potential upside in production from its plantations rehabilitation going forward. Elsewhere, Astra Agro offers strong dividend yields and a large-cap index exposure (which would benefit from sustained strong CPO prices). However, we acknowledge that CPO production from smaller planters will show relatively strong growth relative to large-cap peers, given the smaller base. As such, companies such as Gozco Plantations (GZCO IJ, Not rated) and BW Plantations (BWPT IJ, Not rated) have been gaining increasing interest for exposure to plantations with strong sustainable growth in the medium term.

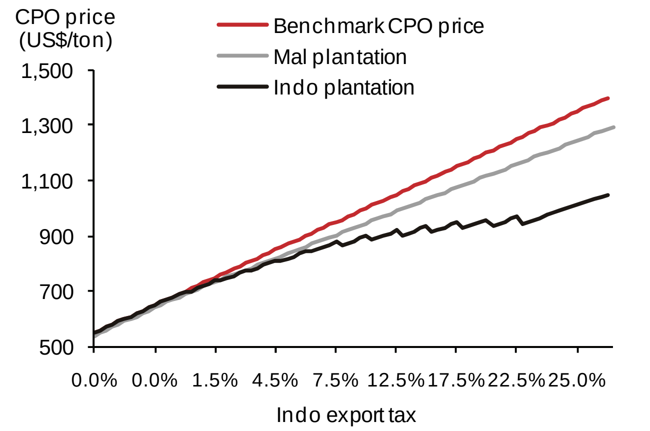
Fig. 70: Plantation valuation summary

Price	Company	Rating	PER 11F (x)	PER 12F (x)	Earnings growth 11F (%)	Earnings growth 12F (%)	PB 11F (x)	ROE 11F (%)	EV/Ebitda 11F (x)	Ticker
23,650	Astra Agro Lestari	Buy	13.3	11.7	55.9	13.4	4.7	37.6	8.7	AALI IJ
2,400	PP London Sumatra	Buy	12.0	11.2	32.1	6.9	3.1	27.7	7.8	LSIP IJ
1,210	BW Plantation*	Not Rated	15.4	12.4	42.8	23.7	3.5	25.0	10.6	BWPT IJ
3,450	Sampoerna Agro*	Not Rated	11.9	11.5	43.5	4.2	2.6	22.5	7.1	SGRO IJ
380	Gozco Plantations*	Not Rated	9.8	9.0	26.8	9.1	1.4	19.0	9.0	GZCO IJ
460	Bakrie Plantations*	Not Rated	12.6	11.0	68.9	13.9	0.7	6.5	9.4	UNSP IJ

Source: Nomura estimates, * Bloomberg

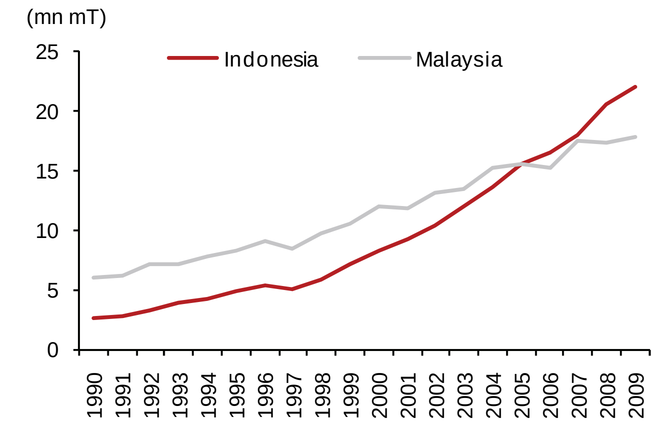
Note: pricing as of 1 June 2011

Fig. 71: Export duty on Indonesian palm oil could act as a positive catalyst if revised downwards



Source: Nomura estimates

Fig. 72: Indonesian CPO production has overtaken Malaysia



Source: USDA

Semen Gresik SMGR.JK SMGR IJ

CONSTRUCTION MATERIALS

NOMURA
EQUITY RESEARCH

Regaining position

Set to claw back market share on the back of capacity expansion

June 7, 2011

Rating Remains	**Buy**
Target price Remains	IDR 11,700
Closing price June 1, 2011	IDR 9,650
Potential upside	+21.2%

Action: BUY on capacity expansion volume growth

We rate Gresik as a BUY with a TP of IDR11,700. We expect Gresik to regain market share that it has lost due to capacity constraints. It plans to increase its production capacity by 20% to 25mn tpa next year, which we think will help it to maintain its status as the largest cement company in Indonesia over the next five years, with some 20% more capacity than the second-largest player.

Catalysts: macro newsflow, higher cement prices, operation of new capacity

We believe sustained strong economic growth will drive cement sales growth and absorb additional volume from capacity expansion. We assume a conservative 5% increase in cement selling prices for 2011 to reflect the higher production costs of cement players, including Gresik.

Valuation: TP of IDR11,700

For FY11F and FY12F, we forecast 13.8% and 21.2% EBITDA growth, driven by capacity expansion that we estimate will underpin volume growth of 6.6% and 16.1%, respectively. We derive our target price using DCF methodology to capture ongoing capacity expansion, assuming a cost of equity of 15% (risk-free rate of 6.5%, market risk of 15%, and beta of 1) and cost of debt of 9%. We consider Gresik the most attractive among domestic peers on P/E and EV/EBITDA valuation.

Risks: higher energy costs and economic downturn

Energy represents 50% of Gresik's production costs. Hence, rising energy costs, mainly coal, could hurt profitability and valuation.

31 Dec	FY10		FY11F		FY12F		FY13F
Currency (IDR)	Actual	Old	New	Old	New	Old	New
Revenue (bn)	14,344	15,955	15,955	19,011	19,011	21,135	21,135
Reported net profit (bn)	3,633	3,898	3,898	4,413	4,413	4,895	4,895
Normalised net profit (bn)	3,633	3,898	3,898	4,413	4,413	4,895	4,895
Normalised EPS	612.5	657.1	657.1	743.9	743.9	825.2	825.2
Norm. EPS growth (%)	9.2	7.3	7.3	13.2	13.2	10.9	10.9
Norm. P/E (x)	15.8	N/A	14.7	N/A	13.0	N/A	11.7
EV/EBITDA	10.9	N/A	10.1	N/A	7.9	N/A	7.0
Price/book (x)	4.8	N/A	4.0	N/A	3.5	N/A	3.0
Dividend yield (%)	3.2	N/A	3.1	N/A	3.5	N/A	3.8
ROE (%)	32.7	29.8	29.8	28.7	28.7	27.3	27.3
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash	net cash	net cash

Source: Nomura estimates

Key company data: *See page 2 for company data, and detailed price/index chart.*
Rating: *See report end for details of Nomura's rating system.*

Anchor themes

Indonesia's economy is set to take on a new growth trajectory. A robust macro story, coupled with deployment of fiscal budget, should help propel investment spending in infrastructure and further unlock the full potential of growth.

Nomura vs consensus

Nomura's EBITDA estimates are 2% below consensus for FY11F and 1% above consensus for FY12F.

Research analysts

Indonesia Basic Materials

Wilianto Ie - PTNI
wilianto.ie@nomura.com
+62 21 2991 3341

Andy Lesmana, CFA - PTNI
andy.lesmana@nomura.com
+62 21 2991 3344

Key data on Semen Gresik

Income statement (IDRbn)

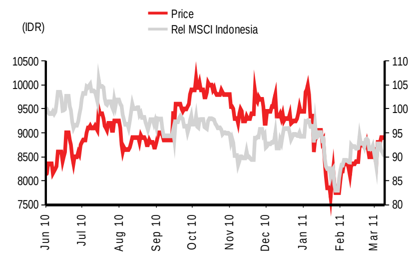
Year-end 31 Dec	FY09	FY10	FY11F	FY12F	FY13F
Revenue	**14,388**	**14,344**	**15,955**	**19,011**	**21,135**
Cost of goods sold	-7,614	-7,534	-8,377	-10,200	-11,528
Gross profit	**6,774**	**6,810**	**7,578**	**8,811**	**9,607**
SG&A	-2,432	-2,321	-2,543	-2,923	-3,242
Employee share expense					
Operating profit	**4,343**	**4,489**	**5,035**	**5,888**	**6,366**
EBITDA	**4,768**	**4,964**	**5,649**	**6,848**	**7,350**
Depreciation	-425	-475	-614	-959	-984
Amortisation					
EBIT	4,343	4,489	5,035	5,888	6,366
Net interest expense	306	203	173	12	184
Associates & JCEs					
Other income	7	30	30	31	32
Earnings before tax	**4,655**	**4,723**	**5,238**	**5,931**	**6,582**
Income tax	-1,302	-1,064	-1,310	-1,483	-1,645
Net profit after tax	**3,353**	**3,659**	**3,929**	**4,449**	**4,936**
Minority interests	-26	-26	-31	-36	-41
Other items					
Preferred dividends					
Normalised NPAT	**3,326**	**3,633**	**3,898**	**4,413**	**4,895**
Extraordinary items					
Reported NPAT	**3,326**	**3,633**	**3,898**	**4,413**	**4,895**
Dividends	-1,606	-1,822	-1,754	-1,986	-2,203
Transfer to reserves	**1,721**	**1,811**	**2,144**	**2,427**	**2,692**
Valuation and ratio analysis					
FD normalised P/E (x)	17.2	15.8	14.7	13.0	11.7
FD normalised P/E at price target (x)	20.9	19.1	17.8	15.7	14.2
Reported P/E (x)	17.2	15.8	14.7	13.0	11.7
Dividend yield (%)	2.8	3.2	3.1	3.5	3.8
Price/cashflow (x)	13.2	14.9	14.8	11.3	10.1
Price/book (x)	5.6	4.8	4.0	3.5	3.0
EV/EBITDA (x)	11.2	10.9	10.1	7.9	7.0
EV/EBIT (x)	12.3	12.1	11.3	9.2	8.0
Gross margin (%)	47.1	47.5	47.5	46.3	45.5
EBITDA margin (%)	33.1	34.6	35.4	36.0	34.8
EBIT margin (%)	30.2	31.3	31.6	31.0	30.1
Net margin (%)	23.1	25.3	24.4	23.2	23.2
Effective tax rate (%)	28.0	22.5	25.0	25.0	25.0
Dividend payout (%)	48.3	50.1	45.0	45.0	45.0
Capex to sales (%)	7.9	28.7	31.9	2.5	2.4
Capex to depreciation (x)	2.7	8.7	8.3	0.5	0.5
ROE (%)	36.4	32.7	29.8	28.7	27.3
ROA (pretax %)	55.8	43.8	35.8	35.6	38.0
Growth (%)					
Revenue	17.8	-0.3	11.2	19.2	11.2
EBITDA	23.5	4.1	13.8	21.2	7.3
EBIT	28.2	3.4	12.2	17.0	8.1
Normalised EPS	31.8	9.2	7.3	13.2	10.9
Normalised FDEPS	31.8	9.2	7.3	13.2	10.9
Per share					
Reported EPS (IDR)	560.82	612.53	657.11	743.93	825.24
Norm EPS (IDR)	560.82	612.53	657.11	743.93	825.24
Fully diluted norm EPS (IDR)	560.82	612.53	657.11	743.93	825.24
Book value per share (IDR)	1,719.24	2,024.18	2,385.59	2,794.75	3,248.63
DPS (IDR)	270.72	307.17	295.70	334.77	371.36

Source: Nomura estimates

Notes

Capacity expansion to drive volume and sales growth

Price and price relative chart (one year)



(%)	1M	3M	12M
Absolute (IDR)	1.6	11.6	16.3
Absolute (USD)	1.9	15.0	25.7
Relative to index	1.6	1.4	-12.6
Market cap (USDmn)	6,704.0		
Estimated free float (%)			
52-week range (IDR)	10350/7250		
3-mth avg daily turnover (USDmn)	6.25		
Major shareholders (%)			
Government	51.0		
Public	49.0		

Cashflow (IDRbn)

Year-end 31 Dec	FY09	FY10	FY11F	FY12F	FY13F
EBITDA	4,768	4,964	5,649	6,848	7,350
Change in working capital	530	-284	-673	-339	-225
Other operating cashflow	-964	-828	-1,106	-1,440	-1,429
Cashflow from operations	**4,333**	**3,853**	**3,870**	**5,068**	**5,695**
Capital expenditure	-1,130	-4,123	-5,096	-481	-514
Free cashflow	**3,203**	**-271**	**-1,227**	**4,587**	**5,182**
Reduction in investments	-1,450	1,077	282	-12	-13
Net acquisitions	0	0	0	0	0
Reduction in other LT assets	-38	25	-2	-3	-3
Addition in other LT liabilities	49	75	38	59	53
Adjustments	0	0	0	0	0
Cashflow after investing acts	**1,764**	**907**	**-910**	**4,632**	**5,219**
Cash dividends	-1,606	-1,822	-1,754	-1,986	-2,203
Equity issue	404	0	0	0	0
Debt issue	-78	485	119	-23	-20
Convertible debt issue					
Others	-7	-15	-15	-18	-21
Cashflow from financial acts	**-1,286**	**-1,352**	**-1,650**	**-2,027**	**-2,243**
Net cashflow	**478**	**-446**	**-2,560**	**2,605**	**2,975**
Beginning cash	3,757	4,235	3,789	1,229	3,834
Ending cash	4,235	3,789	1,229	3,834	6,809
Ending net debt	-4,036	-3,103	-424	-3,052	-6,047

Source: Nomura estimates

Notes

Operating cash flow is expected to increase significantly post completion of new plant, turning free cash flows to positive trend

Balance sheet (IDRbn)

As at 31 Dec	FY09	FY10	FY11F	FY12F	FY13F
Cash & equivalents	4,235	3,789	1,229	3,834	6,809
Marketable securities	1,049	113	150	150	150
Accounts receivable	1,425	1,717	1,967	2,344	2,606
Inventories	1,408	1,624	1,721	2,096	2,369
Other current assets	91	94	146	174	193
Total current assets	**8,207**	**7,338**	**5,214**	**8,597**	**12,127**
LT investments	565	423	104	116	129
Fixed assets	4,014	7,663	12,144	11,667	11,196
Goodwill					
Other intangible assets					
Other LT assets	165	140	143	145	148
Total assets	**12,951**	**15,563**	**17,605**	**20,525**	**23,600**
Short-term debt	91	87	23	20	12
Accounts payable	776	892	918	1,118	1,263
Other current liabilities	1,427	1,539	1,239	1,479	1,662
Total current liabilities	**2,295**	**2,518**	**2,180**	**2,616**	**2,938**
Long-term debt	107	600	782	762	750
Convertible debt					
Other LT liabilities	231	306	344	403	456
Total liabilities	**2,633**	**3,423**	**3,306**	**3,781**	**4,143**
Minority interest	120	133	149	167	187
Preferred stock	0	0	0	0	0
Common stock	2,051	2,051	2,051	2,051	2,051
Retained earnings	8,146	9,955	12,099	14,526	17,218
Proposed dividends					
Other equity and reserves					
Total shareholders' equity	**10,198**	**12,006**	**14,150**	**16,577**	**19,269**
Total equity & liabilities	**12,951**	**15,563**	**17,605**	**20,525**	**23,600**
Liquidity (x)					
Current ratio	3.58	2.91	2.39	3.29	4.13
Interest cover	na	na	na	na	na
Leverage					
Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash
Activity (days)					
Days receivable	37.0	40.0	42.1	41.5	42.7
Days inventory	73.0	73.4	72.9	68.5	70.7
Days payable	37.9	40.4	39.4	36.5	37.7
Cash cycle	72.1	73.0	75.6	73.5	75.7

Source: Nomura estimates

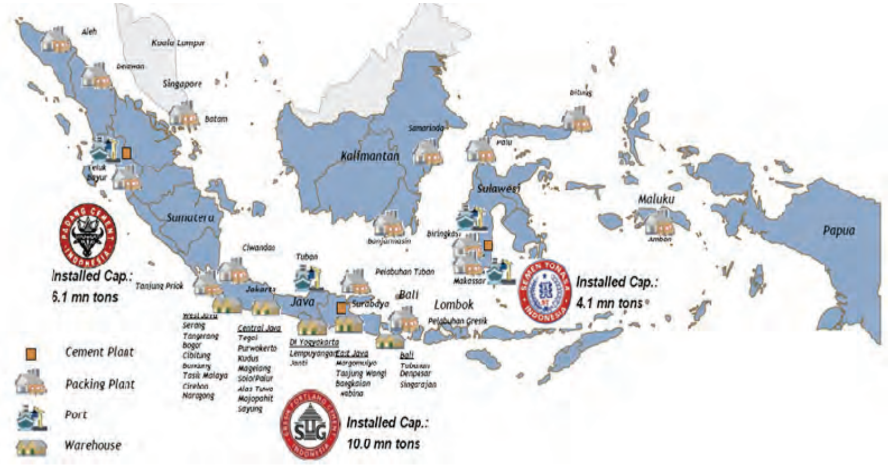
Notes

We expect Gresik to remain conservative in managing its balance sheet and net leverage to remain low

Key charts

Fig. 73: Gresik's distribution network

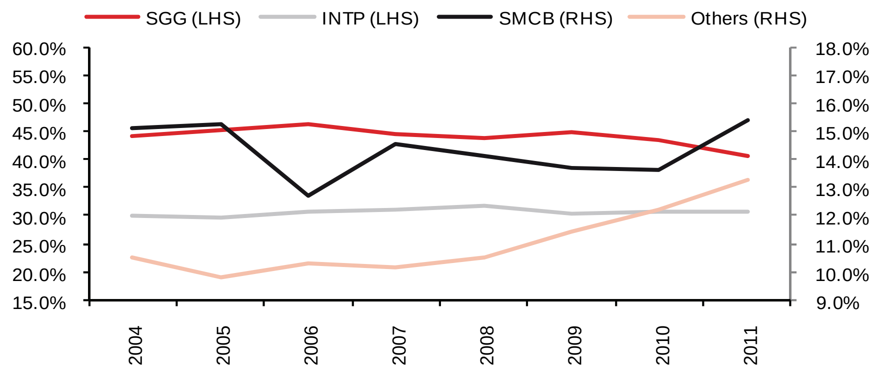
Gresik has the widest distribution network, with capacities located in 3 different main islands



Source: Company data

Fig. 74: Historical trend of domestic market share of cement companies

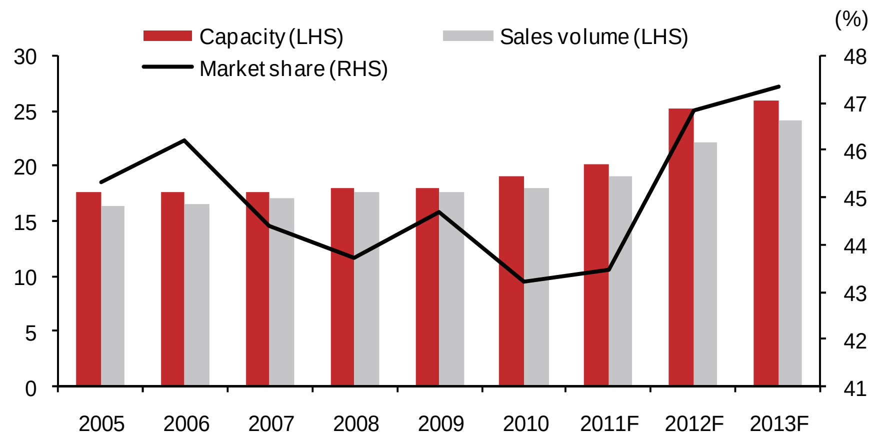
Gresik has been losing market share given limited capacity



Source: Indonesia Cement Association

Fig. 75: Gresik is increasing its capacity by 20% starting 2012

Capacity to increase to 25mtpa allowing company to re-gain its market share



Source: Indonesia Cement Association, Company data and Bloomberg

Company overview

Gresik is the largest cement company in terms of capacity, with the widest distribution network in the country. The company offers growth prospects as capacity expansions coming on stream as early as next year have a strong history of good dividend payout.

Gresik is the largest cement company in Indonesia, currently operating with 20mn tonnes per annum of production capacity, spread across three locations in Indonesia. With its subsidiaries present on three main islands in Indonesia, we believe the company also has the best market coverage across the nation, which should enable it to capture growth in cement demand nationwide. The Indonesian government is the largest shareholder of the company.

Gresik, established in 1957, was publicly listed in 1991. In 1995, along with the government's push for privatisation, the company conducted a rights issue and acquired sister state-owned cement companies Semen Padang in West Sumatera and Semen Tonasa in Sulawesi.

In 1998, also within the privatization framework, the Indonesian government sold its 14% stake to Cemex, which further increased its ownership in the company to 25% through market purchase of Gresik's shares. In 2006, Rajawali Group, a private Indonesian business conglomerate, bought Cemex's 25% equity stake and became the second-largest shareholder in the company. In early 2010, Rajawali placed out its Gresik shares to the market, leaving it with a minority 1% stake.

Set to regain market share

Over the past five years, on account of its limited capacity expansion, Gresik has seen its domestic market share decline from 46% to 43% in 2010. We believe the trend is set to reverse starting next year, when new capacity commences commercial operation, increasing its overall capacity by 20%. Assuming a 75% utilization rate for the new capacity and considering a lack of new additional capacity in the market, we expect Gresik to regain its market share over the next two years.

This additional capacity, in our opinion, should also help Gresik shift its earnings growth base from price increase-driven growth to more volume growth.

Dividend appeal

Gresik has been a strong dividend play for investors, thanks to government ownership that typically requires a significant dividend payout from its state-owned companies. The company has a historical record of a 50% dividend payout ratio.

Valuation methodology

We derive our TP of IDR11,700 using the DCF method to capture the company's growth potential resulting from its capacity expansion. We assume a cost of equity of 15% (derived from a risk-free rate of 6.5%, market risk of 15%, and beta of 1), a cost of debt of 9% and a target leverage capital mix of 70% net debt-to-equity. We use 8x EV/EBITDA for our terminal value in 2020F.

Risks that may impede the achievement of the target price

Downside risks include: 1) delays in commercial operations of its new plant; 2) lower-than-expected price increases; and 3) higher production costs. Upside risks: 1) selling prices come in higher than our expectations; and 2) more aggressive capacity expansion through reasonably priced acquisitions.

Jasa Marga JSMR.JK JSMR IJ

TRANSPORT/LOGISTICS

NOMURA
EQUITY RESEARCH

Beneficiary of upcoming land law

New land law to accelerate toll road development and enhance traffic growth

June 7, 2011

Rating Remains	Buy
Target price Remains	IDR 4,100
Closing price June 1, 2011	IDR 3,500
Potential upside	+17.1%

Action: Main beneficiary of land acquisition law; reiterate BUY

Jasa Marga, one of our most preferred stocks in the Indonesian infrastructure sector, stands to be a key beneficiary of the new land acquisition law. We believe this will accelerate toll road development and significantly improve Jasa Marga's growth profile (~185km of additional toll roads or 35% of Jasa Marga's existing toll road are pending development, according to the company).

Catalysts: New land law legislation and tariff increase

Parliament is currently evaluating the draft of the new land law and is expected to pass the law during the upcoming plenary meeting in early 3Q11. In addition, most of Jasa Marga's tariffs are due for adjustment in 4Q11, which should drive revenue growth in 2012.

Valuation: TP derived on DCF valuation

We expect Jasa Marga to record a 12% EBITDA CAGR over the next three years on a revenue CAGR of 13%. Traffic volume growth, tariff adjustments and the commencement of new toll road commercial operations will be key growth drivers, in our view. As such, we value Jasa Marga on a DCF basis, with our TP of IDR4,100 assuming a cost of equity of 15% (risk-free rate of 6.5%, market risk of 15% and beta of 1) and cost of debt of 9%.

Risks: delayed land law and lower-than-expected tariff adjustments

Any delay in the passing of the new land law (or even cancellation at the parliament level) could prolong toll road development and reduce potential future traffic volumes.

31 Dec	FY10	FY11F		FY12F		FY13F	
Currency (IDR)	Actual	Old	New	Old	New	Old	New
Revenue (bn)	4,380	4,954	4,954	5,793	5,793	6,399	6,399
Reported net profit (bn)	1,193	1,159	1,159	1,429	1,429	1,295	1,295
Normalised net profit (bn)	1,193	1,159	1,159	1,429	1,429	1,295	1,295
Normalised EPS	294.5	289.6	289.6	360.7	360.7	331.7	331.7
Norm. EPS growth (%)	39.1	-1.7	-1.7	24.6	24.6	-8.0	-8.0
Norm. P/E (x)	11.9	N/A	12.1	N/A	9.7	N/A	10.6
EV/EBITDA	11.8	N/A	11.1	N/A	10.2	N/A	10.0
Price/book (x)	3.1	N/A	2.8	N/A	2.5	N/A	2.3
Dividend yield (%)	2.5	N/A	1.7	N/A	2.1	N/A	1.9
ROE (%)	16.0	14.3	14.3	16.0	16.0	13.2	13.2
Net debt/equity (%)	60.6	72.1	72.1	95.4	95.4	103.1	103.1

Source: Nomura estimates

Key company data: *See page 2 for company data, and detailed price/index chart.*
Rating: *See report end for details of Nomura's rating system.*

Anchor themes

Indonesia's economy is set to take on a new growth trajectory. A robust macro story, coupled with deployment of fiscal budget, should help propel investment spending in infrastructure and further unlock growth potential.

Nomura vs consensus

Nomura's 2011-12F EBITDA estimates are 6-7% below market consensus.

Research analysts

Indonesia Basic Materials

Wilianto Ie - PTNI
wilianto.ie@nomura.com
+62 21 2991 3341

Andy Lesmana, CFA - PTNI
andy.lesmana@nomura.com
+62 21 2991 3344

Key data on Jasa Marga

Income statement (IDRbn)

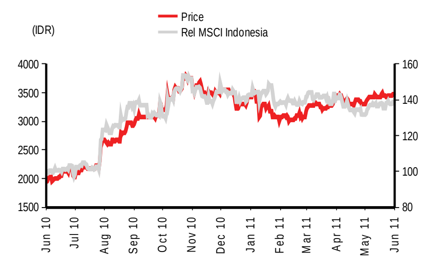
Year-end 31 Dec	FY09	FY10	FY11F	FY12F	FY13F
Revenue	**3,692**	**4,380**	**4,954**	**5,793**	**6,399**
Cost of goods sold	-1,528	-1,646	-2,021	-2,346	-2,699
Gross profit	**2,164**	**2,734**	**2,933**	**3,447**	**3,700**
SG&A	-648	-745	-839	-947	-1,106
Employee share expense					
Operating profit	**1,516**	**1,989**	**2,094**	**2,501**	**2,594**
EBITDA	**1,849**	**2,412**	**2,689**	**3,202**	**3,431**
Depreciation	-333	-423	-595	-701	-837
Amortisation					
EBIT	1,516	1,989	2,094	2,501	2,594
Net interest expense	-445	-533	-653	-720	-977
Associates & JCEs					
Other income	23	20	20	20	20
Earnings before tax	**1,094**	**1,476**	**1,462**	**1,801**	**1,637**
Income tax	-212	-292	-292	-360	-327
Net profit after tax	**882**	**1,184**	**1,169**	**1,440**	**1,309**
Minority interests	-14	9	-10	-12	-14
Other items					
Preferred dividends					
Normalised NPAT	**868**	**1,193**	**1,159**	**1,429**	**1,295**
Extraordinary items					
Reported NPAT	**868**	**1,193**	**1,159**	**1,429**	**1,295**
Dividends	-353	-596	-406	-500	-453
Transfer to reserves	**515**	**597**	**753**	**929**	**842**
Valuation and ratio analysis					
FD normalised P/E (x)	16.5	11.9	12.1	9.7	10.6
FD normalised P/E at price target (x)	19.4	13.9	14.2	11.4	12.4
Reported P/E (x)	16.5	11.9	12.1	9.7	10.6
Dividend yield (%)	1.5	2.5	1.7	2.1	1.9
Price/cashflow (x)	14.0	8.7	8.0	5.9	7.0
Price/book (x)	3.3	3.1	2.8	2.5	2.3
EV/EBITDA (x)	14.8	11.8	11.1	10.2	10.0
EV/EBIT (x)	18.0	14.3	14.3	13.1	13.3
Gross margin (%)	58.6	62.4	59.2	59.5	57.8
EBITDA margin (%)	50.1	55.1	54.3	55.3	53.6
EBIT margin (%)	41.1	45.4	42.3	43.2	40.5
Net margin (%)	23.5	27.2	23.4	24.7	20.2
Effective tax rate (%)	19.4	19.8	20.0	20.0	20.0
Dividend payout (%)	40.7	50.0	35.0	35.0	35.0
Capex to sales (%)	46.9	59.8	57.7	83.3	50.4
Capex to depreciation (x)	5.2	6.2	4.8	6.9	3.9
ROE (%)	12.6	16.0	14.3	16.0	13.2
ROA (pretax %)	12.6	14.3	12.9	12.7	11.2
Growth (%)					
Revenue	10.1	18.6	13.1	16.9	10.5
EBITDA	8.0	30.4	11.5	19.1	7.2
EBIT	10.6	31.2	5.3	19.4	3.7
Normalised EPS	103.6	39.1	-1.7	24.6	-8.0
Normalised FDEPS	103.6	39.1	-1.7	24.6	-8.0
Per share					
Reported EPS (IDR)	211.68	294.46	289.58	360.69	331.68
Norm EPS (IDR)	211.68	294.46	289.58	360.69	331.68
Fully diluted norm EPS (IDR)	211.68	294.46	289.58	360.69	331.68
Book value per share (IDR)	1,060.15	1,146.36	1,262.54	1,405.72	1,536.95
DPS (IDR)	52.10	88.28	60.31	74.61	67.88

Source: Nomura estimates

Notes

Negative cashflow through 2013F given capex requirement on new toll road projects

Price and price relative chart (one year)



(%)	1M	3M	12M
Absolute (IDR)	6.1	8.5	79.5
Absolute (USD)	6.4	11.8	94.0
Relative to index	6.0	-1.6	50.6
Market cap (USDmn)	2,787.5		
Estimated free float (%)	30.0		
52-week range (IDR)	3900/1900		
3-mth avg daily turnover (USDmn)	3.19		
Major shareholders (%)			
Government of Indonesia	70.0		
Public	30.0		

Cashflow (IDRbn)

Year-end 31 Dec	FY09	FY10	FY11F	FY12F	FY13F
EBITDA	1,849	2,412	2,689	3,202	3,431
Change in working capital	127	278	277	438	-40
Other operating cashflow	-954	-1,057	-1,206	-1,280	-1,451
Cashflow from operations	**1,022**	**1,633**	**1,760**	**2,359**	**1,939**
Capital expenditure	-1,732	-2,618	-2,860	-4,825	-3,222
Free cashflow	**-710**	**-985**	**-1,100**	**-2,466**	**-1,283**
Reduction in investments	448	14	27	0	0
Net acquisitions	0	0	0	0	0
Reduction in other LT assets	-608	77	-320	-271	-223
Addition in other LT liabilities	0	41	23	66	44
Adjustments	445	252	281	220	166
Cashflow after investing acts	**-425**	**-601**	**-1,089**	**-2,451**	**-1,296**
Cash dividends	-353	-596	-406	-500	-453
Equity issue	-22	-40	0	0	0
Debt issue	506	1,870	502	2,035	1,302
Convertible debt issue	0	0	0	0	0
Others	231	65	54	91	155
Cashflow from financial acts	**362**	**1,299**	**150**	**1,627**	**1,004**
Net cashflow	**-63**	**698**	**-938**	**-824**	**-291**
Beginning cash	3,377	3,314	4,012	3,074	2,249
Ending cash	3,314	4,012	3,074	2,249	1,958
Ending net debt	3,514	4,686	6,126	8,986	10,579

Source: Nomura estimates

Notes

High capex requirements to complete development of existing concessions likely to keep cashflow negative

Balance sheet (IDRbn)

As at 31 Dec	FY09	FY10	FY11F	FY12F	FY13F
Cash & equivalents	3,314	4,012	3,074	2,249	1,958
Marketable securities	41	27	0	0	0
Accounts receivable	0	0	0	0	0
Inventories	0	0	0	0	0
Other current assets	75	52	56	65	72
Total current assets	**3,430**	**4,091**	**3,130**	**2,315**	**2,030**
LT investments	116	116	116	116	116
Fixed assets	11,506	13,695	15,964	20,093	22,482
Goodwill	37	43	39	35	31
Other intangible assets					
Other LT assets	1,084	1,007	1,327	1,597	1,821
Total assets	**16,173**	**18,952**	**20,576**	**24,156**	**26,480**
Short-term debt	2,183	1,440	2,452	1,404	1,542
Accounts payable	104	130	136	159	175
Other current liabilities	679	908	1,183	1,607	1,557
Total current liabilities	**2,966**	**2,478**	**3,771**	**3,170**	**3,274**
Long-term debt	4,645	7,258	6,747	9,831	10,995
Convertible debt					
Other LT liabilities	817	858	881	947	992
Total liabilities	**8,428**	**10,594**	**11,400**	**13,948**	**15,261**
Minority interest	562	619	684	787	956
Preferred stock	0	0	0	0	0
Common stock	5,735	5,735	5,735	5,735	5,735
Retained earnings	1,448	2,004	2,757	3,686	4,528
Proposed dividends					
Other equity and reserves					
Total shareholders' equity	**7,183**	**7,739**	**8,492**	**9,421**	**10,263**
Total equity & liabilities	**16,173**	**18,952**	**20,576**	**24,156**	**26,480**
Liquidity (x)					
Current ratio	1.16	1.65	0.83	0.73	0.62
Interest cover	3.4	3.7	3.2	3.5	2.7
Leverage					
Net debt/EBITDA (x)	1.90	1.94	2.28	2.81	3.08
Net debt/equity (%)	48.9	60.6	72.1	95.4	103.1
Activity (days)					
Days receivable	0.0	0.0	0.0	0.0	0.0
Days inventory	0.0	0.0	0.0	0.0	0.0
Days payable	18.2	25.9	24.0	23.0	22.6
Cash cycle	-18.2	-25.9	-24.0	-23.0	-22.6

Source: Nomura estimates

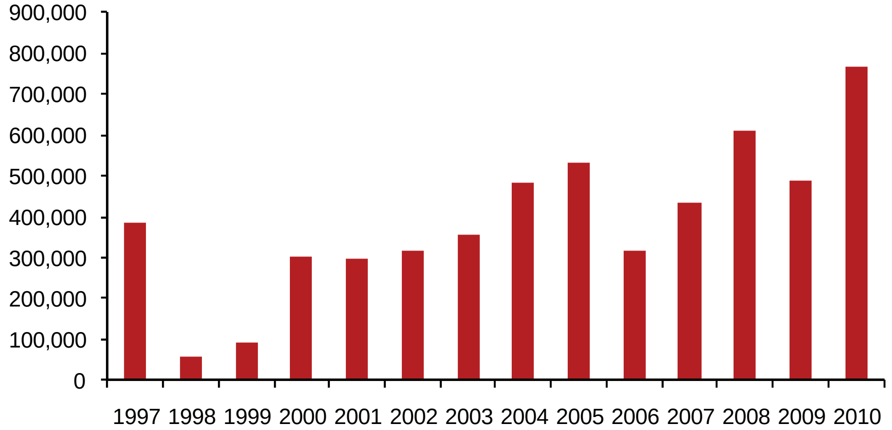
Notes

Net leverage to rise as the company raises new funding for new capex; we assume no new equity issue

Key charts

Fig. 76: Indonesia: historical car sales trend

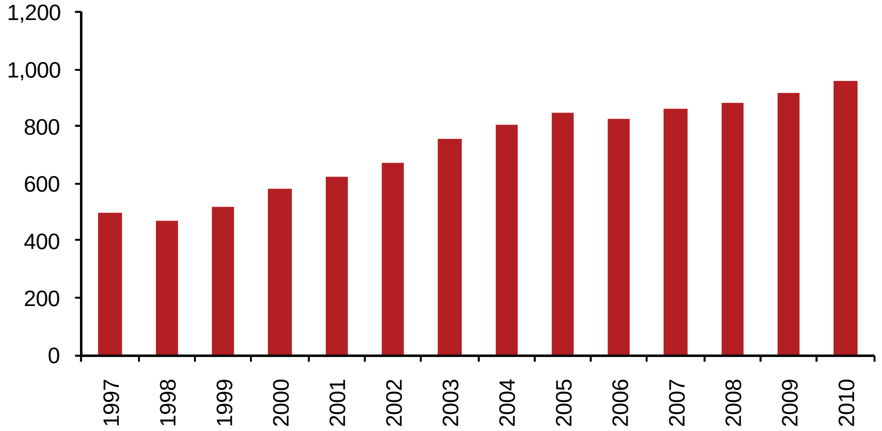
Car sales growth in Indonesia recorded an 11% CAGR over the past 10 years



Source: Gaikindo, Nomura research

Fig. 77: Jasa Marga: historical traffic volume trend

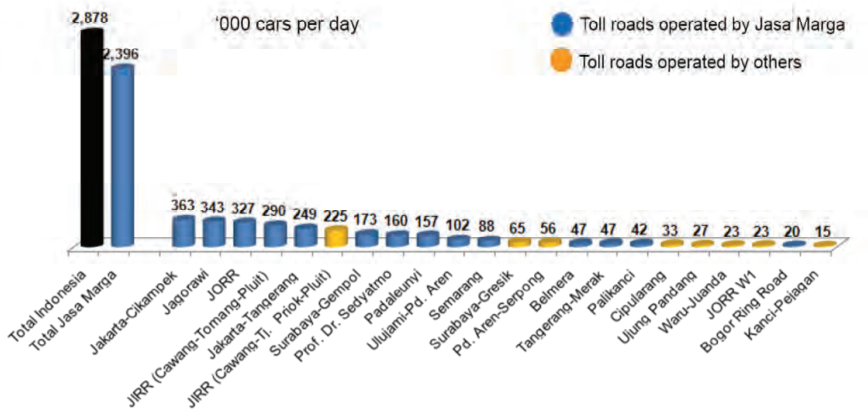
Jasa Marga's traffic volume has been growing by only 5% pa, capped by capacity



Source: Company data

Fig. 78: Indonesia: toll road comparison (as of December 2010)

Jasa Marga controls more than 80% of toll road traffic in Indonesia



Source: Company data

Company overview

Jasa Marga is Indonesia's main toll road company, operating more than 70% of total toll roads by length and capturing more than 80% of toll road traffic in Indonesia. We expect the company to be the main beneficiary of legislation of the new land acquisition bill.

Jasa Marga is the first and main toll road operator in Indonesia, with 32 years of operating experience. The company participates in the toll road bidding process, develops and operates toll roads on a BOT model, typically for a long-term period of 40 years. Being a pioneer in the toll road industry in Indonesia has allowed the company to operate some of the busiest toll roads in the country, with its high-yielding cashflows in turn providing a stable funding source for other toll road developments.

The company currently operates 11 main toll roads, mainly located in Jakarta and Java, with a total road length of 531km. While the company operates 73% (by length, according to the company) of total toll roads in Indonesia, the average daily traffic along Jasa Marga's toll roads represents 83% of total toll road traffic in Indonesia. The company went public in 2007, offering a 30% stake to the public.

Beneficiary of legislation of land acquisition law

Over the past five to six years, Indonesia has seen some 135km of toll roads developed, roughly a 25% increase in total toll road length since 2004, half of which was built by Jasa Marga. There is another 1,400km or so of toll roads that was initially planned by the government to be developed during the same period (2004-10), but construction for which is yet to commence.

Land acquisition has been the main roadblock, owing to speculation on land price increases. Against this backdrop, a new land acquisition law that would allow the government to enforce land acquisition at market value (determined by a third-party value appraiser) has been proposed to parliament for legislation. With this law, the land acquisition process is expected to be much easier, thus helping to accelerate infrastructure projects such as toll roads. We believe Jasa Marga, with some 187km of new toll road concessions yet to be fully developed, stands to benefit from the law given that some of these new toll roads are still in the challenging land-acquisition stage.

Accelerated toll road development, triggered by the new land acquisition law, would likely also help to accelerate traffic growth on existing toll roads. Over the past 10 years, Indonesia has witnessed an average 11% CAGR for car sales. During the same period, total traffic grew by only 5%, we believe primarily due to high density and high congestion on the existing toll roads. The development of more toll roads in Indonesia would help the congestion issue and allow higher traffic growth in toll roads, in our view.

With its strong balance sheet and operating cashflow generated by its existing toll roads, plus its wealth of experience as a toll road operator in Indonesia, we think Jasa Marga could become a strong consolidation agent in the toll road sector, given that the government is evaluating the performance of current toll road operators and plans to revoke concessions of non-performing operators.

Valuation methodology

We derive our TP of IDR4,100 using the DCF method, given the typical long-term nature of toll road/infrastructure businesses and the coming on stream of additional toll road concessions that Jasa Marga currently holds (which will contribute to cashflows). We assume a cost of equity of 15% (derived from a risk-free rate of 6.5%, market risk of 15% and beta of 1), cost of debt of 9% and target leverage capital mix of 70% net debt to equity. We use EV/EBITDA of 8x for our terminal value in 2020.

Risks that may impede the achievement of the target price

Downside risks include: 1) a delay in the development of new toll roads; 2) lower-than-expected tariff adjustments; 3) higher-than-expected development costs. Upside risks include: 1) new toll road development; 2) potentially higher traffic resulting from connectivity of newly built toll roads.

PP London Sumatra LSIP.JK LSIP IJ

CONSUMER RELATED

NOMURA
EQUITY RESEARCH

LonSum our top plantation pick in Indonesia

Possible reduction in CPO export tax a positive catalyst

June 7, 2011

Rating Remains	**Buy**
Target price Remains	IDR 3,050
Closing price June 1, 2011	IDR 2,400
Potential upside	+27.1%

Action: Reiterate BUY on strong earnings and compelling valuation

We reiterate our BUY call on LonSum as a respected liquid large-cap exposure to the Indonesian plantations. We think that sustained strength in the CPO price (+32% y-y YTD) should continue to drive earnings, while the possibility of a reduction in the Indonesian export tax structure will provide a strong re-rating catalyst.

Catalyst: Review of export tax structure a positive catalyst

The Indonesian government is considering lowering the maximum tax rate of 25% for crude palm oil exports and possibly using domestic Indonesian CPO price as a reference price for export tax (vs the Rotterdam prices used currently). We have in the past flagged that this would be a very positive catalyst for planters, as any savings from a change in export tax structure would go straight to the bottom line for planters. A 1% reduction in export taxes would lift FY11F earnings by up to 1.6%, we estimate.

Valuation: Production to recover in 2011, rubber and seed exposure a bonus

We believe LonSum's 12x FY11F P/E (close to its mean of 11.1x) is compelling. Our bullish view on palm oil prices in 2011F (+11.8% y-y), coupled with better CPO production (+8% y-y), leads to our forecast of stronger EPS growth of 32% in FY11F. Current estate rehabilitation efforts also present an upside risk to yields. Continued strong rubber price and seed sales, which both contribute more than 20% of FY11F EBIT, remain growth drivers. We note too that LonSum is the largest producer of certified sustainable palm oil locally.

31 Dec	FY10		FY11F		FY12F		FY13F
Currency (IDR)	Actual	Old	New	Old	New	Old	New
Revenue (bn)	3,593	4,315	4,315	4,586	4,586	4,642	4,642
Reported net profit (bn)	1,033	1,365	1,365	1,459	1,459	1,405	1,405
Normalised net profit (bn)	1,033	1,365	1,365	1,459	1,459	1,405	1,405
Normalised EPS	151.5	200.0	200.0	213.8	213.8	205.9	205.9
Norm. EPS growth (%)	46.1	32.1	32.1	6.9	6.9	-3.7	-3.7
Norm. P/E (x)	15.8	N/A	12.0	N/A	11.2	N/A	11.7
EV/EBITDA	9.5	N/A	7.8	N/A	7.2	N/A	7.3
Price/book (x)	3.6	N/A	3.1	N/A	2.7	N/A	2.4
Dividend yield (%)	2.5	N/A	3.7	N/A	4.5	N/A	4.3
ROE (%)	24.7	27.7	27.7	25.7	25.7	22.0	22.0
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash	net cash	net cash

Source: Nomura estimates

Key company data: *See page 2 for company data, and detailed price/index chart.*
Rating: *See report end for details of Nomura's rating system.*

Anchor themes

Continued tight global vegetable oils outlook, a stronger crude oil price, weaker USD and bullish outlook for global agri-commodities (including non-oil crops) should sustain higher CPO prices and drive earnings.

Nomura vs consensus

We are more bullish on our FY11-12F forecasts for CPO prices, which translate into our 4% higher TP for LonSum over the street.

Research analysts

ASEAN Agri-Related

Ken Arieff Wong - NSM
kenarieff.wong@nomura.com
+60 3 2027 6895

Key data on PP London Sumatra

Income statement (IDRbn)

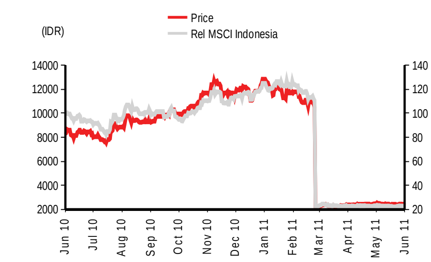
Year-end 31 Dec	FY09	FY10	FY11F	FY12F	FY13F
Revenue	**3,200**	**3,593**	**4,315**	**4,586**	**4,642**
Cost of goods sold	-1,809	-1,821	-2,276	-2,422	-2,532
Gross profit	**1,390**	**1,771**	**2,038**	**2,164**	**2,110**
SG&A	-372	-372	-354	-370	-389
Employee share expense					
Operating profit	**1,019**	**1,400**	**1,684**	**1,794**	**1,721**
EBITDA	**1,171**	**1,598**	**1,892**	**2,025**	**1,974**
Depreciation	-153	-198	-208	-231	-253
Amortisation					
EBIT	1,019	1,400	1,684	1,794	1,721
Net interest expense	-34	-1	42	50	55
Associates & JCEs					
Other income	24	-17	-20	-20	-20
Earnings before tax	**1,008**	**1,382**	**1,706**	**1,824**	**1,756**
Income tax	-301	-348	-341	-365	-351
Net profit after tax	**707**	**1,033**	**1,365**	**1,459**	**1,405**
Minority interests					
Other items					
Preferred dividends					
Normalised NPAT	**707**	**1,033**	**1,365**	**1,459**	**1,405**
Extraordinary items	0	0	0	0	0
Reported NPAT	**707**	**1,033**	**1,365**	**1,459**	**1,405**
Dividends	-285	-413	-614	-730	-703
Transfer to reserves	**422**	**620**	**751**	**730**	**703**
Valuation and ratio analysis					
FD normalised P/E (x)	23.1	15.8	12.0	11.2	11.7
FD normalised P/E at price target (x)	29.4	20.1	15.3	14.3	14.8
Reported P/E (x)	23.1	15.8	12.0	11.2	11.7
Dividend yield (%)	1.7	2.5	3.7	4.5	4.3
Price/cashflow (x)	21.8	9.4	9.3	9.0	11.8
Price/book (x)	4.3	3.6	3.1	2.7	2.4
EV/EBITDA (x)	13.6	9.5	7.8	7.2	7.3
EV/EBIT (x)	15.6	10.9	8.8	8.1	8.4
Gross margin (%)	43.5	49.3	47.2	47.2	45.5
EBITDA margin (%)	36.6	44.5	43.8	44.2	42.5
EBIT margin (%)	31.8	39.0	39.0	39.1	37.1
Net margin (%)	22.1	28.8	31.6	31.8	30.3
Effective tax rate (%)	29.8	25.2	20.0	20.0	20.0
Dividend payout (%)	40.3	40.0	45.0	50.0	50.0
Capex to sales (%)	14.7	11.0	15.1	14.2	14.0
Capex to depreciation (x)	3.1	2.0	3.1	2.8	2.6
ROE (%)	20.2	24.7	27.7	25.7	22.0
ROA (pretax %)	25.3	32.7	36.3	35.3	31.1
Growth (%)					
Revenue	-16.8	12.3	20.1	6.3	1.2
EBITDA	-18.5	36.4	18.4	7.0	-2.5
EBIT	-22.5	37.4	20.3	6.5	-4.0
Normalised EPS	-23.7	46.1	32.1	6.9	-3.7
Normalised FDEPS	-23.7	46.1	32.1	6.9	-3.7
Per share					
Reported EPS (IDR)	103.69	151.45	200.00	213.85	205.93
Norm EPS (IDR)	103.69	151.45	200.00	213.85	205.93
Fully diluted norm EPS (IDR)	103.69	151.45	200.00	213.85	205.93
Book value per share (IDR)	558.92	667.48	777.48	884.40	987.36
DPS (IDR)	41.80	60.58	90.00	106.92	102.96

Source: Nomura estimates

Notes

Strong earnings growth expected in FY11F on account of higher CPO price assumptions

Price and price relative chart (one year)



(%)	1M	3M	12M
Absolute (IDR)	-2.0	7.9	-70.9
Absolute (USD)	-1.7	11.1	-68.6
Relative to index	-2.1	-2.3	-99.8
Market cap (USDmn)	1,917.9		
Estimated free float (%)	40.5		
52-week range (IDR)	2600/1490		
3-mth avg daily turnover (USDmn)	5.02		
Major shareholders (%)			
PT Salim Ivomas Pratama	59.5		

Cashflow (IDRbn)

Year-end 31 Dec	FY09	FY10	FY11F	FY12F	FY13F
EBITDA	1,171	1,598	1,892	2,025	1,974
Change in working capital	43	95	19	-35	-418
Other operating cashflow	-463	41	-144	-165	-165
Cashflow from operations	**751**	**1,734**	**1,766**	**1,824**	**1,391**
Capital expenditure	-470	-396	-650	-650	-650
Free cashflow	**281**	**1,338**	**1,116**	**1,174**	**740**
Reduction in investments	0	0	0	0	0
Net acquisitions	-12	-312	-122	-122	-122
Reduction in other LT assets	30	2	5	0	-77
Addition in other LT liabilities	58	64	19	20	338
Adjustments	0	11	-8	-2	16
Cashflow after investing acts	**356**	**1,103**	**1,011**	**1,071**	**896**
Cash dividends	-285	-413	-614	-730	-703
Equity issue	0	0	0	0	0
Debt issue	-713	-235	0	0	0
Convertible debt issue					
Others	290	24	-30	-30	-30
Cashflow from financial acts	**-708**	**-625**	**-644**	**-760**	**-733**
Net cashflow	**-352**	**478**	**367**	**311**	**163**
Beginning cash	1,034	682	1,161	1,527	1,838
Ending cash	682	1,161	1,527	1,838	2,001
Ending net debt	-447	-1,161	-1,527	-1,838	-2,001

Source: Nomura estimates

Notes

Strong free cashflow should be used for active landbank and planted hectarage expansion, in our view

Balance sheet (IDRbn)

As at 31 Dec	FY09	FY10	FY11F	FY12F	FY13F
Cash & equivalents	682	1,161	1,527	1,838	2,001
Marketable securities	0	0	0	0	0
Accounts receivable	65	26	31	33	34
Inventories	192	264	331	352	368
Other current assets	25	36	15	16	17
Total current assets	**964**	**1,487**	**1,904**	**2,239**	**2,419**
LT investments					
Fixed assets	3,559	3,748	4,175	4,579	4,961
Goodwill					
Other intangible assets					
Other LT assets	329	327	322	321	398
Total assets	**4,852**	**5,561**	**6,401**	**7,139**	**7,779**
Short-term debt	204	0	0	0	0
Accounts payable	60	83	99	105	110
Other current liabilities	422	539	592	575	168
Total current liabilities	**686**	**622**	**691**	**680**	**278**
Long-term debt	31	0	0	0	0
Convertible debt					
Other LT liabilities	322	386	405	425	764
Total liabilities	**1,039**	**1,007**	**1,096**	**1,105**	**1,042**
Minority interest	0	0	0	0	0
Preferred stock					
Common stock	682	682	682	682	682
Retained earnings	2,071	2,807	3,557	4,287	4,989
Proposed dividends					
Other equity and reserves	1,060	1,065	1,065	1,065	1,065
Total shareholders' equity	**3,813**	**4,554**	**5,305**	**6,034**	**6,737**
Total equity & liabilities	**4,852**	**5,561**	**6,401**	**7,139**	**7,779**
Liquidity (x)					
Current ratio	1.41	2.39	2.75	3.29	8.69
Interest cover	29.7	1,160.5	na	na	na
Leverage					
Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash
Activity (days)					
Days receivable	9.4	4.6	2.4	2.6	2.6
Days inventory	40.9	45.8	47.7	51.6	51.8
Days payable	16.5	14.3	14.6	15.5	15.5
Cash cycle	33.8	36.1	35.5	38.7	38.9

Source: Nomura estimates

Notes

Strong balance sheet and good cash flows could translate into higher dividend payouts

Respected large-cap, liquid planter

Focus will be on the upstream – palm oil the main driver of earnings

The strategy of Lonsum is mainly to stay in the upstream space, and we understand that the group has no immediate plans to expand into other crops such as sugar, as is actively being done by its parent IndoAgri.

Currently, close to 80% of the group's planted hectarage is in palm oil, followed by its next largest crop, rubber, at 17% of planted hectarage, and others (including cocoa, tea and coconut plantations) amounting to 4% of planted hectarage. Historically, palm oil earnings contributions to total EBIT ranged from 56% when palm oil prices were lower (in 2006) all the way to 93% (when rubber prices and seed sales collapsed in 2009). We estimate palm oil will continue contributing the majority of (74-82 %) of group EBIT in FY11-12F.

100-year heritage, best-in-class sustainable practices, strong balance sheet and cashflow

Lonsum is one of the oldest plantations company in the region, with more than a 100-year history. It is mostly seen as a respected planter (especially with its strong balance sheet – net cash position as well as strong free cashflow generation), with leading R&D capabilities as evidenced by its industry-leading seed production. It is also a leader in sustainable practices, having one of the highest proportions of Sustainable Palm Oil production (~50% of production) certified by the Roundtable on Sustainable Palm Oil (RSPO).

Valuation methodology and risks: main downside risks include CPO prices and CPO production

We derive our TP by pegging it to 15.3x FY11F P/E (FY11F EPS est=IDR200). This is based on a valuation of +0.9x above its standard deviation, which we believe is fair in the current upcycle. The main downside risk to our view and earnings is lower-than-expected CPO prices, especially if CPO production (together with other vegetable oils globally) comes in stronger than expected (watch for 2H11, where there may be a recovery), or slower-than-expected demand from the main CPO-consuming markets of China, India and the Eurozone. Lower-than-expected production is also a negative risk to earnings, while on the company front, slower-than-expected plantings will be negative to future growth.

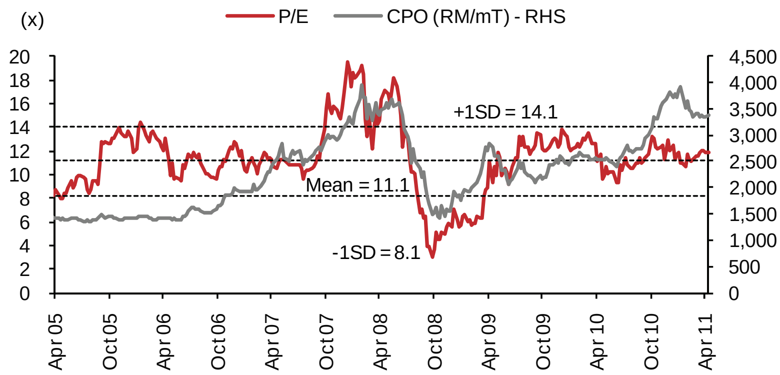
Fig. 79: Nomura palm oil snapshot: London Sumatra

Metric	1	2	3	4	5	Comment
Age Profile			✓			Lonsum's tree age profile is relatively young with an average age of 11 years old, though we think there is risk of replanting at its older estates (7% of its trees above 20 years old)
Yields		✓				Yields are below its peers such as Golden Agri and Astra Agro, but we think this can be improved with the younger trees increasing its yields and better infrastructure being put in place at its South Sumatran estates
Oil Extraction Rate				✓		Oil Extraction rate of above 23% is very high versus its peers and we think the group should be able to maintain its
Expansion Rate				✓		The group has, the landbank, the planting materials and the financial resources for expansion, and we are confident that the group will be able to meet its plantings targets in the long run (which should grow panted hectarage by ~9-10% per annum.
Costs of Production			✓			Cost of production for the group is average and we do not see much change until it completed the infrastructure improvements in South Sumatra
Sustainable production					✓	Lonsum is the leading listed planter in Indonesia, with the most production certified sustainable by the RSPO. We think the group's commitment to sustainable plantings will continue.
Corporate Governance				✓		We have no major issues with the Corporate governance of the group in recent times.

Note: (5= Best in Class, 3 = Average, 1= Poorest in Class). These are arbitrary measures based on our view of operational metrics as compared to other palm oil companies within the region. Source: Nomura securities.

Fig. 80: London Sumatra P/E

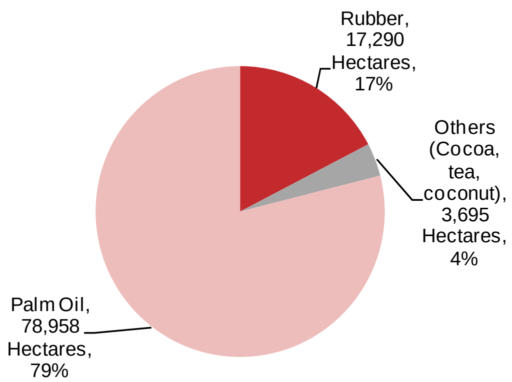
Compelling valuation with P/E still close to mean, while CPO price close to +1SD



Source: Nomura research, Bloomberg

Fig. 81: Planted hectarage

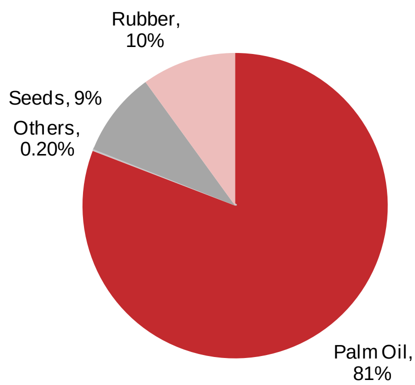
Mainly dominated by Palm Oil



Source: Company data

Fig. 82: EBIT contribution, FY11F (%)

Rubber and seeds should provide buffer to earnings



Source: Nomura estimates

Astra International ASII.JK ASII IJ

AUTOS & AUTO PARTS

NOMURA
EQUITY RESEARCH

Indonesian champion

Buying opportunity in these uncertain times

June 7, 2011

Rating Remains	**Buy**
Target price Remains	IDR 68,000
Closing price June 1, 2011	IDR 59,100
Potential upside	+15.1%

Action: Overweight ahead of trajectory growth

We believe Astra is operating in the right sector to benefit from the rising purchasing power of the middle class in Indonesia, as well as growing demand for palm oil and coal globally. Its market-leading position in the cars and motorcycles market should allow it to benefit from trajectory growth in automotive demand in the years ahead. Current market concerns regarding inflation and production disruption do not alter its positive outlook and present a buying opportunity, in our view.

Catalyst: Prime exposure to rising Indonesia

We expect Astra to sell 75% more cars and motorcycles in 2015 vs current levels. Astra's other key divisions will likely continue to be winners in the next five years, we believe. Its Financial Services division will likely continue to ride on strong growth in automotive sales, while United Tractors and Astra Agro should benefit from high coal and palm oil prices.

Risks to our view

Risks include negative impact from competition, government intervention and a major slowdown in Indonesia's GDP growth (including any impact from global economic shocks). Also, like other businesses, Astra is exposed to risks from natural disasters and other such risks.

Attractive valuation for prime assets

Our TP of IDR68,000 is based on a target P/E of 15x FY12F, which implies 4.1x FY11F P/BV and a 4% discount to our forward NAV estimate of IDR70,900. This is supported by a three-year earnings CAGR of 13.6%, a high ROE of 30% and 3.5% dividend yield, on our estimates.

31 Dec	FY10		FY11F		FY12F		FY13F
Currency (IDR)	Actual	Old	New	Old	New	Old	New
Revenue (bn)	129,991	146,938	146,938	170,599	170,599	197,797	197,797
Reported net profit (bn)	14,366	16,217	16,217	18,605	18,605	21,042	21,042
Normalised net profit (bn)	14,459	16,217	16,217	18,605	18,605	21,042	21,042
Normalised EPS	3,571.6	4,005.8	4,005.8	4,595.7	4,595.7	5,197.7	5,197.7
Norm. EPS growth (%)	45.6	12.2	12.2	14.7	14.7	13.1	13.1
Norm. P/E (x)	16.5	N/A	14.8	N/A	12.9	N/A	11.4
EV/EBITDA	10.6	N/A	9.2	N/A	8.0	N/A	7.1
Price/book (x)	4.9	N/A	4.2	N/A	3.6	N/A	3.1
Dividend yield (%)	2.7	N/A	3.4	N/A	3.9	N/A	4.4
ROE (%)	32.2	30.4	30.4	30.0	30.0	29.2	29.2
Net debt/equity (%)	50.0	38.1	38.1	27.4	27.4	17.8	17.8

Source: Nomura estimates

Key company data: *See page 2 for company data, and detailed price/index chart.*
Rating: *See report end for details of Nomura's rating system.*

Anchor themes

Astra will likely continue benefiting from a growing middle class and strong economic growth driving auto sales higher. Also a beneficiary of higher palm oil and coal prices via subsidiaries.

Nomura vs consensus

Our FY11F earnings forecast is 7% above consensus, largely driven by our higher assumptions on sales volumes, palm oil and coal prices, and recovery in profitability of its coal mining services.

Research analysts

Indonesia Autos & Auto Parts

Wilianto Ie - PTNI
wilianto.ie@nomura.com
+62 21 2991 3341

Key data on Astra International

Income statement (IDRbn)

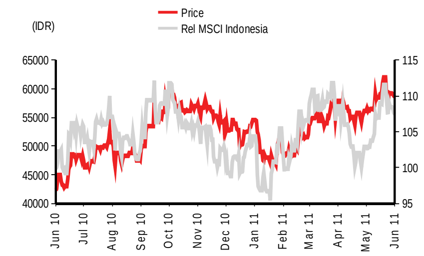
Year-end 31 Dec	FY09	FY10	FY11F	FY12F	FY13F
Revenue	**98,526**	**129,991**	**146,938**	**170,599**	**197,797**
Cost of goods sold	-75,755	-103,117	-115,820	-135,094	-157,417
Gross profit	**22,771**	**26,874**	**31,118**	**35,505**	**40,380**
SG&A	-10,015	-12,149	-13,821	-15,950	-18,359
Employee share expense					
Operating profit	**12,756**	**14,725**	**17,297**	**19,555**	**22,021**
EBITDA	**16,180**	**20,038**	**22,862**	**25,620**	**28,086**
Depreciation	-3,409	-5,298	-5,500	-6,000	-6,000
Amortisation	-15	-15	-65	-65	-65
EBIT	12,756	14,725	17,297	19,555	22,021
Net interest expense	78	18	-401	-420	-391
Associates & JCEs	2,567	4,896	5,389	6,409	7,384
Other income	890	1,485	1,662	1,920	2,112
Earnings before tax	**16,291**	**21,124**	**23,947**	**27,464**	**31,125**
Income tax	-3,958	-4,027	-4,625	-5,252	-5,925
Net profit after tax	**12,333**	**17,097**	**19,322**	**22,212**	**25,200**
Minority interests	-2,404	-2,638	-3,105	-3,607	-4,158
Other items					
Preferred dividends					
Normalised NPAT	**9,929**	**14,459**	**16,217**	**18,605**	**21,042**
Extraordinary items	111	-93	0	0	0
Reported NPAT	**10,040**	**14,366**	**16,217**	**18,605**	**21,042**
Dividends	-4,518	-6,477	-8,108	-9,302	-10,521
Transfer to reserves	**5,522**	**7,889**	**8,108**	**9,302**	**10,521**
Valuation and ratio analysis					
FD normalised P/E (x)	24.1	16.5	14.8	12.9	11.4
FD normalised P/E at price target (x)	27.7	19.0	17.0	14.8	13.1
Reported P/E (x)	23.8	16.7	14.8	12.9	11.4
Dividend yield (%)	1.9	2.7	3.4	3.9	4.4
Price/cashflow (x)	8.2	11.0	5.9	5.3	4.8
Price/book (x)	6.0	4.9	4.2	3.6	3.1
EV/EBITDA (x)	13.5	10.6	9.2	8.0	7.1
EV/EBIT (x)	16.5	13.5	11.5	9.9	8.6
Gross margin (%)	23.1	20.7	21.2	20.8	20.4
EBITDA margin (%)	16.4	15.4	15.6	15.0	14.2
EBIT margin (%)	12.9	11.3	11.8	11.5	11.1
Net margin (%)	10.2	11.1	11.0	10.9	10.6
Effective tax rate (%)	24.3	19.1	19.3	19.1	19.0
Dividend payout (%)	45.0	45.1	50.0	50.0	50.0
Capex to sales (%)	7.5	6.4	4.8	4.1	3.5
Capex to depreciation (x)	2.2	1.6	1.3	1.2	1.2
ROE (%)	27.5	32.2	30.4	30.0	29.2
ROA (pretax %)	20.2	21.1	20.5	21.4	21.9
Growth (%)					
Revenue	1.5	31.9	13.0	16.1	15.9
EBITDA	11.9	23.8	14.1	12.1	9.6
EBIT	7.4	15.4	17.5	13.1	12.6
Normalised EPS	13.0	45.6	12.2	14.7	13.1
Normalised FDEPS	13.0	45.6	12.2	14.7	13.1
Per share					
Reported EPS (IDR)	2,480.02	3,548.60	4,005.82	4,595.65	5,197.75
Norm EPS (IDR)	2,452.60	3,571.57	4,005.82	4,595.65	5,197.75
Fully diluted norm EPS (IDR)	2,452.60	3,571.57	4,005.82	4,595.65	5,197.75
Book value per share (IDR)	9,854.44	12,180.33	14,183.24	16,481.06	19,079.94
DPS (IDR)	1,116.01	1,599.86	2,002.91	2,297.83	2,598.87

Source: Nomura estimates

Notes

Astra set to generate more than USD20bn in revenue in 2013F

Price and price relative chart (one year)



(%)	1M	3M	12M
Absolute (IDR)	5.3	9.4	38.2
Absolute (USD)	5.6	12.8	49.5
Relative to index	5.2	-0.7	9.4
Market cap (USDmn)	28,022.7		
Estimated free float (%)	49.0		
52-week range (IDR)	62150/41950		
3-mth avg daily turnover (USDmn)	22.74		
Major shareholders (%)			
Jardine C&C	50.1		

Cashflow (IDRbn)

Year-end 31 Dec	FY09	FY10	FY11F	FY12F	FY13F
EBITDA	16,180	20,038	22,862	25,620	28,086
Change in working capital	1,563	-2,827	-581	-834	-961
Other operating cashflow	11,379	4,453	18,573	20,399	22,474
Cashflow from operations	**29,122**	**21,664**	**40,855**	**45,185**	**49,598**
Capital expenditure	-7,358	-8,371	-7,000	-7,000	-7,000
Free cashflow	**21,764**	**13,293**	**33,855**	**38,185**	**42,598**
Reduction in investments	0	0	0	0	0
Net acquisitions	0	0	0	0	0
Reduction in other LT assets	73	81	0	0	0
Addition in other LT liabilities	0	0	0	0	0
Adjustments	693	-3,228	-1,089	-1,098	-1,034
Cashflow after investing acts	**22,530**	**10,146**	**32,766**	**37,087**	**41,564**
Cash dividends	-4,518	-6,477	-8,108	-9,302	-10,521
Equity issue	1,292	1,527	0	0	0
Debt issue	-1,612	9,817	-3,636	-5,211	-3,855
Convertible debt issue	0	0	0	0	0
Others	-122	505	405	566	650
Cashflow from financial acts	**-4,960**	**5,372**	**-11,339**	**-13,947**	**-13,726**
Net cashflow	**17,570**	**15,518**	**21,427**	**23,139**	**27,838**
Beginning cash	8,944	8,771	7,078	6,224	4,577
Ending cash	26,514	24,289	28,505	29,363	32,415
Ending net debt	13,150	24,660	21,879	18,314	13,745

Source: Nomura estimates

Notes

Strong cashflow to support growth and dividends

Balance sheet (IDRbn)

As at 31 Dec	FY09	FY10	FY11F	FY12F	FY13F
Cash & equivalents	8,771	7,078	6,224	4,577	5,291
Marketable securities	0	0	0	0	0
Accounts receivable	7,579	9,391	10,615	12,325	14,290
Inventories	7,282	10,842	12,178	14,204	16,551
Other current assets	2,333	3,628	4,101	4,761	5,520
Total current assets	**25,965**	**30,939**	**33,118**	**35,867**	**41,652**
LT investments	11,484	15,053	17,747	20,952	24,644
Fixed assets	24,555	27,547	29,047	30,047	31,047
Goodwill	0	0	0	0	0
Other intangible assets	0	0	0	0	0
Other LT assets	26,934	39,318	41,881	45,253	48,860
Total assets	**88,938**	**112,857**	**121,793**	**132,119**	**146,203**
Short-term debt	11,254	17,803	15,764	12,841	10,678
Accounts payable	7,278	9,275	10,418	12,151	14,159
Other current liabilities	8,203	10,046	11,356	13,184	15,286
Total current liabilities	**26,735**	**37,124**	**37,537**	**38,176**	**40,123**
Long-term debt	10,667	13,935	12,339	10,051	8,358
Convertible debt	0	0	0	0	0
Other LT liabilities	2,604	3,109	3,514	4,080	4,731
Total liabilities	**40,006**	**54,168**	**53,390**	**52,307**	**53,212**
Minority interest	9,038	9,379	10,984	13,091	15,749
Preferred stock	0	0	0	0	0
Common stock	3,130	3,130	3,130	3,130	3,130
Retained earnings	35,586	44,731	52,839	62,142	72,663
Proposed dividends	0	0	0	0	0
Other equity and reserves	1,178	1,449	1,449	1,449	1,449
Total shareholders' equity	**39,894**	**49,310**	**57,419**	**66,721**	**77,242**
Total equity & liabilities	**88,938**	**112,857**	**121,793**	**132,119**	**146,203**
Liquidity (x)					
Current ratio	0.97	0.83	0.88	0.94	1.04
Interest cover	na	na	43.1	46.5	56.4
Leverage					
Net debt/EBITDA (x)	0.81	1.23	0.96	0.71	0.49
Net debt/equity (%)	33.0	50.0	38.1	27.4	17.8
Activity (days)					
Days receivable	25.5	23.8	24.8	24.6	24.6
Days inventory	38.4	32.1	36.3	35.7	35.7
Days payable	34.0	29.3	31.0	30.6	30.5
Cash cycle	29.9	26.6	30.1	29.8	29.7

Source: Nomura estimates

Notes

Solid balance sheet, with most subsidiaries in net cash positions and most debt from financing and contract mining subsidiaries

Leader of the pack

Astra International is the largest stock on the Jakarta Stock Exchange in terms of market capitalisation. It has diversified businesses, with a high ROE of 30%, a solid balance sheet with a low consolidated debt-to-equity ratio (net cash at holding company) and strong cashflow to support growth ahead.

Well diversified in the prime sectors in Indonesia

We believe Astra is one of the best stocks to capture the Indonesian story. It sells automotive products to an expanding middle class in this underpenetrated market, offers financial services to harness the value chain and enjoys significant exposure to palm oil and thermal coal (two of the fastest-growing commodities in Indonesia).

Generally, about half of Astra's consolidated earnings over the past three years have been driven by domestic consumption, some 15% by financial services and 35%-40% by commodities. The three segments do not always run at the same cycle, but current trends suggest all three will be in an upcycle over the next three years.

Catalysts that will likely move the stock

Astra's car sales expanded by 51% y-y in 2010 (company data) and we expect sales to grow by 10% y-y in 2011F and 15% y-y in 2012F, even allowing for the government's plan to remove fuel subsidies for private cars. Similarly, we forecast motorcycle sales will increase 15% pa. Thus, we estimate both car and motorcycle sales will be 75% higher in 2015 vs 2011.

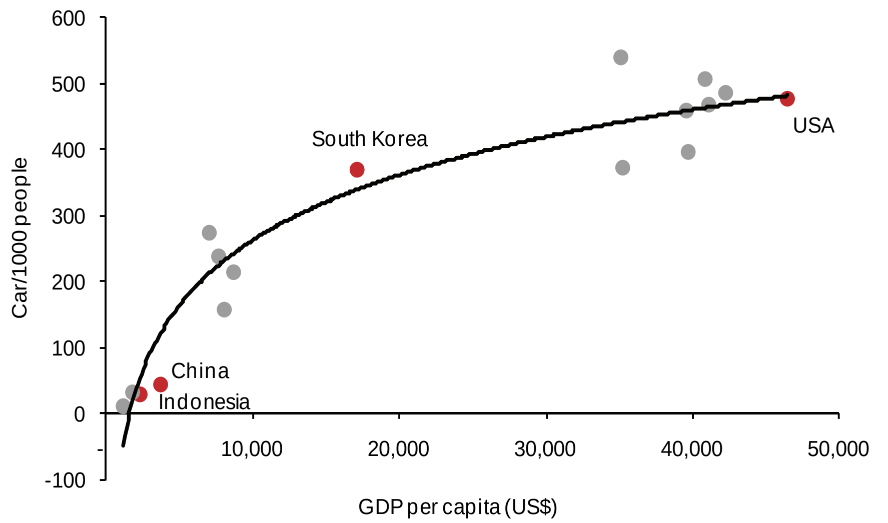
We think Astra's earnings and the company's value will also strengthen on strong palm oil prices (CPO spot price of USD1,100/tonne is 28% above the 2010 average of USD862/tonne) and rapid expansion by coal mining companies. We believe strong palm oil and coal prices will boost the earnings and share prices of its commodity-related subsidiaries, such as United Tractors (UNTR IJ, Not rated) and Astra Agro (AALI IJ, IDR23,600, BUY), which together account for 40% of Astra's earnings and 38% of its SOTP valuation in 2011F, on our estimates.

Sector/strategic context

Astra International is well positioned to benefit from rising discretionary spending in Indonesia, on the back of its strong market share in car and motorcycle sales, in our view. It commands a 56% market share in car sales, 47% in motorcycle sales, 47% in heavy equipment and 40% in coal mining contracting (as of 2010). We think Astra's strong distribution network, good after-sales services and solid product range from its strong principals (Toyota, Daihatsu, Isuzu, BMW and UD trucks) are the key success factors.

Despite record-high car sales of 700k units in 2010, car penetration in Indonesia remains low, at less than 3% (source: Gaikindo, Nomura research). To reach a car penetration rate of 25% (G7 country average: 46%), Indonesia needs to sell another 54mn cars, or 10x the total number of cars on the street today and 77x annual car sales in 2010, on our estimates.

Fig. 83: Car penetration and GDP per capita comparison



Source: Nomura research, Korean Automobile Manufacturers Association, Worldbank, CEIC, European Environment Agency

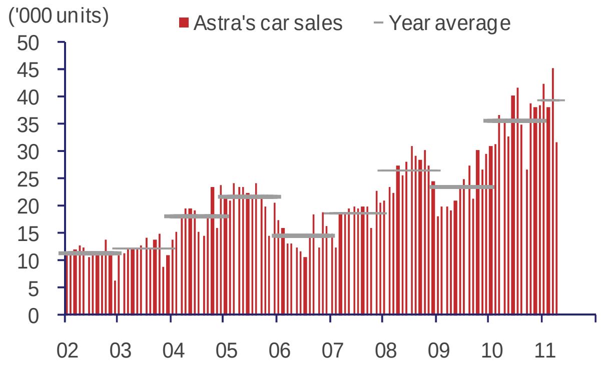
Fig. 84: Astra International: key assumptions

	2008	2009	2010F	2011F	2012F	2013F
Astra's car sales volume	317,967	281,013	415,000	456,500	524,975	603,721
Astra's motorcycle sales volume	2,874,576	2,701,278	3,300,000	3,795,000	4,364,250	5,018,888
Komatsu's volume	4,348	3,111	5,500	6,100	7,015	8,067
Pama coal extraction (mn tons)	77	88.6	97.4	107.1	77	88.6
Astra Agro's FFB production (nucleus only)	2,910,041	3,337,433	3,279,733	3,334,466	3,413,594	3,545,758
Growth (% y-y)						
Astra's car sales volume	42.5	-11.6	47.7	10	15	15
Astra's motorcycle sales volume	34.3	-6	22.2	15	15	15
Komatsu's volume	26	-28	77	11	15	15
Pama coal extraction	8	15	13	15	10	10
Astra Agro's FFB production	3	15	-2	4	2	4

Source: Nomura estimates, company data

Fig. 85: Strong underlying demand for cars

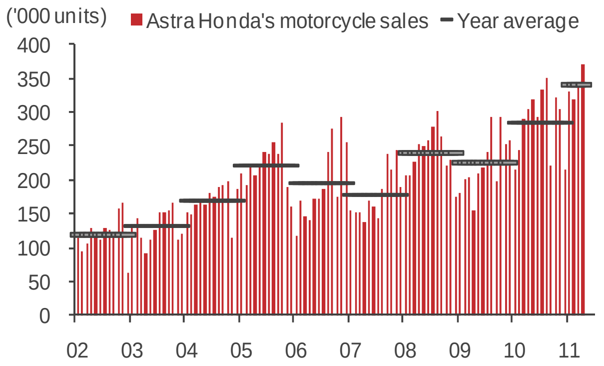
Production disruptions will likely cause a temporary dip in car sales



Source: Gaikindo, Nomura research

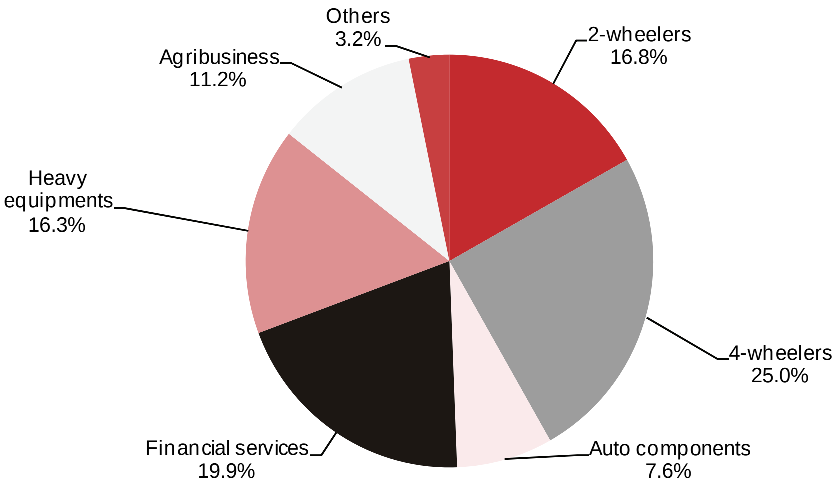
Fig. 86: Motorcycle sales will remain strong

No production disruptions expected for motorcycles



Source: AISI, Nomura research

Fig. 87: Astra International: earnings breakdown (FY10)



Source: Company data

Fig. 88: Astra International: principals in automotive biz

Division	Activities	Principals/JV partners
4-wheeler	Wholesale, dealership, manufacturer (minority stake)	Toyota, Daihatsu, Isuzu, UD trucks, Peugeot, BMW
2-wheeler	Manufacturing & wholesale (50:50 JV), dealership	Honda
Component parts	Dealership, manufacturing, private brand	Denso, GS Yuasa, Aisin, Nippon Gasket, DIC Corporation, Akebono, Spring, Kayaba, Toyoda Gosei, Mahle, Nittan Valve, Daido Steel, Keihin.

Source: Company data, Nomura research

Valuation methodology

Our target price of IDR68,000 is based on a target P/E of 15x our FY12F EPS of IDR4,595, which implies 4.1x P/B and a 4% discount to our forward NAV per share estimate of IDR70,900.

Risks that may impede the achievement of the target price

Risks include a negative impact from competition, government regulatory intervention and a major slowdown in Indonesia's GDP growth (including any potential impact from global macro economic shocks). Like other businesses, Astra is also exposed to risk from natural disaster and other non-controllable risks of that nature.

Adaro Energy ADRO.JK ADRO IJ

METALS & MINING

NOMURA
EQUITY RESEARCH

Quality operation

Good track record; positioned for further growth

June 7, 2011

Rating Remains	**Buy**
Target price Remains	IDR 3,000
Closing price June 1, 2011	IDR 2,425
Potential upside	+23.7%

Action and catalysts: BUY with target price of IDR3,000/share

We reiterate our BUY call on ADRO, with a target price of IDR3,000/share, which implies 9.9-5.1x FY11-12F EV/EBITDA and 23.4-10.9x FY11-12F earnings. Potential share price catalysts include better-than-expected ASPs, continued volume recovery and progress in its projects.

Integrated operation with strong track record

ADRO has an integrated operation, from mining to shipping coal, which enables it to operate efficiently. In our view, it also has a good track record of ramping up production, which has gone from 1.0mn tons in 1992 to 42.2mn tons in 2010 (23% CAGR). We forecast it will continue to ramp production, reaching 80mn tons by 2016F (a 2010-16F CAGR of 11%).

Diversified customer base provides buffer and upside

With ~75% of sales exported and ~25% sold domestically, ADRO, in our view, stands to benefit from rising thermal coal prices and faces limited downside risk.

Hidden value in the Maruwai project

ADRO has a 25% stake in the BHP IndoMet Coal Project located in East and Central Kalimantan. The project, now at the feasibility study stage, covers seven Coal Contracts of Work (CCoWs) with undeveloped metallurgical and thermal coal resources estimated at 774mn tonnes.

Risk to our call

Key risks to our call are execution risk, land acquisition, Wara performance, mining contractor risk and exchange rate volatility.

31 Dec	FY10	FY11F		FY12F		FY13F	
Currency (IDR)	Actual	Old	New	Old	New	Old	New
Revenue (bn)	24,689	31,174	31,174	44,781	44,781	49,931	49,931
Reported net profit (bn)	2,207	4,106	4,124	8,804	8,830	10,240	10,269
Normalised net profit (bn)	2,379	4,106	4,124	8,804	8,830	10,240	10,269
Normalised EPS	74.4	128.4	128.9	275.2	276.1	320.1	321.0
Norm. EPS growth (%)	-45.5	72.6	73.4	114.4	114.1	16.3	16.3
Norm. P/E (x)	32.6	N/A	18.8	N/A	8.8	N/A	7.6
EV/EBITDA	9.9	N/A	7.6	N/A	3.9	N/A	3.1
Price/book (x)	4.2	N/A	3.5	N/A	2.6	N/A	2.0
Dividend yield (%)	1.0	N/A	1.1	N/A	0.6	N/A	1.1
ROE (%)	12.3	20.1	20.2	33.6	33.6	29.7	29.8
Net debt/equity (%)	43.4	33.1	33.0	6.1	6.0	net cash	net cash

Source: Nomura estimates

Key company data: *See page 2 for company data, and detailed price/index chart.*
Rating: *See report end for details of Nomura's rating system.*

Anchor themes

Nomura's global mining team forecasts that the global thermal coal market will remain in deficit over the next five years as demand growth from China and India outstrips supply growth from Indonesia and Australia. Strong domestic demand in Indonesia is another boost for the sector.

Nomura vs consensus

Our FY12F earnings estimate is 42% higher than consensus on our higher coal price assumption.

Research analysts

Indonesia Metals & Mining

Isnaputra Iskandar, CFA - PTNI
isnaputra.iskandar@nomura.com
+62 21 2991 3346

Key data on Adaro Energy

Income statement (IDRbn)

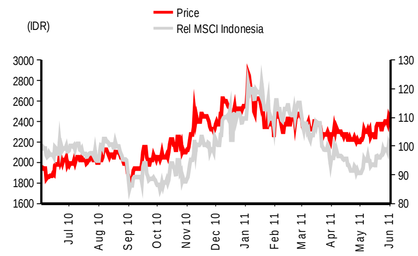
Year-end 31 Dec	FY09	FY10	FY11F	FY12F	FY13F
Revenue	**26,938**	**24,689**	**31,174**	**44,781**	**49,931**
Cost of goods sold	-15,900	-16,957	-21,215	-26,039	-28,701
Gross profit	**11,038**	**7,732**	**9,959**	**18,742**	**21,230**
SG&A	-1,109	-958	-1,120	-1,426	-1,565
Employee share expense					
Operating profit	**9,928**	**6,774**	**8,839**	**17,316**	**19,665**
EBITDA	**11,221**	**8,677**	**11,236**	**20,218**	**23,136**
Depreciation	-763	-906	-1,105	-1,315	-1,568
Amortisation	-529	-997	-1,292	-1,587	-1,904
EBIT	9,928	6,774	8,839	17,316	19,665
Net interest expense	-848	-1,006	-830	-753	-485
Associates & JCEs	0	0	-13	-13	-13
Other income	-502	-718	-492	-486	-486
Earnings before tax	**8,578**	**5,050**	**7,503**	**16,063**	**18,680**
Income tax	-4,119	-2,669	-3,377	-7,228	-8,406
Net profit after tax	**4,459**	**2,381**	**4,127**	**8,835**	**10,274**
Minority interests	-49	-3	-3	-5	-5
Other items	-43	0	0	0	0
Preferred dividends					
Normalised NPAT	**4,367**	**2,379**	**4,124**	**8,830**	**10,269**
Extraordinary items	0	-172	0	0	0
Reported NPAT	**4,367**	**2,207**	**4,124**	**8,830**	**10,269**
Dividends	0	-761	-859	-441	-825
Transfer to reserves	**4,367**	**1,446**	**3,265**	**8,389**	**9,444**
Valuation and ratio analysis					
FD normalised P/E (x)	17.8	32.6	18.8	8.8	7.6
FD normalised P/E at price target (x)	22.0	40.3	23.3	10.9	9.3
Reported P/E (x)	17.8	35.1	18.8	8.8	7.6
Dividend yield (%)	na	1.0	1.1	0.6	1.1
Price/cashflow (x)	10.9	30.0	12.5	7.4	6.1
Price/book (x)	4.4	4.2	3.5	2.6	2.0
EV/EBITDA (x)	7.2	9.9	7.6	3.9	3.1
EV/EBIT (x)	8.2	12.6	9.6	4.6	3.6
Gross margin (%)	41.0	31.3	31.9	41.9	42.5
EBITDA margin (%)	41.7	35.1	36.0	45.1	46.3
EBIT margin (%)	36.9	27.4	28.4	38.7	39.4
Net margin (%)	16.2	8.9	13.2	19.7	20.6
Effective tax rate (%)	48.0	52.8	45.0	45.0	45.0
Dividend payout (%)	0.0	34.5	20.8	5.0	8.0
Capex to sales (%)	4.1	9.1	16.3	9.3	4.7
Capex to depreciation (x)	1.5	2.5	4.6	3.2	1.5
ROE (%)	27.8	12.3	20.2	33.6	29.8
ROA (pretax %)	31.8	20.5	23.9	43.0	46.8
Growth (%)					
Revenue	48.9	-8.3	26.3	43.6	11.5
EBITDA	155.1	-22.7	29.5	79.9	14.4
EBIT	135.7	-31.8	30.5	95.9	13.6
Normalised EPS	246.6	-45.5	73.4	114.1	16.3
Normalised FDEPS	246.6	-45.5	73.4	114.1	16.3
Per share					
Reported EPS (IDR)	136.54	69.00	128.92	276.06	321.04
Norm EPS (IDR)	136.54	74.37	128.92	276.06	321.04
Fully diluted norm EPS (IDR)	136.54	74.37	128.92	276.06	321.04
Book value per share (IDR)	545.39	580.77	695.89	946.16	1,211.99
DPS (IDR)	0.00	23.80	26.85	13.80	25.78

Source: Nomura estimates

Notes

Strong EBITDA on higher volume and ASPs

Price and price relative chart (one year)



(%)	1M	3M	12M
Absolute (IDR)	10.2	0.0	26.3
Absolute (USD)	10.5	3.0	36.5
Relative to index	10.3	-10.0	-2.4
Market cap (USDmn)	9,079.5		
Estimated free float (%)	40.2		
52-week range (IDR)	2900/1760		
3-mth avg daily turnover (USDmn)	16.20		
Major shareholders (%)			
Adaro Strategic investments	43.9		

Cashflow (IDRbn)

Year-end 31 Dec	FY09	FY10	FY11F	FY12F	FY13F
EBITDA	11,221	8,677	11,236	20,218	23,136
Change in working capital	1,836	-1,716	-72	-709	-155
Other operating cashflow	-5,959	-4,371	-4,948	-9,006	-10,216
Cashflow from operations	**7,097**	**2,590**	**6,216**	**10,503**	**12,765**
Capital expenditure	-1,114	-2,251	-5,067	-4,167	-2,340
Free cashflow	**5,983**	**339**	**1,149**	**6,336**	**10,425**
Reduction in investments	1	-3,208	0	0	0
Net acquisitions	-100	-3,747	0	0	0
Reduction in other LT assets	82	-417	0	0	0
Addition in other LT liabilities	-688	49	0	0	0
Adjustments	611	3,611	0	0	0
Cashflow after investing acts	**5,889**	**-3,373**	**1,149**	**6,336**	**10,425**
Cash dividends	-761	-859	-441	-825	-1,766
Equity issue	0	0	0	0	0
Debt issue	4,497	-1,179	-1,378	-1,406	-1,608
Convertible debt issue					
Others	-766	-403	19	5	5
Cashflow from financial acts	**2,969**	**-2,441**	**-1,801**	**-2,226**	**-3,369**
Net cashflow	**8,859**	**-5,815**	**-651**	**4,110**	**7,056**
Beginning cash	2,416	11,275	5,460	4,809	8,918
Ending cash	11,275	5,460	4,809	8,918	15,975
Ending net debt	3,665	8,058	7,337	1,821	-6,843

Source: Nomura estimates

Notes

Strong internal cash flows to fund capex

Balance sheet (IDRbn)

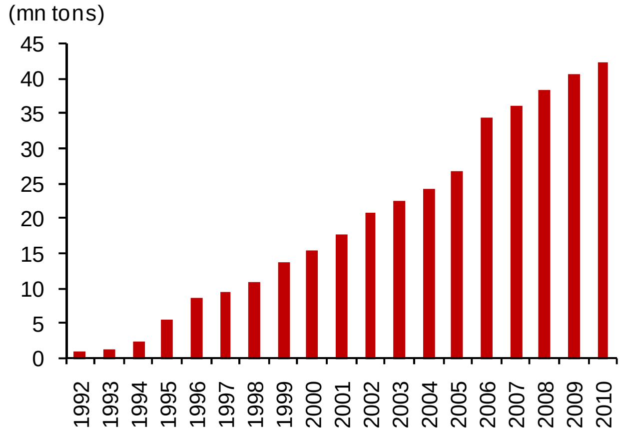
As at 31 Dec	FY09	FY10	FY11F	FY12F	FY13F
Cash & equivalents	11,275	5,460	4,809	8,918	15,975
Marketable securities	0	0	0	0	0
Accounts receivable	2,882	2,476	3,127	4,492	5,008
Inventories	250	289	289	289	289
Other current assets	1,396	1,975	1,975	1,975	1,975
Total current assets	**15,804**	**10,200**	**10,199**	**15,674**	**23,247**
LT investments	5	3,213	3,213	3,213	3,213
Fixed assets	7,416	8,810	12,700	15,465	16,134
Goodwill	9,092	8,462	7,976	7,490	7,004
Other intangible assets	9,792	9,246	8,751	8,256	7,761
Other LT assets	253	669	669	669	669
Total assets	**42,360**	**40,601**	**43,509**	**50,768**	**58,029**
Short-term debt	2,012	1,347	1,406	1,608	945
Accounts payable	2,168	2,413	2,992	3,647	4,009
Other current liabilities	3,783	2,033	2,033	2,033	2,033
Total current liabilities	**7,963**	**5,794**	**6,431**	**7,289**	**6,988**
Long-term debt	12,928	12,171	10,740	9,131	8,186
Convertible debt					
Other LT liabilities	3,957	4,006	4,006	4,006	4,006
Total liabilities	**24,848**	**21,970**	**21,177**	**20,426**	**19,180**
Minority interest	67	54	73	78	83
Preferred stock	0	0	0	0	0
Common stock	13,931	13,931	13,931	13,931	13,931
Retained earnings	4,028	5,377	9,059	17,064	25,567
Proposed dividends					
Other equity and reserves	-514	-731	-731	-731	-731
Total shareholders' equity	**17,445**	**18,576**	**22,259**	**30,264**	**38,767**
Total equity & liabilities	**42,360**	**40,601**	**43,509**	**50,768**	**58,029**
Liquidity (x)					
Current ratio	1.98	1.76	1.59	2.15	3.33
Interest cover	11.7	6.7	10.6	23.0	40.5
Leverage					
Net debt/EBITDA (x)	0.33	0.93	0.65	0.09	net cash
Net debt/equity (%)	21.0	43.4	33.0	6.0	net cash
Activity (days)					
Days receivable	35.3	39.6	32.8	31.1	34.7
Days inventory	6.4	5.8	5.0	4.1	3.7
Days payable	54.7	49.3	46.5	46.7	48.7
Cash cycle	-13.0	-3.9	-8.7	-11.5	-10.3

Source: Nomura estimates

Notes

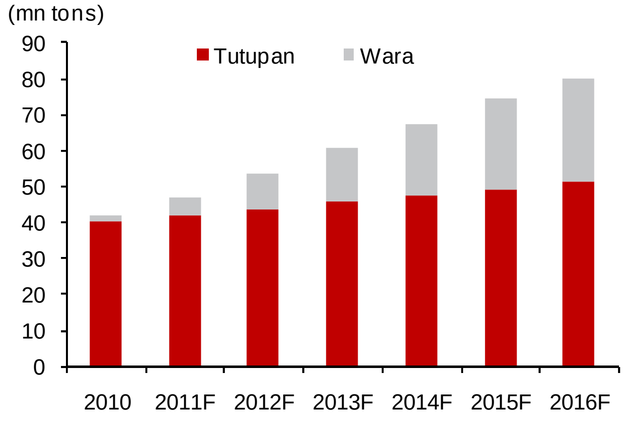
Healthy balance sheet with lower gearing going forward

Fig. 89: Strong production track record



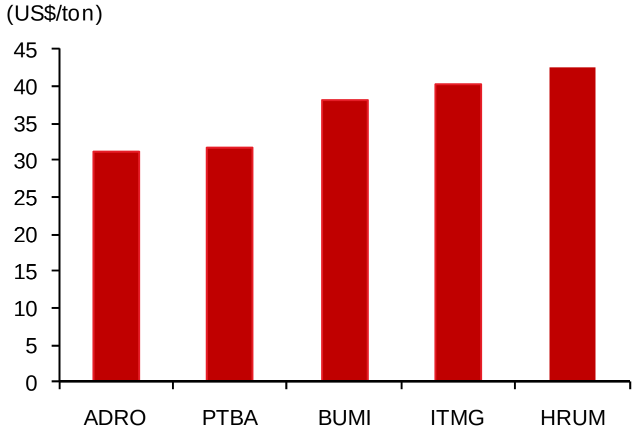
Source: Company data

Fig. 90: Production up to 80mn tons in 2016F



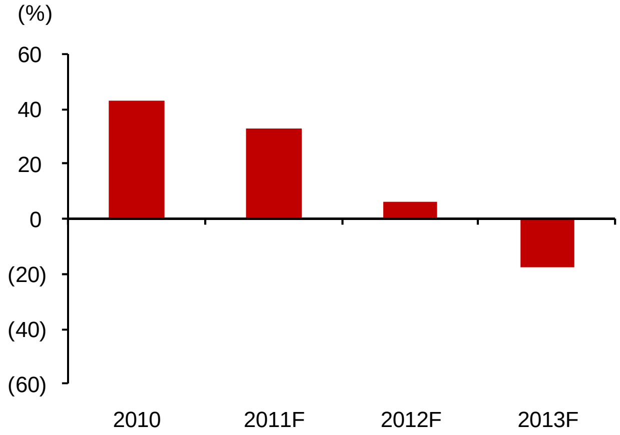
Source: Company data, Nomura estimates

Fig. 91: ADRO has competitive production cash cost (2010)



Source: Nomura estimates

Fig. 92: ADRO expected to be debt-free by end of 2013F



Source: Company data, Nomura estimates

Valuation Methodology. We set our 2011-end target price for ADRO at IDR3,000, equivalent to FY11-12F EV/EBITDA of 9.9-5.1x and P/E of 23.4-10.9x. We derive our target price using DCF methodology, with discount rates of 10.0% and 11.3% for the coal and non-coal businesses, respectively. We set 8% and 0% terminal value growth rates for coal and non-coal businesses, respectively. For ADRO's stake in the IndoMet Coal project, our valuation is based on an acquisition cost of USD350mn.

Risks. Key risks to the achievement of our target price include execution risk, land acquisition, Wara performance, mining contractor risk and exchange rate volatility.

Bumi Resources BUMI.JK BUMI IJ

METALS & MINING

NOMURA
EQUITY RESEARCH

A financial and operating leverage play

The most exposed to seaborne market with improving balance sheet profile

June 7, 2011

Rating Remains	**Buy**
Target price Remains	IDR 4,750
Closing price June 1, 2011	IDR 3,350
Potential upside	+41.8%

Action and catalysts: BUY, target price IDR4,750

We reaffirm our BUY rating on BUMI with a target price of Rp4,750, implying 2011-12F EV/EBITDA of 8.3-4.3x. Key catalysts include a CIC debt/equity swap, operational improvements and coal price recovery.

Improved risk profile post the Vallar deal

We expect lower balance sheet risk and better corporate governance post the Vallar deal. On potential CIC debt restructure, the most likely scenario would be the swap of CIC debt with Vallar shares on, among others: 1) CIC would have access to ~25-30% of Indonesian coal production; 2) it would face less Indonesian capital market regulatory issues, as there would be no dilution impact to BUMI shareholders; and 3) this would be in line with Vallar's strategy to increase its stake in BUMI to ~50%.

Ongoing production expansion

We forecast production to go up to 106mn tons in 2014F from 61mn tons in 2010 (15% CAGR). Total capex for 2010-13F is US$1,250mn, where ~US$800mn will be spent by third parties and the rest by BUMI.

Valuation: Discounted EV/EBITDA

BUMI's 2011F and rolling-forward EV/EBITDA valuations imply: 1) a 25% discount to the peer average; and 2) a 36% discount to its 5-year average.

Risk factors

Key risks include execution risk, external mining contractor risk, balance sheet risk, tax dispute risk and share price volatility risk.

31 Dec	FY10	FY11F		FY12F		FY13F	
Currency (USD)	Actual	Old	New	Old	New	Old	New
Revenue (mn)	4,370	5,556	5,556	8,156	8,156	9,543	9,543
Reported net profit (mn)	311	302	302	925	925	1,310	1,310
Normalised net profit (mn)	311	302	302	925	925	1,310	1,310
Normalised EPS	0.0	0.0	0.0	0.0	0.0	0.1	0.1
Norm. EPS growth (%)	63.4	-2.9	-2.9	205.9	205.9	41.6	41.6
Norm. P/E (x)	24.8	N/A	25.6	N/A	8.4	N/A	5.9
EV/EBITDA	7.8	N/A	6.0	N/A	3.1	N/A	2.1
Price/book (x)	4.8	N/A	4.2	N/A	2.8	N/A	2.0
Dividend yield (%)	0.8	N/A	0.8	N/A	0.8	N/A	2.4
ROE (%)	21.0	17.4	17.4	40.4	40.4	39.9	39.9
Net debt/equity (%)	227.8	177.3	177.3	81.8	81.8	20.0	20.0

Source: Nomura estimates

Key company data: *See page 2 for company data, and detailed price/index chart.*
Rating: *See report end for details of Nomura's rating system.*

Anchor themes

Nomura's global mining team forecasts the global thermal coal market to remain in deficit over the next five years as demand growth from China and India outstrips supply growth from Indonesia and Australia. The strong domestic demand in Indonesia is another boost for the sector.

Nomura vs consensus

Our FY12F earnings estimates are 42% more bullish than consensus on our higher coal price assumption.

Research analysts

Indonesia Metals & Mining

Isnaputra Iskandar, CFA - PTNI
isnaputra.iskandar@nomura.com
+62 21 2991 3346

Key data on Bumi Resources

Income statement (USDmn)

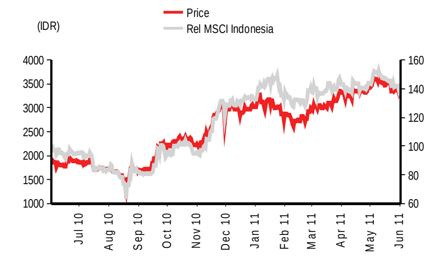
Year-end 31 Dec	FY09	FY10	FY11F	FY12F	FY13F
Revenue	**3,665**	**4,370**	**5,556**	**8,156**	**9,543**
Cost of goods sold	-2,549	-2,744	-3,375	-4,452	-5,013
Gross profit	**1,116**	**1,626**	**2,181**	**3,704**	**4,530**
SG&A	-477	-527	-616	-791	-895
Employee share expense					
Operating profit	**638**	**1,099**	**1,564**	**2,913**	**3,635**
EBITDA	**753**	**1,234**	**1,711**	**3,081**	**3,823**
Depreciation	-114	-135	-147	-167	-188
Amortisation					
EBIT	638	1,099	1,564	2,913	3,635
Net interest expense	-181	-630	-594	-572	-484
Associates & JCEs	83	236	132	134	134
Other income	-23	295	-17	-8	16
Earnings before tax	**518**	**999**	**1,085**	**2,468**	**3,302**
Income tax	-234	-456	-488	-1,111	-1,486
Net profit after tax	**284**	**543**	**597**	**1,357**	**1,816**
Minority interests	-93	-232	-295	-433	-506
Other items					
Preferred dividends					
Normalised NPAT	**190**	**311**	**302**	**925**	**1,310**
Extraordinary items					
Reported NPAT	**190**	**311**	**302**	**925**	**1,310**
Dividends	-97	-59	-62	-60	-185
Transfer to reserves	**94**	**252**	**240**	**864**	**1,125**
Valuation and ratio analysis					
FD normalised P/E (x)	35.1	24.8	25.6	8.4	5.9
FD normalised P/E at price target (x)	49.8	35.2	36.3	11.9	8.4
Reported P/E (x)	35.1	24.8	25.6	8.4	5.9
Dividend yield (%)	1.4	0.8	0.8	0.8	2.4
Price/cashflow (x)	27.2	24.9	20.5	8.5	5.7
Price/book (x)	5.5	4.8	4.2	2.8	2.0
EV/EBITDA (x)	11.7	7.8	6.0	3.1	2.1
EV/EBIT (x)	13.6	8.6	6.5	3.3	2.3
Gross margin (%)	30.4	37.2	39.3	45.4	47.5
EBITDA margin (%)	20.5	28.2	30.8	37.8	40.1
EBIT margin (%)	17.4	25.1	28.2	35.7	38.1
Net margin (%)	5.2	7.1	5.4	11.3	13.7
Effective tax rate (%)	45.2	45.6	45.0	45.0	45.0
Dividend payout (%)	50.7	19.0	20.6	6.5	14.1
Capex to sales (%)	14.5	12.9	6.3	4.3	3.7
Capex to depreciation (x)	4.7	4.2	2.4	2.1	1.9
ROE (%)	15.1	21.0	17.4	40.4	39.9
ROA (pretax %)	11.7	16.9	19.6	34.1	41.0
Growth (%)					
Revenue	8.5	19.2	27.1	46.8	17.0
EBITDA	-35.7	63.9	38.7	80.0	24.1
EBIT	-42.1	72.2	42.4	86.2	24.8
Normalised EPS	-48.8	63.4	-2.9	205.9	41.6
Normalised FDEPS	-48.8	63.4	-2.9	205.9	41.6
Per share					
Reported EPS (USD)	0.01	0.01	0.01	0.04	0.06
Norm EPS (USD)	0.01	0.01	0.01	0.04	0.06
Fully diluted norm EPS (USD)	0.01	0.01	0.01	0.04	0.06
Book value per share (USD)	0.07	0.08	0.09	0.13	0.19
DPS (USD)	0.00	0.00	0.00	0.00	0.01

Source: Nomura estimates

Notes

Robust EPS growth

Price and price relative chart (one year)



(%)	1M	3M	12M
Absolute (IDR)	-2.2	12.6	75.4
Absolute (USD)	-1.9	16.0	89.5
Relative to index	-2.1	2.6	46.7
Market cap (USDmn)	8,146.0		
Estimated free float (%)	91.3		
52-week range (IDR)	3650/1280		
3-mth avg daily turnover (USDmn)	39.30		
Major shareholders (%)			
Vallar	25.0		

Cashflow (USDmn)

Year-end 31 Dec	FY09	FY10	FY11F	FY12F	FY13F
EBITDA	753	1,234	1,711	3,081	3,823
Change in working capital	-817	-398	36	-71	-39
Other operating cashflow	310	-525	-1,370	-2,098	-2,435
Cashflow from operations	**246**	**311**	**377**	**912**	**1,350**
Capital expenditure	-532	-564	-350	-350	-350
Free cashflow	**-286**	**-254**	**27**	**562**	**1,000**
Reduction in investments	-554	-311	0	0	0
Net acquisitions					
Reduction in other LT assets	-1,075	-332	5	5	5
Addition in other LT liabilities	-145	-15	0	0	0
Adjustments	709	521	127	129	129
Cashflow after investing acts	**-1,351**	**-391**	**160**	**696**	**1,134**
Cash dividends	-97	-59	-62	-60	-185
Equity issue	0	360	0	0	0
Debt issue	1,527	314	-79	-276	-821
Convertible debt issue					
Others	-191	-30	295	433	506
Cashflow from financial acts	**1,239**	**584**	**154**	**96**	**-500**
Net cashflow	**-112**	**193**	**313**	**793**	**634**
Beginning cash	172	60	253	567	1,359
Ending cash	60	253	567	1,359	1,993
Ending net debt	3,431	3,686	3,294	2,225	770

Source: Nomura estimates

Notes

Strong free cash flows on higher volume and ASPs

Balance sheet (USDmn)

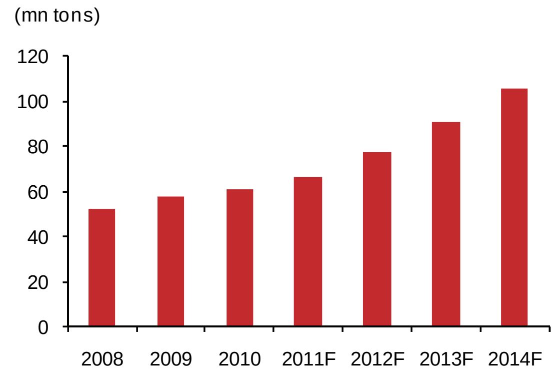
As at 31 Dec	FY09	FY10	FY11F	FY12F	FY13F
Cash & equivalents	60	253	567	1,359	1,993
Marketable securities	229	230	230	230	230
Accounts receivable	831	763	835	993	1,078
Inventories	199	169	169	169	169
Other current assets	1,026	1,777	1,777	1,777	1,777
Total current assets	**2,345**	**3,192**	**3,578**	**4,529**	**5,247**
LT investments	857	1,166	1,166	1,166	1,166
Fixed assets	1,140	1,093	1,296	1,479	1,640
Goodwill	366	344	324	304	284
Other intangible assets					
Other LT assets	2,646	2,978	2,973	2,968	2,963
Total assets	**7,354**	**8,773**	**9,337**	**10,446**	**11,301**
Short-term debt	422	9	276	821	600
Accounts payable	398	278	386	473	519
Other current liabilities	1,384	1,759	1,759	1,759	1,759
Total current liabilities	**2,204**	**2,045**	**2,420**	**3,053**	**2,877**
Long-term debt	2,305	3,563	3,218	2,397	1,797
Convertible debt	764	367	367	367	367
Other LT liabilities	601	585	585	585	585
Total liabilities	**5,874**	**6,561**	**6,590**	**6,402**	**5,626**
Minority interest	126	595	889	1,322	1,828
Preferred stock	0	0	0	0	0
Common stock	1,472	1,832	1,832	1,832	1,832
Retained earnings	853	1,105	1,345	2,209	3,334
Proposed dividends					
Other equity and reserves	-971	-1,319	-1,319	-1,319	-1,319
Total shareholders' equity	**1,354**	**1,618**	**1,858**	**2,722**	**3,847**
Total equity & liabilities	**7,354**	**8,773**	**9,337**	**10,446**	**11,301**
Liquidity (x)					
Current ratio	1.06	1.56	1.48	1.48	1.82
Interest cover	3.5	1.7	2.6	5.1	7.5
Leverage					
Net debt/EBITDA (x)	4.56	2.99	1.92	0.72	0.20
Net debt/equity (%)	253.5	227.8	177.3	81.8	20.0
Activity (days)					
Days receivable	54.9	66.6	52.5	41.0	39.6
Days inventory	25.2	24.5	18.3	13.9	12.3
Days payable	46.9	45.0	35.9	35.3	36.1
Cash cycle	33.2	46.1	34.9	19.6	15.8

Source: Nomura estimates

Notes

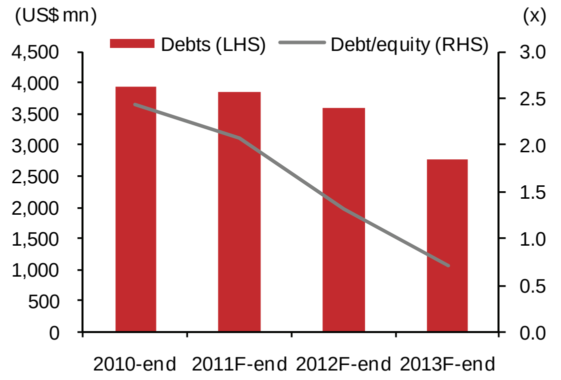
Lower gearing going forward

Fig. 93: Consistently growing production



Source: Company data, Nomura estimates

Fig. 94: Lower gearing going forward



Source: Company data, Nomura estimates

Valuation Methodology. Our target price of IDR4,750 is based on a sum of the parts (SOTP) methodology (multiplied by BUMI's stake in each of its assets) as follows: 1) for the existing mines, KPC and Arutmin, we value the assets using DCF at a 12.36% discount rate. Our cash flow projections for this DCF value are until 2021F assuming 10% terminal growth; 2) for KPC's and Arutmin's resources, we value the assets at USD0.8/ton; 3) for the reserves and resources of BUMI's two subsidiaries, Fajar Bumi Sakti (FBS) and Pendopo Energi Batubara (PEB), we assign a valuation of USD0.1/ton; and 4) for BUMI's stake in Darma Henwa (DEWA IJ) and Bumi Resources Minerals BRMS IJ), we use the closing prices as of 30 December 2010 of IDR71/share and IDR670/share, respectively.

Risks. Key risks include execution risk, external mining contractor risk, balance sheet risk, tax dispute risk and share price volatility risk.

Tambang Batubara Bukit Asam

PTBA.JK PTBA IJ

METALS & MINING

NOMURA
EQUITY RESEARCH

A defensive play

Good operations with high upside potential

June 7, 2011

Rating Remains	**Buy**
Target price Remains	IDR 30,000
Closing price June 1, 2011	IDR 21,400
Potential upside	+40.2%

Action and catalysts: BUY, target price IDR30,000

We reiterate our BUY call on PTBA with a target price of IDR30,000, implying 23.6-13.6x FY11-12F earnings. Catalysts include coal price recovery, strong ramp-up in railway volume and good progress in projects.

Downward protection

PTBA's long-term contract with PLN, now 8.0mn tonnes pa, should give the former not only a captive market but also downside protection. In our view, pricing should not be an issue due to: 1) its link to the international price; and 2) no government intervention in pricing negotiations.

Resilient to oil price increases

PTBA's efficient production cash cost structure enables it to face cost challenges, driven by higher oil prices. As 35-40% of its production facilities are run on electricity, fuel costs account for, on our estimates, only ~ 5% of total cash costs, far less than other coal companies' 20-30%.

Projects on the table

PTBA's USD2.3bn in projects can more than quadruple production to 50mn tonnes in 2016F, we estimate. Execution is key, but PTBA's strong partners should lower the risk. In our view, funding should not be an issue given the projects' leverage and PTBA's small stakes and strong cash positions.

Risk factors

Key risk factors are high reliance on a single customer, high reliance on railway performance, execution risks, external mining contractor risks and exchange rate volatility.

31 Dec	FY10	FY11F		FY12F		FY13F	
Currency (IDR)	Actual	Old	New	Old	New	Old	New
Revenue (bn)	7,909	10,374	10,374	14,824	14,824	16,721	16,721
Reported net profit (bn)	2,014	2,929	2,929	5,099	5,099	5,777	5,777
Normalised net profit (bn)	2,014	2,929	2,929	5,099	5,099	5,777	5,777
Normalised EPS	874.3	1,271.4	1,271.4	2,212.8	2,212.8	2,507.0	2,507.0
Norm. EPS growth (%)	-26.2	45.4	45.4	74.0	74.0	13.3	13.3
Norm. P/E (x)	24.5	N/A	16.8	N/A	9.7	N/A	8.5
EV/EBITDA	18.8	N/A	11.6	N/A	6.2	N/A	5.2
Price/book (x)	7.7	N/A	5.9	N/A	4.1	N/A	3.3
Dividend yield (%)	2.5	N/A	2.0	N/A	3.0	N/A	5.2
ROE (%)	33.4	40.0	40.0	50.4	50.4	42.7	42.7
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash	net cash	net cash

Source: Nomura estimates

Key company data: *See page 2 for company data, and detailed price/index chart.*
Rating: *See report end for details of Nomura's rating system.*

Anchor themes

Our global mining team forecasts that the global thermal coal market will remain in deficit over the next five years, as demand growth from China and India will outstrip supply growth from Indonesia and Australia. Strong domestic demand is another boost to the sector.

Nomura vs consensus

Our FY12F EPS estimate is 21% higher than consensus on higher coal price assumptions.

Research analysts

Indonesia Metals & Mining

Isnaputra Iskandar, CFA - PTNI
isnaputra.iskandar@nomura.com
+62 21 2991 3346

Key data on Tambang Batubara Bukit Asam

Income statement (IDRbn)

Year-end 31 Dec	FY09	FY10	FY11F	FY12F	FY13F
Revenue	**8,948**	**7,909**	**10,374**	**14,824**	**16,721**
Cost of goods sold	-4,104	-4,259	-5,227	-6,597	-7,529
Gross profit	**4,844**	**3,650**	**5,147**	**8,227**	**9,192**
SG&A	-1,295	-1,346	-1,436	-1,631	-1,754
Employee share expense					
Operating profit	**3,548**	**2,304**	**3,711**	**6,596**	**7,438**
EBITDA	**3,602**	**2,354**	**3,774**	**6,684**	**7,551**
Depreciation	-54	-49	-63	-88	-113
Amortisation					
EBIT	3,548	2,304	3,711	6,596	7,438
Net interest expense	202	244	152	164	229
Associates & JCEs					
Other income	15	57	57	57	57
Earnings before tax	**3,765**	**2,605**	**3,919**	**6,817**	**7,723**
Income tax	-1,033	-601	-980	-1,704	-1,931
Net profit after tax	**2,733**	**2,005**	**2,939**	**5,113**	**5,792**
Minority interests	-2	10	-10	-14	-16
Other items					
Preferred dividends					
Normalised NPAT	**2,731**	**2,014**	**2,929**	**5,099**	**5,777**
Extraordinary items					
Reported NPAT	**2,731**	**2,014**	**2,929**	**5,099**	**5,777**
Dividends	-1,007	-1,236	-1,004	-1,465	-2,549
Transfer to reserves	**1,724**	**779**	**1,925**	**3,634**	**3,227**

Valuation and ratio analysis					
FD normalised P/E (x)	18.1	24.5	16.8	9.7	8.5
FD normalised P/E at price target (x)	25.3	34.3	23.6	13.6	12.0
Reported P/E (x)	18.1	24.5	16.8	9.7	8.5
Dividend yield (%)	2.0	2.5	2.0	3.0	5.2
Price/cashflow (x)	17.9	19.8	23.1	11.4	9.0
Price/book (x)	8.6	7.7	5.9	4.1	3.3
EV/EBITDA (x)	12.4	18.8	11.6	6.2	5.2
EV/EBIT (x)	12.6	19.2	11.8	6.3	5.3
Gross margin (%)	54.1	46.2	49.6	55.5	55.0
EBITDA margin (%)	40.3	29.8	36.4	45.1	45.2
EBIT margin (%)	39.7	29.1	35.8	44.5	44.5
Net margin (%)	30.5	25.5	28.2	34.4	34.5
Effective tax rate (%)	27.4	23.1	25.0	25.0	25.0
Dividend payout (%)	36.9	61.3	34.3	28.7	44.1
Capex to sales (%)	0.7	7.3	6.9	4.9	4.3
Capex to depreciation (x)	1.2	11.8	11.4	8.1	6.3
ROE (%)	56.3	33.4	40.0	50.4	42.7
ROA (pretax %)	110.3	65.5	83.9	111.2	103.3

Growth (%)					
Revenue	24.0	-11.6	31.2	42.9	12.8
EBITDA	40.5	-34.7	60.4	77.1	13.0
EBIT	42.3	-35.1	61.0	77.8	12.8
Normalised EPS	60.0	-26.2	45.4	74.0	13.3
Normalised FDEPS	60.0	-26.2	45.4	74.0	13.3

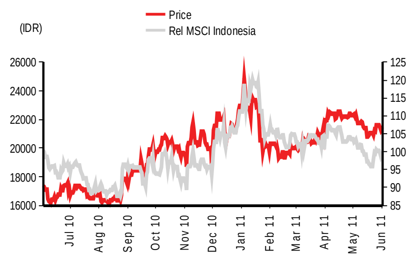
Per share					
Reported EPS (IDR)	1,185.30	874.28	1,271.39	2,212.79	2,507.04
Norm EPS (IDR)	1,185.30	874.28	1,271.39	2,212.79	2,507.04
Fully diluted norm EPS (IDR)	1,185.30	874.28	1,271.39	2,212.79	2,507.04
Book value per share (IDR)	2,474.41	2,763.18	3,598.64	5,175.74	6,576.38
DPS (IDR)	437.26	536.36	435.93	635.69	1,106.40

Source: Nomura estimates

Notes

Robust earnings growth on higher volume and better ASPs

Price and price relative chart (one year)



(%)	1M	3M	12M
Absolute (IDR)	-4.0	6.5	27.0
Absolute (USD)	-3.8	9.6	37.2
Relative to index	-4.0	-3.6	-1.7
Market cap (USDmn)	5,771.8		
Estimated free float (%)	35.0		
52-week range (IDR)	26000/15950		
3-mth avg daily turnover (USDmn)	7.11		
Major shareholders (%)			
Government of Indonesia	65.0		

Cashflow (IDRbn)

Year-end 31 Dec	FY09	FY10	FY11F	FY12F	FY13F
EBITDA	3,602	2,354	3,774	6,684	7,551
Change in working capital	-152	249	-846	-866	-399
Other operating cashflow	-690	-113	-795	-1,497	-1,661
Cashflow from operations	**2,760**	**2,490**	**2,134**	**4,321**	**5,491**
Capital expenditure	-64	-581	-720	-720	-720
Free cashflow	**2,696**	**1,909**	**1,414**	**3,601**	**4,771**
Reduction in investments	3	-144	0	0	0
Net acquisitions	-10	-150	0	0	0
Reduction in other LT assets	-79	-174	0	0	0
Addition in other LT liabilities	236	222	0	0	0
Adjustments	-161	29	0	0	0
Cashflow after investing acts	**2,686**	**1,691**	**1,414**	**3,601**	**4,771**
Cash dividends	-1,007	-1,236	-1,004	-1,465	-2,549
Equity issue	0	0	0	0	0
Debt issue	0	0	0	0	0
Convertible debt issue					
Others	-11	-110	10	14	16
Cashflow from financial acts	**-1,019**	**-1,346**	**-995**	**-1,451**	**-2,533**
Net cashflow	**1,667**	**345**	**419**	**2,150**	**2,238**
Beginning cash	3,042	4,709	5,054	5,473	7,623
Ending cash	4,709	5,054	5,473	7,623	9,861
Ending net debt	-4,696	-5,041	-5,473	-7,623	-9,861

Source: Nomura estimates

Notes

Strong cash flows

Balance sheet (IDRbn)

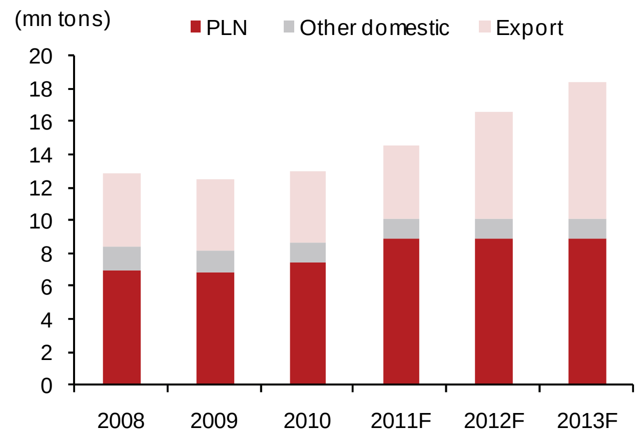
As at 31 Dec	FY09	FY10	FY11F	FY12F	FY13F
Cash & equivalents	4,709	5,054	5,473	7,623	9,861
Marketable securities	0	0	0	0	0
Accounts receivable	1,505	997	1,745	2,494	2,813
Inventories	410	424	522	659	752
Other current assets	159	171	171	171	171
Total current assets	**6,783**	**6,646**	**7,912**	**10,947**	**13,597**
LT investments	123	267	267	267	267
Fixed assets	447	921	1,578	2,209	2,816
Goodwill					
Other intangible assets	199	188	188	188	188
Other LT assets	527	701	701	701	701
Total assets	**8,079**	**8,723**	**10,645**	**14,312**	**17,569**
Short-term debt	14	13	0	0	0
Accounts payable	58	73	74	93	107
Other current liabilities	1,309	1,061	1,061	1,061	1,061
Total current liabilities	**1,381**	**1,148**	**1,135**	**1,155**	**1,168**
Long-term debt					
Convertible debt					
Other LT liabilities	912	1,134	1,134	1,134	1,134
Total liabilities	**2,293**	**2,281**	**2,269**	**2,288**	**2,302**
Minority interest	84	75	84	98	114
Preferred stock	0	0	0	0	0
Common stock	1,183	1,183	1,183	1,183	1,183
Retained earnings	4,519	5,184	7,109	10,743	13,970
Proposed dividends					
Other equity and reserves					
Total shareholders' equity	**5,701**	**6,367**	**8,292**	**11,926**	**15,153**
Total equity & liabilities	**8,079**	**8,723**	**10,645**	**14,312**	**17,569**
Liquidity (x)					
Current ratio	4.91	5.79	6.97	9.48	11.64
Interest cover	na	na	na	na	na
Leverage					
Net debt/EBITDA (x)	net cash	net cash	net cash	net cash	net cash
Net debt/equity (%)	net cash	net cash	net cash	net cash	net cash
Activity (days)					
Days receivable	58.8	57.7	48.2	52.3	57.9
Days inventory	36.9	35.7	33.0	32.8	34.2
Days payable	5.7	5.6	5.1	4.6	4.8
Cash cycle	90.0	87.8	76.1	80.5	87.3

Source: Nomura estimates

Notes

Debt-free balance sheet

Fig. 95: Resilient domestic as most go to PLN

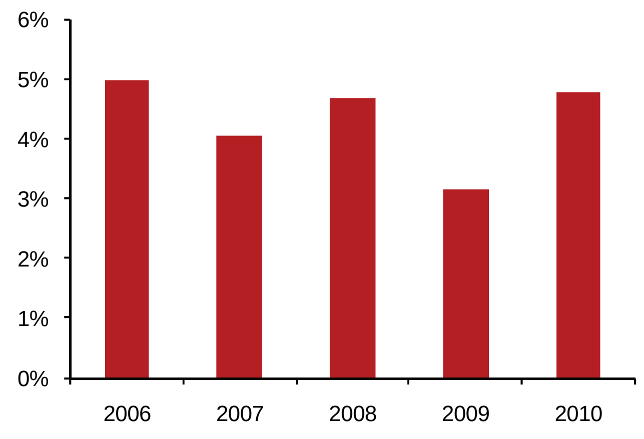


Source: Company data, Nomura estimates

Fig. 96: High exposure to domestic market

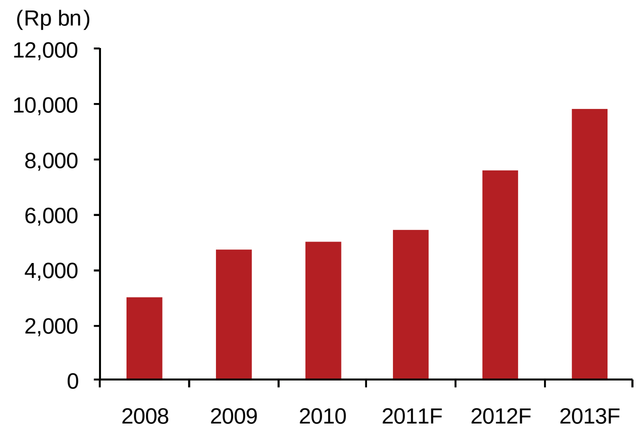
Source: Company data, Nomura estimates

Fig. 97: Low fuel cost/production cash cost ratio



Source: Company data, Nomura estimates

Fig. 98: Strong cash position with no debt



Source: Company data,, Nomura estimates

Valuation Methodology. Our target price of INR30,000/share is based on DCF methodology with an 11.9% WACC. Our DCF valuation is based on our 10-year (2012-21F) financial forecasts, and afterwards we take a terminal value based on 10% terminal value growth for the available reserves after 2021. In addition, due to the significant resources that PTBA has, we add valuation of PTBA's resources in our DCF calculation based upon USD0.25/ton of resources.

Risks. Key risk factors include high reliance on a single customer, high reliance on railway performance, execution risks, external mining contractor risks, and exchange rate volatility.

Bank Rakyat Indonesia BBRI.JK BBRI IJ

BANKS

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EQUITY RESEARCH

Rakyat company update

Converging tailwinds make Rakyat our top pick in the Indonesian banking sector

June 7, 2011

Rating Remains	**Buy**
Target price Remains	IDR 8,400
Closing price June 1, 2011	IDR 6,250
Potential upside	+34.4%

Action: Reaffirming BUY; TP of IDR8,400

- A convergence of macro (moderating inflation, interest rates) and micro (no rights issue, loan composition change) positives serves to highlight the most attractive P/E-ROE dynamics in ASEAN. Rakyat is unaffected by regulatory issues weighing on peers and has a robust urban strategy balancing its unique exposure to Indonesia's rural income theme.
- The moderating inflation outlook (Nomura recently cut 2011F CPI to 5.7%, from 6.4%) is especially positive for Rakyat, in our view, given its core low-income micro/small loan customer base. A more subdued rate outlook (Nomura cut its end-2011 policy rate forecast to 7.25% from 7.5%) should ease margin pressure on fixed-rate micro/small loans. Rakyat is also unaffected by regulatory issues such as LDR-linked reserve penalties and the new rate benchmark for gov't recap bonds.
- While Rakyat will likely continue to grow its loan book at 25% annual rate, the 'back to basics' shift in favor of micro/small consumer lending is, in our view, positive for margins and provisioning. Rakyat should not require an ROE-sapping recapitalization given: 1) strong internal capital generation post-PSAK 50/55 accounting adj and ASEAN-leading 30% ROE; 2) dividend payout cut to 20% (FY09: 35%); 3) changing loan mix to lower risk-weighted micro/SOE lending; 4) option to tap sub-debt.
- **Catalysts:** Sustained growth in loan book share of high-margin, low-NPL micro and small loans, peaking inflation and interest rates.
- **Valuation:** Our GGM-based BV multiple is 3.4x (14.5% cost of capital, 28% sustainable ROE, 9% long-term growth), yielding a target price of IDR8,400 or 3.4x FY12F book, and 13x EPS.

31 Dec	FY10	FY11F		FY12F		FY13F	
Currency (IDR)	Actual	Old	New	Old	New	Old	New
PPOP (bn)	22,288	23,877	23,877	27,820	27,820	33,008	33,008
Reported net profit (bn)	11,473	12,984	12,984	15,557	15,557	17,577	17,577
Normalised net profit (bn)	11,473	12,984	12,984	15,557	15,557	17,577	17,577
Normalised EPS	465.01	526.25	526.25	630.56	630.56	712.45	712.45
Norm. EPS growth (%)	57.0	13.2	13.2	19.8	19.8	13.0	13.0
Norm. P/E (x)	13.4	N/A	11.9	N/A	9.9	N/A	8.8
Price/adj. book (x)	4.2	N/A	3.3	N/A	2.6	N/A	2.1
Price/book (x)	4.2	N/A	3.3	N/A	2.6	N/A	2.1
Dividend yield (%)	1.5	N/A	1.7	N/A	2.0	N/A	2.3
ROE (%)	35.9	30.9	30.9	28.9	28.9	26.0	26.0
ROA (%)	3.2	2.9	2.9	3.0	3.0	2.8	2.8

Source: Nomura estimates

Key company data: *See page 2 for company data, and detailed price/index chart.*
Rating: *See report end for details of Nomura's rating system.*

Anchor themes

Indonesian banks are headed for a period of supernormal growth underpinned by political stability, pro-growth fiscal and monetary policies, and settled interest rate/FX outlooks.

Nomura vs consensus

NIM/provisioning may surprise positively on rising share of micro loans, and fee income upside from heavy investments in urban infrastructure, are underestimated. We are 5% above consensus.

Research analysts

Indonesia Banks

Anand Pathmakanthan, CFA - NSL
anand.pathmakanthan@nomura.com
+65 6433 6986

Manjith Nair - NFASL
manjith.nair@nomura.com
+91 22 4053 3672

Key data on Bank Rakyat Indonesia

Profit and Loss (IDRbn)

Year-end 31 Dec	FY09	FY10	FY11F	FY12F	FY13F
Interest income	35,333	44,615	51,792	62,787	74,315
Interest expense	-12,286	-11,727	-15,275	-20,709	-25,164
Net interest income	23,048	32,888	36,517	42,078	49,151
Net fees and commissions	2,118	2,829	3,394	4,073	4,888
Trading related profits	619	878	854	939	1,033
Other operating revenue	198	1,805	2,055	2,363	2,717
Non-interest income	2,935	5,511	6,303	7,375	8,638
Operating income	25,983	38,399	42,820	49,454	57,790
Depreciation	-557	-821	-945	-992	-1,041
Amortisation	0	0	0	0	0
Operating expenses	-11,401	-15,290	-17,999	-20,642	-23,740
Employee share expense					
Op. profit before provisions	14,025	22,288	23,877	27,820	33,008
Provisions for bad debt	-5,465	-7,884	-7,515	-8,005	-10,505
Other provision charges	0	0	0	0	0
Operating profit	8,560	14,404	16,362	19,815	22,503
Other non-operating income	1,331	505	505	505	505
Associates & JCEs	0	0	0	0	0
Pre-tax profit	9,891	14,909	16,867	20,320	23,008
Income tax	-2,583	-3,436	-3,883	-4,763	-5,431
Net profit after tax	7,308	11,473	12,984	15,557	17,577
Minority interests	0	0	0	0	0
Other items	0	0	0	0	0
Preferred dividends	0	0	0	0	0
Normalised NPAT	7,308	11,473	12,984	15,557	17,577
Extraordinary items	0	0	0	0	0
Reported NPAT	7,308	11,473	12,984	15,557	17,577
Dividends	-2,558	-2,295	-2,597	-3,111	-3,515
Transfer to reserves	4,750	9,178	10,387	12,446	14,062
Valuation and ratio analysis					
FD normalised P/E (x)	21.1	13.4	11.9	9.9	8.8
FD normalised P/E at price target (x)	28.4	18.1	16.0	13.3	11.8
Reported P/E (x)	21.1	13.4	11.9	9.9	8.8
Dividend yield (%)	1.7	1.5	1.7	2.0	2.3
Price/book (x)	5.7	4.2	3.3	2.6	2.1
Price/adjusted book (x)	5.7	4.2	3.3	2.6	2.1
Net interest margin (%)	8.74	9.65	8.72	8.48	8.44
Yield on interest earning assets (%)	13.39	13.09	12.37	12.65	12.76
Cost of interest bearing liabilities (%)	5.04	3.72	3.97	4.55	4.72
Net interest spread (%)	8.35	9.36	8.40	8.10	8.04
Non-interest/operating income (%)	11.3	14.4	14.7	14.9	14.9
Cost to income (%)	46.0	42.0	44.2	43.7	42.9
Effective tax rate (%)	26.1	23.0	23.0	23.4	23.6
Dividend payout (%)	35.0	20.0	20.0	20.0	20.0
ROE (%)	29.5	35.9	30.9	28.9	26.0
ROA (%)	2.60	3.18	2.93	2.95	2.84
Operating ROE (%)	34.5	45.1	38.9	36.8	33.3
Operating ROA (%)	3.04	3.99	3.69	3.76	3.63
Growth (%)					
Net interest income	17.3	42.7	11.0	15.2	16.8
Non-interest income	23.1	87.8	14.4	17.0	17.1
Non-interest expenses	10.1	34.1	17.7	14.7	15.0
Pre-provision earnings	25.3	58.9	7.1	16.5	18.6
Net profit	22.6	57.0	13.2	19.8	13.0
Normalised EPS	22.6	57.0	13.2	19.8	13.0
Normalised FDEPS	22.6	57.0	13.2	19.8	13.0

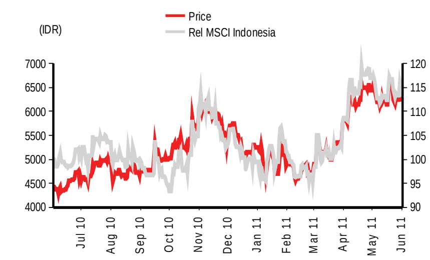
Source: Nomura estimates

Notes

PSAK 50/55 accounting changes in FY10, primarily to the methodology used to recognize accrued interest on fixed-rate loans (previously equally distributed over the life of a loan; now front-loaded) has lifted earnings to a new base

Continues to command the highest ROA and ROE in the sector (BCA is a close second)

Price and price relative chart (one year)



(%)	1M	3M	12M
Absolute (IDR)	-3.1	27.6	49.7
Absolute (USD)	-2.8	31.4	61.7
Relative to index	-3.0	17.5	21.0
Market cap (USDmn)	18,047.8		
Estimated free float (%)	30.0		
52-week range (IDR)	6650/4150		
3-mth avg daily turnover (USDmn)	24.28		
Major shareholders (%)			
Government of Indonesia	56.8		

Balance Sheet (IDRbn)

As at 31 Dec	FY09	FY10	FY11F	FY12F	FY13F
Cash and equivalents	8,139	9,976	14,678	16,680	22,487
Inter-bank lending	49,502	94,523	103,975	114,373	125,810
Deposits with central bank	12,893	14,183	14,892	15,636	16,418
Total securities	39,371	36,152	36,494	35,306	34,678
Other interest earning assets	0	0	0	0	0
Gross loans	208,046	252,381	313,598	389,986	467,165
Less provisions	-11,280	-13,991	-15,000	-16,500	-18,000
Net loans	196,767	238,390	298,598	373,486	449,165
Long-term investments	7,103	7,363	9,204	11,505	13,806
Fixed assets	1,365	1,569	1,719	1,869	2,019
Goodwill	22	14	14	14	14
Other intangible assets	0	0	0	0	0
Other non IEAs	1,786	2,116	2,346	2,605	2,885
Total assets	316,947	404,285	481,921	571,474	667,282
Customer deposits	255,928	333,652	397,776	471,233	549,084
Bank deposits, CDs, debentures	6,067	6,372	6,956	7,599	8,307
Other interest bearing liabilities	16,178	11,524	12,929	14,545	16,403
Total interest bearing liabilities	278,173	351,547	417,662	493,377	573,794
Non interest bearing liabilities	11,517	16,065	16,897	17,775	18,700
Total liabilities	289,690	367,612	434,559	511,151	592,493
Minority interest	0	0	0	0	0
Common stock	6,165	6,167	6,167	6,167	6,167
Preferred stock	0	0	0	0	0
Retained earnings	10,810	19,148	29,837	42,798	57,264
Proposed dividends	0	0	0	0	0
Other equity	10,283	11,358	11,358	11,358	11,358
Shareholders' equity	27,257	36,673	47,362	60,323	74,789
Total liabilities and equity	316,947	404,285	481,921	571,474	667,282
Non-performing assets (IDR)	7,258	7,113	9,247	12,021	15,628
Balance sheet ratios (%)					
Loans to deposits	81.3	75.6	78.8	82.8	85.1
Equity to assets	8.6	9.1	9.8	10.6	11.2
Asset quality & capital					
NPAs/gross loans (%)	3.5	2.8	2.9	3.1	3.3
Bad debt charge/gross loans (%)	2.63	3.12	2.40	2.05	2.25
Loss reserves/assets (%)	3.56	3.46	3.11	2.89	2.70
Loss reserves/NPAs (%)	155.4	196.7	162.2	137.3	115.2
Tier 1 capital ratio (%)	12.0	12.0	13.2	14.1	14.5
Total capital ratio (%)	13.3	13.9	15.0	15.7	16.0
Growth (%)					
Loan growth	28.5	21.2	25.3	25.1	20.3
Interest earning assets	30.3	28.4	18.5	18.7	16.2
Interest bearing liabilities	33.0	26.4	18.8	18.1	16.3
Asset growth	28.8	27.6	19.2	18.6	16.8
Deposit growth	27.0	30.4	19.2	18.5	16.5
Per share					
Reported EPS (IDR)	296.22	465.01	526.25	630.56	712.45
Norm EPS (IDR)	296.22	465.01	526.25	630.56	712.45
Fully diluted norm EPS (IDR)	296.22	465.01	526.25	630.56	712.45
DPS (IDR)	103.68	93.00	105.25	126.11	142.49
PPOP PS (IDR)	568.44	903.35	967.77	1,127.60	1,337.89
BVPS (IDR)	1,104.79	1,486.43	1,919.68	2,444.99	3,031.32
ABVPS (IDR)	1,104.79	1,486.43	1,919.68	2,444.99	3,031.32
NTAPS (IDR)	1,103.91	1,485.84	1,919.09	2,444.40	3,030.74

Source: Nomura estimates

Notes

Pre-2008, credit cost was <200bps; could return to this level, especially as NPL-laden commercial lending is curbed

With the dividend payout ratio now cut to 20%, faster growth in lower risk-weighted loans (micro) and an elevated earnings base, we expect capital ratios to rise despite forecasting FY11-12F 25% annual loan growth

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Appendix A1

ANALYST CERTIFICATIONS

We, Yougesh Khatri, Euben Paracuelles, Craig Chan (Nomura Singapore Ltd), and Alastair Newton (Nomura International PLC) hereby certify (1) that the views expressed in this report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this report, (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report and (3) no part of our compensation is tied to any specific investment banking transactions performed by Nomura Securities International, Inc., Nomura International plc or any other Nomura Group company.

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Online availability of research and additional conflict-of-interest disclosures

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The analysts responsible for preparing this report have received compensation based upon various factors including the firm's total revenues, a portion of which is generated by Investment Banking activities.

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Valuation Methodology - Global Strategy

A “Relative Value” based recommendation is the principal approach used by Nomura’s Fixed Income Strategists / Analysts when they make “Buy” (Long) “Hold” and “Sell” (Short) recommendations to clients. These recommendations use a valuation methodology that identifies relative value based on:
a) Opportunistic spread differences between the appropriate benchmark and the security or the financial instrument,
b) Divergence between a country’s underlying macro or micro-economic fundamentals and its currency’s value and
c) Technical factors such as supply and demand flows in the market that may temporarily distort valuations when compared to an equilibrium priced solely on fundamental factors.

In addition, a “Buy” (Long) or “Sell” (Short) recommendation on an individual security or financial instrument is intended to convey Nomura’s belief that the price/spread on the security in question is expected to outperform (underperform) similarly structured securities over a three to twelve-month time period. This outperformance (underperformance) can be the result of several factors, including but not limited to: credit fundamentals, macro/micro economic factors, unexpected trading activity or an unexpected upgrade (downgrade) by a major rating agency.

Issuer Specific Regulatory Disclosures
Mentioned companies

Issuer name	Ticker	Price	Price date	Stock rating	Sector rating	Disclosures
Adaro Energy	ADRO IJ	2,425 IDR	02-Jun-2011	Buy	Not rated	
Astra International	ASII IJ	59,100 IDR	02-Jun-2011	Buy	Not rated	
Bumi Resources	BUMI IJ	3,350 IDR	02-Jun-2011	Buy	Not rated	8,47,48
Jasa Marga	JSMR IJ	3,500 IDR	02-Jun-2011	Buy	Not rated	
PP London Sumatra	LSIP IJ	2,400 IDR	02-Jun-2011	Buy	Not rated	
Semen Gresik	SMGR IJ	9,650 IDR	02-Jun-2011	Buy	Not rated	
Tambang Batubara Bukit Asam	PTBA IJ	21,400 IDR	02-Jun-2011	Buy	Not rated	
Bank Rakyat Indonesia	BBRI IJ	6,250 IDR	02-Jun-2011	Buy	Not rated	

Disclosures required in the U.S.

47 **Manager/Co-Manager in the past 12 months**
Nomura Securities International Inc. and /or its affiliates has managed or co-managed a public or Rule 144A offering of the company's securities in the past 12 months.

48 **IB related compensation in the past 12 months**
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Previous Rating

Issuer name	Previous Rating	Date of change
Adaro Energy	Not Rated	18-Jan-2011
Astra International	Not Rated	10-Jan-2011
Bumi Resources	Not Rated	18-Jan-2011
Jasa Marga	Not Rated	02-May-2011
PP London Sumatra	Neutral	15-Dec-2010
Semen Gresik	Not Rated	02-May-2011
Tambang Batubara Bukit Asam	Not Rated	18-Jan-2011
Bank Rakyat Indonesia	Not Rated	25-Jun-2009

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STOCKS

A rating of '**Buy'**, indicates that the analyst expects the stock to outperform the Benchmark over the next 12 months.
A rating of '**Neutral'**, indicates that the analyst expects the stock to perform in line with the Benchmark over the next 12 months.
A rating of '**Reduce'**, indicates that the analyst expects the stock to underperform the Benchmark over the next 12 months.
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SECTORS

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A '**Neutral'** stance, indicates that the analyst expects the sector to perform in line with the Benchmark during the next 12 months.
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Explanation of Nomura's equity research rating system for Asian companies under coverage ex Japan published from 30 October 2008 and in Japan from 6 January 2009

STOCKS

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A '**Neutral'** recommendation indicates that potential upside is less than 15% or downside is less than 5%.

A '**Reduce'** recommendation indicates that potential downside is 5% or more.

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Explanation of Nomura's equity research rating system in Japan published prior to 6 January 2009 (and ratings in Europe, Middle East and Africa, US and Latin America published prior to 27 October 2008)

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Explanation of Nomura's equity research rating system for Asian companies under coverage ex Japan published prior to 30 October 2008

STOCKS

Stock recommendations are based on absolute valuation upside (downside), which is defined as (Fair Value - Current Price)/Current Price, subject to limited management discretion. In most cases, the Fair Value will equal the analyst's assessment of the current intrinsic fair value of the stock using an appropriate valuation methodology such as Discounted Cash Flow or Multiple analysis etc. However, if the analyst doesn't think the market will revalue the stock over the specified time horizon due to a lack of events or catalysts, then the fair value may differ from the intrinsic fair value. In most cases, therefore, our recommendation is an assessment of the difference between current market price and our estimate of current intrinsic fair value. Recommendations are set with a 6-12 month horizon unless specified otherwise. Accordingly, within this horizon, price volatility may cause the actual upside or downside based on the prevailing market price to differ from the upside or downside implied by the recommendation.

A '**Strong buy'** recommendation indicates that upside is more than 20%.

A '**Buy'** recommendation indicates that upside is between 10% and 20%.

A '**Neutral'** recommendation indicates that upside or downside is less than 10%.

A '**Reduce'** recommendation indicates that downside is between 10% and 20%.

A '**Sell'** recommendation indicates that downside is more than 20%.

SECTORS

A '**Bullish'** rating means most stocks in the sector have (or the weighted average recommendation of the stocks under coverage is) a positive absolute recommendation.

A '**Neutral'** rating means most stocks in the sector have (or the weighted average recommendation of the stocks under coverage is) a neutral absolute recommendation.

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