Indonesia

A worthy BRIC contender

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The BRIC acronym can be misleading since it includes four very different types of countries. Brazil is now a middle income country and steadily becoming wealthier due to prudent economic policies introduced in the mid-1990s that have resulted in sustained economic growth and improved financial stability. In contrast, Russia's population is in danger of ageing and shrinking before becoming rich, while its economy is unable to free itself from the impact of global oil and gas prices. India remains the poorest member of this group on a per capita basis but its young population, improving productivity, heavy infrastructure investment and positioning as a large English speaking market for outsourcing of services, should see the country grow strongly for many years to come. China continues to astound economists as it has maintained near double-digit growth for (now) over 30 years, transforming the country from a poor rural backwater into a modern, majority urban society with the second largest economy in the world.

South Africa has been lobbying for some time for inclusion in this exclusive BRIC club. However the BRIC group is far from uniform, except that they all have large populations and a decade ago were expected to grow very fast for many years and eventually challenge developed nations at the top of the world's economic tables. If the application process were open to all countries and the main criteria included a large population and high growth rate then the obvious contender for inclusion would not be South Africa but Indonesia.

Indonesia and South Africa share a common history of Dutch colonisation, but are very different societies. The country is made up of over 17 000 islands and has a population of 240 million people, making it the fourth most populous nation after China, India and the US. It is commonly cited as the largest Muslim nation and (some recent instances aside) a fairly tolerant multi-cultural and multi-racial society. The 50 years after independence from the Netherlands were varied with some periods of decent economic growth, but also challenging political eras – firstly under Sukarno and later Suharto who both ruled with an iron first. Over the years the economy became dominated by a few powerful families with close ties to the ruling regime and it was at times impossible to bypass these families when doing business in the country.

The Asian Crisis of 1997 – 1998 changed things forever. No other country affected by the crisis experienced trauma to the extent that Indonesia did. The currency depreciated from 2 600 rupiahs per dollar to a low of 14 000 rupiahs per dollar (over 500%), the economy shrank by 13% and the banking system collapsed requiring virtually a complete central government takeover of the financial sector. All this turned out to be somewhat of a blessing in disguise as the ensuing public outcry against the country's leadership led to the fall of the ruling regime and the advent of competitive multiparty politics for the first time. Many family conglomerates were wiped out by the collapsing banking system and their stranglehold over the economy was finally broken. In the space of a few months, the country was given a chance to reshape its destiny. Consequently, Indonesia has emerged as one of the most attractive investment markets at current valuations.

Since the turn of the century the country's economy grew at an average rate of 5.4% per annum, raising living standards substantially. GDP per person in 1998 was $478, today it is over $3 000 helped in part by a recovery in the currency. Inflation has mostly been in single digits throughout this period, while the banking system has been nurtured back to health and mostly freed of government ownership. It is difficult to believe that a country that just over a decade ago teetered on the edge of bankruptcy, today boasts a debt to GDP ratio of 25%, a fraction in comparison to most of the first world debt to GDP ratios, and can borrow in international capital markets in dollars for 10 years at 4.5% interest rates.

For foreign investors there are several industries that are attractive in Indonesia, the most obvious of which is mining since the country is blessed with abundant natural and mineral resources. Indonesia produces more coal than South Africa, with higher energy content, lower extraction costs and easy shipping routes to major consumers like China. It is a top 10 producer of timber and forestry products, while it is the largest producer of palm oil, a key ingredient in cooking and detergents. Indonesia has dozens of listed companies offering investors exposure to all these sectors.

The consumer sectors offer arguably even greater potential. On almost every measure Indonesia's consumer sector is just starting to, for lack of a better word, consume. Per capita consumption of most fast moving consumer goods (FMCGs) that we would consider everyday items is lower than most other countries at a similar level of development, and a fraction of consumption in the developed world. It is no surprise that the world's biggest multinationals view Indonesia so favourably that they are rapidly expanding operations there. Companies like Unilever, operating in the country since the 1930s, believe that they can sustain the 15% annual revenue growth they have achieved over the last decade for at least another decade.

Historical precedent elsewhere in the region suggests this expectation is not misplaced – as people become wealthier and their base needs are satisfied they start to trade up and consume greater quantities of FMCGs. Once a certain threshold is reached they start to purchase durable household products like washing machines and vacuum cleaners to make their lives easier. Consumption of big ticket items in Indonesia is abnormally low for the same reason that vehicle finance and mortgage lending are relatively non-existent – Indonesia's banking system has only just started lending.

Prior to the Asian Crisis, most banks simply collected deposits from the public and provided cheap finance to the family conglomerates that controlled them. Any independent company dealing with a conglomerate had to use the designated bank for all transactions and this helped to keep money 'in the family'. The collapse of the banks and workout of bad loans means that for the first time in the country's history, banks now actually collect deposits from the public and lend to people and small businesses. Lending to individuals and small to medium enterprises for consumption, vehicles and property can grow at double digits for many years and Indonesia will still rank as one of the least banked countries in Asia.

In the process, millions of new homes and commercial properties will be built and tens of millions of families will purchase motorbikes, cars, white goods and televisions for the first time. This is a huge market opportunity for many manufacturers in the region who, till now, have relied on an industrialising China as their main target market. Telecommunication infrastructure is also expected to develop rapidly – most of this disperse country is covered by mobile operators despite the geographical challenges they face, giving people access to voice services for the first time. Data consumption has barely started and internet usage has historically been shown to boost productivity and hence GDP growth even further.

Indonesia faces many challenges, not least of which is endemic corruption that has barely been tackled despite the obvious effect it has on the public sector. Fuel subsidies consume 10% of the public budget and attempts to reduce these have often been met by rioting on the streets. Yet overall the steps taken since 1998 and the continued emphasis on investment in infrastructure suggest the country can maintain the 6% growth rate required to double the size of the economy every 12 years. At these sorts of growth rates, within 20 years the Indonesian economy could overtake Russia's in size, so perhaps South Africa's claim for inclusion in the BRIC grouping has less merit than we care to admit.

Coronation's Global Emerging Markets Funds hold two Indonesian stocks in the respective portfolios. Global Mediacom is the largest free-to-air television broadcaster in the country and also happens to have a very strong pay-TV business. This company should benefit tremendously from increased advertising spend by multinationals looking to build their brands in such a large and attractive consumer market that cannot be effectively reached by print media due to that industry's fragmented nature and the huge distribution costs in such a disperse nation. We like the broadcasting model since it is very cash generative once mature, and tends to reward companies with the largest share of the market disproportionately well due to the advertising rates that they command. Our other holding is Mayora Indah, a confectionery company, with many top tier brands in biscuits, candy, chocolates and instant coffees. The company continues to grow sales and earnings strongly at 20% p.a., despite strong competition from all the established multinationals. It can be bought at 16 to 17 times earnings compared to 26 times earnings for the more glamorous Unilever Indonesia.

On-the-ground experience of visiting a country adds tremendous value to understanding how its businesses operate and the assessment of the underlying management culture. With this in mind our team has visited Indonesia twice since our funds were launched three years ago and we are due to visit again before the end of the year. Through this ongoing process we hope to find more opportunities to deliver sustainable market-beating returns for our investors.