

Pitfalls & Principals of Financing in Emerging Markets INDONESIA

August 2012



- **“Remarkable Indonesia” – An Economic and Business Overview**
- **Legal Legislative and Political Nuances**
- **Bankruptcy Framework**
- **Nature of Transactions**
- **Control is Happiness**
- **Back to Basics – how to address the five C’s of Credit in Emerging Markets**
 - **Character**
 - **Cashflow**
 - **Collateral**
 - **Capacity**
 - **Conditions**
- **The Insomnia Effect – “What keeps us awake at night”**
 - **Due Diligence**
 - **Local Legal Framework (“the changing sands”)**
 - **Enforcement**
- **Legal Opinions – the Good, the Bad and the Ugly**
- **Life in the Trenches**
- **Guiding Themes**

- [embed video file]

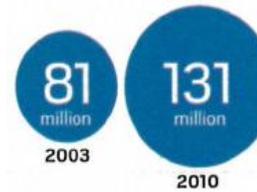
Economics – A Macro View

Indonesia is An Emerging Global Powerhouse in Asia



Indonesia's middle class has expanded dramatically...

7 MILLION PEOPLE A YEAR ARE CLIMBING THE INCOME LADDER



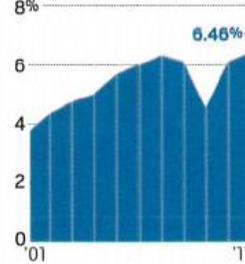
... along with average personal wealth...

AVERAGE WEALTH PER CAPITA



... and the size of the national economy.

INDONESIA GDP GROWTH



Indonesia Factsheet

Population	237 million
GDP	US\$ 834.3 billion (as end of 2011); YoY +6.5%
Key Industries	Wholesale & Retail Trade (11%), Agriculture (Foods & Estate Crops) (10%), Constructions (10%), Mining (10%), FMCG (7%)
Credit Rating	Fitch: AAA; S&P: BB+; Moody's: Baa3
Fx Reserves	US\$106 billion (Feb '12) (source: www.imf.org)
Inflation	Inflation rate YoY 3.79%

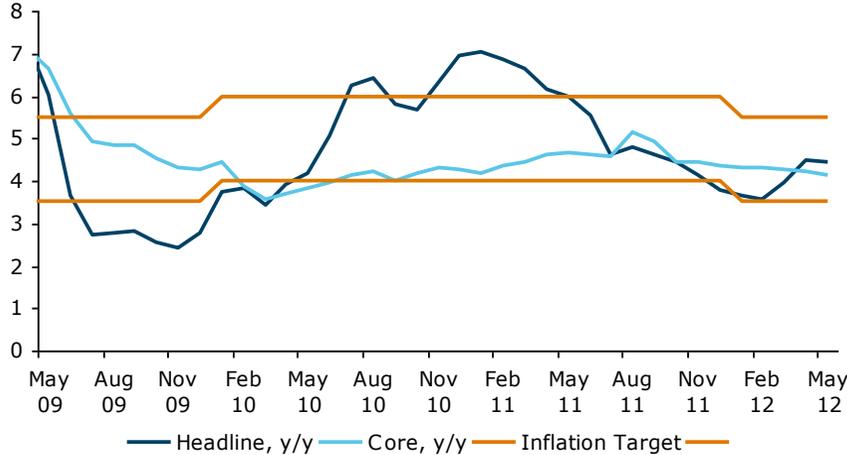
Australia (2011)

Population	22.5 million
GDP	US\$ 1,507.4 billion; YoY Growth 1.8%
Key Industries	Services (79.1%), Mining (7.6%), Manufacturing (11%), Agriculture, Forestry and Fishery (2.3%)
Credit Rating	Fitch: AAA; S&P: AAA; Moody's: Aaa
Fx Reserves	US\$41.3 billion (Feb'12) (source: www.imf.org)
Inflation	Inflation rate YoY 3.4%

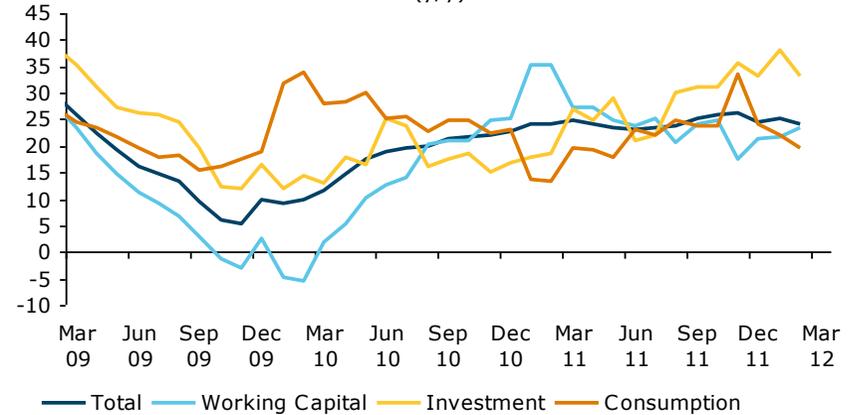
Top Foreign Investors 2011	Exports	Imports
1. Singapore	US\$ 8.8b	US\$ 16.1b
2. Japan	US\$ 15.9b	US\$ 10.2b
3. USA	US\$ 9.3b	US\$ 7.3b
4. Europe	US\$ 11.7b	US\$ 9.0b
5. S. Kor/China	US\$ 9.9b	US\$ 14.5b

Inflation has lowered, domestic credit activity remains strong

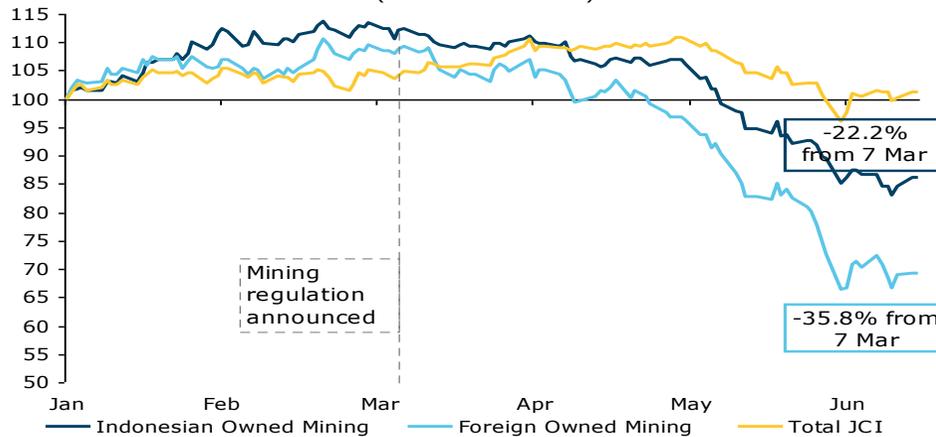
Indonesia - CPI Inflation



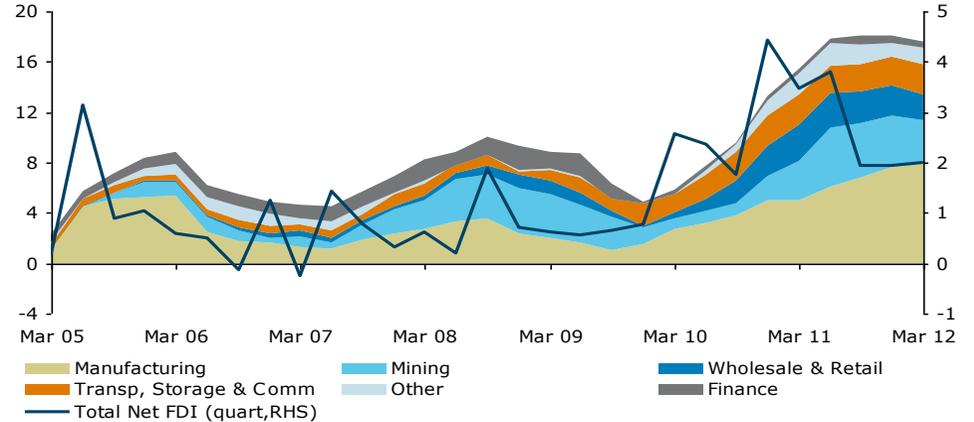
Indonesia - Commercial Bank Credit Growth (y/y)



Indonesia - Mining Company Price Performance vs. JCI
(02 Jan 2012 = 100)



Indonesia - Total FDI inflows by sector
(USDbn, 4Q rolling sum)



- Recent monetary, banking, mining policy shifts are well intentioned
- Side effects need to be carefully considered
- Lack of fuel price adjustments is not just a fiscal issue, it is also fuelling the external imbalance
- Some market volatility is unavoidable when policy shifts materialise
- Impact of portfolio flows seems to have increased.
- Structural reforms (regulatory framework, financing, land acquisition) are key to sustaining strong investment
- Growth drivers remain intact
- Low public and external leverage and sound banking system reduce vulnerability against unexpected shocks
- Investment grade rating matters for investors, however predictability is a key driver to investor sentiment
- Market deepening and sustaining the localised 'safe haven' status of government debt is crucial in limiting volatility.

The Legal Framework

- **Indonesia Legal Framework** is a complex confluence of **three distinct systems**, a melting pot of:
 - **Adat (customary) law** born of Indigenous kingdoms (pre 17th Century)
 - **Dutch Colonisation** for 350yrs from 17th Century through to end of WWII
 - **National Legal System** developed post Indonesian Independence 1945
- **Constitutional Structure – the 1945 Constitution applied**, unamended until 1998 (including no change during Suharto's reign of 32 years), then amended several times, with far reaching changes including:
 - **Limitation of the powers** and terms of office of President
 - **Decentralisation of central government** to provincial governments
 - **Creation of additional constitutional bodies** including House of Regional Representatives and the Constitutional Court.
 - The **House of Peoples Representatives (DPR)** consists of 500 elected and appointed representatives. Its main function is to make legislation and hold President/ministers accountable.
- **Modern Indonesian legislation** comes in a number of forms.
 - The **variety in categories and sources** creates a complex web for foreigners seeking to understand the law.
 - Whilst there is a clear process for new legislation, including gazetting, publication and guidelines for interpretation, **introduction of new laws is commonly a cause for great confusion** and further refinement, often over several years after first publication
- The **judicial system comprises several types of courts**, under oversight of the Supreme Court
 - Per the civil law tradition of The Netherlands, **Indonesian Courts do not apply the principal of precedent**
 - Most disputes appear before courts of general jurisdiction, the first being the **State Court**
 - There are over **250 State Courts in Indonesia**, each with its own territorial jurisdiction
 - **Appeals** from the State Court are **heard before the High Court**, of which there are 20 in country
 - The High Court is effectively a district court of appeal
 - **Appeals from the High Court, may be made to the Supreme Court**
 - **In 1998, Indonesia established a Commercial Court** – initially to handle bankruptcy and insolvency applications (Asian Crisis)
 - **In 2001, a Constitutional Court** was also established

- 2011 “Cabinet” reshuffle coincided with a substantial “sea-change” in policy approach
- 2014 elections have the potential to add a further level of uncertainty regarding the continuity of the reform agenda and recent corporate governance initiatives.
- Mining Sector Reforms: The recently announced rules restricting foreign ownership of new mines [Mining GR24], export proceeds, and export taxes, indicate a degree of increased protectionism, with undesirable consequences [Japan & Indian responses]
- Banking Ownership: initial rules related to the single ownership of banks onshore were proposed last year, and have undergone major revision this year [DBS/Danamon]
- Subsidy framework: liberalisation of the wider framework, especially for gasoline [USD\$23b], has seemingly stalled on political concerns. Uncertainties are particularly acute at the sub-sovereign level as local governments continue to have broad licensing and regulatory powers, often overlapping with conflicting outcomes
- A case in point is the granting of mining permits, which has been deregulated to the state levels.
 - Amid the push to decentralize the allocation of mining licenses, confusion arose as local and regional governments individually granted licenses for the same concession area to different parties.
 - The resulting conflicts, predominantly arising from newer mining licenses, have plagued the industry in recent years and have stymied’ pursuit of new Greenfield projects. [Churchill/Nusantara/Freeport/Intrepid Mines]
 - Achieving stability and predictability will require conscious efforts by decision makers at all levels.
 - Land acquisition issues remain a [the] major impediment to further development

- Sophistication and the nature of transactions continues to evolve
 - From the vanilla to the exotic [Bumi Resources]
 - The orthodox to the 'surreal' [eg, coal put/call options/Royalty off-take]
- Foreign Direct Investment – broader industry, origin and investment
- Somewhat Nascent DCM, but developing
- Unique ECM [practice is to list ~15% to ~20% as much for a 'badge of honour' as it is for capital/equity raising]. Threshold of tax breaks encourage higher listings.
- Now Investment Grade – so what.....

Emerging market risks are not eliminated

- Despite its investment-grade sovereign rating, Indonesia remains an emerging market with its inherent risks. Some of these risks, which vary from country to country, are captured in a country's sovereign rating (e.g. policy framework), but some go beyond its scope.
- Indonesia's positive developments have to be balanced against our ongoing concerns related to governance (particularly at the sub-sovereign level), corruption, legislation and regulation, which remain Indonesia's weak points. Concern about emerging market risks may be reduced but are far from eliminated.
- Moreover, Indonesian corporates remain largely family controlled businesses which tend to have less transparent operations and disclosures.
 - Of the top Indonesian corporates, >90% have concentrated family ownership structures. Although experienced and professional management may be employed, such structures raise concerns about the safeguarding investor interests and whether the founder families are able to exercise undue control to the detriment of other stakeholders.

- A robust legal system that enforces obligations is a must.
- Bankruptcy laws were reformed post Asian Crisis in the late 1990's
- Some quirks in the fine print, however overriding approach has been to encourage negotiation between parties rather than initiate bankruptcy proceedings
- "a petition filed by a married person may only be accepted if the partner of the applicant agrees"
- Social Stigma attached to bankruptcy is substantial, thus official bankrupts are kept low as debtors seek to negotiate to 'save face'.
- According to a recent study of bankruptcy, spanning from 1998, the relatively low asset recovery rate is attributed by creditors to:
 - poor transparency and accountability;
 - lack of professionalism among officials;
 - difficulties in discovering and controlling debtor assets;
 - problems in allocating and distributing the proceeds;
 - problems in selling assets;
 - failure to take full advantage of the law's legal tools; and
 - lack of understanding of the new law and regulations.
- On the whole Indonesian Bankruptcy Law is not viewed as a serious tool to be used for enforcement of obligations

Control is Happiness

Character

- the most important factor in any financing arrangement is the character of the borrower/counterparty/partner/bank.
- No matter how attractive a transaction may seem, if there is any concern about the integrity or reputation of character, no go
- Use of 'Mud Maps' and market intelligence, both 'hard' and 'soft' is key
- Trust your instincts – if you are not happy, pull back
- Understand who you are financing
- Control is happiness – what is leverage, how to implement, when to use it, how to use it...

Cashflows

- Source of cash
- Variability vs predictability
- Waterfalls and Lock Ups
- Subordination issues
- CAMA/Escrow/Debt Service Reserve Account structures

Collateral

- Mortgage – types of real estate titles
- Fiduciary – fungible or personal property, including Inventory, AR's, Equip
- Pledges – over tangible, removables and shares
- Security Assignments
- Guarantees

Capacity

- Equity vs Debt Risk
- Relative scale and size of transaction
- Management and governance capacity
- Market size/shape of competition
- Sensitivity to adverse movements

Conditions

- Conditions Precedent
- Representations and Warranties
- Covenants

Due Diligence

Verification: “Who’s who in the zoo”

Corporate Authorisations – Board of Directors/Board of Commissioners, Articles

Reliability of public registers

Rule of Law

Observing the rule of law, impacted by:

the role of the patrimonial state, the colonial contract legacy,

Legal infrastructure for dispute resolution

Legal training, bias, corruption and inconsistent decision-making.

The role of local lawyers is often expanded to include acting as ‘cultural’ advisers on local government and business practice.

Bespoke financing structures needed eg govt ownership of assets in O/G sector has lead to use of trustee borrowing scheme.

Offshore for Arbitration (but ultimately onshore for enforcement)

- Key issues around the technicalities of reviewing and enforcing Indonesian court decisions.
- Judicial independence, resulting from the Supreme Court using a loophole in the law to thwart the implementation of court decisions, including its own, particularly those which are against government interests.
- Somewhat impractical five-tier judicial system, with a trial in the District Court, an appeal to the High Court, cassation in the Supreme Court, Supreme Court review by a different panel and the Chief Justice's final 'veto'. It is easy to understand the major loss of faith in the judiciary when such a practice
- Crucial to understand steps of enforcement; make sure all documents carry the usual waivers of Indonesian law (eg for GX's), set off, termination and other provisions
- Enforcement through power of sale; court administered auction processes, private sale is possible, but can involve greater risk
- Lack of clarity in laws on certain key areas, eg currency law or the use of Bahasa
- Ensure all documentation is comprehensive and duly perfected
- Local Indonesia Law for security instruments
- Offshore for Arbitration (but ultimately onshore for enforcement)

An issue that takes some getting used to, the nature and substance of Legal Opinions:

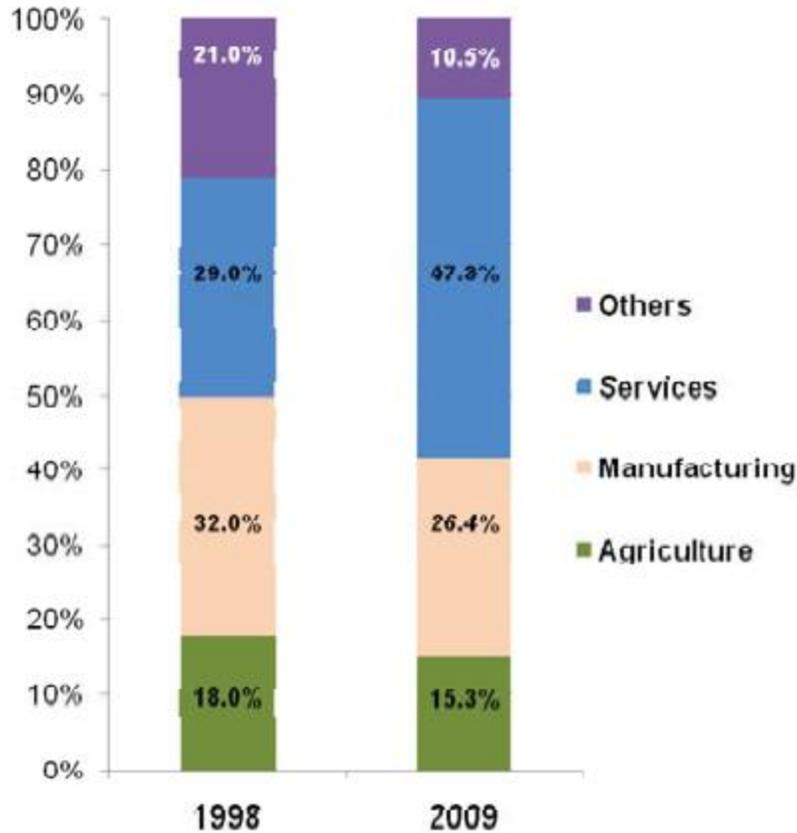
[Copy of live example]

Each jurisdiction is unique, however often themes are similar; in Indonesia, an extra depth of diligence is advisable:

- Know your counterparties
 - Verify, verify, verify
 - Understand the deal within the deal
 - Run the what if's "what does the dark side of the moon look like?"
 - Laws may or may not be present, when and how to navigate the judicial system is more important
 - Control is Happiness – work out what 'control' is and how to maintain it
 - Expect the unexpected – power base, political, cultural aspects and regulatory changes
-
- Key References/additional reading:
 - Lindsey, T. (2008), (editor and contributor), *Indonesia: Law & Society*, Federation Press, Sydney (**2nd and fully revised edition**) *
 - Dr Benny S Tabalujan (2002), Features – The Indonesian Legal System: An Overview

Q&A

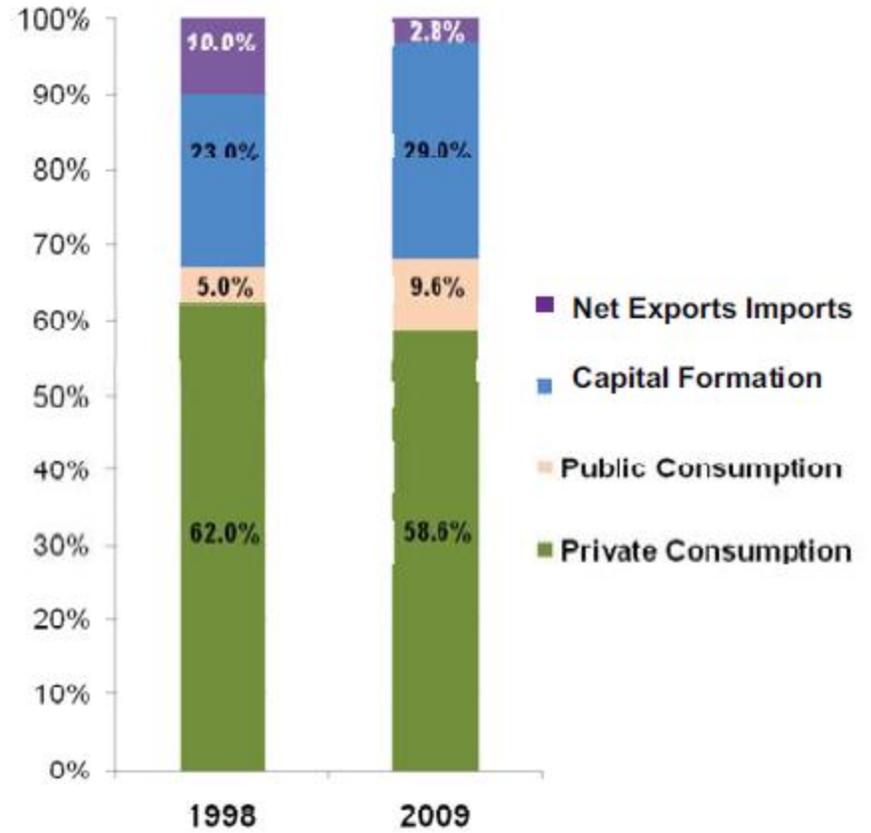
GDP by sector



Source: Bank Indonesia, Bappenas

■ Contribution of services has grown in the last decade

GDP by component



Source: Bank Indonesia, Bappenas

■ Private consumptions remains the main economic driver

	1990-2007	2008	2009	2010	Forecasts		
	Average				2011	2012	2013
World (PPP)	3.6	2.5	0.8	5.0	3.7	3.5	4.0
World (Market)	3.0	1.5	-0.7	4.2	2.8	2.7	3.2
<i>G7</i>	2.4	-0.4	-3.7	3.0	1.4	1.7	2.1
US	3.0	-0.3	-2.6	3.0	1.7	2.4	2.7
Euro zone	2.2	0.2	-3.3	1.7	1.4	-0.5	1.0
Japan	1.2	-1.1	-6.3	4.5	-0.7	2.4	1.6
UK	2.6	-1.1	-4.9	2.1	0.7	0.7	1.8
Canada	2.7	0.7	-2.5	3.2	2.5	2.1	2.3
<i>Asia-Pacific</i>	5.2	5.1	4.1	8.1	5.8	6.1	6.2
<i>Asia-Pacific less Japan</i>	7.0	6.6	6.4	8.9	7.1	6.8	7.0
Australia	3.2	2.5	1.4	2.5	2.1	3.8	3.3
New Zealand	3.0	-0.1	-2.1	1.3	1.4	1.9	3.2
China	10.0	9.6	10.3	10.3	9.2	8.6	8.3
Hong Kong	4.2	2.3	-2.7	7.0	5.0	4.4	5.1
India	6.1	6.2	7.0	9.6	7.1	6.0	6.4
Indonesia	4.9	6.0	4.6	6.1	6.5	6.3	6.6
Malaysia	6.5	4.8	-1.7	7.2	5.1	4.6	6.1
Philippines	3.7	4.2	1.1	7.6	3.7	5.0	5.3
Singapore	6.8	1.7	-0.8	14.8	5.0	2.7	4.9
South Korea	5.8	2.3	0.2	6.2	3.6	3.4	4.8
Taiwan	5.5	0.7	-1.9	10.9	4.0	4.0	5.1
Thailand	5.2	2.5	-2.3	7.8	0.1	5.5	4.1
Vietnam	7.5	6.3	5.3	6.8	6.1	5.5	6.6
<i>Latin America</i> ¹	3.5	4.3	4.0	6.2	4.4	3.7	4.0
Brazil	2.3	5.2	4.4	7.5	2.7	3.3	4.4
Mexico	3.2	1.2	3.4	5.4	3.9	3.5	3.4
Argentina	3.8	6.8	3.4	9.2	8.9	3.5	3.4
OECD	2.5	-0.2	-3.3	2.6	1.3	1.4	2.0
Emerging Economies	5.8	5.8	5.6	7.8	6.2	5.7	6.0