Asia Credit Research

OCBC Bank

Indonesian Bond Market

Tuesday, 02 May 2017

- **Outstanding bonds in 2016Q4 totalled USD250.1bn[1], of which 35% are USD denominated issues. Total outstanding bonds grew at a 14.0% CAGR[2] and Indonesia has become increasingly reliant on foreign currency ("FCY") bonds since and this trend shows little sign of abating.**
- **26.0% of total outstanding corporate bonds will expire within 3 years while 21.1% of the government bonds will expire within 3 years. 67.1% of government debt will mature in the medium to long term (>5years)**
- **In terms of capital controls, Indonesia's capital markets are not fully open to non-resident portfolio investments. Foreign investor participation in the local bond market is subjected to regulatory approval, although such restrictions are not applicable to Indonesian government bonds.**
- **The success of the Tax Amnesty Program – netting in IDR135tn of tax revenue (USD10.1bn) would provide the Indonesian government more leverage to push S&P for a rating upgrade to its sovereign bonds. If successful, this would encourage capital inflows in the future.**

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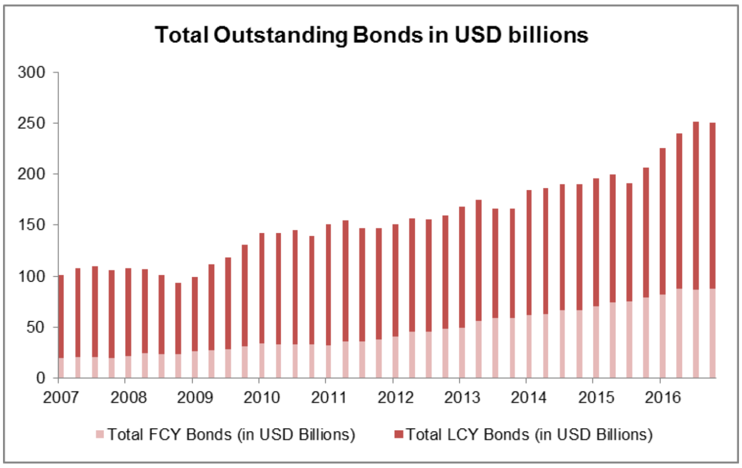
1) Bond Market Sizing

Outstanding bonds in 2016Q4 totalled USD250.1bn, of which 35% are USD denominated issues. Total outstanding bonds grew at a 14.0% CAGR and Indonesia has become increasingly reliant on foreign currency ("FCY") bonds since and this trend shows little sign of abating. This was a result of 1) persistent budget deficit[3] (though now the fiscal budget is more disciplined) and 2) relative ease of tapping the bond market in FCY due to the volatility of the IDR. As at 2016Q4, there are USD87.5bn of FCY bonds outstanding, representing a 4.7x increase as compared to 10 years ago. Local Currency ("LCY") bonds, on the other hand, only saw a 2.1x increase (in USD terms) for the same time frame. In terms of the composition of the type of issuers, government bonds account for majority of the market, for both LCY and FCY bond markets as at 2016Q4.

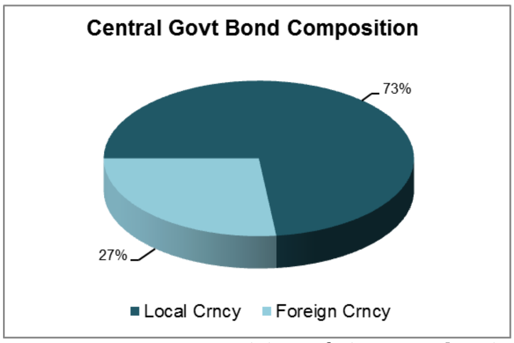
[1] *USD250.1bn include total Local Currency (LCY) bonds and Foreign Currency (FCY) bonds listed in **Indonesian Stock Exchange only***
[2] *Compounded Annual Growth Rate*
[3] *Indonesia has ran a budget deficit since 1996, with the largest deficit (as % of GDP) in 1998, which exacerbated the aftermath of the Asian Financial Crisis*



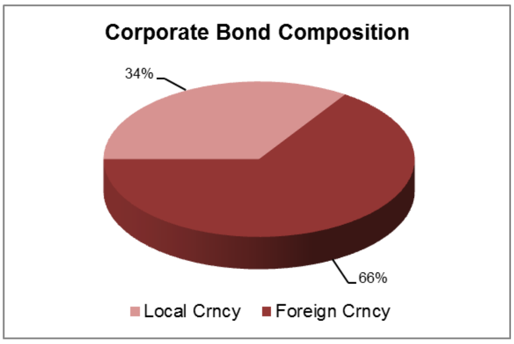
Source: Asian Bond Online

When looking at the composition of sovereigns and corporates in terms of currencies, there is a significant difference; where majority of the bonds issued by the central government[4] is denominated in LCY, while corporates prefer to issue bonds in FCY (Bloomberg data as at 5 Apr 2017). This may be a result of companies trying to access lower cost of funding by tapping onto more "complete[5]" foreign bond markets.

Issuers may borrow offshore to access more or less "complete" bond markets, where differences in liquidity, diversity or risk characteristics lead to relative cost differentials. More complete markets are more likely to develop where there is a large, relatively heterogeneous investor base with varied risk preferences and a range of derivatives to transform risk. In general, borrowers from less complete markets are likely to be able to lower funding costs by using more developed markets. Similarly, issuers from more complete markets may be able to fill gaps in less complete markets, for example by creating a low default risk asset where sovereign credit quality is relatively low. These differences between markets may enable issuers to lower their funding costs by issuing offshore in a more or less developed market and swapping the proceeds into local currency.



Source: Ministry of Finance, Indonesia

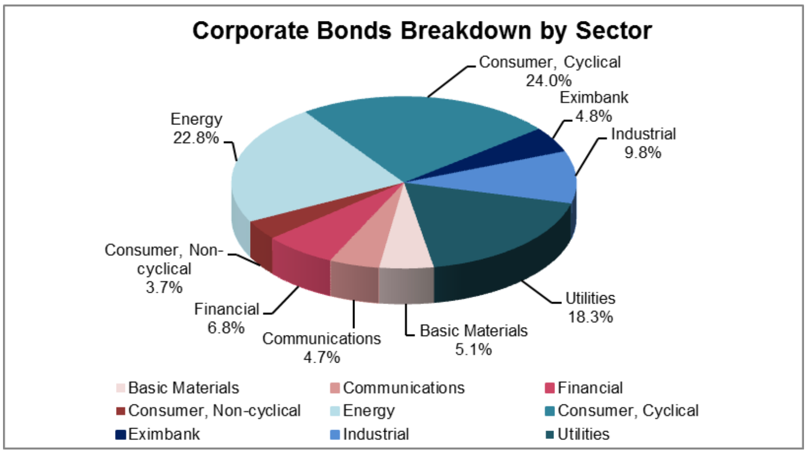


Source: Bloomberg

Within the corporate bond market, majority of the outstanding bonds are issued by corporates in the consumer cyclical and energy sectors, with these 2 groups taking up around 44.5% of the total market. The other 2 major industry issuers are the utilities sector (17.8%) and the Indonesia Eximbank (8.9%).

[4] *According to Indonesia's Ministry of Finance statistics, dated 28 Feb 2017*

[5] *According to BIS's "Why issue bonds offshore?" paper, issuers may borrow offshore to access more or less "complete" bond markets, where differences in liquidity, diversity or risk characteristics lead to relative cost differentials.*

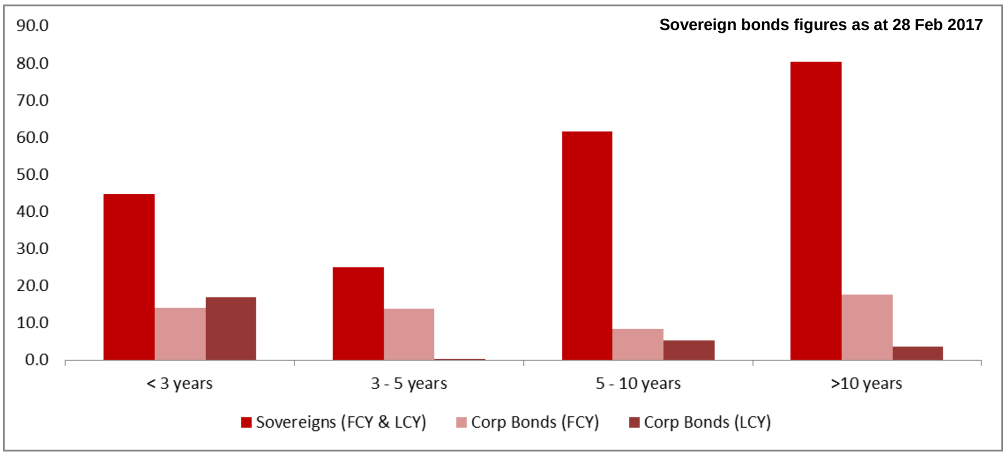


Source: Bloomberg

2) Bond Market Demand & Supply

Bond Pipeline/Supply

A significant portion of the corporate bonds (26.0% of total outstanding amount) in the Indonesian bond market[6] will expire within 3 years and hence, we can expect healthy supply/issuance, especially with corporates having to refinance maturing debt obligations. On the flipside, majority of the government bonds (67.1% of government bonds) will expire after 5 years, with 38.0% of the bonds with >10 years term to maturity.



Source: Bloomberg, Ministry of Finance (Indonesia)

The most recent corporate issues include: BEIAIJ 3.87%'24s, PNBNIJ 10.25%'24s, SRIRJK 6.87%'24s. Most of the latest corporate bond issues (since Mar 2017) are denominated in IDR (23 out of 28 bond issued), possibly reflecting demand by foreign investors for higher yielding, emerging-market currency denominated debt.

Government bond issuance is expected to increase this year, following Indonesia's Parliamentary Budget revisions in June 2016 which estimated a larger budget deficit at around USD22.3bn (2.35% of GDP), up from the original USD20.5bn (2.15% of GDP). According to Asian Bond Online, the bulk of the issuance (74%) will be issued in local currency and the remainder will be sourced from international bond issuance[7].

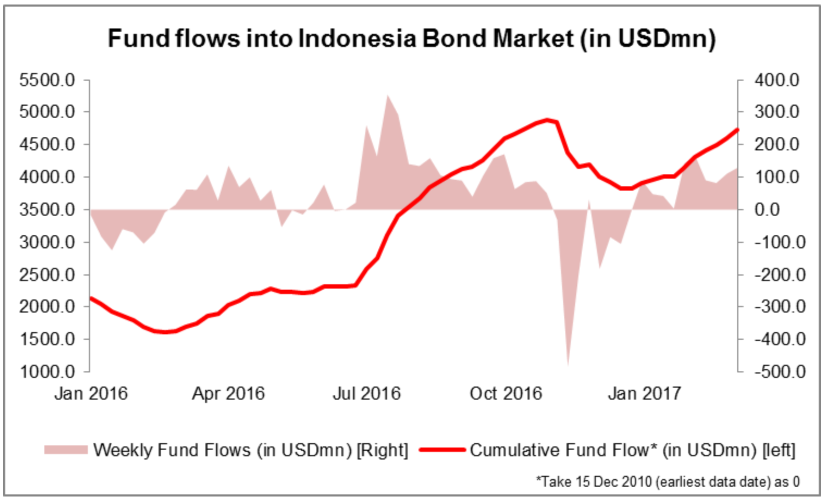
Capital Flows/Controls

Indonesia's capital markets are relatively open to non-resident portfolio investments, although there are notable restrictions and regulations on foreign investments in bonds and foreign currency transactions. Foreign investor participation in the local bond market is subjected to regulatory approval, although such restrictions are not applicable to Indonesian government bonds. Non-residents are not allowed to purchase more than 1% of a local investment fund.

[6] *Amount Outstanding in USD, as at 5 Apr 2017*
[7] *Source: AsianBondsOnline Indonesia Sep 2016 Bond Market Summary*

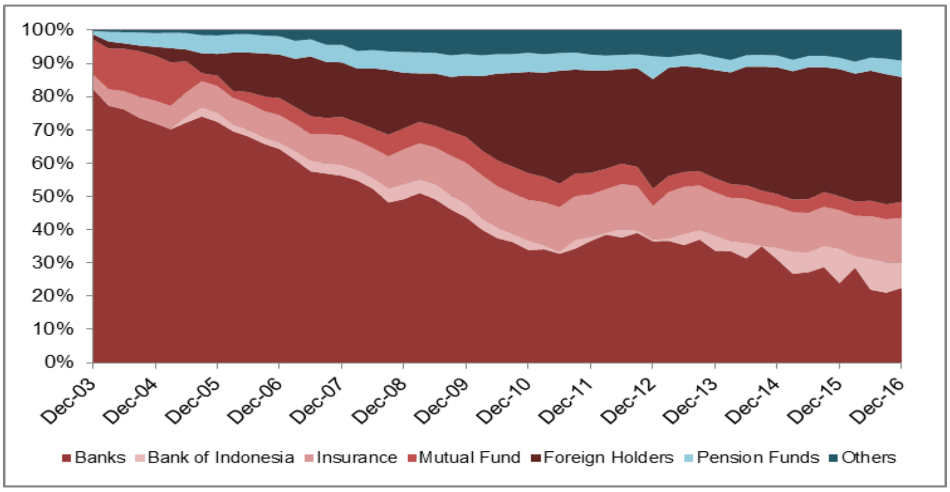
According to Asian Bond Online, local mutual funds, on the flip side, are not allowed to invest abroad; while pension and provident schemes are required to direct funds towards (i) bank time deposits and certificate-of-time deposits, (ii) corporate shares and bonds as listed on Indonesia Stock Exchange, (iii) promissory notes, (iv) corporate equities, (v) land and buildings.

Policy changes has supported domestic demand for bonds, such as the restriction imposed by the Financial Service Authority (OJK) in early 2016 which required insurance companies and pension funds to hold 20% of their portfolio in government bonds (conventional and sukuk) in 2016, and 30% in 2017. There has also been strong interest in the Indonesian bond market by foreign holders. In 2016, EPFR data showed strong fund flows into the Indonesian bond markets, with 20 out of 52 weeks posting net inflows. Cumulative net inflows for 2016 stood at USD1.67bn, despite strong outflows after the US elections. Fund flows quickly reversed and YTD net inflows into the Indonesian bond market currently stood at USD904mn, with weekly numbers showing inflows for the all of the past 10 weeks since 2017.



Source: EPFR

The key investors in the bond markets also experienced significant shake-up throughout the years. In terms of LCY government-issued bonds, there has been an increasingly significant participation by foreign holders[8], and more recently, policy developments, encourage demand for LCY government bonds.



Source: Asian Bond Online

In stark contrast to sovereigns, foreign investors only hold a small proportion of corporate bonds. According to data from Kustodian Sentral Efek Indonesia (KSEI), per February 2017 foreign investors held IDR 21.14 trillion (approx. USD1.6bn) worth of Indonesian

[8] *As much as there is no restrictions on foreign investors owning Indonesian government/corporate bonds, there has been little/no policies to encourage foreign holdings as well.*

corporate bonds, or 6.72 percent of the total outstanding IDR 314.77 trillion (approx. USD24bn). Indonesia Investments[9] identify the main reason for the lack of interest to be the illiquid secondary bond market. Activity in the secondary bond market for corporates was only 6% (or IDR800bn) of IDR13.5tn of total transactions per day.

Bond Market Dynamics: Liquidity & Ease of Access to Bond Markets

According to a World Economic Forum white paper published on May 2016, the time required to complete a bond issuance process in Indonesia can take up to four to six months, as compared to peer markets, where approval time is under eight weeks. Moreover, the transaction costs of issuing a corporate bond can be high, as regulators are funded by fees related to bond issuances.

Moreover, underdeveloped plain vanilla products (derivatives, bond ETFs, asset-backed securities) make hedging and trading difficult, limiting the growth of a strong investor base. According to the paper, poor coordination between regulatory bodies and a lack of adequate development of an electronic platform with wide participation from local and foreign dealers pose extra hurdles for Indonesia to build a strong investor base.

Sovereign Ratings

Indonesia has been assigned credit ratings of 'BB+/Baa3/BBB-'(S&P/Moody's/Fitch). This puts the sovereigns issued by the government a notch away from investment grade from all three rating agencies. President Joko Widodo has been trying to push for an upgrade for some time. S&P placed Indonesia's 'BB+' ratings on positive outlook on 21 May 2015, and even though the other 2 rating agencies has revised the outlook on Indonesia's sovereign rating to positive (Moody's on 8 Feb 2017, Fitch on 21 Dec 2016), S&P has yet to upgrade Indonesia's credit rating to investment grade.

Finance Minister Sri Mulyani has pointed to recent reforms and the success of the tax amnesty program a reason why Indonesia is deserving of the upgrade by S&P. Coordinating Minister for Economic Affairs Darmin Nasution met with delegation from S&P on 22 March 2017 to prepare for S&P's review on Indonesia in June. An investment grade upgrade would boost the country's appeal among conservative investors, potentially boosting inflows by USD3bn to USD5bn over the next year, Goldman Sachs Group Inc. estimated in March.

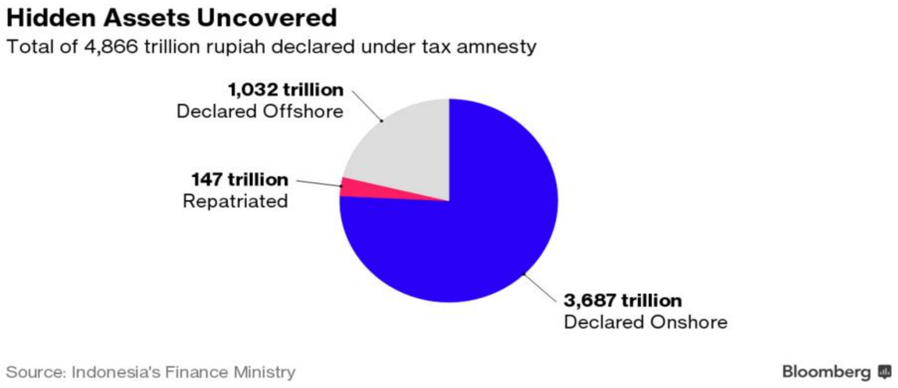
3) Key Policy developments

Tax Amnesty Program

Launched in late July 2016, the tax amnesty program was a move aimed to haul in undeclared assets (and tax revenue), onshore and offshore, held by wealthy Indonesians. The Finance Ministry of Indonesia targeted USD308bn of undeclared assets and expected tax take amounts with magnitude of around USD13bn. Although the program got off to a slow start, it quickly gained traction and by the end of the 9 month program which concluded 31 March 2017, Indonesian citizens declared a total of IDR4.87tn (USD365bn) of assets hidden from tax authorities.

According to Bloomberg, the Indonesian government was able to net in IDR135tn of tax revenue (USD10.1bn) from the program, and Finance Minister Sri Mulyani has pointed to recent reforms in Indonesia as a reason why the nation was deserving of an upgrade from S&P. As mentioned, this is likely to encourage even more capital inflows in the future.

[9] *Founded by Van der Schaar Investments (VDSI)*



Source: Bloomberg

Offshore assets declared and repatriated enjoy lower penalty tax rates, and can be invested in a variety of assets, including Indonesia's sovereigns and SOEs, (according to Regulations 122 and 123 released on 8th August) during a 3-year lock-up period.

While the full impact (and timing of impact) of the tax amnesty program on Indonesia's bond market may be hard to quantify or pinpoint, the injection of fresh capital back into Indonesia (IDR145tn, ~USD11bn) will likely trigger a slight lifting of the Indonesian sovereigns market, as well as other asset classes which the tax amnesty program channels the repatriated funds to.

Change of Bank of Indonesia reference rate to 7-day Reverse Repo Rate

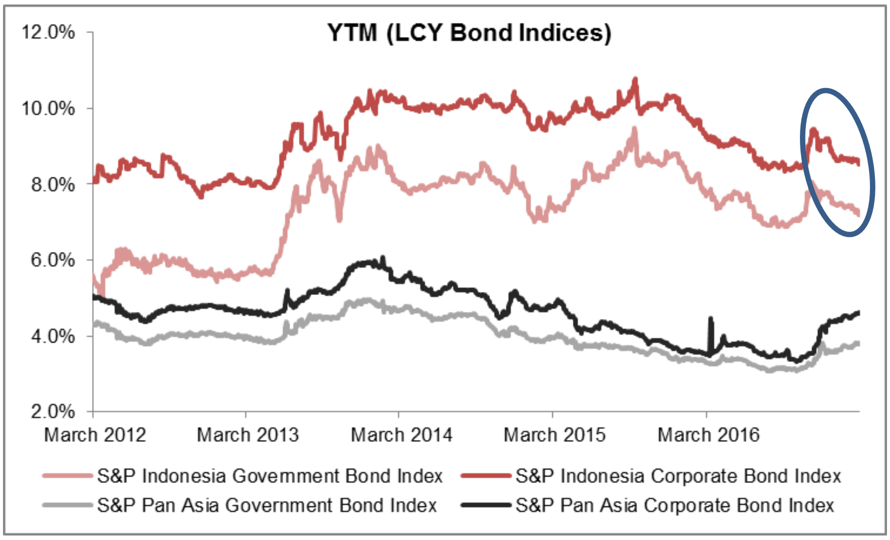
Effective on 19 August 2016, the Bank Indonesia (BI) replaced the old BI 12-month policy rate with a 7-day reverse repo as its new policy rate. The switch was meant to better reflect money market rates, and making monetary policy pass through more effective. BI's goal is to see a better environment for monetary policy transmission, where any upward or downward shift it makes to its policy rates would bring about corresponding moves in the rates at which banks charge businesses and consumers for loans.

In the short-term, the switch will have minimal (if any) impact on Indonesia's bond market, especially since this is merely a fine-tuning of the framework rather than a change in monetary policy stance. In the longer term, however, the switch may reduce transactional friction and bring down costs of funding to banks, and subsequently as a knock-on effect, to bond-issuing businesses.

4) Indonesian Bond Market Returns & Yields

In terms of LCY bond yields, Indonesian bonds in general fetch higher yields compared to its APAC[10] peers. Yield differentials for LCY corporate bonds (5-year average) are around 469bps, compared to that of LCY government bonds (5-year average) of around 344bps. Spreads of both Indonesian LCY government and corporates (over S&P Pan Asia Bond Indices) have peaked during 20153Q, amid a period of sluggish economic growth[11]. Spreads gradually narrowed thereafter, as the economy rebounded after a series of successful policy reforms and economic fundamentals[12].

[10] APAC Peers include China, Hong Kong, India, South Korea, Malaysia, Philippines, Singapore, Taiwan, Thailand
[11] OECD projected Indonesia's GDP to grow at 4.79% in Dec 2015, the lowest level seen since the GFC (projected: 4.70% in Dec 2009). Low growth was attributed to a myriad of factors, including forest fires & haze, lower global oil and commodity prices.
[12] OECD projected Indonesia's GDP to grow at 5.1% in 2016, and 5.3% in 2017, in Jan 2017.

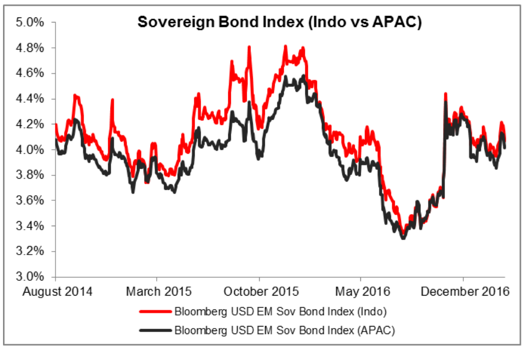


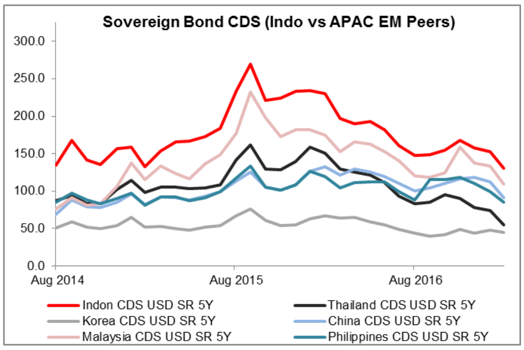
Source: S&P, Bloomberg

Focusing on the past year, the attractive yields of Indonesian bonds appealed to investors and paved the way for strong fund flows into the Indonesian LCY bond market. This was especially so during the period after the US election, which initially triggered heavy outflows[13], a function of renewed concerns over a strong US currency. This provided buying opportunities for investors, and after (1) markets stabilized; and (2) USD strength has been all/mostly priced in, the Indonesian bond market saw fresh money flowing back[14]. Indonesian bonds shined compared to their APAC peers, mainly due to Indonesia's relatively stronger insulation to downside risks of protectionistic tendencies by U.S, due to strong domestic demand.

Moreover, according to Bloomberg article "World's Biggest Hedge Fund Pivots to Local Emerging Bonds", funds are already starting to increase exposure to the LCY bonds. This is mainly a function of emerging market currencies looking "very cheap" as "Fed's rate hikes are already priced in, so there's no additional strength for the dollar".

Looking at USD-denominated sovereigns[15], however, Indonesia only offers yields marginally better than its APAC peers. Taking the price of CDS as a proxy measure of credit risk on the sovereign bonds, we see that the Indonesian sovereigns are overpriced (when looking at yields), considering the higher credit risk that investors have to stomach.





Source: S&P, Bloomberg

Both corporates and the government took on more leverage (as % of GDP) over a span of 5 years. Private sector credit grew rapidly over the past 5 years, with total credit accounting for 39.8% of GDP by 2016Q3. Public sector debt grew, slowly but steadily, by 2016Q3 accounting for 27.5% of GDP, with majority of debt issuance through LCY.

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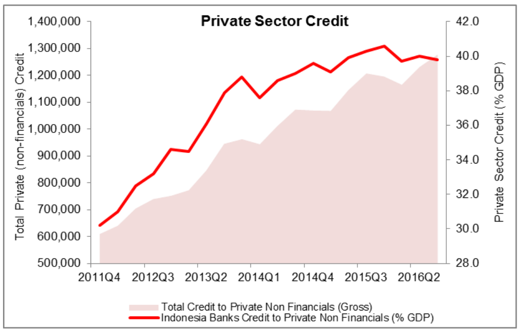
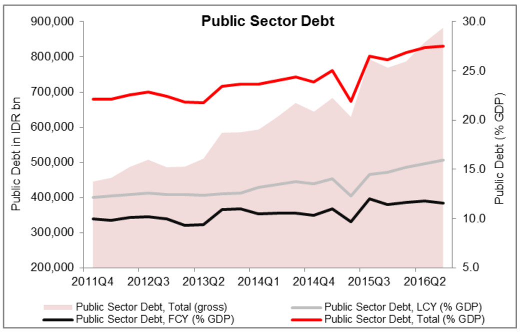
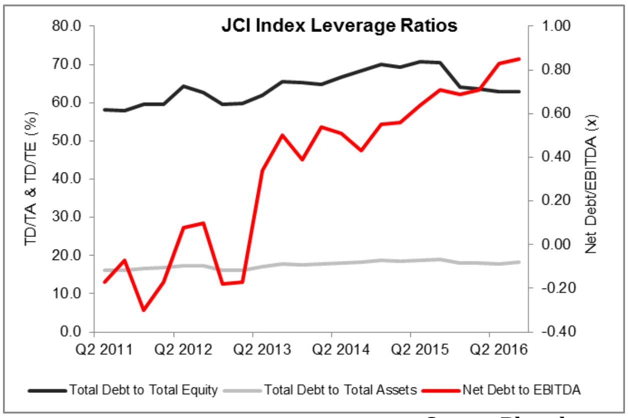
[13] According to EPFR, the week ending 16 Nov 2016 saw record high outflows of USD483mn, week ending 23 Nov 2016 printed outflows of USD203mn
[14] YTD, weekly fund flows into Indonesian bond market has been net positive prints
[15] FCY Sovereigns account for 66% of Indonesia's FCY bond market.





Source: Bloomberg **Source: Bloomberg**

Despite private sector credit close to doubling over the past 5 years, corporates are still able to maintain healthy balance sheets. Leverage ratios[16] for corporates are currently at healthy levels of around 0.80x, but has spiked notably over a 5-year period, from around -0.20x initially. Earnings (using EBITDA as proxy) were not able keep up with the rapid rate of debt accumulation, but for now, with Net Debt/EBITDA ratios still less than 1.0x, we find debt still at controllable levels.



Source: Bloomberg

Since 2003, in response to the aftermath of the Asian Financial Crisis, Indonesia has passed a law which limits the maximum budget deficit at 3% of GDP. The policy ensures that public debt grows at a sustainable level. A key concern, though, would be the high reliance of the government on FCY denominated debt. The proportion of FCY to Total Government debt climbed to 29.6% as at 2016Q4 (2011Q4: 18.8%, 2006Q4: 8.6%).

5) Concluding Remarks

The Indonesian Bond Market is going through significant reforms and changes which would reduce cost of debt for corporates and allow for financial deepening. Government policies and support are pushing the bond market in the right direction, although it will still take time before the bond market can be considered developed. On the corporate side, companies do not have ease of access to credit[17], and this is apparent in their under-leveraged balance sheet, considerably smaller corporate bond market[18], and limited foreign participation. On the sovereigns side, the Indonesian government exercises fiscal prudence and has been issuing debt sustainably after a painful lesson from the Asian Financial Crisis. Foreign participation is much more significant in the sovereign space, with foreign investors holding up to 39% of Indonesian government debt, possibly a consequence of capital controls which was mentioned earlier in this report.

[16] *Measured using Net Debt/EBITDA ratios. Ratio was calculated using Bloomberg figures*
[17] *Indonesia fared only moderately well in OECD's "Doing Business" survey, which takes into account ease of a company getting credit. In terms of "Strength of legal rights index" and "Depth of Credit Information", Indonesia scored 6.0 and 6.0 respectively. Refer to Appendix 1 to see comparison of scores.*
[18] *In a report published in April 2017, McKinsey & Company scored Indonesia's capital markets (in terms of development) at 2.2 out of 5.0. Indonesia ranks below most its Asian peers. Refer to Appendix 2 to see comparison of scores*

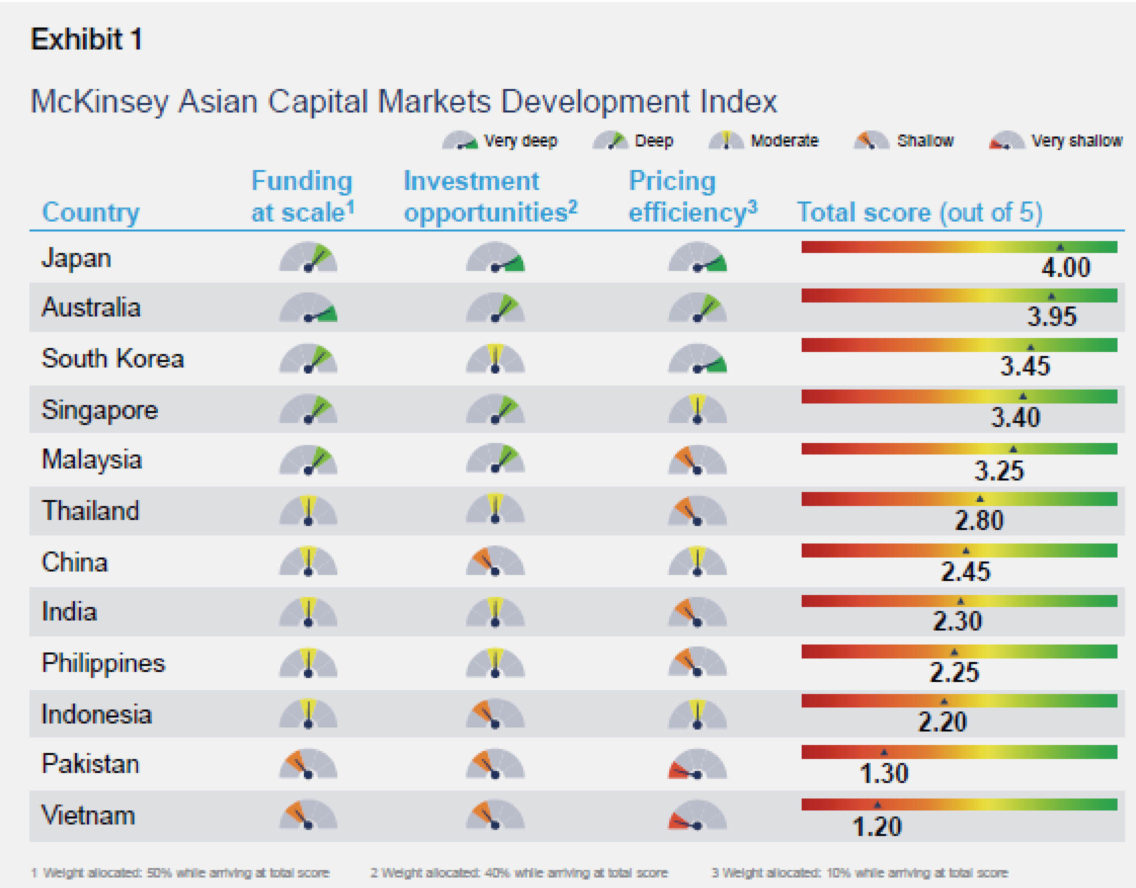
6) Appendix

Appendix 1 – OECD "Doing Business" Survey (Getting Credit)

	Metrics Used to Gauge Ease of "Getting Credit"			
Economy	Strength of legal rights index (0-12)	Depth of credit information index (0-8)	Credit registry coverage (% of adults)	Credit bureau coverage (% of adults)
Indonesia	6	6	51.8	0
Malaysia	7	8	62.4	76.4
Brazil	2	7	53.4	78.9
China	4	8	91.1	21.3
Singapore	8	7	0	65.7
Hong Kong SAR, China	8	7	0	100
France	4	6	46.7	0
Australia	11	7	0	100
Germany	6	8	1.9	100
Japan	4	6	0	100
United Kingdom	7	8	0	100

Source: OECD

Appendix 2 – McKinsey Asian Capital Markets Development Index



Source: McKinsey & Company

The credit research team would like to acknowledge and give due credit to the contributions of Yeo Jin Peng.