

# INSIGHTS

## GLOBAL MACRO TRENDS

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### Indonesia: Harnessing its Potential





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# Indonesia: Harnessing its Potential

*Our recent trip to Southeast Asia leads us to upgrade our investment outlook for Indonesia. The country has one of the most compelling demographic stories that we see across KKR's global footprint, with working age population not peaking for several decades. More important in the near term, though, is that — from a macro investing standpoint — Indonesia has emerged as somewhat of a pure-play on our thesis that large, domestic economies will prosper in a world that now favors domestic agendas over global ones. And unlike in past trips, we are now confident stating that we think Indonesia is harnessing its long-term potential into near-term economic and investment realities. To be sure, there are still risks, but our research and our visits lead us to conclude that Southeast Asia, Indonesia in particular, may be one of the areas where investors are not fully up to speed on the compelling macro backdrop. In our view, therein lies the opportunity.*

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**Berakit-rakit ke hulu, berenang-renang  
ke tepian. Bersakit-sakit dahulu,  
bersenang-senang kemudian.**

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INDONESIAN PROVERB THAT TRANSLATES TO  
“YOU HAVE TO GO THROUGH PAIN AND HARDSHIP FIRST  
BEFORE YOU CAN ACHIEVE SUCCESS AND HAPPINESS.”

After completing a comprehensive deep dive on Indonesia back in early 2013, my colleague Frances Lim and I authored a report titled “[Indonesia: Turning Potential Into Reality](#).” The punch line of the report was that, while Indonesia enjoys massive demographic tailwinds, the country needed to clean up its finances, improve its infrastructure, and further diversify its economy before it would be ‘all clear’ for increased capital deployment by foreigners.

Whether we were lucky or good when we voiced our concerns, we will never know. But we do know that the United States Federal Reserve, by hinting that it would be making a shift in monetary policy, immediately thereafter shocked Indonesia and many of its emerging market peers by inspiring what is now called the ‘Taper Tantrum.’

Fast forward to Spring 2017, and the outlook for Indonesia appears quite different. Deficits are more balanced, the currency is more stable, and infrastructure outlays are accelerating. Our recent onsite visit to Indonesia with our local team of KKR professionals confirmed a similar feeling, and as such, we came away from our trip believing that Indonesia has — at least on the macro front — finally begun to visibly turn its long-term potential into near-term economic and investment realities. We note the following:

- **The country’s macro game plan now seems more in synch with the potential obstacles the country faces.** Just consider that government funding for infrastructure projects jumped by over 20% in the latest 2017 budget, and it now stands at 2.5 times what was allocated just three years ago. Meanwhile, the country’s reserve base is now near record levels, and unlike many other EM countries we visit, there is no excessive credit overhang about which to worry. Maybe more important, though, is that central bankers, government officials, and CEOs all now seem more committed to delivering on the “game plan” that is needed to elevate Indonesia into one of the EM market’s elite destinations for investor capital.
- **Within our ASEAN footprint, Indonesia has clearly emerged as one of the most attractive pure-plays on our view that global capital flows will increasingly migrate towards economies with large domestic consumption.** In Indonesia, GDP-per-capita is still increasing 8.2% per annum (i.e., 2.5 times as fast as the U.S.), which represents a distinguishing feature in today’s growth-starved, geopolitically unsettled world. Indeed, with half its population of 260 million under the age of 30, private consumption as a percentage of GDP already totals 58%, a figure that we think could increase another five to seven percentage points during the next decade.
- **Within the region, we see several industries in transition where investors should be buyers when prices become more realistic.** E-commerce, health services, wellness, entertainment, nourishment, education, and even consumer financial services all represent strong secular growth areas that warrant investor attention. However, valuation matters, and as good as these opportunities may be, these secular tailwinds are not worth harnessing unless investors can partner with the right local entrepreneurs.
- **While absolute rates are low in Indonesia relative to history, local debt actually looks compelling.** Now that Indonesia has been

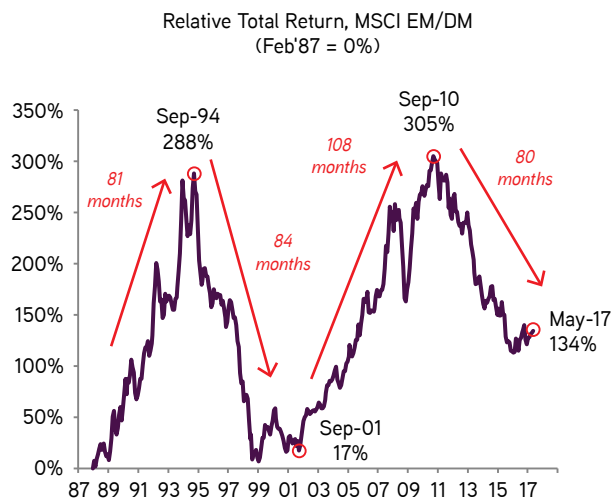
upgraded to investment grade by all three major ratings agencies, it is one of the highest yielding sovereign securities in the world within its ratings designation.

- **Consistent with this view on local debt, we are now more sanguine on EM currencies.** This statement is significant, as currency usually accounts for one-third of the total return equation during an EM performance cycle. If we are right, then less capital will need to be allocated towards hedging on a go-forward basis.
- **Private Credit in Indonesia represents an opportunity,** but deal sizes are still small and sourcing engines will likely be needed to boost capital deployment in this product area. From a structural standpoint, however, Indonesia lacks local deposits, and its bank executives are increasingly shying away from complexity, particularly in the middle market. Meanwhile, foreign banks have pulled back, with loans as a percentage of GDP falling to 13% in March 2017, compared to a peak of 16% in September 2015. In our view, this backdrop could be bullish for private credit, particularly as there are a growing number of more difficult transactions that require speed of execution.
- **Our research on Indonesian Public Equities suggests that we are at an inflection point.** After a multi-year period of stagnant growth, earnings are poised to finally reaccelerate, we believe. As such, we expect the Indonesian Public Equity index to outperform many of its more prominent EM peers during the next few years. Not surprisingly, though, within the Indonesian Public Equity index investors has efficiently bifurcated valuations between banks and consumer stocks, a gap we do not see closing in the near term.
- **Similar to what we have seen in other big EM markets, we believe that the opportunity for investors to use Private Equity to arbitrage the Public Equity markets is large and growing.** For example, in Indonesia, the Public Equity benchmark actually has a zero percent weighting to Technology, one of the areas we find most compelling in the region. So, if we are right about the growth trajectory of areas like e-commerce, mobile payments, and logistics, then large institutional investors will want to move beyond the public indexes to gain private exposure to areas of the economy that actually capture the bullish GDP story that we have been highlighting.

In terms of the bigger picture, we left Southeast Asia (SEA) even more convinced that the global macro outlook we laid out in January (see *Outlook for 2017: Paradigm Shift*) has momentum. Indeed, spending time in the region with CEOs, central bankers, and sell-side experts only reinforced many of our core investment themes, including the following: 1) Emerging Market Equities have turned up and may have begun a multi-year outperformance run versus Developed Market Equities (*Exhibits 1 and 2*), 2) our thesis about performing private credit over non-performing private credit is a global, not a specific regional insight (which is good for SEA, including Indonesia), 3) consumer spending on experiences over things is gaining momentum in both developed and developing markets; and 4) we continue to see investment opportunities on a global basis to buy complexity (e.g., carve-outs, dislocated securities), but sell simplicity (e.g., over-priced sovereign debt and high PE consumer staples stocks).

# EXHIBIT 1

## It Has Been a Long, Hard Road in Emerging Markets...



Data as at May 30, 2017. Source: MSCI, Bloomberg, Factset.

# EXHIBIT 2

## ...But Our Model Now Suggests EM Has Bottomed

	"RULE OF THE ROAD"	MAY'15	JAN'16	AUG'16	CURRENT SIGNAL
1	BUY WHEN ROE IS STABLE OR RISING	↔	↔	↔	↗
2	VALUATION: IT'S NOT DIFFERENT THIS TIME	↔	↗	↗	↗
3	EM FX FOLLOWS EM EQUITIES	↘	↘	↔	↔
4	COMMODITIES CORRELATION IN EM IS HIGH	↔	↔	↔	↔
5	MOMENTUM MATTERS IN EM EQUITIES	↘	↘	↗	↔

Data as at May 31, 2017. Source: KKR Global Macro and Asset Allocation analysis.

Another major macro conclusion from the trip is that Asia's current savings glut (e.g., China has a 50% savings rate) is likely to put continued downward pressure on global interest rates, even if global QE normalizes. This viewpoint is significant because it likely means that capital markets return assumptions may need to be further adjusted downward. In addition, it suggests that investors and corporations that can lower the cost of their liabilities via cheap funding sources like Japanese banks or Chinese insurance companies are likely to earn excess returns relative to those that do not adjust to the new environment we are now envisioning. In our view, too few investors in the United States and Europe are taking advantage of regional funding arbitrage that we believe has emerged in Asia these days.

# EXHIBIT 3

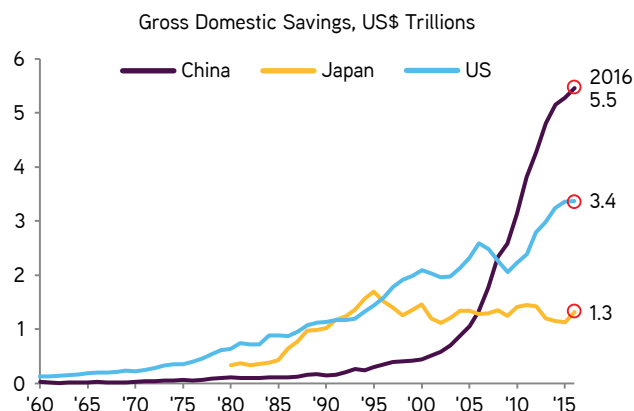
## China Has Already Had a Crash in Nominal GDP, Which Is Important for Framing the Asian Opportunity Set



Data as at 1Q2017. Source: China National Bureau of Statistics, Haver Analytics.

# EXHIBIT 4

## While China's Economy Is Just \$11.2 Trillion vs. \$18.6 Trillion for the U.S., It Has 1.6x More Savings



Note: Total savings estimated by deducting final consumption expenditure from nominal GDP. 2016 number for China's saving is our own estimate. Data as at December 31, 2016. Source: Maybank Kim Eng Economics Research, *China's Rising Wall of Savings*, April 2017; CEIC.

From a macro investing standpoint — Indonesia has emerged as somewhat of a pure-play on our thesis that large, domestic economies will prosper in a world that now favors domestic agendas over global ones.

If we are wrong about our positive views on the opportunity set that we now see in Southeast Asia, we think it will be because capital flight trumps a high savings rate in China, or the end of quantitative easing leads to a significant flight of institutional and retail capital from EM bonds (e.g., 38% of Indonesian bonds are held by foreigners). Neither outcome is our base case, but we do think these risks are worth highlighting, particularly when deploying capital in the emerging markets.

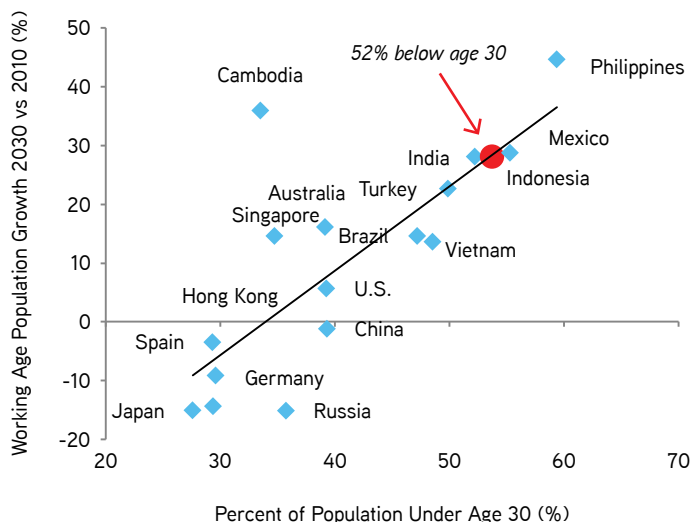
## DETAILS

**The Structural Backdrop in Indonesia Remains Extremely Compelling** After multiple visits throughout Indonesia during the past 22 years, we retain our long-held view that Indonesia has one of the most compelling demographic stories that we see across KKR's global footprint, with working age population not peaking for several decades (*Exhibits 5 and 6*). By 2050, Indonesia will have the third largest middle class population in the world, trailing only China and India (*Exhibit 7*). Without question, these trends are constructive for investments in sectors like healthcare, education, e-commerce, food safety, transportation, payments and housing/financial services.

Maybe more important in the near term, though, is that — from a macro investing standpoint — Indonesia has emerged as somewhat of a pure-play on our thesis that large, domestic economies will prosper in a world that now favors domestic agendas over global ones. With half its population of 260 million under the age of 30, consumption as a percentage of GDP now totals 58%, ahead of China's 38% and nearly on par with India's 56% (*Exhibit 9*). Against this backdrop, household consumption reached \$500 billion in 2015, up 167% from 2005, and we look for GDP-per-capita to expand another 49%, or 8.2% per annum during the 2017-2022 period (*Exhibit 8*). If we are right, then household consumption could total at least \$740 billion by the end of the decade.

### EXHIBIT 5

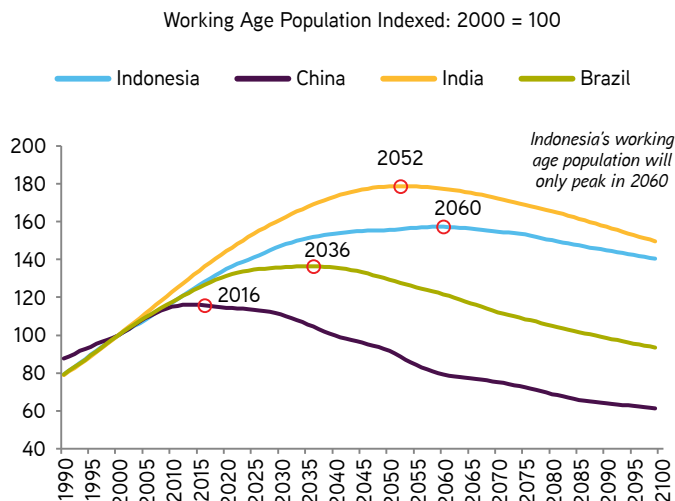
Indonesia Has One of the Most Compelling Demographic Stories Across KKR's Global Footprint...



Data as at July 30, 2015. Source: United Nations World Population Prospects, Haver Analytics.

### EXHIBIT 6

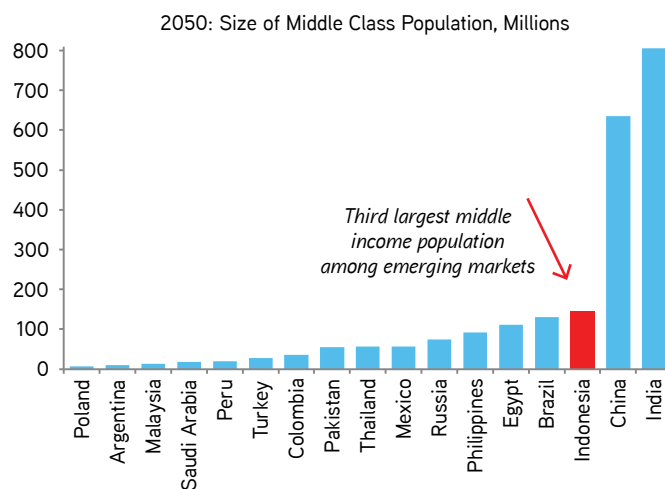
...Its Working Age Population Is Already the Fourth Largest in the World and Will Only Peak in 2060



Data as at December 19, 2016. Source: United Nations World Population Prospects, Haver Analytics.

### EXHIBIT 7

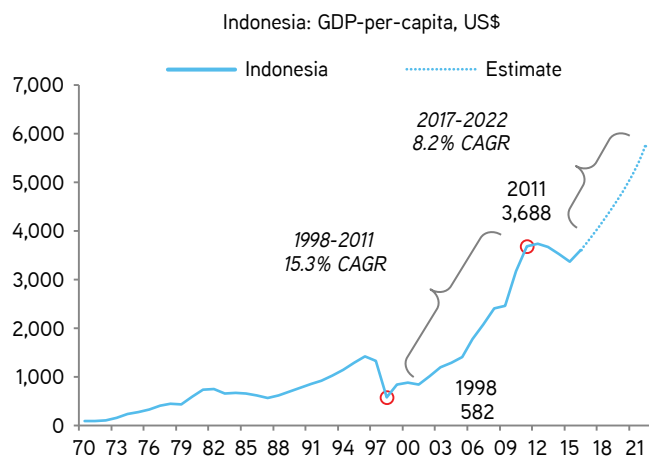
By 2050, Indonesia Will Have the Third Largest Middle Class Among Emerging Markets



Source: HSBC report "Consumer in 2050" dated October 2012.

## EXHIBIT 8

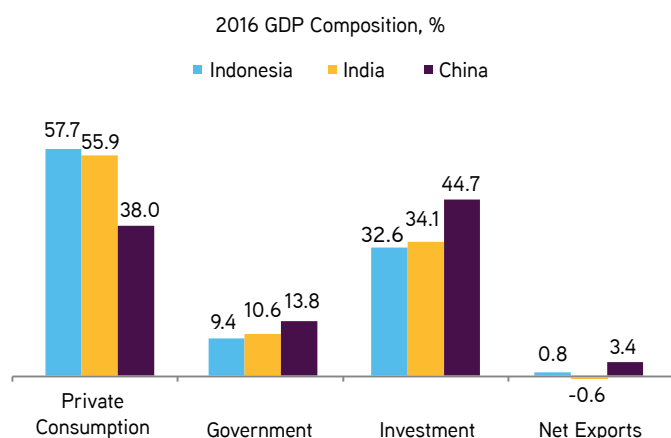
GDP-Per-Capita Should Grow by 49%, or 8.2% Annually, Over the Next Five Years



Data as at April 18, 2017. Source: Biro Pusat Statistik, IMF, Haver Analytics.

## EXHIBIT 9

Consumption in Indonesia Is Higher Than India's Economy...



China data as at 2015. Data as May 5, 2017. Source: India Central Statistical Organization, Biro Pusat Statistik, and China National Bureau of Statistics.

## EXHIBIT 10

...As Household Consumption Grew 167% from 2005 to 2015

COUNTRY	HOUSEHOLD CONSUMPTION IN \$ TRILLIONS		% CHANGE FROM 2005 TO 2015	CONSUMPTION AS A % OF GDP, 2015
	2005	2015		
CHINA	0.9	4.3	363%	38%
PHILIPPINES	0.1	0.2	179%	74%
INDONESIA	0.2	0.5	167%	56%
INDIA	0.5	1.2	156%	59%
U.S.	8.8	12.3	40%	68%

Data as at April 17, 2017. Source: World Bank, Haver Analytics.

Interestingly, when we talk to U.S. and European investors about both the absolute and relative size of the Indonesian consumer opportunity, many are unfamiliar. Rather, they are more focused on higher profile BRIC countries like India and China. In our view, this more narrow focus is a mistake. China's working age population is now contracting the equivalent of the total population of Singapore per year, while Brazil continues to struggle with declining productivity, political discord, and excess credit. India does have a compelling demographic profile with good growth, but there are times when its highly democratic approach can slow down the reform process. As such, our advice continues to be that participation/diversification across *all* these countries, particularly those with large consumption economies, is likely the best way to generate top-tier returns in the emerging markets throughout this cycle.

### Importantly, the Near-Term Macro Backdrop Looks Pretty Good

After getting negatively repriced during the Taper Tantrum fallout in 2013 and then suffering through the China slowdown/commodity bust in 2014 (and subsequent increase in NPLs), the Indonesia macro story appears to be more stable. At \$116 billion (*Exhibit 11*), reserves are near record levels, the country is enjoying the benefits of a cyclical rebound in commodity prices, and President Widodo's government has focused more on increasing infrastructure spending as well as broadening the tax base.

From a political standpoint, there is now enough growth to boost local morale towards optimistic levels, but not so much that the government has lost its focus on reforms and structural improvements.

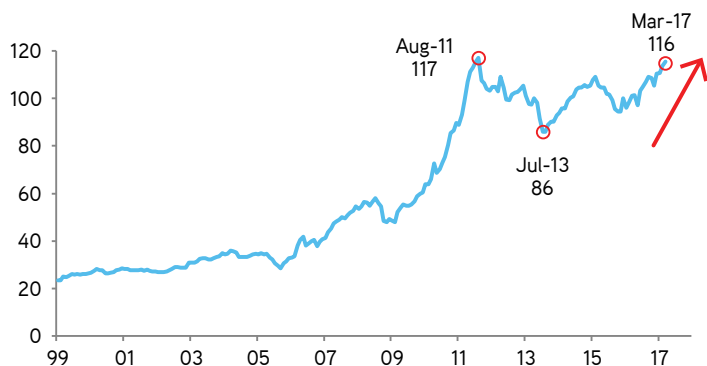
Indonesia's macro game plan now seems more in synch with the potential obstacles the country faces.



# EXHIBIT 11

## Indonesia's FX Reserves Are at the Highest Levels Since August 2011

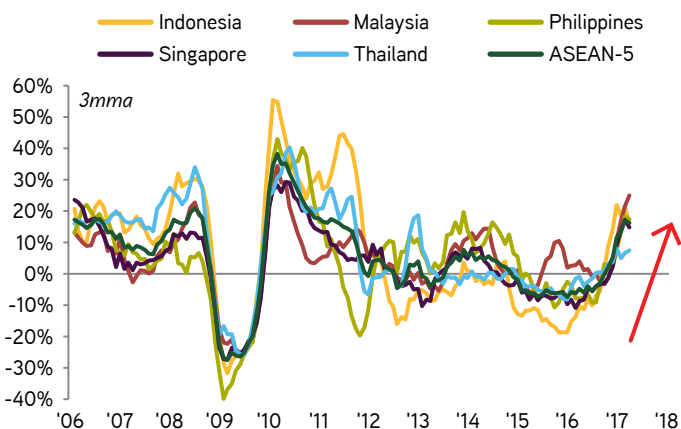
Indonesia: Foreign Exchange Reserves, US\$B



Data as at March 31, 2017. Source: Bloomberg.

# EXHIBIT 12

## A Synchronized ASEAN Export Recovery Has Now Occurred, Though It Has Been Mainly Due to Higher Prices, Not Volumes



Data as at April 30, 2017. Source: Bloomberg.

Budget allocations for priority areas such as infrastructure, education and healthcare have increased significantly under Indonesia's seventh president, Joko Widodo. All told, central government funding for infrastructure, an area that we have traditionally viewed as notably inadequate in Indonesia, jumped by over 20% in the latest 2017 budget, and it now stands at 2.5 times what was allocated just three years ago (*Exhibit 13*). The other piece of good news is that the government's infrastructure plans (~\$370 billion over 2015-19) are backed by diverse funding sources (*Exhibit 14*.) Previously, infrastructure spend was not only low but also highly concentrated in energy and subsidies (*Exhibit 13*).

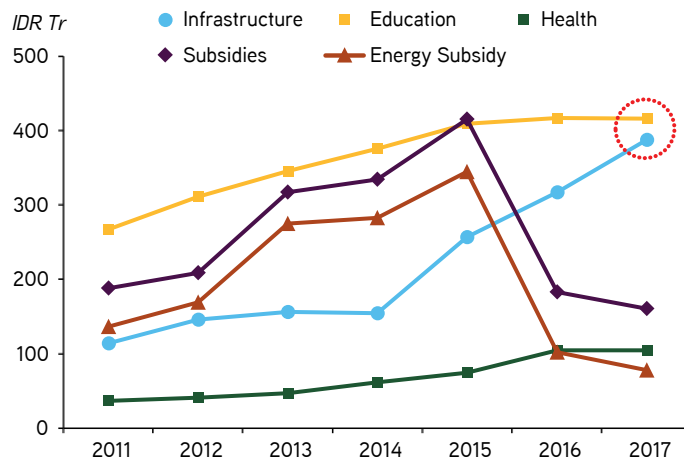
We view the president's game plan as quite favorable, and we were encouraged by what we heard on the ground in the country's capital, Jakarta. CEOs appear content to invest in the current environment, and when the local banks are unwilling to lend on key infrastructure projects, China clearly has a mandate from Beijing to step in and serve as the marginal capital provider.

However, as the country turns towards the election season in 2019, investors need to ensure that the government does not lose its long-term focus in favor of more short-term growth to boost political sentiment. There is also risk that religious tensions flare up heading into election season in 2019. Both of the aforementioned risks (i.e., budgetary and sectarian) are manageable, but do warrant investor attention in the coming months, in our view.

# EXHIBIT 13

## Government Funding for Infrastructure Projects Is 2.5x More Than What Was Allocated Three Years Ago

2011-2017 Indonesian Government Funding by Project Type

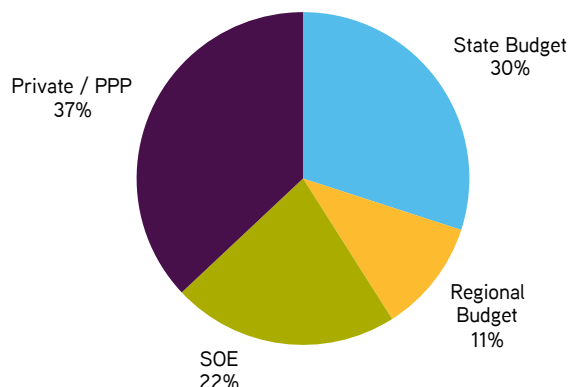


Data as at January 2017. Source: BofAML Global Research estimates, CEIC.

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**Within our ASEAN footprint, Indonesia has clearly emerged as one of the most attractive pure-plays on our view that global capital flows will increasingly migrate towards economies with large domestic consumption.**  
 ”

## Indonesia Is Now Funding Its Infrastructure Spending Through a Wider Variety of Sources

Funding Source for US\$370B of Infrastructure Projects (2015-2019)



Data as at January 2017. Source: BofAML Global Research estimates, CEIC.

**Achilles Heel: Indonesia Still Runs With Twin Deficits, Finances Itself With Foreign Capital, and Is Still Dependent on Commodity Exports** In what is an unusual set-up for an Asian country, Indonesia actually runs both a current account and a fiscal deficit. One can see this graphically in *Exhibit 16*. What's the problem? While the country has a decent commodity export franchise, it has not been as successful in the traditional manufacturing space as some other emerging market countries. As a result, its large consumption economy often creates demands for imports that its export economy can't always offset.

Another macro issue for investors to consider is that fully 38% of the country's bonds are held by foreigners (*Exhibit 15*), which makes it more vulnerable to sudden capital outflows in the case of a global shock. From what we can tell, lax tax collection, particularly as it relates to the country's sizeable informal economy, remains a major issue. Finally, most of its exports are commodity related, while many of its imports are non-commodity related (*Exhibits 17 and 18*).

The offsets to these potentially precarious macro statistics include a low debt-to-GDP ratio (at just 31%) and a notable increase in reserves (to \$116 billion – the highest since August 2011). Also, the government has a self-imposed fiscal deficit cap of three percent, which we believe is prudent policy to keep its current account in check. However, we note that this is at the expense of more rapid growth funded by government spending.

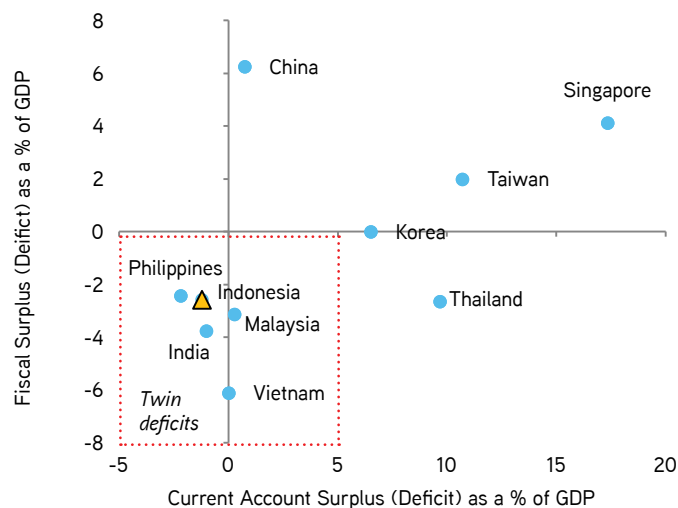
Also, as we mentioned earlier, there are cyclical tailwinds in Indonesia's favor. For example, there has been a major acceleration in regional trade, with ASEAN-5 exports now growing at the strongest pace in six years. Moreover, unlike in the U.S., Indonesia has followed through on a successful tax amnesty program (yielding \$10 billion in tax-related revenues linked to \$365 billion of previously undeclared assets).

## High Foreign Ownership of Indonesian Bonds Leaves the Economy Vulnerable to Sudden Capital Outflows



Data as at March 31, 2017 or latest available. Source: Respective national security agencies, Haver Analytics.

## Unlike Most Asian Countries, Indonesia Has Twin Deficits



Data as at March 31, 2017 or latest available. Source: Respective national statistical agencies, Haver Analytics.

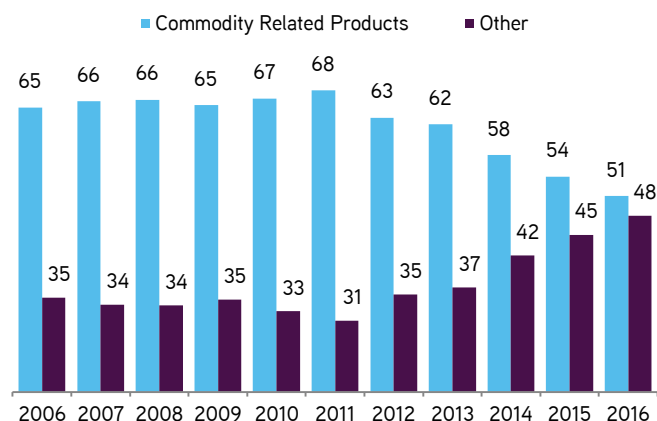
**We are now more sanguine on EM currencies and if we are right, then less capital will need to be allocated towards hedging on a go-forward basis.**



# EXHIBIT 17

## Indonesia's Export Basket Is Changing for the Positive, as It Becomes Less Reliant on Commodities...

Indonesia: Export Composition, % of Total



Data as at April 18, 2017. Source: Bank Indonesia, Haver Analytics.

Our bottom line: We want to keep an eye on foreign ownership of bonds as well as encourage a further broadening of the export economy via improved manufacturing capacity. However, we do not think a limited increase in the country's current account deficit or the ongoing Fed tightening campaign will cause 'Taper Tantrum II.' This sentiment is noteworthy, as it reflects a 180 degree change (i.e., a major improvement) in our opinion versus the more cautionary macro outlook that we laid out during our last visit in 2013.

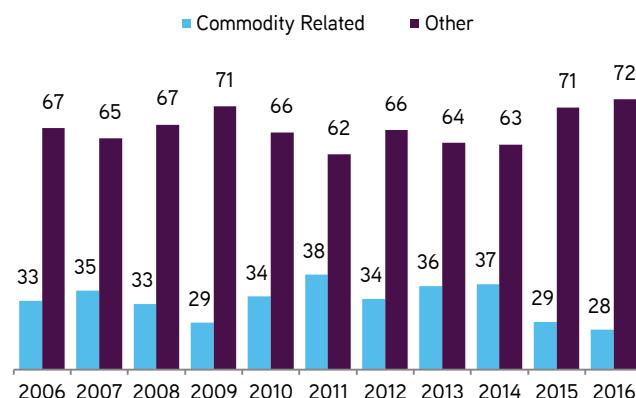
Longer-term, though, Indonesia needs to leverage the inherent benefits of its resource-rich heritage to develop more robust manufacturing and services offerings that can compete on both a regional and a global basis. In order to achieve this, the country must continue to upgrade its human capital by investing in education and training.

This economic transition will not happen overnight, we acknowledge, but we do view it as a critical next step in helping to prevent the country's dual deficits from becoming more problematic. Importantly, if the government can help the country's private sector to broaden its base of output, it would provide a compelling addition to what is already one of the strongest consumption stories across the emerging markets.

# EXHIBIT 18

## ...While Its Imports Are Generally Non-Commodity Based

Indonesia: Import Composition, % of Total



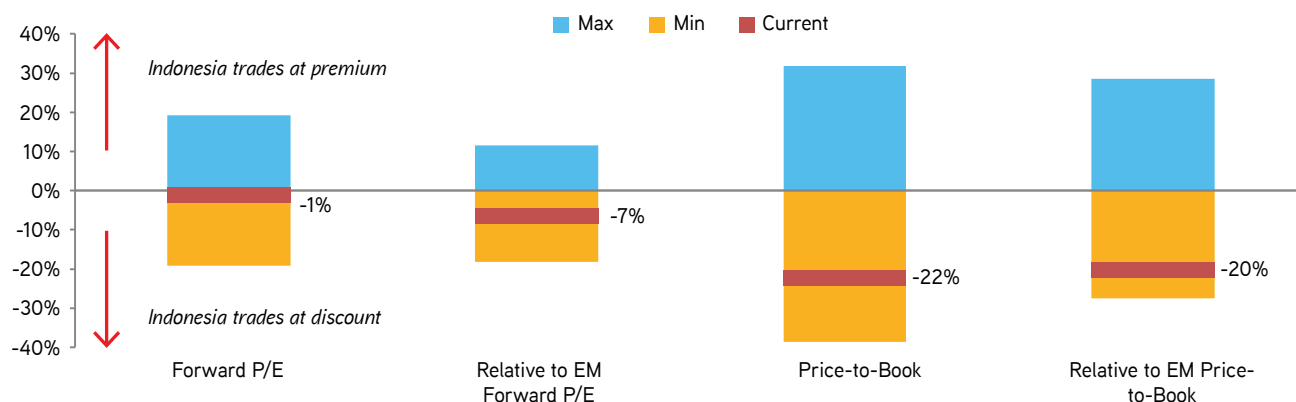
Data as at April 18, 2017. Source: Bank Indonesia, Haver Analytics.

**Public Equity Valuations: A Tale of Two Cities** After heavily re-researching the outlook for local Indonesian public equities, we came away thinking of the current regime as somewhat of 'A Tale of Two Cities.' On the one hand, Indonesian equities are now trading in-line with their long-term uptrend on a *price-to-earnings* basis, despite the market's ROE falling 35% to 15% from 23% in 2011. On the other hand, Indonesian stocks appear more compelling a *price-to-book* basis, trading at more than one standard deviation below trend in

# EXHIBIT 19

## Indonesian Valuations Suggest That Stocks Are Trading at a Discount Relative to Trend on a P/B Basis, But Not From a P/E Perspective

Indonesia Valuation: Discount/Premium Relative To Trend



Data as at April 27, 2017. Source: Factset Aggregates.

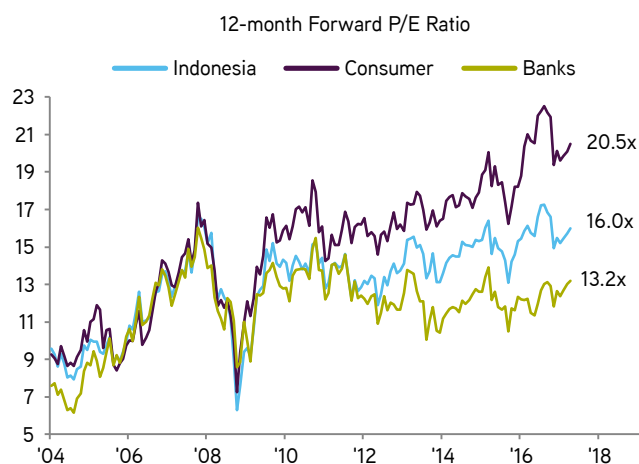
absolute terms and relative to other emerging markets (*Exhibit 19*).

We link the discrepancy between an upward moving price-to-earnings ratio and a downward moving price-to-book ratio to two factors. First, 12-month forward EPS growth – until recently – has been essentially flat since 2011. Second, book value growth has been in a steady uptrend during this same period, driven largely by what we believe to be additional equity issuance, some dividend cuts, etc.

Also, intertwined in the aforementioned valuation anomaly across Indonesian equities is that there is a large and growing valuation differential between consumer stocks and bank stocks. All told, during the past six years, consumer stocks (staples, discretionary and healthcare) have experienced the lion's share of re-rating, with PE multiples expanding by a full 36% from 15.1x to 20.5x (*Exhibit 20*). On the other hand, bank stocks, which account for fully 36% of the total index, have actually de-rated over this period, with multiples contracting 7% from 14.1x to 13.2x today.

#### EXHIBIT 20

There Are Currently Big Valuation Differentials Between Consumer Stocks and Bank Stocks in Indonesia



Note: Consumer = Staples, Discretionary and Healthcare stocks. Data as at April 30, 2017. Source: MSCI, Factset.

#### EXHIBIT 21

An Analysis of Earnings Yields Tells a Similar Story



Data as at April 30, 2017. Source: MSCI, Factset.

Based on a continued improvement in fundamentals across the Indonesian macro and micro landscapes, we expect the valuation differential between the country and the rest of its EM peers to narrow in the coming quarters. However, we actually do not expect the gap between consumer and bank stocks to follow a similar path. First, we expect consumer earnings to inflect upward in 2H17. Already, several consumer businesses with which we spoke are seeing upticks in sales, albeit we do not think that we are going back to levels experienced during the China Growth Miracle period (2000-2013). On the other hand, we think that the regulator's decision to cap the rates that banks can charge customers is increasingly crimping net interest margins, while loan-to-deposit ratios remain extended (*Exhibit 22*). This latter point is significant, and as we discuss below, it bodes well for our positive thesis around private credit in Indonesia.

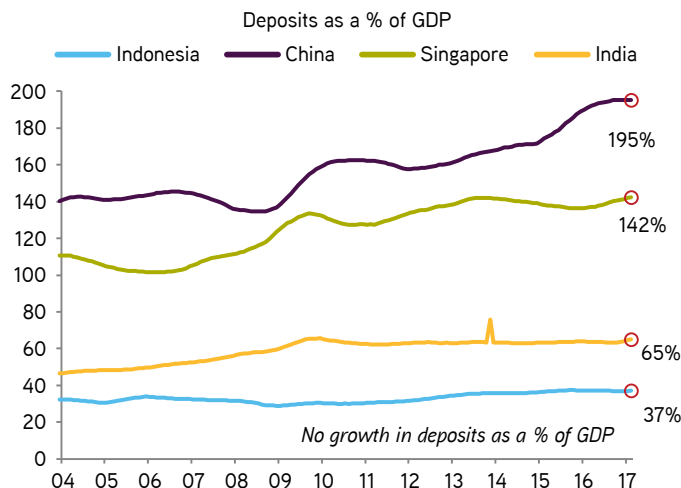
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**Another major macro conclusion from the trip is that Asia's current savings glut (e.g., China has a 50% savings rate) is likely to put continued downward pressure on global interest rates, even if global QE normalizes. This viewpoint is significant because it likely means that capital markets return assumptions may need to be further adjusted downward.**

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# EXHIBIT 22

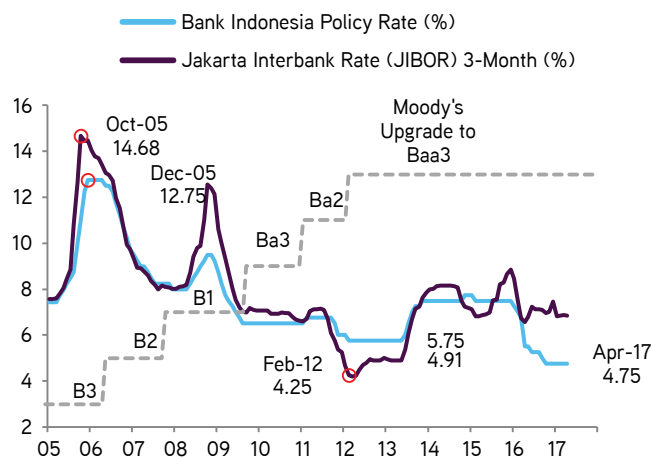
## Indonesia Suffers from Too Few Deposits, Not Too Many Loans



Data as at March 31, 2017. Source: Bank Indonesia, Biro Pusat Statistik, People's Bank of China, China National Bureau of Statistics, Monetary Authority of Singapore, Singapore Department of Statistics, Reserve Bank of India, India Central Statistical Organization, Haver Analytics.

# EXHIBIT 23

## Interest Rates Have Moved to 4.75% from 12.75% in 2005, Reflecting Both a Better Macro Backdrop as Well as the Global Effects of Quantitative Easing



Data as at April 30, 2017. Source: Bank Indonesia, Bloomberg, Haver Analytics.

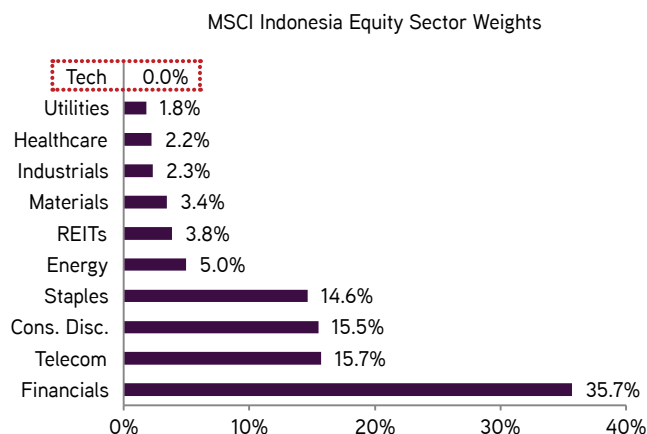
## We See an Excellent Opportunity for Private Equity Arbitrages

**Relative to the Public Markets** Similar to the message we have laid out in other large economies like China (e.g., where state-owned banks largely dominate the local index's weightings), the public market indices are often not the appropriate investment vehicles for investors to actually gain access to compelling GDP-per-capita stories. Without question, this investment conundrum exists in Indonesia. Just consider that the MSCI Indonesia index has a *zero* weighting to technology, compared to a full 24% for the aggregate MSCI EM equity index (*Exhibits 24 and 25*). As a result, there are essentially no liquid

public securities to gain access to the significant change in consumer behavior that is happening because of the growth of e-commerce, mobile payments, etc.

# EXHIBIT 24

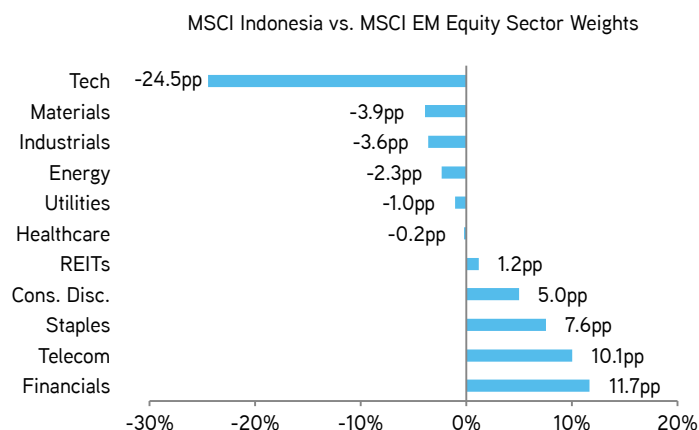
## Public Markets May Not Always Be the Appropriate Vehicle to Play Indonesia's Compelling GDP-per-Capita Story



Data as at April 30, 2017. Source: MSCI, Factset.

# EXHIBIT 25

## MSCI Indonesia Index Has Zero Exposure to Tech vs. a Nearly 25% for MSCI EM Index



Data as at April 30, 2017. Source: MSCI, Factset.

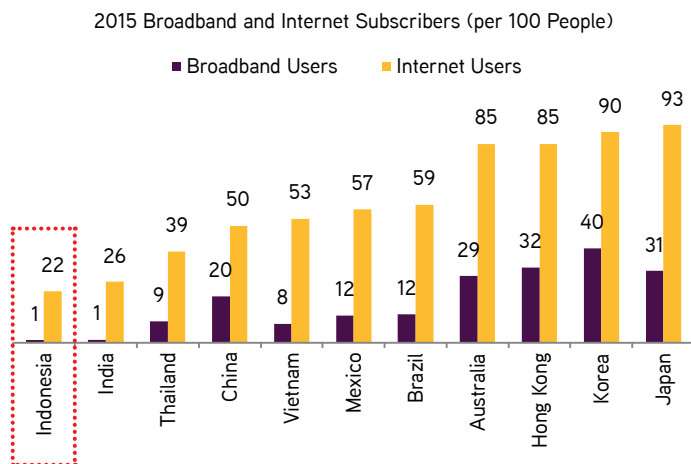
**We expect the Indonesian Public Equity index to outperform many of its more prominent EM peers during the next few years.**



Without question, the growth opportunity for both local and foreign firms with technology industry expertise is significant. Indeed, Indonesia's Internet penetration significantly lags behind its peers in Asia, with just 22 Internet users per 100 people vs. 50 users per 100 people in China and 90 users per 100 people in Korea. Meanwhile, while mobile payments are growing in favor, Indonesia's e-commerce efforts appear much more nascent than what we see in more 'mature' EM economies such as China.

#### EXHIBIT 26

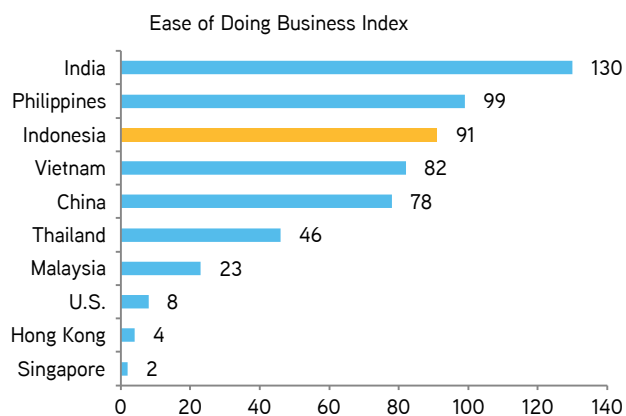
### Indonesia Lags Its Asia Pacific Peers in Internet and Broadband Usage



Data as at October 5, 2016. Source: World Bank, Haver Analytics.

#### EXHIBIT 27

### Indonesia Trails Many EM Economies in the Ease of Doing Business



1 = Most Business Friendly Regulations; 189=Worst

Data as at April 19, 2017. Source: World Bank, Haver Analytics.

Unlike our last visit, however, there are now large and growing local technology companies as well as mobile payment players that need access to capital. Beyond capital, the thought leaders overseeing these companies are seeking counsel around key business priorities, including scaling, operations, and employee incentives. Importantly, many of the local operators with whom we met now appear more receptive to embracing a partnership with private equity investors. Indeed, many of the second generation family members of these businesses are Western-educated and have had exposure to the value that private equity investing can offer on financial, operational, and governance issues.

Importantly, though, this viewpoint is not restricted to just the technology sector. In fact, we left Jakarta — amongst other places we visited — believing strongly that there are several other growth industries where private equity can actually play a more meaningful role in attractive sectors that are not well represented in the traditional public market indexes. Indeed, across health services, wellness, entertainment, nourishment, education, and even financial services, we see huge growth in GDP-per-capita, particularly as it relates to accelerating urbanization trends.

One lingering issue, however, is that Indonesia lags behind other Asian economies when it comes to the ease of doing business. It is currently ranked 91, ahead of the Philippines (99) and India (130), but well behind China (78), Thailand (46), and Malaysia (23). While this ranking represents an improvement versus some prior years, both locals and foreigners expressed concerns around permitting, legal processes, and corruption.

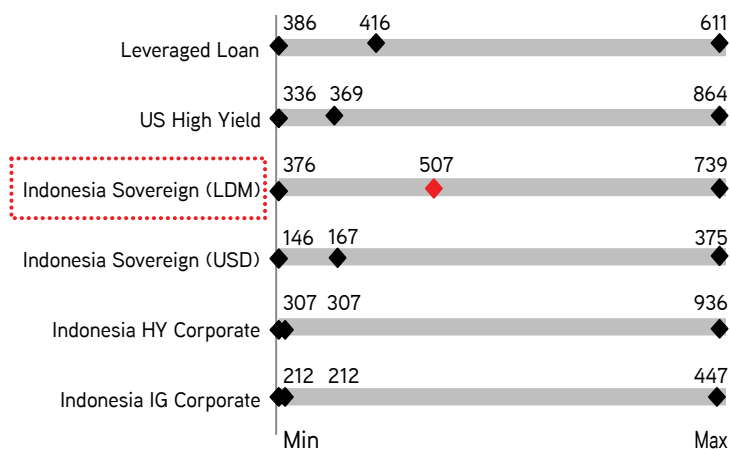
Our bottom line: Similar to what we have seen unfold in major markets like China and India, we expect private equity to serve as an important vehicle for investors to actually gain direct exposure to compelling GDP-per-capita stories during the next three to five years. Over time, however, as the public markets become deeper and broader (i.e., some of these GDP-per-capita stories do already enjoy public listings), these public securities will represent a more competitive alternative to the notable benefits that direct investing now provides to foreign investors seeking to access the country's strong underlying growth trajectory across several high value-added sectors.

**Within Fixed Income, Credit Spreads Appear Tight Relative to History, Particularly USD Denominated Indonesian Securities** With strong investor appetite for higher yielding EM debt securities of late, Indonesia's credit spreads have collapsed in recent months. Indeed, USD-denominated sovereign bonds, high yield corporate bonds and investment grade corporate bonds in Indonesia all trade at least one standard deviation below average relative to US Treasuries<sup>1</sup> (*Exhibit 28*).

<sup>1</sup> Spreads are based on Government option-adjusted spread, i.e., comparing Indonesian bonds to their equivalent duration in US Treasuries. In this case, average duration is 8.75 years for Indonesia IG and 4.77 years for Indonesia HY.

## Indonesian Local Currency Sovereign Debt Still Appears to Have Room for Spread Compression

Comparable Spread Products, Basis Points  
Max/Min Based on Trailing 5 Years



Data as at May 31, 2017. Source: Bloomberg, BofAML Bond Indices.

Against this backdrop, it appears that Indonesian local currency sovereign debt is the only sector to still offer attractive “carry” and some room for spread compression (*Exhibit 28*). Now that S&P has upgraded Indonesia’s sovereign debt to BBB-, its local bonds are some of the highest yielding investment grade securities in the world. Moreover, with an investment grade rating from all three rating agencies (Moody’s upgraded in 2012, Fitch in 2011), Indonesia sovereign debt could see additional sources of inflows, particularly from yield hungry Japanese institutional investors. Indeed, Japanese allocation to Indonesia’s local currency bond market is still very small at \$2.2 billion, compared to Mexico at \$17 billion. Hence, the investment bank Goldman Sachs estimates \$5 billion of potential inflows into Indonesia from Japan over the next year on the back of the S&P upgrade.

Another point that global asset allocators must consider is that Indonesia local bonds appear quite attractive relative to their equity counterparts. One can see this in *Exhibit 30*. Given Indonesia’s strong macro backdrop, we find this arbitrage particularly compelling. Indeed, we generally prefer local debt in countries like India and Indonesia, both of which have strong nominal growth, compelling demographics, and less mature fixed income markets.

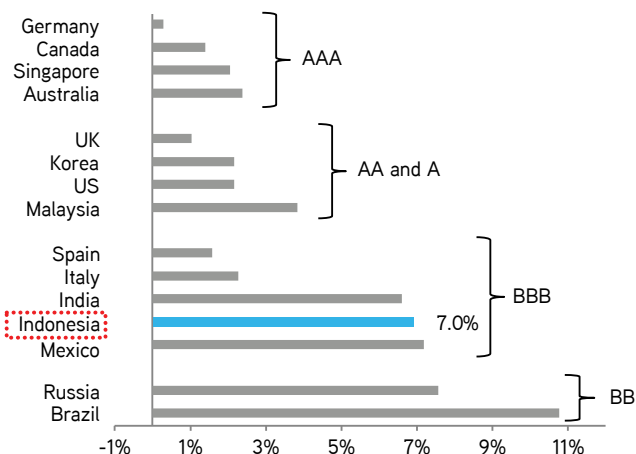
“

**Based on a continued improvement in fundamentals across the Indonesian macro and micro landscapes, we expect the valuation differential between the country and the rest of its EM peers to narrow in the coming quarters.**

”

## While Indonesia’s Local Sovereigns Are Trading at the Tightest Level Since October 2013 Relative to U.S. Treasuries, the 7.0% Yield Remains High in Absolute Terms

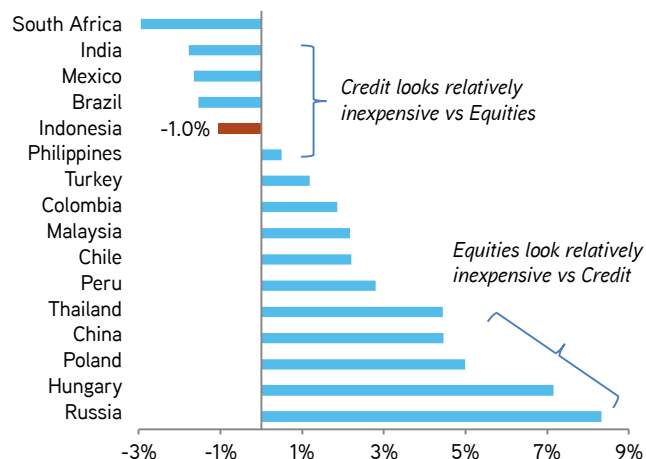
10-year Government Bond Yield, %



Data as at May 31, 2017. Source: Bloomberg.

## Equity Earnings Yields in Indonesia Are Still Lower Than Bond Yields

Earnings Yield Less Local Currency Sovereign Bond Yield, %



Note: 12 month forward earnings yield of MSCI Indices vs. JPM GBI-EM YTM. Data as at May 31, 2017. Source: Bloomberg.

**Private Credit Is Also Emerging as an Interesting Opportunity in Indonesia** While not as sizeable as what we are seeing across the U.S. and Europe, there is a small but growing opportunity in performing private credit in Indonesia, particularly as credit growth through the traditional banking channel has slowed significantly. Not surprisingly, many of the companies seeking credit solutions from non-traditional sources are skewed to the mid-size market, though we did speak with several large, successful entrepreneurs who prefer private credit solutions versus more vanilla bank offerings.

The pullback in local bank lending is a combination of tighter banking regulation, weak bank balance sheets, limited deposit growth, and a preference for lending to large corporations. Foreign banks too have pulled back, with loans as a percentage of GDP falling to 13% in March 2017 from 16% in September 2015. Our on the ground conversations also reminded us that there have essentially been no bond offerings in the \$100-\$200 million range since the Great Financial Crisis, and as such, private credit mandates have increasingly emerged as the 'go to' solution in this area of the market versus a more traditional bond offering.

#### EXHIBIT 31

### Foreign Banks Have Pulled Back From Indonesia



Data as at March 31, 2017. Source: Badan Pusat Statistik, Haver Analytics.

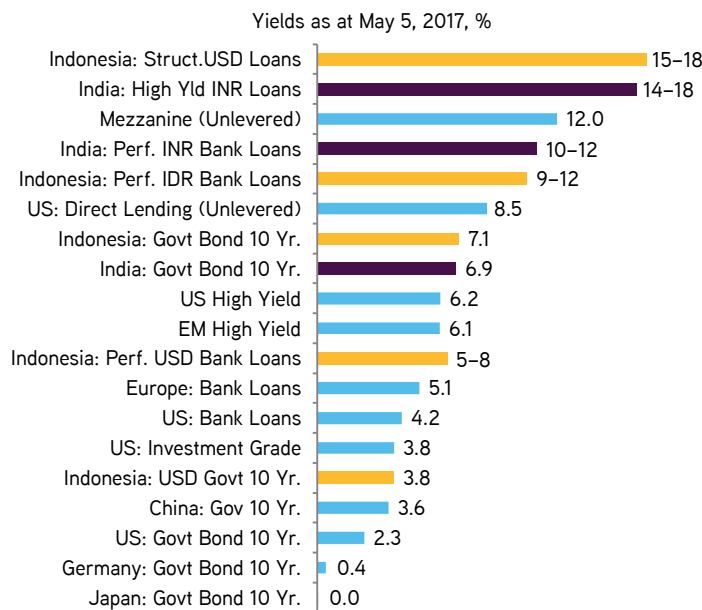
The key, of course, is to get compensated for the risk taken for extending non-traditional corporate credit in an emerging market. So, how should one think about absolute and relative returns for investors who may want to pursue these opportunities across Asia? In India, for example, performing private credit earns a rupee yield of 10-12%, while structured loans earn closer to a 14-18% local coupon (*Exhibit 32*). As a result, when one adjusts for the hedging cost against potential depreciation (i.e., approximately four percent), the USD returns on Indian hedged performing private credit of six to eight percent still appear attractive versus U.S. Investment Grade yields of just 3.8%. So too is the Indian hedged structured credit yield of 11-13%.

As we show in *Exhibit 32*, gross yields in Indonesia appear equally as compelling. A key difference, however, is that the credit is transacted

in *USD* in Indonesia as opposed to *local* currency in India. Given the nascent nature of the private credit business in Indonesia, foreign investors are still less comfortable taking both currency risk and credit risk. Over time, though, we expect – similar to what we have seen in other EM countries – for returns to move to 100% local currency.

#### EXHIBIT 32

### Indonesian Private Credit Is Another Interesting Play on Our Illiquidity Premium Thesis. Importantly, Many Transactions in Indonesia Provide Investors With Dollar-Based Structures

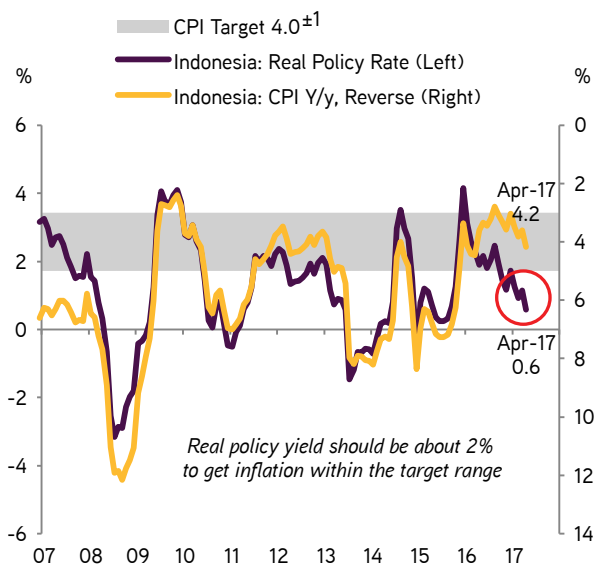


Data as at May 5, 2017 Source: Bloomberg, KKR Estimates.

Just consider that the MSCI Indonesia index has a zero weighting to technology, compared to nearly 25% for the aggregate MSCI EM equity index. As a result, there are essentially no public securities to gain access to the significant change in consumer behavior that is happening because of the growth of e-commerce, mobile payments, etc.



## Indonesia Needs to Make Sure That Real Rates Do Not Go Too Low; Otherwise, It Could Subject Itself to Poor Capital Allocation and/or Capital Flight



Data as at April 30, 2017. Source: Bank Indonesia, Bloomberg, Haver Analytics.

### CONCLUSION:

We left Indonesia feeling better about the macro backdrop. Indeed, unlike in past trips, we are now confident stating that we think that Indonesia is now effectively harnessing its long-term potential into near-term economic and investment realities. In particular, President Widodo's commitment to infrastructure development is beginning to yield results, and we feel that the central bank is now more aware of the threats that Indonesia faces from a structurally slowing China as well as a Federal Reserve committed to raising interest rates.

Importantly, the economy is not growing so fast that the government can turn a blind eye towards some of the ongoing structural reform that is still needed. Also, while China's economy has bounced of late, we – and the CEOs with whom we spoke – do not believe that it is again on a sustained upward trajectory. This viewpoint is significant as China accounts for one-third of global growth (and nearly 60-70% if one includes its trading partners).

Within Indonesia, though, the macro alone is not enough to ensure success; patience is required. Indeed, we hold strongly to our view that operators in the private markets need to embrace at least a five-to-seven year view to be successful. Local partnerships are also critical, and we think that one will likely need to be active across real estate, private equity, and private credit to justify the effort as Indonesia remains a tough place to do business.

In terms of key themes, we remain structurally bullish on GDP-per-capita stories across a variety of industries within Indonesia. In our view, the macro backdrop represents a significant opportunity for private equity. However, we fully acknowledge that valuations are currently expensive in many segments, and as such, a long-term

focus is warranted. The good news, though, is that valuations and sentiment can change quickly in emerging markets.

The investment community must also appreciate that the macroeconomic landscape in Indonesia remains dynamic, as there are important changes occurring underneath the surface that warrant investor attention. For example, we met with a variety of executives who confirmed that several large industries, including retail, payments, and logistics, are all transitioning towards more of an e-commerce direction. In our view, these changes represent important opportunities to 'get ahead of the puck.' On the other hand, the risk of disintermediation and/or displacement across many of these industries has increased too, raising the risk of capital impairment if an investor is not fully up to speed on these important changes.

Where do we go from here and what would we like to see to sustain the country's current momentum? First, continued progress on the reform front is a prerequisite for achieving higher productivity and potential GDP growth. In order to facilitate this transition, however, the political backdrop must remain constant through elections in 2019. Second, we would need to see continued commitment to keep inflation under control. In our view, this initiative will entail positive real rates, restraint on government consumption spending (e.g., government wages, fuel and food subsidies), and continued focus on addressing supply side constraints (i.e., infrastructure). Finally, as most economies are credit and external capital driven, there is a risk of capital flight if the European Central Bank, the Bank of Japan or the Federal Reserve tightens monetary policy sharply or if anti-corruption policies cause a sudden rush of domestic capital flight. As such, we would like to see Indonesia continue to diversify somewhat its large base of foreigners who own its bonds, given what we believe is an attractive cost of capital at the moment.

To be sure, there are still risks, but our research and our visits lead us to conclude that Southeast Asia, Indonesia in particular, may be one of the areas where investors are not fully up to speed on the compelling macro backdrop. In our view, therein lies the opportunity.

“  
**Unlike in past trips, we are now confident stating that we think that Indonesia is now effectively harnessing its long-term potential into near-term economic and investment realities.**  
 ”

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