HEYÓKHA
BROTHERS

See No Evil, Hear No Evil, Speak No Evil

The most useful piece of learning for the uses of life is to unlearn what is untrue.

-Antisthenes-

3Q 2018

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Heyokha's Zen

10th anniversary of the GFC: what we have (not) learned this decade

See No Evil, Hear No Evil, Speak No Evil

Ten years ago, the world was shocked as longstanding financial institution Lehman Brothers failed, the housing market crashed, and the US government spent $700 billion to bail out banks and avoid deflation.

The Global Financial Crisis (GFC) was one of the early 21st century's defining moments, with its aftermath still spreading across the world today. Since this quarter marks the 10th anniversary of the GFC, it prompts the question of whether the world is a financially safer place today.

Financial institutions more resilient

The GFC thrust the financial industry into public scrutiny, with "greedy" bankers being put to shame in the media and movies (see grey box). In pursuit of a safer financial system, regulators implemented new supervisory and regulatory standards and as a consequence, many banks now have stronger balance sheets and show resilience in stress tests.

Yet, the same risks emerged. And more.

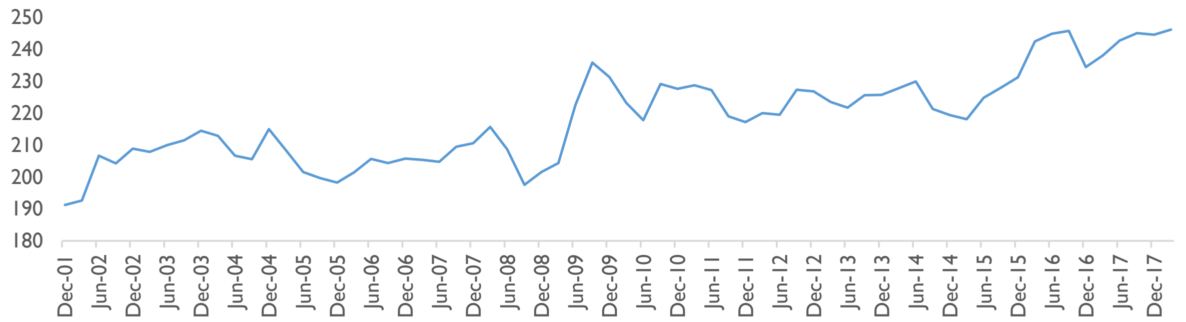
Debt addiction relapses

With the widely held notion that the GFC was driven by unsustainable borrowing and lending, one would expect strong deleveraging post-GFC. Well, that didn't happen.

In fact, the world took on USD 72 trillion of extra debt[1] since the end of 2007, bringing the global debt-to-GDP ratio to a record high of 246% (from 210% prior to GFC).

Global debt is at a record high

Global non-financial debt to GDP ratio, as a percentage



Source: Bank for International Settlements (BIS)

The very core of the problem, i.e. addiction to debt, has not been resolved at all. While consumers and financial institutions were the main drivers of global leverage leading up to the GFC, post-GFC leverage was driven by heavy borrowing on the books of governments and corporations (see chart on the next page).

BIS data also shows that external borrowing has continued to rise in most emerging market economies. You can be sure that the potential impact of increasing sovereign bond yields if inflation in advanced economies rises will not be pleasant. In addition, further appreciation of the US dollar would aggravate liabilities in these economies.

[1] Combined global debt of governments, nonfinancial corporations, and households, per March 2018 as published by BIS.

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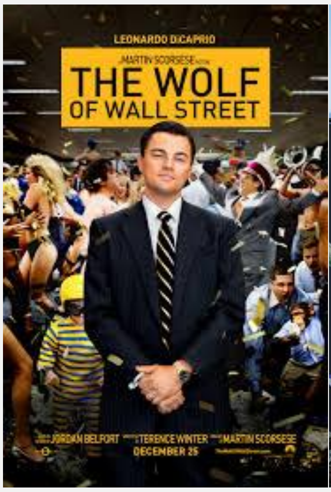
Governments and corporations driving global debt levels post-GFC

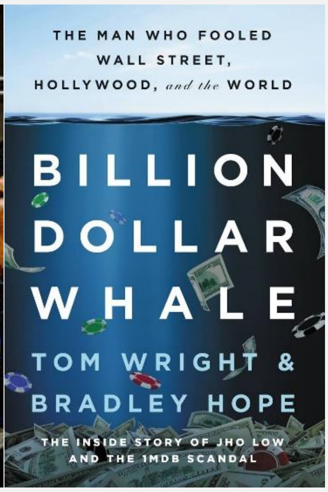
Debt as a percentage of GDP

	Total Debt		General government		Households and NPISHs		Non-financial corporations	
	2017	Δ '07-'17	2017	Δ '07-'17	2017	Δ '07-'17	2017	Δ '07-'17
Japan	357.9	+51.8	201.0	+56.1	57.0	-1.7	99.9	-2.6
China	255.7	+110.8	47.0	+17.7	48.4	+29.6	160.3	+63.5
US	248.7	+22.7	97.1	+39.3	78.0	-20.5	73.6	+3.9
Euro	248.1	+31.8	86.6	+21.6	58.1	-1.4	103.4	+11.6
World	239.7	+40.9	81.0	+20.3	62.0	+2.1	96.7	+18.5

Source: Bank for International Settlements

From Wolf to Whale; human nature doesn't change





Post GFC, many movies highlighted the excess and greed of investment bankers. A good example is The Wolf of Wall Street, which portrays the extravagant, yet bizarre life of a Wall Street banker. Ironically, the movie was funded by the man behind the iconic 1MDB fraud case: Jho Low.

The unbelievable story about the rise and fall of "Asian Great Gatsby" Jho Low has recently been exposed in "Billion Dollar Whale", a page-turner about the 1MDB corruption, written by veteran WSJ journalists Tom Wright and Bradley Hope.

The story is worth learning for several reasons:

Firstly, the amount of corruption involved is staggering: USD13bn. The book's early pages on Low's 31st birthday party in Las Vegas offers a glimpse of how the money was spent.

Source: Getty Images, Daily Mail

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Secondly, it provides a great lesson for parents. Right from Low's formative years at boarding school in England and business school at Wharton, he consciously fostered an aura of a "rich prodigy", associating himself with the likes of Middle Eastern and Asian royals. He deliberately didn't correct the rumours that he was a "prince of Malaysia", a claim that made other Malaysian students laugh.

In particular, Low began cultivating an image that allowed him to get what he wanted from whoever he wanted in the future. The moral of the story is: sending your kids to the most prestigious school is worthless if not being taught the right values.

Thirdly, Low's story involved so many big names, from A-list Hollywood celebrities, heads of state to financiers. Greed, naiveté, and scorn for rules allowed Low, a self-taught con artist built on shell companies and contrived connections, to mislead sophisticated politicians and businesspeople.

In fact, he purposefully involved lawyers, bankers, auditors, and valuation experts to give his deals reputability, making sure that their results were in line with his vision. When we ask ourselves if finance has been "fixed", then we must conclude that human nature does not change and that people will always find a way to feed their greed.

No end to debt addiction in sight…

While much was done on the side of monetary policy in an attempt to mend the wounds of the GFC, governments have done too little on the fiscal and structural sides. The US, for example, will need to pile up more debt to fund its $779bn budget deficit that has widened by $113bn YoY in the fiscal year 2018. Worryingly, the increasing shortfall is occurring during a period commonly perceived as "good times".

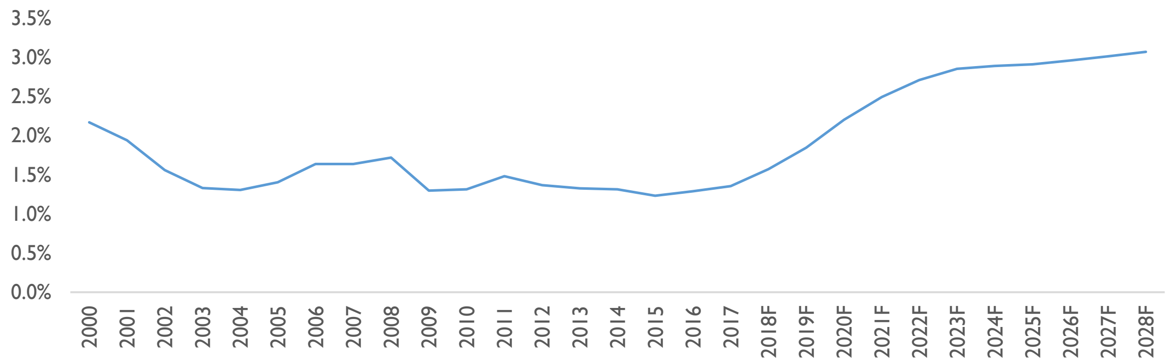
In the next decade, a wave of retiring baby boomers and rising dependency ratios will increase mandatory spending for Medicare and Social Security, while simultaneously budget receipts will be weighed down by another planned tax cut ahead of the US midterm elections.

Thus, the US Congressional Budget Office (CBO) projected that the US deficit will break the $1trillion dollar mark in 2019 and exceed $2 trillion by 2028; this amounts to a staggering 4.6% and 5.1% of GDP respectively.

Exacerbated by rising interest rates, the Federal Government will need to spend $485bn in interest payments by 2020, a substantial 84% increase compared to 2017.

Interest burden of the US expected to double from pre-GFC levels

Interest expense as a percentage of GDP



Source: Congressional Budget office, World bank

Funny enough, a March 2000 Simpsons episode made an uncanny prediction about the US economy, depicting US bankruptcy caused by huge debt and budget crunch due to policies imposed by the Trump administration.

"Bart to the Future" – season 11 episode 17 of The Simpsons
Source: The Independent, Daily Mail

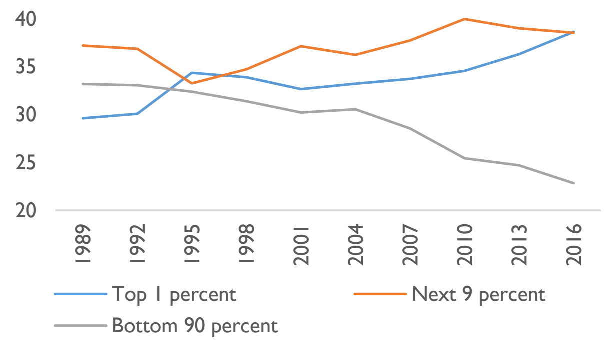
While this prediction may have looked ridiculous back then, Donald Trump is now the US president and his administration has caused a widening budget deficit to be filled with additional debt, largely thanks to the massive tax cuts that are not affordable in the long run. Worryingly, the episode's prophecy now doesn't seem entirely far-fetched.

Unequal recovery to be exacerbated, leading to more populism?

While the US recovered quickly from the financial crisis in terms of household wealth and GDP, this recovery was not equal for everybody. According to the Survey of Consumer Finances by the Federal Reserve, the share of US total wealth held by the richest 10% has increased post-GFC but decreased for the bottom 90%.

Inequality on the rise

US share of total wealth by percentile



Compared to 2007, only the top 10% has gotten richer. The economy might seem to have recovered since the GFC, but only for the wealthy.

Source: Survey of consumer finances

As written in our [1Q 2016 report], we argued that the recent trend towards populism was driven in part by rising inequality and that inequality was turbocharged by central bank money printing policies.

While the election of Trump as the US president is often seen as a symptom of the anger about inequality, his recent tax cuts for corporations may drive inequality even further.

"He wears a mask, and his face grows to fit it."

--George Orwell-

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Trade wars; the big threat to the global economy is now political?

In a recent interview with Kiril Sokolov, legendary investor Stan Druckenmiller expressed his concerns about the erosion of the global trust in the US due to Trump's approach to trade.

He argued that Trump became destructive "once he figured out how powerful a weapon the US banking system was and how powerful sanctions are". "He's like a little kid that found this water gun, and he's just running around going all over the place with it."

The US and China have been slapping each other with trade tariffs in 2018 and despite a recent "truce", the US just opened up a new front in the US-China trade war by arresting the CFO of Chinese telecommunications company Huawei. While other countries may not intend to follow Trump, the behaviour of companies in non-US territories is impacted nonetheless.

For example, an article in FT dated 5th October 2018 "Oil industry snubs EU effort to defy Trump sanctions on Iran" highlighted that big European oil companies are spurning the EU's attempts to shield Iranian crude from US sanctions. The reason is that they fear the effort would leave businesses exposed to harsh penalties from the Trump administration.

As a global citizen, it is worrying to see how the current political *Zeitgeist* of appealing to latent nationalism will play out. In history, we have seen many times before how charismatic strongmen stirred those that felt unrepresented against perceived elites, and how they rallied people against "foreign enemies". In a historical context, we know that most of the time, this does not end well.

"It is only when you see a mosquito landing on your testicles that you realize there is always a way to solve problems without using violence"

- Lao Tzu -

Where to invest ten years after the GFC?

If we put on the shoes as an investor, we see many great opportunities in this current backdrop. We see the unfolding of major value dislocations/mispricing. And even more interestingly, we see triggers of major trend changes, a rather rare occurrence. When you catch them, they can be very rewarding.

One thing we can be certain of is that there will be another recession in the not too distant future. Unfortunately, this time around the options for governments and central banks to respond are much more limited now than it was in 2008. Deficits and debts are already high and interest rates low. The instant painkillers used last time will not work effectively this time. The disease has developed its immunity.

One of the major structural changes will probably be a secular rise in interest rates and inflation after a 35-year decline (since 1981). With this in mind, we are ever more stoked with some of the new emerging themes that will ride this tailwind (or shall we call it headwind?).

For example, 1) Agflation, 2) Unsustainable low oil prices, 3) South East Asian manufacturing, 4) Inflation plays such as strong franchises, utilities and precious metals.

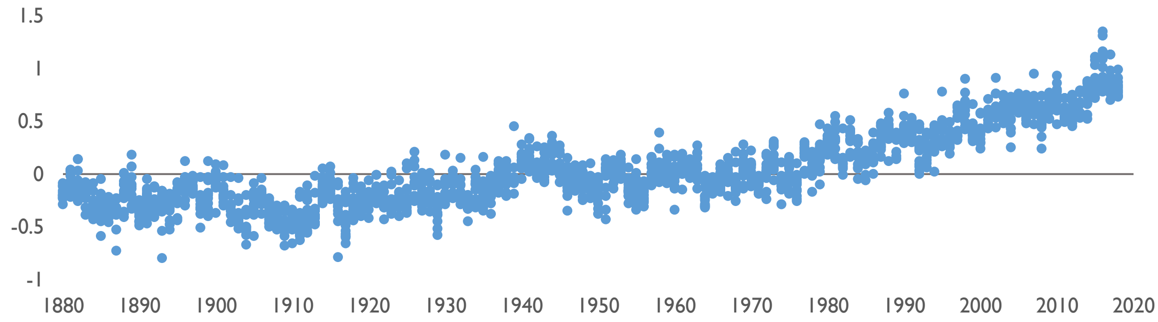
"The season of failure is the best time for sowing the seeds of success."

-Paramahansa Yogananda-

Case #1: Agflation, accelerating climate change

Monthly average temperature relative to 1951-1980

Monthly active users, in millions



Source: NASA GISS Surface Temperature Analysis

Since the 19th century, humans have been concerned with the advent of climate change. We have long noticed the signs of global warming and the potential harm it will bring.

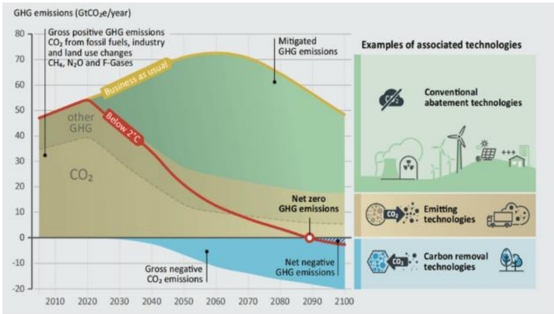
Continuous increases in human population, urbanisation, and industrialisation have accelerated the progress of climate change, yet, the inconvenient truth remains largely ignored.

At the 2015 Paris Agreement, the world set a target to limit the global average temperature rise to less than 1.5 degrees Celsius above the pre-industrialisation level. Although drastic change is required to meet this target, improvements in technology have made this technically achievable.

Unfortunately, the transition requires political and economic sacrifice that is increasingly more difficult to make. Case in point is the recent riot in France.

The planned hike on fuel tax, to promote environmentally-friendly energy, fuelled the worst anti-government riot since 1968. Consequently, President Emmanuel Macron's approval rating fell by 6% in a month to only 23% in November 2018, according to a poll by IFOP.

In addition, the unattractive economic return of "cleantech" projects deters many R&D investments. As emitting carbon is not penalised in most places today, there is not enough economic reward to attract investments in projects such as carbon capture or clean energy, which is a prerequisite if we want to meet the Paris Agreement goal.



Switching to clean energy is not enough. Carbon removal is required in order to meet the Paris agreement goal.

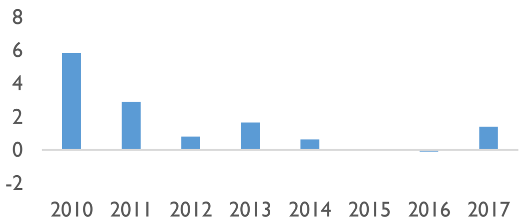
Source: United Nations Environmental Program

Fatih Birol, IEA executive director said: "Our analysis shows that over 70% of global energy investments will be government-driven and as such the message is clear – the world's energy destiny lies with government decisions."

Sadly, in today's nationalistic world, it is even less likely that we will find the required collaboration to stop climate change.

Global energy-related CO2 emissions

Change YoY, in percentage



CO2 emissions started to rise again in 2017 after being flat for two years

Source: International Energy Agency

The US even took a step backward by withdrawing from the Paris climate agreement. “The Paris Agreement is fatally flawed because it raises the price of energy for responsible countries while whitewashing some of the worst polluters”, said Trump.

When you want to fool the world, tell the truth.

-Otto von Bismark-

Food production is at risk

In our previous 1Q18 report, we discussed that the increase in crop production in the past 22 years has been almost entirely driven by yield improvement.

Technology advancement such as usage of GMO seed has improved crop yield dramatically. However, there is a limit on GMO seed adoption and we are seeing this rate plateau.

Click here for our 1Q18 report

At the same time, crop yields will continue to be suppressed by rising Earth temperature and the increasing frequency of extreme weather caused by climate change.

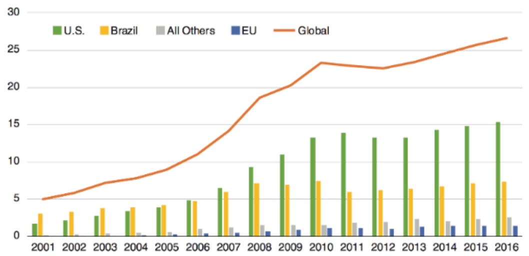
A study by the US Proceedings of the National Academy of Sciences (PNAS), shows that for each degree Celsius increase in global temperature, yields of corn are expected to decrease by 7.4%, wheat by 6%, rice by 3.2%, and soybean by 3.2%.

Assuming that yield improvement is no longer a viable way to really increase production, then the growth should come from increased farm area or the number of plantings; both suggest higher seed demand.

Additional crop demand from ethanol mandates

Ethanol production has increased substantially

Ethanol production in billion gallons



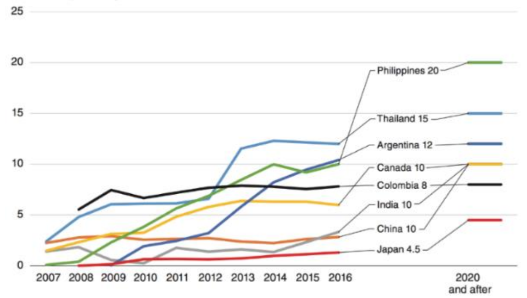
Global ethanol production surged more than five-fold between 2001 and 2016.

Source: USDA, US Department of Energy, Energy Information Administration, 2000-12 data; Renewable Fuels Association, 2013-16 data.

Heightened efforts to fight climate change has supported mandates of higher biofuel usage, including ethanol. In the past decade, we have seen an increasing number of countries imposing higher ethanol fuel mandates.

More countries are imposing higher ethanol mandates

Historical ethanol blend rates and medium-term targets (%)



Data for 2007-2015 are actual blends rates; data for 2016 are estimated blend rates; for 2020 targets are the blend rates set by Government mandates. Thailand’s production targets are converted to a percentage.

Source: USDA, Economic Research Service calculations from USDA, Foreign Agricultural Service reports.

This trend is not slowing down; the preceding chart shows several countries with medium-term targets to increase ethanol blend rates. More importantly, in the past year, the two biggest economies of the world, the US and China, announced new mandates to support higher ethanol content in fuel.

In 2017, China announced its plan to impose a 10% minimum ethanol content on fuel by 2020, also known as the E10 mandate.

As the biggest motor vehicle market in the world, this will have significant effects; it is estimated that China will need an additional 3.6 billion gallons of ethanol per year to comply with this new rule, which requires around 30mn tons of corn as the likely ingredient.

Moreover, the US recently announced its plan to scrap the ban on 15% ethanol fuel during the summer. As a majority of fuel blends in the US currently contain only 10 percent ethanol this mandate will increase corn demand up to 50mn tons annually.

In total, these two mandates alone create a whopping 80mn additional tons of corn demand per year. To put this into perspective, the top global producer USA produces 371mn tons of corn in 2017, and Indonesia only harvests 28mn tons.

Indonesia as the beneficiary

As major trends suggest decreasing productivity and rising demand for crops, Indonesia's agriculture sector is a potential beneficiary considering the availability of productive farmland with relatively low hybrid seed adoption, offering plenty of room to increase production.

Although we are not claiming that Indonesia will be among the top global crop exporters (since GM seed is not permitted), Indonesia is still a good candidate to become a net exporter in the Southeast Asia market due to its proximity compared to major crop exporters. In fact, Indonesia's corn export has surged to $72.8mn in 10M18, from less than $1mn in 10M17.

Case #2: Upside case for precious metals and oil price

While politicians joined forces to battle the GFC, in today's nationalistic world, it is more popular to promote policies that are in the self-interests of individual countries. This trend has fuelled trade wars and increased political friction.

One clear piece of evidence is the abuse of power and the dollar weaponisation by the US. Placing sanctions on Iran, for instance, was a unilateral decision by the US, unlike in 2012, when the EU was on board.

This disagreement has spurred the EU to lead efforts to bypass the US sanctions on Iran, by creating a new and independent alternative to the SWIFT payment network that the US used to enforce the sanctions.

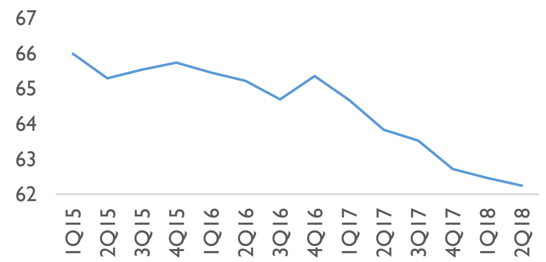
Likewise, India found a way to bypass the Iran sanctions by setting up a Rupee payment mechanism. Separately, Russia developed its own version of SWIFT that diminished the effect of US sanctions.

These are a few examples that underscore a concerted effort to decrease global dependency on the US financial system.

On top of that, the trade war has fuelled increasing efforts to fight US dominance. Trump's view on global trade as a zero-sum game and his intention to reduce the US trade deficit will no doubt accelerate the decline of US Dollar hegemony.

U.S. Dollar share of global allocated currency reserve

In percentage



The share of US dollar as global allocated currency reserve has been shrinking at an accelerating pace.

Source: IMF, Currency Composition of Official Foreign Exchange Reserves (COFER), International Financial Statistics

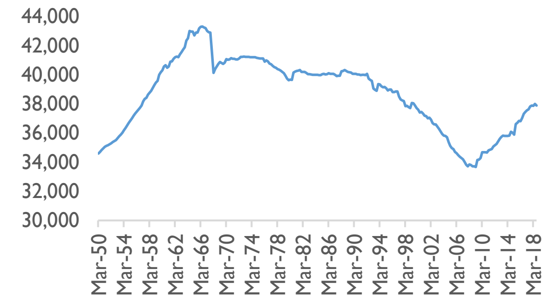
Central banks diversifying to gold

The dwindling dominance of the US Dollar has increased the demand for gold as a substitute. Central banks have been on a gold buying spree in the past decade and recent political developments suggest that it is not ending soon.

Last time this trend occurred was back in the 1950s, when gold was the world reserve standard. The difference is that this time, the motivation is to voluntarily diversify from the US Dollar.

Gold held by central banks

In million ounces



Source: Bloomberg, IMF

In our 4Q 2017 report, we discussed our case for higher gold prices.

Click [here]() for our 4Q 2017 report

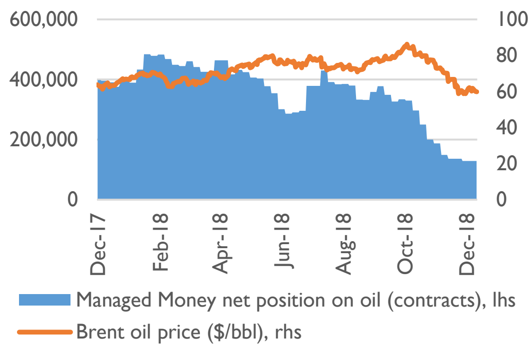
Today, increasing political uncertainty, an ongoing trade war, and rising inflation further support our argument for having gold to insure against these risks. Note: we are not gold bugs but there is a time for every asset class. We are simply saying the risk/reward for gold miners are looking better and better.

Unsustainably low oil prices

Although we are seeing increasing geopolitical tension, oil prices have declined by about 30% from its recent peak in October 2018. As illustrated by the chart below, hedge funds and money managers reversed their strong bullish views and significantly reduced their net long positions on oil.

Money managers are less bullish on oil price

In contracts



Source: Bloomberg, CTFC

While concerns on weaker demand have contributed to the decline, the more volatile oversupply issue plays a bigger role. Yet we believe that the supply glut should be temporary.

OPEC production overshoot has been resolved

Recall that one of the contributing factors to the oil price rally was US sanctions on Iran. As the OPEC boosted production in anticipation to replace lost exports from Iran, Trump unexpectedly announced waivers for eight Iran's oil key buyers a few days before sanctions were to apply.

This caught the Saudis by surprise and as a result, OPEC production came in higher than expected. Never-theless, OPEC and its allies, including Russia, have recently agreed to cut oil production by 1.2mn barrels per day.

US shale oil unlikely to fully offset declining conventional oil production

While the Saudis want higher oil prices, the US would prefer the opposite. This remains the main argument of oil bears. It is true that the US shale oil boom has been one of the most significant factors driving global oil production growth.

However, we believe that it will not be enough to offset the declining production of conventional oil in the long term.

According to IEA's executive director Fatih Birol, an oil supply crunch could develop by the mid-2020s based on the low number of recently-approved drilling projects in major oil-producing countries.

For the US to solely offset the decline of global conventional oil production, the country needs to almost double its own production by 2025, which is a very optimistic scenario.

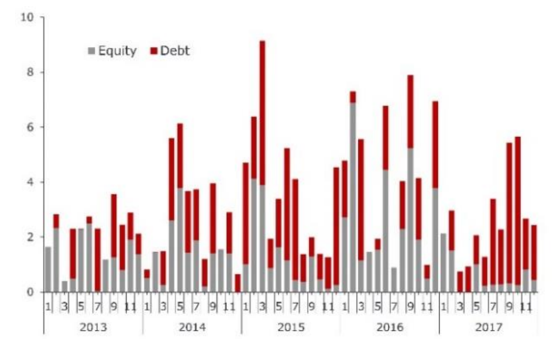
Also, it is likely that investments in shale oil will slow down if oil prices stay at current levels. According to a report from the Institute for Energy Economics and Financial Analysis and the Sightline Institute, the 33 publicly traded small and medium-sized shale oil drillers in total posted $3.9bn negative free cash flow in the first half of 2018 when oil prices averaged at $71.

In fact, data published by Baker Hughes shows that the number of US oil rigs decreased by 10 in the week ended 7 December 2018, marking the steepest weekly decline since April 2016.

In addition, rising interest rates and the increasing portion of low-rated debt could dry up the much-needed funding to boost production. Since oil price recovered in 2017, debt contributed to the majority of US shale oil funding.

US shale oil producers are increasingly reliant on debt

Issuance of public debt and equity by a sample group of companies in NA shale, in US$ billion



Source: Rystad Energy, Bloomberg

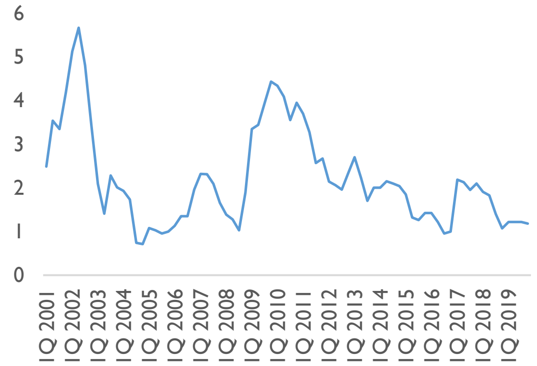
OPEC spare production capacity is getting perilously thin

As OPEC replaces the disrupted oil production of troubled countries including Venezuela and Iran, spare production capacity is expected to shrink to a worryingly low level of 1.07 million barrels per day in 4Q18, or only about 1% of global oil demand.

This leaves the oil market increasingly vulnerable in the event of another supply disruption, even more so if we consider the increasing geopolitical uncertainty that we previously discussed in our 1Q 2018 report.

OPEC spare production capacity has fallen to the lowest level since late-2016

OPEC spare capacity in million barrels per day



Source: US Energy Information Administration

Case #3: Manufacturing to diversify away from China to Southeast Asia

Companies are repositioning their supply chain regardless of the trade outcome

As for the US-China trade war, we don't think we need to add our colour. It's been a daily topic in recent months.

It's like watching a couple in a bad relationship: hoping for things to improve without making any changes themselves. The differences in governance and values are so deep that reconciliation is extremely difficult.

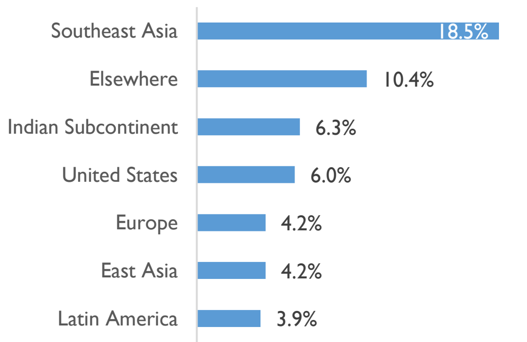
Whether or not there will be a trade deal, the trust between these two giants has eroded so much that companies operating in China will have no option but to hedge the risks.

To start, those companies who rely heavily on China as their production base, need to start looking for alternatives. Based on the following figures, companies seem to favour Southeast Asia.

Southeast Asia seems to be the most favourable choice

US companies in China prefer moving production to Southeast Asia

% of US companies based in China that have moved production abroad or considering it



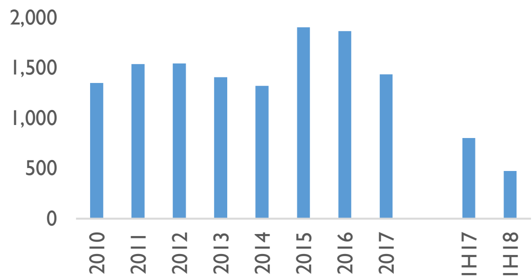
According to a survey by AmCham, about a third of 430 American companies in China have moved production abroad or are considering it. At the top of their lists is Southeast Asia, based on this survey

Source: AmCham China, AmCham Shanghai

The figures above are also supported by the latest FDI numbers, in which Southeast Asia saw strong growth despite the total global FDI flows nearly halving in the first half of 2018 compared to the same period last year.

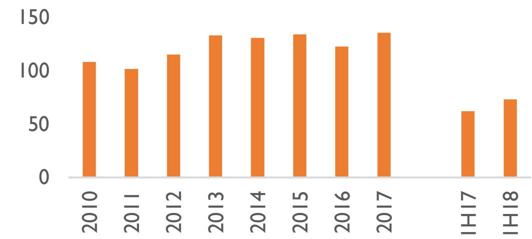
While Global FDI nearly halved in 1H18

In billion US dollar



...Southeast Asia showed strong growth

In billion US dollar

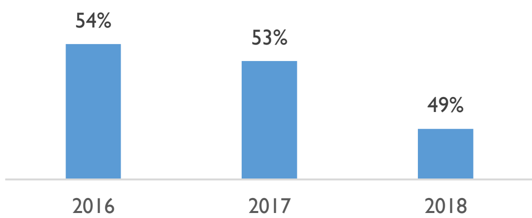


Source: World Development Indicators

It is not just US companies that are moving production away from China. For example, Li & Fung, the leading supply chain manager for American and European brands, has reduced goods sourced from China. They are diversifying away from China to the countries listed below, dominated by Southeast Asian countries.

Li & Fung sourcing less from China

In % of COGS source from China



Source: Li & Fung company presentation

From China to these countries:

Apparel	Footwear	Hardgoods
Bangladesh	Vietnam	Cambodia
Vietnam	India	Indonesia
India	Indonesia	Philippines
Pakistan	Italy	Taiwan
Central America	Spain	
Jordan	Eastern Europe	
Philippines		
Turkey		

: *Southeast Asian countries*

Source: Li & Fung company presentation

Reading the news is all well and good, but this is also playing out in our everyday lives. One of our team members, who flies the Jakarta - Hong Kong route almost weekly, noticed that nowadays flights are fully occupied (economy and business class alike) by Chinese mainlanders.

A friend flying the Manila-Hong Kong route also noticed similar phenomena. We believe these guys are more likely to be on a business trip than on a vacation.

From the above statistics and anecdote, it is clear that companies are planning to move production to Southeast Asia. This region is not only appealing due to its proximity to major growth markets but also due to the availability of cheap labour. This is especially true for Indonesia.

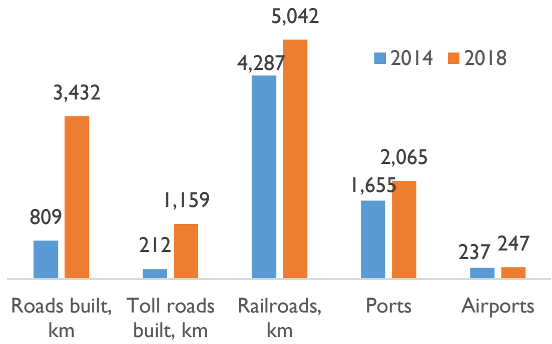
Indonesia is not the top choice, but even a small China spillover will be significant

However, most of the articles we read seem to agree that Indonesia will not be the main beneficiary from the US-China trade war. For example, a report by The Economist Intelligence Unit[2] provides analysis on countries that will receive a windfall from the trade war, divided into three industries.

The analysis favours Vietnam and Malaysia for ICT products, Thailand and Malaysia for automotive, and Vietnam for readymade garments. Indonesia is only positioned as a minor beneficiary because of poor logistics and a challenging regulatory environment.

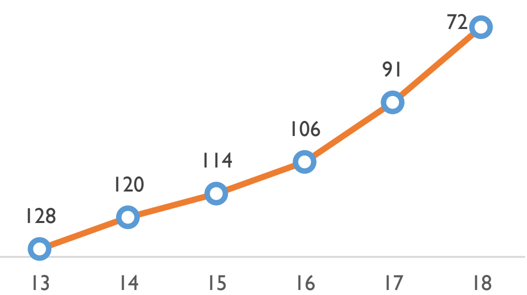
Although this did not come as a surprise to us, we are quite intrigued that the main issues remain logistics and regulatory environment. Apparently, President Jokowi's focus on building infrastructure and improving the ease of doing business in Indonesia has not turned the tides yet.

Indonesian infrastructure has improved significantly



Source: Kompas

Indonesia's rank in Ease of Doing Business improved significantly



Source: World Bank

[2] The Economist Intelligence Unit (October 2018), "Creative disruption: Asia's winners in the US-China trade war"

Some Indonesians are complaining about lower transportation cost

We attended an event where a speaker blamed infrastructure projects for lower crop prices, citing its negative effects on farmers (it is a political year, after all).

He said that this was due to better logistics and cheaper transportation costs. As his example, onion farmers in Brebes, Central Java, are suffering because farmers from other areas can supply onion to their region at a cheaper price.

Obviously, this argument is, in essence, saying that we shouldn't invest in infrastructure because this results in tougher competition and lower cost structure.

Needless to say, we disagree, but the point here is that the government efforts to build infrastructure have successfully lowered transportation costs.

Obviously, Indonesia is coming from a very low infrastructure base, so even after the current government stepped up infrastructure spending, it may not be enough for Indonesia to be competitive.

Despite significant improvements, Indonesia is still ranked 6th for ease of doing business in Southeast Asia in 2018. It shows that Indonesia probably needs another five years or more of major overhauls in infrastructure and regulations to improve its business environment.

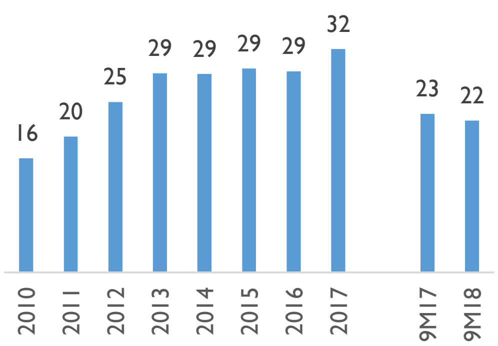
With Southeast Asia becoming more attractive for doing business, we think foreign direct investment (FDI) to Indonesia could re-accelerate as it has stagnated for more than five years.

Despite the fact that Indonesia is not the main beneficiary among Southeast Asian countries, we do not think that Vietnam, Malaysia, and Thailand have the resources to absorb the full "exodus of manufacturers" given the scale of China.

As such, any spillover of FDI from China would be very significant to Indonesia.

Indonesian FDI realization has been sluggish

Foreign direct investment realisation, in US$ billion



Source: Indonesia Investment Coordinating Board

ASEAN Country

Country	DB 2017	DB 2018
Singapore	2	2
Malaysia	23	24
Thailand	46	26
Brunei	72	56
Vietnam	82	68
Indonesia	91	72
Philippines	99	113
Lao PDR	139	141

Source: World Bank

Investment implications

Based on our channel check, there are a few Indonesian industrial estates that are seeing more inquiries from China in the past two months. Yet, most industrial estates admit that demand remains weak, supposedly in anticipation of the upcoming elections in Indonesia.

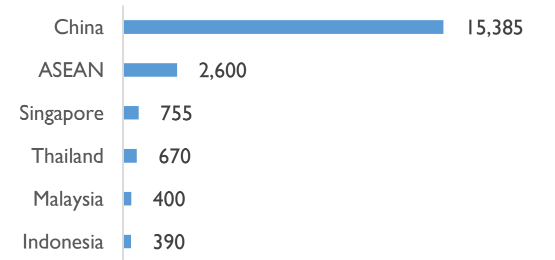
Industrial land sales in Indonesia have been declining dramatically 2011, as FDI remains sluggish.

The valuations of Indonesian industrial estate development companies reflect this trend. Because of these low valuations, some companies that have recurring income and strong balance sheets could be an interesting play on the "China spill over" theme.

Another sector in Southeast Asia that we expect will benefit from FDI flows to manufacturing, is the industrial gas sector (which is driven by manufacturing activities).

China gas market is 6x Southeast Asia size

Industrial gas market in 2015, in US$ million



Source: Gasworld

The Chinese industrial gas market is 6x the size of the Southeast Asian market. Let's say, if 10% of Chinese manufacturing moved to Southeast Asian countries, then this could potentially increase the Southeast Asian industrial gas demand by 60%.

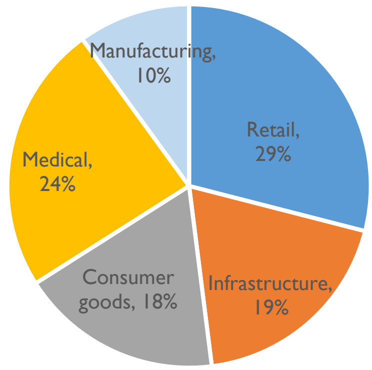
Assuming Indonesia would only get 10% of the spill over to Southeast Asia, the industrial gas demand in Indonesia could increase by 40%. An Indonesian industrial gas company that we like – the country's largest player - should benefit from this.

The good thing is that even without counting on the "China spillover", our industrial gas company would already make an attractive investment.

We expect that the company could still grow at double digits per annum organically and that profit margins will improve on the back of increased capacity utilisation.

Manufacturing is only a small portion of their business at the moment

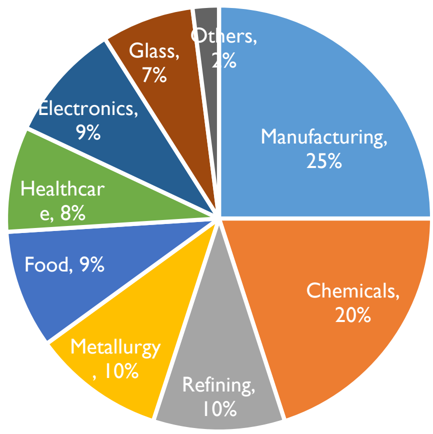
A major Indonesian industrial gas company's revenue source



Source: Company data

Meanwhile manufacturing accounts about a quarter of ASEAN industrial gas market

Southeast Asia industrial gas market based on sector



Source: Gasworld

Not to mention, the valuation is currently very attractive at only 0.6x Price to Book and 5.5x EV/EBITDA, which is a 70% discount to its peers.

Enjoy reading our reports? Check out our website for more!

-The End-

------------- Appendix I -------------

Opportunity amidst volatility

Recently, the Indonesian seed maker BISI International (BISI), faced headwinds due to weather disruptions.

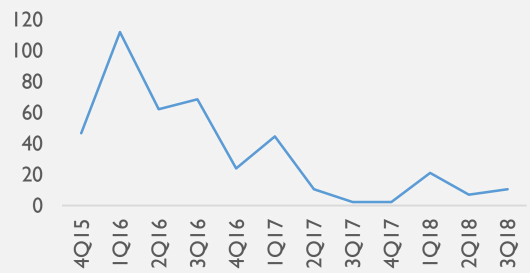
With inadequate production and inventory levels, the company had little inventory to sell, almost entirely erasing net profit during the first half of 2018. Consequently, the stock price declined following the earnings result announcement.

As illustrated by the chart below, BISI had near-zero corn seed inventory since last year as production capacity can't keep up with the strong growth in demand.

This explains the company's earnings volatility in recent quarters; sales volume has been entirely dependent on production, whereas production volume is highly dependent on weather.

Thin inventory levels due to strong demand

Corn seed (finished goods) inventory days



Source: Company data

Historically, quarterly earnings have always been volatile. However, seasonally adjusted growth is very consistent on an annual basis, as illustrated by the rolling 4 quarter earnings chart below.

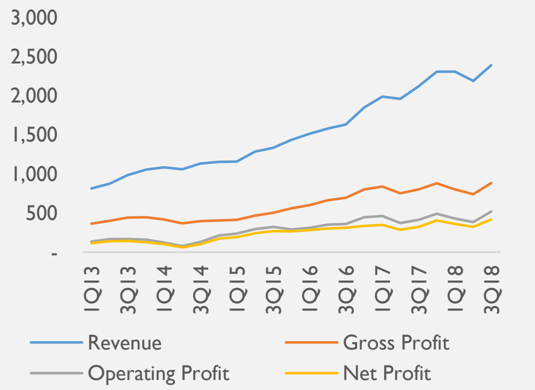
We are seeing the same scenario this year; net profit in the single quarter of 3Q18 alone has exceeded last year's nine months profit, fully compensating for the disruption in the past two quarters.

Also, 4Q18 earnings will be helped by an increase in pesticide sales as a lagging effect from strong seed sales in the previous quarter.

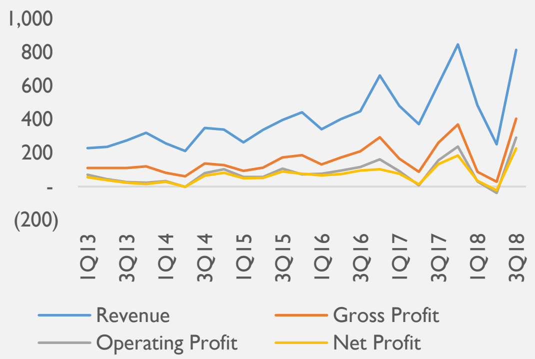
Going forward, earnings volatility will become less of a concern. BISI acquired a processing facility from

Quarterly earnings volatility cloud the improvement

Trailing last 12 months financial in billion rupiah



Quarterly financials in billion rupiah



Source: Company data

Monsanto in November 2017, increasing its production capacity by 60%.

This will allow the company to ramp up production to maintain a healthier inventory level for times of unfavourable weather conditions.

The company has a robust growth outlook, strong balance sheet, cash flow, and dividend generation, as well as attractive valuation.

The dividend payout ratio for the fiscal year 2017 was 74%, translating to a lucrative 6.25% yield while still maintaining a solid double-digit earnings growth outlook in the coming years.

Yet, its stock price is still under-appreciated by the market. Even after addressing concerns on earnings volatility, the stock price has not recovered.

Considering its growth potential, valuation is very attractive at only 9x P/E.

The 'what if' question on Indonesian 2019 election

We are soon entering the 2019 election year for Indonesia. Since government policies play an important role in Indonesia's agriculture sector, it is important to study how the industry will be impacted.

If President Jokowi manages to secure a second term, it is obvious that he will continue the reform agenda and we might even see the efforts accelerating. The infrastructure developments under Jokowi administration is not yet over and we have yet to realise the full effect that they will bring.

Assuming the opposition wins, we can also safely assume that the agriculture sector will continue to grow rapidly considering the pro-agriculture policies based on the vision and mission statements. One major initiative is the target to add 2 million hectares of farmland to create food self-sufficiency.

Also specified in their mission statement is the effort to promote Indonesia's ethanol industry, with the goal to create jobs and reduce the dependency of oil imports. This initiative will provide additional upside for corn demand as the likely feedstock for ethanol.

Hence, we can remain assured that Indonesia's agriculture sector will continue to grow regardless of the election outcome.