Indonesia Market Strategy

Re-awakening?

Figure 1: Our long-term exposure

<table>
<thead>
<tr>
<th>Ticker</th>
<th>Rating</th>
<th>Market cap US$ bn</th>
<th>Share price</th>
<th>Ups.</th>
<th>P/E (x)</th>
<th>P/B (x)</th>
<th>ROE (%)</th>
<th>P/B rel. less ROE rel. (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>BMRI</td>
<td>O</td>
<td>6,900</td>
<td>8,950</td>
<td>30</td>
<td>12.7</td>
<td>2.6</td>
<td>24</td>
<td>-14%</td>
</tr>
<tr>
<td>BBNI</td>
<td>O</td>
<td>3,675</td>
<td>5,000</td>
<td>36</td>
<td>12.3</td>
<td>1.8</td>
<td>16</td>
<td>-13%</td>
</tr>
<tr>
<td>UNTR</td>
<td>O</td>
<td>22,700</td>
<td>28,000</td>
<td>23</td>
<td>15.6</td>
<td>4.0</td>
<td>28</td>
<td>8%</td>
</tr>
<tr>
<td>SMGR</td>
<td>O</td>
<td>9,200</td>
<td>11,000</td>
<td>20</td>
<td>14.2</td>
<td>3.9</td>
<td>29</td>
<td>-11%</td>
</tr>
</tbody>
</table>

Source: Company data, Credit Suisse estimates

- Gauging the upside potential. We believe Indonesia needs to achieve 7%+ economic growth for the market to significantly re-rate further. However, in order to achieve 7%+ real GDP growth, in our view, annual investments must surge to US$364 bn per year for the next five years, which is 58% higher than 2010A levels. The experience of India has shown that when the country’s investment to GDP ratio surged by 14% over five years, its equity market’s valuation re-rated by 117% to peak at a 57% premium to MSCI NJA (based on P/B less ROE), at 23.4x P/E. Indonesia currently trades at a 30% premium to MSCI NJA, at 16x P/E, implying potential for 27–46% upside from the current level.

- Developments to watch. First, the land reform bill—which we believe is a pre-requisite for Indonesia to ease its infrastructure bottleneck—needs to be passed for the country to start moving towards a higher investment cycle. Currently, the bill is being discussed in Parliament, and we expect it to be passed late 2011 or 1H12. Second, evidence of the ability to secure necessary funding and that investments are well-targeted towards the right sector and at the right pace of expansion is required. Third, groundbreaking and satisfactory deliveries on investment realisations are required to boost investor confidence. Given the progress of the land reform bill in the past 12 months, we believe Indonesia has a 60% probability to achieve higher investment and real GDP growth, and in turn, a valuation re-rating. We will increase our probability to 75% once the land reform bill is passed.

- Our long-term portfolio for Indonesia. Between 2002 and 2007, when India delivered a rapid pick-up in investments, the industrials, materials and financial sectors outperformed the country’s broad market performance. Learning from India’s experience, we construct our long-term portfolio for Indonesia, aiming to benefit from the country’s entry into the multi-year higher investment cycle, which comprises BMRI, BBNI, UNTR and SMGR.
Focus charts

Figure 2: Indonesia needs higher investment for 7%+ real GDP growth

Figure 3: India was re-rated when investment picked up and de-rated when delivery was below expectations

Source: CEIC, Credit Suisse estimates

Figure 4: India – winning and losing sectors 2002-07

Figure 5: India – winning and losing sectors 2007-now

Source: Bloomberg, CEIC, MSCI, Credit Suisse estimates

Source: Bloomberg, Credit Suisse estimates

Source: Bloomberg, Credit Suisse estimates
Re-awakening?

Indonesia has caught the eye of many investors, particularly given its resilient economic growth and its ability to deliver +4.6% real GDP growth even amid the 2009 global financial crisis. In turn, Indonesian equity market valuations have surged from a 167% discount to MSCI NJA in January 2003 to a 30% premium currently (based on P/B less ROE). The main question now is whether Indonesia is re-awakening from the disastrous 1998 Asian financial crisis or is what we have seen so far all that the country has to offer.

Choosing future path

Much of Indonesia’s resilient economic growth has been achieved with limited policy intervention. We believe that the support of well-targeted policies is required to drive the country’s economic growth to surpass the 7% mark. However, achieving 7%+ economic growth would require higher investment to prevent Indonesia from succumbing to structurally high inflation due to capacity constraints, similar to the issues confronting India at the moment. We estimate that Indonesia’s investment per year needs to surge to US$364 bn (from US$146 bn in the past five years).

No harvest without planting

To increase investment, we believe Indonesia should first address its infrastructure constraints, which implies that it is imperative that the land reform bill be passed. We expect the land reform bill to be passed by Parliament some time between 2H11 and 1H12, and believe it will be a key catalyst for the outlook on the Indonesian equity market. In our view, a combination of domestic bank loans, bonds, foreign debt and foreign direct investments (FDI) is required to fund Indonesia’s relatively sizeable investment needs. Indeed, just to fund 40% of the required investments, domestic banks’ deposit growth needs to reach 32%, twice its historical average growth. While often perceived as a challenge, the high funding requirements paint a robust picture for the growth outlook of Indonesia’s banking system.

Mapping the path ahead

We believe that in mapping the outlook for the Indonesian equity market, one can benefit from India’s experience. The Indian equity market reached a 57% premium to MSCI NJA (based on P/B less ROE), at 23.4x P/E, in 2006–07 when the country was boosting investment. During the period, the industrials, materials and financial sectors outperformed the broad market. Thus, if Indonesia moves into a higher investment cycle period, we foresee further re-rating of the country’s equity market by about 27–43%, with winners, including BMRI, BBNI, UNTR and SMGR. However, India’s lower-than-expected investment delivery resulted in the market being de-rated to a 12% premium to MSCI NJA, at 15.1x P/E, with more defensive sectors such as healthcare, consumer discretionary and consumer staples outperforming the broad market. Thus, in the event that Indonesia fails to boost investment and/or investment progress comes in below market expectations, we foresee the risk of the Indonesian market de-rating by up to 18%. Given India’s experience, in this scenario, we prefer ASII, GGRM and INDF.

However, given that the land reform bill—which represents the most imperative catalyst for Indonesia to move into the higher investment cycle in our view—may not be passed until late 2011 or early 2012, we believe much of the re-rating and de-rating potential lies in 2012 rather than 2011. Therefore, we maintain our index target of 4150, based on 16x 2011E P/E. We maintain our most preferred picks of the Indonesia market (BMRI, BBRI, INDF and TLKM), while ADRO, UNVR, KLBF and BBCA are our least preferred picks.
Choosing future path

Policies have been more reactive than proactive

Post the 1998 Asian financial crisis, Indonesia has delivered a robust recovery, with relatively stable real economic growth. From 2002 to 2010, Indonesia’s real GDP growth remained above 4%. Even amidst the global financial crisis, Indonesia delivered 4.6% real economic growth in 2009.

Figure 6: Maintaining robust growth

Surprisingly resilient growth since 2002

More impressively, Indonesia’s robust and resilient real GDP growth post 2002 has been achieved largely with minimal government policy intervention. Indonesia’s central bank’s inflation targeting policies have so far been relatively a reactive rather than a proactive

Figure 8: Policy rates reacted to inflation

Figure 9: Little correlation between government’s budget deficit and real GDP growth

Source: CEIC, Bank Indonesia, Credit Suisse estimates

Source: CEIC, Bank Indonesia, Credit Suisse estimates

Source: CEIC
Indonesia Market Strategy

Indonesia’s ability to deliver robust and resilient economic growth post the 1998 Asian financial crisis, even with limited government policy intervention, highlighted the fundamental strength of the country’s economy. Therefore, it is no wonder that Indonesia’s capital market valuation surged from a low of 4.4x P/E (61% discount to MSCI NJA) in 1H03 to a peak of 18.6x P/E (17% premium to MSCI NJA) in 1H10 and 16.4x P/E currently (19.3% premium to MSCI NJA). Similarly, using P/B less ROE, relative to MSCI NJA, we find that the Indonesia equity market’s valuation recovered from the massive discount in 1H03 to peak at a premium of 35% in 2H10 and stands at a 30% premium currently. For more details on Indonesia’s macroeconomic performance, refer to Credit Suisse Economic Research, 10 January 2011, *Indonesia: Rightly re-rated?,* by Robert Prior-Wandesforde and Kun Lung Wu.

**Auto-pilot era may be coming to an end**

Indonesia’s ability to deliver resilient economic growth post the 1998 Asian financial crisis, despite relatively minimal government intervention may lead many to assume that the country’s economy is running on auto-pilot. However, it is imperative to question the sustainability of such a condition. For one, our simple analysis indicates that Indonesia’s excess capacity is depleting. Our analysis is derived by taking the differential between the actual GDP and the estimated GDP, calculated based on regressing the actual GDP with the time variable. The declining access capacity of Indonesia’s economy is in line with the lack of investment in Indonesia post the 1998 Asian financial crisis.

In the aftermath of the 1998 Asian financial crisis, Indonesia’s investment to GDP dropped to 20–24% of GDP, versus the 26–32% range before the crisis. That is to say that the 1998 Asian financial crisis has created significant excess capacity in Indonesia and much of the economic growth post the crisis has been serviced using the then existing excess capacity. However, lack of investment or capacity addition post the 1998 Asian financial crisis means that the increase in utilisation rate during that period resulted in the country’s excess capacity being eroded.
A parallel can be drawn between Indonesia’s and India’s economic trends. Since 2002, India has experienced a rapid decline in excess capacity. India’s capacity constraint may have been the reason that the country experienced a relatively higher inflation than Indonesia. The neoclassical economic theory states that robust economic growth that is not balanced by an increase in capacity may result in an upward pressure on inflation.

Figure 12: Declining excess capacity – Indonesia

Figure 13: India – Similar decline in excess capacity

Interestingly, however, we find that India experienced upward pressure on inflation, while in Indonesia, with the exception of periods when the government revised up the subsidised fuel price, the inflation rate remained relatively in line with its historical range (for more details, refer to Credit Suisse Economic Research, 18 May 2011, Indonesia & India: A reversal of fortunes? by Robert Prior-Wandesforde). This upward pressure on India’s inflation, but not on Indonesia’s, is even more interesting considering that India’s investment to GDP ratio increased from an average of 27% (1998–99 to 2003–04) to 38% (2004–05 to 2010–11). The increase in India’s investment to GDP ratio began when the country’s excess capacity resumed the downtrend in 2004–05. In Indonesia, on the other hand, the ratio remains relatively low at 21.6% (1999–2010) versus the 28.6% average (1993–98).

To achieve 7%+ economic growth, higher investment is imperative.
The question then is: how could India, which seemed to have managed its investment (and thus, capacity expansion) better and in a timely manner suffer from an inflationary threat, whereas Indonesia, which has not managed it as well, did not have to face this threat? The answer lies in real GDP growth. Between 2002 and 2010, Indonesia’s excess capacity depletion dropped by an average of 2.2% of GDP per year. India’s excess capacity depletion between 2003 and 2011 averaged around 2.9% per year. The main difference was that India’s real GDP was growing at an average of 8.4% per year during 2003–11, while Indonesia’s was growing at an average of 5.4% per year between 2002 and 2010. The higher real GDP growth, by default, implies that India’s investment to GDP ratio needs to be higher in order to provide the economy with sufficient capacity expansion to prevent it entering a stretched capacity condition.

As a result, even though India was delivering higher investment, the investment to GDP ratio per 1% increase in real GDP growth actually dropped from 5.1% in 1998/99–2002/03 to 4.5% in 2003/04–2010/11. On the other hand, Indonesia’s investment to GDP ratio per 1% real GDP growth actually increased from 3.7% between 1994 and 1996 to 4.3% between 2000 and 2010. India was experiencing an excess capacity expansion when investment to GDP per 1% real GDP growth came at 5.1%, but was experiencing an excess capacity contraction when investment to GDP ratio per 1% real GDP growth dropped to 4.5%. Thus, the historical trend implies that for India to achieve 9% real GDP growth, it must have a 40.5–46% investment to GDP ratio.

Learning from India’s experience, we believe that Indonesia has two choices. The first is to boost investment, allowing for higher GDP growth but at a minimal risk of inflationary threat. The second choice is for Indonesia to sustain its level of investment to GDP at the current level, but at the same time, maintain growth at below-optimal levels to prevent upward pressure on inflation. Of course, there remains the third choice, which is for Indonesia to aim for higher growth without boosting inflation. In the absence of investment contributions to GDP, much of the real GDP growth will rely on private consumption, government expenditure and net exports. While to begin with, it is difficult to envisage Indonesia achieving above-7% real GDP growth without the support of higher investment, forcing such a high economic growth target without balancing it with capacity expansion would almost certainly lead the country to suffer hyperinflation after a few years.
No harvest without planting

Reaching for 7%+ economic growth

We believe that boosting investment is imperative for Indonesia to achieve an above 7% real GDP growth, without being exposed to structurally high inflation. We assume inflation to be 6% in our scenario analysis. However, our assumption does not account for externally induced high inflation such as the massive surge in commodity prices; it just accounts for the structural inflation inherent by the economy accounting for capacity availability.

![Figure 18: Significant surge in investment per year needed](image1)

![Figure 19: In the next five years, Indonesia needs US$1.9–2.6 tn of investment](image2)

Assuming that for every 1% real GDP growth, Indonesia needs to deliver an investment to GDP ratio of 4.5%, the country needs to deliver a 32–41% investment to GDP ratio to achieve 7–9% real GDP growth. In turn, extrapolating 7–9% real GDP growth with 7% inflation and a 32–41% investment to GDP ratio would bring us to US$364–US$497 bn of investment requirement per year in the next five years. The US$364–US$497 bn investment per year would imply that the average investment needed per annum in the next five years would be 149–240% higher than the average investment in the past five years. However, we believe that the magnitude of investment required is not out of reach, at least on the lower end of the target. The investment target implies a CAGR of 15–23% in the next five years, which we believe remains attainable.

Overcoming challenges

It is theoretically simple to say that in order to achieve above 7% real GDP growth, Indonesia needs to boost investments to prevent entering structurally high inflation. However, there remain vast challenges operationally and practically that prevent the country from materialising and achieving its dream. Of the vast number of challenges, we identify two key challenges—land reform law and funding requirement for investments.

Challenge 1: Land reform law

One of the key challenges often cited by industry players when it comes to capacity expansion is the infrastructure bottleneck. Indonesia’s infrastructure bottleneck is largely driven by the repetitive delay in many infrastructure project constructions. These significant delays are induced largely by challenges developers face on land acquisition.
Recognising land acquisition as the source of the bottleneck in infrastructure development, the Indonesian government is proposing a land reform bill. The bill has currently been submitted for parliamentary discussion. The draft of the bill is based on the Presidential Decree signed on 15 December 2010, after being delayed for a number of years.

Our recent conversation with Indonesia’s Minister of Finance indicates that the government still aims to get the land reform bill passed by Parliament in 2H11E. Parliamentary discussion on the land reform bill will commence in August 2011. However, if no agreement is reached by the end of November 2011, the discussion will be continued in February 2012 after Parliament reconvenes after the year-end recess.

The aim of the land reform bill is to reduce delays in infrastructure development induced by land acquisition by setting a time limit for almost every phase of development. Based on the current draft land reform bill, from preparation for land clearing to compensation for land acquisition the time taken should not exceed five months.

In order for Indonesia to move into an era of higher investment, it is imperative that the land reform bill be passed. However, having the bill passed, though necessary, does not guarantee an instantaneous pick-up in investment.

**Challenge 2: Funding the investment**

In order to achieve 7–9% real GDP growth in the next five years, we estimate Indonesia will require US$1.8–US$2.5 tn in investment versus the US$729 bn investment realised by the country from 2006 to 2010 combined. One potential challenge would be to find funding sources for these investments.

We estimate that maintaining a cap of 100% LDR—assuming that non-investment loans grew at the historical average of 22%—to satisfy the funding need of Indonesia’s investment to achieve above 7% real GDP growth, the country’s banking sector’s deposits would need to grow by 55–63% p.a., versus the historical average of 15% deposit growth p.a. Thus, we believe that funding Indonesia’s investments via the domestic banking system is rather unlikely. We see the potential for around 20% to a maximum of 40% of funding needs for investment to be sourced from domestic banks. Even at 40% of funding needs, Indonesia’s banking system would need to more than double its historical deposit growth from 15% p.a. to 32–38% p.a.

**Figure 20: Massive surge in investment required**

<table>
<thead>
<tr>
<th>Economic growth (%)</th>
<th>20%</th>
<th>40%</th>
<th>60%</th>
<th>80%</th>
<th>100%</th>
</tr>
</thead>
<tbody>
<tr>
<td>@ 7%</td>
<td>20%</td>
<td>32%</td>
<td>41%</td>
<td>48%</td>
<td>55%</td>
</tr>
<tr>
<td>@ 8%</td>
<td>22%</td>
<td>35%</td>
<td>44%</td>
<td>52%</td>
<td>59%</td>
</tr>
<tr>
<td>@ 9%</td>
<td>24%</td>
<td>38%</td>
<td>48%</td>
<td>56%</td>
<td>63%</td>
</tr>
</tbody>
</table>

Source: CEIC, Credit Suisse estimates

Another alternative source of funding would be bond issuance. However, the current government bond outstanding stands at US$68 bn while corporate bond outstanding is
US$16 bn, implying a total bond outstanding of US$84 bn. The total amount of investment funding needed for Indonesia to achieve above 7% real GDP growth stands at US$364–US$497 bn p.a., 4.3–5.9x the total bond outstanding in Indonesia. Even just funding 20% of the total investment required for Indonesia to achieve above 7% economic growth would imply US$73–US$99 bn of bond issuance per year, 5.0–6.7x of the annual government bond issuance.

Figure 22: Bond market may absorb only 20% of investment

<table>
<thead>
<tr>
<th>Econ. growth (%)</th>
<th>20%</th>
<th>40%</th>
<th>60%</th>
<th>80%</th>
<th>100%</th>
<th>Bond outs. (US$ bn)</th>
<th>Govt bond issuance (US$ bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>7%</td>
<td>73</td>
<td>145</td>
<td>218</td>
<td>291</td>
<td>364</td>
<td>68</td>
<td>16</td>
</tr>
<tr>
<td>8%</td>
<td>86</td>
<td>171</td>
<td>257</td>
<td>343</td>
<td>428</td>
<td>68</td>
<td>16</td>
</tr>
<tr>
<td>9%</td>
<td>99</td>
<td>199</td>
<td>298</td>
<td>397</td>
<td>497</td>
<td>68</td>
<td>16</td>
</tr>
</tbody>
</table>

Source: Bloomberg, Credit Suisse estimates

Another alternative would be to fund 40% of Indonesia’s required investment to achieve above 7% real GDP growth via the domestic banking system and 20% from bond issuance. Such a combination would leave 40% of the investment unfunded. Assuming that the remaining 40% is funded via foreign debt, Indonesia’s foreign debt to GDP ratio may surge from 29% currently to 78–90% by 2015E.

Given the sizeable investment magnitude needed to bring Indonesia’s economic growth to surpass 7%, we believe that the required investments may be funded via a number of alternatives such as a combination of domestic banks, bond issuance, as well as direct foreign and domestic investments. However, given the fact that Indonesia’s infrastructure developments have experienced multi-year delays, we see the risk that investors or banks may require government guarantees, particularly in initial projects, before committing their funds.

Either way, we believe that the large investments required bring Indonesia’s real GDP growth to surpass 7% means only one thing—it paints a very positive outlook for Indonesia banking sector, particularly for banks with sufficient liquidity. Given the potentially large funding requirement, we foresee the potential for Indonesia’s banking system to be a lender’s rather than a borrower’s market.

Challenge 3: The right investments at the right pace

It is fine to analyse that Indonesia requires higher investment in order to avoid confronting stretched capacity. However, it is imperative for the country to invest in appropriate sectors in accordance with its need. The failure to identify the sectors accurately may result in a catastrophe. Before the 1998 Asian financial crisis, Indonesia engaged in a variety of investments. However, much of these investments were not targeted accurately and the pace was probably too aggressive.

In our view, two main key factors need to be considered thoroughly as Indonesia moves into a higher investment phase. First is for the country to finance the investment appropriately without exposing itself to excess borrowing as it did in the pre-1998 Asian
financial crisis. Second is for the country to invest in sectors to enhance capacity in accordance with demand growth. Such targeted investment should aim to reduce the risk of entering into an excessive consumption-driven current account deficit, which may result in the risk of weakening the currency, as well as exposing Indonesia to the threat of higher inflation.

In our view, in order to be effective, Indonesia would not only require higher investment to enhance its economy’s capacity, this investment should also be well-targeted and the current administration would need to implement policies that shape the progress of investment into the desired sector, at the right pace. Failure on the part of the government to manage the direction of investment may well result in déjà-vu, wherein Indonesia may end up repeating its history of excessive expansion that led the country to succumb to the 1998 Asian financial crisis.
Mapping the path ahead

Drawing parallels with India

We find significant parallels between Indonesia and India. The only difference is that Indonesia has not kept the foot on the pedal in forcing high growth. As a result, its excess capacity has not been exhausted at the same rapid rate as in India. Having said that, unless Indonesia starts to encourage investment, there is a good risk that the country may end up with structurally high inflation, similar to what India is facing at the moment.

Figure 24: Indonesia – Declining current account surplus

Figure 25: India – Expanding current account deficit

Early signs show that Indonesia’s capacity is getting stretched

India’s current account rapidly declined from the surplus of 1.64% of GDP in 2003 to a deficit of 3.35% of GDP by 2010. Tightening excess capacity combined with continuously strong real GDP growth forced India to assume higher imports to satisfy higher consumption demand. While a current account deficit is generally acceptable for emerging countries, a deficit that is induced due to consumption is perceived unfavourable.
Indonesia’s current account contraction has been slower than India’s. Its current account remains positive, though it has contracted significantly from the peak of 5.04% of GDP in 2000 to 0.79% by 2010. We believe unless the country starts to encourage investment, Indonesia’s current account may soon move into a deficit led by the need to import to satisfy higher consumption needs.

Indeed, examining the trend of headline and core inflation in Indonesia, one can see preliminary indications of stretched excess capacity. Historically, a decline in headline inflation was generally followed by lower core inflation. That is, even a decline in headline inflation that is led by lower commodity prices, for example, often translates into higher purchasing power for the public. In turn, suppliers often resort to increasing utilisation rates (due to availability of excess capacity) to increase production volume, leading to lower core inflation. However, in 2011, the decline in headline inflation was not been followed by contracting core inflation, indicating that rather than resorting to higher volume output, suppliers may have increased prices in the wake of higher purchasing power of the public (reflected by lower headline inflation), which potentially indicates that there is now limited excess capacity available.
During the period when India was accelerating investments, the equity market peaked at a 57% premium to MSCI NJA (based on P/B less ROE) with its P/E multiple reaching a high of 23.4x. However, the market started to be de-rate as delivery of investment turned out to be below expectations and inflation started to pick up. Currently, the Indian market is trading at a 12% premium to its regional peers with a P/E of 15.1x.

Interestingly, during the period when India’s investments were picking up, the market provided a massive premium to the valuations of the Indian market (based on P/B and relative P/B to MSCI NJA). This premium was given despite the fact that ROE declined (potentially diluted by higher investment and thus, book value). However, once the market saw a decline in investments, the P/B and relative P/B of the Indian market were de-rated, and were simultaneously accompanied by ROE contractions.

India’s experience indicates that the market is willing to provide a valuation premium for countries that are undergoing capacity expansion as the ROE contraction is perceived to be temporary. However, once it is perceived that the capacity expansion has not been sufficient and the risk of structurally high inflation starts to surface, the market quickly erases the valuation premium.

Learning from India, if investment is done right, there’s potential for the Indonesian market to re-rate further.

But if done wrong, the Indonesian market could de-rate.

Source: CEIC, Bloomberg, Credit Suisse estimates

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**Figure 32: Indian market’s P/B**

![Graph showing the relationship between investment to GDP and P/B ratio for India over time.](source)

**Figure 33: Indian market’s ROE**

![Graph showing the relationship between investment to GDP and ROE ratio for India over time.](source)

**Figure 34: Indonesian market’s P/B**

![Graph showing the relationship between investment/GDP and P/B ratio for Indonesia over time.](source)

**Figure 35: Indonesian market’s ROE**

![Graph showing the relationship between investment/GDP and ROE ratio for Indonesia over time.](source)
During the period when India’s investments picked up, the industrial, material, financial and energy sectors outperformed the Indian market. However, we believe that the outperformance of the energy sector may have been driven by the commodity price boom between 2002 and 2007. The outperformance of industrials, materials and financials, however, was in line with our expectations. During this period, discretionary consumer, utilities, healthcare, IT and consumer staples underperformed the market, due to the more defensive nature of these companies.

During the period when India’s investment realisation came in below the required level defined by India’s strong real GDP growth, stocks from healthcare, consumer discretionary, consumer staples and IT outperformed the market. We believe that their outperformance is largely defined by the strong purchasing power exhibited by India during the period on the back of the country’s robust real GDP growth.

**Figure 36: India – winning and losing sectors 2002-2007**

<table>
<thead>
<tr>
<th>Sector</th>
<th>2002-2007 Rel CAGR (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrials</td>
<td>60</td>
</tr>
<tr>
<td>Materials</td>
<td>50</td>
</tr>
<tr>
<td>Financials</td>
<td>40</td>
</tr>
<tr>
<td>Energy</td>
<td>30</td>
</tr>
<tr>
<td>Cons Disc</td>
<td>20</td>
</tr>
<tr>
<td>Utilities</td>
<td>10</td>
</tr>
<tr>
<td>Health Care</td>
<td>0</td>
</tr>
<tr>
<td>IT</td>
<td>-10</td>
</tr>
<tr>
<td>Cons Staples</td>
<td>-20</td>
</tr>
</tbody>
</table>

Source: Bloomberg

**Defining the two paths ahead**

From the experience of the Indian market, we see the potential for the Indonesian market’s premium to reach 57% if the country is able to deliver its required investments. The increase in investment may potentially translate into ROE contractions, due to increasing book value on the back of higher capital expenditure. However, in India’s case, the market seemed to have been willing to overlook the temporary ROE compression and awarded the market up to 83% premium to regional peers based on the P/B valuation method.

Thus, our bull case scenario implies that the Indonesian market is able to deliver its investment needs and move into a multi-year capex cycle. Under such a scenario, we see the potential for the Indonesian market’s valuation to expand from the current 30% premium to a 57% premium to MSCI NJA (based on P/B less ROE). However, we believe that the re-rating may not be instantaneous given: (1) we expect that the earliest Indonesia will pass the land reform bill will be in 2H11E, which implies that ground breaking will be some time in 2012E, (2) investors have been relatively disappointed with the lower-than-expected realisation from the Indian market and as a result, are unlikely to re-rate the Indonesian market abruptly but, rather, to assign higher valuations as the country delivers on its investment target.

However, the experience of the Indian market suggests that in the event the delivery of investment disappoints, the Indonesian market could de-rate from its current valuations of a 30% premium to MSCI NJA (based on P/B less ROE) to a 12% premium.
Net-net, for YE2011, we maintain our JCI index target of 4150 points, based on 16x 2011E P/E as we believe that ground breaking and the start of investment realisation will not take place until 2012E. In 2012, we foresee the potential for the Indonesian market to trade at an even higher premium, potentially re-rating by 27%, if the government is able to convince the market that the country will be entering a multi-year capex cycle. However, if Indonesia delays its entry into a higher investment period, then we see the potential for the market to de-rate 18%.

Taking into account India’s experience, we construct two baskets that address the two potential scenarios. The first scenario assumes Indonesia enters a high investment period. Again, keeping India’s experience in mind, our basket for this scenario covers stocks from financials (BMRI and BBNI), industrials (UNTR) and materials (SMGR) sectors. The second scenario assumes the absence of high investment growth and this basket covers stocks from the consumer sector (ASII, GGRM and INDF).

Figure 38: Two baskets covering the two scenarios

<table>
<thead>
<tr>
<th>Ticker</th>
<th>Rating</th>
<th>Market cap (US$ bn)</th>
<th>Share price (Rp)</th>
<th>Upside</th>
<th>P/E (x)</th>
<th>P/B (x)</th>
<th>ROE (%)</th>
<th>P/B less ROE rel. to Indonesian market (%)</th>
<th>P/B less ROE rel. to Asia Ex-Japan (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>BMRI O</td>
<td>19</td>
<td>6,900 8,950</td>
<td>30 12.7 11.3</td>
<td>2.6 2.2</td>
<td>24 21</td>
<td>-14%</td>
<td>3%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BBNI O</td>
<td>8</td>
<td>3,675 5,000</td>
<td>36 12.3 9.4</td>
<td>1.8 1.6</td>
<td>16 18</td>
<td>-13%</td>
<td>-5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>UNTR O</td>
<td>10</td>
<td>22,700 28,000</td>
<td>23 15.6 13.9</td>
<td>4.0 3.4</td>
<td>28 26</td>
<td>8%</td>
<td>49%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SMGR O</td>
<td>6</td>
<td>9,200 11,000</td>
<td>20 14.2 12.7</td>
<td>3.9 3.3</td>
<td>29 29</td>
<td>-11%</td>
<td>18%</td>
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<td></td>
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</table>

Moderate to soft investment growth

<table>
<thead>
<tr>
<th>Ticker</th>
<th>Rating</th>
<th>Market cap (US$ bn)</th>
<th>Share price (Rp)</th>
<th>Upside</th>
<th>P/E (x)</th>
<th>P/B (x)</th>
<th>ROE (%)</th>
<th>P/B less ROE rel. to Indonesian market (%)</th>
<th>P/B less ROE rel. to Asia Ex-Japan (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASII N</td>
<td>27</td>
<td>56,400 64,000</td>
<td>13 15.1 14.2</td>
<td>4.0 3.5</td>
<td>29 26</td>
<td>-4%</td>
<td>30%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>GGRM O</td>
<td>10</td>
<td>43,750 53,000</td>
<td>21 16.8 14.9</td>
<td>3.4 3.0</td>
<td>22 21</td>
<td>11%</td>
<td>48%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>INDF O</td>
<td>5</td>
<td>5,200 6,400</td>
<td>23 13.8 12.7</td>
<td>3.0 2.4</td>
<td>24 21</td>
<td>-13%</td>
<td>8%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

O = Outperform; N = Neutral
Source: Company data, Credit Suisse estimates

Given our view that the rapid up-cycle in investment will only commence earliest in FY12, we maintain our 12-month portfolio. For our preferred picks, we include BMRI, BBRI, INDF and TLKM whilst our least preferred picks include ADRO, UNVR, KLBF and BBCA.

Figure 39: Our top picks for 2011

<table>
<thead>
<tr>
<th>Ticker</th>
<th>Rating</th>
<th>Market cap (US$ bn)</th>
<th>Share price (Rp)</th>
<th>Upside</th>
<th>P/E (x)</th>
<th>P/B (x)</th>
<th>ROE (%)</th>
<th>P/B less ROE rel. to Indonesian market (%)</th>
<th>P/B less ROE rel. to Asia ex-Japan (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>BMRI O</td>
<td>19</td>
<td>6,900 8,950</td>
<td>30 12.7 11.3</td>
<td>2.6 2.2</td>
<td>24 21</td>
<td>-14%</td>
<td>3%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BBRI O</td>
<td>18</td>
<td>6,250 8,330</td>
<td>33 11.5 10.0</td>
<td>3.3 2.6</td>
<td>32 29</td>
<td>-34%</td>
<td>-21%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>INDF O</td>
<td>5</td>
<td>5,200 6,400</td>
<td>23 13.8 12.7</td>
<td>3.0 2.4</td>
<td>24 21</td>
<td>-13%</td>
<td>8%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>TLKM O</td>
<td>18</td>
<td>7,450 9,750</td>
<td>31 11.7 10.8</td>
<td>3.0 2.7</td>
<td>27 26</td>
<td>-31%</td>
<td>-21%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Least preferred

<table>
<thead>
<tr>
<th>Ticker</th>
<th>Rating</th>
<th>Market cap (US$ bn)</th>
<th>Share price (Rp)</th>
<th>Upside</th>
<th>P/E (x)</th>
<th>P/B (x)</th>
<th>ROE (%)</th>
<th>P/B less ROE rel. to Indonesian market (%)</th>
<th>P/B less ROE rel. to Asia ex-Japan (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ADRO U</td>
<td>9</td>
<td>2,400 2,050</td>
<td>(15) 18.8 12.5</td>
<td>3.7 3.1</td>
<td>21 27</td>
<td>36%</td>
<td>88%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>UNVR U</td>
<td>13</td>
<td>14,600 14,000</td>
<td>(4) 25.6 22.3</td>
<td>22.2 19.7</td>
<td>96 94</td>
<td>296%</td>
<td>662%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>KLBF N</td>
<td>4</td>
<td>3,250 3,400</td>
<td>5 19.9 16.9</td>
<td>5.2 4.4</td>
<td>28 28</td>
<td>42%</td>
<td>111%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BBCA N</td>
<td>20</td>
<td>7,000 8,700</td>
<td>24 17.3 14.1</td>
<td>4.4 3.6</td>
<td>27 28</td>
<td>16%</td>
<td>64%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

O = Outperform; U = Underperform; N = Neutral
Source: Company data, Credit Suisse estimates
Appendix A: Land reform bill

When will the land reform bill be passed?

The MoF hosted an analyst meeting on 20 May 2011, where a part of the discussion centred on the long-awaited land reform bill to be passed by Parliament. The MoF’s view is that the bill is likely to be passed by 2H11. The President has signed the draft of the bill in mid-December and it is currently being discussed in Parliament.

Draft of the land reform bill

The draft of the land reform bill is based on the Presidential Decree signed on 15 December 2010. A summary of the draft is given below:

- **Preparation for land clearing.** The public will be consulted on the implementation of the construction plan within a maximum of a two-month period. Should one reject the plan, there should be a re-consultation within a maximum period of one month. And if, after the first re-consultation, the plan is still rejected, the institution that requires the land should report the disagreement to the ministry who is responsible for national planning and development, and a decision will be arrived at within a maximum of 14 working days, in which the ministry will then issue the acceptance/rejection of the objection.

- **Compensation.** The National Land Agency (BPN) will appoint a third-party independent appraiser to evaluate compensation. The value of compensation is the value at the time of announcement of the final construction location. BPN will then discuss the matter with the related party in order to settle the amount of compensation. If the related party refuses the settlement, they can object to the district court within a maximum of 14 working days after the settlement discussion, and the district court will decide the amount of compensation within a maximum of 30 working days, where the latter's decision will be the final verdict.

- **Land clearing.** This will be implemented by private; individual and/or legal corporates and the GoI will administer the area of land clearing.

- **Source of land clearing.** State budget (APBN) and regional government budget (APBD)

- **Definition of public facilities.** (1) roads, toll roads, tunnels, railway, rail stations, and rail operation facilities; (2) dams, irrigation systems, drinking water pipelines, sanitation pipelines; (3) ports, airports, and terminals; (4) oil & gas, geothermal infrastructure, including oil & gas, geothermal transmission and/or distribution; (5) power plant, transmission, electricity distribution networks; (6) telecommunication and information networks; (7) waste development facilities; (8) state hospitals; (9) state cemetery; (10) public safety facility; (11) natural and cultural preservation; (12) national defence and security; (13) government offices; (14) slump area rehabilitation; (15) education facilities/state schools; (16) state sports facilities; (17) other public constructions based on Presidential Decree.
## Appendix B: Comparative valuations

**Figure 40: Comparative valuations**

<table>
<thead>
<tr>
<th>Company name</th>
<th>Ticker</th>
<th>Ratg</th>
<th>Mkt cap (US$bn)</th>
<th>6M ADTV (US$ mn)</th>
<th>Price Current</th>
<th>Price TP</th>
<th>Upside (%)</th>
<th>P/E (x)</th>
<th>P/B (x)</th>
<th>ROE (%)</th>
<th>EV/EBITDA (x)</th>
<th>P/B rel. less</th>
<th>ROE rel. to (%)</th>
<th>Avg 5-yr. P/B rel. less ROE rel to (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indofood</td>
<td>INDF</td>
<td>5.3</td>
<td>5.7</td>
<td>5,600,000</td>
<td>23.1</td>
<td>13.8</td>
<td>32.7</td>
<td>24.0</td>
<td>11.0</td>
<td>14.0</td>
<td>27.0</td>
<td>11.0</td>
<td>9.7</td>
<td>11.0</td>
</tr>
<tr>
<td>Kelme Farma</td>
<td>KLF</td>
<td>3.9</td>
<td>8.3</td>
<td>3,250,000</td>
<td>4.6</td>
<td>19.9</td>
<td>6.2</td>
<td>4.4</td>
<td>28.0</td>
<td>13.9</td>
<td>11.5</td>
<td>22.0</td>
<td>4.0</td>
<td>9.0</td>
</tr>
<tr>
<td>United Tractors</td>
<td>UNTR</td>
<td>9.9</td>
<td>12.9</td>
<td>22,700,000</td>
<td>23.3</td>
<td>15.6</td>
<td>3.4</td>
<td>3.0</td>
<td>25.0</td>
<td>11.5</td>
<td>16.0</td>
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<tr>
<td>Indocomcement</td>
<td>INTP</td>
<td>7.1</td>
<td>8.2</td>
<td>16,500,000</td>
<td>5.5</td>
<td>16.7</td>
<td>3.9</td>
<td>3.0</td>
<td>21.0</td>
<td>15.7</td>
<td>11.5</td>
<td>14.0</td>
<td>7.8</td>
<td>9.0</td>
</tr>
<tr>
<td>Semen Gresik</td>
<td>SMGR</td>
<td>6.4</td>
<td>7.8</td>
<td>9,200,000</td>
<td>19.6</td>
<td>14.2</td>
<td>3.9</td>
<td>3.0</td>
<td>29.0</td>
<td>12.2</td>
<td>11.8</td>
<td>21.0</td>
<td>8.9</td>
<td>11.0</td>
</tr>
<tr>
<td>Holcim Indonesia</td>
<td>SMCB</td>
<td>1.9</td>
<td>2.6</td>
<td>2,100,000</td>
<td>14.3</td>
<td>15.7</td>
<td>3.0</td>
<td>3.0</td>
<td>21.0</td>
<td>12.7</td>
<td>14.4</td>
<td>21.0</td>
<td>7.8</td>
<td>34%</td>
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<td>Adaro Energy</td>
<td>ADRO</td>
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<td>16.0</td>
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<td>-1.46</td>
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<td>3.1</td>
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<td>12.8</td>
<td>13.7</td>
<td>21.0</td>
<td>3.8</td>
<td>11%</td>
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<td>ITMG</td>
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<td>13.0</td>
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<td>4.4</td>
<td>53.0</td>
<td>9.0</td>
<td>9.8</td>
<td>56.0</td>
<td>6.1</td>
<td>10%</td>
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<tr>
<td>TB Bukit Asam</td>
<td>PTBA</td>
<td>5.7</td>
<td>8.2</td>
<td>20,950,000</td>
<td>26.5</td>
<td>12.7</td>
<td>5.2</td>
<td>4.2</td>
<td>49.0</td>
<td>11.5</td>
<td>11.5</td>
<td>40.0</td>
<td>7.5</td>
<td>9%</td>
</tr>
<tr>
<td>Borneo Lumbung</td>
<td>BORN</td>
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<td>8.1</td>
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<td>11.9</td>
<td>3.0</td>
<td>2.5</td>
<td>29.0</td>
<td>10.4</td>
<td>10.9</td>
<td>26.0</td>
<td>6.7</td>
<td>8%</td>
</tr>
<tr>
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<td>HRUM</td>
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<td>5.8</td>
<td>9,250,000</td>
<td>3.8</td>
<td>15.5</td>
<td>7.0</td>
<td>8.0</td>
<td>56.0</td>
<td>11.0</td>
<td>10.4</td>
<td>52.0</td>
<td>7.3</td>
<td>10%</td>
</tr>
<tr>
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<td>INDY</td>
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<td>7.2</td>
<td>3,950,000</td>
<td>36.7</td>
<td>10.0</td>
<td>2.9</td>
<td>2.5</td>
<td>33.0</td>
<td>11.2</td>
<td>11.2</td>
<td>32.0</td>
<td>7.4</td>
<td>9%</td>
</tr>
<tr>
<td>INCO</td>
<td>INCO</td>
<td>5.3</td>
<td>5.6</td>
<td>4,575,000</td>
<td>-3.8</td>
<td>11.1</td>
<td>2.8</td>
<td>2.6</td>
<td>27.0</td>
<td>13.9</td>
<td>11.2</td>
<td>20.0</td>
<td>6.8</td>
<td>7%</td>
</tr>
<tr>
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<td>4.3</td>
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<td>1.9</td>
<td>1.8</td>
<td>18.0</td>
<td>11.0</td>
<td>11.0</td>
<td>18.0</td>
<td>6.3</td>
<td>8%</td>
</tr>
<tr>
<td>Telkom</td>
<td>TLKM</td>
<td>17.6</td>
<td>19.6</td>
<td>7,450,000</td>
<td>30.9</td>
<td>11.7</td>
<td>3.0</td>
<td>2.7</td>
<td>27.0</td>
<td>11.8</td>
<td>11.8</td>
<td>26.0</td>
<td>4.1</td>
<td>32%</td>
</tr>
<tr>
<td>XL Axia</td>
<td>EXCL</td>
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<td>1.7</td>
<td>5,950,000</td>
<td>21.0</td>
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<td>3.5</td>
<td>3.0</td>
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<td>1.5</td>
<td>1.4</td>
<td>7.0</td>
<td>11.0</td>
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<td>11.0</td>
<td>5.0</td>
<td>4%</td>
</tr>
<tr>
<td>Sarana Menara</td>
<td>TOWR</td>
<td>1.3</td>
<td>0.1</td>
<td>10,500,000</td>
<td>38.1</td>
<td>38.7</td>
<td>7.1</td>
<td>6.0</td>
<td>11.6</td>
<td>25.0</td>
<td>23.0</td>
<td>25.0</td>
<td>5.6</td>
<td>14%</td>
</tr>
<tr>
<td>Tower Bersama</td>
<td>TBIK</td>
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<td>1.4</td>
<td>2,225,000</td>
<td>19.1</td>
<td>14.8</td>
<td>3.5</td>
<td>2.8</td>
<td>26.0</td>
<td>11.0</td>
<td>11.0</td>
<td>28.0</td>
<td>8.3</td>
<td>9%</td>
</tr>
<tr>
<td>Perusahaan Gas Negara</td>
<td>PGAS</td>
<td>11.2</td>
<td>15.5</td>
<td>3,950,000</td>
<td>26.6</td>
<td>13.1</td>
<td>5.5</td>
<td>4.7</td>
<td>47.0</td>
<td>13.1</td>
<td>11.0</td>
<td>39.0</td>
<td>8.3</td>
<td>9%</td>
</tr>
</tbody>
</table>

O = Outperform; U = Underperform; N = Neutral.

Source: Company data, Credit Suisse estimates.

15 June 2011
Companies Mentioned  *(Price as of 13 Jun 11)*

- Aneka Tambang Tbk (ANTM.JK, Rp2,125.00, NEUTRAL, TP Rp2,600.00)
- Astra International (ASII.JK, Rp56,400.00, NEUTRAL, TP Rp64,000.00)
- Bank Central Asia (BBCA.JK, Rp7,000.00, NEUTRAL, TP Rp8,700.00)
- Bank Danamon (BDMN.JK, Rp6,050.00, NEUTRAL, TP Rp7,000.00)
- Bank Mandiri (Persero) (BMRI.JK, Rp6,900.00, OUTPERFORM, TP Rp8,950.00)
- Bank Negara Indonesia (BBNI.JK, Rp3,675.00, OUTPERFORM, TP Rp5,000.00)
- Bank Pan Indonesia Tbk (PNBN.JK, Rp1,000.00, UNDERPERFORM, TP Rp965.00)
- Bank Rakyat Indonesia (BRI.JK, Rp6,250.00, OUTPERFORM, TP Rp8,330.00)
- Bank Tabungan Negara (BBTN.JK, Rp1,600.00, NEUTRAL, TP Rp1,725.00)
- Excelcomindo Pratama PT (EXCL.JK, Rp5,950.00, OUTPERFORM, TP Rp7,200.00)
- Gudang Garam (GGRM.JK, Rp43,750.00, OUTPERFORM, TP Rp53,000.00)
- Holcim Indonesia TBK PT (SMCB.JK, Rp2,100.00, NEUTRAL, TP Rp2,400.00)
- Indoocement (INTP.JK, Rp16,500.00, NEUTRAL, TP Rp17,400.00)
- Indofood Sukses Makmur (INDF.JK, Rp5,200.00, OUTPERFORM, TP Rp6,400.00)
- Kalbe Farma (KLBF.JK, Rp3,250.00, NEUTRAL, TP Rp3,400.00)
- Perusahaan Gas Negara (PGAS.JK, Rp3,950.00, OUTPERFORM, TP Rp5,000.00)
- PT Adaro Energy Tbk (ADRO.JK, Rp2,400.00, UNDERPERFORM, TP Rp2,050.00)
- PT Astra Agro Lestari Tbk (AALI.JK, Rp22,700.00, NEUTRAL, TP Rp26,000.00)
- PT Borneo Lumbung Energi & Metal Tbk (BORN.JK, Rp1,520.00, UNDERPERFORM [V], TP Rp2,000.00)
- PT Harum Energy Tbk (HRUM.JK, Rp9,250.00, NEUTRAL [V], TP Rp9,600.00)
- PT Indika Energy Tbk (INDY.JK, Rp9,350.00, OUTPERFORM, TP Rp5,400.00)
- PT Indo Tambangraya Megah (ITMG.JK, Rp46,000.00, OUTPERFORM [V], TP Rp57,000.00)
- PT Indosat Tbk (ISAT.JK, Rp5,100.00, OUTPERFORM, TP Rp7,900.00)
- PT International Nickel Indonesia Tbk (INCO.JK, Rp4,575.00, UNDERPERFORM, TP Rp4,400.00)
- PT London Sumatra Indonesia (LSIP.JK, Rp2,325.00, NEUTRAL, TP Rp2,900.00)
- PT Sarana Menara Nusantara (TOWR.JK, Rp10,500.00, OUTPERFORM, TP Rp14,500.00)
- PT Tambang Batubara Bukit Asam Tbk (PTBA.JK, Rp20,950.00, OUTPERFORM, TP Rp26,500.00)
- PT Telkom (Telekomunikasi Indo.) (TLKM.JK, Rp7,450.00, OUTPERFORM, TP Rp9,750.00)
- Salim Ivmosas Pratama (SIMP.JK, Rp1,210.00, OUTPERFORM [V], TP Rp1,856.00)
- Sampoenra Agro Tbk (SGOJ.K, Rp3,375.00, NEUTRAL, TP Rp3,717.00)
- Semen Gresik (Persero) (SMGR.JK, Rp9,200.00, OUTPERFORM, TP Rp11,000.00)
- Tower Bersama (TBIG.JK, Rp2,225.00, NEUTRAL [V], TP Rp2,650.00)
- Unilever Indonesia (UNVR.JK, Rp14,600.00, UNDERPERFORM, TP Rp14,000.00)
- United Tractors (UNTR.JK, Rp22,700.00, OUTPERFORM, TP Rp28,000.00)

**Disclosure Appendix**

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<table>
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<tr>
<th>Stock Rating</th>
<th>Global Ratings Distribution</th>
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<tbody>
<tr>
<td>Outperform/Buy*</td>
<td>48% (62% banking clients)</td>
</tr>
<tr>
<td>Neutral/Hold*</td>
<td>40% (56% banking clients)</td>
</tr>
<tr>
<td>Underperform/Sell*</td>
<td>10% (50% banking clients)</td>
</tr>
<tr>
<td>Restricted</td>
<td>2%</td>
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