GIB ASSET MANAGEMENT

On the road: Engagement in action

Value unlock in Indonesia & Vietnam

Similar Past with an Equally Bright Future

By Megan Ie

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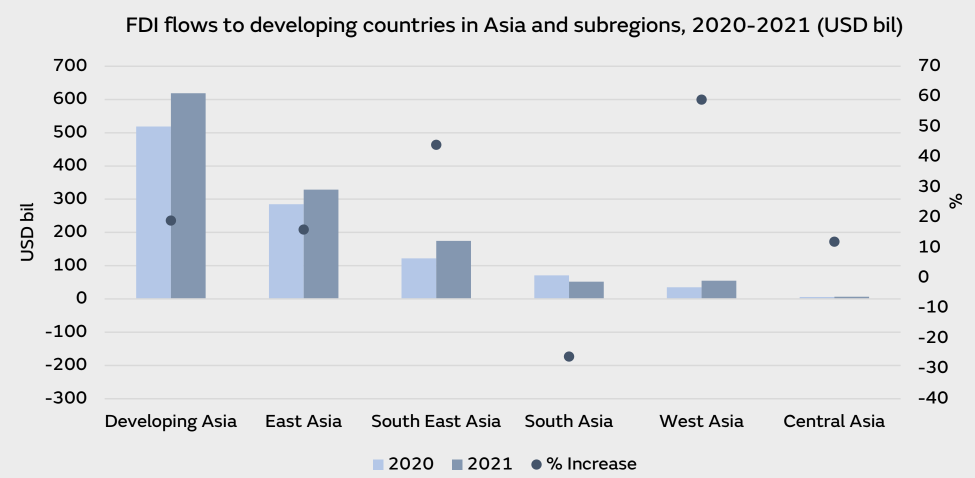
Currently the seventh largest economy in the world with a combined GDP of USD 2.6 trillion, the bloc of ten ASEAN countries is expected to become the 4th largest single market in the world by 2030[1], behind the US, China and EU. With a population of approximately 660 million[2], the region is the 3rd most populous market after China and India. The strong structural investment story is driven by its favourable demographics - a relatively low median age of 35 years in 2040, vs 47 years in China and 50 years in Japan[3], alongside a growing working population and burgeoning consumer market.

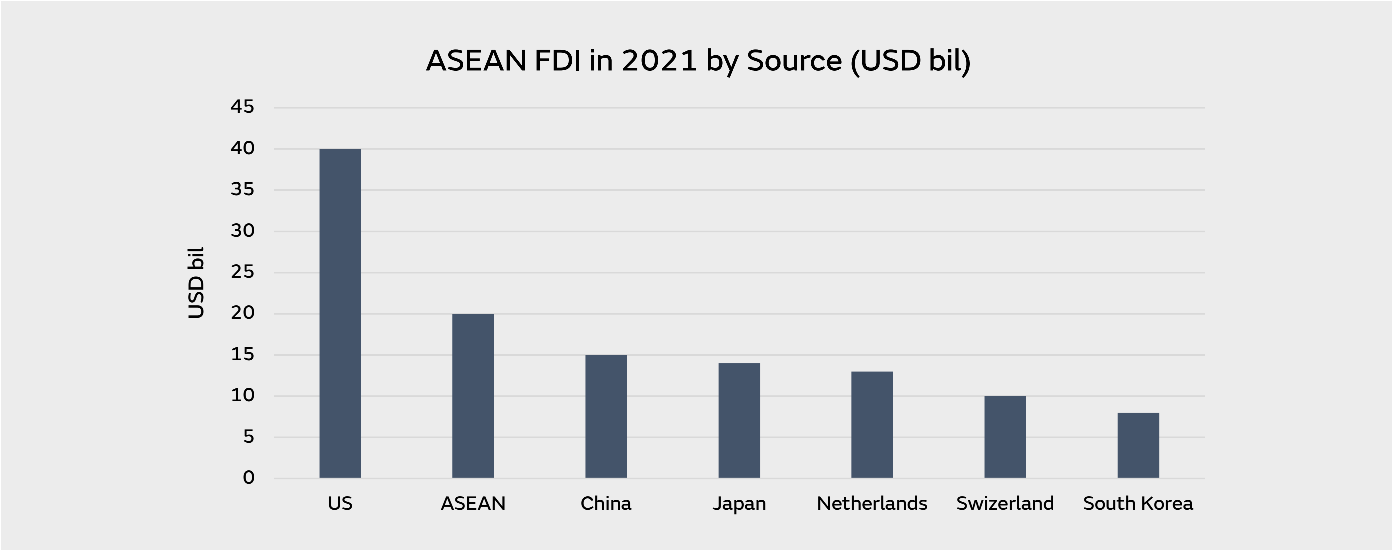
The region's diversity in almost every aspect from economic development and capital markets to governance, language and culture have historically been seen as a divisive weakness. However, the general humility in respecting each other's sovereignty and that same empathy displayed in global affairs have propelled this same point into an advantage in today's age of global power competition.

Because of the need to diversify supply chains, seek alternative growth opportunities due to mounting hurdles of geopolitical tensions in the form of tariffs and investment curbs, Southeast Asia has emerged as a key diplomatic and economic relationship that other countries need. Not surprisingly, the surge in foreign direct investment inflow has also confirmed this change in status.



Source: UNCTAD World Investment Report 2022

[1] https://www.enterprisesg.gov.sg/overseas-markets/asia-pacific/asean/overview
[2] https://www.statista.com/statistics/796222/total-population-of-the-asean-countries/
[3] https://www.uobgroup.com/web-resources/uobgroup/pdf/research/ASEAN-Focus_II_3q19.pdf



Source: ASEAN Secretariat, S&P Global

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A tale of two thriving countries: Same same, but different

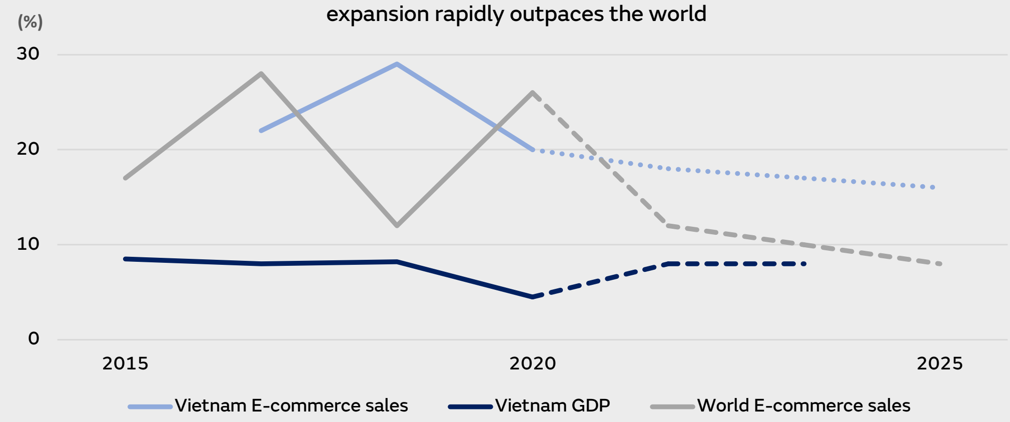
Indonesia and Vietnam were the first two in Asia to declare independence in 1945 after the Japanese occupation. Both countries had the most violent and complete colonial break relative to other Southeast Asian countries. Yet one key difference remains today – the different political system of choice that resulted in different process of nationalization, policies concerning foreign investments and the extent of state control over the economy.

Today, the pandemic had brought to fore the urgent infrastructure and inequality gaps in both countries. In Indonesia, the use of state-owned-enterprises (SOEs) as agents of developments has been especially prominent in the case of infrastructure, providing one third of infrastructure investments.[4] Similarly, the SOE sector is one of the main pillars in the formerly centrally planned Vietnamese economies, accounting for about 28% of GDP.[5] Similar to trends observed around the world, limitations on mobility due to the pandemic have accelerated the rise of the digital economy. Against this background, the development and prioritization of building a digital economy was apparent in both countries when we visited.

The Government of Vietnam has singled out digital transformation as one of the core objective of its 2021-2030 National Development Strategy. According to the World Bank,[6] up to 60% of local businesses in Vietnam have already established and or increased their online presence in order to access a growing base of connected customers. The government has also digitized more than 2000 public services and procedures. E-commerce sector revenues are targeted to reach US$35billion by 2025 if the e-commerce development plan approved by the government materializes.[7] In the case of Indonesia, while citizens are connected and tech-savvy, internet penetration remains low, signalling the long runway of opportunities in digitalisation. According to Mckinsey, an estimated USD 150 billion in growth, about 10% of GDP, will be unleashed by 2025 if the country embraces digitalization.[8] As both countries transition from the traditional old to the new (tech) economies, investment opportunities in many areas of both markets were presented.

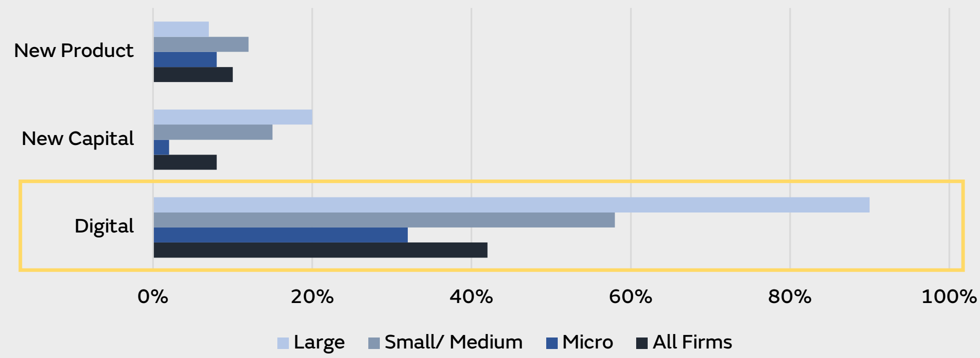
[4]Asian Development Bank – "Unlocking The Economic and Social Value of Indonesia' State-owned Enterprises" Dec 2022
[5]Asian Development Bank Institute – "State-Owned Enterprise Reform in Vietnam: Progress and Challenges" (2020)
[6]The World Bank – "Digital Vietnam: The Path to Tomorrow" (2021)
[7] National Master Plan on E-Commerce Development (2021-2025), Vietnam. http://news.chinhphu.vn/Home/Master-pan-on-national-ecoomerce -development-through-2025-ap-proved/20205/40160.vgp
[8] McKinsey & Company – "Unlocking Indonesia's Digital Opportunity" (2016)

Digitalization Opportunities in Vietnam gaining good ground as its E-commerce expansion rapidly outpaces the world



Source: World Bank staff calculations using data from the World Bank and Statista 2021

Similar strong digitalization trend in Indonesia - Share of Firms reported responses to Covid-19



Source: World Bank Survey, “Beyond Unicorns: Harnessing Digital Technologies for Inclusion in Indonesia”, 2021

Indonesia

Over 7000 miles from London, we set foot on the unruly urban sprawl of warungs, tokos and skyscrapers known as Jakarta amidst the torrential rain. Despite the weather, Jakartans continue to move on with their day-to-day, collecting dimes and pennies along the way. No better homecoming for me after 3 years. An interesting welcome to the other side of the world for Greg Konieczny, Head of Emerging Markets at GIB Asset Management, who arrived with his luggage still stuck in Europe. Nevertheless, the Indonesian tradition of gotong royong (spirit of cooperation and mutual help) meant that there will always be a better situation; handy for us to get on with our busy schedule as planned.

Showers of blessing for the trip

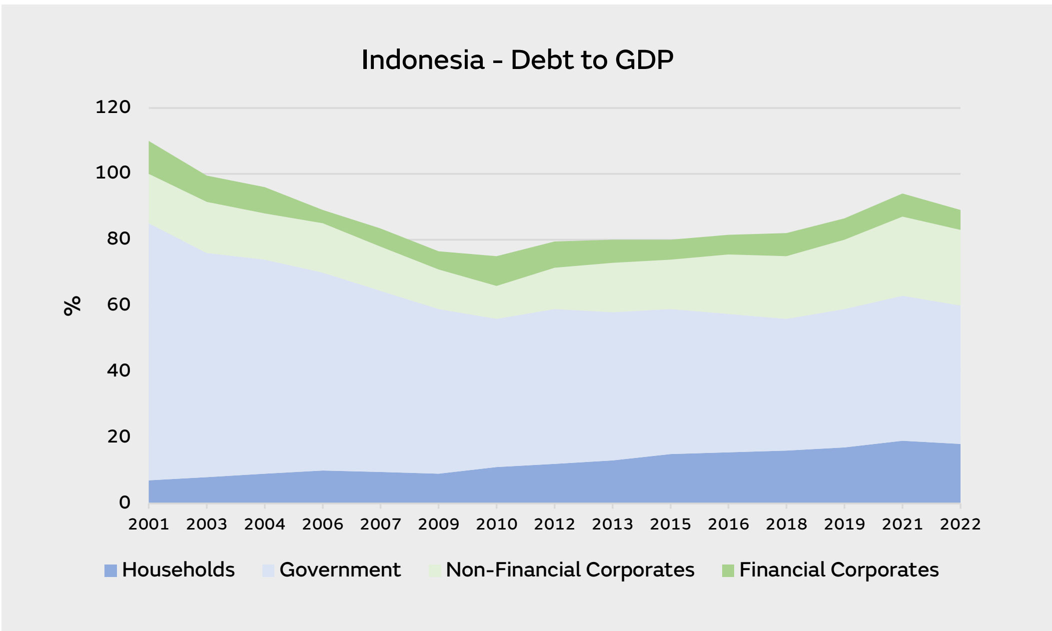
Warung – traditional channel of distribution in Indonesia

Having been encouraged by one of the strongest Indonesian macro environment seen in a decade with vast growth potential alongside attractive opportunities presented company specific competitive advantages, we had invested in a financial company with considerable assets in the country and a consumer company with market dominance at home.

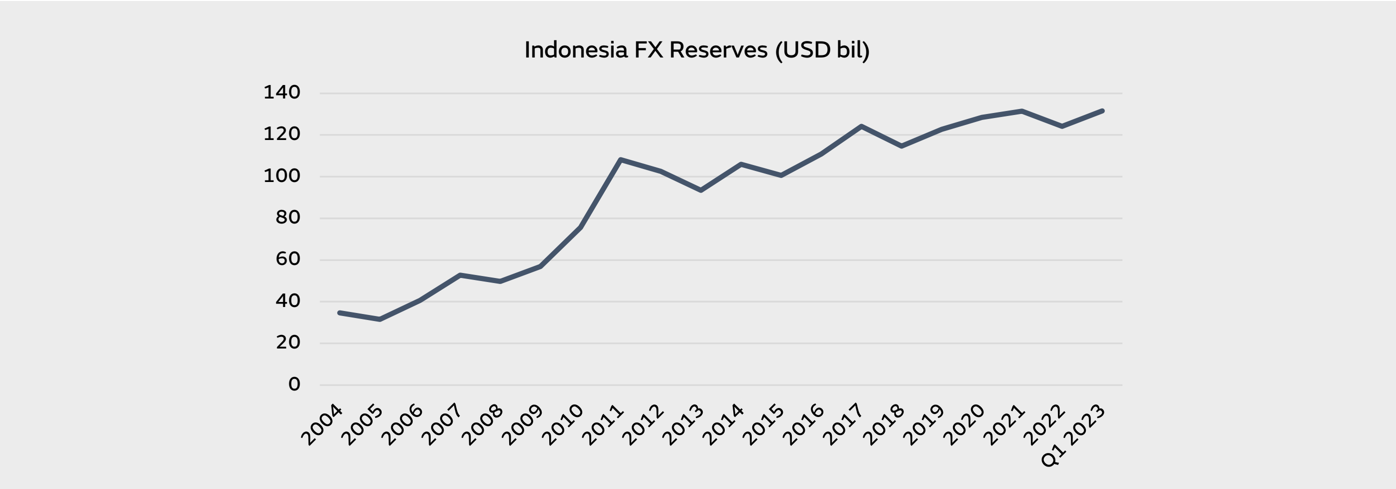
Indonesia's key indicators on a positive trend driven by increased productivity and sound economic management relative to history

↓

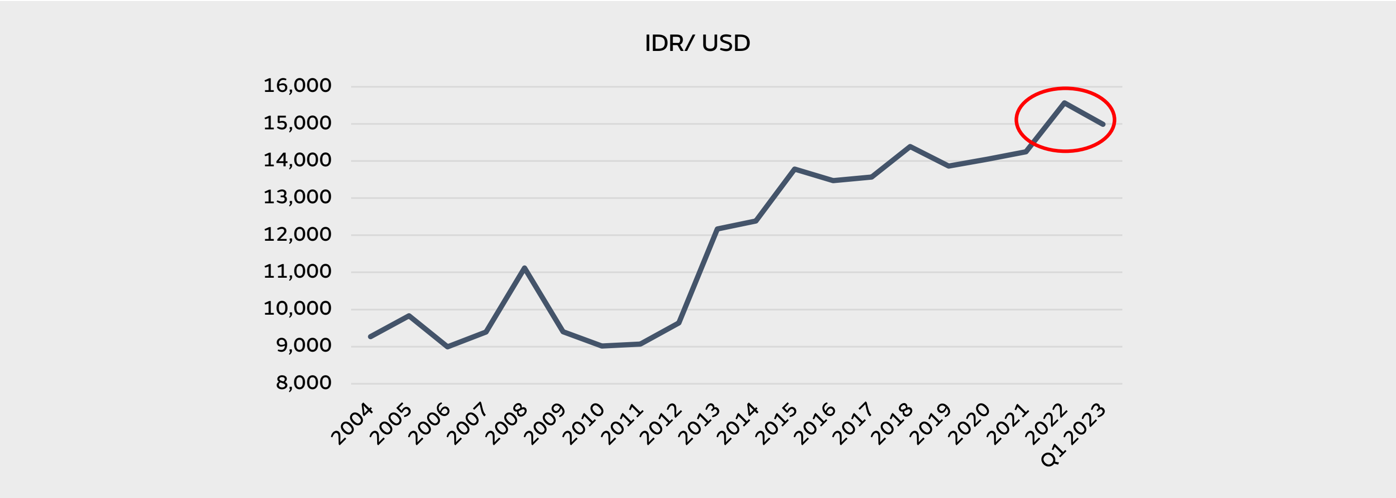
Improving Debt to GDP, highest ever FX reserves, stabilising currency since pandemic years - induced volatility



Source: IIF; Macquarie Research (May 2023)



Source: IMF; GIB AM

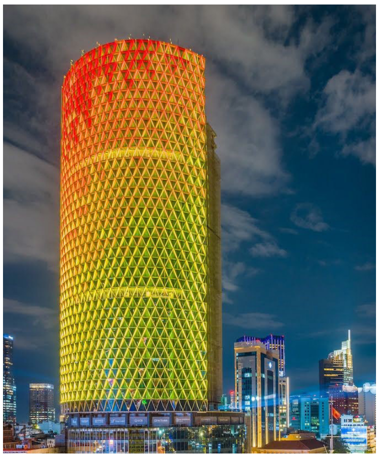


Source: Bloomberg; GIBAM

Vietnam

After three days of meetings in Indonesia and Singapore, we visited the best performing economy in Asia in 2022 in terms of GDP growth (8%) despite rising interest rates and weakening global demand. It does not take long for one to realise how Ho Chi Minh has changed in the last decade. Organized in a much-disorganized way, the chaotic Duongs of traffic across all directions just work. Along the way, we marvelled at the ironic contrast of a well-polished city skyscraper on one half, with more improvements clearly needed on the other half.

Regardless, well endowed with a young population and highly skilled workforce, Vietnam is positively placed to gain from the reconfiguration of global value chain amidst its transformation into a relevant manufacturing powerhouse. Taking a constructive view of the country's macro stability, continued momentum of urbanization and booming IT sectors, we are invested in one of the most innovative technology companies in Vietnam that is also fast becoming a global player.



2 sides of the same building – incomplete construction back vs completed and flashy front

Walking the ground

Our Emerging Markets Active Engagement strategy is anchored on investing exclusively in emerging and frontier market companies where potential change through engagement is key to the investment thesis. This often involves the identifying of unappreciated businesses with misplaced valuations. Against this background, we seek undervalued high quality companies – not because of core fundamental deficiencies, but due to deficit factors that are fixable. These are often in the form of governance, capital allocation, disclosures, approach to material environmental issues and strategic urgencies. Once alignment between key stakeholders and investors is in place, corporate decision-making becomes more straightforward with inherent incentives to unlock value through relevant enhancements. From our experience, it is the power of ideas rather than the muscle of the voting power that matters most. Just like how it has always been in Indonesia, it is the small improvements sought by the same people in the many kampungs around the country that ultimately accumulates to something meaningful. In this respect, we remain hopeful this is just the beginning for our portfolio companies and us, as embodied by the national flower of Vietnam the Lotus – commitment and optimism for the future.

Value unlock in a region where market activities are increasingly adopting new technologies and the increasing focus on sustainability

Over the course of our trip, we presented our recommendations to all portfolio companies in Indonesia and Vietnam. Our company visits typically last a few hours and involve an operational update with management teams in their offices, followed by a presentation to management and/ or board members in which we walk them through our suggestions for further value crystallisation. Our 'Engagement Value Creation' presentations showcase prior work with portfolio companies, introduce a number of steps we believe can unlock signification shareholder value, outline the likely impact they can have on the businesses' return profile and introduce comparisons or case studies with peers companies globally to better illustrate the suggestions. We have always stood by the commitment that we fly the same flag as our portfolio companies. In return, we have been impressed and comforted by the high quality meetings with all of the portfolio companies' management teams, especially so in terms of their openness and receptiveness to discuss, debate and define clarity.

In total, our trip covered 26 Action Points which focus on the two key outcomes discussed earlier: (i) improving businesses' compounding power, and (ii) reducing their market implied cost of capital. Levers to achieve these outcomes range widely, including introducing measures to enhance Governance, improving Strategic Capital Allocation, building operational effectiveness, drafting Disclosure & Investor Relations, and introducing our material Sustainability framework to each company. A combination of higher incremental returns alongside a lower implied cost of capital will drive higher Economic Value Added (EVA), and in turn justify a valuation multiple re-rating.

1. Compounding power: Value unlock through protecting and improving free cash flow profile

In the first pillar of engagement, we typically work with portfolio companies in enhancing their compounding power via the establishment of a pathway to higher Return on Invested Capital (ROIC). This usually hinges on suggestions addressing strategic capital allocation, review/ reassessing reinvestment strategy and operational improvements programmes. A clear capital allocation strategy that balances the priorities of reinvestment and capital efficiency helps drive further upside. All companies presented good opportunities for value unlock via better capital allocation and the alignment of incentives to those that matter most.

For one of the largest banks in Indonesia with a long-standing history aligned with the nation's independence, the market needs convincing that the current new management team is committed to Return on Equity (ROE) optimization. Overcoming the ghost from the past of slower lending growth against the system credit growth can be achieved via ambitious but calculated loan growth trajectory with any optimization of the loan book composition. To that, we suggested a further acceleration in the proactive drive to seek efficiencies in the balance sheet and capital ratios via higher loan/deposit ratios. As ROEs improve beyond 15%, growth can be funded internally, in turn driving higher valuation multiple and driving further upside. In addition, we proposed the formation of a robust long-term share incentive plan to the value creators of the company via an update of incentive programmes. In the near term, an aspect we have identified is in the transformation of the Digital optionality into a more tangible equity story.

In the case of the diversified food company with market leadership at home in Indonesia looking to replicate the same success internationally, the market is sceptical about its global ambitions. Despite the strength of the international business acquired with sufficient track record, concerns range from i) the lack of awareness and unfamiliarity of the evolving opportunities of the recently acquired international business to ii) the precedent set for compounding businesses globally to destroy value via diminishing ROIC remain an overhang.

Against this backdrop, we suggested how a well communicated five-year capital allocation vision of capacity expansion plans and debt repayment programme in line with their global ambition will bolster the market's confidence that the Board and Management are thoughtful in driving long-term shareholder value. When investors remain confident that ROIC is protected, a positive valuation re-rating should naturally follow since compounding power is maintained.

A portfolio holding in one of the largest technology companies in Vietnam with significant market share in each of its operating areas is becoming an emerging global dominant player powered by a structurally growing market. The company's success in the form of strong financial stewardship with an attractive business model has resulted in a strong balance sheet today, which however is dampened by high cash balance (~20% of market cap) that is a drag on its Return on Equity (ROE). To that, we proposed the articulation of a wider Capital Allocation vision with a focus on i) formalized progressive dividend policy (50%+), ii) opportunistic buybacks (to incentivise and enhance talent retention programme) and iii) roadmap of accretive M&A (incorporating IRR hurdles, inorganic strategic priorities). Alongside this proposal, we suggested for the management to consider a more robust long term ESOP plan that will further align the interests of all shareholders and management by linking a wider ESOP award to business model diversification targets that are integrated in the Capital Allocation vision.

2. Cost of capital: Levers to reduce implied cost of capital through improved perception and lower risk

The second pillar of value unlock engagement entails the lowering of market implied cost of capital, which typically will help command a higher justified valuation multiple of portfolio companies. Here, we focus on the integration of our material Sustainability framework and enhancing disclosure and reporting standards. While these may seem superficial to the more perceptive investors, such improvements are material in the emerging markets. Local language reporting, absent IR and inadequate disclosures are glaring untapped opportunities for further value unlock.

To be fair, all companies we met have made good progress in each of their Sustainability framework and were able to articulate sound sustainability practices which they have incorporated to their respective core operations. These companies all appreciate the benefits of staying on the right side of being sustainable in the longer term – better operational efficiency and sustainability, good risk management and lower cost of capital. Pleasingly, one portfolio company in Indonesia has taken our suggestions from a year ago with their inaugural Sustainability report published and first appointment of female board member in 2022 – this represents progress in a market not known for gender diversity.

Rising Awareness of Sustainability

Summary of responses to "To what extent would a company's ESG actions influence your behaviour to purchase a product or service from the company?"

	Global	US	Germany	Indonesia	Philippines	Vietnam	Malaysia	Thailand	China	Singapore	South Korea	Hong Kong
Environmental	30%	29%	20%	33%	38%	46%	38%	30%	34%	21%	28%	23%
Social	40%	39%	32%	43%	52%	51%	49%	42%	43%	31%	34%	32%
Governance	41%	35%	28%	50%	56%	59%	50%	44%	45%	32%	41%	37%

Blue shading denotes above global average

Source: PwC Global Consumer Insights Survey, June 2022

Governance matters and markets increasingly care. For both companies in Indonesia, we proposed further improvements in Board independence and diversity, conduct a peer comparison review to determine disclosure gaps for enhancements and meaningful ways to address related party transaction risks that typically concern markets. These enhancements are important as valuation multiples are most sensitive to a reduction in the cost of capital; there is a correlation between better-perceived companies from a governance perspective and a higher valuation multiple.

In two of our companies in Indonesia, we highlighted the importance of adequate disclosure to fully engage the market. Citing successful examples from companies we have worked with, we proposed organizing an on-site Capital Markets Day to i) showcase and demonstrate strategic and financial roadmap of transformation, ii) quantify impact, and iii) link milestone KPIs to incentives for value creators.

Current sustainability standing still offers an opportunity for change. While all companies have made commendable Sustainability commitment and progress, efforts are not widely appreciated. To that, we suggested the improvement of disclosure and progress to better showcase these efforts to attract incremental sustainability aligned investors via proactive and timely update of Sustainability platforms and rating agencies.

At the end of the day, it is about addressing any misconception and helping investors get over the line to build their investment case in each of these companies.

Looking ahead

"None of us can change our yesterdays, but all of us can change our tomorrows" – Colin Powell

A promising start but still far from perfect, we still see many opportunities in all our portfolio companies for further value unlock via engagement.

As the world embarks on a path of recovery after two pause years of pandemic, the quality of growth will be different given the varied nature of the emerging market economies. Nevertheless, it will not be long before investors take note of Southeast Asia's structural strengths – demographic dividend, low digital and credit penetration and attractive valuations relative to history.