The Coming Boom in Infrastructure

Driven by a boom in the natural resources sector and irresistible international economic forces, Indonesia is finally on the verge of a boom in infrastructure.

by Thomas W. Shreve

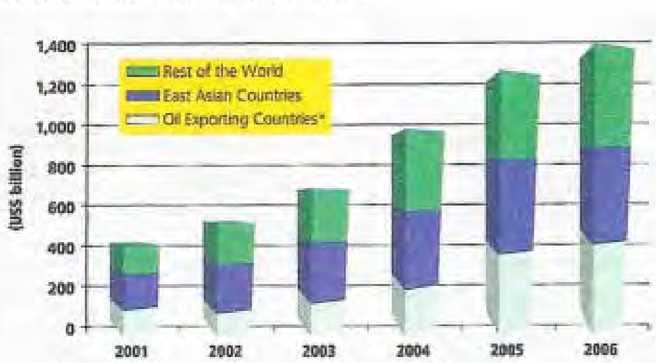
After numerous false starts and disappointments, the stars are aligned and greater activity in the sector is finally at hand.

The Indonesian Government estimates a need for US$22 billion of spending on basic infrastructure per year. This figure relies too heavily on the private sector and foreign aid, and will not be achieved. Yet the need for infrastructure is actually far greater than this. There is a huge amount of catch-up expenditures that are desperately needed immediately to improve the competitiveness of Indonesia's economy.

Forward progress on the principal policy impediments to infrastructure development is slow, but perceptible. However, policy is not as important as the policymakers would like to believe. Regardless of regulatory reform and legal infrastructure, the largest determinants of investment are the market forces that govern the movement of capital.

Huge profits and surpluses are being generated in East Asia and in oil-exporting countries as a result of both higher commodities prices and generally favorable worldwide conditions for economic development. In 2006, the amount of excess capital generated in these countries was US$930 billion. These profits were mostly invested in developed markets.

NET CAPITAL OUTFLOWS FROM COUNTRIES WITH CURRENT ACCOUNT SURPLUSES



** Including Indonesia* *Source: McKinsey Global Institute 2008*

While its performance is not as astonishing as that of China or Dubai, Indonesia is among the countries with large surpluses. Indonesia generated about US$10 billion in current account surpluses in each of 2006 and 2007 – in fact, it has generated a current account surplus in every year since 1998. Foreign exchange reserves have increased from US$34.6 billion at the end of 2005 to US$58.9 billion at March 31, 2008, including a US$1.85 billion increase in forex reserves in March alone.

Those responsible for deploying and safeguarding international capital surpluses are currently devising better strategies for the use of this money. East Asian and Middle Eastern industrialists and fund managers want Indonesia exposure because of its wealth of natural resources, and they want long-term as well as short-term investments.

At the same time, developed market investments have become less attractive. The beginning of the end of complacency with the major markets can probably be traced to 9/11. Subsequently, the US dollar began its long decline, wiping out returns on many US dollar-denominated financial assets.

The current phase in this process is the subprime mortgage crisis. We do not think this episode creates any greater danger of a crash than did 9/11, US dollar devaluation, or skyrocketing crude oil prices. Rather, it is just spurring the continued reduction, at a measured pace, in the dependency on developed country financial markets. But for a neglected market like Indonesia, even a small movement in this gigantic pool of capital can have dramatic effects.

As assets are diversified, the search for better yields will attract capital to Indonesia. While growth potential has proven to be greater in China and India than in Indonesia, Indonesia's lagging performance has led to greater potential for value appreciation. For example, Grade A Jakarta office rents average about US$12 per m2 per month, according to Cushman & Wakefield, compared to US$40 in Ho Chi Minh, US$53 in Shanghai and US$108 in Mumbai. Property values correlate strongly with rental rates.

In infrastructure projects, Indonesia's difficulties in making itself investor-friendly will actually result in increased returns for those who persevere. Competition for projects is less, and the price appreciation in infrastructure assets generally, evidenced by dramatically increased selling prices in privatization transactions around the world, has not yet occurred in Indonesia.

Does this mean the Indonesian Government will be paying too much for private financing of infrastructure? Definitely. But while this is a challenge for the Government, it is an opportunity for investors. With a wide range of projects available, investors must choose their projects carefully based on complete information, and work actively to minimize the risks which have led to reduced competition for deals.

To take advantage of the current favorable environment for infrastructure investment, while short-circuiting some of the issues that have scared off investors, the Government should sell off, or invite private sector participation in, operating infrastructure assets. Existing assets are easier to finance and will receive a much more enthusiastic reception from investors. In the current environment, private sector interests will happily cover the long-term financing costs of infrastructure if the development and construction risks have been removed, and income generation can begin immediately.

The Government should therefore apply a share of its limited infrastructure budget to building infrastructure projects for immediate sale to the market. As long as the sale proceeds can be earmarked for further infrastructure development, this will serve to multiply the Government's infrastructure budget. The sale of a new toll road or power plant will not only supply a budget to finance the next project, it will actually generate a profit as against the development cost incurred by the Government.

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Infrastructure Finance & Investment

Thomas W. Shreve, President Director of Glendale Partners presented his view about "Infrastructure Finance & Investment", which was held on March 27th, 2008 at the Financial Club Jakarta. The meeting was well attended by 40 prominent businessmen.

Present at the meeting among others were Giuseppe Nicolosi (Ernst & Young), Mark Wong (SingCham), Scott Younger (Glendale Partners), Mariko Asmara (JAC Indonesia), Peter Fanning (International Chamber of Commerce), John Lummis (BEI), Denny Suryo (Telkom Indonesia) and Mike Nicholson (Shields Security Solution).

Thomas W. Shreve, President Director of Glendale Partners.