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INDONESIAN STATE FIRMS ROAD TEST NEW FINANCING METHODS

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A cut in government funding is causing Indonesian state-owned developers to seek private capital through asset sales and securitisation, as Mirzaan Jamwal reports.

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After a painstakingly slow start, President Joko Widodo's ambitious IDR 4,796trn (USD 360bn) infrastructure program is gaining momentum. In May, over 40% of the 225 national strategic projects had entered construction.

These priority projects include highways, railways, airport revitalization works and construction of four new airports, which are part of a larger plan for infrastructure development over 2015-2019.

The government has used its own and state-owned enterprises' (SOE) balance sheets to speed up infrastructure development over the last few years, effectively putting projects out of the private sector's reach.

Infrastructure spending rose over 2014 and 2015 but since last year the economy has not been growing as fast as expected. "That has impacted the government's ability to fund projects that they have already started," says Jakarta-based Tusk Advisory's Managing Director Raj Kannan.

SOEs that could previously rely on the national budget to fund projects are now seeking alternatives for financing projects. Toll road developers and operators, Jasa Marga and Waskita Karya, have taken steps towards selling equity stakes and securitising assets. A subsidiary of state utility PLN is also seeking to raise capital through securitisation of revenue from an operational power plant.

The Widodo administration has realised the limitations of the state-funded model, says Indonesia Infrastructure Finance's (IIF) President and CEO Ari Soerono. He expects a "wave" of securitisations and asset sales within the next year.

> *Some of these SOEs are really struggling to fund the projects, Easy Arisarwindha, senior investment manager, Saratoga Capital.*

"Some of these SOEs are really struggling to fund the projects" says Easy Arisarwindha, senior investment manager at Saratoga Capital. "Putting 30% equity into each of their projects is going to take a huge amount of capital, which is why the President said that SOEs need to sell the assets they are currently holding if it is operating."

The government intends for SOEs to recycle capital from toll roads, power plants, airports and ports to deploy into new infrastructure. President Widodo has also urged SOE subsidiaries to go public to raise funding for infrastructure projects.

"Over the last 24 months we are beginning to see a revision of policies on how to scale the financing and investment for infrastructure", says Edward Gustely, managing director of Penida Capital Advisors.

The government started off using the PPP structure as an adjunct to what the state budget could provide. In Indonesia, 99% of the infra projects are greenfield so the challenge has been how to get the typical institutional investors engaged in infrastructure which is not operational yet.

"We're now at the cusp of the government looking at what is in its inventory of existing infrastructure assets which are cash flow positive that they can sell down to investors and operators, recycle the capital to underwrite its SOEs that they are utilising to build out new infrastructure", Gustely adds.

Indonesia is hoping to attract foreign institutional investors following Standard & Poor's upgrade of its credit rating to investment grade in May. The country is now rated investment grade by all three major rating agencies for the first time in almost 20 years.

Kannan says the upgrade is reflected in growing interest from investors. "We are aware of some of institutional investors, particularly from Japan, who were not able to invest in Indonesia in the past and now are now free to invest in the country."

The government has been in talks with Canadian and Japanese pensions and other long-term investors regarding investment into SOE-built projects, sources said.

Divestment

Jasa Marga and Waskita Karya have been among the first SOEs to announce divestment plans for their toll roads.

The roads sector has seen a number of projects take off after the government's National Middle Term Plan 2015-2019 (RPJMN) set a target to add 1,000km toll roads.

As Indonesia's biggest toll road operator, Jasa Marga manages 593km of toll roads in the country. To support the government's agenda, its management aims to add around 667km of new toll roads to reach close to 1,260km at the end of 2019.

However, analysts say financing remains a major hurdle for the company. A rough calculation shows the company could deploy around IDR 65trn in total capex for 15 new projects, which is higher than the company's FY16 total assets (IDR 54trn). For FY17, management expects to spend roughly IDR26tr.

For this year, Jasa Marga plans to increase its cash assets through selling its 19% stake in the Kebon Jeruk-Penjaringan section of the Jakarta Outer Ring Road (JORR) W1 and sell 10-15% of its 74% stake in subsidiary Trans Marga Jateng which owns the Semarang-Solo toll road.

BCA Sekuritas analysts value the two toll road sections at IDR 7.3trn and estimate the developer may be able to generate around IDR 1trn fresh money from these transactions.

Investment in toll road projects has become construction company Waskita Karya's key growth driver. It has gone from having less than a 100kms of toll roads three years ago to concessions covering a network of 800km.

Its road developer and operator subsidiary, Waskita Toll Road (WTR), is working on 14 toll projects all at the same time including several sections of the trans-Java toll road linking Jakarta and Surabaya which is due for completion in 2018-2019. WTR's highways cover 760km and require IDR 115.5trn to build.
Waskita plans to sell a minority stake in WTR to raise equity for these projects and the deal has attracted interest from international strategics as well as Indonesian private investors, sources said.

In February, Waskita sold a 29% stake in the road developer to state-owned infrastructure financing company Sarana Multi Infrastruktur (SMI) and government pension Dana Tabungan Dan Asuransi Pegawai Negeri (TASPEN). It raised IDR 3.5tr at around 1.5 times the price to book value.

The transaction was a "breakthrough" that marked the first equity deal for a local pension as an alternative to state funding for SOEs, according to Ratih Nawangsari, partner at Ashurst's Indonesian associate law firm at Oentoeng Suria & Partners.

She advised SMI and TASPEN, who were instructed by the government to invest in projects owned by other SOEs.

Investors

While the state has started to encourage local institutional investors to invest in infrastructure assets, a dearth of capital available from Indonesian pension funds and insurance companies means the sector needs foreign investors, says Adelia Pratiwi, an official at Indonesia's Ministry of Finance.
However, the SOEs are loath to sell 100% ownership of their assets and industry sources say not many private investors may be willing to partner with SOEs because of non-financial risks and governance concerns.

One of the challenges for SOEs is that there is essentially a two tier reporting system, Gustely notes. If you're state owned, you are accountable to Parliament, to the Ministry of SOEs and the Ministry of Finance who is the ultimate shareholder on behalf of the taxpayers.

> *The process could lead to secondary sales as local financial investors sell down the assets to foreign investors as the market matures, Indonesia Infrastructure Finance's (IIF) President and CEO Ari Soerono*

"That creates some cumbrance in the governance aspects", he says. SOEs want to act as commercial and independent as they possibly can with their peers in the private sector but they are always stuck between wanting to do the things they know they need to do and seeking permission from the government to do those things. The result can often be a bureaucratic quagmire.

International investors are also waiting to see what assurances they have that there is not going to be regulation that subsequently changes the rules and asks the private sector to divest, Gustely adds.

If foreign capital does not participate then Gustely expects that the go-to capital will be state owned pensions, state owned insurance funds putting their capital to work to kick start the process. "The government will learn from that and see what are their concerns and issues are and address it domestically first before trying to go out to the external market."

The process could lead to secondary sales as local financial investors sell down the assets to foreign investors as the market matures, IIF's Soerono adds.

Securitisation

The government is encouraging the use of new debt instruments that are tradeable in the market for institutional investors who are wary of buying into illiquid investments.

The Financial Services Authority of Indonesia (OJK) in November allowed pension and insurance firms to invest half of the minimum 30% of their assets they have to allocate to government bonds in infrastructure bonds issued by SOEs.

Work is underway to devise securitisation products and project bonds to accelerate financing. Pratiwi says the government is also considering how to debottleneck some structural issues, for example hedging tools to mitigate FX currency risk.

There is capacity for SOEs to raise approximately IDR 1.015trn (USD 75bn) in debt, according to government data.

Since greenfield projects are high risk, Pratiwi says asset backed securitisation (ABS) can be used to monetise existing assets and use the proceeds for construction of new infrastructure. “The ownership is still with the SOE but the right to collect part of the revenue is transferred to the investor holding the ABS instrument.”

The ABS will typically have two tranches. The senior tranche is the one being rated and offered publicly to investors. OJK regulation requires the senior tranche to be 90% from total, Pratiwi says. First loss will be taken by junior tranches and a government guarantee or insurance can also be provided as cushion for the first lost coverage so the ABS quality can increase, she adds.

Jasa Marga has begun working to securitize about half of the IDR 4trn in revenue expected over five years from the Jagorawi toll road linking Jakarta to cities in West Java province.

State electricity firm PLN’s subsidiary Indonesia Power will issue securities backed by the projected five-year income of IDR 10trn from the Suralaya power plant and use the proceeds for a capacity expansion project.

The transaction is waiting for final confirmation on tax treatment by the Directorate General of Taxes before being offered to public expectedly this year. Indonesia still needs a clear legal framework for the ABS market’s tax regulation, Pratiwi adds.

The Ministry of Finance is analysing options for a market maker for corporate bonds and ABS instruments to deal with liquidity concerns, and whether they can do a repo market, Pratiwi says.

Limited Concession Scheme

Tusk’s Kannan says the firm is working with the government to introduce recycling of operating assets through a limited concession scheme (LCS).

The scheme is at the concept stage and Tusk recommends the government starts with an airport as a pilot project.

Under a LCS, the private sector would pay the government upfront for the right to take over, expand and run operating assets such as airports, ports or transmission lines for an agreed period. The concession fee paid to the government can be used for infrastructure projects that are not commercially viable for the private sector.

“We recognise there will be an impact on the SOE which is currently operating these assets and they could be compensated from the funds received upfront by the government. Plus they will continue to own some equity in the asset.”

He emphasises that SOEs are capable but lack funding and human resources, gaps which he believes could readily be filled by the private sector.

The optimal way forward may be for Indonesia to put together a framework that builds an ecosystem of funding structures. In the next 24 months, major projects will come online and “so when this plethora of state-sponsored assets do have that five to 10 year cash flow history they can be recycled,” Gustely says.