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China's investment foray into Indonesia

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Written by Gavin Bowring

Sinochem and ZTE Energy, an agribusiness arm of the Shenzhen-based telecoms manufacturer, both bid for 150,000 hectares of palm-oil plantations in 2012, but were promptly rejected.

Gandaria City is the largest retail mall amid the growing high rises of south Jakarta, but for many years it stood as a half-finished skeleton. Its Indonesian-Chinese developer, Pakuwon Group, racked up huge debts during the Asian Financial Crisis of 1997 and was unable to complete the project.

Yet soon after making forays into China during the mid-2000s, the firm suddenly found itself in a position to finish the massive complex - supported, it is widely believed, by deep-pocketed Chinese investors. Such informal flows of money into Indonesian property, as well as natural resources, agriculture, retail and trading businesses, underpin China's economic clout in Southeast Asia's largest economy.

Gandaria City shows how Chinese investment has benefited Indonesia. But at a more macro level, many ambitious Chinese investment promises never materialize or disappoint in delivery. In part this is due to the two countries' sharply contrasting legal frameworks and a mutual lack of familiarity: having only re-established diplomatic relations in 1990, distrust still lingers below the surface. More important, the relationship lacks strong foundations. There is little integration of manufacturing supply chains and, apart from oil and gas, most Chinese investment is limited to short-term resource deals or equipment contracting. Unless Chinese companies establish deeper roots in Indonesia, China's influence there is likely to wane as international competition heats up, notably from a rejuvenated Japan.

The lure of the tropics

When the Asian financial crisis brought economic turmoil to Indonesia in 1997, most foreign investors fled - except for Chinese companies, which won infrastructure tenders on a wave of cheap financing. Under Indonesia's chaotic transition from dictatorship to democracy, independence was granted to nearly 500 sub-regional governments. Local governors sought to exploit resource-rich lands by issuing lucrative mining and land-use licenses to Chinese investors. As commodity demand started to take off, Chinese companies entered in droves. The numbers mushroomed in 2009-10, when laws on foreign ownership were relaxed.

By 2011, Indonesia had issued over 10,000 mining licenses, compared to 500 just a decade earlier. Since the late 1990s, Chinese investments have grown in both size and scope. They run the gamut from transport to finance, shipping to light manufacturing (mainly textiles and air-conditioners). There have been some genuine success stories?notably Huawei, which manages a large chunk of Indonesia's telecoms market in a partnership with mobile operator XL Axiata; Haier, which acquired Sanyo's Indonesian household goods businesses in 2012; and China Harbor Engineering, which built Indonesia's longest bridge, linking the islands of Java and Madura.

Still, the focus of China's economic interest in Indonesia remains skewed heavily towards raw materials extraction and power-plant contracting.

Over the past decade, state-owned power companies China Huadian, Dongfang Electric and Sinohydro won major contracts to build coal-fired power stations and hydro plants. China Power International (CPI) and China International Corporation (CIC), China's sovereign wealth fund, were given significant stakes in coal mines in turn. Yet many investments have disappointed. Take the Cilacap plant in south Java, built by China Huadian and Shanghai Electric, which opened two years late, operates at 60-70 percent capacity, and requires frequent maintenance. Critics accuse Chinese companies of importing thousands of Chinese workers to build plants, and blame their poor management for faulty machinery.

Tensions over Chinese resource acquisitions and have spilled over into the central government, notably over China's reluctance to revise a major natural gas delivery contract. In 2002, BPMigas, then Indonesia's oil and gas regulator, signed a deal with China National Offshore Oil Corp (Cnooc) to deliver an annual 2.6 million tonnes of liquefied natural gas from Papua's Tangguh field to Fujian. The deal was based on a global oil price of US$25 a barrel, but when delivery began in 2009 the oil price had risen above US$100. Cnooc refused to renegotiate the price with BPMigas, partly in a tit-for-tat response to Indonesian complaints about faulty Chinese machinery in other projects. This was a major contributing factor to the decision by Indonesia's Constitutional Court to dissolve BPMigas and hand over its responsibilities to the energy ministry.

Greasing oily palms

Opposition to the infrastructure-for-resources model extends far beyond minerals. In 2005, President Yudhoyono announced the "Kalimantan Border Palm Oil Megaproject," a 1.8 million hectare plan that would destroy extensive areas of forest along the Malaysian border. Under the plan, several Chinese companies including state-owned investment company Citic Group was to acquire one-third of the area in return for building roads and railways. But critics viewed Kalimantan as a crony deal to clear land for lucrative timber, and popular opposition forced the government to scrap the project. The Chinese companies involved became tarred with the brush of corruption.

Since then, a number of other investments in Indonesian agriculture have never materialized, including Cnooc's US$5.5 billion plan to convert 1 million hectares of land in West Kalimantan into palm oil and biodiesel facilities.

Other firms have had to scale down their ambition. One is China Sonangol, a controversial Hong Kong-Angolan oil dealer with murky links to the Chinese state. Seeking new markets outside Africa, it tried - and failed - to use its political connections to get a foothold in large integrated mining and infrastructure projects in Sumatra. Instead it settled for a modest stake in the Cepu oil block, one of Indonesia's most promising recent oil discoveries, and a chunk of Jakarta real estate. That was not such a bad outcome, but it was much less than China Sonangal had hoped for. In addition, many ambitious Chinese railway investments in Sumatra and Kalimantan have failed to materialize.

Many resource-based investments by China's state-owned enterprises (SOEs) have been scuppered by unrealistic targets or political backlash. Yet an even bigger obstacle for all Chinese firms is their inability to get to grips with Indonesia's institutions. Indonesia's legal framework is highly arbitrary and convoluted?allowing contrasting interpretations at central, provincial and sub-provincial levels, and between Dutch civil, Islamic shariah and traditional adat law. Social, ethnic and religious tensions add further complexity in Indonesia's resource-rich hinterlands.

Chinese companies have found that investment security is not guaranteed, and that contracts are often renegotiated or cancelled whenever a governor is replaced. Under Indonesian law, a regional authority can revoke a mining license even if it is at fault for any mismanagement! Legal uncertainties are responsible for a long list of failed investment pledges. Constant changes to regulations in mining and and other resource industries have deterred would-be investors. Between 2005 and 2010, scores of Chinese provincial government delegations signed agreements directly with local governments, yet they have little to show for it.

"Part of the problem is that, because China's investments in Indonesia are often highly opportunistic, many companies rely on brokering deals with the government through their links with Indonesian Chinese businessmen," says Julian Hill, a consultant at Deloitte. "Chinese companies often believe these middlemen can help them weave through Indonesia's bureaucratic web, but in fact they wield much less real political power than counterparts elsewhere in Southeast Asia."

Where's the cash?

Yet a handful of other companies have had more success. Petrochemicals conglomerate Sinochem, which claims to be the largest direct supplier of Indonesian rubber to China, owns huge plantations across the country. Even smaller Chinese agribusinesses such as Mazhongdu International and Hainan Baisha own tens of thousands of hectares. Nor have Chinese SOEs scaled back their ambitions to win infrastructure tenders. Sinohydro is repowering dams in West Java; Gezhouba Group, China Huadian and its subsidiaries as well as China Power International are still pushing ahead with various coal and hydro power plants; and Shanghai Construction and China Harbor Engineering are building toll roads in Java with financing from state policy lender China Eximbank.

There is no shortage of ambitious infrastructure plans. China Harbor Engineering and China Railway Construction want to build railway systems, including a Jakarta airport express train and a double track railway from Jakarta to Solo. Chinese companies are still actively bidding for a US$3 billion Central Kalimantan coal railway. In Sumatra, China Development Bank (CDB) wants to finance a US$1.3 billion, 300-km coal railway line and a US$1.5 billion, 1,200MW coal-powered plant.

Most ambitious of all is China Railway Construction's plan to build a US$11 billion suspension bridge connecting the main islands of Java and Sumatra.

The biggest issue for these projects is financing. The cost of capital in China is rising, and most Chinese lenders now refuse to lend to Indonesian projects that do not come with some form of sovereign guarantee. Yet a large chunk of Indonesia's US$100 billion of foreign exchange reserves is already being used as collateral for existing projects. And neither Chinese lenders nor Indonesia's Ministry of Finance are willing to assume increased levels of financial risk.

As Chinese lenders reduce their exposure to non-sovereign-backed projects, opportunities are growing for international competitors. Japanese and South Korean companies have re-entered Indonesia, competing in a wide range of construction tenders under the Indonesian government's "Master plan for Economic Development."

Japan has embarked on a multi-pronged charm offensive, in part to secure crucial gas supplies to replace its shuttered nuclear facilities. Japanese and Korean companies are often more willing than their Chinese competitors to assume operational risks in project finance schemes such as build-operate-transfer deals. And they enjoy easy access to record low costs of capital, an advantage traditionally enjoyed by Chinese state-owned players. Japan's five biggest trading houses - Mitsui, Mitsubishi, Sumitomo, Marubeni and Itochu - already have more than US$9 billion in current Indonesian lending exposure. This is continuing to grow rapidly, with Itochu developing major geothermal and coal power plants in Java and Sumatra, while Mitsui recently bagged a contract to expand Indonesia's largest port.

Japanese lending institutions are committed to financing a wide range of projects, such as the Jakarta monorail and a Jakarta-Bandung express train. And small Japanese manufacturers are flocking to Jakarta's industrial estates.

Uncertain times ahead

Looking ahead, Chinese investment in Indonesia will shift away from coal mining and palm oil. Sinochem and ZTE Energy, an agribusiness arm of the Shenzhen-based telecoms manufacturer, both bid for 150,000 hectares of palm-oil plantations in 2012, but were promptly rejected. Indonesia plans to restrict new plantations to a maximum 100,000 hectares and extend forest moratoriums.

Oil and gas look a better bet. China is a significant player in Indonesia: CNPC is its seventh largest oil producer, Cnooc has several major oilfield stakes, and Sinopec has various exploration contracts and storage facilities. Indonesia's existing oilfields are maturing and urgently need new investment. Finally, there is considerable

potential to boost investment in agriculture beyond palm oil. Indonesia has huge swathes of uncultivated arable land and sorely needs to increase rice production and productivity, while China is keen to supplement its own diminishing reserve of farmland.

If Indonesia's leaders have their way, they will steer foreign investment away from resources and into manufacturing. Unfortunately for them, most Chinese companies view Indonesia as an export market rather than as a competitive production base. Passengers on planes from China to Indonesia are filled with small traders from Guangdong and Anhui carrying boxes of basic consumer goods destined for markets in Jakarta or Surabaya.

There are few integrated supply chains between China and Indonesia to compare to those with Malaysia and Singapore. Indonesia's trade deficit exceeded US$1bn during 2012, and remains at risk of widening. That would not be good for increased economic engagement.

For the moment, Chinese investors are also nervously awaiting 2014's presidential elections. Some worry that potential frontrunner Prabowo Subianto?a son-in-law of President Suharto, who is known for his strong nationalist sentiments?harbors a deep anti-Chinese grudge. Rumor has that he was complicit in 1997 riots which targeted the local Chinese community, killing hundreds. These fears may well be exaggerated, but it would not be hard for politicians to exploit Indonesia's undercurrent of economic nationalism and sensitivity over the trade balance. Until these political uncertainties are resolved, many Chinese investments will remain off the table.

(This is excerpted from the China Economic Quarterly published by GaveKal Dragonomics, a financial services firm for institutional investors and high net worth individuals)

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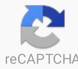

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