Winners in a Down Market

A Case for Innovation

ORC International

Introduction

When company executives hear words such as “Economy declining” or “Market slow down”, there is the inevitable move to tighten belts and weather the upcoming storms. Discretionary spend is reduced or altogether removed, and company executives scale back their grand plans of conquering markets. These market slowdowns usually last a few quarters, and once the market picks up again, company executives hope that the company’s position in the industry is where it was before the slowdown. In these chaotic times when markets pick up and slowdown with increasing frequency, and for shorter durations, there are some visionary companies who behave differently. They do not belong to the “wait and watch” brigade; they are instead actively shaking up their industries through innovative thinking and action. We often hear the excuse that innovation is for the young and/or immature industries, and might not be applicable in mature industries. We beg to differ and think that innovation is equally applicable across all industries. As Joe Tripodi, chief marketing officer of Coca-Cola, said “if you do not like change, you will like irrelevance a lot less”.

The example we have chosen for this report is from an industry that is considered to be one of the most staid and mature industries in the world – cement. Read on to discover how innovative thinking has disrupted the industry and yielded enormous benefits for a visionary company.

Global Performance 2013[1]

Positive Returns, but Mostly Driven by Developed and Frontier Markets. Most Emerging Markets Regions and Countries Displayed Negative Results.

The latest Morgan Stanley Capital International (MSCI) report displayed substantial returns in global equity markets. The flagship MSCI global index, comprised of over 8,500 large, mid and small cap securities across 23 Developed and 21 Emerging Markets showed healthy double digit returns, delivering higher returns of 19.58% in 2013 compared to 13.70% in 2012.

A number of regional and country Developed Markets (DM) delivered strong positive returns in the double digits for 2013. The World Index, for example, posted a return of 22.50%, while the top performing regional index, the North America Index, returned 26.56%. Along the same lines, the Frontier Markets (FM) produced mostly positive results, returning 20.53% over the same 2013 period.

On the other hand, majority of the regional and country Emerging Markets (EM) Indices posted negative 2013 returns, with the overall Emerging Markets Index losing 5.67%. Four Emerging Markets did show positive returns, but in the low single digits – Egypt, Taiwan, Korea, and Malaysia. All other countries yielded negative returns.

Indonesia is one of the emerging markets posting negative returns for 2013. In this report, ORC International will be focusing on the benefits of innovation during a declining market in Indonesia, the largest economy in the ASEAN cluster, and a country within the geographic coverage of ORC International Asia Pacific Strategic Research.

MSCI International Equity Indices - Country and Market Coverage 2013 YTD

Developed Markets

Americas	Europe	Pacific
Canada	Austria	Australia
United States	Belgium	Hong Kong
	Finland	Japan
	France	New Zealand
	Germany	
	Greece	
	Ireland	
	Italy	
	Netherlands	
	Norway	
	Portugal	
	Spain	
	Sweden	
	Switzerland	
	United Kingdom	

22.50*%

Emerging Markets

Americas	Europe, Middle East & Africa	Asia
Brazil	Czech Republic	China
Chile	Egypt	India
Colombia	Hungary	Indonesia
Mexico	Israel	Korea
Peru	Morocco	Malaysia
	Poland	Phillippines
	Russia	Taiwan
	South Africa	Thailand
	Turkey	

5.67%

Frontier Markets

Americas	Central & Eastern Europe & CIS	Africa	Africa	Asia
Argentina	Bulgaria	Botswana	Bahrain	Pakistan
Jamaica	Croatia	Ghana	Jordan	Sri Lanka
Trinidad & Tobago	Estonia	Kenya	Kuwait	Vietnam
	Lithuania	Mauritus	Lebanon	
	Kazakhstan	Migeria	Oman	
	Romania	Tunisia	Qatar	
	Serbia		Saudi Arabia	
	Slovenia		United Arab Emirates	
	Ukraine			

20.53%

*Based on World Index

[1] MSCI

Indonesia's Economy[2] Slowest Growth in Four Years

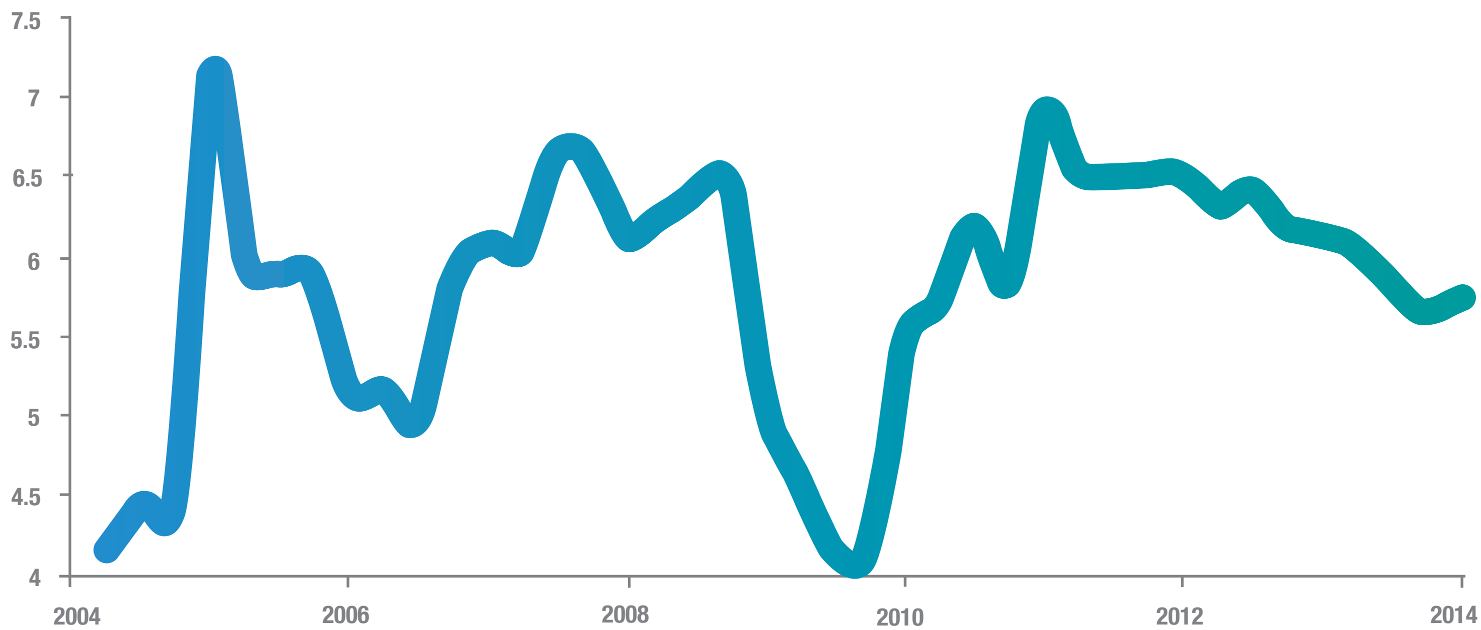
Indonesia's economy in 2013 grew at its slowest pace in four years (data from Indonesia statistics bureau) as the end of a commodities boom undermined exports, and higher interest rates dragged on consumption.

The country's gross domestic product (GDP) rose 5.78% for the year 2013, compared to 6.23% in 2012, marking the slowest growth since 2009.

Southeast Asia's biggest economy, Indonesia, had enjoyed annual growth of more than 6% in recent years, strengthened by increasing spending among its growing middle class. In 2013, domestic demand started to feel the impact of aggressive interest rate increases by the central bank aimed at easing the current account deficit and reining in inflation.

Indonesia GDP Annual Growth Rate

Percent Change in Gross Domestic Product



Source: www.tradingeconomics.com I Statistics Indonesia

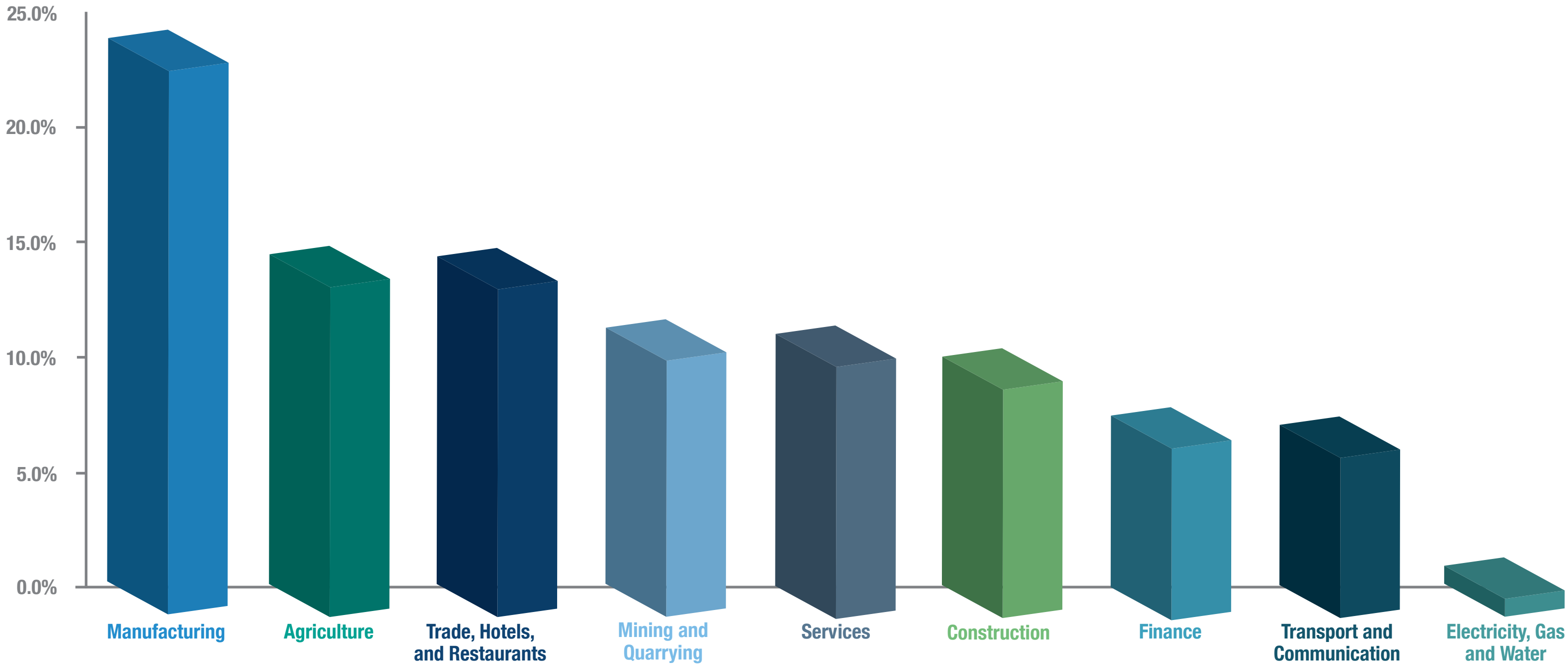
GDP Contribution by Industry[3] Predominantly Manufacturing

Broad grouping of "Industry" accounts for the largest share of GDP (47%). Within industry, the most important is manufacturing, which has been one of the main growth engines of the country (24% of total output). Mining accounts for 11%, construction for 10% and electricity, gas and water for less than 1%. Services constitute 38%

[2] Reuters article
[3] Statistics Indonesia; Tradingeconomics.com

of total GDP. Within services, the most important are: trade, hotel and restaurants (around 14% of GDP); transport and communication (7% of GDP); finance, real estate and business services (7% of GDP) and government services[4] (6%). Agriculture accounts for the remaining 15%.

Indonesia GDP Contribution by Industry (% of GDP), 2013



Source: Statistics Indonesia

Recognizing the importance of manufacturing to the economy of the country, ORC will now focus on the cement industry.

The movements in the key metrics for the cement industry are recognized as signals for other top economic indicators, including household consumption. Cement consumption is closely associated with economic growth, and is a main driver for the construction industry.

Indonesia's Cement Industry Consumption Slowing

In 2013, total Indonesian domestic cement consumption reached 58 million tons, a 5.5% increase from 2012. However, this was far below the double-digit growth rates in 2012 and 2011, as the country's economic growth slowed significantly in 2013.

Indonesia's cement sales in January 2014 declined 1% to 4.65 million metric tons from the same month in 2013 (4.68 million metric tons). The decline was partly attributed to severe flooding in selected areas in the country brought about by high rainfall during Indonesia's rainy season, and partly attributed to the slowdown in the economy.

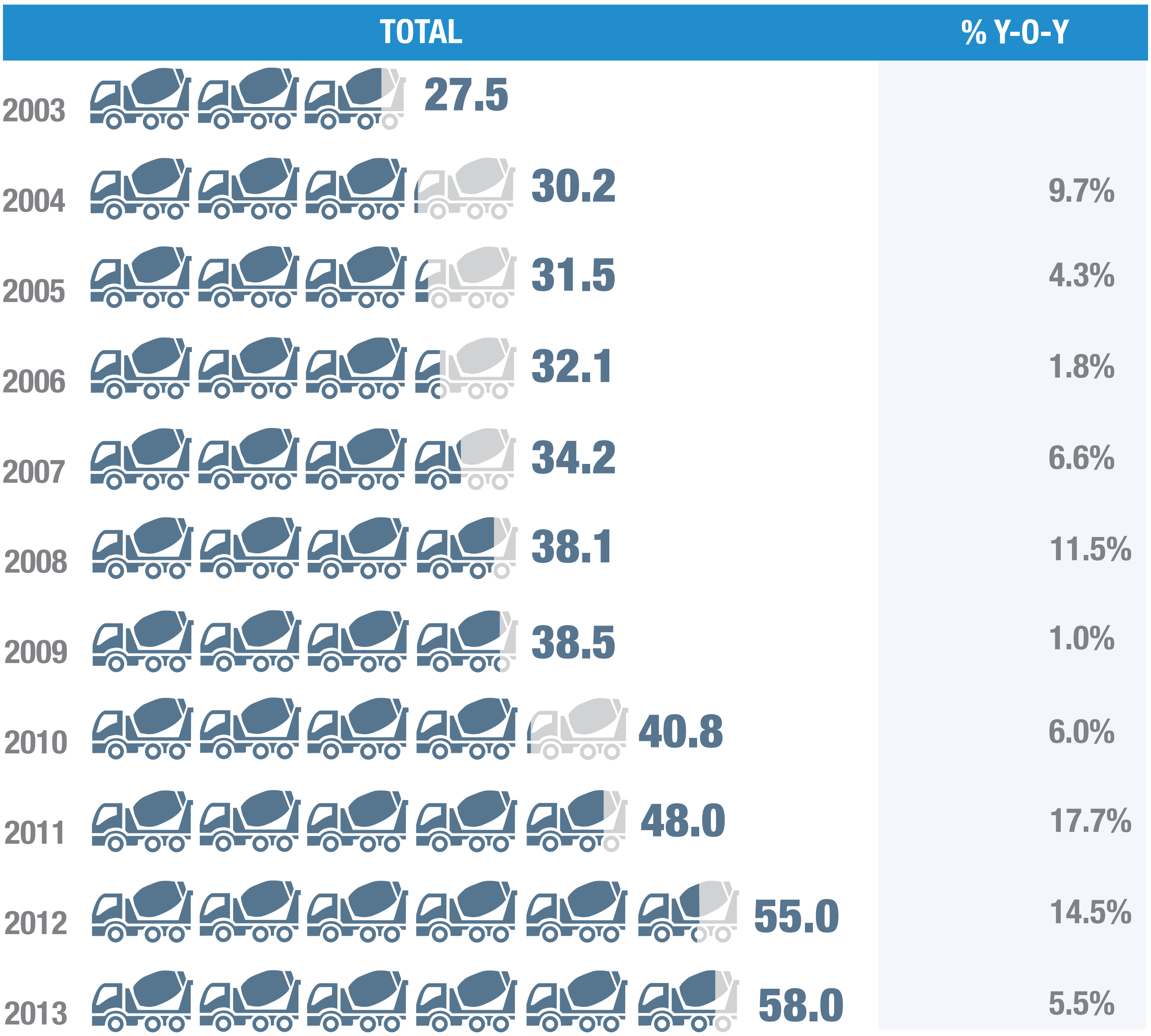
The floods caused disruptions in distribution networks, blocking cement shipments to wholesalers and retailers. In addition, these weather conditions caused delays or postponement in several construction activities, thus further reducing demand for cement.

[4] Government services in this context belongs to the 'services' expressed in the charts

According to published news reports, cement sales declined 1% in Sumatra (to one million tons) and 2% in Java (to 2.5 million tons). Together, both of these regions account for about 75% of total Indonesian cement sales in January 2014. In other regions of Indonesia, cement sales also declined except for Kalimantan and Sulawesi. Sales in Kalimantan rose 7.2% to 374 thousand tons, while in Sulawesi sales surged 21.5% to 348 thousand tons.

Domestic Cement Consumption Year to Year

(million tons)



Source: Indonesia Cement Association

Cement consumption and general economic growth are closely related - cement consumption has slowed amid a slowing economy (the country's GDP growth pace slowed from 6.23% in 2012 to 5.78% in 2013). In 2014, forecasts for growth of cement consumption suggest a slight improvement to a growth rate of 6% (to 61.5 million tons), but still far lower than 2011 and 2012 levels.

Winners in Industries with Declining Growth

There are a number of cement players in the Indonesian market, but most of the manufacturing capacity, volumes, and sales are concentrated only among a few players. The industry practices an oligarchy system where only two main players dominate most of the cement volumes.

Indonesian Cement Players and Domestic Sales

(volumes in tons) (2012)

Company	Sales (millions tons)	%
PT Semen Indonesia	21.6	37.2%
PT Indocement	17.6	30.3%
Holcim Indonesia	8.4	14.5%
PT Semen Baturaja	1.3	2.2%
Others	9.1	15.7%
Total	58.0	

Source: Indonesia Cement Association

Public companies, PT Semen Indonesia and Indocement, hold almost 70% of market share, with market leadership in terms of coverage, manufacturing capacity, and branding. Other minor players are international player Holcim, recently listed PT Semen Baturaja, PT Semen Andalas, PT Semen Bosowa and PT Semen Kupang.

Sales growth for most of the cement companies have been mostly positive year-on-year, with the exception of Holcim Indonesia (posted a decline). Growth, however, was observably more skewed towards market leader, PT Semen Indonesia, than anyone else in the market.

Second placed Indocement had negligible growth from the previous year, and lost about 2% points in market share. Other companies in the mix had moderate growth rates that were more or less at par with industry growth (~5.5%) or lower.

Domestic Sales: 2012 to 2013
(volumes in tons)

Company	Sales (million tons)	Growth Y-O-Y
PT Semen Indonesia	21.63	14.1%
PT Indocement	17.64	0.2%
Holcim	8.43	(1.4%)
PT Semen Baturaja	1.27	2.5%
PT Semen Padang	6.39	5.5%
PT LaFarge	1.92	6.8%

Source: Indonesia Cement Association; Company Annual Reports

Segmenting the Growth of Cement Players

Segmenting the Growth of Cement Players gives us an understanding on how real 'growth' was achieved

For further analysis on the growth rates of cement players in the country, the ORC International Analyst team has segmented the growth into 3 buckets (from McKinsey's Growth Decomposition Tool):

1) Industry Growth
2) Growth from Acquisitions
3) Growth from increase in Market Share Profits

If the industry grew by 5.5% from 2012, the analysis assumes that each cement company would have grown at a similar rate. Any growth that exceeds industry rate is expected to have come from internal company efforts and/or acquisitions and/or at the expense of other companies' subpar performances.

Using the above growth decomposition, a company's sales performance (or growth) can be segmented into four levels:

LEVEL 1
Growth exceeding that of the industry (> 5.5%)

LEVEL 2
Growth at par with that of the industry (~5.5%)

LEVEL 3
Growth below that of the industry (<5.5%)

LEVEL 4
Negative growth (<0%)

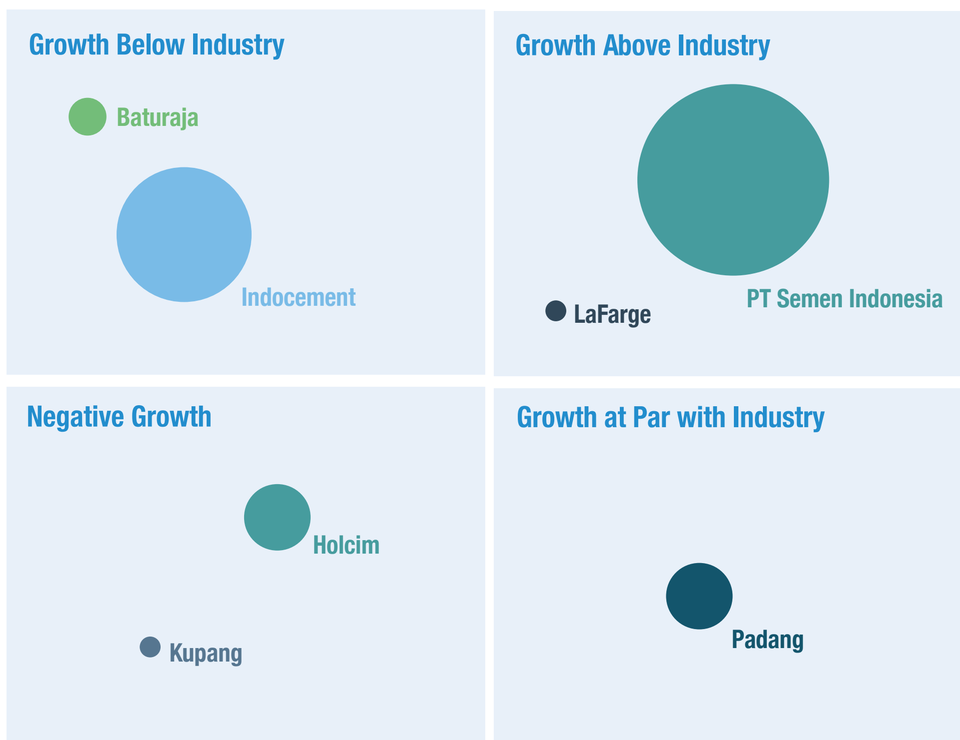
Since there were no acquisitions in the Indonesian cement market in 2013, any growth rate that surpasses industry growth is labeled as 'market share' growth.

Applying this concept to actual company performance, the growth segmentation analysis reveals each company's performance in 2013.

ORC Growth Segments

As defined by domestic sales (Y-O-Y)

* Size of the bubble denotes revenue size
Source: ORC Analysis, Company Annual Reports



Isolating the Winner

Several companies have experienced growth from the past year in-scope but isolating the true winners yielded only two – PT Semen Indonesia, carried by two of its top-performing subsidiaries (Gresik and Tonasa), and LaFarge.

Given its relative positioning in the market, as well as growth that was believed to be brought by its small base, LaFarge will be kept out of scope from any further analysis.

PT Semen Indonesia

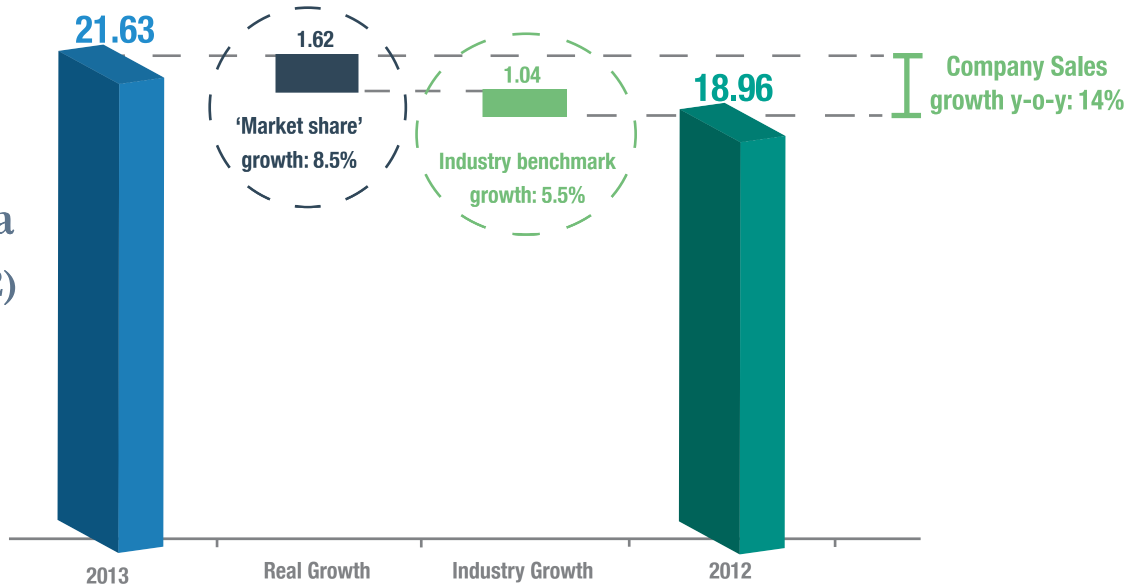
Winner by a Wide Margin

In an effort to understand the extent of growth that the company has realized, ORC International has dissected PT Semen Indonesia's growth by the model highlighted earlier. In the chart below, the company has grown by about 14% from its 2012 sales. Removing the industry benchmark growth rate of 5.5%, the remaining rate of 8.5% is treated as 'market share' growth and regarded as growth brought about by company initiatives.

PT Semen Indonesia

(million tons, 2013 and 2012)

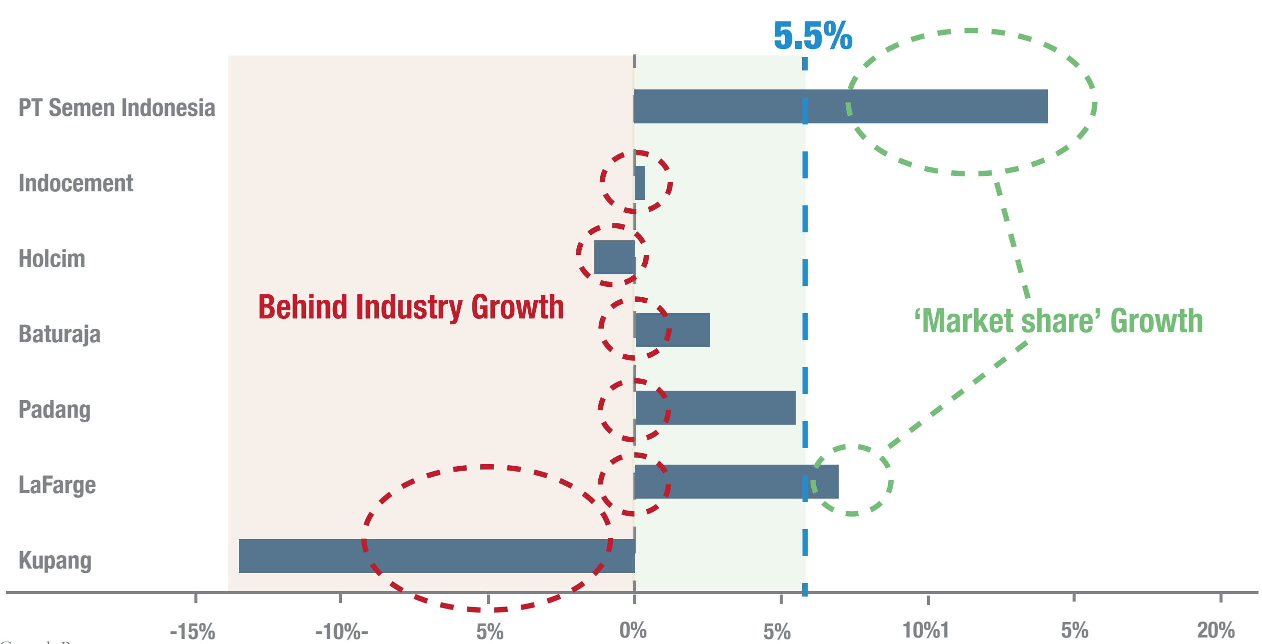
Source: ORC Analysis, Indonesia Cement Association



Compared to other players in the market, PT Semen Indonesia has fared relatively well within the assessment period. Not only was it the market share leader, its growth has surpassed that of its competitors by a wide margin.

Company Growth Rates

(domestic sales, 2013 and 2012, %)



---- Industry Growth Rate
Source: ORC Analysis, Indonesia Cement Association

Path to Success

Innovation and Globalization[5]

The company's growth has been tied closely to innovation. From company reports to the public, our understanding is that their focus is as follows:

> "Innovation has been the work culture in the company and is one of the valuable intellectual capital to enhance the competitiveness of sustainable growth in accordance with the expectations of the stakeholders interests. Indonesian Cement Innovation Management System continues to be improved so that innovations are born every moment, and can be used optimally. Company continues to encourage all employees to explore creative ideas aligned with the business strategy of the Company"

Furthermore, the company has identified four pillars of management strategy to support its long-term development plans - revenue management, cost management, capacity management and increasing competitive advantage - to support accelerated growth.

1 Revenue Management

Management of the Company's revenue potential is performed by strategies to ensure optimal distribution of products in areas that provide the optimal operating margins while still searching for new market opportunities in other potential areas

2 Cost Management

Focus on cost efficiency efforts through management of raw materials, packaging , maintenance, energy, distribution and logistics of the product to achieve optimal bottom lines

3 Capacity Management

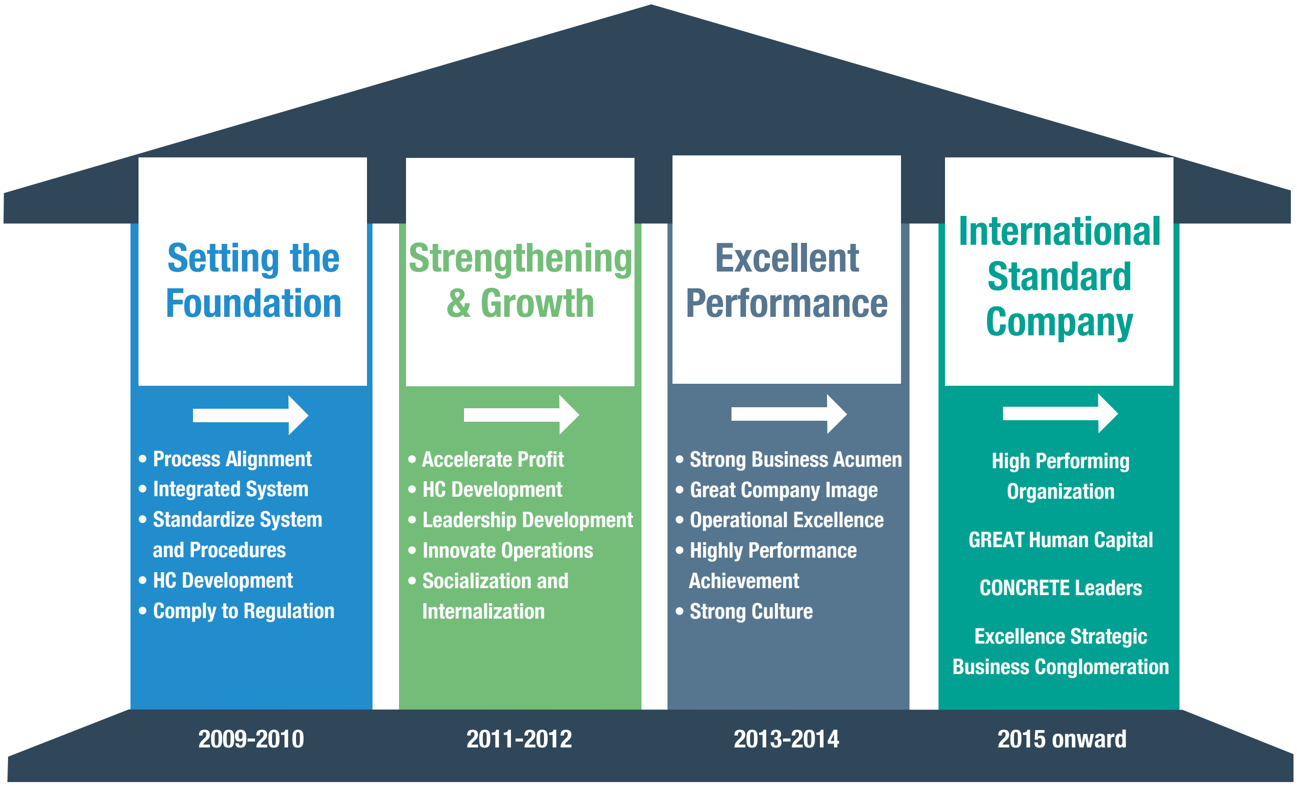
Increased production capacity, implemented through organic and inorganic means, including maintaining stable operation at high utilization rates, to maintain market share and could answer the needs of the ever increasing demand for cement

4 Increasing Competitive Advantage

Enhance the competitive advantage through corporate restructuring, subsidiary management, human resource development competencies, and refinement of information and communication technology within the group

[5] PT Semen Indonesia Annual Report, Press and publications

Based on these four pillars of strategy, PT Semen Indonesia has outlined its roadmap for the next few years as follows:



Recognizing that capacity building is crucial to keep up with industry demand, PT Semen Indonesia has also committed to expanding frontiers in other ASEAN locations.

Three-Way Strategy:

1) Maintain domestic dominance and achieve higher market share through branding and fulfillment of product demand
2) Acquisition of foreign company to enter new frontiers
3) Creation of a new brand to cater to other ASEAN markets

Source: PT Semen Indonesia Globalization Strategy Deck

In conclusion, this report showcases that even in declining markets, winners find ways to grow. The winner in this case has achieved growth in a very mature industry by focusing on innovating their business model. They have also achieved competitive differentiation by improving the delivery of their value proposition to their customers more effectively through faster distribution, better cost efficiency, and achieving operational excellence.

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