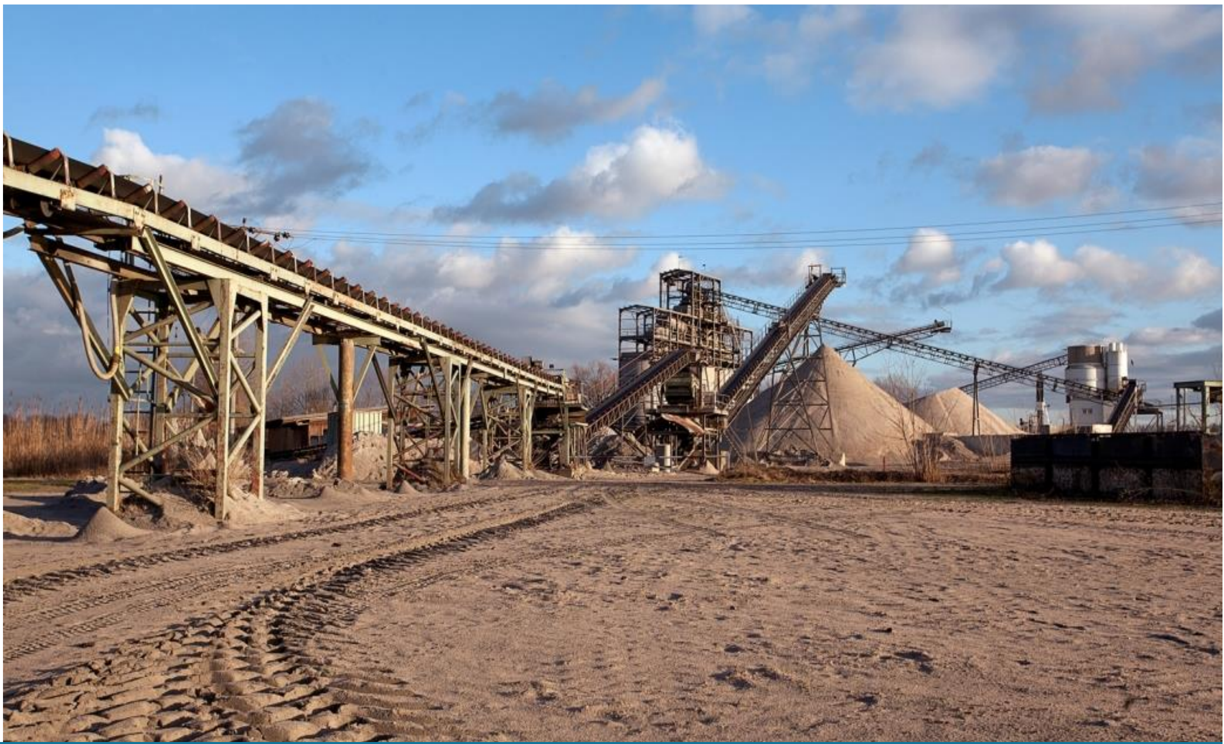
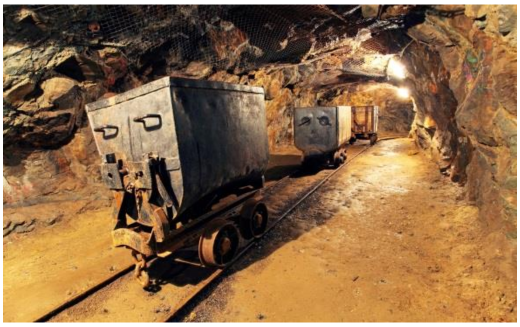
Issue ID 2 | February 17, 2014

Indonesia: Mining Industry



Indonesia Export Ban



Prepared by: Daniel Bellefleur
For: Publication

About Tractus

For the last 20 years, Tractus has advised and assisted multinational companies to help them make intelligent decisions about where to locate and how to structure their direct investments in Asia. We have a team of 60 professionals in offices in Myanmar, Thailand, Indonesia, Vietnam, China and India. Tractus' full service market-entry and expansion practice areas include initial market research and corporate strategy implementation; distributor and partner search assistance; merger & acquisition and fund raising; site location advisory, and; regulator and private-party negotiations assistance. Tractus also has a substantial public sector practice area that provides services such as government advocacy, trade and investment promotion, public policy and economic development program advisory services.

Indonesia Moving up the Mineral Value Chain – Sound Economic Development or Nationalistic Fervor

While Indonesia continues to be a weighty player in the global mining industry with significant levels of exports of both metallic and non-metallic minerals, recent regulatory changes are impacting the industry and the environment for foreign investment. On the positive side: corporate social responsibility and environmental laws have been strengthened to protect Indonesia's landscape, forests, and citizens. These laws now require license holders to demonstrate a greater level of oversight and responsibility for their operations. On the negative side: changes to export regulations and ownership by foreign companies threatens Indonesia's investment climate as the government aims to claim a larger stake for itself and Indonesian companies from foreign investors.

It is important to note that the Indonesian central government historically plays a major role in the industry starting with the fact that it retains ultimate control of all mineral rights and determines areas that can be mined, collecting royalties on all exploitation. The Mining Law passed in January 2009 replaced the 1967 Mining Law with significant changes. Contractual-based concessions are no longer available for new mining projects. The well-regarded contract of work (CoW) framework for foreign investors and Kuasa Pertambangan ("KP"), or mining rights, framework for Indonesian investors, were replaced by a single area-based licensing system. Most importantly, under the 2009 Mining Law, foreign companies active in mining extraction were allowed to register 100% foreign ownership but with the stipulation that after 5 years 20% of shares had to be sold to a private entity or government. Again in March 2012 the Mining Law was amended becoming more restrictive on foreign ownership. Under these amendments holders of mining business permits (IUPs) and special mining business permits (IUPKs) whose shares are owned by foreign parties are required to divest a portion of their shares to the central government, regional governments, state-owned enterprises (BUMNs), region-owned enterprises (BUMDs) or national companies all of which are considered Indonesian entities. Moreover, the 2009 Mining Law stated that mining companies would need to process minerals in-country by 2014. This stipulation came into action in the most recent Ministry of Energy and Mineral Resources (MEMR) Law 1/2014 on the Improvement of Value Added Minerals through Processing and Purifying Minerals.

This law requires mineral producers to meet specific purity levels in order to export mineral commodities abroad.

Highlighting the current foreign investment scenario, an international company may invest as a 100% foreign owned mining company for a period of 5 years after which it will be required to divest to over a 5 year period so that a minimum of 51% shares are owned by Indonesian entities. The schedule for divestment at a minimum is: at least 20% in the sixth year; at least 30% in the seventh year; at least 37% in the eighth year; at least 44% in the ninth year; and at least 51% in the 10th year. The central government has the first priority in the divestment process, followed by the regional governments, BUMNs and BUMDs and national companies. The mechanisms for the priority divestment procedure, and for determining the share prices for divestment, are laid out in Minister of Energy and Mineral Resources Regulation No. 27 of 2013 (MEMR 27/2013). Luckily, this regulation does not apply to foreign owned exploration, transportation/trading and processing/refining companies, rather, only companies operating under a production operation IUP. Even if a foreign company follows the divestment procedures, that company is still mandated by law to process the minerals in-country before exporting abroad.

Currently, MEMR 27/2013 still allows for foreign controlled ownership in value-added mineral processing and engineering which can by fully owned and controlled by a foreign company up to 100%. Processing production such as beneficiation currently does not fall under divestment law as long as the company doing the processing is not held by the same holding company as its mining operations. On a positive note there are some tax and non-tax investment incentives available for foreign investors in processing operations based on investment level, geographic location, and scope of business.

Foreign investors are also allowed to own up to 100 percent of a sales and distribution company for minerals into Indonesia. However, Indonesia's insular business environment and reputation for difficult local business practices often results in foreign companies utilizing local sales and distribution partners.

Hugh Parker Group Managing Director, for AMCOL Performance Minerals, Asia the world's largest bentonite company had this to say, "Demand from Indonesia for our products, especially bentonite sold to automotive foundries is rapidly growing and we are bullish on Indonesia. However, due to the ever-changing regulatory environment and difficulties in doing business in Indonesia we have not had the appetite for investing into mining, mineral processing or distribution and rely on a long-term local partner to access and grow the market."

Indonesia Investment Incentives for Foreign Investment Mineral Processors	
Import Duties	• 0% import duty on importation of capital goods, namely machinery, equipments, spare parts • 0% import duty on importation of goods and materials required for processing
Tax Facilities	• An Investment Tax Allowance in the form of taxable income reduction as much as 30% of the realized investment spread in 6 (six) years • Accelerated depreciation and amortization • A Loss carried forward facility for period of no more than 10 (ten) years • A 10% income tax on dividends, and possibly being lower if stipulated in the provisions of an existing particular tax treat
Export Manufacturing	• The company can import raw materials required regardless of the availability of comparable domesitc products • Restitution (drawback) of import on the importation of goods and materials needed to manufacture the exported finished products
Corporate Income Tax	• An exemption from corporate income tax for 5 to 10 years beginning from the date commercial production commences • A 2-year 50% reduction in corporate income tax liability after the end of the tax holiday period • An extension of the exemption or reduction in corporate income tax depending on the competitiveness and strategic value of the industry

***The Corporate Income Tax Incentive is reserved for approved investment plans of $US 100 million and above*

The Central Government historically has the authority to control production and export of mined materials. Mining companies must comply with the Domestic Market Obligation ("DMO") requirements by selling to domestic consumers of minerals. DMO requirements will depend on the product being mined and volume. Just last month In January 2014, Indonesia passed long-debated legislation prohibiting the exportation of a multitude of raw mineral resources in an attempt to stimulate investment into downstream facilities. This law has seriously shaken up the industry as many in-country miners assumed it would not be approved or that the government would quickly retract the requirement in favor of export revenues.

Unfortunately for those participating in mining and exporting crude ores from Indonesia, this has not yet been the case as the government has stuck to their guns and is taking the risk of distressing the sector in its search for value-added investments. Even a month after implementation, some of the largest industry players such as Newmont and Freeport, two of the World's largest copper producers, are unable to export their copper concentrates which was approved by law during last minute governmental debates. On the other hand, nickel and bauxite producers are feeling the brunt of the ban as they are not allowed to export raw minerals or any form of concentrate. Coal, one of Indonesia's most significant exports, is not governed by the ban as there is little value added through processing activities.

How this export ban will impact the industry in the long run is yet to be seen, but what is certain is that in the short-run, Indonesian mineral export revenues are likely to decrease, investors will need to consider investments into value-added mineral processing facilities, and world prices for the major mineral exports such as nickel and bauxite from Indonesia are likely to increase as export volumes of these key minerals decrease in 2014. China, the largest consumer of Indonesian minerals commodities, will likely be the most heavily impacted. The effect on other commodities such as copper, iron ore, manganese, and zinc will be stretched over the next three years as producers are still allowed to export concentrates, although at an increasing tax rate set to reach 60% by 2017.

This export ban, which was originally written into the 2009 Mining Law, was so poorly implemented that most mining companies did not know how the legislation would actually come into play in 2014. Interviews with numerous industrial mineral companies in late 2013 highlighted that they had little idea how the law would affect their business while even the majors did not plan to build processing facilities prior to the law coming out. Every company spoken to stated that all expansionary investment plans were on hold until the law came into effect. Now, many of these same companies that did not build processing facilities are scrambling to figure out a way to stay in business or hoping the government begins issuing exemptions. Subsequent interviews in 2014 show that mining companies are still not confident that the government can holdout against the private sector and faltering trade balances. Mining companies are hoping the government relaxes the ban within a couple of months depending on export figures, while it is also hoped that the newly elected president will "save the day" when voted into power later in the year.

In the short term, the mineral export ban will negatively impact most Indonesian mining companies and labor. Currently there are only a few processing, purification, or smelting facilities in Indonesia as a majority of the country's raw minerals were exported as crude ores. As such, most companies do not process themselves nor have domestic refining partners. Reuters reports that already 100 junior miners have slowed or stopped operations while majors are slackening production. With reduced demand for product, companies will of course lay off workers due to the lag in production. The Indonesian Chamber of Commerce and industry has warned that as many as 800,000 jobs are at risk due to the export ban. Moreover, it is highly unlikely that companies will invest into additional exploratory or expansionary activities until smelting and/or processing facilities come online.

While the industry itself slows, government tax revenues are forecast to decrease as total export shipments of minerals valued at US$10.4 billion recorded in 2012 fall. This will limit the nation's ability to reinvest into society and severely demanded infrastructure, including power plants needed to fuel mineral processing facilities. Chatib Basri, the Indonesian Minister of Finance stated that the policy will cut government tax revenues collected on mineral exports by as much as 10 trillion rupiah (over US$820 million) in 2014.

In the medium to long-term, the export ban is likely to achieve Indonesia's goal of attracting investments into downstream processing facilities while increasing the value-added of the archipelago's mineral resource exports. Although smelters and processing facilities can take a long time to construct, the government expects that the future returns from refined ores will strengthen the overall Indonesian economy. In an interview with the American Chamber of Commerce Indonesia, R. Sukhyar, the Mineral Resources Director General stated that around 253 companies have already made a commitment to invest in value-added processing. Now, 112 companies are doing feasibility studies, 25 have started construction, while the remainder are still in the planning stage.

In 2013 alone, investments into smelting and refining reached US$6 billion while a number of international commodity giants, such as GlencoreXstrata and RUSAL, have expressed interest in setting up refineries in Indonesia. As these large capital projects come online, Mr. Sukhyar is upbeat that the export ban will have positive impacts by 2017 where it is expected that state and foreign exchange revenues will increase. The Minister is quoted "We have estimated that forex revenue from mineral ore will decline to around $2.5 billion in 2014 from an estimated $4 billion in 2013, but it will be compensated by higher revenue from refined minerals. We believe forex revenue from refined minerals such as copper cathode and aluminum may double from the $4.9 billion estimated for 2013."

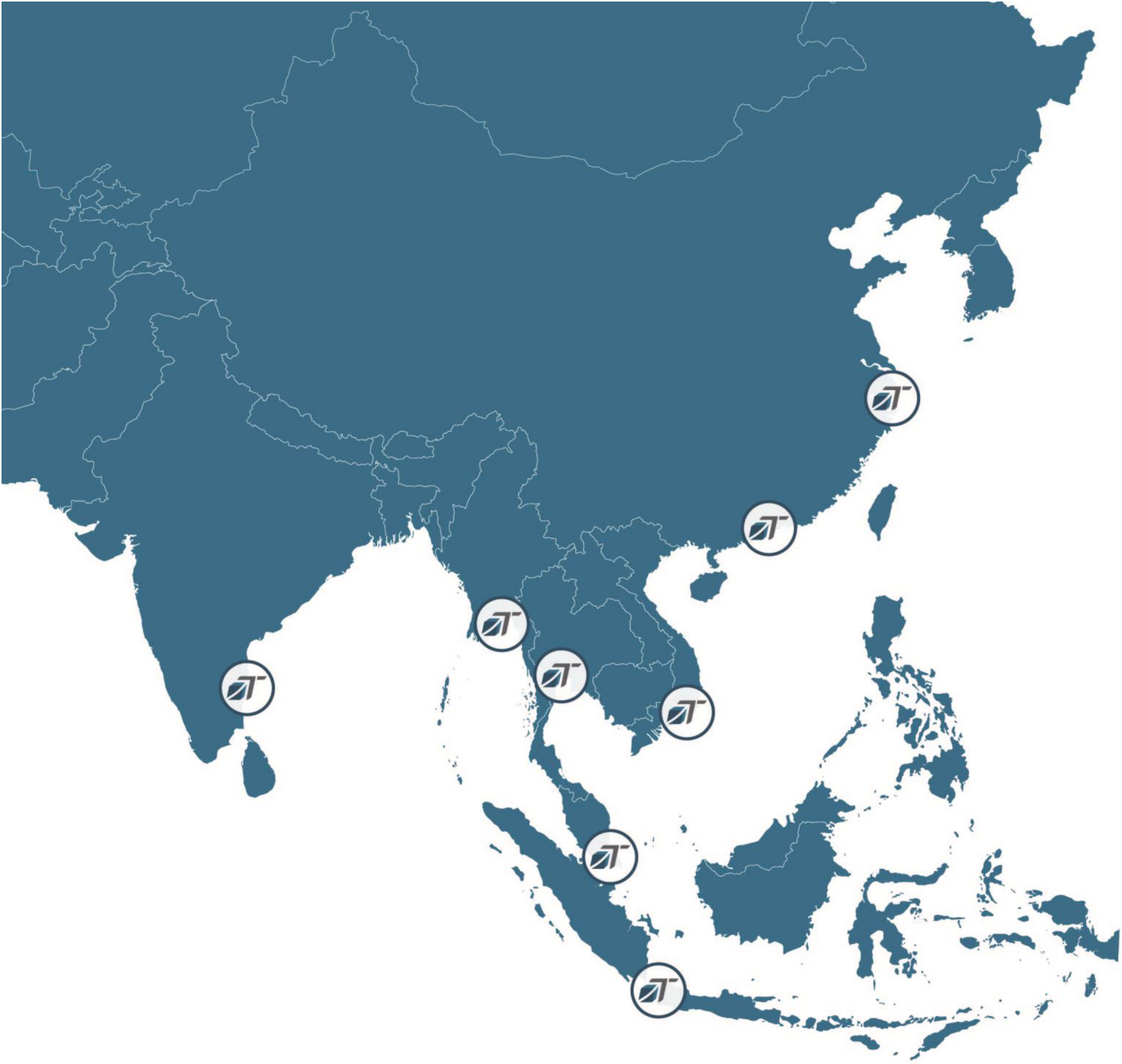
Although the ban is affecting the local mining industry across the board, it certainly favors larger companies that have the capital or access to finance to weather the storm and independently build processing facilities or partner with specialized processing companies. This bodes ill for smaller miners who were once profitable exporting raw minerals based on their solid resource endowment. If these companies are unable to find a way to process their minerals in-country, they will edge towards bankruptcy where miners with capital or investment firms snatch up assets at significantly reduced costs.

Despite the uncertainty of the changing regulations, companies willing to consider investing in processing capabilities could be poised to prosper. With certainty of investments likely to occur across a broad spectrum of industrial minerals providers of engineering services and processing equipment and technology could see a serious boon from Indonesia's regulatory changes. In addition, independent power producers and suppliers of diesel generators will also be in demand as energy intensive processing facilities are often remotely located and off the power grid.

Thomas Heckmann, Managing Director, AKW Apparate + Verfahren GmbH, a leading German engineering firm and manufacturer of state-of-the-art hydrocyclones for wet separation of kaolin, sands, feldspar, and other minerals stated " The recent changes to the Indonesian regulations on export of crude ores are already resulting in increased interest in our services and equipment."

Although there is this incredible opportunity for mineral processors, service firms and equipment suppliers in Indonesia, investors must heed caution as the archipelago is a challenging place to do business. The World Bank Ease of Doing Business study ranks Indonesia 116th out of 189 countries, with Starting a Business, Paying Taxes, Enforcing Contracts, and Resolving Insolvency indicators scoring particularly poorly. On a mining policy basis, the Fraser Institute ranks Indonesia towards the bottom for its unfriendly mining industry regulations. Particular issues for concern are the 10-year foreign ownership divestment requirements for mines, domestic market sales obligations, limitations on the sub-contracting of "core" business activities, preference for local subcontractors, benchmark pricing frameworks, and a moratorium on the grant of new licenses in peat land and primary natural forest. These are just a few of the issues that will challenge companies looking to enter the dynamic Indonesian market. Given these issues, companies looking to open in Indonesia must come prepared, utilizing those with on-the-ground experience and knowledge into the ins and outs of Indonesian business processes.

It will be an incredibly interesting year in Indonesia for the mining industry with the launch of the mineral export ban at the same time the Country has revised its social security system and is experiencing slower economic just prior to an upcoming presidential election. Companies looking to enter the market should take their time to research and analyze specific market opportunities as well as gain an understanding of how to do business in this dynamic market.



Tractus

Building Business in Asia

Shanghai . Hong Kong . Pondicherry . Jakarta . Yangon
Singapore . Bangkok . Ho Chi Minh City