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‘Living less dangerously’ in Indonesia

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“In the West, we want answers for everything. Everything is right or wrong, or good or bad. But in the [wayang puppet] shadow play, no such final conclusion exists.” Quote from the 1982 film “The Year of Living Dangerously.”

Indonesia, the biggest economy in Southeast Asia and its only member of the G20, is on its way to becoming an extraordinary economic and political force. While the 1997-98 Asian financial crisis had a devastating impact on the country, since that time the country has significantly restructured its governance systems and experienced rapid economic growth and a good, though volatile, performing stock market.

From 1997 to 2014, Indonesia’s gross domestic product has grown at an average of 5.4 percent annually, and would have been much higher

if not for negative growth during the Asian financial crisis. The stock market, meanwhile, has generated an annual return of 6.4 percent during the last five years. The Indonesian economy, blessed with an abundance of natural resources such as tin, coal and gold, continues to be one of the fastest-growing economies in the world, with GDP growth in 2015 of 5.8 percent – but just slightly over 5 percent in the third quarter of 2017. This economic surge has opened numerous business opportunities. Thus, it is not surprising that foreign direct investment into Indonesia has increased dramatically during the last five years, from a low of Rp 35.4 trillion in 2010 to a high of Rp 99.4 trillion ($7.6 billion) in 2016. This investment has come from multinational corporations across a wide variety of industries, including resources, consumer products, financial services, infrastructure and manufacturing.

Despite this recent market performance, success by companies operating in Indonesia (particularly foreign companies) is far from certain. How do international companies address specific institutional challenges and organizational obstacles when doing business in Indonesia? There are numerous examples of multinational corporations with reasonable business strategies suffering major financial and reputational failures in Indonesia. While the use of objective information about the competitive environment, the technological and sociopolitical context, and consumer preferences is important to the development of a business strategy here, specific attributes of the Indonesian market may make this information necessary but not sufficient for driving organizational success.

For example, enticed by the economic prospects in the world's fourth-most populous nation, Cemex, the Mexican global cement giant, in 1998 bought a considerable number of shares in the largest Indonesian cement company (state-owned), Semen Gresik. However, Cemex underestimated several issues that led to a protracted dispute between its global headquarters and its Indonesian subsidiary. Eight years later, Cemex was forced by the Indonesian government to sell its 25.5 percent stake in Semen Gresik, worth more than $500 million at that time, at a loss to Indonesia's Rajawali Group. This happened because Semen Padang, the state-owned subsidiary responsible for many of Cemex's problems during those years, refused to collaborate under the reins of a foreign company, citing cultural differences. Misreading the cultural and legal context of Indonesia was disastrous for Cemex.

Similarly, an Australian mining company invested heavily in developing an Indonesian mine but dramatically misread the Indonesian business context, leading to major losses. The corporation neither had a reliable local partner nor access to local managerial talent to deal with contradictory pressures from stakeholders. Furthermore, Indonesia's underdeveloped governance structure left the local subsidiary strategically clueless. The promising venture completely failed and the Australian company had to sell its stake at a multimillion-dollar loss. These examples illustrate why understanding and adapting to the Indonesian business context, while maintaining international standards, is

critical for international companies hoping to avoid the pitfalls and pain suffered by other international firms, and as such "live less dangerously" in Indonesia.

Challenges and obstacles

Our research suggests that organizations operating in Indonesia by either starting a joint venture, directly investing through mergers and acquisitions, investing in the local capital market, setting up operations or directly selling products through local distribution channels face structural challenges and organizational obstacles – besides the usual strategic competitive forces. These obstacles stem from two sources: first, weak institutions and an unreliable legal system that lead to institutional voids; and second, potential conflicts of interest at the company level. Combined, these can create threats to organizational reputation and financial performance.

Besides the macroeconomic issue of institutional voids, specific organizational obstacles add additional complications to doing business in Indonesia. The Indonesian economy is dominated by state-owned enterprises and family businesses, resulting in potential conflicts of interest at a microeconomic level, stemming from concentrated local organizational ownership. More than 70 percent of the 50 largest firms in Indonesia based on revenue (or market cap) are either state-owned enterprises or family conglomerates. Indeed, it has been estimated that today, about 58 percent of all assets in Indonesia listed on the Indonesia Stock Exchange used to be controlled by 10 major families. Admittedly, since the 1997 financial crisis, some of that power in the hands of Chinese conglomerates (especially the banks) has been dispersed. Nonetheless, this high ownership concentration – among the highest in Asia – creates an environment where minority shareholder rights may not be duly respected. Minority shareholder rights can easily be undermined by biased decision-making or even expropriation of valuable assets by family majority shareholders. These potential conflicts of interest are mainly due to specific characteristics in Indonesia: extensive cross-ownership ties with pyramidal ownership structures; extensive family ownership with a high degree of overlap between controlling family ownership and management; significant state ownership with direct political influence over management appointments; and the relatively limited use of professional managers in top management. Taken together, they create a situation where international players

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may face profound governance risks.

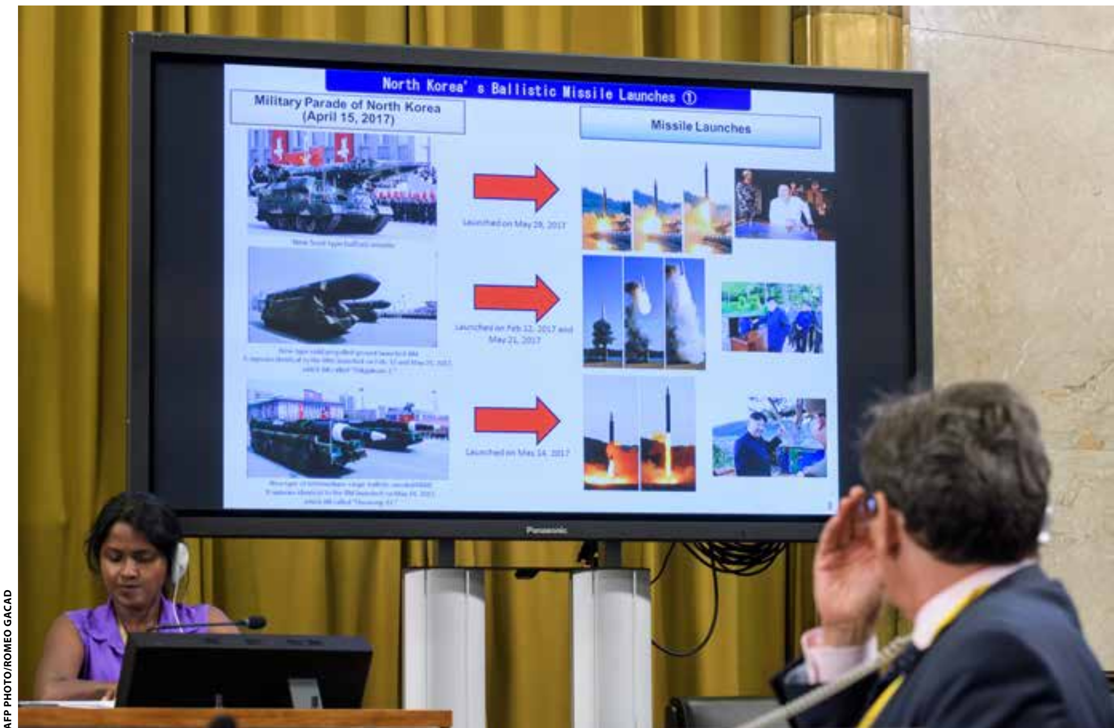
Corporate governance within Indonesian listed and unlisted companies lags behind the standards of other Asia-Pacific countries, such as Malaysia and Thailand. Analyzing the boards of a number of the top 85 companies listed on the Indonesia Stock Exchange, only a few can be considered as conforming to best corporate governance practices. For example, one of the authors of this essay was involved with the initial public offering of a private local company. However, in the IPO process the name of a primary shareholder did not appear on the shareholders' list of the newly listed company. Through a complicated pyramidal structure, the well-connected patriarch was hidden from the public eye. This practice is not uncommon in Indonesia, as key businesspeople within Indonesian conglomerates attempt to "keep a low profile" to avoid both public and government attention. However, there is increasing pressure from both regulatory authorities and minority investors to fully disclose beneficial ownership.

On the other side of the extreme, relying only on reputable business networks as a mitigating factor to reduce risks may seriously backfire. In 2010, Nathaniel Rothschild, the wealthy British financier, invested $3 billion in the Bakrie Group, the prominent family-owned Indonesian business conglomerate, during the global coal boom. The scion of the Rothschild banking dynasty did not foresee the enormous conflicts of interest that would ultimately undermine this joint venture. Rothschild acquired an interest in Indonesia's Bumi Resources and Berau Coal (one of the largest coal exporters in the world) from Bakrie. The newly created joint venture, named Bumi PLC, was listed on the London Stock Exchange. By having the venture listed, Rothschild assumed that the formal legal system in Britain would provide protection from biased decision-making by its Indonesian majority owners or neutralize weak formal governance mechanisms in Indonesia. But even being listed in London did not bridge the differences in business approach and culture between the two partners. When insurmountable governance differences emerged in the joint venture, Rothschild attempted to remove Bakrie from its board. However, despite Western-style governance structures at the London Stock Exchange, this was unsuccessful, leaving Rothschild with no other choice but to "write off" his investment in 2014.

Institutional voids

Relative to developed countries but similar to other emerging countries, Indonesia is noted for having very weak and unreliable institutions at a macroeconomic level that create institutional voids. For example, the legal system has been characterized as unpredictable and inconsistent, with patchy implementation and enforcement of rules and regulations. One major challenge to doing business in Indonesia is that, following the collapse of the late President Soeharto's regime in 1998, more than 500 regional governments were given autonomy to create new local bylaws and interpret and enforce other laws.

In many cases, these autonomous regions have created or interpreted laws in an inconsistent manner. For example, duplications



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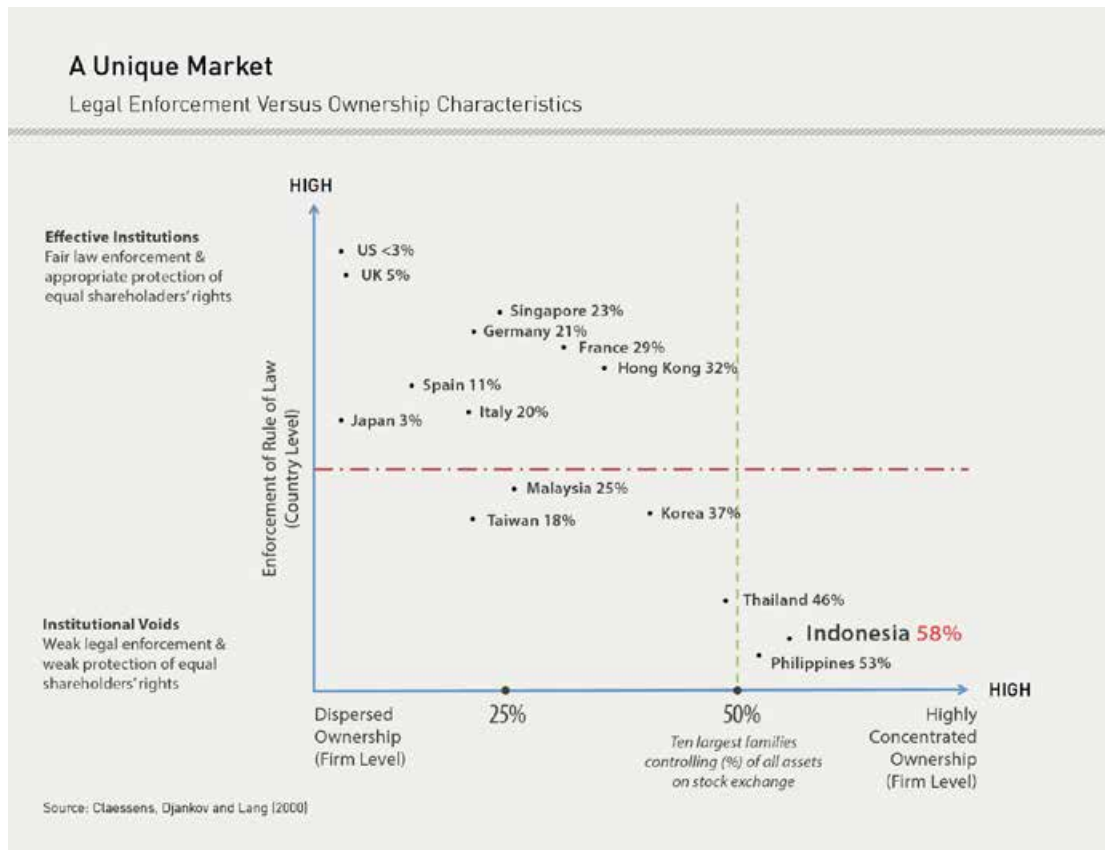
or inconsistencies in tax law or regulations on work visas and business license processes create confusion for companies and make it difficult to operate across different regions.

Another challenge is that laws and regulations can change quickly in Indonesia with little notice. There are several recent examples where laws and regulations impacting business (eg, *halal* food labeling, exporting natural resources or hiring expatriates) were dramatically changed with little prior notice. When the political environment and legal framework does not provide the necessary certainty to make substantial investments, businesses may attempt to circumvent these ambiguities by looking for legal loopholes or by relying on useful informal business relationships, potentially resulting in corruption.

For example, Freeport Indonesia, the local subsidiary of the US-based global mining giant, experienced a significant challenge in renewing a major mining permit. Freeport believed that the original contract, signed with the previous Indonesian government, provided for a clear option to renew. However, some ministries within the current government adopted a different orientation toward the Indonesian resource sector relative to previous governments. This led to the government developing a different interpretation of the prior contract and creating great commercial uncertainty for Freeport. As a result, top executives within Freeport could no longer

rely on the legal contractual framework previously negotiated and had to renegotiate the entire joint venture arrangement. The matter became even more complicated when, during negotiations, the speaker of Indonesia's House of Representatives (DPR) was alleged to have attempted to extort shares from Freeport Indonesia in exchange for a new contract, indicating the incredible ambiguities and complexities of relationships with Indonesian politicians.

Doing business in a murky environment can be frustrating and quite time-consuming for business executives attempting to navigate legal uncertainties and power plays. While small and medium-sized Indonesian enterprises may not be confronted with the same level of direct political interference as multinational corporations, they may still be burdened by structural inefficiencies of bureaucratic red tape, or even outright extortion. Despite enormous institutional progress during the last decade, doing business in Indonesia remains unpredictable because of weak institutions. When asked to describe the legal and jurisdictional environment faced by Indonesian and international companies, a former vice chairmen of the Indonesian Bank Restructuring Agency stated: "Even if you have the formal law on your side, you still are not



sure at all whether the judge's ruling will be fair and according to the rules. Often it all boils down how much the judge is paid by whom."

As illustrated in Figure 1, the combination of institutional voids due to weak legal institutions and law enforcement, inconsistent government policy at the country level and potential conflicts of interest at an organizational level due to concentrated ownership makes Indonesia a very unique market within which to conduct business compared to other developed and developing economies. Furthermore, the combination creates an environment that allows for or tolerates forms of corruption. This is clearly illustrated in the low ranking of Indonesia in Transparency International's annual corruption index.

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Thus, leaders doing business in Indonesia must answer two key questions: first, how to protect the organization's reputation and investments against weak legal enforcement and political inconsistency as a result of these institutional voids; and second, how to ensure that minority shareholders' rights in international ventures are respected by majority owners according to charter agreements and international rules. As the examples discussed above illustrate, a failure to address these two business challenges can greatly increase the risk of international business ventures failing in Indonesia.

Guidelines for success

So, how does Indonesia address these barriers? We suggest effective management in three areas: first, corporate governance practices; second, ethical organizational culture and proper character of leadership; and third, social capital or networks of crucial decision makers within companies are crucial building blocks for business success in Indonesia and Asia.

Social capital can provide informational resources that reduce the potential risk of information asymmetry generated by institutional voids. Without a doubt, the darker side of social networking cannot and should not be ignored. Hence, corporate leadership needs to ground its social capital within an ethical organizational culture based on sound and best governance practices, which not only allows leadership to navigate easier given the ambiguities and uncertainties as a result of institutional voids, but can also help alleviate potential conflicts of interest in Indonesia (see Figure below).

Ideally, Indonesia's legal framework and its enforcement should be strengthened and regulations should become more consistent over time instead of adding to the inherent uncertainty. At the organizational level,

business leaders can more easily intervene and reduce concerns by implementing good corporate governance and pursuing ethical organizations. At the institutional level, business leaders have only informal and indirect influence over the DPR and politicians who legislate and execute the rule of law in Indonesia, albeit imperfectly.

And, obviously, the independence of a fair and just judicial branch in Indonesia can also be seriously questioned. Hence, while using informal networks to reduce institutional uncertainty may not be ideal, from a practical business perspective it enables bringing different necessary parties together, similar to innovation that relies on collaborative teams within and between organizations.

Conflicts of interest

To prevent potential conflicts of interest that may surface between partners in the Indonesian market, or abuse of power by majority shareholders and their managers, we recommend that firms invest in two critical areas: implementation of appropriate corporate governance practices and the formation of a highly ethical culture through formal and informal organizational practices.

The first key to preventing conflicts of interest is the implementation of sound corporate governance. Good corporate governance occurs when practices are implemented that: first, clarify the duties and roles of the board members; second, ensure disclosure of information in a transparent and timely manner; third, secure proper oversight and monitoring; and fourth, install the right size and composition at the board level to steer and guide top executive decision-making. However, the achievement of these four objectives is complicated within an Indonesian setting by the fact that Indonesian firms have a dual-board system, in contrast to an Anglo-Saxon context that allegedly drives global corporate governance practices.

Addressing the Barriers

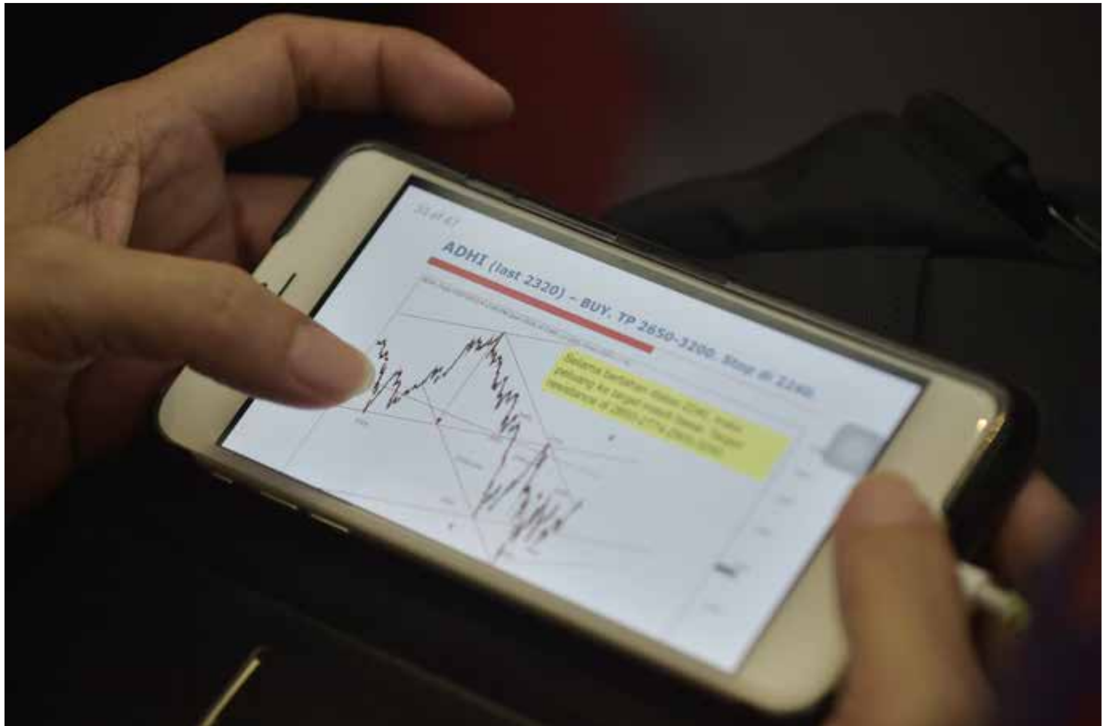
Indonesian Market Challenges, Concerns and Guidelines

Challenges	Business Concerns	GES - Guidelines
1. **Conflict of Interest:** (Micro- or organizational level)	• Weak Corporate Governance	1. **Governance Framework** Translation of international corporate governance best practices into local frameworks that provide oversight and advisory.
	• Obstrusive Relationships	2. **Ethical Culture** Formation of formal and informal rules, values and norms that curtail inappropriate behavior within the firm, based on proper character of leadership.
2. **Institutional Voids:** Macro- or institutional level	• Weak Legal Framework and Enforcement • Inconsistent Policies and Regulations & cultural misunderstandings	3. **Social Capital** Formation of key relationships of trust that provide informational resources that help management contextual ambiguities, asymmetric information deficiencies and legal uncertainties.

Yet, even with the dual-board system, the implementation of innovative governance practices can lead to positive business outcomes. For example, the partnership between the Indonesian national telecommunications company, Telkom Indonesia, and the Singaporean investment company Temasek Holdings illustrates how good governance structures can support successful multinational partnerships. Telkom partnered with Temasek to form the mobile phone business Telkomsel. In order to reduce potential conflicts of interest between majority and minority shareholders, Telkom implemented governance reform whereby the supervisory board of the company was directly involved in supporting and simultaneously supervising the executive board. For example, any investment higher than $10 million required a consensual decision by a unified board. Having the supervisory board more transparently involved in key investments and key appointments created a more coherent and consistent policy- and decision-making process, which has helped create a financially successful business. Telkomsel is the Indonesian market leader in terms of mobile revenue with a 56 percent market share in 2016.

However, even if formal corporate governance practices are in place, there is still a need to go beyond legal compliance to help insure against conflicts of interest between Indonesian and non-Indonesian partners. In the Indonesian culture, as in other Asian cultures, close personal relationships are a foundational element of how individuals conduct business. However, these informal networks – based on the reciprocity principle of *koneksi* (useful connections), *hutang budi* (as in a debt of gratitude) and to a lesser extent the traditional Javanese community-based practice of *gotong royong* (sharing the burden of community work) – are admittedly often not transparent and can easily turn into nepotistic or even corruptive relationships, leading to the misuse of economic and political power. Hence, the importance of investing in policies and practices that guide and shape executives' and managers' understanding of what is appropriate behavior, and not allowing these relationships to lapse into patronage, nepotism and clientelism. In other words, competence that is often lauded as a crucial strategic asset may be a cornerstone for any successful company, but the character of the organizational leadership is as crucial as the North Star in navigating stormy weather. This is especially true in an Indonesian context, where, unfortunately, patronage often trumps meritocracy.

Unilever, a well-known and extremely successful global conglomerate in the Indonesian market, has taken a zero-tolerance stance on corruption with its work force. The corporate narrative goes that several years ago, when one of Unilever's best Indonesian sales teams was caught offering a $4,400 bribe to a potential customer, a very small amount compared with the team's annual remuneration package and the total revenue it generated, the team was unceremoniously fired without a warning letter. Similarly, Unilever will not negotiate with tax officials to reduce its overall tax obligation, although they have a nonexecutive director on the supervisory board whose primary focus is keeping good



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relationships with government officials. This zero-tolerance approach has brought Unilever Indonesia a stellar reputation over all these years. Similarly, Astra, a diversified conglomerate and consistently considered one of the best-managed firms in Indonesia, has been characterized by a high-quality code of conduct and extensive ethics training. Furthermore, the firm has invested heavily in training and development programs for young managerial talent to help guide and develop employee behavior. Publicly listed, Unilever Indonesia and Astra are both considered attractive stocks for international investors, rated among the best-governed companies in Indonesia, and are also rated as attractive places to work for local managerial talent.

Navigating institutional voids

Our research suggests that one way companies can navigate institutional voids is by developing strong local social capital. Social capital – the relational networks of a company's members – will help managers and leaders gather information on what is actually happening within the company's external environment and understand what are the available options for managing the situation. Social capital can be created by both the organization's formal external social relationships and the informal actions and capabilities of leaders within the firm.

By effectively managing both formal and informal social networks, international

companies can form constructive dialogues with external stakeholders that enhance their abilities to appropriately respond to external factors (eg, changes in government regulation or enforcement), while also enhancing their

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credibility and reputation. Although we all may wish for needed political and judicial reforms to make Indonesia (and other Southeast Asian countries) more politically progressive and less unstable, international businesses may be able to help promote these desired reforms. But overall, as writer Michael Vatikiotis noted in his book "Blood and Silk": "formal institutions' governing political activities often do not adhere to operating principles or overarching goals based on abstract ideals for the common good." Most political power is personal and consequently there has been a lack of importance attached to institutions, with the exception of the Indonesian Corruption Eradication Commission, which wields some actual "institutional" power (although lately the agency has been under attack by self-righteous politicians who prefer to continue to promote patronage, relying on interpersonal networks rather than on institutions governed by rules that are predictable and more objective.) The result often is political impunity, which is why foreign businesses need to be pragmatic while at the same time adhering to their own values of integrity, to sustain their own corporate reputations.

Unilever, an early entrant into the Indonesian market, provides a good example of how formal practices can create beneficial informal social capital – to be clearly distinguished from its darker side: nepotism and patronage. The company consistently appoints a nonexecutive director to its supervisory board whose sole task is to develop and maintain good relationships with government institutions and officials. One benefit of this approach is that Unilever is able to maintain operational integrity and have an accurate understanding of its tax liabilities in an Indonesian environment where tax law and enforcement has fluctuated greatly over the years. Furthermore, these relationships have helped the company develop trust and respect, providing a certain benefit of the doubt that goes a long way in the complex and often ambiguous Indonesian business context.

The effective management of formal organizational relationships can be particularly useful in business sectors facing a high level of scrutiny. For example, Indonesia is the world's largest producer of palm oil and the industry is a critical component of the Indonesian economy. However, the Indonesian palm oil industry is plagued by inconsistent government

regulation and legal enforcement, resulting in negative behavior by some producers. As such, the industry has courted substantial local and international controversy due to concerns over deforestation, environmental sustainability and pollution. Several major environmental nongovernmental organizations have run campaigns against major clients of Indonesian palm oil companies in lucrative markets (eg, Europe and the United States). Under enormous pressure from nongovernmental organizations and faced with major institutional voids, and after a long and rather hostile relationship, some major Indonesian palm oil producers, including Wilmar (a Singapore-listed company) and Sinar Mas Group, have formed more constructive relationships with environmental groups such as Greenpeace, World Wildlife Fund and Friends of the Earth Indonesia. These relationships allow the organizations to gain information on how to address the huge environmental and social challenges attributed to the ever-increasing demand for palm oil in consumer products.

The consideration of social capital in the selection and development of senior organizational leaders can also be important to companies conducting business in Indonesia. For example, Trakindo Utama, the local representative of Caterpillar since 1971, has developed a very positive reputation within the market by attracting independent board members who carry impeccable reputations within the Indonesia market. Trakindo's board looks after governance mechanisms within the company and helps the firm navigate between international governance and investment requirements and local demands by clients, suppliers and government officials.

As negotiators know from experience, any successful deal that requires tough bargaining boils down to a number of variables that are crucial in reaching a fair deal – overcoming potential conflicts of interest and institutional weaknesses. What alternatives does one have to materialize the desired transaction? How much information (how good corporate governance processes can prevent potential conflicts of interest) do they have that is crucial to make an informed decision? What is the status (ethical reputation or cultural norms) of the two negotiating partners that may give advantage to the most reputable one? How strong is the social capital of the negotiator that may affect the transaction, especially when government officials are involved, reducing the competitive alternatives?

Living less dangerously

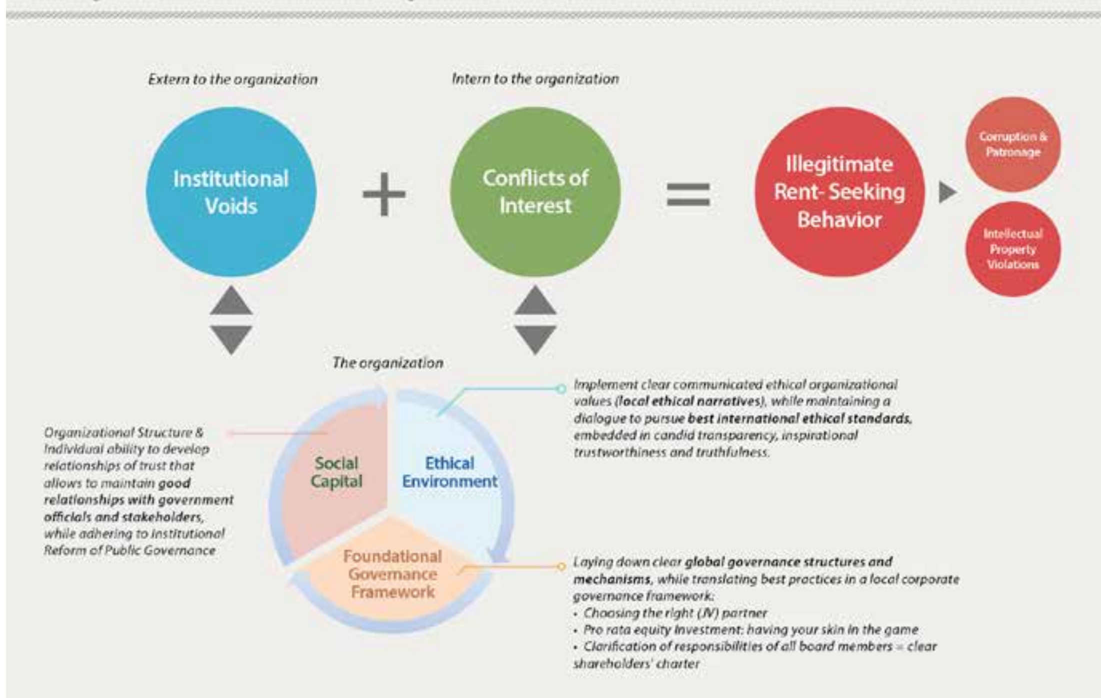
Mastery of industry, understanding the sociopolitical context and assessing business opportunities that can be translated into a superb strategy may not be enough to survive in the long term in an Asian environment. Additional pitfalls and voids loom and need to be incorporated in a board's thinking and analysis to decide about scarce tangible and intangible resources in those emerging markets. To be successful in Indonesia and other similar members of the Association of Southeast Asian Nations, companies may want to safeguard their reputations and investments – whether in operations or equity – by taking these potential

unique pitfalls seriously.

First, the organizational potential for conflicts of interest because of the biased interests of family businesses and publicly listed state-owned enterprises requires a profound knowledge of the family or government culture and values.

Mere compliance with corporate governance rules does not safeguard minority shareholders' rights, whereas encountering obtrusive relationship building often glides into nepotism and even outright corruption if not managed carefully. Addressing the potential abuse of power by major shareholders and/or conflicts of interest in an Indonesian business context may be best served by putting in place a highly ethical organizational foundation, based on the "good" character of the leadership, be it through implementation of ethics programs, codes of conduct and ethical values in the operational activities of the firm, or by enhancing the integrity of the firm's leadership.

Second, structural institutional weaknesses or voids continue to put enormous premiums on particular relationships with the elite and to undermine best corporate governance practices, creating legal uncertainty and ambiguity. Being confronted with weak legal frameworks often results in intellectual property theft, complex labor laws, an ambiguous political system of patronage and unreliable legal enforcement.



Being operational in an environment with a very different sociocultural and political mindset and understanding, compared to a Western setting, often causes misunderstanding or outright management confusion. In addition, political risk assessments and "regulatory risk" – in the sense of frequent ad hoc rule changes, weak minority shareholder rights related to determining dividend strategy and takeovers, and allowing related-party transactions – complicate the usual business challenges in Indonesia. We suggest that developing and maintaining social capital – relationship building, or "*guanxi*" – may be instrumental in dealing with these institutional voids, especially filling some of the gaps related to weak legal enforcement and policy inconsistency in provincial regions. Social networking should not fall into the potential trap of nepotism and other asocial and immoral behavior. Obviously, although institutional political and judicial reform remains paramount, (international) business can and should be guided by and grounded in competitive merit, formal principles and fair procedures, and informal ways to stick to ethical practices, even if that would be "costly" in the short term.

In a nutshell, the proper use of social capital may be able to address some of the institutional voids, and ethical principles of integrity may be able to reduce potential conflicts of interest. When considering entering Indonesia for business, a think and act "glocal" adage, as in a beneficial interdependent assimilation of international standards with local customs, may help companies to overcome the structural institutional voids and potential conflicts of interest at the organizational level. Both social capital that enables maintaining an open dialogue with the political and business elite and an ethical environment within the company are underpinned by having strong "best" corporate governance foundations. Institutionalizing corporate governance practices also implies choosing the right local business partner who is willing to have skin in the game (at pro rata effective, paid-up capital investment) and having a detailed shareholders agreement that specifies the unique equity partnership roles, while clearly defining the duties and role of each of the board members to secure oversight of and advice to top executives.

It is obvious that in a market where institutional voids are rampant and asymmetric information puts international companies at a disadvantage, good and sensible risk management and appropriate emotional and moral intelligence aligned to technical skills are vital to survive. Mindful relationship-oriented and ethical leadership, being concerned with the company's reputation in the market, sensitivity to individual and social responsibility in the organization, and the ability to fall back on proper institutionalized governance foundations of accountability and transparency can indeed successfully reduce some of those specific institutional and organizational pitfalls. Using social capital and emphasizing ethical values underpinned by strict corporate governance practices may allow foreign investors or joint venture partners "to live less dangerously" in Indonesia.