FRONTIER MARKET
Asset Management, LLC
...the road less traveled

Strength is in Unity – Georgia, Ukraine, Romania and Bulgaria

By Thea Jamison July 2012

"History is a guide to navigation in perilous times. History is who we are and why we are the way we are."

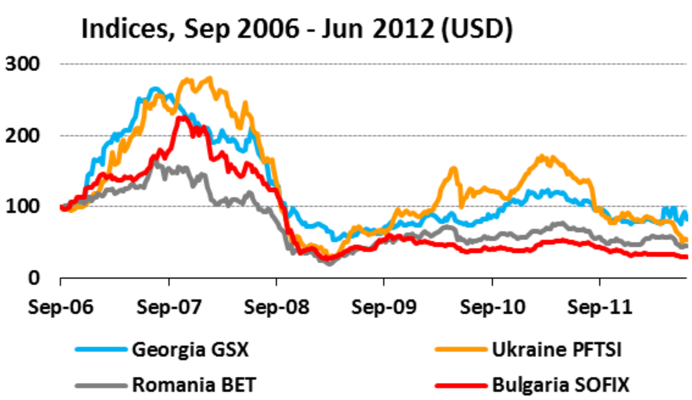
– David C. McCullough

During the spring we traveled to Eastern Europe with two of our investors. The grim news from Western Europe has continued to weigh on the stock markets of this frontier region. The markets of Georgia, Ukraine, Romania, and Bulgaria remain well off their 2007 peaks (Exhibit 1). As of early this year, the Georgian market is down 70% since July of 2007 in terms of the US dollar. The Ukrainian index is down 79% from its November 2007 peak. In Romania, the BET Index is down 75% since July of 2007. The Bulgarian market has been the weakest; it is down over 85% since the peak of October 2007. Investors who flocked to frontier Europe in 2007 when Price to Earnings ratios hovered above 20 times have long moved on.

http://europe-maps.blogspot.com

Today, the markets are depressed in valuation and overlooked by fund managers. Liquidity, as measured by daily trading volume in US dollars, is only a fraction of the peak level. Market participation has changed from foreign to local domination. We find such conditions interesting for patient stock pickers. Our report starts with a write up on Georgia, which we visited for the first time. Following, we provide an update from our return to Ukraine, Romania, and Bulgaria.

Exhibit 1



Sources: Frontier Market Asset Management; Thomson Reuters

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GEORGIA

The country of Georgia, about the size of the state of South Carolina, is nestled between the eastern coast of the Black Sea, south of Russia, and north of Turkey, Armenia, and Azerbaijan. Although geographically a part of Asia, Georgia considers itself a part of Europe. It is perhaps the crossroad location between two continents that explains the varied influences over the country throughout the centuries. Georgia was at times ruled by the Romans, Arabs, Turks, Mongols, Ottomans, Persians, Russians, and most recently by the Soviets. Our visit discovered a culture of perseverance, national pride, and entrepreneurship. It is not surprising that the country's motto is *Strength is in Unity* (*ძალა ერთობაშია*). Complex history and culture explain the dispute over the regions of Abkhazia and South Ossetia, occupied by Russian military since 2008. The situation remains frozen in time—Georgia and most of the world consider the two regions a part of Georgia, while Abkhazia and South Ossetia themselves, along with countries including Russia, Nicaragua, and Venezuela, declared the areas independent.

In spite of the regional conflict, Georgia has made significant progress over the past decade. The Rose Revolution of 2003, which took place over disputed elections, ushered in an era of economic and political change. Market-oriented reforms have vastly improved the investment climate in the country. According to the 2012 *Doing Business* survey by the World Bank (http://www.doingbusiness.org/rankings), Georgia ranks 16th of 183 countries for overall ease of doing business. The ranking is an equally weighted compilation of ten business criteria. In the latest survey, Georgia moved up on eight of the ten criteria, with only scores for trading across borders and enforcing contracts declining. In the category of registering property, Georgia ranked first in the world!

Source: CIA World Fact book- www.cia.gov

The Heritage Foundation also ranks the country highly. Georgia is 34th of 179 in the *Index of Economic Freedom* survey (http://www.heritage.org/index/ranking). The survey incorporates the study of ten criteria within the areas of Rule of Law, Government, Regulatory Efficiency, and Open Markets. Georgia scores above world averages in labor freedom, trade freedom, fiscal freedom and business freedom. For example, it takes two procedures and two days to start a new business. Labor-related regulations concerning work hours and employee costs are employer friendly. The categories of freedom from corruption and property rights, however, score at or lower than world averages. The Heritage Foundation cites, specifically, the effectiveness of the court system and the protection of intellection property rights as areas in need of reform.

The business-friendly climate has attracted foreign direct investment over the past decade. Real GDP growth has been strong, surpassing 10% during 2006 and 2007. Recently, the global financial crisis has negatively impacted capital flows to the country. However, the long-term prospects for Georgia as a regional transportation and logistics hub remain intact. The country has undertaken various projects to facilitate and benefit from regional trade, such as the Baku-T'bilisi-Ceyhan oil pipeline, the South Caucasus gas pipeline, the Kars-T'bilisi-Baku railway, and the Port of Poti free industrial zone. The projects are helping to diversify the economy, which was historically agriculture based and then industrialized during the Soviet era. Today, output is composed of 60% services and tourism, 30% industry, and 10% agriculture. Growth for now appears resilient to the problems of the West. Real economic output grew by 6.8% in the first quarter and is expected at above 5% for this year (Exhibit 2).

Exhibit 2

Indicator	Georgia	Ukraine	Romania	Bulgaria
Real GDP Growth (2011 actual)	7.0%	5.2%	2.5%	1.7%
Real GDP Growth (2012 est)	5% - 5.4%	3.5% - 3.9%	1.8% - 2.3%	0.5% - 1.2%
Inflation (2011 actual)	2%	5%	5.8%	4%
Inflation (2012 est)	6.0%	2.6%	3.0%	2.1%
Unemployment rate (2011)	14.0%	7.8%	5.1%	11.2%
Population, mil (July 2012 est)	4.5	44.8	21.8	7.4
% Literate (2005-2010)	100%	100%	98%	98.2%
Life expectancy (2010)	74.0	68.7	74.2	73.8
% Urban (2010)	53%	69%	57%	71%
GDP / cap (PPP), $ (2011)	3,200	3,438	8,523	7,230
Land, sq miles	26,911	233,031	92,043	42,823
Number Listed Stocks (May 2012)	135	197	81	93
Market Capitalization, $ bil (2011)	0.8	25.6	21.2	8.3
Market Capitalization / GDP	5.6%	16.6%	11.4%	15.5%
GDP, $ bil (2011)	14.40	154.0	185.8	53.5

Source: CIA, World Bank, Eurobank EFG, Eurostat, EC, UNICEF, State Statistics of Ukraine, S&P

The ongoing infrastructure investments have both economic and geopolitical significance for the country and region. The Baku-T'bilisi-Ceyhan oil pipeline was conceived after the collapse of the Soviet Union. Previously, all transportation routes from the oil rich Caspian Sea came through Russia. The new route accomplished the objective of diminishing geopolitical risks. The pipeline, commissioned in 2005, is 1,099 miles long and transports 1 million barrels of oil per day. It starts near Baku in Azerbaijan to the east, crosses Azerbaijan, Georgia, and Turkey to the west, and ends on the Mediterranean coast of Turkey.

The South Caucasus Pipeline (also known as Baku-T'bilisi-Erzurum gas pipeline) is a natural gas pipeline running parallel to the Baku-T'bilisi-Ceyhan oil pipeline. It is 430 miles long and was commissioned in 2006, with original capacity of about 310 billion cubic feet. Currently, the pipeline supplies gas to Turkey and Georgia only. However, over time, it will be connected with planned pipelines, such as Nabucco, extending into Europe and the Trans-Caspian Gas pipeline into Asia. In light of future plans, the route is undergoing capacity expansion to 710 billion cubic feet.

The Kars-T'bilisi-Baku railway, approximately 60 miles long, is another transportation project aimed at facilitating regional trade. It is scheduled for completion in 2012. Just as the oil and gas pipelines, the railroad bypasses Russia and will thus reduce geopolitical risks for commerce between Asia and Europe. In a further attempt to establish itself as a regional trade and transportation hub, Georgia created the first free economic zone in the Caucuses. The port of Poti, located on the eastern Black Sea coast, is a joint project with the UAE. Over time, the strategy would be to deploy best practices from experiences in Dubai. The Investment Authority of the UAE bought a 51% stake in the port and signed a 49-year management contract to develop Poti in a free industrial zone.

Source: Wikipedia

Georgia undoubtedly has a strategic geographic location. With the projects underway, the country can ensure a central and advantageous role in trade between the East and West.

Our visit to Georgia confirmed our cautious optimism for the country. Furthermore, we are excited about some stock opportunities. The market is overlooked and undeveloped. Market capitalization as percent of GDP at 6% is one of the lowest in the frontier universe. Our two bank holdings have good growth prospects and profitability due to the low sector penetration in the country. Bank of Georgia is the leading bank in the country with over 35% market share. The company is estimated to grow earnings by over 20% with the addition of new customers and introduction of innovative products. Liberty Bank is a smaller bank undergoing restructuring efforts. At near collapse in 2009, an experienced management team bought the company and has since returned it to growth and profitability. Both stocks trade at an estimated 5 to 6 times Price to Earnings ratio and below book value.

UKRAINE

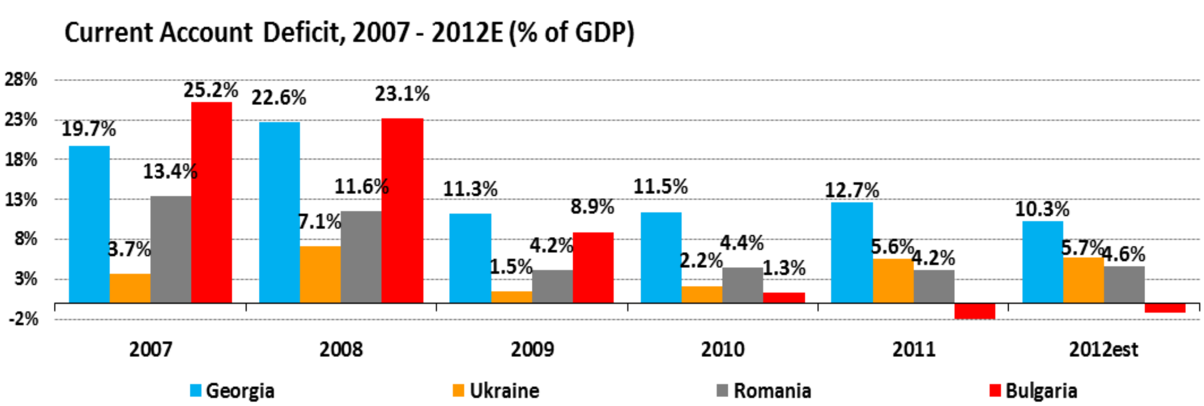
Ukraine is a complex country. By size of its area and population, it has great potential to be an important world power. Ukraine is the second largest country in Europe by territory and sixth by population. It has a strategic location between Russia and Europe. Yet poor governance appears to often minimize its role to a pawn in a chess game between super powers. Despite some progress after the Orange Revolution of 2004, the country has lagged in implementing economic and political reforms. The business environment is challenging as documented by various organizations including the World Bank and the Heritage Foundation.

The most recent news remains mixed. Over the past year, according to the World Bank, Ukraine made starting a business easier. However, trading across borders became more difficult and thus the overall country's ranking for ease of doing business dropped further to 152nd. The Heritage Foundation noted improvements in the categories of Rule of Law and Regulatory Efficiency but a decline in the Open Markets criteria. The overall country score encouragingly rose slightly to 163rd. In March, however, citing "significant" funding risks because of stalled IMF bailout negotiations, Standard and Poor's cut Ukraine's credit-rating outlook to negative. To top it off, the political wrangling between President Viktor Yanukovych and former Prime Minister Yuliya Tymoshenko culminated in the jail sentencing of Tymoshenko over a disputed contract for natural gas imports from Russia.

Source: CIA World Fact book- www.cia.gov

Despite the negative sentiment, we noted some improvement in macroeconomic indicators. Both current account and budget deficits have narrowed since their peaks (Exhibits 3 and 4) and the Ukrainian Hryvnia (UAH) is supportive to exports after the 2008 devaluation (Exhibit 5). Cost of production remains low, with wages at about USD 300 per month. There are efforts to reclaim "Europe's bread basket" status lost after decades of mismanagement. Ukraine, approximately the size of Texas, has over 50% arable land! The soil is so fertile that it generated over 25% of all agricultural output in the fifteen Soviet republics. Yet today, agriculture accounts for just 9% of the economy, with industry accounting for 35% and services for 56%.

Exhibit 3

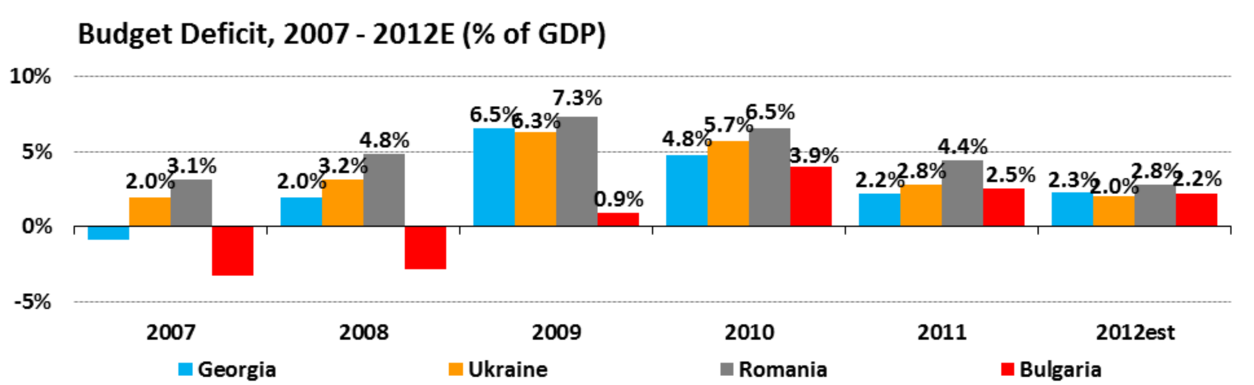


Sources: Frontier Market Asset Management; Thomson Reuters

During our visit, we noted a revival of Ukraine's agriculture. There is an emergence of agricultural companies which are consolidating fragmented farm land. The potential is tremendous. In the sector, we met with Astarta - a sugar producer, Mriya - a diversified crop grower, MHP – an integrated poultry company, and Milkiland – a dairy company. All four shared aggressive expansion plans in pursuit of domestic and export growth opportunities. The cost of production is competitive due to reasonable land leases and high soil productivity. As a result, the Ukrainian agricultural companies are very profitable with Return on Equity in the 20% to 30% range. The main threat to the sector is a legislation proposal limiting the size of land that companies can lease. For now, this plan has been tabled because of strong opposition by the farming constituency.

With the macroeconomic concerns hanging over Ukraine, it is not surprising that we found the stock market depressed. The main index is well off its 2007 peak. Foreign investors have fled and liquidity is down. According to Dragon Capital, the largest Ukrainian broker, the equity market is trading below 5 times both trailing and current Price to Earnings multiples. We look for quality companies that have good growth prospects and trade at attractive valuations. In Ukraine, for the first time, we have found stock opportunities. MHP is the country's largest poultry producer with 50% market share. Chicken consumption in Ukraine is growing from a low base (53 kg/person versus 80 kg/person in Europe). The company is expanding capacity and is expected to grow earnings by over 20% annually over the next five years. The stock is interesting at 4 times estimated 2012 Price to Earnings ratio. Motor Sich is also a leader in its industry. The company is a manufacturer of aviation engines primarily for the export market. It projects earnings growth of over 20% with Return on Equity of 30%. The stock trades at two times estimated 2012 Price to Earnings ratio.

Exhibit 4



Sources: Frontier Market Asset Management; Thomson Reuters

ROMANIA

We find the investment climate in Romania encouragingly distinct from other parts of Eastern Europe. While rule of law is a concern in countries such as Ukraine and Bulgaria, in Romania, we find the opposite problem: deep-rooted bureaucracy. The latter, we believe, is a better starting point for a country with a nascent democracy. Romania was slow in privatizing state owned assets after the fall of Communism. As a result, the country prevented the massive grab of properties by those with privileged access. Over time, a part of the state owned assets were distributed to the entire population as vouchers, which later became shares in publicly traded closed-end funds. Other assets seized by the Communists were returned back to the original private owners from whom they were taken. The remainder, such as monopolies in electricity and transportation, remain held by the government and are now scheduled for privatization under the guidance of the International Monetary Fund.

Despite the red tape, Romania has successfully implemented structural reforms. Their progress is documented by the Heritage Foundation as the country has consistently risen in its economic freedom ranking since 1995. Today, Romania is ranked 62nd of 179 countries, above France and all the BRICs. Further upside can be derived by improvement in the Freedom from Corruption category. Similarly, the World Bank scores Romania 72nd of 183 countries for its ease of doing business. If the government implements the simple change of shortening the procedures for a new business to get electricity, currently the lowest scoring component, the country can further improve its ranking. On the positive side, both income and corporate tax rates are flat at 16%, which is beneficial for foreign direct investment and business formation. The unemployment rate at about 7% is one of the lowest in Europe.

Source: CIA World Fact book- www.cia.gov

During the global financial crisis, the government showed ability to implement strict austerity measures. In 2010, public sector wages and pensions were reduced by 25% and 15% respectively. Sales tax was increased from 5% to 24%. After a tough initial adjustment, the economy accelerated to 2.5% real growth in 2011. The current account and budget deficits declined substantially. The country is now in a position to raise public wages and pensions, thus stimulating a domestic recovery. Ironically, despite the success of the measures, the center-right government was toppled and a new center-left cabinet was formed earlier this year. Barometers of risk, such as sovereign interest rates, currency movement, and stock exchange performance, seem to indicate a stable environment. Treasury rates have declined to around 6%. The Romanian Leu (RON) has been one of the best performing currencies in Central and Eastern Europe, depreciating by only 3% to the Euro this year. The stock market has recorded a 6% gain in local terms for the first half of 2012. Fitch Ratings recently affirmed its stable outlook for the country.

However, the most important news since our last visit to Romania in 2010 was the discovery of natural gas in the Black Sea. In January of this year, just months after starting deep-water offshore drilling, Petrom (a holding in our portfolio) and ExxonMobil operating as joint venture partners, announced the finding of natural gas. Size estimates of the initial discovery are for 84 billion cubic meters of gas, which equals six years of the country's domestic consumption. While the extraction will take years to materialize, the prospects for the economy and Romania's geopolitical role in the region can be significant. The natural gas market is currently regulated. Local producers, mainly Petrom, are forced to sell gas at about 30% discount to international prices. With new domestic sources, the government can initiate this market's liberalization. Furthermore, with prospects for gas exports, the economy can further diversify its revenue sources and composition (now 30% agriculture, 23% industry, and 47% services).

Source: www.nabucco-pipeline.com

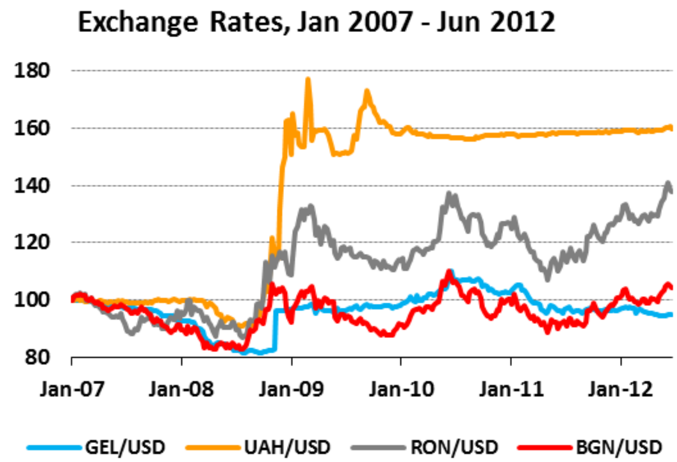
Transportation of the new gas could be assisted by the construction of the EU-backed Nabucco pipeline. This project, which has been in the works since 2002, involves Turkey, Bulgaria, Romania, Hungary, and Austria. It aims to bring gas from the Caspian region and the Middle East to Europe. If successful, the pipeline will provide a new gas supply corridor, reduce geopolitical risks from Russia, and raise the significance of the participating countries. Romania and Petrom, a shareholder in Nabucco through its majority owner OMV, stand to benefit greatly.

The Romanian stock market, we believe, has good prospects. While visiting the country, we met with the leadership team of the Bucharest Stock Exchange. We were impressed by management's openness about investor feedback and vision for future growth of the Romanian market. We learned the stock exchange is working closely with the government and the IMF to jumpstart a new privatization phase in the country. There are already plans for further divestment by the government in some listed companies and initial public offerings in state owned monopolies. The main risks to the market development, we believe, will be market conditions and the pursuit of dual listing overseas by local companies. The Property Fund, a closed-end fund created for restitution purposes, accounts for about a quarter of the daily trading volume. Encouraged by activist shareholders looking to raise the profile of the fund and widen the investor base, the Board recently approved a dual listing on the Warsaw Stock Exchange. While the strategy may work for the Property Fund, it could also dampen the prospects for development of the local equity market.

At the Bucharest Stock Exchange (left to right): Lucian Anghel, President of the Board of Governors of the Bucharest Stock Exchange; Thea; Anca Dumitru, Deputy General Manager, BSE; and Virgil Stroia, CFO, BSE.

Romania, we feel, is fertile for patient stock pickers. The market boasts world-class companies, at undemanding valuations. Petrom, the largest oil and gas company in Southeast Europe and a subsidiary of OMV Austria, has excellent management, good growth prospects, and profitability. The stock currently trades under 4 times estimated 2012 Price to Earnings ratio. BRD, the local subsidiary of Societe Generale, was a market darling during the boom years. Today, it trades below book value and less than 5 times estimated Price to Earnings ratio. The bank is a beneficiary from the flight to safety away from the Greek banks (accounting for 16% market share) in the country. As a result, it has grown its deposits and market share, expanded its net interest margins, and become self-funded. It is now well positioned to extend loans in a recovering economy. Biofarm is a small pharmaceutical company and one of the few remaining independently held in Eastern Europe. It has a focus on the preventive care market, which continues to grow at a healthy 8% to 10% rate as Romanians become more educated on the topic. The company is also pursuing export opportunities, which can bring earnings growth in the mid-teens. It seems a likely candidate for takeover as market conditions improve.

Exhibit 5



Sources: Frontier Market Asset Management; Thomson Reuters

The Property Fund, trading at over 50% discount to adjusted net asset value, is another interesting investment opportunity. Currently about 45% of its assets comprise of listed equities (mainly Petrom) and cash, which prices the rest of the holdings at zero. Upon successful listing of its private holdings, scheduled by the end of 2013, the weight of assets will rise above 70% of NAV. Lastly, the closed-end privatization funds, named SIF1, SIF2, SIF3, SIF4, and SIF5 seem interesting at the current discounts to NAV in the range of 40% to 60%. The trigger for narrowing the discount is change in management. Since formation, the SIFs have been managed by state appointed personnel. Poor management was difficult to challenge as shareholders were only allowed to hold a maximum of 1% in each fund. A new law introduced this year, changed the maximum holding to 5%. The SIFs are now a possible target for activist investors who can appoint professional management to realize the value of the assets. While we are optimistic about our holdings in Romania, we remain cautious as we recognize the risks of association with ailing Western Europe.

BULGARIA

I found my home town, Sofia, quieter than usual. Perhaps, that could be explained by the expansion of the new subway. Construction of the Sofia Metro started in the 1990s and is scheduled for completion by 2015. The city residents are very proud of the accomplishment in progress. The operating stations are rich in art and well maintained. People can now choose first-class transportation over the Communist era alternative of broken-down trolleys and trams. Traffic in this sprawling city is also noticeably lighter.

These days, Bulgarians have more to be proud of. As in other parts of the globe, Bulgaria had experienced high growth rates between 2004 and 2008 (average 6% real GDP growth) resulting from foreign direct investment, access to credit and rising incomes and consumption. However, when the music stopped worldwide, Bulgaria had secured a chair. Since the fall of Communism, Bulgaria has introduced significant structural reforms. The Heritage Foundation has recorded consistent improvement in the country's rankings starting in the 1990s.

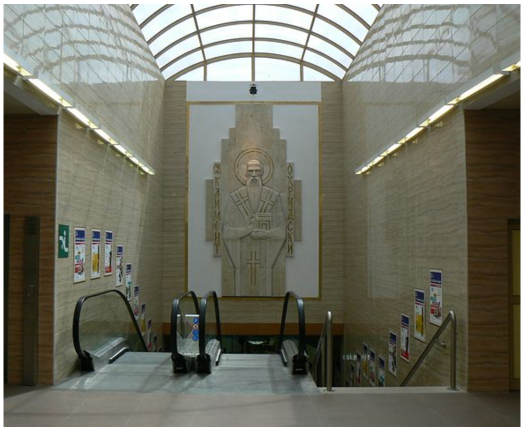
Source: CIA World Fact book- www.cia.gov

Today, the country scores in the top third of all ranked countries for economic freedom and ease of doing business. Bulgaria has the lowest tax burden in the entire European Union with flat 10% income and corporate tax rates (Exhibit 6). Such environment has been conducive to entrepreneurship and investment. During 2011, according to the Bulgarian National Revenue Agency, the number of Greek and Romanian companies registered in Bulgaria grew by remarkable 72% and 50%, respectively.

Exhibit 6	**2012 Ease of Doing Business Rank of 183 countries**	**2012 Index of Economic Freedom Rank of 179 countries**	**Income Tax Rate**	**Corporate Tax Rate**
Developed				
USA	4	10	35	35
Germany	19	26	47.5	15.8
Japan	20	22	40	30
France	29	67	41	34.4
Greece	100	119	45	24
Emerging				
Brazil	126	99	27.5	34
Russia	120	144	13	20
India	132	123	30.9	34
China	25	138	45	25
Frontier Europe				
Bulgaria	59	61	10	10
Georgia	16	34	20	15
Romania	72	62	16	16
Ukraine	152	163	17	23

Source: World Bank and Heritage Foundation

Since our last visit in 2009, most macroeconomic indicators have improved. Economic activity has recovered from the recession, although it remains subdued and exposed to troubles in the West. The current account deficit has swung to a small surplus. The budget deficit has declined to about 2% and the public debt is comfortable at about 17% of GDP. Despite the encouraging developments, there is still much to be tackled. According to the Heritage Foundation, the Rule of Law is applied inconsistently. Organized crime, perhaps weaker than a decade ago, is a threat to society and business. Government corruption is widespread. The demographics are challenging with low fertility and an aging population.



Sofia University "St. Kl. Ohridski" Metro Station (Wikipedia)

From an investment perspective, we are yet to find a compelling opportunity in Bulgaria. The stock market is depressed in liquidity and valuation, and there are few active foreign investors. However, transparency and corporate governance remain of concern. We look for quality companies that have good growth prospects and trade at attractive valuations. We are still on the lookout, with some possible prospects on the horizon.

Conclusion:

We believe this is a good time to revisit the investment case for some countries in frontier Europe. In Georgia, we found a vibrant economy and entrepreneurial people. The country is poised to benefit from the ongoing regional trade realignment. Ukraine remains a tough place for business and the valuations reflect that. Perhaps there is most upside where you least expect it. Romania has emerged stronger from the recent recession. With the prospects of natural gas discoveries, the country's role in Europe can rise in significance. The stock market, we believe, presents interesting opportunities. Bulgaria is structurally stable. With improvement in the application of Rule of Law, its prospects can improve further.

About Frontier Market Asset Management

Founded in 2006, Frontier Market Asset Management holds more than 35 years worth of investment experience including work in Emerging and Frontier Markets since 1987. For more information, please contact us at (858) 456-1440.