

## In Search of the Good: *Kenya, Serbia, Romania & Ukraine*

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*Plitvicka Jezera National Park, Croatia*

*"Le mieux est l'ennemi du bien" – The perfect is the enemy of the good*  
- Voltaire, *La Bégueule*

During the Balkan conflict, soldiers fought at the Plitvicka Lakes. The bear and deer were killed for food. The land was despoiled. Now, nature has reclaimed it, and the beauty of the place is breathtaking.

It would be nice to say that the economies in the Balkans have recovered just as fast, but that is not true. The old ways of corruption and bureaucracy die hard, and they nourish the common notion that the Balkans and indeed all of frontier markets are places of intractable problems and low growth. Fortunately, there is evidence to the contrary.

Frontier markets are far from perfect... but perhaps they are good enough. Our challenge is to overcome the prejudice that frontier markets are truly bad and filled with unsavory despots, corrupt politicians and dicey companies that follow dubious business practices. In our recent research trip, we traveled in Kenya, Croatia, Serbia, Ukraine and Romania. We took more than a dozen flights, and we met with more than 30 companies. Our travels (and occasional travails) reassured us that this is a good time to be researching investments in the frontier.

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The table at the right shows one of our favorite indicators of quality: the ranks of Economic Freedom from The Heritage Foundation. These ranks combine measures of the ease of doing business from the World Bank, corruption ranks from Transparency International and several measures of economic policy.

As the table shows, most of the countries we visited on our trip compare favorably with popular emerging markets such as Russia, India and China, as well as with Italy.

Kenya, Croatia, Serbia and Romania all rank better than Russia, China and India. And Croatia and Romania are better than Italy.

Ukraine has its problems, and because of them, its rank has dropped 5% since 2009. Kenya has dropped as well, but its rank may rise following the peaceful March 2013 election.

| <b>Economic Freedom</b> |      |            |
|-------------------------|------|------------|
|                         | 2013 | 4 yr % chg |
| Kenya                   | 55.9 | -5%        |
| Croatia                 | 61.3 | 11%        |
| Serbia                  | 58.6 | 4%         |
| Romania                 | 65.1 | 3%         |
| Ukraine                 | 46.3 | -5%        |
| Russia                  | 51.1 | 1%         |
| India                   | 55.2 | 2%         |
| China                   | 51.9 | -2%        |
| Italy                   | 60.6 | -1%        |

Source: Heritage Foundation, 2013

During the course of our trip, we met with companies that had a range of stories to tell: from optimistic and hopeful, to depressed and dismal, to “pie in the sky” and questionable. Overall, the African growth story is much more interesting than the “turn-around” opportunity of Eastern Europe, but there are good and bad stocks in both places. A few common themes prevail: the middle class is becoming a more powerful force in economies everywhere; local knowledge matters in the face of competition; and markets are underpenetrated.



**Kenya**

In the early morning hours of August 7<sup>th</sup>, fire destroyed the international terminal at Jomo Kenyatta International Airport in Nairobi. In the chaos, the fire engines took two hours to arrive and, in the aftermath, some police are themselves being investigated for looting.

Despite this catastrophe, there may be a silver lining: no longer will travelers have to endure the decrepit old terminal’s crowded hallways, dingy trinket shops and malfunctioning restrooms. And now, the new terminal next door, being built by Chinese contractors, is being rushed to completion by year-end instead of next spring. Meanwhile, international flights at back on schedule using temporary facilities.



We had passed through the old terminal in June and we do not mourn its loss. Our destination in June was the Windsor Golf Hotel northwest of town. Staying at this resort may be a poor way to see Kenya, but it's a good way to meet with fifteen companies in two days at the fourth annual African Alliance conference.

The conference itself is an indicator of change in the frontier, because its popularity signifies the maturation of the Sub-Saharan financial markets, the growing sophistication of local companies and the rising interest of foreign investors.

Kenya has been through a lot lately, with its troops sent into Somalia, bomb blasts in Nairobi, travel advisories and election uncertainties. It seems likely that the path ahead will be less bumpy. If so, the ride should be smoother for many companies as well.

One of the depressing and dismal stories we heard was that of Kenya Airlines, whose stock has plunged 80% in three years. Its cabin factor (the percent of seats filled) has sunk to 68%. However, things may get better if rebuilding the airport leads to more tourist arrivals and more local air travel. A recovery in the cabin factor to 72% will put the airline in the black.

A "pie in the sky" story lies at the other end of the transportation spectrum. The Rift Valley Railway (RWR) is being rebuilt by Transcentury and its lead partner, Citadel, based in Egypt. At its peak in the 1980s, RWR hauled 4.8 million out of 7 million tons of freight from Mombasa port to Nairobi. Today, the railroad is lucky to haul 1.7 million tons, while the rest of the port's 16 million tons is slowly moved by truck. RWR's fleet includes 150 locomotives, but 80 are broken. Plans to repair twelve this year are proving optimistic. Only three have been fixed through June because most repair parts for the forty year-old engines have to be custom fabricated. And of 4,000 wagons, 2,500 are broken. The track is so worn that despite replacing 70 kilometers of curves, derailments are frequent. A fully loaded train cannot make the entire trip to the end of the line in Uganda.

Not only is transportation from Mombasa an embarrassment, but the port itself is decrepit. The tonnage handled by Mombasa in a year is what Singapore and Shanghai handle in a week. Wolfgang Fengler of the World Bank wrote:

*"To import a container from Singapore, your goods would spend 19 days on the sea (over 7,500 kilometers), but they would need 20 more days just to make it from Mombasa by road to Nairobi. Bringing a container from Tokyo to Mombasa would cost you less than bringing it from Mombasa to Kampala [Uganda]."*

Realizing the Kenyan Dream, Fengler, 2013

On the brighter side, a ring road around Nairobi has been finished, cutting the drive from the Windsor Golf Hotel to the airport by an hour. And Kenya's GDP growth is 5-6%.

Two companies from Rwanda told optimistic stories, based on 7% GDP growth and the focus on efficiency by the government. Rwanda is seeking a knowledge-based economy with high growth in IT, services and finance. It has an Economic Freedom Rank of 64.1, up 18% since 2009. We learned that Rwanda has a huge cement project underway that will make the country self-sufficient. Nothing had been said of this by Bamburi, Kenya's leading cement company. They had boasted instead of the high prices of their exports to Rwanda, at \$220/ton versus \$140 in Kenya. Cement is indeed a growth story in the frontier countries compared to the rest of the world: Kenya consumes only 90kg/capita per year and Uganda only 50, compared with 230 in South Africa and 610 in Egypt. But the problems in cement are not growth, they are potential over-capacity and competition.

Bamburi recently had a cautionary experience in Uganda where its long-held mining license was suddenly revoked by the Minister of Energy and given to East Africa Gold Sniffing Company Limited. EAGSCL has no known assets, but was granted both an exploration and development license overnight on grounds that the Bamburi's license was not valid. The government claimed that Bamburi's local subsidiary had been invalid since it filed for a name change in 1999... As they say, "the matter is in the courts."

Research in the frontier often requires being prepared for the unexpected and being careful to check on what you hear. For example, the Dutch manager of a Tanzanian bank complained that one of his competitors was "running hard" and "facing some corporate governance issues". Then we learned that the competitor had just won a license to service all of the government employees in Dar es Salaam. This choice piece of business had been the "bread and butter" of the Dutch manager's bank, and he was fighting all the way to the Supreme Court to prevent losing it... We would prefer to own the competitor.

In general, though, the banking sector in the region is thriving, with net interest margins of 5% or more. The banks complain that there is pressure on margins, but then they say that competition from ex-patriot banks is over-rated. Nigerian banks have been struggling in East Africa, and Equity Bank, which has led the market in Kenya, is struggling to gain a foothold in Uganda.

We believe that the landscape of financial services in Africa is changing rapidly and it is presenting huge opportunities for both the participants and their customers. New technologies have accelerated this process, as with "M-Pesa" introduced by Kenya's cellphone leader, Safaricom, in 2007. It allows for person-to-person transfers of money using codes on their phones. A worker in the city can easily send money to parents in a rural village, where they simply take their cellphone with a PIN number to a retailer authorized to disburse the cash. Now, Safaricom customers are moving \$1 billion each month, and they are applying for loans using their phones as well. Meanwhile the banks have responded with networks of agents in convenience stores that can provide certain banking services. Consumers will be the winners as banks realize that their depositors can no longer be fleeced with low deposit rates and high cost loans.



**Croatia**

With stock markets closed over the weekend, we took the opportunity to return to Croatia, where wilderness awaits just two hours from Zagreb. In contrast to its neighbors, Croatia seems like a developed country with a broad auto-route slicing across mountains and gorges. Our destination in Croatia was Plitvicka Jezera (pronounced "Plit-vitch-ka Yazera").

This is a land of falling waters, with wooden walkways crossing over torrents of water. Two years ago in winter, it was spectacular, laced with snow and ice. Now in the green of early summer, it was doubly impressive as the upper lakes were now open, displaying exotic formations of their own.



*Plitvicka Jezera National Park,  
Croatia*

We have not yet found stocks in Croatia that present the right balance of value and price, but we are watching the market in hopes that opportunities will occur. Croatia is a wonderful country, and its recognized tourism attractions seem to have spilled over into relatively rich valuations of its stocks.



## Serbia

Serbia is still struggling with the aftermath of the Balkan crisis, when Milosevic led it into a horrible war of aggression. The chronology is worth remembering:

|             |                  |  |
|-------------|------------------|--|
| <b>1991</b> |                  | Slovenia declared independence and won a short war.  |
| <b>1991</b> | <b>June</b>      | Croatia declared independence, and immediately its Serb minority in Krajina declared independence from Croatia.  |
| <b>1991</b> | <b>Summer</b>    | Yugoslav Army seized 25% of Croatia and blockaded its ports; costing 10,000 Montenegrin troops lives.  |
| <b>1991</b> | <b>October</b>   | Bosnia & Herzegovina declared independence, which led to four years of civil war in Bosnia between Bosniaks, Bosnian Serbs and Bosnian Croats. Cost: 200,000 lives |
| <b>1992</b> | <b>January</b>   | UN brokered ceasefire in Croatia, which joined the UN in May.  |
| <b>1993</b> |                  | Serbian hyperinflation, 500 Billion Dinar bank notes were printed.   |
| <b>1993</b> | <b>January</b>   | Croatian army offensive against Serbs in Krajina.  |
| <b>1993</b> | <b>May-Aug</b>   | Croatian army offensive against Serbs in Slavonia, east of Zagreb, Serbs shelled Zagreb.   |
| <b>1995</b> | <b>July</b>      | Bosnian Serbs, led by Ratko Mladic, massacred 8,000 Muslims at Srebrenica.   |
| <b>1995</b> | <b>September</b> | NATO air strikes against Serbia ended the siege of Sarajevo in Bosnia.   |
| <b>1995</b> | <b>December</b>  | Dayton Peace Accord, set Croatian borders and partitioned Bosnia & Herzegovina by ethnicity into three regions.  |
| <b>1998</b> | <b>January</b>   | Serbs moved to ethnically cleanse Kosovo of Albanians. Macedonia sheltered 400,000 Kosovar Albanians.  |
| <b>1999</b> | <b>June</b>      | Serbs, under Milosevic, withdrew from Kosovo after 78 days of NATO bombing Belgrade, Serbia.   |

Scars of the bombings are still visible on the former military buildings in Belgrade, but there is much new construction outside of the old town.

Serbia's economy is now growing modestly at 1.5-2% with exports driven by a Fiat plant that produces the new Fiat 500L 4-door. Despite this progress, unemployment is high at 22%, and distortions in the economy result in a large "informal" sector (underground) representing more than 30% of total economic activity. Employment is only 36.7% compared with 60-70% in Europe.



*Belgrade government building*

Unfortunately, many Serbian and Eastern European business practices fall in the category of dismal and questionable. One pharmaceutical company spent a quarter of its market capitalization on improving the computer efficiency of its plant. The cloak of "IT spending" is often used to hire friends and relatives for idle work rather than to achieve technological progress. Some of this work must have made a

contribution, since the company does now have plenty of excess production capacity, but perhaps the money would have been better spent on licensing its products in Europe rather than IT. In the banking sector, one bank, known for aggressiveness, sports a 29% non-performing loan ratio and has lots of litigation underway. We heard the comment that: “they don’t have a risk department... They just have lots of good lawyers who take your house, your wife, your kidneys or whatever.”

Greek banks had a strong presence in Serbia until recently, but now they are being shown the door. Piraeus Bank will have a challenge in exiting its 20% stake in one local bank as the controlling shareholder is said to be trying to depress the price of his own stock in order to buy them out cheap.



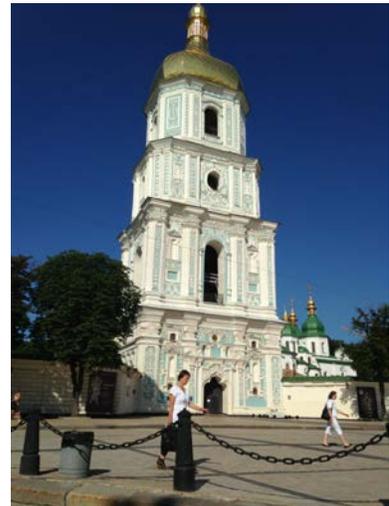
Map of Eastern Europe, History-map.com

It was a good reminder of the many cultural commonalities that exist throughout the Balkan Region. This style of coffee was introduced to the region by the Ottomans sometime around the middle of the last millennium and has endured to the present. In Croatia, it is referred to as “*Turska Kava*” and in Serbia as “*Domacha Kafa*” (domestic coffee). It is what you should expect to receive if you simply ask for “*Kafa*” in *Bascharshiya*, the old Turkish town in Sarajevo, Bosnia and Herzegovina.



Ukraine was the industrial heartland of the Soviet Union, with GDP per capita 10% higher than that of Russia. Its steel, chemicals and aircraft manufacturing plants produced 40% the Soviet Union’s weapons during the Cold War.

Ukraine has also been an agricultural breadbasket, possessing 30% of the world’s black earth. The nation’s flag symbolizes fields of grain under a blue sky. This land has been enormously productive through the years, although it collapsed under Stalin’s disastrous collectivization program. The resulting famine killed 11 million people in 1932-33, including one out of every five Ukrainians. Another notorious consequence of Soviet times is Chernobyl, 60 miles north of Kiev, still radioactive 21 years after its nuclear meltdown.



Kiev church

Today, Ukraine is cursed with some of the murkiest politics in the world. Former President Tymoshenko is in jail for her crimes and corruption, but her deeds were no worse than those of the current politicians in power.

With Tymoshenko in a prison hospital with a bad back, politicians may agree to a deal to send her to Germany so long as she doesn’t return. Elections are coming up in 2015, and the government is worried. It is said that, “If a donkey makes it into the second round against President Yanukovich, the donkey wins.”

Meanwhile, the country suffers under Tymoshenko's onerous gas price deal with the Russians, at \$520 per trillion cubic feet, less a \$100 discount for allowing the Soviet fleet to use Sebastapol until 2042. The deal cuts GDP by 2% a year, resulting in zero growth in 2012 and probably 2013 as well. In the absence of a growing economic pie, politicians are trying to take a bigger slice for themselves. Yanukovich is said to be holding up land reform until a land bank is established that his family would run. As a result, land values are down 40% since 2007, and re-zoning for development has been held up.

Even simple businesses, like dairy processing, are impaired by political maneuvering. A recent report on Milkiland by Dragon Capital explains, that "legislation...has been known to change on short notice with regard to subsidies for dairy producers and raw material price regulation." This refers to a recent scheme whereby the government took VAT transfers from the producers and then paid the farmers rather than having the producers pay the farmers directly. Milk prices went up when the government proved inept (or corrupt), causing delays in payments to the farmers.

In an example of unsavory regional politics, Russia claimed that Ukrainian cheese was tainted with palm oil. After banning imports for four months last spring, inspectors found no trace of palm oil. The ban was lifted... at exactly the time when Ukraine's relations with Russia improved.

Ukraine's stock market also has its quirks. Only a handful of stocks trade locally and even then half their volume is done off the board. Meanwhile 80% of Ukrainian stock trading volume is done either in London or Poland, and most companies have legal domiciles in places like Luxembourg, the Netherlands, Cyprus and the U.K.



Romania

"Don't get sick in Romania. Or get sick only at the beginning of the month. If you go to the doctor, you need to look both very sick and very poor." Thus spoke the head of a successful pharmaceutical company that specializes in the OTC market. They avoid government-funded healthcare, because it is so bad. Cost containment is based on limiting drugs to sickest, poorest patients. Everyone else has to fend for themselves.

Despite this, we like Romania, because the current account deficit is running a slight surplus thanks to draconian budget cuts a couple of years ago. Collateral damage was protests that led to a change in government last year. GDP growth expected to be 2% this year, low by the standards of Sub-Saharan Africa, but the highest among countries we visited in the region.



Stalinesque building in Bucharest

State Investment Funds (SIFs) control much of the economy, and some act like closed-end funds with a license to steal. Many are run by long-time bureaucrats who loaf on the job and commute in flashy SUVs. They are required to hold 80% of assets in publically traded equities and are limited to annual turnover of 10%, a limit that most of them never reached because of managerial inertia. Until recently shareholders

were limited to 1% of each SIF, so shareholder activism was just a dream. Now this is changing: shareholder limits have been raised, and one SIF has recently taken over the management company of another SIF.

## Conclusion

*“Speak the truth, but leave immediately afterwards” – Slovenian proverb*

In order to understand the frontier world, it is helpful to travel quickly across it - perhaps not so quickly as the sun does, but quick enough that the impressions of one frontier country are fresh enough to contrast with the others. On this trip, we started in Africa, changed planes three times in Vienna to connect between cities in Eastern Europe, and ended at an Africa conference in London.

|                          | Croatia  | Ukraine | Serbia   | Romania  | Kenya   |
|--------------------------|----------|---------|----------|----------|---------|
| GDP Growth (2013 est)    | 1.0%     | 0.0%    | 1.5%     | 2.0%     | 5.0%    |
| Inflation                | 4.0%     | 1.0%    | 5.0%     | 3.0%     | 6.0%    |
| Population (mil)         | 4.5      | 44.6    | 7.2      | 21.8     | 44.0    |
| People / km sq           | 79       | 74      | 93       | 91       | 76      |
| % Literate               | 99%      | 100%    | 98%      | 98%      | 87%     |
| % Literate Female        | 98%      | 100%    | 97%      | 97%      | 84%     |
| % under age 15           | 15%      | 14%     | 15%      | 15%      | 43%     |
| Life expectancy          | 76.2     | 68.9    | 74.8     | 74.5     | 63.3    |
| % Urban                  | 58%      | 69%     | 56%      | 22%      | 22%     |
| GDP / cap (PPP)          | \$18,100 | \$7,500 | \$10,600 | \$13,000 | \$1,800 |
| Electricity/cap kWh      | 3,731.8  | 3,933.1 | 5,159.5  | 2,466.3  | 125.2   |
| % Unemployed             | 20%      | 7%      | 22%      | 40%      | 40%     |
| Land (km sq)             | 56,974   | 603,550 | 77,474   | 238,391  | 580,367 |
| Market Cap (\$ bil)      | \$21.3   | \$25.6  | \$9.5    | \$29.6   | \$10.2  |
| Market Cap/GDP           | 37.3%    | 14.5%   | 25.5%    | 17.4%    | 24.8%   |
| GDP (Official Exch Rate) | \$57.1   | \$176.2 | \$37.4   | \$169.4  | \$41.1  |
| Military exp % GDP       | 1.5%     | 0.6%    | 1.8%     | 1.9%     | 1.8%    |

Source: CIA Factbook, 2013

In our last meeting on our last day of the trip, we asked Dr. Adesola Adeduntan of African Finance Corporation about corruption problems in the countries where he makes loans across Africa. He said “transparency moves with democracy” and added that in Angola transparency would directly reduce corruption. In Nigeria, Dr. Adeduntan said that open elections have led to better managers being elected in more state and that today 60% of budgets are being spent responsibly, versus only 10% just a few years ago.



Plitvicka Jezera National Park, Croatia

We cannot say that the frontier is a completely wonderful place filled with opportunities everywhere. We need to be realistic about the shortcomings, but we also need to recognize the progress. Sir Watson-Watt, father of radar, favored the “cult of the imperfect”, saying “give them the third best to go on with, the second best comes too late, the best never comes.”

We believe that frontier markets are good “to go on with” today. They are far from perfect, but many of them surprise us with how much better they have become, since the old days when we called them the “third world”

### 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.

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