Lions in Winter –
Frontier Markets in a Cold World

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Lion at dawn… The last day of winder in Nairobi National Park

It is easy to get confused these days.

On March 17, BBC news reported on a conference of African officials with Gordon Brown in London saying: "Downturn 'risks Africa conflict'". On the same day, we attended a nearby conference of companies from Sub-Saharan Africa that was upbeat, with forecasts of slow but positive growth for the continent. Then, on a night flight to Nairobi, we happened to meet James Musoni, Minister of Finance and Economic Planning of Rwanda, who was one of the delegates meeting with Gordon Brown. "BBC completely misrepresented the conference," he said adding that the discussion was not about conflict but focused on urging that some bailout funds be allocated to the poorest countries instead of the richest bankers.

We are bottom up stock pickers, but in these times, it helps to do a reality check from the top down perspective on some of the macro factors affecting our investment opportunities. On this trip, we went to cool and cosmopolitan Nairobi in Kenya, hectic Dar es Salaam in Tanzania (where the traffic belies the city's name as a "haven of peace"), and exotic Zanzibar, an island off the cost of Tanzania, whose narrow streets and pungent smells recall its wild past. We met with more than a dozen companies and talked with business moguls, economists, company managers, fund managers, brokers, students, a news

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reporter and several friends including one who is an agricultural expert.

After hearing the wide range of opinions we wondered if we were becoming bi-polar, but our mood swings eventually sorted out into thoughts along four dimensions of global competitive advantage: **resources, geography, talent** and **productivity**. In the developed world, increased credit leverage has been the prime force creating economic growth (credit grew more than five times as much as GDP in the US in the past ten years). The frontier countries, on the other hand, can grow on their own, the old fashioned way, by seizing basic productive opportunities, copying the best practices of the developed world, and leaving the rest behind.

KENYA

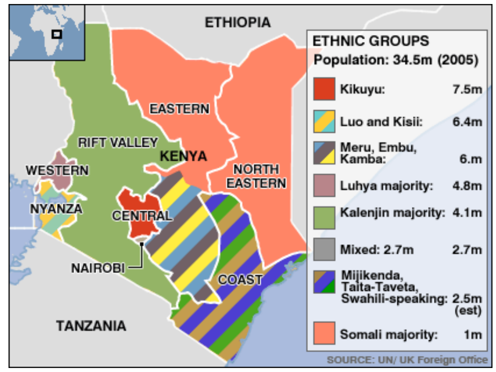
Today, Kenya is a country where **geography** and **talent** make up for the lack of natural **resources**. The story of Kenya is well told in The Lunatic Express, by Charles Miller, 1971, which recounts the saga of the Kenya-Uganda railway. Built with the dream of harvesting resources from the interior, it had to contend with the hostile Masai tribe, challenging terrain that rose to 8,000 feet, malaria and attacks by wild animals, including two lions that ate 28 workers at Tsavo in 1898. Even the Superintendant of Railway Police was eaten while he waited at night in a railway car to catch them.

Strathmore University MBA Program, Nairobi

Nairobi was founded in “an unhealthy locality swarming with mosquitoes,” but it gained “first mover advantage”. By 1904, when a committee of doctors petitioned to relocate it, Nairobi was too big to move. Today, the swamps have been cleared, and the city benefits from its cool climate at 5,000 feet. Lions no longer prowl Sixth Avenue (one was shot trying to enter the post office in 1905), but we did find seven lions stalking zebra barely ten miles away in Nairobi National Park.

With 2.5 million people, Nairobi has a depth of **talent** unmatched in East Africa. An insurance entrepreneur in Dar es Salaam told us that it took him two years to find a good senior staffer in Tanzania, and he still keeps all his back office workers in Nairobi. We were very impressed with the bright MBA candidates at Strathmore University where we fielded challenging questions for two hours one evening. Tapping into Kenya’s talent pool, Scangroup is a local advertising agency that is expert in the marketing nuances of East Africa, so it serves most of the global advertising networks for their business in the region. Kenya is also the headquarters of Access Kenya, an internet services provider that offers satellite service that is slow, but still the best in town. They charge $125 per month for 64k service speed. With this, it took two hours at the Stanley Hotel to check emails that we could have viewed in minutes at home. All of this will change dramatically when Seacom completes its submarine cable in June 2009. The painfully slow internet service that prevails throughout East Africa will see a tripling in speed and a 60% drop in cost according to Access Kenya. The impact on **productivity** will be huge.

A reflection of Kenya's independence from the world economy is that there is more concern on the streets over the late arrival of rainy season, which is critical to farmers in the north, than over the bailout packages on Wall Street. Reflecting Africa's diversity, 400 miles to the south, Tanzania Breweries complained that the construction of their new plant in the southern highlands has been delayed by too much rain.



When it comes to government, Kenya certainly has its challenges. Last year post-election violence killed 1,500 people until a coalition government was agreed upon (with heavy outside pressure).

Problems with corruption still persist, and they have probably increased since the coalition government has swollen the ranks of patronage seekers. There are now 42 ministries with mouths that need to be fed…. On the other hand, there is some progress with an infrastructure program that will spend $200 million on the airports, $55 million on geothermal power in the Rift Valley and $365 million on roads. This can't come too soon, given the vast traffic jams we confronted….

A six lane traffic jam with alternate lanes moving in opposite directions!

Better infrastructure will further strengthen Nairobi's position as a transit point in East Africa adding to Kenya's **geographical** advantage and its **productivity**. Already Kenya Airlines' hub makes Nairobi the only alternative to flying through Johannesburg when traveling between countries in the region.

TANZANIA

Arriving in Dar es Salaam on Kenya Airlines, we noticed a promotion at their city office for popular destinations: Nairobi, Mumbai, Johannesburg and, last but not least, China. These don't include destinations that might seem popular to us, such as London, Paris or New York, but this is a sign of the times. Both India and China are big investors in the region.

On the ferry to Zanzibar, we saw several Chinese visitors who were friendly but silent about their business in the country. At Tanzania Breweries, we learned that the Chinese had been active decades ago during Tanzania's socialist period, building textile factories and roads, but now with the country's new spirit of private enterprise; they have returned looking for timber and agricultural land to grow products for export to China.

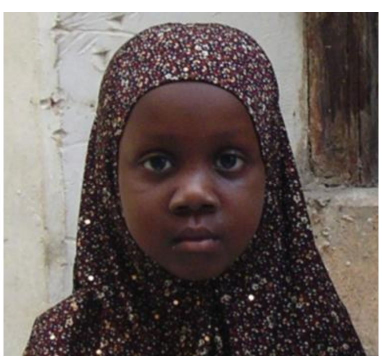
Kenya Airlines promotions

Much of their investment is going into rural areas, and they are securing nickel and platinum concessions. The Exchange, a magazine published by the East African Securities Exchanges, reports that China is persuading countries to open Special Economic Zones (SEZs) in the region. This echoes the SEZs that jump-started economic growth in China 25 years ago. State Bank of Mauritius confirmed that China plans to invest $2.5 billion in a “free” hub in Mauritius which will include warehouses and light industry to facilitate China-Africa trade. China has also proposed a mining based SEZ in Zambia’s Copperbelt region and a logistics hub in Dar es Salaam. Additionally, China is funding the upgrade of the Tanzam railway line from Dar es Salaam to Lusaka in Zambia, which the Chinese had built in the 1970s. From Lusaka, they will upgrade the line across to Benguela in Angola, near the Atlantic coast. They have already invested in the Dar es Salaam port and built the new customs building. This infrastructure corridor will change the logistical dynamics of the continent. With a bi-coastal east-west passage across Central Africa, Tanzania will gain a **geographical** advantage and many shipments will bypass South Africa.

China’s investment in a trade corridor through Tanzania echoes that of the Sultans of Oman who took Zanzibar from the Portuguese in 1698 and used it as a trading hub for spices, ivory and slaves. In 1837, the Sultan liked it so much he moved there from Oman with his many concubines and eunuchs. It was a colorful place, with routine kidnappings and murders; and the narrow alleyways were notorious for their stench - some still are… In 1866, the daughter of the Sultan, 22 year old Princess Salme, had an affair with a German merchant and fled, five months pregnant, aboard a British gunboat. A British man-of-war had to be sent in to prevent the wholesale massacre of foreigners. Fortunately, things have calmed down a bit since then.

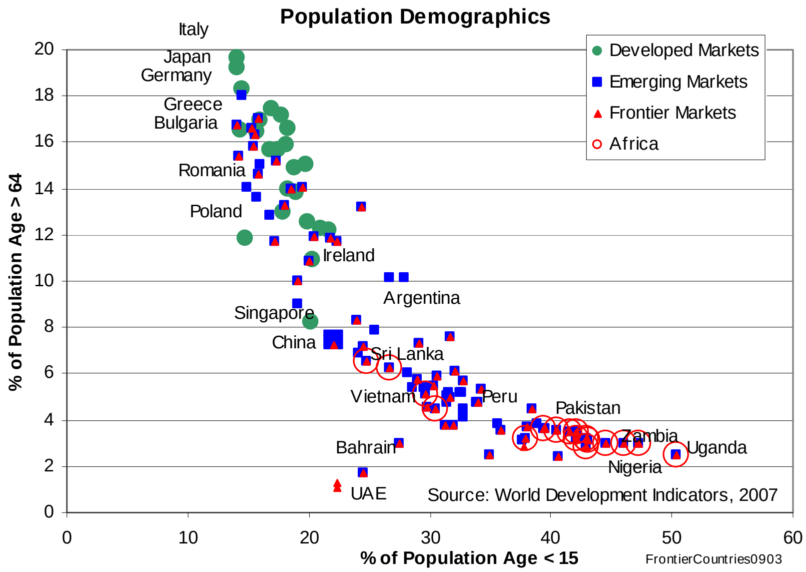
If Zanzibar’s doorways could talk….

Although Tanzania’s political situation is not great, it is presently better than in Kenya. It seems that people everywhere have a cynical view of their politicians (as some do here in the US). In Dar es Salaam, our taxi driver called his president “Mr. NATO - No Action, Talk Only”. Still the entrepreneur running an insurance brokerage firm said that he had moved from Kenya because Tanzania is starting from a low base and the change is positive. His business has doubled each year, and he is optimistic. Although he joked that it takes eleven laid-back Tanzanians to equal one Kenyan, we suspect he was exaggerating somewhat.



Tanzanian Breweries emphasized one of the big advantages of frontier markets: youth. Currently beer consumption is 5-6 liters per person per year, compared with 45 liters in Mexico and 62 in the U.S. On the other hand, the drinking age is 18 and 43% of the population is under age 15. Clearly as the population matures, beer consumption will rise, but more importantly, there will be a bigger pool of not just beer drinkers but workers with **talent** entering the labor force. As shown by the open red circles in the chart below, Africa is defined by its young population, 30-50% of the total under age 15; this will be a competitive advantage as the developed world ages (along with China due to its one child policy). Urbanization is another trend that will continue, and as it does, it will have additional positive influence on **productivity**.

Achieving this productivity depends on job creation; and one example of this was provided by Swissport Tanzania, the locally listed subsidiary of the global cargo handler. Until recently, output of the country's small flower industry was shipped to Europe via the limited space on KLM passenger jets out of Nairobi. Now USAID has helped with the construction of a cold storage warehouse at Kilimanjaro airport close to the growing areas. This will allow faster shipment of greater quantities, thus helping to expanding Tanzania's budding horticultural industry.



Challenges

Although our impressions on the ground in Africa are mostly positive, there are challenges.

Some are due to the global financial crisis, such as the decline in foreign direct investment, especially in mining where prices have fallen. Also, remittances from workers abroad have dropped, although given the weak currencies, the local currency amounts are not down as much as the dollar amounts. And foreign aid may drop, which is especially critical to countries like Malawi and Tanzania where aid is a big part of government receipts (41% for Tanzania). On the other hand, food aid to Kenya's farmers was recently doubled by the UN, so the outlook is not entirely bleak.

Finally, some countries, such as Nigeria, are struggling with self-inflicted problems. Nigeria's stock market boom has collapsed, and the regulator has made matters worse with temporary trading halts. In addition, the currency is down, and the central bank even closed the foreign exchange market briefly. Many banks have had large margin loans to stock market speculators, and now the banks hold the collateral – mainly shares of the banks themselves. These cross-holdings overstate the capital base of the banking system and overhang the market. Furthermore, Nigeria's National Petroleum Company has delayed payments to downstream processors who have seen interest rates on their loans go from 10% to 30%, threatening defaults. Meanwhile, there is no central credit bureau in Nigeria, so banks can't tell if a prospective borrower has many loans already outstanding to other banks. There may be bargains there, but it's not for the faint of heart.

Fortunately, these problems do not prevail in most frontier countries where conservative lending is more the norm.

Conclusion

Zanzibar children beneath a health poster

In early March, Mr. Dominique Strauss-Kahn of the IMF said, "Even though the crisis has been slow in reaching Africa's shores, we all know that it is coming-and its impact will be severe." In response, our friend and classmate, Jon Auerbach, head of the brokerage firm Auerbach Grayson, responded: "personally, having just returned from a month in Africa…I am appalled and incredulous… [Either] he is shamelessly setting himself up to take credit down the road for the miraculous contribution Africa will make as global growth recovers [or,] it just confirms how out of touch they are."

It is often easy to look at things without truly seeing them. On our trip we tried hard to see beneath the surface and gain an understanding of the dynamics at work in frontier markets. In the past 20 years, subtle differences in emerging markets have resulted in big differences in progress, resulting in the major differences today between Brazil and Mexico, between China and India and between South Korea and Malaysia. Today, there are both subtle and not so subtle differences between frontier countries like Kenya and Tanzania or Botswana and Zambia. Some countries will lead while others will catch up, and a few may be lost in the wilderness (as have the emerging countries of Thailand and the Philippines over the past decades). We are optimists on frontier markets because we believe that they have many global competitive advantages in **resources, geography, talent** and **productivity**. Overall, we believe most of them will succeed. Even without strong economic growth in the developed world, the frontier countries can be self-sufficient and successful, just like the lions in winter in Nairobi National Park.

Patience is required, whether in investing or watching a Polaroid picture develop…

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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