



On the Silk Road – Kazakhstan & Uzbekistan

By Lawrence Speidell

In December, Almaty is bright with holiday lights everywhere: in parks, on buildings, on lampposts on fences and strung across the major streets. Trees are covered with lights, and where there are no real trees, they are made from strings of lights in a cone, with a star on top. There are lighted figures of lambs, snowmen and polar bears. There are even lights depicting sleighs with a jolly chap inside, but this is not Saint Nick. Father Frost rules the celebration of the New Year season in Kazakhstan, and there is a frenzy of shopping. Upscale shops line many streets, and Tiffany & Co. has just opened its store.



Holiday lights are bright in Kazakhstan
All photos: Frontier Market Asset Management

We journeyed to Kazakhstan and Uzbekistan in search of stock markets that might be less picked over than those in Eastern Europe, and we were pleased with what we found. The stock market valuations are more in line with those in Bangladesh or Sub-Saharan Africa, although there are challenges.

Things are tightly controlled in both countries, with police checkpoints especially noticeable in Uzbekistan. Longtime president Karimov has tightened security under the guise of terrorist threats in this country of 26.6 million people, of which 85% are Muslim. During an hour's drive out to the mountain resort of Beldersay, one passes half a dozen guard posts where motorists are randomly stopped to check papers. Among other things, the government limits the volume of loudspeakers that carry the call to prayer from the mosques, and the BBC website is blocked. Meanwhile in Kazakhstan, President-for-life Nazarbayev is less noticeable (his pictures aren't in every office), but there is no mistaking that this is a former Soviet state, with the government owning a lion's share of many businesses. Nazarbayev is reported to be one of the world's richest men.

Resource wealth is huge in Central Asia, and the energy resources are summarized in the table below. While total world oil reserves have risen from 667 billion barrels in 1980 to 1,208 billion in 2006, Kazakhstan's proven reserves have grown from zero in 1980 to 39.8 billion today, ranking it 9th, just ahead of Nigeria. In addition, both Kazakhstan and Uzbekistan have significant gas reserves, ranking 11th and 19th respectively.

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| Oil Reserves (Billion barrels) | | | | | Gas reserves (trillion cubic meters) | | | | |
|--------------------------------|------|-------|---------|---------|--------------------------------------|------|------|-------|---------|
| | Rank | 1980 | 2006 | % Total | | Rank | 1980 | 2006 | % Total |
| Saudi Arabia | 1 | 168.0 | 264.3 | 22% | Russian Federation | 1 | - | 47.7 | 26% |
| Iran | 2 | 58.3 | 137.5 | 11% | Iran | 2 | 14.1 | 28.1 | 16% |
| Iraq | 3 | 30.0 | 115.0 | 10% | Qatar | 3 | 2.8 | 25.4 | 14% |
| USA | 11 | 36.5 | 29.9 | 2% | USA | 6 | 5.6 | 5.9 | 3% |
| Kazakhstan | 9 | - | 39.8 | 3% | Kazakhstan | 11 | - | 3.0 | 2% |
| Uzbekistan | 49 | - | 0.6 | 0.05% | Uzbekistan | 19 | - | 1.9 | 1% |
| TOTAL World Oil | | 667.1 | 1,208.2 | 100% | TOTAL WORLD Gas | | 84.7 | 181.5 | 100% |

Source: BP Statistical Review 2007

In addition to its oil and gas, Kazakhstan ranks first in the world in zinc and tungsten reserves, second in silver, lead and chromium, third in copper, fourth in molybdenum and sixth in gold. Uzbekistan is the world's second largest exporter of cotton, but gold and uranium are also significant products.

The region is rich in history, with trade routes across the "steppes" (plains) of Central Asia dating back 3,000 years. Threads of Chinese silk have been found on Egyptian mummies. And in Rome 2,000 years ago, Pliny was scandalized by women in silk garments who were "dressed yet nude". Not only was Central Asia the route of the Silk Road, it was home to fierce tribes. Herodotus in ancient Greece heard of warrior women called the Amazons, and now archeologists have discovered graves near Almaty of women soldiers, buried with swords, daggers and arrows.

Later, in the thirteenth century, Genghis Khan led the Mongol hordes, 200,000 strong across the region. "You could smell them coming, it was said, even before you heard the thunder of their hooves. But by then it was too late. Within seconds came the first murderous torrent of arrows, blotting out the sun and turning day into night. Then they were upon you – slaughtering, raping, pillaging and burning." (*The Great Game*, Peter Hopkirk, 1990). Later, in the 19th century, Russia seized control over much of the region, and then 100 years ago, it was the scene of The Great Game, a battle of intrigue and espionage between Russian and British interests.

Finally in 1991, the "Stans" of Central Asia became independent and are now rebuilding their national identities. This is a special challenge in Kazakhstan which blends a population that is 53% Kazakh with minorities of Russians and Ukrainians who arrived during Khrushchev's Virgin Lands Campaign.

Both countries have achieved high growth rates of 7% plus, but at the cost of inflation that is officially single digits but in actuality is around 15% or more. Kazakhstan is richer, having benefited from its raw material base and achieved GDP per capita that is \$1,978 compared with \$652 in Uzbekistan (on a purchasing power parity basis, the gap is even greater at \$9,400 versus \$2,000). This contrast is certainly apparent while driving around Almaty, with its flashy SUVs and tall buildings, compared with Tashkent, where traffic is sparse and the potholes on side streets are much like those in Kampala, Uganda.

| | Uzbekistan | Kazakhstan | Emerging Mkts | USA | EAFE |
|-------------------------|------------|------------|---------------|----------|----------|
| RGDP Growth (2008e) | 7.0% | 6.0% | 4.0% | 2.5% | 2.0% |
| GDP/Capita | \$652 | \$1,978 | \$4,427 | \$36,655 | \$26,229 |
| Inflation | 15% | 15% | 3.5% | 2.0% | 1.5% |
| Population (mil) | 26.6 | 15.1 | 4756.6 | 296.5 | 582.2 |
| Population % <15 years | 34% | 24% | 29% | 21% | 17% |
| Population % > 65 years | 5% | 8% | 7% | 12% | 15% |
| Corruption (10=best) | 2.2 | 2.6 | 3.9 | 7.6 | 8.25 |
| Market Cap (\$ mil) | \$1,177 | \$64,000 | | | |
| PE | 4.6 | 15.0 | 17.3 | 17.4 | 15.0 |
| PB | 2.0 | 3.0 | 2.8 | 3.0 | 2.3 |
| ROE | 33% | 20% | 16.2% | 17.0% | 15.4% |

Source: World Bank, S&P, MSCI & Ondine, 2007



Uzbekistan

In 1865, Russian Major-General Chermayev, “The Lion of Tashkent”, seized the city with a small force and without direct orders from the Tzar. His bold stroke led to the fall of the khans and to Russian rule that ended only with the collapse of the Soviet Union.



Most of Uzbekistan is desert, and the country is notorious for the environmental disaster of the Aral Sea in the northwest, which is drying up because the Soviets diverted its rivers to produce cotton. International attention is starting to slow the deterioration, but improvement is years away.

Uzbekistan has a young population, with 36% of its 27 million people under age 14 (as compared to only 8% in Bulgaria), and they work hard for low wages of \$100-150 per month. High commodity prices for cotton, oil, gold and uranium have helped the economy lately. And a long term positive is the government’s enlightened tax policy: in the past three years, corporate taxes have been reduced from 20% to 10%. As a result, taxes as a percent of GDP have fallen from 41% in 1996 to 30% today, and the private sector is growing rapidly.

Once past lengthy delays at passport control and customs, one finds Tashkent to be a modern city of wide boulevards but little historical character. Most of the buildings date from the Soviet era, because much of Tashkent was leveled in an April 1966 earthquake that left 300,000 people homeless.

Changing \$50 into local currency results in a wad of “so’m” that is over an inch thick, since no bills are bigger than 1,000 units. Some say that this is good, because carrying lots of bills makes people feel richer, but the most likely reason is that the government wants to control the underground economy, by making it hard to hide a big stash of wealth. Over a lunch of plov (lamb, rice and spice), we talked about the good food, the mild climate and the inexpensive property market. \$100,000 buys a nice 1,000 square foot flat that could cost five times as much in Almaty or Dubai and ten times as much in Moscow.



Uzbekistan has a small stock market, roughly one fourth of the size of the markets in Botswana and Zambia, although it is double the size of Uganda's stock market. Investing can be tricky, since Uzbekistan does not recognize fund documents notarized in the U.S. Paperwork has to be notarized, then sent to the county level, the state level, the U.S. Secretary of State and then finally the Uzbek Embassy for approval. Once past this hurdle, restrictions prevent foreigners from owning shares in the banks, unless a local company is set up to hold them. Getting research is not any easier because corporate reporting is primitive, and investor relations is practically unheard of. Furthermore, it is difficult to calculate earnings per share because this concept has yet to be adopted as a valuation tool.

Is the Uzbekistan market worth the trouble? Time will tell, but the market is certainly cheap at less than 5x earnings. Reforms will come; and by the time they do, prices may be much higher.

| Uzbekistan Stocks | Industry | Net Income (\$ US) | # Shares (mil) | EPS 06 | P/E 06 | Mkt Cap (\$ mil) |
|------------------------------|-------------------|-----------------------|-------------------|--------|--------|---------------------|
| Uzneftmahsulot | Oil and gas | \$190.00 | 266.4 | 0.713 | 3.9 | \$748.6 |
| Kyzylkumcement | Cement production | \$39.80 | 2.0 | 20 | 5.0 | \$199.0 |
| Uzbektelecom | Telecommunication | \$2.83 | 32.0 | 0.088 | 35.4 | \$99.9 |
| Uzpromstroybank* | Banking | \$6.49 | 12.3 | 0.528 | 4.3 | \$27.9 |
| Yulreftrans | Transportation | \$3.45 | 21.9 | 0.158 | 6.2 | \$21.4 |
| Pahtabank* | Banking | \$4.49 | 20.0 | 0.224 | 3.7 | \$16.4 |
| Gallabank* | Banking | \$1.58 | 140.0 | 0.011 | 7.3 | \$11.5 |
| Ipotekabank* | Banking | \$2.76 | 11.0 | 0.251 | 3.7 | \$10.3 |
| Alokabank* | Banking | \$0.23 | 80.0 | 0.003 | 42.6 | \$9.6 |
| Uzqishloqhujaalikmashleasing | Leasing | \$2.21 | 4.3 | 0.52 | 3.8 | \$8.3 |
| Khamkorbank* | Banking | \$3.41 | 75.0 | 0.045 | 2.2 | \$7.3 |
| Ipak Yuli Bank* | Banking | \$1.00 | 64.0 | 0.016 | 6.2 | \$6.2 |
| Turonbank | Banking | \$0.36 | 5.0 | 0.073 | 11.8 | \$4.3 |
| Alskom | Insurance | \$0.17 | 1.6 | 0.104 | 21.7 | \$3.7 |
| Madad | Insurance | \$0.04 | 3.0 | 0.014 | 49.8 | \$2.2 |
| Qurilishleasing | Leasing | \$0.29 | 1.0 | 0.291 | 3.0 | \$0.9 |
| Ravnaqbank | Banking | -\$0.65 | 1.1 | - | - | \$0.0 |
| | | \$258.47 | | | 4.6 | \$1,177.5 |

Source: East Capital, Ondine, Dec 2007



Kazakhstan

All the construction cranes in the world were said to be in China or in Dubai. Unfortunately, this is not the case because hundreds have found their way to Almaty.

Real estate prices are up 90% in four years - a pre-construction apartment selling at \$2,600 per square meter last December had soared to \$4,400 by July 2007. While construction to meet demand is generally good, the problem is that demand has been built on cheap financing with some mortgages denominated in dollars. Local banks have borrowed heavily in Europe, sourcing 50% of their funds from abroad. This has led to an explosion of consumer debt, 23% of GDP compared with 8% in Russia. Now, the sub-prime loan problem that started in California has come home to roost in Almaty.



More flats are coming on the market

Kazkomertzbank says that \$250 million borrowed in Europe cost 8.5% in July 2007, but now would cost 13.5%. As a result, some banks are invoking a “special circumstances” clause in their loans and ratcheting up the rates for borrowers. Construction activity has stalled, and now the government has stepped in with \$4 billion of funding to support building. Another \$8 billion is said to be needed next year. A sharp credit contraction could hurt the Tenge which briefly weakened from 120 per dollar to 135 before recovering. Still, the disaster scenario of a sharp slowdown in growth, rising unemployment and currency weakness is possible.

On the plus side, this is an oil rich economy with a positive trade balance. The current account balance is negative simply because there is so much investment flowing into the country. Furthermore, the government is pro-business (although the corporate tax rate remains too high at 30%) There are fears of a Russian-style takeover of the oil industry, but this is probably unlikely. A current dispute with the Italian oil firm ENI over the Kashagan field in the Caspian is more about ENI's incompetence than Kazakh avarice.



The Kazakh stock market has 74 listed stocks, but other companies are listed in London, Germany and the U.S. Liquidity is good in many of these names, and research is available, although not exactly abun-

dant. The oil industry is now covered by some global analysts and some stocks may be attractive simply because they have historically been overlooked. Among the banks, which are down a third or more in price since the summer, the challenge is to figure out which ones are in distress, and whether the government will bail out the entire sector. For example, Halyk Banks, which have been conservatively run, is concerned that the government may fall into a moral hazard trap by bailing out the weak banks, leading to a new and even more aggressive borrowing binge in the future.

We are on the optimistic side regarding Kazakhstan, but it would be easier to have conviction if the sub-prime loan problems were not still unfolding in the U.S.

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Conclusion

Behind a wall of billboards in front of the mayor's office in Almaty, there is a huge construction project that is turning an old Soviet bomb shelter into a new underground shopping mall. Like "beating swords into plowshares", this transformation symbolizes the change in Central Asia - from a history as warriors to a future as consumers. While not easy to get to, these Frontier Countries are well worth close attention. Their people are wonderful, and some of their companies are as well.



Happy New Year!

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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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