

## Return to Eastern Europe – The Lone Travelers

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With Eastern Europe hitting headlines of the Wall Street Journal in March of 2009 – “*Easy credit fueled a boom in the ex-Communist world too*”, we thought a visit to the region would be timely.

We had avoided investment in the frontier Eastern European Market since inception of the fund due to concerns about corporate governance, hefty valuations, demographics, and rapidly growing economies on empty tanks (current account deficits were running in the teens through 2008). However, dramatic equity valuation corrections (Romania’s MSCI index was down 67%, Bulgaria down 83%), caused us to return to the region, analyzing a country at a time, and most importantly each individual stock. By February, we carefully established top stock choices and started investing.

Although under the same umbrella of Central and Eastern Europe, the countries of Bulgaria, Romania, Slovenia, Croatia, and Serbia are quite different. With geographic proximity, they share common cultural similarities and language (with the exception of the Romanian language with its Italian roots). From an investment perspective, however, it is important to differentiate by stage of development, demographics, macroeconomic indicators (Table 1), currency regimes, and opportunities for companies to prosper and reward investors.

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If we had to generalize, we would suggest that the trip opened our eyes to positive changes in politics and demographics, as well as a capitalist friendly environment. The trip also confirmed the notion of poor sentiment due to the slowing economic times, but also brought to light the long term case for catching up with Western Europe.



## BULGARIA

We began our trip in the capital of Sofia, the country's largest city with about 1.4 million population, a city where I was born and raised through my teenage years. It had been two years since my last visit, during which I helped my parents relocate to Washington State. Given the widely publicized crisis in Eastern Europe, my expectations were low. However, my first impressions were overall good; the airport was renovated and expanded (with an organized taxi system) and the streets of Sofia were visibly cleaner (some beautified with young trees.) We also felt safe taking strolls at day and night



Source: *The CIA Fact Book*; [www.cia.gov](http://www.cia.gov)

As a native who has followed the work of a dozen or so Bulgarian governments since the fall of Communism in 1989, I share the apathy of the people for its politicians. Politicians are so corrupt that the European Union, after admitting Bulgaria in 2007, quickly reversed its stance and halted subsidies a year later, citing a failure to stem corruption and organized crime as its reason for reversal.

In light of these developments, our visit just days after the most significant Parliamentary elections in years, was very informative. We learned that the people of Bulgaria stood-up in record voter turnout to elect the pro-market opposition party, led by the Mayor of Sofia. At the time of writing this report, some signs of improvement such as changes in government employees and the judicial system were being implemented.



*Sofia's history goes back 700 years; Alexander Nevsky Cathedral.*

If the new Prime Minister follows through on his promises to clean up and bring accountability and help from the International Monetary Fund and World Bank, the future of Bulgaria once again looks promising. The country's location in proximity to Western Europe and the Middle East appears of strategic importance as it is located in a corridor of significant commerce. Corporate and individual taxes are attractive at 10%. Cost of labor is low, with average wage at approximately USD 400 per month, which is a fraction of its neighboring countries and the West.

The education system has been successful in producing talent. The younger generation, enjoying the opportunities of capitalism, is driven and motivated. As my friend, a senior partner at Deloitte in Sofia, spoke: "the opening of the economy has created an enormous amount of young, wealthy individuals, many started small businesses, not all corrupt, but simply open to the opportunity..."

Which brings us to the most serious fear we have for Eastern Europe over the long term, and that is demographics. To help us relate the concern, we compiled a table ( Table 2) showing estimates for key demographics from the CIA World Fact Book for countries of interest around the world; representing Eastern Europe, Africa, Asia, South America, the Middle East, the developed world and the world in aggregate. A crude snapshot shows Eastern European population aging, declining in numbers, with low fertility and continued emigration in some countries. Africa's demographics depict a young population, with high fertility rates contributing to rapid growth. Asia, South America, and the Middle East all share average population age, growth, and good fertility. The developed world, as expected, shows aging population, with below average growth and fertility rates.

Within Eastern Europe, Bulgaria's demographics stand out as most alarming. Population growth is estimated at -0.79% for 2009 and ranks as the 232<sup>nd</sup> of 234 countries tallied by the CIA study. The population is aging, with median age of 41.4 years. Fertility at 1.41 children per woman is below the replacement rate of 2 children per woman and is the 193<sup>rd</sup> lowest of 224 countries researched. The birth rate, which depends on both the fertility and age of population, is logically estimated low at a 9.51 per 1000, placed 205<sup>th</sup> of 224 countries. While this snapshot is concerning, we believe that the relative numbers are somewhat improving.



*Unicredit Bulbank's downtown branch in Sofia; also my grandfather's workplace as Chairman of the Bulgarian Agricultural Bank before Communist takeover.*

The National Statistical Institute of Bulgaria compiles demographic statistics and a table for 2006, 2007, and 2008 is showing improving crude birth and total fertility rates 9.6%, 9.8% and 10.2% for the former for the respective years and 1.38, 1.42 and 1.48 for the latter. More anecdotal, during our visit to Sofia we saw more young children and families, heard of fertility clinics opening up, and ran into friends considering a second child.

With the rise of living standards over the past ten years, an unexpected improvement in demographics may be around the corner.

While the near future in Bulgaria remains of challenge, we believe that some of the fundamentals for improvement are in place, and we will continue observing the developments. Our friend, who is the branch manager for Unicredit Bulbank's downtown branch, shared an interesting statistic which provided some hope. Only 5 of the 500 loans that she had extended and is responsible for monitoring are late on payments. However, the slowdown in industrial production, retail sales and real estate transactions show a more somber picture. At the stock level, we are yet to find a company that meets our hurdles for investment but we will continue to search.



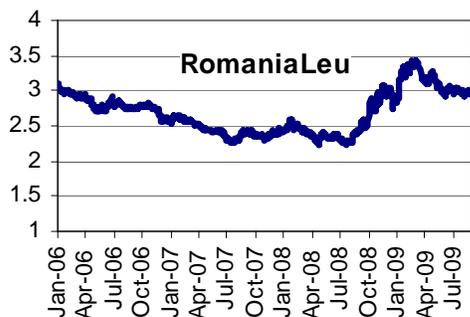
## ROMANIA

My childhood memory of Romania is a vast country with diverse terrain and a large population. During the mid 1980s, my family and I crossed the country by train, starting in Sofia, north through Transylvania and into Hungary. At various stops, Gypsies greeted the train with offers of basic necessities, such as bread and soap. Much has changed since the fall of Communism and mostly over the past ten years. After meeting strict standards, the country joined the European Union in 2007 and is now a recipient of over USD30 billion in infrastructure funds for integration.



Source: The CIA Fact Book; www.cia.gov

The country is the 7<sup>th</sup> most populous state in the EU, with approximately 22 million people, and is the 9<sup>th</sup> largest by territory. Romania's location similarly to Bulgaria, is one of strategic importance to Western Europe, with access to the Black Sea and proximity to Russia. This may partly explain why in March of this year, international organizations such as the International Monetary Fund, the World Bank and the European Bank for Reconstruction and Development provided a EUR20 billion aid to the country to buffer spillover effects from the financial crisis. The confidence boost has worked well so far with the currency, the Romanian Leu, appreciating from a low of about RON3.43 to the USD in early March to under RON3 to the USD now.



Source: Bloomberg, Frontier Market Asset Management, LLC, July 2009.

At a macroeconomic level, the country appears more attractive than Bulgaria, as well as Croatia and Serbia. Public debt is manageable at about 20% of GDP. The current account deficit has shrunk and is now estimated below 6% for 2009.

The freely floated Leu is less expensive, possibly undervalued, compared to its 2007-2008 strong level of RON2.3 to the USD. Other investment friendly factors are still in place: flat corporate tax rate of 16%

introduced in 2005 and low labor costs with average wage at approximately USD600 per month.

The demographics are average or better compared to the others in the region. The population size is one of the largest of the region, the median age is lower, the birth rate is higher, and the net emigration and population decline seem subdued. In meetings, we asked the question about the "brain drain" - so prevalent in Bulgaria, and were told that if anything, with the crisis in Western Europe, many of the 2 million people who had left mostly for Italy and Spain during the economic boom there are now returning.



While in Bucharest we stopped by for lunch – it was busy!

The reversal from net emigration to net immigration would be a welcome surprise. The impact may be initially negative for employment and government budgeting, however over the long term it could lead to improvement in demographics and a boost for consumer spending.

Romania also appeared attractive from an investment perspective. The stock market has depth and diversity; large and small capitalization companies with various sectors represented (oil and gas, electricity, banking, pharmaceuticals, consumer, construction, and closed end funds). Yet, some of the key sectors, such as transportation and airports are yet to be privatized. Our favorite bank acted conservatively during the credit expansion years and seems to be in better shape than the competition. For example, the maximum amount of loans extended in foreign currencies was set at 12% of total loans, in addition mortgage loans required a 60% loan to value margin. As a result, non-performing loans are rising, estimated at 8% by 2009 year end that are about 40% lower than the sector average. With better capital adequacy, improving competitive environment and rising net interest margins (pricing pressures and funding cost have subsided) the bank is set to take market share and improve long term profitability.

There are other opportunities for companies to prosper and reward investors. Petrom, the oil giant in the country, now partly owned by OMV of Austria, is successfully exploring across the Black Sea and Kazakhstan region, expanding its well-regarded brand in downstream marketing. Petrom is known for high quality at reasonable price (as opposed to Lukoil, consumers said) throughout the neighboring countries and is poised to improve profitability as a result of restructuring and cost cutting efforts.



*Bucharest is grand – combining beauty of old and new. This building is nicknamed Little Paris.*

In the pharmaceutical sector, the potential for rising consumption is very appealing. We would expect to see continue acquisition activity by Western pharmaceutical companies looking for growth opportunities. Annual consumption per capita in Romania is at about EUR40, half the level of more developed yet still emerging Hungary. The current consolidation wave in the distribution network is presenting another opportunity for nimble players to gain market share.

In spite of the significant economic slowdown, we believe that careful investing in Romania would reward investors in the long term. Crises may present opportunities, and the companies we have identified seem to be capitalizing on those.



## SLOVANIA

In terms of economic development, Slovenia is years ahead of Bulgaria and Romania. My parents still comment that the former Yugoslavia, probably due to its geographic proximity to the West, always maintained an economic edge over the Southeastern Balkans. This is most prevalent in the westernmost parts and subsiding to the East. The country is small by land and population, but gorgeous with its mountainous terrain.



*Source: The CIA Fact Book; www.cia.gov*

The economy is a part of the Euro Zone (although healthier) with lower debt burden and current account deficit. Tax policy, as in the rest of the region, is investor friendly and set to decline over the coming years. However, we sensed some government protectionism in a meeting with an infrastructure company, possibly following the example of the West.

The demographics of the country are similar to those of the others we visited, although the net immigration rate is a positive exception. Our hosts commented about the return of young Slovenian professionals who have gained experience in the West and are now able to get good jobs with competitive compensations back home. In a lower cost environment, they improve their standard of living while enjoying the support of family network.

Unlike the Romanian stock market, Slovenia's stock market lacks depth. The advanced stage of development and consumption also limits our choices. However, there are companies that are poised well to reward investors, companies that are capitalizing on the Balkans regional market expertise and long established relationships.

We met with management of a company betting on expansion into the underpenetrated Southeastern Europe, where they understand the language, culture and history. With lower competitive hurdles, but stronger currency and financial strength, this expansion should be fruitful.



*Ljubljana is small, pristine, quaint, and well organized; The Ljubljana Stock Exchange.*

Another Slovenian company in the pharmaceutical business is taking advantage of its strategic location and unique understanding of both Western and Slavic European cultures. It is expanding generic drug production and distribution capacities across the continent. The company is set to benefit from rising consumption due to establishment of insurance systems in the least developed countries of Europe and the aging population. The economic slowdown has presented another opportunity for organic and acquisition based growth – the company's savvy Finance Director commented "our aggressive competitors are gone and many are weak".



*Krka's headquarters in Novo Mesto on the way to Croatia.*

Slovenia is a beautiful country we would recommend visiting. However, there are limited opportunities for investors searching rewards from the closing gap between consumer incomes in the developed and developing worlds. On the other hand, there are some attractively priced companies poised to benefit from expansion in the frontier region.

A favorite part of the trip was driving from country to country. After the company visits in Slovenia's capital of Ljubljana, we drove southeast through the country, with a stop at a corporate campus in Novo Mesto for one more meeting and then on to Zagreb, the capital of Croatia. Border crossing was reasonably quick. We noticed many EU licensed cars with families headed for vacation in Croatia.



## CROATIA

Croatia is known for the beauty of its Adriatic Sea coast, envy of the neighboring countries. The coastline area makes up about 35% of Croatia's total surface area. With such geography, the country is a tourist hub. During the Communist years, only few Eastern Europeans could afford to vacation at the coast. Today, tourists are attracted from most parts of Europe. The cost of vacationing in Croatia is still lower than in the West.



Source: *The CIA Fact Book*; [www.cia.gov](http://www.cia.gov)

In addition, we were told, the ease of reservations is unmatched - last minute arrangements are feasible. That, combined with convenient and easy access location for Europeans from West and East, may explain why even amidst the economic slowdown, Croatian tourism has been strong. Through August, cumulative year over year arrivals have seen only a 2% drop. For the month of August, which accounts for 25% of annual arrivals, the change has been a positive 3% versus 2008.



*The disputed border at Bay of Piran in the Adriatic.*

Unfortunately, the Adriatic coastline has also been a source for a dispute between Slovenia and Croatia. Since their independence and split from former Yugoslavia in 1991, the two countries have argued over the exact border between the two at the small Bay of Piran (about 8 square miles in surface).

More recently, the dispute was brought up by Slovenia as reason to veto Croatian EU accession talks. Interestingly, besides some media clips on TV, we did not encounter anyone discussing the issue. It could be that people of the Balkans are used to living with border disputes.

Our visit in Croatia, just as in Bulgaria, was also timely to gain some insights about the country's political developments. Just weeks prior to our visit, Croatia's Prime Minister had resigned unexpectedly. Media speculated that the PM was unwilling to cut government spending, yet something had to be done with lower expected receipts from tourism – a key foreign exchange earner – vital in supporting the managed float of the local currency against the Euro. On the ground we learned that the change in government had been smooth and welcome. The new PM has already been successful in warming up the unions to salary and benefit cuts. With tourism stronger than expected and recent currency appreciations in the neighboring countries, the devaluation debate seems to have been put aside.

On the demographics front, Croatia shows some positive signs. The median age and fertility rate are about the same as the region average. However, the net immigration estimate of 1.59 entrants per 1000 population is in stark contrast with the average 0.14 leaving per 1000 population in the region.

As in Slovenia, we heard of young professionals coming back to the country, after obtaining Western education and or experience. At Jarun Lake Park, just minutes from downtown Zagreb, we saw young adults and families enjoying summer strolls and visits with friends. We felt encouraged.



*A very popular summer destination – Dubrovnik.*

The Croatian stock market has some variety of companies, although pricier than other parts of the frontier. One exception is the telecommunication company which is inexpensive, cash rich and well managed. Growth opportunities include new but complementing business lines (such as information technology turnkey solutions) and regional expansion. The banking sector is not as attractive due to the relatively high penetration. For example, loans as percent of GDP amount to about 80%, compared to under 50% in most of the countries where we own bank stocks. The consumer goods sector also seemed more saturated than that of a typical frontier country. However, opportunities resulting from the economic slowdown bode well for some consumer companies. The management of one stated "this macro environment is very well suited to grow without paying a premium".

Our visit to Croatia was timely and very informative. We did not walk away with brilliant ideas but learned about some new opportunities of areas of underdevelopment which we will continue researching. After our meetings, we were off on a four hour drive to Belgrade, Serbia. I had been very much looking forward to the experience of crossing the border and driving through Serbia. It had been years since we did that in our family's Moskvich.



## SERBIA

On our drive from Zagreb to Serbia, our local friends brought out the lack of any Belgrade highway signs in Croatia, as if the city didn't exist - they commented. The tension between the Croats and Serbians is still there but they seem to have found a way to coexist. Crossing the border was uneventful, although a bit slow. That highway provides connection for commerce between the East and West parts of the continents. We saw many Turkish trucks en route. It reminded us of the Balkans strategic geographic location. The hours-long drive through rural Serbia showed abundance of arable land and the country's potential as the "bread basket" of the region.



Source: *The CIA Fact Book*; [www.cia.gov](http://www.cia.gov)

The economic stage of development in Serbia is similar to the one in Bulgaria. In fact, the similarities go beyond that; Cyrillic alphabet, Slavic language and culture as well as Orthodox Christian religion. The demographics are almost identical as well, with the exception of net migration which is estimated at zero and contributes to a lower rate of population decline. This is a significant improvement from the past trend of "brain drain" to the West.



*Turkish trucks slow down border crossing into Serbia.*

At the macroeconomic level, Serbia has suffered from long periods of current account deficit and dependence on foreign investment. With the recent drop in imports, however, there is some improvement in the trade deficit. The weaker Dinar may be also helping exports.

Just as in Romania, the International Monetary Fund came to rescue with promise of USD4 billion standby credit to the country, contingent on spending and employment cuts in the government sector. The tough budget constraints are likely to delay recovery in the country, as may be the case in Romania. Croatia and Bulgaria could face a similar outcome if they strike IMF deals to preserve the managed currencies.

Over the long term, Serbia appears to be well poised to bridge the gap with Western Europe. Many of the market friendly requirements are in place: low corporate rate tax at 10%, attractive cost of labor, with average wages of approximately USD 670 per month and excellent geographic location. There are various sector opportunities for investors; the banking sector is underpenetrated and the infrastructure can be enhanced and expanded. Corporate governance and investor disclosure is improving, possibly as result of the severe stock price declines. The management teams that we met were all knowledgeable, experienced, and willing to open up.

The management of a large bank that we met with spoke about the impact of the financial crisis on the sector and economy. The numbers were staggering – about 20% of all deposits came out of the system during the fourth quarter of 2008. With strong capital adequacy of 23%, due to strict requirements of the local regulator, the banks survived without the need to raise capital. Then, by the end of second quarter of 2009, the deposits came back. With a healthy banking system, the real test for the economy in Serbia would be the impact of declining foreign direct investment, currently about 40% lower than last year's.

We left Serbia with encouragement over the long term - the frontier story in this part of the world is alive. We believe it is only a matter of time before the economy is further incorporated into Europe. With the outlook of rising disposable incomes, investors would likely return and search to capitalize on the opportunity.

## CONCLUSION

As we look back on our trip to frontier Europe, we reflect on the experiences. A visit to Bulgaria and driving through Romania, Slovenia, Croatia and Serbia has been invaluable to appreciate the differences and resources of the neighboring countries.

Romania is vast with a big population, natural resources and exposure to the Black Sea. Slovenia and Croatia have tremendous tourism potential with beauty of the terrain, exposure to the Adriatic and proximity to the West. Serbia has rich agricultural resources and a road network which combined with Bulgaria's, should over time facilitate rising commerce flows between the West and East. All countries share the resource of a talented, driven and an increasingly English speaking population. Demographic trends, we hope, may be turning a corner.

As we travelled, we asked our local hosts about the last time they were visited by US-based investors. In Slovenia, it was November of 2008. Very little interest in the region could make one question the investment case. The economies are slowing down and may be slow to recover. However, companies that we met are capitalizing on the opportunities presented by the crisis. Many are growing as a result of competitor weakness. Others will emerge stronger once the secular trend of rising disposable incomes resumes again. The lone but cautious traveler, we believe, would be rewarded.

## REFERENCES

Table 1

<b>Key Market Indicators</b>	<b>Table 1</b>				
<i>(2009 estimates provided by our local brokers)</i>					
	<b>Bulgaria</b>	<b>Romania</b>	<b>Slovenia</b>	<b>Croatia</b>	<b>Serbia</b>
<b>Inflation</b>	2% to 4%	5.5%	0.4%	2.9%	8.0%
<b>GDP Growth</b>	-4% to -6%	-6.5%	-4.0%	-4.5%	-2.0%
<b>Current Acct Balance</b>	-16%	-6.0%	-2.2%	-6.3%	-12.0%
<b>Currency Status</b>	Managed	Floated	Euro	Managed	Floated
<b>Corporate Tax Rates</b>	10%	16%	21%	20%	10%
<b>Avg Wage, USD per mo</b>	414	618	1992	1490	665

Table 2

Key Demographics 2009 Estimates						Table 2
	Total Population	Median Age (in years)	Population Growth Rate (in percent)	Birth Rate (births per 1000)	Net Migration Rate (migrants per 1000)	Fertility Rate (children per woman)
Russia	140,041,247	38.4	-0.467	11.1	0.28	1.41
Bulgaria	7,204,687	41.4	-0.790	9.51	-3.11	1.41
Croatia	4,489,409	41	-0.052	9.64	1.59	1.42
Romania	22,215,421	37.7	-0.147	10.53	-0.13	1.39
Serbia	7,379,339	41	-0.468	9.19	0	1.38
Slovenia	2,005,692	41.7	-0.113	8.97	0.52	1.28
<b>Avg E.Europe</b>		<b>40.2</b>	<b>-0.340</b>	<b>9.82</b>	<b>-0.14</b>	<b>1.38</b>
Kenya	39,002,772	18.7	2.691	36.64	0	4.56
Nigeria	149,229,090	19	1.999	36.65	-0.1	4.91
<b>Avg Africa</b>		<b>18.9</b>	<b>2.3</b>	<b>36.6</b>	<b>-0.1</b>	<b>4.7</b>
China	1,338,612,968	34.1	0.655	14	-0.39	1.71
Bangladesh	156,050,883	23.3	1.292	24.68	-2.53	2.74
Vietnam	86,967,524	27.4	0.977	16.31	-0.38	1.83
<b>Avg Asia</b>		<b>28.3</b>	<b>0.975</b>	<b>18.33</b>	<b>-1.10</b>	<b>2.09</b>
Brazil	156,050,883	28.6	1.199	18.43	-0.09	2.21
Colombia	45,644,023	27.1	1.377	19.57	-0.26	2.46
<b>Avg So America</b>		<b>27.9</b>	<b>1.288</b>	<b>19.00</b>	<b>-0.18</b>	<b>2.34</b>
Qatar	833,285	30.8	0.957	15.61	-3.58	2.45
UAE	4,798,491	30.1	3.689	16.02	22.98	2.42
<b>Avg Middle East</b>		<b>30.5</b>	<b>2.323</b>	<b>15.82</b>	<b>9.70</b>	<b>2.44</b>
United States	307,212,123	36.7	0.975	13.82	4.31	2.05
EU	491,582,852	NA	0.108	9.90	1.46	1.51
<b>Avg Developed</b>			<b>0.542</b>	<b>11.86</b>	<b>2.89</b>	<b>1.78</b>
<b>WORLD</b>	6,790,062,216	28.4	1.167	19.95	NA	2.55

*Information was compiled from CIA - The World Fact Book*

## 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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