



## The Rich Frontier: UAE, Qatar, Bahrain, Kuwait & Ukraine

By Larry Speidell

My recent visit to four countries in the Middle East and one in Eastern Europe provided dramatic contrasts:

- Snow skiing indoors in the Dubai desert.
- Roaring through the historic streets of Kiev, oligarch style, in a chauffeured black Range Rover with tinted windows.
- Boarding a plane to Qatar with a hundred frightened Indian laborers jamming the ramp, fearful of being left behind.

There were unexpected overnights due to flight delays, including one out of Kiev that was accompanied by reports of troop movements near the city. While my trip also included speeches to CFA Societies in the United Arab Emirates and Bahrain and a conference in Ukraine, there was considerable opportunity for stock market research.



*"Ski Dubai" at the Mall of the Emirates, 400 meter runs with a 60 meter vertical drop*  
All Photos: Frontier Market Asset Management

The countries on this trip are not typical of Frontier Markets because they are more developed than most. Still, none are included in the Morgan Stanley Capital International (MSCI) Indexes of developed or emerging markets. This exclusion increases the likelihood of finding neglected stocks, possibly at attractive prices.

From an economic standpoint, Qatar, Kuwait, the United Arab Emirates and Bahrain are among the richest countries in the world because of their oil reserves. Along with Saudi Arabia and Oman, they form the Gulf Cooperation Council (GCC). A consequence of oil and its rising prices has been high economic growth (7-16% in 2007) and big budget surpluses. For example, Qatar took in \$22 billion of government revenues in 2006 and managed to spend only \$17 billion, including capital expenditures of \$2.2 billion.

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With currencies pegged to the dollar, interest rates have been held down, and inflation has been creeping up. These countries have a bias toward youth in their populations, but much of this is a result of large numbers of third world ex-patriot workers from places like India, Pakistan and the Philippines who do much of the heavy lifting. Ukraine, by contrast, shares its unfavorable demographics with the other Eastern European countries, where birthrates are low. The fertility rate in Ukraine is 1.24 children/woman versus 2.86 in Kuwait, and its population is shrinking by 0.7% annually. In terms of corruption, Ukraine is also at a disadvantage, sharing its low score with Kazakhstan and Zimbabwe, while the GCC countries are more like South Korea, Taiwan or Hungary.

Both China and the Mid-East are receiving large wealth transfers from the West, but there are outflows as well. While it is recognized that there are large capital flows from China to many countries in the less developed world (such as the resource rich countries in Africa), there are also important flows from the Mid-East on the part of governments and private companies to other countries in the Muslim world as well as remittances from ex-patriot workers to their home countries in Asia.

|                         | UAE      | Qatar    | Bahrain  | Kuwait    | Ukraine  | Emerging Mkts | USA      | EAFE     |
|-------------------------|----------|----------|----------|-----------|----------|---------------|----------|----------|
| RGDP Growth (2007e)     | 16.0%    | 13.0%    | 7.3%     | 12.0%     | 4.5%     | 4.4%          | 2.8%     | 2.0%     |
| GDP/Capita              | \$22,975 | \$36,000 | \$14,588 | \$20,578  | \$960    | \$5,265       | \$36,655 | \$26,229 |
| Inflation               | 8.0%     | 11.0%    | 6.0%     | 5.0%      | 5.0%     | 4.8%          | 2.0%     | 1.4%     |
| Population (mil)        | 4.5      | 0.8      | 0.7      | 2.5       | 47.1     | 3549.1        | 296.5    | 582.2    |
| Population % <15 years  | 22%      | 22%      | 27%      | 25%       | 15%      | 25%           | 21%      | 17%      |
| Population % > 65 years | 1%       | 1%       | 3%       | 2%        | 16%      | 8%            | 12%      | 15%      |
| Corruption (10=best)    | 6.2      | 5.9      | 5.8      | 4.7       | 2.6      | 3.9           | 7.6      | 8.3      |
| Market Cap (\$ mil)     | \$80,600 | \$40,400 | \$21,300 | \$131,400 | \$24,976 |               |          |          |
| Float (S&P/IFC)         | N/A      | N/A      | N/A      | N/A       | \$2,468  |               |          |          |
| PE                      | 10.5     | 10.9     | 10.4     | 11.3      | 11.7     | 15.4          | 17.3     | 15.7     |
| PB                      |          | 2.3      |          |           | 2.9      | 2.5           | 2.9      | 2.4      |
| ROE                     |          | 21.1%    |          |           | 24.9%    | 15.9%         | 16.6%    | 15.4%    |

Source: World Bank, S&P/IFC & MSCI



## United Arab Emirates

The United Arab Emirates consists of seven emirates or states, with a total population of 4.8 million, 80% of whom are ex-patriots. Most visitors focus on Dubai, the commercial and entertainment center, and Abu Dhabi, which is the largest and wealthiest emirate.



Despite fourteen lanes on Sheikh Zayed Road, Dubai's infrastructure can't keep up with the demand. Rush hour quadruples the normal twenty minute travel time from Emirates Towers to the airport, causing anxious moments for travelers (myself included). Highway and building construction is underway everywhere, from the Burg Dubai, soon to be the world's tallest building, to Formula One World, being built in the Motor City area of Dubailand, a Disney-style theme park. All these are designed to increase tourism from 4% of GDP to 15% over the next seven years.

A key question is whether there is a bubble, and if so, when it will burst. With its currency pegged to the dollar, the United Arab Emirates are stuck with low U.S. interest rate levels while petro-dollars make them awash with liquidity. This is similar to Ireland's position in the European Union, where its growing economy may be over-stimulated by Europe's low interest rates. One difference is that in the Mid-East, taxes aren't just low, they are non-existent.

Despite possibly the largest concentration of construction cranes in the world, Dubai may yet avoid a bubble, as did China during the huge construction of Pudong in Shanghai. Looking at real estate in Dubai, a 1,000 square foot apartment would cost roughly \$400,000 and could be rented for \$20,000 for a 5% rental yield, not far away from the local 7-8% mortgage costs. When one takes account the 30% increase in rents last year due to the scarcity of apartments, the balance still seems tipped in favor of sellers and developers, especially when many ex-patriot professionals continue to arrive from the developed world where similar housing could sell for much higher prices. It has been feared that a glut of completed units would hit the market in 2008, but now completions appear to be stretched out to a more measured pace. A rough survey of apartment/condominium prices collected on my trip suggests that prices in Dubai are not unreasonable on a global basis.



*Burg Dubai Tower, 162 floors in 2009*

1000 square foot apartment (100 sq meters), in a newly completed building in the city center, ready to move in

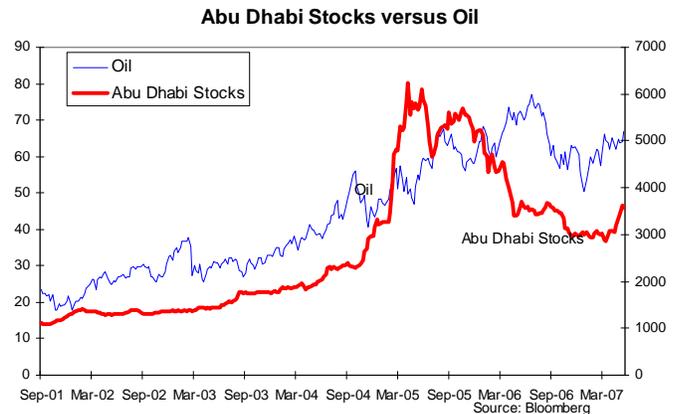
| City            | Price       |
|-----------------|-------------|
| Dublin          | \$1,100,000 |
| Paris           | \$1,000,000 |
| London          | \$1,000,000 |
| Moscow          | \$850,000   |
| San Diego       | \$800,000   |
| Kyiv            | \$650,000   |
| Dubai           | \$400,000   |
| Kuala Lumpur    | \$350,000   |
| Dakkar, Senegal | \$200,000   |

Source: Frontier Market Asset Management estimates

An hour and a half down the road from Dubai is Abu Dhabi, capital of the emirate of the same name and of the UAE overall. It is the largest of the emirates, accounting for 56% of the GDP and 94% of the oil reserves of the UAE. While practically anything goes in Dubai with its carnival atmosphere of high end resorts and world class sports events in tennis, golf and horse racing, Abu Dhabi is more conservative, partly because it has more oil wealth. As a result, it has the largest sovereign-wealth investment fund in the world, ADIA, estimated at \$875 Billion by Morgan Stanley (Economist 5/26/07). This fund has been diversifying Abu Dhabi's assets from oil receipts into overseas markets since 1976, but now the government is shifting some of these flows to internal development. It remains to be seen whether Abu Dhabi can catch up with Dubai, but on paper, the plans are impressive. They include skyscrapers on Shams

Island, a Ferrari Theme Park near the airport and the development of Al Lulu Island, an artificial island more than 2.5 miles long, dredged from the sea in that Arabian Gulf opposite the Corniche Road.

Stocks throughout the Gulf region are down in the past year as the frenzy over rising oil prices has cooled. Excluding Saudi Arabia, which is not open to foreign investors yet, the markets boast more than 300 stocks of potential interest. GDP growth rates are high, and this feeds into the profitability of companies in a broad range of sectors. Real estate and construction are obvious candidates, but industrial development and service sectors are growing as these countries attempt to diversify away from oil.



## Qatar

Only a third the size of Belgium, Qatar has 800,000 people, but only 200,000 citizens. Despite its small size, Qatar is on track to become the second largest hydrocarbon producer in the world in five years, as its huge Japanese financed liquefied natural gas project comes on stream.

Internationally, Qatar swings more than its weight. It is host to a base from which B-1 bombers fly to Afghanistan. It provided UN troops in Lebanon last fall. And, showing balance, it maintains friendly relations with Iran and Syria.

Development in Qatar includes The Pearl, an 8,000 unit residential development on an artificial island off the coast of Doha. Here, prices for a 1,200 square foot unit start at the attractive level of \$275,000. In addition, a new airport is planned with its goal to be a regional hub for 40 million passengers a year.

The Qatar stock market lists 36 companies, and trades for 2.5 hours a day from Sunday through Thursday. It includes eight banks and five insurance companies as well as industrial and service companies in shipping, leasing, fuel and real estate. At 10.9x earnings the market is reasonably cheap, given expected real GDP growth of more than 10%.



## Bahrain

Bahrain is a small island, three and a half times the size of Washington, D.C., that is connected by a causeway to Saudi Arabia. Ruled by a Sunni family that conquered the Persians more than 200 years ago, the majority of citizens are Shia, and there is an elected legislature. In the face of dwindling oil re-

serves, it has become a financial center and boasts 75 members in the local CFA Society. Interestingly, Bahrain recently voted to tighten restrictions on alcohol after being more open for many years.



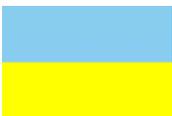
## Kuwait

It's 111 degrees in Kuwait City, but life goes on in the shaded souks where you can buy everything from meat hooks to rugs from Afghanistan. On the street outside, Bentleys and BMWs fight the steaming traffic (big cars are the norm since gasoline costs only \$18 a tank-full). Meanwhile, less daring shoppers head for the air-conditioned refuge of places like the vast, newly opened Sharq Mall, anchored by IKEA and Carrefour and filled with high end luxury stores.



Out of a population of 2.5 million, less than one million are Kuwaitis, while the ex-patriot community includes Indians, Pakistanis, Filipinos and many other nationalities. "Wasta", the hierarchy, places Kuwaitis at the top, followed by senior Saudis, then Americans and then other westerners. At the bottom, often unfairly treated, are the vast numbers of third-world ex-pats, who do much of the work. Out of total employment of 1.7 million, there are 300,000 public sector jobs, 90% held by Kuwaitis because they like the salary floors and protection from layoffs. Meanwhile, nearly 95% of the 1.4 million private sector jobs are held by foreign workers.

On May 19<sup>th</sup>, Kuwait abandoned its dollar peg in favor of a basket of currencies, and the Dinar rose by 3%. The change was in response to rising inflation pressures (approaching 5%), but it drives a wedge among Gulf countries that had been hoping for currency union by the end of the decade. It remains to be seen if other countries will follow Kuwait's lead, since the dollar is now up from its low over the past month. Also, there may be little difference between real revaluation through inflation and nominal revaluation through currency, when the cause remains the strong exports of oil, tied to the dollar.



## Ukraine

My last visit was on a rainy October day in 1991. Kiev was a drab city with Soviet era apartment blocks, ponderous Stalinesque government buildings and deteriorating old landmarks from a better past a hundred years earlier.

In the last 16 years, Kiev has brightened considerably. Modern cars jam the streets, and signs of a retail economy are everywhere, from the abundant signs and banners to the packed retail stores lining the streets. Soviet apartment blocks remain, dirtier than ever, with exterior balconies that look like they might

fall off at any minute, but they are joined by new towers with refreshingly decorative architecture. There is a scarcity of apartments that has pushed prices for a nice 1,000 square foot unit to \$1 million and rents to \$4,500 a month.

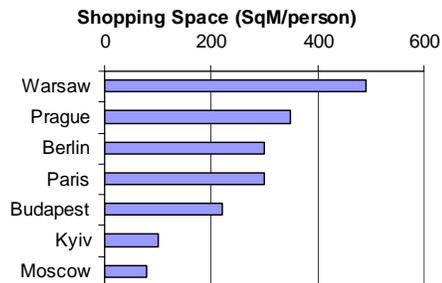
Ukraine was once the industrial heartland of the Soviet Union, with GDP per capita 10% higher than that of Russia. Its steel, chemicals and aircraft manufacturing plants produced 40% the Soviet Union's weapons during the Cold War. Ukraine has also been a breadbasket, possessing 30% of the world's black earth. 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 five Ukrainians. Today, the nation's flag symbolizes fields of grain under a blue sky. Another notorious consequence of Soviet times is Chernobyl, 60 miles north of Kiev, still radioactive 21 years after its nuclear meltdown.



*Old Buildings at the Pyrohovo Museum*

Today, Ukraine's GDP per capita is \$960 versus \$2,445 for Russia (boosted by high oil and gas prices). Still, Ukraine has attracted investor attention lately, and its stock market is up 70% so far this year.

Despite such progress, Ukraine is troubled by government infighting and murky meddling from Russia (on which, Ukraine depends for oil and gas). Russia provides a third of Ukraine's imports and is customer for 20% of its output. After the "Orange" revolution two years ago, Russia cut gas supplies and reduced product orders, imposing a painful penalty on growth. Lately, there has been infighting between President Viktor Yushchenko, who leans toward the West, and PM Viktor Yanukovich, who is pro-Russia. This even led to troop movements near Kiev, before the two agreed to hold elections in September. Although economic policies have improved in recent years, there is still judicial corruption and a high tax burden. Despite a 16% flat tax on income, high payroll taxes make business costly. Government revenues are a lofty 40% of GDP, versus 30% for the former Soviet Union countries (CIS-10). One result is that the "underground" economy is 45% of total economic activity.



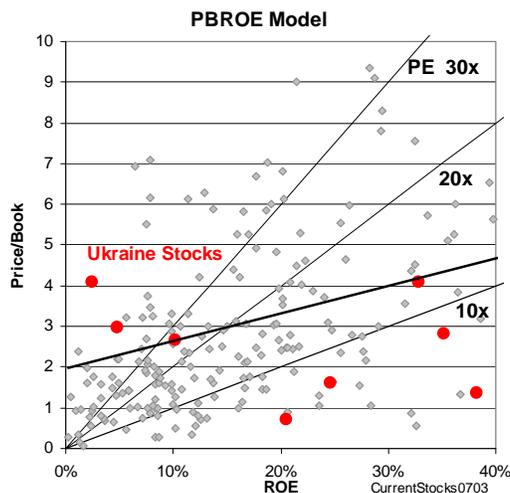
A conference sponsored by Dragon Capital was attended by more than 100 investors from Europe, the U.S. and Eastern Europe. The atmosphere was buoyant, spurred on by good recent returns and talk of

deals in the pipeline. Despite the need for reforms, foreign direct investment is flowing in, and local developers are building shopping centers, supermarkets and retail stores to supply the robust consumer economy. A shoe retailer observed that customers in Kiev buy 3.1 shoes per capita annually, not far below the 4.0 level of Europe. Other industries also are doing well. For example, one vodka producer boasted of its market potential since vodka consumption in Ukraine is only 7.5 liters per capita annually versus 20 in Russia (it is 1.5 liters in the U.S.).

|  |                                       | Mkt Cap \$ |       |     |      |
|--|---------------------------------------|------------|-------|-----|------|
| <b>Security</b>                              |                                       | mil        | P/E   | ROE | P/BV |
| Raiffeisen Bank Aval                         | Diversified Banks                     | \$2,838    | 247.6 | N/A | N/A  |
| Poltava Ore Mining and Processing Enterprise | Steel                                 | \$1,227    | 18.1  | N/A | N/A  |
| Ukrsotsbank                                  | Diversified Banks                     | \$2,414    | 72.5  | N/A | N/A  |
| Avdiivka Chemical-Recovery Plant             | Diversified Metals & Mining           | \$412      | 3.5   | 21% | 0.7  |
| Stirol chemical company                      | Diversified Chemicals                 | \$455      | 3.5   | 38% | 1.4  |
| Mariupol Metallurgical Plant Illicha         | Steel                                 | \$2,405    | 6.5   | 25% | 1.6  |
| Azovstal Iron and Steel Works                | Steel                                 | \$1,748    | 5.6   | 47% | 2.7  |
| Ukrnafta oil company                         | Oil & Gas Exploration & Production    | \$3,902    | 8.0   | 35% | 2.8  |
| Krivorizstal                                 | Steel                                 | \$5,118    | 12.5  | 33% | 4.1  |
| Ukrtelekom                                   | Integrated Telecommunication Services | \$4,163    | 26.1  | 10% | 2.7  |
| Nizhniodniprovsky pipe-rolling plant         | Steel                                 | \$1,681    | 11.5  | 49% | 5.6  |
| Centrenergo electric utility                 | Electric Utilities                    | \$1,215    | 62.1  | 5%  | 3.0  |
| Zahidenergo electric utility                 | Electric Utilities                    | \$1,110    | 164.6 | 2%  | 4.1  |
| Dniproenergo electric utility                | Electric Utilities                    | \$1,374    | 54.0  | 38% | 20.3 |

Source: S&P/IFC & MSCI

When we look at stocks in these countries, it is useful to compare them with others in Frontier Markets using a P/B-ROE model, illustrated by a plot of the Price/Book of each stock relative to its return on equity (ROE). Since the Price/Earnings ratio equals Price/Book divided by the ROE, the chart also shows relative PEs as well as a fit line for the expected normal value of Price/Book at each level of ROE. As ROEs rise, the expected Price/Book indicates a lower PE, because the market applies a discount for the sustainability of ROEs at higher levels. As shown in the chart below, several stocks in Ukraine may be attractively priced. Although more than 100 stocks trade on the stock exchange and fourteen are in the S&P/IFC database, there are often more attractive opportunities in IPO and pre-IPO financings if investors can accept limited liquidity in return for more attractive valuations.



## Conclusion

This trip spanned widely different cultures and widely different investment opportunities. Dubai is trying hard to become the financial center of the Mid-East, and it shows potential to bridge the openness and freedoms of the West with the traditional practices of Muslim countries. The other countries we visited in the region are watching Dubai carefully and taking various degrees of steps in the same direction. Thus, this region could move towards sustainable non-oil development as well as becoming a fulcrum for redirecting finance to other less fortunate parts of the Muslim world. Ukraine has a different opportunity. It sits at the geographic crossroad between Europe and Russia, and politically, it is at a crossroad between Western capitalism and Russian style development. Hopefully, it will choose openness, transparency and rule of law rather than heavy-handed and corrupt government interference in the economy. Having started its reforms late, it can catch up rapidly whichever direction it chooses.

Overall, this was an exciting trip in countries that look toward a bright future. In some cases that is reflected in current stock prices, but there are still many opportunities for investors who can dig beneath the surface in search of stocks that offer both value and growth.



*Kuwait Towers*

About Frontier Market Asset Management

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