

Tale of Three Cities – Big Bad Lagos, Upscale Amman and a Better Beirut

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Graffiti – Beirut, October 2009

In the bad old days in Beirut, you always drove with the radio always on and tuned to traffic reports. They reported on gunfights and recommended detours around them just as routinely as reports in the west cover traffic jams. It was also wise to drive with your windows open so you could hear what direction gunfire might be coming from. Today's young adults who grew up during the civil war (1975 to 1990) speak nonchalantly of those times, saying how life went on for them as children, going to school and playing. One individual mentioned a shrapnel wound when a bomb exploded nearby, and another recalled vividly watching Israeli jets fly low overhead and blow up the nearby sports arena. "The explosion was just like movies of American jets bombing Vietnam".

Fortunately, today's visitors to Beirut don't have to worry about gunfights. On the other hand, travelers in Nigeria do need to worry about a few basic problems, and compared with other African destinations, Lagos, Nigeria is much more challenging. For instance, Murtala Muhammed Airport in Lagos is thronged with masses of milling people, some meeting passengers but others seeking trouble. You don't dare take a taxi, and if you hire a car to meet you, you need to make sure that the driver who greets you is from the company you hired. There are instances of passengers being pirated by free-lance drivers, who see names on another driver's signboard and then simply make up their own sign to pick them off. Typically these "entrepreneurs" drive the customers to their destination and then insist on payment in cash. However, there are stories of robberies and worse. Another thing to expect at the airport is requests for

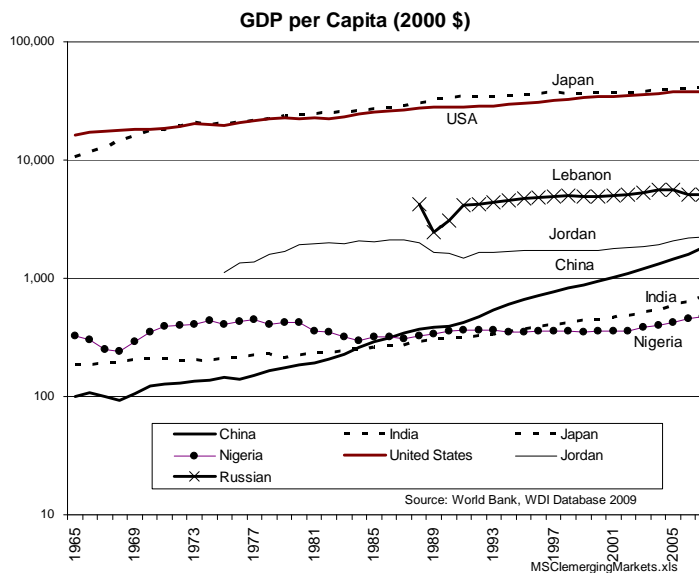
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“gifts” from customs officials, baggage handlers and semi-official security guards. Feigning ignorance is generally the best defense.

Our trip was designed to answer some questions about three countries that are significant in the world of frontier markets. Although we don’t compare our portfolio directly with the indexes, Nigeria is 23% of the S&P Frontier BMI ex-GCC Index (excluding the rich Middle-East countries), and it is 27.4% of the MSCI Frontier ex-GCC. Jordan is 4.4% and 11.8% of those benchmarks respectively, and Lebanon is 2.9% and 8.0%. Thus, these three countries combined equate to roughly 30% of the S&P index and 48% of the MSCI index.

While investment opportunities can exist whether or not a country is doing well, our bottom-up approach doesn’t rule out awareness of country level macro impressions. We confess that we went to Nigeria with low expectations, and unfortunately after this trip we have lowered them further. On the other hand, Jordan met our expectations, as it has continued along its path of progress that was in place when we visited some years ago. In addition Lebanon, where our expectations had been low, turned out to be a positive surprise.



	Jordan	Lebanon	Nigeria	Emerging Mkts	USA	EAFE
RGDP Growth 2009e	3%	3%	4%	3.0%	0.0%	0.0%
GDP/Capita	\$2,248	\$5,111	\$471	\$5,344	\$38,096	\$28,900
Inflation	0%	3%	9%	5.0%	2.0%	2.0%
Population (mil)	5.7	4.1	148.0	4,756.6	301.6	582.2
% Rural	22%	13%	52%	29%	19%	17%
% Literate	80%	80%	80%	87%	100%	100%
Electricity (kWh/capita)	1,676	2,242	127	2,902	13,648	9,822
Corruption (10=best)	4.7	3.0	2.2	4.1	7.2	8.2
Market Cap (\$ Bil)	\$41.2	\$10.9	\$86.3	NA	\$19,947	NA

Source: World Bank, S&P, MSCI, Transparency Int'l & Frontier Market Asset Management, 2009



NIGERIA

The Russia of Africa?

Independent since 1960, Nigeria has 150 million people in a country roughly double the size of California. Most of them are great folks, but there are quite a few scoundrels who see fit to make money in unorthodox ways. It is estimated that the “informal” or underground economy is two thirds of Nigeria’s overall total economy. Some of the informal players are “PEPs” (politically exposed persons) who make off with much of the country’s oil revenues. This has led to predictable unrest in the oil rich Niger Delta, where kidnappings have become routine. Violence in the Delta cut oil production to 1.3 million barrels per day versus a potential 2.5 million capacity and the current OPEC quota of 1.7 million. Combined with declining oil prices, oil revenues have dropped, hurting the economy. Inefficiency is also to blame, because a lack of finished petroleum products has caused a 27% plunge in electricity production, with a negative impact on broad sectors of the economy.



Dangote Sugar Refinery Plc, Lagos, Nigeria

Lagos is one of the largest and dirtiest cities on earth, with an estimated 17 million people. Thanks to an enlightened governor, there are patches of green parks cropping up these days, but they are dwarfed by huge sprawling slums. Given the overwhelming traffic problems of Lagos, it would have been impossible to see very many companies by car, so we were privileged to attend the first ever investment conference in Nigeria, which was sponsored by CSL Stockbrokers Ltd. It was attended by more than 70 people, a third from local institutions. Presentations ranged from inspired to pedantic to pedestrian. In line with the profile of the market, most of the presenters were from banks although some of those cancelled at the last minute due to jitters over ongoing government bank audits.

A presentation by Tunde Lemo of the central bank mentioned the recent crackdown by new Central Bank Governor Lamido Sanusi who sacked five bank chiefs and removed their executive boards in August; and more heads are expected to roll...Mr. Lemo discussed many problems in the banks, which include:

domineering chief executives, insider abuse, weak board oversight, low confidence in data integrity, etc. There are many stories of unsavory activities in the Nigerian banking sector. For example, some bank officers like to make favorable loans to officers of other banks and expect similar “sweetheart loans” in return; many banks have made far too many margin loans to retail speculators who have now lost everything, leaving the banks stuck with the collateral shares in bank stocks. On top of this, some banks decided to support their own stock prices with direct purchases in the market, but then booked these shares as if they were as margin loans rather than treasury stock. It has been reported that this could be a third of some banks capitalization.



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

During one of the presentations, a bank spokesman nonchalantly explained that a barrier to foreign entrants in Nigerian banking is the amount of money laundering required to do business. Adding to the problems, there is no central credit bureau to prevent customers from easily getting simultaneous loans from several banks which do not performing any cross-checks or due diligence. One businessman who is launching a credit bureau said the banks have little interest in it, perhaps because it would expose their inefficiencies. To clear up these problems will take time, and it will probably involve consolidation in the sector, from the current 24 banks to something like 15. Once that happens, there could be huge opportunities for the survivors as there are currently only 20 million bank accounts for 150 million people in the country.

Fortunately, Nigeria’s stock market is not entirely composed of banks. There are interesting companies in cement (Nigeria needs lots of that to improve its ragged infrastructure), and beer (Guinness reports that it sells more stout here than in Ireland). Dangote Sugar is another company that is worth a visit. We made a long trip across town to the port and visited its impressive refinery in oppressive heat and high humidity. The company has tariff protection against imports of refined sugar in the entire ECOWAS region (Economic Community of West African States). As a result, they are expanding with a new plant in Algeria where people consume five times as much sugar as Nigerians. The biggest sugar addicts, however, are in Brazil where consumption is 56.0 kg sugar per capita per year versus ECOWAS - 9.1, India - 18.1, South Africa - 23.0.



Dangote Sugar Refinery Plc, Lagos, Nigeria

The challenge in Nigeria is to look past its obvious problems and see the potential for improvement. The government is having success with an amnesty program for rebels in the Delta, and reduced violence there could lead to increased oil production. That, in turn, could lead to increased investment over the long run. And thus would also lead to a reduction in the shortages of petroleum products and electric power that have plagued the economy as a whole. Despite complaints about Nigeria's corrupt inefficient government, Diego Cortez, general manager at Dangote Sugar (who is from Panama) said that dealing with Algeria's government over their new plant there is much more challenging. So maybe on a relative basis Nigeria isn't so bad. And just because Nigeria has a bad reputation doesn't mean investors should stay away. They just need to be careful, as they do in Russia....



JORDAN

While Dubai is glitzy and Kuwait City is austere, Amman feels comfortable. Set on seven hills, like Rome, the city has its share of upscale hotels and shining new office towers, but it also has old neighborhoods with narrow streets and excellent traditional restaurants. West of the center, there are comfortable mansions, selling for \$2-3 million in neighborhoods that boast chic boutiques and even Starbucks. (A good thing for us because the night-flight from Lagos on Middle East Airways doesn't allow much sleep).

After losing the West Bank to Israel in the 1967 War and then nearly losing the monarchy to Palestinian rebels in 1970, King Hussein and, since 1999, his son King Abdallah II have pragmatically led the nation through the conflicting interests of its neighbors, while they have instituted an open government with parliamentary elections.



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

With 6.3 million people in an area the size of Indiana, Jordan includes fabulous sights like Petra and the Dead Sea (408 meters below sea level). Even in Amman, one can visit Roman ruins of temples and a theater. Included in Jordan's population are 1.8 million Palestinian refugees and 500,000 Iraqi refugees. The United Nations Relief and Works Agency (UNRWA) is very instrumental in helping the refugees, and was a client when I traveled to Amman several years ago.



Banks in Jordan use iris recognition to verify customer identity (top right)

Economically, Jordan benefits from being 78% urbanized, with two thirds of its workers in service industries, especially banking. Lacking oil, potash is its main resource, while its manufacturing sector benefits from low labor costs, trade treaties in the region and a special trade agreement with the US covering exports that have Israeli content.

Manufacturing labor costs are \$300, only 10% above the level of China's coastal cities. Incidentally, our neighborhood hotel, the Al Qasr, at \$155 a night was the bargain of the trip, while the 5 star Gefinor Rotana in Beirut was very nice at \$205 and the new Southern Sun Ikoyi in Lagos was the worst room of all but cost \$318.

The Jordanian stock market is large, (\$41 billion) but thin, with only a few stocks having significant trading volume. The largest company is Arab Bank, where the young great granddaughter of its founder is currently Executive Vice President and the head of investor relations. With its reputation for staunch conservatism and an ROE of only 11%, this may not be as much a bargain as the smaller banks, but it is extremely high quality. Several banks have exposure to Palestine, so they would benefit from any improvements in the situation there.



Ecumenical Amman: Muslim & Christian side by side



LEBANON

At the airport, Madonna, a Muslim girl from Tripoli, told me a story. "When God created Lebanon," she said, "he gave her beautiful beaches, majestic mountains and a temperate climate... The angels asked, 'But why do you give her so many wonderful things?' And God replied, 'Wait until you see the neighbors I give her...'"

Indeed, Lebanon is in a troubled neighborhood, but with the end of the civil war in 1990, Beirut has been regaining some of its old persona as the "Paris of the Middle East". Still, the road has been bumpy, as this chronology illustrates:



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

- 1970: Palestinian militants, defeated in Jordan, move to southern Lebanon. PLO begins attacks on Israel.
- 1975: Civil war begins, Muslims, 60% of population, fight Christians seeking greater representation in government. Fighting along the "Green Line" divides West Beirut (Muslim) and East Beirut (Christian), destroying the city center.
- 1976: Syrian troops enter Lebanon.
- 1982: Israel invades Lebanon fighting PLO and Syria. 86 Syrian Jets shot down. Beirut bombed for 10 weeks.
- 1983: U.S. barracks in Beirut bombed, killing 220 Marines. U.S. withdraws.

1990: Civil war ends, GDP down 50% versus the 1975 level.
 2000, May: Israel withdraws from southern Lebanon.
 2005, Feb.: Assassination of former Prime Minister Rafiq Hariri and 22 others with 1,000 kg bomb near St. George Hotel, anti-Syrian demonstrations, "The Cedar Revolution".
 2005, April: Syria withdraws from Lebanon.
 2006, July/Aug: Hezbollah kidnaps 2 Israeli soldiers; 34 day Israeli-Hezbollah conflict kills 1,200 Lebanese civilians, \$3.6 billion damage. Israel failed to defeat Hezbollah.
 2007, Sept: Lebanese Army defeats Palestinian extremists but destroys refugee camp.
 2007, Nov: Political stalemate leads to sectarian and political violence.
 2008, May: New Government formed under army chief, President Sulayman.
 2009, July: Parliamentary elections successful, Prime Minister Sa'ad Hariri, son of slain prime minister, to form government
 2010: ???

With eight million Lebanese in the overseas Diaspora, the four million Lebanese in the country benefit from remittances and deposits from abroad. As a result, while bank loans are roughly equal to GDP (similar to advanced economies), bank deposits are three times GDP. Some of this is due to high savings on the part of a populace accustomed to instability, but the lions share of these deposits come from abroad. Deposit growth slowed below 4% during the 2005 conflict, but soared in 2008 as the financial crisis in the developed world contrasted with relative stability in Lebanon.



A reminder: the gaunt ruins of the Holiday Inn, Beirut

The Lebanese banks have several strategies for growth. One is based on the hope of financing opportunities if a stable government decides to privatize sectors like telecommunication and power generation. Another strategy is that a stable economy will prompt corporations, foreigners and locals to borrow more. And finally, the other MENA countries have now opened up their borders to Lebanese banks. Several banks speak of aggressive plans for branch networks in Saudi Arabia, Jordan, Sudan, Cyprus, Iraq, Egypt, the UAE and even Yemen. This may be especially timely, given that many banks in the rich GCC countries are stretched to the limit with high loan/deposit ratios and rising loan losses.

In 1994, following the end of the civil war, Rafiq Hariri organized SOLIDERE (Societe Libane pour le DEVELOPMENT et la REconstruction de Beirut) to rebuild the central district. Class A shares were granted in exchange for property rights in the ruined area while class B shares were sold to new investors. Although the renovation phase of damaged buildings has been largely completed, the company retains a land bank of 2 million square meters, 75% of which is on the waterfront where development has barely begun. Recently, Solidere has sent a signal by renting rather than selling some properties.



The Green Line divided Beirut during the civil war

While some accuse the company of destroying value by not taking a quick profit, it is possible that Solidere will be vindicated if Lebanon follows a positive path and future values prove to be far above those of today.



Youssef al Rami Street in 1990 from Beirut's Memory by Ayman Trawi



...and in October 2009

Our crystal ball is not good enough to tell us that, but it is not inconceivable that fresh thinking in the Middle East could result in a future that is very different and much better than the past.



The St. George Hotel, site of the bomb blast that killed former Prime Minister Hariri, February 2005

Conclusion

When we travel to frontier countries, we frequently meet people who are prone to forming strong opinions on insufficient information. With only a few days in several countries, we need to be intellectually modest about our conclusions. And we also need to check that our crystal ball is not simply rearview mirror.

With this in mind, we are carefully optimistic about the three countries we covered on this trip. Albert Einstein said that “problems cannot be solved by the same thinking that created them.” Clearly, there is some fresh thinking going on in the Middle East. Some of the old leaders are still there, but others are new and hopefully more pragmatic.

“For progress to occur, two generations have to agree” - Anon



Ruined buildings rebuilt with fashionable shops and trendy cafes in Beirut.

About Frontier Market Asset Management

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