



FRONTIER MARKET
ASSET MANAGEMENT

Dawn in Karachi?

By Larry Speidell
March 2015

"If there is no struggle, there is no progress. Those who profess to favor freedom, and yet depreciate agitation, are men who want crops without ploughing up the ground. They want rain without thunder and lightning."

– Frederick Douglas

Hawks soar across a red sun at dawn in Karachi. The murky haze fades to reveal this chaotic city of 25 million people coming to life with the beep of horns and the rap of motorbikes, teeming in the streets.

Karachi is a microcosm of its country - both have had their share of troubles, many self-inflicted by bad government and an overambitious military.

Yet despite these troubles, Pakistan's stock market rose 31% in 2014, 35% in 2013 and 34% in 2012. Thus, it is hard to ignore the market. Furthermore, it reached 11.4% of the Russell Frontier ex-GCC Index in December 2014. Our own portfolios hold roughly 5% in four Pakistani stocks; so it was timely to make my third visit to Karachi.

These days a journey to Pakistan is not taken lightly. Precaution is gained by traveling alone with a young bright analyst, Tahir Saeed, rather than in a conspicuous group. And there is some comfort in arriving at midnight and leaving before dawn the next day. Still, it is sobering to note that the day I left, the U.S. Department of State issued a Travel Warning for "U.S. Citizens to defer all non-essential travel to Pakistan."



"Karachi at dawn from the Avari Towers"

Pakistan is home to 200 million people, 60% of whom work in agriculture, which is only 25% of GDP, compared to 22% in Industry and 53% in services. Literacy is a problem at only 55%. It is 68% for men and a deplorable 40% for women. One manager says this is the legacy of an archaic feudal system of land ownership that was never reformed as was done in India. Despite spending 2.1% of GDP on education, much of it goes through corruption to “phantom schools” that make no contribution to the next generation. Meanwhile, 3% of GDP goes to the military.

GDP per capita is a moderate \$3,100, versus \$1,700 in Tanzania, \$1,800 in Kenya and \$2,100 in Bangladesh. In all these countries, the underground, informal economy is roughly equal in size to the formal economy, allowing many people to afford luxuries, such as the ever-present motorbikes, with tiny 70 cc motors (roughly the size of your fist) and custom fabric covers that adorn the gas tank and seats.

	Pakistan	Tanzania	Argentina	Ukraine	Georgia
GDP Growth (2015 est)	4.5%	7.0%	0.0%	-5.0%	5.5%
Inflation	5.0%	7.8%	40.0%	15.0%	2.0%
Population (mil)	196.2	49.6	43.0	44.6	4.9
People / km sq	246	52	15	74	71
% Literate	55%	68%	98%	100%	100%
% Literate Female	40%	61%	98%	100%	100%
% under age 15	33%	45%	25%	14%	18%
Life expectancy	67.1	61.2	77.5	69.1	75.7
% Urban	36%	27%	92%	69%	53%
GDP / cap (PPP)	\$3,100	\$1,700	\$18,600	\$7,400	\$6,100
Electricity/cap kWh	357.3	68.6	2,583.7	3,933.1	1,900.5
% Unemployed	7%	8%	8%	8%	15%
Land (km sq)	796,095	947,300	2,780,400	603,550	69,700
Market Cap (\$ bil)	\$43.7	\$1.8	\$34.2	\$25.6	\$0.9
Market Cap/GDP	18%	6%	5%	15%	6%
GDP (Official Exch Rate)	\$236.5	\$31.9	\$709.7	\$175.5	\$16.0
GDP % Agriculture	25%	28%	9%	10%	9%
GDP % Industry	22%	25%	30%	30%	22%
GDP % Services	53%	47%	61%	61%	70%
Military exp % GDP	3.0%	1.1%	0.9%	0.6%	2.9%
Electricity Cons Bil kWh	70.1	3.4	111.1	175.3	9.4

Source: The World Factbook, CIA, <https://www.cia.gov/library/publications/the-world-factbook/> 2015



Tank and seat covers everywhere... helmets optional...

"It's Always Darkest Before the Dawn..."

In May 2013, Pakistan had the first peaceful, democratic transfer of power since its independence in 1947; however, Prime Minister Nawaz Sharif has struggled to make reforms. Last August, thousands of protesters from the opposition PTI, led by cricket star, Imran Kahn, marched on Islamabad. Over ensuing weeks, they and other opposition groups clashed with police, and it seemed that the government might collapse. Even the entire democratic system seemed to be crumbling. By November, it looked like a military government would take over, but then Army Chief Raheel Sharif stepped back from the brink of a return to military rule (last seen under Musharraf from 2001 to 2008).

The Army does not want to rule, but it is demanding that the government take action on reforms. With the Army's oversight, government bureaucrats know that they will lose their jobs if they don't produce. A cynic would say that since the Army has significant business interests, it wants a better economy to better to fill its own pockets... Still, progress is progress.

As if political crisis were not enough, December brought the Taliban massacre of 140 children. That action may have produced a turning point: the Army is now tackling security issues seriously, encouraged to do so by the formation of the All Parties Conference for a unanimous anti-terrorism policy.



A noisy bird guards the Sind Club...

This could be the dawn of a much better time in Pakistan, a time when world perceptions may change, and a time when delayed opportunities may be achieved.

Over lunch at the Sind Club, we discussed some of the broader ramifications of these changes with Arif Islam, the head of Meezan Bank, an Islamic bank that is one of the fastest growing in the industry.

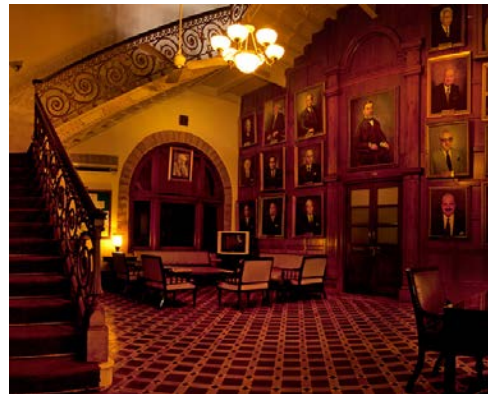
Inside the doors of the clubhouse built in 1871, the days of British Raj seem alive again. Dark paneled walls are hung with portraits of past presidents, while a cast iron staircase leads to large function rooms above.

The restaurant serves a menu that may not have changed since the 1950s, delivered by formally dressed by waiters in puttees and elaborate headscarves. To discourage doing business in this genteel atmosphere, briefcases must be checked at the entrance, but I concealed my notes in my pocket.

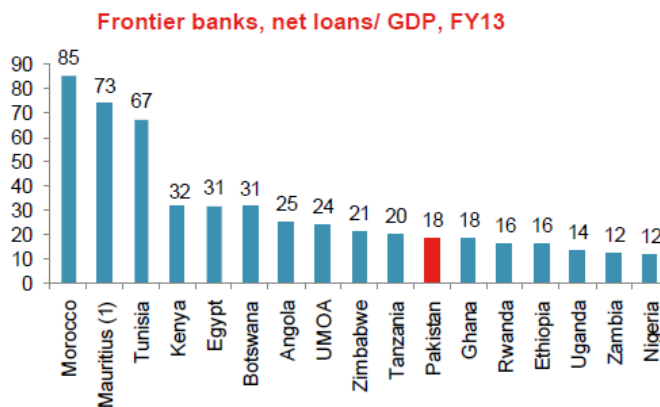
Economically, Pakistan stands to benefit from its new *"General System of Preferences"* status for exports to Europe, granted in 2014. This will help Pakistan industries, especially textiles, where the country is self-sufficient in cotton (compared to Bangladesh which must import cotton).

Now that oil prices, have fallen, inflation is dropping below 6% and there is room for another 150 basis point interest rate cut following a similar decline last year. This should lead to higher growth,

perhaps to 5% or more, and more opportunities for lending by the banks. As shown below, bank lending in Pakistan is only 18% of GDP, so there is plenty of room for increases. The classic frontier bank model has been to take deposits and simply buy government bonds such as PIBs (Pakistan Investment Bonds). In Pakistani banks, investments represent 45%+ of assets with loans of only 35%, while in Nigeria, those percentages are reversed. As bond rates fall, the banks stand to gain both from shifting their asset mix to higher margin loans and from the appreciation in their bond holdings. However, Meezan, as an Islamic bank, is not able to buy PIBs but must invest in Sirkuks that are structured to provide an equity type return rather than interest. Because these are in short supply, the cost of funds in Islamic banks is 50 basis points higher than for conventional banks, but this is made up by the “stickier” deposits from loyal customers. Meezan is doing everything it can to reduce the COBM – “Cost Of Being Muslim”. The evidence shows that Islamic banking is gaining share in all Muslim countries, and that Islamic banking is more resistant to downturns.



Source: <http://www.sindclub.org.pk/>



Source: *South Asian Banks, Exotix, Feb 2015*

Turning to energy... In addition to the direct benefits of lower oil prices on consumers and on the government budget in terms of reduced subsidies, there is some improvement in “circular debt.” This is a unique problem in Pakistan where some government entities down the energy supply chain don’t pay their suppliers causing unnecessary borrowing at all levels of the chain. At the top, PSO (Pakistan State Oil) imports and distributes petroleum products to IPPs (Independent Power Producers), who then sell it to the National Electric Power Regulatory Authority. The Authority in turn sells to government owned entities, such as the National Railway. These end-use customers serve their own interests by delaying payments to their suppliers, so every link in the chain has to incur unnecessary short term borrowings to cover its overdue accounts receivable. A culture of unenlightened self-interest has led to massive borrowings and energy shortages. Lower prices improve but do not eliminate this unfortunate, illogical systematic inefficiency. This falls in the category of what we call “Welcome to the Frontier” issues... Meanwhile, fortunately, reforms to improve energy supplies are occurring elsewhere in the system, such as a deal to import LNG from Qatar.

The new government has even resolved a politically motivated gas crisis that cut supplies to Engro Fertilizer from 189 days in 2011 to 45 days in 2012 in order to favor a politically connected competitor. Now, Engro can get enough gas to operate at 80% of capacity and has gone from the brink of bankruptcy to paying down its debt and even paying a small dividend.

Meanwhile, Karachi Electric (KEL), majority owned by the government, has taken matters into its own hands by adjusting blackouts to penalize those who don't pay. They also identify Transmission & Distribution (T&D) losses, so that where losses are over 40% of power transmitted, customers can expect blackouts for 6 hours a day or more. With these kinds of incentive, and by installing "Ariel" cables that are harder to tap into for stealing power, KEL has cut T&D losses from a shocking 36% in 2009 to a merely appalling 23% today. They say they can get to 15%...someday.

Pakistan isn't just banks and government utilities. A generic pharmaceutical industry thrives, and is constantly introducing new higher margin products as older ones mature. One company even speaks of setting up generic manufacture in Europe, where its low cost experience can bring a competitive edge.

"Karibu" – Welcome to Tanzania

It is a long day of travel from Karachi to Zanzibar, but if you leave early enough, you can arrive in time to see children walking the narrow roads home from school, with the girls in cream headscarves that drape to their waists above blue skirts.

Tanzania is 30% Christian, 35% Muslim and 35% "indigenous beliefs", but on the island of Zanzibar, the population is 99% Muslim. Still it appears that women's education is as much a priority as that of the men, and the simple, open-air schoolhouses show neatness and discipline.

Zanzibar is romanced in story and in song – there is even in a Zanzibar perfume by Van Cleef & Arpels. Thirty miles offshore from Dar es Salam, this was where the Sultan of Oman set up his court in the 1830 with his wives and 75 concubines. He found refuge from the desert heat, and from here, he took dominion over much of East Africa. This was where he insisted on planting clove trees that make Zanzibar today the largest spice exporter in the world. And this was also once a notorious, murderous den of iniquity, where anything could be had from guns to slaves to tusks. In 1866, Princess Salame, a daughter of the Sultan, had an affair with a German businessman. Once the result became obvious, she had to take refuge on a British gunboat, and a warship had to be dispatched to prevent the wholesale massacre of foreigners.



School girls on the road....

Fortunately, things have calmed down since then. Eventually, Arab rule in Zanzibar yielded to the British, while on the mainland, German control in Tanganyika yielded to the British as well. With independence in 1964, the two joined to form Tanzania (which explains the correct pronunciation: tan-ZAH-nee-uh rather than tan-ZANE-ee-uh).

The feeling of welcome on arrival is endemic in much of Africa, but especially here, where it comes with the Swahili word, "Karibu", plus a broad smile, and often followed by "Jambo" (hello). Underlying this cheerfulness is optimism that was echoed by the companies at Standard Bank's East Africa conference. Despite the temptations of the nearby beach, two days of meetings with more than a dozen companies was intense. Among these was Safaricom, that boasts 40%+ EBITDA margins on the back of its 3G and 4G telecom systems that have literally created the new world of mobile banking through its pioneering mPesa platform. There were also banks from Kenya, Uganda, Tanzania and Rwanda, boasting net interest margins of up to 10% and loan growth as high as 20% plus. Insurance companies are prospering too, since penetration is so low, and the population is awakening to the merits of risk protection. The only trouble spot is in motor insurance of the jitney busses that careen around wildly packed with passengers. Called "Matatus" in Kenya and "Deli-Delis" in Zanzibar, they are avoided by the better insurers.

There was much discussion of progress in African infrastructure. "All Aboard", *The Economist*, February 28th, 2015, highlights the impending completion in 2016 of a road from Cape Town to Cairo (after 100 years!), as well as a road across the Sahara from Algiers to Lagos. In Kenya and Tanzania, roads are under construction everywhere, often with Chinese financing and Chinese construction companies on the ground (although there are local subcontractors). Kenya has unlocked a logjam of projects with its program of devolution, giving more authority to the local counties for their own budgets. While this has led to some duplication of staff, it has also led to greater commitment and greater action. Some counties say they are now getting their first new paved roads since independence in the 1963!

Railways are being built and rebuilt as well. The decrepit Rift Valley railway has been undergoing repair for some time, but now the Chinese are building a new standard gauge railway from Mombasa to Nairobi, which will eventually continue on to Uganda. Another rail link will tie Kenya's new port of Lamu (to relieve the gridlock in Mombasa) with South Sudan. And in Uganda, the bickering that has lasted since oil discovery in 2005 is finally over, and an oil refinery is breaking ground to bring the oil in Lake Albert to market.



Source: *The Economist*, April 28, 2015

The Long View

Stepping back from the adrenalin rush of travel, it is helpful to put things in perspective. Economic Freedom ranks from the Heritage Foundation in the table below can help us do that.

Economic Freedom - 2015 (Frontier blue, Emerging green)							
Hong Kong	89.6	Botswana	69.8	Italy	61.7	Mozambique	54.8
Singapore	89.4	Latvia	69.7	Croatia	61.5	India	54.6
New Zealand	82.1	Jordan	69.3	Paraguay	61.1	Greece	54.0
Australia	81.4	Belgium	68.8	Dom Rep	61.0	Bangladesh	53.9
Switzerland	80.5	Uruguay	68.6	Azerbaijan	61.0	Yemen	53.7
Canada	79.1	Poland	68.6	Guatemala	60.4	Mauritania	53.3
Chile	78.5	Barbados	67.9	Slovenia	60.3	China	52.7
Estonia	76.8	Cyprus	67.9	Morocco	60.1	Liberia	52.7
Ireland	76.6	Peru	67.7	Serbia	60.0	Guinea	52.1
Mauritius	76.4	Jamaica	67.7	Uganda	59.7	Russia	52.1
Denmark	76.3	Spain	67.6	Namibia	59.6	Cameroon	51.9
United States	76.2	Costa Rica	67.2	Lebanon	59.3	Vietnam	51.7
United Kingdom	75.8	Slovakia	67.2	Mongolia	59.2	Ethiopia	51.5
Taiwan	75.1	Macedonia	67.1	Bosnia	59.0	Laos	51.4
Lithuania	74.7	Hungary	66.8	Zambia	58.7	Nepal	51.3
Germany	73.8	Bulgaria	66.8	Sri Lanka	58.6	Haiti	51.3
Netherlands	73.7	Oman	66.7	Cote d'Ivoire	58.5	Belarus	49.8
Bahrain	73.4	Romania	66.6	Indonesia	58.1	Lesotho	49.6
Finland	73.4	Mexico	66.4	Senegal	57.8	Ecuador	49.2
Japan	73.3	Portugal	65.3	Tunisia	57.7	Algeria	48.9
Luxembourg	73.2	Rwanda	64.8	Nicaragua	57.6	Angola	47.9
Georgia	73.0	Montenegro	64.7	Tanzania	57.5	Uzbekistan	47.0
Sweden	72.7	Panama	64.1	Cambodia	57.5	Ukraine	46.9
Czech Republic	72.5	Trinidad	64.1	Moldova	57.5	Burma	46.9
UAE	72.4	Kazakhstan	63.3	Bhutan	57.4	Bolivia	46.8
Iceland	72.0	Turkey	63.2	Brazil	56.6	Congo	45.0
Norway	71.8	Ghana	63.0	Mali	56.4	Argentina	44.1
Colombia	71.7	S. Africa	62.6	Kenya	55.6	Iran	41.8
South Korea	71.5	France	62.5	Pakistan	55.6	Eritrea	38.9
Austria	71.2	Kuwait	62.5	Nigeria	55.6	Zimbabwe	37.6
Qatar	70.8	Thailand	62.4	Guyana	55.5	Venezuela	34.3
Malaysia	70.8	Philippines	62.2	Egypt	55.2	Cuba	29.6
Israel	70.5	Saudi Ar	62.1	Malawi	54.8	North Korea	1.3

Source: The Heritage Foundation, 2015

As shown in the third column of the table, Tanzania, at 57.5, ranks above Brazil on this broad measure that includes the World Bank's ease of doing business scores as well as Transparency International's corruption index. Kenya and Pakistan rank above the emerging markets of Egypt, India, China and Russia.

We believe that Pakistan and East Africa are worthy places to search for investment opportunities. As risk takers in the frontier, we don't have to ride on the roofs of buses like the brave travelers on the aptly named bus in Karachi (at the right).

But if we travel carefully and invest wisely, we can navigate through the risks in places where the returns and rewards make the journey worthwhile.



"Risk Taker! - Riding High in Karachi,,,"

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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