



FRONTIER MARKET
ASSET MANAGEMENT

The Taste of Freedom: Georgia, Latvia, Estonia, Ukraine

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Maidan Square, Kiev, June 22, 2014

*History says, Don't hope
on this side of the grave.
But then, once in a lifetime
the longed for tidal wave
of justice can rise up,
and hope and history rhyme.*

- Seamus Heaney, The Cure at Troy

Please Note: We took this trip a month prior to the destruction of Malaysia Air Flight MK17. Our thoughts are with the families of victims. This tragedy should never have occurred. We hope that it will never be forgotten.

Descending from Mikhailovsky Monestary in Uppertown, Kiev, you can hear sound coming from the Maidan ('My-don') before you see it. Loudspeakers are playing music, speeches, and tributes to those who died. Maidan means 'square'; but now it also means the movement that took its name from the place and went on to overthrow the government in February.

You enter Maidan past piles of truck tires, bricks and cobblestones - past banners, shards of lumber - past wreaths and shabby army tents, still occupied by the few Maidan protesters who vow to remain until reforms are passed. The smell of ash is in the air. But so too is the feeling of freedom.

Speeches and songs ring out from a bandstand with a large-screen TV and a row of memorials to the hundred who died here in February.



Maidan Square, Kiev

This is the epicenter. This is where 20,000 protesters clashed with police and invaded government buildings. Here they endured tear gas, flash grenades and sniper fire. This is where violence caused the government of Victor Yanukovich to finally decide that the price of power would come at too great a cost in human lives.

We decided that this was an important time to travel to Ukraine. We decided that it was also a good time to go to Georgia, Latvia and Estonia which are in the shadow of Russia. The contrasts between countries that have tilted West, and those that have remained in Russia's sphere of influence is striking. Estonia and Latvia have thrived, while Ukraine has struggled to prosper. Georgia appears to be managing a delicate balancing act. As we have noted in previous commentaries, economics, and not necessarily ideology, has encouraged Ukraine's bold move towards Europe.

Economically, these countries are generally well-off with GDP per capital ranging from \$24,000 in Estonia and \$19,100 in Latvia (roughly half the level of Australia) to \$6,100 in Georgia and \$7,400 in



Source: <http://www.worldatlas.com/webimage/country/eu.htm>

Ukraine. Aside from Ukraine, inflation is not a problem for them, but unemployment is, due to a skill shortage among the rural population. The Baltics are small countries, with Estonia the size of Vermont and New Hampshire combined, while Latvia and Georgia are 50% larger, similar to West Virginia. Ukraine is ten times the size of Latvia, and from east to west it spans the distance from New York to Chicago. At 10% of GDP, agriculture is important in Ukraine; its rich black earth makes it one of the world's breadbaskets. This is double the levels of agriculture in the Baltics and Australia, but still it is only a third of the level in Sub-Saharan countries such as Kenya.

	Ukraine	Georgia	Latvia	Estonia	Australia	Kenya
GDP Growth (2014 est)	-5.0%	5.5%	4.0%	1.5%	3.3%	5.0%
Inflation	15.0%	2.0%	0.2%	1.0%	2.1%	6.0%
Population (mil)	44.6	4.9	2.2	1.3	22.0	44.0
People / km sq	74	71	34	28	3	76
% Literate	100%	100%	100%	100%	99%	87%
% Literate Female	100%	100%	100%	100%	99%	84%
% under age 15	14%	18%	14%	16%	18%	43%
Life expectancy	69.1	75.7	73.4	68.9	81.9	63.3
% Urban	69%	53%	68%	70%	89%	22%
GDP / cap (PPP)	\$7,400	\$6,100	\$19,100	\$24,000	\$42,400	\$1,800
Electricity/cap kWh	3,933.1	1,900.5	2,956.1	6,318.0	10,392.9	125.2
% Unemployed	8%	15%	10%	11%	5%	40%
Land (km sq)	603,550	69,700	64,589	45,228	7,741,220	580,367
Market Cap (\$ bil)	\$25.6	\$0.9	\$1.2	\$2.3	\$1,198.0	\$10.2
Market Cap/GDP	15%	6%	4%	10%	78%	25%
GDP (Official Exch Rate)	\$175.5	\$16.0	\$30.4	\$24.3	\$1,542.0	\$41.1
GDP % Agriculture	10%	9%	5%	4%	4%	29.3%
GDP % Industry	30%	22%	26%	30%	27%	17%
GDP % Services	61%	70%	69%	66%	69%	53%
Military exp % GDP	0.6%	2.9%	0.9%	2.0%	3.0%	1.8%
Electricity Cons Bil kWh	175.3	9.4	6.4	7.9	228.8	5.5

Source: CIA Factbook, 2014



GEORGIA

Tough location, good country...

First the Romans marched in, then the Persians, Arabs and Turks. After a brief Georgian golden age, the Mongols marched down the Silk Road in 1236. Then Georgia became part of the Ottoman and Persian empires before being absorbed by Russia. It was independent for three years (1918 – 1921) while Russia was busy with its revolution, but was forcefully absorbed by the USSR until the iron curtain fell in 1991. As if that weren't enough, Russian troops marched into the Georgian provinces of Abkhazia and South Ossetia and unilaterally declared them independent of Georgia in 2008.

In fact both provinces view themselves as ethnically different from Georgians, and they fought with Georgia in the early 1990s. Abkhazia, with Russian help, defeated Georgia in 1993 and then ethnically "cleansed" Georgians from their province. Given the realities of those two regions, it appears that Georgia has moved on.



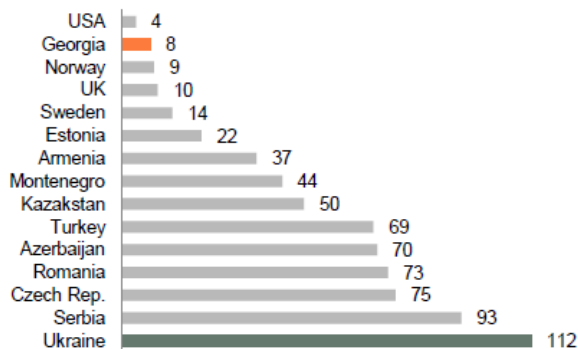
Tbilisi, Georgia



Rustaveli Avenue, Tbilisi, Georgia

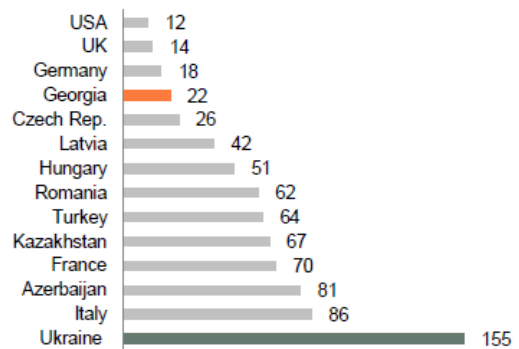
What Georgia has moved on to a miracle of reform. The country has shrugged off the corruption of Soviet times and achieved one of the cleanest economies in the world. Corruption was punished with jail terms for hundreds of officials. The formerly bloated government has shrunk so much that it freed up 50,000 square meters of office space, including making room for a new Marriott Hotel in the former Ministry of Agriculture building.

Ease of Doing Business, 2014



Source: Doing Business, WB

Economic Freedom Index, 2014



Source: Heritage Foundation

Georgia is expected to rebound from weak economic conditions caused by the surprise election victory of the Georgian Dream party funded by billionaire Bidzine Ivanishvili. His promise of closer ties with Russia, and pro-labor policy changes caused a decline in business investment. There was general concern that the government would roll back the clock on eleven years of business friendly reforms under Mikheil Saakashvili. Fortunately, the Georgian Dream party has taken a practical approach to balancing labor and business interests in implementing modest policy changes.

The next challenge for Georgia is to improve capital market depth. The central bank is spearheading this effort by establishing liquidity in local FX and government bonds. For now, we are investing via London in select financial stocks that should benefit from a pick-up in GDP growth this year and greater loan penetration.

Among the companies we visited, Liberty Bank is already delivering loan growth ahead of our expectations and Bank of Georgia is planning an IPO of its non-core healthcare division. Health is an interesting growth industry in the frontier world, and this IPO could help spearhead additional local listings.

At dawn, our Air Baltic flight 725 rises northwest from Tbilisi, above green hills punctuated with limestone escarpments. It climbs above the pronged white peaks of the Caucasus Mountains, into Russia east of Sochi. Then the flight passes on a line into Ukraine, east of Crimea and the Sea of Azov and above Donetsk, with its pro-Russian separatists. Below us lie tranquil fields of rich Ukrainian farmland with serenity in the morning light that belies the troubles and dangers of this region. After four hours in the air, we arrive in Riga, Latvia, our second stop on this trip around Russia's frontier.



The disputed territories of Abkhazia and South Ossetia are de facto independent from Georgia

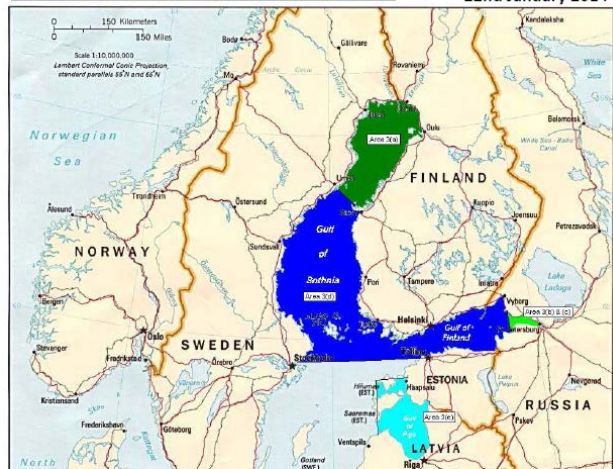
Source: http://en.wikipedia.org/wiki/Georgia_%28country%29



Tallink dominates the ferry market in the Baltic with 18 ice class ships that have enough horsepower to drive through the meter thick ice that can raft up in winter. Even during the warm celebrations of the "white nights" of summer solstice the temperature in Tallinn was in the low 50s Fahrenheit, and it had snowed the week before.

Despite Riga's scattered crumbling Soviet-era apartment blocks, the Baltic countries feel mostly Scandinavian. A restaurant in Vanalinn (Tallinn's Old Town) says diplomatically that:

Joint Hull Navigating Limits - Baltic Sea Ice Update 22nd January 2014



Ice in the Baltic Sea, January 22, 2014

"[The people]...have assumed for themselves the best from all the nations with whom they have lived together. Serenity from Swedes, common sense from Danes, determination from Germans and the true belief in the rightness of their path from Russians...."

Sadly, the phrase "with whom they have lived together" might more accurately be rendered as "been occupied by"...

A challenge these days is that the Baltics seem to have adopted a laid back, egalitarian Scandinavian mentality. They've made great progress, but the easy gains have been made... the low hanging fruit has been plucked:

- The European Union has welcomed them.
- They've embraced the Euro (with Lithuania expected to adopt it in Jan 2015).
- Infrastructure has improved (though a superhighway or high speed train between Riga and Tallinn would be worthwhile).
- Wage gains have narrowed the gap from a tenth or a quarter of Western European levels to roughly half (1,200 euros / month for a factory worker here).
- Finally, the rising middle class has risen.

Compared with ten years ago, when retail space was in short supply, stores are now ubiquitous, as projects rolled on during the global financial crisis, despite practically bankrupting their sponsors.

In any event, the results are pleasing to behold. The Old Town in Tallin is alive with trendy shops and restaurants (although one might not want to be here when the cruise ships roll in with up to ten thousand tourists).



Gertrud, Leib Restaurant, Tallin

The Baltic stock markets are small, but definitely worth a look. Two pharmaceutical companies in Latvia stand out: OlainFarm and Grindeks. Both survived Soviet times as generic manufacturers and have blossomed under private ownership. They are world class in their production quality, handily meeting Global Laboratory Standards, and have significant research efforts to pioneer new products, typically based on compounds coming off patent. Grindeks also develops proprietary pharmaceuticals and is close to entering clinical trials in a new cardiovascular treatment.



Grindeks Pharmaceutical, Riga, Latvia

Both companies sell 75-80% of their products in CIS states, primarily in Russia, where local drug production quality remains low and consumption has tremendous upside potential. Both companies are very experienced operators in Russia. They also have a competitive advantage in developing and producing Active Pharmaceutical Ingredients, (APIs) that Russia can no longer make.

Although Tallink Grupp is the largest stock listed on the Estonian exchange, it is challenged by the limited growth prospects for ferry service in the Baltics, competition and impending clean-fuel requirements that will squeeze margins.

Some of the smaller Baltic companies, in retailing, clothing and engineering, are also dealing with competition and could benefit from consolidation. Harju Elekter, which produces electrical equipment, operates quite efficiently on thin margins, but at times competes directly with Sweden's ABB. Certain divisions would be a strategic fit for ABB, however we did not note an appetite for any large mergers. On the contrary Harju Elekter is in acquisition mode. Meanwhile, AS Baltika, a specialty retailer, is dealing with challenging conditions in Ukraine and Russia. The company is moving to a franchise model in Ukraine, and is trading on depressed margins. Longer term AS Baltika could be an interesting turnaround story.



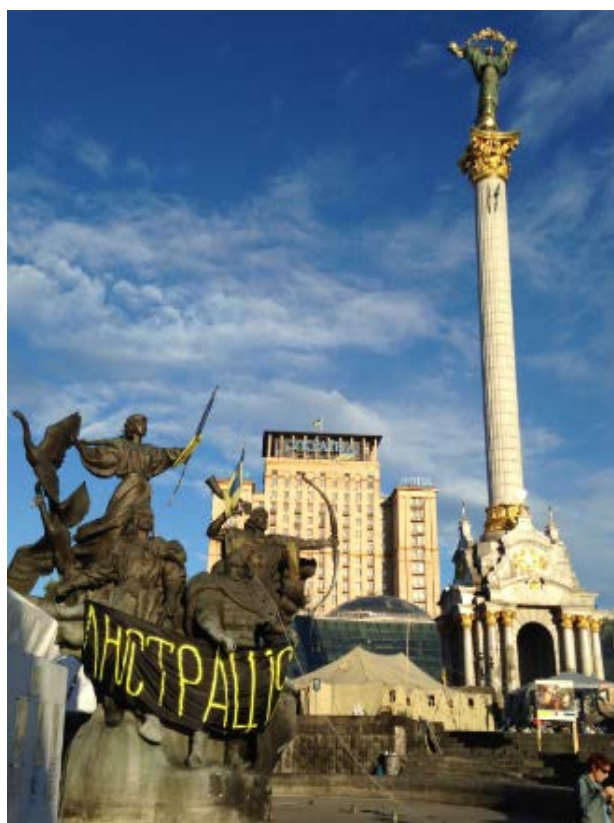
Ukraine

"Truth is the first casualty of war"
– Aeschylus, 525-456 BC

"Never wear your best trousers when you go out to fight for freedom and truth"
– *An Enemy of the People*, Henrik Ibsen, 1882

In 2010, the court supported Yanukovich in replacing the 2004 parliamentary constitution with one granting more power to the president. This became a rallying point for the opposition, especially after Yanukovich amassed a personal fortune through corruption, jailed his predecessor, Tymoshenko, and built a lavish mansion with a personal zoo.

In November 2013, protests began when Yanukovich waffled between accepting bail-out funds from Russia and opening free trade with the West. As things dragged on into February, the radical Pravy Sektor, or Right Sector, armed with Molotov cocktails, bats and pistols joined the crowd in Maidan square and contributed to the violence. The tragic events of Ukraine's geopolitical crisis have been well publicized, with the entire world transfixed on the alleged downing of Malaysian Airlines Flight 17 by Russian armed militants. A timeline of events in Ukraine has been provided in the closing of the trip report.



Maidan Square, Kiev

In Kiev, everyone speaks of Russia as having, in effect, already “invaded” the eastern provinces. One person said: “Don’t call them ‘separatists’ or ‘insurgents’ - they are terrorists.” Yet many believe Putin’s objective is simply to create a long and costly conflict in Ukraine. The renegade provinces of Donetsk and Luhansk would be no prize for Russia, as they are a net drain on Ukraine’s economy.



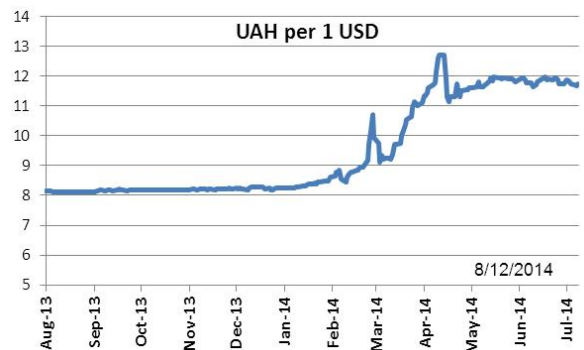
Eastern Provinces of Ukraine

The coal produced there costs \$250 per ton compared with the world price that peaked at \$80 in 2011 and is \$60 today. Steel and other industries aren’t competitive either, and the provinces require \$3 billion of social services transfers per year. Some of the IMF aid funds must go to pay salaries and pensions in the east.

With respect to Crimea, Ukraine is probably better off without it. Approximately 30% of the population is retired Russian military who had settled there for the warm climate. They and the older Russians in eastern Ukraine who support separation really don’t want Russia so much as they want the old Soviet Union back. Until now, Crimea has depended heavily on tourism, with 65% of its six million annual visitors coming from Ukraine. It is doubtful that very many of these will be going back in the near future.

As for the outlook on Ukraine, Poroshenko is believed to be a pragmatist. He seems inclined to finding a “modus vivendi” with Russia, rather than enduring a long conflict. It is likely that Ukraine’s GDP will fall 6-7% this year and inflation will be 15%. This is mainly due to the drop in the hryvnia, down 38% this year at its low and down 33% YTD as of the end of July.

Many companies have taken a hit from revaluation of foreign debt and will likely incur higher gas prices given the country’s estranged relationship with Russia and the government’s economic reform agenda. But some have gained an advantage from currency devaluation via attractive export prices. The recently signed trade agreement with the EU will open new markets for the country’s sizable agricultural industry.



Source : Bloomberg

For example, MHP, a chicken processor, began directing exports away from Russia a few years ago and is optimistic about Europe. They may even buy a small German processor that will receive whole chickens from Ukraine and sell them as European processed.

Already, the new government has made some progress on reforms. Gasoline prices are now at market levels. The gas price for home water heating was increased 50%. Interestingly, tax collection is up 10% in the first five months of the year because of less cheating. Also, the treasury is no longer burdened by Yanukovich's scheme of bringing in billions of dollars of fuel for "re-export" and then selling it at a 50% higher price locally, with the difference going to his family. Ukraine's current account is now nearly balanced because consumer spending is down (car sales are at a record low). The new government has invited Georgia's chief reformer for multiple visits to assist in reforming the bloated bureaucracy.

A final piece of the puzzle is land reform. Presently, land sales are prohibited, ostensibly to "protect" small holders. With the help of consolidators, the large industrial agricultural producers lease thousands of hectares at \$100/hectare which is modest compared to its presumed market value of \$1,500 / hectare (and very modest considering that such land in Europe would command ten times the price). While some large producers favor the current system because it lowers their capital costs, others such as the CEO of IMC, who has a PhD in agriculture, believe this is short-sighted as it discourages investment in the land, such as irrigation. Poroshenko favors reform, so it will be interesting to see how things develop.

Another interesting company is DUPD, a real estate developer with a property portfolio that is valued at a fraction of its net worth. Sales in both Kiev high rises and suburban developments are tracking well. The company has taken a conservative approach to valuing its assets and managing future development.

For Ukraine, there are important milestones that need to be achieved; peace in the east, a gas deal with Russia, parliamentary elections and the implementation of reforms. Back in April, Dragon Capital held its annual investor conference. Turnout was good, but subsequent buy orders have been few. Investors said they wanted to wait for the presidential election. Now they say they want to wait for the parliamentary election. Perhaps by then, the future will be clearer. But if so, stock prices will likely be higher. Perhaps investors who look seriously at Ukraine now will be rewarded.



Mikhailovsky Monestary, Kiev

Conclusion

*"To those who have fought for it, freedom has a taste the protected will never know"
Khe Sanh, Vietnam, 1968*

Many had criticized the West, particularly Europe, for its inaction in the face of an emboldened Putin. Yet Putin's world is one of power politics that sells short the strength of the people who rise up and demand justice. Freedom is a powerful motivating factor. Despite the global financial crisis and problems with the Euro, nation after nation in Eastern Europe has elected to join the European Union. The new strength of Europe comes from these Eastern nations that have already shown huge increases in broad based standards of living. While Putin and the Russian oligarchs can enrich themselves while promoting nationalistic ambitions, the best among their people will not accept this twisted version of reality for long.

We are optimistic that countries in the shadow of Russia will find a new dawn coming from the west, not the east. Ukraine is pivotal in this movement, but Georgia, Latvia and Estonia are well on their way.

Appendix:

Ukraine - 2014 timeline:

February 18: Protesters set fire to barricades of tires and wood, and they occupied buildings of the Ministry of Defense. At this point, however, the outcome was still unclear. A commentary from the intelligence service, Stratfor, wrote: "the opposition is incoherent. The large turnout at Tuesday's protests belies the actual weakness of the political opposition."

February 20: Minister of Internal Affairs Zakharchenko signed a decree authorizing the use of live ammunition against protesters, resulting in more than a dozen dead that morning. The death toll continued to rise, while photos showed protesters with guns as well as uniformed snipers on rooftops.

February 21: Parliament dismissed Zakharchenko and condemned the use of force. Yanukovich signed a compromise deal with opposition leaders to implement constitutional reforms.

February 22: Yanukovich accused his political opponents of staging a coup and compared the events to Nazi Germany, while speaking from his support base in the eastern city of Kharkiv. Meanwhile, parliament reinstated the 2004 constitution and voted 328-0 to impeach Yanukovich.

February 28: Yanukovich showed up in Russia, but he was merely a bystander as armed men in uniforms without insignia seized the airport in Crimea, The local government blocked the causeway from the rest of Ukraine and Russia issued Russian passports to Russian Crimeans to "protect" them.

March 1: Russian Foreign Ministry claimed that unidentified armed men from Kiev had attempted to seize the Crimean Interior Ministry. Aksyonov, the Chairman of the Council of Ministers of Crimea appealed to Russia for assistance. Putin requested and received approval from the Russian parliament for use of force in Ukraine. Six thousand Russian Special Forces troops were reported to have arrived in Crimea.

March 5: Russia blockaded Ukraine's fleet in Crimea by sinking a mothballed cruiser at the mouth of its harbor.

March 18: Russia and Crimea signed an accession treaty.

March 28: Stratfor reported that: "U.S. military intelligence has reason to suspect that Russia has deployed elements of the 45th Spetsnaz regiment, affiliated with the Russian Main Intelligence Directorate, or GRU, in eastern and southern Ukraine."

April 14: Unidentified protesters and masked gunmen stormed and occupied government buildings in eastern Ukraine.

April 16: Ukrainian troops took and held an airstrip in eastern Ukraine under attack by "armed men in green uniforms with no insignia." Stratfor reported: "There are also substantial signs that Russia's GRU (foreign military intelligence agency) is present in the east. Signs range from well-organized militant outfits with considerable equipment (likely coordinated by GRU operatives) to reports of specialized vehicles with communications equipment."

April 30: IMF approved a \$17 billion aid package in return for reforms that includes a 50% hike in natural gas prices.

May 2: Two Ukrainian helicopters shot down, evidently by man-portable air defense systems.

May 11: The eastern provinces of Donetsk and Luhansk held referendums on independence and claimed 85% support even though there was only a 35% turnout.

June 7: Petro Poroshenko elected president. He is wealthy from chocolate manufacturing and has holdings in auto assembly, TV, banks and insurance. He was also in government for many years, supported the Orange revolution and served as Secretary of Defense and Minister of Trade prior to Yanukovich taking power. He is believed to be pragmatic and pro-West, although there are lingering corruption issues.

June 16: Gazprom cuts off gas supplies to Ukraine over failure to gas debt.

June 19: Poroshenko declared unilateral cease-fire in eastern Ukraine to last until June 27.

June 24: Pro-Russia separatists shoot down a Ukrainian helicopter despite the cease-fire.

June 27: Deep and Comprehensive Free-trade Agreement (DCFTA) signed with European Union by Ukraine, Georgia and Moldova. This is to begin the process of harmonizing legal frameworks with the EU. Russia threatens "serious consequences". Meanwhile, during the "cease-fire" separatists are blowing up rail tracks and bridges.

July 17: Malaysian Air flight MH 17 shot down by pro-Russian separatists.

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