

## *The Case for Frontier Investing:*

### **On the Streets of Bangladesh and Sri Lanka**

November 2019

In a one room sheet metal school building in Korail in Dhaka, we are greeted with songs, dances and smiles. The kids here, from 8 to 10 years old, were not born when we began our work in frontier markets, and they have grown up poor. Korail is the largest slum in Dhaka, with 17,000 families that include 20,000 kids. Korail sits on 100 acres jutting into polluted Banani Lake, across from luxury apartments on the opposite shore.

We are here on a research trip to Bangladesh and Sri Lanka with two clients and a busy schedule of investment meetings. Our focus is on companies and their financial metrics, but it is worth taking time to remind ourselves of the fundamental reasons why our capital and capitalism are important here.



**BRAC School, Korail Slum, Dhaka, Bangladesh**

Twenty six of those reasons are in this classroom photo. And it is the fuel of investment that enables companies in Dhaka to provide jobs for their parents as factory and service workers. These kids can see what is possible on the other side of the lake, and they have a great desire to live better than they and their parents do.

Research Report by  
**Larry Speidell**

Since we first began in 2006, it has been a bumpy ride for these kids in Korail and for investors in frontier markets as well.

Bangladesh, for example, had a military coup in 2007, a stock market collapse fueled by margin debt in 2012, a textile factory collapse that claimed 1,100 lives in 2013, terrorist attacks against foreigners, and now a single party state that has diminished democracy.

Meanwhile, Sri Lanka had the devastation of the tsunami that killed 45,000 people at the end of 2004, a bloody civil war that finally ended in 2009, political upheaval that shut the government in 2018 and the Easter Sunday terror attacks in 2019 that killed 320 people. To these homegrown problems, we must add the global financial crisis beginning in 2008, persistent US dollar strength and now the US-China trade war.

The bumpy ride for investors is shown in the chart of index results since 1998.

Frontier markets did well from 2000 to 2008. Then they fell, in line with emerging markets. Next, driven by stimulus from China, emerging markets surpassed the frontier in the recovery. Frontier did very well from 2013 to the beginning of 2015. But the past four years have been disappointing; with the frontier index roughly flat while the US has been strong.

Now the frontier story has cracks in it. Asset flows have reversed. Liquidity has declined. MSCI has shuffled the deck of frontier countries, making it hard to measure the results of frontier managers. Globalization is yesterday's news. The world is stuck with more than \$12 trillion of negative interest rate debt. And frontier stocks have failed to keep up with their currency declines. Some investors question whether frontier markets are stuck.

The frontier has been vulnerable to allocation decisions to abandon it in favor of broad emerging market mandates or to abandon developing countries altogether.

I believe there are solid reasons to invest in the frontier, and I think the next ten years will be brighter than the past.

This trip offers a framework for reevaluating the thesis of investing in frontier markets by reviewing both the macro factors and our impressions of the companies we met in Bangladesh and Sri Lanka.

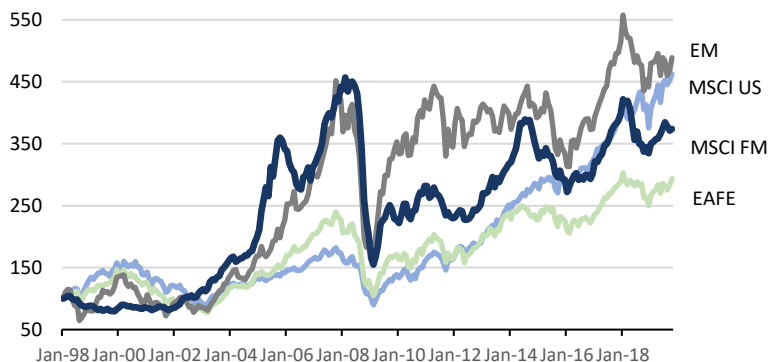
### Demographics

The frontier countries are home to 1.3 billion people, and their number will grow from a quarter of world population to 30% by 2050. Meanwhile, their working age population will increase by 43% versus declines in emerging and developed markets.

Sadly, these countries are often viewed as charity cases rather than investment opportunities by many people in the developed world. In her book *Dead Aid*, Dambisa Moyo<sup>i</sup> described the social worker syndrome at the country level, where aid becomes counterproductive by discouraging independence. I believe it is time for investing in addition to donating.

In *Memos from the Chairman*, Ace Greenberg, the legendary chairman of Bear Sterns, wrote that he liked to hire people with a "PSD" degree, "Poor, Smart and a Deep Desire to be Rich" rather than MBAs.<sup>ii</sup> He felt that they would be scrappy, hardworking and creative, while MBAs would be complacent, entitled and high maintenance. I think he's right about people - and about countries too.

US, EAFE, Emerging & Frontier Indexes

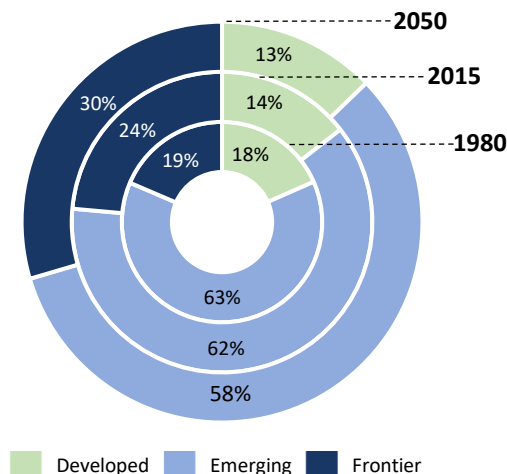


Source: MSCI, S&P, FactSet, 2019

Working Age Population, Ages 20-60

	2020	2050	% Change
Developed	479,278	466,647	-2.6%
Emerging	2,514,846	2,420,199	-3.8%
Frontier	876,798	1,256,844	43.3%
<b>Total</b>	<b>3,870,922</b>	<b>4,143,689</b>	<b>7.0%</b>

Population 1980, 2015 & 2050



## Progress in the Frontier

### a) Infrastructure

The frontier has an image problem. It is easy to go to Lagos or Nairobi or Dhaka today and say that these places look the same as they did ten years ago, or twenty or thirty.

On the other hand, my impression of Accra in Ghana is that it is far cleaner and more livable than it was on my first trip 12 years ago. And so is Saigon, and Colombo. But unlike in China, where progress has been easily seen in the gleaming buildings, roads and railways, improvements in the frontier are often less dramatic.

And when they are visible in the frontier, the media sometimes carries a mixed message, and as in a recent CBS News report: “New road brings hope & pain in Mozambique,” which featured poor farmers forced to move to new houses away from their old neighborhood and smugglers taking advantage of the bridge while the reporting underplayed the main message of improved trade and economic growth<sup>iii</sup>.

In Dhaka traffic remains bad, but it’s better than it was because of new flyovers (overpasses). And pilings stand alongside several roadways as part of a Japanese-built metro scheduled to open in 2024. And an even more ambitious project is the Padma Bridge south of Dhaka that will connect the northeast half of Bangladesh with the southwest. It is hard to imagine the US without bridges over the Mississippi, but that is how it has been in Bangladesh. Now, after the World Bank walked away from the project over corruption claims that were disproven<sup>iv</sup>, China is getting it done, most likely by 2022.



Source: *The Economist* Sept 8, 2012

A beneficiary will be IFAD Autos (June 2020 PE 8.3x<sup>v</sup>), that sells Ashok Leyland heavy trucks from India and is starting to build truck bodies and cabins locally. They foresee big increases in truck usage as roads improve.



UM Runner Renegade Commando 150

The Padma Bridge will provide a direct route for trans-shipment to the isolated part of India that lies east of Bangladesh, and there will be another route north to serve Nepal.

Runner Automobiles, a recent IPO, is another company in transportation. It sells the pestilential Tuk-Tuks made by Bajaj in India, but primarily it manufactures terrific looking motorbikes and has an 80% market share in the under-80 cc market.

Meanwhile, in Sri Lanka, construction is everywhere. Since my first visit in 2006, highways now connect the Colombo airport to the city and connect Colombo to Galle on the southern tip of the country. More highways will soon connect Colombo with Kandy to the east, and others will run to the northeast. The port in Colombo has been expanded and now has a deep water pier (20 meters deep) to handle the largest vessels. Also, there is the new Hambantota port in the south that adds to Sri Lanka’s trans-shipment and bunkering capacity. We believe it’s because of poor planning by the Sri Lankan government rather than debt-trap diplomacy by China that the port (named after the former president by himself) has been leased to China for 99 years.

On the Colombo waterfront, a huge tract of filled land will become a mixed development of residential and office towers, a financial center and shopping centers.

We met with John Keells (March 2020 PE 17.6x). This is the biggest and most liquid stock in Sri Lanka, trading \$700,000 per day, but it is in six businesses: port operation, supermarkets, hotels, soft drinks, real estate development and insurance. Given its generous PE, Keells concludes there is no need to unbundle, but I think each piece would be much better on its own. As it is, estimating results for the conglomerate is clouded by seemingly endless “one-offs” in the different divisions.

Tokyo Cement (March 2020 PE 6.2x) is a more direct play on Sri Lanka infrastructure. The cement market leader, with 38% share, TKYO’s product line includes Nippon Pro, the highest quality cement, and Tokyo Superbond, the standard for tile cement.

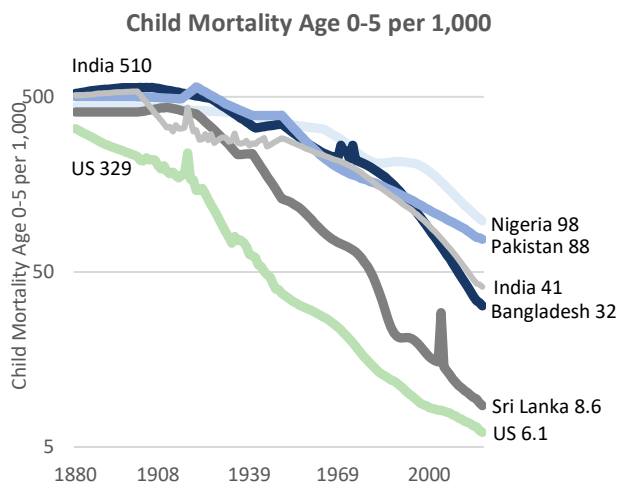
They import clinker from Vietnam, and there is some concern that clinker prices might rise because China is cutting its own clinker production to reduce pollution. But TKYO is starting to add 15% fly ash to its cement which is cheaper and actually improves quality.



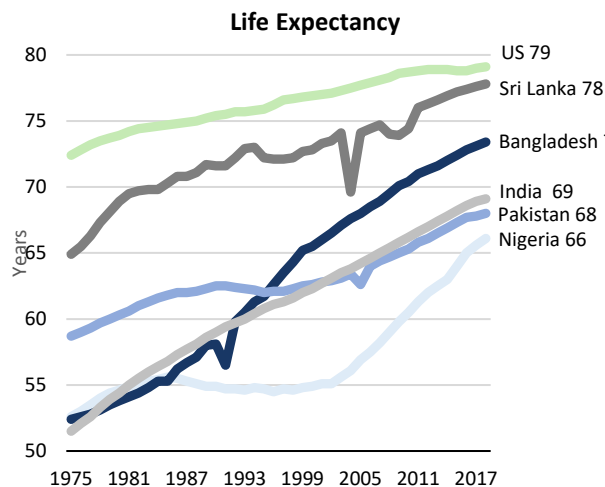
At a new John Keells supermarket

**b) Health**

In 1995, when the International Finance Corporation created its Frontier Composite to recognize the frontier stock markets, infant mortality in Bangladesh was poor: 114 babies out of 1,000 died before age 5, which was the same as it had been in the United States in 1927.<sup>vi</sup> By 2018, Bangladesh reduced this to 32 by training midwives and providing birthing kits and standardized birth mats (that show when bleeding is excessive). To put this in hard numbers, to have the 26 kids in our Korail classroom, 27 were born. But out of 27 born in 1995, only 24 would have survived. Two kids would have been missing from our class.



Source: Gapminder child mortality 190209



Source: Gapminder LifeExpectancy190209.xlsx

We met with Beximco Pharma (June 2020 PE 9.9x), which is a generic drug manufacturer with 500 products sold under its own brands. It is the second largest pharma company in Bangladesh and is #1 in analgesics, anti-hypertensive and cardiovascular. Prices are low relative to the rest of the world, so there is little price pressure from the government. Electric power is now in surplus in Bangladesh, so their electricity cost is 40% cheaper than in India.



Because Bangladesh is a Less Developed Country per the World Bank, its pharma companies have been able to manufacture patented drugs without a license. However, this is expected to end in 2024, when Bangladesh is expected to be upgraded to the Middle Income Country category. Meanwhile, Bangladeshi pharma companies are rushing to start production on as many new patented products as possible to get under the exemption before then.

We also met with Hemas (March 2020 PE 12.7), a Sri Lankan company active in consumer products and pharmaceutical distribution. Its consumer products include soap, baby oil and hair oil, and they have a 25% market share versus 55% for Unilever. Also, they control 75% of the pharmaceutical distribution in the country. Hemas was squeezed when Sri Lanka's currency devalued 16% in 2018 due to US Fed tightening, the US China trade war and the local political upheavals. The government was slow to respond with increased price ceilings to offset their higher import costs. On the other hand, the company is starting local manufacture under very favorable terms with the government.

### c) Financial Inclusion

The World Bank measures financial inclusion with a survey that covers more than 700 dimensions, including age, sex, type of account and goal of account. As the table shows, financial inclusion in the frontier is up from 44% in 2011 to 56% in 2017 (the latest date in the survey). Meanwhile, Bangladesh is up 29%, from 32% to 41%, and Sri Lanka is up 7% on a higher base, from 69% to 74%.

**Financial Inclusion (accounts over age 15)**

	2011	2014	2017	% Change 17/11
Frontier ex GCC	44%	51%	56%	26%
Emerging	52%	64%	68%	29%
Developed	94%	97%	97%	3%
GCC	75%	77%	81%	8%
Bangladesh	32%	29%	41%	29%
Sri Lanka	69%	83%	74%	7%

Source: World Bank, Global Finance Index, 2019

BRAC Bank (December 2020 PE 11.9x) is a company that is driving financial inclusion. It is 44% owned by BRAC, one of the world's largest NGOs. Among its many services, it runs schools that educate more than 1 million children, including those in our classroom in Korail. The bank expresses BRAC's mission by making retail and microfinance loans, but its real focus is on SME loans (to small and medium size enterprises) where it is seeing 25% growth. In addition BRAC Bank owns 51% of bCash, in which Alibaba has taken a stake. This is a mobile money transfer platform similar to the mPesa system started by Safaricom in Kenya ten years ago.

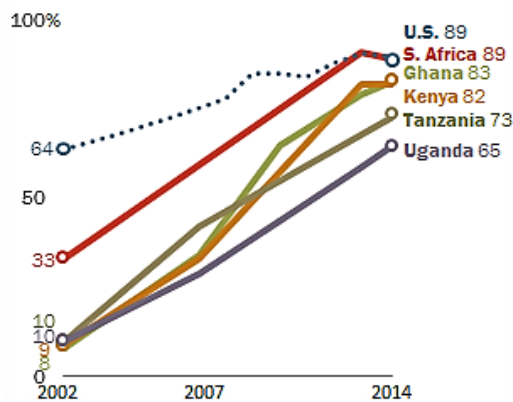
### d) Telecommunications

The arrival of the cell phone has probably had the greatest impact on developing countries of any technology since the wheel. The chart at the right is from a 2014 Pew survey that shows the explosive growth of cellphones in Africa.

Gone are the interminable waits for land lines. I recall that in Eastern Europe in the late 1980s, a quarter of the people of the waiting list had died before national phone companies could get around to installing their phone. Now in Africa<sup>vii</sup>, money transfer is routine, and innovative products are burgeoning. Farmers get insurance when they buy seed, and money is sent to their account automatically when agronomists determine that their crop will fail.

In Bangladesh, Grameenphone (December 2019 PE 12.2x) has 54% of mobile revenues. It has a 60% gross profit margin, while the other three players are unprofitable.

**Cell Phone Ownership Surges in Africa**  
Adults who own a cell phone



Source: Pew Research

55% owned by Telenor, GRAM has moved from 2G in 2009 to 3G in 2013 to 4G which is now 50% of traffic. Because Bangladesh lagged behind the world in moving to 4G, its equipment is more advanced and thus is adaptable to 5G which will start rolling out in 2020. Mobile penetration in Bangladesh is 56%, moving towards 75%, while data is nascent. Prepaid users account for 98%, and that will move gradually to more profitable postpaid.

Meanwhile, in Sri Lanka, Dialog Axiata (December 2019 PE 7.2x), which is 83% owned by Axiata Group (spun out of Telecom Malaysia), has a 60% mobile market share and is #2 to Sri Lanka Tel in fixed line. Mobile penetration here is much more advanced at 150%, with 32 million phones for 22 million people, but they will be a year or so behind Bangladesh in moving to 5G. Sri Lanka has had a dysfunctional government, and one example is the problems DIAL has had with the regulator in getting a new fiber license. It turns out that the regulator is the brother of the chairman of Sri Lanka Tel. Meanwhile, because of its more mature and more competitive market, DIAL's gross margin is 40% versus the 60% at GRAM.

### e) Rising Middle Class?

One of the disappointments in the past dozen years has been the pressure on consumers that has undermined the story of a rising middle class. Some countries have done better than others at promoting overall growth while also promoting the education of women which is associated with slowing population growth. Together, these have led to rising GDP / capita and more spending power for consumers in many countries, although Nigeria has lagged in the table below.

	Bangladesh	Sri Lanka	Pakistan	India	Nigeria
	2013-2018	2013-2018	2013-2018	2013-2018	2013-2018
GDP/Cap (PPP)	8%	5%	5%	8%	
Population (mm)	6%	5%	11%	6%	
	2018	2018	2018	2018	2018
GDP/Cap (PPP)	\$4,364	\$13,450	\$5,544	\$7,762	\$5,980
%Literate Female	71%	91%	46%	66%	53%

Source: World Bank WDI, 2019

In the consumer sector, in addition to Hemas, which is doing well in its consumer division, we met with Melstacorp (March 2020 PE 8.8x), and we sampled their fine bottles of their Arrak, a coconut liquor which is a Sri Lankan favorite. The product is a mature but steady grower that is taking share from home brew. Meanwhile, however, their tea plantations, for which Sri Lanka has been famous for centuries, have been hurt by sanctions on Iran, which was a big customer.

Teejay Lanka in Colombo (March 2020 PE 11.3x) is an example of a company that has benefitted in the current environment. Teejay does dyeing, finishing and printed of knit fabrics for clients that include L Brands, PVH (Van Heusen, Tommy Hilfiger & Calvin Klein), LiDL (German), Decathlon (French) and now UNIQLO (Japanese, but with 500 stores in China) and Nike. There has been a shift of production out of China due to the trade war, and Sri Lanka benefits, along with Vietnam and Bangladesh. PVH, for example, is shifting production to Teejay from China.

### The Bottom Line

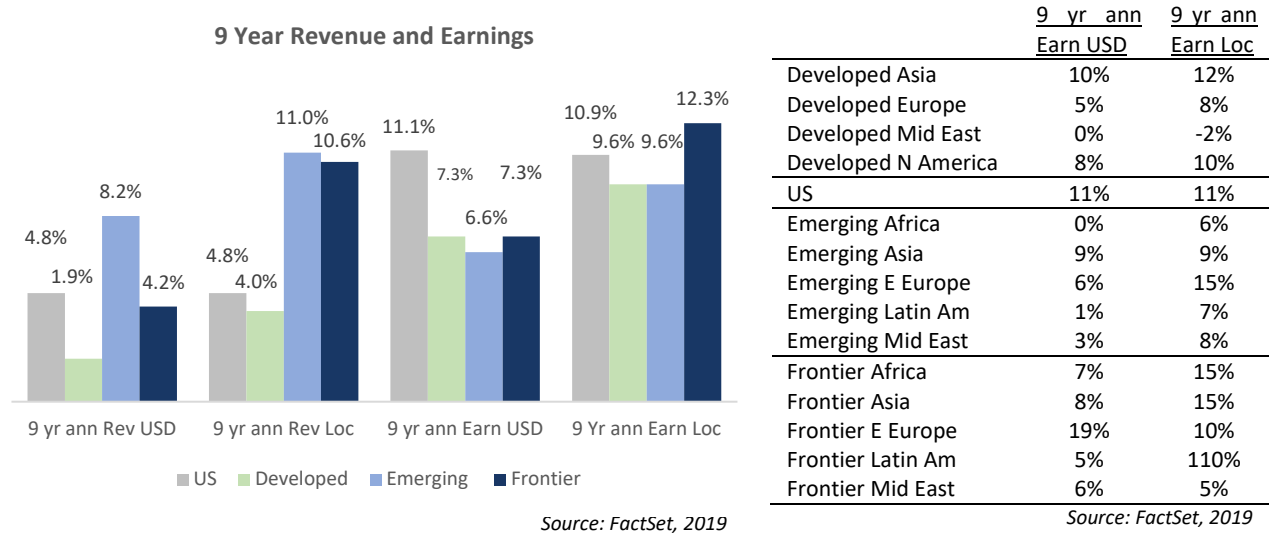
While frontier macro factors, including demographics, health, infrastructure, banking and technology have been favorable, frontier market returns depend on earnings growth and PE multiple revaluation.

### a) Fundamental Growth

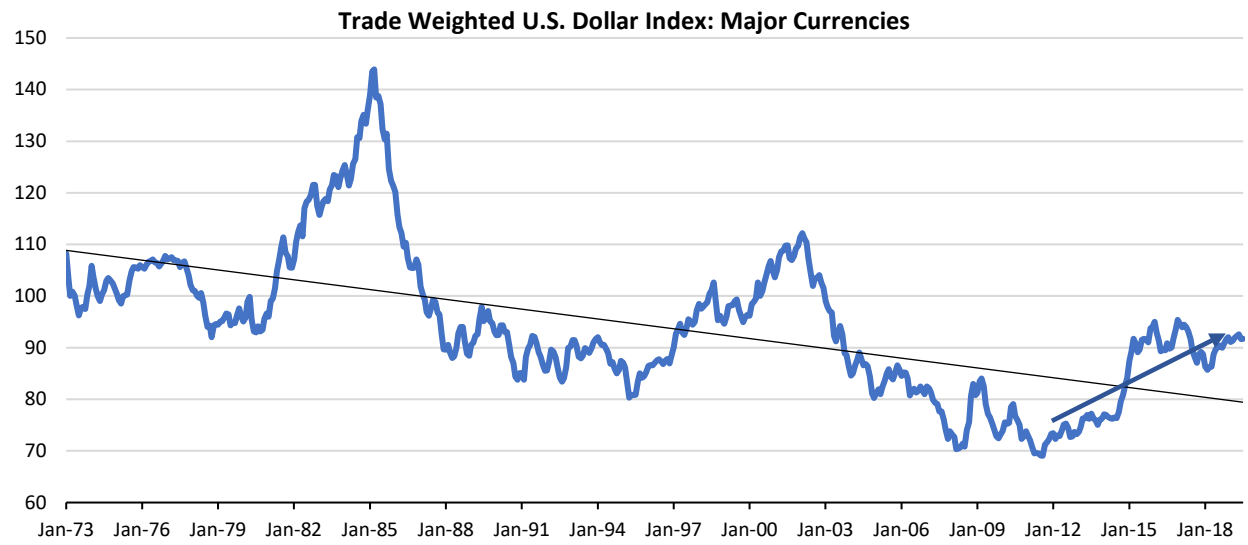
We studied the growth in company earnings by screening the FactSet database for the income statements of 34,000 equities over the years from 2009 to 2018, starting after the distortions of the 2008 financial crisis. As shown in the chart, earnings growth in local terms was strongest in the frontier, up at a 12% rate. However, when translated into US dollars, the US was strongest, up at an annualized rate of 11%, versus 7% for frontier and developed (ex US) and 6% for emerging.

Looking deeper into revenue and earnings, the table shows that frontier has done well in each region, surpassing emerging in Africa, Eastern Europe, Latin America and Middle East. In Asia, frontier was close, up 8%, versus emerging up 9%.

As shown, however, the brightest spot over the past nine years has been the US, while the rest of the world has struggled with currency weakness.



The chart of the trade-weighted USD shows that the dollar has declined over the past 45 years. However, from 2011 to 2016, the dollar rose, and it has been roughly flat since.



That said, many frontier countries could have done a better job of managing their current account balances, reserves and overall economies.

I hope that the challenges of commodity price volatility and trade conflicts will settle down, and I also hope that frontier governments are learning from their mistakes. Finally, frontier countries should see the benefits of their investments in literacy and health that will provide demographic dividends for many years.

## b) Valuation

We ran estimates of forward PE ratios for our FactSet equity universe and found estimated PE ratios for 13,721 companies. We then calculated the harmonic weighted average PEs for 2019 and 2020 by category and country.

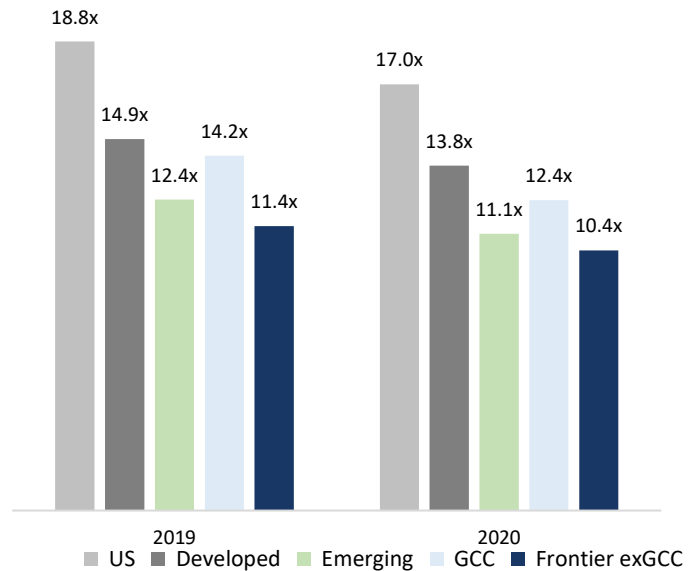
The Frontier ex GCC (excluding rich oil producers in the Gulf Cooperation Council) is selling at a 2020 PE of 10.4x versus 11.1x for emerging markets, 13.8x for developed countries excluding the US and 17.0x for the US. This makes the frontier look attractive, but there is more to a bargain than low PE.

To put these PE ratios in perspective, we need to consider growth. The IMF World Economic Outlook data from their October 2019 report<sup>viii</sup> provides a possible guide. While we cannot know whether currency headwinds will be as adverse as they have been recently, real growth adjusted for inflation offers a reasonable underpinning for the progress of individual companies themselves. For our measure of steady-state long term growth, we use the IMF growth forecasts for 2024, and these are plotted in the scatter chart compared with 2020 PEs. We have highlighted Sri Lanka and Bangladesh with bigger blue symbols.

Overall, we believe that the blue circles of frontier countries present many opportunities to capture excellent growth at modest PEs. Meanwhile many of the emerging countries (red triangles) are attractive as well.

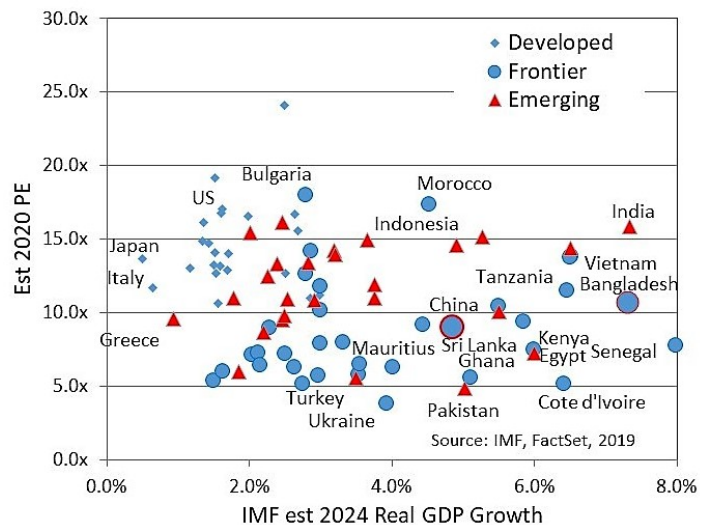
Furthermore, within many of these countries, less expensive stocks can be found. In Sri Lanka, for example, John Keells is the largest company and sells at a 17.6x PE on March 2020 earnings and a 16.6x on March 2021 earnings. This skews the PE of the Sri Lanka market, where many stocks sell considerably below those levels. In addition, active managers can often find lower valuations. Our portfolios, for example, are priced at PEs below 8x 2020 estimated earnings.

PE Ratios



Source: FactSet, 2019

PE 2020 versus 2024 Real GDP Growth



Source: IMF, FactSet, 2019



## Conclusion

*“Ring the bells that still can ring  
Forget your perfect offering  
There is a crack, a crack in everything  
That’s how the light gets in”  
Leonard Cohen, Anthem, The Future, 1992*

The frontier is far from making a perfect offering to investors. There are indeed cracks in the frontier story. But there is also light in these corners of the world.

Some of that light shines in the face of the teacher at the BRAC school we visited. People like her are on the front lines of the path to a better future. They are the heroes of the frontier.

In this brief report, we have considered demographics, infrastructure, health, financial inclusion, telecommunications, the middle class, growth and valuation. Yet we have left much out that we have written about before, such as the low correlation of frontier with emerging and developed markets and the lower volatility of frontier portfolios that results from low cross-country correlations.<sup>ix</sup>

In the end, echoing our investment philosophy, we believe that investing is a matter of finding quality at a reasonable price. On our iPhone’s Uber app when we were in Colombo, we found that we could select “uberTUK” to order a Tuk-Tuk for our transportation. The accommodations were cramped, the ride was bumpy, and there were no seat belts. But we traveled the equivalent of thirty blocks in New York City for a mere \$0.30.

There is a price for everything... and for frontier markets as well.



*Teacher BRAC school, Korail slum, Dhaka, Bangladesh*



*School bus, Gulshan District, Dhaka, Bangladesh*

## About Frontier Global Partners

Frontier Global Partners manages a focused set of investment solutions covering international, global and frontier market equities, asset allocation and alternative investments. Under the direction of managing partners Lawrence Speidell, CIO, and Horacio Valeiras, CEO, the organization sustains a dynamic investment culture rooted in behavioral finance. The firm's investment strategies reflect a shared commitment to investing in high-quality securities at prices that represent good value and to managing portfolios that exhibit low turnover. Born of twin organizations that covered separate and distinct global market segments with common approaches, the firm manages concentrated equity portfolios drawn from the breadth of the world's markets. Frontier Global Partners is an independent, employee-owned organization headquartered in La Jolla, California with the majority of the firm owned by its minority partners.

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Frontier Global Partners, LLC  
7817 Ivanhoe Avenue, Suite 200  
La Jolla, California 92037  
Telephone: (858) 456-1450  
Fax: (858) 456-2040  
[www.frontierglobalpartners.com](http://www.frontierglobalpartners.com)

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*All photos are courtesy of Larry Speidell*

<sup>i</sup> Dambisa Moyo, *Dead Aid: Why Aid Is Not Working and How there Is Another Way for Africa*, Penguin Books, 2009

<sup>ii</sup> Ace Greenberg, Chairman of Bear Sterns, distained MBAs and preferred candidates with a PSD = poor, smart and a deep desire to be rich, *Memos from the Chairman*, Alan Greenberg, Workman Publishing, 1996

<sup>iii</sup> CBS News, Oct 9, 2019, <https://www.cbsnews.com/video/new-infrastructure-brings-hope-and-suffering-to-mozambique-i-cried-a-lot/>

<sup>iv</sup> Padma Bridge, Wikipedia, [https://en.wikipedia.org/wiki/Padma\\_Bridge](https://en.wikipedia.org/wiki/Padma_Bridge)

<sup>v</sup> PE ratios are based on Frontier Global Partners estimates

<sup>vi</sup> Gapminder, [www.gapminder.org](http://www.gapminder.org)

<sup>vii</sup> Pew Research , <https://www.pewresearch.org/global/2015/04/15/cell-phones-in-africa-communication-lifeline/africa-phones-7/>

<sup>viii</sup> International Monetary Fund, World Economic Outlook, <https://www.imf.org/external/pubs/ft/weo/2019/02/weodata/download.aspx>

<sup>ix</sup> Frontier Global Partners, "Moving the Needle. The Optimization Opportunity in Frontier Markets"

<https://www.frontierglobalpartners.com/wp-content/uploads/2018/05/Optimization-Opportunity-25May18.pdf>, "The Magic of Low Vol in Frontier Markets, Standard Deviation & cross-country Correlations", <http://www.frontiermkt.com/wp-content/uploads/2018/01/Low-Vol-and-Cross-Ctry-Correlation-Jan-2018.pdf>