



Across the Wild Zambezi – Springtime in Zambia, Zimbabwe and Malawi

November 2010

The Zambezi River flows clear and cool from springs at 5,000 feet in the hills of northwest Zambia. It travels southwest into Angola and then south past Zambia's rich mineral deposits of the copperbelt where mining activity is on the upswing. Then the Zambezi turns east and forms Zambia's border with Namibia and briefly with Botswana before it broadens out and tumbles into the gorges carved by Victoria Falls. Here Zambia and Zimbabwe begin sharing the river for 300 miles until it enters Mozambique on the last leg of its 1,600 mile journey to the sea. In the lower section, the Zambezi will soon be dredged so that barges can travel up to source new coal mines in Mozambique and a new port on the Shire River in Malawi.



Aerial view of Victoria Falls

In April, Victoria Falls present a spectacle of the greatest volume of any waterfall in the world, stretching more than a mile across its rim from bank to bank. However, our visit in October, Africa's spring, coincided with low water and prime conditions for rafting the wild class 4 and 5 rapids that lie downstream, where the river snakes beneath sheer cliffs 700 feet high. You can even taste gulps of the river if you happen to be desperately seeking oxygen while clinging to an overturned raft in a rapid, named "The Muncher". Further along you can walk 100 yards on rocks in Zimbabwe to bypass the maelstrom of rapid # 9 called "Commercial Suicide".

Among other seductive attractions at Victoria Falls are bungee jumping, zip lining and flying in a micro-light aircraft, the latter seeming akin to clinging on a flying toilet seat as it banks over the giant bowl of the Falls.

Africa has three faces: tourism, media and business. The first, at Victoria Falls, is thrilling for all who see it. The second, media coverage of the continent, is alarming. It explains why many choose not to come here, but those who do typically find that the media have exaggerated the problems and understated the opportunities of Africa. The real purpose of our trip, however, was not to test our physical and emotional limits as tourists or media observers. Instead, we were here to explore the business side of Africa. Along with four clients and friends, we had roughly twenty meetings with companies and local organizations in Zambia, Zimbabwe and Malawi. These countries are all close to the banks of the Zambezi, and their fates are linked to it.

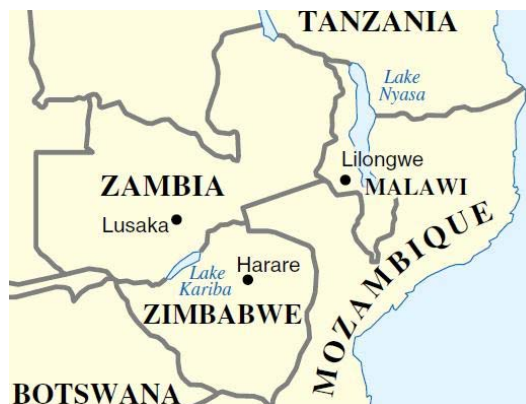
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	Zambia	Zimbabwe	Malawi
GDP Growth	6.0%	2.2%	6.0%
Inflation	7.5%	5.0%	7.2%
Population (mil)	11.8	11.4	15.0
People / km sq	16	29	127
% Literate	80.6%	90.7%	62.7%
% under age 15	45%	44%	45%
Life expectancy	38.6	45.8	50.0
% Urban	35%	37%	19%
GDP / cap (PPP)	\$1,600	\$100	\$800
% Unemployed	50%	95%	50%

Source: CIA World Fact Book, September 2010, www.cia.gov; www.un.org.depts/cartographic/map/profile/africa



Zambia – Copper Capital of Africa

Zambia, named Northern Rhodesia until 1964, has had a tough time in the past two years. Prior to the global crash, copper prices were \$8,900 / metric ton, but they fell to less than \$3,000 in 2009. Mines were shut and the economy practically ground to a halt.

Now copper is back to \$8,400, and several exciting things are afoot:

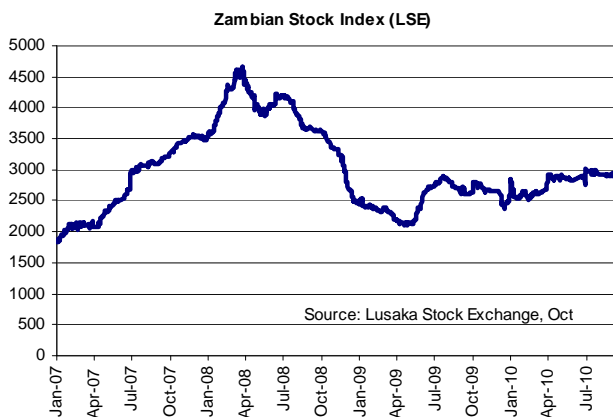
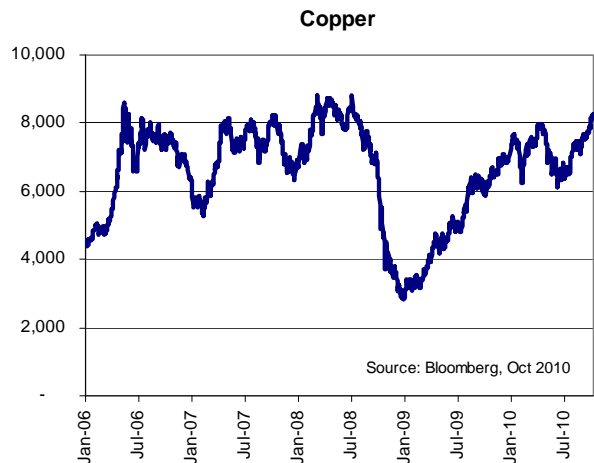
- 1) New mines are opening in the north, with considerable investment from China. Meanwhile mines that had been shut down are reopening.
- 2) A rail line is being built from the north to take the stress of heavy trucks off the roads. In addition to the northern rail line, the line from Lusaka to Dar es Salaam in Tanzania is being rehabilitated and another route to the Indian Ocean through Malawi is being developed. Also, there will be a new line running into Angola.
- 3) New hydro-power projects are being planned.



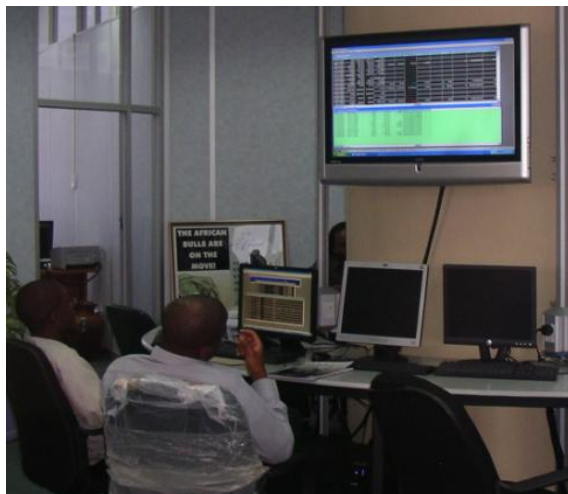
Kenya Airways poster in a Lusaka travel bureau

Electric power has been a serious obstacle to growth throughout Africa, and Zambia is no exception. On the plus side, however, Zambia has 40% of the water in southern Africa; so increased hydro-power has huge potential. Copperbelt Energy Corporation (CEC) is building a 40 kilowatt plant in the Kabompo Gorge in the north to provide power to the mines at 11 cents per kilowatt hour. Existing plants are 500 kilometers to the south and have been selling power over long transmission lines at only 4.4 cents per kwh. This is clearly uneconomical, so the government and the mines have agreed that this rate will increase to 9 cents per kwh in the next five years. CEC missed out on the Kafue Gorge project to a Chinese consortium, but now the government has authorized CEC to explore a 300 megawatt project on the Congo border. Zambia and the Democratic Republic of the Congo would share the power 50:50, and they would also share 20% ownership of the project.

Cell phones have been having a huge impact on Africa, and change is occurring with the acquisition of Zain by Bharti, a successful, aggressive Indian company. Among Zain's assets is Celtel Zambia which will be renamed Airtel. Bharti is moving quickly to make changes in its new African network, including the signing of IBM as its IT partner. In Kenya, they have launched aggressive pricing to capture market share from the leader, Safaricom. And in Zambia, the Finance Director reports that Bharti's philosophy is "change for the better" as Zain had skimmed on spending and suffered declining market share. Cell phone penetration in Zambia is only 40% and Celtel/Airtel has a 65% market share, so an all-out price war is less likely than a strategy of increased investment to raise penetration. This will need to be done carefully, as blanketing the sparsely populated areas may not be profitable given that Zambia has only 16 people per square kilometer compared with 300 in parts of India.



The small Zambian stock market suffered during the crisis with annual trades totaling around 5,000 in 2009 compared to 10,000 in 2008. Now business is up to an annual rate of 7,000. Soon the stock exchange hopes to have an agreement to have its index quoted on Bloomberg, which should provide more visibility. Zambia's tiny market is only 0.16% of the S&P Frontier BMI Index and 0.03% of the Russell Frontier Index. Still, we believe the good values there are worth a look.



The sign reads, "The African Bulls are on the move." - Lusaka Stock Exchange



Zimbabwe – Mugabe and Mao

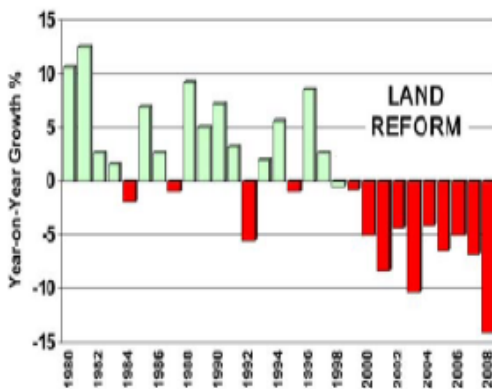
Flying south from Lusaka, across the Zambezi River, we arrive at Harare's airport: modern and clean, but empty and dark. Driving to the city, a billboard proclaims: "Pro Brand Candles – They Burn up to 10 Hours." There is little traffic on the streets and few pedestrians in the downtown business district. Shops have many empty shelves.



Downtown Harare with the Jacaranda trees in bloom

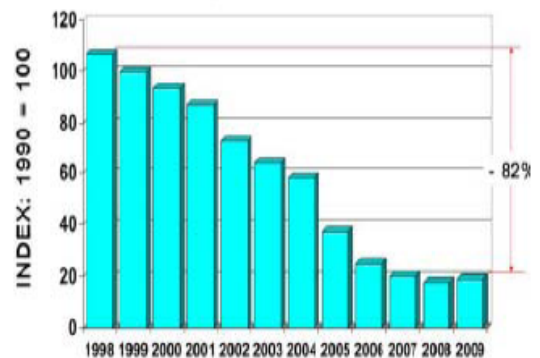
At the classic Meikles Hotel, the décor and atmosphere seem like 1984 rather than 2010; and there are other parallels to George Orwell in the politics of this troubled country. We wonder, however, if the surreal feeling of being caught in a quarter-century time warp could be just a sad step back before a potentially brighter future.

Zimbabwe GDP Annual % Change



Source: Robertson Economic Information Services

Manufacturing – All Groups Annual Indices



Source: Robertson Economic Information Services

Source: Imara Africa Securities, June 2010

Robert Mugabe, president since 1987, set out to mold his country in the image of China, with strong central control but emphasis on social progress. A former schoolteacher, he increased spending on education so that today, literacy is an impressive 90% of the population (versus 80% in Zambia and 63% in Malawi). This and other programs cost money and then in 1998, he added a military venture in the Congo to support his friend, president Kabila. After losing support of the unions and the white farmers, Mugabe resorted to coercion, unleashing war veterans to invade the farms and seize property with support of the government in the 2000 election. With this “land reform”, Mugabe undermined property rights and destroyed Zimbabwe’s highly successful and productive agricultural sector.

As the economy shrank, the central bank printed money to pay for expenditures causing the currency to fall and prices to rise. Mugabe responded with price controls which became a license for government agents to steal goods and sell them on the black market at multiples of the controlled price. Naturally, stocks disappeared from stores and production lines halted. During the “lost decade”, GDP shrank at roughly a 5% annual rate, while inflation gained momentum. Finally, the inflation rate from January to September 2008 was estimated at an annualized rate of 536×10^8 . In November 2008, prices were doubling daily, whereas in the infamous hyperinflation of Weimar Germany in October 1923, prices it took almost four days for prices to double. To keep up, the central bank printed money in ludicrous denominations such as Ten Trillion Zimbabwe dollars.

Finally, in February 2009, hyperinflation ended by adopting dollarization, actually a “multi-currency” system, predominately based on the U.S. dollar but also using the South African Rand in the southern part of the country. While the system works, there are several curiosities. For example, most of the dollars are practically falling apart, since they left the U.S. years ago. Another challenge is due to the lack of coins for making change. Thus minibus taxis that charge 50 cents will accept a dollar and then return as change a bundle of three billion Zim dollars that are actually worthless.



While dollarization has brought a huge improvement in the economy, there are still major issues:

- 1) Indigenization: The Indigenization and Economic Employment Regulations will require that all companies with a net asset value more than \$500,000 must be 51% owned by indigenous people. The definition of indigenous is unclear, however, given that many citizens originally came from abroad but have been in the country for generations.
- 2) Wages: The government implemented a minimum wage for public employees of \$100/month, and this has impacted the private sector. As a result, manufacturing has become uncompetitive. For

example, Meikles Holdings complains that in their tea business, workers are paid \$80/month compared with \$30-40 elsewhere in the world.

- 3) Elections: The current Government of National Unity (GNU) is united in name only, and there is fear that an election would lead to violence. On the other hand, Joe Mutizwa, the well-connected Managing Director of Delta (the leading producer of beer and soft drinks), suggests that neither party really wants an election any time soon (despite proclamations otherwise by Mugabe). In his opinion, the earliest would be 2012. Despite politically motivated comments by Mugabe, the mechanics of the process will take time.

Our guess is that we'll see Robert Mugabe around for some time longer. Prime Minister Tsvangirai heads a disorganized opposition, and Robert is a crafty politician. At 85, he is vigorous, eats organic food and is up each day at 4am to go to the gym. He has copied Chairman Mao in many ways, including the depredations of his own version of a "cultural revolution". The question is whether he and his ZANU-PF government can become more pragmatic, keeping the multi-currency system and moderating the indigenization program. If so, the economy could continue to recover, and profits could show considerable upside leverage from a small base. There could even be a reversal of the "brain drain" that has seen up to 25% of Zimbabweans move outside the country. Meanwhile, the stock market is cheap, with PE ratios generally below 10x and in some cases below 5x.



Malawi – The Warm Heart of Africa

Traveling north across the Zambezi, we change planes in Lilongwe, the capital of Malawi and travel to Blantyre, the business center. Malawi is a poor and densely populated agrarian country, much like China was half a century ago. Only 19% of the population lives in urban areas compared with roughly double that in Zambia and Zimbabwe. While literacy is low, the clean country-living results in a life expectancy of 50 years versus 46 in Zimbabwe and 39 in Zambia.

The economy is focused on growing burley tobacco which represents almost 60% of exports. This is a rougher grade than Virginia tobacco, but it is popular as a blend in cigarettes. Also, it is easier to produce since it is air-dried rather than flue-cured with heat in expensive brick barns. Aside from the decline in cigarette consumption in developed countries, there are two current problems with Malawi's dependence on tobacco.

One is that Canada is lobbying to ban the use of burley tobacco as a health hazard. Regardless of the merits of this claim, the impact on Malawi's 15 million people would be severe. Malawi is working to diversify its sales to Asia, where any ban might not take effect. It is hoped that some resolution of this challenge may be achieved in the coming months.

A second problem is the seasonality of tobacco revenues that are realized from March to October. Foreign exchange is available when tobacco exports are made, but it is scarce the rest of the year. This makes it hard to import necessary equipment for investment and even fuel for operating the economy.

A possible solution to Malawi's currency problem, one favored by most people we met, is the devaluation of the Kwacha from 150/\$ to 185 or 190. Whether this would solve things, however, is not clear, given the likelihood of an immediate offsetting inflationary impact, which is well illustrated by the history of countries like Argentina over the recent decades. The government currently is in discussions with the International Monetary Fund, so some other plan may be in the works.

A more positive outcome for Malawi could come from increased incentives for foreign investment. Fortunately, foreign investment is rising. Uranium deposits in the north have been known for many years,

but now they are being developed by two Australian companies. The first uranium exports of around \$300 million occurred this year, and this should rise to \$800 million in 2011. Meanwhile, there have been more reserves found.

In another development, Mota-Engil, a Portuguese company, has made a bold investment in a new port facility in the south at Nsanje on the Shire River. The cost of dredging the Shire and Zambezi for barge traffic has been reduced by sharing with the developers of coal deposits in Mozambique that were not anticipated when the project was begun. Together with a 160 kilometer road, the port is expected to reduce transportation costs for Malawi by 60%, amounting to \$175 million. The first two barges with fertilizer are due in October.

Another bright side of Malawi is tourism. Lake Nyasa is 700 kilometers long, and in addition to fishing and commerce, it has a number of attractive resorts. And in the south, Majete Wildlife Reserve is being developed. Blantyre itself, the commercial center, is ringed by beautiful hills and is only 70 km from the reserve.

“Away, we’re bound away...” - Across the Wild Zambezi

Bringing clients to Africa is a bit like inviting friends to watch one’s child perform in a dance recital. One nervously hopes that the advance billing will be fulfilled at least by a smooth, if not brilliant performance. In the frontier, we hope to that our expectations will be met or exceeded, and we hope to meet with experienced management teams sharing exciting business prospects that make investor’s eyes light up.

On this trip, crossing the Zambezi six times, our hopes were confirmed. With the exception of Bata Zambia, where the management was a bit unfocused, we met with managers who seemed both capable and confident. We explored the impact of significant developments in infrastructure along the Zambezi, where hydropower, rail and marine shipping are all likely to change the face of the economies in Zambia, Zimbabwe and Malawi. And we found stocks that seem to represent excellent values.



Across the Wild Zambezi...

Note: “Across the Wild Missouri” is from “Oh Shenandoah,” a 19th century boatman’s river chanty, later sung by The Kingston Trio, Bob Dylan, et al.

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