April 2011

Asian Travels - Vietnam, Bangladesh, UAE, and Sri Lanka

By: Thea Jamison and Ning Ma

For ten days in early December, we set out to Asia and the Middle East, travelling to Vietnam, Bangladesh, Sri Lanka, Abu Dhabi and Dubai. The choice of countries seemed timely. Bangladesh and Sri Lanka had experienced strong rallies for three and two years, respectively. Vietnam and the United Arab Emirates, conversely, dragged by debt concerns, had not participated in the global rebound of 2009 and 2010. With many questions in mind, we set out in search of answers. Our trip included management meetings with 35 companies; we obtained valuable insight into stock and sector opportunities and we extended our knowledge of vastly different cultures, religions, and government structures.

	Vietnam	Bangladesh	Sri Lanka	UAE
GDP Growth	6.8%	6.0%	6.9%	2.6%
Inflation	11.1%	8.1%	5.6%	2.2%
Population (mil)	89.5	156.1	21.5	5
People/km sq	270	1084	327	59
% Literate	90.3%	47.9%	90.7%	77.9%
Education % GDP	5.3%	2.4%	N/A	0.9%
% Under age 15	26.1%	34.6%	23.9%	20.4%
Life expectancy	71.9	69.4	75.3	76.3
% Urban	28%	28%	15%	78%
GDP/Cap (PPP)	$3,100	$1,700	$4,900	$40,200
% Unemployed	6.4%	5.1%	5.4%	2.4%
Source: CIA World Factbook, January 2011				

Vietnam

Vietnam was a part of French Indochina until it declared independence after World War II. In 1954, under the Geneva Accord, the country was divided in two: the North, supporting Communism and the South, anti-Communist. It was in 1975 that the North took over the South to unite the country as a Communist state.

2218 Avenida de la Playa
La Jolla, CA 92037
United States

p 1+858-456-1440
f 1+858-456-2040

Even today, Vietnam offers different perspectives between the North and South. The locals are first to point to the differences: Northerners are conservative, Southerners are practical. We found both regions home to hard working people. We observed strong work ethic and contagious desire to pursue the capitalist dream. Both Saigon and Hanoi are buzzing with activity (and incomprehensible traffic!). Work starts early and ends late. One of our company meetings ended at 6pm on a Friday, just in time for the management team to start their next meeting. And while this may not be a surprise for frequent travelers to the emerging and frontier world, to Thea who grew up in a Communist country, it was eye opening. Prior to 1989, in Eastern Europe, people would say, “we pretend to work, and they pretend to pay us”.

Source: CIA World Fact Book; www.gia.gov

That was certainly not the case in Vietnam which is still governed by a central command Party. Ning who grew up in market-friendly Beijing found the drive for profit normal. It is truly extraordinary to observe the impact of the unleashed spirit of capitalism, even in a depressed political environment. Emboldened, young Vietnamese seemed outspoken in criticism of their government. The most important components of the economy are still state-owned, heavily regulated, and thus subject to poor central command decisions.

One example is the failing state-owned shipbuilder, Vinashin, which has a $4.5bn debt and in December 2010 defaulted on a loan to international creditors. The impact on the banking system is unclear, but could be significant. With rising indebtedness, the government has added more pressure on the managed currency. The current account and fiscal deficits are high. Inflation is rising. The population has lost confidence in the currency. The gold and informal dollar markets are thriving. This has led to four devaluations in the past 16 months with the most recent one, announced in early February, close to 10%.

The Vietnamese are young, driven and unstoppable.

To top it all, the government has accepted little responsibility. Although the former General Secretary of the Communist Party of Vietnam was replaced at the 11th National Congress in January 2011, the more influential Prime Minister successfully retained his job. Without accountability for poor decisions, the government’s credibility is at further risk.

To our surprise, dissatisfaction was present in both the more vibrant, commercial capital of Vietnam, Saigon and the more conservative, political capital of Hanoi. Political changes are not always predictable. From our investor perspective, however, we find the opportunity for exposure to the country on hold for the time; but we also find the markets potentially appealing with any sign of political change. The country has favorable demographics. With more than 88 million people today expected to grow to 115 million by 2050. Vietnam is ranked 13th in the world by population size. The population is hard-working and young (26% is under 14 years old with only 5% over 65). The middle class is rising, partly as a result of urbanization. Hanoi is the tenth fastest growing city in the world (and one of only two in the top ten outside Africa), with projected growth of 25% between 2010 and 2015. There is further scope for growth with a low urbanized population rate of 30.4%.

In preparation for the 11th National Congress of the Communist Party in January 2011

Overexcitement about Vietnam was apparent in the last decade. According to S&P data, the market price to earnings multiple at the end of 2007 was over one hundred times. Today, the problems of Vietnam seem to be mostly discounted by the market. The Ho Chi Minh Stock Index is 60% off its March 2007 peak. The valuation multiples of the companies which we visited ranged between 7X and 12X price to earnings ratios. In most instances, management expected over twenty percent earnings growth. However, to finance the growth, most companies are looking to raise equity (due to high priced debt) which in turn dilutes the earnings per share growth. Companies in the real estate, commodity and heavy industry sectors appeared more vulnerable to financing needs and government regulation. Conversely, consumer oriented businesses, such as those in staples distribution and technology services showed more sustainable business models. We are still in search of the best stocks, and believe that with thorough diligence and patience, investment in Vietnam over the long-term would be rewarding.

Bangladesh

Weather conditions in Hanoi delayed our flight to Dhaka through Singapore. Thanks to good connections, the City Bank, Auerbach Grayson's local partner, was able to reschedule our meetings into the late evening. This was a good example of the investor friendly environment in Bangladesh. Other examples include reduced corporate tax rate for listed companies to 27.5% compared to 34% for unlisted companies, and zero tax treatment for the power sector over the next 15 years. A negative example for portfolio investment, however, is that the government recently implemented a capital gain tax of 15% applying only to foreign investors, who now have to obtain a tax certificate before they can repatriate sale proceeds. This new law has created backlogs in trading implementation and endangers portfolio investment in the country.

Bangladesh was a part of British India. As East Bengal and together with West Pakistan, it separated from India in 1947 to form Pakistan. In 1971, as East Pakistan, the region seceded from the union and formed independent Bangladesh. After a military regime implemented in 2007 to remove corrupt politicians, Bangladesh held peaceful elections in 2008. Also about that time, the government implemented a law which legalized money made in the informal sector through investment in the stock market before July of 2010. This law may explain why the Dhaka Stock Exchange had the third highest growth in value traded between 2004 and 2009 of 1541%. ("Steady as she staggers", *The Economist*, January 6, 2011).

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

The market also showed tremendous resilience during the global crisis. According to S&P data, Bangladesh was up 128% in 2007, 5% in 2008, 40% in 2009, and 38% in 2010. Such performance attracted retail investors, with many building up wealth (as witnessed by the new cars on the roads). We trimmed our exposure beginning in mid-2010 on concerns of stretched valuations. The Central Bank also raised liquidity requirements which impacted margin lending and eventually led to a sharp correction in the stock market. Unaccustomed to market declines, investors rioted after the market plunged 21% during several weeks beginning in mid-December. At the time of this writing, the stock market is off 35% from its peak in early December 2010, although showing some recover in March 2011.

Infrastructure: power, telecommunications and roads are all ripe for investment.

When valuations become attractive, we will again revisit stock ideas. The market is deep and there are many companies set to benefit from the secular rise of the Bangladeshi consumer. Bangladesh is the least developed country among the four countries we visited in this trip. Yet, it is the world's 8th most populous country with more than 156 million people living on land smaller than the state of Iowa. As such, it faces urgent need for infrastructure development. The capital, Dhaka, houses 19 million people and is notorious for its traffic. We experienced it first hand. The flight from Bangkok was quick in comparison to spending an hour at immigration arrivals at the Dhaka Airport and then another two hours travelling to downtown. The roads are narrow and the buildings alongside very old.

That said the prospects for the country's continued growth are strong. Bangladesh was recently ranked as the 4th largest clothing exporter by the WTO. Inexpensive labor costs provide the country with a competitive advantage. Also, Bangladesh is rich in water and is believed to be one of the world's largest producers of rice, potato, and mango. The population is young and growing with 35% under age 14, and there is further potential of urbanization which is currently only at 28%. The government has been successful in establishing political stability, and is now focused on improving economic conditions. Education, infrastructure development and foreign direct investment are a high priority. The fundamentals for improving the lives of Bangladeshi appear to be in place. Once the dust settles and at the right price, we believe re-entry in the stock market, would be very rewarding.

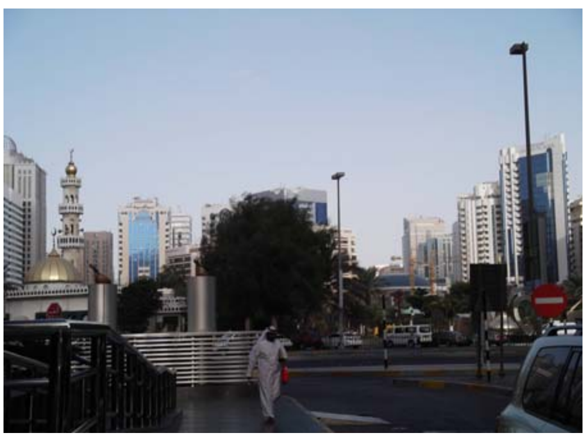
With extra navigation, old buses compete with new cars for the right of way.

United Arab Emirates

We are told that on most days, there are three full Emirates flights from Dhaka to Dubai. Only five hours long, the flight is a bridge between two vastly different places. As we arrived in Dubai, we are reminded of discrepancies, but also hopeful of a flat world. As a regional hub, the UAE has the potential to contribute to convergence between the developed and the developing worlds. The country has important resources, human capital, and a strategic location.

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

According to the CIA World Factbook, the UAE has the highest net migration in the world of 21 migrants per 1000 population. About half of the estimated 5 million people in the country are South Asian. Indian, Bangladeshi and Pakistani workers migrate to the Middle East to earn a living and send money back home. With the economic slowdown, however, some have returned home with savings and skills. In total, expatriates account for about 85% of the work force. It was clear from our company meetings that the country has attracted talented and hard working professionals from around the world. We were also encouraged by evidence that the work ethic and "know-how" are transmitted through the ranks. One of the Australian managers that we met shared stories of a laid back corporate culture when he first arrived years ago. With increased competition, now there is more accountability (and longer working hours!).



Downtown Abu Dhabi is experiencing road and building renovations.

The Untied Arab Emirates is the result of the 1971-72 merger of seven Persian Gulf sheikdoms which were previously British protectorates: Abu Dhabi, Dubai, Sharjah, Ajman, Fujairah, Umm al-Quwain, and Ras al-Khaimah. The discovery and trade of oil (6th largest proven oil reserves in the world) have generated significant wealth, although most concentrated in the hands of few. That said the government has taken steps to spread the wealth by investing in infrastructure and attracting multinational employers. The contribution of oil and gas has been reduced to 25% of GDP for the UAE. However, an unintended consequence of the aggressive expansion, especially in Dubai, was overextension. As a good neighbor, oil-rich Abu Dhabi stepped in and bailed out some projects. The crisis is not yet behind them with another $18bn of principal coming due this year.

While debt fears still loom in Dubai, during our visit we learned that the economies of the emirates are rebounding. External sectors such as tourism, transportation and logistics have been strong. Passenger traffic at Dubai airport grew 15% in 2010. In a February 2011 report, Citigroup stated expectations of 4.7% real GDP growth in 2011, and 6.3% in 2012. Abu Dhabi is also recovering: In November 2010, Abu Dhabi registered a 27% increase in hotel guests compared to the previous year. The emirates' Tourism Authority expects another 15% increase in 2011. Abu Dhabi National Hotels shared that historically travel to this emirate, was all business and government related. With the ambitious Abu Dhabi 2030 Plan that is changing. The tourist sector will be a focus with both the Guggenheim and the Louvre expected to open museums in Abu Dhabi in 2012. Other targeted sectors are transportation (rail, water and air ports), manufacturing, nuclear energy and sports (in competition with Qatar!).

Emirates is now the third largest airline in the world.

From investment perspective, the UAE is a curiosity. Traditional metrics of wealth surpass the definition of a frontier market. However, local corporations such as DEPA (commercial interiors) and Drake and Skull (building engineering systems) are rapidly increasing their exposure to emerging and frontier countries. Competitive advantages include human resources, location and expertise. The management of both companies is forecasting more than 20% sales growth which seems realistic given the infrastructure needs of new markets such as Syria, Angola and Vietnam. Since our return however, the uncertainty of the regional exposure has risen due to the uprisings and violence in Tunisia, Egypt, Bahrain and Libya. In response, pledges by Middle Eastern governments to increase spending on infrastructure can contribute to growth, although private sector projects can stall. Investor pessimism appears priced in with the DFM General Index trading at 80% off its peak in 2006. According to Bloomberg, Dubai trades at 5.7X forward price to earnings, the lowest level of the markets they track worldwide. Abu Dhabi based stocks also offer similar valuations. Good due diligence and patience can prove rewarding.

Sri Lanka

Sri Lanka, also known as "the Pearl of the Indian Ocean", is an island nation surrounded by the Indian Ocean, the Gulf of Mannar, the Palk Strait and lies in the vicinity of India and Maldives. The island is rich in tropical forests, white beaches and has a long and colorful history and culture. Sri Lanka in its local language means "bright and rich promised land". However and sadly contrary to its beautiful name, the country was cursed with a long-lasting civil war between the government and the terrorist group representing the nation's Tamil minority. For more than 25 years, the conflict caused significant hardship to the population, environment and the economy of the country. It was estimated that approximately 80,000 – 100,000 people were killed during the war. Billons of dollars were spent. War costs consumed around 30% of the government's budget and have been estimated to have cost the country over USD200bn over the years. (shttp://www.asiaecon.org/special_articles/read_sp/12556).

In May 2009, the 30 year long conflict against terrorism was brought to a brutal end with the liberation of the North and East, which opened a new chapter for the country. As soon as we landed, we found that the entire country is full of optimism and excitement about the future development. Tourism and port business are the two sectors that almost everyone is talking about. The government expects the number of tourist to grow from 500,000 to 2.5 million by 2016. It wants to position Sri Lanka as the center of the silk route and capture the rising economy of India.

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

There is a heavy military presence in Sri Lanka; Cannon at the beach of the Colombo.

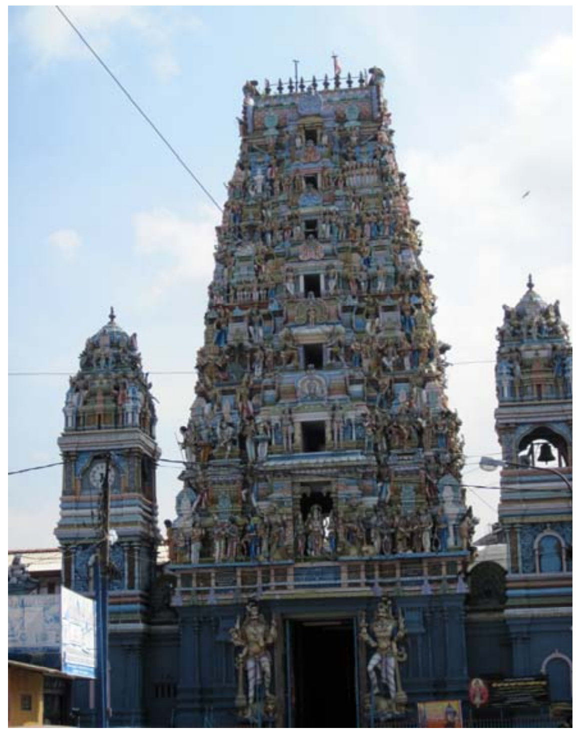
In order to reach its strategic goal, the government is aggressively investing in the infrastructure and implementing tax reforms to boost the development of the private sector. For example, five key ports are being developed in strategic locations around the country, thereby providing the necessary infrastructure and facilities in order to position Sri Lanka as premier global port destination.

Expansion projects have been carried out at the Bandaranaike International Airport with the construction of new passenger terminals, export cargo terminals and further developments are in the pipeline. The second international airport is under construction in Mattala, Hambaantota. Corporate tax was reduced from 35% to 28%; VAT was reduced from 20% to 12% for financial services.

The enthusiasm can be felt even stronger when you talk to the managements of the companies. Ning visited 10 companies and half of them are talking about expanding or starting investments in the leisure/hotel sector, especially in the North and East. People are extremely confident and optimistic on the growth opportunities. However, when managements were asked further about the real development of the North and East, they started to share concerns over the slower-than-expected development in the prior war zone. The reality is people are slow to move back and restart their life from scratch as they receive easy money from the international organizations for staying in the camps. None of the companies Ning visited have brought in any profit from the North and East and the managements don't see profits coming for at least three to five years.

The discrepancy between the hope and the reality gave us conflicted feelings. On one hand, we are confident about the growth potential of the tourism sector. English is widely spoken here. Anyone who visits the country will fall in love with its natural beauty and wonderful architecture, especially the temples. The country's strategic location allows it to benefit from the economic growth of India and China. We were also amazed by the high quality of the managements. They are well-educated, knowledgeable, pragmatic, and seemingly honest. The average people here are also very friendly, hard working and confident on their country's promising future. On the other hand, we are a bit concerned on the slower-than-expected development. People may be a bit over-excited about the end of the war and the rosy pictures the government has laid out. The stock market was up 96% in 2010 which made it the second best performed market after Mongolia. Finding a cheap stock with good growth potential becomes hard. Given the reality on the ground, we think many companies now look expensive. Therefore, we trimmed back some of our positions here but are still watching the market closely, waiting for good opportunities to reenter the market.

A Buddha statue on the side of a street.



A Hindu Temple in Colombo.

Conclusion

Our research trip was timely and informative. We confirmed the long term reasons to invest in Bangladesh, Sri Lanka and Vietnam. The economies are expanding rapidly and the wealth effect is spreading through the general population. The rising middle class is consuming more and businesses are benefiting. People are working hard and embracing the opportunity of capitalism. In Bangladesh and Sri Lanka, democracy is growing roots, while in Vietnam and the UAE, change towards freer society may take place sooner than expected.

We also recognize that in many ways our travels took place at a turning point. In Bangladesh, the market peaked in December and has since corrected about 35%. Throughout 2010 we wondered about the source of liquidity. Daily trading volumes had increased more than tenfold in just two years. Valuations became stretched. Our visit confirmed concerns of speculative local retail investment. Having avoided the recent meltdown, it may now be appropriate to reevaluate investment options. In Sri Lanka, we are encouraged by the government's new 2011 fiscal budget proposals which are to increase public investments in infrastructure, education and health; to boost the growth of the private sector and create a more investor friendly environment by various tax incentives. Meanwhile, we are aware of the challenges the country faces and that it may take longer than expected to fulfill their dreams. Although the valuations are stretched today, as long-term investors, we believe due diligence and patience will lead us to the best stocks. In Vietnam, the hard working spirit and drive were contagious. However, the lack of confidence in the government and its economic policies was also evident. Since our visit, the Central Bank announced a further 10% devaluation of the Dong. Initially the market reacted negatively but is now showing signs of stabilization. Volatility is almost certain in Vietnam, although for the enduring, rewards may be in store.

The most significant development since our trip, however, has been the uprisings in the Middle East. The prospects for democratization in the region over the long term are very encouraging, but concerns about short-term uncertainty are well founded. All stock markets of proximity have experienced corrections, and some are at multi-year lows. We are embracing the opportunity to research and diligently increase our exposure to the best companies.

About Frontier Market Asset Management, LLC

Founded in 2006, Frontier Market Asset Management holds more than 45 years worth of investment experience including work in Emerging and Frontier Markets since 1987. For more information, please contact us at (858) 456-1440.

This is not an offering. An offering will be made only by means of a final offering memorandum and only in those jurisdictions where permitted by law. The fund is subject to a variety of risks, including but not limited to: investments may be volatile depending on the type of hedging techniques employed and subject to stock market risk; investments may be illiquid; an investor could lose all or a substantial amount of any investment in the fund; there is no secondary market for interests in the fund nor is one expected to develop, and there are substantial restrictions on transferring an investment in the fund; fees and expenses of the fund may be higher than those of other investments and will reduce the portfolio return. Consult the fund's offering memorandum for complete risk disclosures and other important information.