FRONTIER MARKET
Asset Management, LLC
...the road less traveled

Late at the Gate – Romania shuffling toward a new dawn

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The Strigoi were incredibly beautiful women who died young. They were so beautiful, it is said, that they could hardly have been human. So when their spirits began roaming the Transylvanian countryside, their bodies were exhumed and wooden stakes were driven through their hearts to stop the nuisance.

Fortunately, healthcare has improved in Romania, and life expectancy is now 74 years. The Strigoi haven't been much of a problem for years, but Romania still benefits from them thanks to the publicity from Dracula by Bram Stoker, 1897. The Count was indeed bloodthirsty, but mostly toward the Turks, whom he routed in a clever battle. He was member of the German Order of the Dragon, or Dracul. This word in Hungarian happens to also mean "devil". Add in a few wolves, since Romanian forests held half the wolves in Europe, and you have the enduring legend of Dracula that is somewhat larger than life (fortunately). All of this occurred in Transylvania, split off from Hungary as the spoils of World War I. This tourist bonanza for Romania still rankles many Hungarians.

Beautiful Bucharest: Belle Époque buildings, new cars…and McDonald's

Romania has been struggling to shake off the old ways of Communist rule. Following the execution of Dictator Ceausescu in 1989, the government was run by former Communists until 1996. Reform has been slow: for example, milk prices were only liberalized in 1997 and natural gas prices are still 60% below the world price. Joining the European Union has helped with infrastructure construction grants, but some of the benefits are delayed because of pressure on the government for reforms that have turned out to be pro-cyclical. While much of Europe has begun to recover from the 2008 economic crisis, Romania struggled in 2010 because of a hike in the Value Added Tax and a mandated reduction of 25% in public sector wage expenditures (either through layoffs or wage cuts). A result has been stagflation: an acceleration in inflation to 8% (estimates are that the government's initiatives caused 5% of this) and a 2% drop in GDP. The pain is palpable among people we spoke with. Also, the public pay cuts have caused many doctors (who are public employees) to emigrate abroad. 2011 may not be much better;

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although a 15% rise is to be permitted in public payrolls, after the inflation, this will only be effectively around 7%.

Structurally, Romania should be in pretty good shape going forward. At the peak in 2007, foreign investment was flowing in causing a current account deficit, and consumers were on a spending spree with consumption equal to 100% of GDP. Now the current account deficit has shrunk to 4% of GDP from its 2008 high of 14%. The country retains its efficient flat tax rate of 16% for both individuals and corporations. Demographics are challenging, but reportedly the birthrate is rising. Unfortunately, there are 6 million pensioners versus only 4.4 million workers actively employed. Increased urbanization would help since 7.5 million rural agricultural workers are underutilized, and they only contribute 3% of GDP. Another challenge is that joining the European Union has meant adopting the EU's restrictive labor laws which are designed for mature economies, not developing ones, as pointed out by Stratfor, "Geopolitical Journey: Romania", www.stratfor.com, November 16, 2010. In this context, some of the corruption in Romania is actually functional in that it enables enterprises to operate under the onerous laws.

	2008	2009	2010	2011
RGDP Growth	7.1%	-7.1%	-2.0%	1.0%
Inflation	7.0%	5.0%	8.0%	4.0%

	Romania	Bulgaria	Zambia	Zimbabwe	Malawi
GDP Growth	-2.0%	0.4%	6.0%	2.2%	6.0%
Inflation	8.0%	3.0%	7.5%	5.0%	7.2%
Population (mil)	22.0	7.1	11.8	11.4	15.0
People / km sq	96	64	16	29	127
% Literate	97.3%	98.2%	80.6%	90.7%	62.7%
% under age 15	16%	14%	45%	44%	45%
Life expectancy	73.7	73.3	38.6	45.8	50.0
% Urban	54%	71%	35%	37%	19%
GDP / cap (PPP)	$11,500	$12,600	$1,600	$100	$800
% Unemployed	8%	9%	50%	95%	50%

Source: CIA World Factbook, September 2010; Frontier Market Asset Management estimates

Bottom-up Travels

We've invested in the small $9 billion Romanian stock market since mid-2009, and our results have been a bit of a roller coaster: up 33% in 3Q09, down 6% in 4Q09, up 24% in 1Q10, down 34% in 2Q10 and up 33% in 3Q10. Overall that adds up to a gain of 33% which isn't bad, but the standard deviation of quarterly returns is 30%. Our return in Romania has been slightly below our overall frontier portfolio return of 37%, but with more than four times the volatility… a wild ride indeed.

On this trip we updated our knowledge on several companies, in addition to giving our second talk to the CFA Society of Romania (the first was in December 2006). Some company summaries are below, but please understand that we are not expressing an investment opinion on the stocks. Rather we feel it is worth sharing with you some features of the companies available in this interesting frontier market:

Source: CIA Factbook

Biofarm is a medium sized pharmaceutical company with a market capitalization of $70 million and a float of $40 million. The company is among the top ten manufacturers in the country, but it has a small 3% market share given imports from the big multinationals. Still, Biofarm makes 160 pharmaceutical products in 50 areas with 75% sold in the over the counter (OTC) market where the government is not involved in reimbursements and therefore is not involved in meddling with the prices. With simple products that include chewable multivitamins for kids, cough syrup and hemorrhoid treatments for adults, Biofarm is the market leader in ten of its products and is a strong player in many others.

Biofarm – clean and impressive

Previously, there was a plan to move to a new plant outside the city, but a real estate collapse has put an end to that dream. Meanwhile, the plant is located in a dingy old building, yet one that is absolutely spotless inside. The five floors include the manufacture of tablets, gel-caps (they are the only producer in the country) and syrups. The plant does blister packaging as well as final product packaging. Operating two eight hour shifts five days a week leaves room for another shift to increase capacity 50%.

Earnings will be flat this year on the back of a big increase in television marketing and tight pricing to gain market share. There is some exposure to the government's new "claw-back" tax on prescription drugs, but this will not affect the full 25% of sales that are through prescriptions as some are paid in cash rather than through government reimbursement. Long term, the real attraction of Biofarm is the potential for huge profit gains in 2012, and a possible sale of the company after that.

BRD SocGen (Bank for Romanian Development) is Romania's second largest bank. It is what we would call a "side-car" investment as 55% is held by Societe Generale of France, resulting in strong management oversight. Thanks to SocGen, efficiency is high with a cost to income ratio of 37%, one of the lowest we've seen, although we wonder if they are skimping on investments for future growth. A spillover from the government's austere 25% payroll cuts has been a rise in retail non-performing loans (NPLs) and an increase in corporate bankruptcies. Loss provisions are up sharply because Romanian accounting requires 100% provisions on loans to bankrupt companies even though interest payments continue to be made and actual recoveries may be significant. Eventual conversion to International Financial Reporting Standards (IFRS) in 2012 could reverse this over-provisioning and provide a windfall boost to earnings.

More important, BRD could capitalize on its dominant position to expand rapidly once Romania gets back on a growth track. Private sector loans are still low relative to the rest of Europe, so there is plenty of room for growth. "Prima casa" (first house) is an interesting government program currently that guarantees 95% of the mortgage to first-time home buyers up to 57,000 euros. This now accounts for half of BRD's mortgage loans, which are 45% of retail loans and 20% of total loans.

Petrom, 51% owned by OMV of Austria, is a major regional oil and gas company, embracing exploration, production and marketing. A meeting with the very impressive CEO, Mariana Gheorghe, confirms the company's aggressive strategy of expansion in the region that includes sophisticated secondary and tertiary recovery in Romania, offshore exploration with Exxon in the Black Sea and increased production in Kazakhstan.

The company is frustrated by the failed promises of the government to liberalize the local price of natural gas, which is controlled at 150 Euros per cubic meter when the world price is 340 Euros. Sadly, the government is even supporting wasteful, power intensive production of fertilizer from natural gas at a time when the country must import 20% of its gas needs. A new strategy by Petrom is to use its own gas in a new electric power plant so that it can at least gain a fair market price for some of its production. On the plus side, Petrom has been cutting costs through reducing the staff count, from 60,000 in 2004 to 25,000 today, with more cuts envisioned. Also, Marc Mobius, executive chairman of Templeton Asset Management, has recently joined Petrom's Board of Directors, so we would not be surprised to see more strategies to unlock value at the company. Also, we believe that ultimately the natural gas price will rise.

SIF Oltena, or SIF # 5, is one of the "State Investment Funds" that were set up to privatize the Romanian economy. Originally, SIF # 5 had a hodge-podge of 800 companies, but this has been whittled down to less than 150, of which 24 are probably worthless. Most of the holdings are now in publicly listed stocks, such as BRD SocGen and Petrom. While a quarter of the net asset value (NAV) is in private companies, 75% of this is in Banca Comercială Română, the largest bank in Romania, which is controlled by Erste Group Bank of Austria.

The most interesting feature of the SIFs today is that they sell at huge 50% discounts to the net asset value (NAV) of their holdings. They are technically closed-end funds, and some discount is typical for such vehicle. The fund manager's desire for job security results in an obvious conflict of interest. However, a 50% discount is hard to justify. It would seem logical for the SIFs to simply distribute shares of their public stocks in kind to the SIF shareholders, but this notion seems to escape the SIF managements as well as the government regulators. Baring that development, we can view the SIFs as leveraged plays on the Romanian market. The discount is likely to narrow in a bull market, perhaps back to 20% or less, as it was during the boom times of 2007.

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Conclusion

"And those who say, 'I'll try anything once,'
often try nothing twice, three times,
arriving late at the gate of dreams worth dying for"
– Carl Sandburg, "Musings - Breathing Tokens"

My first work in Eastern Europe was for a project at Batterymarch Financial Management in 1991 to launch a "Soviet Companies Fund". We renamed it the Russian Companies Fund after the Soviet Union collapsed. Unfortunately, the project was abandoned in the face of insurmountable corruption. In those days, store shelves were empty and former Communists were grabbing all the country's wealth they could get their hands on. Now much has changed, as we discussed in previous trip reports: "Return to Eastern Europe" October 2009, "On the Silk Road – Kazakhstan & Uzbekistan" December 2007, "The Rich Frontier – UAE, Qatar, Bahrain, Kuwait & Ukraine" June 2007, "The Gemini –Bulgaria & Romania" January 2007,

Arriving in Romania these days is easy and quick. No visa required, no landing card is required, and it only took ten minutes to get from the plane to a waiting car with all my bags. Only Dubai is a minute or two quicker! Since my last visit to Bucharest, the traffic is easier and the city is cleaner. There are still beautiful old buildings in need of rescue, but there are as many of the glitzy shops that one might see in London!

We are optimistic that a new dawn is arriving in Romania. The short lived boom of 2007 was a false one based on borrowing and spending. This time we hope for a new dawn that will not only drive away the Strigoi but will finally see the country's dreams fulfilled. Hopefully Romania's exports will recover, its willing workers will find jobs, and investors will find that their patience is rewarded.

Ready for action at Biofarm: Larry, Katie Bach (MIT Sloan School, formerly World Bank) and Razvan Lefter, Eurobank EFG Securities

<u>*About Frontier Market Asset Management, LLC*</u>

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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