



States within States

Kurdistan/Iraq, Palestine/Israel and their Neighbors

November 2011

Masgûf, served at the Venus restaurant in Erbil, is strange and somewhat dangerous but tasty. It is carp, caught live (or pulled from a tank) and roasted on a fire in halves, sliced down the middle. Crispy on the outside, dangerous because of many sharp bones and yet tender, moist and delicious... It is said to have been a favorite of Saddam Hussein.

Erbil itself, and indeed the rest of Iraq today, is similar to Masgûf... strange, dangerous but good – or at least getting better. In the north, it is home to 1.5 million people and is the fourth largest city in Iraq after Baghdad, Basra and Mosul. Fortunately for us, it ranks as the safest city in Iraq these days, because it is in the heart of Kurdistan.



Erbil from the Ottoman Citadel on top of the Tell

Erbil (sometimes spelled Arbil) is perhaps the oldest continuously inhabited city in the world, founded 8,000 years ago by the Mesopotamians, who were followed by Assyrians, Babylonians, Medes, Persians, Arabs, Ottomans, Kurds and Iraqis. It is a stretch to say that Alexander the Great “slept here”, but almost certainly his defeated opponent Persian King Darius III did after their battle 60 miles west of town in 331 BC.

Our Middle Eastern trip in the fall after the “Arab Spring” was targeted at pockets of opportunity that may prove rewarding. Iraq and Palestine are literally on the frontier of the frontier, while Jordan, Lebanon, Qatar and the UAE are a bit more main-stream. We are encouraged by what we saw, but success is not a given in any of these places.

There is confusion in many quarters these days about the Middle East, and even the geography can be baffling to some, as in a recent Fox News map...

Twenty years ago, I made several trips to Abu Dhabi in a corporate jet, and I recall that in December 1990 we had to alter our route. Normally, we would refuel in Cypress and then fly straight over the Iraq pipelines to the bottom of the Arabian Gulf.



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This time, however, we went further south and refueled in Cairo, where Kuwait's airliners had taken refuge in the midst of the Iraqi invasion. From there we flew east to Abu Dhabi, and our pilots noted that, for the first time, all the air traffic controllers' voices were pure American accents.

Fortunately, the days of Desert Storm and the Gulf War are long past, and air traffic is back to being controlled by locals. There is even a choice of airlines to fly into Erbil, including Austrian Air, Lufthansa and Royal Jordanian.

	Iraq	Kurdistan	Israel	Palestine	Jordan	Lebanon	Qatar	UAE	Serbia	Zambia
GDP Growth (2011 est)	9.8%		4.0%	10.0%	3.0%	5.0%	14.0%	3.0%	3.0%	6.0%
Inflation	7.0%		5.0%	3.0%	5.0%	4.0%		4.0%	7.0%	7.5%
Population (mil)	30.4	4.9	7.5	4.0	6.3	4.1	1.5	4.9	7.3	12.9
People / km sq	69	120	360		71	394	129	58	95	17
% Literate	74%	75%	97%		90%	90%	89%	90%	96%	70%
% under age 15	38%	40%	27%		34%	26%	22%	20%	15%	46%
Life expectancy	70.6	70.6	81.0		78.9	73.7	76.1	76.5	70.1	48.7
% Urban	66%		92%		78%	87%	96%	84%	52%	36%
GDP / cap (PPP)	\$3,800	\$4,600	\$29,800	\$2,900	\$5,100	\$11,100	\$121,400	\$48,500	\$11,000	\$1,600
% Unemployed	15%		6%	24%	13%	9%	1%	4%	17%	50%
% Literate Female	64.2%				84.7%	82.2%	88.6%			
Land (km sq)	438,317	40,643	20,770		88,802	10,400	11,586	83,600	77,474	752,618
Market Cap (\$ bil)	\$4.4	NA	\$182.0	\$2.5	\$30.0	\$12.5	\$87.0	\$104.7	\$9.7	\$2.8
Market Cap/GDP	4.1%	NA	85.4%	42.8%	100.0%	43.9%	155.4%	29.2%	20.9%	47.5%
GDP	\$108.60	NA	\$213.00	\$5.73	\$30.00	\$28.50	\$56.00	\$358.00	\$46.40	\$5.90





Iraq



Iraqi Kurdistan

It is good news in Iraq that people have been protesting in the streets this year... good because it means that they have a government to protest against, and good because they are confident enough about their safety to gather in groups and protest.

After legislative elections in March 2010, it took 9 months for the Council of Representatives to approve the new government. Since then, there has been more squabbling than action, and some violence continues. Forty-four people were killed in four bombings in the four days we were in Iraq. Fortunately, the attacks were in Baghdad, a five hour drive from Erbil. Although Mosel and Kirkuk have had problems, they are 50 miles away.

After years of struggle for Kurdish independence that go back more than a century, the Kurds are still divided into populations in Turkey, Iran and Iraq. In the 1980s, after giving up on his war with Iran, Saddam Hussein brutally crushed the Kurds in northern Iraq with a campaign that included genocide and the use of chemical weapons. His atrocities included murdering 5,000 civilian men, women and children with poison gas in Halabja, 100 miles southeast of Erbil, on March 16, 1988.

In the Iraq War, armed Kurdish fighters, the Peshmerga, fought with the U.S. Army and are believed to have been responsible for the capture of Saddam Hussein in December 2003. Since the war, no coalition soldier or foreigner has been killed, wounded or kidnapped in Kurdistan. While independence movements by Kurds in Turkey and Iran continue, the Kurdish Regional Government in Iraq has a decent working relationship with Baghdad and seems willing to move forward as part of the nation where it represents 16% of the population with 9% of the land and a 25% higher GDP per capita.



Oil from the region must be exported under Baghdad's control, and some payments have been delayed. Also, Kurdistan has negotiated separate oil exploration and production agreements that hopefully will be accepted by Baghdad.

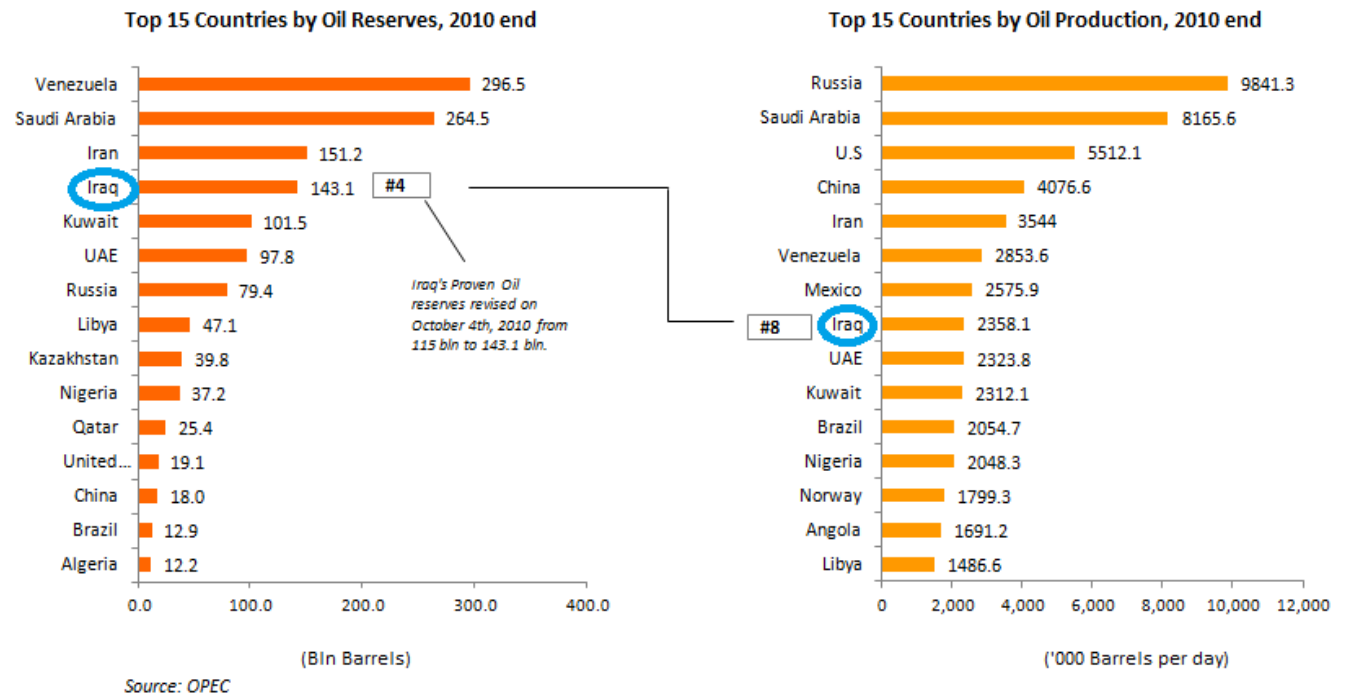


Barefoot entrepreneur in the shoeshine business

Meanwhile, its safety makes Erbil an ideal spot for foreign business men and women to meet their Iraqi counterparts. And in our case, it was an ideal spot for Rabea Securities to hold their first investor conference of companies in the Iraqi stock market. There were 100 people in attendance, more than a dozen Iraqi companies and roughly 35 representatives of foreign investment firms, half of whom have already invested in the market (including us). It was a learning experience for all. The Iraqi companies, especially the banks, operate in much different ways than those in the rest of the world. And they are just beginning to understand why investor relations could be important and what investors would like to know. One company, Baghdad Soft Drinks, refused to attend, saying that they prefer the price stay low so they can buy shares themselves...

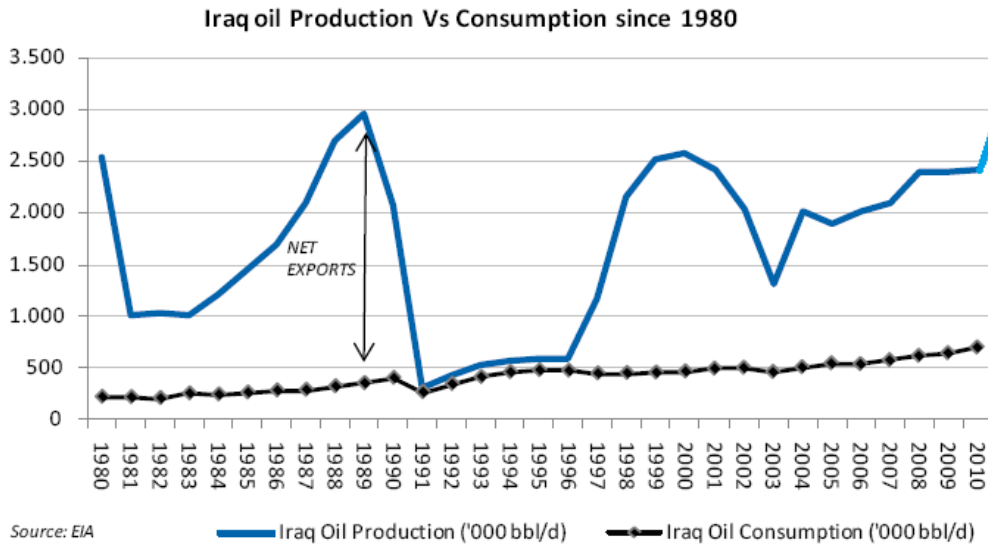
Iraq's economy is improving, with GDP growth up from 3% in 2010 to more than 9% in 2011. The economy is expected to grow at 8% for the next few years. Inflation is up to 7% from 4% but has generally stabilized, although housing prices have tripled since 2008!

Much of the story of Iraq is an oil story, based on its reserves that rank fourth in the world.



As shown in the chart below, Iraq's oil production has been rising and just now regained the old highs of the late 1980s. On this basis it would rank 6th, above Venezuela and Mexico. While the country's

ambitious expansion plans suggest a capacity increase to 6 million barrels per day, political constraints within OPEC may hold Iraq to a level just below Iran's production.



As for the stock market, at \$4.4 billion, it is only 4% the size of the Iraqi economy, one of the lowest figures in the world. On the other hand, the economy's size is inflated by the oil business which does not have the potential for local listing as it is controlled by the government and global oil companies. Of nearly 90 companies listed, most are banks, representing 85% of the market's capitalization. There are, however, real estate companies and others that manufacture white goods, air conditioners and electronic parts for telecommunications. Some of them have undervalued land holdings that may not be recognized in their valuations. As for the banks, loan/deposit ratios are low and they focus much of their business on lucrative bank guarantees of contracts, letters of credit for import/export and foreign exchange charges. As the economy develops, growth in the banking sector is pretty much assured. In general, valuations seem to reflect the risks inherent in the environment of Iraq.



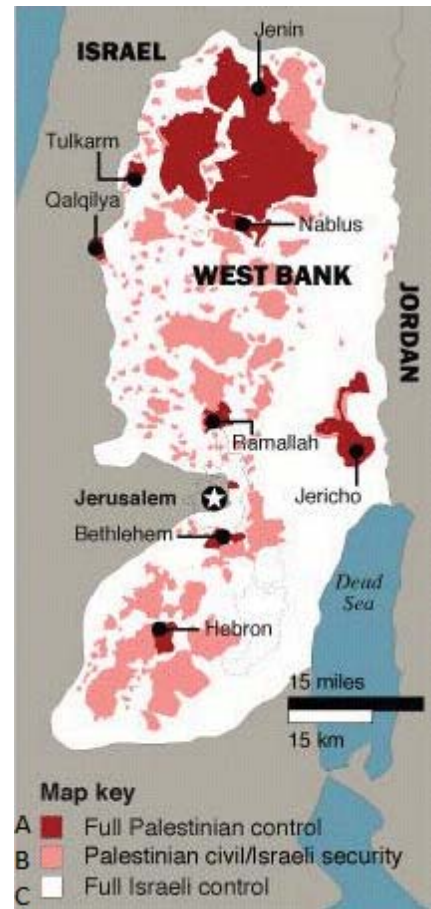
At the Marina Restaurant in Erbil



Palestine

Timeline:

<p>Ancient 1948</p> <p>1967 June</p> <p>1979</p> <p>1982</p> <p>1987</p> <p>1993</p> <p>2000</p> <p>2005</p> <p>2004 Nov</p> <p>2006 June-Aug</p> <p>2007</p> <p>2008 Dec</p> <p>2010 Sept</p> <p>2011 October</p>	<p>The Holy Land, cradle of great religions</p> <p>Israel established. 700,000 Palestinians fled to Jordan, Lebanon, Syria and Egypt. Arab-Israeli War, Jordan captured the West Bank. Egypt captured the Gaza Strip.</p> <p>1967 War: Israel captured the West bank, Gaza Strip and Sinai Peninsula. More Palestinian refugees fled to camps in Jordan, Lebanon and Syria. Israel begins policy of settlements in occupied lands.</p> <p>Israel-Egypt Peace Treaty</p> <p>Israel withdrew from the Sinai Peninsula, Israel occupied southern Lebanon</p> <p>Palestinian Intifada against Israel</p> <p>Oslo Accords provide for interim Palestinian self-rule. First Intifada ended</p> <p>Second Palestinian Intifada began. Israel began construction of "seam line" separation barrier</p> <p>Israel disengaged from the Gaza strip, evacuating settlers and military. Also withdrew from four settlements in the West Bank</p> <p>Arafat died, leading to hope of moderate Palestinian regime</p> <p>Israel disappointed in 34-day conflict with Hezbollah (Iran backed) in southern Lebanon</p> <p>Palestinian regime split between radical Hamas in Gaza and moderate Fatah in West Bank</p> <p>Israel 23-day conflict with Hamas in Gaza Strip</p> <p>Israel resumes settlement construction</p> <p>Prisoner exchange with Hamas</p>
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Palestine West Bank

A setting sun sharpens the contrasts in the harsh dry hills of the West Bank. We stand 10 miles north of Ramallah on a hilltop looking across the construction project of Rawabi, a planned city of 6,000 homes. With a \$500 million commitment from the government of Qatar, Bashar Masri is carving out this project to establish a new city for Palestinian families and businesses. For now, however, the final result is a dream. We have come here on a narrow winding road that runs a gauntlet between wire fences under an Israeli guard-tower. The pavement is intentionally rough to explode any bombs we may be carrying. On a Saturday afternoon, we joined a number of families that had come to consider advance purchase of one of the units for possible occupancy in 2013. Their children played in the playground while the adults prepared to enjoy a barbecue. We stood on the hilltop, looking to the northwest, where the tall buildings of Tel Aviv loom 25 miles away, seemingly in another world. To our left in the distance glints of sun shone off Mediterranean waters, while on a nearby ridge was an Israeli settlement. In the valley between, Rawabi hopes to build a more efficient road to Ramallah, but this has been held up in negotiations with Israel.



Rawabi at dusk

The West Bank is divided into three zones: A with full Palestinian control, B with Palestinian civil control and Israeli security and C with full Israeli control. Area C covers 80% of the land in the West Bank, while Area A is only the major cities. There are 100 checkpoints in the West Bank, which can make travel problematic. Furthermore, our clearance from Jordan at the shabby border by the Allenby Bridge required four hours. Our friend, Jon Auerbach, of Auerbach Grayson, <http://www.agco.com/>, described it thus:

"Entering the occupied territory of Palestine, problematic at best, reached new heights over the weekend for our merry band. One of us, a UK citizen by birth, with one of those funny names including the letter 'K' was interviewed for over an hour by soldiers and others convinced he was Iranian. I, always intrepid and straight forward with authority, failed the metal detector at the Allenby bridge and was immediately segregated in a holding area for a 30 minute wait until I was pulled into a cubicle by a security person, who pulled the curtain closed and began slipping on rubber gloves; I prepared for the worst. He smiled and simply said, 'So, where do you have the weapons?'...'You have got to be kidding', I responded as I explained the location of my titanium prosthesis (Superman for those who play squash with me). An intimate pat down and wandling followed after which he said 'OK' and pointed me to the next waiting station, without passport, by the way. Around an hour later 3 soldiers, one with my well-worn passport, called me away and interviewed me. 'Why are you coming to Palestine?' Answer: 'I am a broker and I am bringing two clients in to look at their investments and perhaps make more' Bad answer? Not where I come from. More waiting followed and finally we were just told to go, met our driver on the other side and headed for Ramallah (another two Israeli checkpoints along the way)."

Although Palestine's territory looks like a piece of Swiss cheese on the map, its economy has been growing coherently and successfully. GDP will grow 5% this year after 9% in 2010. Although Palestinian exports are restricted by Israel and Israel exports to Palestine are not. Surplus chickens and wheat sometimes depress the Palestinian market, but the local companies have demonstrated a dogged determination to overcome obstacles. One advantage is in labor cost: an IT programmer makes \$800-1,500 per month in Ramallah compared with \$2,400-6,000 in Tel Aviv.

Paltel, the largest company with 40% of the total \$2.4 billion market cap, has a PE of 8x, a yield of over 7% and an ROE of 20%+. They have to route some of their customer calls through switching equipment in London because it is forbidden to be imported into the country, and Paltel had to set up an Israeli company to get wireless coverage in Palestine by using some of their base stations in Area C. Paltel has

good growth, based on increasing wireless penetration (currently 68% versus 140% in Israel). Looking further into the future, Paltel will benefit if there is “right of return” to Palestine for some of the Palestinian refugees who have been living in camps in Jordan, Lebanon and Syria, roughly 1 million in each country. These people have been in camps since 1967 and in some cases since 1948. Many were born there. They are not citizens of those countries and are generally excluded from working in the economy. Sadly, their plight is one of the bargaining chips in the debate over a Palestinian State.

PADICO, Palestine Development and Investment Company, owns 31% of Paltel which suggests that, at current market prices, the rest of PADICO is free. The rest includes Golden Wheat Mills, profitable but operating at 1/3 of capacity because of imported products, PIIC, poultry and vegetable oils, and the stock exchange, which is to have a public offering soon..



Ramallah in the foreground, Israeli settlement on the ridge

Enjoying dinner in the upscale Orjuwan restaurant in Ramallah, it is hard to believe that this an occupied land, but Palestine’s 4 million people (1/3 in Gaza and 2/3 in the West Bank) benefit from high level of education and from remittances by the diaspora of 7 million Palestinians overseas. According to Jihad Al Wazir, the very impressive Governor of the Palestinian Monetary Authority, the rise in banks’ loan/deposit ratios from 26% to 52% signals new confidence in investing in the local economy rather than sending money overseas. This is echoed in a pick-up in housing starts and an increase in tourist arrivals, both of which have tripled since the dark days of 2008.

What’s needed now according to Samir Huleileh, CEO of PADICO, is “an end to the siege of Gaze, reconciliation between Hamas and Fatah, and free trade”. Palestinian statehood would be icing on the cake.

The Neighborhood:

Jordan, Lebanon, Qatar, Dubai, Abu Dhabi

Standing amid ruins of the Roman Temple of Hercules on the Citadel in Amman, the evening call to prayer rose from all sides. Flocks of birds whirled in confusion. Time seemed to stop beneath the great bowl of deepening blue sky. The spiritual sound seemed to come from earth itself.

We continued our trip through the rich and varied tapestry of Middle Eastern culture (my friend Ashik's phrase).

Amman: In Jordan, where half the citizens are of Palestinian origin, we confirmed the quality of the banks and the deftness of the government in dealing with its geopolitical challenges. There is talk that Saudi Arabia wants to have Jordan join the Gulf Cooperation Council (GCC – typically the club of rich oil producers). The benefit to the GCC would be military cooperation and a balance to the Shiite Crescent (Iran, Iraq and Syria). For Jordan, it would mean subsidies of \$2.5 billion over five years, free movement of workers to the Gulf and a \$10 discount per barrel of oil.



Temple of Hercules, The Citadel, Amman



Rock of Raouché

Beirut: It's a short flight to Beirut and our plane flew low over the beautiful Corniche and the iconic Rock of Raouché off the shore. Beirut is back to its old lively (and decadent) ways. Since our last visit in 2009, Prime Minister Najib Mikati has assumed power. He is a moderate and a businessman, formerly a telecom tycoon. Also, it is said that with Hezbollah as part of the government, they are starting to care more about the economy. One of our friends described his youth during the civil war (1975-1990), going to bed fully clothed in case there was an attack during the night. Nobody wants to go back to that.

The Lebanese are concerned about Syria. Some banks have branches there, and they had been optimistic that Assad was moving toward greater openness and moderation. Then early this year, a local official arrested some teenager boys and girls. He had their fingernails pulled out as punishment, which led to protests that spiraled out of control. Now the outlook is grim. Assad's Alawite sect are only 20% of the population and resentment runs deep. Fadi Osseiran, General Manager of Blom Bank, asks why workers in such a rich country as Syria were coming to Lebanon to seek jobs. For now, Syrian bank loans are being repaid, and we were told that construction projects financed by Syrian families outside the country are

being rushed to completion before things get worse. Of Lebanese exports, which are 10% of GDP, 24% goes through Syria. Three quarters of that is transshipped to the Gulf and fortunately, security is good on the desert road.

Doha: Sheikh Hamad bin Khalifa Al Thani in Qatar, who seized power from his father in 1995, is a bright man...and a bold one. Fruition of longstanding LNG projects has resulted in 21% GDP growth this year (slowing to 10% in 2012). Out of a population of 1.7 million, the 225,000 Qatari citizens have an average per capital income of \$88,000, the highest in the world. On the policy front, the Sheikh was quick first to support the Libyan rebels – with six Mirage jets. He has helped with rapprochement between Hamas and Fatah and has made contributions to stabilize politics in Lebanon. The al-Jazeera, Arabic news network is based in Qatar, and the government has supported its call to end the Assad regime in Syria. Recently, the U.S. has backed the opening of a political office of the Taliban in Qatar.



Home from School, Beirut

Meanwhile, the Qatar Foundation works in research and education with Georgetown, Cornell and other institutions. The government allocates 2.5% of GDP to funding research there. Finally, Qatar is looking to invest \$100 billion in infrastructure projects leading up to the World Cup in 2022.

Dubai: The tower of 2716 ft high Burj Khalifa (formerly the Burj Dubai) is finally complete, and the economy is licking its wounds from its overexpansion. The new Ferrari Park down the road in Abu Dhabi is open and boasts of the world's fastest rollercoaster. New hotels begun in boom times continue to come on stream, and occupancy rates are headed down to around 65% from 80-85% levels in 2007 and 2008. It is scant relief that some tourists are now passing up troubled Egypt and coming to The Emirates instead... there are simply not enough of them. In an interesting aside, Abu Dhabi National Hotels reports that its liquor stores boast a 50% profit margin. They make discrete deliveries to customers who wait in their cars outside. A new store is to open in the Etihad Airways building near the airport and demand from flight crews is expected to be high....

Conclusion – States within States

*“One must wait until evening to see how splendid the day was.”
- Sophocles*

It has been a good trip, but a long one. With many early morning flights, we have sustained ourselves on coffee of all kinds. We saw Starbucks in Amman, Beirut and Dubai, and we also saw some imitations: “Costa-RICA Coffee” in Iraq and “Stars and Bucks Coffee” in Ramallah...

Midway through our journey I accidentally dropped my Blackberry on a street in Jordan. A good person found it, worked hard to contact me and dropped it off with my local friends in Amman. A week later it arrived home in San Diego. I don't think I'll try dropping my phone in San Diego, New York or London....

As the Arab Spring turns into fall, the verdict on many countries is still out. Tunisia's progress may be the most advanced, while Libya is mopping up the old regime, and Egypt is trying to find its footing. Bahrain has shut down the opposition, while Syria is attempting to kill it.

Meanwhile the new government in Iraq is facing the challenges of governing, while its Kurds wait for the recognition they deserve and need to remain part of the state. In Israel, the Palestinians are polishing their message of independence to the world rather than focusing on their history of violent confrontations .

As investors, the risk reward trade-off needs to dominate our geopolitical emotions. We are hopeful for the places that may be emerging from troubled times, but more importantly, we believe that the valuations of many of the opportunities in both Iraq and Palestine offset the risks.



*"The time will come, when you see we're all one"
The Beatles, George Harrison, Within You Without You, 1967
Seen on the wall of the Hard Rock Café in Beirut
Photograph taken in Erbil, Iraq*

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