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

Learning Lessons… in Bangladesh, Laos & Vietnam

By Larry Speidell
December 2013

Scholastica, Dhaka, Bangladesh

“The best way to predict the future is to invent it” - Alan Kay
(A sign at Envoy Denim, Dhaka, Bangladesh)

Perhaps you can recall timing a pendulum through ten swings in physics class. In doing so, you could plot the period of oscillation and compare it for different lengths of string. It would be nice if stock market cycles worked that way, but for the students at Scholastica in Dhaka, it is one more step on the path of learning, graduating and helping them to make Bangladesh a better country. With 6,000 students overall and 2,000 of them at this Gulshan campus, Scholastica is one of many private schools that provide an alternative to public schools for students in Dhaka. For $120/month, students get an education that places most of them in college and many of them in top institutions abroad. It is no wonder that parents make sacrifices, sometimes driving their kids two hours each way through the gridlock of Dhaka’s traffic.

On our latest trip in frontier Asia, with a friend of the firm, we focused on two markets that have been disappointing for several years, Bangladesh and Vietnam. In addition, we travelled to Laos, a market that is small but has much promise. There are lessons to be learned in these places that can be rewarding for investors.

7776 Ivanhoe, Suite 150
La Jolla, CA 92037
United States

858 456 1440

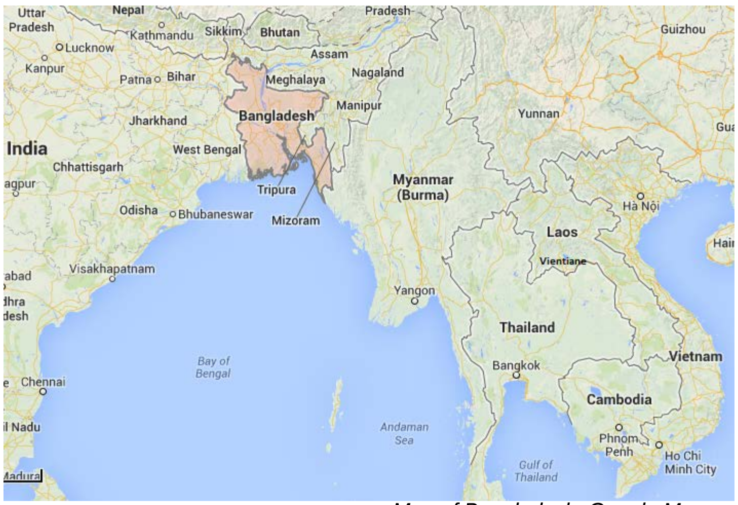
The table at the right shows the ranks of Economic Freedom from The Heritage Foundation for these countries. These ranks combine measures of the ease of doing business from the World Bank, corruption ranks from Transparency International and several measures of economic policy.

The countries we visited on this trip rank in line with Russia and China and fall somewhat below India and Italy. Bangladesh shows the greatest improvement since 2009.

Economic Freedom

	2013	4 yr % chg
Bangladesh	52.6	11%
Laos	50.1	-1%
Vietnam	51.0	0%
Russia	51.1	1%
India	55.2	2%
China	51.9	-2%
Italy	60.6	-1%

Source: Heritage Foundation, 2013



Map pf Bangladesh, Google Maps

During our trip, we met with a dozen companies in businesses that included taxis, auto dealerships, textiles, jewelry, real estate, construction engineering and banking. Management quality ranged from outstanding to abysmal, while valuations ranged from demanding to attractive. We reaffirmed our impressions of several companies that we own, and we uncovered some fresh ideas.

Economically, these three countries range from high growth in Laos to sluggishness in Vietnam. Demographically, they are all young, but Bangladesh is shamefully lower in literacy. Interestingly, all of them have GDP/capita that is higher than in Kenya, one of the richest countries in Sub-Saharan Africa. In electric power consumption, Vietnam leads the list, but Laos, with its huge hydropower potential, is gaining fast. Another interesting feature of these countries, according to Citi Brokerage in Dhaka, is that banking penetration is low, at 15% in Bangladesh and 23% in Vietnam, versus 32% in India and 47% in Indonesia. This represents a huge opportunity for growth in the financial sector.

	Bangladesh	Laos	Vietnam	Kenya	Croatia
GDP Growth (2013 est)	6.0%	8.0%	5.0%	5.0%	1.0%
Inflation	7.7%	5.0%	9.0%	6.0%	4.0%
Population (mil)	163.7	6.7	94.5	44.0	4.5
People / km sq	1137	28	285	76	79
% Literate	58%	73%	93%	87%	99%
% Literate Female	53%	63%	91%	84%	98%
% under age 15	33%	36%	25%	43%	15%
Life expectancy	70.4	63.1	70.2	63.3	76.2
% Urban	28%	34%	31%	22%	58%
GDP / cap (PPP)	$2,100	$3,100	$3,600	$1,800	$18,100
Electricity/cap kWH	212.8	333.1	1,100.8	125.2	3,731.8
% Unemployed	5%	3%	4%	40%	20%
Land (km sq)	143,998	236,800	331,210	580,367	56,974
Market Cap ($ bil)	$23.6	$1.2	$38.2	$10.2	$21.3
Market Cap/GDP	19.2%	12.5%	27.7%	24.8%	37.3%
GDP (Official Exch Rate)	$122.7	$9.2	$138.1	$41.1	$57.1
Military exp % GDP	1.4%	0.2%	2.5%	1.8%	1.5%

Source: CIA Factbook, 2013

Bangladesh

My last trip to Bangladesh was in July 2010 and my trip report then observed that, "We are less enthusiastic about the stock market in Bangladesh these days." The reason was an end to the government's amnesty policy whereby individuals with "Black Money" (illegally gotten gains) could pay a 10% tax and turn it into "White Money," so long as they invested the balance in the stock market. The chart at right shows that this policy had a significant impact from 2007 to 2010.

When the program ended, and then a 10% capital gains tax was imposed on institutions, the market responded dramatically by dropping by 50%.

Now, banks and stockbrokers are saddled with $2 billion in bad margin debt loans on accounts that had originally been at 100% margin but have now fallen to 25% of their original value. On the way down, the government stepped in with a misguided policy banning "trigger" sales of customers' positions. Adding to the brokers' misery, stock market volume has fallen from $250 million per day to $50 million.

It would be nice to say that the stock market is cheap, but most stocks sell at PE ratios in the high single digits, so we have to dig deep for good ideas.

Fortunately, there are signs of hope. An international ruling granted Bangladesh 200 square nautical miles of offshore oil territory that had been in dispute with India and Myanmar. This zone is now being explored by ConocoPhillips. Also, after years of ineptitude, the government has actually completed some infrastructure projects. Since my visit in 2010, power outages are down from one hour out of three to roughly one hour twice per day. Several bridges have been completed in Dhaka along with one "fly-over" intersection. Three more fly-overs are under construction, but probably not in time to save the incumbent government in the January 2014 election. No government has ever been reelected in Bangladesh where the "begums" (woman leaders) heading the two parties have feuded for years.

Our school visit at Scholastica showed that attention is being paid to education, although it will take years for the effort to pay off. In the short term, the macro picture is good, with 6% growth, inflation estimated at 7.7% and the current account balance turning positive this year. The foundation of success for Bangladesh has been its people, and some interesting comparisons with India are in the tables below:

	Bangladesh	India
Life Expectancy	68.6	64.4
% children underweight	41.3	43.5
Fertility rate	2.2	2.7
Mean schooling years	4.8	4.4
Under 5 mortality (per 1,000)	5.2%	6.6%
Immunization, DPT vaccine	94%	56%

Source: Citi Brokerage, 2013

Labor Cost	$/hour	$/month
Bangladesh	$0.23	$37
India	$0.51	$82
Pakistan	$0.41	$66
China	$1.08	$173

Source: Citi Brokerage, 2013

A large part of Bangladesh's economy is composed of "ready-made garment" manufacture (RMG), which contributes 10.5% of GDP and employs 4 million workers, which is 45% of the industrial workforce. Despite the collapse of the Rana Plaza factory complex in April, killing more than 1,100 workers, Bangladesh clothing exports rose 24%, year over year, in the third quarter of 2013. The reason is that wages still remain low despite several rounds of increases. A proposed wage increase may take Bangladesh to $67/month, which is still compelling for many producers. This competitive advantage should keep Bangladesh's economy humming while it upgrades the quality of its education and moves upscale in the production chain.

Laos

Laos is roughly the size of Utah, and its population of 6.7 million is dwarfed by Vietnam and Bangladesh (95 and 164 million respectively).

The kingdom of Lan Xang ("a million elephants") ruled what is today Laos, Cambodia and part of Thailand. The elephant remains the symbol of Laos today. The kingdom declined and was under control of Siam, until the French took Laos and made it part of "Indochine", while the British took Siam, west of the Mekong, and made it Thailand. The Pathet Lao took over Laos in 1975, ending a six-century monarchy.

This communist state has been a slow learner and it only recently began to open up with reforms. The tiny stock market was launched in 2011 and still has only two listed companies: Banque Pour Le Commerce External Lao (BCEL), which is 70% owned by the government, and Electricite Du Laos – Generation (EDL-Gen), 75% government owned through its parent, EDL. Their market capitalizations are $160 million and $990 million respectively, with floats totaling only $175 million.

More offerings are expected in telecom, transportation, agriculture and real estate, but progress is slow and the government has delayed a much needed capital raise by BCEL simply because it would reduce the government's stake and its share of dividend income.

The government of Laos may be a slow learner, but despite this, the economy is growing at 8% and inflation is modest at 5%. The country's mountainous terrain and abundant rainfall give it a wealth of hydro-power opportunities making it an exporter to its power poor neighbors. By 2016, new hydro-power projects totaling 7,000 MW per year will have been completed since 2012.

Pha That Luang, Vientiane

Ngem at the Kualao Restaurant, Vientiane

Vietnam

In Saigon, officially Ho Chi Minh City, there are eight million people and four million motorbikes. Thanks to this, the traffic flows. This is a delightful contrast with Dhaka, where drivers think only of themselves, use their horns as weapons, and ignore traffic lights and lane markers.

Four aboard, photo by Bob Bukowski

Saigon traffic flows organically like schools of. Motorbikes and cars simply turn into fish oncoming traffic, which smoothly parts to make room and then closes behind them. Even for pedestrians, it is somewhat unnerving but reasonably safe to simply step off the curb, trusting that traffic will find its way around you. (Don't try this in Paris or London…)

The adaptability of Saigon traffic is echoed in the adaptability of Vietnam in coping with unproductive government mismanagement while still achieving reasonable prosperity.

The latest financial crisis is looming at EVN, Electricity Vietnam, which has run up huge losses and huge debts by selling underpriced power. This has met political objectives but discouraged investment in new private power generation. Meanwhile, the government bureaucrats running EVN have a vested interest in blocking reforms.

Unfortunately, even the EVN situation is dwarfed by the ongoing crisis of bad debts in the banking system. These probably equal 5% to 10% of GDP, although some estimates run as high as 30%. In contrast, Nigeria moved swiftly to set up a government credit agency to take bad loans out of the private banks, this has not happened in Vietnam. The reason is that many Vietnamese government officials understand that if the bad debts were recognized, their complicity would be revealed and they would land in jail.

How and when these issues get resolved is sheer guesswork, but perhaps things need to worsen first. Meanwhile, the stock market has been stuck. The Vietnam Stock Index had a wild ride in 2007, when it peaked at 104 times trailing earnings. Then, the market dropped 80%, tripled in 2009 and has gone mostly sideways since then.

Beyond politics and the banking system, another problem is poor management at Vietnamese companies. Most of them over-diversified outside of their core businesses with unrelated investments in banks, real estate and raw materials. Knowing nothing about running these new acquisitions, they

Riding in the rain photo by Bob Bukowski

mismanaged them with disastrous consequences, yet their problems are still not fully recognized or understood by their own managements.

One example is a company we met with in consumer durables. They just suffered a big earnings drop because of their investment in a bank… run by the husband of the consumer company's chairwoman. Another company is in construction engineering, yet it holds an office park that produces an abysmally low rental yield. Now they are buying minority stakes in power companies. Then there is a fine consumer staples company that went on to buy a bad bank and a tungsten mine. Sadly, most of these companies are in denial about the limitations of their talents and their need to focus on building their own competency.

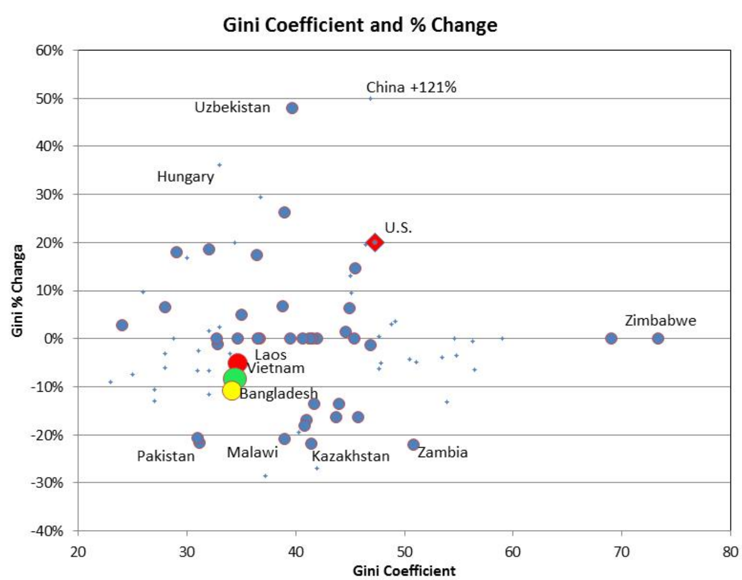
Conclusion

Our friend at the Vietnamese brokerage firm is not sure about the near term outlook for his country, but he is very optimistic over the next decade. He has a new baby to prove it, and says his son will go to private school despite its $20,000 annual cost. The young boy will have stiff global competition from the Scholastica kids.

Along with education and the hope for better politics, we believe that the core opportunity in these countries and elsewhere in the frontier is the development of a rising middle class. The evidence for this is sparse because countries do not report income distributions on a regular basis.

To measure middle class opportunity, we use Gini coefficient from the United Nations University – World Institute for Development Economics Research, http://www.wider.unu.edu/research/Database/. In simple terms, this coefficient is zero if everyone in a country has the same income, and it is one if one person has all the income and the rest have none. The chart below shows the coefficient for all countries with stock markets, and those in the frontier are in larger blue dots. Laos, Vietnam and Bangladesh are shown by green, red and yellow dots respectively, while the U.S. is the red diamond.

Several countries have only one data point for the Gini coefficient, so they are at zero on the horizontal axis. Zimbabwe is at the far right, with the most unequal society, although the official data may overstate things since the informal economy is said to be twice the size of the official economy. The vertical axis shows improvements (falling coefficients such as Pakistan and Malawi) and worsening inequality (rising coefficients such as China, off the chart up 121%, Uzbekistan, and the U.S). Laos, Vietnam and Bangladesh all look reasonably good by these measures. Their coefficients are low at 34-35, and they have dropped by from 5-10% over periods where we have data that range from



Source : Frontier Market Asset Management, LLC two to six years.

We are optimistic about the frontier in Southeast Asia. Their political problems will continue to be a drag, but on the streets the quality of life is improving. People are starting to have to learn lessons about budgeting their spending on small luxuries rather than living hand-to-mouth. The middle class is rising!

Thumbs Up, Scholastica, Dhaka, Bangladesh

<u>*About Frontier Market Asset Management*</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.

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.