FRONTIER MARKET
ASSET MANAGMENT

From Almaty's Calm to Cairo's Buzz

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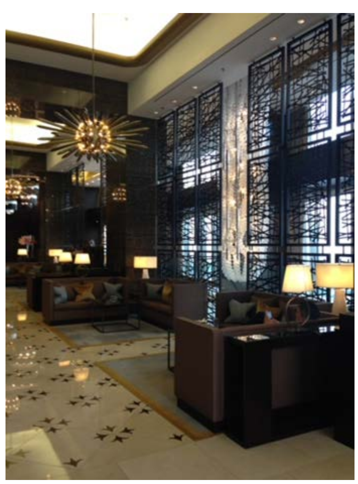
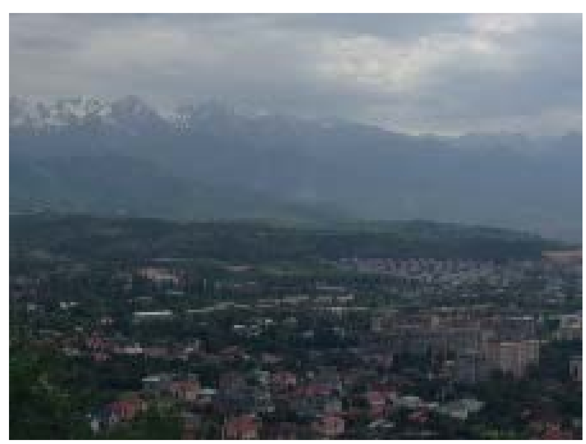
After a failed attempt to visit Cairo following Kenya this past January, I tried again, this time on the way back from Almaty, Kazakhstan. Since I would be free of yellow fever exposure in Almaty, proof of vaccination would not be necessary this time around. Yes, I have been vaccinated; however, I did not have the card handy when attempting to board my Cairo bound flight at the Nairobi airport earlier this year.

Egypt and Kazakhstan provided a sharp contrast in one trip; the two countries share little in common. Egypt is the world's most populous Arab nation (there are 24 million residents in Cairo alone). It is currently on fragile financial footing, due to limited FX reserves, a sizeable fiscal deficit, and years of subpar economic growth during the revolution. It is constantly busy, hot, and dusty. My hotel in Cairo was running close to 90% occupancy, and in need of refurbishment following years of no capital investment. Traffic was intense, restaurants were crowded, and security tight; metal detectors and bag searches are the norm in Cairo.

By comparison, Kazakhstan is the largest former Soviet republic excluding Russia, populated by a mix of Kazaks and Russians. It has minimal government debt, a small relatively wealthy population, sizeable oil and gas reserves, tame traffic, and frigid winters. All was quiet in Almaty, where I was one of a few guests staying at the Ritz Carlton, which abuts a luxury mall anchored by Saks Fifth Avenue – yesterday's commodity windfall clearly visible. There was relative calm and a sense of safety when walking around Almaty.



Ritz Carlton Almaty



Almaty, Kazakhstan Skyline

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	Kazakhstan	Egypt
Population	18M	88M
GDP 2014	$212B	$286B
GDP per capita (PPP)	$24,000	$10,900
Population below poverty line	5%	25%
Literacy	99%	75%
Life Expectancy	71yrs	74yrs
Current Account Balance % GDP	1.6%	-0.8%
Fiscal Balance % of GDP	-1.6%	-12.9%
Banking Sector Non-Performing Loan %	20%	9%

Source: World Bank Data, IMF

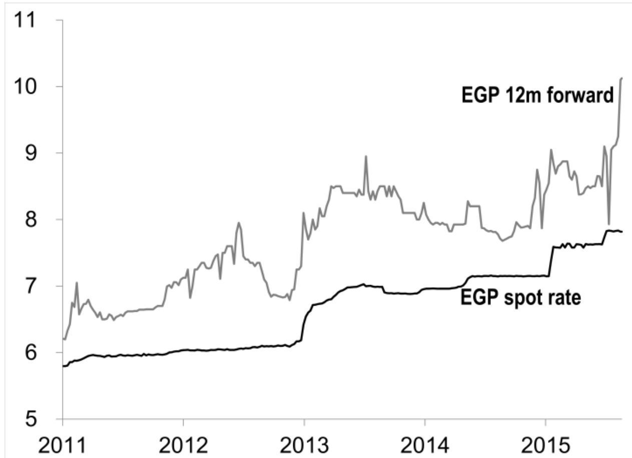
Government and Currency

Clearly different, but like many frontier markets the two countries do have a few similar features. Currently both are run by governments that would be considered autocratic by Western standards. After the economic unraveling of the Morsi government, frustrated Egyptians took to the streets, forcing the military to intervene in the country's political process. Egypt opted for a more technocratic government under President Abdel Fatah Al Sisi, a former general, who remains quite popular despite an aggressive crackdown on Morsi and his Muslim Brotherhood Party. For three years the country has been without a Parliament, which has allowed President Sisi to push through strict antiterrorism laws, most of which have been criticized by human rights organizations. Egyptians will go to the polls in October to elect a new Parliament, without participation of the now banned Muslim Brotherhood Party. Often we judge the politics of foreign countries based on personal experience. In the case of Egypt, it is easy to frown upon overtly strict rules governing speech and political opposition from a Western democratic position. However, perhaps this is the price Egyptians are willing to pay for some level of stability.

Although not as extreme as Egypt, the Kazakhstan democratic process also raises a bit of skepticism across the West. Kazakhstan has been run by President Nursultan Abishuly Nazarbayev since 1991. He is considered the "First President of Kazakhstan", secured 97% of votes in the most recent election, and is not subject to term limits. Given the country's history under Soviet rule and prosperity thanks to a natural resources boom, political complacency is somewhat understandable.

The other commonality is currency vulnerability. Egypt is suffering from a US dollar shortage, has restricted FX repatriation, and relies heavily on Gulf funding to maintain import coverage. The country's Investment Minister recently mentioned that the Egyptian pound will have to weaken to preserve FX reserves. The forward curve is factoring in 20% devaluation, and London GDR stock prices of local companies reflect currency pressure. The challenge for the Central Bank is to allow some currency depreciation without stoking extreme inflation. Because the private sector credit penetration is low, it is difficult for them to control rapid price increases with rate hikes.

Egyptian Pound – Forward Curve vs Spot



Source: Citi

Kazakhstan's currency pressure has been caused by plummeting oil prices and rapid depreciation of Russia's ruble. Cheap Russian imports are squeezing local manufacturers, but government officials had been reluctant to devalue the tenge. They attempted to protect local manufacturers through subsidies; however, that program quickly ran up against a stubbornly weak ruble and a sudden devaluation of the Chinese yuan. This forced the Central Bank's hand, and the tenge became free floating in August after a 26% devaluation, the largest decline since 1998. Most local companies and analysts agreed that the currency was overvalued – all expected a "muddle through" approach, not the recent sharp, quick adjustment. Whether the currency falls under further pressure is highly dependent on the oil price.

The Outlook and Opportunity

Kazakhstan – Slow and vulnerable to continued oil price weakness

The shock of lower oil prices, an extremely weak trading partner in Russia, and sharp currency devaluation is clearly negative for Kazakhstan's economic growth. A 2015 contraction is unlikely, but economic expansion will be anemic, around 1%. Oil and gas account for 86% of exports and approximately 40% of GDP. Banks are already dealing with asset quality problems, with the country's average non-performing loan (NPL) level hitting 24% in 2014. The government has mandated that NPL ratios be brought down to 10%, so any sizeable credit expansion is clearly off the table. Furthermore, many of Kazakhstan's undeveloped energy resources are expensive to develop. Against this backdrop, it is hard to get excited about the country's prospects. However, Kazakhstan will probably go on to deliver low to mid-single digit economic growth in the medium term. It is a small market, and doesn't have a wide selection of consumer facing stocks we can choose from, but valuation multiples are reasonable, so it warrants some attention.

Advertising Mobile Deals in Almaty

I met with banks and telecom companies while in Almaty, as the oil and gas industry is based in Astana, the country's capital. The telecom industry is extremely competitive, with four players vying for the attention of subscribers who already have multiple SIM cards. Kazakhstan has 170% mobile penetration. Kaztelecom is the lumbering fixed line incumbent, yet, it is also the first to be awarded a 4G mobile license. This has allowed them to pick up 20% mobile market share, but on the back of high subscriber acquisition costs. Margins are quite low, and thanks to government ownership reducing the bloated workforce will not be easy. The company has secured 80% share in broadband with decent fiber to home penetration. Perhaps margins could expand; still the mobile market share game is probably not over. I would expect an aggressive response from other operators once the company loses 4G exclusivity. It is clear that competition is hitting margins of mobile market-leader Kcell, which were exceptionally high for the region already – an invitation to regulatory intervention, competitive price gouging, or both. Since the government will award additional 4G licenses next year, Kcell will likely target Kaztelecom's subscriber base. This will cost Kcell, in terms of marketing and capital investment for 4G equipment, which unfortunately is priced in US dollars. I've seen this movie before in developed Europe – it may be best to wait until margins converge before making a move in this sector.

The financial industry is up against a tough backdrop as well. The banks do not expect much in the way of loan growth this year (excluding any FX revaluation of US denominated assets). Halyk appears to be appropriately positioned for Kazakhstan's challenges, and has already restructured some US denominated assets to tenge, possibly warding off further delinquencies. The bank's NPL ratio is below the country average, capital adequacy is sound, and return on equity remains close to 20%. Conversely, Kazkommertsbank (KKB) is dealing with high nonperforming loans, high costs, and a recent acquisition that adds further stress to credit quality. The company's ROE is only 5%. Perhaps it can only improve from here, but we would prefer to err on the side of caution and look towards Halyk when investing in Kazakhstan.

It is clear that Kazakhstan's economic growth will slow, and the country will move from both a fiscal and current account surplus to modest twin deficits. The country's fiscal breakeven price of oil is $79/billion barrels ("bbl"), while the external breakeven price is $85/bbl (source: IMF).

Fortunately the marginal cost of production (the cost of producing oil from developed wells) is not demanding at $17/bbl. Unfortunately, the cost of developing Kazakhstan's Kashagan oil field, a massive discovery that holds ~13 billion barrels, is already running above its $10 billion estimate, to the tune of $50 billion and climbing. Now ranked as the world's most expensive oil project, the field's complexity has also caused major production delays, which adds addition pressure to the fiscal outlook. The government has been dipping into the coffers to support the economy through subsidies and infrastructure investment. That can't last with oil below $50/bbl – fiscal consolidation will be necessary at some point. One development that might help alleviate budget pressure is the reduction in subsidies to local manufacturers battling cheap Russian imports. Devaluing the tenge will help local manufacturers compete more effectively without the government backstop.

Egypt – If not for the currency, and sadly security

Unlike my reaction to Kazakhstan, I left Egypt excited about the economic possibilities. Putting aside politics and security for now, Egypt ticks all the boxes: it has a young population, is underpenetrated across several consumer sectors - especially banking, and is home to several well managed companies. The country has hit the economic reform path in earnest by reducing fuel subsidies, revamping taxes, consolidating fiscal spending, and expediting infrastructure projects. Capital investment is on the rise, as companies are expanding capacity to satisfy demand. Multinationals, such as Coca Cola and Nestle, have also invested in local manufacturing facilities. Italian oil and gas company ENI recently discovered a massive gas field off the Egyptian coast that is 45% of the country's current reserves. The field's development will create jobs, with production commencing in 2016. Egypt could once again become an energy exporter.

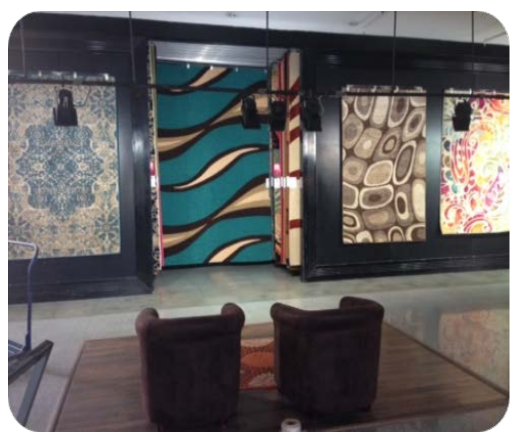
Cairo at night

Not all is fine in Egypt, however. The security situation continues to deteriorate, and the military response hints at possible mismanagement – case in point: the most recent attack on a group of White Desert tourists that were mistaken for terrorists. While militant Islamist groups have mainly targeted the Sanai peninsula, there have been periodic attacks in Cairo and around highly popular cultural attractions. Tourism is important to Egypt's economy, and it will not recover under these circumstances. It is also a source of foreign reserves, and the country is in great need of US dollars. The Gulf States have provided a backstop to the Egyptian pound, but with oil at current levels, their ever dwindling reserves have many wondering when the support might run dry… Yet it may not run dry. As the world's largest Arab nation, a stable Egypt is critical to a region embroiled in turbulence. It almost behooves the Gulf States and Western nations to help keep Egypt's economy humming, which in turn should keep domestic unrest in check.

Top on the list of quality companies I encountered on my visit is Commercial International Bank (CIB). It is the country's largest private lender, with an enviable cost to income ratio in the low 20%'s and high NPL coverage at ~150%. Since 2011, Egyptian companies have been in lock down when it comes to borrowing for capital investment. Now business sentiment has turned more positive. Banks are expecting 25% loan growth this year. They are also just starting to see the wider population open deposit accounts, and already have low loan to deposit ratios, around 40%, providing a solid foundation for credit expansion. CIB is not an inexpensive stock, but the company has a record of consistent results and remained quite profitable during the global financial crisis and Egyptian revolution.

On the investment banking side, Efg Hermes is a high beta play on Egypt's capital markets. The company's IPO book is solid, but trading volume has slowed over concern that a lower oil price means less Gulf support for Egypt. As I noted earlier, it seems unlikely that the surrounding region will pull critical FX support from the country, lest economic pressure incite another round of domestic tension. The company is also diversifying into equipment leasing, which should help balance revenue over time.

Egypt's large, young population is also a potentially lucrative consumer base. I have been told that eating is a favorite pastime in Egypt and across the MENA region. Edita, a recently listed snack company, sells Hostess products under license and its own branded products. Like many companies in Egypt, Edita is an expanding to meet growing demand from local residents and export customers. Although margins have weakened slightly, as the company ramps up production and boosts advertising; Edita is in a good spot to tap into the MENA region's robust appetite for snacking.



Oriental Carpet in Cairo

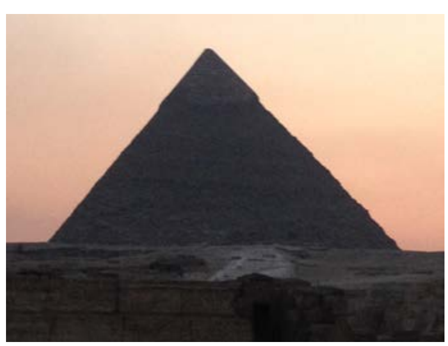
Oriental Carpet is one of the world's largest carpet manufacturers, selling all grades of fabric and distributing handmade rugs from Turkey and India. Production is based in Egypt, which gives the company a cost advantage regionally. The weaker Egyptian pound and lower polypropylene prices should also support margins this year. Oriental Weavers is a preferred supplier to the Four Seasons, as well as other high end hotel chains. As Egypt's occupancy levels normalize, hotels are beginning to refurbish properties.

GB Auto, the MENA region's largest automotive company, is Egypt's exclusive dealer for Hyundai, Mazda, and China's Geely. The company also manufactures buses locally with a Brazilian JV partner and 2-3 wheelers with India's Bajaj. Egypt's auto penetration is only 30 cars per 1000 people. Demand should drive sales despite the insane traffic around Cairo. Many companies have moved to East and West Cairo, where gated communities are thriving. This "suburban" migration should underpin vehicle demand. GB has struggled to compete with European imports that benefit from a new free trade agreement, but the government has announced a major reduction in Asian auto import tariffs. Additionally, GB expects to drive margin expansion through vehicle financing and after sales service and parts.

One of those gated community developers, Six of October Development (SODIC), focuses on upper middle class buyers. Working capital is funded by the customer via deposits and 5-year payment plans. This eliminates the need for upfront debt financing. Real estate sales are progressing well, and the company trades at a fraction of NAV.

I am optimistic about Egypt, a country that straddles emerging and frontier classifications. The challenges are numerous, but the potential opportunities are vast. Capital investment appears to be trending higher in several industries, and the government remains committed to economic reform. The missing component in Egypt's path to greater economic development is tourism. My hope is that the country will remain stable, security will improve, and tourists will return to view its renowned historical treasures.

Diversity across countries is one of the great attractions in frontier market investing. Egypt and Kazakhstan exemplify this trait. Clearly the countries are quite different, yet I am hopeful that both will be able to navigate their respective challenges. As stock pickers, we consider the broader macro picture, but look past the headlines and often discover solid companies that can manage through the cycle. I believe that to be the case in Kazakhstan and Egypt.



About Frontier Market Asset Management

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