



**FRONTIER MARKET**  
ASSET MANAGEMENT

## Back to the Future in Argentina

*Seeking new opportunities in a former economic power*

**Chris Herrera**

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**Founding symbol** – The Obelisk of Buenos Aires stands on the site where the Argentine flag was first flown over the country in 1812.

*Photo: Chris Herrera*

**BUENOS AIRES** -- Despite how far Argentina has fallen, optimism remains. There is a sense here that the economic bottom is now behind South America's second-largest economy and that far better days lie ahead.

A pronounced change in political leadership, the exit from a debilitating 15-year sovereign default and last year's devaluation of the country's currency all are contributing to economic advancement and to the increasing attractiveness of investment opportunities here. To be sure, fear and skepticism still exist. But that is only to be expected in a country that was once among the 10 richest in the world and now finds itself grouped among countries at the earliest stages of development.

### A Different Kind of Frontier Country

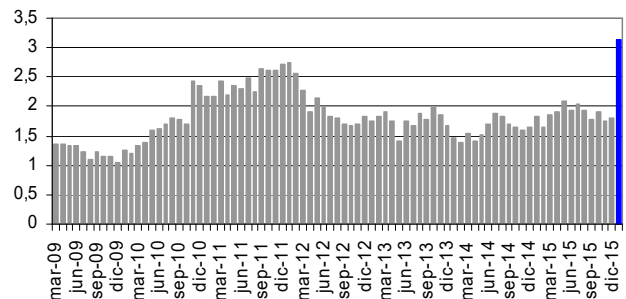
Among frontier markets, Argentina is clearly a special case. The country designs, manufactures and operates satellites for use in earth sciences. It has a uranium and nuclear power industry that extends back to the earliest days of atomic development. And it is the only frontier economy to hold a seat in the G-20 group of developed nations.

Some of the most profound differences between Argentina and its frontier peers were reinforced on our recent trip to Buenos Aires.

In architecture, infrastructure, history and industry, Argentina stands in stark contrast to the average frontier economy. Touring the financial and government districts of this capital city of 3 million people (13 million in the metro area) one sees signs of grandeur and past economic might tracing to 19th century mills, mines, factories and wharves. The city is stylish and decidedly first world with wide boulevards connecting expansive plazas, an orderly street plan and modern mass

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**Government Confidence Indicator**  
Torcuato Di Tella University



Source: CMA based on UTDI

**Rising Optimism** – The 2015 election of reformist center-right President Mauricio Macri has served as a catalyst for improving confidence in the Argentine government.

transit. And then there is tango, a national dance form to challenge all others in artistry, passion and intensity. These elements reinforce both the city's sobriquet, the Paris of South America, and the tragedy of its lost decades.

Argentina's path out of the frontier market classification and back to emerging market status will likely be complicated by the country's continued use of capital controls, which restrict foreign investors' direct and unfettered access to Argentina's financial markets. Currently, the Argentine Central Bank imposes a 120-day minimum holding period on portfolio investments in Argentina, a restriction at odds with modern interpretations of shareholder rights and value. As a result, many investors, Frontier Market Asset Management included, access Argentine equities through ADRs and GDRs instead of investing in ordinary shares.



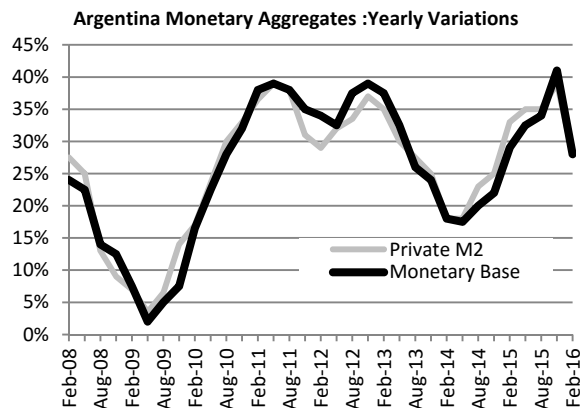
**Paris, South America** – An opulent Buenos Aires shopping mall reinforces the country's reputation as a bastion of Western culture and consumption.

*Photo: Chris Herrera*

During our visit, we met with company management in the fields of power generation, oil and gas, banking and consumer discretionary services. These executive teams expressed optimism for their companies in the post-default economic environment developing under new Argentine President Mauricio Macri. The new president, widely viewed as a center-right politician, succeeds the administrations of Cristina Fernandez de Kirchner, president from 2007 - 2015, and her late husband Nestor Kirchner, president from 2003-2007. The Kirchner administrations were widely viewed as center left to leftists, exemplified by the renationalization of select industries under Nestor Kirchner's administration and the excessive government spending of Cristina Kirchner.

### A Tall Order for Macri

Macri's administration has difficult work ahead: Tame inflation, promote economic growth, manage the federal deficit and finalize resolution with the remaining holdout creditors of its sovereign debt, among other challenges. One Macri initiative, designed to help reduce the federal deficit, is a program to drastically decrease subsidies for electric power consumption. In addition to shoring up the country's finances, the program holds potential to boost the business fundamentals for utility companies, including Pampa Energia, a vertically integrated energy company and a new holding in our portfolios.



**Monetary Reform** – The Argentine central bank has absorbed pesos in an effort to manage inflation and remove trading pressure in the absence of currency controls.

Another initiative has been to enhance confidence in the official currency, the Argentine peso. By allowing the official exchange rate to float, the central bank has reined in the informal exchange markets that at times charged up to double the official rate for the purchase of dollars, euros or other currencies. This rationalization of the currency is benefitting the banking sector by increasing transparency and reducing most of the conditions that supported informal foreign exchange markets. Argentine banks are also benefitting from signs of consumption growth and increases in agriculture output and export. We met with the management of Banco Macro to discuss these catalysts. Macro has a broadly distributed branch system across Argentina that holds specific advantages within its industry to benefit from both rural and urban growth and development. Fast food giant Arcos Dorados (not currently a portfolio holding) is also being served by growth in consumer spending. This McDonald's franchiser is showing resilient same store sales growth strong amid economic volatility in Latin America.

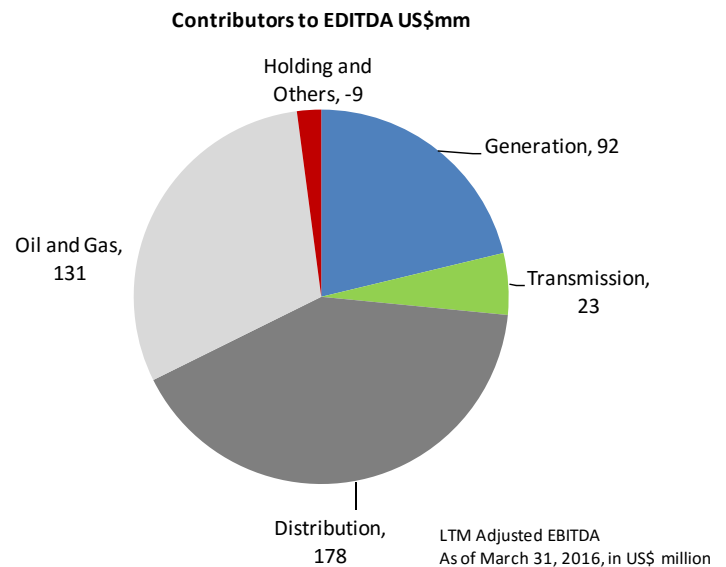
**Pampa Energia**

As the Argentine economy struggled over the past decade, Pampa Energia built itself into a formidable vertically integrated electric utility and oil and gas production company.

Pampa generates and supplies electricity throughout Argentina from its own hydro and thermal facilities. Its oil and gas properties produce fuel for thermal power generation along with crude oil for sale on the national market.

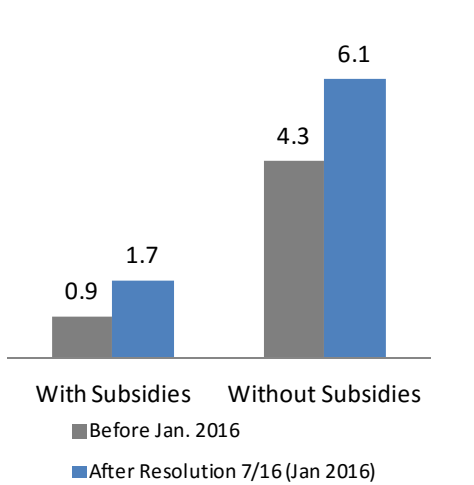
This year, Pampa has agreed to purchase a two-thirds interest in Petrobras Argentina from the struggling Brazilian oil giant. The result is the largest fully integrated electric company in the country and a formidable producer in Argentina's oil and gas industry.

With the recent reduction in subsidies for power consumption, Pampa stands to realize significant top line and margin growth. Not only has the percentage of Argentine ratepayers receiving subsidies dropped from 92% of ratepayers to 22% but the average subsidized price per kilowatt-hour of electricity has nearly doubled. At the same time, the average non-subsidized price has increased roughly 40%.

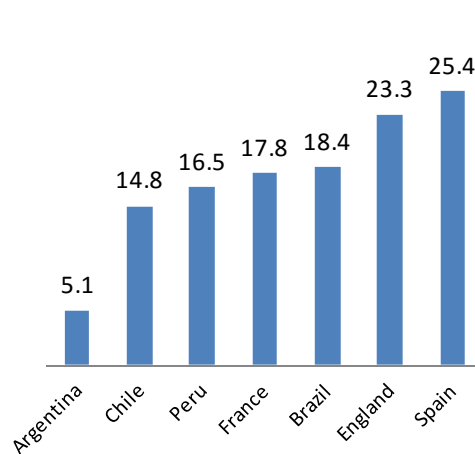


**Profit Centers** – Pampa Energia derives earnings from multiple business units.

**Argentine Electricity Costs (ARS/per Kwh)**



**Average Electricity Costs (ARS/per Kwh)**



**Improving Fundamentals** – Prices for electric power have risen for both subsidized and unsubsidized Argentine ratepayers. However, even after the recent tariff changes, Argentine ratepayers receive bargain-priced power.

Source: Pampa Energia

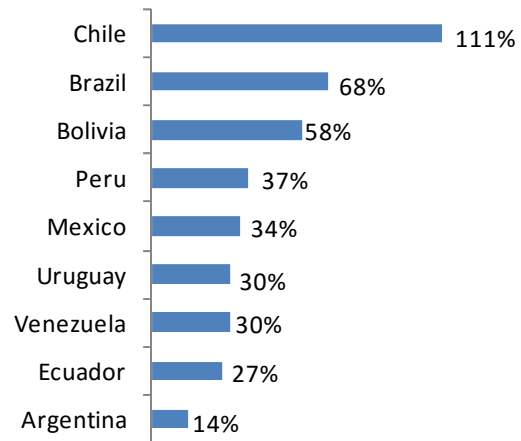
We view the company as well positioned to benefit from growth of the Argentine economy. The vertically integrated nature of Pampa and its diversified generation portfolio help to mitigate supply chain and regulatory risks.

**Banco Macro**

Argentina currently has the lowest ratio of private sector debt-to-GDP of any nation in Latin America, a reflection of the poor investment environment in the country in recent years under conditions of sovereign default, high inflation and a controlled currency. The Macri administration's initiatives to improve the monetary environment in Argentina hold potential for improvement in the banking sector in general and for Banco Macro in particular.

The company has demonstrated an ability to grow deposits, consumer credit and net income in the improving national financial climate, all without sacrificing credit quality. We believe Macro offers good value given its record of superior earnings growth and improvement in operating efficiency.

**Private-Sector Credit/GDP (2015)**



**Upside Potential** – With the lowest level of private debt-to-GDP of any Latin American nation, Argentina holds potential to responsibly leverage its future growth, providing upside potential to the banking sector.

Source: World Bank

## Arcos Dorados

Arcos Dorado, the Argentina-based master franchise owner of McDonald's restaurants throughout Latin America and the Caribbean, is seeing growth in its store volumes and in constant-currency sales at



casual dining outlets throughout the region. For Latin American consumers, a meal at McDonald's continues to hold aspirational value and represents a highly desired in-store family dining experience. In the current economic environment, the attractiveness of such offerings as the highly promoted ClubHouse burger or the child-pleasing Peanuts Happy Meal represents an affordable splurge.

For many families in the region, casual dining had been a suppressed desire during recent years of economic uncertainty. Today consumer sentiment appears to be improving. Arcos, which operates over 2,000 McDonald's restaurants across Latin America, reported nearly a 25% increase in store volumes for the Argentina region alone in the beginning of 2016.

**Consumer Play** – A McDonald's meal holds high aspirational value for many Latin American families, with promotions like the ClubHouse burger and Peanuts Happy Meal offering good value and a highly desired in-store family dining experience.

Company officials note that they are making progress is monetizing select real estate holdings to reduce corporate debt levels. The company also reports success in refranchising some underperforming restaurants, moving them from

Arcos management to local franchisees in remote, less profitable locations. Company management views these results as demonstrating progress in the company's three-year strategic plan for long-term growth, margin improvement and improved profitability. We continue to monitor the stock for progress in improving the levered balance sheet.

## An Economy in Transition

By nature of its history, infrastructure, global standing and workforce characteristics, Argentina holds potential to restore domestic growth and reclaim regional leadership. As the economic headwinds of default and currency controls subside, we expect to see the realization for robust growth from a low base.

The country's status as a frontier market is likely to be temporary, however. Although the market has rallied on the Macri dividend, we believe there are select opportunities in Argentine equities. Modest exposure to the Argentine market could diversify risk and enhance potential returns for frontier market investors.



**“Just, Free, Sovereign”** A mural in Buenos Aires’ Montserrat neighborhood expresses national ideals

Photo: Chris Herrera

### About Frontier Market Asset Management

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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