



FRONTIER MARKET
ASSET MANAGEMENT

The European Frontier Revisited

Balkan countries plot independent courses through uncertain EU waters

Andrea Clark
October 2016

Driving along the Adriatic coast from Montenegro to Croatia, it is easy to forget you are traveling in the frontier. The coastline is immensely beautiful, and the infrastructure and commercial activity in the Balkan countries present a region seemingly much further along the economic development curve than many frontier markets. It is also a remarkable recovery from its recent history of ethnic warfare. Despite its relatively compact scale, the region offers remarkable contrasts of culture, business sophistication and investment opportunity. This type of diversity remains one of the most appealing aspects of our investment universe.

My trip covered Bulgaria, Montenegro, Croatia, and Slovenia. As members or aspiring members of the EU, they share many of region's structural challenges: an aging population, low economic growth, high unemployment, and a fragile banking sector. The region's troubles moved into the global spotlight when I woke in Montenegro to learn that, despite reassuring poll numbers the prior evening, Great Britain had voted to leave the EU. The immediate impact was clearly negative - though not quite the doomsday scenario painted by the CEO of Montenegro's Jugopetrol (more about that discussion later). The longer term impact of Brexit continues to be forecast and debated. I actually visited London on my way back to the US and nothing seemed out of sorts. The infamous referendum made for interesting conversation in the taxis, however (along with the taxi drivers' plans to celebrate our July 4th in the US – who would've imagined?). My hope is that Brexit will usher in a more pragmatic approach to the currency union and economic integration across the disparate countries in Western Europe that, like the Balkan countries, share a long, complicated history.



Pearl of the Adriatic – Dubrovnik Croatia serves as a production site for Game of Thrones and as a prime destination for a burgeoning tourism industry.

Photo: Andrea Clark

Bulgaria, Croatia, and Slovenia are all EU members, and Montenegro is an applicant for EU membership. Although there are similarities across the countries – particularly among the former Yugoslavia members – I also found clear distinctions in culture and opportunity.

Slovenia, Croatia and Montenegro all featured in the Yugoslav Wars of the 1990s. Slovenia's Ten Day War for independence in 1991 resulted in 63 deaths and began the process of breaking up the former

7776 Ivanhoe Avenue, Suite 150
La Jolla, California 92037
Telephone: (858) 456-1450
Fax: (858) 456-2040
www.frontiermkt.com

Yugoslavia. The more protracted Croatian War of Independence, from 1991 to 1995, resulted in an estimated 20,000 to 25,000 deaths, the displacement of a half million people from their homes and horrible atrocities. It involved Croatia and, to a lesser extent, Montenegro. Montenegro was part of Serbia from the end of World War I until a narrowly won 2007 independence referendum. The country maintains close ties with Serbia, but it has a more Mediterranean feel. Croatia and Slovenia were members of the Austro-Hungarian Empire before becoming incorporated in Yugoslavia following the end of World War II. The architecture of their capital cities, Zagreb and Ljubljana, is reminiscent of Austria, and the quality of companies in both is typical of Austria's corporate sector.

Bulgaria has been greatly influenced by the post-World War II period spent under Soviet influence.

On the economic front, Bulgaria and Montenegro would be well served to accelerate economic reforms in order to speed up expansion. Bulgaria's efforts to root out corruption appear to have stalled, while the Montenegrin government's ownership of assets remains high. Slovenia and Croatia are wealthier and have more developed corporate sectors, but they too could do more to penetrate greater Europe, invite consolidation, and expand to other regions. Accelerating reform could help alleviate the region's chronic underemployment.

Distinct Markets – The nations of Europe's Balkans region are marked by differentiated cultures, character and economic infrastructure.

	Bulgaria	Montenegro	Croatia	Slovenia
EU Status	Member	Candidate	Member	Member
Language	Bulgarian	Serbian	Croatian	Slovenian
Currency	Lev	Euro	Krona	Euro
Population	7.2M	0.6M	4.4M	1.9M
Median Age	42	39	43	43
Population Growth (2015E)	-0.6%	-0.4%	-0.1%	-0.6%
GDP per capita (PPP) USD (2015)	19,097	16,123	21,581	31,007
GDP Growth 2017 E	2.3%	2.5%	2.1%	2.0%
Unemployment (2015)	9%	19%	17%	12%
Fiscal deficit/GDP (2015) ¹	-2.8%	-1.8%	-5.0%	-1.0%
Gov't Debt/GDP (2015) ¹	26.4%	59.5%	89.5%	62.7%
Current Account Surplus/Deficit/GDP	1.0%	-0.5%	2.1%	3.1%

¹ Montenegro 2014

Source: IMF, CIA World FactBook

Bulgaria

Driving around Bulgaria, I was intrigued by the sight of Porsche Panameras around every corner. Obviously, we see a wide range of luxury cars cruising around our offices in La Jolla, but I didn't expect to see so many in a frontier market. Perhaps the country's reputation for corruption and "informal" wealth is on the mark. I also sensed weak corporate governance during some – but, not all – of my management meetings. Throughout a conversation with a road building company, it became apparent

that operating margins were not the main focus of management. Granted they are involved in an inherently low margin business, but the lack of strategic vision did little to instill confidence.

I also met with a company we currently own, Chimimport. This diversified conglomerate holds investments in banking, transportation, and real estate. Its stock is relatively liquid (for Bulgaria) and often acts as a bellwether for the local market. However, the operating performance has been poor, particularly in the transportation division where Bulgaria Air is facing stiff competition from low cost carriers. In addition, the financial division has been struggling with loan loss provisions. Refreshingly, management acknowledged that they had not been diligent in making investments backed by EU funding. Return on investment had not been the company's main priority in allocating capital, but according to management it will be going forward. This brings me back to Brexit. Perhaps the vote will have favorable consequences, such as the end to complacency among some EU fund recipients. Chimimport is launching a low cost air carrier, selling non-core real estate assets, and expanding into leasing. These are encouraging signs. We are closely monitoring the company's operating performance.

My confidence in Bulgaria's corporate sector improved after meetings with managements from the pharmaceutical company Sopharma, the courier Speedy, and Sirma, a software service provider. Speedy has been a star performer since its November 2012 IPO. It commands 37% of the local courier market and has delivered 24% CAGR earnings' growth over the past five years. However, the stock is rich at 19x 2016 estimated earnings. Sirma manages a wide range of IT service companies globally and is dealing with issues inherent to that industry, particularly rising labor costs and a shortage of talent. Like many of the region's generic pharmaceutical companies, Sopharma is working to operate more efficiently in a world of pricing pressure and rising competition from larger players with substantial scale. The wide range of corporate governance standards illustrates the need for additional economic reforms in Bulgaria. Many have set a good standard; it is important for the rest to follow their lead.

Montenegro

Montenegrins have a flair for the dramatic. I was sometimes reminded of Italy, when, during my days as a consumer analyst, I was held sway by the "passionate" management of Berlusconi's Mediaset. On this trip, the attentive local broker who accompanied me to meetings ensured that my time was well spent and all questions answered. During a meeting with Plantaze, the world's largest geographically contained vineyard, he apologized to me for abruptly stopping our dialogue (which was being translated) to openly argue with the managing director in Serbian. The managing director responded by laughing. Later, the broker told me that this happens at every investor meeting when he has to remind the director that the government is not the only



Growth Potential – Montenegro, with its Mediterranean lifestyle and Serbian personality, holds potential for solid growth led by advances in tourism and maritime industries along with urban and infrastructure development.

Photo: Andrea Clark

shareholder and that her response to my questions regarding the weak margins was unacceptable. She basically admitted that the company overemploys, pays workers 30% more than the country average and that Montenegrins are lazy. I actually appreciated her candor. If nothing else, it appears there could be quite a bit of low hanging fruit that can be cut across the country's state-owned companies.

The Jugopetrol meeting had a similar dynamic, but for different reasons. The company commands 55% of Montenegro's oil marketing industry, is majority owned by Greece's Hellenic Petroleum and is very well managed. Perhaps because he sits near the epicenter of Europe's ongoing financial tragedy, the executive director was inconsolable over the Brexit vote. He was certain that financial Armageddon, on par with the global financial crisis, was imminent. Once again the broker interrupted the conversation to the tune of: "What are you talking about? No one cares about little Montenegro. The market hasn't moved since the crisis. Plus, you're not an asset manager. She is. So stop talking about your global market predictions and tell her about Jugopetrol." And so the conversation went back to business. Jugopetrol continues to invest in boosting environmental standards and bolstering non-fuel retail revenues. We have some exposure to the company through our holding in a local mutual fund, Trend Fond.

Although small, and not very liquid, there is clearly opportunity in Montenegro. The coastline is spectacular and is being developed for tourism and various commercial uses. Utility company Prenos is part of a major underwater cable project spearheaded and mainly financed by Italy's Terna. The project will provide Prenos with 20% of the cable's capacity to import and export power with Italy.

Croatia

After spending a taxing (relaxing!) weekend in Dubrovnik – Pearl of the Adriatic and production site for Game of Thrones – I arrived in Zagreb to meet with several companies. Almost immediately I detected a developed-market level of corporate governance and business management. The only obstacles to allocating more heavily to Croatian equities is liquidity and in some cases rich valuations.



Commercial Heart – Zagreb, Croatia's capital city is home to one-fourth of the country's population. It serves as the country's financial and industrial center.

Photo: Andrea Clark

Auto parts manufacturer AD Plastik is a key supplier to the Smart Car. The company delivers a 12% dividend yield and is working to boost ROE. However, with Renault responsible for approximately 54% of sales, the company carries a certain level of client-concentration risk. Atlantic Grupa distributes and produces fast-moving consumer goods, specializing in food and beverages. However, the company's execution of an acquisition-led growth strategy has not been seamless. The sports nutrition division, for example, produces several high-margin products that are distributed across the region, but it is struggling due to fragmented distribution. Management is developing a mass retail strategy for that division.

Valamar Riveria operates resorts, hotels and camps across Croatia. Security issues in Turkey and Egypt – once favored destinations of European tourists – have created a windfall for Croatian tourism. In addition, company fundamentals are solid – EBITDA margins are in the low 30's and management is targeting 35-38%. However, the

company's success appears to be reflected already in the stock price and valuation – PE 2016 of 20x. Ledo – an ice cream and frozen food company caught my interest, possibly because they showered me with samples. Being from Northeast US, I am a serious ice cream fan. It always seemed odd that a cold weather region would be a major ice cream consumer, but Ledo told me the Skandia countries are among Europe's biggest ice cream enthusiasts. The company has developed a proprietary technology that layers cake and other fillings in ice cream bars. In addition, Ledo has penetrated the US market via a deal with supermarket giant Kroger. Trading volume is light, but this is one we will watch.

I also met with incumbent telecom operator Hrvatski Telekom and telecom equipment/service company Ericsson Nikola Tesla. Both are well managed with reputable majority owners (Deutsche Telekom and LM Ericsson Telefon) and generous dividend yields, but it is difficult to envision much growth going forward.

Slovenia

As part of Yugoslavia under a command economy, Slovenian businesses often served as a source of hard currency for the country. As a result, the business sector was more vibrant than that of a typical state-managed economy. That business insight was apparent during my visit to the country. Krka is the fifth largest generic pharmaceutical company in Europe. This is a competitive industry, subject to government price caps that have become more restrictive under austerity programs launched across the continent. The company has worked hard to protect operating margins, but its exposure to Russia and government price controls have caused some erosion. Still the company remains very profitable, operates a state-of-the-art, fully automated local production facility and is expanding into oncology. At a more compelling valuation multiple, Krka could be a solid portfolio candidate.

I also met with NLB, a private regional bank that is planning an IPO for later this year. The bank's operations in Macedonia (which we own through its publically listed subsidiary) are its most profitable, delivering strong results despite the country's labor unrest. Operations in Bosnia and Kosovo are also performing well. NLB could be an interesting play on regional banking post the IPO. I also met the leading oil marketing company Petrol dd Ljubljana and insurance company Zavarovalnica Triglav dd. Petrol operates in a regulated market, but the government appears committed to liberalization, albeit at a modest pace. The company is looking to grow by expanding into gas and electricity distribution. Zavarovalnica Triglav pays a generous dividend, but, like many insurance companies in the developed world, low interest rates are denting growth prospects. The stock trades below book, but as the ECB is unlikely to change course in the near future, upside appears limited.

Sometimes I come away from a research trip with a wealth of new ideas. This tends to happen when country fundamentals are shifting. Europe is a bit different. Given the level of development across



Alpine Roots -- Slovenia's character reflects roots deep in Austria and the Hapsburg Empire. Its capital city Ljubljana hums with activity of a dynamic business sector.

Photo: Andrea Clark

frontier Europe, including the Balkans, the focus in this type of region should be more about stock picking, than in capturing a transition in a country's economic prospects. However, the Brexit outcome has introduced a level of uncertainty that must be considered when searching for ideas in frontier Europe. Further enlargement of the EU seems unlikely in the near term, which could jeopardize the pace of reform in EU applicant country Montenegro. Whether Brexit alters the prospects for continued business integration, funding conditions and the use of the common currency also remain unknown. The Balkans have produced many high quality companies that could be compelling at the right price. At this point, we are watching events in Europe closely, hopeful that the unexpected Brexit vote leads to positive change in a part of the frontier, that, for me at least, feels most like home.

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.

This is not an offering and is for informational purposes only. 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. Past performance is no guarantee of future return.

The information has been compiled from sources we believe to be reliable, but we do not hold ourselves responsible for its correctness. Opinions are presented without guarantee.

