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# CAMBODIA – THE NEW EMERGING MARKET..?

Chris Tell – http://www.capitalistexploits.com/2012/01/cambodia-the-new-emerging-market/

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The last time I spoke with my friend Doug Clayton our attention was focused on the unfolding and rapidly rising market in Myanmar, a country Doug is heading to shortly and one I'll be returning to later this year with some friends. I caught up with Doug fresh off a plane from Haiti, back home in Cambodia.

Doug has lived in Asia for the past 26 years, in 5 different countries and moved from country to country as each has transitioned, or been transitioning, allowing him to pick the low-hanging fruit.

He began in Korea in 1983, then Hong Kong in 1986, Thailand in 1989, Singapore in 2001 and moved to Cambodia in 2007.

Doug has had the good fortune of visiting nearly every Asian country during the 1980's and 90's. This allowed him a bird's eye view of countries in this region emerging and changing, which provided him with critical reference points to work with, something that many foreigners moving into Asia lack.

With that intro now behind us, I have had our most recent conversation transcribed below for your enjoyment. I'm sure you'll find Doug's thoughts enlightening... l always do.

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**Chris:** So Doug, why Cambodia?

**Doug:** Nearly five years ago I saw that Cambodia was a country that was in my view going to go from being just another "frontier market," to being an actual "emerging market," as so many other Southeast Asian countries have done.

**Chris:** Right, keen observation.

**Doug:** So I quit my job, I moved my family to Cambodia; I rounded up some friends and set up Leopard capital to create the first investment fund for Cambodia.

The challenging part was that the financial crisis was just unfolding and I had to raise the fund during the 2008/2009 crisis, after Lehman had gone bankrupt and all the investment banks were tottering. So it was a challenging environment, but we managed to raise this fund from over 100 contrarian investors. Now we've fully-invested that fund and are looking for opportunities in other frontier markets around the region.

**Chris:** That's an interesting point that you bring up, discussing the Lehman collapse while we're discussing frontier markets. With the developed world facing some very, very serious problems, as a result, almost as a defensive measure, although that's not in our nature, we are inclined towards investing in what are somewhat uncorrelated markets, which coincidentally hold great potential. With regards to choosing unrelated, uncorrelated markets, what's your view of Cambodia and Laos relative to the west?

**Doug:** Well actually I think one of the drivers of our strategy was that we started with a a very negative view of the world economy. Our Chairman is Dr. Marc Faber of the Gloom, Boom & Doom Report, and one of our Directors is Dr. Jim Walker, an Austrian school economist that was equally prescient in calling the collapse of the

West. So, we were guided by an aversion to traditional investment strategies, and a desire to find defensive or uncorrelated opportunities.

The countries we focus on, like Cambodia, Laos, Myanmar, Bangladesh and Haiti are on a very different trajectory than the rest of the world economy. In most cases, they're coming out of fifty years of gross mismanagement or war, and are just not very integrated into the world economy. They are starting at the bottom and have very little to fall. It's like the Developed World is standing on top of a step ladder and we're sitting on the floor.

There's not much downside when you haven't leveraged your economy up or relied heavily on Western consumer spending as your economic base.

So, these countries are being driven almost entirely by domestic factors or intra-regional Asian trade and investment, rather than a reliance on leverage or financial engineering, or extensive trade with Europe or the U.S.

**Chris:** I can't argue with that.

**Doug:** So, in our view frontier markets are bottom-up opportunities, they're not that correlated, riding on global trends or whatever. They're isolated countries that are finally getting their act together and entering the modern world. And when investing in a country like Cambodia, there's really no need to watch CNN or CNBC or Bloomberg because what's driving your investment returns is so localized.

**Chris:** Fascinating. That's something that Mark and I focus on.

When you're dealing with a company for example, and you're dealing face-to-face with the CEO and with the underlying fundamentals relevant to that particular business, then a lot of that, shall we call it noise, becomes a whole lot less relevant. It provides us with a lot more control over our investments, and certainly a greater level of confidence and understanding of that business, which allows us to ride through any events that could otherwise move us out prematurely.

I think that's what you're getting at here. When you're dealing on the ground in places like Cambodia, you're getting your information from sources that you're accessing directly and you're not reliant upon media and what often amounts to a lot of BS, or "marketing speak" from the news channels.

**Doug:** I agree completely. Our investment strategy, to give you an idea, is that we're simply betting that these countries are going to change. They're going to outgrow the rest of the world economy by becoming less inefficient, by improving their infrastructure or by improving their investment environment through greater political stability or more friendly regulations.

We're betting that the forces that have powered the whole region will spread across borders as the barriers come down. So, the theme of regional integration means that you should buy the poorest house in the neighborhood and sell the richest house because the whole neighborhood is becoming more integrated and uniform.

**Chris:** I just want to tap into a point that you made regarding integration.

If you're looking at integration that is forced by a bureaucracy, like that of the Eurozone and the one currency, those sorts of integrations are often at odds with market forces. We're clearly seeing the outcome of that in Europe. Whereas if you look at Asia, there are multiple countries that have dragged themselves out of poverty, one after another.

We're potentially seeing that taking place right now in Myanmar, where they've literally tried every disastrous policy one can think of for as long as I can remember. At the same time, they've had the ability to look around at their neighbors and see what they've been up to and realize there exists a better way. I wonder whether that is something they're legitimately moving towards.

In Cambodia I actually passed on what was to become a fabulously successful real estate development three and a half years ago. At the time I preferred to allocate my capital elsewhere, which, in retrospect I clearly wish I hadn't done. Even now though Cambodia seems relatively cheap in terms of real estate. What are your thoughts on that?

**Doug:** Well, like all frontier markets, Cambodia is an inefficient market. Price discovery is not easy there. That's a favorable environment for a locally-based investor because you can stumble across some very good deals. In these sorts of countries what you do not want to do is go to the leading property agency and say, "What properties do you have for sale?" because then you pay the full market price.

**Chris:** Absolutely. What Mark refers to as the "gringo price" (Laughs)

**Doug:** But if you go in through building a local network, and you find out who needs money and needs to sell something quickly, then you get an entirely different price structure.

**Chris:** Yes, of course. We have friends doing that successfully in other parts of Asia and Latin America as we speak.

**Doug:** Secondly, like many Asian countries where there is only one city of any real size, normally the capital city, the rest of the country is an under-developed countryside.

Prices tend to be expensive in the downtown capital cities across Asia, because that's the easiest property to access or to value. Once you get into the countryside the prices vary widely from lot to lot.

The land value can be unlocked if the government decides to build a new road, a bridge or other infrastructure. You might get ten times the upside if your remote beach suddenly has a road leading to it, for example.

So this is what's going on. People are, as you said in your recent post, front-running liquidity, getting ahead of the infrastructure projects. That's always a good strategy in a frontier country or market because it takes a while to get infrastructure funded and built, and all along the way there's a value escalation. You can play that trend as a fairly easy way to invest.

**Chris:** I spend a fair chunk of my time in that part of the world, as you well know. If I look around Thailand, where we typically base ourselves, it seems to me that we've got this credit-fueled boom driving the speculation that accompanies easy credit.

I've noticed this in Bangkok, and places like Phuket, Pattaya, and Manila too. Vietnam is a different story, and fundamentally it makes much more sense.

As an investor, there is reason to be attracted to a market where liquidity is lacking and price discovery is difficult.

What are the credit markets in Cambodia like with regards to financing of real estate? How about the speculation that might come with credit and increased liquidity?

**Doug:** I should point out that Cambodia has a very under-developed banking market. Although there are 30 banks already, and new ones coming in all the time, the total loans to GDP are around 30%. It's not a leveraged economy like we're used to in the West.

Even during the global banking crisis of 2008/2009 no Cambodian banks had to be rescued, bailed out or shut down. Cambodia's banks sailed through the crisis because they have conservative lending practices. As an investor in banks, or from a macroeconomic viewpoint that's a good thing.

However, as an investor in real estate you're on the other side of that. You're dealing with bankers who are very traditional, very conservative; a typical loan to value ratio might be 30%. The banks only lend against land titles, so businesses or investors who have a land title to pledge can usually get some financing, particularly if it's an urban environment where it is easier to value the land. If you want to finance something in a rural area there might be fewer banks willing to take that risk.

**Chris:** Interesting.

**Doug:** So, generally most investments in Cambodia are equity financed. Leverage is an exotic concept to most investors here.

**Chris:** Which provides me a whole lot more comfort. I mean, the risk level simply rises with leverage, everybody understands that. Buying into un-leveraged, illiquid markets provides the opportunity to have values increase with the liquidity of those very same credit markets.

You've spent such a long time in Asia. If you go back ten years in Cambodia and look at the banking infrastructure and credit markets that existed then, what's your viewpoint now given what you've seen on the ground? How are they developing that?

**Doug:** The banking system is growing. The loan growth in Cambodia is impressive on a global basis. We've invested in the largest bank here, and they're getting about 30% loan growth going forward, after having even higher rates in the past. Because it's still a virgin market for the banks, there's still a lot of relatively safe lending available. Eventually they will likely get into more exotic uses of their capital.

Like I said earlier, the main feature of the credit market in the last few years is the vast increase in the number of banks here. Cambodia operates a liberal, laissez faire philosophy towards business, where the government doesn't get in the way and try to dictate the rules too much. Rather they open up the markets and let everybody come and the best ones can survive.

**Chris:** Right. What a concept huh?

**Doug:** Exactly! It's really like free market capitalism the way the world used to be. Even if we compare Cambodia with Thailand, whose economy is 30x as big as Cambodia's, there are 30 banks in Cambodia versus 15 in Thailand, and nine cellphone operators compared to just three or four in Thailand.

Cambodia has a very different approach to business than most of Asia. It forces prices down for consumers due to the free competition. The government also doesn't intervene or distort the price signals by setting a lot of subsidies or minimum prices on things. It really is one of the most free market environments around.

**Chris:** Doug, that free market environment you just described bodes pretty well for an economy on the whole. What are the things that you're currently looking at, or feel have the most risk/reward potential in the country?

**Doug:** Our fund has a very broad mandate. It can invest in almost anything as long as it's not harmful or too controversial.

**Chris:** No slave trading then!

**Doug:** Right, absolutely not. So, we've been able to try out various strategies and invest in quite a few different sectors. But, ultimately our portfolio is focused on three main themes. One is bringing financial services to the rural areas, because that is where there's minimal competition and the margins are the best.

**Chris:** Right, that's usually the case globally.

**Doug:** This also provides a nice social benefit, giving poor people access to finance. We've invested in both rural banking and micro-finance, and these have been good investments.

Even though there's a lot of banks here, there's scope to expand banking services into areas like trade finance, auto loans, leasing, and other things beyond property-based lending.

The second theme has been bringing basic utilities to rural areas. We've found there's more affordability in the countryside than most people would expect. There's a large underground economy, and being a farmer in the last few years has not been the worst profession, due to the higher crop prices.

Around 80% of Cambodians live in the countryside, and many are willing customers. They want electricity, cellphones, and bank accounts. We've invested in all these areas and are happy with the returns so far.

The third area has been the whole food production value chain, all the way from agriculture to producing branded food and beverage products.

That is an area that still has a lot of opportunity for growth, because when you go to a grocery store in Cambodia many of the labels are written either in Thai or Vietnamese since the products are being imported. Most of the local Cambodian consumers cannot read those languages, so they're not really sure what they're buying. It seemed to us that creating high-quality local products, with labels written in the local language, would be a good concept to invest in.

So far we've focused on beer, mineral water and shrimp. As for agriculture, you can see in the countryside that a lot of people are still farming the same way their ancestors did a thousand years ago, with cows pulling wooden plows on small lots.

**Chris:** That's what we would have seen in places like in Chiang Mai as little as 10 or 15 years ago.

**Doug:** Exactly, when my wife came to Cambodia she said it reminded her of her childhood back home in Northern Thailand. Thais of her generation have watched their country leap from Cambodia's current level, to middle-income country status.

The modernization process is now starting in Cambodia's rural areas, and the people there are starting to get plugged into the rest of the country through better roads, cellphone networks, schools, and jobs for some family members in Phnom Penh's garment factories. They start to use banks instead of money lenders. They watch TV. But still, Cambodia doesn't have everything yet. It's going to get much better over time, and the trend will play out for a couple decades as it did in Thailand.

So those three areas are our core investment themes and they are really applicable to all frontier markets in Asia.

**Chris:** This segues nicely into another question I've been pondering. When investing in early stage companies, how do you include those positions for the fund? From the perspective that your funds have a ten year lifespan, and you need some sort of exit strategy to be able to return the money to your investors, how do you deal with that?

**Doug:** With every investment we make, the first thing we have to consider is how could we get out of it.

We use different strategies. There's no cookie cutter approach. One thing we look at is the unusual interest that multi-nationals have in accessing new emerging markets like Cambodia, where there's still not a lot of brand awareness yet. The population is very young, so it is a tantalizing market to multi-nationals whose home countries are stagnating.

Pioneer investors like Leopard can front-run the multi-nationals by creating new businesses they will want to acquire later. You discussed Front-Running Liquidity in a recent post, it's a great strategy.

For example we've started a small world-class beer company in Cambodia called Kingdom Breweries. If we look globally, the beer industry consolidates and independent local brands get bought out by multi-nationals. However, most of the beer giants are still not in Cambodia yet, so we're creating a vehicle that they can buy later and gain instant access to the market whenever they decide to come in. There aren't many other candidates for them to buy.

**Chris:** Savvy, very savvy!

**Doug:** That's one of our pre-planned exit strategies, a trade sale to a strategic investor.

We're also creating a bottled mineral water company to flip to a multi-national. We create a cool brand and build a factory with the same technology and equipment that a multi-national uses, and even hire retired managers that worked for the same multi-nationals that we aim to sell to later. We can create a company that will fit very nicely into a multi-national's global portfolio later.

M&A is really our core exit strategy.

A second one is using the business' cash flow to provide our returns, usually through high-yield debt, enhanced with an equity kicker so that we get both a fixed return plus a variable return based on performance.

That structure works best when the cash flow is predictable, usually not in a startup unless there's a contract in place providing visibility into the cash flow generation. For example, we financed a new power grid this way, as their income is steady.

A third strategy is investing in companies just before they go public. Here the best approach is to take a small stake in a large company so that you are not subject to a lockup period. We invested in the biggest hydropower company in Laos, and the price doubled after it went public, allowing us to take some nice quick profits.

**Chris:** We love hydropower. Mark helped seed a run of river hydropower company in Nepal, which is another Frontier Market Worth Exploring.

**Doug:** Our fourth strategy is to sell our position back to the company's promoters or co-investors. In some cases owners may want us in their company for a period of time while they are scaling up. So we can sometimes negotiate put options or pre-planned sales back to our co-investors.

**Chris:** Okay, interesting.

I was just thinking about some of these countries - the Philippines and Vietnam jump to mind - where the manner in which businesses tend to operate with regards to record keeping, is, shall we say, a bit "spotty." Private companies often don't keep reliable books, and there's no receipts in terms of taxes paid or anything along those lines.

What they do is wait for the government tax official to show up and then sit down with the guy, have a beer and negotiate a "price." This is why government numbers in these places are so skewed and unreliable.

This is incompatible with functioning capital markets and transparency for investors. In order to encourage private companies to go public, it means that the old way of doing things has to change regarding book keeping and taxes.

Mark feels this is the main reason the Chinese reverse mergers blew up so spectacularly. A good number of those companies were either fudging the numbers somewhat, or just out and out lying. They had no intention of changing.

Essentially, accessing the capital markets needs to be more productive and economic than fudging the books in order for the liquidity to come to these markets.

On the Cambodian exchange, which opened back in July of last year, one of the problems that they naturally had was there weren't any national companies ready to go public yet. Do you think that the environment is getting better and more attractive for companies that are considering going public, and what is the state of play within the exchange now?

**Doug:** The "three sets of books," which is what you are discussing, is something common to all Asian counties; it's a traditional family business approach to running a company. In our case we tend to avoid the problem through the way we screen partners.

We don't go to the big local tycoons and say, "We want to invest in your old-style family business and make you modernize it." Rather, we tend to seek out younger companies and start-ups, and set the governance and accounting policies from early on.

100 percent foreign ownership is allowed in Cambodia, so often we are investing alongside other foreign investors who want transparency as much as we do. Or, we may invest with Diaspora returnees who learned the Western style of business while living abroad.

Companies that have multiple sets of books and underpay their taxes are not suitable investment targets for our fund.

**Chris:** Right, they just can't be fixed that easily, it's more hassle than it's worth in most cases.

**Doug:** Developing a stock exchange is an important driver for the economy and for modernizing business practices. A listing gives a financial incentive for traditional companies to become more transparent because they will get a higher market valuation if they report all their profits. Competitors who choose to remain unlisted usually have higher financing costs than those who clean up their books and list.

In Cambodia they've launched the stock exchange as an organization, but haven't listed any companies yet. The launch of trading has been delayed several times already, so no one really puts much faith on the planned start date, which always seems to be a moving target. But, I'm sure it will happen eventually, as the government really wants an exchange and some companies do want to list.

A few brokerage firms have set up trading floors and have hired analysts to write research. Two things are holding back the launch of trading. One is that not all the legislation has been finalized, like the ecommerce law and updating the share ownership registration procedures.

Secondly, only one company has applied and been approved to list their shares, and the Exchange wants to start with two. The Laos stock exchange opened with two companies last year.

**Chris:** And interestingly the demand for the shares of those companies was very strong.

**Doug:** Initially they were great fun. Since then trading has died down. They need some new listings to stimulate it.

**Chris:** They need to go further with those initial listings. But irrespective of the stock exchange, I think the critical point that you've made is that a stock exchange isn't a prerequisite to investing in a particular country. It makes it a little bit tougher without one, and illiquidity is of course an issue without a smoothly functioning capital market.

The flipside of that is that price discovery is more difficult and buying assets at ridiculously cheap valuations is possible. In a fully-functioning, liquid capital market those opportunities are harder to find and usually priced in.

**Doug:** Right. Yes, the inefficiency can be your friend because it allows you to stumble across deals that shouldn't be priced the way they are.

**Chris:** In terms of the growth in Cambodia the rate in 2010 was around 6% if I remember correctly. What do you see going forward?

**Doug:** I think Cambodia's natural GDP growth rate is around 8%, and I believe we'll see that rate going forward. If it goes above 8%, you start to draw unproductive real estate speculation. When the world economy lurches downward, Cambodia's economy dips temporarily before bobbing back up to its natural growth rate.

The average age of Cambodia's population is just 21, so roughly 300,000 people reach the working age every year, going from being dependents to economic contributors. So, the labor force is expanding by roughly 3% per year and its quality is continuously improving because education is getting better - from a very low base.

In the late 1970's Cambodia's school system was shut down by the Khmer Rouge who murdered a lot of its most educated people. They decimated the talent pool. But in the past two decades there has been a gradual re-normalization of the economy and the social system, and literacy rates are rising.

There isn't a safety net or minimum wage, so everyone basically has to find work. You have this upgrading and expansion of the workforce, coupled with factors like higher commodity prices, rising foreign investments, better infrastructure and greater inter-regional trade. All of these things underpin an 8% baseline growth rate without much correlation to the world's advanced economies.

**Chris:** Doug, thank you very much, it's been fascinating!

**Doug:** My pleasure Chris, any time.

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Chris again... Clearly Doug and his partners have executed on a thoughtful and prudent strategy for investing in frontier markets.

As an individual investor it can be tough to penetrate new, emerging capital markets, but Doug lays out some very good examples of how an investor should be "thinking" about ways to do so. There are myriad opportunities available for entrepreneurs, investors and speculators if you learn the patterns that occur in every developing market.

If you have questions for Doug just drop us a comment, or an email and we'll pass it along to him!

- Chris

*"Having emerged from its dark 1970s past, Cambodia is solidifying the remarkable progress it had made since its 1990s embrace of free market economics. The country's 9.8% GDP growth rate over the 1998-2007 decade ranked sixth in the world and fastest in the Far East, after China."* - Leopard Capital