Can Frontier Markets Deliver?

"WE ARE TARGETING HIGH RETURNS OF AT LEAST 30%," SAYS ONE FUND MANAGER

By Peter Shadbolt

Poor, corrupt, politically unstable, and disaster stricken, Haiti might not seem a top pick for most fund managers, but for the growing breed of frontier investors, cases like the Caribbean republic tick all the boxes.

Seeking opportunities in places that have low market capitalization and poor liquidity but also a resilient and resourceful population with a huge capacity for hard work, frontier funds kick over the tailings of economies that are generally believed to be either exhausted or pre-emerging.

In many cases, they're finding sizable nuggets, clocking returns of 25–35% a year.

Like a realtor that drives around the outer ring of a city looking for properties just outside the reach of gentrification, Doug Clayton, CEO of frontier fund Leopard Capital, uses a negative correlation when deciding where to invest. "Haiti is our latest frontier investment," he says. "People said we were mad to go in there, which is always a pretty good indication that we should be there."

KEY POINTS

Return-hungry investors are targeting high-growth "pre-emerging" markets where perceived risk exceeds actual risk.

Certain Southeast Asian countries are generating excitement and attracting frontier funds.

Frontier investing challenges include monetizing "tiny" opportunities, dealing with endemic corruption, and overcoming a lack of experienced company managers.

Leopard Haiti Fund is targeting established companies that are engaged in four sectors: tourism, construction, renewable energy, and food production. It's also eyeing opportunities in the sewing and textile industry (one of the island's major employers).

So far, Leopard Capital has almost fully invested its funds in some 12 different investments, gaining three early exits and reportedly grossing a return on investment of 35% on all the funds (if blended together). "We are about three-and-a-half years into an eight-year fund," Clayton says. "We have some time left."

Most recently, Clayton has been in Thimpu, Bhutan, looking at a potential investment he did not want to disclose. A far cry from the boardrooms of most fund managers, Clayton's line of work sees him more likely to be contending with the Himalayan city's stray temple dogs than with a PowerPoint presentation about a profit–growth matrix.

The appeal of frontier markets isn't hard to understand. These economies are expanding rapidly at a time when much of the rest of the world is stagnant or in decline. "Global investors are increasingly worried about their traditional investments and are eager to find something that will give them some alpha or even some beta," says Clayton. "They are getting crushed on a lot of things, like real estate or currencies or equities or bonds. Things that used to be considered safe have turned out to be much more risky than they thought. Even on bonds, the risk profile has gone way up."

Clayton isn't alone in his assessment. "Investor appetite towards frontier markets is strong," says Marvin Yeo, managing partner of Vietnam-based Frontier Investment & Development Partners. "With an increasing global population and globalization, we see the world as a giant convergence trade; there is limited growth left in developed markets, but asset prices are still relatively high."

"We are focusing on high-growth pre-emerging markets that are resource rich and politically stable and where the perceived risk is higher than the actual risk," he continues. "Investors that have already filed into China, India, and Indonesia may need to go further out on their risk, and this is where frontier markets come in."

But frontier markets are also tiny relative to other global asset classes. "The challenge is just, how do you monetize this opportunity as a foreign investor?" says Clayton. "Some things that we have done have worked very well, and some things have proved to be harder than we thought."

BIG OPPORTUNITIES IN SOUTHEAST ASIA

As the BRIC economies (Brazil, Russia, India, and China) show their limitations in the wake of the global financial crisis, Southeast Asia is emerging as a prime target for frontier funds. Compared with many other regions, it is relatively underinvested, which is exactly the kind of opportunity frontier investors look for.

The BRICs turned out to be much more integrated into the global economy than many expected, whereas Southeast Asia had quietly decoupled more than a decade ago, forming its own free-trade zone within its own ASEAN (Association of Southeast Asian Nations) bloc. China plays a part in this story too. Chinese investment is leading to improved infrastructure in previously remote regions of Myanmar, Laos, and Cambodia, so goods and services can be moved around more easily and their economies can expand.

The region has another advantage. Southeast Asia went through its major financial and economic crisis in the late 1990s, which has helped to position it for growth now while many other economies are still struggling through an extended downturn.

"Southeast Asia is coming out of its long down cycle in pretty good shape," says Clayton. "It has a healthy banking system and a comparatively much healthier property market,

all of which is showing the limitation of the BRICs economies."

Recent economic stories of countries such as Laos give cause for investor optimism. Landlocked, isolated, hilly, counting almost half its gross domestic product in subsistence farming, and deriving 45% of its energy from firewood, Laos may not sound like a good bet. But the country is embarking on massive hydropower schemes in an attempt to turn its strategic position (sandwiched as it is between Thailand, Vietnam, Myanmar, Cambodia, and China) to its advantage.

Touting itself as the "Battery of Asia," it has an estimated potential of 26,000 megawatts (mw) of hydroelectricity, most of it earmarked for export to its energy-hungry neighbors in Thailand and Vietnam.

According to Soulivong Daravong, the Laotian minister of energy and mining, 10 hydro projects are currently under construction. In 2010, the massive Nam Theun 2 dam began operations and is expected to deliver a projected US$2 billion in revenue to the government over the next 25 years. "Fifteen years ago, we only had 200mw of capacity," Daravong says. "As of today, we have 2520mw."

Laos is currently on track to post 8.3% GDP growth in 2012, according to the IMF, making it the fastest-growing economy in the region. As the country's fortunes turn, the government's attention is slowly turning to the domestic market.

"We used to use this power purely for export, and only a small percentage was used inside the country, but more and more, the private sector is looking towards the domestic market and the timing right now is good for them," says Daravong.

The power market is now one of the fastest-growing sectors in the Laotian economy, expanding as much as 19% a year. "Mining activity is increasing in our country—in particular gold and copper—and all of this takes energy to extract," Daravong adds.

Financing projects on this scale has been outside the scope of the country's budget, but development banks and frontier investors have not been slow to see the attractiveness of the Laotian hydro story. "The government can only finance a very small number of projects, so we've approached foreign direct investors and the private sector to build these projects," says Daravong. "They sometimes hold a 100% majority. The government now holds only 10% or less of these projects."

ASEAN economic integration, planned for 2015, is also likely to provide an additional boost to Laotion growth prospects by creating a single regional market, removing tariffs, and revamping customs and labor migration laws. Hydro projects have been developed with integration in mind, and long-term power-purchase agreements have been arranged with other countries. "The lenders also ask for power purchase agreements," says Daravong. "Up until now, hydropower projects in our country have been competitive, especially as far as Vietnam is concerned, where the markets are freer. But with countries where the government sets the tariffs, it's a little more difficult," he says. "We are currently negotiating with Cambodia, but we need long transmission lines from our projects. At this stage, we are also trying to develop some projects very close to the border, which maybe later will come on-stream when they require the electricity."

GAME CHANGERS

Another Southeast Asian country also is showing signs of standing on its own feet. Cambodia, once regarded as a spillover investment from Vietnam, is starting to produce strong returns for frontier funds. Regional players have expanded into Cambodia. Vietnam's largest asset manager, Vinacapital Investment Management, launched a US$100 million dedicated fund in 2011 targeting Cambodian real estate, infrastructure, hospitality, and agriculture investments.

Leopard Capital's investment in a hydropower scheme has shown annual returns of 66% on a partial exit, and the country's first mobile telephone group, CamGSM, is showing an initial rate of return of 25–30%.

"Cambodia is positioned to outgrow most of the world, as it has avoided any debt crisis, has a young population willing to work hard for modest wages, and is resource rich," Clayton says.

Cambodia's energy infrastructure still bears the scars from decades of war. The country imports 67% of its power from Vietnam, 32% from Thailand, and 1% from neighboring Laos. It currently needs investment of more than US$1 billion in its energy infrastructure.

Only 35% of the population is on the national grid. The country imports more than 45% of its electricity, and its electricity prices are among the highest in Asia, with some rural areas paying as much as US$1 per kilowatt hour.

Meanwhile, demand for power is expected to increase by as much as 500% over the next 15 years, reaching about 3,000mw by 2050. The country has long-term contracts to get power for the next 25 years from its neighbors in Thailand and Vietnam, but the focus is on gaining its own generation capabilities.

Ith Praing, Cambodia's secretary of state for energy, says his country is almost completely dependent on public–private partnerships to develop its infrastructure because of the country's difficulty in accessing the soft loan market. As Cambodia's GDP catches up, money from the soft loan markets could start to become available.

"Some loans from exim [export–import] banks or commercial banks stand at 6–7%. If we compare this with the interest rates for public–private partnerships, there's not very much difference," he says.

Other methods of raising finance, such as a bond market, are currently beyond the scope of Cambodia's financial infrastructure. "We simply don't have that kind of financial system at this stage," says Praing.

Marvin Yeo of Frontier Investment & Development Partners believes Cambodia's energy paradigm has the potential to offer even more upside than that of Laos. "Laos has a lot of similarities with Mongolia; it's landlocked, with a small population and a large land mass," says Yeo. "There are a lot of big opportunities in the resource and agricultural sector, and there are smaller investments available in financial services, hospitality, and manufacturing. Our fund is looking primarily at agricultural processing opportunities."

Even though Laos has numerous hydro and mini-hydro opportunities, Yeo's firm prefers the power sector in Cambodia "because it has one of the highest power costs in Asia,

resulting from the huge gap between demand and supply." And arbitraging this disparity has worked well for FIDP. "We are targeting high returns of at least 30%, which is commensurate with the perceived risk of investing in frontier markets," Yeo says.

FIDP's biggest investment has been a leading commercial bank in Cambodia. "That one is really impressing us—almost every quarter they exceed our forecast," says Yeo. "The bank has successfully expanded into Laos and has slowly become profitable there, and it now has a license to expand into Myanmar, which is a country four times as big and with the exact same model. It should work really well there. This is the one that, when we look back on it, we are really happy we bought this. And, fortunately for us, we put a big bet on this one."

The new market on the block, Myanmar, could be the game changer in the region. With a population of 60 million and a GDP of US$45 billion (an undeveloped economy that is already three times the size of Cambodia's yet less than half that of Vietnam), it is poised to be one of the fastest-growing markets in Asia over the next few years as it emerges from decades of stagnant growth under a military dictatorship.

"It adds a lot of excitement to the ASEAN story as well as the frontier market story, which has a slightly different geography," says Clayton. Leopard's fund has identified three main opportunities. The first is real estate. "This is one of the only real estate markets in the world that is really undersupplied, and there is going to be a lot of money made," says Clayton. "It needs billions of dollars invested in a short time to bring it back to regional averages."

The second focus is likely to be on corporate private equity to modernize local family businesses that have never faced foreign rivals. "This will make them ready for the multinationals that are about to pour in," he says. "The third opportunity is to invest with the multinationals, some of whom need help in unrolling their businesses in Myanmar."

RISK MANAGEMENT

While the returns for frontier investment can be stellar and investors can benefit from a strong pick (often made at the bottom of the market), the weak investments carry with them the flavor of catastrophe.

While the Cambodian commercial bank has been the star player in Leopard Capital's portfolio, other investments have tanked. The worst was a seafood company in Cambodia, "where we had to take a write-down and got into a legal battle, which we recently won in a Cambodian court," he says. "The whole thing was a very costly and time-consuming mistake."

In his view, the cause of failed investments invariably is poor management. "The number one problem in frontier investment is execution and human resource capability," says Clayton. "Because you're dealing with small to medium-sized companies that don't have the budget to go out and hire world-class star management, if something goes wrong, you can't go to a headhunter and get the best guy in the world like you would be able to at a big investment firm." Thus, frontier investors have to stretch smaller budgets and take chances on inexperienced and unproven management teams.

For Marvin Yeo, skirting trouble spots by treading in the shadow of larger players is par for the course. "The legal and regulatory frameworks in these markets are not as well developed as in other markets," says Yeo. "There can be a cowboy element, but we try to mitigate these risks this by having good people on the ground and by working very closely with developmental institutions. In terms of this, we've paid our tuition fees over the years and are now in a strong position to execute."

Yeo stresses the importance of development institutions. "These are some of the poorest countries in the world, and they are heavily dependent on development institutions," he says. "So, while the risk of expropriation or risk of a powerful local entity muscling into a successful investment is always there, it is mitigated by working closely with these development institutions."

Corruption is another major concern. It's often said that borders attract brigands, and frontier funds, more than other established fund classes, have to contend with endemic local corruption. Governments are increasingly reluctant to tolerate or become involved in deals that, through corruption, could later backfire or have unintended consequences. But corruption remains an important consideration for fund managers.

Clayton believes corruption should be viewed as simply a part of the landscape. "Certainly, we wish that there was no corruption and everything was transparent, but that is unlikely to happen in our lifetime," he says, noting that corruption is a problem even for developed economies. "It is not a reason to avoid these countries, but it is a reason to operate very carefully—to avoid certain sectors and certain practices—but you can't just skip countries because they might be too corrupt."

Generally, highly regulated sectors with heavy government involvement send out the most warnings or signals. Although Cambodia consistently is ranked low in corruption by many indices, Leopard Capital still avoids certain sectors in the country and concentrates on those that are more resistant to corruption. "In our portfolio," says Clayton, "[corruption] is not a major barrier to success because we invest carefully."

Peter Shadbolt is a freelance journalist and writer based in Hong Kong.

KEEP GOING

***Frontier Market Equity Investing: Finding the Winners of the Future*, Research Foundation of CFA Institute (www.cfapubs.org)**

"The Mist of Myanmar," *CFA Institute Magazine* (July/Aug 2012) (www.cfapubs.org)

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