The Case for Asia's Frontier Markets

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Asia Frontier Capital was created by Thomas Hugger through an MBO of Leopard Capital's Frontier Asia Fund, which was consequently renamed "AFC Asia Frontier Fund". The fund launched in March 2012 and has gained +9.0% in 2013 and +16.6% over the last 12 months. The AFC Asia Frontier Fund (ISIN: KYG0132A1013) invests in listed equities of companies that have their principal business activities in Bangladesh, Cambodia, Iraq, Laos, Mongolia, Myanmar, Pakistan, Papua New Guinea, Sri Lanka, and Vietnam and accepts monthly subscriptions from both US and non-US investors. The minimum subscription amount is USD/EUR/CHF 50,000.

I visited Karachi last December at a time when Pakistan was perpetually in the news for its sectarian violence, political uncertainty, and growing Islamic fundamentalism. But despite its reputation, congested traffic, and frequent power outages, I saw sparkling new shopping malls filled with Western fast-food franchises and was met with companies capitalizing on Pakistan's expanding middle class and growing consumption levels. Unlike emerging markets such as India, China, and Brazil, which are now highly correlated with global markets and have slumped in response to the US Federal Reserve's decision to taper quantitative easing, the Karachi Stock Exchange is skyrocketing, with the KSE 100 Index up 46.5% YTD. Pakistan makes up part of the Asian frontier markets asset class, a far-flung assortment of exotic exchanges from Bangladesh to Papua New Guinea that offers attractive returns and a low correlation to global markets.

Mostly unknown, unheralded, and under-researched, Asia's frontier markets have begun to attract investor interest as the region's economies have grown and stock exchanges have soared. Countries like Vietnam, Bangladesh, and Sri Lanka have similar demographics to the tiger economies of the 1980s and 1990s but have the advantages of better technology and a more integrated trade environment than their predecessors. Today, Asian frontier markets – with their robust economic growth reflected in domestic stock exchanges – present an exciting investment opportunity that parallels the rise of China, India, and Thailand over the last few decades.

But what are the underlying catalysts driving this boom in Asia's frontier markets?

Lower Correlation to Global Markets

In general, frontier markets are relatively insulated – they tend to have low or negative correlations with global markets and are less affected by problems in developed countries. When the Federal Reserve announced recently that it would taper quantitative easing, it had a ripple effect across the globe, causing many financial markets to plunge and foreign currencies to slide against the dollar. Currencies in most Asian frontier markets, however, withstood the turbulence, and stock markets in Bangladesh, Pakistan, and Vietnam

Correlations Between Indexes	5 Year	10 Year
MSCI Indexes		
MSCI EM Index v MSCI World Index	0.91	0.88
MSCI Frontier Index v MSCI World Index	0.81	0.63
MSCI Frontier Asia Index v MSCI World Index	0.35	N/A
Country Indexes		
Pakistan: KSE 100 Index v MSCI World Index	0.31	0.30
Mongolia: MSE Top 20 Index v MSCI World Index	0.28	0.12
Iraq: ISXGI Index v MSCI World Index	-0.05	N/A
Bangladesh: DSE 30 Index v MSCI World Index	-0.68	N/A
Vietnam: VN Index v MSCI World Index	0.59	0.40
Sri Lanka: Colombo All Share Index v MSCI World	0.36	0.27

(Source: Bloomberg, based on monthly return data)

outperformed neighboring emerging markets like India, Indonesia, and Thailand. This is partially attributable to the relative obscurity of these stock exchanges, as foreign capital inflows to frontier markets pale in comparison to inflows to emerging markets.

With foreign participation and correlation to world markets still low, frontier markets are a very appealing choice for portfolio diversification. These economies are being propelled by the growing class of domestic consumers who will continue to buy mobile phones, biscuits, and auto parts regardless of whether or not Ben Bernanke reduces bond purchases. Countries like Bangladesh and Vietnam, which traditionally relied almost entirely on low-value agricultural exports, are experiencing robust economic growth as disposable income levels rise and burgeoning industries develop in electronic parts manufacturing, textiles, pharmaceuticals, machinery, and chemicals.

Promising Demographics

One of the key elements spurring frontier market growth is favorable demographics. The 10-country, pan-Asian universe in which Asia Frontier Capital invests had a combined population of 569 million in 2012, putting it third in the world behind China and India and considerably ahead of the United States and Indonesia. While labor pools are forecasted to shrink in Japan and Korea, the workforce is expected to grow by 35% in Pakistan, 31% in Cambodia, and 29% in Bangladesh between 2010 and 2020. This increase should buttress persistent economic growth as manufacturers capture the benefits of low-cost labor, creating jobs and raising domestic consumption levels.

Asian frontier markets are also experiencing massive improvements in education, political reform, and economic development. Increasingly educated labor pools are helping these countries become more globally competitive. In Sri Lanka, secondary school enrollment increased from 56% to nearly 100% over the past three decades, helping the economy pivot away from the traditional mainstays of tea, coconuts, and tobacco and towards manufacturing, IT services, and logistics.

In the political realm, there has also been vast progress, with conflicts winding down and governments drafting pro-business legislation as they realize the benefits of foreign investment. Cambodia and Sri Lanka have emerged from decades of instability and civil war, while Myanmar has unveiled a wave of recent reforms paving the way for increased political dialogue and economic liberalization. Hoping to shed its long-standing notoriety as a pariah state, Myanmar can look to Vietnam for guidance. Since Vietnam liberalized trade and restored ties with the US in the early 1990's, the country has joined ASEAN and the WTO, established two stock exchanges with almost 700 listings, and seen GDP and total exports balloon by over 8x and 22x respectively from 1994 to 2012.

It is not only Myanmar that is improving its economic environment. Southeast Asian frontier markets will see a major boost from the full integration of the ASEAN Economic Community (AEC), slated for 2015. The implementation of the AEC will encourage trade and investment by creating a single market and production base, removing intra-ASEAN tariffs, streamlining customs procedures, and enabling the free movement of skilled labor.

Asian frontier markets have also witnessed a significant population shift as an increasing number of rural workers move to cities, lured by job creation and improving infrastructure. This mass migration has already occurred in emerging markets and can be used as a template for frontier markets' development. In the BRIC countries (Brazil, Russia, India, China), 60.3% of the population lives in urban areas, and this rate is growing at 1.8% per year. In Asian frontier countries like Bangladesh, Pakistan, Sri Lanka, and Vietnam, only 28.3% of the population lives in cities, but urbanization is growing at 2.8% per year.

Forbes recently ranked Karachi, Pakistan's financial center, in first place on its list of the world's fastest growing megacities, with 80.5% population growth from 2000-2010. Dhaka, Bangladesh's capital, tied for fifth on the list, posting 45.2% population growth over the same period.

These rapidly growing urban areas will bolster growth in construction, infrastructure, and public services, as well as creating employment and increasing income levels. Migrating to cities encourages residents to participate in a more formalized economy, boosting both consumer spending and tax revenue. Keen to cater to rising levels of disposable income, businesses will look to expand, which ultimately drives further growth.

Country	*Urban population (% of total)*	*Mobile subscriptions per 100 people*	*Internet users per 100 people*	*Access to electricity (% of population)*
Bangladesh	29%	64	6	47%
Cambodia	20%	132	5	31%
Myanmar	33%	11	1	49%
Pakistan	37%	67	10	67%
Sri Lanka	15%	96	18	77%
Vietnam	32%	149	39	98%
Frontier Markets Average	**28%**	**102**	**16**	**64%**
Brazil	85%	125	50	99%
China	52%	81	42	100%
India	32%	69	13	75%
Russia	74%	184	53	100%
BRIC Average	**61%**	**115**	**40**	**94%**
USA	83%	98	81	100%

Source: World Bank

Despite their growth, frontier markets still have large numbers of people living without electricity. In Bangladesh and Myanmar, less than half of the population has access to power; that figure alone accounts for over 100 million people. As infrastructure improves and future generations can connect to reliable power, these populations will see substantial increases in productivity, industry, and growth.

Internet penetration, measured by the number of internet users per 100 people, is another untapped area. In Asian frontier markets, penetration averages 16%, contrasting to 40% for BRIC and 81% for the US. This translates to over 400 million people in the sampled Asian frontier countries who currently lack web access. The significance of this statistic should not be overlooked – a 2011 McKinsey report found that the internet accounted for 10% of GDP growth over the past 15 years in advanced economies. Harnessing the internet's potential will support rapid growth and increasing entrepreneurship in Asia's frontier markets moving forward.

Despite low access to electricity and the internet, frontier markets are using technology to sidestep many of the hurdles that emerging and developed countries once faced. Mobile phones, for example, are relatively widespread, allowing frontier market countries to leapfrog the inefficiency and high cost of installing landlines. The introduction of mobile phones has had a profound impact on populations in frontier markets through innovations in mobile banking, remittance transfers, and seamless connectivity – rural farmers can now check market prices with a phone call instead of a two-day journey.

Strong Economic Indicators

Asia's frontier markets have experienced solid economic growth which is expected to continue. Across the 10-country universe in which we invest, GDP growth averaged 7.2% in 2012 and is projected to achieve 7% this year. The IMF forecasts a 7% GDP compounded annual growth rate for these markets from 2011-2018, outstripping BRIC countries. In aggregate, the combined GDP of AFC's universe reached

US $867 billion in 2012, comparable to emerging and developed economies (larger than Thailand, the Netherlands, and Turkey; just smaller than South Korea, Indonesia, and Spain). Investing through local stock exchanges is an ideal way to gain exposure to this opportunity, as most frontier countries have listed equities across multiple industries.

Remittance inflows have been an important contributor to growth. Millions of diaspora and overseas workers send money home to their families, supporting domestic consumption and investment. This 'home country bias' indicates that foreign workers tend to invest in their countries of origin, rather than the countries in which they earn their livings. Remittance inflows account for 10.8% of GDP in Bangladesh, 8.7% of GDP in Sri Lanka, 7% of GDP in Vietnam, and 5.8% of GDP in Pakistan. As access to finance and mobile banking increases, remittance inflows will continue to grow and drive economic growth.

Foreign direct investment (FDI) is surging into frontier markets to capitalize on rich endowments of resources, low labor costs, and growing consumer markets.

Frontier markets in Asia have enormous reserves of commodities, including oil (Iraq), liquefied natural gas (Papua New Guinea), copper (Mongolia), timber (Myanmar), and hydropower (Laos). Exxon Mobil's US $19 billion LNG project in Papua New Guinea is slated to double the country's GDP, and FDI has supported the boom in Mongolia's mining industry. Iraq is experiencing an unprecedented oil boom, attracting energy companies from the US, China, and Europe. Alongside these natural resource projects, supporting industries in construction, real estate, infrastructure, and consumer products have sprung up as expatriates arrive and foreign cash flows in.

But Asian frontier markets are much more than just a commodity play. Low labor costs are luring manufacturers from traditional hubs like China and Korea. In the 1980s, China's Guangdong Province became a hub for export manufacturing and a powerful contributor to the country's economic growth. But double-digit wage increases in China and a strengthening Renminbi have caused a steady migration of manufacturers to cheaper locales like Vietnam, Bangladesh, and Cambodia, where operating a factory costs far less – Cambodia's US $80/month minimum wage is one-third of China's.

Asia's Frontier Markets Resemble Emerging Markets in Previous Decades

Country	GDP growth (%)	GDP per capita (current USD)	Market capitalization to GDP (% of GDP)	Power consumption per capita (kWh)	Value-add industry (% of GDP)
Bangladesh	6.3%	$747	15.0%	274.4	28.5%
Cambodia	7.3%	$946	N/A	143.8	23.5%
Mongolia	12.3%	$3,673	12.6%	1554.5	32.9%
Pakistan	4.2%	$1,290	19.0%	457.8	25.5%
Sri Lanka	6.4%	$2,923	29.0%	449.2	29.9%
Vietnam	5.0%	$1,596	23.0%	1034.6	39.9%
2012 Average, Frontier Markets	**6.9%**	**$1,862**	**19.7%**	**652.4**	**30.0%**
South Korea, 1979	6.8%	$1,747	N/A	880.6	36.0%
Thailand, 1986	5.5%	$813	N/A	434.8	33.0%
China, 1998	7.8%	$821	22.7%	870.5	46.2%
India, 1998	6.2%	$425	24.5%	383.6	25.7%
Indonesia, 2004	5.0%	$1,222	28.5%	478.6	44.6%
Historical Average, Emerging Markets	**6.3%**	**$1,006**	**25.2%**	**609.6**	**37.1%**

Source: World Bank, UNESCO

Luckily for less developed nations like Cambodia and Bangladesh, a development model has already been established in Asia: countries start out producing low-margin, low-cost goods for export, and as income levels rise and technology improves, they begin to produce more advanced goods using increasingly skilled labor, seeing corresponding rises in income and development along the way. This ultimately leads to a transition from a lower-income, export-driven economy (i.e. Cambodia) towards a middle-income, domestic-consumption based one (i.e. Thailand).

Consumer classes in Asian frontier markets have already begun to expand rapidly and multi-national corporations have taken notice as they compete to access "untapped" customers – Ford and Coca-Cola have recently entered Myanmar, McDonald's has plans to open in Vietnam, and Honda and Toyota have unveiled showrooms in Cambodia.

FDI, which historically came from the West, is now chiefly coming from Asian powerhouses such as China, Japan, Korea, Singapore, and Thailand. In Myanmar, 80% of FDI comes from China, Thailand, and Korea, a figure that will be sustained by Thailand's ambitious plan for a US $50 billion industrial hub and deep-sea port at Dawei on the Andaman Sea. China has invested heavily across Asia's frontier markets, from a US $7 billion fast-speed rail project it is financing through Laos to a US $2.9 billion debt facility it has extended to Papua New Guinea. In contrast, many Western companies and governments are looking to play catch up with their Asian counterparts, as some of these markets have historically been off-limits (Myanmar, Iraq) or ignored (Laos, Sri Lanka).

Infrastructure, long a hindrance for exports and efficiency, is improving rapidly. Bangladesh aims to curb its infamous traffic jams with a US $2.8 billion metro rail system in Dhaka and Sri Lanka's ports and container terminals are undergoing a massive overhaul thanks to Chinese financing.

Ignored and Unheralded Capital Markets

Despite the positive indicators, frontier markets are often ignored by investors due to perceptions of illiquidity and high risk. Larger funds tend to be deterred by foreign ownership restrictions and a lack of custodian licensing. Too often, frontier markets become victims of perpetual negative press coverage, even as their markets are doing well. Stories on Pakistan inevitably focus on bombings in the Tribal Regions, but rarely mention that the Karachi Stock Exchange has been one of the world's best-performing stock markets for the last two years. The end result is that Asian frontier markets offer attractive valuations and dividend yields, with less competition among foreign investors compared to their emerging market peers.

Asian Frontier Index Valuations

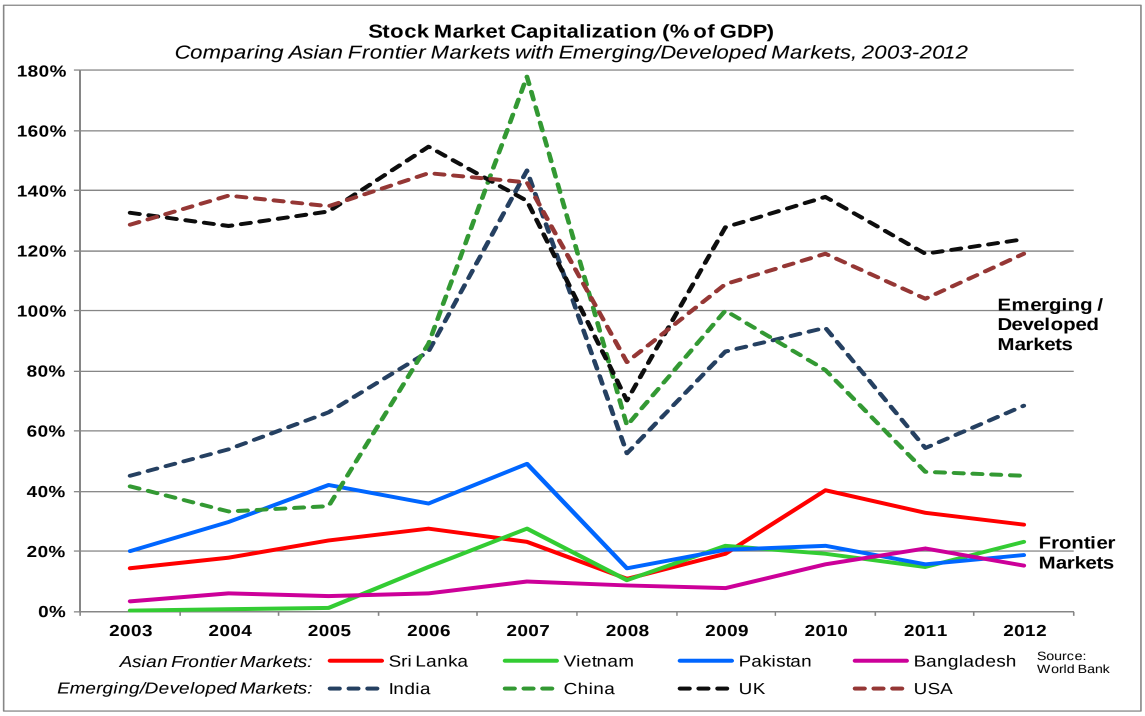
Country	*Index*	*P/E (x)*	*P/B (x)*	*Dividend Yield (%)*
Laos	Laos Composite	9.1	1.3	8.0
Pakistan	Karachi 100	9.8	1.8	5.2
Sri Lanka	Colombo All Share	11.5	1.5	2.8
Vietnam	VN Index	12.3	1.7	4.1

Emerging Asia Index Valuations

Country	*Index*	*P/E (x)*	*P/B (x)*	*Dividend Yield (%)*
China	Shanghai Composite	11.4	1.5	2.9
India	S&P BSE 500	16.7	2.1	1.6
Indonesia	Jakarta Composite	18.0	2.8	2.3
Malaysia	FTSE Bursa KLCI	16.6	2.3	3.3
Philippines	PSEi Index	18.1	2.7	2.4
Thailand	SET Index	15.3	2.2	3.1

Source: Bloomberg

One metric used to compare market valuations is stock market capitalization to GDP, described by Warren Buffett as "probably the best single measure of where valuations stand at any given moment." In developed markets, market capitalization is often equal to or greater than GDP (The US' market cap-to-GDP was 119% in 2012, while the UK's was 124%). In frontier markets, however, market cap-to-GDP remains quite low (Bangladesh's market cap-to-GDP is 15.1% while Pakistan's is 18.9%), indicating undervalued indexes.



In general, frontier markets as an asset class remain under-researched and misunderstood. Perceptions of illiquidity abound, even though turnover ratios in frontier markets (measured as the total value of shares traded in the market divided by the average market capitalization for the period) are often on par with emerging markets. It may be surprising to learn that Bangladesh's turnover ratio exceeded that of India and South Africa last year. Another misconception is that frontier stock exchanges are dominated by commodities. In fact, market capitalization is widely distributed over a variety of sectors. In Sri Lanka, the top five stocks by market cap are in tobacco, consumer staples, logistics, financial services, and conglomerates.

In Asian frontier markets consumer stocks are particularly attractive – these tend to be debt-free local companies that pay healthy dividends and have huge valuation gaps relative to their emerging and developed market peers. Investing in consumer staples is an ideal way to gain exposure to domestic growth, as these companies provide cooking oil, soap, and food & beverage products to growing populations that are consuming more than ever due to rising disposable income. Consumer-focused companies tend to be resilient to outside factors, as customers will continue to buy detergent and tobacco regardless of whether a protest occurs in the country. Additionally, consumer stocks are less vulnerable to political interference and government regulation than, say, energy or utilities. Attractive consumer-related stocks in these markets include a Bangladeshi shoe retailer with healthy free cash generation and return on equity that sells affordable footwear to its customers. This stock currently trades at a P/E of 16.1x, much lower than its regional peers. Another attractive consumer stock is a Vietnamese consumer food products company whose net income has almost doubled in the past five years and trades at a P/E of 9.0x with a dividend yield of 8.6%. These stocks reflect the kind of value that Asian frontier markets offer and are good ways to gain exposure to growing consumption in Asia's frontier markets.

The misunderstanding of Asia's frontier markets creates immense opportunity for investors to find value and growth investments. These countries possess all of the preconditions for healthy long-term returns; young, growing populations with rising disposable income levels, development of new industries, and sweeping economic reform. Lower correlations to global markets create diversification benefits, and any savvy investor with a long-term investment horizon should not ignore the Asian frontier market growth story that will surely continue for decades to come. These frontiers previously perceived as obscure backwaters are now building the next phase of Asian growth and the creation of the AFC Asia Frontier Fund provides direct access to investors across the globe.