

Frontier Markets

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Taking the long view

Global Frontier Markets are about to register yet another strong annual performance since the launch of the MSCI Frontier Markets Index in 2003.

Frontier Markets are up 24%, while Emerging Markets (EM) are down 4% this year according to the relevant MSCI index in USD terms. This strong performance, in what has been a challenging market environment for Emerging Markets equity investors, illustrates just how uncorrelated Frontier Markets are to herd-like market dynamics and the conventional drivers of global growth – whether in the local economy or in corporate profits. It is important to understand how these returns have been possible and, looking ahead, whether these are sustainable going forward. In our view, the answer is a resounding 'Yes'.

What are 'Frontier' Markets?

From an equity market perspective, we define Frontier Markets as any that are not included in MSCI's 'developed' or 'emerging' market classification. This means that the frontier universe as we know it currently includes 81 markets. By way of comparison, only 25 countries are included in the MSCI Frontier Markets index. Investors who are willing to truly take advantage of the full opportunity set on offer in this space will therefore have to engage in active management and be prepared to invest in off-benchmark countries. Frontier Markets tend to be relatively small and shallow. Liquidity tends to be low.

The total size of the assets under management remains small, approximately USD 18bn, according to EPFR. This compares to USD 8.6trn in developed markets and USD 1trn in EM equities. Still, the asset class is growing rapidly. This year alone fund flows have increased dramatically while flows into EM equities have struggled. Frontier Markets remain an under-allocated asset class, but it should continue to grow rapidly due to the long-term, uncorrelated growth story currently unfolding in these countries.

Economic backdrop

Frontier Markets occupy a special niche in the investment universe, and they are likely to benefit particularly from the gradual unwinding of global imbalances over the coming decade. The global economy is currently in a state of extreme disequilibrium, and we expect the great global imbalances between heavily indebted developed countries (HIDCs) and reserve-rich Emerging Markets eventually to be ironed out via a resurgence of

Fig 1: An expanding investment universe

Lat Am / Caribbean	EMEA			Asia
No. of listed companies: 142	No. of listed companies: 743			No. of listed companies: 232
Total market cap: USD 163.4bn	Total market cap: USD 882.0bn			Total market cap: USD 158.3bn
Argentina Bahamas Barbados Bolivia BVI Cayman Costa Rica Cuba Curacao Ecuador El Salvador Jamaica Panama Paraguay Puerto Rico Trinidad & Tobago USVI Venezuela	Azerbaijan Belarus Bosnia Bulgaria Croatia Estonia Georgia Lithuania Macedonia Malta Montenegro Moldova Romania Serbia Slovakia Slovenia Ukraine	Bahrain Iraq Jordan Kuwait Lebanon Oman Palestine Saudi Arabia	Benin Botswana Burkina Faso Cameroon Congo Gabon Ghana Kenya Malawi Malawi Mauritius Namibia Nigeria Rwanda Senegal Sierra Leone Swaziland Togo Tunisia Uganda Zimbabwe	Bangladesh Cambodia Cook Islands Fiji Kazakhstan Kyrgyz Republic Laos Mongolia Nepal Pakistan Papua New Guinea Sri Lanka Turkmenistan Uzbekistan Vietnam

Source: Ashmore, MSCI, Bloomberg as at September 2013.

inflation in developed economies and resulting currency realignment in favour of Emerging Markets. But the appreciation of EM currencies will be driven by central bank reserve diversification and will prove particularly challenging for larger, more liquid EM markets due to central banks' strong preferences for liquid assets. On the other hand, smaller and less liquid Emerging Markets should experience less appreciation because their currencies are less tradable. This means that equity markets should do better in Frontier Markets. These markets will benefit

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from rising global growth and a weaker US dollar, both of which will put upwards pressure on commodities, but at the same time they should not experience the crippling currency appreciation which we believe will afflict larger EM countries.

One way to approach the concept of a Frontier Market is to think of all countries as existing on a continuum from the lowest income countries with the shallowest (or even non-existent) markets to the richest countries with the deepest and broadest capital markets.

Along these lines, while the definition of Frontier Markets tends to vary from institution to institution, one commonly used threshold is gross national income (GNI) per capita. JP Morgan defines Emerging Markets as countries with GNI per capita below USD 18,690 in 2013. While there is no agreed lower income threshold that separates Frontier from Emerging Markets one can think of Frontier Markets as countries towards the lower end of the GNI per capita scale within the Emerging Markets distribution. They tend to have both lower income and shallower markets.

Because the continuum of countries traverses two separate dimensions (income per capita and capital market depth) it is possible for a country to exist in one grouping on the income criterion, but in another on the market development criterion. This is often the case with economies in the Middle East which rank among the more advanced EM or even DM countries on income criterion, but which fall on the low end of the spectrum on market liquidity considerations. They are 'frontier-like'.

Still, despite the lack of a rigid economic definition, the spirit is clear: Frontier economies tend to be low-income countries with strong growth convergence potential and illiquid, immature markets. They tend to have low public debt levels, higher growth rates and they are often driven by strong demographics and important structural transformations. By virtue of the relative simplicity of their economies, Frontier Markets are often (but not always) more exposed to commodity price volatility and weather shocks, both on the import and export side of the economy, than developed economies. They tend to have very small pension systems and many of them rely on external sources of concessionary financing from international donor agencies,

though this is changing very rapidly. Their countries are therefore more vulnerable to shocks, but also offer higher potential returns.

According to the World Bank, the combined GNI of countries that are not included in either 'emerging' or 'developed' markets is about USD 5trn, but countries that have yet to establish stock exchanges comprise a further GNI USD 3trn.

Understanding the drivers of frontier growth

Frontier Markets are where Emerging Markets were 20 years ago. They are characterised by a young population, increasing trends in household formation, basic access to infrastructure, healthcare and education, and low but rising wages and increased urbanisation.

Consumer growth

One of the key themes which have driven Emerging Markets growth has been the rise of the 'emerging' middle class over the last two decades. We believe that we are well into the early stages of a similar trend in Frontier Markets. One of the most telling statistics is related to the proportion of the population which is of working age. Due to higher mortality rates in earlier decades, this statistic for Frontier Markets is currently slightly lower than in emerging and developed markets. However, with improving healthcare, better access to basic services, increased education and even increasing wages, that trend is reversing. According to the United Nations' population forecasts, the percentage of working age people in Frontier Markets is set to exceed both developed and Emerging Markets within the next 20-30 years. As a result of this particular profile of population growth, dependency ratios are falling, and household formation and rates of urbanisation are increasing. This in turn, is leading to a more educated labour force, with higher skills and training, and significantly higher growth in consumer demand for products and services. Two telling statistics lie in the average number of bank account holders in Frontier Markets, and the proliferation of mobile phones and devices. On average, 53% of the population in Frontier Markets has a bank account – virtually the same as in EM. In many frontier economies mobile phone penetration is in excess of 100%, with a growing trend in both data usage, and, more recently, mobile banking. For active managers, one of the more exciting aspects of Frontier Markets is how many industries, such as banking, are developing different business models to those pursued by developed market companies. In addition to mobile banking, the pursuit of a banking model in which borrowers are initially sourced through non-bank employees or 'agents' is a creative and low capital-intensive growth strategy.

Equity market opportunities

So what are the investment opportunities in frontier equity markets? According to MSCI's Global Frontier Markets IMI index, the size of Frontier Markets is only USD 164 bn, with a total of 376 'investable' companies. Thus the index coverage only amounts to a paltry 3.5% of Frontier GDP (source: MSCI, Citibank). In our view, this is a significant under-representation of the full investment opportunity set – the total size of the Frontier equity market is far larger. We estimate the market

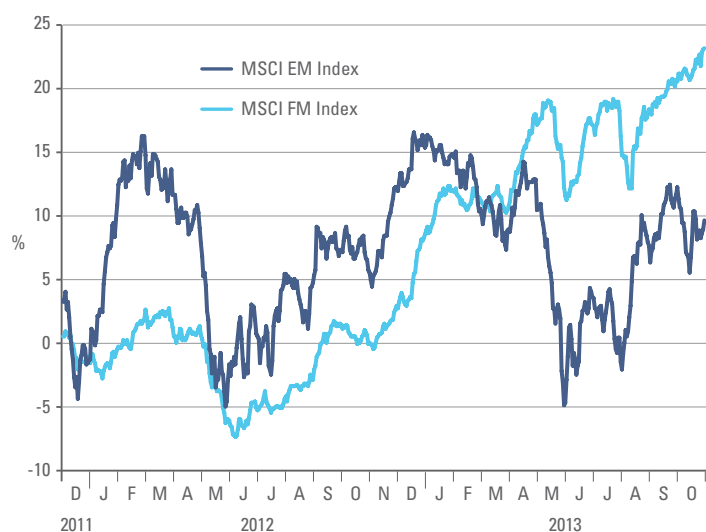
size to be in the region of USD 1.2trn (source: Ashmore, Bloomberg). This represents approximately 23% of global Frontier GDP and includes the 81 markets listed above, with over 1,000 listed equities.

Because of the relatively low coverage of issuers by index providers and market makers alike, sell-side analyst coverage of Frontier Markets is generally poor as well. According to a recent study by Citibank, on average a Frontier Market stock is covered by 3.5 analysts – and this is for markets that actually feature in the MSCI Frontier Markets index. This compares with about 14 analysts per stock in EM and nearly 20 analysts per stock in developed markets. The implication is that a significant amount of independent research is required to evaluate the investment case for a particular stock. Careful analysis of financials, assessing balance sheet strength, access to financing, sustainable earnings growth, cash generation, etc., are but a few examples of the analyses required. Furthermore, actual company visits help reveal aspects of the business that are difficult to measure in numbers, such as labour practices, management quality, supply chain, customer feedback, brand reputation, operating environment and corporate governance. Because so many companies in Frontier Markets are either simply not covered or are misunderstood, digging deep into these companies and markets can lead to investment opportunities that are superior return generators.

Frontier Markets are beginning to attract more attention. Faced with the recent disappointing returns in Emerging Markets and stratospheric valuations in developed markets, investors have started taking another look at Frontier Market opportunities. Frontier Markets have significantly outpaced EM this year, up 24% to Dec 17, outpacing EM by 28% according to MSCI.

The divergence in returns between Frontier and Emerging Markets is nothing new. The correlation of returns to developed markets has been persistently lower for Frontier than for Emerging Markets – currently at just 43% over last three years – symptomatic of more domestically driven economies that are not caught up in the global cycle (source: Bloomberg, MSCI).

Fig 2: Frontier Markets returns have exceeded Emerging Markets



Source: Bloomberg, MSCI.

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Fundamentals

Because Frontier Markets have outperformed EM significantly this year, some investors have been drawing attention to the relative attractiveness based on valuation levels. Certainly based on trailing and current earnings levels, Frontier Markets as a whole may look relatively similar to Emerging Markets; however, *looking forward*, there is still a very attractive case for Frontier Markets. The difference in expected earnings growth and dividend yield alone is compelling. Because of the strong – and rapidly improving – domestic fundamentals, companies in Frontier Markets, in our view, still have significant room for upside. Clearly homework is required to separate the fairly-priced or even expensive companies from the truly undervalued opportunities – where quality is high, and sustainable earnings growth is achievable. Some of this value may take time to be fully achieved – this is the nature of frontier investing – however with the higher levels of dividends that can be achieved investors are effectively being paid to be patient.

Fig 3: Fundamentals are attractive

	MSCI EM	MSCI FM
Current (trailing)		
Price / Earnings	12.4	12.8
Price / Book	1.6	1.7
Dividend yield	2.6%	3.7%
Based on 2014 projections		
Return on equity	12.93%	17.27%
Earnings growth	12.7%	43.4%

Source: MSCI for current/trailing info (as of end Nov), Bloomberg for forecast info (as of end Nov).

Risks

Investing in Frontier Markets – like any equity market – has risks. Due diligence is required, understanding not just company fundamentals but also the general operating environment and domestic issues, such as socio-political developments, can have an impact on short-term profitability.

One of the main issues which have arisen in recent years has been political risk. For example, the on-going conflict in Syria has deterred investors from investing directly in the region or indirectly through a global frontier strategy due to the perceived risk that the conflict will spill over into the region. The reality is that, so far, the conflict in Syria has had an impact primarily on just two relatively small markets in the region: Jordan and Lebanon. Other significantly larger markets such as Saudi Arabia, UAE and Qatar have been largely unaffected. In fact, these

markets are up 27%, 58% and 31% in USD terms respectively. This does not mean that political risks don't exist, but the trend toward reduced levels of conflict over the past 25 years seems undeniable. In Africa, there are currently 10 times more functioning democracies than at the end of the Cold War. The rise of stable and functioning political systems has enabled governments to introduce – and enforce – regulations, policies and laws which enable businesses and people to grow and thrive. Understanding the dynamics in the market and the implications that these have for the growth prospects of individual companies in the longer term will help clarify the merits of the investment case.

The next risk that investors worry about – and this is an area that continues to evolve – is corruption. This issue continues to make headlines – and not just in Frontier Markets. However, according to a World Bank report ranking countries according to their control of corruption, a number of frontier countries have been making progress in this area. According to the World Bank, out of 76 Frontier Markets measured, 39 (or 51%) have improved their global ranking compared to 2002. In some cases, such as Botswana, Ghana, Namibia, Qatar and Saudi Arabia, these markets have higher rankings than even the largest Emerging Markets, such as Brazil, China, Mexico and Russia. As with any investment, even in low-scoring markets where corruption is generally high, doing one's homework can pay off and it is possible to find well-functioning companies able to add consistent shareholder value over time.

The last main risk to consider is liquidity. In very small Frontier Markets such as Cambodia and Zambia, daily liquidity can be hard to find, so despite finding a compelling investing opportunity, the ability to add a position to the portfolio can take significant time and potential cost. Investing in Frontier Markets requires a long-term approach, by building positions over time, and importantly, building relationships on the ground that will facilitate sourcing pools of liquidity. According to research by Citibank, volumes in Frontier Markets have tripled in the past year. While on average these trading volumes are still lower than those in EM, the overall performance of Frontier Markets, and inflows into the asset class have driven further investors to take another look. As an example, trading volumes in Saudi Arabia average USD 2bn per day – more than South Africa and as much as Russia. There is liquidity – even if the market is not in the mainstream indices or is poorly covered by the sell-side analysts.

Conclusion

The investment case for Frontier Markets is clear. More markets are opening to investment, volume is improving and fundamentals are attractive. These markets may not be perfect but they are improving. Homework is required to understand each individual business, the market environment, regulatory and political framework of the country and the ability to invest in the business. No opportunity should be ignored – the investment case is broader and deeper than perceived but certainly risks exist. By taking a long-term view and deploying the due diligence required, investors have a real opportunity to achieve superior long-term returns in this ever-evolving asset class.

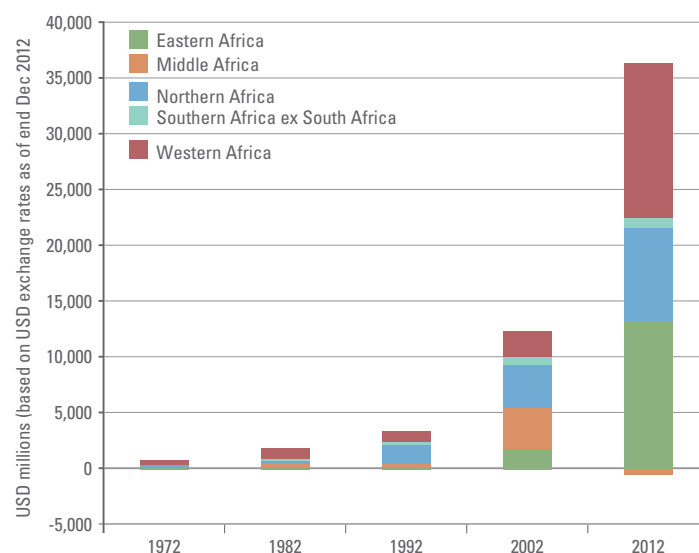
Case study: Frontier Africa, 20 years on

Defining Frontier Africa

African Frontier Markets are comprised of any market that is not included in the MSCI Emerging or Developed Market indices. These include all markets on the African continent other than Egypt and South Africa. Currently there are 27 exchanges representing frontier African equity markets, with the oldest – Casablanca Stock Exchange in Morocco – dating back to 1929. Many of these markets are relatively small and illiquid, yet in the last two years volumes have picked up as investors seek new sources of uncorrelated growth. In Kenya, the second largest frontier equity market on the continent after Nigeria, volumes have nearly doubled (source: Bloomberg). These markets still represent a relatively small proportion of GDP. We expect at least one or two countries to be promoted to 'Emerging Market' status in the next 10 years, with more markets opening to foreign investors.

The attraction of these markets continues to be driven by dynamic domestic demand. One of the main developments on the continent over the last 10-15 years has been the relative economic stability within the region. Africa has 10 times more functioning economies than at the end of the Cold War. Foreign direct investment has multiplied more than seven times in the last 20 years (source: UNCTAD). These significant milestones have led to increased spending in infrastructure, a growing middle class and greater consumption growth.

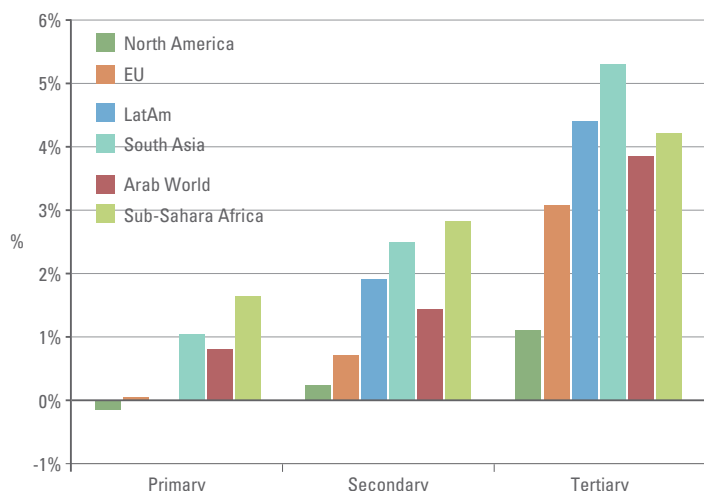
Fig 4: Foreign direct investment is accelerating



Source: UNCTAD (UN Conference on Trade and Development), Ashmore.

The sheer scale of opportunities is evident. The growth in the working age population in Africa exceeds every other region in the world and is expected to account for 40% of world population growth in the next 20 years. Over half of the population is under 20 years old – that compares to just 28% for China (source: UN World Population Prospects). In terms of education, over the last 20 years, growth in primary and secondary school enrolment in Sub-Saharan Africa has been the highest in the world and third only to South Asia and Latin America in tertiary education.

Fig 5: Growth in education enrolment 1990 - 2011



Source: BofAML, Ashmore October 2013.

The evolution of African markets continues to impress. Mobile phone penetration is growing at a rapid pace, in some cases exceeding both Emerging Markets and developed economies. In Africa, the number of mobile phone subscribers per capita is amongst the highest in the world, with Botswana the highest amongst African countries. Mobile phone banking is also growing rapidly, particularly in Kenya and other Sub-Saharan markets. On average, less than 20% of the African population has a bank account, due to an underdeveloped branch network especially in more remote, rural areas (source: World Economic Forum, BofAML). The banking landscape in Africa remains underpenetrated and at times is considered to be a greater barrier to doing business than corruption. This is an area that will continue to grow in the long-term as Africans turn to mobile phones as a way to access banking services. Loan penetration to small businesses varies significantly across countries and on average is well below global peers – we expect this to grow with economic development and foreign investment in the region.

One of the most often cited risks of investing and doing business in Africa is corruption. The level of corruption in Africa countries varies significantly but dramatic improvements have been made in some markets over the last 10 years. According the World Bank, countries such as Botswana, Rwanda, Namibia and Ghana were amongst the highest rankings in terms of countries with good control of corruption, yet none of these are included in MSCI's Frontier Markets index. As a result of relative political stability, higher education rates, and increased foreign investment over the years, these markets have implemented regulatory frameworks – the most recent has been in Kenya, which has had one of lowest corruption rankings in the past. In 2011 it passed a Competition Act to modernise regulations allowing for greater competition, consumer protection and to establish a Competition Authority, aimed especially towards banking, energy and insurance. Numerous other examples exist across Africa. It is clear that investment opportunities exist if one is willing do the homework. Consumer growth continues to dominate investment opportunities along with infrastructure developments. Across the continent we continue to find attractive opportunities in companies that are trading at a significant discount to their long-term value. Companies are finding new ways to enter markets, capture the demographic dividend and introduce products and services where gaps exist. They are maintaining a strict view on costs, and growing revenues consistently and reinvesting towards growth. In our view earnings in those areas exposed to these trends will flourish over the next decades.

Accessing these markets today continues to present challenges given the size of the markets and liquidity, but we expect this to improve over time as more investors uncover these markets. We expect more African markets to become members of the major index providers, whether as 'emerging' or 'frontier', boosting overall coverage and investment opportunity.

Africa, along with Frontier Markets, remains one of the most exciting areas of investment in equities in the long term. Doing the homework, maintaining a broad view of the opportunity set and maintaining a strong discipline on valuation and quality will, in our view, drive performance in years to come.

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