PREMIER ISSUE

Alternative Emerging Investor

Mark Mobius:

The Father of EM Funds on Alternative Assets

African Investment Risk

Perception vs. Reality

In-Depth Coverage

Emerging Market Real Estate

Issue 1 - May / June

In 2007, I left management consulting in Beijing to seek new challenges in South America, landing in Buenos Aires with one suitcase full of clothes, one full of books and a laptop. At the time, as I saw it, there was little to connect the two regions aside from the fact that I could practice my Mandarin at any local grocery store.

Six years later, the world is a different place: The crash of late 2008 swept aside the perception of polarity, creating a continuum of investment and trade between emerging markets: China has become Brazil's number one trade partner, overtaking the U.S.; Brazil's economy has surpassed that of the U.K.; China invests heavily in African infrastructure Brazil launches the largest African private equity fund – we're seeing a continually increasing interconnectivity. Today's world finds most developed nations having a 100% debt to GDP ratio or larger, coupled with 1% growth. Emerging markets have a 50% debt to GDP ratio and 5% growth, along with growing foreign reserves, and our net-debtors are becoming our net-creditors; a new world is taking shape.

This new emerging market world is what Alternative Emerging Investor was created to explore. As the need to increase EM allocations becomes less of a preference and more of a necessity, we have tasked ourselves with providing the key component of investing in these regions – local knowledge – to a global audience. Through extensive research and interviews, we bring actionable on-the-ground intelligence from Asia, Africa and Latin America to an investment community looking for alternatives to traditional investment options.

As a perfect complement to our inaugural issue we've spoken with Dr. Mark Mobius, one of the most recognized experts in emerging market investment, to learn from his extensive experience where these markets are going and how alternative assets have grown. For our in-depth coverage we look at real estate in all sectors from the low leverage, high growth of LatAm to the volatility of Hong Kong and the incredible demand of Africa, which is met with minimal supply.

It is with great pride and excitement that we launch this inaugural issue of Alternative Emerging Investor. We welcome any comments, suggestions or complaints in order to make this publication as useful as possible.

Saludos,

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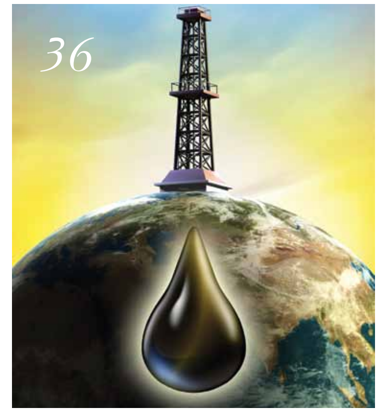

In-Depth: Real Estate

Regional

ALTERNATIVE
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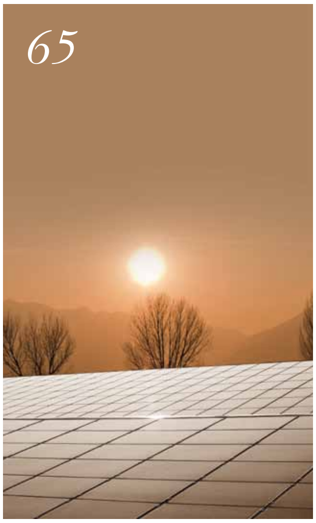
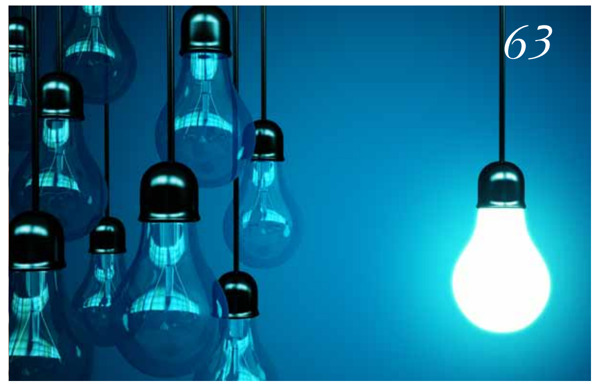




Sector

Asset Class

Cover

Myanmar

Southeast Asia's New Frontier

The emerging markets of Southeast Asia continue to generate highly attractive investment opportunities. The newly open economy of Myanmar offers fresh prospects to investors, particularly in the gas and oil industry, but assessing the risk of operating in such a dynamic region can be challenging.

In both a fledgling economy like Myanmar and more established Southeast Asian investment destinations such as Malaysia or Singapore, a macro view of a country's political climate often paints a very different picture than what is happening on the ground.

Chris Larkin, founder and Managing Director of political and market intelligence company CLC Asia, has a decade of experience working with corporate clients and governments in the Association of Southeast Asian Nations (ASEAN) countries (Indonesia, Malaysia, the Philippines, Singapore, Thailand, Brunei, Myanmar, Cambodia, Laos and Vietnam).

"I think what you see on the BBC and CNN paints a certain picture of an environment," Mr. Larkin says. "The classic example is Philippine mining. The issue of the Muslim insurgency down south tends to cloud the whole of the Philippines, although the country is a very prospective area and the mines up north operate perfectly well."

Upheaval in Myanmar may prove to be more widespread, although functioning business environments need not be regionally separated from social unrest. Contacts on the ground provide insight into the importance of local knowledge when assessing "country risk," no less so than in Thailand where Mr. Larkin is based.

"People get a snap view quite quickly," Mr. Larkin says. "In Thailand, you have coups, you have riots, you have all sorts of things that happen here, but at the end of the day,

business keeps ticking over. The Thai stock market keeps doing very well. For an outsider who doesn't know the country, those issues might scare people, but when you're on the ground it's just not an issue whatsoever; things keep moving on."

From a county risk perspective, Mr. Larkin says, Myanmar is the "new kid on the block," and in-depth country risk assessment is still in its early stages, as the government has not yet had a chance to respond to issues.

"In places like Myanmar, we're yet to see how macro issues play out," he explains. "The laws and institutions there are a work in progress and remain untested. So while there is an obvious commitment to opening up and to transparency, the typical problems when a country democratizes happen. You'll get increasing opposition to foreign investment and you have to see how the government reacts to that. You'll start getting interest groups with legitimate concerns on things like social and environmental issues, and again you have to see how the government responds. All these remain relatively untested."

"Hopefully, over time we'll get a clearer picture," Mr. Larkin continues. "There's always new issues arising; you've got ongoing tension between Muslims and Buddhists, which are capturing the headlines at the moment, although whether that reduces the attractiveness of the country remains to be seen. In my experience, those issues tend to remain isolated and distinct from doing business in a particular country."

Risk and company size can also share an inverse relationship. Mr. Larkin explains that larger companies have the luxury of sitting back and waiting to see how issues pan out, whereas smaller companies will often take on more risk for the benefit of being first on the ground.

For those companies that are averse to directly entering a newly opened country like Myanmar, indirect inroads are a possibility. Taking note of the inter-connectivity between Southeast Asian nations can often alleviate some part of higher country risk.

The geological maps for the country are 50-60 years old so there is a huge amount of exploration to be done. Myanmar is still a few years off an extractive industry like shale gas – a sector which is rapidly growing in Indonesia.

"Thailand had no sanctions against Myanmar, so there's greater inter-connectivity between the nations," Mr. Larkin says. "Thai business people have been on the ground there for 20 years and are well placed to enter the market. So people who are based in Thailand, or know Thailand quite well, have a head start. Businesses are quite quickly realizing this and looking at exploiting a Thai angle into Myanmar."

As well as close interaction with a well established network of ground-level associates, Mr. Larkin points to the importance of establishing a client's goals and expectations from the very beginning.

"We investigate to make sure we can offer clients answers to their questions," Mr. Larkin says. "We don't accept every job that's offered to us. If we're able to tap the right resources and human capital, to help our clients answer their questions, then we will. Regardless of where you are in Southeast Asia, there are various similar themes in how government works or what the incentives within governments are."

While Mr. Larkin's operation is client driven and country agnostic, naturally he receives inquiries about some countries more than others.

"Myanmar, Indonesia and Thailand are the key countries which we get asked about the most," Mr. Larkin says. "Countries like Malaysia and Singapore are less inherently risky than most others in Southeast Asia, from a country risk perspective."

For Mr. Larkin, assessing country risk involves an understanding at an operational level, rather than solely prognosticating on economic and political risk.

"A hedge fund will be reacting to, for instance, something very macro and will be looking for that information on an instantaneous basis. We don't really serve that market. Our clients like to look at the risk factors which may affect them more directly," Mr. Larkin says.

"In Myanmar, for the past 12 months it's been about looking into market entry and figuring out who's who," he continues. "We've had a lot of interest from people looking to deal with the oil and gas sector because potential there is massive. There's been some interest in the mining sector. The geological maps for the country are 50-60 years old so there is a huge amount of exploration to be done. Myanmar is still a few years off an extractive industry like shale gas – a sector which is rapidly growing in Indonesia."

Mr. Larkin uses the example of Indonesia to expound on the importance of closely monitoring specific case studies of past incidents when assessing country risk for clients.

"In Indonesia's mining sector there is often very good news, but every year or two there will be a story about expropriation," he says. "They're often not clear on whether it's government-led or bad governance on behalf of the firms themselves; we try to get to the bottom of those stories."

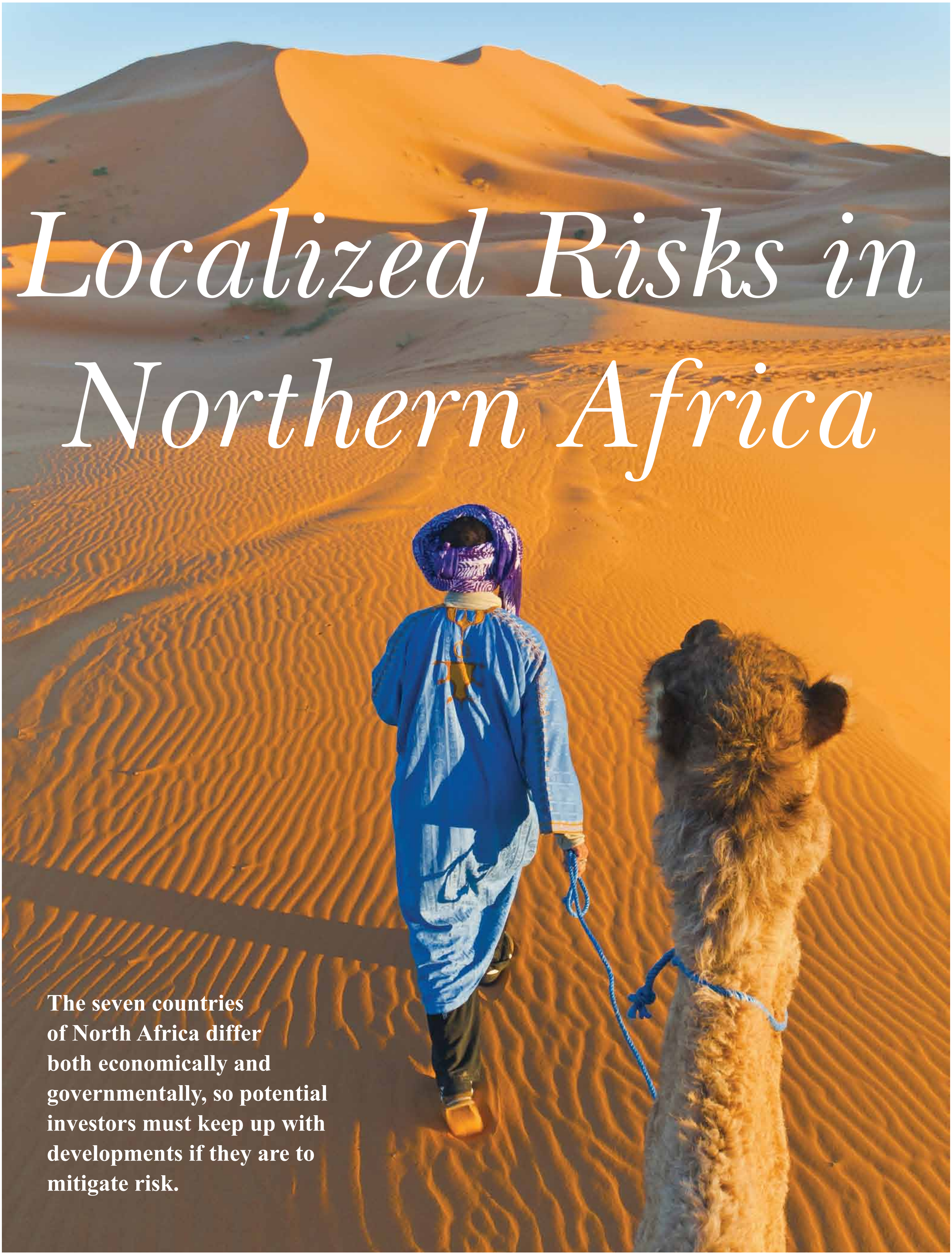
Most of CLC Asia's clients are from North America and Europe. Mr. Larkin explains that local companies doing business in Asia are often more comfortable with business being more conservative and slower. Local firms "are probably mitigating their risk fairly differently," he says. "Obviously, foreign firms have compliance teams and compliance issues which they need to address. Their work is more 'check list' based in some cases; making sure their compliance teams are happy with whatever transaction or business venture they're entering into, and we can help from that focus."

Mitigation of risk, or Phase II of operations to Mr. Larkin, involves basic application of lessons learned and the more nuanced fostering of relationships within a country.

"Sometimes it's very common sense stuff; looking at case studies about how other people have done things," he says. "Mining is a classic example; many junior mining companies who've just raised some money in Singapore or Toronto and don't have much cash may not think it's important to develop roads or schools to help bring local people on-board. The more savvy try to partner with people in-country who have a bit of influence or are respectable enough that potential events may not affect them as much."

For Mr. Larkin, country risk is an evolution of the concept of political risk. It is important to understand risks and frame them from a project valuation stand point, and assessment of country risk must incorporate aspects of business and society within the context of the whole risk area.

Access to on-the-ground information is imperative to mitigating risk, both for the larger investor wishing to put out feelers in Thailand while events play out in Myanmar, or the small company wishing to reap the rewards of making early headway into a country that is obviously rich in potential.



Localized Risks in Northern Africa

The seven countries of North Africa differ both economically and governmentally, so potential investors must keep up with developments if they are to mitigate risk.

Having spent several years working for a large political risk firm, Dr. Geoff Porter founded North Africa Risk Consulting, Inc (NARCO), a political risk firm specializing in North Africa and the Sahara. NARCO has extensive experience helping firms navigate Maghreb markets. Recent events in North Africa and the Sahara have heightened the need to understand political circumstances, their trajectories and implications for the business environment.

Dr. Porter states that in order to provide actionable intelligence to clients it is vital to have a very limited geographic reach, as well as a narrow sectoral coverage. For this reason NARCO covers five countries: Mauritania, Morocco, Algeria, Tunisia and Libya, focusing primarily in oil, gas and mining.

Oil and gas exploration in North Africa goes back 60 years, so there is a backlog of seismic and geographic information available. Companies are now better equipped with more advanced exploratory technology, so those drilling have never been better placed to unearth new sources of gas and oil. The extraction process has also evolved and some forms of drilling, such as offshore, have become far cheaper. Whereas in the past extracting oil was often deemed uncommercial due to excessive overhead, new price bands and more efficient equipment result in financially viable new discoveries.

"No North African country has really gotten very deep into EOR (enhanced oil recovery) or IOR (improved oil recovery) although Algeria is considering launching a big round for shale or tight gas which would involve extracting. One of the heads of the Libyan petroleum institute is a huge advocate of postponing new exploration activities in order to focus on EOR from maturing fields. It is something that the IOCs (international oil companies) want; the overhead of deploying EOR or IOR on maturing fields is considerably less than the entire expenditure of new exploration and production. You don't have to find it, you just have to employ the right techniques, whereas if you're shooting seismic it can take three to four years," says Dr. Porter.

The influence of media can drive perception, and Dr. Porter believes much of the hype generated by news outlets to be damaging.

North African countries are different from one another in many ways, so it is difficult establishing a common risk with regard to investing. Dr. Porter uses Morocco as an example of a country making a concerted effort to bring in foreign investors in a bid to increase GDP and employment opportunities for the local population. "They are privatizing SOEs as quickly as possible. Obviously there are some red lines. They won't privatize subsidized food stuff industries like sugar, oil and flour, and they are aware that foreign investment brings some negatives, such as a flow of revenue away from the country. But they feel the positives outweigh the costs. If you go to Morocco now, I've been working there for 20 years, you'll find English as commonly spoken in the hotels as French." Many of the major American companies have also set up shop in Morocco, including Coca Cola, Pepsi, and Microsoft, but not every country in North Africa is so FDI friendly.

Algeria is fundamentally a state-run economy, and the government is concerned about the short-term negative implications of FDI. "If you bring in an foreign investor who, for example, sets up a plate glass factory, the private factory is probably going to be much more competitive than the state-owned one. As a consequence the state-owned factory will lose sales and end up laying off workers, so in the short term there isn't any immediate uptake in employment activity although over the long term there will be," says Dr. Porter. For the moment entry barriers in Algeria are therefore very high and provide a stark contrast to Morocco. Dr. Porter goes on to describe Morocco's market as "saturated" whereas he describes Algeria's as "almost virgin." Libya, on the other hand, presents risks in that the country is experiencing a profound transition, with no real judiciary and no effective banking system in place, so there is a serious security and general regulatory risk. "We don't know what Libya's going to look like in the middle of 2014. Anyone who tells you otherwise is simply blowing smoke."

When asked if Algeria is unnecessarily protectionist Dr. Porter touches upon an unnamed consumer goods company that is totally committed to operating in the country, dealing in everything from laundry detergent to diapers. He explains how it will have first-mover advantage, as Algerians have demonstrated a tremendous brand loyalty, so the company has a good chance of monopolizing the market before it opens up. "There are huge opportunities there, it's just a question of whether a company has the fiscal leeway to go to a country and spend several years establishing a business in the hope that they will be able to recoup their investment and start making money within a five to ten year period."

However, there is evident demand for consumer goods in Libya, such as telecoms, but due to infrastructure any long-term project involving power generation facilities or desalination facilities may prove costly and dangerous. There is no guarantee that the security environment will remain stable and allow continuous operation. However, if you are bringing goods into the country you are able to "leave them on the dock or at the airport while you wait a situation out, that should be fine," says Dr. Porter. Perceived risk and actual risk in North Africa is dependent on each particular sector. Market perception of risk can also vary, and if an organization believes an aspect of trading or exploration to be a risk, irrespective of whether it is or not, this can increase or decrease oil prices. Dr. Porter says, "We are always trying to thread a needle between what's a sensationalist market-moving event regardless of whether or not it actually has implications for production or supply. There's generally a pretty large gap between perceived country risk and actual country risk, and one of the things we specialize in is helping clients to understand what the real risks are."

The influence of media can drive perception, and Dr. Porter believes much of the hype generated by news outlets to be damaging. "I'm not being critical of journalists – they generally try to do the best job they can. It's more indicative of how the publishing industry works now and what sorts of stories make the headlines and what doesn't," says Dr. Porter. This is where NARCO comes in, by stipulating the difference between the actual risks and the perceived risks. "A client emailed yesterday saying they received a report showing that the risks in Algeria were increasing due to protests in the south of the country. They wanted to know my perception. They wanted to hear why I hadn't told them about this. I replied saying that the reason I had not mentioned it was because it did not matter to their business. Yes, there are protests and if you happen to be in that town it is risky, but you're not, so don't worry about it," says Dr. Porter.

Dr. Porter's analysis is by no means set in stone, and he is the first to state that his company's risk assessments should not be taken as gospel. They are of course accurate and thoroughly researched, but the risk analysis industry needs risk in order to successfully operate, and even if there is minimal risk, the risk is still present, no matter how large or small it is. "Without sounding too cynical, there's a tendency within the risk analysis industry to hype the risk. It's analogous to what you find in the due diligence industry," observes Dr. Porter. He explains that if a client commissions a risk assessment and received a report of a clean bill of health on a particular country's situation, the client may wonder if NARCO, or any other risk assessment company, has done its job properly. There is therefore a tendency within the corporate investigations community to find red flags when they are not necessarily present, "because it makes the client feel as if they have actually paid for something useful; if you tell a client there is no risk they wonder why they are paying you. This is not just specific to North Africa, I think it is universal," continues Dr. Porter.

Attempting to mitigate risk in North Africa can be difficult depending on what type of specific risk you are trying to address. Security risks, for example, can be limited with increased expenditures on security protocols. It is possible to invest money into training personnel in how to deal with volatile situations, and if you ensure that you have the property security personnel in place at different installations you simply need to pay for it. Regulatory risk is far more difficult to mitigate, just as corruption is difficult to allay. But even so, there are steps that can be taken to limit risk. "It's really important to know who your counterparts are, what their policy proclivities might be," says Dr. Porter. "It is a little bit similar to how industries in the U.S. have lobbyists in Washington who spend their time on Capitol Hill trying to figure out which way legislators are going to vote on issues pertaining to their industries and what lobbyists are actually trying to do to mitigate regulatory risks. While foreign companies more often than not do not lobby the government, they do need to know who their counterparts are, and understanding what their counterparts' policy proclivities are, and what their constituencies think about specific policies, can help clients understand the regulatory trajectory and then prepare for it."

When it comes to dealing with corruption, though, Dr. Porter suggests clients take a different approach. "My advice to clients who encounter corruption is just to close up shop. They can try to report it to the local authorities but this usually opens up another can of worms."

Brazil's New Port

Hopes to Raise US$27 Billion

Infrastructure bottlenecks are commonplace in Brazil and truck drivers can spend days queuing up to offload grain and other commodities at busy ports like Santos in the state of São Paulo. With a record grain harvest of 185 million tons in the last year, the country's overburdened port, road and rail network casts a dark cloud over Brazil's booming commodities industry.

Ana Mano for PaRR

But last December the government began to address the problem by reforming the regulatory framework covering ports in an effort to attract private investment and boost competition in the sector.

Brazil is hoping to lure US$27 billion in private money through 2017 by offering returns of 8% to 10% to investors, according to Pedro Brito, head of the country's National Waterway Transportation Agency (Antaq), in an exclusive interview with PaRR.

The Brazilian government should invest some US$3 billion in waterways, roads and railway systems, giving access to 18 publicly run ports including Manaus, Ilheus and Espirito Santo, according to a report by the consulting firm KPMG. Most of this investment is going to fund the second phase of a dredging program, according to a report by Antaq.

The government reformed Brazil's 1993 ports law through Provisional Measure (MP) 595 in December 2012, but the new rules still must be approved by Congress, and lawmakers are likely to endorse the new proposals by mid-May, Mr. Brito says.

According to Mr. Brito, companies benefiting from the new regulatory framework include Hong-Kong based Hutchingson Port Holdings, Denmark's APM Terminals, PSA (Singapore) and Dubai Ports World, which taken together command a 50% share of the global container cargo market.

"These companies are just waiting for the new regulatory framework to come into effect to start or strengthen operations here," Mr. Brito says. While Hutchingson and PSA do not operate in Brazil, APM and DP World operate terminals in Fortaleza, Itajai and Santos.

Any future investments in the Brazil port sector will likely involve a three-way consortium comprising a domestic engineering, procurement and construction company (EPC), a foreign facility operator and an international sovereign fund, according to a São Paulo-based lawyer specializing in infrastructure M&A.

Those "writing the checks" will either be sovereign wealth funds from the Middle East and Asia, or the large infrastructure funds set up by the likes of BTG, Itau BBA and Credit Suisse, according to the lawyer.

Brazil has EPC companies that are among the "best in the world" but only a few port operators, so those will have to come from overseas, the lawyer notes.

Mr. Brito says the state-controlled Brazil Development Bank (BNDES) is also likely to fund some future port projects. And while the presence of international companies will boost competition, Mr. Brito sees local operators joining forces to compete for future port contracts.

One of the most important innovations in the new law allows private companies to operate port terminals. Previously, only companies transporting their own cargo were authorized to operate a private facility. Another key aspect of the new law allows Antaq to initiate the bidding process for terminals with expired licenses, or licenses expiring in the 18 months following the implementation of the new law.

"What the private sector fears is Antaq's inability to process so many of these license upgrades," notes the lawyer specializing in infrastructure M&A.

Mr. Brito downplays those fears, however, insisting the government is taking measures against a bureaucratic backlog by outsourcing viability studies as well as the bidding and contracting process to an outside company. Three types of licenses can be granted under the new law: to operate terminals whose licenses have expired, to operate new terminal leases, and for new port concessions, Brito says. Assuming Congress makes no changes to the new port law, this should level the playing field for private operators to compete with the public port sector, the lawyer says. However, for private companies already using public ports such as Santos, the new framework may be detrimental to their business. "There are operators complaining that the new law made it more expensive to move cargo at a public port after the MP [new law] because a privately owned terminal does not incur certain mandatory costs," the attorney explains. One of the most contentious aspects of the new law exempts private port operators from hiring unionized workers, which is mandatory at all public ports.

Mr. Brito declines to say whether Congress will amend this aspect of the law, or predict whether port concessions that expired before 1993 will be renewed or revoked by Congress.

Another change in the regulatory framework relates to the manner in which the next public tender process will be conducted, according to a report by the Lefosse law firm.

New port concessions and terminal leases will no longer be awarded to the highest bidder but will be awarded to those charging the lowest amounts to operate the port facilities, the report says.

Policy and Regulatory Report

Author Biography

Ana Mano is a reporter for The Policy and Regulatory Report (PaRR), an intelligence and analytical news service that focuses on the development and adaptation of competition law around the world. PARR's coverage spans North America, South America, Europe, the Middle East, Africa and the Asia-Pacific region. PaRR focuses on the intersection of global competition law with intellectual property, trade and sector specific change in which there is a direct impact on the fair market practices of governments and corporations worldwide. To learn more about PaRR visit: www.PaRR-Global.com

It's Complicated

Juggling a Pan-Regional Private Equity Portfolio

In recent years investors are increasingly investing in Asian frontier markets, as opposed to regional expansion. Real estate in Vietnam has attracted a great deal of attention, and countries such as Sri Lanka, Cambodia, Mongolia and Myanmar, which are relatively new emerging markets, are seeing investment.

"I head up the ARIA family of pan-Asian growth and expansion capital funds at CLSA Capital Partners," says Miranda Tang, Managing Director and Head of ARIA. "This is my 18th year with the firm, which I joined in 1995." Ms. Tang has witnessed a number of investment and economic cycles in the region. ARIA is a group of Pan-Asian growth and expansion private equity funds and one of the pioneers of the Asia private growth equity sector. ARIA generally invests in established businesses that are well positioned for growth, with strong management and clear competitive advantages that are likely to benefit from Asia's rising domestic demand as well as intra-regional trade and cross-border activities. ARIA funds focus on four sectors: retail and consumer, specialized manufacturing, food and beverage and consumer technologies.

Ms. Tang has seen significant change in the private equity industry in the past 20 years. When she joined ARIA in 1995, the industry was relatively small with only a handful of players. In the last decade private equity has evolved in two different ways. First, global names have become interested in Asia, and secondly a number of locally raised funds have emerged.

In Asia, private equity is showing its potential in growth and expansion capital due to the consumer boom in the developing economies. “It is also cultural,” says Ms. Tang. “A lot of the time, when you’re talking to family run businesses and entrepreneurs, the mind set is still not 100% receptive regarding a buyout scenario. But you can see that this is gradually changing; if you look into developed economies like Japan, Korea, Singapore and Australia you will see it’s more of a buyout situation.”

When it comes to political risk, ARIA’s focal markets are situated in geographies that they are familiar with, where they have executed successful deals in the past. China, India, Taiwan, Korea, Singapore, Indonesia, Malaysia and to a certain extent Vietnam are the company’s main targets. Ms. Tang explains that Myanmar, Cambodia and a number of other frontier markets do not yet present a safe enough environment to make them worth considering.

Consumer markets in Asia are fueling investor led ventures. “For over 70% of our portfolio companies we help them grow inorganically by way of mergers, acquisitions and joint ventures. ARIA’s consumer focus has evolved. ARIA’s early funds were focused on small candy bars, small detergent bottles, etc., and gradually we migrated to over-the-counter drugs and discount stores. With our third fund we started looking into consumer gadgets such as smart phones,

tablet PCs, and in our latest fund we are focusing on luxury goods and high-end retail. As the Asian middle class grows, their spending power also grows, and the type of consumer trends that we are capturing is evolving."

Ms. Tang explains that ARIA feels more comfortable targeting the high end of the market in countries with high GDP per capita, but it is a migration process from the middle to high end of the market, so variation occurs between countries. Private equity is always a long-term (3-5 years) investment product, so it is important to pick companies that come with substantial market share.

Ms. Tang says that investing in a company, as opposed to a brand, proves more fruitful because "brands come and go just like country sentiment," so ARIA invests in companies that are either luxury high-end retail proxy or infrastructure proxy, with a strong foothold in the supply chain and able to supply with a command on price-setting. By doing this, it is easier to "hedge out the risk and maximize the chances of investing in a potential market leader. It's a different angle to play," she says.

When looking into potential companies to invest in, ARIA's due diligence process involves checking whether the company in question has sustainable growth, expansion potential and a substantial market share. "At a micro level we look into a couple of things, such as whether we would be able to work with the owner or management team. Secondly, we look at corporate governance and internal controls. Being able to work productively with company owners during times of difficulty is important. It is also essential that we are on the same wavelength and agenda. People whom we could work with and company which has good corporate governance are the two core elements," says Ms. Tang.

With regard to exit strategy, Ms. Tang says, "I would say that we exit roughly 50-60% of investments by IPO and about 20-30% by trade sale; with the rest we exercise a redemption option. In a handful of cases we have done a pre-IPO placement and then an IPO. We've also done a trade sale and an IPO process in parallel. In one case the IPO gave a better valuation and in another case a trade sale gave a better valuation," says Ms. Tang.

"A lot of the time, when you're talking to family run businesses and entrepreneurs, the mind set is still not 100% receptive regarding a buyout scenario. But you can see that this is gradually changing"

When looking at countries in the region that stand out in terms of growth stories, it is difficult to pinpoint one particular nation. Indonesia was attracting investors back in 1995, but it turned sour because of foreign currency and the fall of the country's long-standing president, Suharto. Similarly, in Vietnam, many people rushed in to take advantage of the real estate opportunities but soon found that liquidity was poor, and the country subsequently became lackluster. In Ms. Tang's view countries currently showing decent growth would include Indonesia, Malaysia and Singapore.

However, the Philippines is not considered so stable. The local news details kidnappings in the local communities, deterring potential investors. "Money must go into safe hands, and we want to see no major disruption throughout our investment period. The Philippines has been having a rough time in the last two decades, which makes it difficult to gauge," adds Ms. Tang.

The U.S. continues to be the major investor in private equity in Asia, perhaps on account of the sector providing a familiar environment for American investors. Europeans also invest in Asia, however, and during the last five years Asian LPs have become more active, as have Middle Eastern sovereign funds. China and Korea are rising as more relaxed regulations allow them to invest overseas.

Mitigating risk when dealing with six or seven countries can present problems. Ms. Tang says, "We take a long term view. Unlike a hedge fund which often knows exactly how long it will hold a position, for us the average holding period is four to five years. Though it's difficult and expensive to purchase hedging mechanisms for foreign currency, ARIA's expertise is in finding solid companies, growing them and then executing an exit plan."

RETURN OF THE RISING SUN

Investors Once Again Turn to Japan

Japan's cultural insularity and particularly high barriers of entry can make investment opportunities challenging to source. Japanese sellers demand strict criteria, and it takes time to build trusting relationships, which immediately puts potential investors at a disadvantage. However, once these obstacles have been successfully navigated, it is possible to acquire proprietary deal flow in the Japanese market.

Being able to execute the management and cultural change of Japanese businesses can present problems for buyers. Japanese businesses are not generally comfortable dealing outside their own cultural ecosystem, so in order to globalize each particular outfit, it is often necessary to instigate high-impact cultural change. "We shut down unprofitable customers and products, we move growth focus on to more profitable customers. It is about de-risking the investment by buying companies that have got the obvious operational improvement depth to create the first few multiples of return," says Mark Chiba, Group Chairman and Partner of The Longreach Group. He is mainly focused on senior relationship-driven deal sourcing and financial services investments. Mr. Chiba has also had senior origination and execution roles in all investments, including the acquisition of 25% of McDonald's Holding Company (Japan), Ltd, the acquisition of 25% of Asia Aluminum Group, the controlling investment in EnTie Commercial Bank, and the management buyout of CYBIRD Holdings Co, Ltd.

The Longreach Group is particularly focused on the technology, industrial, financial services, business services and consumer related sectors. It is uniquely positioned as a private equity firm to deliver world-class growth, operating and profitability standards, with approaches that can secure intense execution commitment from local management and employees and the support of other key stakeholders such as customers and suppliers. When asked about the major trends he is seeing in the sectors The Longreach Group operates in, Mr. Chiba believes the consumer side of Japan is showing obvious patterns, such as the fact that the nation holds many strong food and beverage companies. The fact that China has a huge appetite for quality food goods means there are opportunities to sell well produced, well branded beverage and food products, from Japan to China, on a grand scale. However, Japanese companies feel a great duty of care toward their subsidiaries. Native businesses are not in favor of selling, as there is a strong feeling of responsibility. "As my Japanese partner puts it, you wouldn't auction off your daughter to the highest bidder," says Mr. Chiba. The Japanese want credible buyers who will take care of the organization. This does not mean that investors are not able to take a hard line in streamlining the business in order to make it successful, "but Japanese sellers are still wary. You don't want a bunch of financial engineering that will just load up companies with debt without much thought to whether they risk going bust or not. That is just unacceptable," says Mr. Chiba.

"What is exciting about Japan is that we are still very much in the industry building phase of the business. The industry went through some severe reversals after 2008 when the bubble burst."

Mr. Chiba has seen China's appeal to investors wax and wane, but now investor attention is being turned to Japan, which until recently was not regarded so highly. "When the world looked like it was dead for growth the one bright spot was China; people flooded in there. This created too much capital formation in private equity, so LPs created another bubble in China that is now being popped. It took us two years to raise 400 million dollars in Japan, and whenever it is hard to raise capital you know it's a good time to invest. So LPs are suddenly starting to wake up to the fact that they have been missing it, and they want the same experience they have had in the U.K. or U.S. or in any developed market, where they have control deals sold via good processes and good due-diligence. They want real businesses, real cash flows, and real governance, but they also want to add a layer of growth which Asia can provide."

To get the maximum benefits of being an investor in Japan it is imperative to be established locally. "You really have to be local to get the best deal flow, you just can't do it on a fly-in, fly-out basis. You have to have a strong local team and in Japan you must be identified as one of the home team firms," says Mr. Chiba. "There is still the sense that people want to deal with locals so one of the reasons we set Longreach up independently of any other global firms is because we regard our independence and local identity as vital to our successful execution." Given that Japan is a highly developed economy it is an interesting market to analyze. However, it is still emerging in the private equity sector, unlike the U.S. or Australia, both of which have well developed equity industries. "Japan has a private equity market, but in relation to the economy's size and the M&A market, private equity is still a very small part of it," says Mr. Chiba. "What is exciting about Japan is that we are still very much in the industry building phase of the business. The industry went through some severe reversals after 2008 when the bubble burst. I do think that has worked through the system now, though, and people are starting to see a steady long-term buyout opportunity in Japan. The market is not going to grow enormously, but if you don't overdo it or pour too much capital into it, there are some very significant deals to be had there. The private equity market will continue to grow relative to GDP."

Now that money is starting to flow back in Japan's direction, there is a sense that more capital is going to make its way to the country. But there is only so much it will be able to take. Mr. Chiba compares it to pouring water into a sink with a small plug-hole; the water will overflow at a certain level regardless of how much water is poured in. Japan's capacity to absorb capital into deal flow is only so large. "We will continue do to what we do but it is going to be measured and very prudent. I think quality is the key word. Scale and quality are rarely compatible. It is a case of steadily increasing capital deployment, but the most important thing is to deliver globally benchmarked, quality returns to LPs. For us to meet the hurdle rate of getting their capital we simply have to create world class return," says Mr. Chiba. Japan has particularly high barriers to entry. The large global firms who set up shop there in 2007/2008 with high hopes of utilizing billions of dollars have subsequently found it difficult. Many of them have encountered problems becoming properly established, and in a country like Japan it takes time to form strong and trusting relationships. However, if a company is able to break through the cultural wall and make it through to the other side, the potential to access deal flow away from open competition and on thoughtful buyout terms is enormous. This is quite different than, say, the U.S. markets and Australian markets, where you have openly competitive deal flow. Becoming a local player in the Japanese market is the "real sweet spot," as Mr. Chiba puts it.

Small but solid

Australia's relatively small population and isolated location offers investors the chance to penetrate a market with a different mindset compared with other more populated nations. The country's innovative nature and willingness to embrace new technologies provides an environment suitable for developing smaller businesses before launching them on the global stage.

Australian Private Equity

"It's about solving problems and creating new markets," says John Dyson, one of the founders of Starfish Ventures, an Australia-based venture capital firm that partners with talented entrepreneurs to build successful, innovative global technology companies. Mr. Dyson has personally overseen nearly 20 investments in a range of technologies and industries. He has also achieved numerous exits for his portfolio companies including NASDAQ listing, ASX listings and trade sales to local and overseas companies.

"Venture capital is a key source of entrepreneurial finance. We are the fuel which drives entrepreneurs to go out and do what they do. Without that capital it makes it impossible for some to achieve their full potential, and with others it makes it so much harder and takes a whole lot longer," says Mr. Dyson.

When asked about the potential advantages of placing money with a domestic team such as Starfish Ventures, as opposed to investing money in a more emerging market such as Singapore or Taiwan, Mr. Dyson says, "There are inherent advantages between the Australian market and the Chinese or Indian market. However, exposure to both markets is super complementary. In Australia it is all about innovation, hard-edge research and development, which is born from world-class university environments."

Due to Australia's small population, it is sometimes not possible to adapt certain business models to suit the country's market. "What I think China does fantastically well is scale. Their markets are all about execution, taking a business model and scaling it and rolling out a business model. It might revolve around technology or services and be able to achieve a critical mass very rapidly," says Mr. Dyson. "For Australia, due to the nature of our market, this is not really the opportunity down here. The opportunity is not to go abroad and to identify a new business model and bring it back. It can happen but it is rare. Australia is a market of roughly 20 million people. If you are very lucky you might be able to find one that scales quickly and becomes a dominant leader."

Mr. Dyson strongly believes in not only investing in promising concepts, but also promising people. When looking for potential investment opportunities within the Australian market Starfish Ventures wants promising, hard-working individuals who are willing to take advice and improve. "It is all about the people, making sure we invest in the right people who have the capacity, who have the expertise to really fulfill the potential of the business. For us there are two main criteria, firstly we want to work with people who want to listen, we can add value and we have access to contacts. Secondly, they need to go out and recruit the best people because if you invest in sub-par people they in turn will recruit sub-par people, so it drips down. I want to invest in people who are smarter than myself. I want the best and brightest and that's how I'm going to make money," says Mr. Dyson.

Big U.S. firms have invested in Australia. Google, for instance, cultivated Google Maps based on work that had already occurred in Australia's technology sector. And although there is potential to make money in Australia, Dyson insists that any company with potential investment opportunity must aspire to have a global presence, saying, "We stress that our companies need to have a high profile. The last thing we want them to be is the best-kept secret in Silicon Valley. People need to know them in terms of winning sales or customers. You can't afford in the modern world to live in a vacuum; you have to have a presence on the web, on social media."

Australia's isolation leads to different market trends, and Mr. Dyson explains that Australian consumers are typically open-minded when it comes to embracing new technologies. This does not make fund raising any simpler, though. Similar to what the U.S. has seen in recent years, evidence suggests that investors are becoming more focused on supporting a smaller number of managers. "Fund raising is a bit like selling. When I go out and knock on the door of potential investors what I need to do is sell the vision of the Australian innovation ecosystem. There is a pool of entrepreneurs who have the expertise, drive, commitment, and persistence to roll their sleeves up, grab an idea and really run with it. To go hard and to put together a team of like-minded managers who are willing to put themselves in a position where they can create a critical mass, globally relevant business," says Mr. Dyson.

And when it comes to exit strategies for companies that have developed in Australia, it is the international players that show the most promise. "The logical outcome is a trade sale to international buyers," says Mr. Dyson. "We look at all the exits we've achieved in the years we have been doing this and the vast majority have been trade sales. Also, one of the easiest ways to get a trade sale is through partnership with existing companies."

Understanding the thinking of a smaller, more localized market is key to successfully investing in a country such as Australia. "Our market is a serious business for serious investors, investors who understand the time horizon. We operate in an asset class for investors who understand the risk profiles and timelines. If they do this they will most likely be rewarded," adds Mr. Dyson.

China's Impact on Global Agriculture

William J. Kiernan

This article is excerpted from an in-depth research paper entitled "Bringing Transparency to the Chinese Oilseed Processing Sector" which is available for purchase from Global AgInvesting Research & Insight. www.globalaginvesting.com/ResearchInsights.

China is increasingly becoming the most important factor in the growth of the global agriculture sector, and this growth is presenting significant opportunity for investors. Fundamental economic, demographic, social and dietary changes are the key drivers, and these include:

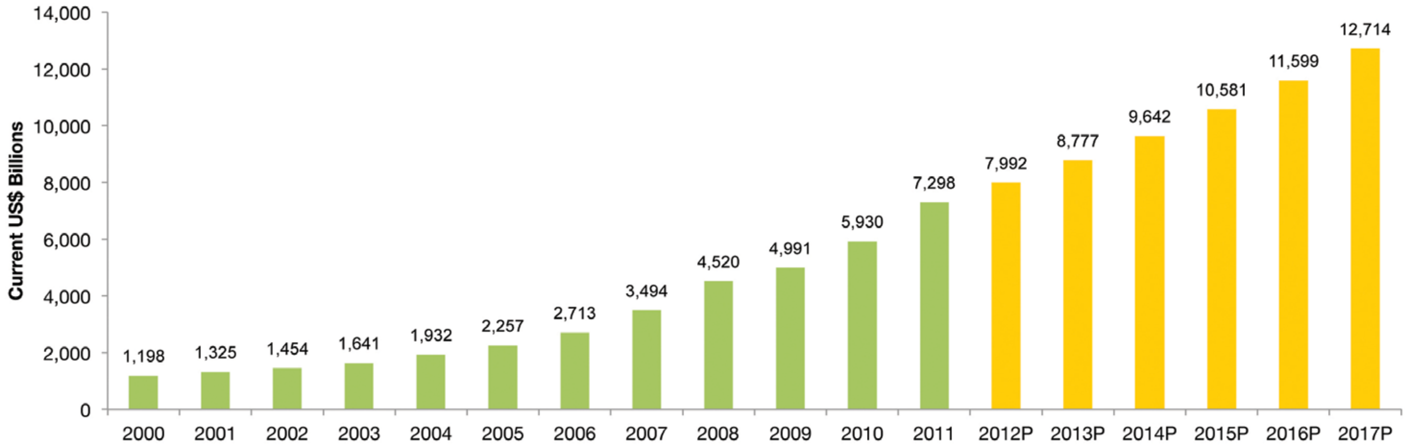
- Strong and sustained economic growth, which is projected to continue
- Slowing population growth, population aging and urbanization
- Rising GDP per capita and a resultant shift in diets from grain and plant-based starches and carbohydrates to animal-derived proteins and cooking oils

To gain an appreciation of just how important events in China are to the global agriculture sector, consider that China currently consumes 49% of the world's pork production, 44% of all peanuts, 31% of rice, 28% of soybeans, 22% of corn and 18% of all wheat, while being home to 19% of the world population. More importantly, Chinese demand for food and agricultural commodities is growing very rapidly. In fact, from 2001 to 2011, China accounted for an astonishing 60% of the total increase in total global consumption of pork, 49% of peanuts, 54% of soybeans, 27% of corn and 12% of wheat. This rapid growth in demand is creating a significant trade opportunity for food exporting nations – including the U.S., Canada, Australia, and nations in Latin America, as well as investors in the agricultural sector. The balance of this article is devoted to examining the key changes in China that are driving growth in the global agriculture sector.

Economic Growth. China's rate of growth over the past 30 years has been remarkable and has not been equaled by any other nation in modern times. During the first 11 years of the 21st century, China's economic growth accelerated, enabling the country to become a dominant global power. In April 2010, China surpassed Japan to become the world's second-largest economy. According to the International Monetary Fund, from 2000 to 2011, China's economy grew at a compounded annual growth rate of 17.85%,

China's Economic Growth:
Gross Domestic Product (Current US$ Billions)

Source: International Monetary Fund

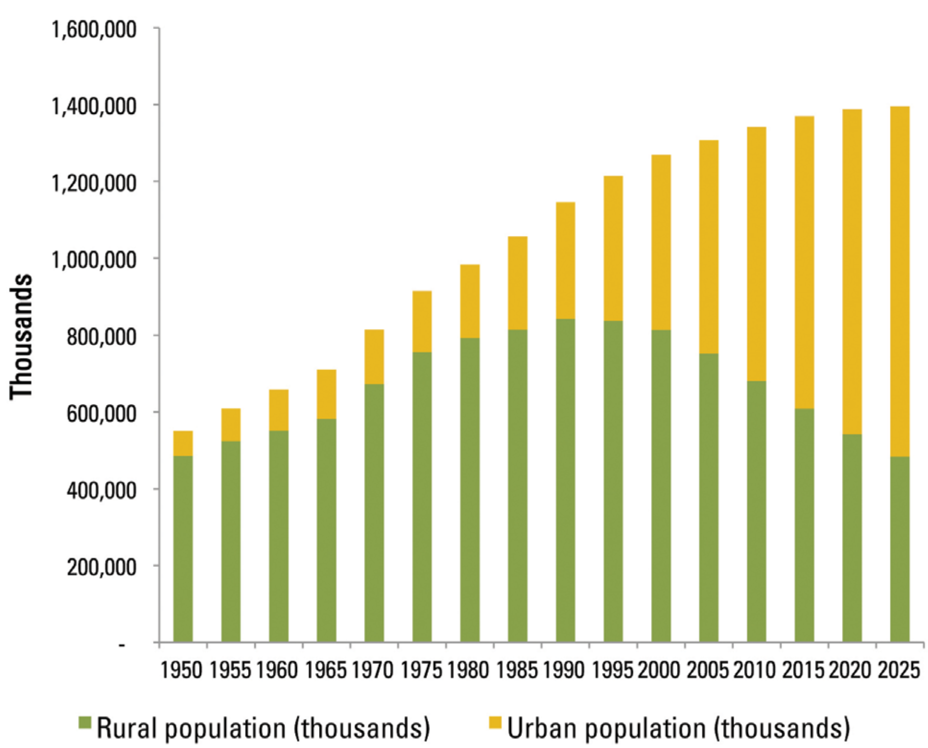


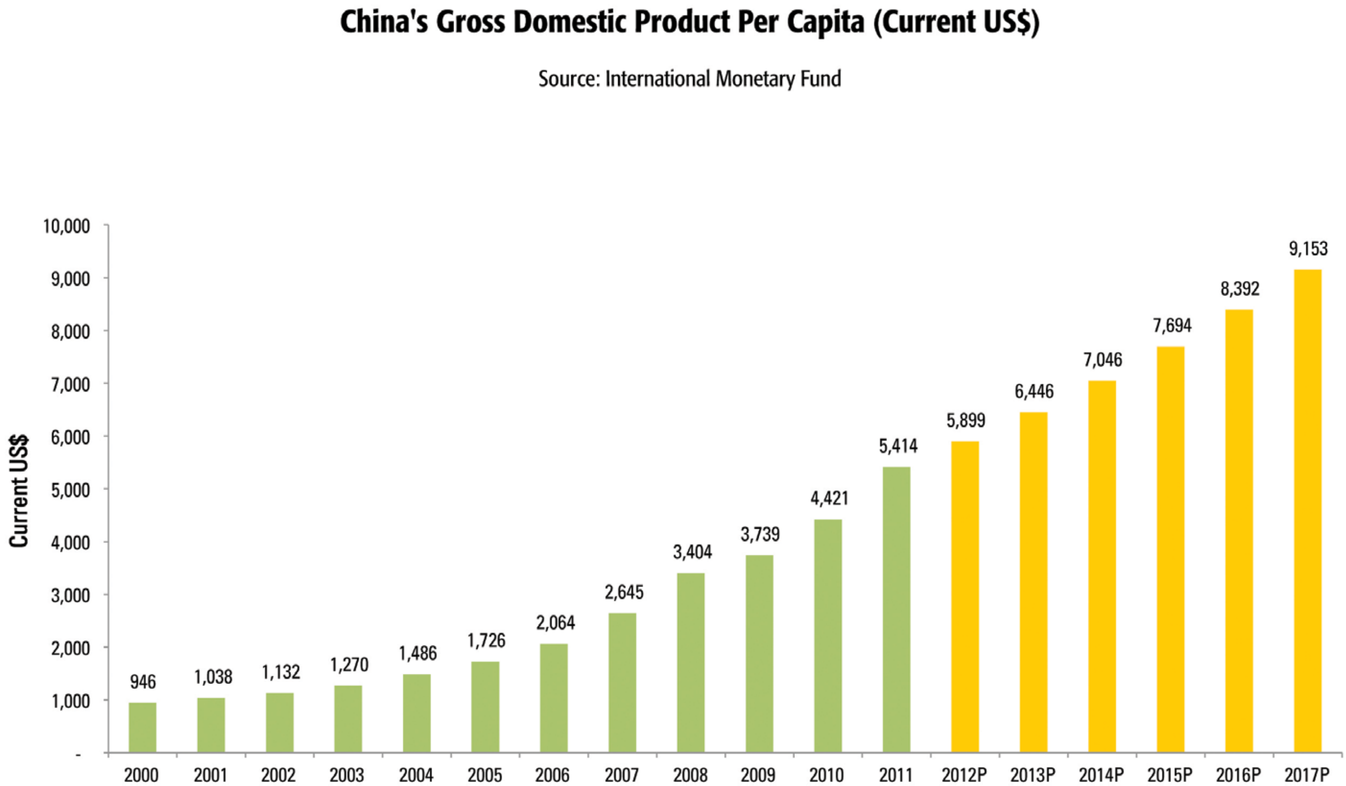
and in 2011 its gross domestic product (GDP) totaled US$7.298 trillion, compared with the U.S. which produced a GDP of US$15.076 trillion in the same year.

Demographic Changes. As of July 1, 2012, China was the world's most populous country with an estimated 1.354 billion inhabitants, or 19.19% of the world population. Furthermore, China's population is growing at a significantly slower rate than its economy – a result of the 1978 enactment of its "one-child policy," which concentrated wealth in the hands of fewer citizens, leading to rising personal incomes and, as we will see, improving diets. A second consequence of the one-child policy is an aging and eventually declining population. China's population is projected to peak at 1.396 billion in 2026 and decline to 1.296 billion by 2050. As the Chinese population ultimately begins to decline, growth in food consumption is expected to decline as well. Nevertheless, given the massive size of its population and improving diets, China is expected to remain a major global consumer of agricultural products.

China's Urbanization
Rural & Urban Populations, 1950-2025P

Source: United Nations Department of Economic and Social Affairs, Population Division





A third demographic change occurring is the rapid urbanization of China's population. In the 1950s, when the vast majority of China's population (88%) lived in rural areas and provided for their own food needs, development of modern agricultural systems similar to those in the western world was not a necessity. As a result, even to this day, China's agricultural sector remains highly fragmented, with an average farm size of 0.6 hectares compared with the average U.S. farm size of 169 hectares.

This is rapidly changing, however. Chinese GDP per capita has increased by more than a factor of five from US$946 in 2000 to US$5,414 in 2011. Current estimates by the International Monetary Fund project China's GDP per capita to grow by a further 69.06% to US$9,153 by 2017. This is illustrated in the accompanying chart.

The increase in China's GDP per capita will likely have critical implications for both China's agriculture sector and the global grain and oilseed trade. Data from around the world points to a strong, positively correlated relationship between rising personal incomes, increased calorie consumption and dietary changes from primarily carbohydrate-based, vegetable and cereal grain diets to diets richer in animal proteins and vegetable fats.

The relationship between rising incomes and the "westernization" of diets is not a new concept. In 1941, M.K. Bennett of the Food Research Institute at Stanford University published comparative studies of the consumption of staple foods that have come to be known as "Bennett's Law." Bennett's Law is the empirical generalization that there is an inverse relationship between per capita income and the percentage of total calories derived from root, tuber and cereal grain carbohydrates in personal diets.

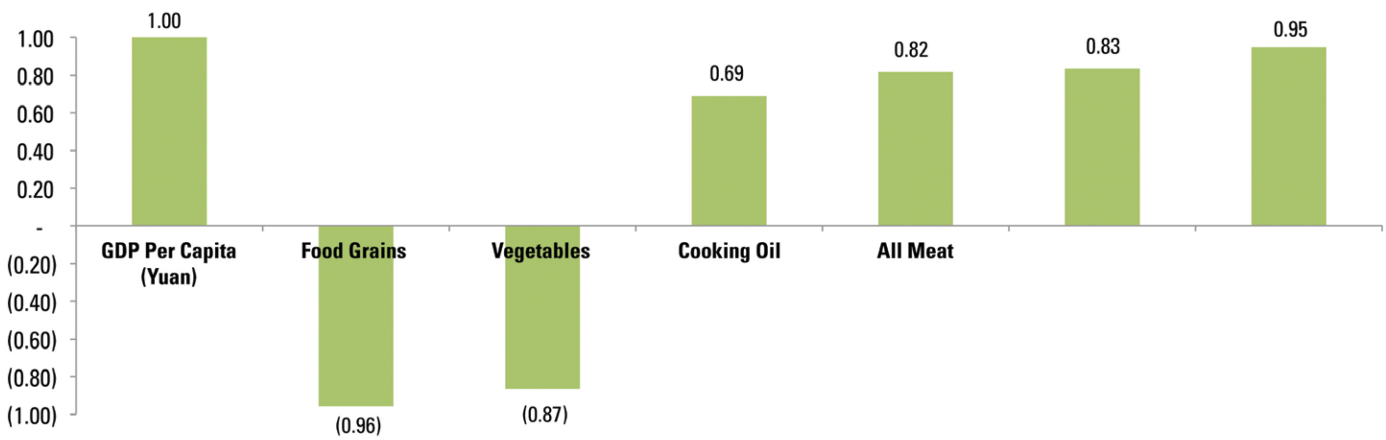
To further develop Bennett's Law, our research indicates that (globally) as per capita income increases, individuals change their diets in the following progression:

- Individuals will first increase their caloric intake.
- Individuals will then replace carbohydrate calories derived from starchy staples such as roots, tubers and rice with carbohydrate calories derived from wheat.
- As personal incomes increase further, individuals will adopt protein and fat-sourced calories from animals (meat, dairy and eggs) and vegetable-sourced fats (cooking oils) as substitutes for carbohydrates from food grains and vegetable-sourced calories.
- In fact, during the 2001-2011 period, meat consumption in China increased by over 21% from 42 to more than 51 kilograms per capita.

The following analysis illustrates the correlations between personal income, total caloric consumption and a dietary migration from food grain and vegetable-based diets to those richer in animal proteins. During the 30-year period from 1979 to 2009, China's GDP per capita increased by 18.58 times. During the same time period, total caloric consumption per capita increased by 44.85%. Additionally, diets have migrated

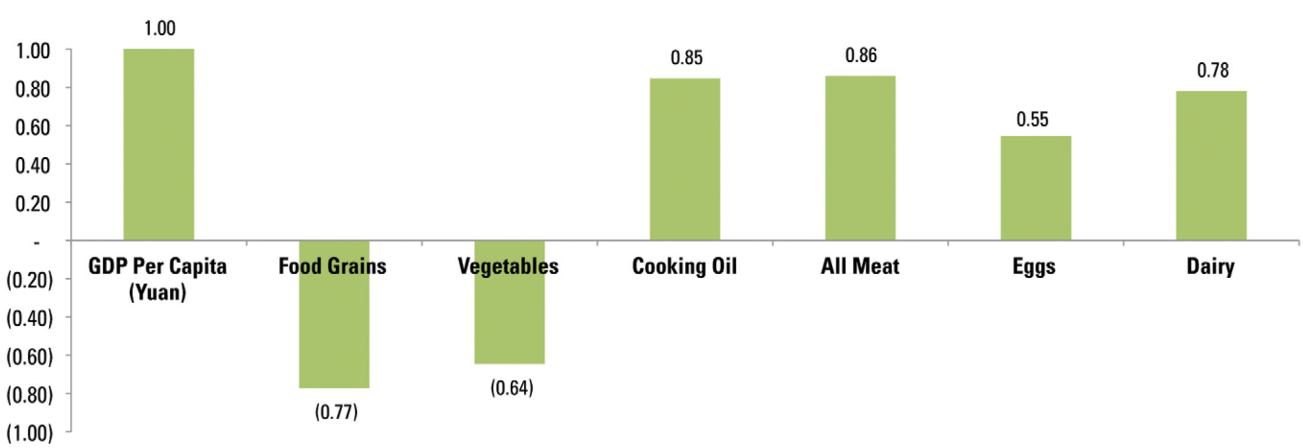
An Average Rural Chinese Resident's Diet Correlated with Their GDP Per Capita, 1985-2010

Source: China State Statistical Board



An Average Urban Chinese Resident's Diet Correlated with Their GDP Per Capita, 1985-2010

Source: China State Statistics Board



as well, as shown in the accompanying correlation analysis between GDP per capita and food consumption changes.

The strong inverse correlation between the direct human consumption of food grains and vegetables and the strong positive correlations with consumption of cooking oils and animal proteins and GDP per capita in both rural and urban populations in China provide evidence of the relationship between rising incomes and westernization of the Chinese diet.

The Multiplier Effect. The significance of the shift in diets in China from grains to animal products and cooking oils is that animal product production is very inefficient in terms of input energy compared to against output energy in the production process: it takes significantly more grain calories to produce an equivalent amount of animal product calories. This in turn creates a significant multiplier effect on the demand for grains and oilseeds to produce animal-derived food products. For example, it takes an estimated 9.93 pounds of grain to produce a pound of beef, 3.58 pounds to produce a pound of pork, and 1.95 pounds to produce a pound of chicken meat. The magnitude of the shift in China's diet resulting from increased personal incomes during the period 2000-2011 is illustrated by per capita consumption of meat, dairy and eggs growing by 19.38%, 222.46% and 24.14%, respectively.

Impact on Grain and Oilseed Demand. This increased consumption of animal proteins and cooking oils coupled with the grain/oilseed multiplier effect of these food products explains why the per capita demand for grains and oilseeds in China has increased overall by 37.58% between 2000 and 2011. Total oilseed consumption also correlates strongly with GDP per capita because the majority of oilseed consumption is in the form of animal feed.

Room for Consumption to Grow. China's GDP per capita and per capita consumption of total calories (including meat, dairy, eggs, feed grains and oilseeds) still rank well below average per capita consumption in the western world. There is significant potential for increased consumption of total calories and additional dietary shift to animal product consumption in China as personal incomes continue to grow. The per capita consumption of various food products in China to consumption in the U.S.

This growth in consumption explains why growth in the agricultural sector has been so positive. With continued growth forecasted for China's economy, we believe that there is a compelling case for investment in this sector.

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China and the United States: A Comparison
Per Capita Consumption of Meats, Dairy, Eggs and Oilseed
Sources: USDA, UN Population Division, IMF, FAOSTAT

	China	United States	China CAGR 2000-2011	China Change 2000-2011
2011 GDP per Capita (Current US$)	$5,414	48,328	17.19%	427.50%
Population (Thousands)	1,341,335	310,384	0.55%	6.18%
Calories per Capita per Day	3,036	3,688		
Per Capita Consumption (Kgs)				
Beef	4.10	37.54	0.18%	1.99%
Pork	37.11	26.87	1.59%	18.98%
Poultry	9.66	51.35	2.45%	30.49%
All Meat	50.87	115.76	1.62%	19.38%
Dairy	24.94	132.46	11.23%	222.46%
Eggs	19.24	14.10	1.99%	24.14%
Oilseeds	88.65	186.66	5.27%	75.98%

Author Biography

William J. Kiernan is the Director of Global AgInvesting Research & Insight at HighQuest Partners LLC and has over 20 years of experience in the investment management and agriculture industries in finance, public equities, private equity and real estate investing. He is currently Director of Research & Insight for HighQuest Partners where he is responsibile for conducting and managing research in the agriculture and investment sectors, as well as providing advisory and research services to clients in these sectors. He can be reached at bkiernan@highquestpartners.com or 1-978-887-8800 ext. 119.

Africa's Food Markets

A Trillion-Dollar Opportunity

Africa's farmers and agribusinesses could create a trillion-dollar food market by 2030 if they can expand their access to more capital, electricity, better technology and irrigated land to grow high-value nutritious foods, and if African governments can work more closely with agribusinesses to feed the region's fast-growing urban population, according to a recent World Bank report.

According to Growing Africa: Unlocking the Potential of Agribusiness, Africa's food systems, currently valued at US$313 billion a year from agriculture, could triple if governments and business leaders radically rethink their policies and support for agriculture, farmers and agribusinesses, which together account for nearly 50 percent of Africa's economic activity.

"The time has come for making African agriculture and agribusiness a catalyst for ending poverty," says Makhtar Diop, World Bank Vice President for Africa Region. "We cannot overstate the importance of agriculture to Africa's determination to maintain and boost its high growth rates, create more jobs, significantly reduce poverty, and grow enough cheap, nutritious food to feed its families, export its surplus crops, while safeguarding the continent's environment."

Agribusiness: Strong growth opportunities

Due to a combination of population growth, rising incomes and urbanization, strong demand is driving global food and agricultural prices higher. Supply issues – slowing yield growth of major food crops, slowdown in research spending, land degradation and water scarcity issues and a changing climate – mean that prices will remain high. In this new market climate, Africa has great potential for expanding its food and agricultural exports.

Africa holds almost 50 percent of the world's uncultivated land that is suited for growing food crops, comprising as many as 450 million hectares that are not forested, protected, or densely populated. Africa uses less than 2 percent of its renewable water sources, compared with a world average of five percent. Its harvests routinely yield far less than their potential, and for mainstay food crops such as maize the yield gap is as wide as 60 to 80 percent. Post-harvest losses run 15 to 20 percent for cereals and are higher for perishable products due to poor storage and other farm infrastructure.

African countries can tap into booming markets in rice, maize, soybeans, sugar, palm oil, biofuel and feedstock and emerge as major exporters of these commodities on world markets similar to the successes scored by Latin America and Southeast Asia. For sub-Saharan Africa, the most dynamic sectors are likely to be rice, feed grains, poultry, dairy, vegetable oils, horticulture and processed foods to supply domestic markets.

The report cautions that even as land will be needed for some agribusiness investments, such acquisitions can threaten people's livelihoods and create local opposition unless land purchases or leases are conducted according to ethical and socially responsible standards, including recognizing local users' rights, thorough consultations with local communities, and fair market-rate compensation for land acquired.

"Improving Africa's agriculture and agribusiness sectors means higher incomes and more jobs. It also allows Africa to compete globally. Today, Brazil, Indonesia and Thailand each export more food products than all of sub-Saharan Africa combined. This must change," says Jamal Saghir, World Bank Director for Sustainable Development in the Africa Region.

Value chains are essential

Africa has become a major consumer and importer of rice, and Africans import half the rice they eat and pay top dollar for it, US$3.5 billion per year and more. Ghana and Senegal are significant importers. Senegal is competitive among its neighbors, but it is held back by the difficulty farmers have in accessing land, capital, finance for irrigation expansion and appropriate crop varieties. Ghana produces fewer varieties of rice than Senegal, but at significantly higher cost, and levies 40 percent tariffs and other charges on imports. Poor grain quality, cleanliness and packaging are major deterrents for consumers constraining the sector's performance.

A food staple for many Africans, maize is grown on 25 million hectares or 14 percent of cropped land. In Zambia where people eat on average 133 kilograms of cereals a year, maize provides half the calories in their diets. Zambia is competitive when importing maize but fails on exports. High transport costs, higher labor costs and lower yields combine to increase costs by one-third compared with Thailand, a major international producer of rain-fed maize. The report argues that Zambia's future competitiveness depends on raising yields, reducing costs and removing disincentives for the private sector in markets and trade.

In addition, the study reviewed value chains for cocoa in Ghana and dairy and green beans in Kenya. "African farmers and businesses must be empowered through good policies, increased public and private investments and strong public-private partnerships," says Gaiv Tata, World Bank Director for Financial and Private Sector Development in Africa. "A strong agribusiness sector is vital for Africa's economic future."

Solutions

Agriculture and agribusiness should be at the top of the development and business agenda in sub-Saharan Africa. The report calls for strong leadership and commitment for both public and private sectors. As comparators, the report cites case studies from Uruguay, Indonesia and Malaysia. For success, engaging with strategic "good practice" investors is critical, as is the strengthening of safeguards, land administration systems, and screening investments for sustainable growth.

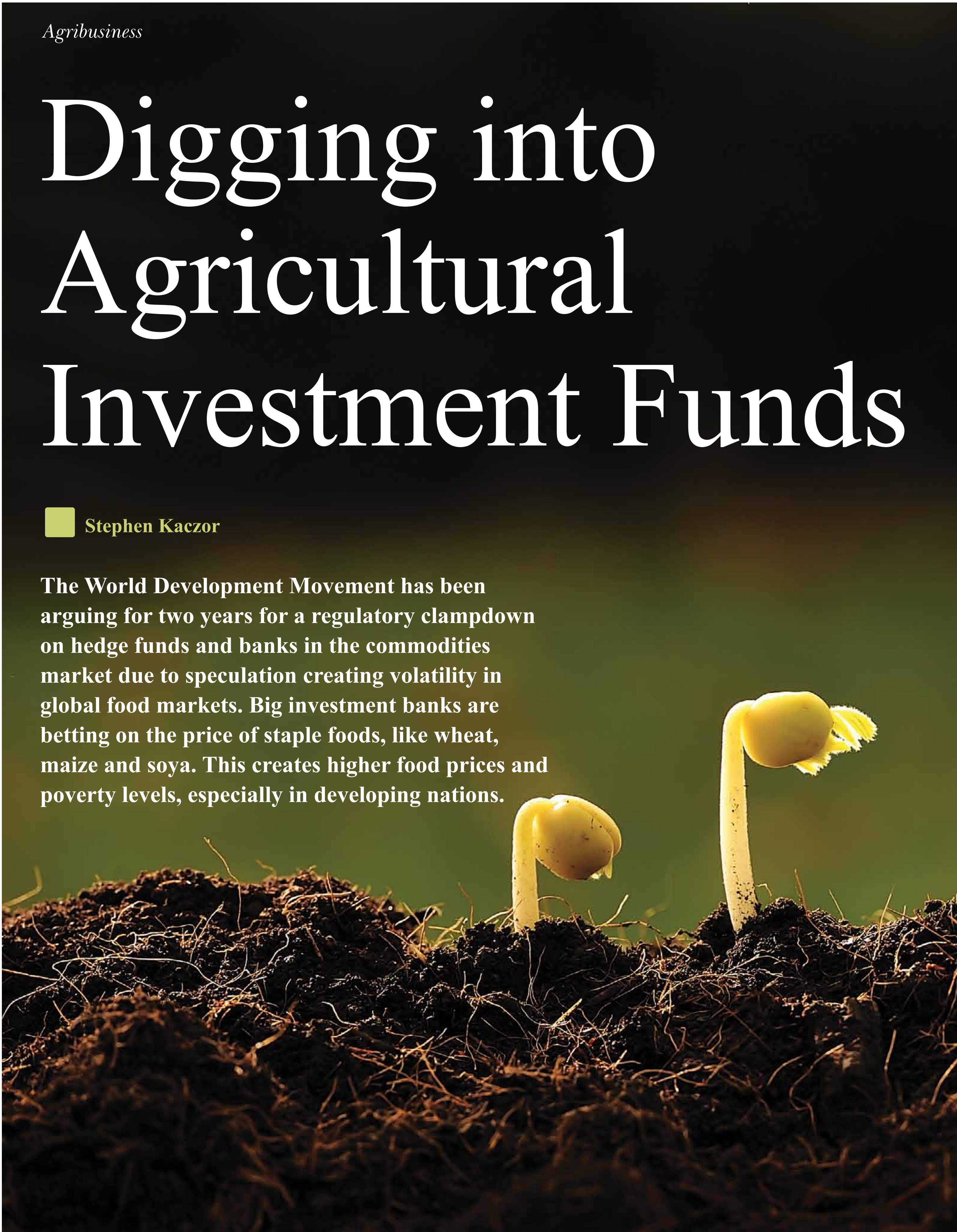
The report notes that Africa can also draw on many local successes to guide governments and investors toward positive economic, social and environmental outcomes.

Original Press Release Issued March 4, 2013 – The World Bank - www.worldbank.org

Digging into Agricultural Investment Funds

Stephen Kaczor

The World Development Movement has been arguing for two years for a regulatory clampdown on hedge funds and banks in the commodities market due to speculation creating volatility in global food markets. Big investment banks are betting on the price of staple foods, like wheat, maize and soya. This creates higher food prices and poverty levels, especially in developing nations.



According *The Guardian*, "at Britain's oldest food market, Borough Market in London, fund managers at one of the biggest investment groups in the world are telling a rather different story." BlackRock is rolling out its World Agriculture Fund for small investors who, it says, can profit from the long-term increase in food prices as rising affluence in China, India and Brazil dramatically changes dietary habits.

BlackRock is not alone in seeing agriculture as an industry ripe for attractive investment returns. Last year, Baring launched a global agriculture fund that allowed its early investors a 30% gain. But there are many agricultural investment funds. We will take a look at the concept in general and introduce three examples. A report from the Food and Agriculture Organization (FAO) framed the challenge this way:

"Investment is essential for the growth of the agricultural sector if there is to be enough food to feed the world population of 9 billion in 2050. In 2007, food commodity prices climbed to record levels, which, among other reasons, contributed to the current global food crisis. Against the background of the high food prices, it is estimated that in 2008, the world's hungry increased by about 80 million to approximately 1 billion people. During the first half of 2009 only, the number of hungry increased by another 105 million."

This figure equals the increase in the number of hungry during the previous 17 years, according to *The Economist*. "And this number has been rising by an additional four million people every week" (Aloisi, 2009). With this increase in demand among a growing global population, there is clearly a role for agricultural investment funds. But many believe the traditional speculative aspects of investment funds have no place in global food markets. This is leading to a new type of investment fund, a change that many believe is justifiable.

The FAO believes agricultural investment funds have underscored public and private sector interest in helping address the resource constraints for achieving food security. One of its report's recommendations is limiting the role of speculators. "The volatility in financial markets and the volatility of commodity prices, which have been partially caused by speculation, must be contained as far as possible. Markets for complex financial instruments related to agriculture will remain attractive for investors. However, from a developmental perspective, there should be a focus on thoroughly assessed investment opportunities in agriculture with a sustainable impact. The FAO report provides detailed case studies, but we will take a brief look at three examples.

In 2008, Sustainable Agriculture Guarantee Fund (SAGF) was established by Rabobank International with a grant contribution of the Directorate General for International Cooperation of the Netherlands (DGIS). The fund has been set up to improve access of cooperatives to formal finance in developing countries through a guarantee scheme for pre-export finance. SAGF issues partial credit guarantees as a risk-mitigating instrument for local financial intermediaries, which offer commercial credit to agricultural cooperatives. The credit guarantee will be phased out step-by-step during the following loan cycles of the recipient. The local bank finances the client on the basis of the sales contract with the off-taker and does not require the borrowers to provide fixed assets as collateral.

Latin America has the climate, soil, labor structure, and financial climate to feed more of the world, driving increases in agricultural exports to neighboring countries as well as Africa and Asia. What is missing is financial and logistical support for cooperatives and small companies to become players in export markets.

The fund is operating in five countries (Peru, Nicaragua, Honduras, India and Mozambique), where it has established partnerships with seven banks and has issued guarantees in the total amount of US$30 million. A specific example is SAGF's funding guarantee in Peru to local institutions dealing with Cepicafe, a cooperative organization consisting of 71 smaller member organizations, which represent a total of 5,000 producers of coffee, cacao and sugar cane. In terms of impact, it is estimated that the Fund has benefited approximately 27,000 producers during the first year of operations.

The Burlington Capital Group's Agribusiness Partners International (API) focuses on agribusinesses in emerging markets. With the fall of communism, the API recognized the opportunity to develop an agribusiness investment fund in the former Soviet Union. It was formed as a $100 million private equity investment fund. The Fund enjoyed the support and partial guarantee of the Overseas Private Investment Corporation ("OPIC"). API invested in eight food and agribusiness sector operations. These investments were primarily early-stage investments or start-ups. The private equity fund invested in companies that acquired old Soviet assets, invested in upgrades and developed modern, world-class competitive companies. Despite severe economic crises, 7 of the 8 are thriving today.

According to its website, API seeks to invest in established agribusiness companies that have the potential to become leaders in their markets with distinct business models, but also have transformational opportunities such as:

- Investing for growth
- Operating improvement opportunities
- Implementing practices that promote

sustainable agriculture
- Expanding geographically
- Repositioning strategically
- Capitalizing on shifting product trends or end users
- Acquiring add-on businesses or product lines

Just this year, TIAA-CREF finished raising $2 billion for its agricultural investment company including commitments from pension funds in Sweden and Canada's British Columbia and Quebec. According to Amy Or reporting for the *Wall Street Journal*, "it was set up as a company instead of a fund and focuses on farmland in the U.S., Australia and Brazil. It aims to invest about 70% of the $2 billion in land that grows annual crops like cotton and soybean and the remainder on land for permanent crops like apples and almonds."

Jose Minaya is TIAA-CREF's head of global natural resources and infrastructure investments. "We see increased protein consumption in developing economies and alternative energy mandates driving increased demand for food, fiber and fuel from a limited resource – land. Direct investment in farmland provides access to the key driver of food production. We believe farmland offers investors excellent portfolio diversification given its low correlation to traditional asset classes like stocks and bonds. Farmland also acts as hedge against inflation within a portfolio," Mr. Minaya said. The journal *Institutional Investor* believes this team may have launched the future of institutional investing.

Look at the constants: diminishing yields, population growth, lack of farmland, growing demand for agricultural commodities from the energy sector. These constants create opportunities where infrastructure can be developed through financing, irrigation and distribution efficiencies.

Latin America has the climate, soil, labor structure, and financial climate to feed more of the world, driving increases in agricultural exports to neighboring countries as well as Africa and Asia. What is missing is financial and logistical support for cooperatives and small companies to become players in export markets. Agricultural investment funds have the potential to join investors' ROI expectations with the need for development of the global food supply.

Author Biography

Stephen Kaczor is Chairman of the Big River Foundation, a non-profit focused on river and watershed ecology conservation initiatives throughout the Americas. He is an organic farmer, eco-entrepreneur, consultant and writer with a documentary film in production in Central America. As a Panama-based consultant, Mr. Kaczor's focus is sustainable organizational development, research & management. In addition to consulting and writing, he is passionate about sustainable agriculture, Latin American culture, travel, and ecology.
www.BigRiverFoundation.org

Mark McHugh & Andre Paes

Petrobras

Between a Rock and a Hard Place

Petrobras, once heralded as one of the few success stories among national oil companies, is now languishing, a victim of state interventionism. It has lost the confidence of the market, with its share price significantly underperforming its peers. Although Petrobras remains the main driver of the Brazilian oil & gas industry and accounts for more than 90% of the country's current crude oil production, it is hamstrung in its ability to execute on ambitious investment plans and meet strategic growth targets. Petrobras has been held hostage by its major shareholder, the Brazilian government, in its desire to control fuel prices and limit inflation, forced to subsidize imports and guarantee lower fuel prices in the domestic downstream market.

Meanwhile, in an attempt to mitigate the impact on its bottom line, Petrobras has implemented a program of reforms under the stewardship of its new CEO, Maria de Graças Foster – cutting back on costs, targeting greater operational effectiveness, reviewing all supplier contracts and starting a fire sale of non-core assets. This in turn is creating a great deal of uncertainty in the market and significant skepticism that Petrobras will meet its goal of increasing Brazilian crude oil production to 5 million boe/day by 2020. Many companies operating in the oil service sector are adopting a wait-and-see approach, cutting back on their own investment plans and realigning to a new reality, conscious of the challenges Petrobras currently faces in delivering on its promises.

While some are taking a more positive view on Petrobras and the company's reforms, this view is out of line with recent results, which have continued to disappoint investors due to weakness in oil production and earnings. Arguably, Petrobras is in the midst of implementing critical reforms that favor long-term growth over the pressure to achieve a short-term profit. As such, the company's future depends on its ability to successfully persuade the Brazilian government to change its policies, which have

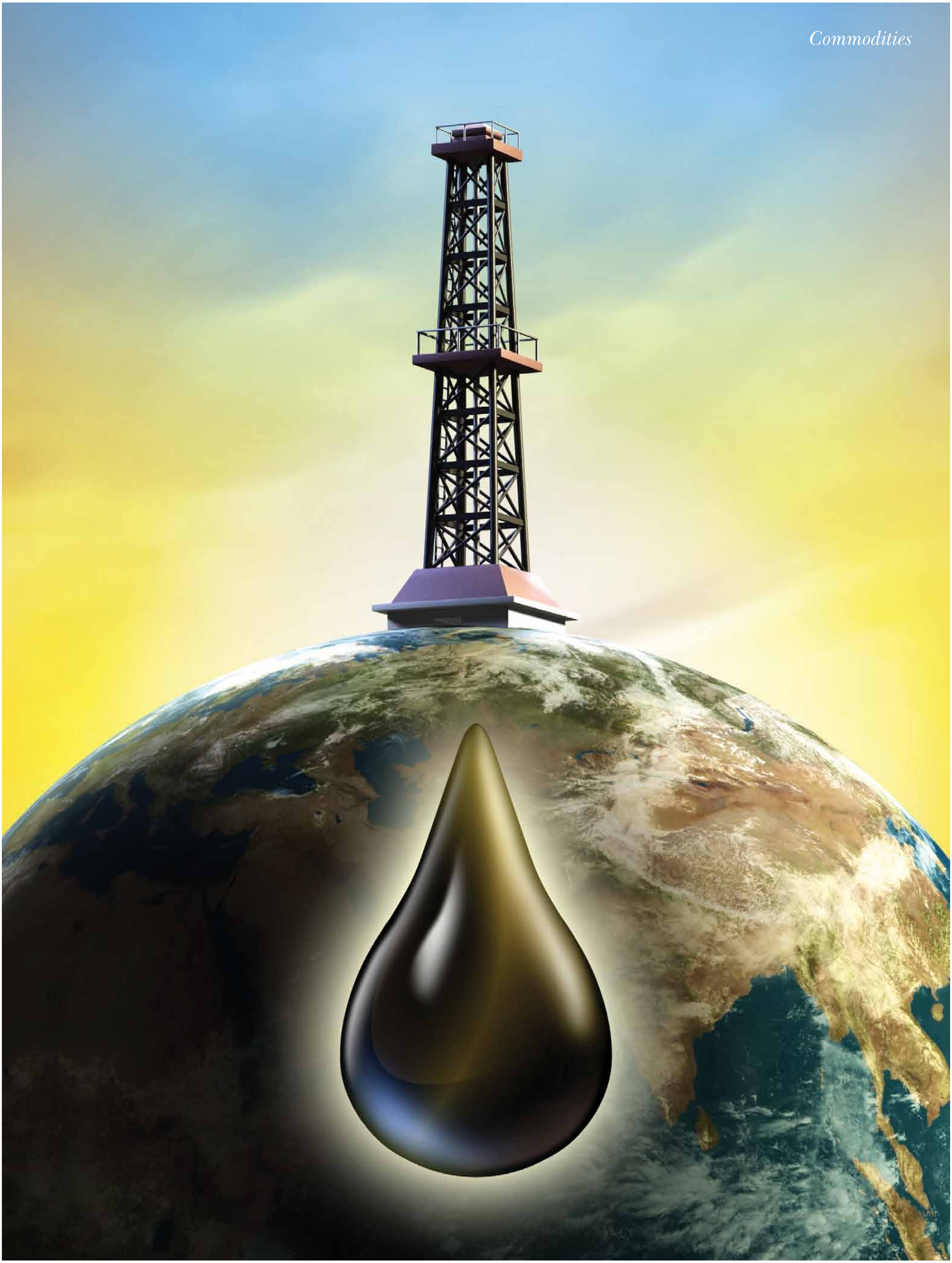


Chart 1: Petrobras ADR (PBR) performance compared to Exxon (XOM), Chevron (CVX) and Royal Dutch Shell ADRs (RDSA) in the last 5 years - September 24, 2010, was the IPO date (source Reuters).

contributed to an unsustainable status quo. Recent fuel pricing changes, although directionally correct, are too little, too late in our view. This further reinforces the difficult outlook for Petrobras in the medium term.

Yet, there are some genuine reasons for greater optimism. Brazil's 11th licensing round was officially announced by President Dilma Rousseff in January, to take place in May 2013 together with a further licensing round for pre-salt blocks due in November 2013. These rounds are expected to attract significant foreign interest. Should exploration prove successful, production from these highly prospective blocks would all but guarantee the country's status as one of the world's most important oil producers until well beyond the end of the current plan period in 2022, particularly as the country's subsalt reserves are increasingly entering production. However, it appears likely that Petrobras's impaired ability to take on additional challenges at this time will severely limit its own participation and share of this new prize.

What impact does the controlling shareholder have on Petrobras

In the recent past Petrobras's valuation was comparable to major IOCs (international oil companies) on a range of metrics. Specifically, over recent years, it has been able to replace its reserves at a greater rate than its peers, particularly following the most important pre-salt discoveries in mid-2008. However, despite this, Petrobras shares have suffered (Chart 1), notoriously after the 2010 IPO, which raised close to US$70 billion (the largest in history) and increased the Brazilian government stake in the company. The IPO was intended to strengthen Petrobras's balance sheet to fulfill the role that the current ruling political party (PT – Partido dos Trabalhadores) envisions for the company: to become the unique operator with at least a 30% stake in every pre-salt block in the Campos and Santos basins and other strategic areas.

Since 2008 when the massive pre-salt discoveries were announced, Petrobras has developed a very ambitious CAPEX program (US$250 billion of investments in 5 years, with around 56% on its E&P operation). This is the largest CAPEX program in the worldwide oil industry today, but so far it has not been sufficient to boost production, and this has put tremendous pressure on the company's balance sheet.

The largest IPO. . . . Was it good for everybody?

The Petrobras IPO process was extremely controversial and required a complex operation involving the Brazilian Treasury, the Brazilian government (the controlling shareholder) and BNDES (the Brazilian Development Bank).

Firstly, it is important to recognize that 100% of the US$70 billion did not turn up as cash on Petrobras's balance sheet. The vast majority of the Brazilian government IPO share was actually paid in oil reserves, in an op-

Chart 2: Annual unemployment rate in Brazil (source IBGE).

eration called Cessão Onerosa. Part of this process involved establishing a fair valuation for recoverable reserves still to be extracted. This issue generated a lot of discomfort among minority shareholders, as the valuation was deemed high at US$8.50/boe. On top of the normal dilution that happens when new shares are issued, the controlling shareholder was allowed to contribute in kind, unlike the remaining shareholders. Moreover, in the contract signed between the government and Petrobras (Cessão Onerosa), any upside on the recoverable reserves is to be reimbursed to the government. In other words, any good surprises will not benefit Petrobras or the remaining shareholders.

The government agenda and the economy – how it affects Petrobras

In order to understand most of the changes in Petrobras, one needs to understand, in addition to the government agenda, the current economic situation. In recent years Brazil has experienced low unemployment rates (Chart 2) as well as a significant growing middle class that has boosted the domestic economy. Most of the "new money" has come from credit available to individuals, which has substantially grown as a percentage of the country GDP.

As most of the country's growth has come from consumption and investment remains very low, there is an inevitable pressure on the CPI (consumer price index), which is the major factor driving government approval ratings and ultimately election results. With constant political pressure to keep inflation low, the Brazilian government has attempted to avoid, as much as possible, the harmful impact of commodity prices on the CPI. This is notably the case for diesel and gasoline. Petrobras has a government mandate to supply the Brazilian market, and under political pressure the company is currently subsidizing transport fuels, which are sold in Brazil below import parity (Chart 3).

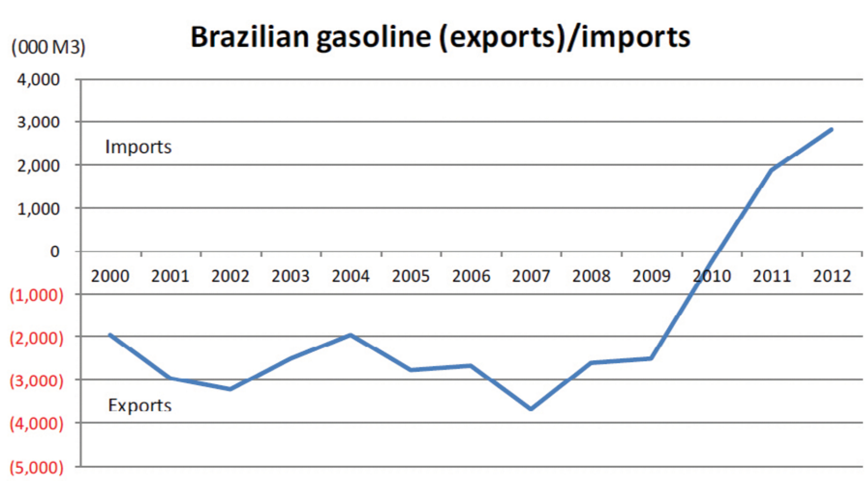


Chart 3: Gasoline prices in Brazil at the refinery gate and in the international market in US$/bbl (source ANP-Platts).

Despite the fact that the country has become self-sufficient in crude oil, it does not possess sufficient refining capacity to process all the domestic crude produced. Hence it is a net importer of refined products, which puts significant pressure on the country's trade balance. To resolve this issue the Brazilian government once again has resorted to Petrobras to implement its strategy. Petrobras is currently building two new refineries at enormous cost to alleviate the adverse trade balance caused by refined products imports. Moreover, there are plans for two more refineries still to be decided upon. This investment in refining capacity harms the company in two ways: current refining margins do not compensate the cost of building new refineries, which are sub-economic; and the refineries that Petrobras is building are very complex and expensive, diverting investment from the upstream and impacting the strategic priorities of the company. In particular, the crude mix that they are expected to process, as well as the cut of the barrel they will produce (naphtha, low sulphur diesel and jet A1), increase complexity and cost. As such, both refineries have high Salomon indices (an index that measures refinery complexity) at 9.6 and 11.2 compared with 8.3 for existing refineries (according to ANP).

To make matters worse, the majority of the Brazilian passenger car fleet has a “flex” feature that makes the selection between ethanol and gasoline dependent only upon the price differential between these fuels. Ethanol and gasoline are available at all gas stations across the country, and it is purely a consumer choice. Flex vehicles now represent more than 75% of all cars sold in the country. Due to the price differential in world markets between sugar and ethanol, the ethanol sector in Brazil has been incentivized to produce more sugar and less ethanol since 2009. This as a consequence has reduced the ethanol volume available in the market and impacted ethanol prices relative to gasoline up to a point that ethanol is no longer the best option at the pump. This in turn has increased the deficit in refined products (Chart 5) and has put more pressure on Petrobras’s P&L, as it is importing a larger volume at international market prices and selling in the domestic market at a loss.

Petrobras’s recent performance

There can be little wonder after reading the above the company’s results are suffering as a direct consequence of the controlling shareholder’s agenda. This is exacerbated by the fact that the company is engaged in a heavy investment program over the next 5 years that is twice the size of its current market capitalization. Even after the massive capital injection from the IPO, Petrobras’s indebtedness (Chart 6) is growing rapidly and in the last quarter (4Q/2012) achieved worrying levels. At the same time, it seems as if the Brazilian government is not willing to change its inflation agenda. The very slim diesel and gasoline price increases announced in January failed to have a meaningful impact on Petrobras. The current price gap between domestic and international prices remains around 10-15% and is fully subsidized by Petrobras.

Taking into account that Petrobras’s production is not planned to grow significantly in the next 24 months (new capacity is only compensating current depletion) and that the Brazilian government will not risk an inflation spike produced by fuel prices in the run-up to the 2014 presidential election, there will be no respite for Petrobras in the medium term. It is important to note that crude oil prices have a very low correlation with the company’s bottom line, as higher crude oil prices imply a higher subsidy burden, which is entirely absorbed by Petrobras. This is distinct from all other IOCs. At the current pace of investment the company will likely reach the 35% limit for net debt/net capitalization ratio this year, which threatens the company’s investment grade status.

What are some of the likely consequences for the oil & gas industry in Brazil?

Petrobras has already announced that it will conduct a substantial divestment program involving US$8 billion of non-core assets by April 2013. Given the pressure on Petrobras’s balance sheet and no signs of a letup,

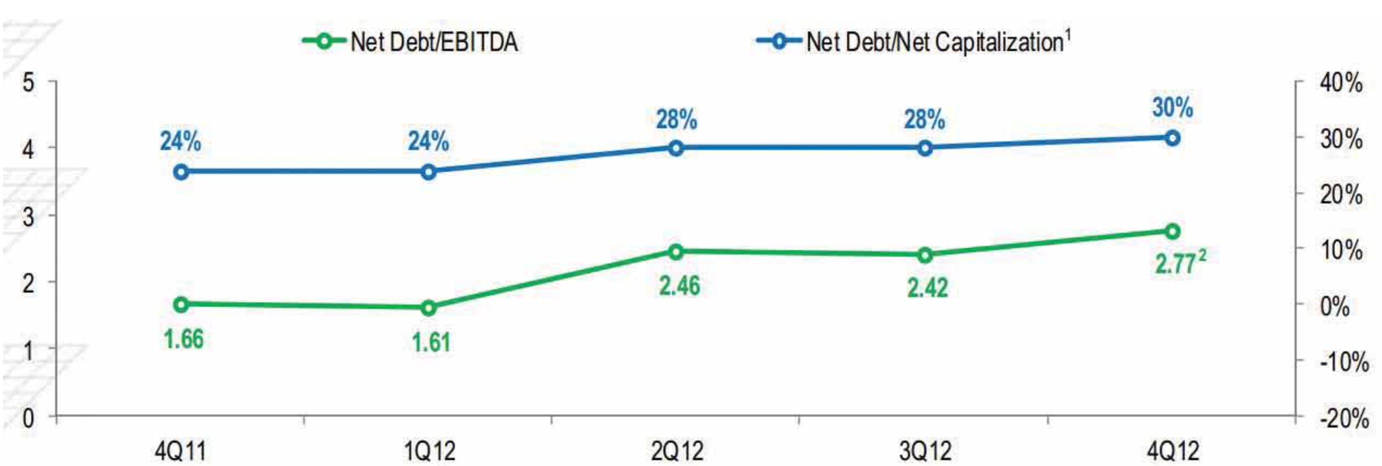


Chart 5: Brazilian gasoline exports/imports from 2000 to 2012 (2012 volume Jan-Nov – source ANP).

the company should be prepared to offer assets at good prices for a quick sale – possibly creating some bargains for investors. However, there is a widespread belief that Petrobras may still try to extract an unrealistic premium upon sale of exploration blocks, such as occurred when OGX acquired Petrobras's stake on the BS-4 block. OGX paid a 20% premium over the price paid to Shell by Queiroz Galvão and Barra Energia for a stake in the same block. Similarly, they failed to sell blocks in the Gulf of Mexico at the end of 2012 in a private placement process, as investors were unwilling to pay the high prices Petrobras was asking.

Upcoming eleventh and pre-salt bidding rounds

There is considerable optimism in the international industry about the forthcoming exploration rounds in 2013. We fully expect the oil and gas industry in Brazil to regain some of the momentum it has lost in the past couple of years. However, it is not likely that Petrobras will be very aggressive in this process, as the new areas will not contribute to the company's valuation or improve the balance sheet in the short term. Nevertheless, given that ANP is heavily influenced by Petrobras, the exploration blocks in the 11th round may not be on Petrobras's priority list.

Oil service sector

Petrobras, under Graças Foster's new leadership, has reset drilling and production targets to more realistic levels. Consequently, there is the potential for service overcapacity in Brazil, and most oil service companies are reevaluating their own plans and investments in this light. Moreover, in the event that the divestment plan is not successful and Petrobras's investment grade is threatened, it is likely that the CAPEX program will be further reduced, and as a consequence the amount of business available for service companies will be diminished. Most companies have put plans on hold, awaiting a clearer outcome of current developments before committing further resources.

Conclusions

Petrobras is significantly outspending cash flow, and its production has fallen short of target. It continues to face a number of conflicting pressures. Rising oil product imports and government fuel price controls are resulting in large downstream losses. Petrobras faces rising debt levels, increasing cost pressures, and execution risks in keeping development projects and production targets on track while achieving cost savings. As a consequence, the market is becoming skeptical about the company's ability to deliver on multiple fronts, within the proposed timeframe.

Hopefully, Petrobras's performance limitations will force the Brazilian government to rethink its role in the development of recently discovered reserves or address the need to run the company in a different manner. Nevertheless, we do not expect a major shift in the run-up to the 2014 election, and we expect Petrobras to continue to be squeezed between the demands of its major shareholder and the pressures of the market in the medium term.

About the authors

Mark McHugh is a Managing Director and Co-Founder of OFS Capital, LLC a boutique investment firm with offices in Houston and Rio de Janeiro, focused on the oil and gas sector in Brazil and Latin America. Mr. McHugh is actively involved in deal making and consulting in the energy business globally. He is based in Brazil and has an extensive international senior level career in the oil industry in marketing, sales, strategy consulting and general management, including 26 years with Shell. During his distinguished career, Mr. McHugh has held a variety of management team positions as VP Marketing Americas, GM Downstream International Consultancy, VP North Latin America and GM Shell Venezuela.

Andre Paes is a Managing Director of OFS Capital, LLC. He is a seasoned oil industry executive with more than 20 years with Shell Oil Company, having held key positions in several countries in Latin America and the U.S. and worked in several capacities in the areas of sales, marketing, process improvement, business development and engineering. As part of his accomplishments he has led a turnaround project in Shell Latin America B2B Downstream operation, which encompasses all lubricants, bitumen and B2B fuel businesses in Latin America.

Why Invest in Alternative Assets?

"We believe alternative investments counteract a low interest rate and low expected return market," says Yoshi Kiguchi, Chief Investment Officer, Okayama Metal & Machinery Pension Fund. "Around 70% of our fund focuses on alternative assets, with 30% in traditional assets," he adds. A speaker at the marcus evans APAC Investments Summit 2013, in Macao, China, April 10-12, Kiguchi gives us his take on generating attractive returns in the alternatives space.

Why are many Japanese pension funds focused on Asian assets?

Asia is a very reliable market for us to invest in right now. The population of the region is growing and so is domestic consumption. We expect steady growth for the next decade or so in India, China, Malaysia, Indonesia, Thailand, as well as possibly Vietnam and the Philippines. Japan is still a terrible market. Although it has improved in recent months, we find that some Pacific countries give us much better returns.

What alternative investments would counteract sovereign risk?

The hedge fund market in Asia is still developing and needs more liquidity and variety for trading markets. In Greater China, many hedge fund managers are experiencing tough times and that kind of experience is helping them polish their strategies. There are many sophisticated hedge fund and credit short-term managers emerging in the region, bringing us more investment opportunities.

The private equity market is still developing. There are few managers who have at least ten years experience, mostly in Singapore, Taiwan and Hong Kong. Thus private equity opportunities are more reliable in these places. For at least five years we never considered investing in the Asian private equity markets, but we have now started to, to take advantage of its growth.

How do you fit alternative assets into your portfolio? What investment opportunities could you point investors to?

Our pension fund is very positive toward alternative investments. Around 70% of our fund focuses on alternative assets, with 30% in traditional assets. We believe alternative investments counteract a low interest rate and low expected return market.

We consider corporate debt strategies to be a promising area, as well as corporate structure arbitrage type of investments. That is an excellent hedge fund category. Leveraged buyout type of private equities and distressed assets are also attractive and produce high returns for us. We make sure to find sophisticated managers to take advantage of these opportunities. It is important to meet and communicate with managers directly, to see what experiences and capabilities they have.

How do you ensure your fund meets regulatory requirements?

The Japanese market is highly regulated, and for us to meet the requirements, we have to do enough due diligence before hiring alternative investment managers. However, some managers do not want to disclose much. We do not need to know all the details. We just need enough information to understand what kind of risk control and market procedures they have in place, so a level of back office transparency is necessary for us to meet requirements.

Interview Conducted By: Sarin Kouyoumdjian-Gurunlian, Press Manager, marcus evans

Company Biography

About marcus evans Summits
marcus evans Summits are high level business forums for the world's leading decision-makers to meet, learn and discuss strategies and solutions. Held at exclusive locations around the world, these events provide attendees with a unique opportunity to individually tailor their schedules of keynote presentations, think tanks, seminars and one-to-one business meetings. For more information, please visit www.marcusevans.com

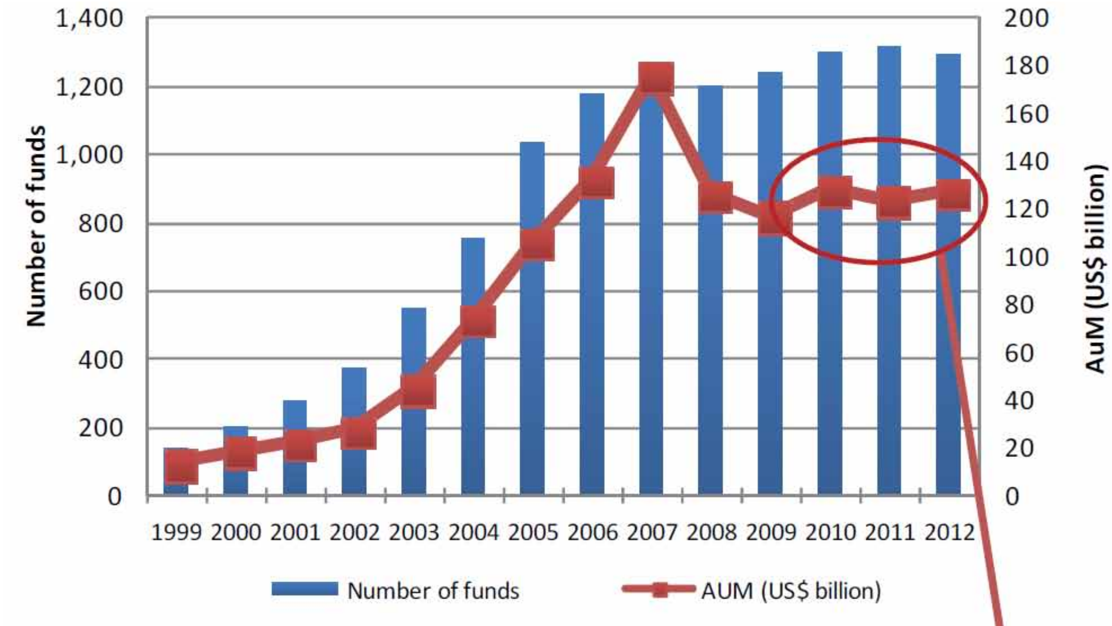
Key Trends in Asian Hedge Funds

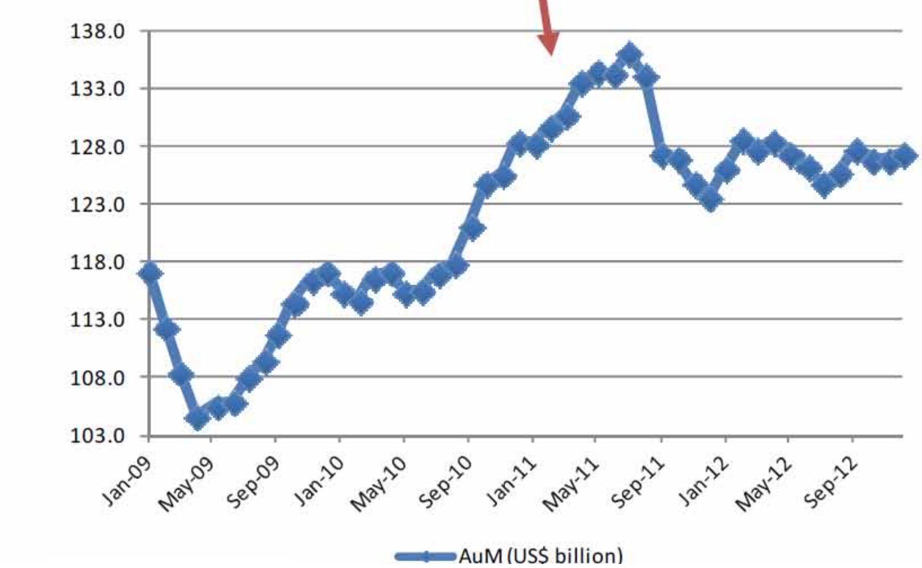
Eurekahedge

The Asian hedge fund industry started 2013 on much firmer ground than in previous years. The Eurekahedge Hedge Asian Fund Index gained 9.79% in 2012 and total assets under management (AUM) in the industry were up during the year – currently standing at US$127.4 billion. The industry witnessed some tough times and fickle fortune since the financial crisis, and over the last five years the sector has faced numerous challenges.

After growing at a tremendous pace in the 2000 to 2007 period, when the number of funds increased sixfold and total AUM grew by more than 900% to US$176 billion, Asian hedge funds were faced by heavy redemptions and significant losses during the financial crisis. The Eurekahedge Asian Hedge Fund Index fell by 20.29% in 2008 and by April 2009 the AUM declined to US$104.8 billion. The industry bounced back after April 2009, with managers posting excellent performance-based returns and also attracting some asset flows. Growth in the post-2008 period has been slow, and it has yet to match what was seen in the industry in the years before the crisis.

Figure 1: Industry growth since 1999





Source: Eurekahedge

Note: All figures are in US$ billion, and rounded up to 1 decimal place

The Eurekahedge Asian Hedge Fund Index gained 26.46% in 2009 and 8.58% in 2010, and during this time managers also attracted some assets from investors to bring the size of the sector to US$128.6 billion by end-2010.

In 2011 the sector witnessed some declines through performance while asset flows were flat to slightly positive for the year. During this time the European debt crisis and concerns over the global economy led to a difficult investment climate with high volatility and sudden trend reversals in the markets – leading to losses and risk-averse investor sentiment.

The first half of 2012 witnessed similar trends in the markets as in the previous year, while bearish investor sentiment resulted in mixed asset flows. The resurgent risk appetite in the second half of the year, following sovereign monetary easing actions, served to bolster the markets and with them hedge fund performance. In the last five months of 2012 the Eurekahedge Asian Hedge Fund Index gained 8.33%.

Asset flows

Table 1 shows the breakdown of Asian hedge fund assets over the last three years as well as the monthly asset flows and performance-based growth/decline. The sector attracted net positive asset flows for 16 consecutive months in 2010 and 2011, before witnessing some net outflows at the end of 2011. Asset flows remained mixed throughout 2012 as investors wavered between the risk-on risk-off modes – net asset flows for 2012 stood at negative US$3 billion.

Launches and closures

The fund attrition rate spiked up at the end of 2008 and early 2009, with the number of

Table 1: Monthly asset flows in Asian hedge funds since January 2010

	Net growth (performance)	Net flows	Assets at end
2009	10.1	(19.1)	117.3
Jan-10	(1.2)	(0.6)	115.6
Feb-10	(0.2)	(0.7)	114.7
Mar-10	2.2	(0.1)	116.8
Apr-10	0.9	(0.4)	117.3
May-10	(2.4)	0.7	115.5
Jun-10	(0.3)	0.4	115.6
Jul-10	1.1	0.5	117.1
Aug-10	0.4	0.4	117.9
Sep-10	2.8	0.5	121.1
Oct-10	1.8	1.9	124.8
Nov-10	0.2	0.7	125.7
Dec-10	2.0	0.8	128.6
2010	7.2	4.0	128.6
Jan-11	(0.5)	0.3	128.3
Feb-11	(0.1)	1.6	129.8
Mar-11	0.8	0.3	130.8
Apr-11	1.7	1.1	133.6
May-11	(1.2)	2.1	134.5
Jun-11	(0.9)	0.7	134.3
Jul-11	1.3	0.5	136.1
Aug-11	(2.4)	0.5	134.1
Sep-11	(4.3)	(2.4)	127.5
Oct-11	1.3	(1.7)	127.0
Nov-11	(1.7)	(0.5)	124.9
Dec-11	(0.6)	(0.5)	123.7
2011	(6.7)	1.9	123.7
Jan-12	2.0	0.5	126.2
Feb-12	2.3	0.1	128.6
Mar-12	(0.2)	(0.6)	127.9
Apr-12	0.1	0.5	128.5
May-12	(2.2)	1.1	127.4
Jun-12	(0.3)	(0.6)	126.4
Jul-12	0.7	(2.2)	124.9
Aug-12	0.5	0.4	125.8
Sep-12	1.5	0.5	127.8
Oct-12	(0.1)	(0.8)	126.9
Nov-12	1.0	(1.0)	126.9
Dec-12	1.5	(1.0)	127.4
2012	6.7	(3.0)	127.4

closures exceeding the launch rate for the first time in the industry's history. The sector recovered in the second half of 2009 as the global economy picked up and funds started to get some allocations. 2010 was another healthy year for the industry with the total number of launches exceeding the closures in each quarter of the year, and this trend continued through to the first half of 2011. In the second half of 2011, with asset flows slowing down and performance running in negative, an increasing number of funds closed shop. 2012 witnessed further consolidation in the sector with the closure rate exceeding the launch rate in all but one quarter. Since the financial crisis most of the investor allocations in Asian hedge funds have gone to the larger, well established hedge funds. Due to the lack of asset flows as well as the inability to generate performance fees in 2011, a number of the smaller hedge funds closed shop in 2012 as it became unsustainable to run their operations on admin fees from a small asset base. While we do not think that a substantial number of funds will close in 2013, the launch activity is also expected to remain low with only those funds launching that have the backing of strong cash-rich institutions.

High water mark

Figure 3 shows the percentage of Asian hedge funds that are above their 2007 NAVs. For this analysis we take the December 2007 NAVs as the high water mark, as that was when the industry was at its maximum size and most hedge funds reached their highest NAVs. The chart shows that the number of funds above their respective high water marks declined substantially after 1Q 2011, and this coincides with a large number of funds closing shop – as a number of hedge funds were running significantly below their high water marks and therefore not earning performance fees. At end-December 2012, about 39% of Asian hedge funds were above their high water marks.

Going into 2013 we expect this number to increase.

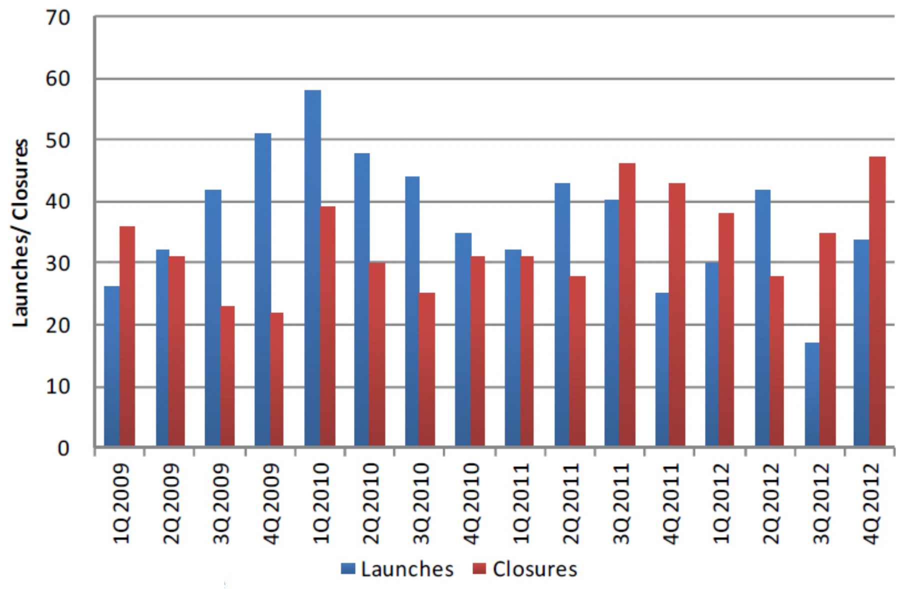
Fund size

The breakdown by fund sizes of the Asian hedge fund industry also supports our observation that a few large funds are increasingly attracting assets at the expense of other smaller hedge funds. In 2007, the split of assets in Asian hedge funds displayed greater equitable distribution, whereas currently a smaller number of very large funds make up a greater proportion of the assets in Asian hedge funds. The most significant change has been the increase in the number of small hedge funds – those with AUM of US$20 million or less. This category accounted for only 27% of the funds six years ago. Heavy redemptions during the financial crisis, along with performance-based losses, resulted in a number of larger funds shrinking in size to fall into this category. Additionally, although start-up activity in Asia ramped up in 2009 and 2010, many new launches could not attract capital and have remained in the smallest category.

Geographic mandates

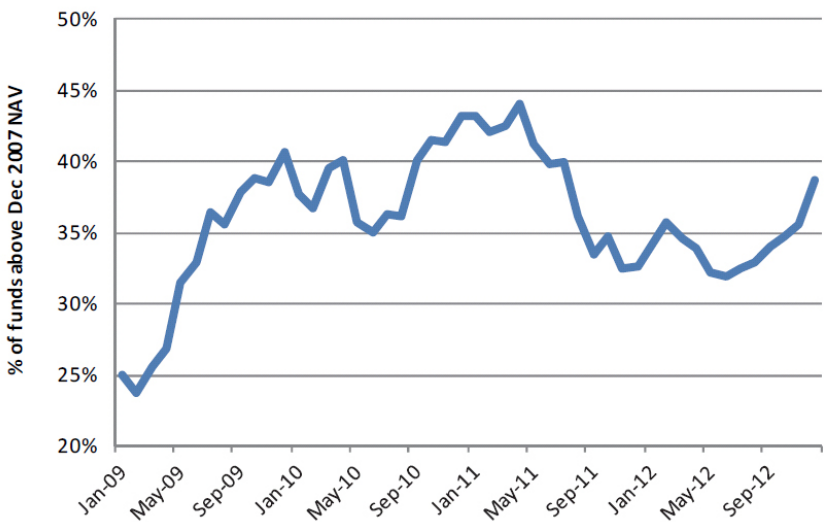
Figures 5a and 5b display the breakdown of assets allocated to Asian hedge funds according to their various regional mandates. The changes in the last five years are quite striking – managers investing with a global mandate account for almost 23% of the industry assets, up from only 14.7% in 2007. Adopting a global mandate has helped fund managers diversify their risks and also access a wider selection of securities. Additionally, globally mandated Asian hedge funds did not suffer losses to the same extent as hedge funds focused specifically on Asia or single countries within the region.

Figure 2: Launches and closures of Asian hedge funds



Source: Eurekahedge

Figure 3: Percentage of Asian hedge funds above their 2007 NAVs



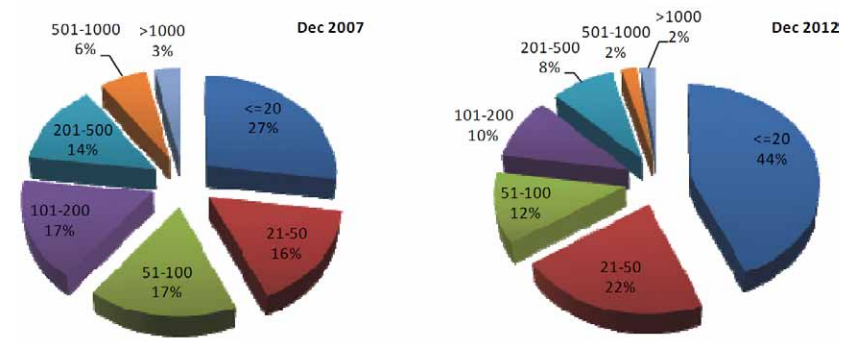
Source: Eurekahedge

Hedge funds investing in Greater China also increased in market share from 9.8% to 13.6% of the universe. Over the years, the growth in China has attracted a number of hedge funds to boost investments into the region as managers seek out opportunities in what seems to be a vibrant and growing economy. Even as many of the managers focus on investing within Asia, very few of them adopt single country regional mandates like India, Taiwan or Korea. The perception among investors is that single country mandates are perceived as riskier for investments, and they also have a greater preference toward broader mandates.

Strategic mandates

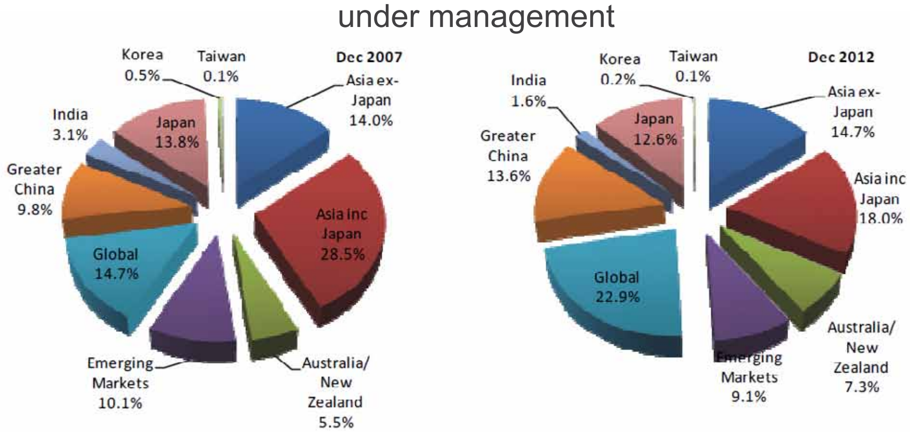
Distribution of AUM across the various strategies has also varied over the years, and the current breakdown is quite different from what it was five years ago – the most promi-

Figures 4a-4b: Breakdown of fund population by fund size (US$ million)



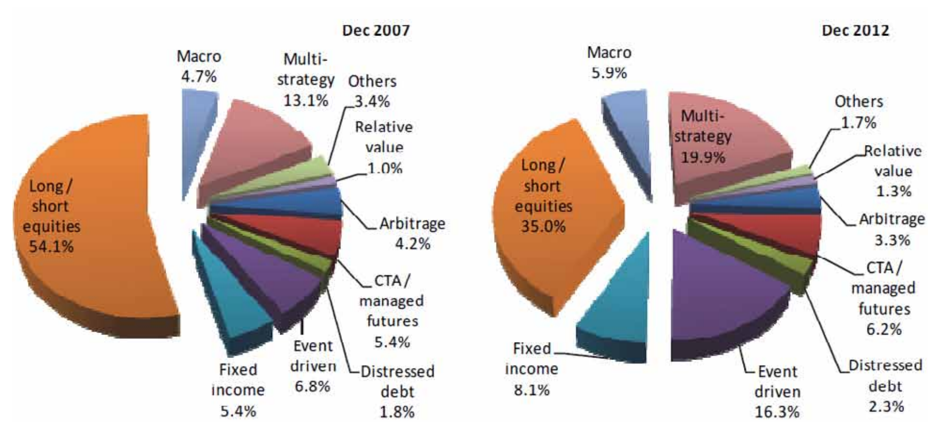
Source: Eurekahedge

Figures 5a-5b: Geographic mandates by assets under management



Source: Eurekahedge

Figures 6a-6b: Strategic mandates by assets under management



Source: Eurekahedge

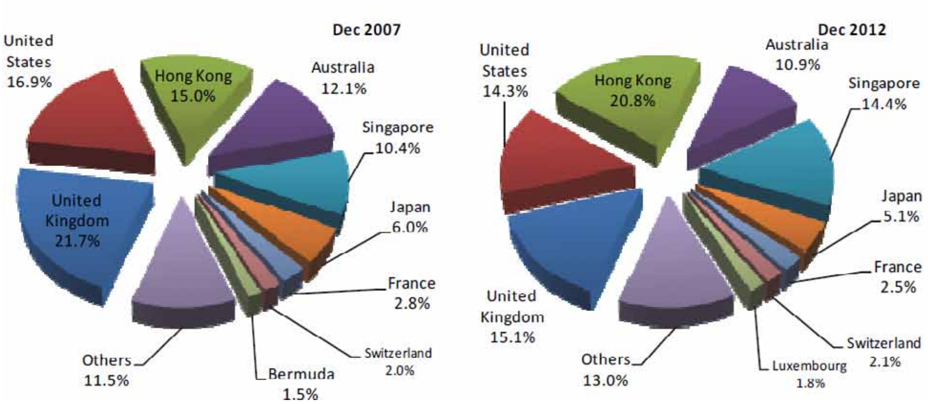
nent change being the decline of assets allocated to long/short equity funds, down almost 20%. Most of this drop happened during the financial crisis when long/short equity managers witnessed heavier losses than most other strategies. Additionally, the declining share of assets allocated to long/short equity managers is typical of a growing and maturing hedge fund industry, which reflects a maturity in risk management across Asian investment styles. The shift from equity-centric styles has been entrenched in both managers and investors in lieu of increased market volatility and the need to be less correlated to underlying markets. This is illustrated aptly by the growth in the assets allocated to multi-strategy funds, which have seen their share of Asian hedge fund AUM increase by almost 7% over the last five years.

Figures 7a and 7b display the changes in head office location of Asian hedge funds over the years, highlighting some interesting trends in the industry. In December 2007, 38.6% of Asian hedge funds were based in either the United Kingdom or the United States. This figure has dropped to 29.4%, with more managers opening offices in Asia. This trend is largely driven by four main factors:

- There have been some well-known hedge fund outfits opening Asian offices over the last few years. These funds have recognized the opportunity presented by Asian markets and also appreciate the value of local presence.
- Managers in Europe and the U.S. are finding it increasingly difficult to trade profitably in a crowded and competitive environment; Asian markets, on the other hand, are growing, inefficient and less sophisticated, so they offer ample opportunities.
- Regulations and taxes. Hedge funds in Europe and the U.S. pay high taxes and would be subjected to new regulations governing the way they take risks.
- The new wave of rising Asian affluence provides a potential pool of investors for hedge funds, which would support having offices in the region.

Local talent. As large banks and funds established their presence in Asia over the past decade and a half, a number of experienced traders moved to the region while new talented traders and managers hired from within the region also developed their skill-sets. These individuals have now branched out to set up their own hedge funds, and many of them have been

Figures 7a-7b: Head office locations by number of funds



Source: Eurekahedge

Tables 2a-2b: Market share of prime brokers by assets under management

December 2007	
Prime broker	Market share
Morgan Stanley	26.62%
Goldman Sachs	26.49%
UBS	9.15%
Bear Stearns	9.13%
Deutsche Bank	7.50%
Credit Suisse	6.60%
Merrill Lynch	3.77%
Citigroup	3.23%
Fimat	0.53%
Others	6.98%

December 2012	
Prime broker	Market share
Goldman Sachs	24.82%
Morgan Stanley	19.77%
UBS	15.71%
Deutsche Bank	10.80%
Credit Suisse	9.70%
Citigroup	5.98%
Bank of America Merrill Lynch	2.20%
Newedge	2.14%
Barclays	1.74%
Others	7.14%

Source: Eurekahedge

successful in raising assets and delivering strong performance.

Prime brokers

Tables 2a and 2b show the distribution of Asian hedge fund assets among the various prime brokers. Many brokers who were on the top 10 list in 2007 retained their market share five years on, with most of them having increased market share. Although Goldman Sachs and Morgan Stanley remain the top two prime brokers in the Asian hedge fund space, they account for a smaller share of Asian hedge fund assets than five years ago, when their combined share was greater than 50% of the total industry assets. The primary reason for this is the distribution of counter-party risk by hedge funds in the post-Lehman scenario; many funds now employ multiple prime brokers, rather than depending on only one. The makeup of small brokers in the industry (i.e. in the "others" category) has not changed substantially over the years, as hedge funds continue to lean toward the larger investment banks for their broking needs.

Administrators

Administrators are taking on a larger role in the hedge fund industry as investors place more emphasis on transparency and risk management. New regulations and requirements by investors also mandate third party custodians, so with an increased number of communicating parties there is a greater role for administrators to connect the front, middle and back offices so as to ensure a seamless operational flow for hedge funds.

Looking at tables 3a and 3b, we can observe that major players in the Asian hedge fund administration industry have started to consolidate as small players exit the industry, due to the closure of small funds and larger funds attracting more capital from institutional investors. Additionally, the increased stress on regulations and diligence in the post-Madoff world means that no investor will consider allocating capital to a hedge fund that does not have proper third party administration. This is the primary reason for the 13.9% decrease in the share of "Others" – which includes internal/self administration. The top three administrators account for 49.8% of the market now, an increase from 47.9% in 2007, while the "Others" category has shrunk to occupy only 19.5% of the industry share.

Performance review

In this section, we take a closer look at the returns of Asian hedge funds by breaking down their performance according to geographic and strategic mandates, taking into account their annual returns over the last three years in the following tables and charts.

Since its inception in December 1999 the Eurekahedge Asian Hedge Fund Index has gained 179% while the MSCI Asia Pacific Index lost almost 17% over the same period. During this time, we witnessed several events of note that affected Asian economies and the markets, namely the dotcom bubble, the SARS flu epidemic and subprime crisis in 2002, 2003 and 2008, respectively. Faced with these challenging economic events, Asian hedge funds not only outperformed the markets but also delivered positive returns through the dotcom bust and the

SARS epidemic. Additionally hedge funds managed to outperform long-only absolute return funds and funds of hedge funds by a wide margin during this timeframe, displaying their ability to adapt to volatile market conditions and capture gains. Between December 1999 and December 2012 Asian hedge funds outperformed the regional long-only absolute return funds by 22% and funds of hedge funds by more than 130%.

Figure 9 and table 4 display the performance of Asian hedge funds across the various regional mandates. Almost all regional mandates ended 2012 in positive territory except Korea. Some mandates such as China, Taiwan, Australia and India delivered double-digit returns amid resurgent risk appetite in the second half of the year. The Eurekahedge Australia/New Zealand Hedge Fund Index gained 11.81% in 2012 and 7.02% in three-year annualized terms on the back of high yielding local currency and the strong performance of long/short equity managers. The Eurekahedge Japan Hedge Fund Index gained 6.14% in 2012 and 3.54% in December, as the yen depreciated and stocks rallied amid expectations of monetary easing measures to be implemented by the Bank of Japan and the new policies of the Liberal Democratic Party. Funds focused on the Greater China region also posted excellent returns for 2012, especially in the second half of the year as the global economic outlook improved.

Table 5 highlights the returns of Asian hedge funds over similar time periods but segregates them according to various strategies. Overall, 2012 finished on a healthy note – compared to 2011, all strategic mandates reported positive returns, with event-driven hedge funds delivering the best performance. Hedge funds employing the strategy are increasingly becoming popular in the region with more than 50% of such funds launched within the last four to five years. Managers have been able to leverage the rapid growth in the regional economies to uncover and profit from special opportunities across different sectors – as displayed by the high average Sharpe ratio of these funds.

Among other strategies, fixed income hedge funds were up by 11.76% in 2012 amid increasing global interest in the region's bond offerings. High yields backed by strong fundamentals and economic growth in the local markets resulted in increased demand for Asian credits – especially in the latter part of the year as risk sentiment improved. In fact the loan volume in Asia for 2012 grew to US$645.3 billion, the highest annual volume in the region. The region's fixed income funds have also grown in size over the last 5 years to account for 8.1% of the total assets in Asian hedge funds. The Eurekahedge Asian Fixed Income Hedge Fund Index has gained 154% since December 1999.

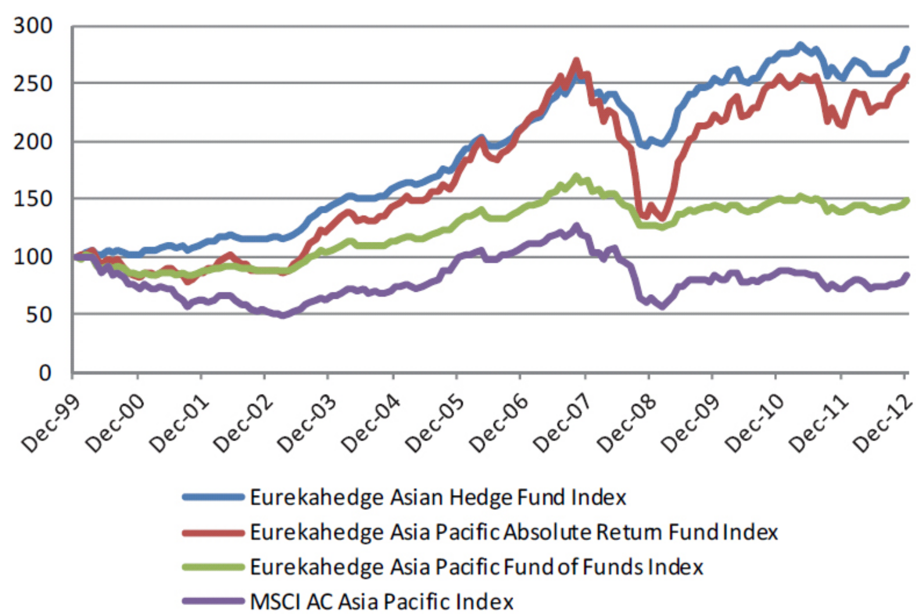
Tables 3a-3b: Market share of administrators by assets under administration

December 2007	
Administrator	Administrator
HSBC	HSBC
CITCO	CITCO
State Street	State Street
Citigroup	Citigroup
Goldman Sachs	Goldman Sachs
PNC	PNC
JP Morgan	JP Morgan
Morgan Stanley	Morgan Stanley
Fortis	Fortis
Northern Trust	Northern Trust
Others	Others

December 2012	
Administrator	Market share
HSBC	20.29%
State Street	17.17%
CITCO	12.32%
RBC Dexia Investor Services	11.88%
SS&C GlobeOp	5.05%
Citigroup	4.34%
Morgan Stanley	3.09%
JP Morgan	2.68%
Bank of New York	1.91%
Northern Trust	1.74%
Others	19.54%

Source: Eurekahedge

Figure 8: Performance of Asian hedge funds versus market index and other investment vehicles



Source: Eurekahedge

Table 4: Performance of geographic mandates

	Arbitrage	CTA	Event Driven	Fixed Income	Long Short Equities	Macro	Multi-Strategy	Relative Value
2012 returns	7.26%	3.55%	15.66%	11.76%	9.86%	5.81%	6.42%	10.70%
2011 returns	(3.64%)	7.30%	0.95%	(4.54%)	(9.69%)	0.88%	(5.25%)	(5.43%)
3 year annualized returns	3.38%	5.59%	9.97%	5.55%	2.34%	3.59%	2.94%	4.67%
3 year annualized standard deviation	3.88%	4.78%	6.81%	7.68%	8.56%	3.85%	5.80%	6.16%
Sharpe Ratio (RFR = 2%)	0.36	0.75	1.17	0.46	0.04	0.41	0.16	0.43

Table 5: Performance across strategic mandates

	Asia	Asia ex-Japan	Australia/ New Zealand	Greater China	India	Japan	Korea	Taiwan
2012 returns	9.79%	11.94%	11.81%	13.53%	12.35%	6.14%	(3.41%)	18.37%
2011 returns	(8.07%)	(12.20%)	(1.78%)	(13.29%)	(24.18%)	(1.35%)	(12.35%)	(20.91%)
3 year annualized returns	3.14%	2.72%	7.02%	2.57%	(1.45%)	4.32%	(1.64%)	(0.18%)
3 year annualized standard deviation	7.68%	10.19%	8.28%	11.84%	15.25%	5.86%	14.09%	13.46%
Sharpe Ratio (RFR = 2%)	0.15	0.07	0.61	0.05	(0.23)	0.40	(0.26)	-0.16

Source: Eurekahedge

Figure 9: Performance of geographic mandates

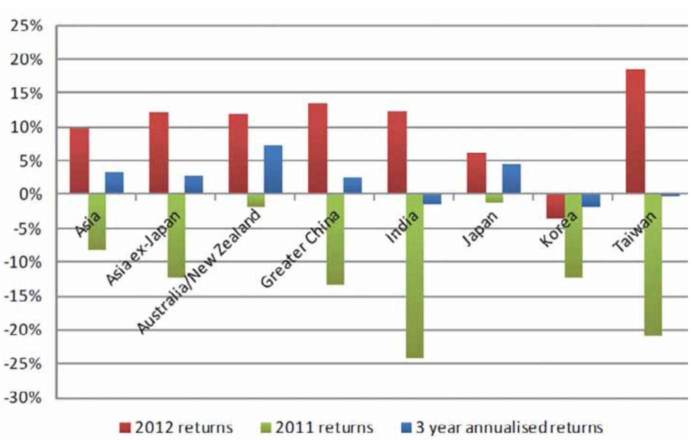
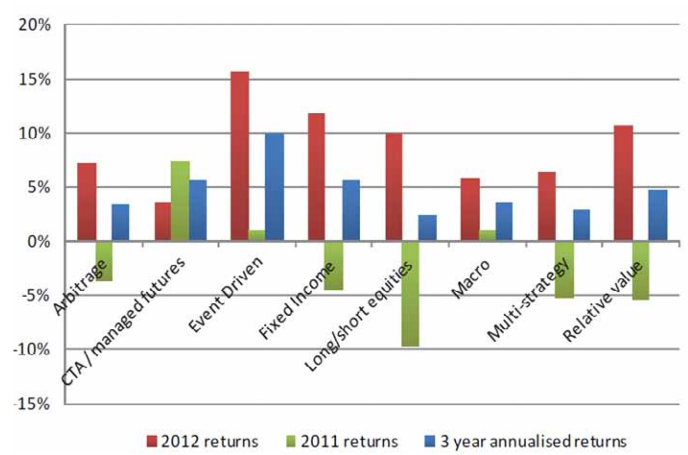


Figure 10: Performance across strategic mandates



Source: Eurekahedge

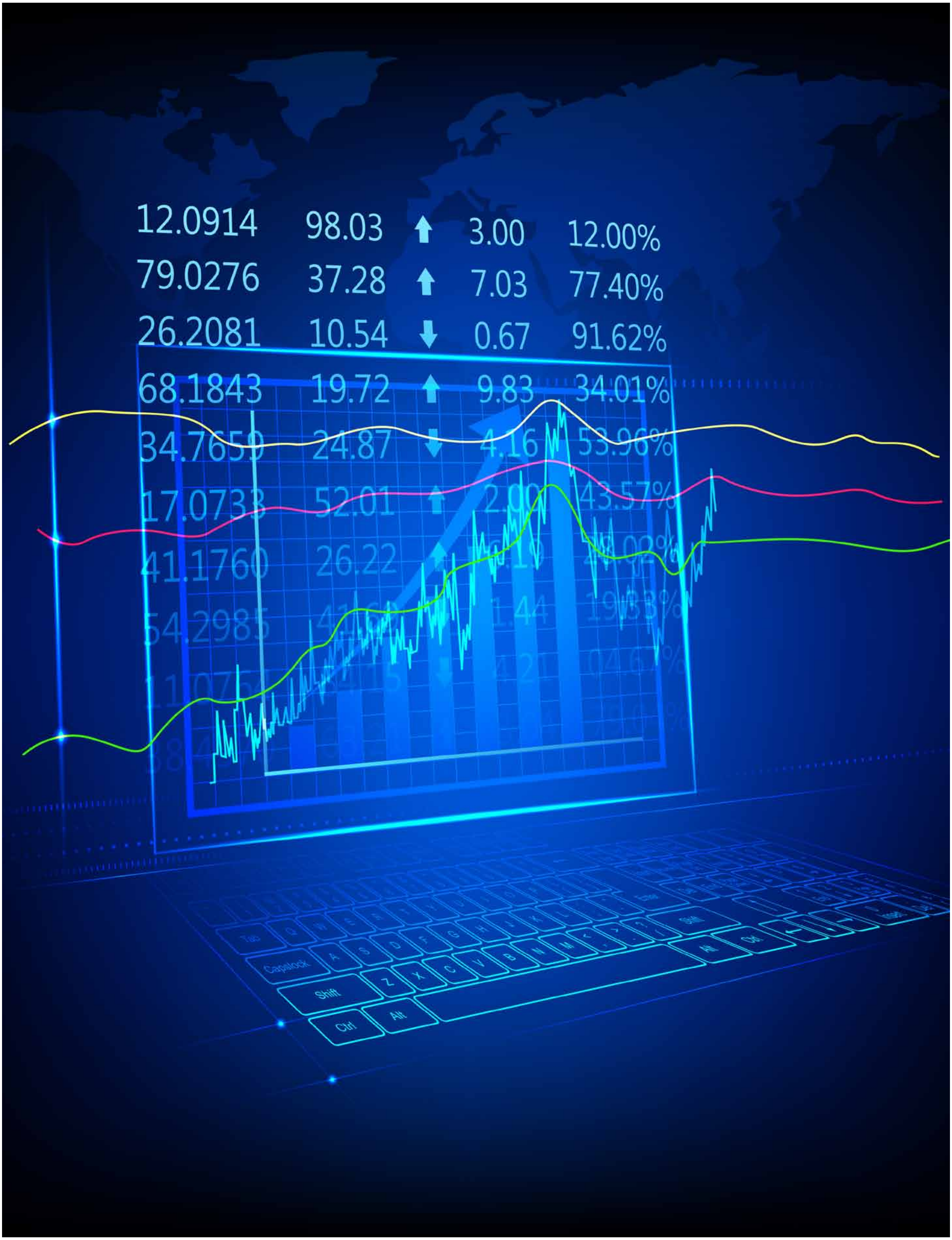
Retail Investors Seek Asian Exposure

Risk is prevalent in Asian markets, many of which have suffered a knock on effect from the European crisis. Inflation is also a pressing issue. However, there are investment opportunities presenting themselves in smaller companies based on U.S. models that have the potential to grow long term.

John Wong, President of Oberweis Asset Management (Asia) Ltd, explains that much of the investment in Asia remains in the form of long funds and that the market has experienced a withdrawal of hedge funds in recent years due to market volatility. Mr. Wong is the lead manager of the Asia Opportunities strategy and co-manager of the China Opportunities strategy. Prior to joining Oberweis Asset Management in September 2007, Mr. Wong was a Senior Portfolio Manager at Wells Fargo Bank in San Francisco. Prior to that, he was part of the International Small Cap investment team at Founders Asset Management and was a portfolio manager of the CVO Greater China Fund at Offitbank. He is a holder of the Chartered Financial Analyst (CFA) designation and is a Certified Public Accountant (CPA).

Oberweis Asset Management, Inc. ("OAM") is an independent investment management firm that invests in high growth companies around the world. The firm specializes in Small and Mid Capitalization growth strategies globally for institutional investors and its own proprietary mutual fund family. Established in 1989, OAM is headquartered in suburban Chicago, with a subsidiary Oberweis Asset Management (Asia) Limited ("OAMA") licensed and located in Hong Kong.

Regulatory compliance on the continent with regard to mutual funds is similar to that in the U.S. Hong Kong and Singapore markets are also on a par in this respect. Hedge funds tend to be domiciled in offshore countries and therefore are subject to different sets of rules.


12.0914 98.03 3.00 12.00%
79.0276 37.28 7.03 77.40%
26.2081 10.54 0.67 91.62%
68.1843 19.72 9.83 34.01%
34.7659 24.87 4.16 53.96%
17.0733 52.01 2.00 43.57%
41.1760 26.22

Recently there has been more investor interest in Indonesia and Thailand, and their young population and growing domestic consumption are key factors. When asked if the growth of local markets in Southeast Asia has competed with direct investments and equity investments, Mr. Wong says, "I don't think they are in direct competition with each other. I think the investors in the private equity markets, alternative investments, and high net worth investors also invest in mutual funds. We have seen an increase in private equity investments in some of these markets, especially in the larger markets," he notes. "In Indonesia, Thailand and India we have witnessed activity in private equity transactions in the last year or so."

IPOs have increased on account of "the sentiment in the equity markets, which has improved," says Mr. Wong. Liquidity is proving problematic in the smaller Asian markets, and even though the Philippines, for example, has done well this year, beyond the 20 or 30 stocks in the country's exchange, "the remaining less established stocks are difficult to buy because liquidity is an issue. Likewise in Indonesia, more interest is on the larger companies," says Mr. Wong.

In the short term, Asian markets tend to react in tandem with events and activities in the U.S. and Europe, and remain correlated. But for long-term investors there is certainly a case for diversification. "When I first started in the business over 20 years ago correlation was actually pretty low and there was obviously a case for diversification, which applied at the time. But in the past 2 years, because of external shocks like the European crisis, sometimes markets move in tandem," says Mr. Wong. "With regard to the long term, I still think there's a case for diversification, especially if you look at countries like China and Indonesia where domestic consumption is growing and the population has become much wealthier, and infrastructure has improved in these countries."

The balance of growth and capital flows between countries in the Pacific Rim is improving, with Japan and China showing encouraging performance. "The Japanese market has done very well due to policies introduced by the new administration. The Chinese economy is also doing relatively well. Obviously, GDP has fallen compared to last year's statistics, but I think the quality of growth we see in China in the coming year will be better than what the country experienced 10 years ago when it was primarily driven by infrastructure and exports. Going forward we are going to see domestic consumption fueling growth in China."

The quality of growth we see in China in the coming year will be better than what the country experienced 10 years ago when it was primarily driven by infrastructure and exports.

Mr. Wong believes that by identifying quality consumer-related companies that cater to the domestic market, investors can generate positive returns. "So basically it's investing in the three Cs in China over the past 20 years – when China first opened up 20 years ago, you invested in cheap labor, then about 10 years ago, you invested in copycats (that is, Chinese companies that copied what worked in the U.S.), and now you invest in Chinese consumers, who will drive the economy going forward," he says.

Oberweis Asset Management's investment focus is primarily on companies listed outside China, but one cannot ignore policy risks. "You have to be aware of the policies that drive the economy in China. This will help you narrow your investment universe and identify companies that will be impacted either positively or negatively by the policies," says Mr. Wong.

The different demographics across Asia, together with varying cultures, combine to create very different markets. "China is the engine of growth in Asia, and many smaller Asian countries are benefiting from it. Africa and South America are also benefiting from the economic growth in China," says Mr. Wong. "Having said that, there are also opportunities in countries like Thailand and Indonesia where the population is much younger compared to China or Japan. India is also driven by a huge domestic market but the risks we see there revolve around the government pursuing populist policies." Many of the companies Oberweis invests in are typically less researched by analysts. Oberweis conducts its own research and talks to management independently. Oberweis believes that, over time, many of these smaller companies can become leaders in their respective industries or sectors.

One risk Mr. Wong sees this year in Asia is inflation. For example, inflation in Indonesia is starting to rise. Although inflation in China remains mild, it is something he watches closely.

Investing in Indian Equities:

Interview with

Dhawal Mehta

Reliance Asset Management

Dhawal Mehta has been the Head of the Equity Investments Team at RAMS and Portfolio Manager of the IEGF LT since August 1, 2010. With over 19 years of experience in Indian equities, he is a well-known name in the industry. He joined RAMS in March 2010 from Deutsche Asset Management (Asia), Singapore, where he managed a US$600 million long-only India-dedicated equity portfolio. Prior to Deutsche, Mr. Mehta managed India equity funds at HDFC Asset Management as a Senior Fund Manager handling six equity mandates totaling US$600 million. He spent over five years at AllianceBernstein doing Asia ex-Japan, Hong Kong and Singapore research on commodities and discretionary consumer sectors. He also managed India-dedicated money for AllianceBernstein totaling US$150 million. He has a consistent and impressive track record in terms of beating benchmark and top quartile performance among peers. Mr. Mehta has extensive sell-side experience as well with marquee firms like IDFC, UBS Securities, UTI Securities and ASK Raymond James. He covered the cement, metals, autos, chemicals, engineering and capital goods, paper and conglomerate sectors as a sell-side analyst. He is a mathematics graduate from the University of Mumbai. He has an accounting qualification (ICWAI) and holds an MBA in Finance from IIM, Kolkata. He is also a CFA charter holder since 2001.

How did your fund perform in 2012 and how did you cope with the often sharp market movements during the year?

The Fund was up 24.6% in CY12. We try and manage market volatility through a two-pronged strategy. Firstly, the stocks that we buy are inherently high quality and typically low beta stocks. We therefore tend to outperform the market significantly during a downturn. Secondly, we vary our cash holdings in the portfolio – for example during 2012 we had cash holdings as high as 36% and as low as 3%. Our cash calls, however, are not so much about trying to time the market but more about maintaining our discipline on selling stocks when they attain their target price and on actively looking for stocks that can generate 25 to 30% annual return.

Many Indian funds that are domiciled in USD have suffered losses due to currency movements during the last two years. How did these movements affect your fund, and what steps have you taken to mitigate this risk?

The INR performance has impacted our performance as well, both in 2011 and in 2012 when the currency depreciated against the USD. Given the high costs of hedging the currency (6 to 7%), it is difficult to justify hedging the full portfolio. Nonetheless, some of the steps that we have taken to partially hedge the portfolio are investing in USD denominated ADR/GDRs whenever possible and keeping cash balance in USD.

How is the India Growth Equity Fund different from other funds that trade Indian equities? What sort of an edge does this fund offer to its investors?

Most of the traditional India-dedicated funds either offer you a long-only benchmarked return or a conventional long/short strategy. In IEGF we target absolute returns to clients in the long term through a long-biased strategy.

Our edge is our own proprietary research on mid/small caps in India. Our parent, Reliance Capital Asset Management, is known for its research into mid and small caps, and we are also dedicated to this strategy.

Could you tell us about the research and analysis that you perform on stocks, before actually investing in them?

We follow a fundamental "bottom-up" stock picking strategy. We perform detailed and rigorous fundamental research on all stocks in our universe. Besides the normal financial and peer group analysis we put a lot of emphasis on quality of management. In a country like India where companies are predominantly promoter-led, we feel it is necessary to gauge the promoter capability, experience and strategy before committing oneself. How the management/promoter has fared on corporate governance issues is a key parameter for us. We also focus a lot on valuation; we are unlikely to pay a very high premium for a quality investment. The objective is to identify the "right business at the right valuation."

On average, how many positions do you hold at any given time? How are these positions rebalanced and how often?

We believe in having a concentrated portfolio – typically we own about 20 positions and most of the holdings would be around 4 to 7% of the fund. There is no pre-determined rebalancing strategy. Our rebalancing actions are purely a function of our view on the stock at that point in time.

How flexible is your fund in terms of its sector diversification? Do you have any cap or restrictions in place in terms of your exposure to each sector?

The fund is very flexible in terms of sector diversification. For example, there are currently two sectors that make up 57% of the portfolio. We do have an internal limit of restricting single-sector exposure to 40% and single-stock exposure to 10% of the portfolio.

What risk management tools do you have in place that help you safeguard your fund's investments? Have these changed over the years to implement key lessons from the financial crisis?

We believe that primary risk control is achieved by the quality of company that we have invested in. There is therefore a thorough analysis of the stocks that we invest in, and on this issue we put specific focus on corporate governance issues and quality of management. One of the added metrics that we now look at post the 2008 crisis is liquidity. We are now much less tolerant of illiquid, small-cap stocks than before and the focus is on having as liquid a portfolio as possible without diluting the kind of stocks that we want to invest in and without diluting the mandate of the fund.

What classes of investors (fund of funds, high net worth clients, institutions, etc.) is your fund targeted toward? And what are the types of investors that have shown interest in your fund so far?

Our current investors are a mix of endowment funds and some family offices. The Fund will appeal to investors looking for long-term exposure to India. Typically we would think that endowments, pensions, other institutional investors and family offices are our targeted investors.

Investors have not been that forthcoming with allocations over the last two years. How has your fund fared in this environment? Can you provide a broad breakdown of your current investor base i.e. region-wise, and by type?

It has been a difficult environment for single-country-focused equity funds, and our experience has not been very different in that regard. Most of our current investors are from the United States.

The Indian government has unveiled various economic reforms over the last few months. How do you expect these to impact the market in the longer term?

The current wave of reforms is very favorable for the Indian economy and for the equity markets in the long term. The immediate positive impact is the likely averting of a sovereign rating downgrade by S&P.

Longer-term, these reforms will re-instill fiscal discipline, accelerate GDP growth, propel investments and lower interest rates.

Could you give us your medium-term outlook for the Indian equity markets? Do you foresee any movements in the market in the near term that might work in your favor?

Our medium-term outlook for the market is positive. GDP growth seems to have bottomed out, inflation and interest rates are clearly headed south, corporate earnings seem to be recovering and the government is unleashing policy reforms. We believe that these factors will keep the momentum going in the near to medium term. Volatility, however, will continue to be high, driven by news flow from domestic as well as regional/global markets. The one risk to watch out for in India is political uncertainty – general elections are due in mid-2014, and that event will impact markets over this period.

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www.eurekahedge.com

Running an Indian Fund: Samir Arora, Fund Manager of Helios Capital Management

Samir Arora is the founder and Fund Manager of Helios Capital Management. His partners at Helios Capital are Dave Williams, who was the Chairman and CEO of Alliance Capital Management for over 20 years, and Karan Trehan, who was Chairman of Alliance Capital Management (India) from 1994 to 2005. Helios has six employees in Singapore, and Helios Capital Advisors has three employees based in Mumbai. The four investment professionals at Helios Capital Management and at Helios Capital Advisors have more than 80 years of India investment experience.

Prior to starting Helios in 2005, Mr. Arora was the Head of Asian Emerging Markets at Alliance Capital Management in Singapore (both fund management and research, covering nine markets). From 1993 to 2003, Mr. Arora was also the Chief Investment Officer of Alliance Capital's India business and managed all of its India-dedicated equity funds.

In 1993 Mr. Arora relocated to Mumbai from New York as Alliance Capital's first employee in India to help start its Indian mutual fund business. He also managed the ACM India Liberalisation Fund, an India-dedicated offshore fund from its inception in 1993 to 2003. Prior to 1993, he worked with Alliance Capital in New York as a research analyst.

India-dedicated funds managed by Mr. Arora received over 15 awards during his tenure, including a AAA rating from Standard and Poor's Micropal for four years in a row (1999 to 2003) for the India Liberalisation Fund. In 2002 he was voted the most astute equity investor in Singapore in a poll conducted by *The Asset* magazine. Helios Strategic Fund has been nominated four times for the Best India Hedge Fund award in the Eurekahedge Asian Hedge Fund Awards and won the award in 2007.

Samir Arora received his undergraduate degree in engineering from the Indian Institute of Technology, New Delhi, in 1983 and his MBA (gold medalist) from the Indian Institute of Management, Calcutta, in 1985. He also received a master's in finance from the Wharton School of the University of Pennsylvania in 1992 and was a recipient of the dean's scholarship for distinguished merit while at Wharton.

"We have also traditionally favored the infrastructure sector but have been net negative on this sector since 2011 due to weak government decision making and policy paralysis in India in the past two years."

Your flagship Helios Strategic fund was up nearly 23% in 2012, while the Eurekahedge India Hedge Fund Index gained 12.35% over the same period. How would you explain this significant outperformance?

We have had our good years and we have had our bad years. We are only proud of the fact that we had more good years and periods than bad.

Last year we added value on both the long and the short sides (i.e. our longs did better than the index and we lost less than the index on our short side). In each of the past eight years we have added value on the short book, and on the long side in six out of eight years.

Which allocations across different industries and asset classes contributed the most to your returns over the course of 2012?

We basically concentrate our long portfolio in only a few themes/sectors. These themes/sectors do not change from year to year. We are bullish on private sector banking, non-banking financial companies, consumer, media, pharmaceutical and IT sectors in general. We have also traditionally favored the infrastructure sector but have been net negative on this sector since 2011 due to weak government decision making and policy paralysis in India in the past two years.

We normally avoid investing in commodity companies, state-owned companies and companies which are aggressive in buying foreign assets.

Your fund was down a lot in 2008. How did this impact the functioning of your fund and the investment process in the following years? What changes have you applied to implement key lessons from 2008?

There were many things that went wrong for us in 2008. Having been a very successful fund manager since 1993, I was overconfident that the Indian corporate sector was not badly affected by the global crisis (and it was not; for example not even one bank needed to raise a dollar for recapitalization, etc., and our portfolio companies had growth earnings even in 2008 to 2009) and therefore did not reduce my exposure to the market. As it turned out, the equity market did not spare any company, whatever its fundamentals. Secondly, SEBI put restrictions on fresh shorting in October 2007, and therefore until late 2008 one could only short via indices and puts, which did not add as much value as shorting of individual stocks would have done in that phase. Thirdly, the INR depreciated by nearly 19% during the year.

The only way to protect performance in 2008 was to completely exit the market, and we failed to do that.

The fact that our performance peaked in December 2007 and bottomed out (more or less) in December 2008 exaggerated the negative performance of 2008 (and also exaggerated the huge performance that we had in 2007 and 2009).

Despite the poor performance in 2008, our returns since inception and since end-2008 are much better than hedge funds in general.

We have made many changes to our risk controls (in terms of position sizes), shorting (primarily stock shorts now versus both stock and index shorts previously), a larger number of shorts (approximately 20 positions vs. approximately 10 before so that we can add to these existing positions at short notice without having to scramble for new ideas in bad times), etc. In general we are now much more paranoid about the downside and much more flexible about reducing our net (and gross) exposure in uncertain times. To paraphrase Piet Hein, we know that we will err and err and err again but hopefully less and less and less.

Can you elaborate a little on the investment strategy and themes of the Helios Strategic Fund? What sort of fundamental/technical analysis do you perform on the underlying securities prior to making an investment?

At Helios Capital we are 100% bottom-up fundamental analysts within the three big-picture themes that we were employing since the 1990s in my previous job. These three themes are:

Theme 1:

Buy companies that compete with the government of India (or government-owned companies):

- India has allowed privatization of sectors without privatizing its incumbent government-owned companies.
- This allows private sector companies to win at the cost of government-owned companies due to better manpower, product, customer experience, technology, etc.
- Major sectors: Infrastructure (ports/airports/roads/power), financials (banking, insurance), healthcare, education.
- Private sector financials, infrastructure, education, healthcare etc.

Theme 2:

Demographic/lifestyle changes:

- Invest in fast-growth “new for India” secular themes.
- Major sectors: air conditioning, wealth management and financial products, mortgage, retail, tourism, cable/satellite television, leisure, vocational education, gaming, liquor, branded goods.

Theme 3:

Factor cost advantage:

- Capitalize on India’s global competitiveness.
- In these sectors, Indian companies do not yet compete with each other.
- Major sectors: IT, IT services, contract research, pharmaceuticals, auto ancillaries etc.

We normally avoid (not necessarily short) the following themes:

Commodities
Global (and not Indian) demand and prices are main determinants of returns in most cases.

‘One billion consumers’ stories
There are ample opportunities for growth in various sectors which are under-penetrated

India has been a great market for investors but is very volatile. We did badly for various reasons in 2008 but have still done better than most long-only funds in absolute performance despite a much lower net exposure and lower beta.

even in urban India. Sectors where the investor has to rely on the billion-plus Indian population to justify opportunity do not appeal to us, as this invariably implies already well-penetrated sectors.

Bet on India, not on Indians
We are negative on Indian companies expanding abroad aggressively.

You launched the Helios India Alpha Fund in July 2011, which is also an India-focused long/short equity fund. How is the investment strategy of this fund different from the Helios Strategic Fund? Are there any specific short-term opportunities that this fund is targeted toward?

With the Helios Strategic Fund we have an average net exposure of approximately 60% (90% long and 30% short).

We launched the Helios India Alpha Fund to have a low net exposure at all times and separately take higher-conviction, specific-event-driven positions in a few stocks. However, we are rethinking the positioning of this fund, as we find that in practice it is not turning out to be too different from the Helios Strategic Fund and creates confusion. We are therefore considering various alternatives (including merging it with Helios Strategic or converting it to a long-only absolute return fund).

What sort of risk control structures do you have in place to manage your fund's investments under different market conditions? Has your risk management been more stringent over the last two years due to the high volatility across different sectors?

After 2008 we have become much more paranoid about the downside. I have had an incredible run in India investing since 1993 and always believed that we knew what we were investing in. In 2008 we discovered that the behavior of investors could not be predicted and we have to learn to react to events that may have nothing to do with the fundamentals of our companies.

We are now much more alert to global events and can quickly rein in our net exposure (to start with) by adding to our existing shorts. In some sense we have now created in-built short capacity by having nearly 20 short positions at all times. We can thus easily add weight to these names at any time and at short notice if we have a negative view on the market for any reason. This is much better and psychologically easier than shorting an index in the face of some global events, for we have much higher conviction in our individual short positions than we will ever have in shorting an index.

How have the recent regulatory changes in Singapore affected your fund's operations?

Recent regulatory changes have not had any impact on our operations, for we have always been well capitalized and have had deep operational strength. We have the same number of employees today as we had at the end of 2007 when our AUM was much larger.

Do you employ any leverage to enhance your returns? If so, how much leverage do you generally use and how is it distributed across different positions?

We do not employ any leverage. Our net exposure to the market is on average 60% (90% long and 30% short).

Fund raising has been a challenging enterprise for Asian hedge funds in general and Indian hedge funds in particular – how have you fared in this regard over the last two years?

We know that we have the track record, team, commitment and integrity to do well in this business. In the short term investors look at momentum of AUM raise as a key parameter, and that is missing for all the India dedicated funds for us. Many investors believe that other investors know better than them and therefore herd into a few funds where there is momentum in AUM (we know and understand that, as we have seen it ourselves in 2005 to 2007). Although the wisdom of crowds cannot be denied, this normally works when everyone takes an independent decision, but here everyone follows one or two large investors. Our goal in the meantime is to improve and strengthen our performance, for we know that this cycle will turn once again. We are here for the long term and have the ability to outlast this phase.

Over the past 20 years – and in this hedge fund over the past seven and a half years – we have seen phases and periods much worse than just investor disinterest and have still totally enjoyed this journey.

Absolute return funds are the current flavor of the month. In recent years, fund managers have preyed on the fears of investors that quality investing cannot be done without 3- and 5-year lock ups and onerous liquidity terms. We have a track record of investing in India since 1993 in very liquid structures (mutual funds and monthly liquidity hedge funds) and we have never seen liquidity of the fund as a handicap. If an investor is choosing quality stocks (as is always claimed) why is one so nervous or scared that he will not be able to even partially liquidate the holding (in the face of some redemption request) without causing permanent damage to stock performance and to other investors? What quality stocks are these which cannot handle even some selling without having their quality and performance permanently impaired?

From our side we know that although our performance in 2008 led to a lot of redemptions we remain 100% committed to our funds and our business. We are certainly proud of the fact that we acted professionally during that stressful period and have many instances where we went out of our way to accommodate investor redemptions. We have a deep sense of responsibility in managing investor funds, and I and my team have had a long and successful track record in India investing; we do not want our lives and our careers to be defined by what happened to our performance in 2008.

In 2005, 2006, 2007, 2009, 2010 and 2012 the fund has had significantly positive alpha (in 2011 even though the fund's performance was about 1100 bps better than the index, alpha was negative due to the low beta, which leads to unintuitive outcomes when returns are negative). In the pre-2008 era we had annualized alpha of 29%, whereas post-2008, annualized alpha has been of the order of 4% plus.

Is there a particular niche of investors that you are aiming to attract for investments into your fund? Would you like to comment on the profiles of investors in your fund and how you think the fund would be suitable for a potential investor looking to gain exposure to the Indian market?

India has been a great market for investors but is very volatile. We did badly for various reasons in 2008 but have still done better than most long-only funds in absolute performance despite a much lower net exposure and lower beta. We have 90 months of monthly data for investors to analyze, so we are not talking about what we can do but what we have done.

We are looking for quality investors – primarily endowments and family offices. As mentioned earlier, we are here for the long term and are absolutely determined to regain our stride that we lost in 2008.

In summary, we have the following issues to highlight:

Alignment of interests:

- Fund manager is currently top investor in both funds
- Insiders invest on same terms as outside investors
- Zero redemptions by employees since inception

Independent oversight:

- Independent administrator for both funds
- Compliance audit by Compliance Asia
- No investments in unlisted securities – therefore no valuation issues

Infrastructure:

- Institutional quality infrastructure
- 3-member experienced operations staff
- Over seven years of operating history & track record

Liquidity and transparency:

- Monthly liquidity terms match underlying liquidity of investments
- No provision of side pocket
- No side pockets/change of terms in 2008
- Complete 30-day trailing portfolio available to investors on non-disclose commitment
- Customized reports prepared on request

Commitment to business:

- Same number of employees today as end-November 2007

Alpha generation:

- Most experienced team in Indian alternative funds industry
- Gross performance since inception is ahead of market benchmarks with net exposure less than 60%
- Positive Alpha in each of 2005, 2006, 2007, 2009, 2010 & 2012

Investing in Ideas

The Enterprise Challenge Fund

Africa presents opportunities for investors looking to address social and environmental challenges. Harnessing the positive power of enterprise while seeing a significant financial return is possible due to the huge amount of land on the continent and development opportunity regarding energy and infrastructure.

The Africa Enterprise Challenge Fund (AECF) is a US$190 million private sector fund backed by some of the biggest names in development finance and hosted by the Alliance for a Green Revolution in Africa (AGRA). Their aim is to encourage private sector companies to compete for investment support for their new and innovative business ideas. Operating from three regional hubs, Nairobi, Accra and Johannesburg, the AECF is open to proposals from all countries in Africa. Multi-country and regional projects are also eligible.

Various funders approach the AECF wanting to promote, for example, investment in commercializing agricultural research or renewable energy. They then design a competition around what the funder is seeking and market it across the globe or wherever interested businesses will be. Businesses then apply. “We are not part of the real investment community, so in this sense we are a bit of a strange animal. Our donors are trying to buy development impact by encouraging the private sector to invest in agribusiness activities across the continent,” says Hugh Scott, Director of AECF.

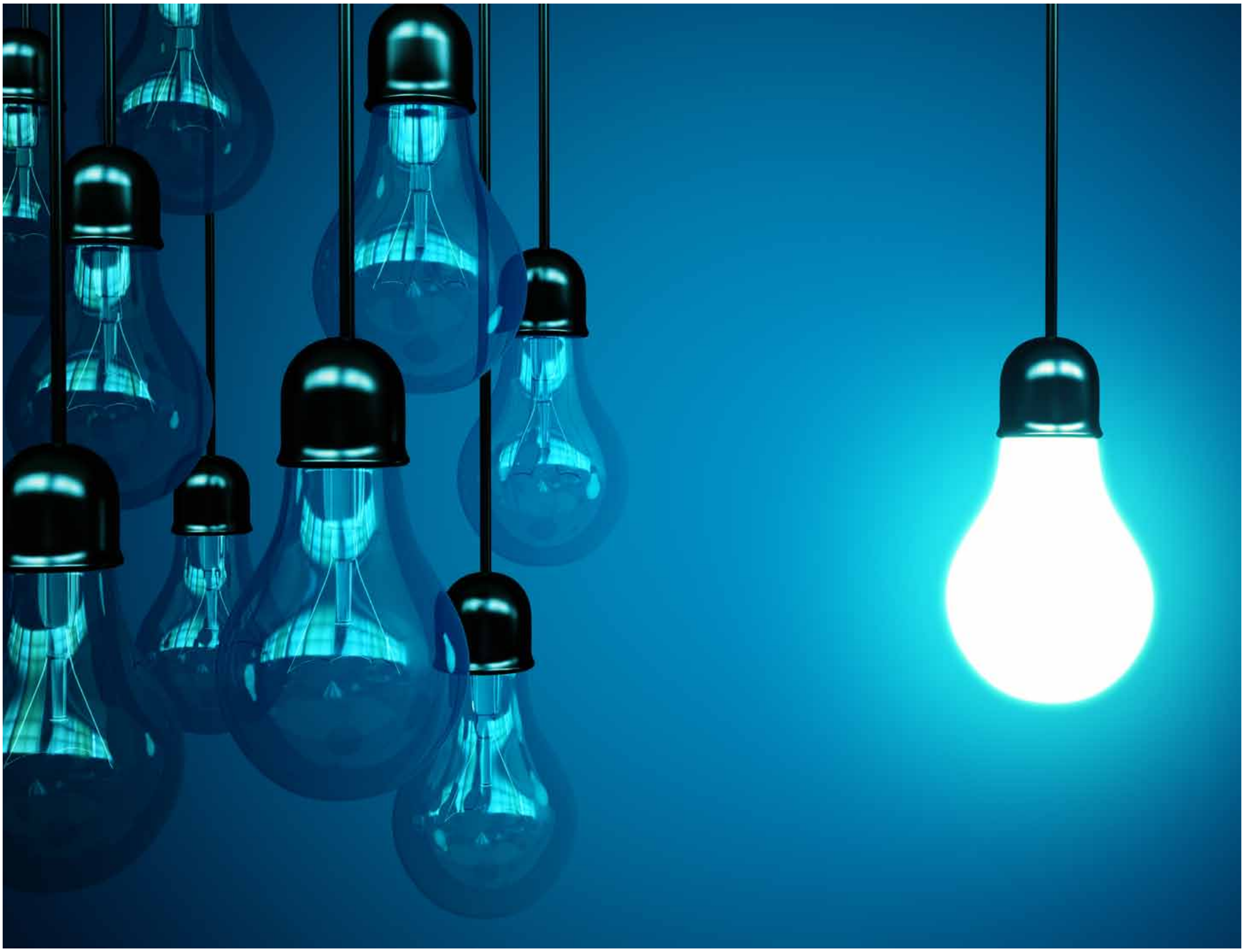
Innovation and impact investment work well together, but given Africa’s size and various levels of development in each specific country, what is regarded as innovative in one region may not be so ground-breaking in another. “Anything in South Sudan is innovative as far as I’m concerned,” says Mr. Scott. “No one is there and no one is doing anything so it’s a great place to instigate new ideas. We are about promoting activity that changes the way others do business, so if we find innovative ideas that affect the market system that others copy, that’s great.” AECF does not promote innovation for innovation’s sake; it’s about building the relationship between investment and invention in order to move market systems.

However, new ideas often need to stem from more developed areas in order to have an impact on rural communities, especially concerning renewable energy sources. The issue is about pushing out frontiers. “If you start a bank you don’t start in the middle of nowhere, you start in the city and you branch out,” Mr. Scott says. Africa is behind much of the developing world in terms of infrastructure, so accessing energy in more remote areas presents difficulties. Consequently, there is room for investment in novel ways to supply power, developing systems to reach communities living off-grid. Trees are being cut down to provide charcoal for cooking and heating, which is not environmentally sustainable without the correct measures in place to replant timber. These problems offer investors the chance to promote green living while providing energy access to those in need. There is great potential for private investment in energy all around Africa.

Mr. Scott says, “Solar is happening but it is about financing very small households. They need lights, radio, TV, to be able to charge cell phones, etc. so if you can do this for an investment of $300 for each household and you can find a way to finance the chain then the demand is enormous.” Low income financing investment is also well suited to Africa considering that the continent’s cities are growing at a rate of 10 to 15% a year. Low cost housing is and will continue to be in demand.

Profitability and sustainable development are closely aligned, and if something is not profitable there is little chance it will exist for long. “You’re never going to have a real impact unless you go to scale and you don’t go to scale unless it’s profitable,” says Mr. Scott in light of the correlation between the success of a business and developmental impact.

“We have seen over 9,000 businesses come to us with ideas. We currently have 180 in our portfolio in 23 countries. For individuals and companies looking to invest in Africa, and not just with regard to agribusiness, you need good partners and an enabling environment in the given country in terms of a suitable political situation and market demand. And if you are focused on agriculture you need to understand property rights and land issues, otherwise you should not engage. Land is heavily linked to politics – these things can be very sensitive,” adds Mr. Scott.



Under the Sun

Africa Ramps Up Use of Solar Power

Renewable energy in Africa is appealing to short, middle and long-term investors. Local knowledge and guidance is key when navigating emerging economies in Africa. However, Africa is on the rise, and due to the continent's geography it is well suited to the implementation of renewable sources.

Stefano D.M. Sommadossi, Founding Partner at NextEnergy Capital and CEO at ix:Africa, says, "We have built a dedicated team of professionals with relevant expertise in the sector working in parallel, securing investment and developing projects at the same time. There are significant opportunities for capital investors in this space and we want to be able to deploy capital straight away."

Mr. Sommadossi believes that "in Africa clean sources (solar, wind, hydro, etc.) in many instances are already competitive compared to carbon based energy sources alternatives. Moreover in emerging economies renewables suit the need for power in the short term. Africa has to triple its capacity in the next 15-20 years. Renewables are the fastest way of deploying power on the ground, as the European experience has demonstrated. In Italy and Germany alone, every 12 months the equivalent capacity of 10 nuclear plants has been installed. So renewables are strategic for Africa." In some areas the only option is to utilize renewables, as many communities are living off-grid, the other polluting and much costlier alternative to this being diesel generators. Some mining companies, for example, use diesel due to limited options as a result of remote locations, and they can use renewables with immediate economic benefit .

Mr. Sommadossi says, "When you are off-grid with solar you can be competitive straight away. The levels of sunlight are very high in some areas in comparison to Europe. So when taking into account that countries such as India and South Africa experience blackouts regularly due to lack of energy, and are experiencing an increase in the cost of managing power, emerging technologies in these areas are becoming much more feasible as opposed to the U.S. and Europe."

Transportation of fuel is another aspect of capturing energy that Mr. Sommadossi believes will be making strides in the near future. "Generating energy that you can use on-grid or off-grid is one thing, and you already have very good technologies like biomass and wind, but you want to conform all this into something that can be transported in a tank, which is biofuel, but generated from waste (a big issue linked to growth of population and changing lifestyles in emerging economies) and non-food related crop or algae." And trends are also appearing in transportation lines for energy, taking power from one area and relaying either above or underground, such as the wind farms in northern Scotland supplying the south of the country.

Infrastructure plays a major role in successfully transporting and storing energy created by renewable sources. A great deal of investment has been focused on supply lines in emerging countries. Large projects are in place dealing with supplying and interconnecting different countries. Therefore, some lines are capable of transporting huge amounts of renewable energy, but sources are not always reliable and are dependent on specific weather conditions, especially with wind. Mr. Sommadossi states that effective and organized grid layout is vital in counteracting reliability issues, or "balancing the grid" as he puts it. "The big advantage of many African countries is that they can skip the power generation-consumption paradigm and skip 130 years of old infrastructures, going to the new distributed paradigm in energy as they are doing with the last available generation in telecommunication. Organizing the grid from scratch is the best way to conquer the issue, creating a flexible system. The new paradigm requires new energy management services, technologies and products, an area we are investing in."

There is a huge demand for financial innovation as well. "In Europe, in Germany, Italy and Scandinavia for example, you have millions of people that are affected by renewable energy and are directly investing in it. It is important to remember that it is not something that is going to happen in the future, it is already happening. There is a huge demand for financial products linked to green power. Even here in the U.K. there are thousands of rooftops installed with solar panels," Mr. Sommadossi says.

In Africa, Mr. Sommadossi believes government support during each stage of investment is key to seeing good returns. In order to "create the correct environment" for investors it is important they have the right approach and partners in order to generate the social, economic and environmental impact that the governments of the specific countries are looking for. Using available guidance, whether it be regional or local, will help potential investors to avoid pitfalls and problems that can be prevalent in African markets, such as bribery and corruption. "If you can work with well known institutions that are able to guide, give you advice, and help you to detect risk, you will have the upper hand. Local, in the know advice is priceless," adds Mr. Sommadossi.

Bad news tends to take precedence on the front page of newspapers as opposed to good news, so the perceived risk in emerging markets may be hyped at times. However, Mr. Sommadossi says that the good news in Africa is that things are changing dramatically, especially the structure of large projects in the sense that they are becoming more effective. A better understanding is being developed with regard to the kind of activity that needs to take place in order to attract successful investment. "Working habits are different in Africa than they are in the U.S., and environmental issues are also different. Even though many aspects are improving it is often a matter of knowing how things work, gaining the necessary inside knowledge, and the advice of a trustworthy local guide."

When investing in renewable energy in Africa, there are short, mid and long-term opportunities. The short-term prospects tend to suit developers who are willing to back projects before construction begins; this usually involves good returns. However, there is more risk involved in the early stage than perhaps the following phases. The construction stage is dependent on the technologies involved, so risk can to an extent be mitigated. "Renewable energy has the best, most stable cash flow ever," says Mr. Sommadossi, "so it is a great product for long-term investment funds such as pension and insurance companies. So long-term investors are only really going to be looking once the construction phase is completed."

Renewable Supply

for African Energy Demand

Clean investments are becoming increasingly important as a result of climate change, and Africa, due to the continent's geographic position and resources, is proving an attractive investment opportunity. However, short-term and often more polluting energy sources are required during the development stage of installing renewable technologies, so mitigating risk and environmental impact is vital.

Youssef Arfaoui is Chief Renewable Energy Specialist for the African Development Bank (AfDB), which he has been with for almost 10 years. He was originally hired to promote clean investment and to examine the use of hydro, wind, solar, geothermal and biomass fuels. However, development has stalled with regard to biofuels as a result of controversy over land use.

Hydropower is being utilized in many African countries, as is geothermal, a relatively new technology that involves deep drilling to source steam. The first project financed by AfDB in Kenya is applying this method, and the government has invested in the production drilling phase.

According to Mr. Arfaoui, Africa has huge potential for renewable energy, but due to the long-term nature of renewable investments, short-term options such as heavy fuel oil and diesel are often favored. Setting up projects and supplying power as quickly as possible is sometimes the main objective, which drives a preference for carbon-based power supplies.

Mr. Arfaoui also says that the AfDB will not consider any project unless a thorough examination of the social and environmental impact has been conducted. Each project analysis is published on the company's website from 60 to 120 days prior to submission to the Board for approval.

AfDB undertakes a strategy review every five years for a specific country in order to assess the available resources of the area. "We can only use what is available in each country we work in, so it is important to examine potential resources," says Mr. Arfaoui. "We have to plan with each government when and how they want their energy delivered. We look at how we can assist them in order to produce electricity, which is sometimes needed instantly. A project may involve thermal energy, for instance, and you have to design a plan of action spanning a number of years." Also, natural disasters can result in a need for quick and direct energy supply, such as the drought in East Africa. "East Africa needed to compensate for lost capacity, and although thermal in the area is beginning to take root, weather conditions and other factors sometimes mean that these sources are not always available, so we collaborate with African countries to provide other sustainable solutions. Energy is key to all sectors, so it is important to assist each particular country in solving problems."

Infrastructure is hugely important, and in some countries the lack of infrastructure can act as a serious barrier to entry with regard to renewable energy. There are, however, African countries that harbor well developed infrastructure systems, such as South Africa, Morocco and Tunisia. Roads, transmission lines and equipment used to install systems vary considerably across the continent. AfDB is currently funding a project in Kenya involving 300 megawatts of wind power northeast of Nairobi. According to Mr. Arfaoui, the project "covers around 460 kilometers of transmission line, and they are going to create over 200 kilometers of new roads so that they can successfully transport the necessary equipment. Lifting equipment is also needed to install the wind turbines, so this is why the costs of developing projects in Africa can be a little high in comparison to the U.S. or Europe, where the infrastructure is available."

The private sector in Africa is currently very active. The potential for financing and investing in projects is growing rapidly. Risk has also been reduced, both in policy and allocation. Much of the financing is done by the public sector, and the structure of each project can be dependent on the technology involved. For example, in Kenya, where drilling for geothermal energy supply is taking place, the public sector, assisted by the AfDB, has taken the lead in mitigating the risks involved with exploration and production drilling, so by the time the private sector comes into play, much of the risk has been mitigated.

In Latin America, the cost of producing each megawatt of renewable energy is higher than carbon based fuels, even though there are sometimes subsidies for locally produced energy. "The problem in Africa is that although it is probably less risky in terms of production costs, much is dependent on the infrastructure of each country. If we take the more expensive technology as an example, there is exploration and drilling risk, not to mention production risk. If it is developed by the private sector, which I am not saying is a bad thing, the project will include the risk and development premium, which will of course affect the financing, making it more expensive. There are therefore many contributing factors that can change the cost of production," says Mr. Arfaoui.

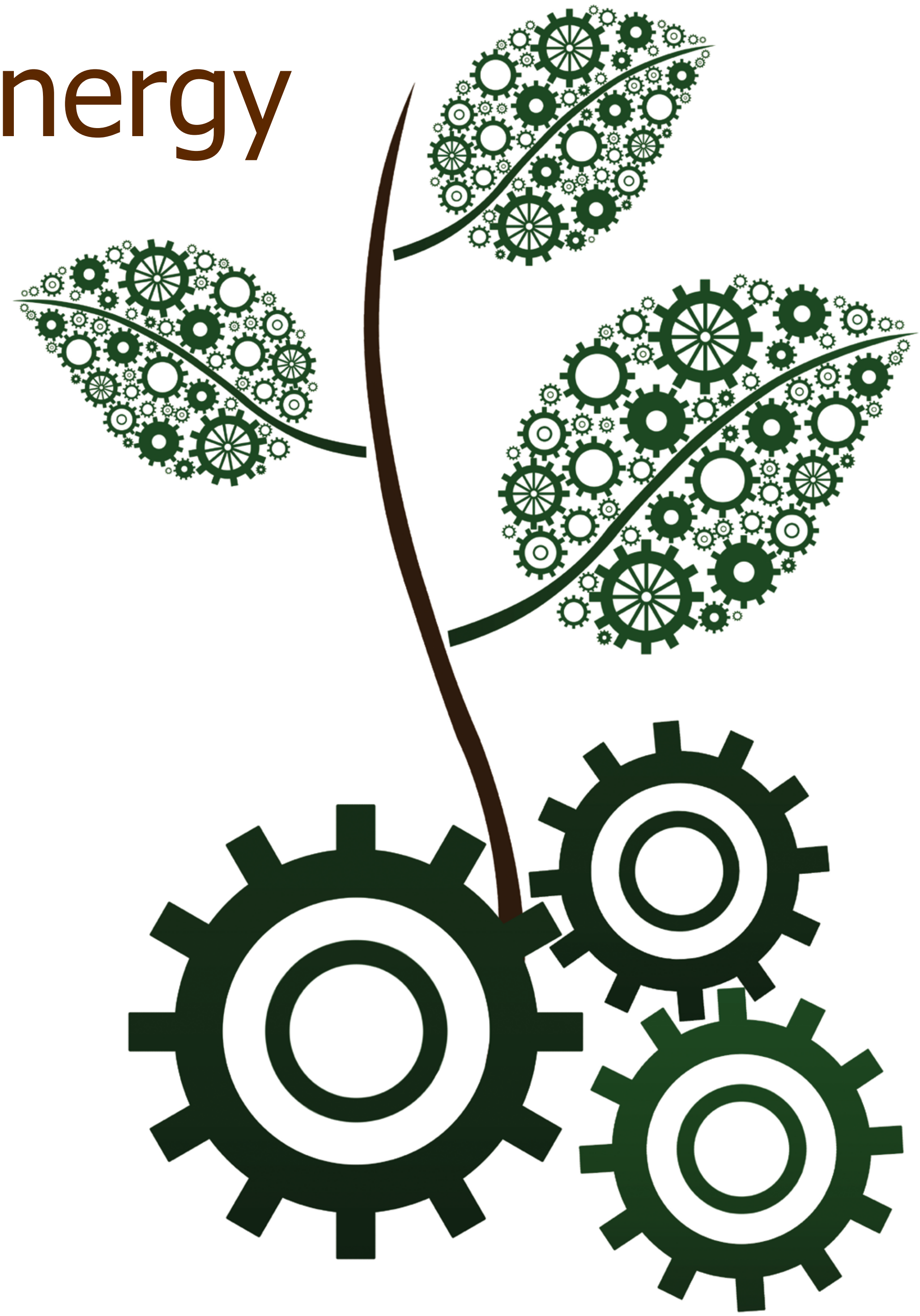
With the growth of renewable energy in African nations, there has been evidence suggesting a slight increase in the production of logistical technology on the continent. Integrating manufacturing of solar equipment and turbines in Africa makes financial sense, but it is still very much in the development process. "We are trying to assimilate manufacturing in order to reduce costs," says Mr. Arfaoui, "and whereas certain renewable technologies are made in Asia, it is sometimes not cheaper producing solar panels in Africa. It can be more cost effective to produce certain components locally, but not always the entire system. However, the towers and blades of wind turbines can be produced locally. We are currently assessing assistance to a project in Ethiopia where the local company will be producing wind turbines. This will show how much the cost can be reduced when certain materials and components are made in Africa as opposed to importing."

Energy efficiency can be problematic, especially with the utility companies in Africa. In some cases the utility companies are collecting less than 60% of capacity. "There are commercial and technical losses. Improving on the production and transmission are ongoing issues that need to be solved. We can provide technical assistance to the utility companies in order to ensure that the company has the human resource capacity so that they can deal with problems. We also work to make these companies bankable and financially viable," says Mr. Arfaoui.

Mr. Arfaoui also says it is very difficult to rank African countries in terms of risk, as it depends on a number of factors. "You look at country risk itself, especially when financing private sector projects, and every country has its specific risks to deal with."

Green Asia

Embracing Renewable Energy



Infrastructure and renewable investments directly affect each other in Asia; one complements the other. Therefore, investors are starting to focus on both when developing projects, as the long-term and short-term benefits of internal transportation systems and efficient supply lines can be invaluable.

Even for private investors, developing supply lines and energy distribution channels to support investments makes financial sense. “It is about realizing our investments in the region are just going to be a drop in the ocean compared to what’s needed, but improvements can be made. A lot of our work is also in the policy and regulatory area, where we’ve provided technical assistance to countries to develop their policies on promoting renewable energy and energy efficiency. We have provided hundreds of millions of dollars for technical assistance; this equates to a large part of our clean energy and sustainable programs. It’s not just about the investments, but also the policy and regulatory dialogue,” says Mr. Samuel Tumiwa. Mr. Tumiwa is currently the deputy representative of the Asian Development Bank (ADB) in Washington. Previously he has helped ADB coordinate and spearhead its investment in clean energy.

Bloomberg New Energy Finance reported that 51% of global renewable energy investments were made in Asia last year. China is currently the world’s largest investor in renewable energy, and India also contributes hugely. Both countries have been involved with renewable energy for a long time. Thailand is also showing encouraging signs, and taking into account that the country does not possess any of its own sources, the government is pushing energy efficiency and now has progressive feed-in tariffs to attract investors. The Philippines, after spending the last ten years formulating a renewable energy policy and another three years implementing it, has started to present some good feed-in tariffs, which appear likely to spur wind and solar investments in the region. Indonesia was once an OPEC member and a huge exporter of coal, but is making amends by working to promote hydroelectric energy. Geothermal is also a viable option in the area due to the available resources, but the Indonesian government has not yet tapped into it because it is easier to utilize diesel. Japan must not be ignored, given that it has a fantastic efficiency record. The Fukushima disaster has resulted in the country pushing renewable in recent months.

At the moment, renewable energy only accounts for 20-30% of the grid in an advanced country such as Norway or Denmark. Mr. Tumiwa says, “I think in Asia if we can get 15% renewable into the grid, that would be very good. So renewable is only going to be a small portion; base load power is still needed, so it is still a large part of the equation.” Coal is often naturally available in many Asian countries, so the resource is used as a matter of cost and convenience. Using it more efficiently is something that new technologies are enabling, and some coal plants have been modernized. China has closed down countless coal-fired power plants in the last two decades, and many of the country’s plants are now far larger and using supercritical technology. India is following suit, so coal is continuing to be used as a fuel and looks likely to have a long future.

“The interesting thing is that the U.S. has said it is going to be self-sufficient in energy production in the next five to ten years; in fact they will be the largest energy producer in the next 20 years. If this happens they will no longer need Middle Eastern oil and gas, and this will most likely lead to Asia sweeping up the reserves in the Middle East,” says Mr. Tumiwa. “This has a lot of real and pressing political implications.”

Mr. Tumiwa also says that Asia’s investment in infrastructure between 2010 and 2020 will reach US$8 trillion, in order to keep up with current economic growth. China and India are manufacturing solar panels and are leaders in wind turbine production. This changes the investment dynamic of these countries. The reliability of renewable technologies has also improved during the last decade, but there is still room for improvement when it comes to conversion of solar and wind. “The next thing the Indians and Chinese need to focus on is the conversion. You can talk about solar PV (photovoltaic systems) but there are various different kinds of solar PV with different conversion efficiencies; that’s what the Asian companies need to do now,” says Mr. Tumiwa. “Clearly in the last ten years they have improved their reliability and efficiency and they will continue to do so, to become world class competitors at a lower price. They will therefore bring down the cost of wind and solar.”

Biomass, or sewage treatment for power, is becoming more prevalent in Asia, but Pakistan and India tend to use wheat due to its abundance. Waste energy from waste water treatment plants is growing to help run the waste water treatment itself. “As for energy from municipal waste, we have made some investments, and there are a lot of opportunities. The problem in Asia is there are very few, if any, sanitary landfills. They are all complete dumps,” says Mr. Tumiwa.

In terms of the direction in which Asia is heading, Mr. Tumiwa believes it is looking good. 10 to 12 years ago when the feed-in tariffs were impressive in Spain, Portugal, Germany and the U.S., there was not much investment coming into Asia because the perceived risk of investing was higher. As the feed tariffs have dried up in Europe and North America, there has been more investment activity in Asia. Infrastructure development has also played a large role in the interest of new investors. Mr. Tumiwa says, “What we are doing now is not simply investing in projects, which we are continuing to do, but we’re innovating the infrastructure and enabling mechanisms in order to produce a really sustainable infrastructure.”

Present at the Revolution

Dr. Mark Mobius, the Foremost Expert on Emerging Market Equity Investments, Talks to AEI About the Industry's Past, Present & Prospects

Looking back on the last quarter-century of investment in emerging markets, 1986-1987 stands out as a watershed moment. That was the year Capital International launched an emerging markets fund for institutional investors, the first of its kind, and Franklin Templeton Investments listed its Emerging Markets Mutual Fund on the New York Stock Exchange. The latter gave individual investors their first access to emerging markets via a fund, and catalyzed the rapid growth of an industry that continues to accelerate today.

To launch that fund, Templeton hired Mark Mobius to be the fund's president and oversee the firm's aggressive expansion into emerging markets. More than 25 years later, as Dr. Mobius continues at Templeton with 50 mutual funds currently under his management, his name has come to be virtually synonymous with emerging market investment. The author of several books and thousands of articles on the subject, he has been recognized by various awards that place him at the top of the industry, including being named one of the top 10 money managers of the 20th century by the Carson Group.

On the occasion of its inaugural issue, AEI spoke to Dr. Mobius about the history, current dynamics, and future of investing in emerging markets. His viewpoint was of particular interest to AEI, as the magazine focuses on alternative asset classes, while Mr. Mobius's professional emphasis has been on stocks and bonds – thus giving him an "outsider" perspective relative to AEI's focus. As he tells it, however, alternatives and traditional vehicles are closely interrelated, and both have strong prospects in the years ahead, as emerging markets solidify their standing not only as strategic destinations for investor money but as some of the strongest economies in the world.

"Anyone with a brain in his head who's looking at fixed-income instruments would begin to think, 'Hey, wait a minute, why am I giving US and European debt triple-A status and not some of these emerging countries. It's not to say that there's no risk, but there's a growing realization that there's value out there, and people are starting to wake up to that reality."

A Long Way

As the man who spearheaded emerging market investment in the early days and saw out the procession of crises, bear markets, bull markets and overall growth that have characterized the space since 1987, Dr. Mobius has a unique vantage point from which to view the tremendous changes in his field. Those changes have manifested, firstly, in the investment industry itself, where he sees markedly more sophistication, competition and capital.

"We were the only game in town," he says of the moment when Templeton launched its EM mutual fund, "with US$100 million AUM and investments in 5 markets globally. Now the fund has US$42 billion AUM, along with over thousands of competitors." Indeed, there are now over 6,000 mutual funds worldwide focused exclusively on emerging markets.

The more interesting changes, however, have been in the underlying markets themselves and their relative importance in the global economy. In 1987, emerging markets accounted for only about 1% of global market cap, but now account for about 32%. In Dr. Mobius's view, the growth and strengthening of these markets is due fundamentally to the political and economic reforms that have spread throughout the world over the last few decades.

"When we started, many of these countries were still on a socialist model of development, and they didn't welcome foreign investment. They were nationalistic. If you take the Andean Pact, for example, it was designed to keep foreign investors out, not in. So that was the environment we were working in.

"But when you look at what's happened since 1987, we have the World Bank, the IMF and these other multi-lateral institutions to thank for telling these countries, 'Guys, your socialist model isn't working, you've got to move to a market economy.' Because of that, you've seen the privatization of state enterprises and the cleaning up of markets."

"A top-down approach can be very misleading. For example, last month, if you picked up a newspaper and read about Egypt, you wouldn't want to go near the place because it seemed so dangerous. But I went to Cairo, had a cup of tea, listened to the speeches, saw people enjoying themselves, and I had to ask myself, 'Where is this crisis?'"

Largely as a result of these reforms, emerging markets are no longer hotbeds of crisis where intrepid investors brave extreme risk to exploit volatility and sniff out arbitrage opportunities. Instead, many of these economies are strong and sound, with the best growth numbers in the world and more impressive creditor status than their "developed" market counterparts.

New Order

Dr. Mobius breaks down this evolving paradigm shift into 4 key points:

- GDP Growth: "Economic growth in emerging markets is now 5 times faster than in developed countries (Europe, U.S., Japan)," he says.
- Foreign Reserves: "The amount of foreign reserves in emerging market countries has surpassed that of developed countries, so you have a situation where net-debtors have become net-creditors."
- Debt: "If you look at the debt-to-GDP rations, the U.S. is now at 100%, Europe at 150, Japan at maybe 200. Emerging market countries have 50% on average."
- Volatility: In spite of these indicators of strength and stability, he notes, "volatility has actually gone up, because there were no derivative instruments before, and now there are. But this is actually a positive development for investors, as it gives them opportunities to buy low and sell high. A good example in recent history is what happened in 2009-2010, when markets went up by 50, 60, 70, 80 sometimes 100%; that's volatility in spades."

With the growth numbers, the strong government balance sheets, increasingly sophisticated markets and still-abundant bargains, Dr. Mobius thinks global investors have no choice but to look at emerging markets.

"If you put it together, anyone with a brain in his head who's looking at fixed-income instruments, for example, would begin to think, 'Hey, wait a minute, why am I giving U.S. and European debt triple-A status and not some of these emerging countries.' It's not to say that there's no risk, that there aren't a few deadbeats among emerging market countries, but there's a growing realization that there's value out there, and people are starting to wake up to that reality."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The Right Vehicle

As investors wake up to this reality, the question then becomes: What is the best way to invest? In terms of vehicles, there's been a huge proliferation.

Though Dr. Mobius has invested in various asset classes with Templeton, including real estate and private equity, his main focus has been on mutual funds, both open and close-ended. He says the main reason mutual funds and public equities are attractive to his investors is because of the liquidity they provide. "For the most part, that's what investors want," he says. "In our private equity area, for example, we have to ask our investors to tie up their money for 5 to 7 years without any hope of getting it back until we've finished our investment cycle."

Nevertheless, Templeton has invested substantially in emerging market private equity, beginning with Russia, China, Vietnam and India, and recently entering Latin America via a Brazilian deal, taking an essentially agnostic approach to seeking out bargains in these markets. "It's about the deal," Dr. Mobius says. "You really have to be open and look at everything that crosses your path."

He notes that the increasing dealflow in the private equity sectors of emerging markets is ultimately beneficial to the public markets, as large private deals look for exits via IPOs.

"When these private equity deals are done, the guys who make the big investments need an exit, and there are only 2 ways they can do it: through a private sale to a big buyer, or by going public. These deals are generally deepening the public market, so we welcome them."

He also sees growing secondary markets for stocks, bonds and alternatives – a proliferation of options that are helping investors and managers mitigate risk, as well as another major development: the appearance and growth of emerging market-focused ETFs, which, he says, "have really captured the imagination of investors around the world."

'There's No Free Lunch'

He stresses, however, that ETFs also add volatility to the portfolio, as they have the power to move the very markets they are meant to reflect.

"Based on all the work we've done, the single most important thing is the people behind the company. It's critical. You've got to understand who is running these companies and how friendly they will be to investors."

"Basically an ETF is trying to duplicate a market," he explains, "whether it be a real estate market, the Brazilian market, whatever, by being pinned to an index. As they get larger, they're becoming the tail that wags the dog instead of the other way around, and this is getting to be very problematic for many of the large ETFs. The derivative market is developing in order to satisfy the requirements of these ETFs, so an ETF manager, instead of actually buying the stock that reflects the market, will try to a buy a derivative which reflects the same thing. But every time you do that, you're establishing risk in other directions. There's no free lunch."

Where over When

Dr. Mobius says he spends about 300 days a year traveling the globe seeking out bargains, and he is renowned for his research-intensive approach to investing. As a result, in his investment management as well as his writing, Dr. Mobius has come to prioritize geography over precise timing when it comes to choosing assets.

"Regardless of what country or sector you're looking at," he explains, "there are companies at different stages of their development. You could find a beer company in Brazil moving at a different pace than a beer company in South Africa. So it's very important to know where: Where are the bargains? Where are the opportunities?"

At the same time, he practices and recommends a bottom-up approach as preferable to a top-down approach, even though each has its essential role in the research process.

"A top-down approach can be very misleading," he explains. "For example, last month, if you picked up a newspaper and read about Egypt, you wouldn't want to go near the place because it seems so dangerous. I went to Cairo and had a cup of tea, listened to the speeches, saw people enjoying themselves, and I had to ask myself, 'Where is this crisis?' [My team and I] went to visit some companies whose businesses were doing well as usual: they were manufacturing, selling. Life goes on.

"This doesn't mean that Egypt isn't in trouble. What it means is that you can't stop and scratch Egypt off your list."

There are, of course, instances where top-down considerations are essential, particularly when it concerns political risk and investment security. "Is the government going to take over my company? Am I going to be able to get my money out? Those are two questions you have to ask yourself that might require you to make the decision to avoid a country," he says. "But other than those 2 things, all is possible."

When looking bottom-up at markets, Dr. Mobius is seeking bargains, but there is a factor even more fundamental to the health and success of an investment.

"Based on all the work we've done, the single most important thing is the people behind the company. It's critical. You've got to understand who is running these companies and how friendly they will be to investors."

Re-Definition

With the changes in the accessibility and stature of emerging markets, Dr. Mobius notes that the scope of what can be considered "emerging" has obviously grown. The BRIC countries that garnered most of the attention from global investors last decade are now being joined by the next tier of large and demographically strong markets, including Indonesia, Mexico, Pakistan, Kazakhstan, Nigeria and Turkey.

But more fundamentally, the aforementioned economic numbers signal that the very concept of emerging has changed in meaning.

"The big question now is, if things continue the way they're going, where emerging markets are growing at 5% and developed markets at 1%, you could find it more difficult to define what an emerging market is. You may have a role-reversal, with so-called emerging markets becoming the richer markets."

For that to happen, the governments of emerging market countries will have to continue the market-friendly reforms of the last few decades, he says. "At the end of the day, the key to all of this is the philosophy of the government. If that changes, you're going to see a very big problem."

And at the same time, for developed market countries to get back on the track, they'll have to resist the drift in the opposite direction.

"I think one of the challenges that faces the U.S. and Europe and developed countries in general is that they're moving inexorably toward a more socialist model," he says, "where the role of the government overtakes the role of the private sector. That's going to be a big question mark going forward."

Repeating Ourselves

As the emerging markets of yesterday come to be increasingly prominent and powerful, and as a new crop of emerging and frontier markets attract global capital, one would hope that some of the errors and crises that have plagued emerging and developed markets alike could be avoided through prudence and strategy.

But Dr. Mobius doesn't buy it, seeing markets as fundamentally psychological, and human psychology as inevitably its own worst enemy.

"These crises are impossible to avoid," he warns. "Unfortunately, human nature never changes. We overdo it: it's the nature of the beast and we're all subject to it, whether you're Joe Blow in Hoboken, New Jersey, or some sophisticated executive in a Manhattan suite.

"The only thing that will change is the speed at which it takes place, and the only thing that might save us, so to speak, is the speed at which we can recover."

After the Decoupling

John Stinson of Cushman & Wakefield Discusses the Magnitude of China's Growth and Its Effects on Post-2009 Asian Real Estate

- Since the global financial crisis, and throughout the subsequent economic downturn, Asian markets have generally decoupled from the West and become more independent and interdependent, with China increasingly fueling the region's growth.
- China's current growth, and projected growth over the next 10 to 15 years, is of an order of magnitude that many investors underestimate. The rise of the consumer middle class and the development of infrastructure have been particularly tremendous.
- As global investors become more sector-focused, they are zeroing in on the retail and logistics sectors in China and the rest of Asia.
- Tourism and hospitality are also growing on the back of Chinese consumer demand, with real estate investment opportunities not limited to hospitality.

The global financial crisis of 2008-2009 and the ongoing global economic downturn have had profound effects on Asian real estate markets. But according to John Stinson, Managing Director of AsiaPacific Capital Markets at Cushman & Wakefield, the world's largest privately held commercial real estate services firm, two developments in particular are shaping the current investment landscape and the manner in which investors are approaching these markets.

One is the regional independence and interdependence that have manifested in Asia in recent years, with China increasingly at the epicenter.

"Many emerging markets weathered the global financial crisis very well, kept afloat by domestic demand," says Mr. Stinson, whose firm performs asset management, capital advisory and investment advisory for its clients, with US$2.2 billion AUM worldwide. "And one of the consequences in Asia was that, in many ways, it decoupled from the U.S. and Europe, and became more reliant on China, with a lot more intra-regional trade."

China's Growth

The rise of the Chinese consumer middle class, the development of the country's infrastructure and the expansion of the economy as a whole are of a greater scale than many Western investors appreciate, and are creating huge investment opportunities in various sectors. Mr. Stinson cites some telling statistics:

- As part of China's current five-year plan, it is expected that 150 million households will join the middle class for the first time by 2015.
- It is projected that by 2025 China will have 15 "megacities" of more than 25 million people.
- In 2010, 1 out of 10 Chinese citizens over the age of 20 had a college degree; by 2020, that number is expected rise to 1 in 5. Part of the current 5-year plan is to create 7 million new graduates per year.
- China has the world's largest high-speed rail network; in 2010 it comprised 8,350 km of railway; in 2012 the network reached 50,000 km.
- In 2010, China's freeway network was roughly the same size as the U.S.'s, at

> *It is projected that by 2025 China will have 15 "megacities" of more than 25 million people.*
>
> *John Stinson, Managing Director, Asia/Pacific Capital Markets, Cushman & Wakefield*

about 75,000 km; it is expected that it will grow another 34,000 km by 2015.
- In 2010, Beijing's Capital Airport became the second-busiest in the world, behind only Atlanta's, moving up 7 places in 5 years; it still held this place in 2012.

East and West

Shanghai and Beijing have been the foci of this development, of course, causing their status to solidify among the more developed Asian real estate markets. "In Europe the concept of a core city in emerging markets doesn't seem to sit very well," says Mr. Stinson, "but we know that Shanghai and Beijing are very much core markets in an emerging country."

And yet he sees substantial real estate development and investment opportunities in the rapidly developing western portion of the country, as well.

"If you look at the development of China over last 20 years," he explains, "much of it has been in the East, in Beijing, Shanghai down through to Hong Kong, Shenzen and so on. That has created higher incomes and a higher economic cost for manufacturing. So what they're now looking to do is to continue to encourage infrastructure inland so they can start developing throughout the West."

Sector Focus

The second important development post-2008/2009, Mr. Stinson says, is that investors have become more sector-focused in their strategies. This phenomenon is global, but it is drawing investors to certain Asian real estate sectors in particular.

As Mr. Stinson points out, the rising middle class in China is already fueling huge demand in the residential and retail sectors – particularly high-end retail, as luxury-label goods "tend to be the benchmark of progress in many emerging markets."

Retail is, in turn, a major reason why logistics is the hottest sector across the region, he says.

"The evolving dynamics of global retail is changing the traditional fundamentals of logistics locations," he explains. "In the U.S., 20% of retail turnover is carried out over the internet, so how and where inventories are held is changing. This trend started to pick up in Asia last year, creating a huge demand for logistics in distribution throughout the region." He points particularly to major hubs such as Osaka, Tokyo, Hong Kong, Shanghai, Beijing, Shenzen, Singapore and Sydney.

"At present logistics is the hottest sector across Asia. The evolving dynamics of global retail is changing the traditional fundamentals of logistics locations, and creating a huge demand for logistics in distribution throughout the region."

Mr. Stinson notes that, in spite of the recent growth of online retail and the related infrastructure, traditional retail demand continues to grow. "It's an interesting dynamic where you're not yet seeing a change in actual storefront premises, because retail turnover continues to grow. Instead of replacing storefronts, the online space is really just adding another sector of activity to the market." Once again, this activity in China is not limited to the major markets in the East. "We've seen a huge number of luxury brands opening stores in markets that might seem surprising, such as Chengdu" in the West.

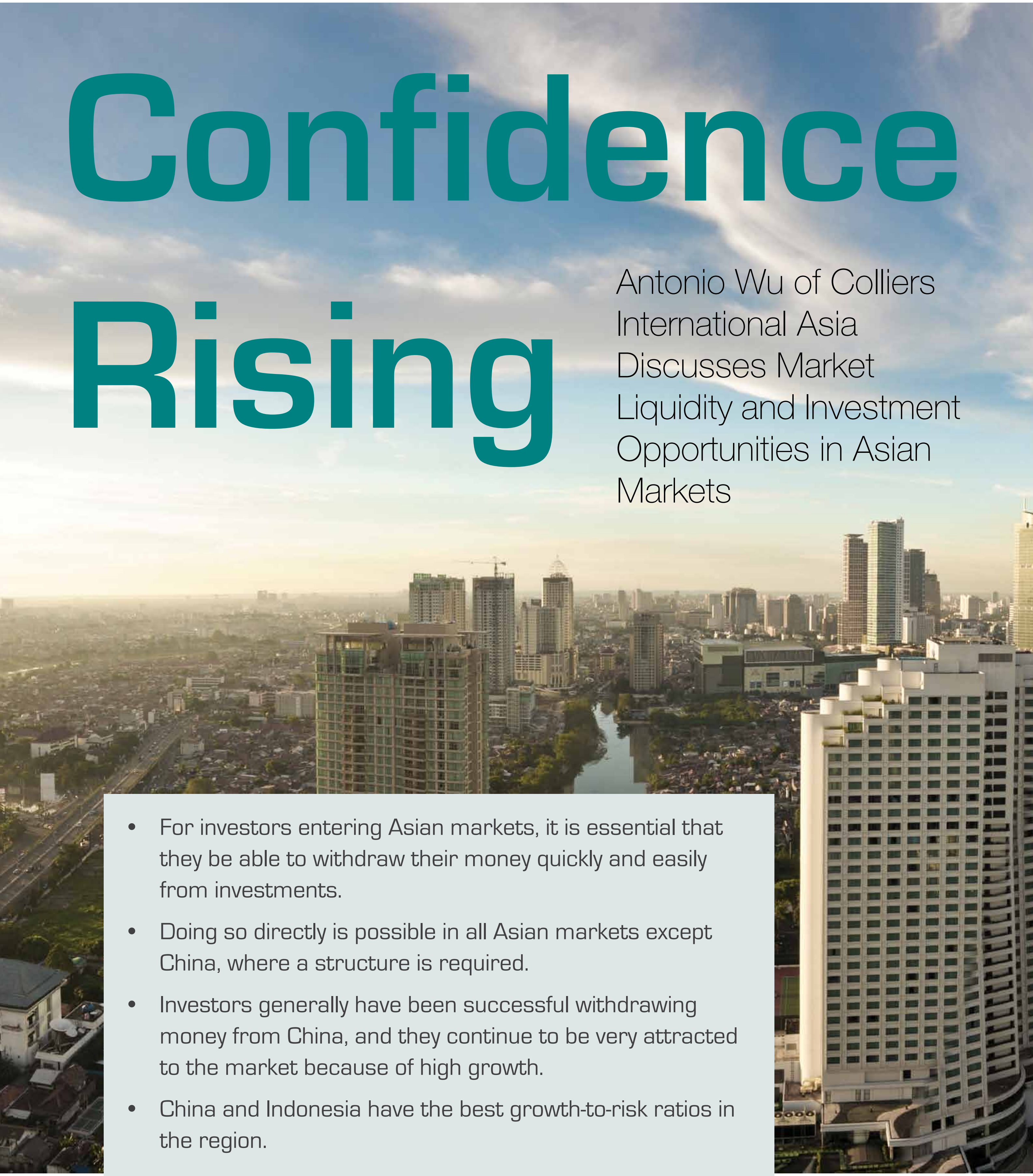
Indeed, the effects are being felt across the region, he says.

"If you look at Hong Kong, it's seen huge growth in retail turnover and retail rents, mainly on the back of increasing consumer spending from mainland China. And we've started seeing the same thing in Tokyo and Singapore, though in Singapore it's high net worth individuals in Indonesia and Malaysia who are fueling the market."

Worlds Unto Themselves

Mr. Stinson also sees huge developments in the hospitality sector region-wide, catering largely to Chinese tourists. Interestingly, the opportunities go far beyond hotel development, as major Asian tourist destinations are beginning to elaborate their offerings to meet the multi-faceted tastes and increasingly sophisticated and demanding travelers.

He points to Singapore as an example of a comprehensive tourist destination. "Over the last 5 years, they've built a Universal Studios and Gardens by the Bay, licensed two casinos, and added about 6,500 rooms to their hotel inventory; and if you go to Universal Studios during the week, 90% of the patrons are from Korea or Mainland China. Previously they'd have to go to Los Angeles or Paris for these options, but that dynamic is changing."



Confidence Rising

Antonio Wu of Colliers International Asia Discusses Market Liquidity and Investment Opportunities in Asian Markets

- For investors entering Asian markets, it is essential that they be able to withdraw their money quickly and easily from investments.
- Doing so directly is possible in all Asian markets except China, where a structure is required.
- Investors generally have been successful withdrawing money from China, and they continue to be very attracted to the market because of high growth.
- China and Indonesia have the best growth-to-risk ratios in the region.

Investors looking to enter Asian real estate markets, particularly the high-growth but less liquid markets of China, Indonesia and Southeast Asia, are often concerned about their ability to exit investments easily. As Antonio Wu, Executive Director of Investment Services for Asia and Deputy Managing Director for Hong Kong at Colliers International Asia, explains, "Investors need to know if they can take the dollar out that they put in. If it takes a while to get your money out, that's not good for any investor."

Hence the attractiveness of the more mature and liquid markets of developed and semi-developed Asia, he says, as well as certain markets within emerging Asia that have become core-quality markets for investors.

"Most foreign investors when they come to Asia they like to look at the mature markets first, places like Hong Kong, Singapore, Japan, now maybe Korea, then Shanghai and Beijing."

In Hong Kong and Singapore in particular, investors are finding attractive cap rates, of 2% to 3%. "That's really low compared to European countries. These markets are also highly liquid and you can find transactions: in Hong Kong, for instance, we have transactions every day."

The continued growth of the Hong Kong market reflects investors' penchant for real assets as a hedge against inflation and currency depreciation. "Hong Kong's currency is pegged to the U.S. dollar," Mr. Wu says, "so we are facing a situation where our currency is depreciating compared to other currencies in Asia, and a lot of wealthy individuals are buying properties now to hold onto a hard asset. The same thing is happening in Singapore with high net worth individuals from Malaysia and Indonesia."

"Indonesia is expanding and there are a lot of opportunities in all sectors, starting with hotels but also in residential, office and retail. There have been a lot more commercial real estate transactions in the last 12 to 18 months than in the previous 5 years."

Antonio Wu, Executive Director of Investment Services, Asia & Deputy Managing Director, Hong Kong, Colliers International Asia

China

Mr. Wu notes that investors can take their money out of investments easily in every Asian market, but in China a fund or business structure is required. Investors are increasingly comfortable entering the Chinese market through these structures, he says. "There continue to be a lot of successful cases of investors getting their money out of China, and then, of course, the underlying growth is still tremendous."

Mr. Wu, whose firm has 9 offices in China, sees it as the market with the best growth-to-risk ratio in the region. "When investors go to China, they'll see a huge amount of growth in Beijing and Shanghai, but also second-tier cities such as Nanjing, Suzhou, Tianjin, Wuhan and Chengdu." Chengdu, a major western city that has long eluded the attention of foreign investors, is developing quickly. "A lot of people in the neighborhood are buying into it," Mr. Wu says. "There's going to be a huge supply of office space in the next two years."

The development of second- and third-tier cities is helping smaller and medium-sized developers cope with the lack of financing. "These developers are hurting because of the tightening on loans from banks, which are controlled by the central government. But at the same time, in these second- and third-tier cities, whenever they build something, they are selling the same amount of units as before; maybe not immediately, but in a reasonable period of time."

Mr. Wu sees the best opportunities in China's industrial and logistics sector, particularly in cities such as Shanghai, Dalian and Chengdu, as well as in the corporate sector.

"Beijing is still suffering from a short supply of offices, because they stopped building new office buildings a few years ago," he observes. "So the rents in Beijing will continue to grow. In Shanghai the economy is gradually coming back; there is still a supply, but over the next two years I think the situation will really improve. You will see some major supply in Guangzhou, Shenzhen and Chungdu while the domestic demand remains strong."

Government Intervention

Prices are rising in these Chinese cities, but in spite of the ubiquitous cranes and construction sites, Mr. Wu doesn't see a bubble in the market, largely because the government has intervened to prevent speculation.

Indeed, government intervention is a trend around the region. "Most of the governments in Asia are using the same strategy," he says, "starting with China and including Thailand, Singapore, Hong Kong and to a certain extent Malaysia: in some way, they are trying to control the market." Some investors are wary of such interference, of course, but Mr. Wu is quick to point out that investors don't like it when their money disappears, either. "At least these governments are trying prevent bubbles, so that you don't have situations where people put everything into the market and then the next day it's gone."

He says many investors also tend to over-estimate the risks of investing in Asian markets, noting that the gap between real and perceived risk is particularly large regarding China. "China might seem really risky, but if you're going in for the long term, you're going to be okay because of the long-term growth: by 2020, the economy will be as big as the U.S.'s, and the prices are only going to go up."

Indonesia

Second on Mr. Wu's list of the markets with the best growth-to-risk ratio is Indonesia. "Indonesia is expanding and there are a lot of opportunities in all sectors, starting with hotels but also in residential, office and retail. There have been a lot more commercial real estate transactions in the last 12 to 18 months than in the previous 5 years. There is a huge domestic market with a rising middle class. So I think the Indonesian market in the next 5 years is going to be very interesting."

He notes that infrastructure in Indonesia is generally inadequate, though the government is responding to the need. Infrastructure development is particularly active in Bali, where there is an effort to revamp the island's hugely popular tourist areas – plans that should come to fruition in the next 2 to 3 years. Mr. Wu gives a panorama of the rest of the region:

Southeast Asia

"I think Malaysia will be quite stable in terms of growth, even if the pace is a bit slow and largely controlled by the government. Thailand is really coming back, and we see growth especially in the hotel sector and in residential. And opportunities are coming back to Vietnam, with a lot of transactions around manufacturing, especially as the price of labor goes up in China; and this is creating more demand in residential as well."

Korea

"Two years ago, Korea had a major supply of office space, but now they're filling it out nicely, demand is coming back and the prices are picking up. I would say logistics, retail and office will be the top sectors in Korea, and also tourism catering to Chinese tourists who are going to Korea now because of the tensions between China and Japan.

Taiwan

"Taiwan recently opened up its policy to allow insurance companies to invest outside of Taiwan, and that makes it very interesting: we're talking about trillions of dollars they need to invest. Much of that money is going to the gateway cities of the world such as New York, Sydney, London, Shanghai, but probably not Hong Kong Singapore, as they're too expensive."

Preparing for the Great Rotation

Nick Axford of CBRE Global Research on the Challenges and Opportunities Presented by Asian Real Estate Markets

As global investors enter the Asian real estate market, whether to capture returns in the high-growth markets of emerging Asia, or to hold stable, income-generating assets in developed and semi-developed Asia, one of the prime challenges they face is finding comprehensive, reliable data regarding assets and investment contexts.

"These markets, even the more mature ones, tend to be much more complex and opaque than markets like the U.S. or the U.K., which are very transparent and where the trends and structural relationships are more clearly established," says Nick Axford, Head of Research Asia Pacific at CBRB, the world's largest commercial real estate services and investment firm. "That explains why the vast majority of investors that come into the market, particularly in their early stages of involvement, tend to work in joint venture with local partners. There's no alternative but to work with an organization with lots of boots on the ground."

Dr. Axford, whose team comprises 9 analysts based in Hong Kong coordinating the work of over 100 specialists in countries across the region, says the analytical challenge is due not merely to the size and complexity of Asian real estate markets, but to the form and

- Asian real estate markets, even the most mature ones, are more opaque and complex to measure and analyze than most Western markets.
- Investors should partner with local groups who understand these markets well, and they should approach data coming out of these markets with a healthy skepticism, relying on multiple sources for verification.
- Experts agree that the information coming out of the Chinese real estate market is increasingly reliable and accurate.
- Improvements in data reporting and collecting, along with improved political and economic stability across the region, make Asian assets better prepared to receive the "great rotation" of money coming out of secure government bonds and back into equities worldwide.

presentation of data and the lack of a shared standard from country to country. "These markets don't necessarily have the same way of classifying and categorizing economic or demographic information. This is a big contrast to somewhere like the U.S., where all the states tend to produce data using consistent methodology, so the information is more comparable."

Even within a given market, basic information such as pricing can be difficult to obtain, he says. "Many transactions are still principal-to-principal, without much openness and transparency regarding pricing information. The price-discovery mechanism doesn't exist in the same way it does in equities and bonds and in other real estate markets."

He notes, too, that many Asian markets do not have clearly established laws and planning policies around their urban structures. "If you buy a particular building or site, it's hard to guarantee that there isn't going to be a competing development right next door," he says. "And in some cases, where formal registration of property title doesn't exist, it's even difficult to guarantee that you bought what you think you bought in the first place."

As a result, he says it's essential for investors to view statistics "with a degree of skepticism, trying to verify trends from other sources before coming to a conclusion."

Data in China

This healthy skepticism is particularly important in China, which is increasingly a top destination for global real estate investors despite the market's reputation for opacity.

"There is a lot of information about China, but not all of it is consistent and correct," Dr. Axford says.

Yet with its 13 offices in China, CBRE has an on-the-ground perspective of this generally misunderstood market, Dr. Axford says. One common misunderstanding is of the government's handling of real estate market data.

"There's a certain amount of unfair criticism of the statistics produced by the Chinese government. Many of the statistics are governmental rather than being verified by any third-party organizations, and there have been well-publicized examples of situations where the government is believed to have manipulated the statistics in the past; and I think that has led to an assumption that all the statistics are manipulated. But I don't think that's the case."

It's in the Chinese government's best interests that the market function efficiently, he says. "Providing good, quality information, even if it reveals the market isn't moving in the direction they might want, is ultimately helpful. Many of the people we deal with say the quality and openness and transparency of the government's economic and financial statistics does seem to be improving quite significantly."

Improvements Across the Region

Mr. Axford sees a trend across the region of greater openness and stability, which mean mitigated political risk. "The region is changing generally from a political point of view: we're seeing at the moment a bit more stability around many markets, a movement towards more open, free societies and away from less palatable forms of government. Myanmar would be a good example of that."

Asia is also witnessing the financial and economic effects of the reforms put in place following the 1997 financial crisis, he says. "The reforms have really paid huge dividends and many of the economies around the region, though still prone to some fluctuations, are really far better-managed than they were."

He observes an optimism among local investors in many Asian markets, especially those who take a relatively long-term view of their investments, seeking capital appreciation instead of short-term income return. "Thinking about value as a multiple of current income is not something that comes naturally to them, which means that they can pay prices that look very expensive to western IRR-driven investors."

He adds, however, that the rates of income growth that his firm has seen in many markets can, in many cases, be much larger than what Western investors would expect.

"It's very difficult to say on short-term basis whether or not pricing looks attractive; but at the moment, because of the weight of money looking at the market, buying good-quality standing investment buildings in many of these markets looks expensive on a risk-adjusted basis to western institutional investors."

He believes the retail sector in China is the top opportunity in the region, but warns that sector strength is no guarantee of a good investment. "Even though everyone sees the broad opportunity, the risk is at the asset level: how can you make sure you're investing into the right place in terms of quality and location?"

The Great Rotation

In the near term, the factor that what will have the greatest impact on the Asian real estate markets is what Dr. Axford calls the "Great Rotation" of money coming out of secure government bonds and back into equities worldwide.

"Many of our multinational corporate clients are as profitable as they've ever been," he says. "They've got huge amounts of cash in reserve; but they're being held back by nervousness over world events, particularly in Europe, North America and to some extent China. And we sense that we're coming to that tipping point: as investors start coming out of government bonds and into equities, equity investors are going to be saying, 'It's not good enough to not lose our money anymore and sit with cash in the bank; you've got to put it to work for a return.'"

He expects it will be difficult for many of these investors to put money to work in Europe profitably, and almost as difficult in North America. "In my view, emerging markets and Asia in particular look like the huge beneficiaries."

"We know that almost all of our multinational clients have very big expansion plans here in Asia to develop their business," he adds. "The only thing holding them back is the fear of what might go wrong elsewhere in the world. But as that fear recedes and the pressure to grow continues, we expect to see quite a sharp increase again in the level of corporate investment and M&A activity that goes on."

Moving on up

Western Africa's growing demand for commercial real estate

- West Africa, and Ghana and Nigeria in particular, have some of the best growth numbers in the world, fueled not only by commodity exports but booming domestic demand.
- International companies entering or already present in the region, along with increasingly wealthy local companies, are putting pressure on Class-A office building supply.
- The development sector, so far, has not been able to meet this demand fully, resulting in very high prime rent prices.
- The challenges facing developers include lack of materials and technical expertise, high import costs and minimal infrastructure.
- In spite of these costs, investors such as Actic are reaping high returns and the sector is growing fast.

Investors are increasingly attracted to the West African real estate sector, with major South African firms such as Sanlam and Atterbury as well as global firms such as Actis making recent moves in the region.

They are attracted largely by growth and improving macroeconomic stability: West Africa has several of the top-growing countries in the world, with the IMF projecting that the region's GDP will grow 5% to 6% over the next 5 years. Ghana and Nigeria in particular are posting attractive numbers: Ghana's GDP grew 14% last year and is expected to grow 10% this year, while Nigeria's has grown 6% to 7% in each of the past 10 years. The countries are benefitting not only from commodities exports (particularly of oil) but from the increasing domestic demand of their emerging middle class.

According to Carlos Matta, CEO of Laurus Development Partners, a real estate developer focused on Nigeria and Ghana, these markets are replacing South Africa as the

top target for global investors searching for returns in African real estate.

"The South African market is much more mature. I wouldn't say it's over-supplied, but it's been developed very heavily over the past 20 years. There's less of an opportunity there than here in West Africa, which is a different world all together."

Filling a Void

Mr. Matta and his firm have been key players in the development of the sector. In 2010, Mr. Matta founded Laurel as a joint-venture with the U.K.-based PE firm Actis, one of the leading PE groups focused exclusively on emerging markets. Actis's second fund, the Actis Africa Real Estate Fund, raised in 2012, provides the capital needed for the projects Laurus develops on the ground. This combination of capital and development expertise is still rare in the region, Mr. Matta says.

"Competition in terms of development and investment is still modest in the region. And this is coupled with a lack of development expertise: there are not many international level developers, like us, who have the skills, the team and the background to develop Class-A assets."

Laurus has a staff of over 20 in two offices, one in Lagos, Nigeria, and one in Accra, Ghana. Much of its staff are "repats" – natives of Nigeria or Ghana who worked or studied for years in mature markets such as the U.S. or U.K. and are now returning with their expertise to West Africa. The platform manages all aspects of the developments on the ground on behalf of Actis, including support to sourcing, underwriting and structuring deals, managing design and leasing; financial controls and supervising construction. Laurus operates in Nigeria and Ghana and has close to US$500 million of real estate development under management on behalf of Actis and their equity partners.

Supply-Demand Imbalance

Mr. Matta notes that demand is particularly high for Class-A office space in the region, which has some of the highest prime office rent prices in the world.

"Prime office rent in Lagos is approximately US$1000 per square meter, which is pretty much London levels." In Accra, he says, prime rents are about half the Lagos levels.

The reason behind these high prices, he says, is constrained supply. "It is still very hard to develop real estate in this market: the costs are very high, the markets are not transparent and there is still chronic lack of capital both on the equity and debt side. So developers are having a very hard time putting up truly international-level products."

Most of the tenants of Class-A office buildings are international companies, he says. "In Accra, about 80% are the usual suspects: General Electric, PriceWaterhouse Coopers, Deloitte, Nestlé, etc. In Lagos there are also a lot of oil companies. Lagos has more local companies, maybe 60% international, 40% local, while Accra is about 80/20. These international companies have been here, in some cases, for 30 years, and now for the first time, there is Class-A office space available."

High Costs, High Returns

One of the primary challenges facing developers and investors in the region is the paucity of materials and expertise. "Execution is a risk," Mr. Matta warns. "It's very hard to get anything done here, because of the lack of skills and lack of expertise. Even on the contractor side, a lot of them lack the technical capabilities in engineering to do a quality building."

In Ghana, he says, there are only 4 or 5 companies who can do Class-A buildings. "What we're trying to do is encourage new entrants, so that there's more choice and more material." Currently, most materials for Class-A office buildings have to be imported, which means high shipment costs and tariffs.

"In Nigeria and Ghana duties, transport, additional costs accounts for 50% of the original cost of material," he explains. "Anything that costs US$100 in New York costs US$150 on site. That is definitely a big problem. But this is complemented by very cheap labor. All in all, you build in Accra pretty much with the same construction costs you build with in Europe."

"The West African real estate market will go through cycles like any other market, but because of GDP growth, the emergence of a middle class and the growing interest from international players, we think market risk is still very low. "

Infrastructure, too, is a problem: with the exception of large planned communities, 95% of sites do not have adequate infrastructure. "So you need to put in your own redundancy. With every building we're doing, we have full power redundancy; we have water tanks for at least 4 days' water needs for the building; and more often than not, we put in our own water treatment plant, as the sewers are non-existent."

Nevertheless, in spite of these exorbitant construction costs, Mr. Matta says investors in these markets underwrite deals at 25% IRR and 2.5 equity multiples. "That's the threshold for us and them to make it worthwhile."

Misperception

The lack of capital in these markets is due largely to an aversion that Mr. Matta believes the facts belie.

"Africa suffers from a misperception: the perceived risk is way higher than the real risk. And this keeps a lot of investors away."

He says political risk, in particular, is "grossly overestimated," pointing to the peaceful passage of power that both Nigeria and Ghana have experienced for several election cycles in a row. The alleged lack of the rule of law, too, is exaggerated in many investors' minds: Ghana in particular has a functioning legal and judiciary system, with clear and effective ways to get rulings enforced, he says.

"One risk left on the table is land title risk," he says. "Land title is not very clear here. But it's getting better, as there have been increased sales of land, with titles changing hands, and that creates a title history showing the legitimacy of the land title."

Finally there is market risk, which he sees as no greater than in other parts of the world.

"The West African real estate market will go through cycles like any other market, but because of GDP growth, the emergence of a middle class and the growing interest from international, players we think market risk is still very low. On the office side, new entrants and the expansion of existing operations will sustain office rents; and on the retail side, we are witnessing a revolution where the growth of consumers and retail outlets have been above and beyond anyone's expectations.

"There are still some risks, but in my view the risk-adjusted returns in West Africa are still higher than in Europe."

Meeting Africa's Demand

An Interview with Jan van der Merwe and Eton Price, Fund Partners of Phatisa's Pan African Housing Fund

The tremendous growth of many countries in sub-Saharan Africa and particularly of their emerging middle classes has created huge demand in real estate across the region, along with increasing investment and development activity. Yet investment vehicles giving global investors exposure to these dynamics remain limited, with few funds and listed equities devoted specifically to the sub-Saharan market.

An important development came in 2011, when the pan-African finance institution Shelter Afrique appointed the sector-focused private equity fund manager Phatisa to manage a new real estate PE fund, The Pan African Housing Fund (PAHF).

Managed by Jan van der Merwe and Eton Price, PAHF is targeting primarily affordable and middle-income residential housing, including as part of mixed-use developments, initially in urban areas in a limited set of geographies, including Kenya, Zambia, Rwanda, Mozambique, Tanzania and Uganda. It deploys equity into Special Purpose Vehicles (SPV) that own housing projects, and always partners with experienced local developers. PAHF has attracted a series of international Development Finance Institutions (DFIs) and African investors including banks and insurance companies. PAHF first closed on US$41.5 million at the end of Q4 2012, began operating in Q1 2013 and is targeting a final close at approximately US$60 million in Q1 2014.

Recently, AEI interviewed Mr. van der Merwe and Mr. Price regarding the opportunities and essential considerations for investors in the sub-Saharan African real estate space.

How would you characterize recent sub-Saharan real estate development and inflows, breaking it down by sector?

East and Southern African (excluding South Africa) real estate markets are starting to recover from the 2008 funding crisis, with strong growth evident in many markets since 2010, with demand for assets from both institutional investors (international and African) searching for yield and growth and also individuals looking for decent affordable residential accommodation to house their families.

Residential markets display good fundamentals with middle- and high-end classes looking to access decent and affordable accommodation. We're seeing high rental yields in many markets.

Despite the growth in recent years of the hospitality sector, prices still reflect an under-supply of business accommodation in the big cities. Many African cities are witnessing the construction of 3-5 star hotels, many driven by international brands keen to extend their footprint into fast growth markets.

Industrial sectors have typically lagged the other sectors as developers have focused on higher-yield commercial and retail projects. In several markets, in response to international retailers, larger-scale distribution centers and light industrial projects are emerging.

How do these sectors vary by country?

Within sectors and also within regions, variances caused by different demand cycles are not uncommon; but this is a similar characteristic to real estate markets elsewhere in the world.

The real difference with sub-Saharan real estate, as a whole, is that because the market has been constrained over a long period, real estate developers will generally move to service the "low-hanging fruit" in any given market before moving into sectors such as middle-income housing and industrial.

Market take-off in many markets is typically evidenced by high-end commercial developments underpinned by strong tenants and attractive rental yields. High-end residential development tends to follow high-end commercial developments. As markets mature, developers seek out yield and growth by moving into middle-income consumer segments, including middle-income residential and medium-scale retail developments.

Who has been investing in these markets?

Private equity firms, insurance companies and private investors dominate the investment side of the value chain. Phatisa is seeing evidence of increasing levels of investment across the continent, from governments and government institutions committing resources to improving infrastructure, to private investors committing resources, knowledge and experience.

Do you see any current or potential real estate bubbles in these markets?

There are risks of asset bubbles when a market is exhibiting strong growth. But generally the strong growth in pricing across many African markets has not been funded by debt, and this suggests that these markets are exhibiting prices mostly in response to real demand. Phatisa also believes that the leverage factor in African real estate markets is not as large a threat as it was in several more developed markets post-2008.

The risk of markets overheating is real, of course, but by observing trends and knowing your market, it is possible to see when the markets are overshooting real demand, and adjust accordingly. For example, residential developers in Nairobi have moved down the housing pyramid and started supplying middle-income stock as real demand in the luxury/high end of the market has slowed down significantly in response to higher supply.

What are the main regulations governing foreign ownership of property in the larger growth countries?

The major African markets have a range of regulations governing foreign ownership of land. In many markets there are few controls on foreign ownership of property or controls on capital flows in and out of country, enabling an easy flow of foreign direct investment into and out of the real estate sector. There are, however, increasing pressures in several markets to limit ownership of land to leasehold and in other markets to limit ownership of the top-structures or improvements.

From a Fund and Fund Manager perspective, Phatisa would not consider outright ownership of a project. Fundamental to our investment thesis is that we partner with local property developers, as we want to enable a local developer class to meet the demands in country.

> *"There are risks of asset bubbles when a market is exhibiting strong growth. But generally the strong growth in pricing across many African markets has not been funded by debt, and this suggests that these markets are exhibiting prices mostly in response to real demand."*
>
> *Jan van der Merwe and Eton Price, Fund Partners, Pan African Housing Fund, Phantisa*

Is local infrastructure developed enough to sustain the increase in real estate?

Most of the African economies are coming off very low bases of infrastructure development. In many countries aged infrastructures cannot cope with current demand. However, over the medium term, we have observed improvements in infrastructure through government-sponsored or -led investment. A case in point is the improved road network in and around Nairobi that has unlocked nodes previously cut off from development.

A further interesting phenomenon is the adoption and installation by developers of green technology, out of necessity, as supply of services (water, electricity, sewerage, etc.) from municipalities/councils is erratic or non-existent. So when driving past any development in Nairobi and the surrounding are you will note solar geysers, solar street lighting, water storage tanks and waste water treatment solutions.

How does political risk affect African RE investment?

There is political risk in real estate, as an unstable political environment will ultimately affect the main drivers of economic development. As real estate investment is a medium for long-term play, investors need to be aware of the potential risks involved over a medium-term time horizon.

As with other investment classes the yield of a sector can tell a story: in several African markets, high rental or prime yields could suggest high risk rather than scarcity and high demand. As bank lending increases across the African real estate sector, it may be easier to get a sense of political risk than in the past, as banks look to price risk across country, counter-party, tenor and overall returns.

What means do investors have for getting African RE exposure?

There are limited opportunities for investors to enter the African real estate market given the absence of a listed real estate sector in almost all geographies outside South Africa. Several private equity funds are targeting the commercial sector and lately the residential sector as well, but these investment vehicles are not easily accessed by private investors. It appears likely that new listed funds representing prime African real estate assets will be available for private and institutional investors within the next year or two.

Exposure for investors with sub-Saharan African real estate appetite are in most cases limited to taking on risk at the project level, something few non-specialist investors have the expertise to manage.

Foreign investors and companies need to understand the local specificities of each market. The promise of high growth and high returns will remain but investors need to do their homework before committing.

Uncertain Spring

Dr. Hatem El Sayed of North Africa Co. for Real Estate Investment on Real Estate Opportunities Amid the Tumult in Egypt

- In spite of investor disquiet in the wake of Egypt's revolution and in the face of its looming energy crisis, many investors still see short- and long-term opportunities in the real estate market, with some believing now is precisely the best time to enter.
- The corporate and residential sectors in and around Cairo are seeing high demand.
- Investors should partner with or buy a local company that already owns land, or approach the government directly regarding a land purchase. The government is generally receptive of development plans, and is selling some valuable land at discounted prices.
- In spite of these opportunities, investors must be wary and well-informed regarding the current risks in the market before entering it.

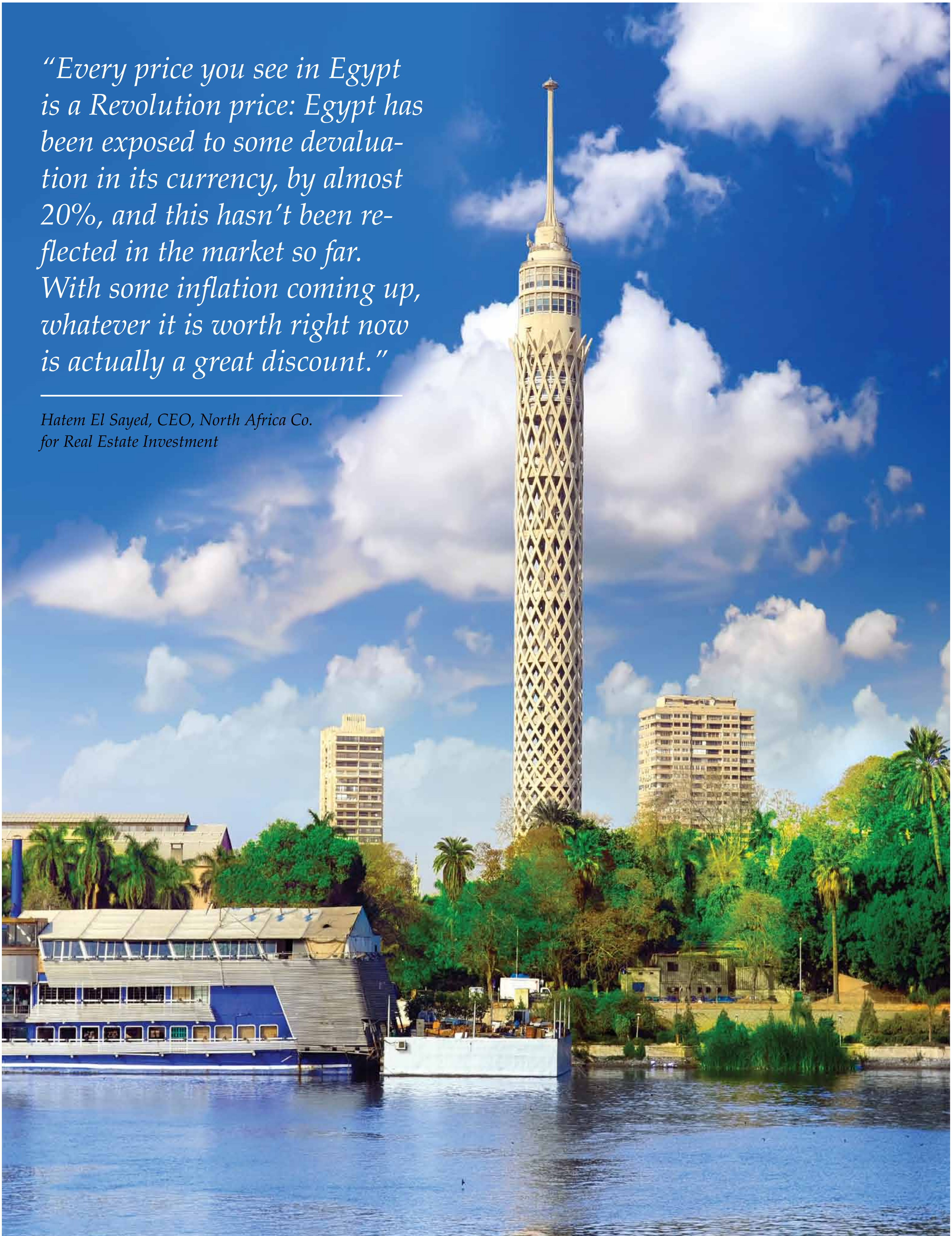
The Egyptian revolution of 2011 that caused the overthrow of the Mubarak regime was disquieting for investors, with a precipitous drop in FDI that year accompanying an abrupt slowdown of the economy as a whole. Even as FDI began rising again in the first half of 2012, the times remain uncertain in Egypt, with the fallout of the revolution still unclear and an apparent energy crisis in the offing.

But many investors believe that Egypt is suffering from the same fate that other countries in Africa suffer perpetually: a widespread misperception of the real risks in the markets. They see wealth of short and long-term investment opportunities against the grain of prevailing wisdom.

"Many investors are a bit discouraged by Egypt's revolution and the instability that came after it, which still exits," says Hatem El Sayed, CEO of North Africa Co. for Real

“Every price you see in Egypt is a Revolution price: Egypt has been exposed to some devaluation in its currency, by almost 20%, and this hasn’t been reflected in the market so far. With some inflation coming up, whatever it is worth right now is actually a great discount.”

Hatem El Sayed, CEO, North Africa Co. for Real Estate Investment



Estate Investment. "But there are many experts who believe that that once Egypt stabilizes, it will grow very fast and there will be a huge opportunity."

Indeed, some investors believe precisely now is the best time to invest, he says, "before the dust clears and everyone knows exactly what they should be doing." He notes that current discrepancies and inefficiencies in the market are creating arbitrage opportunities. "Every price you see in Egypt is a Revolution price: Egypt has been exposed to some devaluation in its currency, by almost 20%, and this hasn't been reflected in the market so far. With some inflation coming up, whatever it is worth right now is actually a great discount."

Corporate and Residential Demand

North Africa Co. for Real Estate Investment is one of a handful of investors seeking opportunities behind the headlines in a country with close to 90 million people, plentiful resources and a highly skilled labor force. Founded in 2005, the firm focuses on the residential and commercial sectors, as well as hospitality, including hotels and hotel-apartments. It was listed on the Cairo stock exchange last December. The majority of investors are from Egypt, Dr. El Sayed says, except in the case of some major projects such as large hotels, resorts and malls, when Gulf investors will participate.

Currently Dr. El Sayed is managing the development of 2 major projects: a residential/commercial project in Cairo, and a resort comprising 6 different components including hotels, commercial areas, educational institutions, wellness and medical facilities, in Marsa Alam on the Red Sea coast of Egypt.

He says some of the best opportunities currently are in the commercial sector. "Egypt has the fewest square meters per capita for commercial space in the region, which means there's a lot of room for growth in that area and good potential for profits."

According to a recent report by Knight Frank Research on African real estate, office sector demand in Egypt has moved to areas peripheral to central Cairo, including 6th of October City and New Cairo, due to congestion and instability in the city. Rents are about half the prime office rents in central Cairo, according to the report.

Supply is a problem in the residential sector, as well, where much of the current development has likewise moved to Cairo's satellite cities. "Egypt has a demand for 500,000 units for year and the current supply does not exceed 200,000 units per year," Dr. El Sayed explains. "So there is a huge gap, and that's why projects in that area would do very well."

According to the same Knight Frank report, the high-end subsector is becoming saturated, and investors are turning toward low- and middle-income residential for greater growth. The report also highlights development in the retail sector, with the large Cairo Festival City Mall set to open in 2013, joining Cairo's already operating City Stars Mall and Mall of Arabia.

How to Enter the Market

Dr. El Sayed explains that there are several ways for investors to enter the Egyptian market: by approaching the government; by acquiring land directly; and by acquiring an existing company that already has land.

"It is not difficult to own land," he stresses. "Any foreign investor can acquire land. If you want land for a resort, for instance, you just have to submit your idea to the Ministry of Tourism and specify how much land you want, and they will give you a schedule to implement your plan. If you implement your plan, then the land is yours; if you don't, they take back the land. All they want to see is implementation. The same is true of the Ministry of Housing."

The Knight Frank report notes that Egypt has also been trying to attract investment to its industrial sector, with government land selling for half the usual price of other corporate land, at about US$15-25 per square meter. Investors must apply to the Industrial Development Authority. Most industrial development is occurring in 6th of October City and 10th of Ramadan City.

"Each of these alternatives has a great benefit and some disadvantage," he says. "If you partner with people already in the business, you tend to make less of a profit; if you go from the very beginning, there will be a hassle with the government, but the profits will probably be higher."

His advice, at the current time, is to team up with a local, respectable company, or to buy an existing company. "In doing that, investors would be buying the experience and the market knowledge and everything that comes with it. There are actually great bargains in the market right now for major companies."

He says investors must be deeply aware of the current political situation, the political bureaucracy and the market situation – including not only the ongoing fallout of the revolution of 2011, but the current energy crisis. "I'm not saying investors should be discouraged, but they shouldn't discover it when they arrive in Egypt; they should know exactly what they're getting into, otherwise they might be surprised and discouraged later on."

High Growth, Low Leverage

James R. Worms of Paladin Realty Explains Why LatAm Real Estate Markets Are so Attractive to Institutional Investors

Large institutional investors are attracted to LatAm real estate markets due to their combination of high growth dynamics and low-leverage opportunities. The growth story is no longer a secret to most investors, after Brazil's tremendous growth over the last decade and the more recent emergence of Colombia, Mexico and Peru, but according to James R. Worms, Chairman and CEO of Paladin Realty, one of the top institutional real estate fund managers focused on Latin America, this growth story is more long-term than many people realize.

- The growth story in LatAm is not a short-term phenomenon but a long-term, demographics-driven trend.
- Institutional investors diversifying into LatAm to capture this growth are finding opportunities for high returns and low leverage.
- LatAm real estate opportunities are demand-driven and can be found in various sectors and income brackets.
- Brazil, Mexico, Colombia and Peru offer the best opportunities currently; Uruguay, and specifically Montevideo, seems poised for development in the medium term.

"From a demographics perspective, the bell-curves show you that the prime earning years of these populations are going to last another 15 or 20 years. With these young populations, it's very similar to what we went through in the U.S. with the now-aging Baby Boomers: when they started to enter the job market, it fueled 30 to 40 years of growth, and you're seeing those same dynamics today in Latin America."

Low Leverage, Low Risk

Mr. Worms emphasizes, however, that while large institutional investors look to LatAm for diversification into growth markets, they are especially attracted by the possibility of targeting opportunistic returns through high profit margins, not through leverage. Indeed, he observes, even if they wanted to use more leverage, it's not available.

"The banks are conservative in these countries: they'll give you some construction financing but only after you've proven the market and the product. So if you've pre-sold 30-50%, then you can go get a conservatively underwritten construction loan."

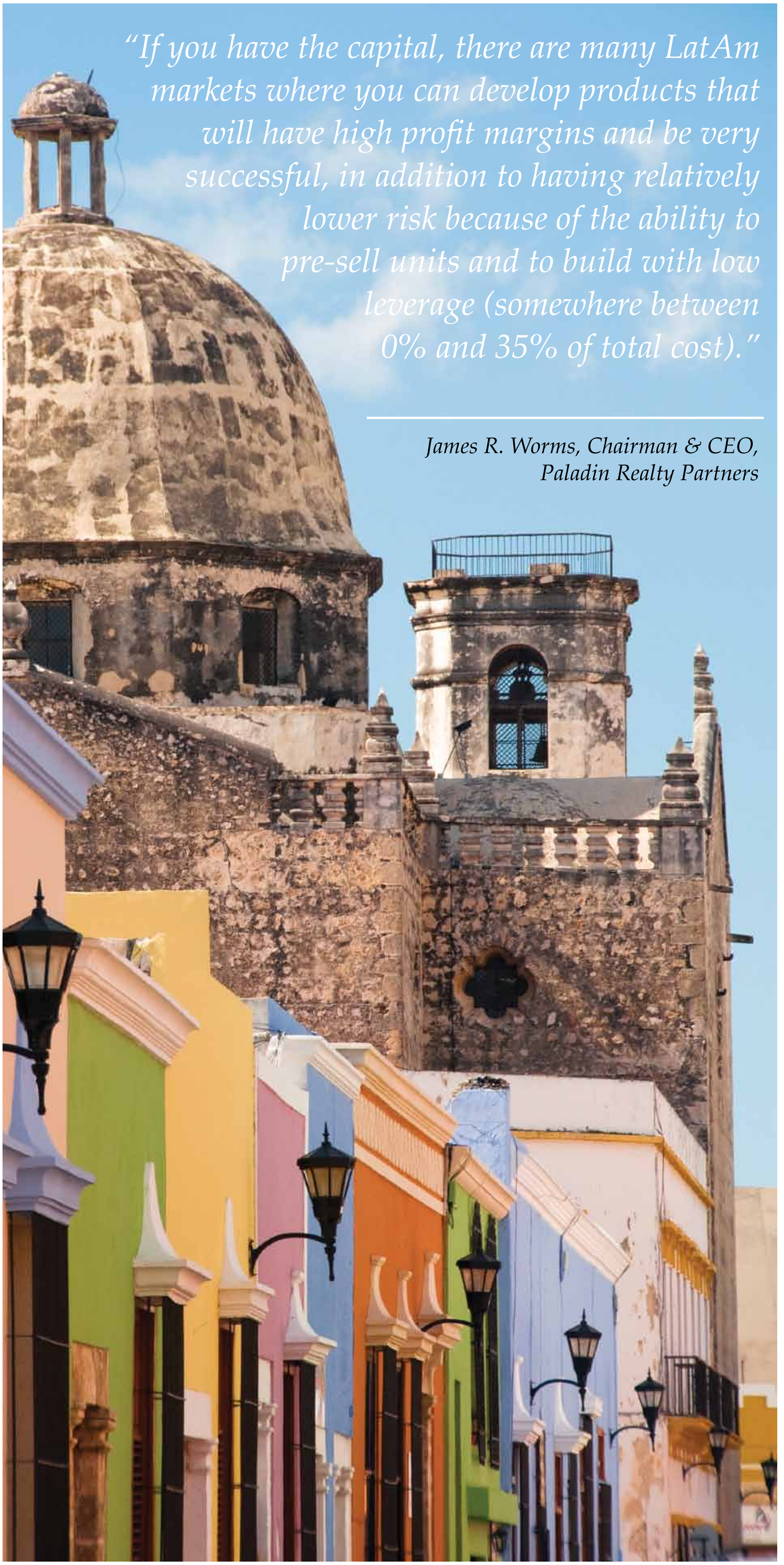
Mr. Worms, who served as Managing Director of Salomon Brothers before joining Paladin in 1995, also notes the benefits of having reasonable interest rates and long-term mortgage financing in many LatAm markets, making it unnecessary to build speculative housing projects. "In the U.S. you might build it, then sell it. Here you pre-sell it before you build it. It's much less risky."

Country-risk has also improved. "All of these countries we invest in are now investment-grade," he says, "which is a big step up from when we started in the business 15 years ago, when only Chile was investment-grade."

Avoiding politically unstable LatAm countries, Paladin has reduced country risk essentially into currency risk. "We stay away from countries where we think there's any kind of political risk. But you're still taking currency risk, so you need higher returns and you need to have things to offset them, which we think the better underlying real estate fundamentals do."

This combination of low leverage, low risk and high returns makes many LatAm markets a logical choice for institutional portfolios, he says.

"If you have the capital, there are many LatAm markets where you can develop



"If you have the capital, there are many LatAm markets where you can develop products that will have high profit margins and be very successful, in addition to having relatively lower risk because of the ability to pre-sell units and to build with low leverage (somewhere between 0% and 35% of total cost)."

James R. Worms, Chairman & CEO, Paladin Realty Partners products that will have high profit margins and be very successful, in addition to having relatively lower risk because of the ability to pre-sell units and to build with low leverage (somewhere between 0% and 35% of total cost). For foreign investors, that's a pretty attractive proposition from a real estate standpoint."

Demand-Driven

Across the region, including in the larger markets of Brazil and Mexico, investors are finding opportunities in many markets and in every sector and income-bracket. Paladin itself has invested in Brazil, Mexico, Colombia, Peru, Chile and several other LatAm countries, mostly in the residential and commercial sectors.

"We're very fortunate that it's a demand-driven opportunity," Mr. Worms says. "There's a shortage of virtually every modern real estate product in these markets, whether in housing, commercial space, hotels."

He points to the office sector, the face of which is changing due to increasing domestic demand. "It used to be that if you built a Class A (or what they call in a Brazil a 'Class AA') building, which would be equivalent to a first class building here in the U.S., the only tenants were multinationals, because they were the only ones that could afford to pay the rent that justified the construction cost. But that's really no longer true in these markets. As domestic companies are growing, they too need to compete globally and they want international quality, whether it's office space or industrial facilities or hotels."

He also observes a shortage of business hotels in many LatAm markets, from luxury to limited service.

"Every international brand is looking at these markets and trying to figure out how they can build the Marriott/Courtyard and Hilton Garden Inns of the world in a cost-effective way. The issue is actually very similar to the office space: these kinds of hotels are mainly in the secondary markets, which are primarily domestic business locations as opposed to being for international travelers. So the question there is, 'Will somebody pay the rate to stay at a Hilton Garden Inn versus the local unbranded product that's half the room rate?' When we looked at this years ago, we thought, 'No, there aren't enough people who will pay that rate,' but we believe there are now."

Partnering Up

As Mr. Worms explains, Paladin – which is based in Los Angles and has staff in Brazil, Mexico and Colombia – generally prefers to target larger markets where they are more likely to find the right local partners.

"Our business model has typically been to do joint ventures with local operating partners, and in these smaller markets we tend to find fewer partners who are willing to put up with U.S.-style governance and controls," he says.

Brazil is the largest market with the most options, but Paladin is looking increasingly at the region's other maturing markets. He points to Mexico in particular, a market that many risk-wary investors have avoided.

"The 'headline risk' in Mexico belies the fact that they've got a higher GDP growth rate than Brazil," Mr. Worms says. "Some of our competitors have decided it's just too dangerous of a place to go and do business. I'm not going to say it's not dangerous, but nonetheless, we do think Mexico's reputation relating to drug violence is overdone and there are tremendous opportunities there today."

He sees great opportunity in Colombia, too, disagreeing with those who see a bubble in that market.

"I don't see a bubble in Colombia at all at this point. Colombia has a higher unemployment rate than Brazil, so I think there's a bit of risk there, and it's a smaller market, so it doesn't have the depth and breadth that Brazil has in terms of the variety of places that you can invest. But it does have a handful of good cities to invest in."

He expects Peru to remain a viable investment destination. "I think we're at the very beginning of what will be a long-term investment opportunity there." He notes, however, that current land prices there and in Colombia are a higher component of cost than in Brazil.

As for Chile, the most stable and financially mature market in the region, Mr. Worms sees lower returns compared to its neighbors. "Chile has the most efficient real estate capital markets," he explains. "In Brazil, for instance, there isn't the financing to build a for-lease office building; they have to be built and sold as condominiums, floor-by-floor or suite-by-suite. In Chile you can get financing for construction and permanent financing to hold an income-producing product. But as a result, the returns are also lower. So we haven't done much recently in Chile, even though it's a strong economy."

Of the less-played markets in the region, he believes Uruguay will have some of the best opportunities in the coming years. "Montevideo is a sizable city," he says, "and there's been nothing new built there in the residential space in the last 8-9 years because the banking system that supplied the mortgages collapsed. So there's a pent-up demand at this point for infill, well-located, middle-income housing, and the government has tried to spur housing development by establishing redevelopment areas where you have very favorable tax treatment for developers. While there's little data to prove that thesis, anecdotally everyone we talk to thinks it's going to be a very good market for a while."

There Are Many Brazils

- Real estate demand in Brazil continues to be strong, bolstered by macroeconomic stability, credit availability and propitious demographics.
- Investors should look beyond the office and high-income residential sectors of Rio and São Paulo to other sectors, income-brackets and regions.
- Low- and middle-income residential in São Paulo, industrial and logistics in the Northeast and Central-West and development surrounding the oil boom in Rio offer the most liquid and high-growth opportunities.
- Foreign investors entering the market should form local partnerships to help them seize the best deals.
- Colombia and Mexico also offer high growth and increasing liquidity and stability.

Marcelo da Costa Santos of Cushman & Wakefield on Brazilian Real Estate Investment's Expanding Horizons

Brazil's is by far the largest and most liquid real estate market in Latin America, and continues to be the most attractive for global investors. According to a recent survey by the Association of Foreign Investors in Real Estate, Brazil ranks second among countries that investors expect will provide the best opportunities for capital appreciation, and this year it replaced China as the most popular emerging market for real estate investment. Over the last decade, the market has seen the emergence of real estate PE funds, both foreign and domestic, as well as publicly listed real estate equities, with over US$7 billion in real-denominated REIT IPOs in each of the last two years. Given the recent announcement that Brazil will no longer charge a financial transaction tax on money transfers from abroad for real estate purchases, these high inflows should continue.

For Marcelo da Costa Santos, Vice President of South American Capital Markets at Cushman Wakefield, the world's largest privately held commercial real estate firm, there are three main drivers behind this sustained and growing demand.

"The first is macroeconomic stability," he says. "Brazil has it, and has had it for the last 15 years. The second is the availability of credit and low interest rates, which Brazil already has; the rates are not as low as the rest of the world, but for the first time in many years Brazil has decent credit available for mortgages."

The third and most important driver, he says, is demographics. "What sustains demand is the demographic structure of the country. In Brazil there are a lot of people going into the real estate market needing housing, second housing, office space, etc., and that presents a sustainable structure for the residential sector."

Underestimation

The growth of the middle class across most emerging markets is no secret to global investors, of course. Yet many investors tend to underestimate the depth, scope and sustainability of this growth in Brazil.

"I'm not talking about the next 2 to 3 years," Mr. Costa Santos says. "I'm talking about the next 30 years."

Investors also tend to underestimate the size of Brazil and, more importantly, its regional diversity, Mr. Costa Santos says; indeed, they even underestimate the diversity within individual cities. Many investors and analysts, for example, when bemoaning the alleged bubble in Brazil's real estate market, seem to believe that Brazilian real estate consists entirely of high-end apartments and Class-A office buildings in Rio and São Paulo.

"There were lots of bubbles in São Paulo in certain regions and income brackets for certain products," he adds, "but it's not for every single sector or for every single region of the city. You occasionally have small bubbles, not a bubble in the market."

He says the tendency to focus narrowly on certain popular sectors in the 2 major city centers blinds investors from the broader opportunities in Brazil. "There are many Brazils: it's the size of Europe or the Continental U.S. So you have to think about which Brazil you›re talking about."

Diverse Options

For example, office space in the city of São Paulo risks being over-supplied in the short term, as does high-income residential. "But that means upper-middle class and upper class, B+ to A+, not low income," Mr. Costa Santos says. "Whatever is low-income-oriented in São Paulo is going to sell like hot buns."

Rio, too, is still a "wonder story," he says, that will surprise many investors, and even Brazilians themselves.

"The city has managed to reinvent itself, and on top of that they got lucky because they hit oil twice. With the first oil wave the city already was coming back, and then the pre-salt oil and gas reserves changed the prospects – for the whole country, but Rio in particular. On top of that, the state government, the city government and the federal government are working in tandem for the first time in 25 years."

"You occasionally have small bubbles, not a bubble in the market. Office space in the city risks being over-supplied in the short term, as does high-income residential – but that means upper-middle class and upper class, B+ to A+, not low income. Whatever is low-income-oriented in São Paulo is going to sell like hot buns."

He sees oil boom and its ripple effects as the city's major growth story, with the upcoming Olympics secondary. "The Olympics for Rio are just the icing on the cake: the city is doing a lot of things already that really have nothing to do with the Olympics. The oil industry is what's driving the growth and demand, not the Olympics."

But the Olympics will force the government to rethink the urban infrastructure and tissue, he says, as will the World Cup throughout the entire country.

"There are two typical legacies of the World Cup. There's the typical 'white elephant' stadiums and infrastructure that no one uses after the event, but there's also the public transportation, and that's what's important. It's changing the way people see public transportation, and regardless of whether it's all finished on time, it will finish eventually."

Beyond these overlooked aspects of the country's 2 most popular real estate markets, he says the best and most liquid opportunities for investors are in the Northeast, specifically surrounding the new port in Pernambuco, where there is already significant investors and development activity.

He believes the country's industrial sector in general will continue to see significant growth, especially in non-urban regions, though he warns that investors need to be wary of infrastructure and water shortages. Specifically, there will be industrial and logistics development surrounding agriculture in the country's Central-West region, and the pharmaceutical cluster surrounding Brasilia will become an industrial cluster in the coming years.

Three Waves of Investment

Mr. Costa Santos sees 3 important waves of investment in Brazilian real estate: two of which define the current market, one of which will shape its future.

"The first wave of investors were those who took risks, who understood the country, its currency, who have local teams and partnerships; there are already a lot of them in the market," he explains. "The second wave is coming now: they see Brazil as investment-grade suddenly, and are setting up joint ventures and buying less-risky properties. That is merging with the third wave: large institutional investors, including many sovereign wealth funds, who will come in and buy assets at 6% or 6.5% cap rates. They are going to make a splash in the market; not right now, but it's coming."

He says the biggest risk for all types of investors is "investing in an asset without understanding the underlying dynamics and idiosyncrasies of the market." That said, he believes many non-Brazilian investors have missed out on opportunities they were slow to seize.

"The Brazilian investors are very fast and can take positions quickly and efficiently," he says. "This second wave of foreign investors will take three months to perform due diligence on an asset, and in the meantime the Brazilian investors will come in and buy it."

For that reason, he says foreign investors are wise to utilize local partners when entering the market. "Otherwise they won't get the best deals."

Mexico and Colombia

In LatAm ex. Brazil, Mr. Costa Santos says Mexico is the most structured and liquid market for investors, and that investors should try to see past the reputation it has garnered in recent years due to drug-related violence.

"Mexico is suffering from a misperception, similar to Brazil in the 1980s," he says, "but I don't think it's an accurate vision. Whoever sees the opportunity through the fog will be able to make huge profits in the short term."

He sees Colombia, too, as an excellent and increasingly liquid market, similar to Brazil in its diversity of options.

"In terms of future growth, I think Colombia is the next hot thing. It's got 50 million people, a young population, access to both the Pacific and Atlantic, there's major infrastructure overhaul underway – big plans being developed. And there are four major cities to do business in – Cali, Medellin, Barranquilla and Bogotá – which you can't say of most other countries in the region. The big question mark for Colombia is whether the infrastructure plans the government is promising will be put in place. But my belief is that they have 10-15 years of strong growth coming."

Land Acquisition in Brazil BY Foreign Investors

Adler Martins & Pedro Andrade

According to a recent analysis by Deutsche Bank based on data from the Land Matrix, emerging countries in recent years have undergone a true "race for farmland." From 2000 to 2010, more than 200 million acres were purchased in developing countries by foreign investors.

In Brazil, despite several laws that restrict the sale of land, about 6.5 million acres were purchased by foreign investors. These lands were purchased for a wide range of economic activities: agriculture, livestock, mining, industry, etc. In this article, we intend to present a legal analysis of this phenomenon, as well as provide guidance to foreign investors who wish to invest in such ventures in Brazil.

Brazilian Regulation of Foreign Purchase of Agricultural Lands

The purchase of agricultural lands by foreigners has always been viewed with some suspicion throughout Brazilian history. More recently, the advent of a globalized economy, as well as the prospect of shortages of strategic resources in various countries, such as water and food, has reignited this debate.

This subject was regulated in Brazil for decades by National Act No. 5709 of 1971. The criterion adopted by this act is nationality for people, and the "majority of the capital stock" for companies.

Under this law, all foreigners, even if living in Brazil, and all companies based abroad or, if based in Brazil, having a majority of foreign capital, would face several restrictions. For example, the INCRA (National Institute of Colonization and Agrarian Reform) would have to approve practically all purchases of land made by those players.

Over the last two decades, however, such limitations had been circumvented.

An amendment to the Brazilian Constitution eliminated the distinction made between "native" and "foreign owned" Brazilian companies. A legal opinion by the Attorney General's Office has made clear that Brazilian companies owned by foreigners cannot be prevented from acquiring land, as this would constitute illegal discrimination among two equal Brazilian entities. (Note that Brazil's federal government is bound by the legal opinions issued by the Attorney General's Office due to Complementary Act No. 73 of 1993.) Therefore, all foreign buyers had to do was incorporate a Brazilian company, and they would have unlimited access to Brazilian rural land.

This situation did not last long, unfortunately.

In August of 2010 the Attorney General's Office issued a legal opinion (Parecer No.

LA-01, August 19, 2010) that has, in practice, reenacted and expanded National Act No. 5709. The opinion put forth an argument that, in very special circumstances, discrimination between Brazilian companies should be considered constitutional. The criterion adopted by this legal opinion was "effective control," which is broader than the "majority of capital" requirement that was previously the only reference presented in law.

There is little doubt that the new legal opinion was drafted with the guidance of the presidential cabinet in order to cater to some specific groups who were disturbed by the growing influence of foreign investors in Brazilian agribusiness.

As a result of the new legal framework, along with the political influence of certain groups, federal agencies such as INCRA have chosen to issue regulations that repeat the restrictive text of National Act No. 5709. This is the case, for instance, of INCRA's Normative Instruction n. 70, which clearly makes reference to the criteria of Law 5.709/1971.

We should also say that, in Brazil, the States Registry Offices (responsible for land registration) are subject to National Act No.

5709, because of a directive from the National Justice Council, which endorsed the new interpretation issued by the Attorney General's Office.

In short, due to political influences, the purchase of rural land by Brazilian companies owned by foreigners became 'irregular.' We opted to say irregular instead of illegal, because there is still doubt about whether the restrictions presented by the new Attorney General's opinion are compatible with the Brazilian Constitution. More on that below.

Legal Uncertainty

We observe that, from a juridical perspective, both the Attorney General's Office legal opinion and the Law 5.709/1971 are formally valid.

However, from a practical perspective, the formal aspects of Law 5.709/1971 are more prevalent among the many federal agencies and registry departments. That is, the criterion of "majority of the capital stock" is the one being analyzed by INCRA and other agencies, rather than the criterion of "effective control." This does not mean that the criterion of "effective control" will never be scrutinized. It only means that, at this point, the agencies are more likely to ignore this criterion in favor of the "majority of the capital stock."

Adding complexity to the situation, we must note that the Attorney General's Office opinion has not clearly defined how "effective control" should be assessed. For example, if the foreign company owns shares/quotas of a Brazilian company ("a"), and this Brazilian company, in turn, owns shares/quotas of another Brazilian company ("b"), should the last Brazilian company in this chain ("b") also be subject to the limitation regarding the purchase of land by foreigners? In other words, how many layers should be evaluated when assessing "effective control"?

The reader will perceive that we are not describing the orthodox procedures currently required by INCRA in order to formally allow the ownership of rural land by foreign investors. That is because we see such procedures as impracticable. In fact, the procedures are so complicated and depend so heavily on political circumstances that they actually constitute a veiled prohibition.

Alternatives

This legal uncertainty has brought many investment plans to a halt.

Some investors are still waiting for a frontal challenge to the constitutionality of the Attorney General's Office legal opinion.

Others have been trying to explore rural land without direct ownership, through long-term rentals or non-equity joint ventures with Brazilian partners.

None of those alternatives is perfect, although the use of specific rental agreements (rental of surface rights) has emerged as a favorite.

Recent Developments

Currently there are several initiatives in Brazil to adapt national sovereignty to the dynamics of international business, for example, Bill 2289 of 2007, pending in Congress. This project creates more liberal rules than the current ones and is likely to be discussed soon.

Irrespective of the parliamentary front, some good news has arisen from the judiciary. Recently, the São Paulo Court of Justice (similar to a state court or court of appeal) ruled that a Brazilian company with a majority of capital owned by foreigners was allowed to purchase land. The company in question was a paper mill and, apparently, needed land to harvest trees in order to maintain its production.

The decision is not final, but it indicates that the Brazilian judiciary is sensitive to the demands of agribusiness, and it may be a hint that, in the future, courts will overturn the legal opinion that bans foreign investors from Brazilian agribusiness.

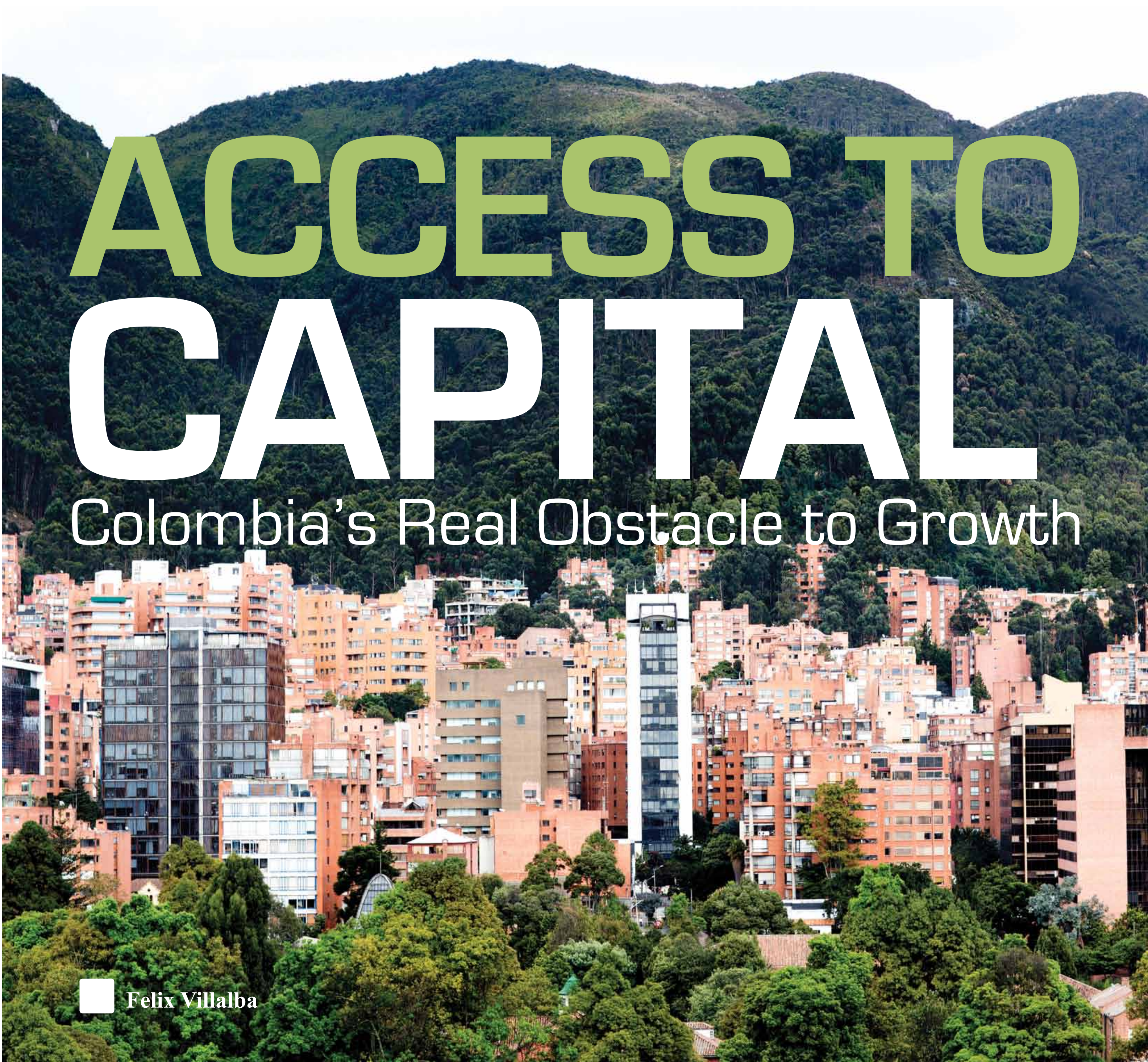
We look forward to it.

Author Biography

Adler Martins is a law graduate from the Federal University of Minas Gerais (UFMG). He holds an MBA from Fundação Getúlio Vargas. Mr. Martins is currently pursuing an LLM at Pontifical Catholic University of Minas Gerais and doing post-graduate work in financial planning at São Paulo City University. He can speak English, Spanish, Portuguese, German and some Chinese (Mandarin). Mr. Adler has working experience in Argentina, Mexico, India, England, China and Dubai, along with extensive experience in Brazil.

Pedro Gustavo Gomes Andrade is a Brazilian international lawyer at Adler Martins & Associates.

Reading the Colombian local newspapers at breakfast the other day I saw a bank ad claiming something like, *We offer low monthly rate lines of credit (1.4%/month)* . . . "What?" I shouted . . . and my wife looked at me and asked, "What's wrong?" That is an effective interest rate of 16.9%. That is not a low interest rate, although it isn't all that bad for a consumer loan. However, when you look under the hood it turns out that most loans are not issued at this "low rate" but rather at a much higher rate: 30%! (Source: Colombian central bank website, www.banrep.gov.co.) Banks in Colombia are growing fat, and that spells opportunity for alternative financing.



ACCESS TO CAPITAL

Colombia's Real Obstacle to Growth

Felix Villalba

Foreign Investment

The attitude and theory of developed economy investors placing investments in Colombia or other developing economies is that the returns have to be outsized. This leads them to lose real opportunities unless the developing economy is the latest follow-the-herd fad, or if they choose to believe that history will repeat itself in a fast changing environment. Mainly, they believe that the outsized returns experienced years ago (when there was little to no competition) can be had today. This presents an opportunity for venture and private equity investors that measure risk by hard arguments and not by betas.

Private equity funds as well as family offices can end up finding good and low-cost opportunities: solid small companies with solid balance sheets operating in an environment that has yielded very good returns for decades, unbeknownst to the average investor. The winning investors are those who look at the inside of a company and learn why and how they are able to navigate their supposedly risky environment.

For decades, the risk measurement issue has generated the exceptionally high interest rates that are so embedded in these economies. The result has been to limit access to capital only to those with wealthy families. Now that emerging economies are in vogue, mainly because the beta theory is proving wrong, it is time to extend access to capital to professionals in these economies that have the capacity and are hungry to grow and, as a result, can yield excellent returns.

Government Intervention

In the last 12 months the Colombian central bank, Banco de la Republica, has lowered the discount rate to banks by 2%. In February the central bank again lowered the reference rate by 25 basis points (0.25%) arguing that the economy had grown below expectations and that inflation was below the 3% target, with no signs of acceleration. Private banks, however, continue to do little in the way of lowering real rates (the spread they charge on top of the inflation adjusted rate "UVR" – equivalent to the U.S. prime rate). This was key among the reasons the central bank cited in lowering the additional 25 bps. The central bank commented that, "In January credit continued its deceleration although at a slower rate. Nominal interest rates indeed experienced a reduction for all the different types of loans except consumer loans. In real terms, however, all interest rates increased in part due to the reduction of inflation (current and expected)."

Two major risks in residential developments: not finishing the building (running out of cash to build) and an unexpected drop in demand/sales prices.

In addition to interest rates, Colombian banks and those in other developing economies charge outsized and numerous fees for bank services to both consumers and companies, compared with banks in the U.S. In addition, the Colombian government charges a penalty on capital movements equivalent to 0.04% for every peso that moves out of any bank account in Colombia. The penalty tax obviously slows down the economy by lowering access to capital. If movements of capital come with a price tag, it follows that access to capital is diminished.

Real Estate/Construction Loans in Colombia

Let us look into construction loans as an example and opportunity. The construction loans offered by Colombian banks are not like those in the U.S., which would typically be large amounts (at least half a million dollars) for the development of high-rise buildings, for instance. Banks in Colombia charge double-digit rates for what amounts to a low-risk bridge loan issued to companies with solid balance sheets, and with a full lien on the land.

Colombian banks will lend money only after the builder has completed 60% to 70% of projected sales. Consumers are now accustomed to this method and consider it business as usual. However, international construction firms can see a market opportunity here to compete with a finished product that the consumer can see and acquire and move into immediately.

Let us figure out the math from the perspective of bankers and investors. Say a completed building's cost (direct and indirect costs) runs up to 70% to 80% of sales. The builder has to place 30% of costs in cash, equivalent to 25% of sales. During construction the builder receives cash from clients for about 15% of sales. So far we have cash equal to 40% of sales or 50% of costs. In other words, for a 12 to 15% compounded interest rate, the bankers require

70% sold (or 88% of costs covered once the building is complete – the bridge). Plus, they know the builder has cash equal to 50% of costs. And yes, you did read that right, and I did mean to introduce the word compounded when referring to the interest rate; bankers will add the interest to the loan balance and charge you interest on that too.

So, what is the bank's risk?

Two major risks in residential developments: not finishing the building (running out of cash to build) and an unexpected drop in demand/ sales prices.

As seen above, bankers in Colombia lend up to 70% of the construction costs. This sounds risky, but the building and cash flow from sales collections during construction equals another 50% of costs. Total costs covered: 120%. The bankers have a 20% cushion on their bridge, and the building will still be built, even if some customers rescind their purchases and the other 30% of the sales are not realized prior to the loan coming due. This methodology seems good and fair for a senior bank loan, but not at a double-digit mid-teens interest rate. That, in my many years of private equity experience, is a sweet double-digit IRR deal for very little risk.

Dear private equity deal makers, here's an opportunity.

Author Biography

Felix Villalba has over 15 years of experience on both the operating side and the investment side of business transactions. After his MBA, Mr. Villalba worked for captive financial services companies at Dell and Whirlpool, and later spent over five years as CFO with two venture backed technology companies. Dell's successful effort to start Dell Financial Services marked Mr. Villalba's official involvement in the venture industry in 1997. After that he joined an Austin Ventures backed company that later led to his joining Pacesetter Capital Group. At Pacesetter, private equity firm, he was Vice President and served as Portfolio Manager for several inherited deals, some of which required intervention strategies. In 2009, Mr. Villalba formed his own Private Equity management firm, Accordo LLC and raised Accordo Fund 1 and 2, placing investments in residential and hospitality developments in Colombia.
Mr. Villalba is a graduate of the University of Notre Dame with three degrees, a Masters in Business Administration, a B.S. in Civil Engineering, and a B.A. in Economics. He successfully completed the Harvard Business School's Executive Management Development Program.

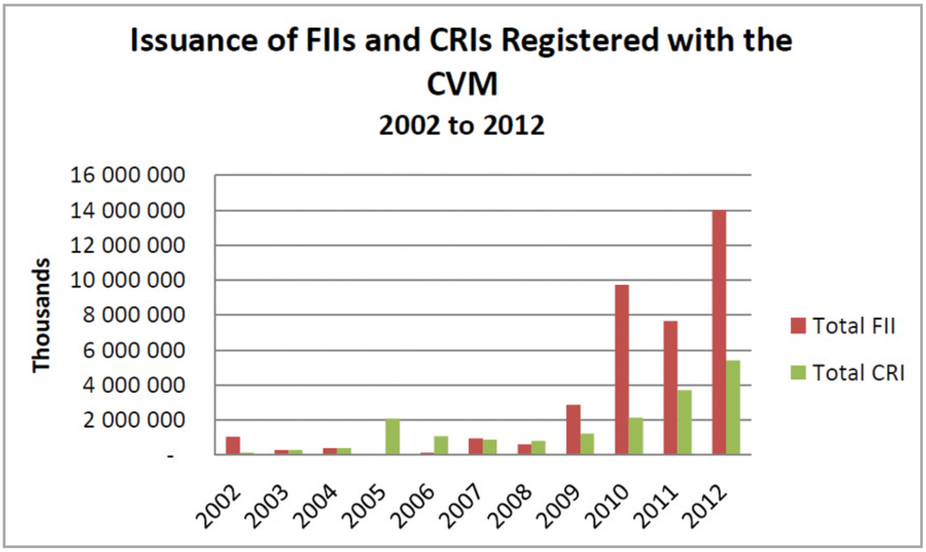
Brazilian REIT Market in Review

Vernon Budinger

Brazil's Fundos de Investimento Imobiliário (FIIs) market had another stellar year in 2012 in terms of issuance and performance. FIIs are the Brazilian legal vehicle that serves the same function as real estate investment trusts. The market is important because it now has roughly 193 deals worth R$44 billion (US$22 billion). The FII market is the most liquid of the structured finance markets in Brazil, but only 50 to 100 FIIs have shares that trade regularly.

Issuance of FIIs has grown spectacularly and will probably grow even more now that the investment has been made more attractive to foreign investors with the government's elimination of the dreaded IOF tax, which deducted 6% from the capital of a foreign investor. The value of new FIIs registered with the CVM almost doubled in 2012 to slightly more than R$14 billion.

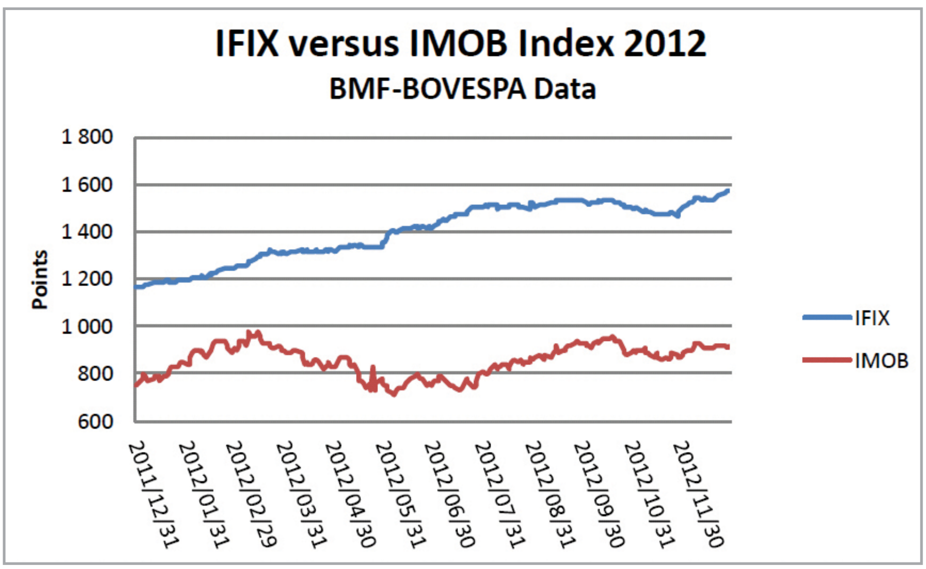
Exhibit 1



In March Uqbar released its Annual Real Estate Review for 2012, a comprehensive review of Brazil's securitized finance market for real estate collateral. We decided to add to the results of their publication with our own analysis of the performance of Brazil's IFIX index, the BMF-BOVESPA index for relatively liquid FIIs.

FIIs have been one of the fastest growing structured finance markets in Brazil and 2012 saw issuance registered with the Comisão de Valores Mobiliários (CVM, Brazil's SEC) break records for FIIs and Certificados de Recebíveis Imobiliários (CRIs). This was even more impressive because of the problems in the FIDC market, the other ABS/MBS market in Brazil.

Exhibit 2



Section 1: FII 2012 Return Analysis

Sector Returns

The IFIX gained 35.04% last year, outperforming BMF-BOVESPA's Building and Construction Index (IMOB, +22.37%) as well as the IBOVESPA, Brazil's Equity Index (+7.40%).

Looking at the Orbis database, the best performing sector was hotels and lodging because it only contains Hotel Maxinvest, a FII that had total return of 75.2% for the year, the second best performing FII overall. The hospital sector had the second best performance with 53.59% due to the 59.16% return on Hospital Nossa Senhora de Lourdes. Offices and Retail – shopping centers basically tied for third with 37.61% and 37.67% return, respectively.

The worst performing FII sectors for 2012 were retail – individual stores with a return of 7.09% and the residential sector with a return of 7.38%.

The best performing FII for the year was Memorial Office with a total return of 84.3%, followed by the previously mentioned Hotel Maxinvest. Torre Almirante (59.2% – offices), Hospital Noossa Senora, and BTG Pactual Fundo de Fundos (50.19% – FII of FIIs and CRIs) completed the top 5 for 2012.

The worst performing FII was Panamby in the multiple type sector with a return of -13.87%

for the year. It was followed by two Rio Bravo FIIs, RB Capital Agre (-9.61% – residential) and RB Capital General Shopping Sulacap (-5.3% – retail shopping centers).

We can see that there was no dominant theme for 2012; the worst performing sectors included FIIs that also performed well, such as the retail individual store sector. Similarly, the best performing sectors also included FIIs that did not perform well, such as multiple use, which also included Panamby. Only the office sector seemed to escape with no poorly performing FIIs; its worst performer was Votorantim Cidade Jardim with 16.30% return for the year.

Analyzing the Factors that Generated FII Returns in 2012

Dividend yield at the start of 2012

We assume that the market-value weighted dividend yield of 7.73% for 2011 was the expected yield for 2012. To maintain consistency, we used only the 41 liquid FIIs with data for both 2011 and 2012. The maximum dividend yield was 25%, the median was 8.33%, and the minimum was 4.5%, according to the data in Orbis. In addition, the approximate weighted average dividend was increased from about R$67.500 in 2011 to approximately R$76.00 in 2012, an increase of 12%.

Real estate valuations

Using the website www.agenteimovel.com.br, we gathered prices and appreciation for real estate in nine major cities in Brazil. The markets in Rio de Janeiro and São Paulo were up 17% in the year ended on February 28, 2013. Given that prices are up only 5% at the most in the last three months (except for Belo Horizante), the bulk of the gain in the Annual Change column in Exhibit 4 came in 2012.

Interest rates

Brazil's Comitê Política Monetária (CO-

Exhibit 3

Sector Breakout for IFIX Index
Data: Orbis

Sectors	Total Return	Weight	Sum of Weighted Return
Schools	**30.85**	**2.27%**	**0.700**
Aesapar	28.83	0.54%	0.155
Anhanguera Educacional	40.78	0.49%	0.201
Campus Faria Lima	27.78	1.24%	0.344
Offices	**37.61**	**56.49%**	**21.242**
BB Progressivo	26.17	3.47%	0.908
BB Votorantim JHSF Cidade Jardim Continental Tower	16.3	1.87%	0.304
BTG Pactual Corporate Office Fund	30.83	10.31%	3.177
Caixa Cedae	34.21	0.88%	0.302
Cenesp	34.54	1.56%	0.537
CSHG JHSF Prime Offices	47.78	1.48%	0.709
CSHG Real Estate	29.16	7.01%	2.045
Edifício Almirante Barroso	46.09	3.31%	1.528
Edifício Ourinvest	30.73	0.35%	0.106
Kinea Renda Imobiliária	46.48	11.24%	5.223
Memorial Office	84.32	0.63%	0.535
Mercantil do Brasil	39.56	0.81%	0.320
Presidente Vargas	36.3	1.70%	0.618
Projeto Água Branca	47.42	1.91%	0.906
Rio Bravo Renda Corporativa	24.97	1.56%	0.391
Torre Almirante	59.21	2.32%	1.376
Torre Norte	37.21	6.07%	2.257
Hotels and Lodging	**75.23**	**1.47%**	**1.103**
Hotel Maxinvest	75.23	1.47%	1.103
Hospitals	**53.59**	**1.72%**	**0.924**
Hospital da Criança	32.59	0.36%	0.118
Hospital Nossa Senhora de Lourdes	59.16	1.36%	0.806
Logistics	**21.30**	**5.09%**	**1.085**
CSHG Logística	23.44	2.65%	0.621
Europar	39.58	0.53%	0.208
GWI Condomínios Logísticos	11.63	0.78%	0.091
TRX Realty Logística Renda I	14.5	1.13%	0.164
Multiple Use	**24.11**	**3.41%**	**0.821**
Panamby	-13.87	0.53%	-0.074
RB Capital Renda I	31.61	0.97%	0.307
RB Capital Renda II	22.56	0.84%	0.189
Square Faria Lima	39.54	0.86%	0.341
TP Corporate	28.86	0.20%	0.058
General and CRI	**29.47**	**8.92%**	**2.627**
BTG Pactual Fundo de CRI	31.95	1.16%	0.370
BTG Pactual Fundo de Fundos	50.19	1.72%	0.863
CSHG Recebíveis Imobiliários	22.73	0.75%	0.170
Fator Verita	28.47	0.64%	0.183
JS Real Estate Multigestão	24.55	2.91%	0.715
JS Real Estate Renda Imobiliária	17.49	0.61%	0.107
WM RB Capital	8.68	0.41%	0.035
XP Gaia Lote I	25.66	0.72%	0.184
Residential	**7.38**	**2.73%**	**0.201**
RB Capital Agre	-9.61	0.08%	-0.008
RB Capital Desenvolvimento Residencial II	1.06	0.84%	0.009
RB Capital Prime Realty I	7.73	0.31%	0.024
RB Capital Prime Realty II	35.28	1.50%	0.176
Varejo - Lojas Individuais	**7.09**	**1.57%**	**0.111**
BB Renda Corporativa	-2.47	1.12%	-0.028
Max Retail	31.33	0.44%	0.139
Varejo - Shopping Centers	**37.67**	**16.35%**	**6.159**
CSHG Brasil Shopping	47.81	6.62%	3.166
Floripa Shopping	6.72	0.27%	0.018
Grand Plaza Shopping	30.59	3.66%	1.119
Mais Shopping Largo 13	-3.42	0.32%	-0.011
Parque Dom Pedro Shopping Center	35.01	2.27%	0.795
RB Capital General Shopping Sulacap	-5.3	0.54%	-0.029
Shopping Pátio Higienópolis	49.43	2.18%	1.076
West Plaza	4.94	0.48%	0.024
Grand Total	**34.97**	**100.00%**	**34.972**

POM) pursued a very accommodating monetary policy which it implemented by lowering the SELIC rate from 10.5% to 7.25% during the first half of 2012. IFIX performance exhibits almost a point-for-point inverse relationship with the level of the Brazilian swap rate. The COPOM's aggressive monetary policy clearly was a major factor in the strong performance of FIIs. In fact, using the Capitalization Rate Model (Dividend/(Discount Rate – Growth Rate) we can make a case that the FIIs should have appreciated even more given the 325 basis point cut in rates. Since the market was only up 35%, we have to ask, "What changed?" We look at the risk premium associated with the discount rate – DR = (Brazilian swap rate) * risk factor. We then adjust for the dividend growth rate assumption.

In Example A below, we hold the dividend growth constant and look for the discount rate necessary to calculate the price given the average dividend for the IFIX. Despite a 325 basis point fall in the Brazilian swap rate, the discount rate only fell about 88 basis points. The calculation below shows the valuation of the average FII if the risk premium had been kept constant at 182% of the Brazilian swap rate and the growth rate remained at a constant ratio (so that the price does not go even higher). The conclusion is that the risk premium being assigned to FIIs today is much higher than a year ago or else the returns on FIIs would have been even higher, more than 60% price appreciation for the year.

Section 2: Uqbar Year in Review for 2012

Record volume

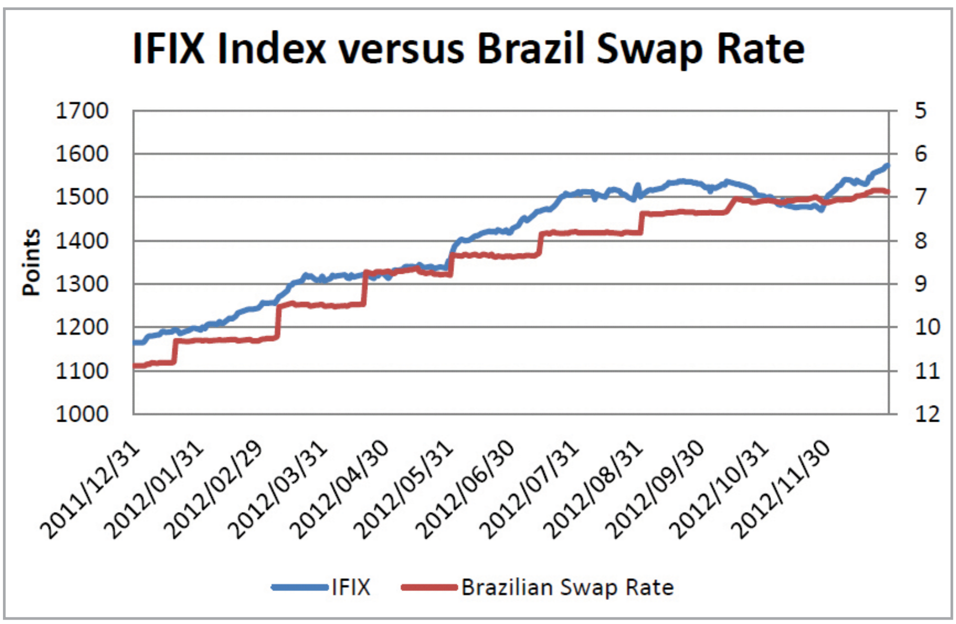
As we demonstrated in Exhibit 1, 2012 was a record year for Brazilian real estate financing that pushed Brazil's real estate finance markets to the limit. The Uqbar report pro-

Exhibit 4

Real Estate Prices						
Median Announced Price						
Market	Current Value	Current Value Meter Squared	Annual Change	One Month Ago	Three Months Ago	One Year Ago
São Paulo	1,286,871.00	6,894	17.0%	6,818	6,547	5,874
Rio de Janeiro	1,388,774.00	7,809	17.0%	7,420	7,340	6,654
Belo Horizante	704,757.00	5,110	8.0%	4,864	4,672	4,740
Salvador	645,564.00	3,972	10.0%	3,965	4,045	3,626
Fortaleza	555,370.00	4,561	14.0%	4,381	4,370	3,991
Curitiba	515,543.00	3,055	8.0%	3,036	3,078	2,832
Porto Alegre	576,791.00	4,293	10.0%	4,256	4,257	3,896
Guarulhos	375,436.00	3,433	10.0%	3,480	3,357	3,131
Campinas	906,974.00	4,305	11.0%	4,433	4,227	3,877
Average			**12.8%**			

Current = February 28, 2013

Exhibit 5



Example A

	Average Price Dividend	Discount Rate	Growth Rate
2011	R$ 936.12 = R$69.00	/ (19.16%	12.0%)
2012	R$1,204.00 = R$76.00	/ (18.31%	12.0%)

	Average Price Dividend	Discount Rate	Growth Rate
2012	R$1,542.14 = R$76.00	/ (13.23%	8.3%)

vides a much more comprehensive analysis of this surge in demand and the changes that it brought to Brazil's real estate finance markets. First, they demonstrated the inflexibility in the traditional government-driven funding sources and pointed to the growth in Letras de Crédito Imobilário (LCI) in 2011 and 2012 as an example of changes in the finance market to accommodate the growth. Banks turned to LCIs despite the maturity mismatches that resulted from using the generally shorter-term LCI to fund longer-term real estate loans. FII and CRIs also played a major role in supplementing traditional financing sources, especially CRIs designed for the Fundo de Garantia do Tempo de Serviço (FGTS) – Brazil's social security system.

Exhibit 6

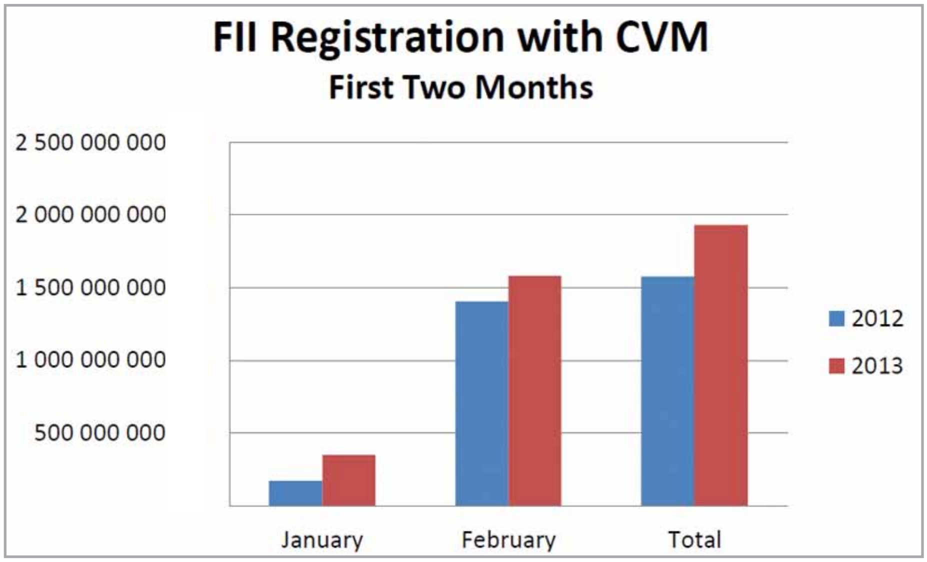
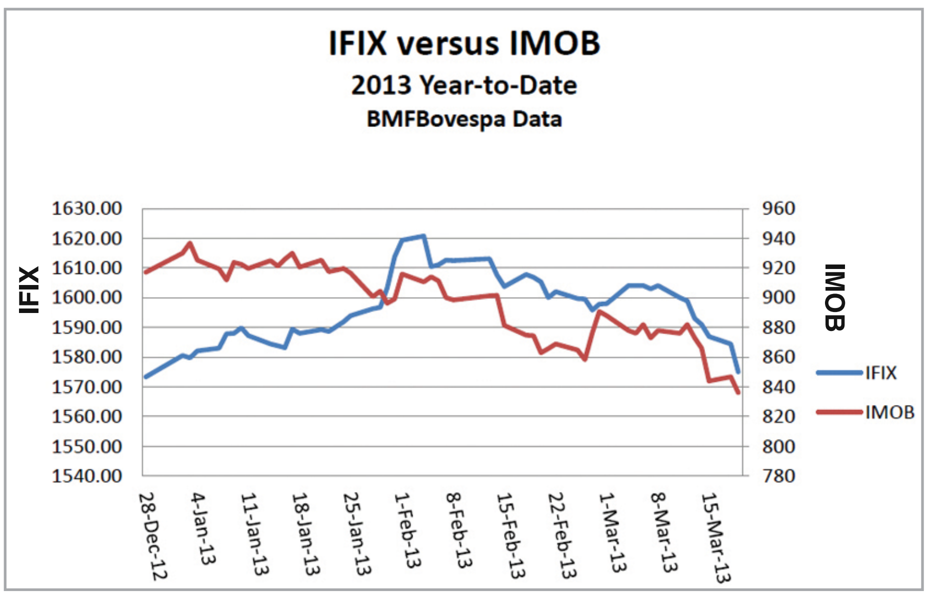


Exhibit 7



Problems with capacity in Brazil's traditional real estate financing markets

Uqbar provided a very thorough analysis of the financing available for real estate from the various financial channels in Brazil – government, banks and securitization. The main conclusion is that the demand for real estate financing was so strong that the traditional Caixa Econômica Federal – FGTS financing channel could not handle the volume. Uqbar explains that the main problem with the FGTS system is that the deposits in this system are not tied to rates in the real estate finance market, so the growth of resources to finance loans through FGTS is inelastic with respect to real estate loan demand.

Section 3: Where are Real Estate and the FII Markets Going in 2013?

While 2012 was a banner year, 2013's start has produced mixed results. On the positive side, issuance is on track to surpass last year, which is good news for the brokers and investment banks that issue FIIs.

However, returns have not been so positive. As of the close on Tuesday, March 19, 2013, the IFIX was even for the year and down 2.83% from its closing high of 1,620.81 on February 4. The lackluster performance in the real estate market is not confined to FIIs; the IMOB is down 8.84% this year.

Expected Performance

Given the analysis for 2012, we can look to see how some of the same variables are lining up this year for the FII market.

Positive Factors

Foreign investors – According to a recent survey by the Association of Foreign Investors in Real Estate and the Wisconsin School of Business, Brazil is second only to the United States as the country providing the best opportunity for capital appreciation of real estate. Brazil is first among emerging market countries in the poll and ahead of China for the first time in at least three years.

Brazil just eliminated the 6% IOF tax on foreign capital brought into Brazil if the investment is a FII.

Continued development tied to infrastructure development, the World Cup in 2014 and the Olympics in 2016 should continue to spur demand for real estate.

Loose credit from government sponsored banks – The Rousseff government has made it clear that it will use the balance sheets of Banco do Brasil and Caixa Econômica to increase lending and lower interest rates.

Momentum from underlying real estate market growth – Brazilian real estate continues to perform well despite the negative outlook from many economists and banks. We believe that the continued appreciation in real estate prices stems from the government's sometimes misguided efforts to support the economy through stimulation of real estate investment.

Negative Factors

Debt service ratio – The DSR for Brazil is at 24% according to Banco Central data, and this compares with a high of 21% for the United States at the height of the housing crisis in 2008 and 2009. (Sources: Banco Central do Brasil and U.S. Federal Reserve.) The indexes for delinquent loans from Serasa/Experian continue to rise to historic highs.

Current real estate evaluations are already high – We are not calling it a bubble, but multiple reports by research firms such as Capital Economics provide compelling analysis to show that the Brazilian property market is expensive relative to other markets.

Real estate loan issues – Direct government subsidy of the Brazilian real estate market is winding down or limited in some areas. An example is the previously discussed limit on FGTS financing: 2011/2012 saw the high point for investments by Brazil's social security system and limits on its ability to meet surges in demand. In addition, part of the reason for eliminating the IOF tax was to reduce reliance on Brazil's development bank, BNDES. In other words, what appears to be government subsidy may be just a shift in resources with no real net gain in support.

Currency – According to *The Economist's* Big Mac Index, the Brazilian real is 10% to 50% overvalued.

Interest rates – The COPOM has made it clear that it is not going to lower interest rates in the foreseeable future. Inflation is heating up and both the market and economists expect the COPOM to start increasing rates once the economy starts picking up again.

Slower growth in China – Trade with China has been an important factor in the strong economic performance in Brazil during the last few years.

Conclusion

We do not see a bubble bursting, but then we do not see the factors in place to drive Brazil's FII market to perform in 2013 like it did in 2012. We think that investors should take this into consideration when allocating to FIIs or any other Brazilian structured finance product that is collateralized with Brazilian real estate.

While there are some positive developments, the FII market is confronting significant headwinds that will contain further appreciation. The COPOM will hold interest rates at the current 7.25% level and may increase rates. We feel that we have made a strong case for linking the performance in 2012 to the falling interest rate environment.

Households are heavily indebted, and this has to affect spending at some point in the future. The high level of consumer debt will affect the residential real estate market directly. However, any reduction in consumer spending will also affect the commercial real estate market, especially the shopping centers, hotels and other developments that depend on consumer spending.

The key factor will be the Brazilian government's staying power and financial creativity. Like the Chinese government, the Brazilians will try every possible avenue for supporting the economy and the development of real estate and infrastructure. The question is, does Brazil have the balance sheet and the staying power to continue to prop up the economy given the limitations on its financial system due to years of misguided misallocation of resources?

Author Biography

LatAm Structured Finance is an investment advisor specializing in Latin American asset-backed securities. The company uses its proprietary technology and experience to identify unique investment opportunities and to protect its clients from risks embedded in complex structures. Vernon Budinger is an investment professional and a CFA with more than 28 years of experience. Prior to forming LatAm Structured Finance Mr. Budinger worked at Western Asset Management, and he spent the last 3 years working for Western in Brazil where he evaluated Brazilian structured finance.

Gazit's Chaim Katzman

'Our Strategy Is Long-term Ownership'

Knowledge@Wharton

Chaim Katzman founded Equity One in 1992 and serves as the Chairman of the Board of Directors. Mr. Katzman served as Chief Executive Officer until 2006 and as President until November 2000. He has been involved in the purchase, development and management of commercial and residential real estate in the United States since 1980. Mr. Katzman purchased the controlling interest of Gazit Inc., a publicly traded company listed on the Tel-Aviv Stock Exchange, and one of Equity One's principal, indirect stockholders, in May 1991, has served as the Chairman of its Board and Chief Executive Officer since that time, and remains its largest stockholder. Shulamit Katzman, Mr. Katzman's wife, is the Vice Chairman of the Board of Directors of Gazit, Inc. Mr. Katzman has served as a director of Gazit-Globe, Ltd., a publicly traded real estate investment company listed on the Tel-Aviv Stock Exchange and one of Equity One's principal, direct and indirect stockholders, since 1994 and as its Chairman since 1998. Mr. Katzman also serves as non-executive Chairman of the Board of First Capital Realty Inc., an Ontario real estate company the common stock of which is listed on the Toronto Stock Exchange and which is one of Equity One's principal, indirect stockholders. Mr. Katzman received an LL.B. from Tel Aviv University Law School in 1973.

Peter Linneman: When and why did you form Gazit?

Chaim Katzman: I formed Gazit in early 1990. To be precise, I bought what was then a publicly listed shell on the Tel Aviv Stock Exchange with the intent to raise capital and to invest it in the U.S. I moved to the U.S. in 1989 when I came across an [interesting] situation in the real estate markets here. Real estate was selling dirt cheap, but there was no financing available. So I went back to Israel, bought a publicly traded shell, then started raising capital with the idea of investing it here in shopping centers.

Linneman: Why shopping centers originally?

Katzman: We looked for an asset class that would be appealing to the institutions in Israel. In the early 1990s, they could not go out and buy on their own outside of Israel because of certain restrictions. The idea was to serve as a vehicle for the institutions to buy real estate in the U.S. by proxy, so they can own real estate through owning our stock. We figured that it would be easy to sell them supermarket-anchored shopping centers because of the stability, the resilience, the sustainable cash flows and all the good things that go along with it. So this is why we went for supermarket-anchored shopping centers. It was an easy sale to the institutions.

Linneman: That was a really small vehicle at the time you started, though.

Katzman: Correct.

Linneman: How did you grow it from essentially a couple of shopping centers into the third- or fourth-largest retail entity in the U.S.?

Katzman: First, you need to remember that in 1991, there wasn't any real big company. We all still remember when Kimco went public in 1991. They owned 120 shopping centers, and that looked unbelievable. We went public with I guess 28. And the others were not that much bigger. It all came together in the last 10 to 15 years, maybe 20. And we just kept buying one at a time. In 1998, we took the company public in the U.S. and that helped, of course. And between 2000 and 2003, through a series of three major M&A deals and, again, in a bunch of one-off transactions here and there, we grew the portfolio to close to 200 shopping centers. Initially we bought a company in Canada that Gazit took over called Center Fund. Now it's called First Capital. That company owned 28 shopping centers in the U.S.

Linneman: Why did you do it through the Gazit vehicle rather than through an Equity One vehicle?

Katzman: Because First Capital was the Canadian entity and Equity One was a U.S. REIT. A REIT has disadvantages in acquiring assets outside the U.S., tax-wise. Also, Gazit already had a base in Canada for almost three years. We started out in Canada in 1997. At that point we already owned 8 or 10 shopping centers. And then this First Capital/Center Fund opportunity came along, so this was clearly something that was for Gazit. We figured out a way to move it over to Equity One. In exchange for stock of Equity One, it went back to First Capital. Gazit really operates through platforms like Equity One or First Capital, and it views it as an extension of Gazit and it would never compete with them. But we also work along borderlines with very well-defined boundaries between companies. We try and are usually successful in not crossing those boundaries.

Linneman: Did you consider other property types in the U.S. or in Canada?

Katzman: We did. We also have a less known small platform of medical office buildings and some retirement facilities in South Florida. We view the medical office building as definitely an asset class that we would like to be involved in both here and in Canada through Gazit America.

Linneman: By the way, we have retirement facilities here. They're called faculty offices.

Katzman: Yes. Yes [laughter].

Linneman: What about outside North America? When and how and why?

Katzman: The answer as to why is, I guess, because it's there. But on a serious note, we view our mission as fiduciary for shareholders, and we need to always be on the lookout to increase our cash flows and dividends, and also make them safer. By diversifying, you get more advantages and get more security in your cash flows, and Europe seemed like a good opportunity. In 2004, we looked at four places in the Nordic region, which very few people even consider to be part of Europe. We started out in Finland. I looked at a map and saw that Finland is part of Europe and the currency is the euro, actually, and I said to myself, "What else do you need to call it Europe?" And we started investing there. We actually gained control through capital market activities over a small company called Citycon, and to date we control it – we took it over. Citycon was about a 200 million-euro company. Today they have about 2 billion euros. We just grew it. We implemented very much the same business philosophy we put to work here in the U.S. and it worked. It goes to demonstrate that people are people all over the world.

Linneman: What about elsewhere in Europe or outside the U.S.?

Katzman: Later on, in 2008, we came across an opportunity in Central Europe. We were with a company that was then called Meinl

Real Estate. Now we call it Atrium. It was a very interesting deal where we could amass a big amount of real estate in one shot. And we took over in a friendly deal. We took it over along with our friends from Citibank through CPI. And that gave us access to Russia, Poland, Hungary, Czech Republic.

Then Gazit started a private arm in Germany where we own 8 or 9 shopping centers, but it's not moving as fast as we wanted. Hopefully that will change. Another place where we have operations is Brazil, where just recently we completed our first ground-up development – and we opened our first mall in Brazil. We own 3 shopping centers there. It takes a long time to buy a shopping center in Brazil, but hopefully we are making progress in that. And then of course we have a little base in Israel, where we actually started owning in 2005, and we have 16 or 17 shopping centers. In Israel we are opening a new one in a couple of weeks.

Linneman: What about future growth targets? China? India? Others? Or is it opportunistic as it arises?

Katzman: Number one, it is opportunistic as it arises. Clearly we are looking for opportunities. We have a whole department here made up of smart kids who went to schools like Wharton and others – and that's all they do. They look for opportunities. And clearly opportunities are something of which we would like to take advantage. We know basically where we want to go. We know we want to be in Europe. So if an opportunity comes up in France we definitely take advantage of it. We constantly look for that. We look also for opportunities within our own territories where we would like to be helpful to one of our platforms, so if an opportunity presents itself in Canada, for instance, we would be more than happy to assist First Capital in taking advantage of it. As for new markets, I think the following would be accurate. I don't think we should go to China. In India we are involved through a fund with some institutions where we try to get some business going, but we are not in a leading position over there. It is managed by Indian guys. India is so complicated that I said to myself that I want to sit next to somebody who knows what he is doing and learn. That is exactly what we are doing over there.

I view some countries in South America as a huge opportunity. Right now we are very focused on growing our base in Brazil. The reason is some exposure that goes along with investing in South America. And Brazil is so big – it is a third of this whole continent. We feel we better focus right now on Brazil as far as our South American efforts are concerned.

"If you also are looking for quality assets, then why sell them? Just keep owning them and extracting more and more from them if you are in the right markets."

Linneman: How do you manage currency? And how do you manage your time – not just yours, your team's time – across platforms?

Katzman: As far as currency is involved, we will always borrow – with the exception of Brazil, and this is why this one is tricky – the same currency that we are buying in. So if we are buying in euros, it would be euros. In Canada, Canadian dollars. In the U.S., American dollars. As to our equity, we made a decision a long time ago that we are happy with what we call the Gazit currency, and the Gazit currency is made of the proportions we are invested in each of those major currencies, with a little bit of Israeli shekels, reais, and what have you. So, in others words, Gazit's equity – if you think about it – all the debt is fully matched to the assets. Then the equity is invested some 25% in the U.S., or 27%; some 30% in Canada, in Canadian dollars; 30% in euros; and whatever is left, a little in Israeli shekels, a little in Brazil and so forth. Brazil is tricky because there is no financing over there. So Brazil is fully financed off our balance sheet. This is why South America is tricky in that regard, because then the question that arises is, "How much exposure do you really want to have to the Brazilian currency knowing that you cannot finance it locally and everything comes actually from your balance sheet?"

As to our time, first, we have teams in each of those locations. Usually we have a team on the ground between a year to 18 months before we make our first acquisition. Sometimes we wait maybe two years before the first acquisition is made. And often the first acquisition would not be the greatest opportunity, but rather done with the understanding that we need to face some entry fee and give our team a chance to learn on the real asset and get its feet wet. That's what we did in Brazil. That's what we did in Canada years ago. And personally I fly around and am constantly jetlagged – visiting the teams and dealing always with the one that has problems. I'm kept around for the bad news, not for the good news.

Linneman: I suspect every place you first appear you get accused of being a short-term flipper, and yet you end up being a really long-term holder.

Katzman: Yes.

Linneman: What is your view of holding, exiting, etc.?

Katzman: I think each company has to figure out its own business model. I have no problem with developers who develop, fill the properties up and sell them if that's the model and if this is what they have advertised. We have a different model. Our model is long-term ownership. We are, I call it, cap-rate players, not IRR [internal rate of return] players. We don't believe in IRRs. That's what we advertise, and our shareholders are ones who are willing to stay with the assets or with the stock for a very long time, get the dividends, see the dividend get increased. Every year we have raised our dividends in the last 10 or 15 years, I think, in double digits. Every year. And we achieve it through a proactive approach to the assets. We work our assets. We are a soup-to-nuts kind of store. We do everything from cleaning the property to redeveloping them. We work for growth. We need more growth and we regenerate it usually from our portfolio. That increases our cash flows that eventually allow us to increase our dividends, and that's the model.

If you also are looking for quality assets, then why sell them? Just keep owning them and extracting more and more from them if you are in the right markets. Now, again, it's not a 100% formula. There are always assets that you should sell, and we do sell – like at the bottom of the barrel – in a constant effort to improve the quality of our portfolio. But basically the strategy is long-term ownership and increasing cash flows from these assets over extended periods of time.

Knowledge@Wharton: You said earlier that one of your objectives is to make the portfolio as safe as possible for your shareholders. What was your strategy for surviving the financial crisis and how did that work out?

Katzman: The number-one secret was to keep low leverage and a lot of equity. I say jokingly that companies with greater equity have a lower propensity to go bankrupt. And I'm sure we can put together a spreadsheet to demonstrate that. But on a serious note, it's all about cash flow and staying power.

Now I would tell you something else. In real estate, a recession or a downturn is not an "if," it is a "when." This is a cyclical business by design. Any CEO who tells you, "Look, it caught me by surprise" should not be the CEO of a real estate company. You need to be ready for a recession every day of the week. You need to have your leverage at such a level that you can cruise through a two-year or three-year period of difficulties comfortably with a combination of long-term debt and available lines of credit that are not in addition to your long-term debt but a shock absorber to fill the gaps in times where the capital markets are wide open for refinancing.

You cannot have borrowed 100% on all the long-term debt you can qualify for, and then get a line of credit and max it out. That's not how it works. The line of credit is a shock absorber for your long-term borrowing. It is meant to help you bridge periods where the capital markets are not open. That has been demonstrated this time around. If you look at what happened to GGP – to General Growth Properties [a large shopping center REIT that failed during the downturn] – this is exactly what happened to it. It is not that they were underwater. They were just illiquid. Liquidity is of crucial importance.

Now, of course, what helps a lot is to have the best assets that suffer the least in such periods of time and generate the cash flows that keep all your lending institutions and bond holders very calm because they know that you have the cash flows to service your loans in a timely manner.

Knowledge@Wharton: Could you describe your management philosophy, particularly your approach to hiring and keeping good people?

Linneman: Not to mention board members.

Katzman: This is something that I admit I have developed with time and age. Today I fully understand and recognize that the company is as good as the people you hire to run it. I'm saying that a real estate company without a great team should trade at a discount. Really, the premium should be assigned to the people who run the company because they can make the company so much better or so much worse, God forbid. We try to attract and to retain talent in the company and I do it throughout many platforms. First, you need to give people the sense and the feeling that they are partners and they are part of it. They are not just hired guns to do something. And sometimes it's not just the paycheck. It's how you treat people and how you make them feel that they are part of something. You have to keep them interested and motivated. You also need to incentivize them appropriately. I would not say this is not part of it. But I think that keeping smart people around – and we have a lot of smart people working for us – you need to do more than just pay them. You need to keep them interested, excited and motivated in what they are doing. That's what we try to do.

Knowledge@Wharton: One last question. How do you define success?

Katzman: I don't know. I haven't reached it yet.

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Microfinance and Patriarchy

‘A Drift Away from Serving Women’

Knowledge@Wharton

Microfinance – an approach to poverty based on providing small loans and other financial services to poor people, primarily women – has inspired extensive press coverage, a Nobel Peace Prize for founder Muhammad Yunus and reams of research in the decades that followed the launch of Grameen Bank in 1976.

Much of the research on microfinance focuses on factors associated with the efficient delivery of loans and their effect on borrowers – in other words, on the financial and economic aspects of the microfinance movement.

But by ignoring microfinance's cultural aspects – including the influence of patriarchal attitudes on lending practices – the ability to make loans to the women microfinance was originally intended to serve can be seriously restricted, says Wharton management professor Tyler Wry. Using data on more than 1,800 microfinance institutions (MFIs) in 168 countries compiled by the Microfinance Information Exchange, Wry and Eric Yanfei Zhao from the University of Alberta School of Business look at policies advocated by the United Nations, World Bank and other development agencies that are intended to build stable infrastructures for microfinance institutions. "We found that countries that do have more liberalized markets, including increased flow of capital and thus the ability to make more loans, also [can] support a lot more microfinance activity, which is good," Wry says. "But we also found that these same factors that would make a country attractive to MFIs also made it less likely that they would lend to women."

He and Zhao present preliminary findings in a working paper titled "Culture, Economics, and Cross-National Variation in the Founding and Social Outreach of Microfinance Organizations."

In their paper, the authors argue that "gender inequality is an important consideration for understanding the . . . focus of MFIs. Our results indicate that a business-friendly economic climate has the potential to undermine" microfinance's goal of empowering women, and that this effect is "amplified in patriarchal countries where the need for lending to women is greatest."

Indeed, the higher degree of patriarchy there is, the more barriers there are to women participating in the economy, the authors suggest, describing patriarchy as belief systems that emphasize women's domestic roles, devalue their education and forbid the inheritance of property "which could be used as loan collateral."

Patriarchy can also reverberate down through the MFIs themselves: Because up to 70% of loans are made to women, access to female employees in MFIs is key. Female loan officers "provide role models for the women in lending groups and offer a tangible example of women's empowerment," the researchers write. In addition, "it is easier for women loan officers to interact with women clients [since] they can easily visit homes to collect installments." Furthermore, "same gender relationships facilitate open dialog about financial questions and problems in the home."

Yet in patriarchal countries, investment in women's education is lacking, the authors add. This situation – along with roadblocks that prevent women from getting training in such important areas as law, accounting and finance – results in most of the loan officer jobs going to men. "Given the difficulties associated with making loans to women absent female loan officers, inequities in professional training may also create a barrier to lending to women in patriarchal countries," the researchers write.

'A Lot More MFIs Doing a Lot Less Good'

The irony in this discussion, as the authors note, concerns how difficult it can be to reconcile the goals of microfinance. "While increased foreign investment, low taxes and supportive regulations may create a [positive] environment for MFIs in some regards," this mainly applies to those MFIs that "emphasize financial sustainability over social outreach," the authors write. In other words, while foreign investors may say they want to promote better lifestyles for women and families, they also expect positive financial returns. And yet the motivation for lending to women is to "create social benefits by serving a population that is excluded from traditional financial channels precisely because it isn't profitable to serve them."

Indeed, studies have shown that MFIs that focus on lending to women "are less likely to be financially self-sustainable and more reliant on government subsidies than their commercially oriented counterparts." Consequently, such MFIs "are not likely to be attractive investment targets," according to the paper.

As Wry notes, "women tend to be really poor clients. That was the reason microfinance was attracted to them in the first place, so that women could access normal channels of lending." But when financial capital comes in, with its emphasis on generating returns on loan repayments, women tend to be "pushed away from the microfinance market," he adds.

"The bottom line is that if you take steps to promote entrepreneurial activity, it has a counterproductive effect in countries where you most need MFIs to reach out with loans to women," Wry says. His research, he adds, "shows that if you only look at the economic side of this, you can start to make decisions that have unforeseen consequences. . . . If we agree that microfinance should help impoverished women break out of cycles of despair, it's important to talk about what is going on when we implement economic policies that the World Bank and others support. [These policies] do have some good consequences, but they also might have some downsides in terms of outreach to women."

The scholarly evaluation of microfinance on the micro level shows, for example, that women borrowers are more likely "to generate financial returns, invest these in their families and repay loans than their male counterparts." But at the macro level, "the potential to deliver these benefits depends on the prevalence of microfinance organizations within a country and the degree to which they focus on women's lending – areas where current studies offer limited insight," the authors write.

They suggest that "economic and cultural factors are important for understanding both the emergence of MFIs and their commitment to women's lending, but that they affect these outcomes differently." They note, in particular, that "a supportive economic environment will lead to higher MFI founding rates because it provides fertile conditions for business creation." At the same time, however, they anticipate that "high levels of patriarchy will suppress both MFI foundings and women's lending because factors associated with gender inequality may limit access to resources such as financial capital, employees and customers."

The authors also predict that a business-friendly economic climate will help offset some of the resource constraints that patriarchy creates for MFI foundings, but will "amplify the suppression of women's lending by creating financial inducements to lend to less-poor male clients."

Patriarchy, Wry says, really changes the outcome when you look at both the economic and cultural factors. "You need to consider both sides of the equation. Patriarchy may be changing the nature of microfinance in many countries. You are seeing an accelerated drift away from serving women. A lot more MFIs are doing a lot less good."

People like to think of capital as "neutral," Wry notes. "But if you want to make money in microfinance, that will have some pretty dramatic effects. You see over time that Grameen Bank was a hybrid organization. It was new and novel, but the mission was very much on the social side. What we are seeing now in the whole sector is that MFIs are still hybrids, but the order in which the two parts are mixed has been flipped. When it started, it was financial tools being used for social good. Now it has increasingly become a social mission used as a way to generate money. Organizations fall between these poles. This minimizes the benefits to women unless you have a country where women don't comprise a disproportionate share of the poor."

But of course in many countries, women tend to be the poorest segment of the population, a status that is further solidified by the existence of patriarchal attitudes. Wry and Zhao at one point cite a widely used definition of patriarchy as "a shared belief system where male domination serves as a model for structuring individual identities, interpersonal relationships and large scale institutional arrangements."

Wry says their paper is the first to offer a large-scale sociological analysis. "Many papers look at single countries or single cases. They have interesting things to say, but they don't look at the broad patterns. We are trying to move the debate to a higher level." Interdisciplinary dialog is important, he notes, "particularly in opening up debate among scholars who bring different, but complementary, tools to the table."

Beyond this, he adds, "I think there needs to be some sober thought about what – as a field – we think microfinance should be doing. So much of the debate gets bogged down in platitudes about sustainability and win-win scenarios when business insights and acumen are applied to the social sector. Yes, it is true that doing this can have some positive effects; we are seeing this with the growing prevalence of MFIs globally. However, these platitudes gloss a fundamental tension – namely that there are limits to what business can do in the social sector, and it may be that you cannot, and should not, be trying to make money by delivering social goods."

There are "many people and problems that you can't make money off of, and this is where governments and public policy need to enter and assert their voice," Wry states. "The aim shouldn't be to temper innovation or enterprise, but to offer subsidy and stability. This is basically what Yunus says, and I think he's bang on."

African Art Gaining Ground

It is now possible to buy important African artworks as the market experiences an influx of unique traditional objects and sculptures that have been hidden in private collections since the beginning of the 20th century.

Many African works that are coming to auction are still relatively inexpensive compared with other genres and periods, so it is possible to acquire masterpieces without having to pay six-figure sums. That is not to say that certain African works have not been sold for over a million dollars, though: only last year, Christie's sold a nine-foot-tall Nkundu reliquary figure for over $3.5 million in Paris, making it the most expensive African object sold at auction.

Christie's holds African & Oceanic art sales twice each year in Paris, the "capital of African art," in June and December, with single-owner sales held in both New York and Paris. The next sale is set for June 12 in Paris.

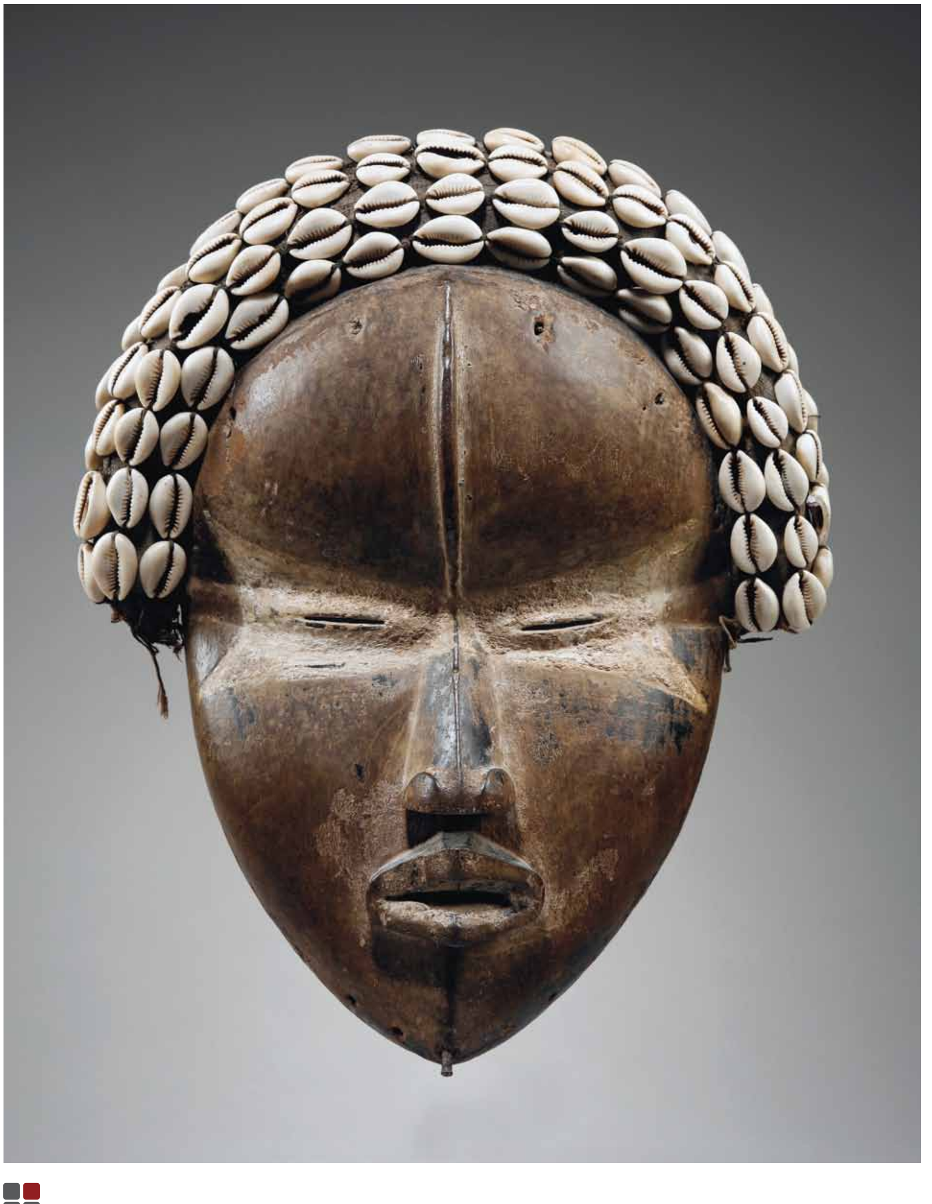
While there are a number of contemporary African artists currently enjoying success, such as the Ghanaian El Anatsui, whose exhibition "Gravity and Grace: Monumental Works" is on at the Brooklyn Museum until August 4, it is the ancient tribal artworks and objects that fetch the highest prices. "These works are no longer made so they are very rare," says Charles-Wesley Hourdé, Christie's African and Oceanic art specialist. "Figurative objects, like those made by the Sanj Tribe in Gabon, and other everyday pieces that represent African life are very important historically."

Much African art was collected at a time when other styles were dominating the art scene, so buyers were able to amass vast collections without serious competition. "In the future many of these pieces will come to the market, because as African works become more popular, collectors will begin to take advantage of this by selling when the prices are high. This is great news, as we will begin to see a greater number of what are considered to be pure examples of tribal art on display," notes Mr. Hourdé.

Opposite: Baga Figure of a Snake, Bansonyi
Republic of Guinea
Height: 190 cm. (74 in.)
Provenance: The Collection of Celeste and Armand Bartos
€800,000-1,200,000

Right: Fang Reliquary Head
Gabon
Height: 23 cm. (9 in.)
Provenance: The Collection of Celeste and Armand Bartos
€300,000-500,000

Below: Dan Mask
Liberia/Ivory Coast
Height: 34 cm. (13. 3/8 in.)
€30,000-50,000



African & Oceanic Art

Charles-Wesley Hourde

1. The African art market is part of the global art market, with a particular emphasis on the antiquities market.
2. Over recent decades interest in African art has increased steadily.
3. African art is attractive to private collectors and important museums all over the world. Buyers are mainly foreign, with fewer African collectors. Some African states such as Nigeria have been active in buying pieces from their own country.
4. Prices have increased 40% over the last 10 years.
5. Pieces of historical importance are seen as an investable asset class; their value will increase, as they are increasingly rare and most of them end up in museums.
6. Top names are kept confidential; some are new buyers coming from the contemporary art world.
7. There are no special current trends in buying. Rare, high-quality items are still what people look for.
8. The global market for 2012 reached about US$40 million in auction houses. There will be three important auctions in May and June, and three in December 2013.
9. Over the next two years we expect a growth of 30% in the volume of important pieces at auction.

Interview with Eric Chang

Senior Vice President International Director Asian 20th Century & Contemporary Art, Christie's

Please define the state of the Asian art market. How is it seen within the art world, as regional, as contemporary, etc.? How has the market developed over the past decade? Who is buying? Are you seeing regional interest grow with growing disposable incomes of local populations? Are the regions attracting more foreign buyers?

The Asian 20th century & contemporary art market is maturing and becoming more and more globalized.

While in its early stages the market for this category was really geographically confined, today the market has expanded considerably and is now a vibrant part of the art scene in many cities & regions around the world – China, Japan, Korea, India, Indonesia, Singapore, Taiwan, Hong Kong, Europe, the Americas, the Middle East & etc. The economic strengthening of Asia has led to a growing interest in Asian cultures from the global community, in their desire to gain a deeper understanding of this fascinating region and cultural aspects. Contemporary art is one of the most direct reflections of this, and it is another factor as to why more and more global buyers are interested in Asian contemporary art.

For instance, in 2002, the first auction of 20th century Chinese art at Christie's Hong Kong had only 45 pieces. But in fall 2012 we got over 590 artworks at Christie's Hong Kong Asian 20th Century and Contemporary Art sales, and in excess of 80% sold. The result conveyed a strong message to the market about the confidence of buyers in this category and reaffirmed the unique aesthetic value of Asian art and the uninterrupted growth of Asian 20th century and contemporary art as a global collecting category.

Christie's Hong Kong's 2011 results reflected the strength of the art market, and this phenomenon continued in 2012. In autumn 2012 we also witnessed a mature and diverse market for Asian contemporary art, with buyers from a broad range of countries and backgrounds and a significant number of new clients entering the market, resulting in growth in sales. In the spirit of our theme of "East meets West," we witnessed truly cross-cultural buying, including European buying of Southeast Asian works and Japanese buying of Vietnamese art. These results are a testament to Christie's ambi-

FERNANDO ZÓBEL (Filipino, 1924-1984)
Arganda
oil on linen

tion over more than ten years to diversify our buyer base by bringing the markets in Asia and the West closer together and promoting globally the appeal of Asian 20th century and contemporary art.

Christie's has tipped the balance of our sales on an international level, with Asia now contributing 16% to global results. Hong Kong, as mentioned, has become an active art and cultural hub, following London and New York.

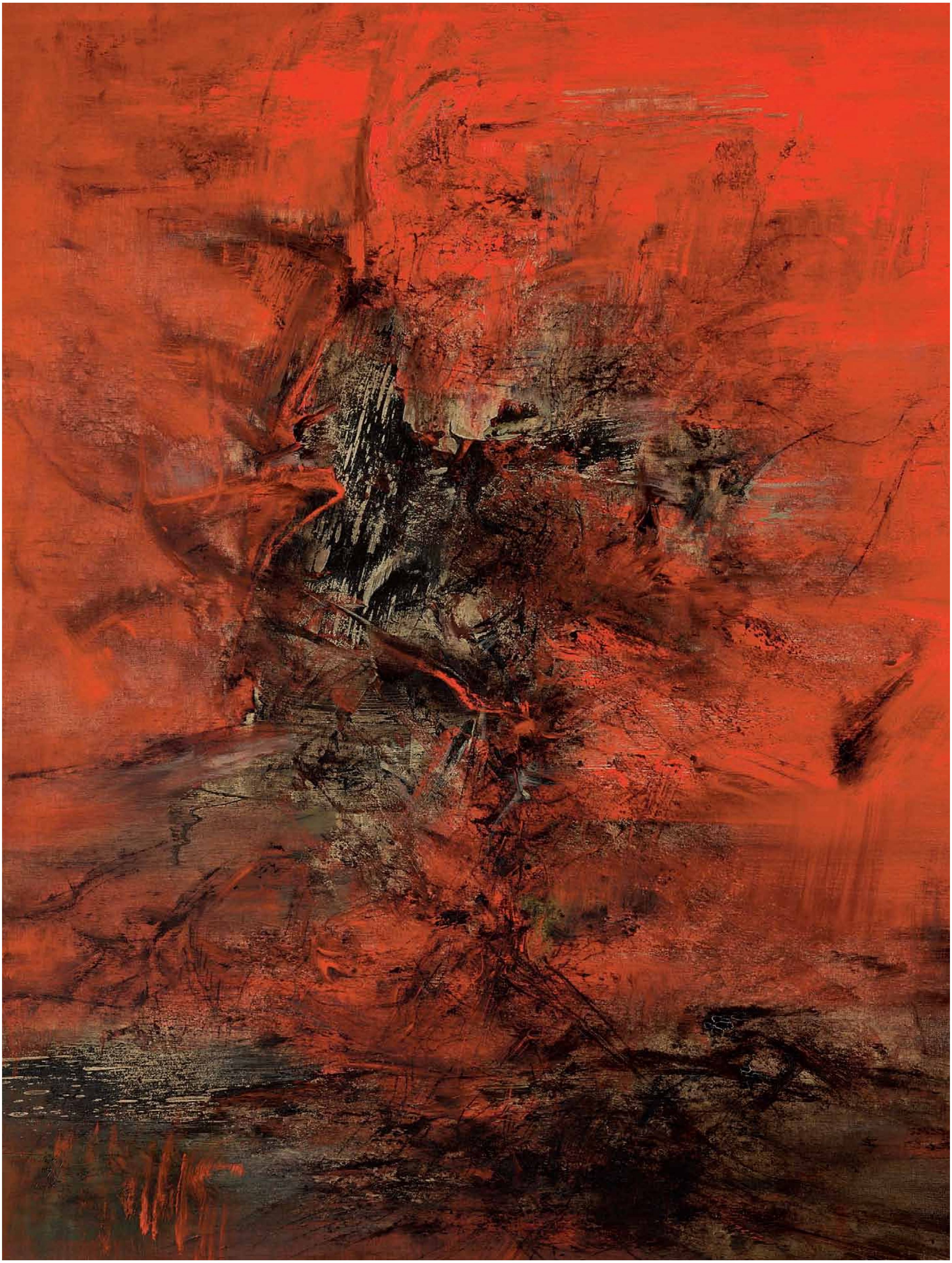
How have prices changed? Are pieces from the region seen as an investable asset class? That is to say, they will grow in value, rather than maintain value like some masters?

Caveat emptor – buyer beware. As an investment category, art and collectibles are increasingly viewed as useful and valuable tools in portfolio diversification. The art and auction markets, like other businesses, are certainly affected by the overall state of the economy, as one can see from the slowdown in sales volume throughout 2009. However, they are not directly correlated with the equity market, in that the inherent nature of art and collectibles makes their prices subject to different factors. Each work of art is unique, and its value is very much determined not only by supply, but also by the medium of creation, the condition, the period, the theme and the collecting trends of the time. Even the "hottest" artists will be valued on the fundamentals of quality, rari-

Left: YAN PEIMING (Chinese, b. 1960)
Bruce Lee - Fighting Spirit
oil on canvas

Below: ZAO WOU-KI (Zhao Wuji, French/ Chinese, b. 1920)
24.1.63
oil on canvas

Opposite: CHEONG SOO PIENG (Singaporean, 1917-1983)
Abstract Triptych
oil on canvas, triptych



YOSHITOMO NARA (Japanese, b. 1959)
Life is Only One!
acrylic on wood

ty, condition and provenance, so it is important to do due diligence before collecting. At the risk of repeating myself, we believe buyers should first consider what they are passionate about, before they consider buying a work of art. And if one is buying art only for investment, my advice to this buyer would be: Turn to another market, as art is not a commodity.

Who are some of the top names? Are these people new to the art world, or longstanding artists only recently getting international exposure?

In terms of Asian 20th century & contemporary artists currently in high demand, artists like Zao Wou-Ki (b. 1921), Chu Teh-Chun (b. 1920), Sanyu (1901-1966) and Zeng Fanzhi (b. 1964) now rank among the top international "stars" worldwide. Japanese and Korean artists such as Yoshitomo Nara (b. 1959) and Hong Kyoung-Tack (b. 1968) are also sought after on a global scale. The celebrated contemporary Southeast Asia artists include I Nyoman Masriadi (b. 1973) and Ronald Ventura (b. 1973).

What are the current trends in buying? Art of specific countries, mediums or styles?

For many collectors, the medium/material is not the main concern, although different collectors are certainly drawn to certain works and forms. We find that the most sought-after works are those that have not only a specific regional/cultural aesthetic, but are also at the same time understood by the international market. But very generally speaking, our sales are often 65% paintings, 20% sculpture, 10% photography or prints (with editions), and 5% installation works or sculpture.

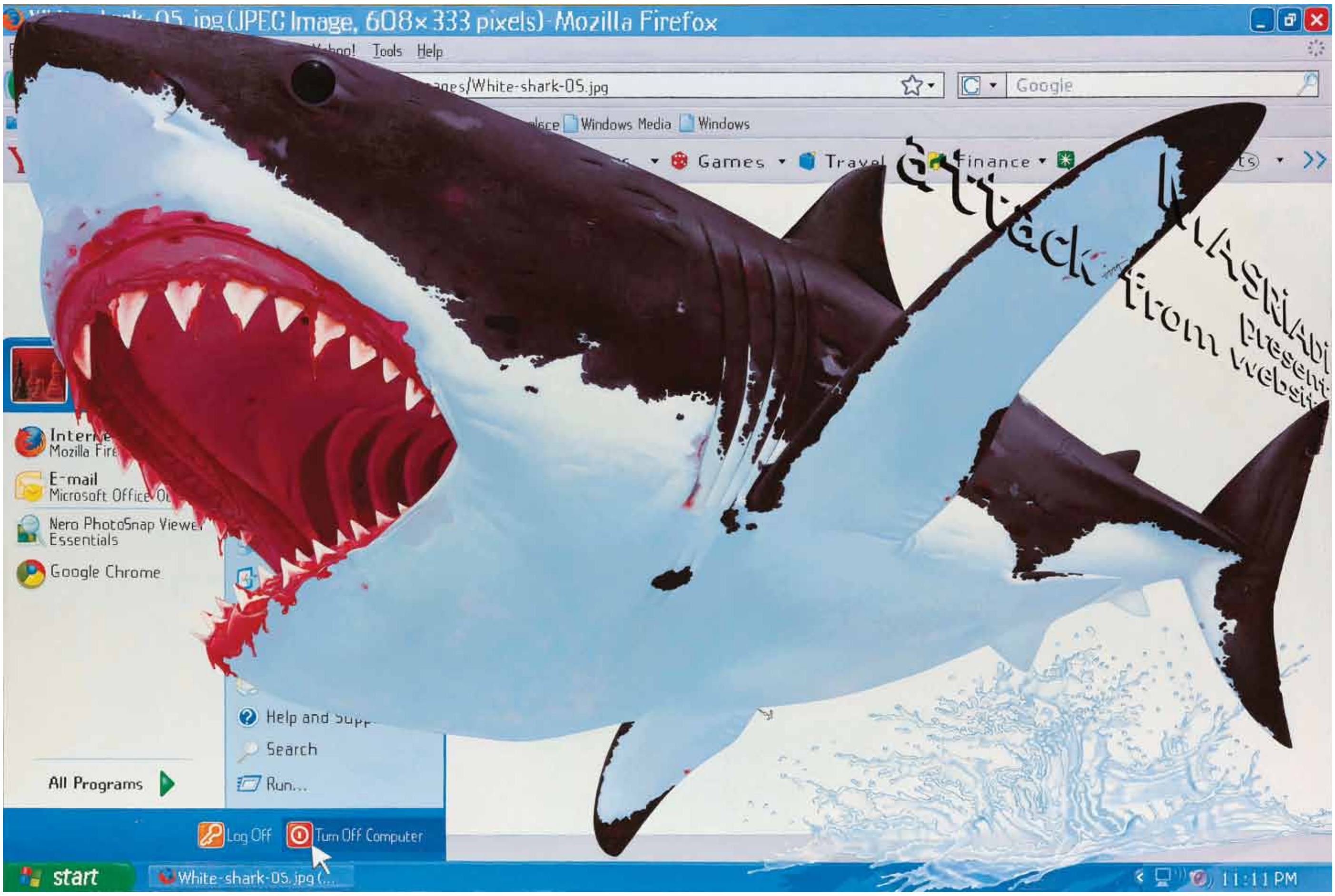
Can you provide data from the most recent auctions? Also, when are the next auctions? How stable do you see the growth (if any) of these art markets, and where do you see them going over the next 2 years?

In last autumn's auctions, three sales of Asian 20th century and contemporary art reached HK$674,575,000 (US$87,492,378), and sold in excess of 81% by lot and 93% by value. About 70% of lots sold above high estimate, and 10 new artists' world records were created, including La forêt blanche II by 20th century Chinese artist Chu Teh-Chun (sold for HK$60,020,000/US$7,784,594) and Abstract Triptych by Singaporean artist Cheong Soo-Pieng (sold for HK$4,220,000/US$547,334).

Christie's will present a diverse range of Asian art across three categories at its Hong

Top: CHEN YIFEI (Chinese, 1946-2005)
Bridge of Light
oil on canvas

Bottom: CHU TEH-CHUN (ZHU DEQUN, French/Chinese, b. 1920)
La forêt blanche II
oil on canvas, diptych



I NYOMAN MASRIADI (Indonesia)
Masriadi Presents - Attack from Website
acrylic on canvas

Kong spring auctions, following the recent highly successful New York Asia Week. “East meets West” continues to be the theme of the Asian 20th century & contemporary art sales, which highlight a number of works by Chinese-French artist Zao Wou-Ki. The sales will also bring Southeast Asian art into the spotlight. Major lots include an important collection by Fernando Zobel, a master of modernism and abstract expressionism, and figurative paintings with avant-garde interpretations by I Nyoman Masriadi.

Author Biography

Eric Chang is Senior Vice President, International Director of Asian 20th Century & Contemporary Art, based in Hong Kong. Born in Taiwan, Mr. Chang joined Christie’s Chinese 20th Century Art Department as a specialist in 2001, and was promoted to Senior Vice President, International Director in August 2006.

In May 2008, Mr. Chang and his team introduced a new element to the sale calendar in Hong Kong: the first-ever Evening Sales of Chinese 20th Century and Asian Contemporary Art. The inaugural Asian Contemporary Art Evening Sale set 8 important world auction records, including the auction record for Chinese contemporary art with Zeng Fanzhi’s Mask Series 1996 No. 6, which realized HK$75.4 million/US$9.7 million.

Together with the companion Day Sales in both categories, the Spring 2008 sales of Chinese 20th Century and Asian Contemporary Art totaled a record HK$813.8 million/US$104.6 million, the highest total ever achieved in the category worldwide. A total of 66 world auction records were set across the spectrum of Asian contemporary art, including multiple new auction records for Japanese, Korean and Indian contemporary artists.

Latin American Art Stays in Focus

The recent progression of both established and emerging artists from Central and South America should not be ignored as a potential investment opportunity.

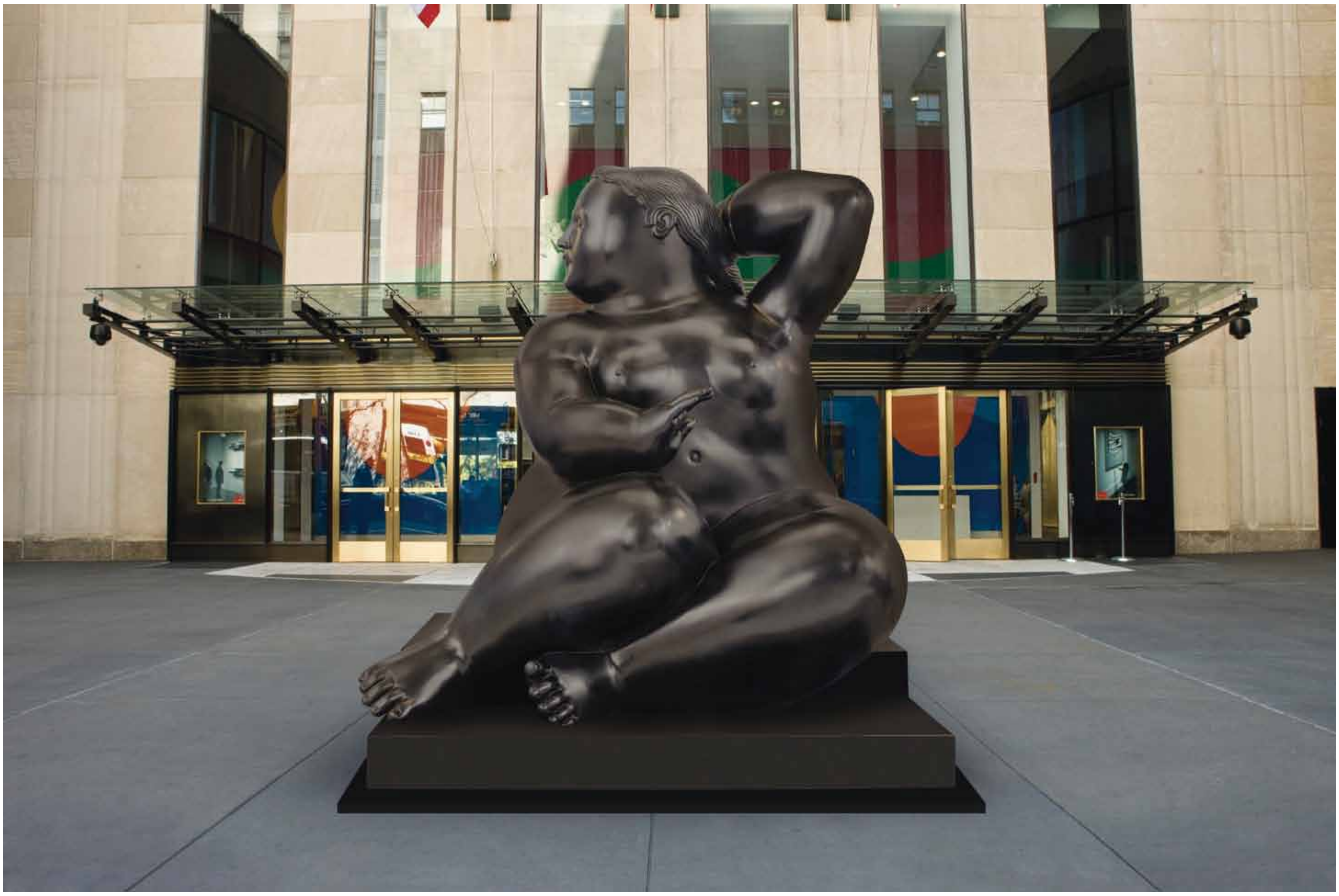
- LatAm art yielding greater investment opportunities after years of steady growth
- Steady growth of LatAm art over the years leads to a safer investment
- Artwork and artists still developing – room for further growth and potential
- Various styles on offer, especially abstract and impressionist

According to Marysol Nieves, Vice President and Specialist for Latin American Art at Christie's, which features some of the most exciting art from colonial, modernist, surrealist, and contemporary masters who have helped shape the artistic landscape throughout the Americas, the LatAm art market "is strong and getting stronger. There are some very well established artists, such as Frida Kahlo and Fernando Botero, who sell very well at auction, but also an increasing number of young, exciting, more under-the-radar artists rising through the ranks."

The popularity of Colombian figurative artist Botero, for example, is evident as far away as China. "I was fascinated to hear a colleague tell me that a number of aspiring Chinese artists are looking at Botero's work and drawing influence from his paintings," Ms. Nieves observes. "This cross-fertilization of artistic styles proves that the work of artists from countries such as Brazil, Colombia and Mexico is reaching further afield and ultimately gaining popularity."

Asked if Latin American art is still viewed as emerging, Ms. Nieves says that it depends on what country you are looking at. "Aside from commercial markets, a number of countries are growing in such a way that promotes the understanding and general impression of LatAm artworks. For instance, many universities are now offering courses dedicated to the history of art in South America and this ultimately opens up new roles to students once they have graduated. Latin artists have been part of the Christie's portfolio since the late 70s, early 80s so they are starting to reap the rewards after years of hard work; they are becoming part of the establishment."

History has taught us that with the rise of one artistic movement comes the gradual phasing out of another, but according to Nieves the artistic ascendency of one par-

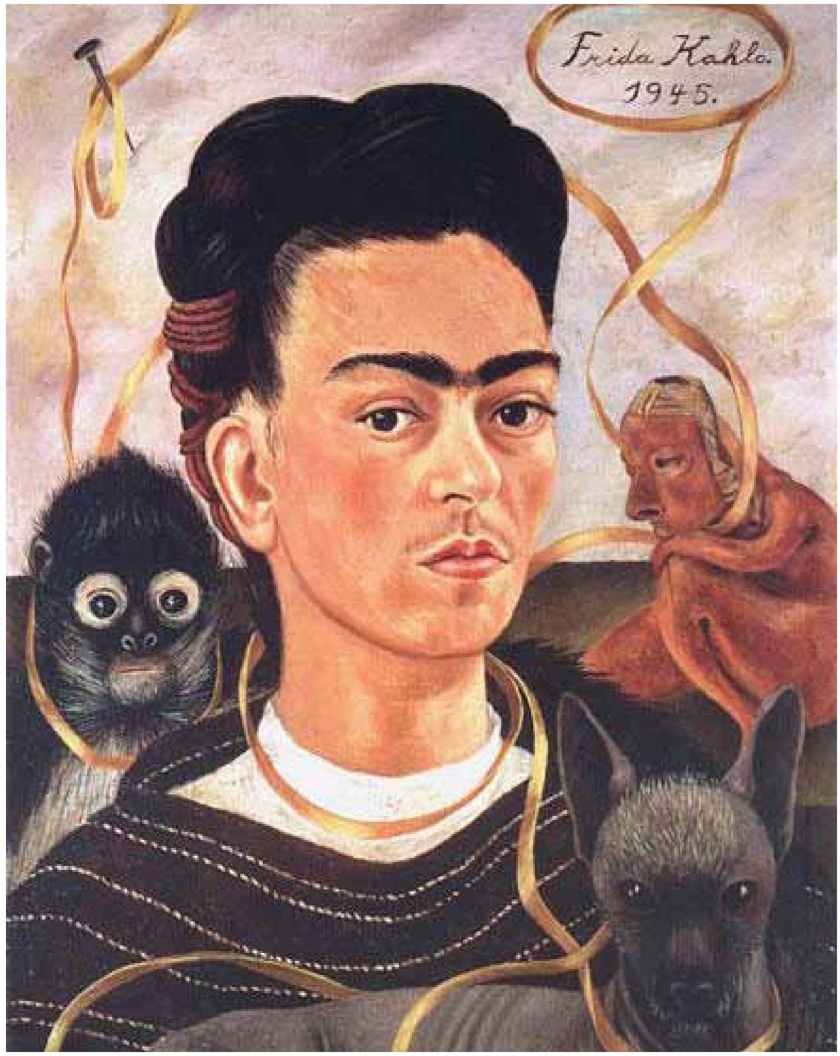


Above: Fernando Botero (Colombian b. 1932)
Seated Woman
bronze with dark brown patina
80" x 76" x 77" (203.2 x 193 x 196.2 cm.)

Right: Fernando Botero (Columbian, b. 1932)
Family Scene
oil on canvas
66" x 70" (169 x 170 cm.)

ticular artist can indirectly impact the popularity of another, even if they are completely unrelated stylistically. “A client who walks into an auction house to view a Latin American exhibition might chance upon another genre or form of art that appeals to them,” Ms. Nieves says. “Just by virtue of being in the building, a client will surreptitiously have access to other exhibitions and theoretically they might be tempted into buying something else, whether that be another a painting by another artist altogether or jewelry.”

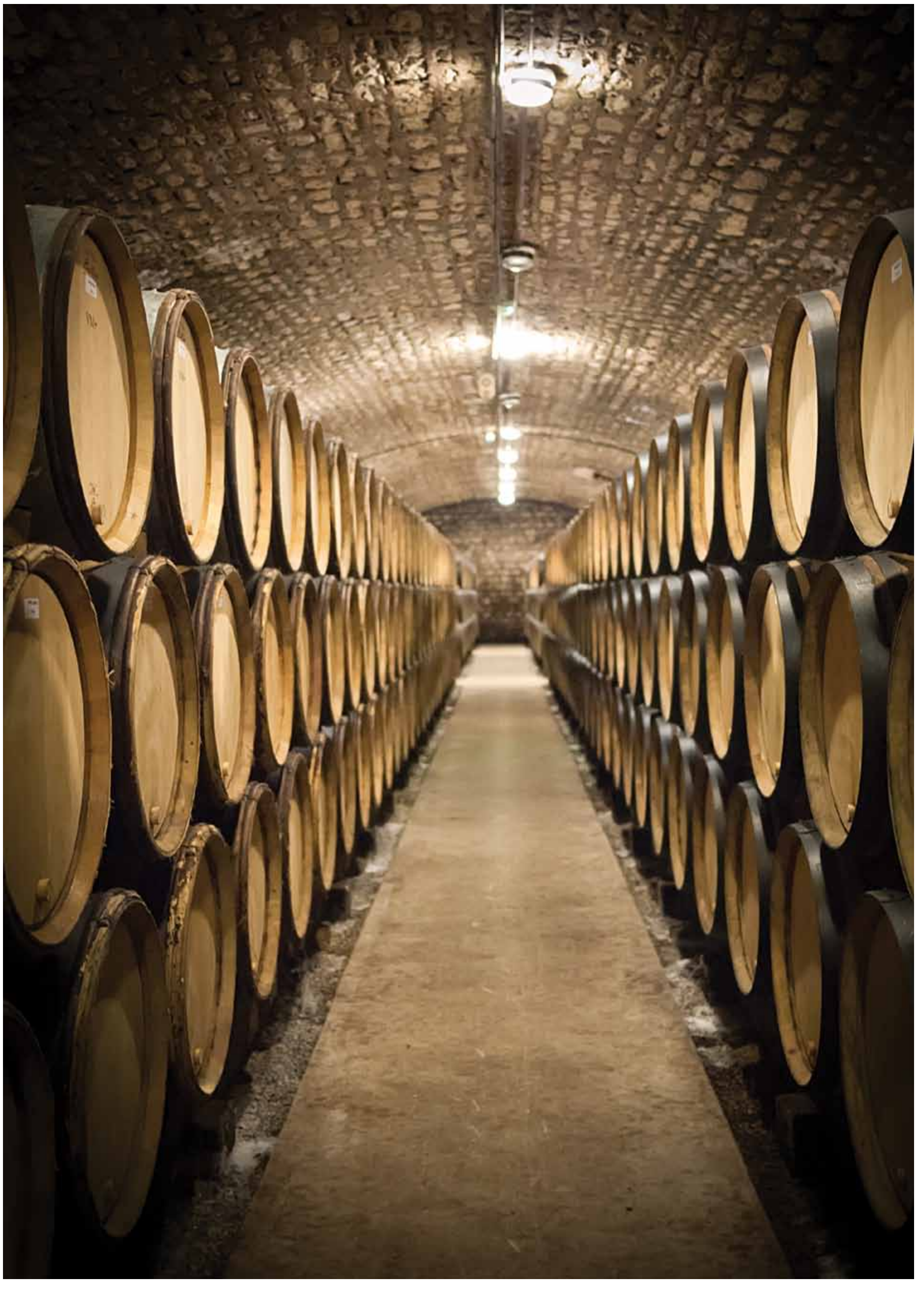
Ms. Nieves has witnessed the rise of Latin artists in recent decades, having previously worked for Sotheby’s and as a private art consultant. She is sure that the measured trajectory at which certain artists have grown strengthens the foundation of Latin American art, and that investing in such works is the safest it has ever been. “Latin artists are still developing artistically, but now that many of them have gained a reputation, their work is becoming more influential. If you look at Cuban artist Carmen Herrera, she sold her first painting at the age of 89 in 2004 after spending much of her life unknown. A new chapter is being written and the layers of Latin American art are starting to be peeled back after years of only scratching the surface.”



Frida Kahlo - Autorretrato con changuito (Self-Portrait with Small Monkey), 1945. - © Collection Museo Dolores Olmedo, Xochimilco, México

Emerging Markets

Stocking up on Premium Wines



Wine negotiates the market differently from other asset classes, and may not necessarily be affected as harshly by economic downturns as real estate, for example. As an investment, it can be less volatile and offers more control in terms of being able to influence the market. However, disadvantages do exist, and unforeseen costs, such as transaction fees, need to be considered carefully.

Professor Lee Sanning, PhD, is a published author and wine expert. He has studied and written about the benefits of adding wine to a classic equity portfolio and is well read in the advantages of diversification. "Investment in wine certainly has its advantages. There are great benefits in returns and a decrease in portfolio volatility," he says.

Dr. Sanning believes that Californian wine trades are going to become more prevalent in the future and suggests investing in the very best vintages of the top years' top producers, such as 1982 first growth wines or similarly the 1996 first growth wines.

The consumption of a particular wine affects a variety's price, which of course has a bearing on the bottle's appeal to investors. As people consume the great wines of a given year, more fluctuation occurs in the wine market. The scarcer wines become, the more expensive they become, as there are only so many bottles made in one calendar year.

It appears that different regions or countries are prepared to pay varying prices for certain wines. "I don't think Americans would likely purchase the Carruades de Lafite at the price it is currently going for. I suspect that most of that variety sold at the auction market in the U.S. is making its way to Asia, where the wine carries great brand recognition," says Dr. Sanning.

With regard to investing in wines from emerging wine markets, Dr. Sanning says that Australia's Penfold Grange is experiencing enough trade to merit starting to analyze the variety as a wine asset even though some may debate whether Australia's wine market is emerging as worthy for investment. "As far as other wine regions go, I have not seen anything in Chile, Argentina or South Africa. These wines do sometimes come up in auctions, though, so it is a matter of keeping one's eyes peeled. I think the emerging markets constitute just a tiny fraction of the wine auction market, just a couple of percent," says Dr. Sanning.

Wine markets at the investment level seem to work in a different way from other asset classes. A recent analytical paper by Philippe Masset indicates how wines fared in the U.S. financial crisis, where broad markets were down nearly 50%. In comparison, top Bordeaux were down by only 15-18%. "When future real investments seem low across markets, if you have low expected growth rates or low future real returns, the marginal utility of savings is lower, so people may tend to consume more, which in turn drives up the price of consumables. Luckily wine is a consumable," says Dr. Sanning. "If my stock fund isn't going to do so well this year, maybe I'll just buy a little more wine, or consume more wine if my marginal utility savings is lower," he adds.

Planning an exit strategy when dealing with wine investments can bring far more joy in comparison to selling non-consumable assets. Investors always have the implied real option to consume. For instance, to maximize the option value one should purchase investment grade wines that you personally hold in high regard; then if prices decline, pop their corks and enjoy drinking them. "In addition, if you're into top grade Bordeaux I would think if you should have an exit horizon of at least two to three months—by the time you contact the wine house and get the wine shipped. As long as you have three months and you're willing to pay the transaction costs, you should be able to exit your position," says Dr. Sanning.

"I think you have to be up on your knowledge, both in financial terms and wine terms, to structure a successful wine fund or wine portfolio," says Dr. Sanning, "whether this balance comes from a management team, large fund, mutual funds, hedge fund, wherever. For instance, you have a team of experts going together and you have someone who is specializing in small cap firms in Southeast Asia and someone else in mid cap firms in Southeast Asia, so you break out your research that way and I'm sure it works similarly in wine funds. I suspect that in some of the wine investment funds that started up, there were more wine experts than finance experts, and that could cause problems. It is a fine balance."

Dr. Sanning says that the benefits of the funds themselves boil down to provenance; if they are large enough the funds can buy directly from the chateau. Similar to a hedge fund, you can have so much capital influence that it is possible to move the market. "If I want to buy some Lafite I have to buy futures and have a relationship with K&L wines in California or Binny's Wines in Chicago, for instance, and they are taking a cut. I eventually get delivery and I put that wine in my cellar. If I'm going to sell it later on, someone is going to want to know if it has been stored properly, so I have to invest in a $4,000 storage cabinet or a $20,000-$30,000 custom cellar with refrigeration and humidity regulators," he says. So storage expenses are another cost of wine investment.


Special Report: Coming June 2013
EMERGING
MINING
EXPLORING NEW
REGIONS AND
MINERALS