ALTERNATIVE
Emerging Investor

Issue 5 - February / March

2013 in Review

- LatAm Hedge Funds
- African Equities
- African Private Equity

China's Liquidity Paradox

Safe in Belize

I would like to first wish all of our readers a happy and prosperous 2014. Thinking about starting a new year, the glass half full view sees all the potential, the possibilities the coming year has to offer, while the opposite view goes along with a “same stuff, different year” mentality. Both sentiments have some value, and it’s true that most industries, plans and trajectories do fall into familiar path and patterns, but the emerging markets are in a constant state of flux. Indeed, this is one of the main reasons they are so interesting.

2014 has started off as most other years have started for emerging markets, with millions of things happening. We discussed Thailand as the stable rock from which to invest in Myanmar, and now we see that stability trading places. Despite the much-maligned Argentina becoming an investment pariah, the local stock exchange was up over 88% last year, confirming the opinion of many contrarian investors. Also, we see increased usage of another Jim O’Neil special, MIST (for Mexico, Indonesia, South Korea, and Turkey). While I believe these acronyms are fairly useless, they do increase the exposure of emerging markets to the world, I wonder if country selection is in any way based on how well it will work as an acronym. My selection would be Peru, Nigeria, Vietnam, but PNV is in no way catchy.

While emerging markets can be confusing, frustrating or challenging, they are never boring. German philosopher Arthur Schopenhauer said, “The two enemies of human happiness are pain and boredom.” I wish you all as little of both as possible in this new and exciting year.

Saludos,

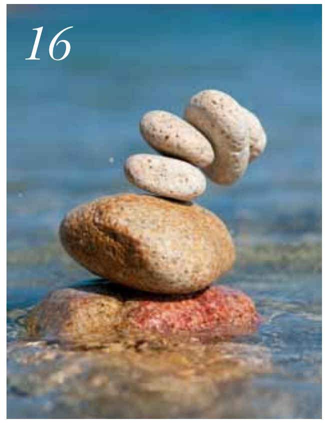
Nate Suppaiah
Managing Editor
editor@aeinvestor.com
202-905-0378

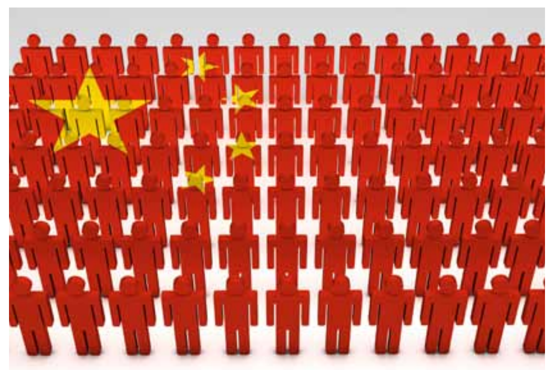
ALTERNATIVE EmergingInvestor

Contact:
info@aeinvestor.com | (202) 905-0378

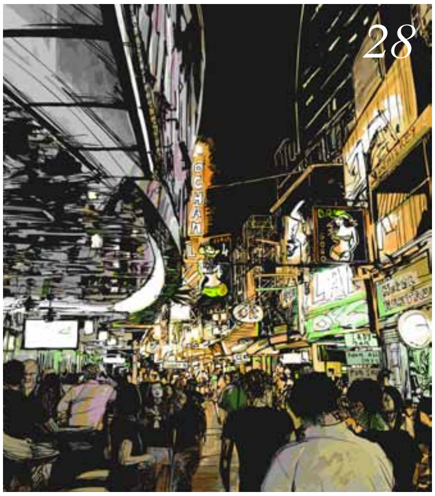
Contents

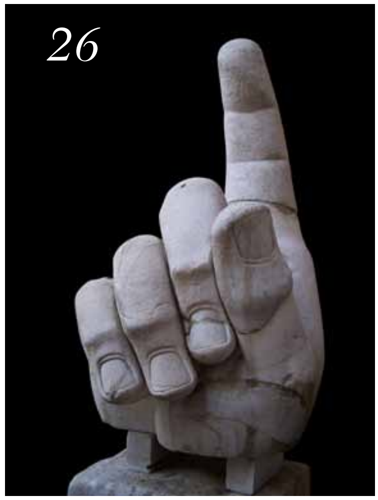
Issue 5 - February / March





24


28


26


67


48

China's Three Challenges in 2014

Minxin Pei

Since ascending to the Chinese Communist Party's top post in November 2012, Xi Jinping has confounded observers. While his political strategy has entailed tightening the CCP's control over ideology, cracking down on official corruption, repressing dissent, and championing a more nationalistic foreign policy, he has announced an unusually bold economic-reform blueprint.

The world will soon find out whether Xi's politically conservative course is intended to facilitate his pro-market economic reforms. Having spent 2013 consolidating his position and formulating his agenda, this year Xi will have to begin delivering on his promises and demonstrating that he is as capable of applying power as he is at accumulating it. His success will depend on how he addresses three major challenges.

The first challenge confronting Xi in 2014 is undoubtedly implementation of his economic-reform package, which has aroused both excitement and skepticism since it was unveiled in mid-November. Optimists point to the package's ambitious goals as evidence of Xi's commitment to reform, while critics cite its vagueness and lack of a specific timetable as grounds for caution.

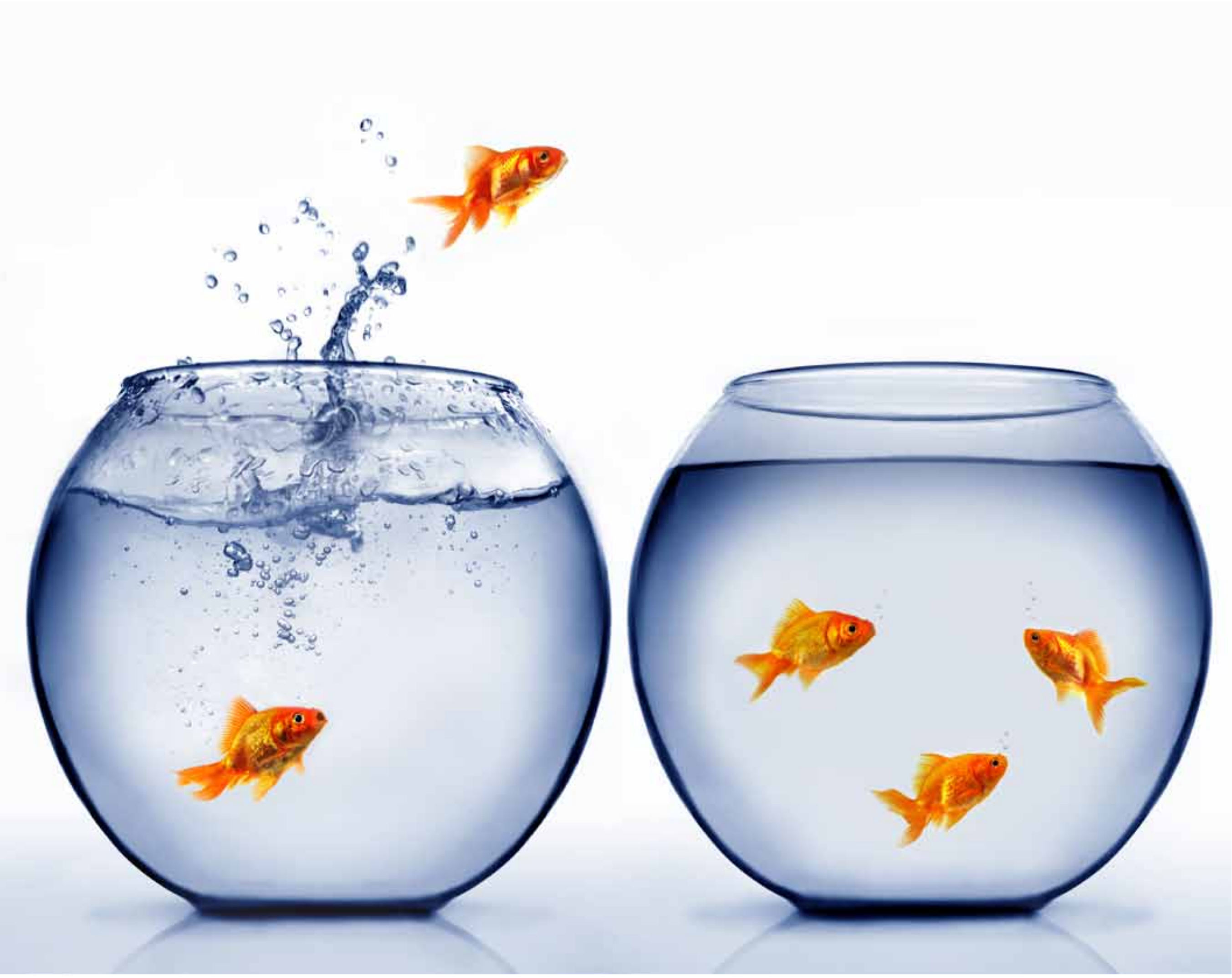
In order to prove the skeptics wrong, Xi must translate rhetoric into policy, and policies into concrete, measurable results. This means starting the new year by implementing reforms that require only administrative action, such as granting licenses to private banks, increasing competition by removing barriers to entry for private firms, liberalizing interest and exchange rates, and extending residency rights to migrant laborers in small cities and towns. Xi will have to follow these measures with legislation that formalizes some of the most critical reforms. Here, land reform will be the most difficult issue. Xi's agenda offers only vague promises of increased property rights for farmers, while recent government pronouncements indicate that the bureaucracy wants to restrict such rights. In this context, Xi must convince the public that he will not allow vested interests to block change.

The second major challenge that Xi faces in 2014 is sustaining his highly popular – and hugely risky – anti-corruption campaign. Given that Xi has ruled out mobilizing the Chinese public to support his reform plans, his only means of forcing the bureaucracy to comply with his agenda is the threat of corruption investigations and prosecutions.

But this strategy will be difficult to execute, owing not only to the vast scale of corruption, but also to its critical role in distributing rents among factions and interest groups. An anti-corruption campaign that targets a large number of Chinese officials is likely to result in alienation, discontent, and division among the ruling elites.

Beginning with Deng Xiaoping, the post-Mao regime has worked hard to ensure the physical security of its top officials, thereby avoiding Mao's mistake of turning internal power struggles into life-and-death contests in which nobody is safe.

The real litmus test of Xi's intentions will be whether his government prosecutes



Zhou Yongkang, a former member of the Politburo Standing Committee, the CCP's highest policymaking body. According to official reports, Xi's anti-graft noose has been tightening around Zhou since the arrest of many of his former lieutenants.

But prosecuting even a retired member of the Politburo Standing Committee would break a long-standing taboo. Beginning with Deng Xiaoping, the post-Mao regime has worked hard to ensure the physical security of its top officials, thereby avoiding Mao's mistake of turning internal power struggles into life-and-death contests in which nobody is safe. Thus, while ordinary Politburo members have been targeted in the past (three have been imprisoned), members of its Standing Committee have been off limits.

So now Xi faces a dilemma. If he abides by the unwritten rule against prosecuting even former Standing Committee members, he risks undermining the credibility of his anti-corruption campaign. But if he puts his former colleague in jail, he could undermine cohesion among China's top leadership.

The third challenge that Xi faces is avoiding an unnecessary conflict with Japan. China's recent announcement of an Air Defense Identification Zone covering the disputed Senkaku Islands (called the Diaoyu Islands in China), followed by Japanese Prime Minister Shinzo Abe's visit to the controversial Yasukuni Shrine, suggest that the bilateral relationship – already at its lowest point in 40 years – will continue to deteriorate.

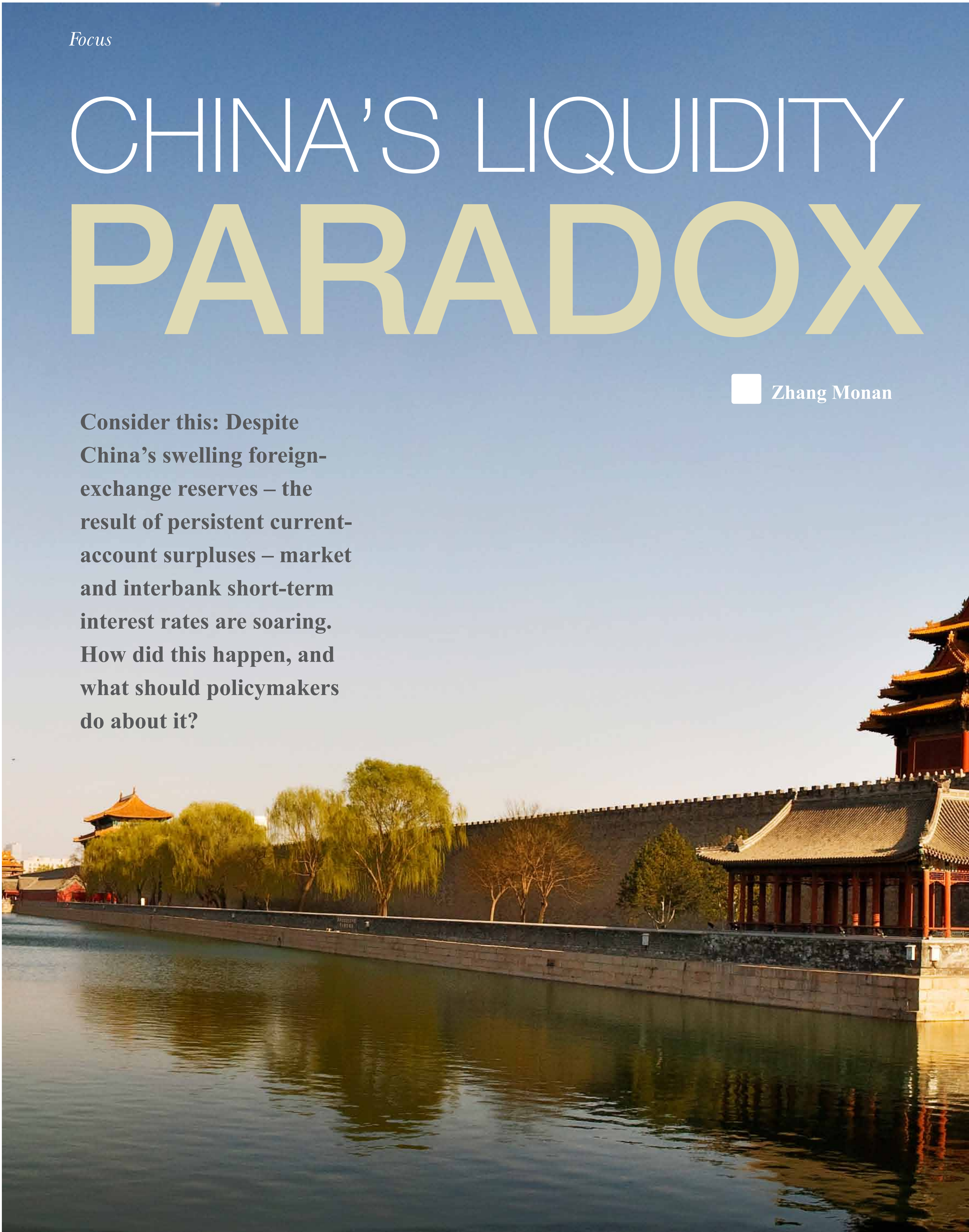
Xi and his advisers should not succumb to the illusory belief that such a conflict would boost their standing with the Chinese public. Japan, with its U.S. backing, would inflict a humiliating military defeat on China. With his political future depending on his ability to deliver on his reform promises, the last thing Xi needs is a foreign-policy distraction – let alone a disastrous military misadventure.

The stakes are high for Xi and China in 2014. That means the stakes are high for the rest of the world as well.

CHINA'S LIQUIDITY PARADOX

Zhang Monan

Consider this: Despite China's swelling foreign-exchange reserves – the result of persistent current-account surpluses – market and interbank short-term interest rates are soaring. How did this happen, and what should policymakers do about it?



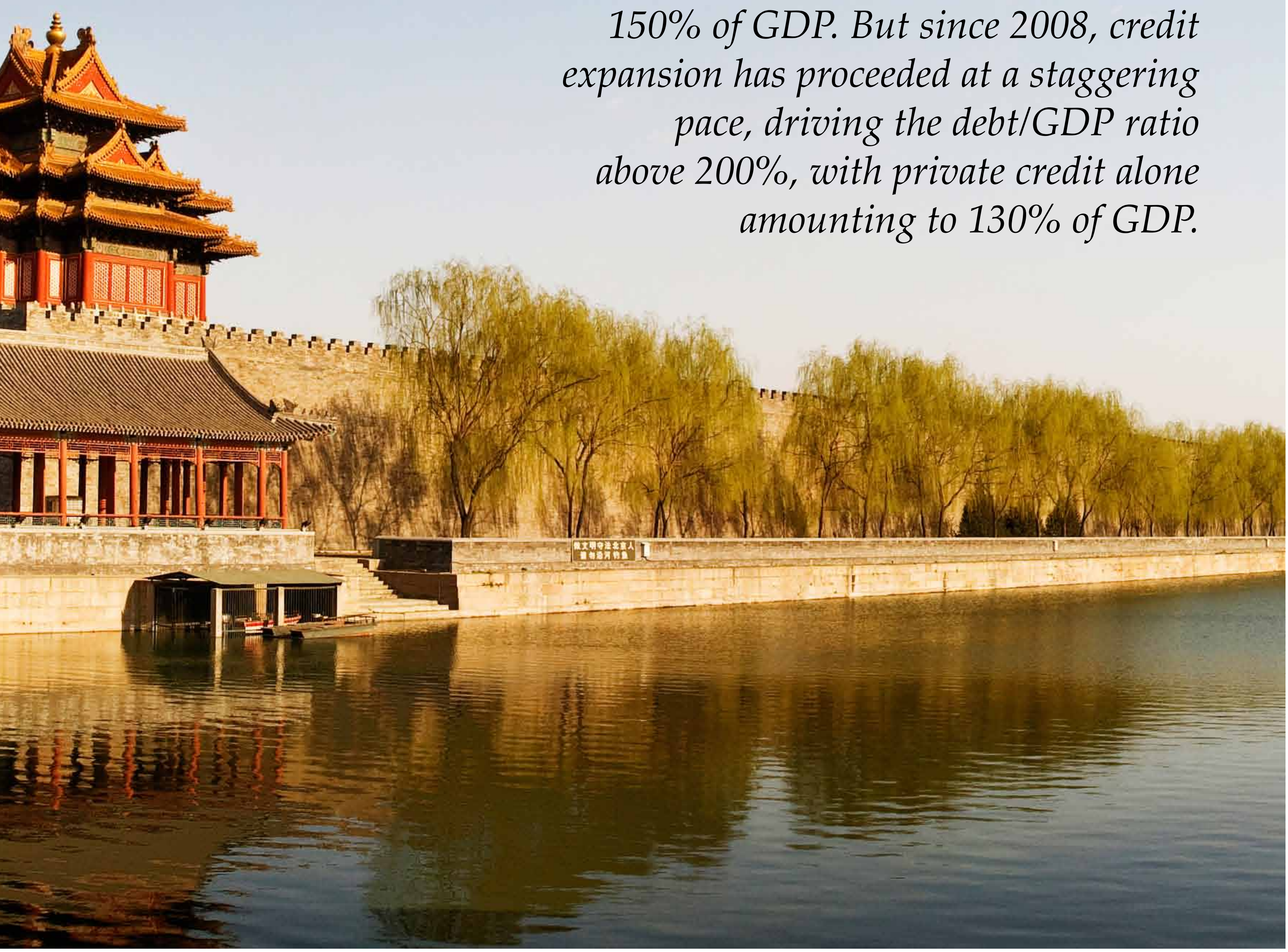
The problem is, at root, structural. China's monetary stock is relatively abundant. As the world's largest currency issuer, China's broad money supply (M2) is 1.5 times larger than that of the United States, with an M2/GDP ratio of about 200%, compared to about 80% in the U.S.

China's economy is also highly leveraged. In the years prior to the global financial crisis, China's total debt hovered around 150% of GDP. But since 2008, credit expansion has proceeded at a staggering pace, driving the debt/GDP ratio above 200%, with private credit alone (including to state-owned enterprises) amounting to 130% of GDP.

Moreover, China continues to attract huge amounts of cross-border capital as advanced countries like the U.S. pursue expansionary monetary policies. According to a recent renminbi credit report, the People's Bank of China's foreign-exchange reserves climbed to ¥27.5 trillion (US$4.5 trillion) in September, up ¥126.3 billion from August – the largest monthly gain since April. At the same time, the PBOC's new renminbi funds outstanding for foreign exchange – the amount of renminbi the central bank spends to purchase foreign-currency assets – totaled ¥268.2 billion, reflecting a monthly increase of almost ¥170 billion.

Instead of easing liquidity constraints, as expected, these gains have exacerbated them, reflected in a spike in the interbank interest rate in October, when the seven-day rate soared to 5% and the yield on ten-year government bonds reached a five-year high. It is here that the paradox plaguing Chinese economic policy lies.

In the years prior to the global financial crisis, China's total debt hovered around 150% of GDP. But since 2008, credit expansion has proceeded at a staggering pace, driving the debt/GDP ratio above 200%, with private credit alone amounting to 130% of GDP.



Increasingly strained liquidity seems to be the consequence of all of the government's recent actions. Earlier this year, the PBOC attempted to clean up its toxic assets and promote bank deleveraging. While these efforts contributed to a contraction in asset and debt growth, they also led to a severe liquidity squeeze that rocked financial markets and sent money-market rates soaring in June.

The PBOC has since resumed its reverse repo operations – purchasing securities from commercial banks with an agreement to resell them in the future – thereby injecting liquidity into the banking system. But, given a rising bidding rate, peaking capital costs, and restrictions on the downstream transfer of assets, these efforts seem unlikely to ease the strain.

Clearly, China's problem is not insufficient assets or liquidity. Rather, capital-structure and maturity mismatches – a result of the rapid and uneven buildup of debt in the last five years – have distorted the allocation of resources, leading to non-performing, idle, and inefficient assets, thereby amplifying the financial system's hidden flaws and increasing risk.

Furthermore, the financial system has become excessively dependent on credit, especially when it comes to risk assets. With financing channels extremely limited, banks have been forced to participate heavily, assuming substantial risk, which is aggravated by underdeveloped bond and stock markets. In such a concentrated risk environment, any shock could amount to a systemic blow to the financial sector.

Making matters worse, the financial sector is increasingly diverging from the real economy. As the money supply grows, capital efficiency declines. With a substantial share of financial resources being allocated to infrastructure and real-estate development, which have lower output efficiency, capital has tended to circle back into the financial system, instead of flowing toward activities in the real economy.

Finally, China's balance-sheet recession has barely begun. Since 2008, liquidity-thirsty local governments have used a variety of measures, including off-balance-sheet loans and interbank debt financing, to channel capital into local-government financing vehicles and state-owned companies. This has driven up the debt ratios of governments, businesses, and banks, causing their balance sheets to deteriorate rapidly. Now, the pressure to deleverage is on – a process that will inevitably lead to liquidity tightening.

In short, China's liquidity troubles are rooted in the recent buildup of leverage, which has triggered debt deflation.

Debt repayment is critical to a functioning financial system. Indeed, according to the American economist Irving Fisher's long established "debt-deflation" theory, when an over-indebted economy suffers a shock, the joint effects of debt and deflation can trigger a downturn.

Such an outcome would cause public- and private-sector balance sheets to deteriorate further, raising fears of default and increasing the cost of financing. Subsequent efforts to deleverage would cause balance sheets to contract and reduce the money multiplier, thereby diminishing confidence and hurting borrowing.

These changes in risk appetite are already contributing to a rising preference for cash. While cash hoarding pushes down nominal interest rates by reducing currency in circulation, the rapid decline in inflation will drive up the actual interest rate, thereby aggravating the debt burden.

In short, China's liquidity troubles are rooted in the recent buildup of leverage, which has triggered debt deflation. With this in mind, macroeconomic policy should not only reduce borrowing and financing costs through cuts in interest rates and reserve requirements, but also work to strengthen balance sheets.

That means abandoning the investment-driven growth model, promoting deep monetary and financial reform, boosting investment efficiency and resource allocation, and improving the government's functioning. This is a tall order – one that can be met only by a long-term commitment from policymakers.

The Global Economy in 2014

Klaus Schwab

At the dawn of a new year, the world is in the midst of several epic transitions. Economic growth patterns, the geopolitical landscape, the social contract that binds people together, and our planet's ecosystem are all undergoing radical, simultaneous transformations, generating anxiety and, in many places, turmoil.

From an economic standpoint, we are entering an era of diminished expectations and increased uncertainty. In terms of growth, the world will have to live with less. To understand the implications of this, consider the following: If the global economy grew at its pre-crisis pace (more than 5% per year) for the foreseeable future, its size would double in less than 15 years; at 3%, doubling world GDP would take about 25 years.

This makes a significant difference to the speed at which wealth creation occurs, with profound effects on expectations. We ignore the power of compound growth to our detriment.

As for uncertainty, the world's four largest economies are currently undergoing major transitions. The U.S. is striving to boost growth in a fractured political environment. China is moving from a growth model based on investment and exports to one led by internal demand. Europe is struggling to preserve the integrity of its common currency while resolving a multitude of complex institutional issues. And Japan is trying to combat two decades of deflation with aggressive and unconventional monetary policies.

For each, the formulation and outcome of complex and sensitive policy decisions implies many "unknowns," with global interdependence heightening the risk of large unintended consequences. For example, the U.S. Federal Reserve's policy of quantitative easing (QE) has had a major effect on other countries' currencies, and on capital flows to and from emerging markets.

When QE was launched, it was the least flawed of the available policies, and it averted a catastrophic global depression. But its downsides are now apparent, and its abatement in 2014 could fuel further uncertainty.

The Fed's QE policy, and variants of it elsewhere, have caused the major central banks' balance sheets to expand dramatically (from US$5-6 trillion prior to the crisis to almost US$20 trillion now), causing financial markets to become addicted to easy money. This has led, in turn, to a global search for yield, artificial asset-price inflation, and misallocation of capital.

As a result, the longer QE lasts, the greater the collateral damage to the real economy. The concern now is that when the Fed begins to taper QE and dollar liquidity drains from global markets, structural problems and imbalances will resurface. After all, competitiveness-enhancing reforms in many advanced economies remain far from complete, while the ratio of these countries' total public and private debt to GDP is now 30% higher than before the crisis.

> *Improvements in the eurozone are real but tenuous. The good news is that the disaster predicted by many pundits has been avoided, and the recession is coming to an end.*

This source of uncertainty coincides with weakening performance in many emerging countries. Back in 2007, emerging-market growth was expected to outpace that of advanced economies by a wide margin, before converging. Today, the advanced economies contribute more to global GDP growth than emerging countries, where growth is forecast to average 4% in the coming years.

Economic conditions are slowly improving in high-income countries, but a range of downward pressures may persist for years. The U.S. economy, for example, remains stuck in a subpar recovery; inflation is too low and unemployment is too high. Official data have often been better than expected, reflecting how resilient, adaptive, and innovative the U.S. economy is, but pre-crisis consumer-spending and growth patterns are unlikely to recur.

Improvements in the eurozone are real but tenuous. The good news is that the disaster predicted by many pundits has been avoided, and the recession is coming to an end. But improvement does not mean resurgence: achieving the robust growth needed to reduce high unemployment, lower the debt/GDP ratio, and improve the fiscal outlook remains elusive. The greatest risk for the eurozone in the foreseeable future

is not a disorderly exit by some countries, but rather a prolonged period of stagnant growth and high unemployment.

Meanwhile, the emerging-market slowdown may well persist, particularly in the largest economies. Over the past 15 years, the BRICs (Brazil, Russia, India and China) have achieved remarkable progress, but their reforms – including new banking regulations and currency regimes – have been among the least difficult to implement.

So-called second-generation reforms, which are more structural in nature, are vital to long-term growth but much more difficult to realize. Elimination of subsidies, labor market and judicial reforms, and effective anti-corruption measures are politically charged and often are blocked by powerful vested interests.

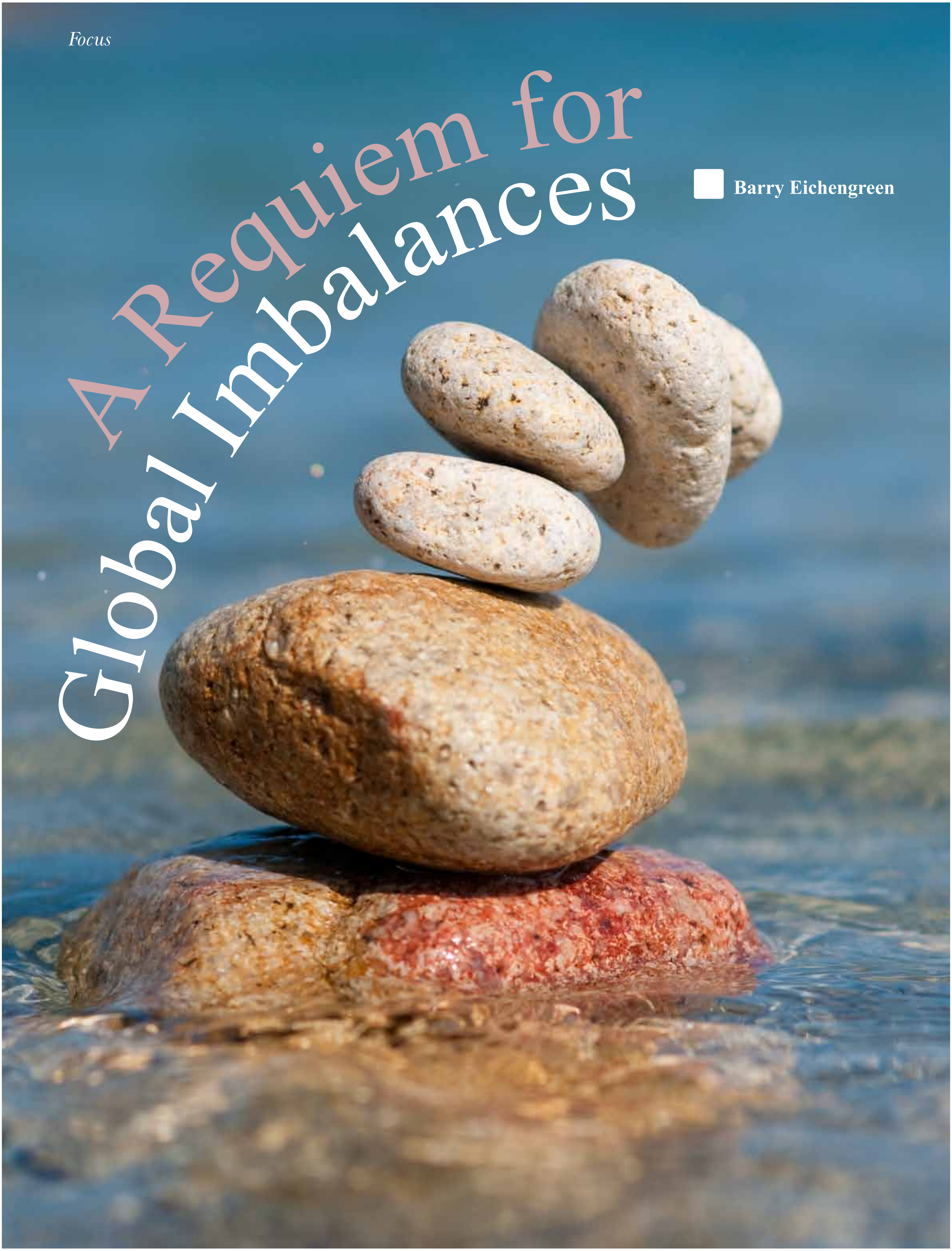
The global growth slowdown is taking place against a backdrop of rising economic inequality, owing to labor's declining share of national income – a worldwide phenomenon, resulting from globalization and technological progress, that poses a serious challenge to policymakers. Systems that propagate inequality, or that seem unable to stem its rise, contain the seeds of their own destruction. But in an interdependent world there is no obvious solution, because the high mobility of capital fuels global tax competition.

Even in stronger-performing countries, such as the U.S. or the United Kingdom, faster GDP growth has yet to boost real incomes. In the U.S., for example, median household income has fallen by more than 5% since the recovery began. More generally, lower growth is fueling popular protest and social unrest, particularly in countries that were growing rapidly (for example, Brazil, Turkey and South Africa), owing to the impact of rising living standards on expectations.

In such a charged social and political context, reviving high-quality economic growth is crucial. But where will it come from? Technological progress is a distinct, but highly uncertain, possibility. Many disruptive technologies (for example, advanced robotics, next-generation genomics, energy storage, renewable energy, and 3D printing) could drive future growth, but their full potential can be realized only in the distant future.

With most governments facing fiscal constraints, officials are reluctant to consider projects that might increase public debt. But there is some low-hanging fruit – productive investments that would boost long-term growth and therefore pay for themselves. A focus on four areas in particular – infrastructure, education, green energy, and sustainable agriculture – could yield high economic and social returns.

Ultimately, however, the path to sustained growth requires not just new policies, but also a new mindset. Our societies must become more entrepreneurial, more focused on establishing gender parity, and more rooted in social inclusion. There simply is no other way to return the global economy to a path of strong and sustained growth.



A Requiem for Global Imbalances

Barry Eichengreen

The start of 2014 marks ten years since we began fretting about global imbalances, and specifically about the chronic trade and current-account imbalances of the United States and China. A decade later, we can happily declare that the era of global imbalances is over. So now is the time to draw the right lessons from that period.

America's current-account deficit, which was an alarming 5.8% of GDP as recently as 2006, has now shrunk to just 2.7% of GDP – a level that the U.S. can easily finance from its royalty income and returns on prior foreign investments without incurring additional foreign debt. Even more impressive, China's current-account surplus, which reached an extraordinary 10% of GDP in 2007, is now barely 2.5% of national income.

There are still a few countries with worrisomely large surpluses and deficits. Germany and Turkey stand out. But Germany's 6%-of-GDP surplus is mainly a problem for Europe, while Turkey's 7.4% deficit is mainly a problem for Turkey. In other words, theirs are not global problems.

Back in 2004, there were two schools of thought on global imbalances. The Dr. Pangloss school dismissed them as benign – a mere reflection of emerging economies' demand for dollar reserves, which only the U.S. could provide, and American consumers' insatiable appetite for cheap merchandise imports. Trading safe assets for cheap merchandise was the best of all worlds. It was a happy equilibrium that could last indefinitely.

By contrast, adherents of the Dr. Doom school warned that global imbalances were an accident waiting to happen. At some point, emerging-market demand for U.S. assets would be sated. Worse, emerging markets would conclude that U.S. assets were no longer safe. Financing for America's current-account deficit would dry up. The dollar would crash. Financial institutions would be caught wrong-footed, and a crisis would result.

We now know that both views were wrong. Global imbalances did not continue indefinitely. As China satisfied its demand for safe assets, it turned to riskier foreign investments. It began rebalancing its economy from saving to consumption and from exports to domestic demand.

The U.S., meanwhile, acknowledged the dangers of excessive debt and leverage. It began taking steps to reduce its indebtedness and increase its savings. To accommodate this change in spending patterns, the dollar weakened, enabling the U.S. to export more. The renminbi, meanwhile, strengthened, reflecting Chinese residents' increased desire to consume.

There was a crisis, to be sure, but it was not a crisis of global imbalances. Although the U.S. had plenty of financial problems, financing its external deficit was not one of them. On the contrary, the dollar was one of the few clear beneficiaries of the crisis, as foreign investors, desperate for liquidity, piled into U.S. Treasury bonds.

The principal culprits in the crisis were, rather, lax supervision and regulation of U.S. financial institutions and markets, which allowed unsound practices and financial excesses to build up. China did not cause the financial crisis; America did (with help from other advanced economies).

This is not to deny the enabling role of international capital flows. But the flows that mattered were not the net flows of capital from the rest of the world that financed America's current-account deficit. Rather, they were the gross flows of finance from the U.S. to Europe that allowed European banks to leverage their balance sheets, and the large, matching flows of money from European banks into toxic U.S. subprime-linked securities. Both critics and defenders of global imbalances almost entirely overlooked these gross flows in both directions across the North Atlantic.

The next time that global imbalances develop, analysts will – we must hope – know to look beneath their surface. But will there be a next time? A couple of years ago, forecasters were confident that global imbalances would reemerge once the crisis passed. That now seems unlikely: Neither the U.S. nor China is going back to its pre-crisis growth rate or spending pattern.

Nor are earlier trade balances about to re-emerge. America's trade position will be strengthened by the shale-gas revolution, which promises energy self-sufficiency, and by increases in productivity that augur further re-shoring of manufacturing production.

Emerging markets, for their part, have learned that export surpluses are no guarantee of rapid growth. Nor do large international reserves guarantee financial stability. There are better ways to enhance stability, from strengthening prudential supervision to taxing and controlling destabilizing capital flows and letting the exchange rate adjust.

All of this suggests that the accumulation of foreign reserves by emerging and developing countries – another phenomenon over which much ink has been spilled – may be about to peak. Then it will be just another problem laid to rest.

Mexico's Second Revolution

Mexico, a stagnant and violence-plagued country in recent years, finally began to overcome its malaise in 2013, thanks to an activist president and a coalition of political parties determined to move the country forward. But alongside substantive changes, there is considerable uncertainty and hyperbole. It could hardly be otherwise.

Jorge G. Castañeda

The situation resembles that of 20 years ago – almost to the day. When the North American Free Trade Agreement (NAFTA) among Mexico, Canada and the United States entered into force on January 1, 1994, it seemed that Mexico was poised for a true takeoff. But a series of events – the Zapatista uprising in Chiapas, the assassinations of a presidential candidate and the incoming president's chief aide, and the collapse of the currency – shook Mexico that year, underscoring the depth of the challenges it faced.

NAFTA brought with it a spectacular increase in Mexican exports, as well as a dramatic shift in their composition. But it proved to be a great disappointment in terms of foreign investment inflows and economic growth, which has averaged 2.6% per year over the last two decades – slower than Peru, Chile, Colombia, Brazil and Uruguay. As a result, Mexico's income gap with the U.S. and Canada has barely narrowed.

Thus, President Enrique Peña Nieto's task since taking office one year ago has been to ensure that the promise of major change in Mexico finally translates into sustained economic growth, improved living standards, and faster convergence with the U.S. and Canada.

While both the foreign and local press refer generally to "reforms," or lump together education, labor, financial, fiscal, energy, telecommunications, and political initiatives, there are significant differences among them. Some consider all of the changes that have taken place in Mexico this year to be equally important. Others have mused that Peña Nieto's administration sometimes seems intent on announcing reforms – regardless of their content, the time necessary to implement them, or their actual impact on Mexican society.

In fact, a clear distinction can be drawn between two subsets of legislative achievements: those that, while not meaningless, are incomplete, superficial, or essentially maintain the status quo, and those that will change Mexico (if all goes well). The changes in how teachers are evaluated and their labor rights (wrongly described as an education reform), together with changes to tax and telecommunications legislation, belong to the first category; energy and political reforms belong to the second.

Energy reform opens up electricity generation and oil exploration, extraction, and refining to private foreign or domestic investment through licenses, concessions, production sharing, or profit sharing. The oil workers' union has been banished from the board of directors of Pemex, the national oil company, and new contracts for shale oil and gas, together with deep-water prospecting and drilling, will be signed with a government agency, not with Pemex.

Once the myriad legal and political obstacles are cleared, Mexico will be able to increase oil and gas production, drive down the price of electricity, and stimulate growth in an otherwise lethargic economy. One hopes that 12 years of obstruction by Peña Nieto's Institutional Revolutionary Party (PRI) will not mean that these reforms are too little, too late.

The second crucial reform is political. For the first time since the early 1920s, Mexican legislators and mayors will be allowed to seek reelection to consecutive terms. While no panacea, reelection is one of the most important instruments of accountability in a democracy, and Mexico has been deprived of it for nearly a century. The same is true of ballot initiatives, referenda, and independent candidacies, all of which were non-existent until the recent reform. For the first time since Mexico left behind 70 years of authoritarian rule, the country has a political and electoral framework that resembles those found in all modern democracies.

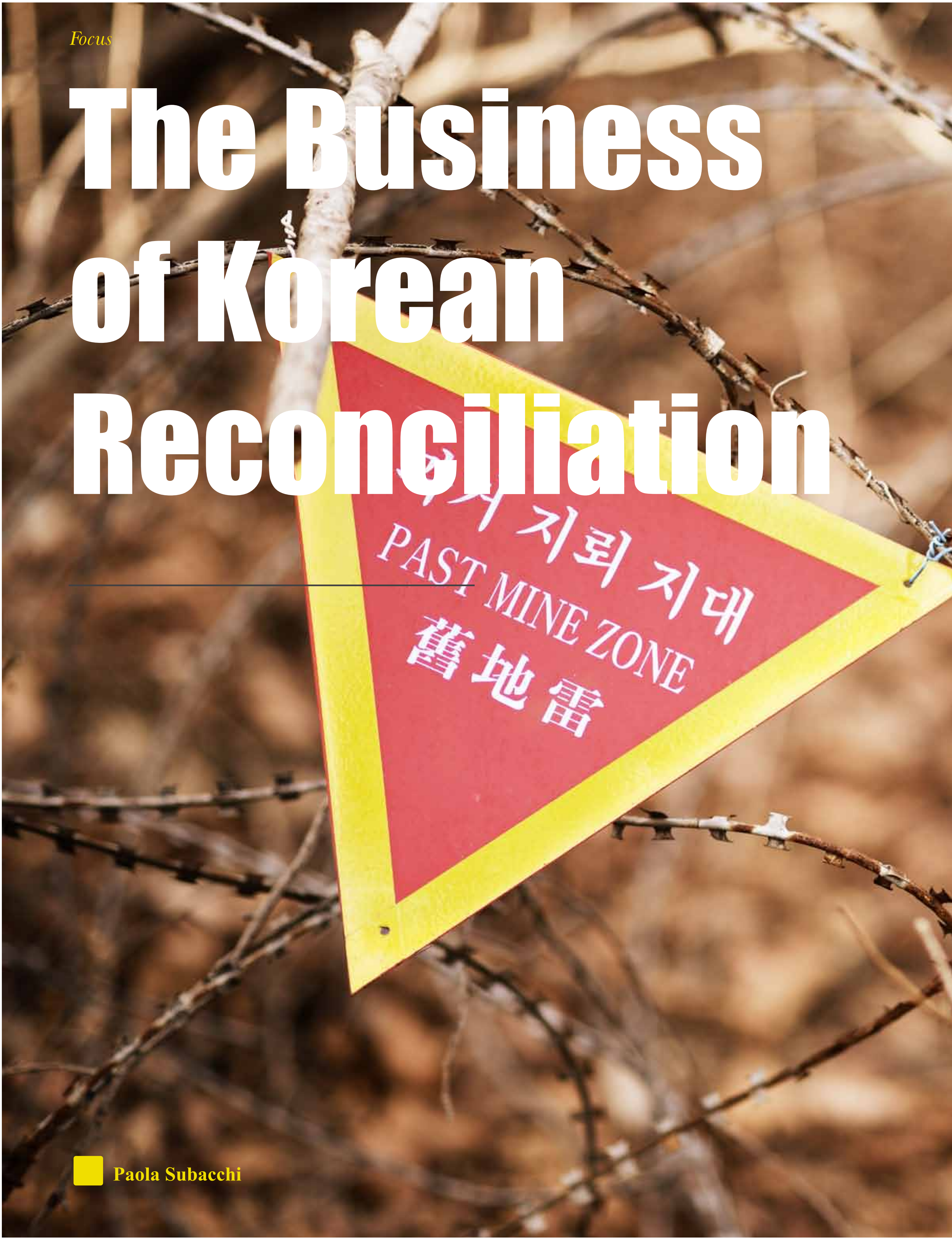
Both reforms are incomplete and may not be sufficient to jump-start the economy and mobilize a singularly passive civil society. Because Pemex, unlike the Brazilian and Colombian state-owned oil companies, will not be listed on the New York or Mexico City stock exchanges, internal reform will be postponed or half-baked. Moreover, it will be years before any oil actually begins to flow from the deep waters of the Gulf of Mexico, and how much shale oil and gas actually exists in northeastern Mexico is unknown. Nor is it certain that foreign investment (or tourism) will increase, given the country's current levels of violence, crime, and human-rights violations.

Likewise, restrictions and ambiguities continue to plague the institutional arrangements sought by the framers of the country's political and electoral reforms. Reelection is permitted only for candidates nominated by the same party for which they originally ran, and the enabling legislation for independent candidates, ballot initiatives, and referenda remains unclear.

Most important, the government appears to be backtracking on a commitment to allow a binding referendum on the opening of the oil sector and other "transcendent" issues. Its reluctance is understandable, because voters are evenly divided on the issue, and no one will invest a cent in Mexican oil or gas if the recently approved constitutional amendment on Pemex can be overturned in 2015, as the opposition claims will happen. But curtailing democracy in order to modernize the energy sector is not a good idea.

Finally, skepticism persists with regard to the Mexican economy's capacity to achieve sustainable 4-5% annual economic growth – the bare minimum needed to ensure long-term prosperity. Deficient education, infrastructure, security, and courts, together with endemic corruption and scant entrepreneurial dynamism, militate against excessive optimism. NAFTA 20 years ago, and Peña Nieto's reforms now, are necessary but insufficient conditions for progress. More is needed, and what is needed is not necessarily attainable.

The Business of Korean Reconciliation



Paola Subacchi

Can trade and commerce foster peace and mutual understanding between hostile governments? When it comes to the Koreas, this question may seem to be beside the point, given the ruthless purge now underway in the North. But it remains an essential consideration for the longer-term future of North Korea and other outcast regimes.

The Kaesong Industrial Complex, a joint venture of the North and South Korean governments, is both a tribute to the concept of diplomatic reconciliation through business and a difficult test of its feasibility. Roughly 50,000 North Korean workers are employed in 123 factories that produce about US$450 million worth of goods (mainly textiles, shoes, and household goods).

Kaesong is an expensive investment for South Korea, which provides capital and infrastructure, including a power station, a water purification plant, and a hospital. But, more than a decade after its inauguration, the complex runs at 40% capacity and has attracted only medium-sized companies.

Despite generous tax incentives, South Korea's huge conglomerates, the *chaebol*, have spurned the experiment, at least partly because of enduring transportation and communications problems. The complex can be accessed only through the demilitarized zone separating the two Koreas, which requires entry and exit passes. The lack of mobile-phone networks and broadband internet means that South Korean managers must communicate with their headquarters by landline phones and fax.

Of course, commercial gain is not the only motivation behind the Kaesong complex. The South Korean authorities are rightly proud of the initiative, which they view as an investment in future reunification with the North.

Seen from this perspective, North Korea's recent announcement that it will open another 14 special economic zones is a positive development – one that is underpinned by significant financial incentives. Aside from enabling the North to acquire technology and learn market-oriented business practices, the Kaesong complex generates about US$80 million annually in workers' compensation (the monthly wage of US$160 is far higher than in North Korea).

But political and historical tensions continue to shape daily life in Kaesong, where companies operate under the constant threat that North Korea, for whatever reason, will react rashly, even abandoning the joint project altogether. Already last year, rising inter-Korean tensions led to a temporary shutdown of the complex.

As a result, firms must dedicate considerable time and effort to dealing with North Korea's often volatile and opaque politics, exemplified in the recent execution of North Korean leader Kim Jong-un's powerful uncle, Jang Song-thaek. This challenging climate undermines the project's viability, even though the business model – based on lower-cost workers from the North producing labor-intensive goods – makes sense.

Despite generous tax incentives, South Korea's huge conglomerates, the chaebol, have spurned the experiment, at least partly because of enduring transportation and communications problems.

Kaesong is a bit of George Orwell's *1984*, with added elements of nineteenth-century paternalism. The atmosphere is stilted and muffled, with workers moving around in silence and guards everywhere. During a recent visit – the first by a foreign delegation since 2006 – the cold and snowy weather intensified this feeling, creating the sense of being suspended in time and space.

The visit began with military jeeps escorting our convoy into North Korean territory. The vehicles' number plates were covered with white cardboard, and red flags had been affixed to the doors next to the side-view mirrors – a detail for which none of our South Korean hosts was able to offer an explanation.

Even the preparation for our visit, which was confirmed less than 24 hours before it began, was somewhat Orwellian. Detailed packing instructions were issued, informing us that we could not bring radios, mobile phones, wireless devices, printed materials, photos, cassette tapes, or DVDs.

Despite being limited to cameras with lenses under 160mm, we were not permitted to take photos of the demilitarized zone between the industrial complex and the border, or of North Korean soldiers or workers. Our cameras were checked when we left the country to verify compliance.

The border between the two Koreas is virtually impenetrable, with gates that open for a half-hour at a time a few times per day. As a result, all personal contact occurs through official channels. Even as diplomatic visitors, we were prohibited from speaking with or giving anything to the workers, whom we watched with a mixture of curiosity and sympathy.

The North Koreans seemed to share our desire to connect, as they sought to engage with us to whatever extent they could. The diminutive border guard looked into my eyes, smiled warmly, and asked where I was from. Likewise, lined-up workers at one of the factories responded to my gesticulations with waves and smiles as we passed them.

Given the prevailing paranoia, fueled by propaganda and genuine ignorance, on both sides of the border, it is possible that our hosts were being excessively cautious. Nonetheless, our pre-trip "indoctrination" stifled our reactions, regrettably preventing us from trying harder to reach out to the workers we encountered – an experience that seemed to exemplify the difficulty of bringing North Korea into the international community.

Despite their flaws, initiatives like the Kaesong complex help to build an environment of collaboration and trust. As Asia's recent history shows, authoritarian regimes tend to open up in response to a combination of grassroots movements and gradual top-down reforms. North Koreans may well be prepared to provide the former, but whether the government is prepared to do its part remains highly uncertain, to say the least.

The expansion of special economic zones – supported by increased private investment, especially from firms that are not South Korean or Chinese – would significantly improve the odds that North Korea's regime eases its repressive rule and embraces a program of economic reform, as China did more than three decades ago. The task of defusing the threat to regional peace and stability that North Korea poses should be one that is shared across Asia.

China's Policy Dishamony

Stephen S. Roach

China was hardly lacking in policy pronouncements in the final months of 2013. From the 60-point reform program issued by the Central Committee's Third Plenum in early November to the six core tasks endorsed by the Central Economic Work Conference a month later, China's leaders proposed a raft of new measures to address the daunting challenges that their country faces in the years ahead.

But, seen in their entirety, the risk of incoherence has become evident. The Third Plenum initiatives, for example, have a strategic focus: promoting the economy's long-awaited pro-consumption structural rebalancing. While the Work Conference's core tasks embody the spirit of these reforms, they also reflect a tactical focus: "keeping growth steady." Given the likely tradeoffs between strategy and tactics – that is, between long-term reforms and short-term growth imperatives – can Chinese policymakers really accomplish all of their objectives?

Of course, such tradeoffs have long been evident in most economies – developed and developing alike. What has separated China from the pack has been its strong inclination to place greater emphasis on strategic objectives in charting its economic-development path.

Even so, new tensions between the Third Plenum's policies and those of the latest Work Conference have raised the question of tradeoffs once again. The consumer- and services-led rebalancing initially proposed in the 12th Five-Year Plan and endorsed by the recently concluded Third Plenum implies slower GDP growth than the 10% average annual rate recorded from 1980 to 2010.

Yet slower growth need not be a bad thing. Employment in Chinese services is about 30% higher per unit of output than in the manufacturing and construction sectors, which means that an increasingly services-led China can accomplish its critical labor-absorption objectives – namely, rapid job creation and poverty reduction – with 7-8% annual growth.

For China, rebalancing and slower growth go hand in hand – and yield the additional benefits of less intensive resource demand, a more subdued rise in energy consumption, and related progress in addressing environmental pollution and income inequality. But the recent Work Conference failed to consider China's growth slowdown in this strategic context, placing considerable weight instead on the macro-stabilization imperatives of "proactive fiscal and prudent monetary policies."

Since the Work Conference was concluded, investors have been debating the 2014 growth target. Will the 7.5% objective set for 2013 be maintained next year, as a recent leak from senior Chinese officials seems to indicate, or do the recent pronouncements indicate further deceleration toward 7%?

The answer will be revealed at the National People's Congress in March. But focusing on a near-term growth target and fine-tuning fiscal and monetary policies in order to achieve it – to say nothing of yet another credit crunch roiling Chinese short-term funding markets – detracts from the emphasis on strategic shifts that economic rebalancing now requires.

Indeed, most of the six major economic tasks for 2014 set by the recent Work Conference – including efforts aimed at ensuring food security, containing local-government debt, and improving coordination of regional development – have little or nothing to do with China's strategic rebalancing imperatives. Though laudable, they seem disconnected from pro-consumption restructuring.

In fact, only two of the six major economic tasks identified by the Work Conference fit neatly with the Third Plenum's strategic agenda. The call for enhanced social security is consistent with the Third Plenum's proposal to allocate 30% of state-owned enterprises' profits to fund safety-net programs such as pensions and health care. Likewise, the emphasis on markets' "decisive role" in upgrading China's industrial structure and eliminating excess capacity is compatible with the Third Plenum's goal of achieving a market-based shift to a consumer society.

But what emerges from all of this is yet another example of the timeworn "kitchen sink" approach to Chinese economic policy-making – countless proposals, initiatives, and goals that are loosely connected at best, and that are often plagued by internal inconsistencies. A new approach is needed, and it will require three key changes to China's economic-policy framework.

First, in keeping with global best practice, Chinese authorities need to be far more explicit (that is, transparent) in prioritizing, or ranking, their policy objectives. Setting different agendas on multiple platforms – Five-Year Plans, Third Plenums, and Work Conferences – is a recipe for confusion and potential conflict.

Second, economy-wide growth targets should be downplayed. Such targets smack of the legacy of a state-directed economy – a legacy that runs counter to policymakers' new emphasis on the "decisive role" of markets.

Finally, there is a need to separate stabilization objectives from strategic imperatives. The former should be handled by an independent central bank with primary responsibility for monetary and currency policies, whereas the latter should be the responsibility of the new Central Leading Group on Reforms, which has just been established by the Third Plenum.

Chinese policymakers' traditional emphasis on long-term strategy has enabled them to steer past the inevitable bumps on the road to economic development. Now, however, as the authorities set out on a new course aimed at sustaining China's extraordinary progress, they should act quickly to achieve greater coherence in their policy agenda.

Europe's Lessons for China's Reformers

Daniel Gros

The most important economic-policy decision of 2013 might well have been taken in November at the Third Plenum of the Chinese Communist Party's Central Committee, which pledged that the market should be given a "decisive" role in guiding China's economy. Because China is now the world's largest exporter after the European Union, and accounts for about half of global growth, decisions made in Beijing could have a more important impact on the world economy than those taken in Berlin, Brussels, or Washington.

But while China's embrace of the market and opening to the outside world has enabled it to achieve astonishing economic progress over the last three decades, the country might now have reached a level of income at which the problem is no longer "too little market." On the contrary, some of China's key problems today require a stronger role for government.

Air and water pollution, for example, can be addressed only by more state intervention, at both the central and local levels. The authorities have now made solving the problem a high priority, and there can be little doubt that China has the resources to do so – much as it created the world's largest manufacturing sector. The fight against smog and water pollution plays to the country's strength: the availability of huge domestic savings to finance the necessary investment in pollution-abatement equipment.

The dilemma for China's leaders is that meeting the need for more investment in pollution control and infrastructure makes it more difficult to achieve their goal of shifting the country's economic-growth model from one based on investment and exports to one based on consumption. But more consumption today would further aggravate the pollution problem. As a result, economic rebalancing may be delayed by the more urgent need for environmental investment.

Other areas of the economy require greater government oversight as well. Network industries like telecoms, gas, electricity and water tend to become monopolistic or oligopolistic if left to market forces alone. Well-run economies achieve higher levels of welfare not because there is less regulation of these sectors, but because more efficient regulation prevents the emergence of cartels, thereby protecting consumers.

Similar reasoning applies to reform of the state-owned-enterprise (SOE) sector. The key problem is less the form of ownership (state or private) than it is the need to ensure that these enterprises operate according to market principles and within a competitive environment.

The European experience confirms this. The Treaty of Rome, which established the common market back in 1957, did not distinguish between state-owned and private enterprises, although vast sectors of the economy (most of the coal and steel industry, and in many countries banking) were in state hands at the time. Instead, the treaty established internal-market rules that barred governments from giving their companies unfair advantages.

The prohibition on state aid was a game changer for Europe, because it forced SOEs to operate on a level playing field and thus to become as efficient as their domestic or foreign competitors. Once local politicians could no longer use the SOEs for their own goals, most member countries decided that they might as well privatize many of them. Of course, downsizing the SOE sector took time, but the direction of the process was never in doubt, because the SOEs' foreign and domestic competitors naturally provided strong political support for the European Commission's vigorous policing of state aid.

In China, too, the key issue today is the rules under which the SOEs operate. Instead of large-scale privatization, it might be better to limit state aid and give competitors legal recourse to seek redress if state aid distorts competition.

The area that has attracted the most attention is finance, and for good reason. In most of the advanced world, investment amounts to little more than 15% of GDP, compared with close to 45% for China. Financial markets are thus even more important for China than for the U.S. or Europe, and there are clear signs that the productivity of investment has been declining rapidly in China.

The lynchpin of the China's planned financial-sector reforms – interest-rate liberalization – might not address the problem. In principle, higher interest rates on lending should help to reduce over-investment. But, in a system with many (often implicit) government guarantees, it is not always the most efficient enterprises that are willing and able to pay more to borrow. Liberalizing lending rates might merely lead those with government guarantees to outbid smaller and more efficient enterprises, resulting in more misallocation of capital. This suggests that financial liberalization might be dangerous until even SOEs are subject to a hard budget constraint.

The global economy's most powerful growth engine does not need simply "more market." It needs a stronger regulatory framework to ensure that its markets maximize efficiency and social welfare.

Investors Wary as Thailand's Political Instability Dampens Medium-Term Growth

Ryan Aherin, Senior Asia Analyst at global risk analytics company Maplecroft

The ongoing political crisis in Thailand has the potential to significantly dampen 2014 growth forecasts. Thailand's economy has already begun to feel the effects of the ongoing unrest. Following a brief slump into recession in 2013, the Thai economy is being battered by weak consumer spending and a prolonged government shutdown that is delaying much-needed infrastructure investment.

The immediate effects of the crisis will be felt primarily in sectors relying on consumer demand and tourism. Consumer spending was responsible for lifting the economy when export demand was constrained, but this appears unlikely to occur again in the near term due to decreased spending as a result of the current political turmoil. Domestic demand contracted by 1.2% year-on-year in the third quarter of 2013, restraining GDP growth to a lower-than-expected level of 2.7% for that quarter.

Recurring instability is likely to continue beyond the current crisis

The most recent protests in Bangkok are the manifestation of a trend of extreme political polarization since former Prime Minister Thaksin Shinawatra was ousted in a military coup in 2006. Social and economic changes are driving the ongoing turmoil in Thai politics, and they will remain a source of division for the foreseeable future.

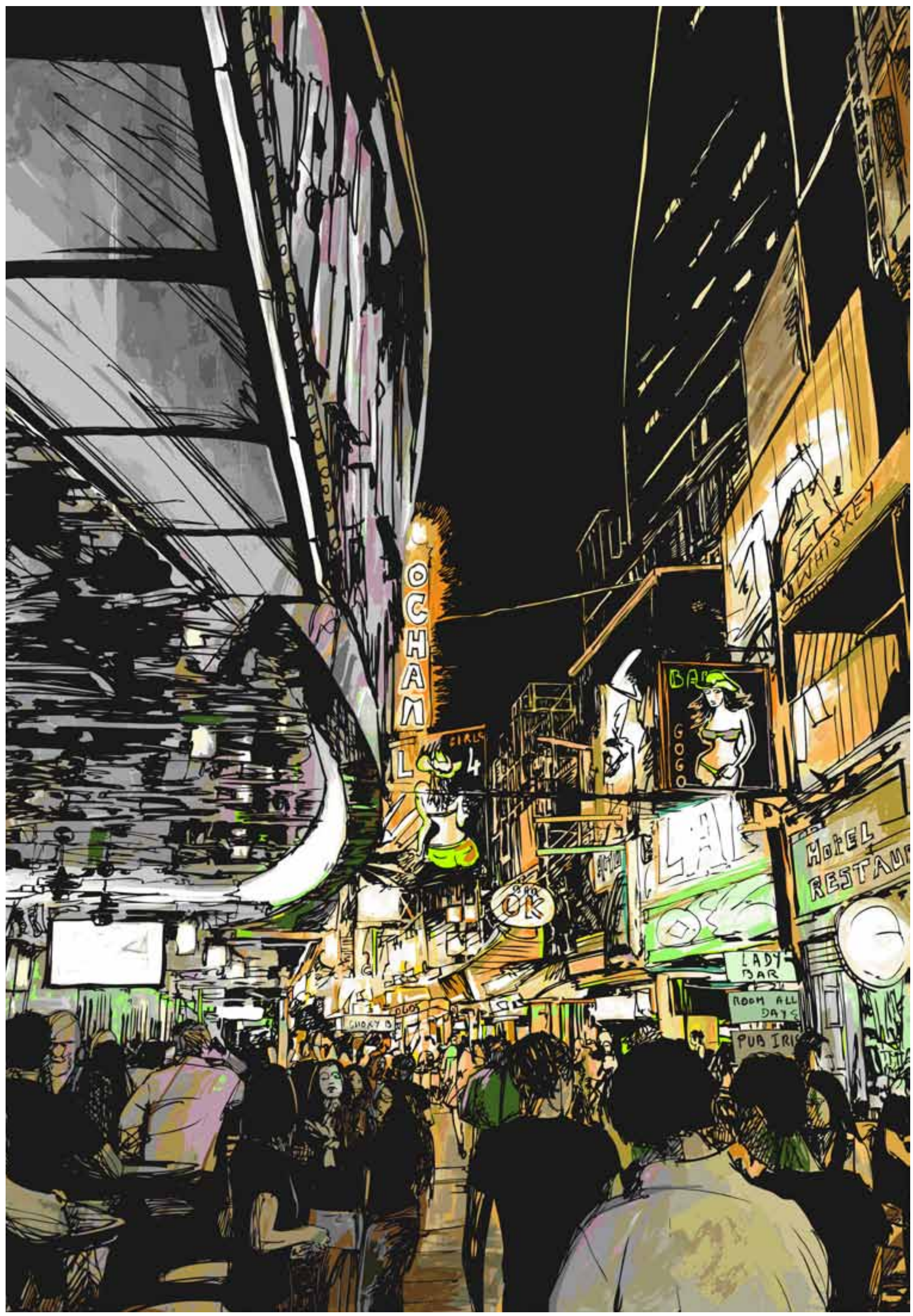
Thailand's rapid economic growth since the 1997 Asian crisis, along with Thaksin's rise to power, has brought about significant change in the distribution of political and economic influence in the country. Thailand's historically impoverished rural northern provinces have seen substantial growth in industrial and infrastructure investment over the last decade. This region has been the main beneficiary of Thaksin's (and subsequently the Pheu Thai party's) populist policies, including the provision of rice subsidies, which many in the opposition see as unsustainable and unfair.

Resentment among Bangkok's middle and upper class toward the rising electoral power of the northern population is fueling political polarization. The Democrat Party, which is largely supported by the traditional political establishment, has not won an election in over 20 years. Much of the population in Bangkok and the southern provinces resents the growing political influence of northern voters, whom they see as uneducated and backward. This resentment is the primary driver behind the protests seeking to oust Prime Minister Yingluck Shinawatra, Thaksin's sister, and remove the Shinawatra family's influence from Thai politics. Due to the high levels of mutual animosity between the opposing groups, political crises often require the intervention of a third party – typically the army or the monarchy. However, since the coup in 2006, the pro-royalist judiciary has become more involved in politics, which is affecting the ability of the current government to push through policy.

Potential judicial intervention could weaken Pheu Thai's ability to influence the current crisis

The military has thus far been reluctant to intervene in support of either side of the current conflict. Nevertheless, if the situation turns violent, risks of a military coup sharply increase. A military intervention can be expected to result in significant delays to projects approved by the Pheu Thai government. In addition, investors would need to engage with new stakeholders, as the cabinet would be reconstituted and senior bureaucrats suspected of being sympathetic to the Pheu Thai would probably be purged.

However, the most likely intervention in the current crisis would come from the judiciary. The judicial branch has become increasingly involved in Thai politics since the military coup that removed Thaksin in 2006. For instance, in 2008, the courts ordered the dissolution of the People's Power Party – the predecessor of the Pheu Thai – for electoral fraud. The judiciary could intervene in the current crisis by denying approval of candidates who failed to complete registration for the February elections (due to candidate registration stations being blocked by protesters). This would prevent the minimum required number of parliamentary seats from being filled, thus effectively leading to dissolution of the government.



The court's increased involvement in politics will also have an impact on investment in Thailand. Of particular importance is the January 8, 2014, rejection by the Constitutional Court of an amendment to the Constitution granting the executive branch greater autonomy in approving international agreements, including trade frameworks. However, the court warned that the legislation would damage the system of checks and balances and reduce transparency in the procurement process. One of the key motivations behind the amendment was to speed up the procedure for approving investments related to the government's initiative to increase investment in the country's infrastructure.

The crisis threatens much-needed investment in infrastructure in 2014

Spending on infrastructure called for in the THB2.2 trillion (US$69 billion) budget approved in November 2013 will almost certainly be delayed due to the current crisis. The Democrat Party has challenged the spending proposal in court, calling it unconstitutional, as it bypassed the annual budget process, and says the bill will raise Thailand's debt levels to unsustainably high levels.

Further cementing the judiciary's importance to current political dynamics in Thailand, on January 8 the judge presiding over the case pronounced that the high-speed rail system envisaged under the infrastructure scheme is unnecessary for Thailand. The judge's declaration, in addition to the ruling against the amendment on international agreements on the same day, comes as a major blow to the Yingluck government. This also signifies that any form of judicial intervention in the current crisis is likely to go against the government, as there is a strong bias against the current government within the nation's high courts.

The high-speed rail project had originally been introduced by the Democrat Party during its 2010 campaign. The about-face on the issue is indicative of some bias from the court against the current government. This case not only indicates the risks of politically motivated delays to infrastructure projects but also represents a direct instance of how judicial activism can encroach into policy-making in Thailand.

Thailand's economic prospects in 2014 are severely hampered by the political crisis and the resultant delays to executive decision making. The baht's depreciation has accelerated more sharply than other emerging markets in early 2014, as concerns over political instability reduce the currency's appeal to emerging market investors. With progress on infrastructure development stalled and tourism and consumer spending down, Thailand's economy will face serious challenges to growth in 2014.

Author Biography

Maplecroft is the world's leading global risk analytics, research and strategic forecasting company. We offer an unparalleled portfolio of risk indices, interactive maps, expert country risk analysis, risk calculators, scorecards and dashboards. These technological solutions identify emerging trends, business opportunities and risks to investments and supply chains worldwide.
http://maplecroft.com

Aquaculture

A New Frontier for Institutional Investors

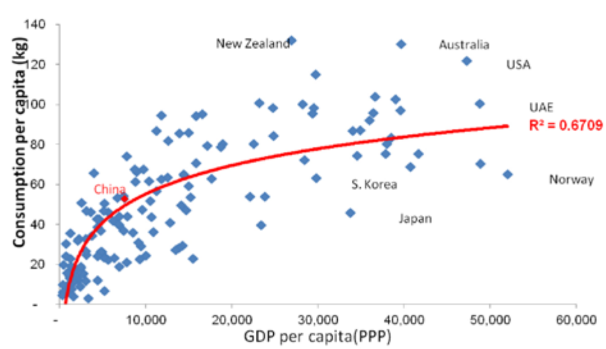
Philippe de Lapérouse
HighQuest Partners LLC

Growing Demand for Seafood

Rising GDP in developing markets throughout Asia, the Middle East and sub-Saharan Africa is resulting in the emergence of highly urbanized middle classes, which are transitioning from primarily grain-based diets to increasing consumption of animal proteins. The strong correlation between animal protein consumption and per capita GDP, referred to as Bennett's law (which posits that as individuals become wealthier, they switch from simple starchy plant-dominated diets to a more varied food input that includes a range of vegetables, fruit, dairy products, and especially meat) is illustrated in Table 1.

Table 1

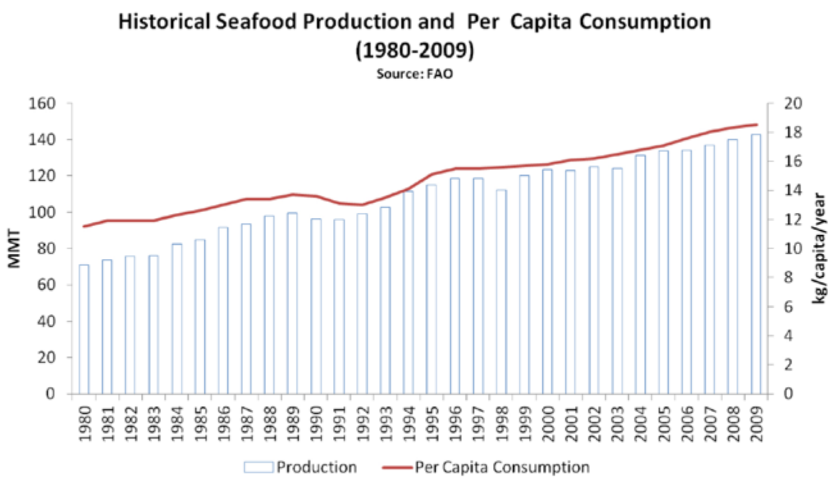
Animal Protein Consumption(kg) Per Capita vs. GDP Per Capita(PPP basis) - 2010



Source: FAO, OECD and HighQuest analysis.

While protein derived from livestock and poultry (meat, milk and eggs) has historically represented a major portion of the animal protein consumed globally in human diets, fish protein, both wild and farm-raised, represents a very healthy and efficient source of animal protein for consumers. With expected population growth in devel-

Table 2



oping markets, demand for seafood is expected to grow dramatically over the next 35 years. At the same time, health consciousness in developed markets in North America and Europe is driving increased demand for high value seafood products in developed markets.

Aquaculture to Meet Future Increases in Demand for Seafood

Due to these developments, per capita consumption of seafood on a global basis has increased by approximately 60% over the past 30 years (1980-2010) with total seafood production doubling during the same period in order to meet this growing demand (see Table 2). With the depletion of wild fish stocks due to overfishing and climate change pressures (and offtake limits imposed globally on wild catch fisheries in order to address these concerns), the volume of seafood derived from wild catch landings remains relatively flat. Therefore, in order to meet growing demand for seafood, aquaculture production will have to double or triple within the next 35 years. In fact, farm-raised seafood production already exceeded wild catch production for the first time in 2013 and is predicted to increase at a much faster rate than wild catch through 2050 (see Table 3).

While China accounts for over 60% of total global aquaculture production (see Table 4), much of it is comprised of low value fish protein produced in land-based systems as opposed to open water. With

Table 3

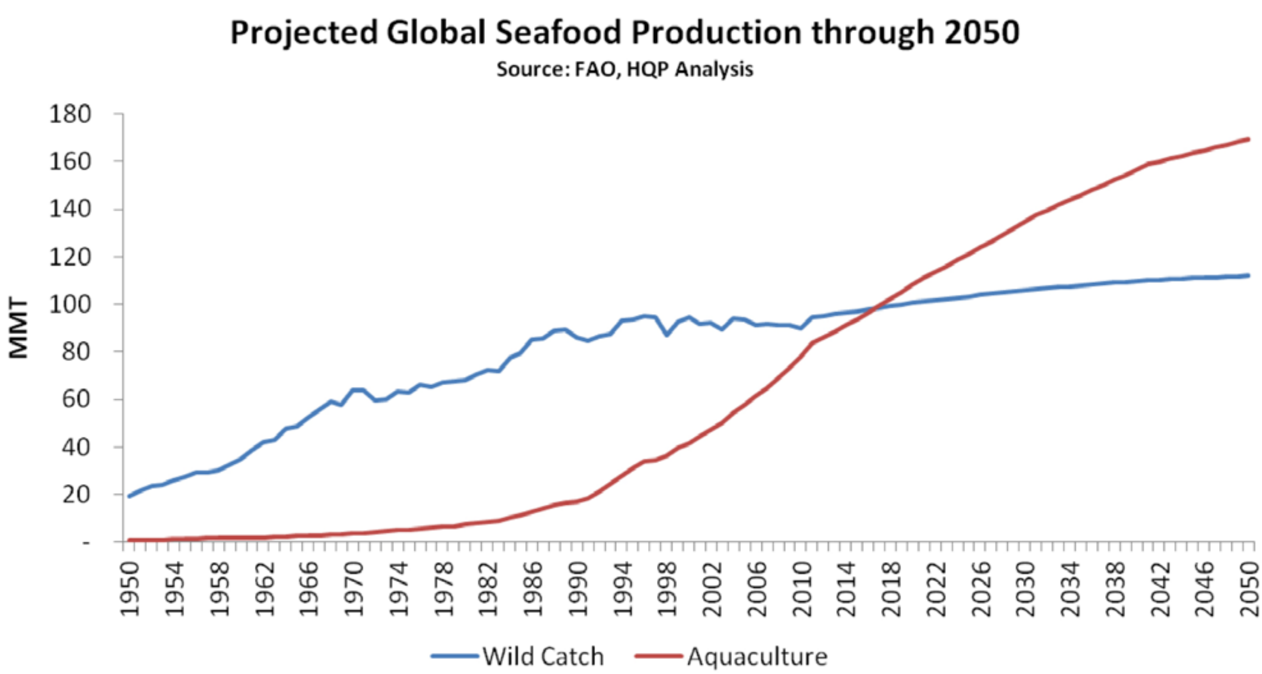


Table 4

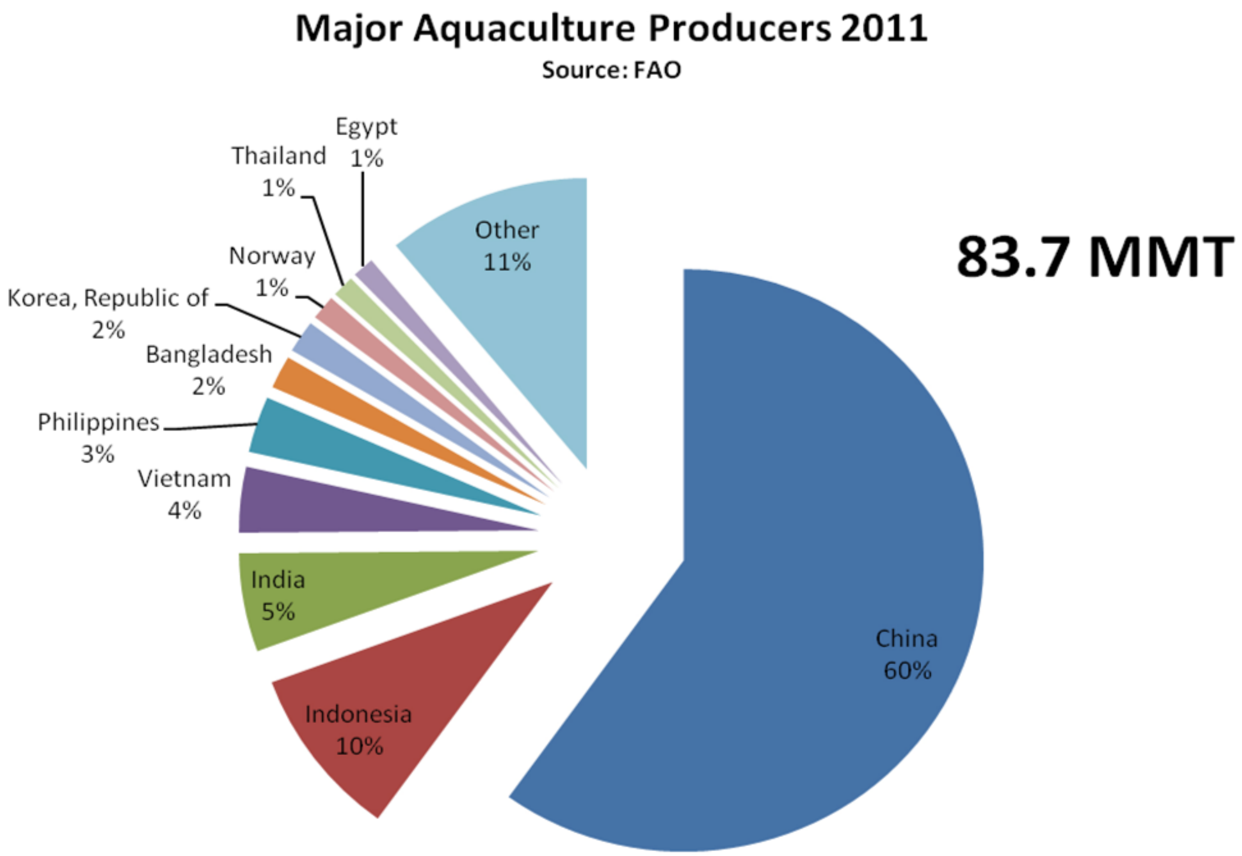
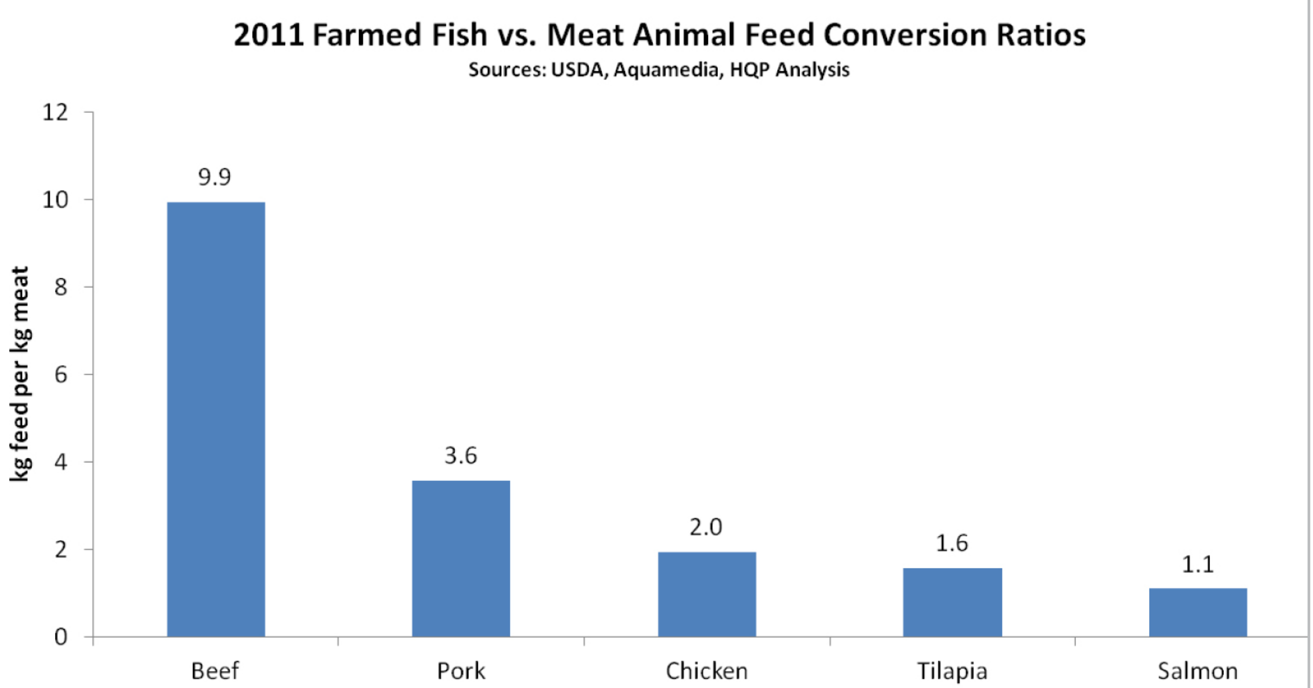


Table 5



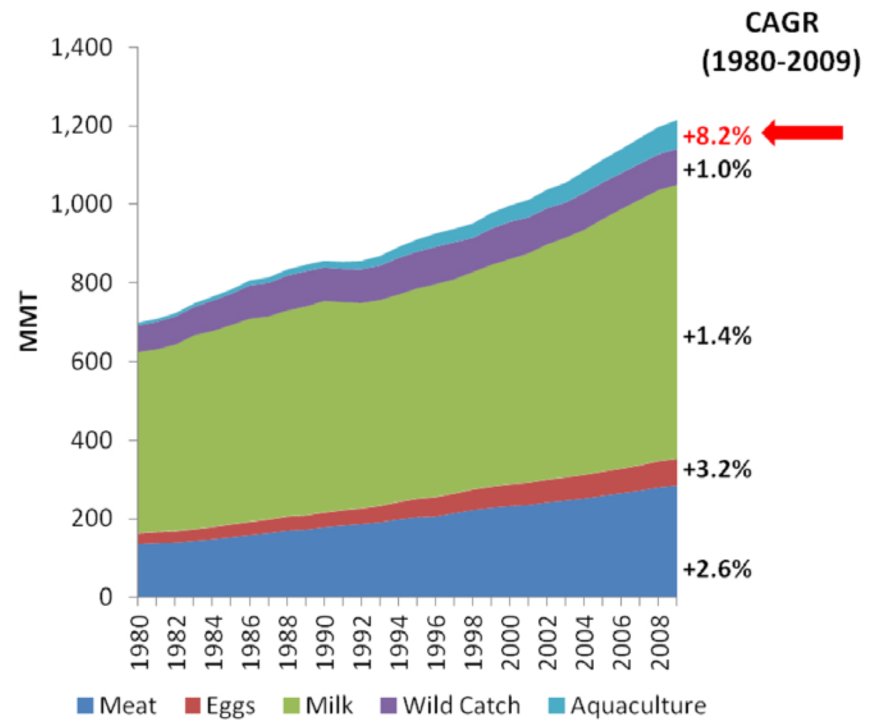
growing demand for seafood, China, historically a net exporter of seafood production, has recently become a large net importer of products to meet growing demand for higher value products, as it lacks the necessary land and water resources required to expand land-based aquaculture production.

In addition, feed conversion rates for producing a unit of farm-raised fish protein are far more efficient than those required to produce a unit of beef, pork or chicken protein (see Table 5). It is therefore no surprise that during the 1980-2009 period global aquaculture production grew at a substantially higher rate (8.2% CAGR over the period) than other sources of animal protein (see Table 6). This comparative efficiency also explains why aquaculture is expected to play a significant role in addressing food security concerns and why it is benefiting from strong support from both multilateral lending institutions as well as governments as an efficient and sustainable means of providing animal protein for growing populations.

Table 6

Global Growth in Protein Production (1980-2009)

Source: FAO



Challenges and Investment Opportunities for Increasing Production

While poised for long-term growth, aquaculture production faces a number of challenges for increasing output, which represent intriguing opportunities for investors who have a long-term focus, a thematic mindset, seek inflation protection and subscribe to the "efficient protein" story of aquaculture.

Compared to land-based animal protein production, aquaculture is a relatively nascent industry. Large-scale pond production was first developed in the 1930s and the first commercial salmon farms began operations in Norway as recently as the 1960s (see Table 7). In order to meet the

Table 7

Aquaculture Development Timeline

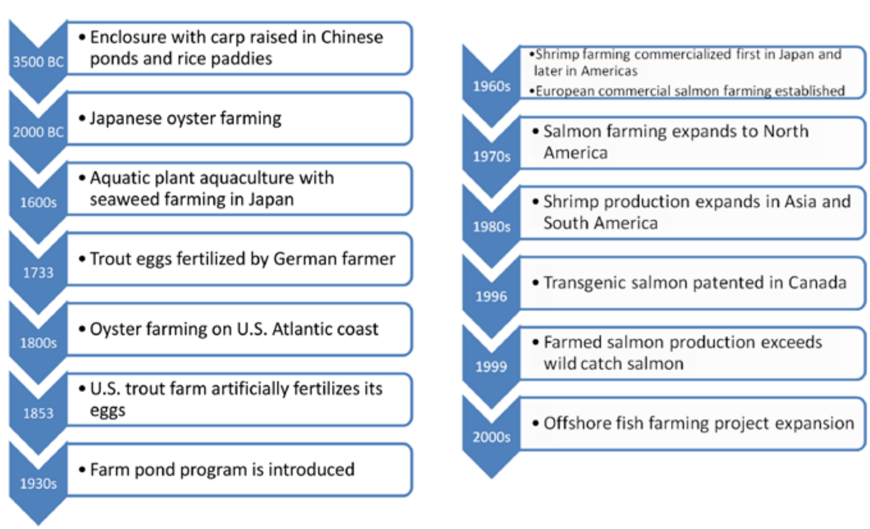
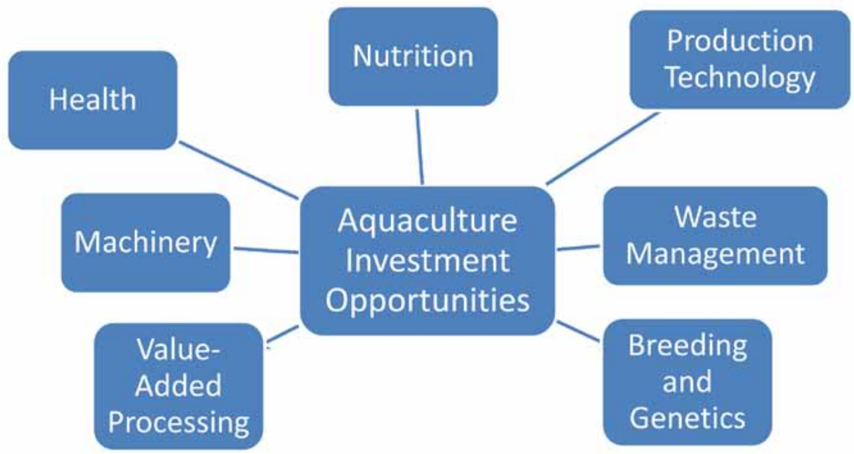


Table 8



rapidly growing demand for seafood, substantial amounts of capital will be required to support the development and commercialization of improved genetics of farmed species and new technologies for sustainable and efficient production systems both in land-based and blue water aquaculture. For example, with the decline in availability of fish meals sourced from depleted wild fish stocks, new sources of feed ingredients addressing the nutritional needs of a wide range of fish species need to be developed. The technological ecosystem required by aquaculture provides investors with a wide range of interesting opportunities to invest in "technology solutions" for the industry as well as in production systems and distribution channels (see Table 8).

As the adoption of new technologies will enable aquaculture production to scale up, the seafood industry, which is highly fragmented compared to the global meat industry (see Table 9), will begin to consolidate. This consolidation, which will be led by both aquaculture producers as well as wild capture fisheries seeking additional volumes of seafood protein to distribute through their supply chain, will also provide investment opportunities.

While targeting the most attractive sectors within aquaculture for investing is challenging, there is no question that this industry is poised for tremendous growth over the next three decades and that those who invest wisely early in the industry's expansion cycle should do well.

About the Author

Philippe de Lapérouse has more than 30 years of senior level experience working with leading global companies in the agro-industrial and value-added food chain, including Ralston Purina and Bunge, as well as working as an investment banker at the beginning of his career. As Managing Director of HighQuest Partners, he has led over 60 engagements advising strategic and financial investors operating and investing globally across the food, biotech and bioenergy value chains on making informed decisions regarding resource allocation and new business opportunities and developing strategies that address the challenges facing the global food and agriculture sector.

Mr. de Lapérouse chairs the Global AgInvestingSM conference series, the world's leading resource for events, research, and insight into the global agricultural investment sector and serves on the Advisory Committee of the Ag Innovation Showcase held annually at the Danforth Plant Science Center in St. Louis, MO.

He received his B.A. degree from Trinity College and an M.B.A. degree from The Darden School of Business at The University of Virginia.

Contact information: pdelaperouse@highquestpartners.com / (314) 994-3282(office) / (314) 960-1632(mobile)

Venezuela
Grim Outlook for 2014

Venezuela's state-controlled economy and volatile regulatory environment make it an increasingly unattractive place to invest, despite the country's tremendous oil wealth.

In June 2013, Venezuela ranked 181st out of 189 countries in the World Bank's Ease of Doing Business index. Among the criteria weighing the country down were a heavy tax burden, low investor protection and the difficulty of trading across borders. President Hugo Chavez's re-election in October 2012 was followed by increased state intervention in the economy and a wave of nationalization of natural resources. When the president's death prompted a new election in April 2013, finance professionals hoped the new government would take a more investor-friendly approach on legislation, but Chavez's chosen successor, President Nicolas Maduro, has remained on his socialist track, resulting in the country's downgrade from various risk-rating agencies.

Victor Rodriguez, President and CEO of financial services company LatAm Alternatives, explains that the investment climate in his home country is suffering dramatically from Venezuela's socialist policies.

"None of the nationals of any country like to speak about what's bad in their own country, but as a responsible Venezuelan I need to be the voice of the financial and private sector in my country: We are extremely concerned about a lack of willingness to take in the opportunities that the whole world economy might be able to present to Venezuela because of arguments and different points of view on how to run a country," Mr. Rodriguez says.

"Venezuela's leaders – government and opposition – must understand that they need to sit at a table and try to at least set some general rules in the country so it doesn't fall apart. In the whole of Latin America you have a very nice outlook but Venezuela is atypical in that you are now seeing the quality going dramatically down compared to countries like Colombia, Peru, Chile, Brazil and Mexico."

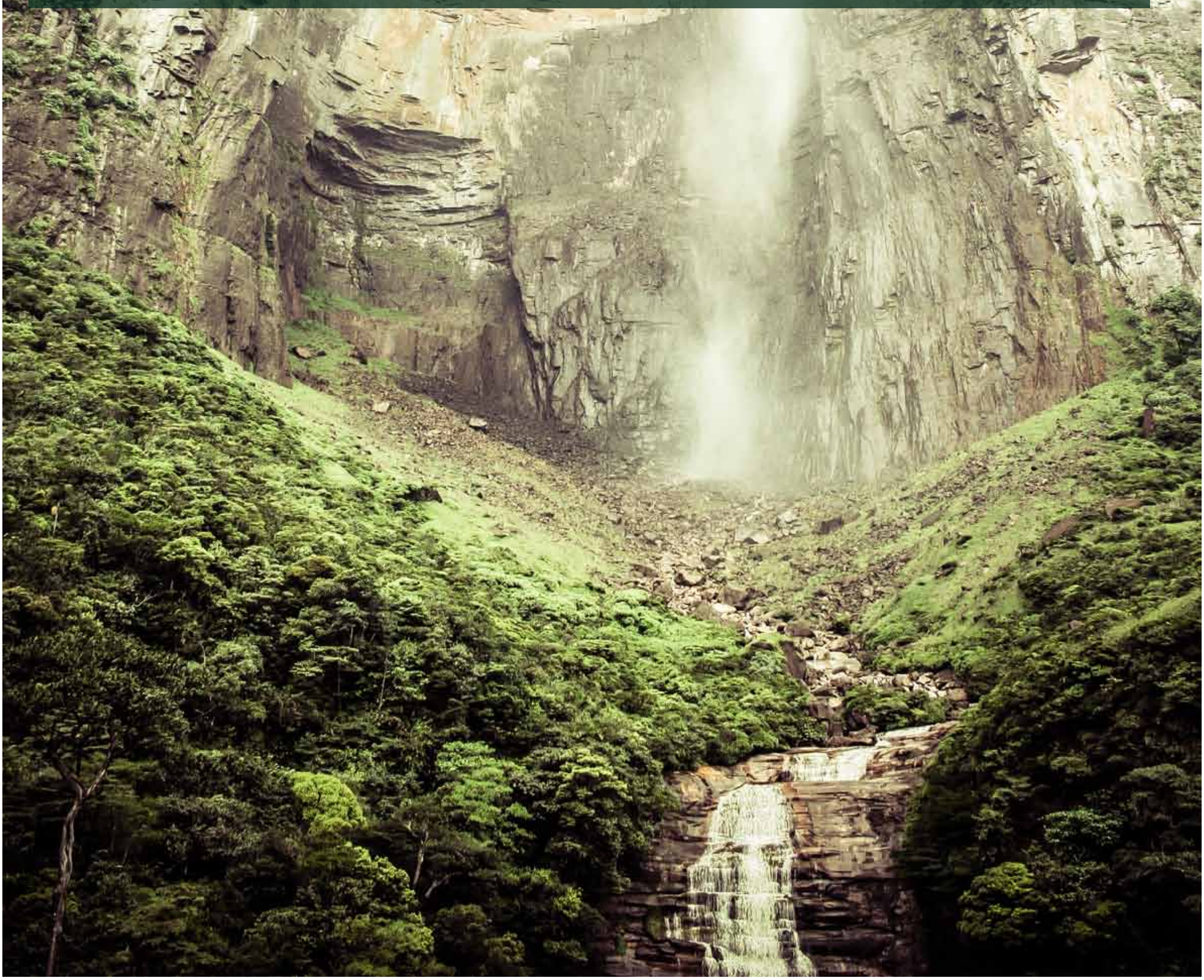
Rodriguez adds that risk-rating agencies are very concerned that what the government is trying implement will create a collapse in the macroeconomic sector and a fall in interest in the service of the debt. This would further degrade the country's financial sector, which has been unable to capitalize on oil revenues.

One area President Maduro has been focusing on is bilateral relationships with China, and speculation about investment agreements has increased since his visit to Beijing in September 2013. However, there are fears that the country's lack of regulatory transparency will impede the signing of contracts that could boost Venezuela's economic outlook.

"The reality is that the lack of transparency leads everybody to be skeptical about the levels of sophistication and technology transfer that these associations are creating for the country. Perhaps [Chinese companies] are willing to do business with Venezuela but there are no clear rules, no clear speakers on behalf of the government. It's very difficult to invest and to understand what would be your rights and that creates a very challenging situation for the overall finance of the country," Mr. Rodriguez says.

He calls for international leaders to step in and encourage Venezuela to establish a national agreement on investment to make sure the country doesn't fall apart.

"As of now I don't think any investor that is looking for risk management is willing to enter Venezuela. The ones that are capitalizing on this are the ones that are willing to take risks and get a big payout because of that. Until recently I was still thinking that in the long term Venezuela might be one of the countries to be in because of the potential rebuilding of all aspects of its economy. But I now believe Venezuela will be going through a lot of challenges for the first two quarters of 2014," he concludes.



Frontier and Emerging Markets Have Potential

The low-yield environment of the developed world continues to drive investors toward emerging markets. Favorable demographics, good balance sheets, the rise of corporate bonds and long-term growth prospects are delivering optimum diversification for investors. If investors understand national and international regulatory conditions and safeguard their investments with the appropriate governance, any red tape can be broken and portfolio gains delivered.

Clear Path Analysis reports discussing investing in emerging and frontier markets include contributions from a range of international regulators and the largest global institutional investors, including:

- International Finance Corporation (IFC)
- International Monetary Fund (IMF)
- United Nations
- East African Development Bank
- Asian Development Bank
- Caribbean Development Bank

For the newly released Investing in Frontier Markets report (available to download for free from https://www.clearpathanalysis.com/product/082-ifm-2013/), Clear Path Analysis interviewed Antti Karhunen (the Deputy Head of Cabinet at the European Commission for Development) about the European Commission's work to unlock the investment potential of the development world. Vivienne Yeda (Director General, East African Development Bank) stressed that even though the dynamism of emerging markets can sometimes suggest instability and volatility, such risks are overstated. "Over the last two decades," Ms. Yeda says, "growth in Saharan African countries averaged more than 5 percent per year, after adjustment for inflation." The report also finds that recent oil and gas discoveries in East Africa (Kenya, Uganda, Mozambique and Tanzania) have dramatically enhanced the region's growth prospects.

With four other reports in the series over the next 12 months, Clear Path Analysis's emerging market report portfolio visits currencies and debt, equities, bonds and frontier markets. (Register your interest to receive the reports at www.clearpathanalysis.com.)

- Investing in Emerging Market Currencies & Debt, Europe 2014 Published April 7
- Investing in Emerging Market Equities, Europe 2014 Published June 9
- Investing in Emerging Market Equities & Bonds, North America Published September 8
- Investing in Frontier Markets 2014 Published December 1


OFFSHORE BANKING IN BELIZE
THE SAFE CHOICE

Nestled in the northeast corner of Central America and facing its magnificent barrier reef, Belize offers undeniable advantages for offshore banking.

Belize has long been an attractive offshore banking destination for U.S. and Canadian customers lured in by a robust British common law system and no-tax, no-currency-control offering, but the country is experiencing a surge in interest from traditional non-U.S. investors.

Filippo Alario, Executive Director of Belize Bank International (BBIL), explains that the expansion of Latin American corporations has translated into more Latin business for the Bank over the last couple of years. "Naturally, Mexico is a two hour's drive north, so we are seeing increased interest from that market. To the south, we are strengthening relationships with our Panamanian counterparts, which in turn service the ever-growing wealth-producing South American Continent."

In terms of sectors, the biggest growth in companies banking in Belize has been in E-commerce – a 15-20% yearly increase at BBIL over the past three years.

Mr. Alario believes that with the impending advent of Foreign Account Tax Compliance Act (FACTA), U.S. related business would be affected, and force Offshore Banks to adapt to a new regulatory paradigm.

"We believe that the increase in non-U.S. business will outweigh any shrinkage in U.S. clients" he says. "The offshore business in the Caribbean is going through significant changes, so unless an offshore bank is nimble and has the ability to adapt and comply, I think some institutions will have a difficult time surviving. The ones that can adapt to the new rules and regulations and capitalize on new markets and opportunities are the ones that will succeed."

Adapting to an onslaught of new rules is not easy; but for the larger, well-established banks like Belize Bank International, compliance is key. "The smaller the bank, the more difficult it is, because the costs involved in establishing a compliance architecture are probably the same. [At Belize Bank International] we already have a strong risk and compliance culture and will abide by all regulations. In fact, that is the bedrock of banking and one of our key appeals."

Stability, privacy and a strict regulatory environment are definitely selling points for Belize, as the country operates under British common law and its BZ$2 to US$1 exchange rate hasn't changed in 37 years. Moreover, the offshore banking system is protected from the ups and downs of the national economy, which makes it even safer for international businesses.

"The country as a whole recently went through a restructuring of its debt, but the international financial sector was largely unaffected which highlights a marked separation from the domestic economy. In fact, the whole international financial sector in Belize is extremely liquid," adds Mr. Alario.

With its convenient location in mainland Central America, Belize enjoys a Caribbean feel and legacy, a largely bilingual population, and the added security of British common law traditions, making it an increasingly attractive destination for companies looking to set up international accounts in the Americas.

About Belize Bank International

Started as a financial holding group (British Caribbean Holdings Ltd), the Bank has had roots in Belize for over 100 years, and as the country's oldest financial institution, it benefits from a reputation of safety and continuity. Belize Bank International does business with clients in over 70 countries and employs 40 people in its international department. British Caribbean Holdings Ltd includes Belize Bank International, the domestic Belize Bank, and Belize Corporate Services (BCS) which does business with over 10,000 companies including trusts and corporations. The international bank offers loans and financing, as well as card services, online merchant accounts and through BCS, it offers clients, the convenience of a one stop solution providing international banking and financial services such as the formation of international business companies, trusts, foundations, LLCs.

Mr. Alario explains that the Bank's success and appeal are in part attributed to its risk-averse policies and procedures that make it a safe choice. "Security is an important element that influences the way we manage our operations, and we are constantly looking at evolving systems of technologies to stay competitive and ensuring the privacy and protection of our clients' data."

"In international banking, a bank's reputation is particularly fragile. We are highly cognizant of this and cannot afford for our name to be misrepresented or associated with anything negative. So for us it's all about profitable, risk-weighted growth."

Maximizing Value in U.K. Residential Land Investment

Interest is growing for U.K. real estate investment, but there are a few things prospective buyers should know in order to maximize value. As established in AEI's December/January issue (The Re-Emerging U.K. Real Estate Market), the delivery of land for residential development in the U.K. presents compelling opportunities. Demographic trends and government policies make it an increasingly attractive asset class, but even in a healthy investment environment, ensuring maximum returns can be tricky.

Chris Westerman, Sales Director at Lucent Group, tells AEI how the land site assembly firm manages and delivers land value in the U.K. "Value is added to land assets as a consequence of them being navigated through the planning process, irrespective of the wider cyclical changes in the real estate market. Lucent does not land bank; instead the focus is on securing an early uplift in land value through the planning process," he says.

The group's flagship fund, Lucent Strategic Land Fund, domiciled in Luxembourg, has returned 69% for investors since its launch in September 2010.

The Lucent Strategic Land Fund has returned 69% for investors since its launch in September 2010.

Mr. Westerman explains that producing shovel-ready, well-designed development sites in line with what is required by the local authority's evolving local plan and exceeding the profitability requirements of the end house builders and commercial developers presents challenges. "Individual national house builders generally prefer sites for 100 to 500 units, whereas Lucent can bring forward land for larger scale development in line with the local authorities' requirement, and then undertake a phased sale of delivery to individual house builders on a scale that meets their preference."

Once the uplift in land value has been maximized through the grant of planning consent, the marketing and disposal process is quickly engaged, minimizing exposure to volatility in the land value market. "Clearly the proposition is not about a speculative increase in land values. Our model is designed to withstand large swings in values. The financial crisis presented a bumpy road for real estate funds in general and gearing was a particular enemy, but with no bank debt Lucent Group would fully expect to weather such a storm," adds Mr. Westerman.

By not relying on rising land or house values, this model is designed to work in static or declining markets, and any real estate value boost (as is currently happening) is seen as a bonus.

Lucent, for example, applies rigorous financial modeling pre-acquisition and is flexed to allow for a 20% drop in house prices and land values and still meet its minimum internal rate of return requirement of 21%. According to Mr. Westerman, "each asset is reverse-engineered from the perspective of an end house builder, which identifies the effects of mercurial changes in house prices, build costs and house builders' rate of sale."

Liquidity

Given the long-term nature of the projects with which Lucent is involved, it manages its liquidity position very carefully. Cash within the Lucent Strategic Land Fund is required to be kept at an absolute minimum of 10% of net asset value (NAV). The fund does not use gearing or leveraging at the asset acquisition level, and is therefore able to call on a standby banking facility for up to 20% of the NAV of the fund at any given time in order to meet redemptions, essentially giving it 30% instant liquidity. Moreover, whereas a commercial property fund that holds a leveraged 50-story office block would find it rather difficult to sell 15 floors to create liquidity, the nature of residential land as an asset means that funds can, if need be, sell off part of a site.

Mr. Westerman takes the example of the Lincolnshire Lakes project (a residential-led development including 3,000 new homes and a 25,000 square meter commercial park) as a multi-exit deal with the phased delivery of the asset to national house builders and commercial participants. "This provides in effect a 'rolling liquidity' – the outline planning consent for the first phase for example is expected during the third quarter of 2014. Lucent anticipates undertaking a contract for sale on this first phase during the first quarter (subject to consent). This will in effect return cash to the fund by the middle of the year and thereby facilitate the rolling liquidity referred to above," he says.

Structure

Whatever structure is undertaken to acquire control of a land site (freehold, leasehold, option or development agreement), the exit strategy needs to be clear before acquisition.

For example, Lucent's Lincolnshire Lakes project is secured by way of an option on the land. As the land owners' interests are capped, this enables a clear arbitration between the acquisition price and the sale price with planning permission and allows a clear phasing strategy to be adopted. As the value of the land increases, the value of the option increases in direct proportion to that capital gain. Upon execution of the option agreement the land is drawn down and sold in phases to the end house builders and commercial developers.

Case Study 1: Royal Pier Waterfront, Southampton

For this project Lucent is entering into a development agreement with the land owners (Southampton City Council, Crown Estates and Associated British Ports) that grants a 20-year option. As master developer, the fund (together with development partner Morgan Sindall) provides the planning expertise and the capital associated with taking the site through the planning process (a projected £10 million). The agreement then provides for the uplift in value, associated with having navigated the planning process, to be shared by the parties to the agreement, with Lucent receiving a priority return as plots are sold down to the end builder or occupier.

The multi-use site will include a casino, a hotel with conferencing facilities and a large amount of residential, retail and office space. It is anticipated that a planning application for the project will be submitted in early 2015.

Case Study 2: Cumbria Partnership

This project is being established as a joint venture partnership between Lucent and the local authority, which recently approved a revised Asset Management Plan (AMP) (2013-2015) and entered into an exclusivity agreement with the Fund in July 2013.

"The partnership provides Lucent with access to a collection of land assets within a single geography, allowing for a holistic regeneration and development approach that is capable of securing a major uplift in land values," says Westerman.

Development proposals for these sites will involve residential, food and non-food retail, family leisure and hotel uses. A staged release of the sites will be made once planning permission is secured so as to provide a steady pipeline of land, which maximizes market interest and values.

"This model is establishing a template that it is expected will be repeated with other local authorities in England. Several authorities have already expressed interest to Lucent in pursuing a similar commercial and structural proposition," Westerman adds.

First the Good News, Then the Bad News…

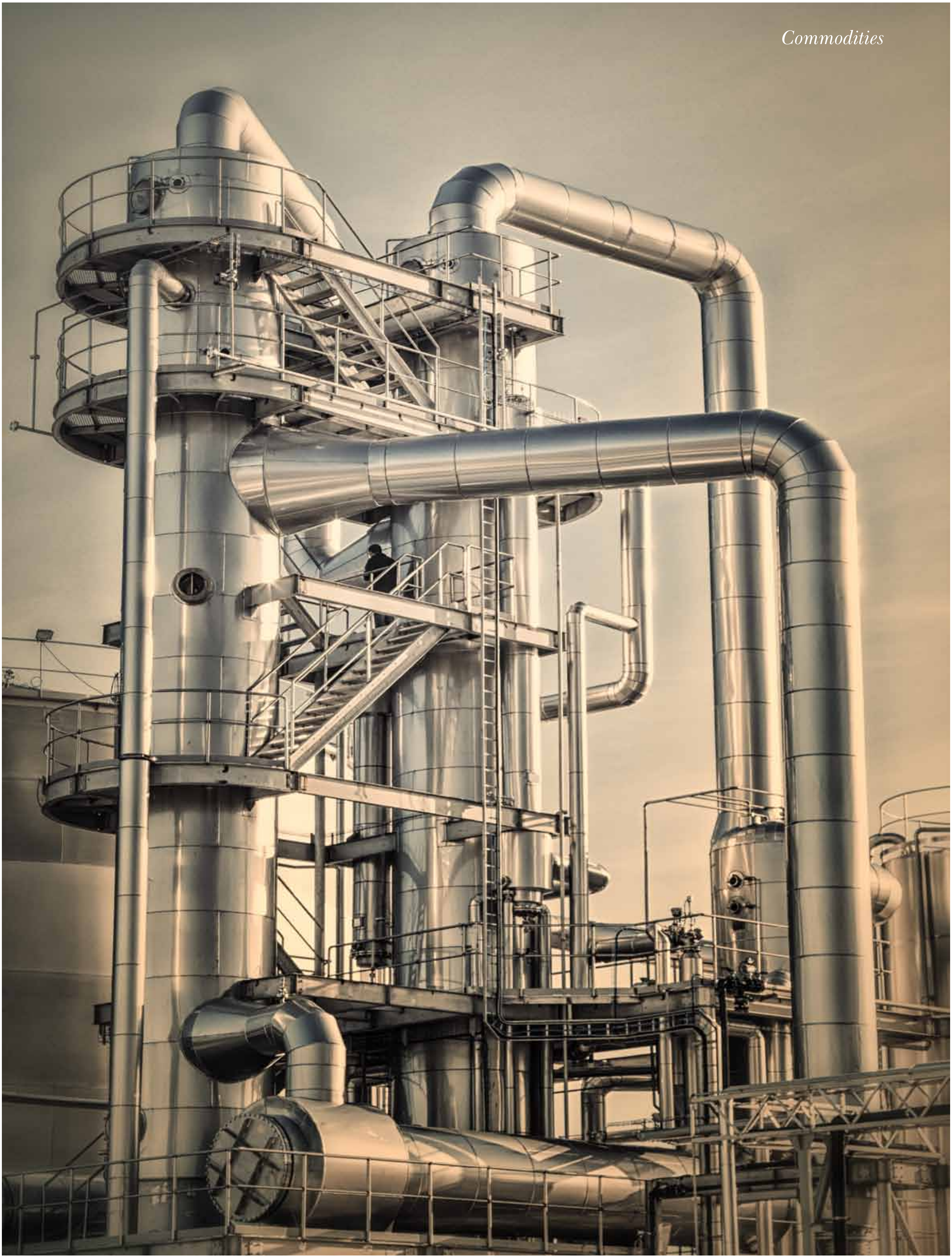
Mark McHugh

Two landmark events have taken place in recent weeks; each represents an important turning point for Brazil's oil & gas industry.

On October 21, amid tight security and violent protests outside, the Brazilian government awarded the auction for Libra, the most important Brazilian pre-salt field yet discovered, to the only bidder – a consortium formed by Petrobras (40%), super-majors Shell (20%) and Total (20%), together with two Chinese state oil companies, CNOOC (10%) and CNPC (10%). This is set to trigger a colossal investment program of up to US$400 billion in a resource that is expected to produce over a trillion dollars of oil in its lifetime. More importantly for the ruling center-left Workers' Party (PT), it manages to keep intact the pre-salt production sharing framework, which forms the centerpiece of a policy effort to develop the world's largest deep-water finds.

Just over a week later, Eike Batista's flagship oil company, OGX, filed for bankruptcy protection with a Rio de Janeiro court after failing to reach agreement with its creditors. This follows a spectacular fall from grace for the flamboyant Brazilian former billionaire. More than just wounded national pride, the biggest corporate failure ever in Latin America has permanently damaged Brazil's image as an important international investment destination. Inevitably, raising capital will become more difficult, particularly in the independent oil & gas sector, where vast amounts are still necessary for Brazil to achieve its promise and become a new non-OPEC source of supply among the top five world oil producers in the coming decade.

The substantial political and economic implications will undoubtedly have lasting repercussions and seem likely to shape the Brazilian oil industry over the next few years. Paradoxically, although the circumstances are very different, both events underline the vital importance of attracting foreign investment and technology to help develop the massive resource potential. For the government and Petrobras, the participation of the super-majors in Libra is a vital sign of the attractiveness of the pre-salt, amid stiff international competi-



tion between resource holders for scarce investment dollars. By contrast, OGX over-hyped the potential and rejected the need for capital and operating partners until it was too late. Instead of seeking to spread their risk in a notoriously high risk business, OGX preferred to go it alone, maintaining that Brazil is not understood well by foreigners. It paid a high price for its arrogance.

When is an auction not an auction?

Veja, the respected Brazilian current affairs magazine, concluded that "The Libra Auction was not ideal, but the promise of the pre-salt is still on track." This seems to reflect the general sentiment in the country, after the news that the consortium led by Petrobras and Shell had won with a minimum bid. Meanwhile, the results were greeted with sighs of relief by Petrobras and the government, despite the nationalist rhetoric by union leaders seemingly opposed to the "fire-sale" of state assets. Failure to get a decent bid under the new regulatory framework would have been a major setback for the government in the run-up to next year's elections. Ironically, the threshold bid by the consortium, which includes Petrobras at 40%, was presented as a very respectable outcome, since it simultaneously minimizes the call on Petrobras's already stretched budget.

Libra is much needed positive news, against a background of a disappointing Brazilian economic performance lately. The economy contracted in the third quarter for the first time since early 2009, together with a steep drop in investment. Confidence is now flagging in one of the most important emerging markets.

With an eye on her re-election campaign, President Rousseff's post-auction address highlighted the merits of Libra and talked about the allocation of all the proceeds to health and education to transform Brazilian society. Meanwhile, the government has been at pains to highlight the success of the new Libra framework of a production sharing agreement. This appears to be a thinly veiled attempt to disarm nationalist sentiment and to counter accusations of a sell-out to foreign oil companies. However, the majority of Brazilians appear to be indifferent to such concerns. Most Brazilians worry more about corrupt politicians and whether they will ever see the true benefits.

Petrobras has been held hostage by its major shareholder, the Brazilian government, in its desire to control fuel prices and limit inflation as part of its political agenda.

Mind-boggling Libra

Libra is one of the most significant public offerings in international oil industry in recent decades and the largest deep-water field in the world. Indeed, all the numbers on Libra are staggering: a signature bonus of US$7 billion; an estimated development cost of up to US$400 billion over the 35-year lifetime of the field, with 12 to 18 large production platforms planned; an estimated 8 to 12 billion barrels of oil in place, representing more than one trillion dollars revenue at today's prices; peak production of 1.4 million barrels per day equivalent to a 70% increase in current Brazilian production. The potential is overwhelming, with a single field that can be expected to generate economic activity equivalent to several percentage points of Brazilian GDP. The "government take" (including production sharing, royalties, taxes etc.) is a massive 71.3% of all revenues, and the total income to the Brazilian treasury increases to 77.5%, including the dividends from Petrobras.

Putting it together

There was some disappointment and even alarm generated in government circles when only eleven players registered for the bid round, particularly after a massive international campaign by the Brazilian authorities. Early expectations were that resource-hungry Asian state oil companies would dominate the auction. Yet for Chinese state producers it represented a change in strategy and an increase in risk profile. After years of buying into operating fields already in production, they appeared to be reluctant to go it alone in drilling for and developing new resources on such a big scale. In the end they chose to mitigate their risk as part of a larger consortium, presumably hoping to gain experience from partnering alongside the European super-majors.

Meanwhile, there was a lot of maneuvering behind the scenes to create the consortium in the run up to the bid. Shell's CEO took the initiative and approached Petrobras early on in April with a top-down proposal. This was followed by shuttle diplomacy, as Shell helped to bring together Total and the Chinese to form the final grouping. Although relations between Shell and Petrobras have been strained in the past, the resulting coalition was immediately welcomed. It delivers strong capital and operating partnership supporting an already stretched Petrobras. Magda Chambriard, President of the ANP, underscored the importance of the companies in the winning consortium, saying they included the most profitable oil firms in the world. "A bigger success is hard to imagine," she said.

No oil bonanza

An important distinction is that unlike previous Brazilian exploration rounds, Libra represents a lower level of "development" risk, as opposed to pure "exploration" risk. Test wells have already proven that there is oil in place. Independent research by industry consultants IHS Cera evaluates potential proved and probable recoverable reserves of 7.5 billion barrels of oil, with a rate of return to the Libra consortium in the range of 11.8%, assuming an average crude price of 80 dollars a barrel. While this is very low from the perspective of the oil industry, arguably it is estimated using very conservative assumptions. Meanwhile, the potential for cost over-run is the key threat to profitability. Huge, technically challenging projects always tend to run late and over budget. This is particularly relevant against the background of stringent local content requirements and the high "Brazil cost," which puts the costs of the Brazilian oil and gas industry 10-40% higher than world market prices on procurement.

The role of the newly created PPSA, which was set up to manage the Production Sharing Agreements, as well as negotiate the sale of the federal government's share of production, will be critical too. The smooth interface with the regulatory body should mitigate problems and unnecessary cost. Hence, it was a decisive factor for Total when the announcement was made that Brazilian oil industry technocrats would be appointed to key roles in the agency.

Stretching Petrobras

Petrobras has been held hostage by its major shareholder, the Brazilian government, in its desire to control fuel prices and limit inflation as part of its political agenda. It is forced to subsidize imports and guarantee lower fuel prices in the domestic market, siphoning off its profits and damaging its share price. Recent business performance has continued to disappoint the markets, not only due to the resulting weakness in earnings, but also due to a shortfall in oil production targets. Petrobras is becoming increasingly challenged in its ability to execute on ambitious investment plans and achieve its strategic growth objectives as it struggles to deliver on the world's largest corporate capital expenditure program. Meanwhile, the markets remain skeptical about Petrobras's ability to perform on multiple fronts, as the number of conflicting pressures grows. Now, as the default operator of the pre-salt and the Libra field, it is becoming progressively stretched. Sooner or later something will have to give and the politicians will need to grant Petrobras more freedom to make commercial decisions, or they will likely kill the goose that laid the golden egg. However, prior to next year's elections it seems unlikely that Brasília will confront this vital issue.

Over-promising

Eike Batista made his first moves to create OGX just as Brazil's big pre-salt finds were becoming public and at a time when oil prices soared toward their all-time high of 150 dollars a barrel. Capital had begun to pour into emerging markets, creating a sense of euphoria in the industry. With the benefit of hindsight, the seeds of failure were already present at the very beginning. Knowledgeable industry observers were incredulous as OGX raised US$4.1 billion in June 2008 with the largest IPO in Latin American history – while possessing nothing tangible, only a handful of exploration licenses and a team of specialists headhunted from Petrobras. It is in many ways surprising how easily hard-nosed investors were hypnotized by Batista's X-factor and promises of multiplying returns, as if he had encountered some magic formula to monetize Brazil's vast resources. It was all done with smoke and mirrors. Not a drop of oil had been produced, and in fact the first oil only came nearly four years later at the beginning of 2012 – just ahead of a precipitous decline in OGX's share price. In July 2013, Mr. Batista acknowledged in a letter published in two Brazilian newspapers that his empire's implosion all began with OGX. The company, he wrote, "is the origin of the crisis of credibility." Those close to him say that he is misunderstood. There was no doubt Batista believed the oil was in the ground. "He was well intentioned but wrong," said Delcídio Amaral, former head of gas and power at Petrobras, who is now a Brazilian senator. "Nobody spends billions of dollars to build offshore oil-production ships if you're trying to pull the wool over people's eyes. It would be insane."

Even so, there was never any rational basis for betting so much on a company that was a pure exploration play with a narrow portfolio. Even within a high risk industry, exploration companies are extremely volatile and most spread their risk through farming out part of their interest and hedge their exposure through geographic diversity. Perversely, OGX was proud of the 100% ownership of most of its blocks, almost entirely focused on Brazil. Share growth post-IPO was driven by a comparatively successful exploration program and by inflated estimates of production growth potential. By the end of 2010, OGX claimed 100% success in exploring for oil in the Campos Basin and set a production target of 750,000 barrels a day by 2015. The hype was pervasive – incredibly, in mid-2012 posters still adorned OGX's office with this discredited objective.

What is perhaps most surprising is the level of complicity with the investment community. Why did the investment analysts overlook the obvious – that there was nothing tangible to back up the claims. Was it just that Batista was such a great salesman? It is hard to believe that so many seasoned investors were taken in by just a sales pitch. OGX raised over US$2.5 billion in a bond issue in May 2011, with some of the world's most sophisticated fund managers, including Pacific Investment Management Co, the world's largest bond manager, and bellwether U.S. private equity group BlackRock Inc. Were they just jumping on the emerging markets bandwagon? In March 2012, Abu Dhabi state investment fund Mubadala bought a US$2 billion stake in Batista's holding company EBX, when the decline had already set in. Normally conservative investors with a low risk appetite bought into the X-factor story and sought comfort in the results of the exploration campaigns, an experienced management, and, at least in the early stages, a good liquidity position to justify their continued optimism.

And under-delivering

The collapse was even more dramatic than the climb. The pivotal events that prompted the colossal slide were linked to the results of OGX's first two production wells in the Tubarão Azul field in the Campos Basin. Its original estimated range of 10 to 20 thousand barrels per day per well was never met. In June 2012 at the start of production, it redefined an ideal flow rate of 5,000 barrels per day per well. However, one well had to be shut in immediately to replace equipment. Hence, OGX began producing at less than 25% of its original minimum target. This became the trigger to accelerate the fall in OGX's share price, which lost half its value in days. While

extrapolating the results of the first two or three producing wells is arguably a tenuous process, what became more significant was the wake-up call the production shortfall had created for investors and analysts. There was now a major credibility gap in company management and guidance estimates, and without clear answers the stock plummeted.

Results continued to disappoint. In January 2013, OGX connected a new third well in Tubarão Azul. In February 2013 it produced the maximum monthly figure of 13,200 barrels from the field. In March 2013, OGX was forced to shut down all three of its production wells. In April 2013, Tubarão Azul produced an average 1,800 barrels of oil equivalent per day from a single well. On July 1, 2013, after attempting repairs to the wells, OGX announced that "there is no technology currently available that would economically allow any additional investment to increase the production for the current three wells, which will now cease to produce in 2014."

Industry observers were perplexed. How could such an experienced ex-Petrobras team have got it so badly wrong? It is widely understood that the Campos Basin is not easy in geological terms and continuously provides new challenges. It has complex reservoirs, which can create significant technical complications. This was particularly true in the case of Tubarão Azul, which was being developed with fewer, horizontal and high-angle wells, drilled through poorly consolidated reservoirs.

The 'dream team' that became a nightmare

At the beginning, Paulo Mendonça (nicknamed "Dr. Oil" by Eike Batista), who was a previous head of E&P at Petrobras, joined as Chief Executive Officer. He was accompanied by many other members of his former team – the same team that had been instrumental in Petrobras's success in the central portion of the Campos Basin and in the most important pre-salt discoveries. At the outset OGX was in a privileged position, with a geo-science team bought from Petrobras that had intimate knowledge of geological region and potential prospects. Normally a good sign in the industry, the new OGX team had already discovered over nine billion barrels of oil equivalent and had know-how on a lot of other basins that had yet to be exploited. The new hires were very well rewarded and under pressure to perform.

Industry observers were perplexed. How could such an experienced ex-Petrobras team have got it so badly wrong? It is widely understood that the Campos Basin is not easy in geological terms and continuously provides new challenges.

While Tubarão Azul was superficially a technical failure, there was clearly an underlying organizational failure as well, based upon the wrong corporate culture. After setting such high initial expectations, nobody wanted to tell the bad news to the boss that OGX had chosen to develop the wrong prospect – especially in a high-pressure environment. Worse, they fed him glowing progress reports to persuade him to pay big bonus checks. Eike Batista's claim that he was misinformed has more than a grain of truth. He now says these executives were experts at finding oil, but not producing it. And they weren't familiar with the geology OGX was working with. His further claim that as a mining executive he didn't have the knowledge of the oil industry to question their reports is a poor excuse. A shrewd operator aware of his shortcomings would have searched for the right staff and created a better culture, or even sought out more experienced operating partners and thus never got into such a predicament in the first place.

When you are in a hole, stop digging!

As OGX's position became more critical, and in an effort to stem the decline in October 2012, Mr. Batista agreed to a put option to buy back as much as US$1 billion of shares in OGX, to guarantee enough cash. Yet seemingly undeterred by the looming problems, in November 2012 OGX continued to expand its portfolio, entering into an agreement with Petrobras to acquire a 40% participating interest in Block BS-4, located in the Santos Basin, for US$270 million. As disappointing results continued and the stock continued in freefall, OGX then began a frantic search for strategic partners, reducing staff and cutting costs. It also reached an agreement to sell part of its interest in Campos Basin blocks BM-C-39 and BM-C-40, encompassing the Tubarão Martelo field, to the Malaysian national oil company Petronas in May 2013. Thus Petronas acquired a 40% non-operating working interest for US$850 million, holding back the majority of the payment in escrow. The field with its 285 million barrels of recoverable resources was probably OGX's most valuable single asset at the time. By mid-May many were bewildered to see OGX participating heavily in the 11th Exploration Round, bidding signature bonuses of US$188 million – the third-highest total. It acquired ten blocks by bidding without partners and three blocks together with international and local partners. Most analysts believed that OGX was already over-extended and the market clearly did not appreciate such a bold move, particularly against the background of serious concerns about liquidity – precipitating a further fall in the stock. Meanwhile, Mr. Batista continued to restructure his ailing empire. He sold control of his electric-power-generation company MPX to German utility E.ON in July, which became Eneva. His MMX mining company later sold a port in Southern Brazil to Trafigura and Mubadala in a US$400 million deal. These deals provided some respite, but still did not address the main issue of finding a solution for Batista's oil interests in OGX and its sister company OSX.

Part of the problem or part of the solution? Batista continued to pin his hopes on some form of strategic partnership to rescue OGX from impending collapse, almost to the bitter end. However, by this stage partnership options had become very limited. His short affair with the investment bank BTG Pactual, which signed a deal with EBX in March, was expected to be the salvation of his empire. BTG's role was as financial consultant and potential provider of long-term financing. However, there was friction from the beginning of the relationship, which broke down acrimoniously toward the end of August. BTG's motives were also questionable, as their interest was probably more in the breakup of Batista's companies than in their long-term continuity.

Meanwhile, there had been attempts as far back as 2010 for OGX to farm out assets to experienced partners. At the time the failure was put down to unrealistic expectations of value by OGX. This was probably Eike Batista's biggest missed opportunity to attract the right sort of capital and operating partners that would have helped him develop their resource base and spread some of the risk. His unwillingness to do business at that stage was probably based upon false expectations of OGX's value,

Part of the problem or part of the solution? Batista continued to pin his hopes on some form of strategic partnership to rescue OGX from impending collapse, almost to the bitter end. However, by this stage partnership options had become very limited.

which was riding high, and even to some extent on believing his own hype. OGX's exploration campaign was successful in identifying potential resources. It would have taken a more experienced industry executive to appreciate that much greater firepower was required to turn a pure exploration play into a true oil company that would be capable of both developing and producing in line with the ambition to become the largest independent player in Brazil, second only to Petrobras. Arguably, this was too big a challenge for a startup company, even with some of the best hired guns from Petrobras. During the final negotiation with bond holders, just prior to filing for bankruptcy protection, the main stumbling block remained Batista's willingness to cede control.

Embarrassing for some

Eike Batista was in many ways the "tame" entrepreneur of PT and particularly the Lula government. The collapse of OGX along with the rest of his business empire raises serious questions about future government policy. His rise lent credibility to the PT's claims that its interventionist economic policies were simultaneously market friendly. The fact that the government has kept its distance in recent months is indicative that Brasília realized early on that Batista's house of cards was too precarious to save. In some ways, the story of Eike Batista mirrors that of Brazil – riding high on a wave of emerging market euphoria and a commodity boom, which then runs into difficulties and collapses in disarray.

So where now?

Brazil's eight-year-old bankruptcy law is similar to Chapter 11 bankruptcy protection in the U.S., and gives OGX a chance to reduce its liabilities and emerge as a going concern. OGX and its creditors are believed to be nearing a deal to transform some of OGX's US$5.1 billion debt into stock, stripping Eike Batista of a controlling stake in the oil company. Bondholders are also considering a proposal to inject US$150 million into the company to bolster capital spending, ramp up output at offshore fields and continue operations. Meanwhile, in separate developments, federal prosecutors in Rio de Janeiro have opened a civil inquiry into alleged possible irregularities by Brazilian regulators in overseeing OGX, and the company has begun producing from its Tubarão Martelo oil field in the Campos Basin. The question now is whether OGX (renamed) will survive at all, re-emerging as a small player in the Brazilian E&P scene, or if the complications of finding a workable solution for OGX and OSX will prove too challenging, and assets will be sold off to pay creditors.

Paradoxically, the elimination of OGX as a highly volatile stock from trading from the Bovespa Index meant Brazilian stocks traded higher despite fiscal weakness.

Keeping it in perspective

This has been an eventful year for the Brazilian oil and gas industry. Three bidding rounds have been held with positive results after an interruption of five years and are leading to an important revival of exploration activity in Brazil. The weakness of the Brazilian independent oil & gas sector has been underlined not only by the bankruptcy of OGX, but also by the lack of exploration success of HRT, the next ranking Brazilian independent. The Brazilian oil industry has been left without a national champion in the private sector, which is a failure for government policy. Yet in a sense the independent oil & gas sector is all a sideshow. Petrobras controls over 90% of Brazilian production today, and the biggest game in town is still the pre-salt and not the shallow waters of the Campos Basin. Even Petrobras, which is acknowledged in the industry to have strong managerial and technical skills, needs help to face the enormous challenges ahead. In truth, whether Brazil will realize its full potential and become one of the world's top oil producers in the next decade will be determined by the success in developing the pre-salt and fields such as Libra. This will in turn be dependent upon the willingness of Brazilians to be pragmatic and work in full partnership with the international oil industry, as providers of capital, technology and operating capability. Keeping things in perspective, the good news of Libra far outweighs the bad news of OGX's bankruptcy.

About the author

Mark McHugh is a Managing Director and Co-Founder of OFSCap, 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 based in Brazil and has an extensive international senior level career in the oil industry in marketing, sales, strategy consulting, and general management, having spent 26 years with Shell. During his distinguished career, he has held a variety of management team positions as VP Marketing Americas, GM Downstream International Consultancy, VP North Latin America and GM Shell Venezuela. He has an exceptional track record in leading new business development, implementing global business strategies, M&A and managing startups. Mr. McHugh graduated as a mechanical engineer from Imperial College, London and has a postgraduate qualification in finance and business administration from the University of Westminster.
For further information on this article or OFSCap, LLC, please contact: mmchugh@ofscap.com.

GRAIN GROWTH

Stephen Kaczor

The Panama Canal channel expansion will remove a bottleneck in grain shipments. The world consumes more grain than it produces, despite the doubling of global grain crops since the 60s. Farmers now produce 2 billion tons of grain annually. Population growth is such that farmers are struggling to feed the equivalent of an additional two countries the size of Spain every year.

This disparity is aggravated by the fact that population growth is creating many more meat eaters. It takes five kilograms of grain to raise one kilogram of meat. So major grain exporters are in a cycle of ever increasing demand.

Larger ships will transit the canal with twice the tonnage when the canal expansion is complete. Already, the canal is experiencing record grain shipments, according to Administrator Jorge L. Quijano. "October 2013's volume of 5.2 million long tons of grains was the highest level recorded since October 2011."

One-fourth of U.S. grain exports flow through the Panama Canal. U.S. ports on both coasts and the Gulf of Mexico are making major investments to keep grain elevators fuller for post-Panamax-sized ships. Locks and channels on rivers like the Mississippi and Columbia are also receiving upgrades to accommodate larger grain shipments.

According to the United States Department of Agriculture's latest World Agricultural Supply and Demand Estimates

Report (WASDE), corn production for 2014 is expected to increase 30% compared with the prior season. Soybean production is expected to increase 7% over the previous year, and soybean exports are set to increase 10%.

"The surge in grain cargo flows through the Panama Canal has been particularly strong for shipments from the U.S. Gulf to China," according to Maria Eugenia Sánchez, Senior Trade Specialist for the Panama Canal's Dry Bulk Market Segment. "Corn, soybeans, sorghum, and wheat destined to China shared 81% of total grain tonnage through the waterway, up from 71% a year ago."

China's problem is a lack of agricultural land sufficient to feed its population. China has one-fourth of the world's population but only 10% of its agricultural land, and double-digit GDP growth is creating demand for a more varied diet, specifically more grain-fed meat.

The U.S. grain industry is also experiencing strong growth in its Latin American market share. U.S. market share in Peru increased from 10% in 2009 to 40% last year. U.S. wheat shipments to Brazil are also up due to a smaller crop in Argentina and quality issues in Paraguay.

While the Argentine wheat crop is down, barley and sorghum exports are increasing from Argentina. Overall increases in South American grain crops have been impressive.

Brazil's February 2014 soybean harvest is expected to be a record 10 million tons. "Once that South American crop comes in, we're going to have ending stocks globally much larger than they were last year. It's that expectation of a very large supply that's going to keep a cap on how high North American prices are going to get during the winter," according to Bill Tierney, an analyst with AgResource.

The E.U. is imposing export taxes on wheat and barley to protect historically low grain reserves. However, "it takes price to encourage a farmer to take the risk to plant a crop, especially when he must buy expensive fertilizers to achieve the required yield," notes Peter Kooi, President of Cargill International.

The U.S. has subsidized grain exports since the 80s. Mr. Kooi explains, "the objective was to compete in export markets but keep domestic prices high. High domestic prices did indeed stimulate production, but low, subsidized export prices inhibited grain production elsewhere. It was more attractive for nations to import cheap grain than to struggle to produce their own crops."

According to USDA's baseline projections, developing countries will account for much of the increase in projected growth in global consumption between 2013 and 2022, during which time demand for agricultural products will increase faster than supply. Developing countries' share of projected growth will account for 92% of the total increase in imports of meats, oil seeds and grains, according to USDA figures.

Today global farmers are struggling to get grain supply back in line with demand.

About the Author

Stephen Kaczor is a regular contributor to Alternative Emerging Investor and 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 a 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.

www.BigRiverFoundation.org

Turkish Wine

Makes a Statement

Mike Veseth, Professor Emeritus of International Political Economy at the University of Puget Sound and editor of The Wine Economist

"There is, perhaps, no country in the world where drinking a glass of wine in a public space has more political significance than in Turkey. Just now, that significance extends to a glass of Turkish wine drunk anywhere in the world."[1]

It's Not (Just) About the Wine

We don't usually think of wine in political terms, but as this quote from Andrew Jefford's June 2013 Decanter.com column indicates, these are unusual times in Turkey, and even otherwise innocent wine is caught in the crossfire. Jefford writes that the world "watched Turkey tumble into political turmoil last week. Protests over a building project . . . erupted into wider discontent about what many see as PM Erdoğan's peremptory paternalism, and the sense that Turkey's hard-won secular traditions were being gradually eroded in a stealthily managed slide towards 'soft Sharia'."

So how does wine fit in? The answer is law number 6487, which piles additional restrictions on the promotion and sale of alcohol, including wine. This law seems a step backwards for a county that seeks to join the European Union, where wine is nearly ubiquitous. But, Jefford explains, it's not about the wine. "As Turkish journalist Sevgi Akarçeşme wrote in her blog in Today's Zaman on May 26th, alcohol is always 'more than alcohol' in Turkey."

A recent article in The Economist provides additional context.[2] "Hoteliers fret that the curbs will scare off tourists. Secularists see another step to sharia rule. After a decade under AK [the ruling party] Turkey feels a lot more conservative. Islamic clerical training for middle-school pupils has come back, Koran courses have grown and finding a drink in rural Anatolia is hard.”

But What About the Wine?

So wine makes a statement in Turkey and Turkish wine, according to Jefford, makes a political statement everywhere else. So what kind of statement is it – as wine, I mean, not as a political symbol? Well, I suspect that most Americans don’t really know and would be hard pressed to find a bottle of Turkish wine to satisfy their desire to lend support to one side or the other in the Turkish protests.

We were fortunate to be given the opportunity to sample a number of otherwise hard-to-find Turkish wines when a local company that is just breaking into the wine import business invited us to sample some Turkish wines being considered for the U.S. market. The local Turkish Commercial Attaché was there to give his blessing – wine may be controversial within Turkey but wine exports apparently are not.

The wines represented a wide range of grape varieties, wine styles and price points. We found much to like even if we liked some better than others, as would be the case in any tasting. Although there were credible wines made from international grape varieties such as Cabernet Sauvignon, Merlot and Shiraz, Sue and I were drawn to the indigenous grape varieties, especially white wines made from Narince and Emir and juicy, fruit-forward red wines made from Öküzgözü.

A Rosè Is a Rosè

Narince and Emir are unfamiliar names to most U.S. wine drinkers, but they are not especially intimidating ones and there is no particular reason why consumers who have only recently learned to say “Torrontes” should not embrace them. If you see one of these wines in a shop or on a menu, try it. Very refreshing.

Öküzgözü is another matter, of course, with its Scrabble-master spelling and abundant diacritical adornment – it really looks like a Turkish name, doesn’t it? I suppose the name alone might stop some consumers in their tracks, which is a shame because we tasted some delicious interpretations of the grape. The literal translation is “bull’s eye” or “ox eye” because the grapes are as large and dark as a farm animal’s pupil and perhaps a clever marketer can exploit that fact to entice consumers to lean in. Hungary’s ”Bull’s Blood” wines are popular, for example, and most people who buy them probably don’t concern themselves that the wine is a blend featuring the Kadarka grape, which is thought to have been brought from Turkey!

So how do you get consumers to try Turkish wines? Well, I’m not sure you have to get

people to try them because many Americans have vacationed in Turkey and tried and enjoyed the wines there (even if they might not have made notes about which particular varieties they liked best). It may only be necessary to reintroduce these former visitors to the wines by inviting them to relive their experiences enjoying Turkish food, culture, and of course its wine.

Beyond Politics: Wine, Food and Culture

The wine taken completely by itself may be a hard sell, I admit, because the market is so crowded and the competition is so fierce, but the key is to present the wines as part of an integrated Turkish cultural package that draws on happy memories and associations and promises to extend them. Italian wines (even those from unfamiliar regions made from hard-to-remember indigenous grapes) have always benefited from this cultural strategy. And while Turkey doesn't have Italy's prime place in American hearts and minds, there are plenty of positive associations to draw upon.

Culture, not politics, is key when it comes to selling Turkish wines in America. Andrew Jefford is probably right that raising a glass of Turkish wine makes a statement just now, but when it comes to expanding the market for the wines, it may be best to keep divisive politics out of it and let the warm and welcoming side of the Turkish people themselves lead the way.

Recommended reading if you are interested in learning more about the controversy: Elin McCoy's report form VinExpo on the challenges and opportunities for Turkish wine.[3] Based on a column originally published in The Wine Economist (WineEconomist.com) on June 18, 2013.

1. *See Andrew Jefford's June 10, 2013 column on Decanter.com http://www.decanter.com/news/blogs/expert/583976/jefford-on-monday-more-than-alcohol (accessed December 19, 2013).*
2. *"Alcohol in Turkey: Not So Good for You." Economist (June 1, 2013) http://www.economist.com/news/europe/21578657-mildly-islamist-government-brings-tough-alcohol-restrictions-not-so-good-you (accessed December 19, 2013).*
3. *Elin McCoy, "Turkey's Vintners Under Seige as Bans Crush Winemakers" Bloomberg News (June 16, 2013). http://www.businessweek.com/news/2013-06-16/turkey-s-vintners-under-siege-as-bans-crush-wine-renaissance (accessed December 19, 2013).*

2014 A Look Ahead at the Nigerian and Brazilian Markets

James Knight

A very happy new year to all our readers. The start of the year is a natural time to take stock, and to prepare for the challenges and opportunities in the year ahead. Of course, it is also a time for the pundits to issue confident predictions about what is going to happen next.

I find this a mug's game. Understanding the forces that shape current political events and their impact on the business and economic environment is difficult enough. And it is usually of more value to investors if you can give them a meaningful understanding of the pressures that are making certain stakeholders act in certain ways.

In the absence of a crystal ball, it is, however, possible to provide scenario planning for the future, in order to see how a business or a portfolio might respond to external shocks or stresses. But the world I see, through the prism of the markets I know best in Latin American, Africa and elsewhere, is becoming increasingly complex, and the impact of events diffuses in unforeseen ways. Right now, Syria would be the epitome of that, but across the Arab world the results of the popular uprisings that gathered pace almost exactly three years ago continue to play out in ways that few could have expected back then.

Brazil's Challenges

Two of the largest markets I cover, Nigeria and Brazil, will be gearing up for elections this year. The distraction of the World Cup in Brazil should not disguise the growth challenges that the country faces. However, the election is still Dilma Rousseff's to lose. The policy focus, such as it is, will be on healthcare and education. That does not bode well for management of the current account, nor for the business environment: long-overdue but politically sensitive reform of labor and tax regulations to improve competitiveness is unlikely to happen anytime soon. Calls for Economy Minister Mantega to go have begun early this year, but he has, until now, been a loyal and useful tool through which President Rousseff has been able to deflect criticism. Make no mistake, she calls the shots in the formulation of Brazilian economic policy. Her personal interest in infrastructure, based on the country's enormous needs, should be where investors focus their energies.

Incidentally, I would stay long on Brazil's neighbor Argentina, on the basis that the current political scenario can only improve after elections in 2015, and the world will continue to need what the country has to offer – competitively priced agricultural products.

Nigerian Elections

Nigeria does not hold a presidential election until 2015, but in a much more charged environment. The unofficial positioning of potential candidates is already in full swing. The presidency of Goodluck Jonathan is looking increasingly isolated, and control of key ministries, namely oil, may not compensate for the feeling, even within the ruling party, that change is due. Grandees of Nigerian politics, such as former President Olusegun Obasanjo, have publicly called for the current incumbent not to seek a second term, and northern politicians feel this is their time. In addition, a newly unified opposition offers Nigerian voters something of a choice, for the first time since the return to democracy in 1999. The country has enjoyed sustained growth, and the Central Bank has done a lot for macroeconomic stability. However, management of the oil industry remains a mess, and the insurgency in the north should not be underestimated.

Mad for MINTS

The newly minted MINT grouping, of which Nigeria is a member (along with Mexico, Indonesia and Turkey) will gain traction this year as another neat emerging market pigeonhole. In some senses, these four countries form a more homogeneous grouping than the disparate markets of the BRICS. For example, they all share participatory democracies, with young populations that will all get richer over the next 30 years. However, each one has its own divisions, which when combined with weak institutionality and corruption tend to present particular market entry challenges.

Finally, we should also look inward, at ourselves as investors and capitalists. What kind of opportunities are we searching for? Are we interested in emerging markets for the prospect of some quick returns, or are we motivated more by longer-term considerations? With whom are we prepared to do business, and how do we want to engage with them? This will affect the risk matrix we are prepared to take on, and where, ultimately, we direct capital.

About the Author

James Knight is a consultant with ten years' experience of working in and with emerging market countries. He is Director of Pionero Partners, a U.K.-based risk and strategic advisory consultancy serving international clients. Prior to his current role he advised a Hong Kong-based fund on various LatAm projects, and previously worked at Barclays Bank plc. He has also handled targeted communications projects for the World Bank and the United Nations. He began his career as a journalist, freelancing for Reuters, The Economist, The Sunday Times, and Africa Confidential covering business, investment and conflict. He holds a degree from Cambridge University.

The Rise of South-South Relations

Tomás Guerrero, Researcher, ESADEgeo - Center for Global Economy and Geopolitics, ESADE Business School

The economic awakening of the Southern Hemisphere has altered the economic and trade patterns that govern the global economy.

Economic growth has focused on developing economies, driven by a commodities boom, low labor costs and the development of middle-class populations. Meanwhile, advanced economies are experiencing a slow recovery process. In 2012, the gross domestic product of developing countries surpassed for the first time that of developed countries. Moreover, developing countries, especially in Africa, are expected to grow three times faster than developed countries in the coming decades.

From a trade standpoint, 2012 confirmed the good health of southern countries. Developing economies showed strong trade growth, close to 5%, aligned with the average growth experienced by world trade in the last 20 years. At the same time, global trade and trade from developed economies grew 2% and 1%, respectively. This reflects a new trend of trade expansion in developed and developing economies diverging. This tendency appeared to consolidate in 2013: World Trade Organization projections forecast a mild recovery of world trade with growth close to 3.3%, stagnation of trade in developed economies around 1%, and a solid growth of emerging economies at around 5%.

In this context, South-South relationships are thriving. Trade flows within the Southern Hemisphere have become key drivers of international trade, going from just 6% of the total international trade turnover in the 80s to 15% now. Asia is playing an important role as a consequence of the huge success of intraregional flows that have expanded in three decades from accounting for 20% of South-South trade to 40% in 2012. Also note the growing prominence of trade relationships of the BRICs with Africa, from US$22.9 billion in imports and exports in 2001 to US$267.9 billion in 2011. The strong presence of China in Africa is also important, reaching 62% of the whole trade between BRICs and Africa. The Economic Commission for Latin America and the Caribbean (ECLAC) forecasts that in 2018 South-South trade will surpass North-North trade, and the WTO predicts that in 2020 South-South trade will represent more than one-third of total world trade.

...the World Investment Report, published recently by the UNCTAD, confirms the shift in economic power toward the South, noting that in 2012, for the first time, developing countries received more FDI (more than US$700 billion) than developed countries (around US$561 billion), which now attract just 42% of the global flows.

South-South investment flows have shown similar behavior. According to the UNCTAD, between 1980 and 2010 southern countries increased their participation in the world's FDI to 30% going from insignificant figures of inward and outward flows of FDI from the South in the 80s to nearly US$400 billion in outward flows and US$700 billion in inward flows in 2010. In this same line, the World Investment Report, published recently by the UNCTAD, confirms the shift in economic power toward the South, noting that in 2012, for the first time, developing countries received more FDI (more than US$700 billion) than developed countries (around US$561 billion), which now attract just 42% of the global flows.

The role played by regional banks and in fostering South-South cooperation has modified the traditional architecture of the programs intended to aid development. This has helped to improve the social conditions of the countries of the south, but forced developed countries to pay more attention to the needs of developing economies.

The predictions of international organizations invite to be optimistic with regards to potential South-South relationships. But for South-South relationships to continue to expand, southern countries will have to face major challenges, such as increasing the added value of their exports, redirection of FDI flows toward technology-intensive sectors, and elimination of tariff barriers

About the Author

Tomás Guerrero is a Researcher at ESADEgeo-Center for Global Economy and Geopolitics of ESADE Business School and SovereigNET Research Affiliate at Tufts University's Fletcher School. Mr. Gerrero specializes in frontier markets, sovereign wealth funds and entrepreneurship. http://www.esadegeo.com/

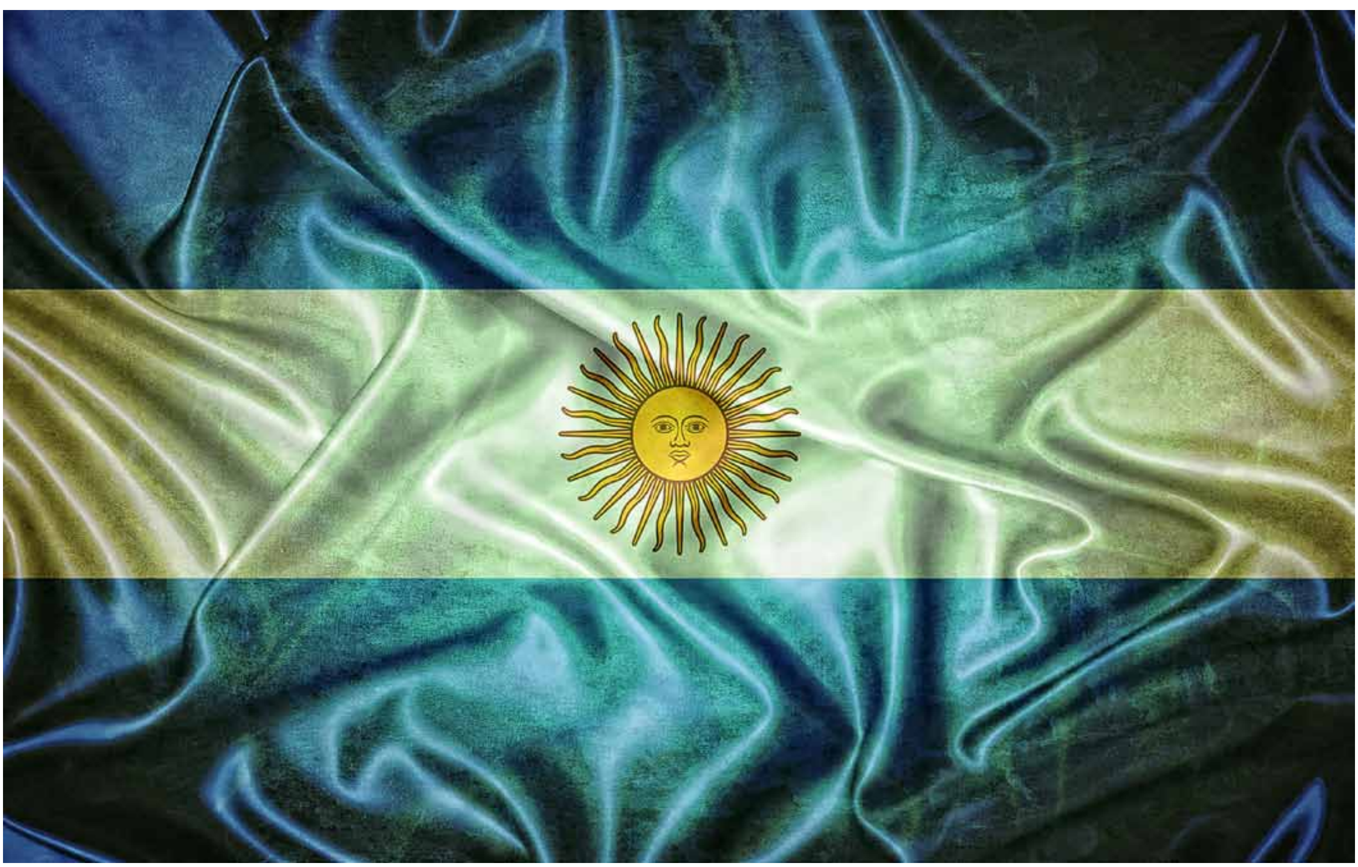
Never a Dull Moment in Argentina

Javier Canosa

It seems that there will be plenty of news from Argentina in 2014. The legal environment is defined by the economy's appetite for dollars and the need to break the inflation fever that has recently broken out. The last few weeks have proven particularly vertiginous.

To give an example, the unofficial rate of exchange on December 2, 2013, was 9.18 pesos to the dollar; on January 17, 2014, the same rate was 11.95 pesos to the dollar. The official rate of exchange on December 2 was 6.10 pesos to the dollar, and on January 17 it was 6.73 pesos to the dollar. Central Bank reserves fell from US$52 billion in February 2011 to US$38 billion in August 2013, and to US$29 billion in January 2014.

These movements in the exchange rate and in the Central Bank reserves have triggered a series of measures from the government aimed at preventing further deterioration of the currency and depletion of Central Bank reserves. Some of these measures go back to October 2011 (the prohibition on purchases of foreign currency for saving) and others have been very recently imple-



mented. The effectiveness of these measures remains to be seen.

Let's take a look at the most recent measures implemented by the Argentine government.

First, as of January 1, 2014, the government has imposed a new internal tax on "luxury" vehicles. This tax ranges from 30% to 50% depending on the value of the vehicle, and it is intended to limit purchases of foreign vehicles by Argentines who are unable to purchase foreign currency and instead buy imported vehicles paid for at the official exchange rate.

Secondly, and in the same line of thought, the government has increased from 20% to 35% (which is the highest rate of income tax) the mandatory withholding of income tax applicable to consumption of goods or services abroad with a credit card, trying with this measure to deter the use of credit cards overseas by Argentines and thus trying to keep more dollars in Argentina; the "tourism" account in the central bank's statements has gone from an US$8 billion surplus in 2011 (foreigners in Argentina spent US$8 billion dollars more than Argentines spent overseas in that year) to a US$6 billion deficit.

Thirdly, as a means of attracting more dollars into the economy the government has extended the tax amnesty known as "voluntary disclosure of foreign currency" (http://www.canosa.com/en/exteriorizacion-voluntaria-de-moneda-extranjera/); this program originally expired on September 30, 2013, and was extended to December 31, 2013, and now it has been extended to April 31, 2014. The government was expecting to receive US$4 billion but has only collected US$570 million. Bear in mind that the only way of applying to this program was by subscribing financial instruments issued by the government.

Finally, and also related to these issues, in October 2013 a new tax was created on the profits derived from the purchase and sale of non-publicly-traded shares or securities and a new tax (on top of income tax) on the payment of dividends (http://www.canosa.com/en/entran-en-vigencia-modificaciones-la-ley-de-impuesto-las-ganancias-transferencia-de-acciones-y-dividendos/).

Although the new year has just started, there seems to be a lot of movement and concern in Argentina, and the pace of the changes is so fast that you should be very well prepared to seize the opportunities that may come around. Stay tuned in to AEI for further news and opportunities from Argentina.

About the Author

Javier Canosa is a partner in the BA firm Canosa Abogados. Mr. Canosa's practice covers corporate law issues, advising several national and foreign companies in various corporate matters, including investment vehicles, corporate management, directors' duties and responsibilities, audits, risk detection and distribution, documents, policies and corporate contracts, and design and implementation of a suitable corporate form for each business.

Before Purchasing a Brazilian Company...

Adler Martins

The market for mergers and acquisitions in Brazil has been very busy in the last few years, especially because Brazil has become as an investment option for American and European companies fleeing from slow-growth markets at home.

I have been noticing that many of the new investors are either individuals or medium-sized companies. This is very different from the usual standard, which was of big multinational companies being the only ones inclined and ready to set foot in a tropical third world country.

This article is intended to give newcomers an overview of the basic elements of due diligence for a Brazilian company, as well as listing the basic public registries that can be consulted in order to avoid uninformed decisions. I will not speak about intangible assets or economic forecasts, but about the very basics of company valuation, such as debt and labor liabilities.

Civil and commercial liabilities

The civil code establishes that new partners to a company or corporation cannot avoid previous debts of the company. This is, any acquirer must be prepared to carry the business's debts and pay them. This provision becomes more relevant if one considers that the "piercing the corporate veil"

Due to this circumstance, the payment of outstanding taxes should be made by the acquirer, prior to or simultaneously with the transfer of the company's ownership. It is important to stress that tax liabilities can, and usually are, transferred from the company to its directors (even new ones).

Labor liabilities

The general rule here is similar: labor debts belong to the company, regardless of its owners.

In more specific terms, this means that the new owner can't expect to lay off a big number of workers right after the acquisition is complete, unless he is prepared to face the payment of worker's compensation.

Similarly, if the company being acquired has laid off many employees before the acquisition in order to improve its books, the new owner must be prepared to support the labor claims that will entail.

Brazilian public registry system

Being a civil law country, Brazil maintains a very formal and organized civil registration system that serves the primary purpose of providing evidentiary records to meet legal and administrative needs.

In the words of the Latin America and Caribbean Council for Civil Registration, Identity and Vital Statistics, "In Brazil each State has its own civil registry. The State organ in charge of supervising the civil registrars is the Judiciary Power through the respective tribunal according to its geographical location in the province and district. In every municipality there is at least one register office."

The use of registration offices in Brazil contributes to the bureaucracy and the sluggishness of the pace of doing business. However, when it comes to mergers & acquisitions, it provides a very good source of information.

Civil courts, federal courts and labor courts will provide a free list of lawsuits in which the target companies, or its shareholders, are parties.

Revenue agencies will provide a list of all the debts that they deem due by the target company. This can be accessed easily, as long as the company's directors allow the acquired to access the government system (or, in the cities where debts are not yet electronically managed, to have access to the company's files).

Other ancillary bodies can provide data on the company's history. The commercial Registry of the State and the Brazilian securities agency (CVM), for example, will provide a complete record of the company's articles of association or trade history. For companies that received foreign investment or that have acquired loans abroad, a consultation of the company's records before the Brazilian Central Bank will also allow for a complete database of this kind of transaction.

Brazil has also developed a comprehensive private database system, notably when it comes to debts before other companies. Consultations to those databanks are easy and cheap, and the information is usually reliable. The most well known one would be Serasa Experian, but there are many others.

Conclusions

The many types of Brazilian public records can and should be consulted in the early stages of negotiation. Many of those can be accessed online, for free. The aid of an accountant and a lawyer is strongly recommended, even in this initial phase. By using these easily accessible tools, the investor will surely increase the safety of any transactions in Brazil. In neglecting them, any investor is doomed to failure. Brazil is not for beginners.

About the Author

Adler Martins is a Law graduate from the Federal University of Minas Gerais (UFMG). He holds an MBA from Fundação Getúlio Vargas and is pursuing a Masters (LLM) at Pontifical Catholic University of Minas Gerais and a post-graduate course in Financial Planning at São Paulo City University. Mr. Martins speaks English, Spanish, Portuguese, German and some Chinese (Mandarin). He has working experience in Argentina, Mexico, India, England, China and Dubai, aside from extensive experience in Brazil.

Mr. Martins is the co-founder of UFMG's group on the study of International Trade Law (GEDICI) and has represented UFMG at the Vis Arbitration Moot, in Austria. He is also a pioneer in legal research of contracts among Brazil, Russia, India and China.

African Hedge Fund Review

2013 was a positive year for hedge funds in Africa, but regional disparities remain.

According to Tutu Agyare, Managing Partner and Chief Investment Officer of Ghanaian-based hedge fund Nubuke Investments, the markets were positive in 2013, with increased interest, funds in place and more sophisticated investors coming into the market. He explains that the U.S. showed more interest than any other country, but that even places like the Far East have started to dip their toes in, encouraged by the African growth story.

"I think the growth of the African middle class is the main focus from a marketing perspective. From a valuation perspective the big, core consumers that have driven a lot of the performance now seem to be significantly overvalued relative to the long-term trend. A lot of money has gone into that but whether that's sustainable or not is another matter altogether," he says.

It seems as though investors are getting past their fears about the African continent, leaving emotions aside, and finally seeing it for the huge opportunity that it is. "If you look at all the big global investment houses, they are all opening in Africa, so the data points continue to suggest – and the return series continues to reinforce – the opportunity, but it's still very small in the context of global opportunity," he adds.

Mr. Agyare also points out that the rise in interest and allocations was much higher in the private space than in the public sphere, but that the majority of private equity firms on the continent are still buying public companies.

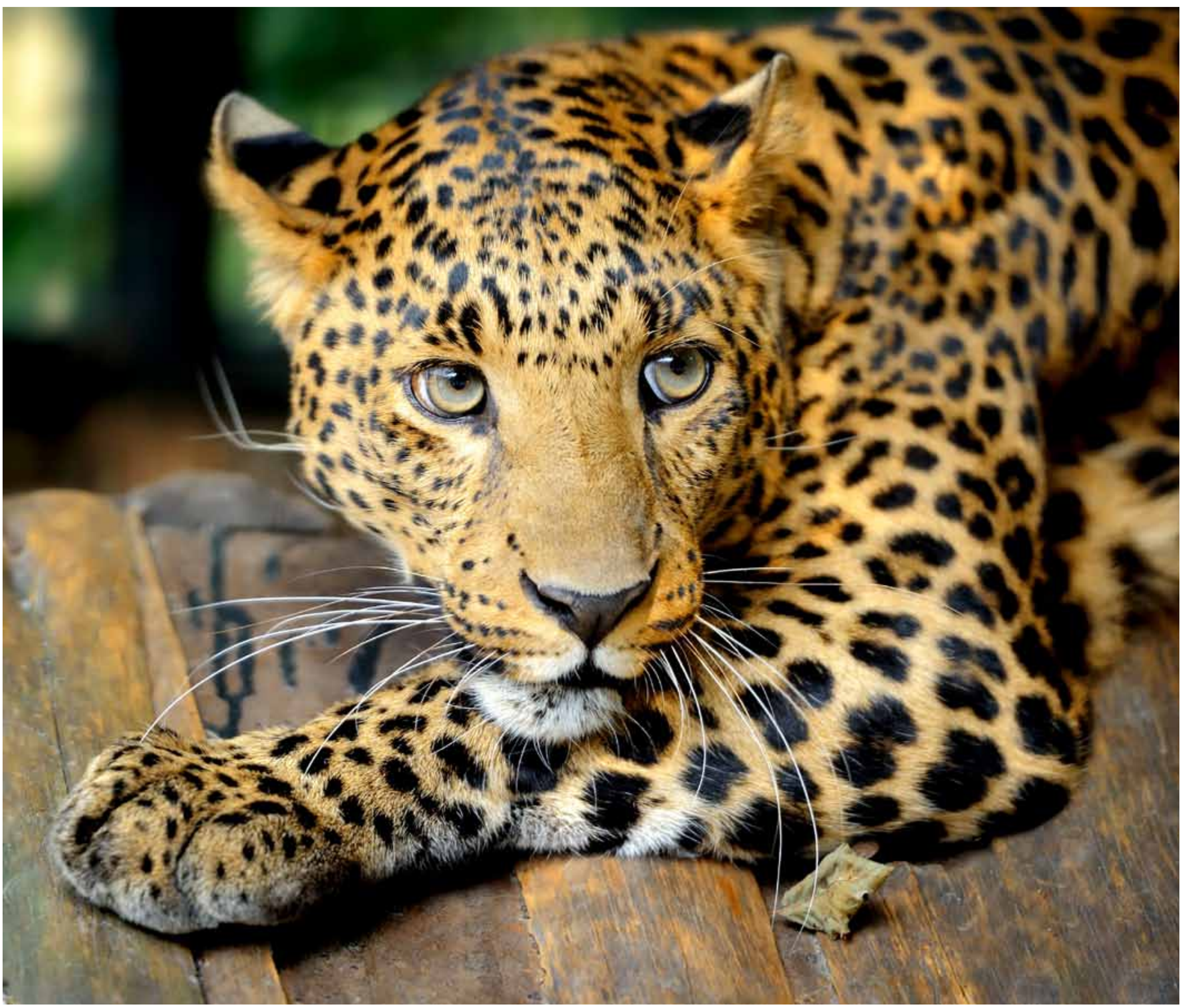
However, the increased interest from investors hasn't necessarily translated into extra liquidity yet. He explains, "I don't think there's been this sort of growth in liquidity relative to the level of interest, and we have not seen as much equity issuance."

Geographically, although investment is much more widespread than in the past, there are still huge gaps between countries. From Nubuke's Ghana office, Mr. Agyare has seen the country go through a rough patch. "The economy in Ghana has deteriorated significantly throughout the year, and it's become less of an attractive destination and liquidity has actually gone down rather than up."

And although South Africa still dominates the continent's hedge fund sector, political uncertainty could lead to a drop in interest in 2014. "In South Africa the overall climate is getting worse, not better. I think that going into elections is something that's going to make it even more challenging. There's going to be lots of questions around the legacy of Nelson Mandela, and although the hard questions are being asked, they're not necessarily being given the right answers," he says.

Meanwhile, North Africa is still benefiting from its close links with the Arab League, and East Africa is the region to watch, particularly in terms of natural resources opportunities. "I think the East African investment story has become the most exciting in terms of change, with mineral discoveries that are making it a quite an exciting destination to make investments."

In terms of prospects for 2014, volatility is the key word, and African hedge funds could find opportunities to capitalize on it. "Given the uncertainties around papering and where the tenure treasury goes, given the fact that we have an election in South Africa, we have what seems to be a bumpy run-up to the election in Nigeria in 2015, . . . we expect to see volatility. And for a fund like ours which can very quickly allocate between asset classes and be long and short, we think that's very fertile hunting ground," says Mr. Agyare.



Character Counts

RBC Wealth Management was ranked "Highest in Investor Satisfaction With Full Service Brokerage Firms" in J.D. Power & Associates 2013 Full Service Investor Satisfaction Study℠.

We are honored to be recognized with this award and believe it is a reflection of our stewardship values in putting our clients first. Contact us today to learn about how we can help plan your financial future.

DENNIS J. STANEK JR.
Senior Vice President – Financial Advisor
20 Church Street, Suite 2300
P.O. Box 1900
Hartford, CT 06144-1900
(860) 241-8652

RBC Wealth Management

There's Wealth in Our Approach.™

RBC Wealth Management received the highest numerical score among full service brokerage firms in the proprietary J.D. Power & Associates 2013 Full Service Investor Satisfaction Study℠. Study based on responses from 4,759 investors measuring 15 investment firms and measures opinions of investors who used full-service investment institutions. Proprietary study results are based on experiences and perceptions of consumers surveyed in January–February 2013. Your experiences may vary. Visit jdpower.com.