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 EmergingInvestor

Issue 2 - July / August

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Correlation

Mauritius
Africa's Gateway

Understanding
African
Exchanges
Nigeria and
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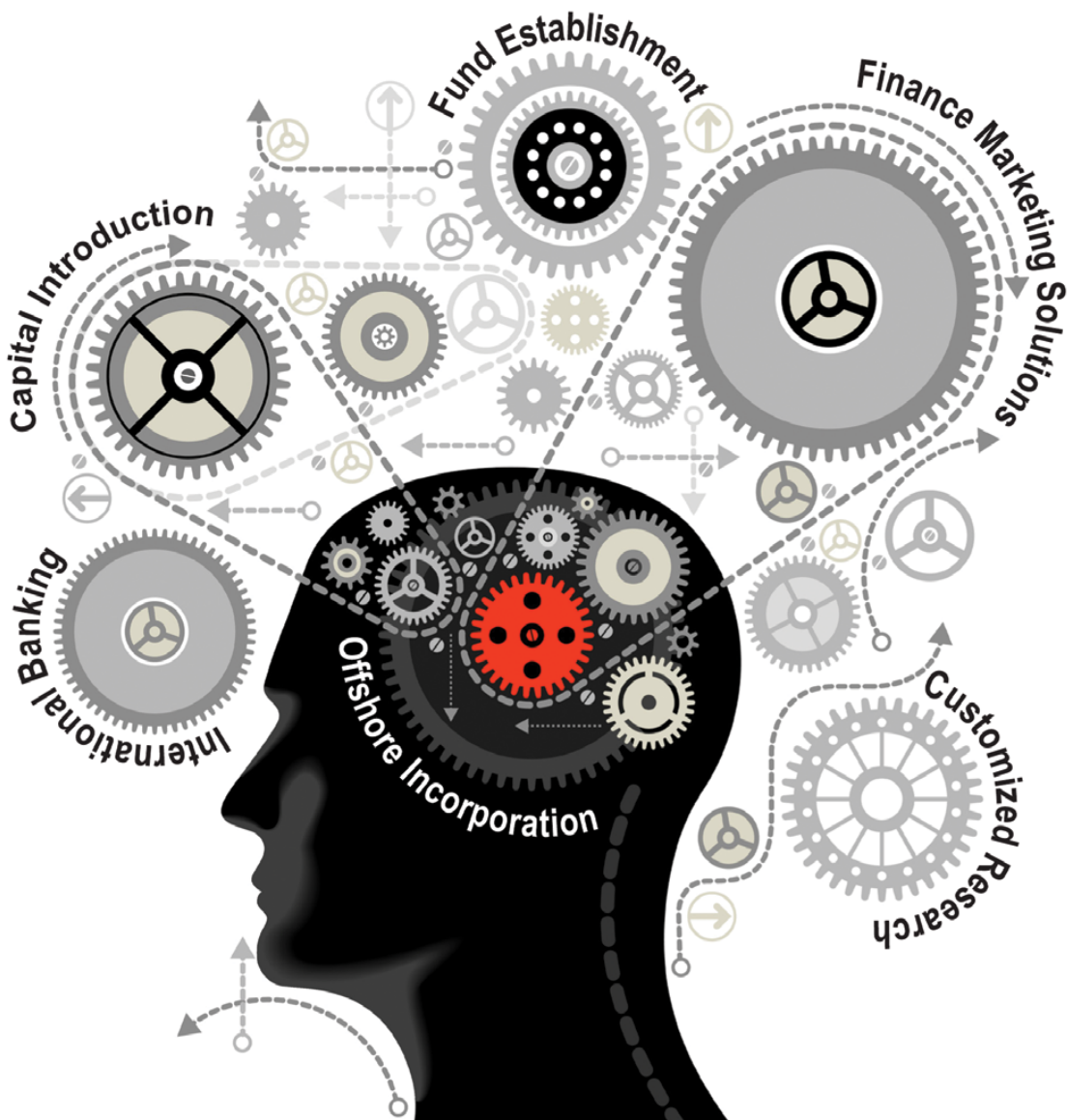
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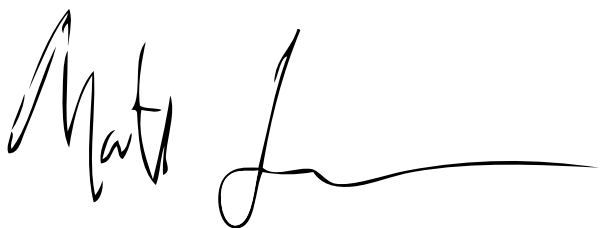
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I would like to start with a question which we'll circle back to, "In practical terms, how different is perceived quality from actual quality?" While the emerging market middle class is increasing, there still exists an incredible gap between rich and poor which creates a unique market for foreign goods and services. In these markets branding and marketing play an important role in the perception of quality goods. In Beijing, Chivas Regal is the preferred scotch, within the local scotch drinking population, over single malts due to marketing. In Buenos Aires Starbucks are popping up at an alarming rate much to the detriment of local street cafes. In the eyes of these consumers, marketing campaigns have established quality.

Why is this relevant? After a year of delays and vaguely written excuses, the SEC has finally voted on the JOBS act, which is to deregulate the marketing ban for private placement, namely hedge funds. How will the industry react? While a parallel can be drawn to the previous restrictions on law firm advertising, law affects almost all of our population, hedge funds are only open to 7% of the U.S.

While I can not comment on the potential perceived quality of hedge funds to be derived from advertising, I do believe there will be an increase in perceived selection. This change in legislation will make it possible for smaller funds, including frontier and emerging market vehicles to get in front of a wider audience through a greater ability to market themselves. While the ability to advertising may not create an increase in funds out there, it may just seem like there are more of them, and greater awareness of alternative vehicles is a good thing for our industry.

Saludos,



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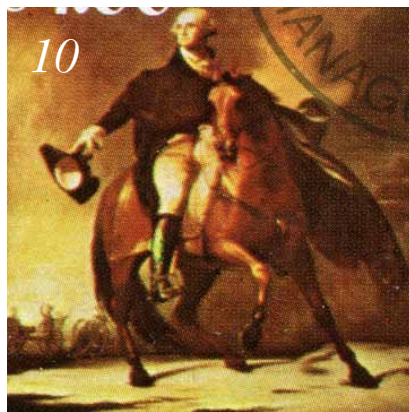
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THE LOGIC OF THE INFORMAL ECONOMY



Ricardo Hausmann

A specter is haunting the world's developing countries – the specter of the “informal” economy. For some, the informal sector includes all businesses that have not been registered with the authorities. For others, it refers to businesses that escape taxation. The International Labor Organization defines it as comprising firms that are small enough to fall outside the labor code.



Whatever the definition, what has concerned many economists and gained policymakers' attention is that the size distribution of firms in developing countries has a long tail. Compared to developed countries, an unusually large number of small, unproductive firms coexist with a small number of large, productive firms.

According to standard economic reasoning, this is inefficient. If the small, unpro-

ductive firms closed down and the larger, more productive firms hired their workers, total output and well-being would rise. This should happen automatically through the invisible hand of competition, because the more productive firms should be able to deliver a better product at a lower price, while luring workers with higher wages.

So, why doesn't this happen routinely in developing countries? Why do the inefficient firms survive, trapping resources in low-productivity activities? What is pre-

venting the market from working its magic and making everyone better off?

For some, the problem is that government regulations make compliance too onerous for small firms. Others claim that tax evasion creates an unfair advantage for informal firms, or that family-wide health care gives households no incentive to have more than one member pay social-security taxes. For still others, programs that target the informal sector distort the playing field.



In an effort to address the problem, governments in Colombia, Mexico, Peru, South Africa, and elsewhere have been busy changing their tax codes, redesigning their registration systems, and exploring the potentially perverse incentive problems associated with social welfare programs. While the jury is still out on the effectiveness of any of these initiatives, I would bet against their success.

It requires many years of training and abstract economic thinking to miss the obvious. The salient characteristic of modern production is that it mobilizes a lot of knowhow – too much to fit in the head of any single person.

Efficient production requires a division of labor among those who know about technology, marketing, finance, logistics, human-resource management, contracts, regulations, distribution, customer service, and much else. It requires manual and intellectual skills that must be used in tandem. Just think of the different specialized skills (many of them recognized by the Oscars) that must come together to make a single film.

To bring these skills together, people have to be integrated into cooperative arrangements in the same firm or within clusters of related firms. But in order to get together to work, people have to travel from their homes to production sites. How do they do that?

In the typical developing-country city, they do so with difficulty. Daily commute times for low-income formal-sector workers often exceed 3 hours, and the average direct cost of transportation is equivalent to roughly 2 hours of work at the minimum wage. An 8-hour shift becomes an 11-hour shift for which net pay is only 6 hours.

This implies an effective tax rate of 45% on low-income formal-sector workers.

Add to this the inconvenience of travel and the potential problems caused by being far from home in case of a family emergency. With these considerations in mind, it becomes easier to understand why people would prefer to do something useful near home rather than where modern production takes place.

But in the shantytowns where developing countries' urban poor live, there are few varieties of skill that people can mix with their own to make things productively. As a result, the only feasible forms of production use very few low-skilled workers – and thus operate at low productivity. They specialize in food preparation, retail, construction, repairs, Internet cafes, and myriad other activities that can be carried out at home and sold to neighbors (often through a window facing the street).

Economists and policymakers have disregarded the physical aspects of urban life. Housing policy is typically discussed with blatant disregard for urban transport and the locations where industrial and business zones are authorized. When planners designed Punta Cana – the very successful tourist destination in the Dominican Republic – or the giant Fiat plant in Betim, Brazil, they forgot to plan for their workers' housing. Not surprisingly, shantytowns quickly developed.

The informal sector is mostly a consequence of the fact that people are disconnected from modern production networks – an inefficiency that will not be resolved simply by reducing the cost of registering a business or forcing small firms to pay taxes. What is required is a redesign of urban space, including subways and dedicated bus lanes, and a more integrated approach to housing, social services, and production areas. Governments will have to start doing some good things, not just stop doing some bad ones.

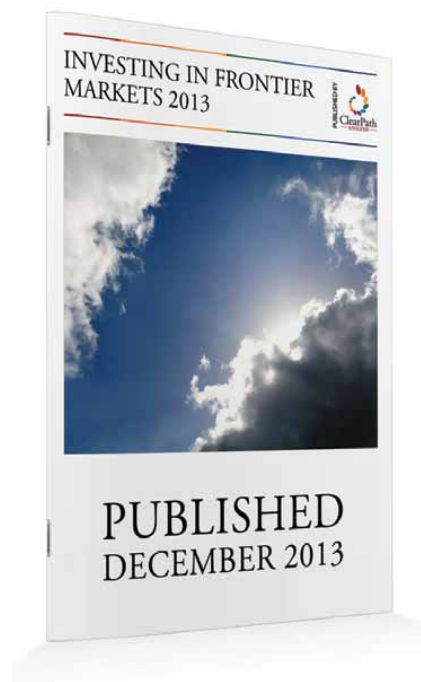
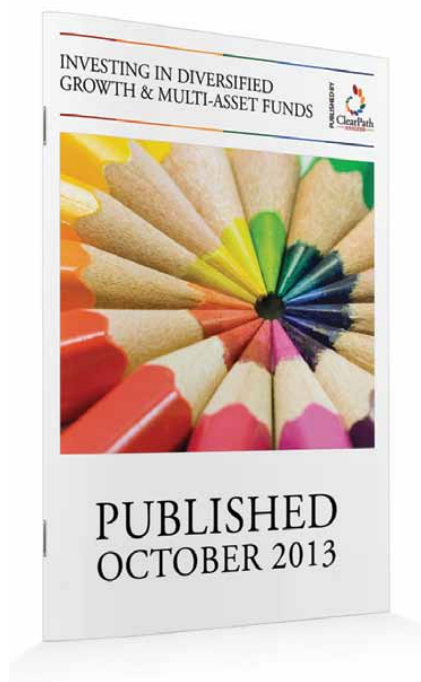
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Is the U.S. Losing Latin America?

■ Shlomo Ben-Ami

It is a mantra increasingly heard around the world: U.S. power is in decline. And nowhere does this seem truer than in Latin America. No longer is the region regarded as America's "backyard"; on the contrary, the continent has arguably never been so united and independent. But this view fails to capture the true nature of U.S. influence in Latin America – and elsewhere as well.

It is true that U.S. attention to Latin America has waned in recent years. President George W. Bush was more focused on his "global war on terror." His successor, Barack Obama, seemed to give the region little thought as well, at least in his first term.

Indeed, at the Summit of the Americas in Cartagena in April 2012, Latin American leaders felt sufficiently confident and united to challenge U.S. priorities in the region. They urged the U.S. to lift its embar-

go on Cuba, claiming that it had damaged relations with the rest of the continent, and to do more to combat drug use on its own turf, through education and social work, rather than supplying arms to fight the drug lords in Latin America – a battle that all acknowledged has been an utter failure.

It is also true that Latin American countries have pursued a massive expansion of economic ties beyond America's sway. China is now Latin America's second-largest trading partner and is rapidly clos-

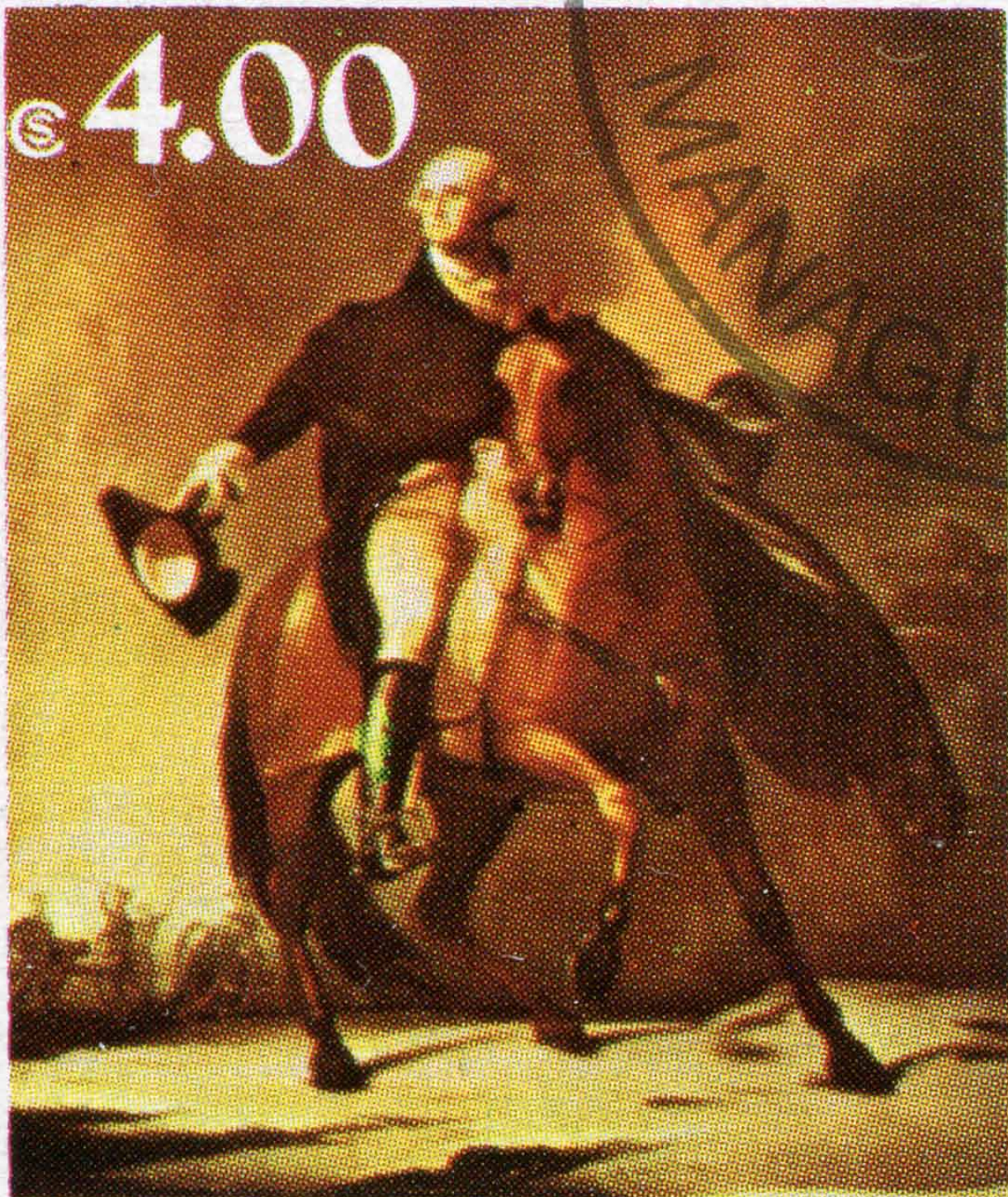
ing the gap with the U.S. India is showing keen interest in the region's energy industry, and has signed export agreements in the defense sector. Iran has strengthened its economic and military ties, especially in Venezuela.

Similarly, in 2008, Russia's then-President Dmitri Medvedev identified the US war on terror as an opportunity to create strategic partnerships with rising powers such as Brazil, and with the Bolivarian Alliance for the Americas (ALBA), a Venezuelan-



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inspired bloc opposed to U.S. designs in the region. The energy giant Gazprom and the country's military industries have spearheaded the Kremlin's effort to demonstrate Russia's ability to influence America's neighborhood – a direct response to perceived American meddling in Russia's own “near abroad,” particularly Georgia and Ukraine.

Yet it would be a mistake to regard Latin America's broadening international relations as marking the end of U.S. preeminence. Unlike in the bygone era of superpowers and captive nations, American influence can no longer be defined by the ability to install and depose leaders from the U.S. embassy. To believe otherwise is to ignore how international politics has changed over the last quarter-century.

A continent once afflicted by military takeovers has slowly but surely implanted stable democracies. Responsible economic management, poverty-reduction programs, structural reforms, and greater openness to foreign investment have all helped to generate years of low-inflation growth. As a result, the region was able to withstand the ravages of the global financial crisis.

The U.S. not only encouraged these changes, but has benefited hugely from them. More than 40% of U.S. exports now go to Mexico and Central and South America, the U.S.'s fastest-growing export destination. Mexico is America's second-largest foreign market (valued at \$215 billion in 2012). U.S. exports to Central America have risen by 94% over the past six years; imports from the region have risen by 87%. And the U.S. continues to be the largest foreign investor on the continent. American interests are evidently well served by having democratic, stable, and increasingly prosperous neighbors.

This new reality also demands a different type of diplomacy – one that recognizes

the diverse interests of the continent. For example, an emerging power such as Brazil wants more respect on the world stage. Obama blundered when he dismissed a 2010 deal on Iran's nuclear program mediated by Brazil and Turkey (despite having earlier endorsed the talks). Other countries might benefit from US efforts to promote

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democracy and socioeconomic ties, as Obama's recent trips to Mexico and Costa Rica show.

Trade relations provide another all-important lever. President Sebastian Piñera of Chile visited the White House recently to discuss, among other things, the Trans-Pacific Partnership (TPP), an ambitious trade agreement that might encompass New Zealand, Singapore, Australia, Mexico, Canada, and Japan. President Ollanta Humala of Peru is expected in the White House next week, while Vice President Joe Biden is scheduled to visit Latin America soon after.

Language and culture matter, too. Given the extraordinary growth of Latinos' influence in the U.S., it is almost inconceivable that the U.S. could lose its unique status in the region to China or Russia, let alone Iran.

Gone are the days when military muscle and the politics of subversion could secure U.S. influence – in Latin America or anywhere else. A world power today is one that can combine economic vigor and a popular culture with global outreach on the basis of shared interests. The U.S. is better positioned than any other power in this respect, particularly when it comes to applying these advantages in its immediate vicinity.

About the Author

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This article was provided by Project Syndicate



Sub-Saharan Africa's Subprime Borrowers

■ Joseph E. Stiglitz & Hamid Rashid

In recent years, a growing number of African governments have issued Eurobonds, diversifying away from traditional sources of finance such as concessional debt and foreign direct investment. Taking the lead in October 2007, when it issued a \$750 million Eurobond with an 8.5% coupon rate, Ghana earned the distinction of being the first sub-Saharan country – other than South Africa – to issue bonds in 30 years.

This debut sub-Saharan issue, which was four times oversubscribed, sparked a sovereign borrowing spree in the region. Nine other countries – Gabon, the Democratic Republic of the Congo, Côte d'Ivoire, Senegal, Angola, Nigeria, Namibia, Zambia, and Tanzania – followed suit. By Feb-

ruary 2013, these ten African economies had collectively raised \$8.1 billion from their maiden sovereign-bond issues, with an average maturity of 11.2 years and an average coupon rate of 6.2%. These countries' existing foreign debt, by contrast, carried an average interest rate of 1.6% with an average maturity of 28.7 years.

It is no secret that sovereign bonds carry significantly higher borrowing costs than concessional debt does. So why are an increasing number of developing countries resorting to sovereign-bond issues? And why have lenders suddenly found these countries desirable?

With quantitative easing having driven interest rates to record lows, one explanation is that this is just another, more obscure manifestation of investors' search for yield. Moreover, recent analyses, carried out in conjunction with the establishment of the new BRICS bank, have demonstrated the woeful inadequacy of official assistance and concessional lending for meeting Africa's infrastructure needs, let alone for achieving the levels of sustained growth needed to reduce poverty significantly.

Moreover, the conditionality and close monitoring typically associated with the

multilateral institutions make them less attractive sources of financing. What politician wouldn't prefer money that gives him more freedom to do what he likes? It will be years before any problems become manifest – and, then, some future politician will have to resolve them.

To the extent that this new lending is based on Africa's strengthening economic fundamentals, the recent spate of sovereign-bond issues is a welcome sign. But here, as elsewhere, the record of private-sector credit assessments should leave one wary. So, are shortsighted financial markets, working with shortsighted governments, laying the groundwork for the world's next debt crisis?

The risks will undoubtedly grow if sub-national authorities and private-sector entities gain similar access to the international capital markets, which could result in excessive borrowing. Nigerian commercial banks have already issued international bonds; in Zambia, the power utility, railway operator, and road builder are planning to issue as much as \$4.5 billion in international bonds.

Evidence of either irrational exuberance or market expectations of a bailout is already mounting. How else can one explain Zambia's ability to lock in a rate that was lower than the yield on a Spanish bond issue, even though Spain's credit rating is four grades higher? Indeed, except for Namibia, all of these sub-Saharan sovereign-bond issuers have "speculative" credit ratings, putting their issues in the "junk bond" category and signaling significant default risk.

Signs of default stress are already showing. In March 2009 – less than two years after the issue – Congolese bonds were trading for 20 cents on the dollar, pushing the yield to a record high. In January 2011, Côte d'Ivoire became the first country to

default on its sovereign debt since Jamaica in January 2010.

In June 2012, Gabon delayed the coupon payment on its \$1 billion bond, pending the outcome of a legal dispute, and was on

ward-looking, and comprehensive debt-management structure. They need not only to invest the proceeds in the right type of high-return projects, but also to ensure that they do not have to borrow further to service their debt.



the verge of a default. Should oil and copper prices collapse, Angola, Gabon, Congo, and Zambia may encounter difficulties in servicing their sovereign bonds.

To ensure that their sovereign-bond issues do not turn into a financial disaster, these countries should put in place a sound, for-

These countries can perhaps learn from the bitter experience of Detroit, which issued \$1.4 billion worth of municipal bonds in 2005 to ward off an impending financial crisis. Since then, the city has continued to borrow, mostly to service its outstanding bonds. In the process, four Wall Street banks that enabled Detroit to issue a total

of \$3.7 billion in bonds since 2005 have reaped \$474 million in underwriting fees, insurance premiums, and swaps.

Understanding the risks of excessive private-sector borrowing, the inadequacy of private lenders' credit assessments, and

would do well to learn the lessons of the all-too-frequent debt crises of the past three decades. Matters may become even worse in the future, because so-called "vulture" funds have learned how to take full advantage of countries in distress. Recent court rulings in the United States

There are no easy, risk-free paths to development and prosperity. But borrowing money from international financial markets is a strategy with enormous downside risks, and only limited upside potential – except for the banks, which take their fees up front. sub-Saharan Africa's economies, one hopes, will not have to repeat the costly lessons that other developing countries have learned over the past three decades.



the conflicts of interest that are endemic in banks, sub-Saharan countries should impose constraints on such borrowing, especially when there are significant exchange-rate and maturity mismatches.

Countries contemplating joining the bandwagon of sovereign-bond issuers

have given the vultures the upper hand, and may make debt restructuring even more difficult, while enthusiasm for bail-outs is clearly waning. The international community may rightly believe that both borrowers and lenders have been forewarned.

About the Author

Joseph E. Stiglitz, a Nobel laureate in economics and University Professor at Columbia University, was Chairman of President Bill Clinton's Council of Economic Advisers and served as Senior Vice President and Chief Economist of the World Bank. His most recent book is *The Price of Inequality: How Today's Divided Society Endangers our Future*.

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African Bonds:

In Search of Investment

In fixed income markets, “yield-hunting” currently seems to be the name of the game, and the economic crisis in the old continent makes Eurobonds issued by African countries very interesting for risk-seeking investors. A smooth meeting between supply and demand is also favored by high interest rates in domestic markets. Nevertheless, there are several factors that investors should pay close attention to, as not all African realities can grant the same investment success.

A recent report from Standard & Poor’s has highlighted the great interest that Africa’s bond markets have attracted in recent months. Rwanda’s US\$400 million Eurobond issue in April 2013 is a good example: the bond was substantially over-

subscribed at a yield of about 7%, only half a percentage point above the average yield to maturity for a U.S. high-yield corporate bond. Until a few years ago South Africa was the only country operating in the Eurobond market, but since 2007 7 other nations started Eurobond issuance. This

trend seems to be accelerating: Ghana, for example, one of the pioneer nations in issuing Eurobonds in sub-Saharan Africa in 2007, has recently appointed Barclays for a new Eurobond issuance in 2013.

Low returns on investments in Europe and the U.S. appear to be attracting international investors to emerging markets such as Africa. Meanwhile, the scarcity of local savings and a history of high inflation keep domestic interest rates very high, making it cheaper for many African countries to issue debt on the international markets rather than domestically. The gap between domestic and foreign rates is currently so wide that it creates a win-win scenario for foreign investors and local governments. Nevertheless, Eurobond issuance in these countries also bears both economic and political risks. That is why it is nec-



essary to make a reflection on these two points. These are countries with negative trade balances, heavily exposed devaluation and, in most circumstances, double-digit inflation. This means it will be more difficult for them to replay a debt in dollars 10 years out. Issuers with reserves of natural resources are less exposed to this risk because they have available sources of dollars to pay off bonds. Another important risk factor to keep in mind is how many political elections will take place during the life of a

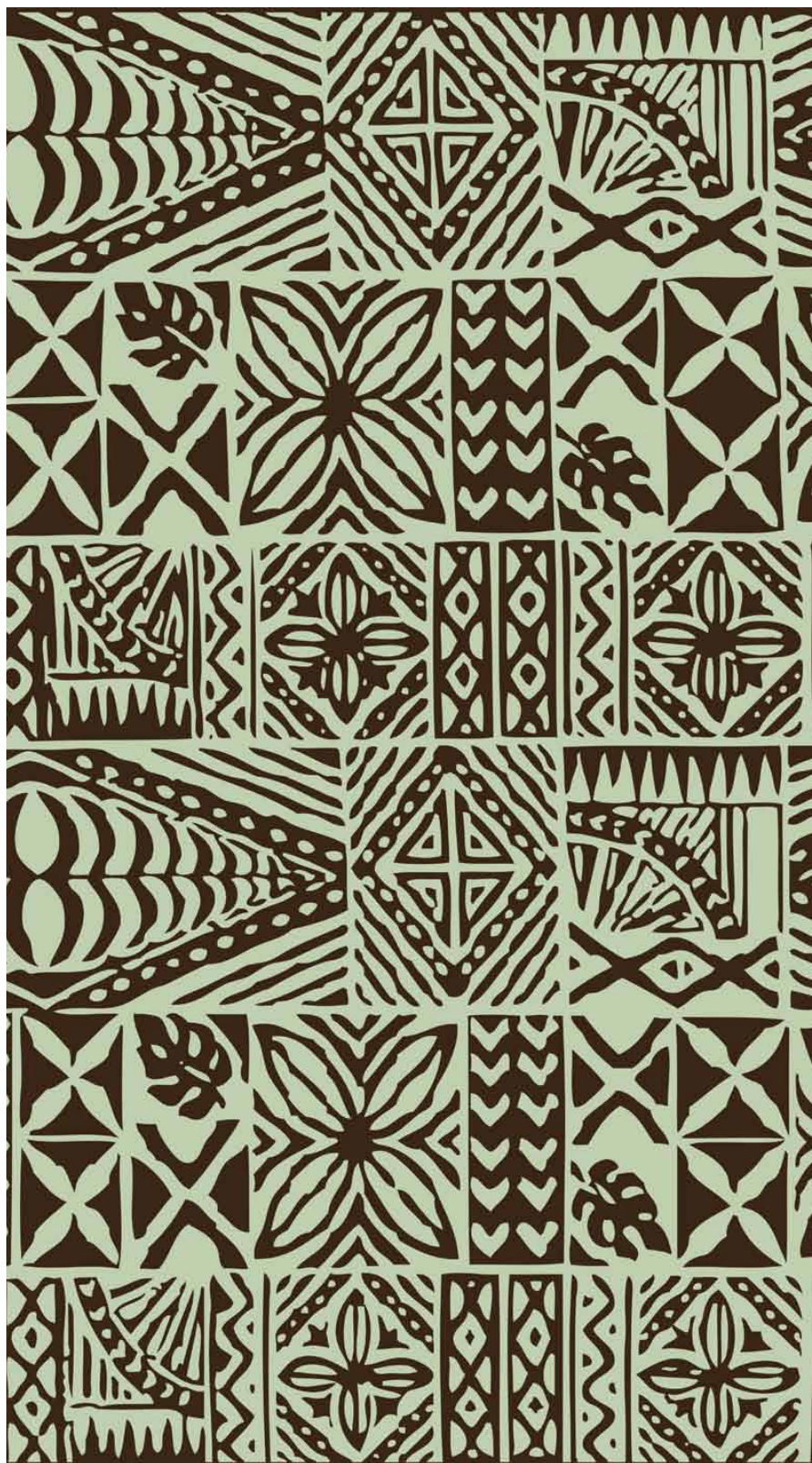
bond. The case of Ivory Coast, in this sense, is quite emblematic: the country has missed 3 payments after one political side rejected the results of 2010 elections, and the new government has of-

fered reassurances that it will pay them this year. Despite that, the Eurobond has incredibly halved its yield at 7% since the beginning of 2012.

About the Author

Federico Chirico is the founder and editor of "The African Frontier," a blog dedicated to the discovery of African financial markets. He started his career at UBS Investment Bank in 2007, and he then moved to Ghana for a few years, where we worked as business analyst for a Ghanaian based financial boutique called Canal Capital. Currently, Mr. Chirico works for a large media and information company as financial markets executive, and is a CFA level 2 candidate.

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Getting Prices Right

■ Andrew Sheng & Xiao Geng

Building and maintaining the infrastructure of property rights – the rules, laws, registers, and administrative and judicial structures that define, protect and enforce such rights and regulate economic transactions – has traditionally been the responsibility of national governments. But as the world economy has become increasingly interconnected, a global property-rights infrastructure (PRI) has emerged further raising the stakes of developing effective national PRIs and accurate price-discovery mechanisms.

The global PRI has arisen through countries' widespread accession to the World Trade Organization, international accounting and regulatory criteria like the Basel Accords, standards established by the International Organization of Securities Commissions, and some aspects of international law. As national economies and multinational companies compete for market share, global standards of market behavior become increasingly important.

Consider the smart-phone industry, in which corporations like Apple, Samsung, Sony,



Nokia and Huawei compete fiercely to secure their global market shares. Given that companies cannot compete effectively in global markets without a sound domestic PRI, such firm-level competition has driven countries to improve the national PRI over the longer term.

Furthermore, establishing accurate asset-price levels is essential to a well-functioning market. The state affects asset prices indirectly through its influence on inflation, interest rates, and the strength of the currency.

Governments can di-

rectly influence the prices of key resources like energy, money and public goods and services through taxation, customs duties, production quotas and natural-resource ownership.

Government intervention in benchmark prices can be justified in the name of macro-economic management or regulatory action to improve the provision of public goods and services. After all, the state determines the supply of fiat money and is responsible for energy and natural-resource conservation. But there is a risk that the state can get important prices seriously wrong.

This is particularly true of money, which has two prices. The government (the visible hand) sets the benchmark price for risk-free financial assets through monetary policy and control over fiscal deficits, while the market (the invisible hand) sets the risk premia of risky assets above the benchmark rate. The distinction between the two prices is the foundation of modern finance theory.

But the system rests on the assumption that the government will set accurate

benchmark interest rates for risk-free assets. As the recent crises in advanced countries demonstrated, this is not a safe assumption: Unsustainable public debt and fiscal deficits forced central banks to expand their balance sheets massively, causing benchmark rates to turn negative in real (inflation-adjusted) terms.

In fact, lowering the benchmark rates for risk-free assets changes the distribution of the risk premia on risky assets, making it too low when asset bubbles are forming and too high when they burst. This pattern was evident in the 1997-1998 Asian financial crisis, the 2008 global financial crisis, and the eurozone crisis that erupted in 2010.

The logic and the mechanism that the government uses to set benchmark prices are very different from those that the market uses to set risk premia. The former implements policy decisions based on economic, social, and political considerations, while profit-maximizing behavior – anchored by the state-determined price and requiring a robust PRI – determines the latter.

Thus, the role of the market in price discovery is inextricable from that of the government. Indeed, there is a complex, non-linear feedback relationship between the two, so developing an accurate capital-pricing system depends on both actors.

Until recently, advanced-country markets predominated in setting risk premia, owing to their mature and well-functioning PRIs, which include clear rules and a high level of transparency in price formation. But, even in advanced countries, the influence of vested interests can lead to collective-action failures and, in turn, to incorrect benchmark rates.

Last year's LIBOR scandal, in which

banks were found to be reporting inaccurate interest rates in order to manipulate the prices of financial instruments, epitomized this risk.

Meanwhile, given that many emerging economies have incomplete or immature PRIs, their influence over market-price discovery is relatively weak. In state-dominated systems like China's, developing an effective PRI – delineating market participants' rights and responsibilities, ensuring the exchange platform's transparency, and creating a fair and equitable process of dispute resolution – is particularly challenging, because the state acts as a regulator, asset owner, enterprise operator, and competitor in the market.

In such systems, the government directly controls the benchmark interest rates. But setting the correct rate for risk-free assets is difficult when capital flows easily across borders, enabling market participants to exploit discrepancies between countries' rates.

Herein lies the dilemma (one that China currently faces) of market-oriented reforms. While cross-border capital flows and interest and exchange rates must be liberalized to maintain economic development, such reforms raise the risk of asset bubbles if implemented under distorted benchmark prices.

Emerging economies have watched the leveraged power of investors distort the price-formation process in crisis-stricken advanced economies. Preventing this from occurring in emerging economies requires that these countries' leaders balance monetary, fiscal and macro-prudential policies in a way that enables correct pricing of risk-free assets.

Striking this balance is made even more complicated by the influence of advanced-country policies on emerging economies. Exceptionally low interest rates and quantitative easing may be appropriate for advanced economies experiencing slow growth, but

About the Author

Andrew Sheng, President of the Fung Global Institute, is a former chairman of the Hong Kong Securities and Futures Commission, and is currently an adjunct professor at Tsinghua University in Beijing. His latest book is *From Asian to Global Financial Crisis*.

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they can be problematic for emerging economies struggling to promote market-oriented price-discovery mechanisms. In this environment, it may be appropriate to strengthen the global PRI further.

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China's Cold Eye on Hot Money

With China feeling the pressure from large-scale inflows of short-term capital, the State Administration of Foreign Exchange (SAFE) issued a notice in early May outlining a set of measures aimed at controlling “hot money” and reducing external risks.

Indeed, the new regulations are essential to managing the renminbi's rapid appreciation and ensuring the accuracy of trade data. But will they be enough?

 **Zhang Monan**



A variety of data indicates the massive scale of the inflows. In the first quarter of this year, Chinese banks' foreign-exchange purchases skyrocketed to a record ¥1.2 trillion (US\$195 billion) – more than double last year's total. Such purchases increased by some ¥294.3 billion from March to April, which was the fifth consecutive month of growth.

Over the same period, China's foreign-exchange reserves swelled by US\$128 billion, to US\$3.4 trillion – the largest quarterly increase since 2011 and equal to the total rise in 2012. Given China's US\$43 billion trade surplus and US\$30 billion in foreign investments during this period, capital inflows must have been a contributing factor.

Furthermore, since the beginning of this year, Chinese banks' valet foreign-exchange settlement (foreign-exchange purchases that designated banks make for their clients and themselves) has outstripped corresponding sales, resulting in a consistently large surplus – also an indication of increased capital inflows. The difference, which banks offset through transactions in the inter-bank currency market, has a significant impact on China's foreign-exchange reserves, but is not equivalent to the net change in foreign-exchange reserves during the same period.

According to SAFE, individuals and institutions exchanged US\$152.2 billion in foreign currency for renminbi through Chinese banks in March, and purchased US\$107.6 billion in foreign currency from financial institutions. As a result, the banks' foreign-exchange surplus reached US\$44.6 billion, rising 38% from February and marking the seventh consecutive month in which bank-to-client transactions created a surplus.

The consequences of abnormal capital flows into China are becoming increas-

ingly apparent, particularly in foreign-exchange markets. Despite slowing GDP growth – currently only 7.7% annually – the renminbi has appreciated rapidly, reaching a record-high central parity of 6.2082 against the US dollar at the beginning of May.

With no sign of improved economic fundamentals, the renminbi's rapid rise must be related to substantial foreign-currency

*By inflating
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– mostly U.S.
dollars – into
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inflows. Since China's current benchmark interest rate is higher than the comparable rate in the United States, individuals and institutions have an incentive to keep renminbi as assets and dollars as debt. The current round of monetary easing underway in many advanced countries, together with strong expectations of renminbi appreciation, are also fueling currency speculation, placing further upward pressure on the exchange rate.

The new SAFE regulations will attempt to curb this trend by imposing, for the first time, limits on net open positions held by Chinese banks with foreign-currency loan/deposit ratios (LDRs) exceeding 75% and by foreign banks with LDRs above 100%. A higher foreign-currency LDR will mean tighter restrictions on long renminbi positions. By providing an incentive for banks to hold more foreign-exchange deposits against their loans, the new rules will drive up the price of foreign-currency loans, thereby deterring firms from using dollar loans to speculate on renminbi gains.

Although the regulations did not take effect until June 1, their impact was felt immediately. The renminbi ended its upward trend against the U.S. dollar on May 6, closing at 6.1667, down 112 basis points from the previous trading day – the steepest decline since last December. On the same day, stricter controls on capital inflows caused the offshore renminbi to close at 6.1790 against the U.S. dollar, down 0.4% – the largest drop since January 2012. This suggests that the measures will succeed in stemming upward pressure on the renminbi.

At the same time, the new regulations aim to end many firms' practice of channeling capital into China disguised as trade bills. By inflating export deals in order to move foreign currency – mostly U.S. dollars – into China, firms have evaded capital controls and distorted trade data. In order to transform the funds into renminbi outflows, the firms then increase the scale of renminbi settlements in cross-border trades. In March and April, cross-border renminbi trade settlement increased by ¥412.8 billion, up 57.6% year on year.

The growing discrepancies between foreign-trade data and port data have cast doubt on the reliability of the former. Last year, China's exports grew by roughly 6.2%, and container throughput completed

at China's above-scale ports increased by 6.8% year on year.

By contrast, in the first quarter of this year, Chinese foreign trade increased to US\$974.6 billion, reflecting a higher growth rate than in 2012, while Chinese ports completed 800 million tons of cargo throughput, representing a growth rate that was 4.2 percentage points *lower* than in the same period last year. In March, container traffic at China's above-scale ports was 15.29 million TEUs (20-foot equivalent units), with month-on-month growth 1.7 percentage points slower than in the previous two months.

Clearly, trade data are being inflated as companies carry out fake transactions to bring capital into the country. Firms know that as long as the hot money can reach mainland banks through Hong Kong, they

can expect risk-free yields of more than 2%. Considering the renminbi's recent appreciation, the rate of return could reach 3-4%.

According to the new regulations, SAFE will issue a warning 10 days after finding that a firm's capital flows do not match its physical shipments. Such firms will be more closely monitored for at least 3 months, until the relevant figures return to normal.

One can only hope that these measures will be sufficient to bring China's export data gradually back to reality. At a minimum, the new measures are an important step toward improved management of cross-border capital flows, which is bound to benefit China's economic transformation and restructuring significantly.

About the Author

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Interest in Myanmar (Burma) has become intense. Last month, Thein Sein became the first president of Myanmar to visit the White House in nearly 50 years, and leaders from British Prime Minister David Cameron to India's Manmohan Singh to Japan's Shinzo Abe have all visited Yangon.

Myanmar's Moment?

■ Martin N. Baily & Richard Dobbs

Indeed, after years of absence, foreign governments are rushing to re-open their embassies in the country. Moreover, multilateral organizations and former ministers from around the world are flocking to help the authorities make progress on their ambitious agenda, from expanding electricity provision to building their own governing capacity. Investors, too, are actively exploring opportunities.

This focus is not surprising. After years of economic isolation and anemic growth, Myanmar is one of Asia's last largely untapped markets. Now that the country is opening up, investors are clearly hoping to establish sources of structural advantage that could last for many years.

But can investing in Myanmar live up to today's soaring expectations? There are undoubtedly major uncertainties

and risks. Investors are rightly nervous about how political reform will evolve, whether the government can maintain the fragile peace between ethnic groups, and how regulation and ownership rights will develop. Moreover, it is difficult to quantify the economy's potential, given the paucity of reliable data; even basic indicators like population size and historical economic growth are shrouded in uncertainty.

There is little doubt that Myanmar begins its development journey from a shockingly weak starting point, as a new report from the McKinsey Global Institute (MGI) demonstrates. Indeed, Myanmar was virtually untouched by the global economy's spectacular growth during the twentieth century. While global *per capita* GDP quadrupled around the world, Myanmar's was virtually flat.

Moreover, productivity is low. A worker in Myanmar added only \$1,500 of economic value, on average, in 2010 – around 30% of the average of eight Asian peers. Myanmar's GDP is now only around 0.2% of Asia's, equivalent to the size of cities such as Bristol, Delhi, or Seville.

Myanmar needs a step-change in productivity growth. Given expected demographic trends and historic labor-productivity growth, annual GDP growth could be less than 4%, lower than the current consensus. But if Myanmar were to boost annual labor-productivity growth from an estimated 2.7% to around 7% – a rate achieved by other Asian economies, including China and Thailand, in recent decades – 8% annual GDP growth would be possible. This could quadruple the size of the economy by 2030, with annual output rising to more than \$200 billion, from \$45 billion in 2010.

But it is virtually inconceivable that Myanmar could achieve such acceleration in growth without large volumes of inward investment. The MGI research estimates that \$170 billion – as well as the transfer of capabilities and knowledge that typically accompany such investment – is needed between now and 2030.

Thus far, much of the interest among investors has been focused on Myanmar's energy and mining sectors – no surprise, given the country's large reserves of oil and gas, its 90% share of global jade production, and its strong position in ruby and sapphire mining. But Myanmar cannot rely on energy and mining alone. It needs

growth that is balanced across sectors, providing diverse opportunities for inward investors.

Five sectors – energy and mining, agriculture, manufacturing, tourism, and infrastructure – could account for more than 90% of Myanmar's total growth and employment potential. Of these, manufacturing, which could take advantage of many companies' desire to relocate from China and other Asian economies where wages are rising, is by far the most important. The manufacturing sector could, according to the MGI report, employ 7.6 million people and generate nearly \$70 billion of GDP by 2030 – more than triple the po-

tential size of the agriculture sector, which currently is Myanmar's largest.

If Myanmar generates the growth and employment that MGI believes is possible, this would help to increase the number of those with sufficient income for discretionary spending from 2.5 million today to 19 million in 2030, thereby tripling consumer spending to around \$100 billion. This would expand the market for companies selling everything from scooters and cars to electronics and financial services.

There should be business opportunities, too, in housing, power, transport, and



energy infrastructure. Roughly \$300 billion in infrastructure investment in these areas is required across the economy, half of which would need to be in large cities, which will expand if Myanmar diversifies out of agriculture. Today, only an estimated 13% of Myanmar's population lives in large cities, but that could rise to 25% by 2030 – an addition of ten million people.

Another \$50 billion is needed in telecommunications infrastructure if Myanmar is to make full use of digital technology to leapfrog stages of development – for example, by using mobile banking or e-commerce to avoid the cost of building

physical banks and shops, and to extend health and education services to even the remotest villages. Today, Myanmar has the second-lowest level of Internet penetration of countries covered by the World Bank's development indicators, and mobile penetration is the lowest.

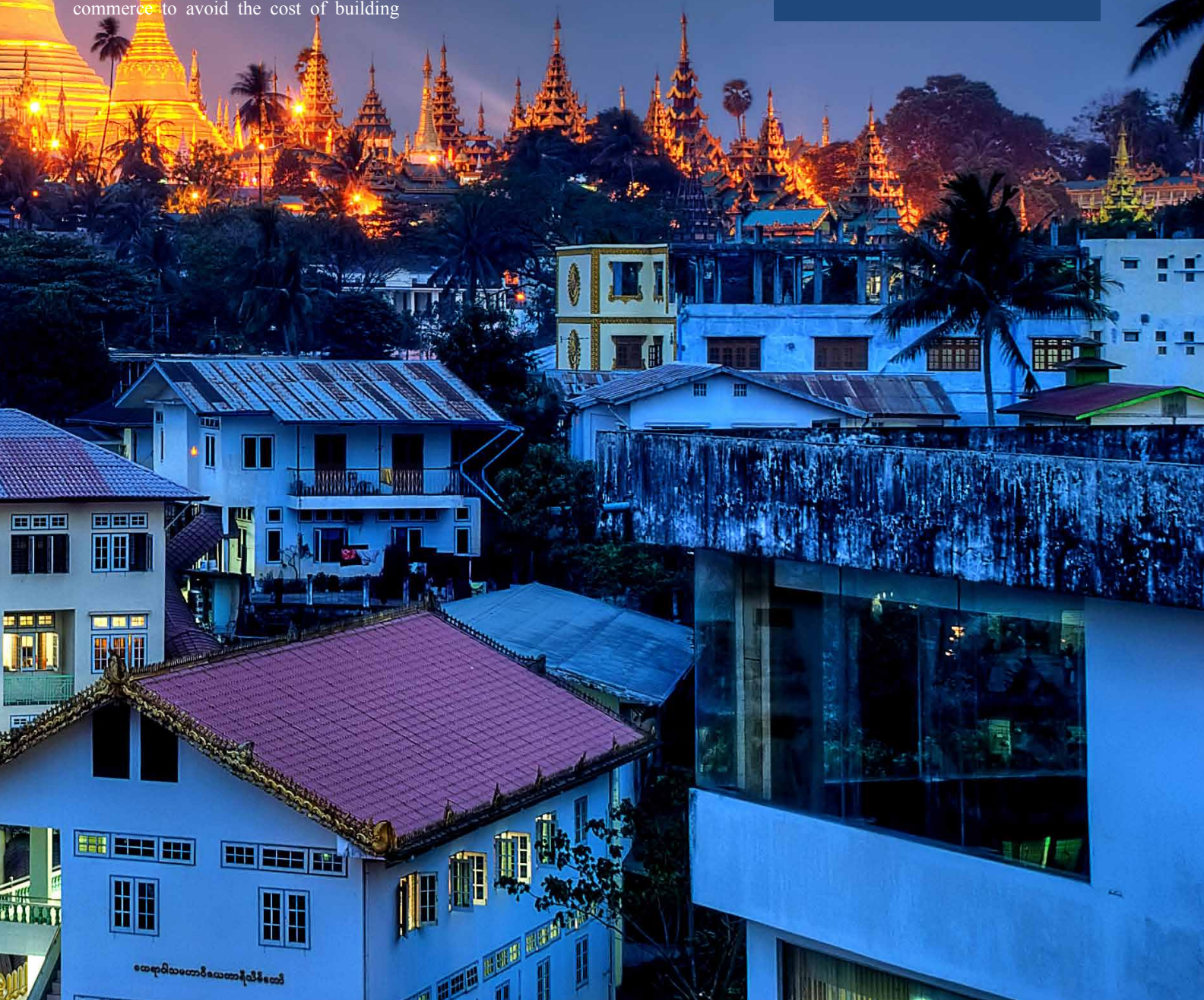
Myanmar faces monumental development challenges that embrace virtually every aspect of the economy. But that implies the broadest possible range of opportunities for companies and investors as well. They should proceed with caution, but with the expectation of tapping into a potentially lucrative new market.

About the Author

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This article was provided by Project Syndicate



Emerging Market Rout Spells Opportunity



■ James Gruber

The investor love affair with emerging markets is quickly fading. For much of the past decade, emerging markets – Asia being the largest and most emblematic example – were the place to be, offering explosive growth compared with the meager offerings of the developed world. The trend spawned sexy acronyms such as BRICS, numerous indices to try to capture the growth and, of course, dedicated emerging market equity and bond funds that attracted billions of dollars.

But like many a love affair, this one too has now soured, with the stocks, bonds and currencies of emerging markets significantly underperforming those in much of the developed world this year. There are a host of reasons for the underperformance, such as fears about the U.S. reducing quantitative easing (QE), much of which has leaked into emerging market asset prices, the fall in commodity prices hurting growth and the unwinding of a credit bubble in China.

Asia Confidential thinks that some of these reasons will prove overblown and that the situation offers long-term investors the opportunity to pick up stocks in countries with still strong growth prospects, principally in Asia. Not all emerging markets are alike, though, and you should avoid those that are reliant on commodities and/or exports. The focus instead should be on those countries with the best domestic consumption stories. On that basis, India and Thailand are our top picks.

■ Emerging Markets Pummelled

Emerging markets have become the ugly ducklings of the financial world. This year the MSCI emerging market index has fallen 4% in U.S. dollar terms, compared with a 14% rise in the S&P 500 and a 5% increase in MSCI Europe. Latin America has been the main culprit, dropping 10%, while Asia ex-Japan has declined 2%.



The notion of the BRIC (Brazil, Russia, India & China) economies was always just a slogan because Brazil and Russia had unsustainable growth models that were over-reliant on commodities.



In Asia, the larger index weights in China and South Korea have dragged on performance, down 6% and 7% in U.S. dollar terms year to date. Notably, though, the world's best performing region since the crisis, Southeast Asia, has also started to turn around. Market darlings Thailand and the Philippines have been hardest hit, falling 8% and 12% in dollar terms over the past month, though they are still up 1% and 9%, respectively, this year.

The currency falls in emerging markets have been even more severe. For instance, the South African rand has declined more than 18% this year, even outdoing the 16% drop in the Japanese yen. The Argentine peso and Brazilian real have also decreased 8% and 4% against the dollar, respectively. The only bright spots have been the Chinese yuan and Mexican peso, up 2% and 1%, respectively.

Emerging market fund flows confirm that investors are heading for the exits. Emerging market equity funds had net redemptions of US\$3 billion in May, the highest since end-2011. Global emerging market funds were the worst hit, with outflows of US\$1.4 billion followed by Asia ex-Japan at US\$872 million, EMEA (Europe, Middle East & Africa) funds at US\$324 million and Latin America at US\$303 million.

Emerging market bond fund flows have also turned negative amid heightened volatility. For the week ending May 29, fund outflows totalled US\$143 million, the first weekly outflow since August 2012.

Reasons for the Fall

There are a host of reasons behind the sharp downturn in emerging markets, including the following:

1. Fears over the U.S. cutting back QE.
Much of the money printed since 2009

has leaked into areas offering growth, particularly emerging markets. If the speculation about so-called QE tapering is right, that supply could soon dry up.

2. Concerns over rising bond yields. Talk of QE tapering has lifted U.S. bond yields and has put upward pressure on emerging market bond yields as a consequence.
3. Continued weakness in commodity prices. That weakness of course impacts commodity-producing nations such as Brazil, Mexico, South Africa and Indonesia. For instance, sugar prices have declined close to 30% since last July, which has an obvious effect on the world's largest sugar producer, Brazil. The rout in gold prices has impacted South Africa, although it has a host of other economic issues it's also dealing with.
4. Weakness in other previously strong growth markets. In China, GDP growth has slowed from the 11% of the past decade to under 8% as a credit bubble unravels. In India, economic growth is the lowest in a decade as investment slows while inflation remains a risk, thereby limiting scope for further rate easing.
5. Perceptions of increased political risks haven't helped. We're primarily referring to Turkey, where there have been major protests against the government's alleged authoritarian ways and attempts to impose Islamic conservative values on a secular state.

EM Story Far from Done

There are good reasons to believe that a number of the factors behind the emerging market underperformance will prove unfounded, or at least exaggerated. For example, concerns over potential QE tapering are likely to be a massive head fake. The primary factor making QE tapering highly unlikely is that deflation remains the central threat to developed markets,

including the United States. U.S. headline CPI inflation has slowed from 3.9% in September 2011 to 1.1%. That means real interest rates are rising, which is inherently deflationary.

Second, money velocity at 60-year lows in the U.S. also signals deflation is the principal risk. After all, money needs to change hands and filter through to the economy for QE to work. That's not happening right now, and it's why U.S. growth remains remarkably weak post the financial crisis.

These strong deflationary trends make QE tapering improbable. And if the Federal Reserve does decide to cut stimulus, it's likely to reverse course quicker than Ben Bernanke can retreat from office to hand Janet Yellen the mess that he's created! There are other factors that are supportive of many emerging markets outperforming their developed market counterparts. I say "many" emerging markets because lumping them together is silly and unhelpful. The notion of the BRIC (Brazil, Russia, India & China) economies was always just a slogan because Brazil and Russia had unsustainable growth models that were over-reliant on commodities.

Even grouping Asia ex-Japan together is somewhat problematic. The region has the world's emerging power, China, which is battling a credit hangover from 2009. India has its own domestic problems, via a combination of slowing growth and still high inflation. Southeast Asia has been traveling better, although Indonesia appears vulnerable given that commodities account for more than 50% of its exports. In other words, Asia is a diverse region and countries within it won't all grow at the same pace. Far from it.

Generalizing, however, Asia ex-Japan still offers the world's best growth story. Compared to developed markets, Asia's GDP



growth is far superior, its balance sheet is sounder, and the region's younger demographics should provide for more productive workforces.

In addition, Asia ex-Japan is cheaper than many developed markets. Its 12-month forward price-to-earnings ratio (PER) of 11x is almost 30% cheaper than the S&P 500 PER of 15x. Asia also offers a better dividend yield of 2.8%, 35% higher than the S&P 500's 2.1%.

Top Picks Are India and Thailand

Within Asia, the best opportunities are likely to be in countries whose growth is driven more by domestic consumption than exports. That's because rising wealth (driven by increased wages) translates into strong domestic consumption, particularly off a low base, as is the case in Asian countries. Those reliant on exports may prove less compelling investments given the tepid growth in developed markets, which may remain for many years to come.

In our view, the two stand-out opportunities right now are India and Thailand. We'll briefly focus on the more controversial recommendation of India. Although GDP growth is at decade-lows and the inflation risk is ever-present, there are positive changes in India that may provide both short- and long-term catalysts.

In the near term, the investment cycle in India is showing signs that it could soon pick up. The long down cycle in investment has been driven by rising interest rates to ward off inflation, a shambolic power sector and subsequent shortage of coal and a bureaucracy afraid to make decisions given numerous corruption scandals among high-ranking officials.

There's been some progress on each of these fronts, raising hopes of an investment

rebound. First, Finance Minister Palaniappan Chidambaram has been using judicial powers to force through price increases for electricity distributed by the State Distribution Boards (SBDs). SBDs have suffered chronic losses and debts due to politicians being unwilling to pass on the full costs of electricity to their electorates. The recent electricity tariff increases will go some way to reducing SBD debts and provide an incentive to produce more power.

Second, the Finance Minister has also set up a special committee on investments to fast-track projects, to bypass bureaucratic inertia. And according to CLSA's Chris Wood, the word is that US\$25 billion in projects have been approved since December.

There are other changes in India that also bode well for the long term: Steps have been taken to cap the subsidies on fertilizers. These subsidies, along with those for food and petroleum, have escalated dramatically since the financial crisis as the Congress Party tries to buy off rural voters. They are the central reason inflation remains an issue in India. The cap on fertilizer subsidies is significant in this context.

Work on providing a unique I.D. and card to all Indians is progressing well. This mammoth task, being undertaken by the former head of tech giant Infosys, has already signed up 245 million people to the system. One of the key potential benefits of this system is that it may help to cut out the middleman in transactions, a key problem in India.

Several state governments are showing impressive economic growth through more business-friendly policies. The state of Gujarat is often cited, but there are four or five others that are equally impressive on this front. There is hope that these examples may have a domino effect across India's 28 states.

The proposed introduction of a value-added tax is far behind schedule but should go ahead in a diluted form. It should raise the tax take by 3-4% of GDP from the current low level of 17%. This may go some way toward reducing the money printing tendencies of the central bank.

This is not to suggest that India doesn't face significant hurdles, particularly with the political shenanigans that will no doubt precede next year's general election. But it's worth remembering that India has had its fair share of issues over the past 20 years, with many inept governments along the way, and it has still managed to produce real economic growth of 6.7% per annum. Some of the changes noted above indicate that India may continue to surprise in future. When combined with reasonable valuations, with a 12-month PER of 13.9x well below the 16.5x historical average, it makes India an attractive long-term bet.

About the Author

James Gruber founded the investment newsletter Asia Confidential in July 2012. Prior to that he was a fund manager, stockbroking analyst and journalist in Asia for 13 years. Most recently, he spent two years as a portfolio manager for Asian equities at AMP Capital. For five years before AMP, Mr. Gruber was a research analyst at Asian brokerage, CLSA, where he covered multiple sectors in Hong Kong, Singapore, Australia, Malaysia and Indonesia. And in a former life he was a television and radio news journalist at the Australian Broadcasting Corporation.

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Chinese investment

A Tale of Two Halves



At the beginning of June, The World Bank cut the growth forecast for China's economy to 7.7% from 8.4%, warning that the country's investment rates are "unsustainable." However, for now at least, China continues to build up its investment drive, both on a global and local scale. And while sovereign wealth funds and private equity houses pour investments, both in and out of China, the country's state-owned enterprises are continuing to expand into nearby emerging market regions.

China's State-Owned Ventures

China's SOEs (state-owned enterprises), which are held by local, provincial and central governments, represent around 70% of the country's economy. According to Matthew Egerton-Warburton, Counsel at Hong Kong-based law firm King & Wood Mallesons, corporates investing within SOEs receive favourable terms from Chinese state-owned banks and are encouraged to work overseas to diversify their global portfolio and wealth base. Additionally, by spreading the risk, SOEs have become resilient to local "market blips", Mr. Egerton-Warburton adds.

Chinese outbound investment is all about opportunity, a foot in the door of a worthy investment scheme, and King & Wood Mallesons' most recent deals serve as examples of this. The law firm recently acted on behalf of the Chinese Southern Wealth Fund (CIC) and an SOE in a joint venture buy-out deal for an Australian lithium company.

"Often in these deals a Chinese company will organise a transaction and then look for debt funding from Chinese banks and equity funding from the CIC."

The CIC recently announced that its total assets increased to US\$500 billion last year, from US\$482 billion in 2011, due to its diversified investment portfolio – 40% of the fund's total assets are now invested overseas.

Mr. Egerton-Warburton explains that Chinese SOE overseas investments are adapting to incorporate more local involvement, with more and more greenfield projects requiring the expertise of local companies. King & Wood Mallesons recently advised a Chinese SOE on an iron ore mining project in Tanzania – an "ambitious"

deal that was considered to be extremely high risk due to the undeveloped lands and lack of roads and railroads. However, Mr. Egerton-Warburton says that the deal went smoothly, largely because of the collaboration between the Chinese SOE and the local government.

"Most funds are Cayman or BVI based funds for tax and governance reasons but Hong Kong will become a more attractive destination when the new corporate ordinance is introduced next year."

"African governments are becoming more sophisticated and are developing in-house expertise to manage these incoming Chinese investments. In the deal, the Tanzanian government received a large minority shareholding in the project, it ensured a certain percentage of senior managers were Tanzanian, and it received a guaran-

tee that excess electricity generated was sold into the national grid."

SOEs are China's most lucrative offering for outbound investments, according to Mr. Egerton-Warburton, and he says that for now at least, other asset classes, such as private equity, are unable to receive the same favourable terms from China's state-owned banks.

The Rise of Funds

Meanwhile, inbound investments into China from overseas funds are also gaining momentum; the Ministry of Commerce confirmed in early June that foreign direct investment (FDI) into China rose to 5.65% in March to total US\$12.4 billion, while February saw FDI flows increase to 6.3%.

Aside from SOEs, the other big players in mergers and acquisitions in Asia are sovereign wealth funds (SWFs), including the Middle Eastern sovereign wealth funds with their oil and gas revenues, the Chinese sovereign wealth funds with their excess foreign reserves and the Singapore funds.

"These funds have an enormous amount of money and are investing in Asia, a region they know well. Temasek (the Singapore SWF) has over US\$198b in investments, 70% of which is invested in Asia," Mr. Egerton-Warburton says.

Another feature of mergers and acquisitions in Asia, Mr. Egerton-Warburton explains, is that while the major global private equity houses have established a presence in the region they are proving a less dominant force than they are in the US and Europe.

"Asian companies are typically family owned and are more likely looking for minority investors (limiting the ability of PE to gain security over assets to help finance

the acquisition). As a result, financing acquisitions is more difficult and often involves less debt and more equity (limiting the size of acquisitions and increasing the risk profile for the private equity house). Also, private equity houses are bidding for assets against Chinese SOEs and SWFs – both of whom have more flexible investment horizons, less pressure on returns and easier access to financing.”

Local wealth funds however, are making an impact on Chinese inbound investments, and over the years have been picking up pace. King & Wood Mallesons is becoming increasingly involved in setting up country specific funds for Chinese in-

vestors, which are also becoming more market specific.

The firm works alongside investors to create the best-suited tax fund model, and Mr. Egerton-Warburton adds that in his experience, Asian investors are more comfortable with using the Cayman Islands model. However, he says that the change in Hong Kong’s regulatory landscape is allowing China to be more investor friendly, and paves the way for further country funds in the region.

“There is a lot of fund formation occurring in Hong Kong and Singapore and King & Wood Mallesons has been very

busy in this sector. Typically the funds being created are country and market specific. We have set up Philippine infrastructure funds, Myanmar funds, Chinese real estate and infrastructure funds and Mongolian oil and gas funds,” Mr. Egerton-Warburton explains. “Most funds are Cayman or BVI based funds for tax and governance reasons but Hong Kong will become a more attractive destination when the new corporate ordinance is introduced next year.”



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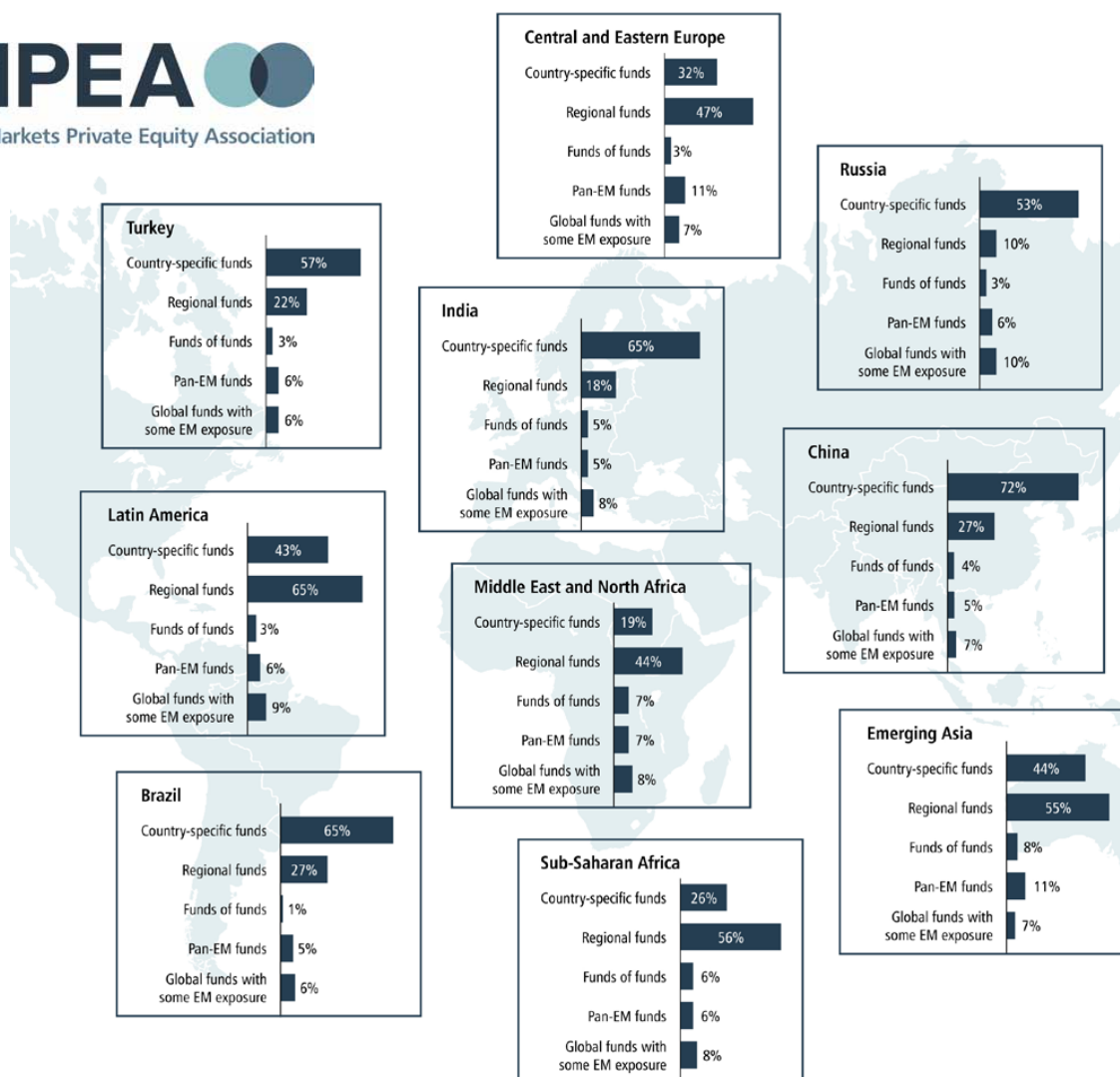

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Institutional Investors Value a Variety of Fund Vehicles

Data Provided by EMPEA's 2013 Global Limited Partners Survey

Limited partners favor country-dedicated funds for the BRICs plus Turkey. Regional funds are most likely to be preferred by LPs seeking to enter a number of markets that they have indicated to be of interest – Sub-Saharan Africa, Southeast Asia and Latin America (excluding Brazil). Pan-emerging market funds and global funds were consistently of less interest to LPs across all emerging market regions.



Inflation Protection *in the Commodities Market*

The commodities market is considered to be one of the most volatile. And for investors, managing the risk can be taxing, especially when hedging inflation.

However, investment management firm Armored Wolf has come up with an innovative ratings tool to manage its investment decisions. The firm, which aims to anticipate its clients' investment needs and provide the necessary solutions, deals with inflation protection orientated funds, the largest of which are in the commodities sector. The firm believes that the glo-

balization and integration of the agrarian segments over the years has driven economic growth, a trend that is expected to continue. Armored Wolf's strategy, therefore, is to deliver risk-adjusted returns for commodity-focused investments.

The group supports advanced commodities, exchange-traded funds (ETF), and U.S. and European inflation protection

funds. To help its clients decide on the best investments and protect their investments against inflation, Armored Wolf has developed a priority sovereign rating system, or an "evaluation" system. After meeting with Moody's, Standard & Poor's and Fitch, the firm has compiled the primary economic indicators that all 3 rating agencies implement to develop its own benchmarking system for its clients. The firm's



unique tool holds the key to what many investors are hoping to find when exploring their investment opportunities or assessing risk management plans.

Douglas Metcalf, Managing Director and Emerging Market Portfolio Manager at Armored Wolf, explains that Moody's, for example, focuses on the country's debt levels and exports when evaluating its ability to pay non-local currency debt. S&P focuses on the country's growth outlook, while Fitch involves itself more in the soft indicators, such as sustainability and transparency. By drawing on all of these methodologies, Armored Wolf is able to track the credit worthiness of a sovereign and evaluate whether it is increasing or decreasing. The overall result, Mr. Metcalf says, has been that the firm is now adjusting country inflation ratings ahead of the bigger rating agencies.

Mr. Metcalf adds: "This tool allowed us to decide on the right countries to invest in. At Armored Wolf, we have a background in inflation protection, as the founder of the firm, John Brynjolfsson, created U.S. and European inflation protection funds in addition to the Alpha Global Macro hedge fund and various commodity and high yield funds. Research that we did into inflation and commodities led us to conclude that energy is the commodity that has the highest correlation with inflation. While some people think it would be gold, it actually doesn't have that high a correlation with inflation; its correlation is higher compared with disruptive monetary policies, as it's more of an anti-currency hedge than an anti-inflation hedge."

Tracking Investments

Armored Wolf uses its rating system when sourcing low-cost commodity producers and integrated oil companies in the emerging markets, such as Pemex and Petrobras.

The firm's next step – when investing in an energy project, for example – is investigating where the oil is being produced and where the exploration is taking place, as well as where the production companies are allocating their expenditure.

"In energy, we like renewables that are price competitive with fossil fuel production. We also follow the integrated oil companies as they develop onshore and offshore projects in the emerging markets. Suppliers, like companies that lease ultra-deep water rigs with contracts to major oil companies that cover total expenses and complete payback as well as collateral with a favorable LTV, should hold up in a downturn," Mr. Metcalf says.

Another area of investment that Armored Wolf focuses on is in sourcing other low cost commodities, such as food production, which is in the "danger inflation area," Mr. Metcalf explains, due to weather variations, as well as the wider economic components. Food production is a key investment area for the company due to its "rising middle class" philosophy.

"At Armored Wolf, we like emerging markets because they are growing 3 to 5 times faster than the developed world, are adding 1 billion people each decade to the middle class and pay higher real interest rates in order to attract capital and technology needed to keep growing. Increased consumer demand for electricity, clean water, better housing and access to markets requires countries to improve their infrastructure, which puts pressure on supply constrained commodities. Also, as the middle class expands, they increase their protein and better quality food so that food, energy and other low cost commodity producers become attractive investment targets. Our top-down approach is to identify attractive emerging market countries that foster development of human and physical capital and are open to importing

what the world has and exporting products that the world wants."

Future Goals

Looking ahead, Armored Wolf is preparing for further investments in the emerging market space, and next up is Africa. The firm has already invested in several African companies with "surprising results," and is now readying itself for further activity. Other regions of interest for the firm, perhaps unsurprisingly, are Papua New Guinea and Myanmar, which although they remain unexplored by the group so far, are now firmly on the radar.

Aside from these countries, the firm is in the process of expanding its portfolio to the Andean region of South America, with a primary anchor in Colombia, Peru and Chile. According to Mr. Metcalf, these countries, along with Mexico, provide great opportunities in looking for commodity producers because they benefit from the "Pacific Alliance," which represents around 36% of the Latin America GDP. The alliance's goals include free trade and economic integration, specifically with an orientation toward Asia.

"Earlier in my career I focused on North-South trading, but since the financial crisis of 2008 I have been more impressed with South-South hemisphere trading patterns," Mr. Metcalf explains. "China has become the leading trading partner with its neighbors in Southeast Asia, but also in many Latin and African countries by offering infrastructure development projects in exchange for raw materials. Frontier market countries that I would not have considered 3 to 4 years ago are showing stronger trends on our sovereign evaluation system."

Armen Ovanessoff
Senior Research Fellow

Accenture's think tank on EM Investing



Do you see any major trends not linked to the emerging market consumer?

The rise of emerging market consumers is undoubtedly one of the defining features of this century. But it's just one part of a bigger story: a broader rebalancing of the global economy, where flows of trade, investment, products, services and information are becoming increasingly multi-directional. The phrase "emerging markets" itself hides a world of complexity and diversity. These economies are evolving at different speeds and in structurally different ways. For some of them, the consumption story is absolutely critical. I'd point to three further long-term trends.

- The growth and evolution of the resource economy will be vital as the world responds to increasing demand for natural resources and the environmental consequences of this. This includes green infrastructure and intelligent energy.
- Infrastructure more broadly remains a priority, whether that's physical infrastructure, digital infrastructure or human infrastructure (healthcare, education, etc.).
- And the rapid proliferation of new technology solutions also promises to have a profound impact on emerging economies, revolutionizing the way people live and work.
- These trends present challenges, of course, but they also promise significant rewards to businesses and investors that identify the right pockets of growth.

2. What pros/cons do you see in emerging market business being able to "skip steps" – go from no banking to mobile banking, or limited organized retail to online shopping?

By leapfrogging to new business models and approaches, emerging market businesses can enjoy classic "fast-follower" advantages. They can benefit from leading prac-



tices from around the world while avoiding the growing pains of their predecessors. This is particularly true with new digital models, as the steps that have been skipped include investments in costly physical infrastructure and systems.

But let's not pretend that businesses face a binary choice of building a bricks-and-mortar business or a digital business. Our research in emerging economies highlights that an online presence is increasingly necessary, but that it is not sufficient for many companies. Infrastructure deficiencies, community structures and ingrained behavioral patterns mean that some steps simply cannot be skipped. Companies operating in these complex markets must be comfortable with operating across multiple channels, catering to a heterogeneous customer base.

It's also worth noting that when it comes to the rapid evolution of technology use by citizens, the pressure is on companies to keep pace. As customers in emerging economies become more empowered and raise their expectations, leapfrogging to new and improved offerings and delivery models goes beyond being an opportunity and becomes an imperative for businesses.

Last but not least, it is important to remember that while some sections of society will be keeping up with new digital business models, others will not. A responsible approach to economic development that manages inequalities of access and progress can help manage risks around social and economic stability.

In what cases is foreign management expertise not of value to a local market?

Foreign management expertise and experience can, in some cases, be essential to success in emerging markets. But foreign managers must have a clear understanding of their role within the local business. Most often, their primary role is to foster skills,

practices, knowledge and cultural traits that will support the implementation of the firm's strategy in that market. Their role is not to impose their opinion and authority on decisions that are sensitive to local market conditions.

This goes to the heart of a perennial challenge for multinationals: how to balance

Let's not forget that the emerging economies have now become major engines of growth, accounting for 50% of the world's output and 70% of the growth in that output.

the benefits of global efficiency and local responsiveness across the global organization. We've undertaken extensive research in this area and tried to uncover what differentiates successful multinationals from unsuccessful ones. For example, we've found that successful companies are more likely to invest in building a flexible international operating model in which people, funds and ideas can flow effectively across countries and business units. Ultimately, the trick is to bring the best of each part of the company

to the rest of the organization. Bear in mind that these flows are increasingly multidirectional; developed markets are finally realizing the degree to which they can learn from emerging markets.

Outside the main sectors, consumer services/goods, energy, infrastructure, etc., do you see any interesting niche industries or secondary markets?

Business-to-business services in emerging markets will be an interesting space to watch in the coming years. As competition in emerging markets intensifies, companies will increasingly look to open their organizations to new sources of innovation and advantage. We've already seen the international success of some emerging market multinationals in this space, like China's Huawei or some of the Indian technology players. The trend is toward movement up the value chain, especially in Asia, where many governments have stated this as a policy goal. For example, we can expect increasing pressure to develop innovative offerings and solutions around sustainability and environmental protection. Trends in consumption, urbanization, demographics and regulation promise to make these kinds of services indispensable across many emerging economies, and beyond.

How do you see the current global interest in emerging markets? Do you believe it is a function of limited developed world growth, which capital will return to, or do you believe interest is due to the stand-alone fundamentals of these markets?

There has been a lot of concern recently about emerging economies slowing down based on recent GDP figures and fears that their ability to attract capital is a short-term trend. It's true that they have caught some of the backdraft from the recession in Europe and general nervousness among investors. But this concern with the short-term slowdown increases the risk that we focus on the wrong things. Let's

not forget that the emerging economies have now become major engines of growth, accounting for 50% of the world's output and 70% of the growth in that output. And the long-term dynamics remain positive: favorable demographics, robust public finances, the rise of the consumer class, and continuing investment in physical and digital infrastructure will all play a role. Even if the growth rates of many of these markets drop, they are still major contributors to the global economy. We'll see more convergent economic growth rates, but that's because so many emerging markets are already serious players in the global economy.

How long do you think we will continue to see 5-10% GDP growth in these markets?

The growth rates of emerging markets will slow – a reassuring thing, when you think about it – but they will continue to be relatively high and the quantity of GDP they add to the global economy will be big. Think about it like this: China (which has received a lot of press for its “slowing” growth rate) underwent 21 consecutive years of 7.5%+ GDP growth up to 2012. In the first year of that growth spurt (1991), GDP grew by 9.2%, which meant an absolute growth of just under US\$50 billion to the size of the

economy. In contrast, the 7.8% GDP growth of 2012 represents an increase of US\$327 billion in the size of the Chinese economy – that's greater than the entire GDP of South Africa for that year. My point is that growth rates are just part of the story, and we need to scratch below the surface of the headline figures. Double-digit growth rates are not always desirable because they cannot be sustainable. The higher objective is to establish the building blocks for sustainable, long-term growth. Hopefully, businesses and governments around the world have that in mind as they choose their priorities for the next phase of economic growth.

About the Author

Armen Ovanessoff is a senior research fellow within Accenture's think tank, the Institute for High Performance, where his focus is on macroeconomic, geopolitical and business trends in emerging economies.

Mr. Ovanessoff's research and publications center on the implications of globalization and the role of new poles of economic growth around the world. With his team, he develops Accenture's position on issues at the intersection of business, government and civil society. His work supports the development of international business strategies and operating models for Accenture and its clients.

Mr. Ovanessoff established the Institute's bureau in India, and he is currently building these capabilities in Brazil. He also manages Accenture's strategic partnership with the World Economic Forum, representing Accenture's point of view on global issues among leaders from business, policy and society. This includes topics as wide ranging as globalization, sustainability and innovation.

Mauritius:

The Investors' Gateway to Africa

With its growing economy and investment outreach, Mauritius is becoming an offshore banking hot spot, and an important springboard for local and foreign investment into mainland Africa.

The country's investment in its banking sector has reached over US\$1 billion, and it has racked up over 32,000 offshore entities, particularly those with many of which have a commercial interest in India, South Africa, and China. Additionally, Mauritius' the country's growing intra-Africa protection agreements and trade-friendly shipping ports are only helping to strengthen the South-South trade ties it has between Africa and Asia. No wonder, then, that investors are lining up to take a slice of the action.

Investment Protection

For international companies looking for a way in to the African markets, Mauritius is one of the best bets. The Mauritian government has so far signed 18 investment promotion and protection agreements (IPPA) with other governments globally, although the majority account for are with African countries. These international bilateral deals between governments aim to protect and encourage investment overseas Mauritian investment.

Georges Chung, C chairman of global business and director financial services

group, Kross Border Trust, explains that Mauritius is working hard to forge further investment treaties, with a particular focus on Africa. He adds that more and more people are investing from through Mauritius as a consequence of its strategic deals with other African countries, which as it helps to mitigate political risk.

"Mauritius has investor protection agreements in place with many other African organizations to secure trade and investment flow partnerships. It also secures protection over its companies, which are factors that any investor who is looking at Africa should take into consideration," Mr. Chung says.

"And if, for example, you invested directly into Mozambique, and there is some sort of political upheaval there, what is going to happen to your investment fund, or capital investment? Is it secure? However, if you invest in Mozambique through Mauritius then your investment will be protected and you can have comfort in that respect."

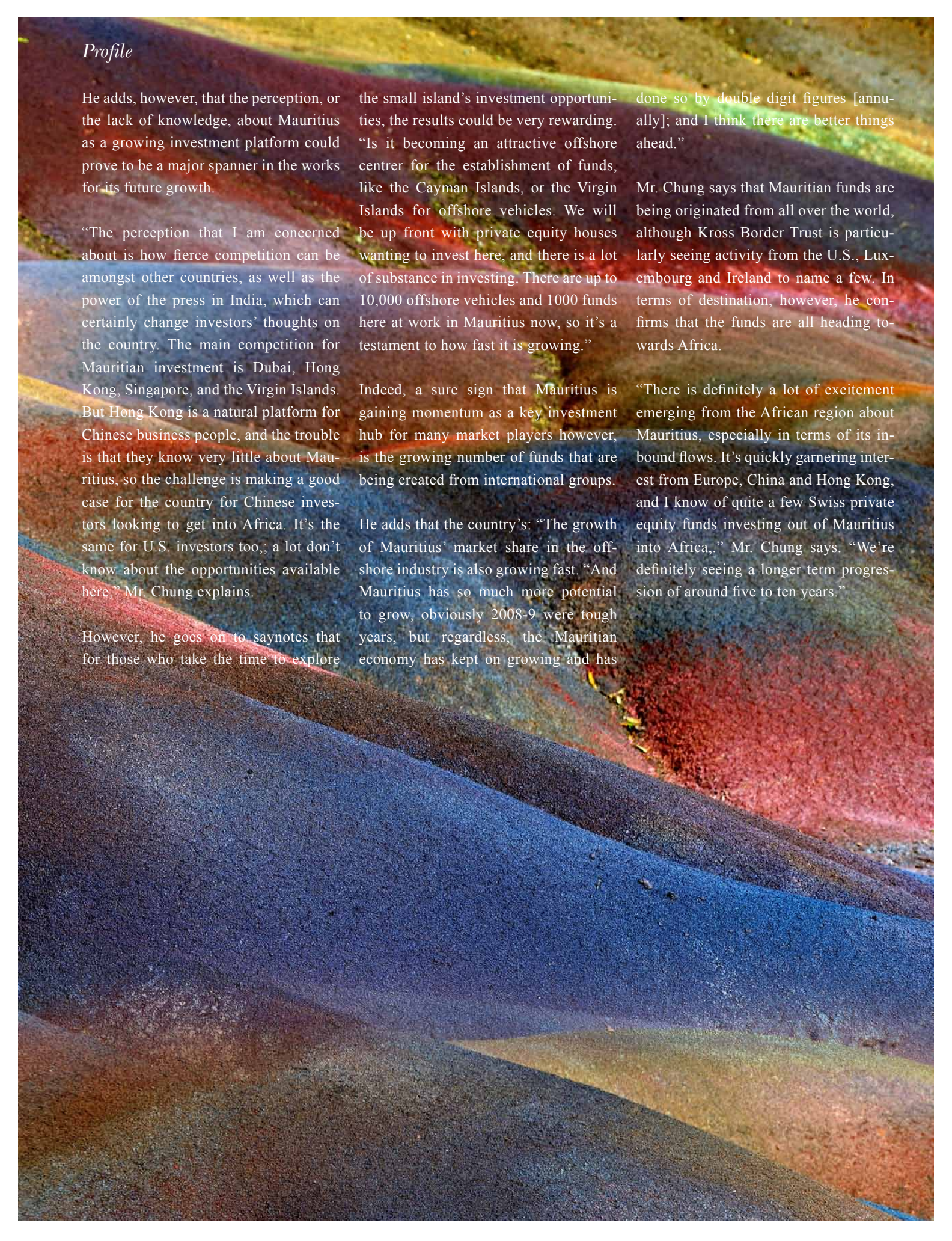
Another investment initiative that Mauritius has to offer is its Double Taxation Avoidance Treaties (DTAs) - the

country is currently the only offshore financial center that has DTAs with the majority of the emerging African economies. The country also has numerous free trade agreements in place that veto eliminate customs tax on any exports to certain other African countries.

An Offshore Centreer Buzz

Although for many, Mauritius is seen as a haven for investors, and a logical next step for those wanting to expand into the African markets, there is still a widespread notion that the country holds far too many risks. According to Mr. Chung, Mauritius' the country's stable political environment, which sees it pegged as number one in the African Democracy Index, is one of the many factors that makes it a sound investment decision.

"I see no reason why Mauritius should be seen as an unstable economy, even from a corporate's point of view. The country has a very long history of democracy, for example, and it has a unity of government - so there is no reason why the perception of Mauritius should be far from its reality."



Profile

He adds, however, that the perception, or the lack of knowledge, about Mauritius as a growing investment platform could prove to be a major spanner in the works for its future growth.

“The perception that I am concerned about is how fierce competition can be amongst other countries, as well as the power of the press in India, which can certainly change investors’ thoughts on the country. The main competition for Mauritian investment is Dubai, Hong Kong, Singapore, and the Virgin Islands. But Hong Kong is a natural platform for Chinese business people, and the trouble is that they know very little about Mauritius, so the challenge is making a good case for the country for Chinese investors looking to get into Africa. It’s the same for U.S. investors too; a lot don’t know about the opportunities available here,” Mr. Chung explains.

However, he goes on to say notes that for those who take the time to explore

the small island’s investment opportunities, the results could be very rewarding. “Is it becoming an attractive offshore centre for the establishment of funds, like the Cayman Islands, or the Virgin Islands for offshore vehicles. We will be up front with private equity houses wanting to invest here, and there is a lot of substance in investing. There are up to 10,000 offshore vehicles and 1000 funds here at work in Mauritius now, so it’s a testament to how fast it is growing.”

Indeed, a sure sign that Mauritius is gaining momentum as a key investment hub for many market players however, is the growing number of funds that are being created from international groups.

He adds that the country’s: “The growth of Mauritius’ market share in the offshore industry is also growing fast. “And Mauritius has so much more potential to grow, obviously 2008-9 were tough years, but regardless, the Mauritian economy has kept on growing and has

done so by double digit figures [annually]; and I think there are better things ahead.”

Mr. Chung says that Mauritian funds are being originated from all over the world, although Cross Border Trust is particularly seeing activity from the U.S., Luxembourg and Ireland to name a few. In terms of destination, however, he confirms that the funds are all heading towards Africa.

“There is definitely a lot of excitement emerging from the African region about Mauritius, especially in terms of its inbound flows. It’s quickly garnering interest from Europe, China and Hong Kong, and I know of quite a few Swiss private equity funds investing out of Mauritius into Africa,” Mr. Chung says. “We’re definitely seeing a longer term progression of around five to ten years.”

OGX's Tubarão Martelo Farmout

Could Be Detrimental to
Unsecured Bondholders



Maria Fernanda and Paula Sambo

OGX Petróleo e Gas Participações (OGXP3:BZ), the distressed Brazilian oil and gas company, has assigned collateral to Petronas to close the recent farmout of its Tubarão Martelo field, according to the minutes of a board meeting held on May 6. In the event of default, the collateral pledge ensures that equity investor Petronas will be senior to the company's unsecured bonds, sources report.

The company declined to comment on the details of the agreement.

Under the agreement, Petronas will be assigned a mortgage for over 40% of the Tubarão Martelo field, representing the stake the Malaysian company bought in the oil block, plus a 20% mortgage over a 40% stake OGX will have in the BS-4 oil field, according to the minutes. The pledge was given as a "penhor," or a mortgage over movable assets, according to a lawyer not directly involved in the transaction. With the lien, Petronas is technically senior to other unsecured lenders including holders of the company's bonds, the same lawyer notes.

The assignment of the collateral to Petronas was approved by the board of directors on May 6, along with the implementation of leasing agreements and charter agreements with OSX Brasil SA (OSXB3:BZ), the sister company of OGX.

OGX's 40% stake in BS-4 oil was just acquired in December. The company paid US\$270 million to Petrobras and will share the block with Queiroz Galvão Exploração e Produção and Barra Energia Petróleo e Gas. BS-4 is located in the Santos Basin, and regulatory approval for the deal is still pending.

Some investors "were scrambling to understand what collateral given to Petronas meant," according to a source. "That information was not originally disclosed [in

the farmout announcement made by the company]," a second source reports. However, OGX had "no choice" because the lien was a "pre-condition" to close the deal with Petronas, according to a third source, who added that the company would be "in a much worse situation without the farmout."

The US\$850 million deal will not provide immediate relief for the distressed company. Some US\$250 million will be paid after all regulatory approvals are secured and should hit OGX accounts by October, as reported. Tubarão Martelo must also produce 10,000 boepd for two weeks straight for OGX to receive a US\$500 million first-oil payment.

Oil extraction at Tubarão Martelo relies on the deployment of FPSO OSX 3, which is being built by OGX's sister company OSX Brasil SA (OSXB3:BZ) in Asia, the third source says. The ship should arrive in Brazil by the end of the year, after which OGX will need additional time to connect the wells, according to sources familiar with the deal.

The remaining obligations under the agreement will be disbursed when operational targets are met. A US\$50 million payment will be released when production reaches 40,000 boepd, followed by a US\$25 million payment when the field produces 50,000 boepd and another US\$25 million at 60,000 boepd.

Although OGX management has been telling the market that Tubarão Martelo will produce 10,000 boepd by December, sources familiar with the deal say the target will most likely be met between January and February 2014.

In the meantime, OGX is still burning cash and must pay for the recent bids for new oil fields. As of 1Q13, OGX reported US\$1.15 billion in cash, down from

US\$1.655 billion in 4Q12. The company could exercise a partial put against its controlling shareholder EBX Participações. In such a scenario, Eike Batista, who controls the X group, could be required to inject as much as US\$300 million into OGX.

OGX is also negotiating government support via the Brazilian Development Bank (BNDES), according to reports. The bank is apparently considering an investment in the company through a mandatorily convertible debenture. However, there is no firm commitment from the state-owned development bank, so Eike Batista needs to "put money in first," according to one source.



About the Author

Debtwire Latin America provides actionable intelligence on event-driven special situations in the distressed and high-yield markets. With an on-the-ground team of journalists based in São Paulo, Buenos Aires, Bogota and Mexico City, Debtwire LatAm closely tracks special situations throughout the LatAm market, providing real-time coverage of primary equity issuance and alerting subscribers early on to restructuring events and key credit situations. Please visit www.debtwire.com for more information.



The success of South America's economic growth over the last decade has been largely attributed to its commodity exports to China. However, as China's economy continues to slow, the impacts on certain Latin American countries could be significant.

The projections for Chinese expansion fell in mid-July on disappointing industrial production expansion, which rose by only 9.3% in April – below the 9.5% expected by economists. Although the difference seems small, economists are projecting a drop in China's GDP growth, which will undoubtedly produce a knock-on effect for all countries that depend on sales to China.

Consequently, Bank of America Merrill Lynch reduced its projection for China's GDP growth in the second quarter of the year to 8.1%. Following suit, consultancy firm Valor released data based on the projections of 12 economists to show that China's average forecast for this year has fallen to 7.8% from 8% in the second quarter of last year.

As a testament to the intrinsic link between China and the Latin American countries, Brazil-based mining company Vale – which sends the majority of its iron exports to China – recorded a sharp drop in its shares in mid-July due to China's economic downturn and falling iron ore prices.

■ China's Slowdown

According to Erik Bethel, Managing Partner at the investment firm Sinolatin Capital, despite China's current woes, intra-country lending has actually increased, and the country's debt has grown exponentially, at both the national and the local level.

He adds, however, that although the market has been flooded with capital, the significant growth that was expected did not materialize. Instead, the economy topped out at 6.6% growth this quarter.

“When capital is pumped into the economy – in this case through debt – one would expect proportionally higher economic growth. The concern that some analysts have is that the recent debt has not gone into the real economy but rather is being used to pay down interest on previous debt. If you recall, China opened the debt floodgates during the 2008-09 financial crisis as a stimulus measure.”

The Chinese-LatAm Correlation



Consequences for Latin America

Mining companies invested in Chinese sales, such as Vale, are expected to feel the heat of China's market drop, as iron ore prices have fallen 20%, coming in at US\$125.50 a ton in the Chinese spot market in mid-July.

Iron ore exports are just one sector that is expected to suffer, but as this makes up a large chunk of South America's trade revenue, the continent is likely to take a hit. "Private hedge fund managers and private equity managers should note that Latin America has grown largely because of China. If there were only one variable to predict Latin America's GDP growth it would be sales of commodities. The largest buyer of commodities has by far been China," Mr. Bethel says.

Mr. Bethel cites China as one of the main reasons behind South America's economic growth in the last decade. He notes that this was made evident during the U.S. financial crisis in 2008, when despite South America's apparent dependence on the U.S. markets, countries such as Chile and Peru actually grew.

"Chile and Peru sell copper to China. Venezuela and Ecuador sell oil. Argentina sells soybeans. The point here is that PE investors need to be aware of the single most important driver affecting the economies of virtually every Latin American economy. I'm referring to commodity sales to China. If China slows down significantly, and I'm referring to the unlikely event of a hard landing, Latin America could bear serious consequences."

However, Mr. Bethel says that contrary to popular belief and economic forecasts,

China's economic slowdown is not one that investors should be overly concerned about. Instead, he believes that as one of the fastest-growing and highest-achieving emerging market economies, it is unsustainable for China to continue growing at 10% a year.

"We are already starting to feel some of the tremors. Nonetheless, a hard landing is not something that investors should be seriously worried about. In fact it may be healthy for China's economy to slow down a bit. In China's recent 5-year plan, Beijing alludes to favoring 'quality growth' over 'fast growth'."

As global companies reliant on Chinese business prepare for sluggish growth, it remains to be seen whether this will prompt Latin American countries to diversify their export markets to make up for projected losses. According to Mr. Bethel, countries

that manufacture and export similar goods to those produced by China, such as Brazil and Argentina with their respective garment industries, are unlikely to compete in the global trade arena.

“The Latin American footwear industry has been decimated, as it is virtually impossible to compete with China on cost. The same can be said for light manufacturing, consumer electronics, and other industries,” Mr. Bethel says. “There is considerable, and understandable, frustration in Latin America from those that believe that the region is being ‘de-industrialized’ and reduced to exporting low value-added raw materials, and then importing higher-value finished products from Asia.”

He adds, “However, there are sensible ways to grow while creating value. Rather than compete with China, why don’t Latin American countries double down on creating value in those sectors where

they excel? Latin America produces the majority of the world’s copper. So why shouldn’t advanced mining geotechnical instruments be developed in countries that have a core competency in mining? Latin America also produces the majority of the world’s soybeans. So why shouldn’t Latin America produce the world’s best soybean monitoring software?”

China’s Urbanization

Despite its most recent problems, China is still receiving huge injections of FDI investment from its neighbors, Japan and Korea, as well as some from Europe. Mr. Bethel says that up to US\$100 billion of FDI a year is coming into China in the form of private equity from corporations such as Honeywell and Caterpillar.

Additionally, China’s flailing market is expected to recover in the long term with the help of the government, which is planning

to urbanize up to 500 million people from rural lands over the next 5 years.

“During the early 2000s it became evident that the ‘China story’ was not only true, but much larger than some predicted. China was unleashing the largest wave of human migration in world history. Every 5 years China created urban populations larger than those of entire countries,” Mr. Bethel says.

The China rural-to-urban migration has caused a number of important transformations. One of them is higher productivity. Another is higher per-capita income and, therefore, increased consumption. With millions of Chinese relocating to urban settings every year, the demand for virtually every commodity, particularly industrial metals, has increased considerably. Industrial metals such as copper, iron and zinc are fundamental in the production/construction of automobiles, buildings, refrigerators and rail, among other products.”

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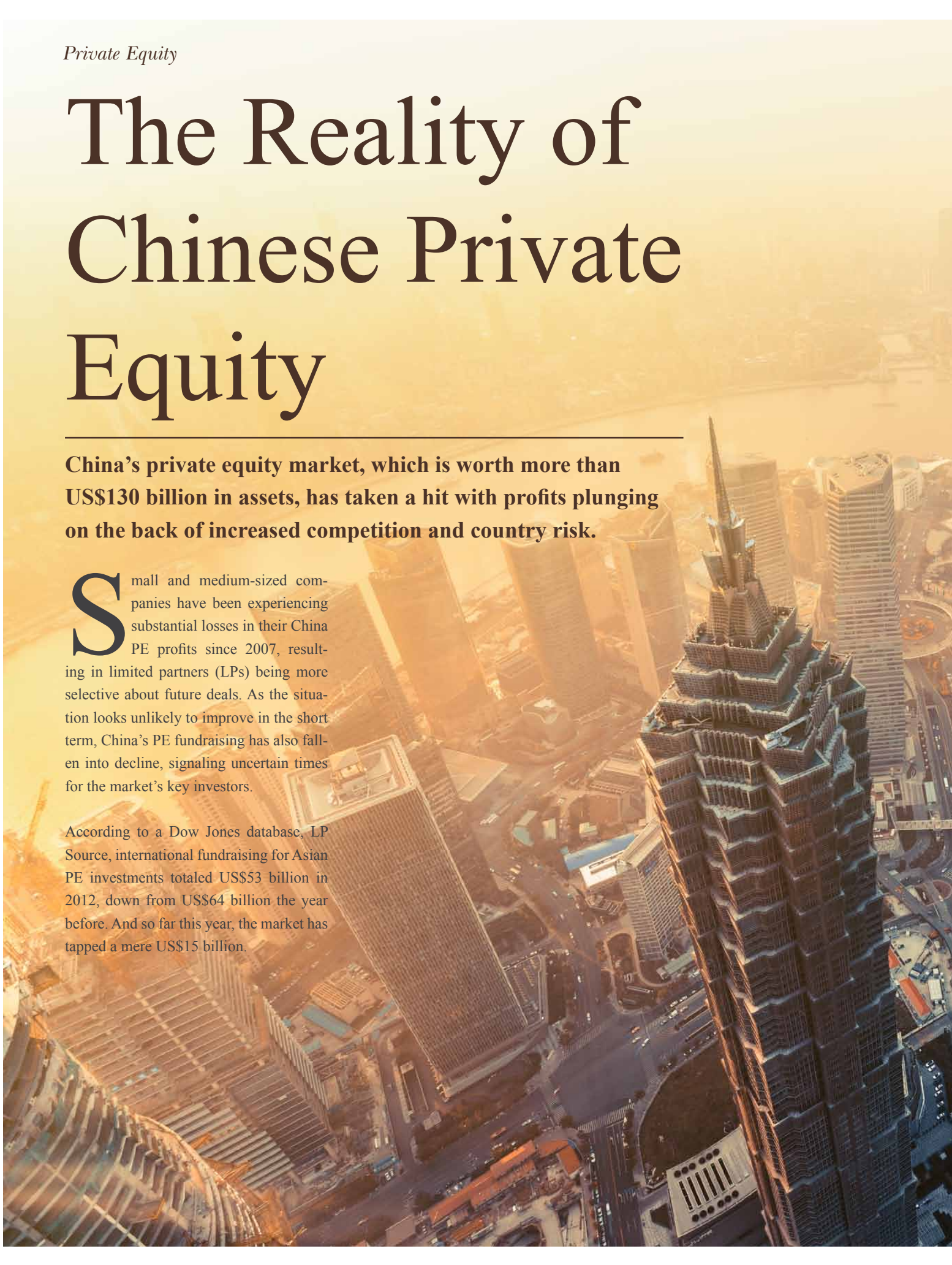


The Reality of Chinese Private Equity

China's private equity market, which is worth more than US\$130 billion in assets, has taken a hit with profits plunging on the back of increased competition and country risk.

Small and medium-sized companies have been experiencing substantial losses in their China PE profits since 2007, resulting in limited partners (LPs) being more selective about future deals. As the situation looks unlikely to improve in the short term, China's PE fundraising has also fallen into decline, signaling uncertain times for the market's key investors.

According to a Dow Jones database, LP Source, international fundraising for Asian PE investments totaled US\$53 billion in 2012, down from US\$64 billion the year before. And so far this year, the market has tapped a mere US\$15 billion.

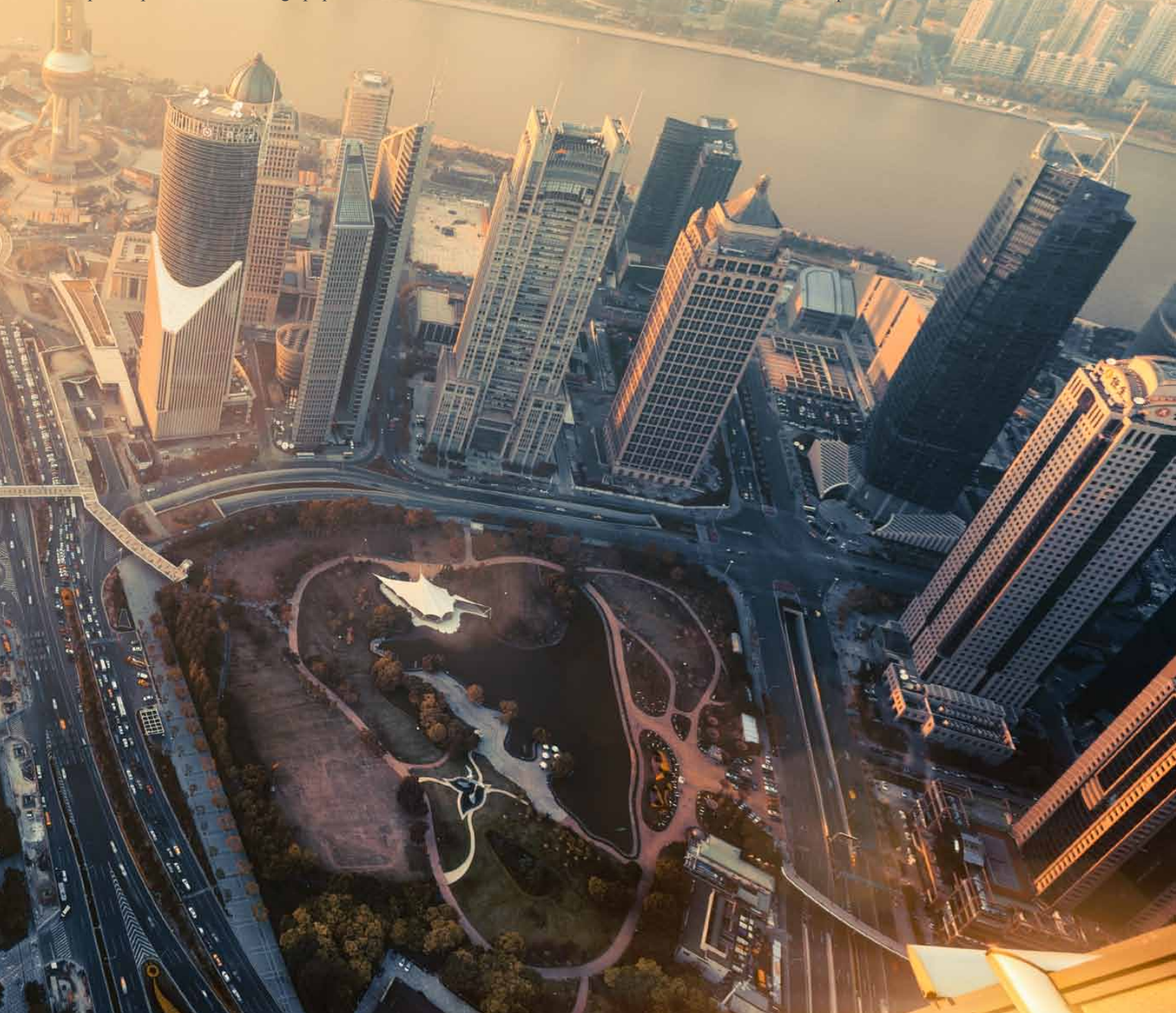


Between 2007 and 2009, global private equity firms posted huge profits, prompting a host of cash-rich corporates to win a slice of the market. Kenny Li, CEO at China private equity and asset management firm KKM Capital, says that this fierce competition has been one of the market's biggest issues.

"Many Chinese corporations have expanded their capacity rapidly while margins have been on a declining trend due to fierce internal competition and a lackluster global economic environment. Furthermore, quality is often compromised for rapid output to cater to a huge population."

David Pierce, CEO of Asia Pacific PE firm Squadron Capital, says that due to these bottlenecks the Asian PE industry has transformed beyond all recognition. "Starting in 2005, there was a substantial boom of investor interest led by global interest in China and other EM markets in the region. Lots of research (published by Goldman Sachs and others) highlighted the remarkable macroeconomic growth of the prior decade and the multiple reasons why such growth would likely continue, not just in China but in the rest of emerging Asia, especially Southeast Asia and India."

He adds: "Also, in 2005 there was a lot of liquidity in the world and a lot of institutional investors observed that the best private equity funds in Europe and North America had significantly outperformed public markets, which promoted the asset class generally. There had been some remarkably successful IPOs of PE-backed Chinese companies in the period prior to the global financial crisis, and this piqued investor interest in the region. In addition, the markets of Asia started to become more receptive to private equity. For example, in Korea the law was changed in 2005 to permit PE firms to invest."



As a result of today's sliding numbers, China's domestic private equity market has been a quieter space, despite its large capacity. Michael Buxton, Private Equity Leader for Asia Pacific at Ernst & Young, says that the global market's expectations of China have not matched the reality, and in fact a hefty amount of recent activity has come from local investors.

"China is clearly the market within the region that is the focus of most attention. Nevertheless, recent activity levels have often lagged expectations, and the market has been much quieter over the last year than most participants would like. However given the economic growth rate and vast potential, China continues to attract the global players, and we are seeing the growth of a large domestic private equity industry as well," Mr. Buxton says.

Forms of PE Capital in China

Despite the recent cooling, however, Chinese private equity is continuing to secure capital from international players, with the most popular form of finance coming from growth capital and minority investments. Finance in the form of venture capital is also being seen, albeit at much earlier stages of the companies, Mr. Pierce explains.

"In the past couple of years a large number of secondary players have been hunting for Asian private equity funds. This seems the natural consequence of a number of factors, including the rapid growth of the industry in Asia, the failure in some cases of reality to meet expectations of performance, and the effects of the global financial crisis on institutional investors."

Additionally, despite the wealth of media coverage that suggests a dwindling volume of leverage buyouts in China, Mr. Li says that the concept is in fact emerging. He says that currently, "a handful" of banks are willing to provide around 50%

of funding needed for a buyout, or acquisition of a majority stake.

"Parameters are similar to the West in the way that target asset quality remains key, but government directives may ascertain policy lending [????] in certain cases. In China, such M&A opportunity could provide more upside compared with developed market – restructuring for operation-

"Funds of funds are out of favor in some quarters but in Asia they are likely to continue to have a large intermediating role even for very large institutional investors, such as public pensions and sovereign funds."

al efficiency, improvement of management expertise, aligning strategic resources and furthering capital for acquisitions. In many cases we provide an opportunity for foreign capital and management expertise to participate in our projects, for enhanced terms of financing and project value," Mr. Li says.

Adding weight to this theory, Kohlberg Kravis Roberts (KKR) closed its Asia II fund at US\$6 billion in mid July, proving that there is still scope and appetite for

pan-Asian leverage buyout deals. The deal is the largest ever pan-Asian private equity fund as well as the company's third round of fund-raising initiatives in Asia.

As part of the fund, KKR invested in China Modern Dairy Holdings, Singapore technology firm Unisteel, and Japanese recruitment firm Intelligence. KKR intends to keep its existing investment shares in South Korea beer and spirit producer Oriental Brewery, which is expected to produce returns four times the size of KKR's original investment.

Looking ahead to upcoming deals, Mr. Li explains that KKM Capital is looking to invest in those companies that have a consumer origin.

"This is a current M&A case we have in China. We have identified a dairy company that has produced high quality products for the last decade or so. Its only liability is a growing order list that the company is unable to fulfill and needs to decline. The company is set to increase its revenue 3 times within 3 years with new equity. By using policy bank financing, it will be in a position to acquire state-owned dairy assets to increase capacity and to improve on quality of output."

Mr. Li adds: "On the investment side, we have arranged a private co-investor that owns a to-be-listed dairy distributor giant in China, which is planning doing a complete buyout of the project at a later stage. The main consideration for participation of foreign capital and management expertise is mainly for quality control and setting up better corporate governance, with which there is also an option to list in the overseas markets."

Sources of Capital

The key PE investors are the larger financial institutions, which generally have suf-



ficient capital, according to Mr. Pierce, although in many cases they lack the adequate human resources to execute local deals on the ground.

“Funds of funds are out of favor in some quarters, but in Asia they are likely to continue to have a large intermediating role even for very large institutional investors, such as public pensions and sovereign funds. Such investors typically have a lot of capital but also human resource constraints. Most do not have big in-house teams, and even those that do are often unable to send people to Asia, much less recruit specialists who speak relevant languages. For them, a fund of funds (and/or a consultant) with roots in the region can serve as an extension of their capabilities.”

Mr. Pierce adds: “In addition, those investors that wish to diversify but are able to write only very large tickets can use a fund of funds to access the smaller funds that predominate in Asia.”

Despite its troubling period, the PE sector in China is still very young, and there are still huge incentives for a lot of major investors to participate in this space. However, Mr. Li warns that lining up the resources can prove tricky, requiring huge government support in the form of incentives and directives.

“As China opens up, the next five years is a crucial period for Chinese corporates to resolve their ability to compete with international peers and corporate succession issues, as the second generation is less inclined to take the helm in traditional businesses.”

An area that is being overhauled and which stands to help new and prospective LPs is China’s due diligence approach. This has notoriously been a sticking point for many, who according to Mr. Buxton have returned to a more basic assessment

model to ensure that their selected companies will merit returns.

“There is much more of a focus on forensic diligence and operational diligence in China, with many funds actually focusing on ensuring that operational activity is in line with the financial records, such as sitting outside of factories and counting the number of trucks coming in,” Mr. Buxton says.

And in terms of exits for China’s PE funds, he adds that the IPO option remains the most favorable, as most investors are generally minority holders.

“The preferred exit route tends to be IPOs in China, particularly as the PE funds are often minority investors, though with the current state of the IPO markets we are seeing more secondaries, trade sales, and sales back to the founders,” Mr. Buxton adds.

■ Outlook for China’s PE Market

The general outlook for Chinese PE is certainly not bleak. Although the Asian market is still at an early stage and competition is intensifying, this slow period could be viewed as a chance for the more patient investors to familiarize themselves with the sector at a local level.

“Everyone is very excited about the ASEAN region, which is an incredibly dynamic and diverse region with a population of over 600 million, and has quite a bit of spread from more of the developed markets,” Mr. Buxton says.

Meanwhile, Mr. Pierce says that China’s governance issues – viewed as being another major factor in the pullback of international capital – are currently being improved and redeveloped by the Chinese government.

“There have been some governance issues with some publicly listed Chinese companies, some of which were backed by PE capital. Some of those situations got more attention than they probably deserved, but regardless there are real concerns about governance that need to be addressed, and it is good that investors have become more skeptical, which is always healthy.”

Mr. Pierce says that the IMF and others, both within and outside China, have been quite clear about rebalancing the economy, shifting away from the export-driven investment-led model of the past 30 years. The Chinese government too is attempting to rein in some of the fixed asset investments that were issued hastily by local governments over the past decade.

And although these new policies and the increased constraints on credit are depressing growth, Mr. Pierce believes that they are imperative in attracting investors back into the market.

“The Chinese economy probably won’t continue to grow at the same rate as achieved in the last several years, but it will almost certainly grow around 5-6% per annum, which is still pretty respectable. More important, private equity investing can be successful even in a shrinking economy. Good PE managers will continue to make good investments in a slower growing or even shrinking economy. This is a micro rather than a macro business.”

Mr. Pierce adds: “Accordingly, I think it is safe to assume that China-focused PE funds will continue to raise their money, maybe not as much as they were, but it will go on and the overall market will expand as investors play on long-term trends such as urbanization and increased pressure for improved productivity as the population ages.”

The Rise of Private Equity in Africa

Africa's economic growth over the last three years has been growing at approximately 5% a year, and according to the IMF's economic outlook for Sub Saharan Africa, it is expected to rise to 5.5% this year and 6% next year. It is no wonder then that more and more international investors are now eyeing up private equity opportunities on the back of the continent's consumer boom and ever-improving regulatory systems.

More and more, global investors are considering private equity (PE) as a more intelligent option over Africa's public equity markets, due to its consumer opportunities, rising middle class, and limited global competition from other PE players.

Although PE has played its part in Africa's success story over the last decade, the continent's accelerating economic growth is enticing an influx of new PE investors and economic activity, with general partners (GPs) and limited partners (LPs) in particular cashing in on the vast untapped opportunities.

The value of investments in sub-Saharan Africa rose by 38% in the first half of 2011 compared to US\$1.7 billion in the first six months of 2010. Additionally, African PE funds raised more than US\$1.7 billion in the third quarter of 2011, with South African funds accounting for only 10% of the total.

According to Ernst & Young, opportunities in sub-Saharan Africa, outside of South Africa, are beginning to pique inter-

national interest, helped by the widening of investment options open to PE investors, which include investments into the financial services, technology, telecommunications, agriculture, consumer products and infrastructure sectors.

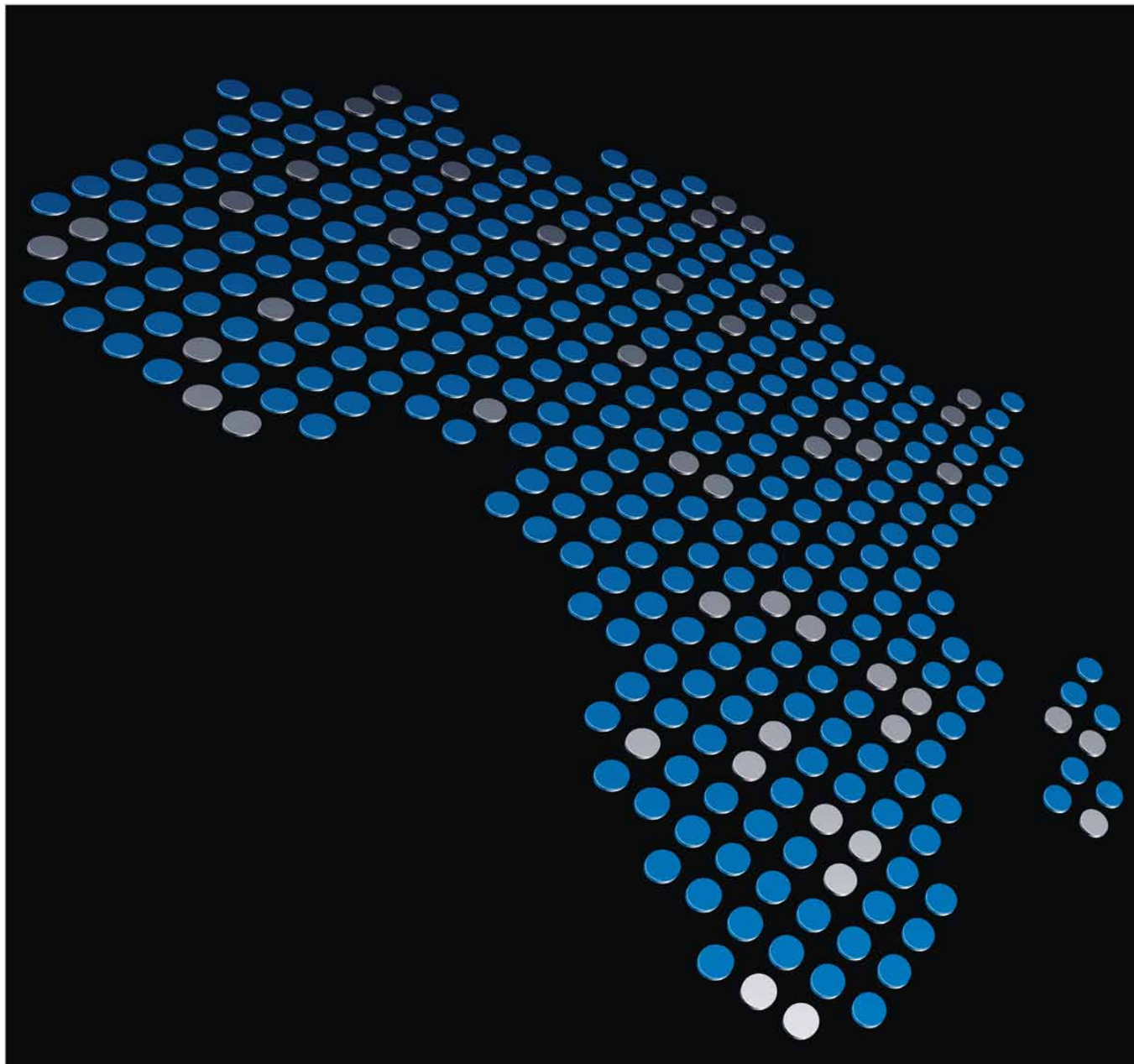
The report also confirms that the last 5 years have seen a higher proportion of capital directed toward sub-Saharan Africa's frontier markets, such as Nigeria, Ghana and Kenya.

■ Piquing Interest

Law firm Freshfields Bruckhaus Deringer has published its latest report on Africa's merger and acquisition sector, revealing that investment into Africa is becoming more focused on the consumer-led industries, including the telecoms, retail, and food and drink, rivaling the better-known investment sectors, such as natural resources. Mergers and acquisitions (M&A) totalled US\$3.8 billion across 71 deals in 2012, up from US\$1.9 billion and 33 deals in 2003, the report notes.

Adiba Ighodaro, Investor Development Partner at private equity firm Actis, says





that investor interest has developed considerably in the last 12 to 18 months, and additionally, there has been more of an understanding about how to participate in private equity funds in Africa, as well as the types of opportunities that exist and where the GPs are.

Ms. Ighodaro adds, however, that many of these deals are made on the back of an industry interest, rather than an interest in a particular part of Africa.

“Private equity commitments coming in from the U.S., for example, are already

being made, and in comparison to when we opened the office in 2000, there are many more GPs investing in Africa now. It’s similar to what we’ve seen happen in Brazil over the last 24 months with the huge amounts of capital rushing in there, although I don’t think we’ll see quite this level of interest in Africa yet,” Ms. Ighodaro says.

“Increasingly, the BRIC countries are becoming interested in our pan-African network and its growing market share, so we have that appetite to capitalize on. A lot of these companies have portfolios of where

they want to invest, and it seems to be industry specific.”

Alex-Handrah Aimé, Managing Director at pan-African private equity firm Emerging Capital Partners (ECP), agrees that the African PE industry has grown substantially in the last five years and that the sector will continue to evolve. However, she adds that the PE industry in Africa still has some way to go.

“The African private equity industry has changed and evolved since ECP began investing in 2000. We are encouraged to

see increasing interest from potential limited partners. There have been a number of changes suggesting the industry is deepening and maturing, such as the introduction of regional funds, for instance in East Africa, or on a country level, as in Nigeria.”

“There are some investors that are beginning to look at sector-focused funds, but it’s not clear that the markets are deep enough yet to support this. You also have several big international investment houses who are now seriously reviewing the African opportunity, which we view as a positive development for the industry,” Ms. Handrah Aimé adds.

Runa Alam, CEO at pan-African private equity firm Development Partners International LLP (DPI), agrees, saying that the continent’s rising growth rates are making many more companies “investable,” which for DPI is something that is crucial in its investment strategy.

“As a firm we rely on this as we don’t invest in startup early-stage businesses. Another change we have seen is the growing interest from investors toward Africa, although how much of that is turning into actual investment is hard to tell. Startup companies are often funded by friends and family, and then once they grow to a bigger size and are in need of capital in order to continue their growth, DPI would get involved.”

DPI opened its doors in 2007 with 6 partners who had more than 70 years of experience between them. The firm’s first fund, the African Development Partners I (ADP I) fund, was euro-denominated (US\$400 million with US\$560 million of co-investment), and was deployed after 4 years.

The firm’s ADP I portfolio grew 19% on the top line and 20% on the net income line in 2012, and this year it is expected to continue growing to produce a return of

US\$50 million in distributions by the fall, predominantly from profits (dividends) from its companies. The fund is now invested in 9 portfolio companies, and DPI aims to have between 8 and 12 companies at any time, while “anything less than that is unlikely to be diversified,” Ms. Alam says.

“The real opportunity in Africa, however,” she adds, “is that such a growth and profit orientated portfolio was bought at 1.3x price to book for the financial companies and 4.4x enterprise value/EBITDA for the other companies. There are very few places in the world where one can still put together an investment portfolio like this.”

PE Sector Draws

According to South Africa-based analytics and consultancy agency RisCura Fundamentals, since 2006 there have been 158 African private equity deals, with 28% including companies in the consumer, industrials, materials and energy sectors.

ECP’s Ms. Handrah Aimé says that the consumer story in Africa has been and will continue to be quite significant, with 25% of ECP’s deals falling into the telecoms sector, spanning both the retail side as well as the power space. Another 25% has been in the financial services sector, with participation from banks, insurance and reinsurance companies, she confirms.

“The rest of our portfolio is quite broad across a range of sectors. We have done agribusiness deals, including helping to refurbish and redevelop a fertilizer company in Nigeria, Notore, and retail investments, such as with the Nairobi Java House, a prominent east African restaurant chain.”

Ms. Handrah Aimé adds: “There are many opportunities across a range of industries, but where a PE firm chooses to focus really depends on the investment mandate

and the target investment size. Across the spectrum, you have for example the infrastructure, energy and construction sectors, which are typically large-ticket deals; conversely, outside of South Africa, there are many industries that are at an earlier stage of development, with few players that can absorb more than US\$50-60 million of equity. Therefore, there are a number of private equity investment firms targeting investments in this size range.”

For Development Partners International, its strategy is primarily investing in companies that are benefitting from the growth of the emerging middle classes. “Within ADP I, we own a pharmaceutical company, an FMCG company, a bank, a consumer credit company, an insurance company and a modular housing and commercial construction company,” Ms. Alam says.

“We anticipate a timeline of between 3 and 7 years from when we invest in a company to exit. Toward the end of the investment period the deal has to start making sense in the shorter time frame as we try to avoid extending the life of the fund.”

For the majority of African private equity funds, exits are seen through trade sales, and Ms. Ighodaro explains that this will continue to be the case in the near future.

“I believe that trade sales will be the main point of exit for the time being. Capital markets have grown significantly over the last few years, and we have been able to IPO a few businesses in West Africa. We can always have that as an option, but it’s not one that we would count on as an exit strategy.”

She adds that as interest grows in Africa, generally from institutional investors and corporates who are increasingly interested in growing by expanding more in Africa, there is a strong appetite for acquiring businesses with good governance.



Ms. Alam explains that DPI expects to have more industry sales than IPOs, although with South Africa and Nigeria, she adds, there is the option of using the stock exchange for exits.

Inside Information

When considering investment options, and particularly in sub-Saharan Africa, one factor that should not be overlooked is acquiring on-the-ground expertise.

Ms. Handrah Aimé says that the investment barriers when entering Africa are significant and that it is crucial that PE participants have experience when considering deals on the continent. ECP, she says, spends considerable time understanding the market, the sponsors, and the management team. Indeed, getting comfortable with the latter two is a crucial aspect of the preparatory deal stage.

“The barriers to entry into African private equity are significant; as a GP, you need to demonstrate significant investment experience. In particular, it is important that you have experienced multiple investment cycles and know how to execute across turbulent markets. This is critical for developing exit strategies and ultimately achieving above-market returns.

It is also critical that you have an on-the-ground network. Unlike in developed PE markets such as the U.S. or Western Europe, you cannot rely on brokers delivering or introducing fully active investment opportunities.”

Ms. Alam agrees: “Due diligence is very intense. We move fast but we follow strict processes. The key factors are local knowledge; knowledge of and chemistry with management, investors and board of the company being invested in; and careful commercial, accounting and financial due diligence using both local and global accounting firms.”

The Future of PE in Africa?

The future of the PE market in Africa looks strong. Ernst & Young’s sector report confirms that the number of new foreign direct investment projects increased from 280 to 460 projects a year in the 2003-2007 period to between 600 and 850 projects a year during the 2008-2010 period. Meanwhile

“We are seeing huge corporations moving into the continent, such as General Electric and Walmart, and they are spending billions on infrastructure. India and China appreciated and seized the African opportunity story sooner.

FDI into Africa is projected to hit US\$150 billion a year by 2015.

Ms. Ighodaro says that Africa is far behind in terms of penetration compared with the other markets, so in this sense it has the ability to absorb a huge amount of capital.

However, this will not be without its challenges. She adds that political risk is a natural concern in Africa but says she hopes

that the media’s influence and coverage over certain political situations will not deter investors.

“We’re hoping that investors will do their own research into Africa and not rely too much on the perceived risk.”

Ms. Handrah Aimé agrees that Africa’s economic success is not widely played out in the global media, and neither is Africa’s consumer expansion and corporate development.

“We are seeing huge corporations moving into the continent, such as General Electric and Walmart, and they are spending billions on infrastructure. India and China appreciated and seized the African opportunity story sooner. It’s really the U.S. companies that are finally coming to the table to understand and explore the vast market potential that Africa represents,” she says.

“The growth and positive developments are self-evident on the ground. Infrastructure has improved dramatically, the rising disposable income, the desire for and access to consumer goods – all these bode well for Africa’s continued development. We think there’s a lot more to be told about Africa, frankly,” Ms. Handrah Aimé adds.

“Without overselling the story, as it is still a complicated market, we’re optimistic about the opportunities for private equity.”

THE PROBLEM WITH LATIN AMERICAN PRIVATE EQUITY REAL ESTATE GPs

■ Tierra Partners

Over the last 18 months private equity real estate GPs appear to have missed the mark in the identification and pursuit of investment opportunities throughout Latin America. During road shows and more public forums, many GPs repeatedly called attention to numerous real estate trends that failed to materialize, while grossly underestimating the role of local capital in meeting financing demand.

The resulting low rate of new LP investment suggests that the current real estate private equity model is no longer operating ahead of the curve and, consequently, LP investors may experience chronic underinvestment for the duration of the current cycle. Worse yet, as GPs feel the pressure to invest, mistakes will be made in terms of the alignment of interests with local partners and capital investment. LPs are now in the unenviable position of being underinvested, or worse, invested in underperforming assets. This scenario has been further complicated by the fact that the increasingly active role of local capital serves to make the operating structure of GPs more expensive and onerous on a relative basis.

As the real estate capital markets continue to evolve in the region, more innovative investment products will become available. LP investors deserve a broader selection of investment vehicles than simply private equity or actively managed equity strategies.

■ Brazil Recap – The Non-Rationalization of Values

By mid-2012 listed Brazilian homebuilders began experiencing a sharp drop in share price. At the time, GPs predicted that a “great rationalization” had begun in Brazil real estate prices. But the deep discounts never materialized on the private side. In fact, one of these GP investors is now reportedly a leading bidder for Gaf-

isa’s master planned community division (Alphaville) – and purportedly at a price equivalent to the entire company’s market capitalization.

Last year one major GP in the region boldly predicted that “There will be a need for capital from private funding sources Whenever there’s any kind of increased inefficiency or stress in the real estate capital markets, it’s harder to get cheap capital.” This turned out to be just an axiomatic sales pitch, as it is equally true that a broken clock will read time correctly exactly two times per day. The misread appears to be a combination of timing (duration of future opportunities), but equally misplaced is the over reliance on past experience as a predictor of future performance.





GPs simply miscalculated the strength of the internal capital markets, as listed Brazilian homebuilders were in fact distressed, but didn't flock to expensive foreign capital for a solution because they didn't have to. Interestingly, of all listed homebuilders in Brazil, this particular GP's investment in Viver stands out as a severe underperformer: based on public filings, the GP's investment may have unrealized losses of approximately 80%.

Why the disconnect? For one thing, GPs underestimated the resilience of the local markets and furthermore have misjudged the active role undertaken by both local public (government) and local private entities (internal capital) in supporting real estate investment. As we have seen in Brazil, many developers were able to foresee the pending mini-crisis and cut overhead and new launches, redoubling their focus on selling existing inventory. In addition, the Brazilian government's CAIXA stepped in to provide more credit, which has led to a fairly robust turnaround for most listed homebuilders. While homebuilders have not fully recovered, many are up over 100% off their 2012 lows – with no bankruptcies.

Mexico Recap – The Increasing Role of Pension Funds and Local Capital

In Brazil GPs missed the mark by being too pessimistic, but for Mexico the opposite appears to be the case. Last year, few foresaw the depth of the losses that homebuilders would experience by 4Q12, which resulted in nothing short of a complete bludgeoning of the industry. To add insult to injury, the recently elected Peña Nieto government has permanently modified the federal homebuilding policy by reducing horizontal exurban financing and, instead, intends to redirect resources to vertical, urban development. This shift is on par with the DOE passing an immedi-

ate carbon tax on car manufacturers in the U.S. The industry is working under a completely new model, the ramifications of which will take time to fully understand, but the old homebuilding model is dead in its tracks. The impacts will not only be on operating companies but also on the value of land across the country. We expect to see a reverberation in related commercial

*LPs are now in
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retail development as well, since much of that was premised on suburban residential expansion.

And the GPs? Here's what a leading Mexico GP said in July 2012: "Mexico has really responded well over the last 12 months." This particular GP was an early investor in Mexico land banking and subsequently monetized much of their residential portfolio via the CKD mechanism. Notably, the GP stated in mid-2012, "We're seeing healthy growth, which is good for real estate." But that is clearly not what happened. More importantly, the Mexican government told the market as much in October 2012 when it announced that it would not increase available mort-

gage credits under the INFONAVIT program. That one announcement amounted to an immediate sell on the entire sector because after that point every homebuilder was told that its revenue would be capped or worse. For an industry built on low margins and high volume, a limiting of the top line potential equates to deprivation of food and water.

Perhaps more concerning is that GPs who have existing investments in Mexico's affordable housing sector remain silent. Where is the tactical response to what is surely going to be a massive write down in land values? Public companies like URBI and GEO are not only being sued by lenders and bondholders, but are actively considering filing for bankruptcy protection. Bankruptcy in Mexico is tantamount to going out of business. There have been no meaningful bankruptcies on the real estate side since the Tequila Crisis in 1994.

Be wary of any GP strategy that involves committing capital to horizontal housing until INFONAVIT defines the new regime.

What Just Happened?

While most market participants would agree that strong macroeconomic conditions are a necessity for a robust real estate market, the evidence suggests that it is incorrect to extrapolate those benefits into being advantageous for private equity. The reasons for this appear to be a combination of two themes. First, GPs have been terribly wrong in their short-term predictions about Brazil and Mexico. Second, the emergence of local investors, mainly pension funds, has proven to be a game changer – especially in Mexico.

On the first point, few GPs have even discussed the possibility of a broad implosion in the Mexico homebuilding industry. In fact, as Mexican homebuilders began selling off in force last quarter, the



idea that they wouldn't rebound was generally discarded by investors. GPs just viewed these companies as attractively priced even though many were trading below their original IPO prices. But the writing was on the wall as early as the fall of 2012 when INFONAVIT announced that it would not increase its 2013 budget, effectively capping the amount of available mortgage credits. Where were the GPs when the government communicated to the market that the sector's top line would not increase? Part of the answer may end up being that they were invested in residential land along with the public builders, but we won't know that for a while. Clearly, however, GPs were not thinking strategically about Mexican homebuilding.

In Brazil, GPs remain busy raising more capital to invest in Brazil's maturing real estate market. Last year Prosperitas raised US\$800 million, almost two times oversubscribed, as global pensions continued to throw money at Brazil-based GPs. Smaller raises were seen for strategies focused on Peru and Colombia, but the real sea change was in Mexico.

For the first time, Mexico's pension industry began to make its voice heard by funding approximately US\$5 billion in quasi-public CKD launches and IPOs of several Mexican REITs or FIBRAs. Most interestingly, foreign buyers represented approximately 50% of demand for Mexico's three largest real estate IPOs last year. With a few notable exceptions, GPs remained on the sidelines in Mexico.

In their defense, the opportunity to participate in Mexico's IPO market would have required GPs to have repositioned from Brazil to Mexico two or three years ago. And as GPs remained focused on Brazil in 2010 and 2011, Mexico was creating the framework for a series of unprecedented public real estate capital raises.

So what have we seen in terms of performance from the GPs over the last year? We've seen Brazil go through a fairly quick recovery without the predicted onslaught of distressed opportunities and the emergence of the local investor in Mexico. Meanwhile, GPs have done little to no new net investing.

The Broken Private Equity Real Estate Model

Why does this matter? First, these trends suggest that the traditional GP/LP private equity model is out of sync with the broader markets in terms of both strategy and timing. The proverbial ship has sailed in Mexico, and the quality invest-

ments have been taken public with significant participation from global public investors. In Brazil, the "great rationalization" simply isn't happening, and yet GPs are sitting on substantial reserves of dry powder.

The real issue for LPs is that for them to make money, their GP needs to not only make good investments but needs to actually invest its capital. If a GP can't put the capital out, or worse, if it can't resist putting capital into a bad deal, it is a losing proposition. Granted, LPs can simply avoid the region, and many do, but is an increasingly concentrated approach really the correct strategy?

About the Author

We have argued for quite some time that most global LPs would be better served by simply investing in a diversified, passive bucket of listed equities. Tierra Partners' Latin America Real Estate Index captures a diverse range of real estate companies in the region with compelling, back-tested risk-adjusted performance.

During the last 12 months, our Index returned approximately 40% with a lower correlation and lower beta relative to both local FX and major benchmarks. Research also suggests that active strategies or passive market cap weighted strategies tend to underperform these same benchmarks. We believe that our index represents an interesting middle ground for investors who seek liquidity, diversified exposure to the real estate sector and compelling risk-adjusted returns.

How to Accomplish Continued Growth of the Colombian Economy?

 Felix Villalba

Sometimes the important points have to be repeated: if Colombia wants to continue its boom, the banking sector will have to lower interest rates. Colombian banks will have to sacrifice short-term margins for long-term gains.

In a small underdeveloped economy like Colombia in the 80s and 90s, bankers and all industry worked under the model of small volume, high margins. (The small volume was due to unacceptable risks associated with the larger population.) However, now in a larger and growing emerging economy the opportunity arises for companies to work with larger volumes and lower margins. The Colombian economy is crying out for

the financial sector to lead the way in order to continue its healthy growth.

I was recently invited to an afternoon coffee with one of the top Executive VPs at one of Colombia's largest banks (name left out so they continue inviting me to coffee meetings). I asked the VP, "Why are banks in Colombia charging such high interest rates?" His answer was related to the challenge that the bank's Treasurer has in plac-

ing bonds at lower rates than those offered by the Colombian government. The VP's answer made sense at first, but after further thought, the explanation seems to be missing something.

Yields on U.S. 20-year bonds are currently about 3.5%. Current yields on 20 year Colombian government bonds are about 7 percent. So in light of the VP's excuse, the U.S. bank should be charging 8% (the Colombian mortgage rate less the difference between the Colombian government bond yield and the U.S. government bond yield) for a 30-year mortgage, not 3%.

A more traditional method for setting mortgage rates would take into account what banks are paying customers for their deposits. Colombian banks are getting



depositors' money for almost free (below the CPI) – and in many cases, on an after-fee basis, for a negative interest rate (the customer pays more in fees than they receive in interest income). The banking executive's explanation just doesn't add up. I have a feeling that they have significantly richer margins than U.S. banks.

Look at it this way: The average home borrower in Colombia is getting an 11.5% 20-year mortgage rate. Colombia's 2012 rate of inflation (CPI) was approximately 3.2%, thus indicating a margin of 8.3% on a 20-year mortgage. The average home borrower in the U.S. is getting a 3% 20-year mortgage rate. The U.S. 2012 rate of

inflation (CPI) was approximately 1.7%, indicating a margin of 1.3%.

So is the Colombian consumer that much riskier than the U.S. consumer? Are Colombian banks that inefficient? Is it really justified that Colombian banks should have a spread of 7% over what their U.S.



counterparts have? I will leave you with that question.

Getting back to my meeting with the bank's Executive VP, he did mention that interest rates are dropping because last year Colombian banks instituted lower rates for higher-income borrowers. In other words, they are segmenting customers by income and issuing differential interest rates accordingly.

This step is considered to be a substantial improvement over the traditional Colombian bank model of one rate fits all. It is clear that there is a great deal of room for improvement because bankers in Colombia can and should start "cherry-picking" customers for lower rates based on their credit scoring. However, according to the banking executive, they are only using credit scoring for a binomial decision: yes or no credit.

What this may indicate is an entry opportunity for more efficient and less risk-averse foreign investors into Colombia's banking and financial industry. Also, and as I mentioned to the banking executive, it spells an opportunity for the local large, strong banks to make a difference and to be the force behind the continued strength of the Colombian economy.

About the Author

Felix Villalba has over 15 years of experience on both the operating side and the investment side of business transactions. After his MBA, Mr. Villalba worked for captive financial services companies at Dell and Whirlpool, and later spent over 5 years as CFO with 2 venture backed technology companies. Dell's successful effort to start Dell Financial Services marked Felix's official involvement in the venture industry in 1997. After that he joined an Austin Ventures backed company that later led to his joining Pacesetter Capital Group. At Pacesetter, Private Equity firm, he was Vice President and served as Portfolio Manager for several inherited deals, some of which required intervention strategies. In 2009, Felix formed his own private Equity management firm, Accordo LLC and raised Accordo Fund 1 and 2 placing investments in residential and hospitality developments in Colombia.

Felix is a graduate of the University of Notre Dame with three degrees, a Masters in Business Administration, a B.S. in Civil Engineering, and a B.A. in Economics. He successfully completed the Harvard Business School's Executive Management Development Program.



An African Fund of Funds

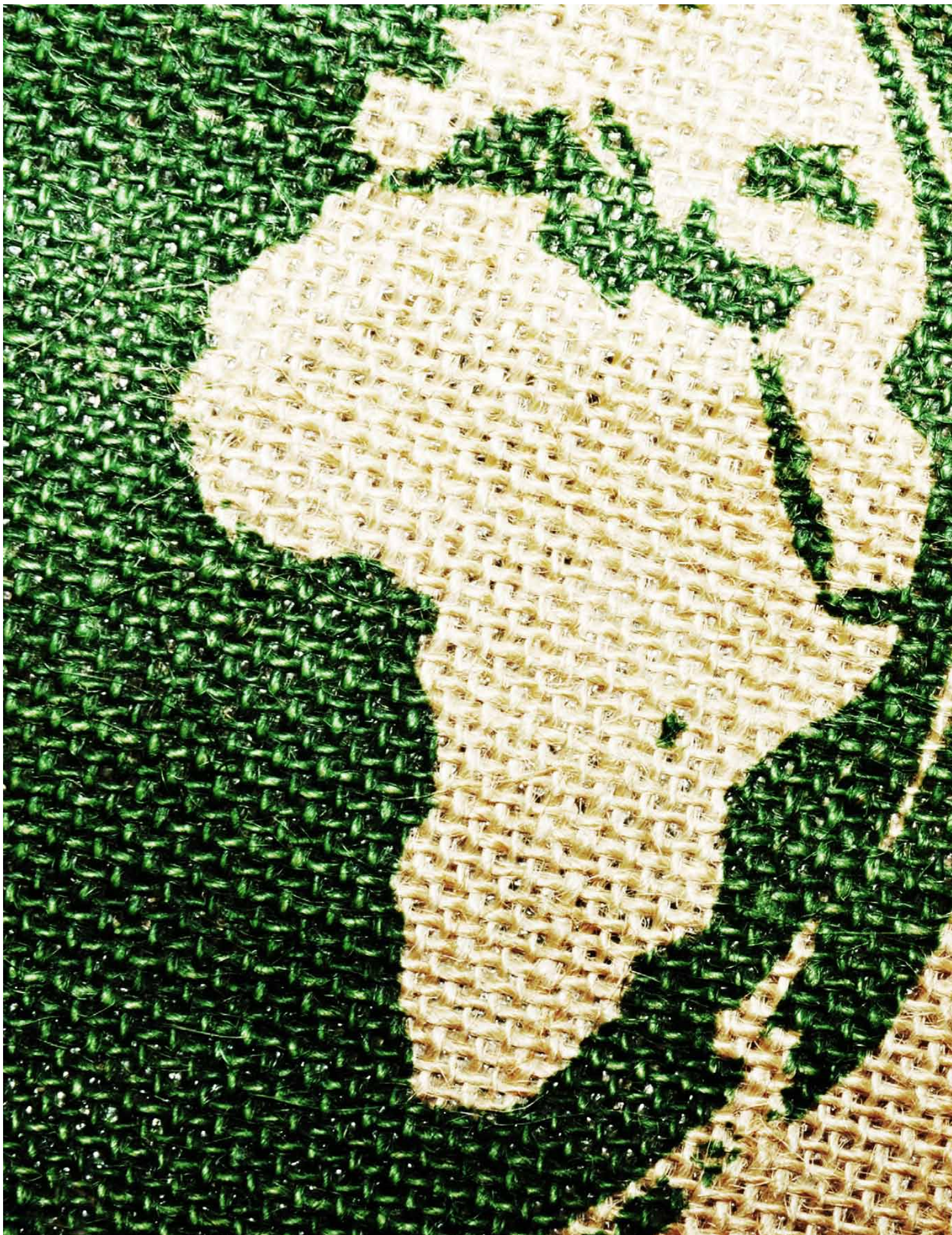
27four Investments is a South Africa-based multi-manager – an investment product that consists of multiple specialized funds. The firm’s responsibility is to construct portfolios for its clients, which include retirement and retail funds, and for individual investors, through the mutual fund industry in South Africa.

The investment firm works across a number of different countries and sectors, and its selection process for choosing its funds requires on-the-ground research and the fulfillment of specific criteria. Fatima Vawda, Principal and Head of Investment at the firm, says that it has met approximately 100 managers over the last 5 years to determine its final fund portfolio. It eliminates those funds that are focused on the retail market and those that have exposure to the Middle East, selecting only the funds that have established track

records. 27four Investments is currently monitoring around 47 Africa funds (out of about 100 Africa funds).

“We only market our solutions to long-term investors like pension funds, predominantly because retail investors, for example, cannot withstand the volatility. These funds have liquidity constraints and do not have a long-term investment horizon, which is normally around five to ten years. There is a long-term growth story in Africa, but it is for a particular type of investor.”

Ms. Vawda explains that the firm prides itself on conducting excellent due diligence when assessing which funds it chooses. The main focus is the fund’s investment capability, together with the long-term attractiveness of the investor. However, in Africa, Ms. Vawda says a lot of the due diligence involves the administration of the back office and compliance, such as the legal aspects and the documentation. “What we do is a combination of qualitative screening and quantitative assessments.”



However, for Ms. Vawda, one of the most exciting funds is its Africa fund of funds. This product specializes in sub-Saharan Africa (SSA) funds only, and excludes South Africa. The fund, which launched in June 2011, is U.S. dollar-based and provides international investors with access to the equity markets in SSA excluding South Africa, using a fund-of-funds investment process.

“We have a suite of different types of investment portfolios, and I think the most exciting out of all of our investment portfolios is our Africa fund of funds. An abundance of international investors have had access to the South African markets for many years because it is a developed market that has sufficient liquidity. A few years ago we made a strategic decision as a business to start researching the African continent and put together a liquid equity portfolio comprising fund managers who have exposure to Africa and are based in and out of the continent. Our funds are mainly invested in pan-Africa and sub-Saharan Africa.”

These funds are backed by a range of European investors, which according to Ms. Vawda have a long history of investing in the African markets, and are mainly from the U.K. and other parts of Europe, particularly the Scandinavian countries. One of the biggest South African investors is Investec, although the largest African fund in the world is a billion-dollar fund based out of Washington, which was bought by Ashmore, she adds.

Why Africa?

Ms. Vawda says that Africa’s overwhelming investor interest has been generated for a number of reasons. Among these are the improving levels of governance and the falling levels of political conflict, in-

cluding the rise of democratic institutions, which never existed before.

“There has also been a big improvement in sovereign and corporate balance sheets;

The African market further provides a great opportunity for portfolio diversification.

There is a historic correlation in the African market of less than 0.5.

It’s an excellent means to diversify a portfolio.

the high costs of credit have been reduced on the balance sheets of many African states. The African market further provides a great opportunity for portfolio diversification. There is a historic correlation in the African market of less than 0.5. It’s an excellent means to diversify a portfolio. The market has also been providing excellent discounts, good fundamentals and it is cheaper than other markets, including South Africa.”

With regard to the long-term growth fundamentals, a lot of African countries have expanded their GDP, and Ghana for example is experiencing 13% GDP growth. Many African governments have also been improving their policies regarding literacy levels, and by 2025, 20% of the world’s young people will be from SSA – A demographic dividend that is similar to that of the U.S. in 1960, Ms. Vawda says.

“Nigeria, for example, has a population of 160 million people. There are certain parts of this market that are growing rapidly. In particular, its banking industry and retail market has seen large growth in the middle class. All of this constitutes a young, growing future workforce in sub-Saharan Africa.”

Fund managers working out of SSA encounter their everyday challenges, however. One of the biggest sticking points, Ms. Vawda says, is the access to and quality of market information, which is often poor and lacking. This includes financial reporting, as many companies do not have investor relations departments in place to manage this much-needed financial information and research.

Additionally, Ms. Vawda says that in terms of trades, working from SSA can be expensive. Brokerage commissions are high, as are currency spreads, which can go up to 350 basis points. Fund management fees are expensive too, and average around the same as hedge fund manager fees, with many charging performance-based fees with high water marks. However, Ms. Vawda explains that in the last two years the market is beginning to see a marked difference, as regulators are beginning to understand that the high charges are deterring international investors.



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African Fund Manager's Continental Outlook

In Africa infrastructure can be a big hindrance in terms of doing business for corporations and other entities.

Whether it is digital or physical, this is one of the main factors that investors must overcome. Understanding the key structural changes that run through the continent is vital, as they explain growth

patterns, which helps investors understand the economic and physical landscape.

“Africa is not as connected as Europe, for instance. If something happens in France, Germany is likely to feel the effects. So the ability to construct a portfolio that is uncorrelated in Africa is much

higher than, say, Latin America. You can therefore end up with a portfolio that can give you a higher return and lower risk,” says Larry Seruma, Managing Principal of Nile Capital Management LLC and Advisor of the Nile Africa Funds. He has over 20 years of experience in portfolio management, investment research,



and quantitative investment strategies. In 2004 Mr. Seruma founded Nile Capital Management, beginning his tenure as Portfolio Manager for the Nile Master Fund, a global long/short equity hedge fund. He has also written many articles on investment in Africa and other emerging markets.

With regard to getting exposure to infrastructure development from a fund perspective, Mr. Seruma believes this is definitely possible in Africa. Physical infrastructure progress is taking place from Cairo to Cape Town in the form of roads, railways, and especially housing, which is in huge demand on the continent. Power

shortages are a common occurrence, so there is room for development in this respect. “Africa recently plugged into data infrastructure, and sea cables are allowing much more information transformation, but the data revolution has not yet taken hold properly,” says Mr. Seruma. “But there has been a revolution in the telecoms

and mobile networks space. So the next wave of this is going to be data that can be transferred through these networks.” Power companies are also currently presenting investment opportunities, as are logistical businesses. Africa’s challenging infrastructure means that the companies successfully navigating ports and transportation are experiencing high returns.

In many cases Africa already has the client base, but the services on offer are not sufficiently developed to serve the burgeoning middle classes. Once an investor comes in, they are able to address these problems. Often it is a case of getting in the right position to invest in a business, and executing a plan that is tailored to an already hungry audience.

Mr. Seruma is sure that over time the perception-versus-reality myth that deters many investors from Africa is going to be resolved because money flows will increase into the continent. “It is really a mystery. You would have thought people in the finance business would have been able to work this out. Over the last 20 years many African countries have improved at managing their finances. They have better physical balances, even relative to many places in Europe. They are much more in control of inflation, and more pro-market policies are in place. They are also trying everything they can on the regulation side,” says Mr. Seruma.

Nigeria is continuing to prove its worth as one of the fastest growing areas with regard to investment. “It has consistently managed its macro-economic environment far better than where it used to be historically. Even during the global financial meltdown, sub-Sahara Africa’s GDP increased by 2.8%, whereas Europe and the U.S. suffered serious contractions.”

Africa’s diversity of language, religion, culture, and business practice can present

obstacles for foreign investors. The continent spans 54 countries, and Mr. Seruma jokes that if you can speak five languages you can go anywhere in Africa. From an investment standpoint, many countries, especially along the west coast of Africa,

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have ties with Europe, and therefore feel any financial contractions that take place in France, the Netherlands, Spain, or the U.K. Another hugely influential factor is religion, which can play an integral role in who actually invests in a specific country, especially in the north of the continent.

North Africa is comparable to the Middle East in many ways. The region attracts a huge amount of investment from countries such as Saudi Arabia because investors feel more comfortable and connected to the religion.

However, Morocco has recently been used by Europe as a location for cheap manufacturing, so it is much more sensitive to what is happening in France and other European countries. The country is also sensitive to tourism from similar areas due to its geography. “Looking at the North African economy, it has some differences attached to it. But it is true that because the region is predominantly Islamic, you find most investments come from the Middle East. If you look at Egypt, the most populous country in North Africa, it has a traditionally open economy, which over the years has helped it grow, but North Africa right now is very challenged in terms of growth and political stability. So recently, many investors have been redeeming capital out of the area due to the risk involved.”

As a result of the global financial meltdown there has been a realization, especially in the U.S., that returns going forward are going to be low in comparison to what they once were. This is evident in both the actions of individuals and companies, as they are starting to look elsewhere: Africa. Mr. Seruma says, “GE (General Electric) reorganized their business three or four years ago under five different divisions. One of those created was GE Africa where they put a GE CEO in Kenya. So GE will be able to sell more gas turbines in Africa than they will in the U.S. The company has generated 3 billion dollars in Africa, and is set to double this in two years.”



Understanding the Johannesburg Stock Exchange

Understanding the Johannesburg Stock Exchange (JSE) is imperative for those wishing to invest in the South African markets. The Exchange launched in 1887, and since then it has developed from a traditional equities trading market to a securities exchange that provides electronic trading, clearing and settlement in equities, financial and agricultural derivatives.

Nicola Comninos, Market Development Manager in the Equity Markets department of the Johannesburg Stock Exchange, explains that South Africa's market has a slightly different structure than some of the bigger stock exchanges. One of these differences, she adds, is that JSE uses a back office system, dubbed a "broker dealer counting system," which enables the organization to conduct real-time surveillance. This system also assumes responsibility from the country's regulatory Financial Services Board to manage its internal regulations.

"The surveillance function we perform is actually quite similar to how the Australian Stock Exchange (ASX) used to operate, but due to regulatory reform in that market, ASIC now performs that function. We are also the listings authority and we thus approve listings of companies and products on the exchange's equity and bond markets. We currently have quite strict trade reporting rules in the JSE Equity Market. This relates to types of reported trades, sizes of trades, and time of reporting. We are currently working with the market to amend some of those rules to enable brokers to report smaller sized trades."

The Johannesburg Stock Exchange has launched a range of new products since the start of this year, the most significant perhaps being exchange traded products, which includes notes and funds. The launch also came with a change in legislation of the exchange's property segment, which fueled considerable growth in the property listings segment. The segment previously had two different types of property entities: loan stock companies and unit trusts. Under the new legislation, both of these can now qualify as a product, otherwise known in the European markets as a VEET.

"An example of an ETF listing this year is the platinum Exchange Traded Fund (ETF), which directly invests in platinum, and doesn't use futures to get exposure to platinum like some other platinum ETPs do. A reason for this listing is that the market has been lobbying our National Treasury to relax our foreign exchange control restrictions by classifying platinum ETFs as local securities. A lot of our South African fund managers can thus now invest more in this type of product, and it has consequently already traded

billions of rands since listing, including various bespoke products,” Ms. Comninios says.



Equity and Commodities Divisions

Johannesburg’s Stock Exchange is comprised of five divisions; an equity market, an equity derivatives market, an interest rate product market (which includes interest rate derivatives and bonds), a currency derivatives market, and a commodity derivatives market.

On the equity market side, the exchange provides close to a full end-to-end service offering, where market participants can trade on the JC and also clear the trade. The division is also responsible for the settlement process, due to it owning a portion of its CSD. In this sense, the Exchange works as a quasi-clearing house.

“Part of the equity business model review project is really looking at whether there are any additional efficiencies that we can potentially create, whether we have to change the way we clear and settle trades by establishing a separate clearing house. Some of the other considerations for efficiency we are looking at are Basel III capital requirements and for equities clearing and settlement to comply with CPSS-IOSCO principles. At this stage the review is still in exploratory phase.”

The Exchange’s commodities derivatives division was once part of the old South African futures exchange, named the agricultural market. Ms. Comninios says this part of the market has been developed substantially, and is now a fully fledged commodities house trading both soft and hard commodities.

She adds, “We have relationships with U.S. commodity markets where their contracts are listed on our market, such as the Chi-

cago Corn and CBOT soybean contracts. This offers our brokers an opportunity to trade and settle a number of international commodities contracts on our market in rands. We have also launched a platform called Global Market, which allows our equities derivatives brokers, as well as our commodity derivatives brokers, to trade these contracts on this market. We have different membership structures for our different markets, but this allows mem-

*The exchange’s
equity market
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daily value traded
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compared with the
same month in
2012.*

bers of two of our markets to access those instruments through existing membership structures.”

The exchange’s equity market average daily value traded for May was approximately 18 billion rand, up more than 30% compared with the same month in 2012. As of the end of May 2013, year to date,

the value traded growth was up by 20%, a significant growth in the number of trades executed on the market, which is up more than 50% year to date, Ms. Comninios says.

As it stands, the Exchange charges the brokers per trade for equity market trading, and because the value traded grew at a far lower rate than the number of trades, it has put cost strains on the market at what is already a tough time. Ms. Comninios confirms that the Exchange is in the process of discussing whether this should be changed to a pure value-based model, something which is currently in consultation, and which will be finalized in early July.

The Johannesburg Stock Exchange’s biggest players, Ms. Comninios says, are mainly the multinationals, such as Deutsche Bank, UBS, Meryl Lynch, Citi Bank, Credit Suisse, and Macquarie. She adds that there are also many local players that make up a large portion of the Exchange’s business, including Paragon Equities, which is rated as the second top broker in terms of trades, and Africapital, owned by Barclays, which is the second biggest in terms of values traded. RNB Morgan Stanley, Nedbank, Standard Bank, Rand Merchant Bank, and First National Bank also have a significant local presence.

“More and more retail brokers are offering online share trading. Nedbank has recently launched its own online share trading platform. Examples of existing successful online share trading platforms are those offered by Standard Bank and PSG. There is definitely a demand for self-management of investments by retail investors and brokers are opening up more and more online trading platforms,” Ms. Comninios explains. “This model is, however, a very low margin business for retail brokers, who still focus most of their efforts on offering investors value added services, like discretionary trading and research.”





News that the U.S. Federal Reserve will curtail its bond purchases put considerable pressure on the global bond market in May, resulting in the market's biggest monthly loss since 2004 and a record withdrawal from bond funds worldwide. Emerging market bonds in particular have fallen by 6.3% since the beginning of May.

However, for David Creighton, President and CEO of private debt fund manager Cordiant, it is business as usual, and the firm recently concluded a US\$250 million first close of its latest emerging market debt fund. Cordiant opened its doors in 1999 and manages 6 funds, 5 of which are dedicated exclusively to emerging market debt.

“In emerging market private debt, we identified an asset class with an attractive risk-return profile that wasn’t being discussed back in the late ‘90s. Five debt funds later, we have made nearly 200 investments in 55 emerging countries and raised over US\$2.4 billion in capital commitments from institutional investors. Through it all, our strategy has never deviated: we provide hard currency loans to high quality borrowers in fast growing emerging market countries.”

Diversifying Risks

Cordiant attributes its success to taking on a pool of emerging market loans, highly diversified across many regions and sectors to protect its portfolio from market volatility. Mr. Creighton says that the firm’s strategy has proven its resilience over the years by weathering significant stresses in the global economy. As a result, Cordiant has thrived where other investment firms have failed.

“Our strategy of diversification dictates that we look not only at the BRIC countries, but beyond into frontier regions where domestic institutions lack the funds and organizational structures necessary to meet the long-term financing needs of local corporates. Demand for the long-term financing that we provide continues to strengthen, and we are seeing a lot of deals with attractive yields to make them interesting.”

Mr. Creighton explains that, even in larger countries like Brazil, Cordiant is increasingly looking at opportunities away from the bigger city hubs, such as São Paulo and Rio de Janeiro. A similar approach has been adopted in India and Russia, moving toward the north and east of the countries, respectively. Just recently, Cordiant was involved in a US\$117.2 million port expansion project in Salvador, on the northeast coast of Brazil. Cordiant provided a US\$20 million loan to Tecon Salvador to finance the refurbishment and expansion of the port terminal’s container handling capacity, in support of Brazil’s growing exports to Europe, the U.S. and China.

“We have expanded the number of countries that we’re operating in. The deals, too, run a wide gamut across different sectors, like infrastructure, cellular technology and financial services. We couldn’t do what we do without a deep understanding of the opportunities, and challenges, inherent in the emerging markets.”

He adds, “The driver behind our investing, and the key to our success, is tapping into the fundamental growth taking place in the emerging markets. Rather than focusing on extractive industries, for example, where risks can be high and the price of the commodity is beyond our control, we are focusing on the economic and demographic shifts that are permanently altering the face of the emerging markets. Rapid urbanization and the explosion of the middle class bring with them a demand for reliable power grids, accessible financial services, and a wide range of consumer goods. Essentially, we’re finding that the most resilient and successful deals are those that satisfy domestic needs.”

Partnering Up

The key to many investments within the emerging and frontier markets is partnering with supranational development

banks. Gaining the financial support of state-owned financial institutions is not an uncommon pursuit for investors; as well as offloading some of the risk, it can benefit the rating class of the asset by making it more credit-worthy. Mr. Creighton says that Cordiant has partnered with many institutions, including the European Bank for Reconstruction and Development, The Inter-American Development Bank, the International Finance Corporation and the African Development Bank.

Cordiant’s clients are primarily pension funds and insurance companies from North America and Europe. They are conservative investors looking for stable and predictable returns and capital protection. They are seeking low-risk exposure to the emerging markets and an alternative to Treasury and government bonds.

“Emerging market debt provides a low correlation against other assets. Its cash-generating properties are gaining a lot of interest right now. In 2025, pension funds expect to have 25% of their portfolios in the emerging markets; I believe that percentage should be higher.”

For Cordiant, the business of emerging market debt has not been without its challenges. Mr. Creighton says that raising awareness of the firm’s unique strategy, particularly in the early days, was a struggle. Only in the last few years has emerging market debt really attracted the attention of a broader range of global investors.



Cambodia: The New Kid on the Block?

With lucrative investment opportunities opening up in the telecom, manufacturing and mining sectors, Cambodia is on its way to becoming a key emerging market contender for the Asia Pacific region.

The difference between the perceived investment risk in emerging market economies and the reality can at times be stark. And never has this been more true of Cambodia. The country's promising GDP growth of 7%, dollar-denominated economy, and cheap labor are slowly but surely beginning to lure in foreign direct investment. The IMF expects the economy

to grow by 4.8% this year. As well as international interest, regional players are beginning to cash in on Cambodia's large untapped reserves, with Chinese, Vietnamese and Korean companies all showing an increased interest in the region.

"The big gap between perception and reality offers a lot of opportunities," says Douglas Clayton, CEO and founder of in-

vestment management firm Leopard Capital. "With Cambodia, the perceived risk is that it is a difficult environment to do business in because it's supposedly corrupt and has a weak legal system. There is also the expectation that, as a foreigner, you're not going to see your money again, but the reality is that investors rarely lose out on anything other than for basic commercial reasons," he adds.

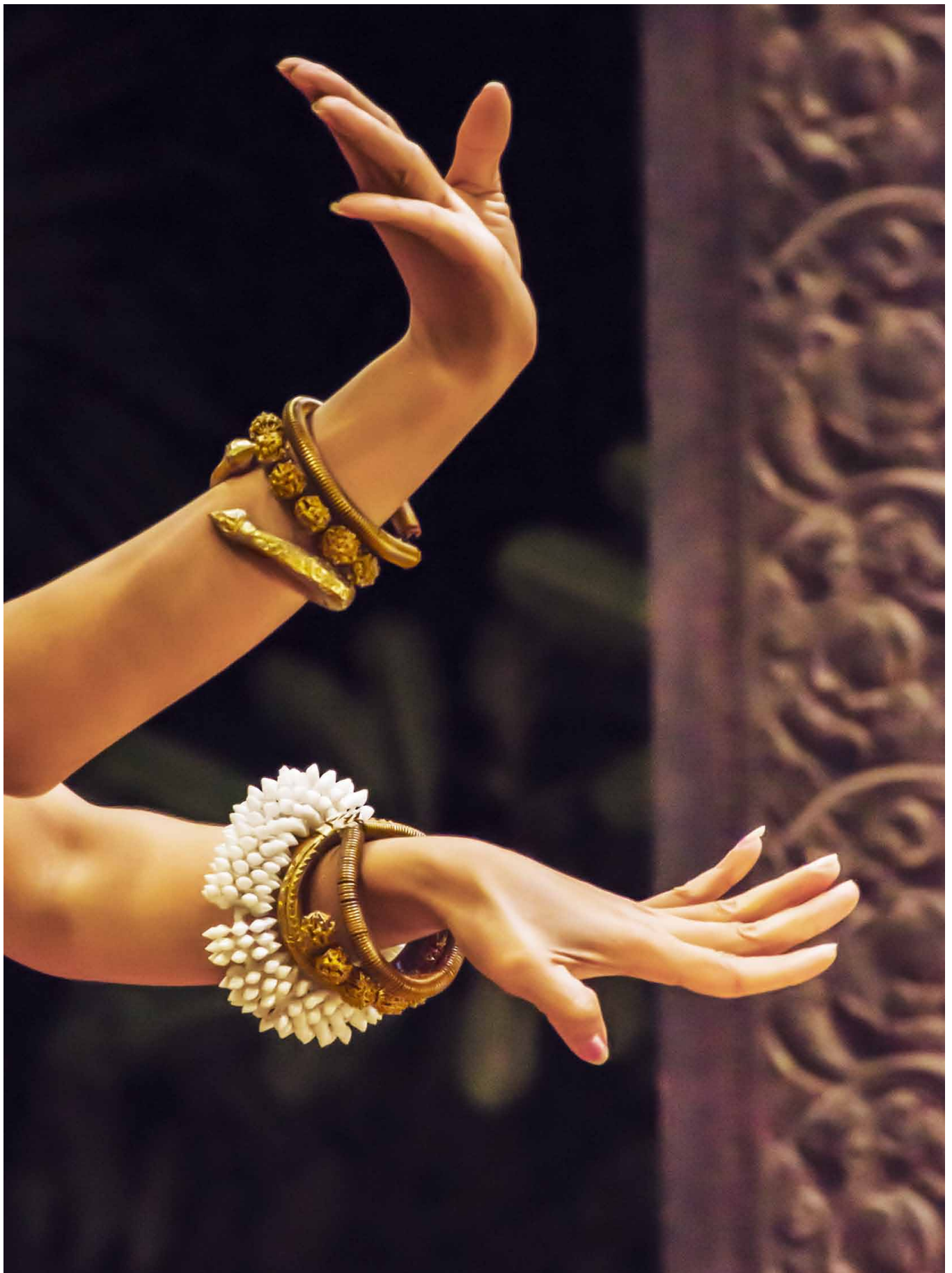
Contrary to popular belief, Mr. Clayton says that the Cambodian government has been very supportive toward foreign investors, and has held back from expropriating or nationalizing foreign-owned assets.

■ Cambodia's Draw

Cambodia's fast-growing economy and investor-friendly environment were some of the many reasons that led Leopard Capital to set up its Cambodian private equity fund in 2008, a time when many players would have taken more care. Mr. Clayton explains that at the time the fund was set up, the Cambodian economy had been largely ignored by international investors, but its open regulatory system, which entitles foreign investors to own 100% of almost any industry, made it an option well worth exploring.

"It has no capital controls and you can wire your money in and out of the country freely, and it also has a low taxation rate, so it has a radically liberal economy. We felt that this framework would continue to support high growth. Cambodia is a dynamic region and its neighbors are increasingly doing business there. It also has a very young population that is eager to get ahead and willing to work hard for low wages," Mr. Clayton says.

Leopard Capital's Cambodia fund raised US\$34 million from over 100 individual investors at its launch in 2008. Not only was it the group's first fund and the first



launched in Cambodia, it was also one of the only Southeast Asian funds successfully raised during the global financial crisis. The fund's investment strategy is to focus on venture, expansion and pre-IPO opportunities. With four years left to run, the fund has so far backed 14 different businesses, with three full and four partial exits; the latest, Kulara Water, was sold back to its founders in May at a profit.

"We feel like Cambodia has all the ingredients for a successful economy. Our challenge was to translate strong economic fundamentals into bottom-line fund performance, to find the most lucrative sectors and companies positioned to ride that economic growth. Overall, Cambodia's growth story has played out as we expected, and our fund is generating positive returns."

Investor Appetite

Mr. Clayton says that prying investors' attention away from ASEAN's larger frontier markets such as Myanmar and Vietnam is one of Cambodia's biggest challenges.

"There are 60 million people in Myanmar, compared to Cambodia's 15 million, so that in itself captures people's imagination and attention," Mr. Clayton says. "Myanmar's significant natural resources, such as oil, gas, mining and hydropower certainly add to its appeal. Cambodia has some of those resources as well, but not nearly on the same scale. Foreign investors look at Myanmar and see that only 3% of the population can afford discretionary spending, while the rest are living without mobile phones, banking services, or electricity, so investors sense a mouthwatering opportunity there. By comparison, little Cambodia doesn't seem that significant, so it gets overlooked."

The lack of investor sentiment in the Cambodian market may soon be a thing of the

past, however, as the success of Leopard's country fund over the last 5 years has served to highlight the ample untapped opportunities to be had. Mr. Clayton adds that the fund has focused on deals ranging in size from US\$1 to US\$5 million, and typically invests as a minority investor in mid-sized companies.

"It [Cambodia] has no capital controls and you can wire your money in and out of the country freely, and it also has a low taxation rate, so it has a radically liberal economy."

He explains that buyouts are uncommon because the founding shareholders of Cambodian businesses are reluctant to give up control this early in the country's development process.

"There are few other private equity investors looking seriously at Cambodia; most of the action is from strategic investors from other Asian countries looking to set up greenfield factories, etc. It's not really an M&A market as of yet, but we expect that will come later. Cambodia is growing 7% a year, and before long its GDP will double, then triple, but you can't escape how small its domestic market is today, which doesn't draw the big players."

He adds that the country comes with its risks too. "Power and transportation costs are high, and foreign investors have to

compete for a small pool of managers with international business skills. Execution risks are greater than country risks," Mr. Clayton stresses.

"Cambodia has certain constraints, but it's an accessible niche market and I think more people will recognize this and come in as time goes on."

The fund is strategically targeting companies providing financial services, electricity, telecoms, and food products to Cambodians who are at the bottom of the pyramid, but starting to "climb their way up." And Leopard Capital is perfectly positioned to help overseas financial investors gain a slice of the action. Its portfolio companies' growth trajectories are well established in and around the Asia Pacific region, and the group, Mr. Clayton says, draws on the practical experience its principals have gained from investing in other Asian developing countries over the past 25 years.

As a testament to the success of Leopard Capital's Cambodia fund, the group is in the process of setting up a four-country US\$150 million successor fund. The fund promises to be unique in its approach, and will invest in Cambodia, Laos, Thailand and Myanmar to capitalize on the increasing trend toward regional integration under the emerging ASEAN Economic Community.

"We are putting investment teams on the ground in each country, to leverage the business networks we have built across this region," Mr. Clayton says. "These four neighbors share important cultural and religious similarities and long borders, and stand to become the greatest beneficiaries of both the AEC rollout and the recent reforms in Myanmar. Yet this exciting growth pocket is still off the radar of most private equity investors. We prefer to invest ahead of the crowd."

The Mongolian Frontier

Resource-rich Mongolia has been planted firmly on the radar of many investment firms worldwide in the last few years. As one of the world's fastest growing economies, the market rose by an impressive 17.5% in 2011. However, with falling commodity prices, Mongolia's economy slumped last year, growing only 12% – a setback that its government is desperately working on.



Among the better-known obstacles hindering Mongolia's economic growth are its "resource nationalism" and limited liquidity. And despite some of the recent developments that are expected to help the country's growth, such as country stocks listed on the Hong Kong, London and New York stock exchanges, Mongolia's lack of liquidity continues to be a sticking point.

Masa Igata, Founder and Chief Executive Officer of investment group Frontier Securities, explains that the country's market works only in the short term, and therefore liquidity so far has been limited. He

remains hopeful, however, explaining that Mongolia's liquidity problem is slowly improving.

Political Risk

One factor that stands in Mongolia's favor is its democratic politics. "Parliament members are selected every four years, and in 2008 and 2012 we had elections," Mr. Igata says. "In the last election there was a change in the ruling party and there is now no military power or hold over the country. You see many investors are interested in Myanmar right now, but it's a country that is ruled by military power; there is no democracy. So here we have an advantage."

However Mongolia's democracy may not be enough to entice investors into the country and solve its lack of liquidity problem. Over the years the Mongolian government has adopted an aggressive nationalistic approach to outside investment, especially with regard to Chinese companies. And with 80% of the country's exports heading to China, Mongolia is at serious risk of shooting itself in the foot.

With resource nationalists making up around a third of Mongolia's parliament, a strategic entities foreign-investment law was recently passed to impose stricter controls over foreign investment projects in Mongolia.



"There is an anti-Chinese sentiment which has caused Mongolia to be more nationalistic in the last two years. Mongolia's previous commitments with some of its Chinese investors have fallen through of late, and so it is here that we have political risk. Major investors are currently negotiating with the government to reactivate previous commitments and are fighting for them to be kept, but the government is stubbornly not agreeing," Mr. Igata says.

One of the better known scandals concerns the Oyu Tolgoi mining project that is owned by Rio Tinto and Canada's Turquoise Hill Resources. The project's first shipments of copper were due to begin toward the end of June, but all exports were suddenly halted at the request of the Mongolian government, which many believe is fearful of losing out financially.

"So far more than US\$6 billion has been invested into this mine, but recently the government has changed its mind, and because of this investors are becoming very cautious about investing in the country. A lot of Chinese companies have been looking for mining deposits and are very keen to invest in copper and minerals, but because of the anti-Chinese policy in Mongolia they are now very wary," Mr. Igata says.

The mining sector is not one that investors in general are pursuing, Mr. Igata observes. "It's tricky, as identifying which mine to invest in can be very difficult, as well as getting around the governance issues. It's also difficult to secure your position, so it's challenging for foreign investors to get involved in this sector, and on the whole it would be time consuming."

However, despite the recent setbacks and scandals regarding the government's resource nationalism, many investors are still showing considerable appetite for Mongolian mining investments.

"Japan and Singapore, and Korea are also looking at Mongolia now, and some investors are looking at listed vehicles from the Canadian and Australian companies that are listed on the stock exchange. They are looking for a growth story in an emerging market, so this is their destination."

Investment Opportunities

Despite current perceptions, Mr. Igata explains that there are numerous ways for investors to enter into Mongolian deals, and one avenue that is growing increasingly popular is investing via big name corporations, such as the Mongolian Mining Corporation and the Mongolian stock exchange. "It can be easier to invest in these wholly integrated companies, and get involved in deals via these vehicles," Mr. Igata says.

"Market players can buy into real estate, and this is a fairly straightforward process for foreign investors, as there are not many restrictions in buying real estate. There is a 2% tax fee so the cost is very attractive. The real estate prices have risen over the last three to five months, and investors have seen a very attractive yield at around 10%, so in dollar terms it is still good; achieving this dollar yield is uncommon for any other market."

Indeed, Mongolia still holds an abundance of untapped wealth and opportunity for global investors. And the government, despite some of its more controversial views about outside investment, is making real progress in growing the country's economy. The EBRD's recent emerging market growth forecast predicted that Mongolia's GDP will increase by 16% next year.

Last year, Mongolia issued its first sovereign debt bond, which at US\$1.5 billion has been delivering a high yield of around 5%. The bond, which has two tranches of 5 and 10 years, will appeal to those inves-

tors that can take risks and are interested in local currency.

Additionally, Mongolia is overhauling its stock exchange to enhance its efficiency and openness in cooperating with global markets. The new Mongolian Securities Law, which is expected to be implemented next year, will make it much easier for investors to explore and participate in deals. Meanwhile, Mr. Igata says that Mongolia's energy sector will be one of its fastest growing, as recent government commitments regarding a push in green energy will attract more foreign direct investment into the country.

"Energy investment is also something that is being encouraged by the Mongolian government because we have had a lot of pollution in the last few years and so it is very keen to get investors in to support the environmental areas, especially with renewable energy. The government is putting very favorable policies in place for renewable energy projects and other green energy sources. There's a great tax incentive, too, which could lure in local and international investors."

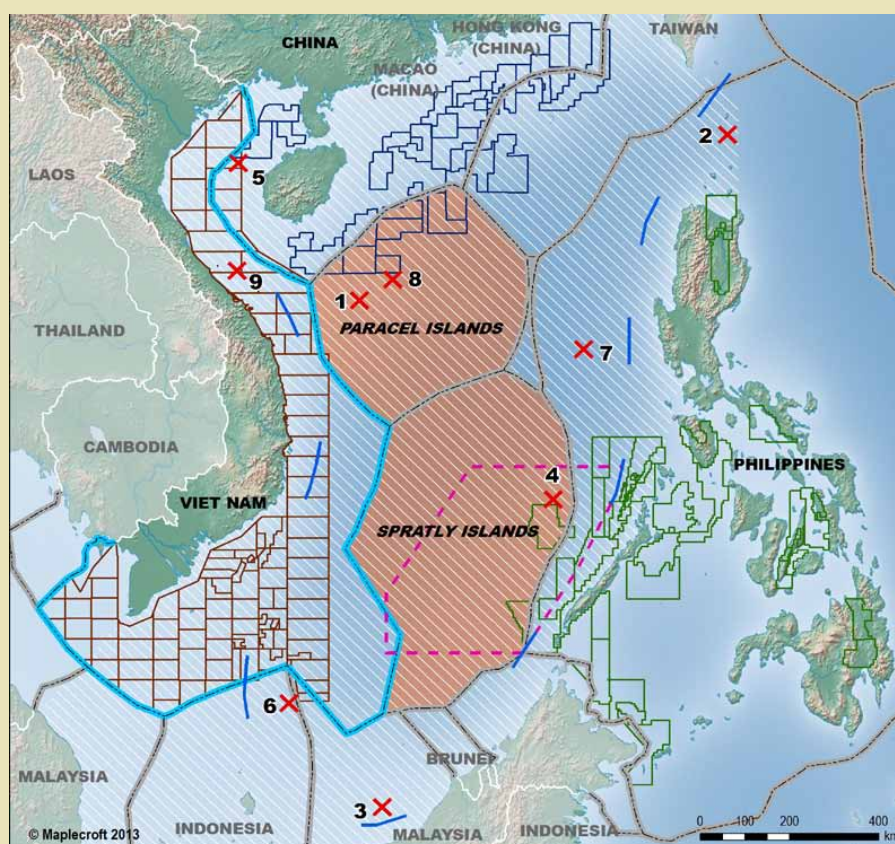
He continues, "At this moment, 90% of the exposure is in the mining sector, but in the next 5 to 10 years the government will push the non-mining sectors because of its experience in 2009. One of the growing sectors is green technology exports from Germany and Japan and from other developed economies. To solve the problem of Mongolia's lack of green energy we have recently started a new environmental ministry which will encourage the private sector to spend more money on green energy."



South China Sea Incidents

Incident Number

1. On 20 March 2013, a Chinese patrol boat fired flares at a Vietnamese fishing vessel near the Paracel Islands.
2. On 9 May 2013, a Taiwanese fisherman was killed when the Philippine Coast Guard fired on a fishing boat.
3. On 20 April 2010, a Chinese Marine Surveillance ship dropped a sovereignty marker in the waters off James Shoal in order to assert the China's claim to the sea.
4. On 2 March 2011, two Chinese maritime surveillance (CMS) vessels forcibly expelled a Philippine seismic survey vessel in the Reed Bank area, North West Spratly Islands.
5. On 26 May 2011, a Chinese maritime surveillance vessel cut across the stern of a PetroVietnam survey vessel, severing its tow cable.
6. On 9 June, 2011, a Chinese fishing boat became entangled in the tow cable of the Norwegian Viking II, which at the time was surveying off the Vietnamese coast near the Vanguard Bank.
7. On 6 June 2012, the last two Chinese patrol ships operating in the lagoon of the disputed Scarborough Shoal were withdrawn to nearby waters in the SCS. This followed the withdrawal of a Philippine ship from the same area two days earlier as a result of bilateral diplomatic negotiations.
8. On 23 July 2012, China established a military garrison on Woody Island in the Paracels. The following day, the city of Sansha, which administers all China-controlled territories in the SCS, was formally established by Chinese authorities.
9. On 30 November 2012, two Chinese fishing vessels cut the tow cable of the Vietnamese Binh Minh 02, a seismic survey ship belonging to Petro-Vietnam.



Another Voluntary Disclosure Program in Argentina

■ **Javier Canosa**

In March 2013 the Argentine tax authorities launched the New Voluntary Disclosure Program, aiming to produce “counter-cyclic measures for the structural development of companies, job growth, maintain the sources of jobs and strengthen the acquisition power of Argentine citizens, and with those tools, consolidate supply and the Argentine domestic market.”

The main advantage of the New Voluntary Disclosure Program compared with the permanent disclosure program (established in March 2010) is the number of installments allowed and the reduction of the financing interest, which provides an incentive for financing through the new program due to the current high inflation rates in Argentina (between 25 and 30% per

year). The maximum term is 120 monthly installments of AR\$150 or more, with payments due on the 16th of each month, and the applicable rate is 1.35% per month.

The New Voluntary Disclosure Program applies to taxes, social security charges and fines and customs charges, along with fines and interest due up to February 28, 2013. In addition, tax debt that was being restructured under another program can be restructured under the New Voluntary Disclosure Program because of its more attractive terms.

However, the New Voluntary Disclosure Program specifically excludes amounts due for taxes on non-registered payments, liabilities that originated as part of tax inspections, withheld taxes, down

payments, health insurance contributions, labor insurance contributions, contributions to the registry of workers and employers, taxes on cigarettes, income and minimum presumed income pertaining to fiscal years of companies or individuals as of October 1, 2012, tax on personal assets for fiscal periods after 2011, VAT for import of services, and certain custom charges for declaring the holding or acquisition of agricultural goods, among others. Subjective exclusions include media companies, individuals with criminal tax and customs charges.

Application to the New Voluntary Disclosure Program is possible until July 31, 2013, and it is a very simple procedure to do through the website of the Argentine tax authorities.



Unlike the previous voluntary disclosure program implemented in Argentina in 2009 through law No. 26,476, the “Former Program,” the new voluntary program provides no waiver of fines or interest. The Former Program, also called the “Anti-crisis Plan,” was intended to aid companies and individuals affected by the economic crisis, and to promote capital repatriation.

The Former Program provided for a significant moratorium. Obligations under

the scope of the Former Program included those in administrative or judicial litigation, provided that the defendant unconditionally acquiesced, and, if necessary, ceased and renounced any right or action, assuming the payment of costs. The law also suspended the term for criminal actions.

The Former Program provided for a scaled reduction of interest depending on when parties signed on to the pro-

gram. If this was done in the first or second month following the law taking effect, the reduction was 70%, in the third or fourth month 60%, and in the fifth or sixth month 50%.

Many Argentine taxpayers applied to the Former Program, and it is expected that many will also apply before July 2013 to the New Voluntary Disclosure Program.

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.



According to a 2013 report by The United Nations Environment Program (UNEP), Global Trends in Renewable Energy Investment, 138 countries now have renewable energy targets and 2 out of 3 are emerging economy countries. Last year, “for the first time, developing coun-

tries came close to advanced nations on investments in renewable energy.” is the fifth-largest producer of geothermal energy in the world. Biomass, solar and wind are increasingly being used in Brazil, Mexico, Guatemala, Argentina and Chile. At present, the IDB is financing large-scale wind farms, solar power systems for rural areas, biofuel facilities that co-generate electricity, retrofitting hydroelectric

needs. The IDB report predicts the feasibility of Latin America meeting 100% of its electricity needs with renewable energy.

A private equity firm in Chile, Mainstream Renewable Power, is bringing 600 MW of solar and wind capacity online by 2016. Brazil and Venezuela have the most hy-

Renewable Energy Sector Growth

■ Stephen Kaczor

tries came close to advanced nations on investments in renewable energy.”

“Latin America uses more renewable energy than any other region in the world,” Inter-American Development Bank (IDB) President Luis Alberto Moreno stated June 18 in Bogotá at the Global Green Growth Forum, “but it faces difficult choices as it seeks to generate the electricity it needs to grow without harming the environment.”

Wind is the fastest-growing non-traditional renewable source in the region. Mexico

facilities with more efficient turbines, and ensuring that new dams and natural gas projects meet stricter social and environmental standards. (Source: IDB Report, Rethinking our Energy Future.)

A 30 MW solar PV plant is currently under construction on Mexico’s Baja peninsula, the biggest in Latin America, powering 160,000 households. This 100-acre project will bring 132,000 solar panels online this year. Mexico’s solar potential is ripe for investment; just 16 square miles of solar installations could supply all of Mexico’s electricity

hydroelectric installations in Latin America, with a combined 85 GW capacity. While other countries are installing more solar and wind plants, countries like Brazil, Venezuela, Colombia and Panama are harnessing rivers to meet growing energy demands. The problem with hydroelectric is that it is promoted as “clean energy,” a misnomer like “clean coal.”

Hydroelectric projects disrupt surrounding riparian systems and cause cascading environmental system failure upstream and downstream of plant sites. This year alone





the U.S. Army Corps of Engineers demolished two major hydroelectric plants to restore health to lifeless river valleys, and construction of two mega-plants in Brazil was suspended by court order.

China has the largest installed hydroelectric capacity in the world with 200 GW compared to only 1 GW solar capacity.

world's largest photovoltaic manufacturer, will supply solar panels for it. Solar Reserve also has two 100 MW solar thermal power plants in the works in South Africa." (Source: Solar Reserve CEO Kevin Smith.)

"Unlike photovoltaic power plants, which deploy thousands of solar panels that di-

"Latin America uses more renewable energy than any other region in the world,"

*Inter-American Development Bank (IDB)
President Luis Alberto Moreno*

China is the largest wind energy provider worldwide, with the installed wind power capacity reaching 42 GW. "The development of wind energy in China, in terms of scale and rhythm, is absolutely unparalleled in the world," according to the Global Wind Energy Council. However, China is using more coal than ever to supplement its wind capacity when winds are insufficient. China is a leader in production of wind turbines and photovoltaic cells.

India is the second best country after China for business investment according to Development Counselors International (DCI). India's renewable energy plan is focused on increasing wind, solar and biomass capacity. The major portion of investment has been made in the wind sector, but much of India's Thar Desert has been set aside for solar projects sufficient to generate 1,000-2,000 GW.

In Africa, Google is financing the 96 MW Jasper solar project in the Northern Cape Province. South Africa has plans for 20,000 MW of renewable energy installations. Solar Reserve of California is developing the Jasper project and two other 75 MW solar plants. "Jasper is a win for China as well. Yingli, the

rectly convert sunlight into electricity, Solar Reserve's solar thermal projects focus mirrors on boilers of molten salt to create steam that drives electricity-generating turbines. The molten salt also stores heat so it can be released to produce electricity at night or on cloudy days, smoothing out the otherwise uneven electricity supply that comes from solar," according to Quartz's Todd Woody.

Opportunities for renewable energy investors in developing markets overtook developed nation market opportunities in 2010, and growth potential remains greatest in places with lagging infrastructure for the distribution of traditional energy sources such as grids focused on fossil fuel energy transmission.

Unlike U.S. and European markets, emerging market investments in renewable energy are growing rapidly. As a result many new investment funds are focusing on this sector. For a list of the top ranked alternative energy investment funds, Renewable Energy World just published a review at: www.renewableenergyworld.com/realnews/article/2013/01/top-ranked-alternative-energy-mutual-funds-and-etfs-for-2013



About the Author

Stephen Kaczor is Chairman of the Big River Foundation, a non-profit focused on river and watershed ecology conservation initiatives throughout the Americas. He is an organic farmer, eco-entrepreneur, consultant, and 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. In addition to consulting and writing, he is passionate about sustainable agriculture, Latin American culture, travel, and ecology.



Stein's Law and the Coming Crisis in Argentine Wine

■ Mike Veseth

Stein's Law, named for famed economist Herbert Stein, holds that if something cannot go on forever it will stop. Unsustainable trends ultimately yield to the inevitable in one way or another.

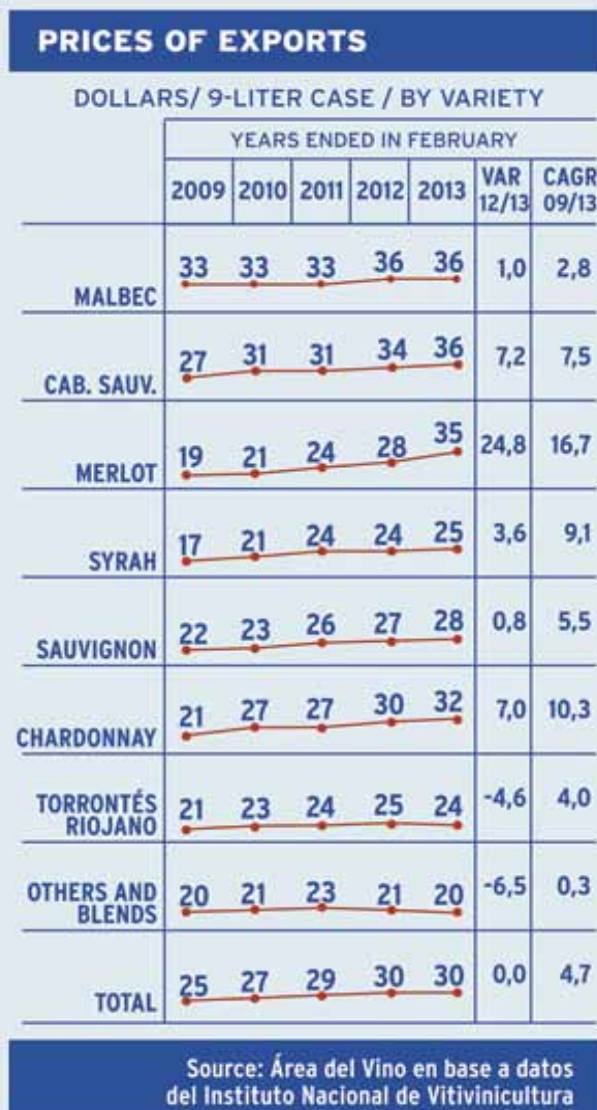
Stein's Law seems to be simply stating the obvious, but you would be surprised how many people find a way to ignore the obvious when it is in their interest to do so. As Upton Sinclair wrote, "It is difficult to get a man to understand something, when his salary depends on his not understanding it."

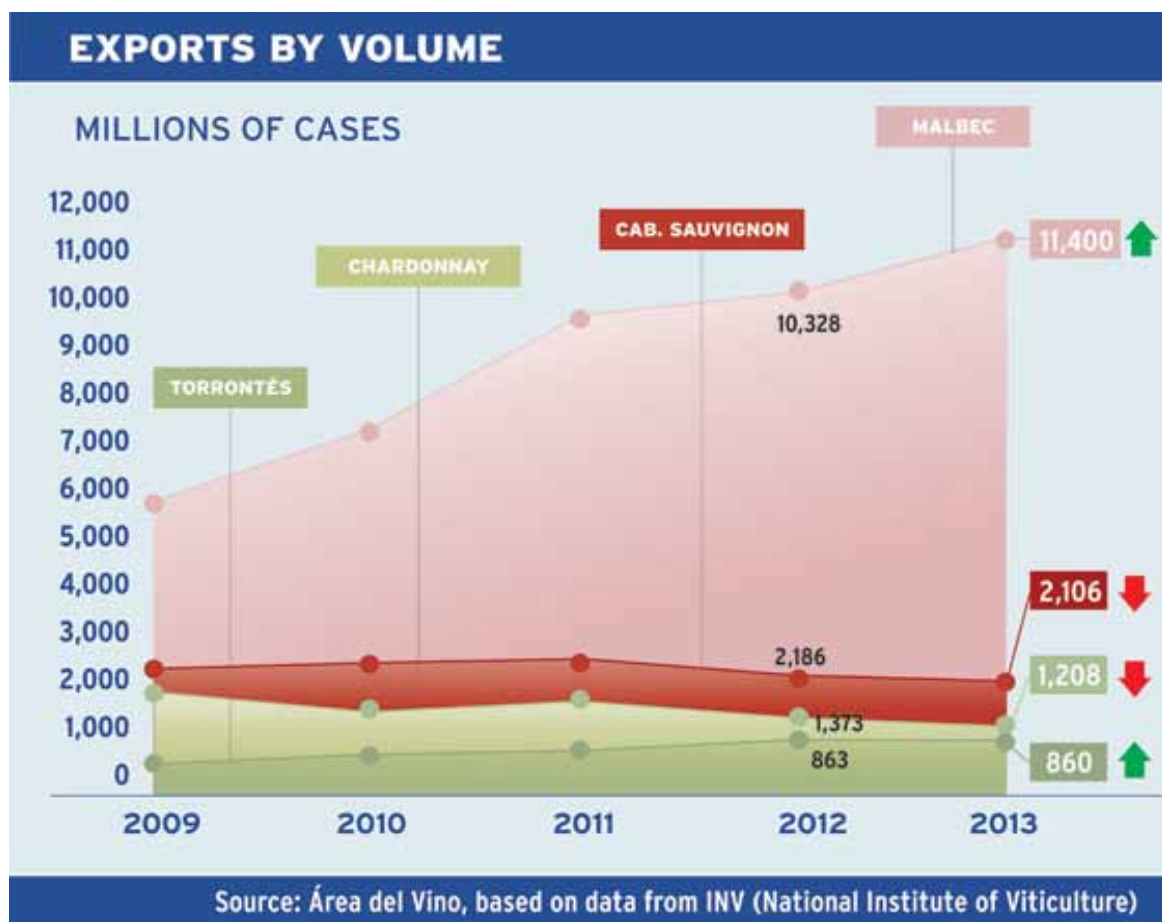
■ Argentina's Inflation Problem

And so we consider the case of the Argentine wine industry. It's not just the wine sector, of course, it's the whole economy, but wine is especially affected. Something's going to happen according to Stein's Law, because it can't go on forever as it has up to now, but it is hard to know exactly what.

The problem begins with Argentina's high inflation rate. The official statistic puts the annual increase in consumer prices at around 10%, but this number is viewed with disbelief by the international economic community. The Economist quit publishing the official figure in 2012, saying "Don't lie to me, Argentina" to the officials there. The most commonly cited estimate of the actual inflation rate is 25% per year.

Inflation is a sensitive political issue in Argentina, as it is in every country that has ever experienced a hyperinflation crisis (think Germany, for example). Some in Argentina go to great lengths to deny the obvious reality of inflation.





The story (which may be true) is told about a McDonald's restaurant in Buenos Aires that displayed all the usual products on its big backlit menu board except the signature Big Mac. Where's the Big Mac? Oh, we have that price hidden around the corner so that no one will see it – especially the people from *The Economist* who use it to estimate the purchasing power of the peso in their Burgernomics index.

■ Inflationary Squeeze

As a recent article on The Drinks Business website suggests, high inflation is putting the squeeze on Argentina's wine producers. (The squeeze is made worse, I understand, by government policies that restrict imports of products used in wine production as part of a general policy to control foreign exchange reserves.) Production costs (grapes, labor, etc.) may have doubled over the past four years, putting a squeeze on margins.

It is difficult to pass these peso costs along to consumers in the U.S., Canada, the U.K. and Brazil, the main export markets. Consumers are price sensitive, and while the average export prices of varietal Cabernet and Merlot wines have risen by 7.2% and 24.8%, respectively, in the past year, this provides only limited

relief from rising costs, since Malbec takes the lion's share of the export market and its dollar export price has risen by just 1% in the last year and by an average of only 2.8% per year since 2009.

■ Purchasing Power Inaction

The textbook remedy to this situation is for the foreign exchange value of the peso to fall to achieve what economists call purchasing power parity (PPP). In a system of market determined exchange rates, according to the PPP theory, a 25% fall in the domestic purchasing power of the peso due to inflation should result in a 25% decrease in its foreign exchange value.

And indeed the peso has depreciated, but not by nearly enough to overcome the inflation difference between Argentina and the four main export markets. The peso has fallen in value by about 20% in the last two years, if we look at the official exchange rate, so each dollar of export earnings brings in more pesos, but inflation-driven peso costs have increased by much more. That puts a real squeeze on margins. This can't go on forever – something has to give. (I'm told that the black market exchange rate is 8 pesos per U.S. dollar, far below the official rate of about 5 per dollar. Such a big differential is often an indicator of crisis to come.)



Something's Gotta Give

What happens when a country gets itself caught in a squeeze like this? Well, the conventional wisdom is that there needs to be a sharp currency devaluation followed by monetary tightening to control inflation. This is a painful process, and Argentina has been through it before. What if the government ignores the conventional wisdom? Internal adjustment must eventually take place to restore competitiveness if external adjustment through the exchange rate is ruled out.

A recent Wall Street Journal article about real estate prices in Buenos Aires shows one pattern of adjustment. The dollar prices of luxury apartments have tumbled as owners seek to cash out of their real estate investments and buy into the more credible U.S. currency.

In May last year, Argentine President Christina Kirchner strictly limited access to U.S. dollars and other foreign currencies in a bid to stem capital flight. With the Argentine peso facing about 25% annual inflation (government figures, widely discredited, set the rate much lower), and an unofficial exchange rate that has effectively devalued the peso sharply, demand is high for dollars. These days, the main feature that foreign buyers say they look for in a Buenos Aires property has nothing to do with closet space or a wide terrace. It is a seller with a bank account outside Argentina

to which they can legally wire funds. This is a way to get around having to convert any dollars wired into Argentina into pesos at the official rate, after which it is nearly impossible to convert back into dollars at the official rate.

Something will have to give in the wine industry, too, if the exchange rate doesn't adjust and the currency controls continue. In the meantime, I think every effort is being made to control costs and to keep margins out of the red. But, as Herb Stein might say, this can't go on forever, so somehow it will stop.

About the Author

Mike Veseth is professor emeritus of International Political Economy at the University of Puget Sound. He is the author of many books, including *Wine Wars* (2011) and *Extreme Wine* (forthcoming October 2013).

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