Travel Journal
Part 2: Bangladesh

Autumn 2014

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Karachi – Dubai - Dhaka

We left Karachi at 22.30. After a stopover in Dubai (direct flights between Karachi and Dhaka only leave weekly), we took the 01.45 flight to Dhaka.

We landed at 09.00. One clear impression at the passport and visa control was the number of other Westerners, tourists, an unusual sight. An obvious difference from Pakistan is the absence of weapons, and the different security situation which immediately is felt. One should never underestimate fear, justified or not, as a factor in investment decisions.

Passport and visa control at Hazrat Shahjalal International Airport

We got to our hotel in time to take the car to our first meeting. We were a little red-eyed, but not for the first time. We started the day by meeting with Marico Bangladesh, where we were greeted by the CFO Iqbal Chowdry. Marico is Bangladesh's oldest listed manufacturer of haircare products. Its bestseller (80% of sales and a roughly similar market share) is still coconut oil, completely free of additives. Its main use is as a haircare product, but it is also edible (as some do, according to the company).

Finance chief Chowdry talks about his company – its bestseller, coconut-based hair oil, in the large blue bottle in the middle

Hair oil may sound like a niche product here in Sweden, but in Bangladesh, Pakistan and India it's a product that's about as ordinary to use as a conditioner. It is often applied before going to bed, and allowed to work overnight. The company is a subsidiary of a much larger Marico in India. Since most Bangladeshis watch Indian TV, this smaller subsidiary enjoys its parent's greater financial resources when it comes to television advertising, which is an important advantage. We also found a good understanding of the need to diversify to meet changing demand patterns in the future. New products in various price ranges have been carefully introduced, and we liked the business thinking behind the pricing and timing of these product launches. Building up 790,000 retailers throughout Bangladesh is another positive in the balance.

After Marico, we visited another company targeting private consumption – Bata Shoes. We are well acquainted with the company's operations, given that we were early investors in Bata Pakistan. Like its Pakistani namesake, Bata is a subsidiary of Bata International, and most Swedes have probably encountered the Bata brand at some point.

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The companies also have in common that they exclusively focus on their own markets, rather than on exports. With nearly 50 years in Bangladesh, it is, just like in Pakistan, the most famous footwear chain. The company has 285 of its own stores throughout Bangladesh, and an additional 450 retailers. In addition to its own simple and affordable products, it is a dealership for Reebok, Nike, Scholl and Hush Puppies. It has these brands in common with Bata Pakistan, combined with a clear strategy to move towards larger and more modern stores. Around 200 million pairs of shoes are currently sold in Bangladesh. With an average of 1.7 pairs of shoes sold per inhabitant, it is unsurprisingly far down the world rankings.

First part of sandal manufacturing, moulded bases being inspected

We were also able to take a tour of one of the two factories, which annually manufactures around 30 million pairs of shoes.

Bata sandals ready to ship

The plant manager gives Tundra a guided tour of the factory

After Bata it was time for Matin Spinning, a yarn manufacturer. With our good knowledge of the Pakistani textile industry, it was interesting to compare. The textile industry was hit hard in 2013. That year saw serious strikes (90 days), but even worse was a major fire in spring 2013, when hundreds of workers died. The fire led to a national audit of all textile factories in Bangladesh, and the industry is now beginning to see light at the end of the tunnel. The most recent development is that audits of 4,000 factories have been completed. According to these reports, problems were revealed in only a few percent of the factories. These have been closed down, and the remaining industry is now beginning to experience normal market conditions. Basically, we are somewhat sceptical towards the textile industry in Bangladesh relative to Pakistan, given the absence of cotton (imported). In addition, Bangladesh has for several years enjoyed particularly favourable export terms with the EU, it is about 6-7 years behind Pakistan (Tundra's impression) in its

energy policy, and it still enjoys subsidised gas prices for its power plants. Bangladesh is clearly heading for a gas shortage unless drilling in the Bay of Bengal yields results soon. At the moment, exploration is at a relative standstill since producers want to negotiate higher prices (USD 6 dollar/MMBtu, against the current USD 3/MMBtu). Just like Pakistan, Bangladesh is sitting on large coal deposits, and there is talk of coal-fired generation, which may initially be fired with imported coal. However, moving from a discussion of possible solutions to actual implementation is a big step. The part of Bangladesh that would particularly need coal as a power source, the south, also has the problem of space (coal-fired power plants require large areas for fuel storage, while Bangladesh is one of the world's most densely populated countries, with a large concentration in the south). We see a potential problem for the future, and perceive some sluggishness towards it. On the positive side, the Bangladesh case is "simpler" for the next few years because of the perceived lower security risk. In a 10-year perspective or longer, however, Pakistan appears better positioned as it is already in the midst of dealing with the problems that Bangladesh may face, and which are currently not being taken seriously. We have a good comparison in Pakistan with Nishat Chunian (mainly a yarn manufacturer). Its share is traded at 6x annual earnings, compared with 14x for Matin Spinning. In addition, Nishat Chunian owns shares in power producer Nishat Chunian Power, worth roughly the entire market capitalisation. Hence we see better investment opportunities in the Pakistani textile industry.

Meeting with representatives of JBL, principal owner of Matin Spinning

Our second day began with a meeting with one of the major cement producers in Bangladesh – Heidelberg Cement. Bangladesh lacks limestone, which means that all manufacturers import semi-finished clinker (except Lafarge Surma, which we talk more about later in this text). This is then milled and blended into cement. Clinker is imported from India, Thailand and Indonesia. This means that the manufacturing cost is relatively high and that pricing in Bangladesh more or less shadows the pricing in countries it imports cement from. It also means that most of the companies work with relatively low margins. As with many other goods, the country protects its manufacturers through high import tariffs on cement. This is a short-term solution that certainly means an industry has evolved, but one can question the long-term sustainability. Bangladesh has a capacity to produce 25 million tonnes of cement annually, but only 15 million tonnes is currently consumed. This overcapacity has its origin in the financial crisis of 2008-09, when cement companies, after several years of strong demand and with the help of extremely low interest rates, built up substantial overcapacity. Demand is growing at about 1.5x GDP growth, which currently appears to mean approximately 10% a year over the next few years. With a P/E valuation of over 20x, the company looks expensive, especially in comparison with its Pakistani competitors, of which several are still traded at below 10x annual earnings.

Meeting with Heidelberg Cement's CFO

We then proceeded to BRAC Bank. This is one of the five largest banks, but also the youngest. An entrepreneur-led management team has built a well-run bank that focuses on small and medium-sized companies. As the company itself puts it: Loans of up to USD 3,500 are managed by microfinance institutions, loans of over USD 20,000 are taken by the larger banks, while BRAC Bank works in the segment in between. Small loans are granted without a collateral or guarantees. This does raise some questions, but it turns out that the company has an organisation that seems well in control to handle this higher risk.

An "account management" system based on accurate knowledge of people means that it gives the impression of having a functioning risk management system. The historically high interest margins (9%), which are well above those of competitors, also indicate this. The company has an aggressive expansion plan, with a target to grow 20% annually, a level it has comfortably managed historically. Its shareholders include IFC World Bank, and the parent organisation, BRAC, has a high level of credibility and a good reputation in Bangladesh. We might be satisfied with just this. But then we come to what's really interesting about BRAC Bank. It owns 51% of a company called bKash. Ring any bells? If we say M-Pesa, it will probably ring a bell for some of our unit holders, at least. bKash's business is, indeed, mobile payments. Since its inception in 2011, the company has grown from nothing to 15 million users. Earlier this year M-Pesa (Kenyan Safaricom's equivalent) was ignored, and today has 13 million active users after its launch in 2007. M-Pesa is an example highlighted as a tremendous success (including by us), and a role model for how to solve payment problems in a country where few people live close to a bank branch. The more we hear about bKash, the more convinced we become. bKash handles payments between mobile phones. You can send money, for example, to your mother in a remote city which does not have access to modern banking facilities, who can then collect the money from any of the company's 100,000 agents.

Shamoon outside one of bKash's 100,000 agents. bKash logo, left

These payments are today used almost exclusively for sending money within the country. Bearing in mind that it can take over an hour to drive through Dhaka, you can understand the point. The solution works, of course, even without a smartphone. You can log in using a special PIN and send your payment via SMS. At present, the service is focused on consumer-consumer and consumer-agent (withdrawals and deposits) use, but in future a full range of services will be introduced. It has also established branches abroad, and money can be sent from, for example, the UK using bKash. This means that a payment is guaranteed to arrive within 10 minutes, compared to the old days when you had to send over money and then collect it from a bank branch.

Tundra with BRAC Bank's CFO

bKash has not been alone, but has left its competitors behind, with 90% market share. At some point, market share becomes a success factor in itself. The success of a new technical solution of course requires, above all, users. How much fun would it be, for example, to be the only user of Facebook? We also note a good mix of people behind the company. Among the developers are the original developers of M-Pesa, and the board includes the founder of Grameenphone. bKash estimates that it will have 25 million users within 3 years. If we look at Safaricom's M-Pesa, one-third of Kenyans use this payment solution regularly, and the corresponding figure in Bangladesh would mean 50 million users. Unlike in Kenya, the Bangladeshi authorities require mobile payment companies to have a banking license, which has blocked the major mobile telecom operators from entering the business. The risks associated with this type of company are of course enormous, but for those who manage to create a killer app it is also this type of company that can offer investors the richest rewards. bKash has left its competitors behind

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during its four years in existence, and has now achieved a significant reach, exponentially decreasing the risk that someone else will outcompete it. Unless the company stumbles along the way, this may be a future gem. IFC purchased a 10% stake in bKash just over a year ago for USD 115 million. If we adjust BRAC Bank's valuation using this figure, its core business ends up at P/E 8 and P/JEK 0.9. Not bad for a fast-growing bank, especially not when "M-Pesa 4 years ago" comes along as an option. We left the meeting with a feeling that we are convinced shareholders in what could potentially become one of the more talked about investments in the frontier universe in the years to come.

Outside BRAC Bank's headquarters in central Dhaka

Next we met Delta Brac House Finance Corp, which commands 40% of the mortgage market in Bangladesh. It is a very well-managed company with an extensive ownership list, including IFC World Bank, BRAC and HDFC (India). Historically very low credit losses, at 0.2% in impaired loans, is a figure we needed to have repeated a number of times before we scribbled it down. The company typically lends 70% of the value of a home and then takes the interest monthly from the borrower. A well-oiled organisation means it is able to act quickly if a borrower is late with payments. A long discussion followed on whether banks offering one-stop-shop solutions will eventually take the market from Delta. We have seen this not only in the West but also in Pakistan, where similar companies are no longer significant providers. Our argument is that banks that are able to offer a full range of services (financial savings, payment cards etc) will eventually have a competitive advantage, but Delta counters that Bangladesh is different. We both agree that, whatever the outcome, change to the current structure may take time. A company that works to provide people with housing finance is needed in Bangladesh. The country's area is about one-third of Sweden's but with 16 times the population. Each year 100,000 people move into Dhaka, which now houses 20 million, as many inhabitants as Karachi but in one-third of the space. We also discussed why we do not see more of what's happening in Karachi, with new housing being built outside the core. For example, Bahria Town about 20 km from Karachi had a smart solution of building its own train line that takes inhabitants to central Karachi in 15 minutes. Dhaka doesn't seem to have come this far yet, and the traffic and time lost from commuting means that residents would rather live in the city. There is a subway system planned, and it's needed.

Talking about the Bangladeshi housing market with Delta Brac House Finance Corp

After this, it's off to Bangladesh's largest cement company, Lafarge Surma Cement. We met the CFO, who has held this position throughout the company's entire transformation into its current situation, while CEOs have come and gone. A good meeting it was. Lafarge Surma is unique in the sector as it is the only company to be fully vertically integrated, and this has been achieved in a rather remarkable way. The company is located in the north, besides the Indian border. Using a 7.5 km conveyor belt over the Indian border, it collects its limestone from its wholly-owned Indian subsidiary's limestone quarry. This is then turned into clinker, which is processed into cement. Since the main existing gas deposits are located just next to Lafarge Surma, it is also first in line for the gas transported in pipelines to the south. Since this gas supply is becoming stretched, and will become even more so in the future, this is an extremely important advantage (the company cannot be cut off from the network). In addition, it buys its gas at exceptionally low rates through existing contracts concluded many years ago. This means that the company's own gas-fired power plant provides the facility with electricity at a cost 60% lower

(USD 0.04/kWh) than the market price through the national grid. The cost of electricity, which typically represents 20-30% of manufacturing costs for a cement company, is only some 10% for Lafarge Surma. The future supply of limestone is good. Recently there has been a lot of discussion about India's limestone reserves becoming exhausted, and this could be a problem for Lafarge in the future, if quarrying is expanded. But given that the region where the company's Indian subsidiary is located, is isolated from the rest of India, both in terms of land borders and physically in the form of a mountain range, it is difficult to view this as a real problem for the company for the foreseeable future. In addition, the company has permission to build a parallel conveyor belt next to the current one, which could eventually double the capacity. Lafarge Surma's prospects are probably the most ideal we have seen for a cement company, and its gross margins of 40% are therefore 7-8% higher than for the more efficient Pakistani producers that have much higher energy costs and more competitive markets. However, Lafarge Surma's valuation is also striking. Investors are now paying more than 30x annual earnings, which is even higher than the African cement companies before the recent share-price drops.

Tundra with Lafarge Surma Cement's CFO. Below a model of the company's factory. Bottom left, limestone arrives from the Indian border

The day ends with dinner with Saifur Rahman, the founder of API manufacturer Active Fine. API stands for Active Pharmaceutical Ingredients, and simply means the ingredients for medicines, like the flour in bread, you could say; the actual base for manufacturing most of the drugs used by the world's pharmaceutical manufacturers. The basic raw material comprises of rice protein, where Bangladesh has an advantage as one of the world's largest exporters of rice, so this kind of manufacturing is fairly logical in Bangladesh. There are a number of pharmaceutical manufacturers in Bangladesh, mainly of generics. Until Active Fine started its business a few years ago, however, 100% of all the ingredients for pharmaceuticals were imported. Active Fine now supplies 10% of the market demand, and this percentage is growing. It is not an easy process, as exemplified by a major poisoning scandal in Pakistan a few years ago. A big challenge for a company like Active Fine is therefore finding skilled employees, something that prompted it to initiate its own college training, using its own chemical engineers as lecturers.

Tundra with the founder of Active Fine

Mr Rahman's personal history and vision are captivating, and would probably make good material for a future movie. He studied in the United States and went for graduate studies, but was recruited by Merck. Once there, he was struck by the simplicity of manufacturing, and also by the low manufacturing costs relative to the end price. He realised that Bangladesh would be ideal for API manufacturing, went back, and the rest is, as they say, history. His vision to develop the company and to ensure that the people of Bangladesh have the same access to medicines as we in the West is also admirable. The risks associated with this type of business are however very large. Everything is based on the brand and reputation, something that can be ruined overnight

at the slightest mistake in the manufacturing process. Potentially, however, the company is a future Asian drugs giant. With its current market capitalisation of USD 80 million and historical growth of 40%, growth that is until now been limited only by capacity expansion, the company seems to be on the right side of risk-reward. We left the table dinner with plenty of new thoughts.

Our last day in Bangladesh started with a meeting with Summit Power, one of the few listed companies in the power industry. The company's offices are located in one of the older business districts of Dhaka, also the location of the city's largest fruit and vegetable market. We had to walk for a short stretch when the road suddenly became impassable in the morning traffic.

Shamoon and Mattias in the morning traffic

More or less all electricity in Bangladesh is currently generated using gas-fired plants. However, the government has understood that gas is becoming a scarce commodity, and there is ongoing drilling in the Bay of Bengal. But negotiations over price are sluggish (the government is offering USD 3/MMBtu, while the producers want USD 6/MMbtu). For this reason, work is proceeding in parallel to stimulate the construction of coal-fired power plants. The problem with these coal based power plants is that it's a bulky business because of the need for large storage areas. Bangladesh has large coal deposits (estimated at 2.5 billion tonnes), which in theory could provide the country with electricity for the next 100 years. However, getting this into production is difficult as long as the gas shortage does not become acute. We recognise this discussion from Pakistan some 10 years ago, which then required a severe energy crisis before (6 years later) the first coal-fired power plants could approach operation. Power cuts are less of a problem for Bangladesh today. In the more vulnerable areas, these may be about 1-3 hours per day. If the country does not get started with building in the next few years, however, there is a risk of it following in Pakistan's footsteps, with a crisis that Pakistan is only just beginning to come out of.

We cruise through the traffic to the next meeting, with Islami Bank, Bangladesh's leading Islamic bank. We have monitored this sector in Pakistan for several years, and we are one of the major shareholders in the leading Meezan Bank. The big difference between Islamic banking and conventional banking is that interest is not charged. If, for example, a company wants to borrow for a new property, the bank instead provides a form of leasing, where the bank is the owner but the "borrower" is able to buy back the asset at a predetermined price or, for longer "loans", gradually pay off the debt. The difference between the original price and the future price can, of course, be regarded as interest. Islamic banking is growing rapidly, and in Pakistan the rate of growth in deposits is twice of that for conventional banking. The sector is also growing rapidly in Bangladesh.

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From a Western investor's perspective, there are some real benefits. The security of the loans is better on paper because the bank already possesses ownership, so the process of liquidating customer assets is somewhat simpler if the loan turns bad. Islami Bank was one of the first Islamic banks in Asia, and is Bangladesh's largest privately owned bank. The company has a market share of 10-15%. Islamic banking has grown in popularity over the past ten years, but this has in turn created a problem for investing customer deposits. Approximately 20% of the company's assets must today be deposited with the central bank at interest of around 2.5%, until Islamic bonds (Sukuks) become available or until there is a larger market for Islamic products. This in turn means that the bank's revenues are substantially lower than for its best competitors in conventional banking. Given the trend around the world, with Muslim countries becoming increasingly active issuers, this should be a temporary problem. At a valuation of 1.2x adjusted equity, and with a customer base currently growing by around 20% a year, valuation appears more reasonable than for competing investment opportunities.

Above: Outside the headquarters of Islami Bank
Below: Tundra with Islami Bank's finance department

From Islami Bank, we headed to a lunch with one of the directors of Olympic Industries, who is also the grandson of the founder of the company. Olympic is now mainly engaged in the confectionary industry, specifically biscuits and cakes. Given our extensive experience in the sector from other markets, the discussion become very interesting, and we even forgot to order food. Tanveer Ali, whom we met, grew up in Canada but moved back to Bangladesh in 2006 to help with the family business. During his time, the company has repositioned its business, from having previously made everything from batteries to ballpoint pens to now making almost exclusively (>90%) biscuits and cakes. The company has been very successful with products that are consumed by all social classes. We see its products in everything from small grocery shops to the typical sales outlets, a hole in the wall on the street. We addressed the question of distribution, which is very crucial for this type of business. The company has 1,000 of its own salespeople, responsible for small geographical areas. This means that the company's products have more or less 100% availability to the population. The valuation is high, but this is a very well-managed company which, in our eyes, holds the key to how to grow in a country with Bangladesh's market conditions.

Tundra with a representative of the owner family of Olympic Industries

From Olympic, we moved on to Envoy Textiles, a denim fabric manufacturer. The company is 100% export-focused, which is common in the textile sector. It manufactures all kinds of denim, which we got an opportunity to see first-hand during a visit to its showroom. However, it has no sewing within the business. According to Envoy itself, it supplies companies such as H&M, Marks & Spencer's and Walmart.

The discussion became highly focused on the difficulties in the sector following the fire (see earlier in our travel journal) in a large textile factory, which cost the lives of several hundred people around 18 months ago. This sparked massive international audit campaign, with over 4,000 factories inspected and checked. The end result was that only a few percent failed to comply with international regulations. This has led to big headlines in local newspapers, including international buyers stating that purchasing will now be resumed. In reality, Envoy believes that the event remains an obstacle when discussing new contracts, an acknowledgment of the risks associated with ESG (environmental, social and governance) issues.

Tundra in the Envoy Textiles showroom

After meeting Envoy, we moved on to ACI Group, which was founded as a subsidiary of an international company ICI, but which is now one of the largest conglomerates in Bangladesh. It is active in everything from pharmaceuticals and agricultural products to its newest area of operations, retailing. We found the company's products in most stores we visited. Much of the discussion focused on the current problem area, supermarket chain Shwapno, where ACI is one of the pioneers of modern retailing. Local people are very critical of the business, which is so far posting losses. The company itself is unfortunately very secretive about what it is doing to reverse the trend. We conclude that the main problem is relatively high rents in central Dhaka and financial costs from the start-up. On a subsequent visit to one of the shops, we note that there is relatively good activity, even though it's late in the evening. The format itself is probably strategically correct. Given the traffic situation in Dhaka, people in the middle and high income bracket still prefer to live centrally to get to work and school. We ended the evening with a visit to a number of grocery stores, including Shwapno and its competitor Meena Bazar (unlisted).

The entrance to Shwapno

Competing Meena Bazar is next-door

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Good activity at Shwapno

Marico's products are well exposed

Our usual review of selection, pricing and positioning in the grocery stores is as interesting as always. Regardless of nationality, we as consumers are ultimately quite similar. Which products stand out? Apart from this, there are also other pieces of the puzzle to sort out. How can Shezan's ketchup (from Pakistan) be as cheap as Pran's (local brand) despite the import tariffs? Have they started local production?

National's spice blends are also sold in Bangladesh. The Pakistanis have generally reached further here.

Even Shezan has found its way onto the shelves in Dhaka

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Our transport from the hotel to the airport left well in advance, as we left the hotel three hours before take-off for the 8 km journey to the airport. As Friday is a holiday (they instead work on Sundays) in Bangladesh, so the traffic was limited, and the journey that took over an hour in the opposite direction now took only about 10 minutes.

It was an informative trip from many aspects. As we expected, we found many common denominators with Pakistan. Our impression was that Bangladesh is some years behind Pakistan. Properly utilized, this gives them an opportunity to learn from their former union country's mistakes, not only in the energy sector. We are by nature critical observers of everything we encounter, and we probably prefer Pakistan's clear understanding of the challenges they face. At several of our meetings in Dhaka, we sensed a slightly more relaxed attitude to the challenges that are only a couple of years in the future. In addition to the energy sector, it should be understood that the system of actively using import tariffs as a tool to promote local production is not conducive to long-term development of productivity. A very important competitive advantage for Bangladesh is its security situation and greater international acceptance. One should not underestimate the effect of investors simply being less afraid to travel to the country. If we add to this the country's cost advantages, plus its developed infrastructure to handle international trade, and if the trend towards new manufacturing origin remains strong (made in China is being replaced with made in Bangladesh/Vietnam/Pakistan), then Bangladesh at least should have 5-10 years of favourable conditions for high growth and thus an opportunity to correct the weaknesses that we find today, as an outside observer.

Boarding the plane to Colombo alone (as usual)

As investors, we noted that, as usual, it can be problematic to stare blindly at the biggest companies in order to assess the valuation of the market. The average valuation of the companies most foreign investors have in their portfolios are stretched, likely reinforced by the fact that this is a stock market driven primarily by smaller local investors (90-95% of trade). However, the picture looks different beyond this segment of companies. As usual, it is simply about digging a little deeper. And I cannot help being pleased that I'm the only Westerner on the plane between Dhaka and Colombo. A good sign that there is more to do. Off to Colombo.