TUNDRA FONDER

Travel Journal
Part 3: Sri Lanka
Autumn 2014

Travel journal – Sri Lanka, autumn 2014

We landed at Colombo after a three-hour flight from Dhaka, noting that since my last visit the airport has been significantly expanded, and we arrived in the new part. Passport and visa control are easy. We find a significantly higher proportion of foreigners. When I last vacationed in the country a number of times in 2007-09, I remember that 300,000 tourists visited annually. The number for 2014 is projected to be 1.5 million, and it's noticeable.

The arrivals hall at Colombo

Waiting for a taxi outside the airport

It doesn't take many minutes to sense the difference between Sri Lanka and Bangladesh/Pakistan in terms of GDP/capita (Sri Lanka about USD 3,500/capita vs Bangladesh and Pakistan 1,000 and 1,300, respectively). We drove straight onto latest section of the motorways now being built all over Sri Lanka.

This stretch is between Colombo and the Negombo suburb (passing the airport). The first stretch built was between Colombo and Galle in 2011, and was extended down to the southern tip in Matara earlier this year. When I holidayed in Sri Lanka as recently in 2009, the 130 km to Tangalle took 6 hours on winding roads. The same stretch now takes 1.5 hours, and the significance is hard to overstate. The country is opening up for economic activity, even outside western Sri Lanka (Colombo), which today represents 40% of the country's GDP. In the next three years, a similar stretch will be built northwards, and even the southern sections are now expanding northeast. The motorway network will be doubled from its current approximately 180 km, and we will talk more about this later. A week of hectic schedules, with sleep having to take a backseat as usual, meant that we reached Colombo slightly worn out, so it was great to arrive at one of the best hotels I've ever stayed at, the Cinnamon Grand. This almost 7-star hotel still cost only SEK 1,000 per night. These are Karachi prices. Being able to enjoy this fine luxury as a base in what I have known as perhaps the world's best tourist destination (and it's not just me – Lonely Planet gave Sri Lanka the same honour in 2013) remains unique to Sri Lanka, and its luxury status at bargain prices remains unchallenged. It doesn't normally take many days to observe that that this is a country with a high quality of life, perhaps higher than for us spoiled Swedes. This came alongside being in the midst of the kind of dynamism that could only be experienced in a country coming from a low base but enjoying 7% growth.

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The taxi drivers proudly boast that Sri Lanka will be the next Singapore. Less far fetched than one might think. We'll come back to this discussion.

The lobby at Cinnamon Grand

Tired and slightly grubby after a week on the road, it was a bit surreal to be served a blue cocktail at check-in, by a waiter wearing white gloves.

On Saturday we rented a car to make our way slowly but surely out of Colombo. The idea was to use this day off to visit a number of shops and check the product ranges available, their positioning and price levels. Colombo is divided into 15 numbered areas. In Colombo 15, we stopped at the old format of retail, a hole in the wall. We talked to the shopkeeper about business conditions, which were their best selling products and so on. We noted that even this small shop had a refrigerator, which is more unusual in Bangladesh and Pakistan.

"What are your best sellers?"

Sri Lankan retailing at the micro level

We continued outwards and passed various buildings, which were generally small – at least from a Swedish perspective.

We travelled to Negombo, taking the old minor roads, which means the 20 km journey took just over an hour. A reminder of the past. We observed the local built environment, which here transforms into houses of slightly larger size, and we also note a local production plant for Cargills Foods, a company which is in our portfolio. During a short stop at a hotel in Negombo, we allowed ourselves a walk on its 100 metre wide beach before heading back. Before joining the motorway, we took the opportunity to visit Cargills Food City and Keells Super, the two dominant grocery chains. Price levels were much like in Pakistan. Cargills, which has its own extensive food production, sells much of its own goods. For the chain as a whole, the company says that its own brands make up less than 25%, but in the smaller shops (<200 sqm) we noted a significantly larger percentage. Once in the larger format stores (>1000 sqm), we felt they were closer to how grocery stores look in Sweden, with all the major brands represented.

Both Keells and Cargills have their own brands. We noted that they don't discriminate against each other, and we found both Elephant House (Keells' brand of beverages and ice cream) and Kist (Cargills' brand of jam and biscuits) in both the stores. Obviously we tasted the ice creams and compared Elephant House to Magic (Cargills' brand). We found them both equal. Positive for both is that the quality was so high that it could be compared favourably with international brands (which were nowhere to be found).

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Out of the two chains, Cargills Food City is significantly larger, with 250-300 stores, compared with Keells' 50-60. The shopping experience was similar, possibly slightly better at Cargills. We also discussed these stores with our driver. He preferred Cargills as they had a higher proportion of discount brands plus a larger section of alcoholic beverages. Notable for Sri Lanka is the lack of out-of-town supermarkets. There is simply no demand at present and, most likely, the infrastructure needs to be built before being worthwhile. It takes a while to get out of Colombo at present (flyovers are planned), and it is still a segregated market, with the modern retail format for a clientele that currently probably prefers convenience over 10% lower prices.

Small format Cargills Food City

Inside Cargills

One of Cargills' own brands - Kist

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Products from own-brand dairy producer Kotmale. All milk is produced locally.

In all its communications, Cargills emphasises its efforts to ensure that all food is locally produced. It has an interesting ecological approach that we are accustomed to in Sweden, but that we rarely encounter in our markets. After having experienced one of Cargills' smaller stores, we went on to look at one of their larger ones, approximately >2,000 sqm.

Larger format Cargills Food City

The shopping experience is enhanced at the larger store, of course. More space, more brands.

Inside a larger format Cargills Food City

Plenty to choose from. Shamoon ponders the range.

Ice cream tasting – Elephant House vs Magic

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On to Keells Super, John Keells' own grocery chain

Cargills' Kist (jams in this case) is also sold at Keells Super

Inside Keells Super

Keells' own brands are more traditional private label; bulk products with limited effort on packaging.

Mattias studying the contents of the freezer

The exception is Elephant House (placed in a separate listed company)

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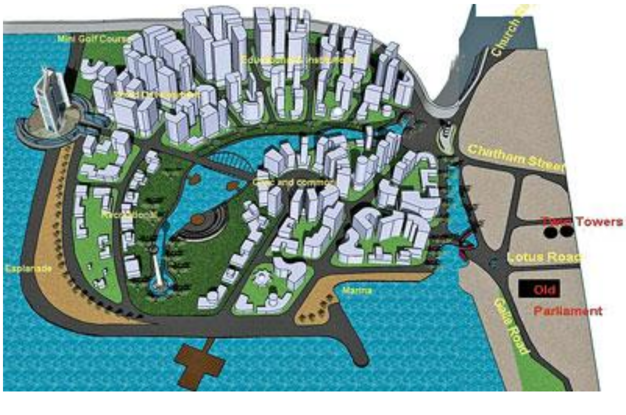
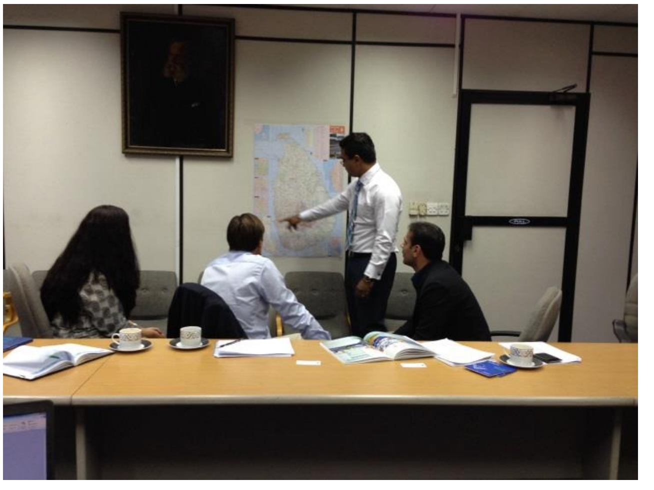
It was an interesting day, with lots of new insights. We returned to the hotel, where we started preparing for our meetings on Monday and Tuesday.

A rescheduled meeting on Monday meant that we instead had a stand-by get-together with MTD Walker, a company we had not looked at before and a competitor to our existing portfolio company Access Holdings. MTD Walker is mainly active in urban planning (roads, buildings and water). There is currently a high level of activity in infrastructure investment, initially mostly in motorways. The expansion of the northern motorway (the next phase is between Negombo and Jaffa in the north) is starting right now, and most of it will be completed by the end of 2018. Similarly, there is an expansion of the motorway in the south, which is now moving east. The scale of the investment taking place, and its impact on construction companies was so striking, that we had to ask the company to repeat the numbers several times. In 2013, MTD Walker had a turnover of approximately USD 100mn. Its share alone of the expansion of the northern motorway (17-19 km) is worth USD 340 million, and similar amounts are on the order book for the expansion of the southern section. In addition, the company has major contracts in housing and other infrastructure that follow the motorway construction. We concluded that the infrastructure investment taking place in Sri Lanka is not only massive, but also looks set to continue for at least 5-10 years, and that's only what's already planned. The motorway projects currently underway alone make up 5% of the GDP over three years. On the way to MTD Walker we passed the Chinese Port City project, which is similar the Jumeirah project in Dubai, where a new land area is being created in the sea. Work started in September, and 5 square kilometres will be filled with stone. The first phase of creating the land area should be completed by the end of 2017, after which the actual construction starts. The investment is expected to amount to USD 15 billion.



Animation of the future Colombo Port City

Overall, these are gigantic projects that mean construction and engineering company MTD Walker will have plenty to do in the coming years.



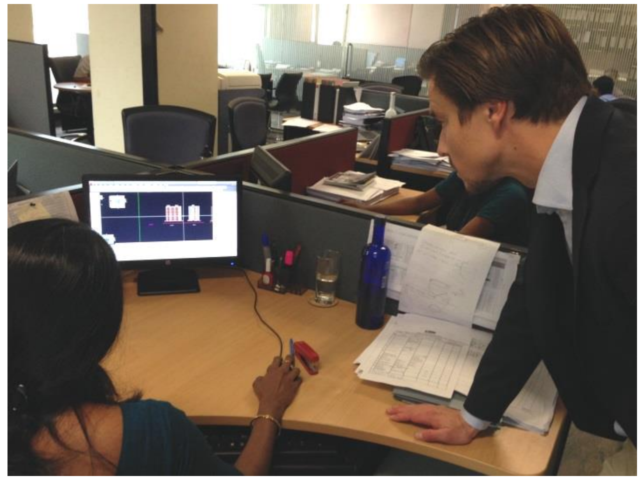
MTD Walker's CFO shows the building projects for the coming years to Rashmina, Mattias and Shamoon

Tundra with MTD Walker's finance department

After MTD Walker, we moved on to Sri Lanka's "Investor", John Keells, a company with 150 years of history and which is today the leader in most of what happens in the country; everything from real estate and land for infrastructure, to retail. We met with the deputy chairman. John Keells is a good meeting to gauge the status of the Sri Lankan economy. We didn't gain much new information. They are conservative investors and returned again and again to focusing on the areas where they are already active and familiar. Most interesting part was probably their optimism in the hotel business, which today represents about 30% of their assets. They are also the largest shareholder of the biggest ongoing construction project in Sri Lanka, Waterfront, an investment of more than USD 800 million. Two years before the apartments are completed, nearly half are already sold. For stock geeks, an amusing detail was that perhaps the world's most famous investor in emerging markets, Mark Mobius, was here a week ago and bought a penthouse on the spot.

Tundra meets John Keells

After John Keells, we travelled to Access Holdings, one of our more successful holdings in recent months. This was also one of our best meetings. We met the CFO, who is also one of the major shareholders in the company, which started its current operations as recently as in 1993. Today, it is one the leading providers of building design and construction, with a particular specialty in more advanced designs. We got a confirmation of the infrastructure boom where Access Engineering is probably the safest option. This company is the only one qualified to operate in all nine construction categories specified by local authorities. In addition, it is by far the first choice for engineering students, which ensures access to the best engineers in future. The company's order book is currently an estimated USD 1 billion, compared with sales of approximately USD 130 million last year. The CFO talks about projects ahead and why the company expects its sales to be three times higher in two years. The most interesting aspect of the meeting, however, is the discussion on what comes after that. According to Access, the construction boom is likely to continue for the next 10-15 years, just with the known upcoming projects. After the current expansion of the motorways comes housing construction, alongside the improved infrastructure. Single gigantic projects, for example Port City (see page 7), comes on top of that. Combined with strong increase in tourist arrivals it is not for nothing that one starts thinking of Dubai ten years back.



Inside Access Holdings' design department. Two new residential buildings on the drawing board

Tundra with CFO of Access Holdings

How many engineers can you get into an elevator? Answer: 14 (plus your fund manager)

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After lunch we journeyed on to another portfolio company, Hemas Holdings, a conglomerate with a focus on consumer products, such as soap. However, the company is also active in pharmaceutical distribution (recently supplemented with generics manufacturing), hotel trade and hospitals. It also owned power generation until very recently, but this has now been sold. This may feel like a sprawling business to us Scandinavians, but it is quite common to come across good companies in the form of conglomerates in these markets, and we only have to look back 50 years at the predecessors of our large Swedish companies today to understand why. We met the new CEO of Hemas, Steven Enderby, who talks a lot about the company's personal care unit, an area that constitutes over 30% of sales, exhibiting strong growth and has achieved great success.

Rashmina, Mattias and Shamoon with the CEO of Hemas

He proudly announced that the company's luxury soap, Velvet, has now overtaken Unilever's Lux as the market leader in Sri Lanka, despite the price being marginally higher. We must admit that it's unusual in frontier markets to see a local brand overtake a foreign in the premium segment. We detected some caution regarding the hospital operations, where the company has three private hospitals in the Colombo area. One of Asia's better public health care systems means that growth and utilisation are still not at levels where the company can show more than marginal profitability, and we suspect that a disposal, like the power business, is not entirely impossible. More interesting was pharmaceuticals distribution, where the company has discerned some restraint towards the range of foreign drugs sold through its pharmaceutical distributor. A certain price sensitivity, perhaps in combination with customer insight that many generics (copies of existing pharmaceuticals with expired patents) work just as well. Similarly, the state health care system has been demanding a greater share of generic drugs in its central purchasing. Consequently, Hemas this year bought a slumbering generics producer, J.L. Morrison, and is now making an effort to expand this business. This acquisition seems interesting given that over 90% of all drugs are currently imported, and given the government's stated desire for a larger share of generics, preferably locally produced. It is also interesting that the company has built up some business in Bangladesh over three years, in personal care. The big seller in Bangladesh is hair oil, and one dominant player, Marico, currently has over 85% market share. Slowly but surely, however, the Hemas Kumarika brand has entered the market and is now the clear number-two, if only with a few percent market share. Local production and local staff mean that Hemas avoids the high import tariffs that Bangladesh generally applies. Sales in Bangladesh still represent only a few percent of turnover for Hemas, but growth is high and the market is large. For a company with exposure primarily to private consumption, its valuation at P/E of 13 for next year is not strained, even though the stock has been very strong since we added the company into our portfolio a couple of months ago. In summary, we left the meeting as satisfied shareholders.

After Hemas, we went to Lanka IOC, a retailer of petroleum products. The company has approximately 170 petrol stations around the country also sell products such as bitumen (for road construction). Lanka IOC is majority owned by the Indian giant IOC. Pricing in Sri Lanka is remarkable. More or less all petroleum products are imported, which normally means that that the prices companies can set are determined by a clear formula (governed by the oil price), but Sri Lanka lacks these. Instead, it has the state-owned Ceylon Petroleum, which dominates the market and acts as a price setter. We questioned whether there was a risk of the state company simply one day deciding to drive Lanka IOC out of the market. The answer came in the form of a statement - that the parent company's market capitalisation is just above Sri Lanka's GDP, and that it would probably not be very politically smart. We had to agree with that. The company has seen demand rising in line with GDP growth (about 5-7%), which is somewhat lower than many companies we met. At the same time, the P/E of 7x is also one of the lowest.

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Tundra with Lanka IOC's CFO

The final meeting of the day was with Sri Lanka's third-largest privately owned bank, Sampath Bank. We had an interesting discussion about the recent problems of gold-secured personal loans. This more or less meant providing microloans using jewellery as collateral (80%). When the gold price fell sharply just over a year ago, there were large bad debt losses in the banking sector. Sampath Bank, with a focus on retail customers and SMEs, was among those that experienced the greatest problems. After large write-downs in the past year, and raising the level of collateral, the situation appears under control. We talked about credit growth, and the company expects 10-12% growth over the next three years. As an outside investor at our first bank meeting, we noted the lack of industrial customers. There is nothing wrong with the service sector, and we believe Sri Lanka could be facing many years of strong growth in tourism (15% of the workforce in tourism), but it is of course thought-provoking that no large-scale manufacturing exists, aside from some textile industry. Is there a risk of skewing the balance of the loan portfolio within a few years?

Tundra at Sampath Bank

At the entrance to Sampath Bank

Between meetings we pass the Port City construction site, where work has started to fill the sea with stone. Five square kilometres will be covered in the next three years.

Tuesday started with a meeting with Cargills Ceylon, a company that was reluctant to meet initally. Our planned meeting with the company on Monday, was cancelled, and we were therefore delighted to meet them. We met with CEO Mr Ranjit Page, whose family controls nearly 90% of the company. Mr Page is a cautious gentleman, reluctant to talk margins and

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growth targets. Cargills is best known for Cargills Food City, a supermarket chain (formats ranging from 200 sqm to 2000-2500 sqm, our estimate) with 261 stores today. In addition, it has presence in all food segments from jams and marmalades to biscuits and drinks. It also works with private label for simpler products, such as salt and sugar. Approximately 70-80% of the company's sales, however, come from retailing. We note that the company's choice to absorb the 11% VAT, introduced in late 2013 on a number of company's main products, seems strange. Our questions about why this tax is not passed on to the consumer was not really answered, but in a side discussion after the meeting it was revealed that this was the company's only option. Consumers would not have accepted it, and all other food stores were forced to do the same. The result was that the company's profitability was wiped out, and its share price has not kept up with the rest of the market. The company likes to talk long-term vision, but every question about the details in the near future was elegantly unanswered. We noted, however, that a reorganisation of the company is underway, which we believe may mean an opportunity to split the business into several companies in the future. IFC World Bank, for example, has bought 8% of the supermarket chain (information that was unknown to our hosts, and this is, after all, the leading investment bank in Sri Lanka). Despite the somewhat cautious provision of information, we can sympathise with the basic idea, of Sri Lankan products for Sri Lanka. The company's focus on high-quality, locally produced brands with a strong ecological concept is maybe a few years too early, but it's a strategy that will strengthen the brand in the long term. During our visit to the company's stores, we noted that the shopping experience was in line with international standards. There also appeared to be some gems among the company's own brands. Dairy producer Kotmale, which buys all its milk locally and has built a strong brand for its products (milk, yogurt, ice cream) has potential, and we understand that Nestlé has made inquiries. Cargills is the market leader in ice cream, and number two (after Nestlé) in milk, and other products are also among the most purchased in Sri Lanka in their categories. In combination with the long-term demand for modern retailing, it may well be that it is getting past the difficulties of recent years. A long-term owner like Tundra is able to devote the necessary time for this type of business.

After Cargills we proceeded to Aitken Spence, Sri Lanka's second-largest conglomerate after John Keells, but with a stronger focus on the hotel business. The company currently has about 500 rooms (of about 16,000 registered in Sri Lanka).

Tundra with the CFO of Aitken Spence

In addition, it has another equal number of rooms in the Maldives plus a few more hotels, including some in the Middle East. Over the coming three years, initiated construction projects alone mean an anticipated doubling of room capacity in Sri Lanka. Asked whether the ongoing tourist boom (20% annual rise, around 1.5 million tourists arriving in 2014) means significantly higher occupancy, they are less specific. Sri Lanka's historical problem has been excess construction in the tourism industry, especially in the southern parts. The company notes that the south remains highly competitive, and that occupancy is rising but not at the pace one might expect. However, occupancy of the company's two hotels in central Sri Lanka, particularly the legendary Kandalama (http://www.heritancehotels.com/kandalama/) is now 85-90%, which basically means full. The company's second hotel in central Sri Lanka, the Tea Factory, is also at similar levels. We talk about Chinese people travelling. The company says that during the 2008-09 financial crisis, large numbers of European and American tourists disappeared from the Maldives and the company anticipated disaster, but instead the Chinese arrived. Today, 20% of the company's hotel guests in the Maldives are Chinese, and they are now starting to see a similar trend in Sri Lanka. So far, the number of Chinese is about 100,000 per year, but this number is growing rapidly. The company is therefore conducting an additional marketing campaign directed towards China, and the outcome will be interesting to follow.

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After Aitken Spence, our journey continued to another portfolio company, Tokyo Cement, which is Sri Lanka's leading cement producer. However, there is very little limestone in Sri Lanka, which means the company, like other manufacturers do in Bangladesh, imports clinker (limestone-based semi-finished product in pellet form) from Vietnam and the rest of Asia. This is then refined into cement and packaged. The company currently has about a 30% market share of all cement sold, slightly more than its biggest competitor, Holcim. Lafarge, which tends to be a dominant player in emerging and frontier markets, has 11% of the market, which, according to Tokyo Cement, has been relatively stable over the past thirty years. Tokyo Cement currently has capacity of 1.8 million tonnes, and by 2016 will have a further 1 million tonnes ready for production. Even though other cement producers are expanding, this will not be sufficient in the coming years since almost 50% of all cement is still imported. The company's main plant is located on the coast of eastern Sri Lanka. It has a great advantage in having a facility adjacent to its own port, and it also uses three of its own ships for imports of clinker and shipment of cement around the island to the main unloading area.

Tundra with Tokyo Cement' finance department, outside the gates of the headquarters

After Tokyo Cement we went back to infrastructure again by visiting SAGT (South Asia Gateway Terminal), which is the John Keells terminal at the main port in Colombo. The Port of Colombo has tripled its capacity in the past ten years, and can now handle around 6.8 million twenty-foot container equivalents per year (6.8 mteu). Just to put this figure in context, the capacity of the ten largest ports in Sweden is approximately 1.5 mteu. Sri Lanka's advantage in ports comes from its geographical location and its deep natural harbours (18-20 metres).

This means that countries with large trade but a lack of deep ports can transit through Sri Lanka for long freight journeys. Traffic with India makes up 75-80% of all container traffic. Smaller vessels load up in India and then drop their containers in Sri Lanka, where larger ships load them for transport to the United States or Western Europe, for example. It is much easier for Indian companies to make the transhipment at geographically neighbouring Sri Lanka than to detour to Singapore or Malaysia for the corresponding freight route. SAGT currently handles about one-third of the port's overall operations. It was an interesting meeting, followed by a site visit that increased our understanding of how freight and port operators (many listed in eg Vietnam) work in practice. The Port of Colombo has a development plan with the potential to almost double its capacity within a decade,to 12 mteu. A small country like Sri Lanka could become an important sea-freight hub is proven by Singapore, which currently has the world's second-largest container port, with more than 32 mteu. The largest in the world is Shanghai (33 mteu), and the largest in Europe is Rotterdam (less than 12 mteu).

After SAGT, we moved on to a mid-range housing project being built by John Keells; a 29-storey building of 475 apartments. With six months left to go before occupancy, 460 of the apartments are already sold, which is another sign that more construction can be expected. The apartments we viewed were in the mid-price segment. Most had three or four rooms over around 100-120 sqm. The price for these apartments ranges around SEK 22-23,000 per square metre, which is quite high for Sri Lanka but of course significantly below Swedish city levels. The building is centrally located in Colombo, with a swimming pool, gym and other amenities. We got to visit an apartment nearing completion, and concluded that the standard is certainly high enough for even a pampered Swede. The view from the 27th floor was fantastic. Potentially Swedes wouldn't appreciate the fairly small and dark kitchens. And most of us wouldn't need the extra little room with a private toilet, intended for the home help.

Tundra viewing apartments

We concluded the Sri Lanka trip, with a visit to Hatton Bank, which is one of the two largest Sri Lankan banks (little different from Commercial Bank).

Hatton Bank's size brings it greater exposure to large companies, and we note that it is slightly more optimistic about credit growth. Adjusted for impairments (it also had some gold-secured loans, albeit to a much lesser extent than Sampath Bank), credit growth for the first 9 months of the year was an annualised 15%, and the past three months in particular have seen significant improvement. This is probably attributable to the construction sector. The company also discussed prospects of strong growth in its 60% insurance subsidiary (permitted in Sri Lanka). This activity is still a small part of the company's total business, but is growing by 15-20% annually in both life and non-life segment.

Shamoon, Mattias and Rashmina with Hatton Bank

Summing up our impressions, our positive view was strengthened. Assuming no global shock (financial crisis or sharply higher interest rates), we consider it likely that the country will face continued strong growth in the coming years. Sri Lanka's unique potential in the tourism industry has a good chance of being realised thanks to the investment in motorways. After having driven 130 km between Colombo and Tangalle in 6 hours, I can personally say that the completing the same journey in 1.5 hours makes a huge difference. The objective for 2017 is to welcome 2.5 million tourists (compared to 1.2 million in 2013 and a projected 1.5 million in 2014), and the increase could probably continue beyond that. This means that the country's dominant service sector (58% of GDP) is well placed to perform solidly over a number of years to come. On top of this is the investment in infrastructure. We believe it is difficult to exaggerate the importance of, in three years, being able to drive from the northern tip to the southern tip in less than four hours, a journey that previously took more than a day. Today, 40% of Sri Lanka's GDP is in Colombo, but the strongest growth over the past year has been seen in the former war-torn northern Sri Lanka, as well as in the southern parts. From the discussions we conducted, we believe it is likely that large investments will be made in the formerly somewhat forgotten parts of the country. The risks in the short term are primarily political. President Rajapaksa has ruled the country with a firm hand (some would call it an iron fist) for two mandate periods, and now intends to seek re-election for a third period during the first week of January 2015. There is bubbling discontent amongst the opposition about what they perceive as the president's overly firm grip on the political agenda, so there may be a reaction. From an investor perspective, there is the risk that the political changes could have adverse implications for the economic activity in the longer term. Moreover, there is a high risk of a bubble somewhere along the way, particularly in residential construction, where the story has been success after success. However, infrastructure projects are being initiated after 30 years of neglected building as a result of the civil war that ended in May 2009. Rebuilding and reconnecting the entire island to a network is a project of at least 15 years. We therefore believe it is likely that Sri Lanka will experience a significant boost in the coming 5-10 years. We currently have a significant overweight in Sri Lanka, but it's a diversified portfolio across numerous sectors, mainly outside the best-known names, companies that we believe are likely to attract the attention of more investors in the next 2-3 years.

This concludes our three-part travel journal. Making a journey as we chose to do this time – across three of the major Asian frontier countries in a short time – provides a strong instantaneous comparison of each country's advantages and disadvantages. Three countries with different levels of development, in different phases of economic growth, but with a combined population size that is not far from Europe's. Both Bangladesh and Sri Lanka are experiencing very strong momentum, with our impressions on the ground confirming the view of at least a few years of strong growth. Pakistan is, in terms of perception, a few years behind, but with a solution to electricity shortages now on the horizon, the country is on the threshold of entering a higher growth trajectory. A joker in the deck (we still want to call it a joker) is, of course, what happens if the recent decline in energy prices, driven by the oil price, proves to be anything other than a short-term phenomenon (see our separate mailing on the impact of oil prices on frontier markets, from late October). If this is the case, everyone, including us, will have to significantly revise growth assumptions upwards for the Asian frontier markets in the coming years. Ultimately, however, it is about finding interesting companies with the potential to grow without ideal conditions. We conclude that the opportunities ahead perhaps look even more exciting. We are aiming for 20 years in the future.