Pakistan

MSCI upgrade and words from the ground

May 2016

TUNDRA FONDER

PAKISTAN - SPRING 2016

Introduction

In October 2016 Tundra Pakistan Fund will celebrate its fifth anniversary. For almost five years we have been working based on three basic principles:

- To take our markets as seriously as European or US fund managers once did. Early 2014 we opened our research office in Karachi. In 2015 our analysts and portfolio managers held 170 company meetings and travelled to 11 countries. Shortly Tundra will announce a new major step towards local presence in our markets.

- To provide safe and credible ways for investors to access inaccessible markets. All our funds comply with the European UCITS rules and are from a legal perspective comparable to any Swedish, US or Indian equity fund out there. The only risk, and that risk is high enough, an investor should take is the risk on the underlying assets performing badly.

- To provide a higher return than any passive investment fund (index funds or ETF:s) with the same investment universe. We today have 9 investment professionals looking for the best investments available in our markets. If that is not translated into higher returns than passively managed index funds investors should choose cheaper alternatives. Since launch our three largest funds (Tundra Pakistan Fund, Tundra Frontier Opportunities Fund and Tundra Vietnam Fund all have significantly outperformed passively managed funds within their asset class or, if passive funds are not available, their benchmarks (which are always an internationally accepted dividend reinvested benchmark).

Our travel journals have always been an essential part in how we communicate. Many of our markets are mysteries to most investors, some of them few would think of visiting. So early on we said: ”If we can’t take our investors to our markets, we will have to take our markets to our investors”.

This travel journal is a bit special. It has been as while since we last communicated and there is a special reason behind that. On May 10th we will issue a press release explaining why. Enough said on that.

A lot of things have happened or is happening right now. We have gone through a terrible time for frontier markets so we include a section where we try to explain the reasons behind that.

The second big issue is obviously that one of our markets is up for ”graduation”. June last year MSCI put Pakistan up for official review regarding inclusion into Emerging Markets.In June 2016 MSCI will make its decision whether to upgrade or not. If the decision is positive Emerging Markets funds with 40x (Tundra estimate) the capital of Frontier funds will be forced to have a look at Pakistan. In our view this is an opportunity with a risk-reward skewed heavily towards the positive side. As you will see this market trades at 8.5x earnings at the same time as companies have grown faster than their Indian peers in USD over the last ten years. Should Pakistan enter MSCI Emerging Markets it does so at more than 50% P/E-discounts to its Asian EM peers. We don’t believe this is sustainable. We add a chapter on that event as well in this report, starting on page 4.

We end this report with the first part of our travel journal from our latest trip to Pakistan which included Lahore, Gwadar, Karachi and Islamabad.

We hope you will find the reading interesting and as always you are most welcome to give feedback or ask questions. Especially the potential upgrade of Pakistan into Emerging Markets is a much more comprehensive discussion than this format allows.If any questions we are happy to discuss them further.

Stockholm May 3rd, 2016

Mattias Martinsson
Chief Investment Officer

UPDATE FRONTIER MARKETS - SPRING 2016

What is happening in frontier markets?

In October 2011 Tundra launched Tundra Pakistan Fund, ridiculed, condemned and eventually one of Sweden's top ten equity funds in three consecutive years from 2012 to 2014. That at the time limited confidence in Pakistan coincided with a fantastic investment opportunity is perhaps not too surprising. Most investors are well aware of the link between low expectations and subsequent returns.

Almost five years later, we find ourselves again in a period of considerable concern. The commodity boom in 2005-2008 was followed by significant investments, particularly in the oil sector. An increased supply coincided with China's shift to a more consumption-driven economy and the extrapolated trend in demand turned out to be too optimistic. Falling commodity prices exposed the weaknesses of many commodity-dependent emerging market economies, and has resulted in a weak currency development in many of them. This has coincided with political turbulence in some of the larger emerging markets (for example Brazil and Turkey), but of course even more troubling have been those in Northern Africa and the Middle East with the emergence of destabilizing factions such as ISIS. Meanwhile, the bailouts for the West in the wake of the 2008 financial crisis have started to be questioned. How long can the West sustain monetary easing and what happens after that?

At Tundra, we have the privilege of working with relatively isolated economies. Countries that continue to work under normal conditions of inflation, positive interest rates and where the debt levels of both private individuals and companies in general are low. Countries whose economies come from a low level and that, with few exceptions, are driven by domestic consumption. Countries where the daily price movements of the stock market is affected very little by what happened with the Dow Jones index the night before. The majority of the markets we work with, especially the Asian markets, benefit from falling commodity prices, particularly now that this coincides with large infrastructure investments currently being implemented. The asset class "frontier markets" should have had two good years behind it, but this has not been the case.

The explanation for this is that the capital flows that went into these markets 2012-2014 stopped as foreign investors became increasingly concerned about the adjustment problems of the world's major emerging markets. Initially there was a distinction between markets. Clear beneficiaries of lower commodity prices, such as Pakistan, Sri Lanka and Bangladesh fared well, while commodity exporters such as Nigeria and Kazakhstan soon got into trouble. Most frontier funds had invested properly in oil price dependent Middle East, despite the fact that many of these markets are no longer classified as frontier markets. But even in energy-importing like Pakistan and energy neutral Vietnam stocks whose earnings are affected by oil prices (oil producers, oil service companies, pipeline companies, etc.) constituted a relatively high proportion (20-30%) of the stock market and the majority of the most index-heavy shares were in this category. This meant that many index hugging frontier funds had a tough end to 2014.

The weak performance of many frontier funds subsequently led to increased outflows and this meant that the selling eventually became non-discriminatory. 2015 turned out to be a year when there were very few places to hide. The last phase which we believe we saw in the first quarter of 2016 were pure capitulation sales where investors, after outflows reached a certain level, were forced to sell even companies that are not at all affected by the global turmoil and whose activities even benefited from the commodity price declines.

For Tundra which managed to maneuver the first phases of the downturn better than most managers through careful stock selection the first quarter was very tough. February. was our single worst month compared with the benchmark index since we started the fund and the first quarter our worst quarter in terms of relative performance since launch.

In the final phase global sell side strategists have been looking for the big global shocks that can drive markets even further downward. A little late, one might think, but typical of the phase we are in. It's about everything from theories of general currency crises throughout the less developed world to more specific concerns that China in two years will be out of foreign exchange reserves and a sharply depreciated renminbi will stifle the next stage of globalization, which has just started in countries such as Vietnam, Bangladesh and Pakistan. One might think that investors should learn from history, i e that the world seldom goes under and trends tend to regularly break, but here we are again. The interest is minimal. To us it sounds like a pretty good investment opportunity.

In this environment we do what we always do – We try to find the best of breed companies which can one day become global giants and we try to catch them early. Sometimes too early, as the beginning of 2016 has shown, but in the long run we believe our way of investing is what Frontier Markets is all about. Focussing on the markets where the potential is the largest and finding the best of breed in the next generation of companies that will thrive in those markets.

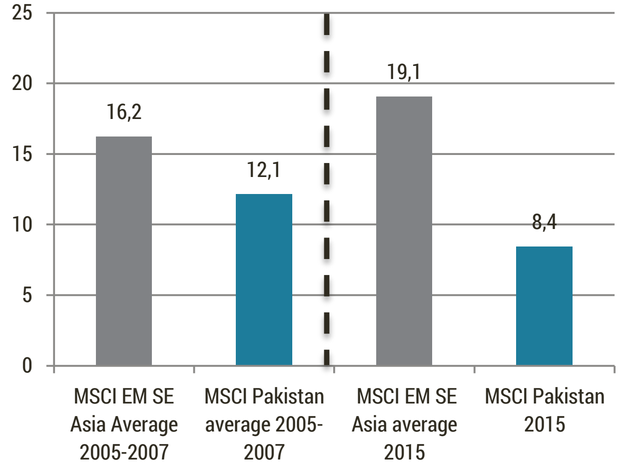
Pakistan back into MSCI Emerging Markets Index?

So. To the subject of this travel journal - Pakistan. In the mid -90s Pakistan and India were very much considered the same. This was before the War on Terror and before any suicidal bombings started within Pakistan's territory. Between 1994-2008 Pakistan was part of the MSCI Emerging Markets Index. After the Balance of Payment crisis in 2008 the country was kicked out and in May 2009 it resurfaced in the MSCI Frontier Markets Index.

In June 2016 MSCI will take a decision whether to transfer Pakistan back into Emerging Markets index or whether it should stay in the Frontier Markets index. For more than 2 years Pakistan has fulfilled all quantiative critera (liquidity and number of investable companies for foreign investors). Currently there is a questionnaire circulating among global EM investors after which a decision will be taken. In our view the odds are 70/30 in Pakistan's favor. The main risk as we see it for a negative decision is possible apathy among Emerging Markets investors after several years of dismal performance.

Pakistan will be small if included in EM-index (0.2%) so there is a risk that investors simply feel there is no need to bother. We think however the risk-reward is on the right side as we believe equity markets today have not priced in Pakistan's return to Emerging Markets.

*Figure 1: P/E-ratios MSCI EM Asia * vs MSCI Pakistan*

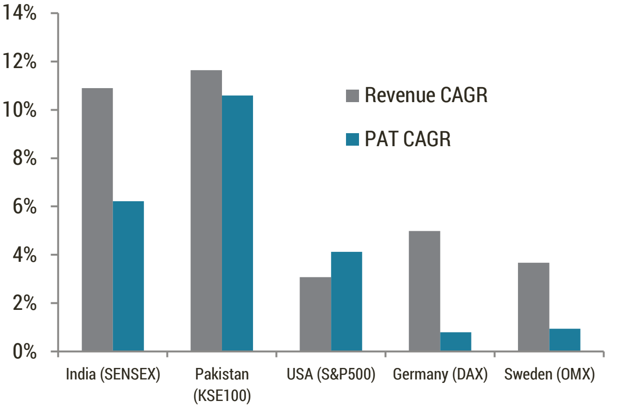


*Source: Bloomberg, * MSCI EM SE Asia is a non weighted average of Indonesia, Malaysia, Thailand, India and the Philippines*

During the last three years before exclusion from MSCI EM, Pakistan traded at an average discount to similar countries of 25%, and recall that this was in the midst of the War on Terror. At the end of 2015 this discount had widened to 56%. In fact this is the second highest discount to its peers (2011 ended at 59% discount) during the years outside MSCI EM.

We then add the argument that Pakistani companies over the last 10 years actually have grown faster than Indian companies, on revenue as well as net profits – in US Dollar. Both countries' companies have obviously significantly outgrown its European and US peers.

Figure 2: Average annual revenue and net profit growth 2005-2015 (USD)

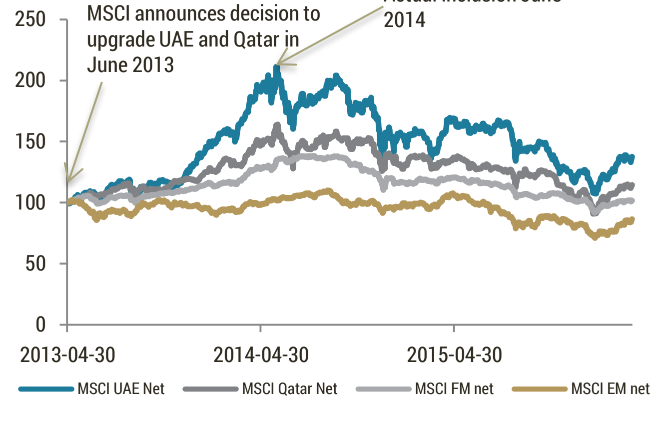


Source: Bloomberg

Many times we find ourselves in the discussion: "How can Pakistan change?". Figure 2 above tells us that if companies continue performing like they do there is actually no need for change. Emerging or frontier markets does not matter. This is regardless an inexpensive equity market where companies historically have outgrown most equity markets around the world. We thus don't believe Pakistan's faith is about MSCI EM inclusion or not. In the toughest possible environment companies have proven they can add value to investors regardless. Tundra Pakistan Fund is up 160% in SEK (120% in USD) since launch.

Based on recent history MSCI EM inclusion could however act as a trigger for some investors. The most recent example was in 2013 when UAE and Qatar were upgraded. That is shown below.

Figure 3: UAE and Qatar after MSCI 's upgrade in June 2013



Source: Bloomberg

During the twelve months following the decision to upgrade United Arab Emirates (UAE) and Qatar, UAE outperformed MSCI Frontier Markets Net index by 68% (USD) and MSCI Emerging Markets Net index by 87% (USD). Qatar outperformed the same indices by 23% (USD) and 43% (USD) respectively. We prefer to focus on fundamental factors and, as the graph shows, both UAE and Qatar peaked within 12 months of the announcement. Given that the Pakistani equity market is well supported by fundamentals it is however not impossible that some investors will see an upgrade as a trigger for a revaluation and will act accordingly.

Conclusions

Summarizing the current status we conclude that Pakistan is at the lower end of its historical valuation versus other South East Asian peers, even comparing to the average discount during its time as a Frontier Market. We would thus say that the downside from a negative decision at the MSCI meeting in June is limited. We believe however an upgrade would force global Emerging Markets investors around the globe to have a closer look. And they just might like what they will see.

- Pakistan is trading at less than half of India's multiples although revenue growth and profit growth has been stronger than India's over the last ten years.

- Growth going forward will be stimulated by the gigantic CPEC investment program * …

- … at the same time as Pakistan is one of the clearest beneficiaries from current low commodity prices.

Is this really a market investors will underweight if it is reclassified into Emerging Markets?

** CPEC is an abbreviation for "China Pakistan Economic Corridor" is an investment collaboration between China and Pakistan where China will invest USD 46 billion in Pakistan over the course of the next 10-15 years in the form of highways, ports, railways, power production facilities and other infrastructure. The CPEC investment amount to approximately 20% of current GDP.*

On the road again

This trip was a little bit more comprehensive focussing on infrastructure and service sector, two areas where we believe Pakistan has a lot of potential. First stop Lahore.

Netsol

The first meeting was with Netsol, an IT company in which Tundra through our various funds owns approximately 6.5% of outstanding shares. Netsol is one of Pakistan's leading IT companies. The sector is in our view highly interesting, an "early India" where several of the leading IT companies grew to international giants. The Pakistani IT sector is still significantly less than the Indian. In India, there are now nearly 300 listed companies in the IT services and software development with a total market capitalization of about USD 180 billion. This compares with Pakistan, where today there are three listed companies with a combined market capitalization of about USD 120 million (Tundra has a significant shareholding in all three). In addition to this, there are a handful of companies that have parts of their operations in the area. In Netsol we met with the principal owners and the CEOs of both Netsol Pakistan and its US parent Netsol Ltd. (separately listed on Nasdaq).

Netsol has chosen to specialize in software for vehicle leasing where it today is one of the world's five leading software developers. Its clients include many of the world's leading automakers. The company's software is in terms of price on the same level as its international competitors. However, the company can be very competitive on price in the consulting business (adapting software to client, upgrades, services). The starting salary for a Pakistani software engineer is about USD 400/month, a salary that after 5 years of experience will rise to about USD 1000/month. We had an interesting discussion of the coming years discussing growth prospects ahead after the recent launch of the new version of their main product NFS Ascent. We then received a tour of the company premises and a description of the company's award-winning HR policy. The company has understood that employee retention is more than paying the highest salaries. We acknowledge the stimulating working environment with employee services that include free motorbikes and corporate pre-schools for young mothers.

The company has a market cap of USD 55 million. Over the last ten years (2005-2015) the company's revenues have grown on average by 17% a year in USD. With the launch of its new software we expect the company's revenue to jump by at least 30% in FY 2016 (Fiscal year ends June 30th). The average net margin during the last ten years has been 29% although with high volatility given the software development cycle. With the current estimated revenue base and based on average profitability through the past ten years the company is trading on a normalized P/E of 5 times which, considering historic strong growth, we believe is attractive. Especially compared to the Indian IT-sector where similar sized companies trade at 10-30 times earnings.

Tundra meets Netsol's CEO Salim Ghauri

Office landscape at Netsol

Free lunch for employees in the canteen

Adamjee Insurance

Next meeting was with the insurance company Adamjee Insurance where we met President Muhammad Ali Zeb and Chief Financial Officer Asim Nagi. Today there are 31 insurance companies listed on the Stock Exchange with a total market capitalization of about USD 1.8 billion. Of these Adamjee Insurance is the fifth largest with a market capitalization of about USD 180 million. The company is active in general insurance as well as life insurance (75% owned subsidiary). Today, roughly 1 out of every 200 Pakistanis holds an insurance, a proportion that may seem unthinkable to us Swedes. With rising asset values (most do not even insure their houses) and increased economic activity (transport and increased international trade), we believe the sector has good growth prospects. Strong growth in motor insurance (which is a legal requirement for vehicle owners) has been an important growth area. Adamjee Insurance for the past three years has grown net premiums by 24% a year and given the low penetration of insurance at the same time as consumer awareness is improving we believe the sector can continue to significantly outpace GDP growth for a foreseeable future (we expect 15-20% annual growth). Its life insurance company has in less than five years reached a 15% market share and we expect this segment in particular to contribute to earnings growth going forward. The company also has a significant surplus value in its portfolio (close to current market cap). With good sales channels (aligned with one of the leading commercial banks MCB Bank) Adamjee Insurance has good potential to maintain and even strengthen its position as one of the leading insurance companies.

The company has a market cap of USD 180 m. It fits well within the Tundra theme given the current low penetration of insurance in Pakistan and likelihood of this to improve in the years to come combined with the company's strong position within the industry and thus good chance to defend its market share. The valuation of P/E 8x for CY (calendar year) 2016 combined with a dividend yield of 5% is attractive we believe.

Tundra with Adamjee's CEO and CFO

Systems Ltd

After meeting with Adamjee Insurance it was time to meet another listed IT company, Systems Ltd. The company was listed as recently as February 2015. It has a market cap of approximately USD 60 million. Tundra owns approximately 2.5% of Systems Ltd. We met with the company's CEO Asif Peer who gave an interesting picture of the company's future development plans. The company has been around since 1977 but especially in recent years embarked on an aggressive roll out under its new CEO. About 50% of the company is owned by current employees, which is something we like. About 20% of sales come from Pakistan. The largest market is instead the United States where about half of the turnover is generated. Systems is more like a traditional IT-consultant, like the larger Indian IT-consultancies, where it delivers high end customized solutions to its clients. Its customers include companies such as Revlon and Engro Foods. The company's CEO previously worked with building up its US operations and in our eyes has a good understanding of the challenges and opportunities facing the company ahead as it takes on its multifold larger Indian competitors.

Out of the three listed IT-companies in Pakistan Systems Ltd probably has the most easily understood business model which basically means building high quality client adapted IT-solutions at a 30% lower cost than its Indian peers (both Pakistan and India continue to take market share from Western based consultants). Just as the sector in general this is mainly an export focused business but in System's case 20% of revenue comes from local business. This means long term they will be able to also capture some of the growth from modernizing Pakistan's IT-infrastructure. Over the last 5 years the company has quadrupled its revenue (CAGR of 32%). Average historic net margins have been 30% but given a higher local share of sales we believe the recent two years of around 20% is more representable going forward. We expect the company to grow its revenue by another 30% this year and assuming a 20% net margin it is trading at just above 10x earnings. We believe this is a company that foreign investors will fall in love with – once they find them.

Mattias and Shamoon with the CEO of Systems Ltd

Pak Elektron

We then moved on to meet Pak Elektron. The company has two businesses: 50% of sales is equipment to the power sector (transformers, energy meters and switchgears) and 50% is white goods (refrigerators, freezers, air conditioners). We see the company as one of the main beneficiaries of the ongoing massive capacity expansion and refurbishing of Pakistan's electricity supply chain.

- Transformers make up 60% of power sector revenues - In the power transformers it has an 80% market share, in the distribution transformers (adapting the voltage to consumer use) it holds a 40% market share.
- Energy meters make up around 10% of revenue and it holds a 25% market share.
- Switchgears (prevents overload and short circuits but some can also switch from external supply to internal supply in times of outages) makes up 10% of revenue and it holds a 24% market share.
- EPC contracts (Engineering, procurement and construction) makes up around 20% of revenue.

As Pakistan aims to increase installed capacity of electricity by 60% in the next 5 years, the demand for equipment will grow with it. Pakistan's current consumption of electricity per capita (448 kWh/year) needs to grow by 50% to reach India, double to reach Philippines, 3x to reach Vietnam's and 30x to reach Sweden's. The capacity expansion is part of the China Pakistan Economic Corridor where China will provided investment and financing of USD 46 billion over the next 10-15 years.

As electricity becomes more available and per capita incomes grow, so will demand for fridges, freezers and air conditioners. Over the last three years the appliances division has grown its revenue by just below 20% per year. More than 95% of sales is refrigerators/freezers. Pak Elektron is the second largest brand in refrigerators/freezers with a 25% market share. Competition from abroad is discouraged by import tariffs of 25-30%.

Pak Elektron's current market cap is USD 285 m. It is trading at a P/E of 10x for CY2016. Based on how we see the market conditions we expect the company to be able to grow its revenue by 20% annually over the next three years and provided it defends its market share , given the still low consumption of electricity and penetration of appliances it should from there be able to outgrow GDP growth for a foreseeable future.

Tundra discussing with Pak Elektron's CEO and CFO

Visiting the showroom

Outside standardized products the company also has larger industrial clients (On the picture is a freezer adapted for Omoré , the ice cream brand of Engro Foods who holds a 50% market share in packaged milk

Next stop Karachi!