July 2, 2009
About Those Brown Shoots

The frenzy buying of high beta stocks is fizzling.
Beta is out, alpha is back.

Green shoots are quickly turning brown.
The water tanks and all the reservoirs are empty.
Because of the global warming, the natural rain fall is no longer refilling these reservoirs.

In last quarter's bear rally, more defensive stocks have logically underperformed.
They had low betas.
Now is the time to refocus on non-cyclical companies with strong FCF and high dividend yields.

Nestle (yawn) is a good example of a company benefiting from stable demand, strong brand recognition and solid pricing power.
By selling non-discretionary goods like chocolate and coffee, Nestle is pretty immune to the coming disappointments on economic growth (or lack of).
However, I believe one can do much better in the food and beverage sector.

Nong Shim, the Korean leading instant noodle manufacturer is now benefiting from everything a value player looks for.
And it is growing to boot.
Nong Shim is cheap, trading at half the EV/sales of Nestle, Unilever, Cadbury or Danone.
It is trading at more than 30% discount on a PER or EV/EBITDA even though earnings estimates are still depressed.

This is because Nong Shim was hit by the perfect storm last year.
Agricultural prices spiked up to unseen heights while the Korean Won collapsed.
Furthermore, the company's signature shrimp crackers were hit by a scandal (don't ask).

That was then. Today, all these trends have reversed.
Agricultural prices have come down as quickly as they went up.
The Won has stabilized and then strengthened against the dollar.
And the scandal is fading without leaving lasting effects.

Here is the dominant player in Korea now trading at 10 times earnings.
Yet instant noodles' demand is not likely to be negatively affected by the global downturn.
I would argue that they will rather benefit from consumers' trading down.
With its strong brand names, the company is very well positioned in Asia where private labels are not a factor.

The icing on the cake?
Growth in the U.S. and China, markets the company is just starting to penetrate.
And then there is North Korea. What if the Kim dynasty does not survive the coming transition of power?
It would be a natural market expansion for Nong Shim.

Anyway, if you are looking to avoid green shoots and old trees dependent on artificial lakes, I suggest you look at Nong Shim.

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June 25, 2009
Baghdad, the New Frontier

I remember shaking hands with Russian soldiers in Potsdam, Germany, when it was still under soviet occupation.
These soldiers were not happy to see us westerners there, but they did not suspect how threatening we were.

We were the avant-garde of the coming flow of capitalist investors determined to erase communism in Germany.

Similarly, I remember buying 10% of Graboplast, a Hungarian company, even before there was a stock market in Budapest.
Actually, to be precise, the Budapest stock exchange had just opened.
It was a small office room with 10 computer terminals or so and trading volumes were dismal.

What sticks in my memory about my first visit to Warsaw in 1991 is how eerily quiet the city was at night.
Only 3 to 5 cars would drive by during my whole dinner at the hotel located on a major square.
They all sounded like law mowers.
A full meal at the hotel cost me less than $2.

This was not so long ago.
But why do I mention this?

Twenty years ago Poland, Hungary or Czechoslovakia were the new frontiers for international investors.
The unique investment opportunity lay in these countries' rapid change after becoming democracies.
It was important to move in quickly, but as I illustrate above, one had to have faith.
Shortly after, other communist countries (China, Vietnam) also became great places to invest because of the implementation of some economic freedoms.

In the early stages, understandably, money flowed slowly into these countries.
By contrast, today, every mutual fund organization has an emerging market fund.
Stocks in China trade at multiples comparable to those in mature countries.
Risk premiums have vanished.
Just like any mature market, most emerging markets have now gone through their bubble-burst cycles.

So, brave investors looking for ever more beta have even been looking at Africa in their pursuit of the next new frontier.
Unfortunately, that seems a bit premature in my opinion.
One is better off looking at a different part of the world that is truly changing.

The new new frontier could very well be Baghdad.

There are some interesting similarities between the Middle East today and Eastern Europe of 20 years ago.

In Wednesday’s Wall Street Journal, a Mr. Ibrahim makes that point quite convincingly even though he is premature in speculating on a victory of Mr. Mousavi in Iran.
“If the forthcoming elections in Iraq proceed without any major setback, then the entire belt from Iran (maybe) to Turkey, including Lebanon and Kuwait, could be on the democratic path.”
Mr. Ibrahim also points out that scholars believe that societies that manage to have 4 consecutive elections will usually achieve an irreversible democratic transition.
Turkey, Kuwait, Lebanon and Iraq qualify.
Egypt is at a turning point with important elections coming up.
Already Egyptian bloggers made their Web sites and twitter accounts available to their Iranian counterparts after the mullahs disrupted Iran’s internet…

In Hungary, I invested $1million to buy 10% of Graboplast in a private placement.
I then left my employer (Mitchell Hutchins) before Graboplast went public.
My successor, if he or she held on to the stocks long enough, could have sold the shares with a huge profit.

I suspect similar tenbaggers might be found today in Northern Iraq.
There are signs that the Kurds are enjoying real good economic growth.
At least, it is worth checking it out.
Stay tuned.

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June 18, 2009
The Appeal of Chinese Warehousing Business

Gentlemen, you have come 60 days too late. The depression is over.
It is with those optimistic words that President Herbert Hoover welcomed his guests in June 1930.

This is one of the interesting quotes one can find in a study published by the Boston Consulting Group entitled “Collateral Damage, Part 7”.
The study also quotes U.S. Treasury Secretary Henry Morgenthau who in 1939 said:
“We have tried spending money. We are spending more than we have ever spent before and it does not work…I say after eight years of this administration we have just as much unemployment as when we started, and an enormous debt to boot!”

Then, BCG looks at a report published by the IMF based on the study of 122 recessions that have occurred globally in the last 50 years.
According to this report two types of recessions are particularly long and severe – those preceded by financial crises and those that are globally synchronized.
The writer notes that the current recession meets both criteria…

Of course, misreading history can be as dangerous as neglecting it.
If anything, this crisis is different from the 1930’s in the way the monetary powers are reacting to it.
That’s why I believe more and more that we are heading for stagflation rather than further deflation.
However, today’s “green shoots’” are eerily reminiscent of Mitterand’s Prime Minister’s words one year into his administration.
After a year of nationalizations, public spending and social programs (the 39 hour work week!), he famously announced that “All the lights are turning green.”
This turned out to be wishful thinking.
A year or so later, Mitterand finally let his Finance Minister, the dour Jacques Delors, do a complete U-turn and slam the brakes.

Eventually, France re-privatized its blue chip companies and a wave of deregulation coming from the UK and the U.S. changed many mentalities.
Mitterand and Jacques Delors – who in the meantime had been named President of the European Commission - even became the architects of Europe’s capitalist mini revolution. First, Delors conceived the Europe 92 project, which imposed a free market zone.
Then he and Mitterand convinced Helmut Kohl to go ahead with the euro currency which forces fiscal discipline on the member countries.

New converts are always the most zealous!

I do not believe that today’s green shoots are much better than Mitterand’s “green lights’.
For the market rally to be sustainable, the fundamental imbalances in the global economy have to be addressed.
Spending our way out of the crisis is not going to work. It never did.

Another myth one hears over and over is that Asia, and especially China, will be first to come out of the recession.

Apparently, a lot of money is flowing back into emerging market funds, especially Asian funds.
But China's growth is driven by communist-style dirigisme. It is not sustainable either.
It is driven by the government's "Three No's" policy – No lay-offs, no salary cuts and no reduction in working hours.
Hence factories are operating at near full capacity even though export demand has collapsed.

Today's best investment in China is in the warehousing business.
But what is going to happen to commodity prices once all the warehouses of the Middle Kingdom are full?

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June 12, 2009
Go Long the Zloty!

The zloty is arguably the best currency to hold at the present time.
It is down more than 30% against the euro since last summer.
Yet, as the World Bank puts it, Poland isn't in a crisis situation.
"Its economic fundamentals are very sound and the government is implementing close to textbook policies."

According to Leszek Balcerowicz, Poland has few "past sins."
It has entered the crisis with a rather low dependency on exports.
The current account deficit, around 5.5%, is coming down.
The public debt and the fiscal deficit are low, 45% and 3.9% of GDP respectively at the end of 2008.
Bank obligations in Poland amount to 75% of GDP, compared to 300% in Germany.
Furthermore, Polish banks have little exposure to toxic assets.

Mr. Balcerowicz is one of my heroes.
He is the architect of Poland's post-communist economic transformation thru "shock therapy".
Not only did he embrace capitalism like no other European politician, but he set the tone for decades.
As a result, Poland is today one of the few champions of capitalism left in the world.

Indeed, going against today's fashionable trends, Poland is responding to the global crisis by deregulating more and cutting public spending.
That's right, reducing government's role in the economy!
It sounds so archaic, but the fiscal rigor is driven by a firm commitment to join the euro zone by 2012.
Hence, the country has a constitutional public debt limit of 60%.

So, why has the zloty been trashed in the aftermath of the Lehman bankruptcy?
I believe there are two reasons.
One, Poland suffered from an association with some of its neighbors who are going through a major crisis.
In the panic of last fall, no distinction was made between the economic fundamentals of Eastern European countries.
It did not matter that Poland's public debt is not comparable to Hungary's or that Poland is less dependent on exports than the Czech Republic.
The second reason is that investors were spooked by the high proportion of mortgages held in foreign currencies.

Both of those concerns were exaggerated.

The Polish consumer has not been hit yet.
Actually, retail sales did not come down and were still up a strong 1% in April.
Mortgage payments in Swiss Francs are biting, but it is only affecting a small number of people.
Consider that at the end of 2007, the total mortgages amounted to only PLN 116 million in a PLN 2 trillion economy.

Furthermore, even with a 30% devaluation, the monthly payments on a 4.4% SFR mortgage are still lower than what it would cost to borrow the money in zloty where mortgage rates were over 8% a year ago.

There is also anecdotal evidence that the march to middle class status is going on unabated.
Polish shoppers are keeping the economy growing.
Danone’s sales are up 20% in volume in Poland.
Jeronimo Martins is still seeing near-double digit sales growth in its Polish retailer.

By the way, with half of its business in Poland, the Portuguese retailer is a good way to participate in this dynamic market.
Overall consumption is growing and the penetration rate of discount food retailers is still low.
At an EV/sales of less than 0.5 and a PE of 12, the stock price is not discounting the strong growth of the Polish business.

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