TUNDRA FONDER

Travel Journal
Part 1: Pakistan

November 2014

Travel journal – Pakistan, autumn 2014

Introduction

Tundra launched its first fund just over three years ago with the vision "to make the inaccessible accessible". We were understandably met with scepticism when we announced our first fund was a Pakistan fund. Almost 20 years of working with new equity markets have taught us that this is one of the best opportunities to actually create added value, while the most dangerous thing for any investment category whatsoever is consensus. When we took on frontier markets over three years ago, we found that these markets, with over one billion inhabitants, were followed by only a small number of investors. With our experience of having previously been involved in introducing new equity markets, we therefore agreed to take these markets as seriously as most people take the stock markets in Europe and the United States. Our research office in Karachi was the first step.

But our work has only just begun. At a presentation I gave a couple of months ago, I was asked "What is your goal for 2015?". I replied: "To be better". Since its inception in October 2011, Tundra Pakistanfond has yielded almost 50% more than its benchmark, MSCI Pakistan Net (SEK). Since its inception in April 2013, Tundra Frontier Opportunities is one of the world's best funds in its category. We have generated an excess return of almost 20% compared to the MSCI FMxGCC Net Index. This is of course a good start. However, when we see how much we have left to do, all the areas we can improve, we conclude that we could have been so much better. We have missed many investment opportunities during this time and conclude that our work for 2015 is therefore about taking another step towards missing less, eliminating gaps in knowledge, one by one. We will continue to build an organisation and perfect an approach that methodically analyses our markets, more companies, more deeply into each company. To constantly improve the quality of our approach to ensure that we evolve as our markets evolve and as new companies emerge. Our part of the world is undergoing constant development and change, and this will only accelerate from here. The work takes place at our desks in Stockholm, and it takes place at our research office in Karachi, but it also takes place through our travels. Qualitative meetings with the actual decision makers, with the people who control these companies' futures, and also with the people who are on their way to listing the next generation of companies. Our meetings are less about obtaining information that is already known through annual reports and other public materials, and more about getting a feel for what information is waiting around the corner. The meetings are very much about reading people, exploring the nuances of what is said. Do we believe in these people? Can these people add value for our unit holders? It's an important part of the puzzle that can ultimately lead to an investment. Our trip this time took us through three countries in eleven days. We outline some of our impressions on the following pages. For reasons of space, we have divided our travel journal into three parts. These pages document our impressions from our latest trip to Karachi.

Enjoy your read!

Mattias Martinsson

Chief Investment Officer, Tundra Fonder AB

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Stockholm – Doha - Karachi

Pakistan was this time the starting point of our journey rather than the main destination. Two days that were devoted mainly to refreshing our current picture, discussions with our colleagues at the Karachi office, and selective meetings with a number of key contacts for future discussions.

The best route to Karachi from Sweden is by Qatar Airways via Doha. In Doha, I always enjoy trying to identify fellow fund managers. This trip, I thought I identified one gentleman, slightly younger, who somewhat nervously changed positions several times in the departure hall. A sudden and loud prayer from a fellow passenger caused my putative colleague to pack and unpack his laptop a few times while he nervously glanced over his shoulder. For a moment I considered whether I should go over and speak to him calmly, but decided that the best way to face preconceptions is by doing just what this individual was about to do, experience it for yourself.

Getting off the plane in Karachi always gives me a sense of confidence. I like the feeling of still, more or less, being the only foreigner on arrival, the worn decor and the curious gazes at me as an outsider. The signs that we are still pretty much the only ones here, and that any glory days still remain in the future.

Heading for passport control at Jinnah International Airport

Waiting for my luggage. So far I've always got ten my suitcase.

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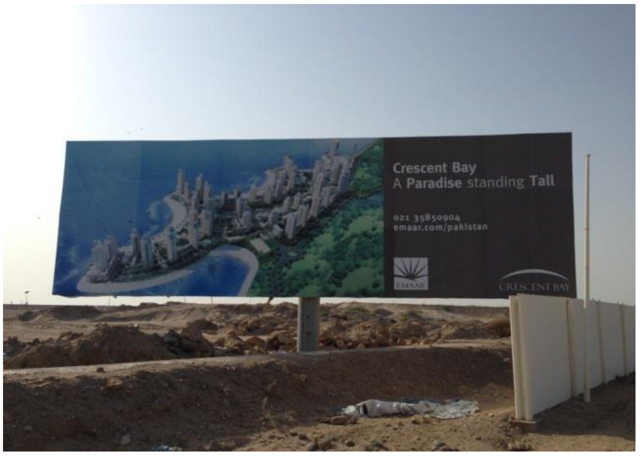
We arrived at the hotel at 2 am local time, so had time for a few hours' sleep before Sunday's agenda began.

Sunday morning in Karachi

Sunday was spent on meetings. We usually try to spend some of these morning researching interesting people in our industry. We have often talked warmly about the general level of expertise in the Pakistani financial sector. Whether the need is short-term or long-term, we always try to have meetings with some of the people who have caught our attention.

After our meetings we head out into town. We start with Emaar's gigantic Crescent Bay project. A total of 39 residential buildings spread over 300,000 square metres make up the zoning plan in this area, which is located on the coast in the DHA area, but a couple of kilometres from the nearest settlement. The project was initiated in 2006, but Emaar's money problems in connection with the financial crisis delayed the project. However, construction restarted last spring. The total project cost is currently estimated at around USD 2.4 billion, and consists of apartments, a shopping mall and a five-star hotel.



The first two 29 storey residential buildings are being built right now. We counted the number of completed floors as 11. This project is scheduled for completion before 2017 and most of these apartments are already sold. Two more residential buildings are scheduled to start in 2015. While travelling by car from our office at Dolmen Beach in "New Karachi", the wide open spaces are striking. As a best estimate, the construction area can accomodate a million people. It has kilometre after kilometre of sea as its closest neighbour.

A few kilometres outside the centre of Karachi in the DHA area. In the background you can just see Creek Vista, one of the first completed residential projects. Standing alone – so far.

In order to avoid the adverse security condition in parts of central Karachi, people prefer to move near the sea. New secure areas are being built around the DHA area, near the Sea View strip, and those who have the capital are abandoning the old densely populated neighborhoods. The Emaar project plan includes thousands of homes, with the average cost of an apartment approximately SEK 10,000 per square metre. Far above the average level in Karachi but, of course, far from the projects by similar contractors in Dubai, for example. There is a conscious idea behind building life-affirming and secure areas and thus encouraging families and young people to stay in Karachi. It's fascinating to see the coastline, with beaches hundreds of metres wide, but where more or less all forms of associated buildings, cafes and restaurants do not yet exist. We see potential here for the next 20-30 years. The hardest part is getting the first construction projects started. Who wants to buy the first apartment? It will gradually become easier when someone else has taken the first step and the infrastructure, including schools, hospitals, swimming pools etc, is in place. Adding new quality residential areas is not a bad way to change things. Cleaning up the worst parts of Karachi is probably more difficult than just moving the people away from those areas.

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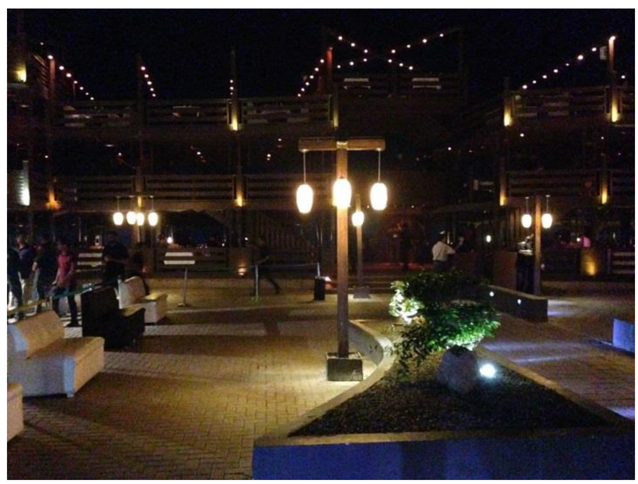
Crescent Bay in a wide-angle perspective

Shamoon and Mattias in front of the first two residential buildings (of 39)

After Crescent Bay, we had lunch with a Pakistani entrepreneur. A fascinating story of the family starting from leather processing to today's conglomerate, with the main expansion taking place in dairy and meat. Our friend, who is attracting great success with traditional pasteurised dairy products (fresh milk and yogurt with a short shelf life that requires refrigerated transport and storage), talked to us about the challenges of the business. According to him, there are 8000-9,000 grocery stores in Lahore, of which only 600 currently have cold storage. But demand is very good. Of the stores with cold storage, the company sells its milk and yogurt to 300-400. Market growth for traditional pasteurised dairy products, which is entirely dominated in Sweden, for example, is still in its infancy in Pakistan. Here it is no help to have by far the largest production facilities and the most milk collecting centres (like, for example, Engro Foods). Here it's all about efficient local production and building a brand (organic). Our friend's company is an example of the new businesses that are emerging in our markets and that could ultimately alter the market structure. The company is likely several years from appearing on the radar for global investors. For Tundra, these are often the most exciting meetings. By getting to know the owners and their businesses now, we will hopefully have the opportunity to be early investors sometime in the future, if our involvement is desirable.

After a few more meetings, we closed the evening with dinner at one of my favourite restaurants in Karachi, Kolachi.



The entrance to Kolachi early in the evening

It is fascinating to drive along the panoramic beach of Karachi. As if cut by a knife, the built-up area suddenly disappears and it gets dark. After travelling a number of kilometres by car, you catch a glimpse of a row of restaurants, around fifteen of them. The restaurant we visited seats about 500 guests. It's crowded, and just as many people are waiting in the courtyard outside. They've even introduced a queuing system with a central number board. The specialty is barbecue. There's something odd about me eating a traditional Pakistani meal while my younger Pakistani colleagues eat a traditional Western meal of hamburger and sides. With the illuminated sea outside, we could at this moment just as well be somewhere in the Caribbean. A foretaste of what Karachi may one day become.

TUNDRA FONDER

Passion för tillväxtmarknader

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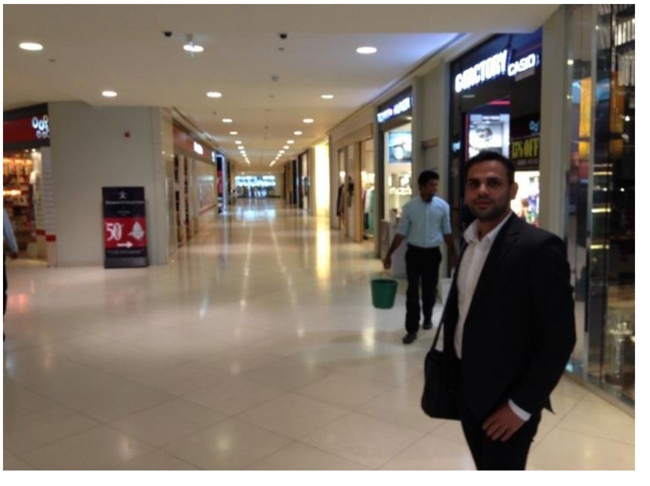
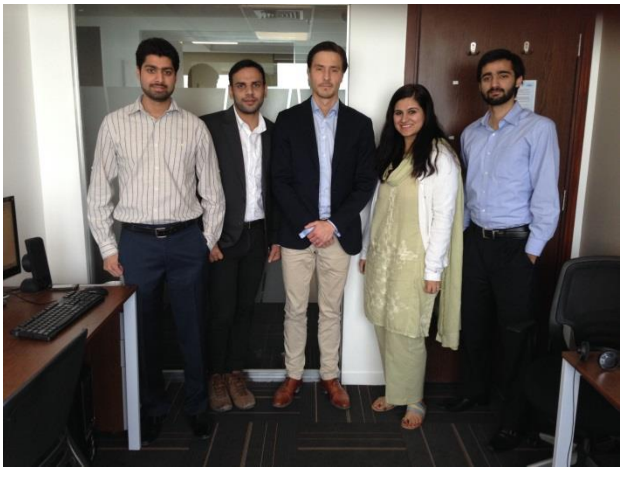
Monday was a busy day. Aside from my meeting with my colleagues at the office, we took our usual tour of grocery stores before more comprehensive company visits. The retail round I always try to take on my travels is made easier by Hyperstar (a subsidiary of Carrefour) having opened an excellent grocery store in the same mall that our office is located above. We begian the day, however, at the office.

Tundra's office is located in a relatively new business district in the DHA area. A secure area experiencing strong growth, right next to the sea. Directly below our office is a newly opened mall that has become a popular hangout for the upper middle class.





At Tundra's office – Top Dolmen Mall in the background. Bottom – Team Karachi – From left to right: Hamza, Shamoon, Mattias, Rashmina and Momin

Dolmen Shopping Mall – An example of a modern business format that's now emerging in Karachi. Bottom Hyperstar (Carrefour)

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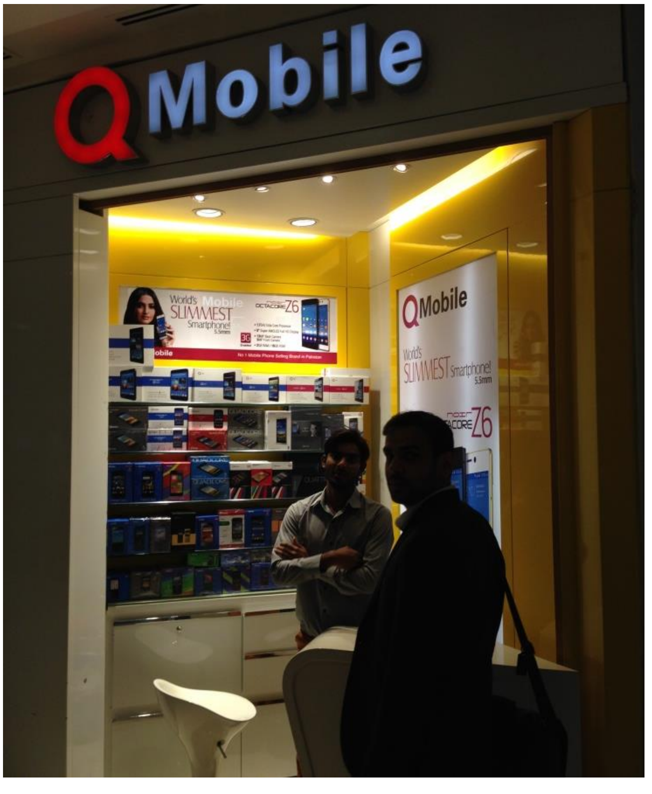
Although a modern shopping mall like Dolmen cannot be seen as representative of Karachi, and even less so of Pakistan, its high prestige status means that the strongest local brands are seeking a presence here. Heard of Q-Mobile, for example? Pakistan's own smartphone brand is currently crushing the foreign competition and it's rumoured that the company is approaching a 10-digit dollar turnover. We visited a small dealership that claimed to have sold mobile phones worth USD 20,000 during the past fifteen days. Unfortunately unlisted – so far. We purchased an example of the most recent model (one-third the cost of a new iPhone) and will provide an evaluation at a later date.



Efficient use of space. A typical dealership for Pakistani smartphone brand Q-Mobile.

We concluded our visit to Dolmen Shopping Mall with an hour in the Hyperstar supermarket, resulting in a full bag of groceries with samples to take home. As usual, we studied positioning, packaging, compared prices, looked for new providers, and also glanced at shoppers' carts. We noted that Shezan appears to have strengthened its position in the juice segment. This is pleasing since we own a few percent of the company.

Similarly, another of our portfolio holdings, National Foods, remains strong in spice blends. However, we

Shezan on the shelves

see a number of new competitors. During our discussion with one of the employees we found out that National Foods and its competitor Shan (rumoured to be heading for a listing) continue to account for about 90% of spice blend sales.

Shan and National Foods dominate among spice blends. A bag of masala mix costs around SEK 3. A sensible cost compared to mixing and grinding it yourself.

We also noted that, for ketchup packaging, it seems that pouches (rather like those with a screw cap used for laundry detergent in Sweden) are being given more space on the shelves. Positive for one of our portfolio companies, Packages, which is a dominant manufacturer of these.

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After the visit to the supermarket, we left for the only actual company visit we had scheduled this time, Karachi Electric. This was an important meeting for several reasons. Not only it is one of our individual largest overweights in both Tundra Pakistan and Tundra Frontier, but it's also a company that has in recent years been a model for the industry, both in terms of efficient electricity production and in evaluating new investments in power capacity. Electricity shortages in Pakistan remain the single biggest problem for companies.

We met the management at Sindh Club. A traditional gentlemen's club that was formed in 1871. It has invested great effort in trying to preserve its original appearance, and seems to have succeeded.

Good company – Mattias inside the Sindh Club

Once inside, we were greeted by the entire company management. Everyone from the CEO and CFO to its largest private owner, Abraaj Group. Abraaj Group, which is one of the world's largest private equity investors in emerging and frontier markets, undertook a seemingly impossible task in 2008 when it became the owner of Karachi Electric. The company has about 2,345MW of its own power capacity and also controls the power grid and consumer distribution in the Karachi area. Of Karachi's 20 million inhabitants, there are 2 million electricity connections, and the company estimates that a further 400,000 use the electricity "for free" (theft). Electricity losses have, however, been reversed with hard work. When Abraaj took over management of the company in 2008, about 36% of all electricity produced disappeared. For 2014, this figure is down to 25%, and the losses continue to decrease by about 2% annually. The company has now reached a level of efficiency where further reductions in losses make an impact on the income statement. The company expects to bring down these losses to 15% in Karachi (sustainable levels internationally are 9-11%). This implies good prospects for strong profit growth. We expect the company's earnings growth to be 50-60% annually over the next three years. This puts the current seemingly high valuation of P/E 16x in a different perspective.

What every company meeting should look like. CFO, owner and CEO present.

After lunch, we headed to the company's largest power generation facility, about 30km outside Karachi, where the next step was explained to us. The first 6 years of work have been about normalising the original business. This has been achieved through the simple method of installing metering equipment and incentivising small areas of population to discourage theft (reporting systems and discounts). The next phase is about expansion. In the next three years, the company's own power generation will increase by about 60%. This power will be sold to new customers where there is full control over who receives the electricity. For example, a newly built "textile city" is being planned, a zone with certain tax exemptions that Karachi Electric is currently in discussions with. This means that losses on this portion of the business are likely to be close to the levels we see internationally. At the core we have a traditional Tundra case, i.e. a very simple product (electricity) that can be sold in larger quantities and to more people as their conditions improve. Once there we received a long presentation, followed by a thorough site visit. We are happy shareholders after our meeting and the site visit.

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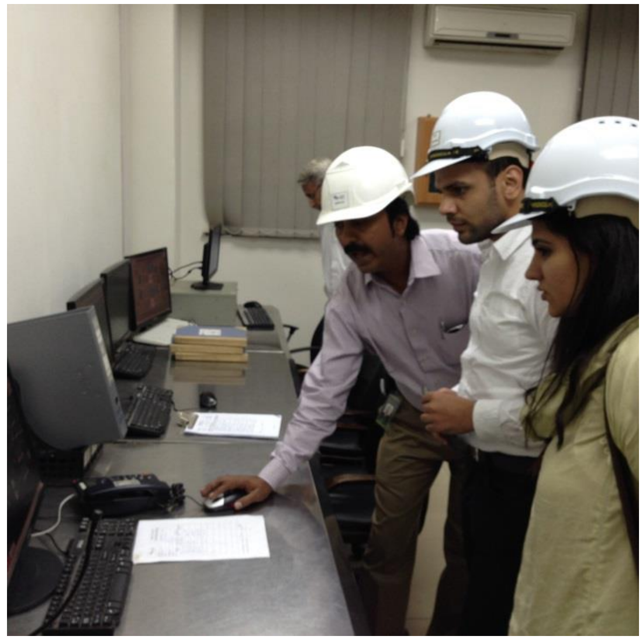
Electricity production for Karachi, a city of 20 million. Shamoon and Rashmina inspect. In the background a power plant with capacity of about 600 MW.

Tundra digs a little deeper in its research. Shamoon inside one of the turbines.



Shamoon and Rashmina in the control room at Karachi Electric

Flying from Karachi can be something of a lottery. Somewhat rushed from the meeting with Karachi Electric we hastened through pretty dense traffic to the airport. We were forced to take a shortcut through one of the more notorious areas of Karachi. In some situations it no longer feels unnecessary to have a Pashtun warrior with an AK-47 in the front seat. But it's fine in the end, and once we arrived at the airport this Monday night it was completely empty. We are suddenly so early that I'm able to write these very words from the departure hall at Jinnah International Airport. On towards Dhaka.