The Boom In Frontier Markets Is Starting To Crack

CAROLYN COHN, REUTERS NOV. 6, 2013

LONDON (Reuters) - Three years ago, a trip to the Southern Kenya production facilities of Canadian company Africa Oil attracted only seven potential investors. Two months ago, 60 boarded the flight.

The investor trip, described by sales staff at Citi following a recent client conference, is just one illustration of the swelling interest in the most esoteric frontier markets.

In a world of low yields and paltry growth, the attraction of frontier markets - the lesser developed emerging markets in Africa, Asia, Europe, the Middle East and Latin America - is pretty clear. Juicy returns, often huge natural resources and young populations provide a stark contrast to the ageing economic profile in the West.

"Everyone and his dog seems to know something about (frontier markets) now," Citi wrote.

And yet, like many small, illiquid and often opaque markets, there's a problem. The surge in interest may already be in the price.

Frontier market stocks have outridden a slump in broader emerging markets this year, with help from long-term investors. Stars include Nigeria's Dangote Cement, up 48 percent, and Dubai's Emaar Properties, up 61 percent.

But these countries' restrictively tiny markets and increasingly pricey stocks are starting to dent their appeal.

"My best-performing stock this year has been a Nigerian cement company. Is that likely to be the case next year? I doubt it," Richard Titherington, CIO of emerging equities at JP Morgan Asset Management, told a recent media briefing.

"You need to be careful about being too optimistic about frontier markets," he added, saying he preferred emerging market companies which paid strong dividends, for example.

One critical warning signal has been the crossover in valuations between frontier and emerging markets.

Frontier companies are traditionally seen as cheap because of the perception of the high risks involved in buying them.

But frontier market valuations have become more expensive than emerging markets, at around 13 times earnings, for the first time in nearly two years. (For GRAPHIC, see http://link.reuters.com/maq93v)

Some stock markets may be close to the top of their game, with Dubai and Kenya near five-year highs.

HSBC emerging equity analyst John Lomax last week downgraded Kenya to neutral. "The market has already run up aggressively and...valuations are beginning to look somewhat expensive," he wrote in a client note.

Individual valuations in some cases look alarming.

Nestle Nigeria has a price/earnings ratio of 40 times, and its 12-month forward PE ratio is at 33, well above its peers, according to Reuters Eikon data.

Another concern is that these markets' small size will struggle to attract new money, with investors finding it difficult to enter the markets without influencing prices.

Templeton Emerging Markets Group, which has $3 billion under management in its frontiers strategy, closed its frontiers fund to new investors earlier this year.

Templeton's role is huge in an asset class where many funds total $100 million or less.

The market capitalisation of the closely-watched MSCI frontiers index is only $130 billion, compared with $3.8 trillion for the emerging markets index, or more than $15 trillion for the S&P 500.

"Frontier markets have had a good run, they have outperformed, but at the end of the day it's a considerably smaller universe than emerging markets," said Maria Gratsova, emerging equities strategist at Citi.

GOOD AND BAD

The MSCI emerging stock index is in the red for the year on weak earnings growth and fears about a reduction in risk-supporting U.S. monetary stimulus. The MSCI frontiers index, in contrast, has climbed 20 percent, in line with moves in developed stocks.

But the frontiers rally masks wide disparities, in market size and performance, with some countries posting losses.

Bulgaria and the UAE are top-performing markets, and off-index plays Saudi Arabia and Iraq have also soared.

But Lebanon and Jordan - down 0.5 and 0.1 percent respectively, and weaker in dollar terms - have suffered from their proximity to Syria. Away from the index, Mongolia has dropped nearly 20 percent, with investors deterred earlier this year by restrictive foreign investment laws.

The MSCI index of 26 countries contains a mix of markets.

Kuwait has a 23 percent weighting, while energy-producing markets United Arab Emirates and Qatar together make up 30 percent. The bias towards these markets makes benchmarking to the index more difficult, potentially adding investment risk.

"We are never going to have a 50-60 percent weighting in countries in the Gulf region," said Andrew Brudenell, frontier fund manager at HSBC Asset Management, which uses a customized MSCI index to match its investment strategy more closely.

Other indices, such as those compiled by S&P and FTSE, contain different markets or have a wider range of countries.

But the larger number of countries can also lead to smaller size and liquidity in each, analysts say, and the indices all use similar market capitalisation criteria which give heavy weighting to only a few markets.

Frontier investors say, however, that despite the difficulties of investing, their markets are enjoying a well-deserved catch-up after lagging emerging markets in 2009 and 2010, and they are confident of longer-term gains.

Veteran investor Mark Mobius, Templeton Emerging Markets executive chairman, has large holdings in Nigeria and says Africa, for example, holds out a lot of investment hope.

"The number of people who have bank accounts is very, very tiny, the growth prospects are very, very good - the future is Africa."

(Additional reporting by Joel Dimmock; Editing by Peter Graff)