

Kyklos Capital

Outlook: Mummy Returns

***"To blame the existence of al Qaeda on poverty like Egypt's is a slur on the poor."* P. J. O'Rourke**

Egypt features prominently at the bottom end of Kyklos's September list of performers. The fund began investing in Egypt about one year ago, and added to holdings after visiting it last February. Both of the companies owned by the fund, Egytrans and Eipico, are highly profitable, with no debt and strong franchises benefiting from high barriers to entry, and in our opinion, strong long-term growth prospects in logistics and pharmaceuticals, respectively. Our analysis showed both companies to be significantly undervalued versus similar global Emerging- and Frontier-market companies, and we identified several potential developments that are likely to lead the market to re-value them higher. Most of our profit up to August came from an appreciation in the Egyptian pound, however, and the investment case for Egypt remains strong. Our proprietary macro country scoring model continues to rank Egypt as a top five Frontier economy.

Risk analysis, however, highlights the clear potential for political disruption which knocked Egypt's market in late September. Government policy under President Sisi focuses-- appropriately-- on long-term economic growth led by private sector initiatives and foreign investment, after years of austerity and currency controls during a successfully-completed IMF program. GDP growth is now over +5%, and inflation has been cut in half. Benefits of that are slow to materialize for Egypt's poor and vulnerable, however, who are now 60% of the population according to the World Bank. Egypt's young and growing population-- the source of its future productivity and consumption growth and a big part of the bullish sentiment toward its market-- may also demonstrate in the streets. We held our positions. With no major elections looming and political opposition limited, the regime is likely to manage through this crisis.

Also in September, we added to an existing position in a Pakistan-listed software company, Netsol Technologies. We originally bought a position in the company earlier this year. Like most Kyklos names, Netsol generates high returns on capital and operating margins, has low debt levels, and was significantly undervalued versus comparable global companies. They sell software to manage large-company automotive fleets for customers such as Daimler and Ford. Their customer base is faced with very fast depreciation of relatively high-valued assets, which makes for a compelling sales proposition, and the company claims a 100% win rate in the

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competition for orders in its core Asia-Pacific marketplace. While Pakistan does not score highly in our macro model, it functions mainly as Netsol's production platform, where they can hire software engineers at a fraction of Silicon Valley rates, and their business is not especially sensitive to domestic demand. This model gives Netsol a revenue base largely linked to US dollars, while its costs are in the recently depreciating Pakistan rupee, leading to FX gains and expanding operating margins.

All that said, we were "early" in our trade, meaning wrong, because the share price subsequently dropped. Before buying, Kyklos sets a level below the market price designed to trigger a fresh look at the investment case if the stock gets there—a soft "stop" price, which Netsol eventually hit. Now significantly cheaper, after an exaggerated underperformance versus its separately-listed US parent, and with strong growth potential still ahead in our opinion, we have added to our stake, betting that a successful global tech company won't trade at Pakistan's discounted stock valuations forever.

Charlie Gushee
October 2, 2019

Interesting September Reading

Just a cost of doing business, but an awfully expensive one: Alfonso Quiroz figures government corruption in Peru cost 40% of government spending and 3-4% of gdp-- every year for 180 years. Old one worth another look: <https://www.amazon.com/Corrupt-Circles-History-Unbound-Woodrow/dp/0801891280>

4% of stocks produced all US stock market wealth created since 1926: <https://www.universal-investment.com/media/document/Do%20Stocks%20outperform%20Treasury%20Bills>

So, Baillie Gifford preaches compounding, small-cap effect in active Europe management: https://www.savvyinvestor.net/sites/default/files/node/paper/file/baillie_gifford_-_the_hunt_for_europes_tenbaggers_-_q2_2019.pdf

NIGERIA/ theft of crude oil +77% in the first half: https://www.spglobal.com/platts/en/market-insights/latest-news/oil/083019-nigeria-says-crude-theft-growing-menace-after-120000-b-d-h1-loss?mod=djem_frontiers

One investor's Africa ideas: https://www.howwemadeitinafrica.com/where-to-invest-in-africa-ranking-the-top-10-countries/63720/?mod=djem_Frontiers

The Mekong delta, one of the many Frontier regions threatened by global warming: https://www.aljazeera.com/news/2019/09/cambodia-lifeline-threatened-mekong-recedes-historic-190920072518567.html?mod=djem_Frontiers

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