

The Last Frontier Market – The Investment Case for North Korea

By Lars Henriksson, Advisory Partner - Southeast Asia & Frontier Asian Economies



Regardless of the outcome of the ongoing historic summit between US President Donald Trump and North Korean Leader Kim Jong-Un, the die is cast. While a comprehensive peace deal may yet prove elusive at Sentosa Island in Singapore this week, the unstoppable historical forces impelling North Korea, the last global frontier market to finally ‘open up’ to foreign investors is irreversible. North Korea, with its unique combination of low cost technologically skilled labor, highly qualified pool of scientists, low taxes scheme for high-tech factories, for the first two years, an absence of corrupt intermediary agents (since all business contracts are made directly with state-owned companies), and hermitic political stability, may yet prove a lucrative destination for ambitious multinational corporations seeking new consumer markets and cheap manufacturing hubs.

After the much anticipated summit, while the attention of the world turns to the finer points of a nuclear détente between the two nations, frontier markets investors will begin a long process of understanding the economic potentialities of North Korea and the opportunities for investors. While many observers have likened the process underway in North Korea to the post-Soviet unification process of East and West Germany, it is likely that the 1991-1993 Vietnam model may be more appropriate for North Korea’s debut. In 1991, President George G.H. Bush offered Vietnam a roadmap for normalizing relations. It set out concrete steps necessary for Hanoi to undertake, such as sharing POW/MIA records and allowing US investigators to pursue reports of live US prisoners, excavate war time aircraft crash sites and improve human rights. In 1993 Bill Clinton allowed Vietnam access to IMF and World Bank programs, and lifted the US trade embargo in 1994 and restored full diplomatic relations in 1995. Vietnam has since rocketed to the top echelons of the global frontier market tables attracting hundreds of billions of FDI since 1994. North Korea may follow a similar pathway.

With a GDP/per capita of about 1/40th of South Korea's – Korean unification may take more much longer to achieve. North Korea's dilapidated infrastructure, weak energy system and inefficient agricultural sector with only 20% of land suitable for cultivation however will present South Korean firms willing to venture north enormous opportunities.

Trying to invest in North Korea at this early stage will not be easy – but not impossible.

Equity pathway

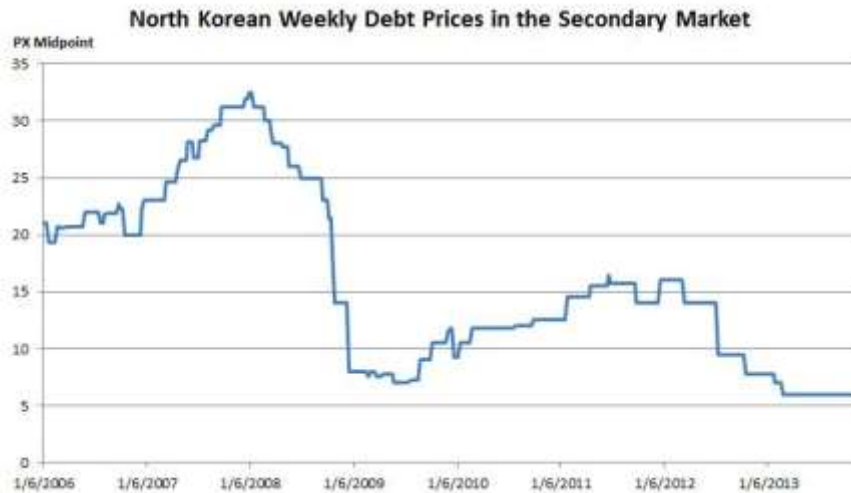
One approach will be to invest in listed Korean and Chinese companies who may be in line to win new lucrative contracts in a New North Korea. Major listed South Korean engineering & construction firms such as (such as **Hyundai Engineering & Construction Co**), cement makers (**Ssangyong Cement Industrial Co, Hanil Cement Co**), railroad makers (**Hyundai Rotem Company Ltd**) clearing mines (**Firstec Co, Welcron**), fertilizer makers (**Namhae Chemical Corp, Hanil Cement Co**) and lift manufacturer (**Hyundai Elevator Co.**) may be one route. Others may include major Chinese engineering & construction companies such as **China Railway Group, China Railway Construction Corporation** and **China Communications Construction**.

Another route could be through **Orascom Telecom Media and Technology (OTMT) Holding S.A** listed in Egypt (also listed in London). With an estimated investment value of some \$1bn, 'Koryolink' is a joint venture (75:25) between OTMT and Korea Post & Telecoms Corporation (KPTC, a state-owned company). Koryolink is North Korea's only 3G mobile operator, and its network covered more than 75% of North Korea's population It is estimated to have about 3m subscribers. After new UN sanctions were imposed in 2015, OTMT was obliged to mothball Koryolink and 'deconsolidate' it from a subsidiary. When UN sanctions are eased, profits repatriated and control taken back of Koryolink, OTMT's sum-of-the-parts value could be boosted by more multiple of probably more than 50% based on calculations by Egyptian-based research houses.

Recently a number of stocks listed on the Korea Stock Exchange (KOSPI) seen as key beneficiaries if Pyongyang inks a deal with Washington have risen by 40%. In the 1990s following German unification the German stock market (DAX) rose more than 300% over the next 10 years following the reunification (presumably this is what investors are hoping for in Seoul).

Bonds

Another route is through North Korean bonds, or the syndicated debt that was repackaged by the French bank BNP in 1997 in a special vehicle called 'NK Debt Corporation' as the country failed to repay sovereign loans from 1970s with an estimated value exceeding \$3bn (such as 1,000 Volvo 144 cars supplied by Sweden in 1974). The trading of these bonds was stopped in 2013 due UN sanctions when they were trading at about 6 cent to the dollar. This is set to likely see a dramatic rise with the end of sanctions.



There is a bullish precedent when East and West Germany were united in 1990 where the richer West paid off East Germany's debt. Before any resumption of trading, there are a number of international institutional bond investors who carry them in their portfolios. For example **Franklin Emerging Market Debt Opportunities Fund**, **which** owns a chunk of North Korean bonds at nil value (per annual report July 2017):

Franklin Emerging Market Debt Opportunities Fund (continued)

	Country/ Organization	Principal Amount*		Value
¹ NK Debt Corp., 144A, zero cpn., 3/12/20	North Korea	4,250,000	DEM	—
Reg S, zero cpn., 3/12/20	North Korea	2,000,000	CHF	—
Reg S, zero cpn., 3/12/20	North Korea	18,000,000	DEM	—

However unlike with the Germany's, South Korea may not be currently able to singlehandedly foot the bill for Korean unification. Starting in October 1990, West Germany transferred 4-5% of its GDP in equalization payment representing 50% of East Germany's GDP. This heavy economic burden of unification was affected by the decision to combine the currencies of both counties at a 1:1 ratio due to political rather than economic considerations. Unifying Korea's bifurcated monetary system, possibly under a U.S. dollar or RMB currency board may help stabilize North Korea's macro economy. The current system, with domestic and foreign currencies used side by-side for domestic transactions, entails great vulnerability should the North Korean won begin to slip in value. Much like what has happened in Zimbabwe, the North Korean won may simply disappear.

Mining

North Korea is endowed with a wealth of minerals and metals products, including zinc, lead, iron, magnesite (reserves second biggest in the world after China), gold and tungsten (its deposits are almost the world's sixth largest). Two other natural resources stand out.

Anthracite coal, which is used for manufacturing steel as a cheaper substitute for coke, is in abundance. Prior UN sanctions, in 2013 North Korea overtook Vietnam to become the world's biggest exporter of anthracite (mostly to China).

Rare earth metals, which South Korea and some Western mining companies could be worth as much as \$6-10trn, which are being heavily utilized in smartphones, TVs, cars, computers and other advanced technological areas.

Prior the UN sanctions China was a big buyer of these metals presumably due to generous pricing.

World Mine Production and Reserves:

	Mine production ⁶		Reserves ⁷
	2016	2017	
United States	—	—	1,400,000
Australia	15,000	20,000	⁸ 3,400,000
Brazil	2,200	2,000	22,000,000
Canada	—	—	830,000
China	⁹ 105,000	⁹ 105,000	44,000,000
Greenland	—	—	1,500,000
India	1,500	1,500	6,900,000
Malawi	—	—	140,000
Malaysia	300	300	30,000
Russia	2,800	3,000	¹⁰ 18,000,000
South Africa	—	—	860,000
Thailand	1,600	1,600	NA
Vietnam	220	100	22,000,000
World total (rounded)	129,000	130,000	120,000,000

Infrastructure

One of the most urgent issues for a new North Korea will be to upgrade/modernize its infrastructure system. Without that it will be hard to unleash potential in commodities, manufacturing and other sectors. Probably the first thing to get off the ground will be modernizing the railway system, which would allow North Korea link more efficiently with China and South Korea (going from Seoul, South Korea via Pyongyang to Shinuiju, China border).

At the moment, the trains break down often due to heavy loads and the average speed is mere 30 miles per hour. Two options are being aired: upgrading the existing rundown railway system to be on par with its neighbors in South Korea and China or a more sophisticated high-speed line, which is estimated to cost \$35bn.

With a 96% literacy rate, home to three top universities: Pyongyang University of Science and Technology, Kim Il Sung University and Huichon University of Telecommunications and average age of 32.9 (vs. South Korea 40.8) and fertility rate of 1.9 (vs. 1.2 in South Korea, EU 1.7 and 4.1 for most Least developed Countries, North Korea may yet offer the demographic attractiveness that foreign investors seeking new consumer markets may find attractive.

Tourism

Tourism to North Korea could also become a major source of revenue. The lack of broader contacts with the world, scenic views (mountains and islands) and proximity to fastest growing external tourism market (China outbound tourism) which has resulted in huge influx of visitors in South Korea, Thailand and other Asian destinations where tourism accounts for 6%-12% of GDP.

Economic reforms

Despite these enormous opportunities, North Korea has to undertake major economic reforms to attract long term FDI. Reforms such as: Transferring ownership of property from the state to the private sector wherever possible, liquidating real assets to generate funds for public investment while allowing private interests to use this property more productively; Unifying the bifurcated monetary system; Unifying the wage system by bringing state salaries in line with market wages, and paying workers directly with real money, rather than ration coupons that stifle productivity and prevent financial savings; Allowing private farming and the private ownership and transfer of farm assets, allowing the agricultural sector to become more productive and thereby increasing the size of the urban workforce and a US Sponsorship of North Korea into a WTO accession process, as it did with China seventeen years ago. WTO accession would be a win for all sides, given it would require most of the above reforms and would open the world's markets to what would no doubt become highly competitive North Korean industries.

China's economic reform role key

Using the Beijing-based Asian Infrastructure Investment Bank (AIIB) China will likely seek to become a 'first mover' in North Korea after a nuclear deal. With a mandate to "improve social and economic outcomes in Asia and beyond" by "investing in sustainable infrastructure and other productive sectors." The AIIB with its 86 members (and growing: Kenya and Papua New Guinea become new members on 2 May), may see strong Chinese influence and ample financial resources, directed at North Korea with access to multi-billion dollar soft loans for infrastructure projects related to the Chinese "One Belt, One Road." Program. North Korea is located in the fastest growing part of the world, Asia, and surrounded by economies which would be keen on capitalizing on its human resources, commodities and manufacturing potentials. In contrast, East Germany was part of the EU which has seen an average GDP growth of 1.8% from 1996 to 2018.

Vietnam model

President Trump's strategy to normalize economic relations with North Korea could track the Vietnam model. Following the end of Vietnam War in 1975, most Americans felt that Hanoi had failed to tackle US prisoners of war and missing in action (POW/MIA), human rights and religious freedom. Since its founding in 2000, the Vietnamese stock market – the Ho Chi Minh Stock Market – has risen from 100 to 952.2 – making it one of the best stock markets in the world. In fact, Vietnam is now the third biggest country in MSCI Frontier Market Index (USD) with a weighting of 14.7% vs. Argentina 21.9%, Kuwait 16.4%, Morocco 8.2% and Nigeria 7.7%.

Widespread support for unification

In September 2017 the Seoul National University's Institute for Peace and Unification Studies conducted a "Unification Perception Survey" which revealed that 53.4% of South Koreans saw unification as 'necessary', but only 2.3% of them believed it was possible "within 5 years," while 13.6% reckoned it would occur "within 10 years."

Without doubt North Korea will chart its own steps and there will be some surprising twists and turns as the country emerges from more than 70 years of near isolation. However there is no going back now!

Contact: Stephanie@DaMinaAdvisors.Com

Tel: +1 905 273 7555

To schedule in-depth Q&A on North Korea's potential future investment opportunities

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