

Trip Report: Cairo, Egypt

This article is authored by Michael McGaughy of Research Alpha.

In my research and investing I stress three things: people, structure and value. I look for companies that are controlled and managed by quality people, have corporate structures that align minority and majority shareholder interests and trade at valuations that are below fair value if not outright cheap. This post is about a recent trip to Cairo, Egypt and touches on people, structure and value – as well as lots more – in that country.

The purpose of the trip was to generate a short list of quality companies I'd like to own stock in if/when the currency is revalued. Egyptian equities appeared on my value screens back in March, but corporate responsibilities kept me tied to home.

I was also concerned that Egypt's currency was going to be devalued. There was a large and growing gap between the official and black market rate. Russian stocks popped higher soon after their currency was floated in early December 2014, and I wanted to get my ducks in line in case the same thing happened in Egypt.

Readers are advised to note that it was my first time in Egypt as well as my first time in the Middle East. Most of what's not referenced below comes from on-the-ground meetings rather than from verified sources. The people I met were mostly financial and corporate professionals, who are generally more conservative, educated and less willing to rock the boat.

Meet the New Boss. Same as the Old Boss?

One of my first impressions of Cairo was the heavy security presence on the way from the airport to my hotel. There were suited 'undercover' security men standing every 400 meters or so on the access road's median strip and straight through the tony Heliopolis neighborhood. Toward the end of my trip I was politely told not to take pictures at a major intersection near my hotel by a serious, well-dressed man with a walkie-talkie.

Despite having one the world's oldest continuous parliaments, the country has been basically under military control since the 1950s. Nasser, Sadat, Mubarak and now Sisi all come from the military. And this doesn't seem likely to change. Nobody I talked to had anything positive to say about Morsi's and the Muslim Brotherhood's short stay, and there does not seem to be any other decent sized and well organized opposition. I was told that most Egyptians feel that the military provides welcomed stability in volatile region.

While nobody I met had anything good to say about Morsi and the Muslim Brotherhood's brief government, I'm sure this view is not shared by all. Members of Hasm, reportedly a new group aligned with the Muslim Brotherhood, certainly don't feel this way. They recently took time and effort away from more productive activities to bomb and kill six police who were stationed on the road leading to the pyramids (see [here](#)).

Much of the outward appearance of stability could be due to suppression of the press and dissidents. The government is not shy about keeping the press under control by jailing journalists, and some reports note that the present government is more repressive than

previous ones (see [here](#), [here](#) and [here](#)).

Foreign Exchange Nirvana

Virtually all discussions on the economy focused on the currency. Egypt imports a lot and virtually all trade is done in USD (United States Dollars). It's one of the world's largest wheat importers for instance.

Virtually every meeting with corporate executives began with a discussion of the currency – how they are sourcing dollars from the 'parallel' market, how much of the higher costs they can pass onto customers, and how and when the situation will end. All were adamant that the situation was unsustainable and had to change. None thought the change would come so quickly.

It happened when I was there which, for an emerging markets geek like me, made it a super exciting week!! So please forgive me if this section is a bit long-winded.

When I arrived on Sunday USD1 bought EGP8.88 at the official rate (EGP stands for Egyptian Pounds). However, the black market rate was EGP15, up from about EGP12 just a few months ago. This means that people who exchanged their USD to EGP on the black market could buy twice as much as if they exchanged their currency at the official rate.

It also means that companies that import raw materials, equipment and finished products needed twice as many EGP to buy the same thing when using the black market rate. Few non-government companies could get enough USD at the official exchange rate so they relied on the parallel market.

By Tuesday – just two days after I arrived – the black market rate shot up 20% to EGP18, before falling by 33% to EGP12 the next day (Wednesday). The dramatic one day fall foreshadowed the next day's news that the currency was going to be set free (Thursday). It fell to EGP15 by the time I left (Saturday). It has declined further and, as this is being written, is trading a little over EGP18.



*Second cheapest Big N' Tasty meal in the world?
USD3.20, Cairo, 5 November 2016*

To put this in perspective, my daily breakfast at the Hilton cost EGP205. At the old official rate of EGP8.88 to one USD, my breakfast cost USD23.08. By the time I left it cost USD13.53, and at the current rate it cost USD11.39, or 50% less than it did at the old exchange rate. Not as cheap as I'd like, but certainly not as expensive as before.

After the change, prices in Egypt are not very expensive. In fact, after Ukraine it has the least expensive Big Macs in the world. At the hotel across the road from my hotel it cost EGP26, or about USD1.50 at current exchange rates. (Link to The Economist's Big Mac index is [here](#)).

A quick stop at Carrefour confirmed this. A 1kg bag of pasta cost EGP10 (US\$0.66),

pre-cooked large salami pizza EGP22 (USD1.46), and a French baguette, EGP5.75 (US\$0.38). This was a month ago and right after the devaluation, and with inflation expected at 25-40% next year, it's unlikely they'll stay so cheap.

Stocks on Sale Too

Another way to look at this is that all the stocks were at a 50% sale for USD investors on Thursday as compared to Wednesday. And who doesn't like a sale?

Investors certainly do and have bought heavily with the headline stock index increasing some 30% in the month since the currency was freed.

For foreign investors there is an additional problem of getting your money out and into the currency you want. It's easy to transfer USD into Egypt, but it may take a while to get it out as government approves all foreign currency outflows. There have been signs of this improving, and with the currency now freely exchangeable, theoretically there should not be any problems. However, governments everywhere are loath to give up power and fiddling with the currency exchange plumbing may be around for a while.

Other potential inflationary reforms have also been implemented. In August Egypt's 150-year old parliament approved a 13% VAT tax, and more recently the government halted many subsidies on food and oil which had been in place for decades.

In addition to freeing its currency, the central bank raised interest by 300 basis points (i.e. 3 percentage points), and Egypt now has some of the world's highest interest rates at over 15%. This was done in a bid to shore up the currency and in an effort to stem inflation.

Long term these reforms should be good for the Egyptian economy, but there's going to be a lot of short term pain.

Going Underground

One saving grace may be Egypt's large underground economy. It's believed to be as large or larger than that tracked by official statistics. Senior bankers note that only about 10% of Egyptians have bank accounts, which means that for the vast majority, Egypt remains a cash based economy. Except for the minority very few Egyptians had access to the official exchange rate, so one could argue the dramatic fall in Egypt's currency had already been absorbed by the majority of the population. The new rate reflects what most Egyptians are already dealing with.

Meeting with consumer goods companies seemed to confirm this. They have been steadily raising prices to cover USD purchases of raw materials like sugar and wheat. Several noted



*Carrefour's Inexpensive Pasta
Cairo, 5 November 2016*

that there was little decrease in demand despite higher prices. Perhaps the economy is more resilient than the official figures suggest. Hope springs eternal.

Crowded House

One big problem could be crowding out by Egypt's state and military owned companies. Egypt's largest fertilizer producers, telecommunications company, and its tobacco monopoly are government owned.

I've not come across any credible figures but it's speculated that the military and the companies they control account for 5-40% of the economy and that they crowd out private enterprise (see [here](#)).

This is not unusual in developing countries. China's PLA and Indonesia's ABRI were also heavily involved in business not that long ago. Troops need to be paid and if the government doesn't have the budget, smart generals do what smart people all over the world do - make do.

An example of this is the military backed cement plant that's being built by a subsidiary of China government owned Sinoma (see [here](#)). According to meetings with cement company executives, Egypt's cement supply is already in surplus and a new plant that doubles capacity is not needed. Governments and state-owned-companies are typically bad at allocating capital and I doubt that two together will be any better.

In addition to curtailing the government and military's business ambitions, Egypt can do a lot more to level the playing field for entrepreneurs and business people. It's ranked 122 out of 190 countries in the World Bank's "2016 Doing Business Report", which looks at the factors that impede or assist in business formation, construction permits, etc. Big macro reforms like those written about above make the headlines, but making it easier to do business by cutting down on the time and costs of starting and running a business is just as much if not more important.

The Only Thing to Fear is Fear Itself

Egypt's reputation is not very good these days. Before my trip literally everybody said I should be very careful there. Between the bombing of a Russian plane last October, continued problems in the Sinai, and fighting in nearby Syria, Iraq and Yemen one will naturally feel nervous. The recent bombings near the pyramids and a Coptic church certainly won't help (see [here](#)).



Selfie With the Locals, Giza Pyramids, 4 November 2016

Tourism is way down and I was told it's not just the Russians and Europeans who are staying away. Regional visitors have curtailed trips for the same reasons. According to the locals, Cairo was a fun destination where Arabs from stricter countries used to go to let their hair down. Alcohol is available, there are no dress restrictions, and the Internet is free and open from what I can tell.

So my guard was up when walking around Cairo and visiting the pyramids. But I encountered no problems besides the usual pesky salesmen. The only people who approached me were overly friendly teenagers wanting to practice English and take selfies with a foreigner. This reminded me of traveling in China some 30-years ago when foreigners were a rare sight and nervous kids yelled a friendly hello to the passing 'laowai'.

My fears seem to have been misplaced. Egypt was recently taken off the US State Department's travel warning list. According to their ranking, traveling in Egypt is safer than anywhere in Europe, if recent reports are accurate (see [here](#)).

Investing

For US investors Egyptian stocks are not very expensive. Measured in USD, its headline index, the EGX30, is bumping along close to the 10-year low levels it reached in 2009 and 2011. However, when measured in EGP the index is at a 10-year high.

Egypt reminds me a lot of Indonesia, a country I've written about before (see [here](#), [here](#), [here](#), and [here](#)). Like Indonesia its demographics are very young with about 30% of its population below 14. Both are the most populous countries in their respective regions. Egypt is the largest in the Middle East and third-most populous in Africa.

Both are overwhelmingly Muslim - about 90% in Egypt. Both are moderate Islamic countries. An example of this is its current domination of women's squash where all three top spots are held by Egyptians (see [here](#)).

While parts of society seem modern, one is also reminded that Egypt has one of the world's highest rates of FGM - female genital mutilation. Despite laws against it, many websites report that it's still widely practiced (see [here](#)).

While Egyptian stocks are now close to the cheapest they've ever been for USD investors, it does not feel like the fat pitch of Indonesia in Sep 1998. This is when the Indonesian index reached its lowest point ever in USD terms. It fell a stunning 93% from July 1997 when the Thai Baht and Indonesian Rupiah collapsed. The low point coincided with widespread riots in Jakarta and other cities, and the stepping-down of then long-term president and military strong man Suharto. One should note here that there were 14 months between the initial

currency fall and when the market and currency hit bottom. It's only been one month since Egypt changed its exchange rate, and instead of the market falling, it's increased. With more inflation to come to an already frustrated and increasingly poor population, political and societal uncertainty are still high and may not be fully reflected in the market.

A big difference is that Indonesia's depreciation was unplanned. All the business people I met in Cairo were anxiously waiting for the currency change so they could get back to business instead of spending time skirting the law in a search for USD.

The change can also help Egypt to become more competitive. I was impressed with the managers I met at one of the world's largest carpet manufacturers, and the lower and free currency means that they can compete very favorably with their biggest competitors in Turkey.

Wrapping Up

I was impressed by the people I met in Cairo as well as the numerous Egyptians I met during a short stay in Dubai. The country has a lot of educated and switched-on people. It should be to Egypt's benefit if their government and military is there to support rather than compete with them.

I don't envy the changes, struggles and hardships that my Egyptian brothers and sisters will likely go through in the next few years. Saying that short term pain leads to long term gain rings hollow when parents have to tell their children they can't afford meat, or to attend the university they expected to go to, or even delaying marriage because there's not enough money.

But as we've seen before, economic reforms can and do work. Indonesia's per capita income fell from USD1,100 to US\$560 between 1997 and 2000, and its poverty rate increased from 17% to 23% over roughly the same time according to the World Bank. Now at USD3,440, Indonesia's per capita income is more than 5 times higher and its poverty rate at 11% has never been lower (see [here](#)).

Postscript: For a very good discussion of the recent currency change, other reforms, and Egypt's economic and political structure, readers are encouraged to watch/listen to the very good Al Jazeera episode, "Can Egypt's currency devaluation boost its economy" (see [here](#)).