Spring Time in Uzbekistan?

Political Risk for Frontier Investors amidst Reform in Uzbekistan

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EXECUTIVE SUMMARY

Uzbekistan is emerging as an attractive investment opportunity for frontier investors. Following the fall of the Soviet Union, the country spent years in a low-equilibrium state of autarkic control. During this phase of Uzbekistan's history, Islam Karimov, the country's strongman ruler, strove to maintain the country's stability and sovereignty, while allowing only gradual reform to take place. Karimov's death in 2016 represented a crucial juncture in the country's history, as the reform oriented Prime Minister, Shavkat Mirziyoyev, took over control and transitioned the country from a period of slow, evolutionary change to rapid, revolutionary transformation. The hallmarks of Uzbekistan's reforms thus far have been exchange rate liberalization, reductions to bureaucratic and regulatory excess, partnerships with multilateral development banks, rapprochement with neighbors, and abolition of capital controls.

While presenting substantial opportunity, Uzbekistan also carries substantial political risk for frontier investors. Chief amongst these are country, regulatory, and financial risk. The overarching concern within country and regulatory risk is that concentration of power within the executive's hands fosters the ability for capricious policy changes. While reforms have thus far been positive, the lack of institutional checks on power means reforms could be rolled back. Meanwhile, liquidity risk is the key financial risk in Uzbekistan. With diminutive capital markets and limited numbers of market participants, investors will face high bid-ask spreads and substantial transaction clearing times, particularly if seeking to unload positions under duress.

Ultimately, while Uzbekistan carries substantial risk for frontier investors, the country's favorable demographics, cheap labor supply, high growth rate, rapid liberalization, and generationally low firm valuations make the country appealing to risk-tolerant frontier investors.

INTRODUCTION

This report focuses on political risk in Uzbekistan as faced by frontier investors interested in engaging in the liberalizing country. 'Political risk' is defined and used in this report as the "possibility that political decisions, events, or conditions in a country, including those that might be referred to as social, will affect the business environment such that investors will lose money or have a reduced profit margin."[1] Specifically, then, this report will focus on how political decisions and related developments may materially impact the prospects for frontier investors in Uzbekistan. This conception of political risk is purposefully broad and includes eight subcategories of risk, including country, macroeconomic, systemic, geopolitical, and several other risks.

The intention with this political risk report on frontier investing in Uzbekistan is to provide a holistic assessment of Uzbekistan and the relevant factors contributing to political risk therein. This necessarily involves understanding the country itself holistically: its history, its sociocultural characteristics, its political process (locally, regionally, and nationally), its economic situation, and its geopolitical situation. The report will proceed by introducing these variables via a succinct overview of Uzbekistan's historical development. This historical analysis is crucial as it allows us to understand and contextualize the political risks present in Uzbekistan today, for the present moment does not exist in a vacuum.

The historical analysis will then lead into a deeper analysis of the salient post-Soviet economic and political institutions and reforms, and ultimately how these developments have recently gone from evolutionary changes to revolutionary transformation. From there this report will elucidate the fundamental changes underway in Uzbekistan today and why frontier investor interest in Uzbekistan has been piqued. The report will then transition into the political risk framework by first comparing and contrasting elements of this report's political risk model with other existing models and ultimately excavating the crucial political risk variables, analyzing both upside and downside risks, facing frontier investors in Uzbekistan. The report will then explain why, nonetheless, Uzbekistan carries substantial upside for frontier investors.

Uzbekistan: Why?

'Welcome to Uzbekistan' is a phrase not many people hear. Yet over the last year Western investors by the bus load have disembarked to precisely those words.[2] Why are they there?

Figure 1 Uzbekistan

Uzbekistan is a landlocked country located in Central Asia, the only Central Asian country that borders all four of its Central Asian neighbors. Uzbekistan is perhaps best known in the West thanks to former Presidential Candidate Herman Cain's reference to the country during a discussion of his foreign policy bona-fides wherein he referred to it as 'Ubeki-beki-beki-beki-stan-stan.'[3]

In the present moment, though, Uzbekistan has been receiving attention for something much more substantial: its rapid economic and governmental liberalization. Following the death of Uzbekistan's post-Soviet leader, Islam Karimov, in 2016 many people were surprised to see 'revolutionary' changes undertaken in reforming and opening up the once autarkic country. The hallmarks of this change include exchange rate liberalization, diminishing regulation and streamlining of bureaucratic processes, rapid opening of the country to foreign investment and international trade, renewing of relations with the multilateral development banks (EBRD, IMF, WorldBank, IFC, etc.), and a rapprochement of relations with the other Central Asia and neighboring countries. As a result of the truly drastic changes, Western journalists (both the Financial Times and Economist have travelled there to report) and investors have given the country an unprecedented amount of coverage and attention. Indeed, the very first dedicated Uzbekistan equity fund, Asia Frontier Capital's Uzbekistan Fund, was launched on March 29th of 2019. Encapsulating the general enthusiasm surrounding Uzbekistan's reforms, the Fund proclaims that firms in Uzbekistan currently offer "generationally attractive valuations."[4] Whereas Uzbekistan was previously considered a backwater not worthy of attention, many people in the West are now looking at Uzbekistan and seeing green.

Uzbekistan: The Foundational History

Despite its name, Central Asia is not often central to many political risk analyses. But the Central Asia region has, historically, been a place of grand strategic importance. This section will introduce three crucial historical moments relevant to Central Asia that have significantly impacted the country's present circumstances.

We begin in the year 753 AD. Competition for influence in the Central Asian region has been heating up. In this year, a decisive battle is waged between two civilizations amassing strength in the region and desirous of geopolitical expansion: the Arab Abbasid Caliphate and the Chinese Tang Dynasty. The battle's result: the decisive defeat of the Chinese at the hands of the Arabs. The defeat was consequential, as it represented what would come to be a serious curtailing of Chinese political and cultural influence in the region that would last up to the present day. While, importantly, heralding an era of Islamization of the region that would carry on in earnest for the next 500 years. The impact of this battle and the ensuing Muslim reign is still felt today, as over

80% of Central Asia's 70 million people still identify as Muslim (a form of Islam known as Halafi, which is considered moderate and non-aligned, i.e. neither Sunni nor Shia).

The next year of focus is 1369. This was the year that the voracious and brutal steppe warrior Timurlane conquered most of Central Asia, deposing and consolidating the former Mongol khanates that had amalgamated power in the region. Under his brutal reign there was an oxymoronic flourishing of cultural development, as the nomadic civilizations of the steppe and the settled civilization of Persia began to merge, which established and cultivated crucial foundations upon which modern cultural identities in Uzbekistan (and the region) rest. Indeed, the architectural aesthetic in Uzbekistan's famous silk-road cities such as Bukhara and Samarkand are characterized by this beautiful intermixing with Persian design. Take, for example, Timurlane's tomb, Gar-e-Amir, in Samarkand (pictured).

Figure 2 Timurlane's tomb in Samarkand, Uzbekistan

More importantly, though, following Timurlane's death, many separate Khanates sprung up following the collapse of the Timurid Empire in the 15th century. This facilitated the emergence of a complex patchwork of ethnic and kin-based identities, called 'clans' that still characterize much of Uzbek and Central Asian social and political life. Clans can be defined as "an informal identity network based on kinship ties that … are stronger than formally institutionalized ethnonational and religious identities."[5] In Uzbekistan, wherein there have historically been three dominant clans vying for power (Samarkand Clan, Tashkent Clan, and Ferghana Valley Clan)[6], this has been a consistently important political phenomena.

The last historical moment(s) occurs across three separate years: 1865, 1918, and 1991. I suspect most readers will recognize the last two years as the rise and fall of the Soviet Union. But the year 1865 is less well known. This year encapsulated the decisive moment in the infamous ‘Great Game’ competition for influence in Central Asia between Russia and Britain, wherein Russia officially conquered Tashkent (critical logistic city, now Uzbekistan’s capital) and decisively established its hegemony in the region. This set the stage for the series of events that would unfold thereafter, with the rise of the Soviet Union and its concomitant political and economic model that would be extended into Uzbekistan. It was this Soviet model that would have the greatest ramifications for modern Uzbekistan and the political risk landscape in the country today, as the hierarchical and corrupt Leninist bureaucracies, command economies, overbearing state owned firms, and autocratic leadership still persist to a large and troubling degree in the country.

Thus three undergirding factors relevant to political risk in Uzbekistan today are addressed here: a population that identifies far more with its religious and ethnic / clan based identities than national identity, the internecine struggles along these lines that have and still do take place within and between countries in Central Asia, and most significantly, the capricious rule of powerful autocrats and the remnants of a failed soviet command economy kept afloat largely due to resource wealth.

Uzbekistan: Post-Soviet Economic and Political Realities

As pointed out in the previous section, the most important thing to contextualizing present day Uzbekistan is understanding the inheritance it received from the USSR. The period from 1990 to 2016 is a crucial period in Uzbekistan, and is frequently forgotten by contemporary analysis. Focusing on this period helps delineate precisely where reforms today are a mere evolution of

Uzbek governmental policy and where things are indeed revolutionary. Many analysts whose reporting is otherwise of utility often miss key nuances due to their lack of understanding of both the Soviet inheritance and the emergent Uzbek political system that developed under Islam Karimov when he rose to power in 1989.

Islam Karimov, the durable post-independence leader of Uzbekistan, set the country on a course that led it to cloister itself from the outside world, become largely autarkic and self-sufficient, stay relatively non-aligned (similar to post-independence USA and India), while engaging in a very slow, but deliberative, process of reform. However, given Uzbekistan's reliance on resource wealth, it also became necessary to employ what scholars have called a 'multi-vector' foreign policy strategy, wherein Karimov attempted to cement his own reign, as well as the sovereignty, stability, and independence of his nascent country, by strategically playing competing super powers such as Russia, the US, the European Union, and China (interested in Uzbekistan for its gold, cotton, copper, oil, and gas) against each other.[7]

One must adopt the mindset of a leader of a country that has been historically dominated by powerful players in its regional backyard. With the shockingly sudden demise of the USSR, countries like Uzbekistan that had been ensconced in Moscow's top down political model now experienced independence. But Uzbekistan's existence as an independent state was immediately threatened not just by a potential Russian resurgence, but also by internecine conflict within and across its borders. The clan and khanate based identity systems that were, and are, so prominent across Central Asia made Uzbekistan's freedom from Soviet Rule perilous. Following the dissolution, the previously interconnected Soviet Republics now engaged in a scramble to claim resources and demarcate their territories, as prior borders had been established by Soviet planners largely without concern for ethnic and clan divisions. These divisions threatened to up-end countries, de-stabilize regimes, and lead countries into territorial conflagrations. Meanwhile the intensity of connections with Russia (millions of ethnic Uzbeks were in Russia, Russian was the dominant language, all transit lines ran through Russia, and all exports went through Russia) threatened to re-inter Uzbekistan as a satellite of Moscow.

It was in this context, then, that Karimov and Uzbekistan disregarded Western advice (from the IMF and WorldBank specifically) to engage in what was known as 'shock therapy,' or the rapid privatization and liberalization of their economic and political systems. The key point to understand about Karimov's regime was its concern for maintaining Uzbekistan's sovereignty and stability following the rapid demise of the Soviet Union. In contrast to Tashkent's (Uzbekistan's capital) previous position as the administrative center of Soviet Central Asia, after the USSR's demise the regime turned the country into an autarky. Employing import-substitution based development, closing off its borders with neighboring Tajikistan, Kyrgyzstan, Kazakhstan, and Turkmenistan to limit interethnic mixing, and retarding almost all trade and regional infrastructure building.

Yet at the same time the Karimov regime understood, almost paradoxically, that economic liberalization and reforms were necessary; they just needed to happen slowly. Karimov "consistently emphasized that his approach to economic change was based on gradualism."[8] Indeed, small-scale privatization was implemented shortly after independence along with other pro-growth policies that resulted in Uzbekistan being the first Soviet successor state to regain its pre-1991 real GDP level. However, Karimov doubted that his generation would be able to steward his country to the promised land of true economic liberalization necessary for sustainable growth. Karimov seemed intent to wait for the next generation of Uzbeks, as he informed an American Congressman during a visit to Washington in 2002:

> "These young people return from abroad more like you than like us." "But they are ours," he continued. "They are Uzbeks, and will be able to lead those changes that we consider inevitable and that many abroad are so eagerly awaiting."[9]

Shavkat Mirziyoyev, the prime minister of Uzbekistan under Karimov from 2003 to 2016, was a moderate, reform oriented technocrat who understood how to work the Uzbek political system to get things done. I offer two examples of the sorts of policies he undertook. In 2004 he launched the "Strategy for Improving the Living Standards of the Population" that worked in collaboration with multilaterals (Asia Development, World Bank, and United Nations Development Program) to begin to reform the oppressive, wasteful, and pollutive practices of the Uzbek agricultural sector (particularly cotton) that at the time employed slave labor and practically destroyed the Aral Sea. The second instance of reform under Mirziyoyev involved private capital. Mirizyoyev considered it important to ensure that bank loans to small and medium sized businesses, especially in rural regions that he was well-familiar with, were expanded. Between 2000 and 2015 bank loans to such entrepreneurs increased 118 times, while microcredits expanded 204 times.[10] These reforms required incredible political savvy and will on the part of Mirziyoyev, and demonstrate that under both Karimov and his Prime Minister Mirziyoyev, Uzbekistan was indeed already on a slow and gradual process of reform that was largely under the radar of most investors, and is still under emphasized (or ignored) by most modern analysts.[11]

Revolutionary Reforms: The Piquing of Frontier Investor Interest in Uzbekistan

Yet it is undeniably true that a crucial historical juncture was realized in 2016 with the death of Islam Karimov. Despite much speculation to the contrary, an orderly transition of power occurred, following the steps established in Uzbekistan's constitution, as Mirziyoyev served as the acting President from September to December of 2016 until a special election certified his position officially (although Uzbekistan has nominal elections these are generally not considered free and fair by outside observers)[12]. The result was the rise of Shavkat Mirziyoyev to the position of President of Uzbekistan. While most insiders expected this technocratic reformer to continue with the gradualism characteristic of his predecessor, it is safe to say few expected to see what in fact occurred. The rise of Mirziyoyev is a crucial juncture because it punctuates the end of a slow evolutionary reform period and the beginning of a revolutionary reform period. As Karimov had predicted nearly two decades prior during his trip to America, the inevitable and eagerly awaited changes were now arriving.

The first signal of Mirziyoyev's intent as President came quickly in October of 2016 with a decree titled "On Additional Measure to Ensure the Accelerated Development of Entrepreneurship, the Full Protection of Private Property, and the Qualitative Improvement of the Business Environment." Only a few months later Uzbekistan's National Development Strategy, developed in conjunction with the WorldBank, for 2017-2021 was adopted. It outlined an unprecedentedly ambitious program of market-oriented reforms, focusing on five crucial areas:

> 1) Reforming public administration; 2) Reforming the judiciary, strengthening the rule of law and parliamentary reform; 3) Reforms in economic development and liberalization, focusing on modernization of Uzbek agriculture and industry and oriented towards greater competitiveness of the products and services; 4) Social reforms: higher incomes, better jobs, higher quality health care, education, housing etc. 5) Reforms in the security area, focusing on improvements to ensure domestic stability and balanced and constructive foreign policy with the ultimate goal of strengthening the independence and sovereignty of state.[13]

Commitment to these radical reforms became manifest in September, 2017 when Mirziyoyev directed the Central Bank of Uzbekistan via the decree on "Priority Measures for the Liberalization of Currency Policy" to finally cease controlling the exchange rate of the Uzbek som. This anachronistic practice, combined with foreign exchange controls that limited both buying and selling of the currency, created major hurdles for Uzbekistan's development and was driving away business, creating serious inefficiencies, and stimulating a black market. Following this decision the som was devalued by 50% relative to the dollar. The government committed to maintain the free float of the currency and has thus far stuck to it.

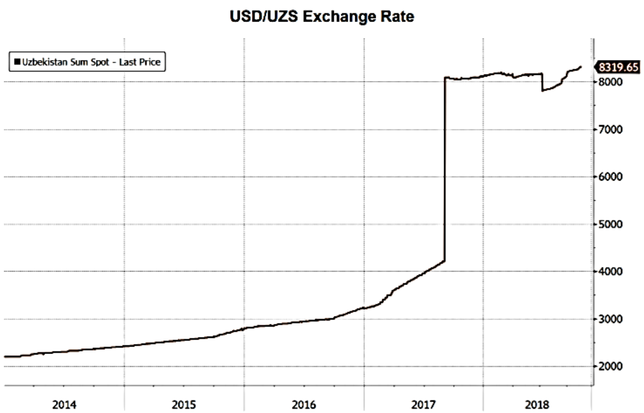


Figure 3 Uzek som devaluation 2017

In addition, the President has introduced reforms on exporting and importing processes and established important new institutions to improve the business climate and drive economic modernization. Regarding imports and exports, Mirziyoyev introduced two decrees. The first sharply reduced customs duties on over 8,000 categories of imported goods, lowered rates to zero for several thousand goods, and lowered the average import rate substantially. The second decree reduced restrictions on foreign trade and, importantly, abolished Uzagroexports (Uzbekistan's state owned agricultural enterprise) monopoly on exporting rights of agricultural products[14]. These reforms intertwine with Mirziyoyev's efforts to increase interconnection with other Central Asian countries, his commitment to privatize all non-strategic (i.e. non energy related) state owned enterprises, with 10 slated for IPO on the Tashkent Stock Exchange (TSE) in 2019 alone, and with Uzbekistan's nascent interest to accede to the WTO.[15] On top of these reforms, Uzbekistan has also recently implemented two important and unprecedented institutions: a Business Ombudsman who will serve on behalf of private businesses and investors, fielding complaints while offering them support vis-à-vis other regulatory agencies[16]; as well as a Credit Markets Development Agency (CMDA) that is taking charge of liberalizing and restructuring the credit markets, headed by Atabek Nazirov, a former Goldman Sachs banker and EBRD employee.[17]

Which brings us to the most poignant change impacting frontier investors. For the duration of Uzbekistan's state-hood it has maintained strict capital controls that prevented foreign investors from investing in its equity markets. But on March 2nd of 2019 changes were finally introduced that resulted in the abolition of capital controls in Uzbekistan, the most immediate hurdle to frontier investors hoping to directly invest in Uzbekistan. As a proof of concept, Asia Frontier Capital (the firm mentioned earlier with the first dedicated Uzbek fund) conducted the very first purchase and sale of stock on the Tashkent Stock Exchange and successfully repatriated the earnings to its Hong Kong bank account.[18] Uzbekistan was finally open for investment.

POLITICAL RISK FOR FRONTIER INVESTORS IN UZBEKISTAN

Transitioning now to the political risk methodology utilized in this paper. The methodology is based to some degree on the 'Delphi method' of seeking out experts and opinion leaders on Uzbekistan and collating their sentiments. Specifically, political risk ratings in this report reflect the author's qualitative judgement based upon personal interviews with numerous individuals including academics, finance professionals, Uzbek citizens, and frontier investors. Additionally, the report reflects and incorporates quantitative data economic data. Other sources include historical books, journal articles, recent media exposes, Uzbek government sources, multilateral development bank reports, credit rating agency reports, and more. The risk ratings in this report take into consideration the methodologies used by other groups such as Political Risk Services (PRS) Group, BlackRock, BERI, VISSOR, EurasiaGroup, and the Economist Intelligence Unit (EIU).

One of the most oft cited indexes for political risk is the PRS Group's International Counry Risk Guide (ICRG). To offer a quick overview of the PRS model:

> "The system is based on a set of 22 components grouped into three major categories of risk: political, financial, and economic, with political risk comprising 12 components (and 15 subcomponents), and financial and economic risk each comprising five components. Each component is assigned a maximum numerical value (risk points), with the highest number of points indicating the lowest potential risk for that component and the lowest number (0) indicating the highest potential risk."[19]

PRS's model takes into consideration over 100 different factors. Another frequently cited risk index is the EIU's Country Risk Model. This model similarly utilizes a 0-100 scale wherein professionals determine ratings across six risk categories (sovereign debt, currency, banking sector, political, economic structure, and overall country risk) as well as dozens of subcategories. Ultimately, though, even these quant-heavy models require professionals to organize and create the methodological weighting framework that allows for scaling and ranking of countries.

An important question to ask, though, is how accurately do these models actually predict political risk? An analysis done on the impact of methodology in forecasting, which focused on the Economist Intelligence Unit and the Business Environment Risk Intelligence (BERI) indexes found that when the 1986 indices were regressed against actual loss data between 1987-1992 the correlation was only r=.33 and r=.51 respectively.[20] This means that the EIU index only explained 11% of the variance in losses, while BERI only explained 25% of the variance in losses. It is important to always be circumspect about the ability of indexes to predict actual events. Indeed, indexes are often poor tools for companies looking to manage risk as they are overly broad and do not give enough information to the individual actor concerned. At the same time, though, it would be ill-advised to not attempt to consider risk, despite its notorious difficulty to predict. Bespoke analyses such as this report, then, can at least inform actors interested in investing in Uzbekistan of the potential risks, if not necessarily offering a predictive solution.

Political Risk in Uzbekistan

The political risk framework employed in this analysis contains eight different variables for political risk, as seen below in the 'Political Risk Nexus'. Each of the eight risk variables is

ordinally ranked on a qualitative basis on a 1-10 scale, with 1 representing the lowest category of risk and 10 representing the highest, based upon the degree of severity they present to frontier investors in Uzbekistan. Based on the research, the report also includes a directional signal for each variable indicating where it is likely to move in the near future (3-5 year time horizon), increasing (↑), decreasing (↓), or remaining stable (—). Finally, the eight variables are grouped together into three risk categories wherein a discussion of them is most appropriately done together, given their interconnecting nature. The variables are defined prior to their discussion.

RISK CATEGORY 1: POLITICAL & POLICY RISK

Country Risk (7, ↓)	• although country risk often has divergent definitions, for this report, it refers to the likelihood of unrest, instability, or other related trouble in a particular country, including risks posed by authoritarian governance model, corruption, internal violence, etc.
Regulatory Risk (7, ↓)	• refers to the likelihood that a government will quickly and capriciously change laws undergirding business activities, which can include nationalization but also other structural legal and regulatory changes that undermine investors.
Soverign Risk (5, ↓)	• represents the risk facing investors and businesses that the government will default on bond and other payments

In Uzbekistan, country risk, regulatory, and sovereign / transfer risk are best considered jointly. The reason for this is the strength of the executive in Uzbekistan and his impact on the country's decisions to implement legal and regulatory reform as well as to influence Central Bank policy. Indeed, this concentration of power is probably the single greatest risk facing the country. The Polity IV Democracy index and the Economist Intelligence Unit, two respected metrics for measuring democracies, both consider Uzbekistan a firmly authoritarian state.[21] Thus in assigning 'high moderate' and 'lower high' risk to these variables, a key reason undergirding this is the ability for the executive to capriciously make changes. In the last few years we have seen Mirziyoyev (and, to a lesser extent, Karimov) use this power benevolently and progressively, but risk must account for the probability that regressive changes can be made, and with few institutional checks and balances in place, it is possible that Mirziyoyev could change direction.

Specifically, the nascent removal of capital controls on the Tashkent Stock Exchange must be seen as a positive development, but cannot be taken for granted. The ease with which repatriation was removed speaks to the ease with which it can be put into place again. However, given recent positive institutional reforms, changes to property rights, improvements to tax and administrative regulations and oversight, combined with a willingness to work with the multilateral banks on reforms, all signs point to the continuation and further entrenchment of Mirziyoyev's revolutionary reform agenda. Indeed, Uzbekistan has gone from 146th on the World Bank's Doing Business Index in 2013 to 76th in 2019, demonstrating that the reforms have had a massive positive impact.[22] But, at the same time, given the lax institutional constraints, the risk of retrenchment is still high.

As Uzbekistan continues to modernize, the government will be increasingly relied upon for credit expansion. Indeed, Uzbekistan issued its first Eurobond late in 2018, and S&P issued Uzbekistan its first credit rating, coming in it at BB-, i.e. 'non-investment grade, speculative' (see table). S&P cited Uzbekistan's sizeable foreign currency reserves and sizeable level of liquid assets (all-in capable of covering 20 months of imports)[23], low public debt, and high economic growth as reasons for supporting its rating.[24] Uzbekistan's first Eurobond issuance in September of 2018 represents the first direct exposure foreign investors could accrue to Uzbek sovereign debt, and while it was oversubscribed and highly successful, there is still substantial underlying risk given the countries weak institutions and thus unchecked ability to default. Uzbekistan is increasing credit issuances in its local debt markets as well, and as the IMF notes, excessive credit growth in the Uzbek economy has recently emerged as a macroeconomic risk factor (discussed further in the macroeconomy section).[25] Overall, though, S&P's BB- rating, placing Uzbekistan squarely ahead of countries such as Argentina and Tukey, is a very positive indicator for sovereign risk in Uzbekistan going forward.

Table 1 S&P Credit Rating Uzbekistan

Country	S&P	Fitch	
Thailand	BBB+	BBB+	Investment Grade
Italy	BBB	BBB	
Kazakhstan	BBB-	BBB	
Russia	BBB-	BBB-	
India	BBB-	BBB-	
Azerbaijan	BB+	BB+	Non-Investment Grade Speculative
South Africa	BB	BB+	
Vietnam	BB-	BB	
Uzbekistan	*BB-*	*BB-*	
Brazil	BB-	BB-	
Georgia	BB-	BB-	
Turkey	B+	BB	Highly Speculative
Belarus	B	B	
Argentina	B	B	
Ukraine	B-	B-	
Tajikistan	B-	N/A	

Ratings as of January 22, 2019

Another important consideration relevant to Country and Regulatory risk is the degree to which corruption still pervades the Uzbek political and economic system. A remnant of Soviet influence, the overbearing regulatory state and lack of checks on power allowed officials to unilaterally extort businesses and individuals as they came into contact with the state (via taxes, licensing, etc.). This still persists, and while it is being addressed (e.g. via the creation and strengthening of the Business Ombudsman) it presents a continuing problem to business operations in the country. This may not only impact frontier investors directly as they deal with local brokers, but also indirectly as the firms with which they invest face additional operating costs as a result. As the EIU states, “officials [regularly] use complexity and non-transparency of business legislation to exploit and undermine contractual rights.”[26]

As Zaigart and Condeelza Rice thoroughly recount in their book ‘Political Risk’, the most prominent threat to foreign operators is no longer outright expropriation, but more insidious expropriation through legal and regulatory changes.[27] While Mirziyoyev has made remedying corruption and extortion a top priority, its omnipresence and pervasiveness makes it a continuing and serious challenge. Thus, corruption, in conjunction with autocratic powers, makes Country and Regulatory risk paramount concerns for frontier investors in Uzbekistan. Though, as the downward arrow indicates, Mirziyoyev’s commitment to reforms means this will likely be moving in a positive direction for the foreseeable future. And, importantly, due to the concentrated power in the Uzbek political system, Mirziyoyev is likely to stay in power for the foreseeable future (nominal elections will occur in 2024 but the result is predetermined).

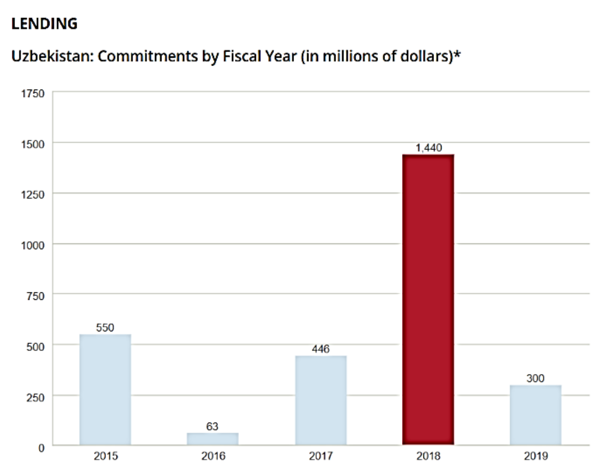
RISK CATEGORY 2: POLITICAL, ECONOMIC, & FINANCIAL RISK

Macroeconomic Risk (6, ↓)	• this refers to macroeconomic policies and their consequences on such things as unemployment, inflation, interest rates, balance of payments, export / import policy, and overall economic functioning
Financial Risk (7, ↓)	• finacial risk refers to liquidity risk (ability to buy and sell positions), interest rate policies and targets, currency volatility and exchange rate considerations, and other direct impacts on investors ability to operate
Systemic Market Risk (5, —)	• Volatility of commodities prices, stability of government’s financial position, potential for undermining corporate cash flow projections, and increasing integration with global market

Combining macroeconomic, financial, and systemic market risk into one discussion makes sense as these touch most directly upon the economic prospects for frontier investors in Uzbekistan. As elucidated earlier in the report, Mirziyoyev's government is working in conjunction with the European Bank for Reconstruction and Development (EBRD), the United Nations Development Project, and the World Bank / International Finance Corporation to implement positive macroeconomic reforms. These reforms include expansion of small business loans, minimization of the regulatory state (which should also help diminish the corruption mentioned above my reducing exploitation opportunities for corrupt officials), and easing of restrictions on imports and exports. Towards this end the EBRD, IMF, and World Bank have all approvingly noted of the reforms going on in Uzbekistan and, more concretely, collectively lent and supported projects worth over $2 billion. IMF Staff's concluding statement after visiting the country in March of 2018 noted that "Uzbekistan has embarked—with great determination—on reforms to address the country's most pressing challenges."[28]

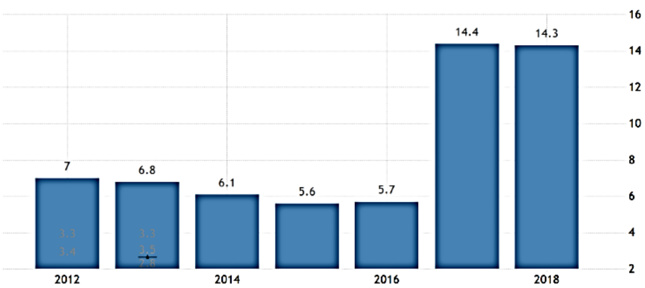
Figure 5 EBRD Project Lending

Figure 4 World Bank Lending



Amidst the promising macroeconomic reforms, and the promising evaluations of these reforms by the multilateral banks, there are still many macroeconomic risks present in the Uzbek economy. The two largest macroeconomic risks in the Uzbek economy are the high inflation rate and the high unemployment rate. As can be seen by the chart to the left, the inflation rate in Uzbekistan has increased drastically since the devaluation of the som in 2017. At the same time, though, as the IMF and other multilaterals have commented, this is likely also due to the improved macroeconomic / statistical reporting recently implemented in Uzbekistan. As mentioned in the sovereign risk section, the IMF has noted that excessive credit growth in Uzbek's local economy may pose a rising threat to macroeconomic stability, particularly in this environment of high inflation. However, the Central Bank of Uzbekistan has recently announced that in addition to no longer regulating the som's exchange rate, it will be transitioning to a regime of inflation targeting, as is done in most developed economies today.[29] Already we have seen increases in interest rates in the country designed to slowly steady inflation, and multiple outlets including the EIU and the IMF anticipate inflation rates dropping to below 10% by 2022. A concomitant risk, then, may be slowing economic growth if interest rates are hiked.

Figure 6 Inflation in Uzbekistan (CPI)



The other major macroeconomic risk factor is unemployment. The massive pool of working age individuals in Uzbekistan today presents both risk and opportunity. While the upside will be further discussed in the next section of the report, the obvious benefits include a large pool of cheap but somewhat educated labor. But, it is crucially important to political stability and to the macroeconomy that young Uzbeks find gainful employment. As Uzbekistan has itself reported, the official unemployment in 2018 was 9.3%, up 3.5 percentage points from the previous year but, again, this is almost certainly due to better recording. Meanwhile, the youth unemployment rate was 15%.[30] These numbers, if anything, likely understate the problem. In order to assimilate these individuals, Uzbekistan must continue to grow sustainably and educate this work force.

The next subcategory is financial risk, which is perhaps the most pertinent risk to investors in frontier markets, and Uzbekistan in particular. Chief amongst the financial risks is liquidity risk, or the challenge investors might face of being able to buy and sell equity or other positions at a given time in Uzbekistan. Specifically focusing on equities, the Tashket Stock Exchange has a capitalization of $2.5 billion, and a free float of a mere $300 million. For comparison, the FTSE's free float is over $3 trillion.[31] Additionally, only $50,000 worth of shares are exchanged on the TKS on the best of days.[32] The ability of investors to engage in the timely buying and selling of equities on the Tashkent Stock Exchange will thus be even more limited than your standard frontier market, due to its smaller than average turnover within its own class and the small overall number of participants. Liquidity risk is similarly present when judged via another common metric: the bid ask spread, or the price differential between what one actor is willing to pay for a security and what another actor is willing to sell the same security for. Although specific data at this point is lacking for Uzbekistan, as Vanguard points out in an analysis of liquidity issues in frontier markets in general, "bid–ask spreads [are] high, compared with products representing more mature markets." For example, the largest frontier-market ETF had a daily bid-ask spread of 0.29%, which is already drastically higher than the .01% typical of S&P 500 ETFs.[33] One can expect that Uzbekistan's bid-ask would be sizably larger than 0.29%, causing substantial friction in trading, which is likely to be exacerbated in times of distress when investors would be rapidly seeking to sell, causing bid-ask spreads to rise to even higher levels and potentially extending the transaction time to worrying durations. This is a major risk for frontier investors.

Other important financial risks facing investors are currency and exchange / conversion risks. While the Uzbek Central Bank has committed to allowing the som to float freely, and investors will get the benefit of free and unhindered convertibility, this comes with the risk of currency volatility. As Uzbekistan's monetary policy is at an incredibly nascent stage, frontier investors transacting and exchanging currencies will face sizeable currency risks that could materially impact their returns. Similarly, although conversion and exchange has been recently liberalized, there is no guarantee, owing to the nature of autocracy in Uzbekistan, that the government might not reinstate exchange restrictions. Overall, financial risk is one of the most poignant and troubling risks facing frontier investors in Uzbekistan, thus earning it a rating of 7. As with the other risks focused on this report, though, the short-term trajectory is promising, particularly as positive attention is drawn to Uzbekistan's reform process by praise from media and multilaterals, which promises to increase investor engagement in the countries equity and capital markets and thus increase their breadth and depth.

The final risk in this category is systemic market risk. The reason this is one of only three variables projected to stay relatively stable over the short-term is that there are countervailing effects at play. Systemic market risk in Uzbekistan does not stem from its plethora of interconnections with world markets, as in fact it is decisively isolated, but rather from the exposure it nonetheless faces due to volatility

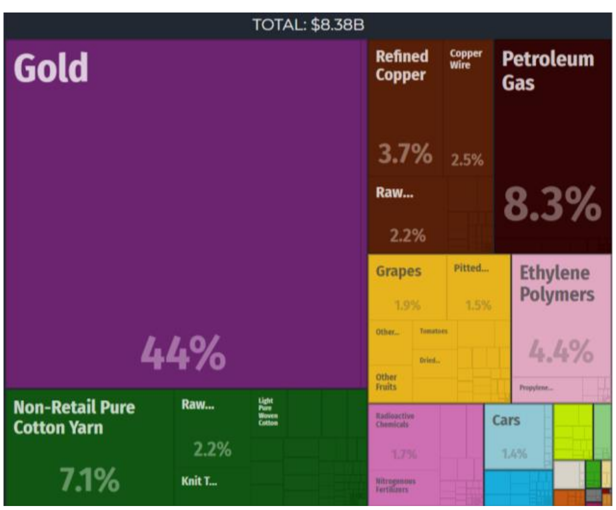


Figure 7 Uzbekistan's Exports

in the prices of key commodities that make up the vast majority of its exports, namely gold (44% of exports), cotton (7% of exports), gas (8% of exports), plastics / hydrocarbons (4.5%), and copper (3.7%), among others.[34] These products provide sizeable foreign currency inflows, support government expenditures, and are major revenue streams for Uzbek enterprises. Fluctuations in commodity prices thus create substantial risk for the Uzbek government, the enterprises that trade and produce them, and investors who will be looking to invest in these firms and in Uzbekistan.

While substantial portions of its economy are exposed to systemic market risk via commodity prices, Uzbekistan is also working to diversify its economy. Indeed, the predominate part of the Uzbek economy is already characterized by small businesses who, owing to the historically autarkic nature of Uzbekistan, today face very little exposure to international and global markets. As can be seen by the graph of GDP and Small Business Development, small businesses as a percent of GDP now account for over 50% of economic activity. Similarly, the table of 'Sectoral Composition of Value-added in Uzbekistan' demonstrates the changing and expanding nature of the economy in Uzbekistan, particularly in regards to construction and services. But, as the liberalization, economic reform and opening up process continues, it is inevitable that the Uzbek economy will gain increasing exposure to global markets. As is already happening, Uzbekneftgas (the largest SOE in the Uzbek energy

Figure 8 GDP Per capita, Poverty, and Small Business

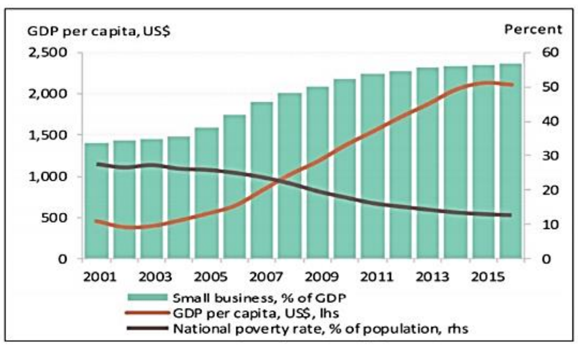


Table 2 Sectoral Composition Value-added Uzbekistan, 1987-2010

	Agriculture	Mining, Utilities & Construction	Manufacturing	Public & Private Services
1987	27.6	10.3	28.0	34.1
1994	37.4	12.2	14.2	36.2
2000	34.4	13.7	9.4	42.5
2004	30.8	15.7	10.2	43.3
2010	19.5	26.4	9.0	45.1

sector) has inked several deals with China National Petroleum Corporation (China's largest energy SOE), demonstrative of a trend of increasing interconnection with the Chines economy. Indeed, Mirziyoyev has begun increasing economic engagement more generally with China (via the Belt and Road Initiative and railroad, energy and infrastructure projects), as well as with Russia (via future potential integration into its Eurasian Economic Union), the EU, the other Central Asian countries, and the world (with increasing attention being given to potential accession to the WTO in the near future). Thus as Uzbekistan's economy liberalizes and diversifies, lowering its susceptibility to commodity price changes, the country will also be tapping into new forms of systemic risks as it increases exposure to the economies of China, Russia, the other former-Soviet republics. All of this will result in increasing Uzbek firms' betas (i.e. covariance) with the global market. While the risk to frontier investors on the systemic risk front is less pronounced than others, it is something that frontier investors must be cognizant of, as the changing nature of systemic risk in Uzbekistan carries substantial implications for firms and the frontier investors that might be investing in them.

RISK CATEGORY 3: GEOPOLITICAL & SOCIOCULTURAL RISK

Geopolitical Risk (5, —)	• the risk that foreign countries activities or policies may impact Uzbekistan. This includes investment activities within Uzbekistan, foreign policies, wars, conflicts, and other forms of spillover.
Sociocultural Risk (5, —)	• refers to the potential impact that internal unrest or problems may have on political stability and the investment climate, stemming in particular from religious, ethnic, and other identiy / socioeconomic variables

This risk category picks up where the left last off. Changing systemic risk qualities interconnects with changing geopolitical and sociocultural risk concerns, both of which are also deeply interconnected. Historically, geopolitical and sociocultural risk has been an omnipresent factor in the region (Abbasid Dynasty vs Tang Dynasty, Muslim expansion, Mongol conquest, Timurlanes conquest, rivalries among Khanates, Britain and Russia's Great Game, etc.). Today, though, there are countervailing forces pushing geopolitical and sociocultural risk in opposing directions, leading to an overall outlook that sees geopolitical risk and sociocultural levels remaining relatively stable. On the positive side, Mirziyoyev has substantively thawed relations between Uzbekistan and the neighboring Central Asian Republics. As made clear in the historical overview, a major risk factor facing Uzbekistan has been conflict between clans and ethnic identities within and across Uzbek borders that threatened to undermine the countries sovereign territory. The recent thaw in relations with Tajikistan (opening of borders and resuming of transnational flights) and Kyrgyzstan (opening of borders) in 2017 and 2018 demonstrates the increasing confidence in Uzbekistan's stability. Furthermore, increasing investment in infrastructure and transportation by Central Asian countries and China promises to increase interconnection and economic development in the region, which should have positive implications for peace and stability. Gallup's 2018 Global Law and Order Report even ranked Uzbekistan the 5th most secure country in the world, demonstrative of overall progress on this front.[35]

Yet sociocultural and geopolitical risks also face downward pressures. It is still true that Uzbek's identify more with their religious identity and their tribal / clan identities than their national identity. One important concern for Uzbekistan is the potential for Islamic extremism with the rise of social media in the country. Indeed, Uzbekistan is known for producing a large number of Islamic State insurgents (the majority are radicalized outside of the country, however). [36] As the country attempts to restore / incorporate Islam into its national identity (it was previously suppressed under Soviet rule), it faces an important battle between its desired moderate stance and other elements fighting for more radical interpretations of doctrine. The country may thus face a 'tail that wags the dog' situation, with a rising potential for theocratic demands.

As far as clans, there are three that have historically competed for dominance in the country, the Samarkand clan, the Tashkent clan, and the Ferghana valley clan. The Samarkand clan has dominated the country, with members including both Karimov and Mirziyoyev. However, the Tashkent clan also occupies important positions in the country, particularly its National Security Service, and is even believed to be behind the brutal arrest and continued detainment of Karimov's own daughter (which the President himself had authorized, likely at the Tashkent clan's behest)[37]. These sociocultural risks are indicative of the subtle machinations that go on under the scenes in Uzbekistan and pose substantial risk to policy implementation.

Meanwhile, geopolitical risk may also increase in the near future as China continues to expand its presence into Uzbekistan, and Central Asia generally, undermining what has historically been Russia's hegemony in the region. At the same time, the Chinese development model has often been noted as less than beneficial to the host country, as China tends to employ its own labor on construction projects and rarely strives to improve host country's corruption or governance standards. Even more worrying, Chinese involvement may flare up sociocultural tensions, as the China-Kyrgyzstan-Uzbekistan proposed rail line demonstrates: the Kyrgz' government is worried that its sizeable ethnically Uzbek population may be incited to push for independence should the proposed railway continue through the Ferghana Valley region. Complicating matters further, Russia is pushing anti-Chinese propaganda (striving to stoke fears of a Chinese invasion) while advocating for its own North-South connection.[38] The messiness of this singular project is indicative of the geopolitical and sociocultural complications in the region broadly. Yet, overall, the potential positive and negative ramifications of these developments seem to roughly cancel out, making both sociocultural and geopolitical risk moderate, but stable.

Uzbekistan: Why Frontier Investors Are Attracted

With the risks duly laid out, the report will now offer a brief overview of why frontier investors find Uzbekistan particularly compelling. Frontier investors have a sizeable risk appetite. That is, these players are highly risk tolerant relative to your typical actor. Being a frontier investor entails being at the vanguard of emerging trends, which inherently embodies sizeable risk. Yet, with great risk also comes the potential for great reward.

The nature of Uzbekistan's economy entails several attractive features that make the potential upside of investing in Uzbek firms substantial. As mentioned previously, many consider firm valuations in Uzbekistan to be generationally low given the prior constraints that firms faced in their operations. Indeed, many firms are trading at price to earnings ratios of roughly 2:1, while their price to book ratios are sometimes less than 1:1.[39]

Uzbekistan also has an extremely young population with roughly 70% of the population of working age and over 85% below the age of 55. While there are potential downsides to this

Company Description	Market Cap USD (million)	*9m 2018 YoY EPS growth*	P/E (TTM)	P/B	Div. Yield
Cement	100	**483%**	2.4	0.59	3.21%
Metallurgy	89	**464%**	2.3	0.56	n/a
Bank	71	**6%**	2.1	0.51	n/a
Consumer Packaging	38	**-1%**	3.6	1.11	13.90%
Financial Services	18	**160%**	8.2	2.93	3.83%
Consumer Goods	10	**340%**	5.4	1.47	1.82%

Table 3 Uzbek Firm Information from Asia Frontier Capital

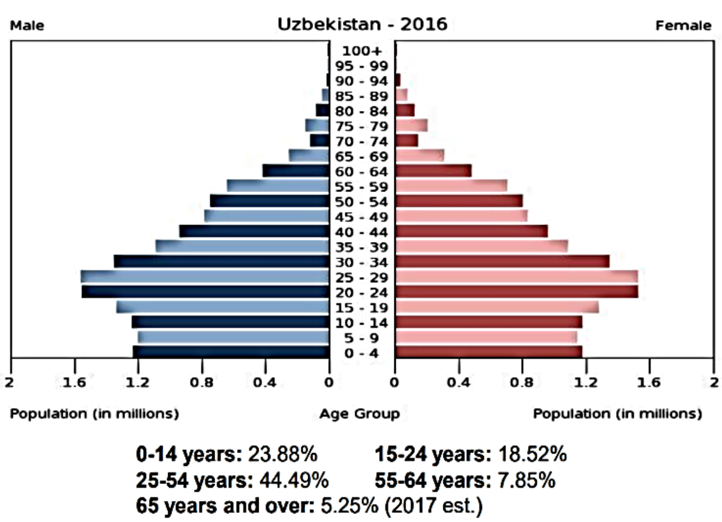


Figure 9 Uzbekistan Population Distribution

(such as threats to political stability, as addressed previously), it also means there is substantial room for economic expansion and consumptive capacity. Meanwhile, the minimum wage in Uzbekistan is very low, even relative to other labor markets, making it incredibly competitive from a global perspective (8% that of China).

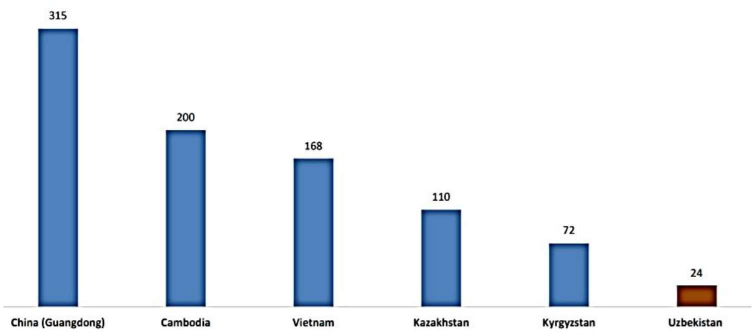


Figure 10 Minimum Wage Rates Per Month in USD

The largest factor encouraging investor attention, though, is the promise of further liberalization and high growth potential of the country. The IMF and the Economist Intelligence Unit are projecting GDP growth rates upwards of 5% over the next several years, while restructuring of the economy is projected to garner substantial FDI inflows, with projections of $4.1 billion in 2019 versus $2.4 billion in 2018.[40]

Combining these factors together we have: low cost of labor (93% cheaper than in China), high-growth in industrial, commercial sectors and the economy overall (5%+ over next several years), growing FDI inflows (70% YoY increase), and substantive liberalizing reforms with room for continuation into the future. Furthermore, Uzbekistan is underleveraged and thus the expansion of credit, though potentially posing its own risks as noted by the IMF, may have knock on effects for growth in construction and consumption. All this poises Uzbekistan to rise as a regional hub: a logistics, transportation, and manufacturing center for Central Asia.

The final set of incentives center around Uzbekistan's unique properties. Namely, as a frontier economy closed from foreign investment for so long, its overall correlation (beta) with the global markets is extremely low, and thus offers an incredible diversification opportunity with high potential upside. Indeed, Morgan Stanley's Capital International (MSCI) index was found to have only a .54 correlation to both common US stocks and emerging-market ETFs.[41] Uzbekistan is likely to have an even lower overall correlation. What's more, given the nature of Uzbekistan's transformation, there is substantial likelihood that it will come to be included in the MSCI index itself. As scholars recently found, in contrast to the strong version of the efficient markets hypothesis, such inclusion actually leads to sustained elevations in prices of firms in the included country's economy. Robert Merton's 'radar screen effect' appears to accurately predict that the increased visibility of a country, like Uzbekistan, being included in an index like the MSCI increases the country's visibility, draws in more distant investors, and decreases required returns (thereby lowering discount rates and increasing valuations).[42] As Uzbekistan continues to reform and grow, there is thus tremendous potential upside.

Recommendations

For frontier investors looking to get involved in Uzbekistan, it is important that they pay attention to the risks outlined in this report. Although there is no way to completely resolve the threats to investments posed by country, regulatory, financial, macroeconomic risk and so forth, there are steps that investors can take to mitigate them.

First, investors can acquire political risk insurance (PRI). In general, PRI is often acquired via the Overseas Private Investment Corporation (OPIC) or the World Bank's Multilateral Investment Guarantee Agency (MIGA). Insurance through these major institutions will generally include coverage on nationalization or the more insidious and subtle form of 'creeping' expropriation, as well as currency convertibility, breach of contract, and outright denial of repatriation.[43] However, due to the large size of these institutions, their insurance products tend to be more standardized, and, furthermore, these firms often demand that claimants follow a stringent check list prior to disbursement, which when combined with a massive bureaucracy, can leave claimants waiting a long time for reimbursement. Smaller frontier investment firms may thus prefer to seek out more bespoke political risk insurance firms such as Zurich American Insurance, Lloyd's of London, Aon Corporation, or Kroll Associates that offer more tailored products. Investors should consider the pros and cons of both, as the former is likely to be cheaper but generic, while the latter is likely to be more expensive. As PRI can cover up to 90% of a fund's investment in a foreign firm, it can be a valuable, if expensive, risk mitigation tool.

Second, investors should strive to understand the motivations of the liberalizing Uzbek government. This understanding should lead investors to appreciate which industries are likely to be higher risk within Uzbekistan and which are likely to be lower risk. As mentioned previously, there are several key export items that are crucial to Uzbek government finances, including gold, cotton, and gas. Investors should be cautions if planning to enter into these industries (insofar as they can), as in an economic slowdown or other calamity these are likely to be the first areas the government will intervene in and potentially retrench investor rights. Meanwhile, the Uzbek government has been systematically striving to expand small business opportunities, increase employment, and roll back regulations that hinder these developments. An excellent way for an actor operating in a foreign emerging market to protect its own interests is to align those interests with the government's interests. In this way, investors can pursue opportunities that have both growth potential as well as beneficial social impact potential. Frontier investors should, where possible, seek out profitable investments that can ingratiate them with the Uzbek government.

Lastly, building off the previous point, frontier investors should remember that the best way to prevent exploitation by corrupt officials is to have lobbying capacity in the local country. As mentioned earlier, Rice makes the point in her book 'Political Risk' that expropriation is no longer done directly but rather subversively via subtle regulatory and legal machinations on the part of corrupt officials. In order to forestall any potential problems that may arise in this regard (such as disputations over equity stakes, repatriation, creeping expropriation, etc.), and as Henisz and Zelner point in their article 'Hidden Risks in Emerging Markets,' frontier investors in Uzbekistan must establish lobbying capacity within Uzbekistan's government.[44] A local office in Tashkent, Samarkand, or Bukhara (a Spanish built bullet-train, comparable to or even better than those in Europe, connects these cities) from which investors can conduct meetings with local officials and establish business connections is a necessity. The social capital and political connections built up will be of great utility when an adverse event needs to be remedied.

Conclusion

This report has offered a historical overview of Uzbekistan, contextualized the current situation, and shown that while many reforms have an evolutionary underpinning, the crucial juncture of Karimov's death in 2016 ushered in an era of revolutionary reforms that have justly piqued frontier investor interest in the country. The report has gone through a vast array of political risk variables that are likely to impinge upon frontier investors in Uzbekistan, highlighting country risk, regulatory risk, and financial risk as the key problems facing frontier investors. The report closed by demonstrating that, nonetheless, there is substantial investor potential that can be tapped into in Uzbekistan, with its generationally low firm valuations and profitable long-term demographic and spatial disposition. This report has attempted to show that Uzbekistan carries substantial risk to frontier investors as well as substantial potential for reward. For the savvy investor, then, opportunity awaits in Uzbekistan.

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