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Tbilisi, Georgia, June 19, 2015

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Welcome to Georgia

Asia's gateway to Europe

still Gergia good place to invest?

BANKING INVESTMENT ECONOMY FINANCE

Georgia: hub of trade and commerce linking Europe and Asia

Georgia has for over a decade hosted the South Caucasus energy corridor linking Caspian resources to Turkey and beyond. As a result, Georgia is today a major economic hub located at the crossroads of Europe and Asia. Bank of Georgia and TBC Bank, both traded on London Stock Exchange, actively support large and small domestic enterprise including health care and hospitals to alternative energy projects. Georgia's Black Sea ports and terminals at Batumi, Poti, Kulevi and Supsa are Central Asia's gateway to the Mediterranean and the world. In July, Tbilisi will host the 13th European Youth Olympic Festival. But Georgia's ability to enable broader Eurasian trade and transit, much less attract foreign direct investment from diverse sources, depends on encouraging the vitality and innovation of her entrepreneurial class and striking an enduring balance between competing states and formidable regional interests.

By Robert M. T. Jutson, Jr., Managing Director at Griffin Capital Partners

SETTING THE STAGE: MARKET ACCESS

Following the dissolution of the Soviet Union, newly independent, oil-rich and landlocked Caucasus and Caspian states were anxious to access world markets. All viewed multiple pipelines as essential to their efforts to ensure that no regional power could exercise strategic control over energy transport, and their broader economic and political ties to western, Mediterranean and Asian partners.

Georgia provided a route to global markets which newly independent states like Kazakhstan, Azerbaijan and Turkmenistan used to export their oil and avoid the tolls and exactions imposed by northern routes. Russia naturally opposed multiple pipelines, reflecting a strong desire to retain control over strategic resources, pipeline and infrastructure networks providing market access. The West's leadership has only recently awaken to how manifestly ambivalent Russia remains about the changed political, economic and military realities on its southern rim and the encroachment of NATO on its western flank.

The dynamic of forces throughout the region changed with the 2008 Georgia-Russia war over South Ossetia. Until that incident, many in Europe hoped the Central Asian republics and the promise of oil from the Caspian shelf would diminish their reliance for energy on Russia. Decades earlier, the US encouraged this expectation by supporting the construction of oil and gas pipelines bypassing Russia, in particular, the Baku-Tbilisi-Ceyhan (BTC) pipeline. The US opposed the shortest pipeline route through Iran and favored the far longer BTC pipeline terminating at Ceyhan, Turkey. In so doing, the US minimized the involvement of Iran in the region's long-term energy developments. (Russia Review, 20 October 1999 http://www.griffincap.com/rfp/r201099.pdf)

"The building of BTC reconfigures the mental map with which political observers and decision-makers in the Caucasus look at the world" declared Svante E. Cornell and Mamuka Tsereteli of the Central Asia-Caucusus Institute in Washington (http://www.cacianalyst.org/publications/analytical-articles/item/10010-analytical-articles-caci-analyst-2005-6-15-art-10010.html). In the decade since the commissioning of the BTC pipeline in 2005, Georgia has established itself as a reliable partner in international trade and commerce, in spite of the 2008 border conflict.

Upon that stable foundation, and an increasingly diversified economy, the IMF, EBRD and World Bank forecast growth in Georgia at 5% this year, declining to 2% in 2016 due to the continuing crisis in Russia. FDI (almost 6 percent of GDP) and official loans (2½ percent of GDP), in addition to remittances remain the main sources of external financing. Following IMF program approval last July, Moody's and Fitch upgraded the outlook on Georgia's sovereign rating to positive (Ba3/BB-), citing improved economic prospects with the provisional application of the Deep and Comprehensive Free Trade Area (DCFTA) agreement with the EU from September 2014. http://www.imf.org/external/pubs/ft/scr/2015/cr1517.pdf

The greatest near term risk to sustaining growth is weakness in its export markets and the stability of the Georgian lari relative to the US Dollar. This will diminish competitiveness with its Euro zone trading partners if USD rates rise while the EU applies quantitative easing. http://www.imf.org/external/pubs/ft/scr/2015/cr1517.pdf According to Fitch, the level of dollarisation in Georgia remains high at about 60% of loans and deposits, although these levels have fallen from over 70% in 2009.

GAINING EXPOSURE TO GEORGIA'S GROWTH

For those whose liquidity preference is strong, diversified exposure to Georgia's growth may easily be gained via Bank of Georgia Holdings PLC (LSE: BGEO LN), a FTSE 250 UK-incorporated holding company of Bank of Georgia. It is the largest bank in Georgia with a market share of over 35% of total assets. The bank offers a broad range of retail banking, corporate banking, investment management, brokerage and insurance services to its clients, and also owns healthcare and real estate businesses. Georgia Healthcare Group, the Bank's wholly-owned healthcare subsidiary, has a 22% market share of hospital beds in Georgia, and is currently planning its international stock market listing, scheduled for the second half of 2015.

As of 31 December 2014, the Bank served approximately 1.5 million client accounts, and this franchise was increased by a further 400,000 clients in January 2015 following the acquisition of Privatbank Georgia. Its shares are held 94% by Western institutional investors and 6% by management. It has little debt in its capital structure and a Tier 1 capital adequacy ratio of 22.1%(Basel I) (31 December 2014).

As many readers will know, the EBRD's relationship with Bank of Georgia dates back to 1995. Though no longer a shareholder, the EBRD has provided Bank of Georgia with a range of products, including SME and energy efficiency credit lines, co-financing facilities as well as subordinated and convertible loans. EBRD is today a shareholder of TBC Bank.

As for FDI, its sources vary considerably, reflecting commercial opportunities and encouraged by supportive government policy initiatives. Regional and global powers have outlined policy initiatives with specific objectives when it comes to promoting influence and supporting investment in the South Caucasus and Caspian region. For example, the "New Silk Road" policy of the US seeks "democracy promotion" while China's "Silk Road Economic Belt" simply promotes "economic development". Russia's policy is not so expressly defined.

After Georgia's August 2008 war with Russia, the United Arab Emirates became Georgia's leading foreign investor in 2009, according to greenfield investment monitor "fDi Intelligence". The United States took the lead in 2010 as did the Netherlands in 2011 and Germany in 2012.

ROBERT MT JUTSON
Managing Director of Griffin Capital

Mr. Jutson founded Griffin Capital in 1985 to acquire corporate real estate and arrange finance for strategic assets and for early- and growth-stage enterprises. Russian and CIS clients include the Tbilisi Marriott Hotel, MTV Ukraine, KazakhstanEnergo, Moscow CableCom Corp., Sakhalin Telecom (Golden Telecom) and NTV Plus. Mr. Jutson served as a Director of Dal Telecom International (1999-2002), the largest GSM operator in Far Eastern Russia (Vimpelcom). He was previously a limited partner of Fieldstone Private Capital Group, L.P., a spinoff of Bankers Trust Company, a Vice President of Eastdil Realty, Inc. and Vice President of Gerald D. Hines Interests. Mr. Jutson graduated Rice University's School of Architecture and attended the Columbia University Graduate School of Business Administration. Mr. Jutson has appeared on CNN International regarding current events in Russia and presented to and chaired numerous finance conferences. rmj@griffincap.ch

In 2013, Georgia received USD 941MM and c. USD 1.27Bn in FDI in 2014 according to preliminary figures from Georgian National Statistics Department, GeoStat. In H1 2014, the greatest amount of investment went to the transport and communications sector (USD 101MM) followed by manufacturing (USD 58MM) and energy (USD 45MM). GeoStat estimates the leading sources of FDI in both 2013 and 2014 were the Netherlands, neighboring Azerbaijan and China.

Tentative improvements in Georgia's bilateral relationship with Russia were illustrated by Russia's modest response to Georgia's signature on the DCFTA. Russia's economic leverage in Georgia is still quite low, accounting for less than 10% of Georgian exports in 1H14. Economic repercussions of the crisis in Ukraine on Georgia have proved limited to date but are beginning to bite with an adverse impact on GDP widely anticipated in 2015 and 2016.

That said, when it comes to FDI, Russian enterprise has a growing presence in strategic sectors of Georgia's economy including energy, transportation and power generation. In 2009, Russia's state-owned oil producer Rosneft announced offshore explorations and development of oil and gas fields in Abkhazia under an agreement signed between the company and Abkhazia's de facto government. It is unclear if anything further has come of the agreement. In late 2014, Rosneft entered Georgia's oil retail market by purchasing a 49 percent stake of Petrocas Energy Ltd., a Georgian oil transportation company which operates in the South Caucasus. (http://www.osw.waw.pl/en/publikacje/analyses/2015-01-14/rosneft-to-invest-georgia) Petrocas's assets include an oil terminal in Poti with a capacity of 1.9 million tons per year as well as a network of 140 gas stations in Georgia operating under the Gulf brand. (CACI, http://www.silkroadstudies.org/publications/silkroad-papers-and-monographs/item/13075-a-western-strategy-for-the-south-caucasus.html)

Rosneft will gain high-quality storage capacity in one of the major oil and oil products hubs in the region, broaden supply route options and enhance its upstream and downstream operations in the Central Asia and South Caucasus markets. Rosneft and Petrocas have also recently established a new joint venture to increase cargo transit through Georgia.

Russian investments have extended to other areas of Georgia's economy including finance, electricity, chemicals, mining, telecoms and agribusiness. For example, in 2003, Russian state-owned electricity trader, Inter RAO, obtained 75 percent of Tbilisi's electricity distribution company Telasi, thermal power generating plants, as well as the management right of two hydropower plants; Khrami I and Khrami II. The Georgian government retained 25%. Russia's VTB Bank, Lukoil and Vimpelcom (Beeline) also operate in Georgia.

The common thread in many of these deals reflects Russia's strategy to strengthen its infrastructure capabilities in the South Caucasus to ensure uninterrupted delivery of oil and other products to Armenia, which recently became a member of the Eurasian Economic Union (EEU) but lacks common borders with other EEU members. The reconstruction of the railway through Abkhazia and the planned Avaro-Kakheti highway from Dagestan to eastern Georgia and then to Armenia support such a strategy.

Beyond energy and transportation, there is power generation. The EBRD reports the sustainability of energy system is still problematic in Georgia. The world's second biggest arch dam, the Enguri HPP, provides more than 40 percent of Georgia's electricity needs. It plays a critical role in Georgia's infrastructure. http://www.ebrd.com/news/video/georgia-enguri-dam-keeps-the-power-flowing.html

The Enguri HPP spans the Enguri river and is located both on Georgian and Abkhazian/Russian controlled territories. The dam itself is on the Georgian controlled side, while the electric station is on Abkhazian controlled territory. It produces about 1.3 GW of electricity a year.

According to an informal agreement reached between Tbilisi and Sokhumi in the 1990s, Abkhazia receives about 40 percent of the electricity generated by the plant as a Soviet-era concession with the balance allocated to Georgia.

In a similar spirit of cooperation and conciliation, five months after the

Russo-Georgian war, at the beginning of 2009, the Georgian government signed a memorandum with the Russian state-owned company Inter RAO to manage the plant for the mutual benefit of Georgia and Abkhazia.

Whether one is a portfolio investor or seeking strategic opportunities for direct investment in companies or projects, the compelling merits of Georgia as an investment destination have been clear to many for years: growth and increasing political stability at a crossroads of international trade. With a coherent national development strategy based on transparency, accountability and sound governance, Georgia will continue to grow and prosper, ensuring its most talented young men and women remain to participate. GF

Influence of Association Agreement on sectoral growth

By Paul Clark and Tengiz Lomitashvili

At TBSC Consulting we are often asked which sectors of the economy will grow faster than others or which sectors are most favorable for investment. Of course we have opinions, based on working in and studying the Georgian economy for more than 15 years. Nevertheless, when asked questions of this type we usually choose to not give definite answers without further research. We have found that the correct answer nearly always depends on the details of the particular question asked.

The EU-Georgia Association Agreement (AA) will have a large impact on the Georgian economy. A client recently asked us if manufacturing is likely to outperform other sectors of the economy due to the Deep and Comprehensive Free Trade Agreement (DCFTA) that is part of the AA. We did some preliminary research, including considering the experience of the New Member States (NMS's) of the EU, after those States signed their AA's in the 1990's. Some results from that research are shown here. To be clear, this is not academic research. Rather, it is focused on answering practical business questions from clients.

EU-GEORGIA ASSOCIATION AGREEMENT

Georgia signed the AA with the EU in June 2014. It will have a significant positive impact on the Georgian economy (estimates of about 6,5 percent of GDP) though the effect on different sectors will vary widely. To better understand those different effects, we studied the sectoral experience of the NMS's that signed AA's in the early 1990's and Acceded to the EU in 2004. One could argue that Georgia now is at the stage of economic development (with the EU), where those NMS's were in the mid-1990's.

NMS's signed AA's from 1992 through 1997 and Acceded to the EU in 2004 and 2007. For the initial analysis, described here, we took the period from 1995 through 2004 as the study period. This is the phase in which Georgia finds itself today (i.e., just after signing the AA).

WINNERS AND LOSERS

Using national account data from EuroStat (nama_nace10_c) we examined changes in Gross Value Added (GVA, at basic prices) for eleven major sectors between 1995 and 2004. Comparing the GVA in 1995 and 2004 we calculated Cumulative Annual Growth Rates (CAGR's).

The following chart shows the CAGR's of the EU-15 (the 15 existing Member States before 2004), the 10 NMS's as a group and each NMS individually. The first row shows the CAGR for the entire economy. The later rows show the CAGR's for eleven sectors that total to the entire economy. We grouped the sectors into three types: soft, real and other. This grouping is not academically oriented, but it helps better answer the question from our client.

Cells in the chart are orange if the CAGR for the sector is 10 percent or more greater than the CAGR for the whole economy. The orange cells can be considered to be the Winner sectors, those sectors that outperformed the whole economy (after signing the AA). Cells are purple if the CAGR for the sector is 10 percent or more less than the CAGR for the whole economy. The purple cells can be considered to be the

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Loser sectors, those sectors that underperformed the whole economy. Even Loser sectors showed positive growth rates; those growth rates were just less than for the whole economy. Cells are gray if they are between the Winners and the Losers. Gray cells can be considered to be the 50-50 sectors, those sectors that have generally performed the same as the whole economy.