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Hilary Kramer
President, A&G
Capital Group

Email Author

Biographical

Good Hope Abounds

By Hilary Kramer

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JOHANNESBURG - The World Summit on Sustainable Development was held here in Johannesburg from August 26th through September 4th. This conference was the United Nations' get-together where global players convened to address important economic and environmental issues from around the planet. Thousands of delegates negotiated everything from reducing carbon dioxide emissions to preventing AIDS to promoting Third World exports. The central players, of course, were the world's governments. In addition, a myriad of other groups, so-called "non-governmental organizations" -everybody from Greenpeace to the World Conservation Union to the Ford Foundation to the Jewish National Fund - were present and quite vocally accounted for.



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Finally, there was Big Business, here to defend against its critics, and at the same time promote its ideas on profitable, sustainable development. That's where I came into the picture. Much of the corporate global elite was here in force - General Motors, Unilever, Daimler-Chrysler, and Hewlett-Packard, to name just a few. These companies recognized the crucial need to be a part of planetary problem-solving and, at the same time, seize an opportunity to show off their good works to the world.

The most compelling story here, however, is that of South Africa's little-known economic boom, which crept up on the world with few investors noticing. Long after the Summit's key issues are dismissed and replaced with new initiatives, the underlying development I have seen in this country will sustain South Africa on a profitable course for years to come. And investors around the world should pay attention.

Before we go any further, though, let's look back. South Africa became an international pariah in the 70s, as its loathsome apartheid system of racial discrimination and categorization became the object of boycotts and corporate-divestiture campaigns. Apartheid came to an end in 1990, when Nelson Mandela was freed from prison. Investors were nervous at the time, as the future direction of the country hung in the balance. When Mandela was elected South Africa's president in 1994, he offered a conciliatory message of leadership to the multiracial nation and brought a new feeling of calm and optimism to the business community.

Indeed, for many, South Africa came to symbolize global hope for Third World development, economic as well as political. That's one reason why this revitalized nation received the honor of hosting the World Summit. But investors still hang back, imposing what might be called a "country risk discount" on the economy here. Moreover, starting in the late 90s, a series of international economic shocks - in Russia, East Asia, and Latin America - rocked the world economy. And South Africa was not spared the jolt of these destabilizing, and continuing, tremors. The country's stock market and currency - the two best indicators of any nation's investment climate - both took hard hits, and nearly five years later, South Africa still finds itself undervalued as the country tries to regain its footing.

In fact, in 2001, South Africa's currency, the rand, fell sharply from 7 rand to the dollar all the way down to 14 rand to the dollar. This devaluation is bad for South African consumers who want to buy foreign products, but it's been a significant benefit to exporters, especially mining companies. In addition, it makes this country a bargain for American tourists - a great meal, including drinks for two, can be had for \$30.

public opinion

Will [importing prescription drugs](#) from Canada help American consumers?

- Yes
- No
- Not Sure



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Of course, markets and currencies always go up and down. But the rand fell hard for two South Africa-specific reasons.

First, investors, both foreign and domestic, have been skittish over the progress of legislation that would transfer mining rights from the private sector to place them in the hands of the state. Jos Gerson, chief economist for Merrill Lynch in South Africa, explains, "Gone are the days when as in the case of so many mines acquired in the 19th century and after, mining companies bought land, usually from a farmer, and thereby acquired a property right." Now those companies will have to pay royalties to the state. Such public ownership of mineral assets is not uncommon; in fact, it is the rule in Canada, Australia, Chile and Brazil. But Gerson emphasizes, "What makes South Africa different from these other states, of course, is the racial configuration of the society and potential conflicts surrounding ownership or proprietorship of economic assets." That is, the mines have been so central to the bitter and sometimes violent history of this country that the government may feel compelled to take drastic action against economically productive assets to satisfy vengefully redistributionist political constituencies. Indeed, a government leak last month on "black empowerment" raised the possibility of expanding black ownership on existing mines to 30 percent, and on new mines, to 51 percent. That is, this possible new policy would go well beyond charging companies for extraction, to forcing new co-ownership of the companies themselves.

Not surprisingly, this black-ownership leak, on top of the pending royalties legislation, caused quite a commotion. In the words of Merrill's Gerson, "The leak sent shock waves through the investment community and caused a damaging run on mining shares." Foreign investors were among those running away. The South African magazine Finance Week reports that in 2002, net foreign disinvestment has totaled 3.5 billion rand, with all of that loss coming since the "empowerment" plan was leaked. By contrast, in 2001, net foreign investment was a positive 30 billion rand. Such a tremendous swing, from positive to negative, got the government's attention.

Most observers, then, do not believe that the leaders of South Africa - who started out as radicals, but seem to grow ever more pragmatic - will ultimately enact this form of "affirmative action," which might be called "affirmative ownership." In other words, the markets here have had a good scare, but should not expect to see ore confidence-diminishing news forthcoming from the government.

Indeed, leaders here take great pains to present themselves as pro-business. They go out of their way, for example, to distinguish South Africa from neighboring Zimbabwe, which is in the throes of a catastrophic campaign of confiscation. In fact, since much of Southern Africa is in turmoil, notably Zambia and Congo, South African leaders must work all the harder to highlight their country's stability. Yes, it may seem unfair to lump different countries together, but as investors know, perception is often tantamount to reality. My own visit here leaves me convinced that the overwhelming majority of South Africans - white, black, and Asian - want foreign investors to feel welcome.

Over time, as the markets have factored in their basic confidence in South Africa's political leadership, the rand has strengthened a bit. It is now about 10 ½ and to one dollar, with the expectation of a continuing strengthening, perhaps to as high as 9:1. Even the Johannesburg Stock Exchange (JSE) is down only seven percent over the last year - and up five percent in terms of the dollar.

Which brings us to today - and more importantly, to the future, which is where all investment opportunities are found.

Let's start with SABMiller (SAB on the JSE and SAB.L on the London Stock Exchange). You might not have heard of SABMiller (formerly known as South African Breweries), but it's been around for more than a century and is the world's second largest brewer with annual beer volumes in excess of 20 million hectoliters. SABMiller is also the world's largest bottler and distribution of Coca-Cola products outside the U.S.

SABMiller's impact is both local and global. It has an astounding 98 percent share of South Africa's beer market. As I have personally

witnessed, Castle Lager is the national brand of choice for all peoples here. Ernest Khuzwayo, a black South African I met in Jo'burg, knows all about SABMiller and praises the company, the product and its contribution to the community." He points out that SABMiller sponsors the national soccer team, the Bafani Bafani (Boys Boys), which has become a symbol of post-apartheid patriotic unity. SABMiller, Kuzwayo says, is "a national asset." That's a level of brand equity and loyalty that few companies anywhere, in any industry, can match.

In July 2002, SAB completed its \$5.4 billion acquisition of Miller Brewing Company, the second-largest brewer in the US. It was a bold stroke for SABMiller. The South African company's revenues are estimated to be \$3.6 billion for this year, and yet it managed to gobble up - or in this case, perhaps, guzzle down - Miller, which has projected 2002 revenues of some \$4.2 billion.

Not only can SABMiller play the trans-oceanic M&A game, however, it can also play the role of brilliant brand manager, marketing its way into the hearts of local consumers worldwide. Its 120 brands, emanating from 111 breweries in 24 countries, include such culturally customized niche players as Snowflake (China), Pilsener Urquell (Czech Republic), Kompania Piwowska (Poland), Kilimanjaro Premium Lager and Elephant Star (East Africa), Suprema, Nacional, and Imperial (Central America). No wonder half of SABMiller's sales come from outside of South Africa.

Interestingly, the company is still on the prowl; other rumored targets include Scottish & Newcastle. To be sure, many good companies have hurt themselves through over acquisitiveness, but I believe SAB is different. That difference lies in the firm's balanced geographic strategy, in which it will seek out huge cash flow from big but mature markets, such as the US, and reinvest that cash-throw off into fast-growing new markets, such as China. In fact, SABMiller is the second largest and most profitable brewer in China with 27 breweries and a combined capacity of more than 31 million hectoliters.

In addition, SAB is a big player in many underserved markets; in fact, in partnership with local cervecerias in El Salvador and Honduras, SAB controls 100 percent of those markets. Such local mergers are an astute strategy because brewing is a capital-intensive, volume-driven business, which is highly scalable and profitable so that such in-market synergies are exponentially effective because of the improvement in capacity utilization, including everything from facilities to advertising to distribution.

Turning to SABMiller's financial performance for their year ended March 30, 2002, volume growth of 15.5% contributed to a sales increase of 4.3% and earnings were up 5.9% to \$904 million. SABMiller's share price closed on the London Stock Exchange on September 6th at \$7.04 down 9.4% from 12 months ago. But it is still a company to invest in, as the dividend yield alone is 3.4 percent. Moreover with an expected five-year growth rate of 11%, the company will provide much greater upside than competitors such as Heineken and Anheuser Busch, which trade at P/E ratios of 20.7 and 23.2 respectively, compared to SAB's 15.5. The investment community underestimates the growth profile and benefits that SABMiller will enjoy through its aggressive expansion and consolidation in the brewing biz.

In addition, the world market underestimates South African companies, as well as South Africa. Therefore, investors can get in cheap, benefiting from the aforementioned "country risk discount". At this price, SABMiller is a relatively risk-free investment, because investors are getting a piece of a firm that has proven itself, both locally and globally.

Next up, Sasol (SOL on the JSE, and [SASOY](#) on NASDAQ). This diversified fuel and chemical company is a world leader. Sasol manufactures more than 240 products, which it makes in South Africa, Europe, North America and Asia, and sells in more than 100 countries.

Sasol, founded in 1927, is perhaps the leading example of a quirk in South Africa's economic history. During the terrible apartheid days, South Africa was boycotted by the rest of the world. Therefore, the country had to develop its own unique industries to make up for the resulting import drought. Since South Africa lacked its own crude oil reserves, Sasol

assumed a leadership role in the production of synthetic fuels and chemicals from low-grade coal - which South Africa has in abundance - and from the conversion of natural gas into high-quality, low-emission diesel fuel. Since South Africa's re-entry into the world market in the 90s, Sasol has become not just a national trailblazer and pioneer, but an international leader. Last year Sasol invested \$400 million in R&D and another \$775 million to build new facilities.

Sasol, which closed at \$11.00 on September 6, has a market capitalization of \$6.8 billion. Sasol's fiscal year 2001 had sales of \$5.4 billion, up 60.3% from the year prior. Earnings of \$917 million were up 71.5%. Sasol also sports a dividend yield of 3.2%. Sasol's P/E ratio reflects "country risk discount". Upon close inspection, the risk here - as with SABMiller - is not as great as it might seem. Indeed, although the World Summit on Sustainable Development may have been something of a fizzle, in terms of planetary politics, it seems to have been a resounding success for the country of South Africa, which put on a professional - and remarkably crime-free - show for tens of thousands of visitors.

Some might say that any company in the business of helping to generate carbon dioxide emissions will face long-term pressure from the anti-global warmers. No doubt this "green" pressure will be a factor. But the loud resistance of the United States - and the quiet resistance of some other industrialized countries - suggests that a strict emissions-limiting regime, as found, for example, in the terms of the still-pending 1997 Kyoto Treaty - is not coming anytime soon. In the meantime, Sasol's many innovative technologies, its unique synfuel know-how, should make it a favorite among pollution-conscious fossil fuel consumers.

Long before global warming becomes a paramount concern, however, it's likely that instability in the Middle East will force oil-importing countries to take a long look at synfuels as an alternative to Persian Gulf oil. In which case, Sasol is poised for significant gains. Analysts within South Africa all seem to agree that Sasol's share price should appreciate 12 percent in the next 18 months to a price of \$13.90. When adding a 3.2 percent dividend yield, the total return could make this an attractive stock indeed.

Third comes Kumba Resources (KMB on the JSE). Kumba is a new company, created in November 2001, when the Iscor Group, the leading steel producer in South Africa, spun off its mining assets. There's a lot of buzz in Jo' burg about Kumba, which mines iron ore, coal, base metals, and heavy minerals. Kumba operates the African continent's largest open cast coal mine and the world's largest coal processing plant. It also manages one of the world's lowest-cost refineries of zinc metal, and operates one of the largest reserves of high-quality lump iron. With reserves of almost 800 million tons, Kumba owns almost half the world's known lump ore reserves.

The company continues to expand; it recently purchased a 46.5 percent stake in Titor Ltd., an Australian minerals sands producer, and Titor SA, a heavy minerals project on the east coast of South Africa. This is projected to produce 250,000 tons of titanium slag per year. Good news for golfers!

Kumba's profits are excellent. For the year ended June 2002, sales were up 33 percent, and earnings up 188 percent. Kumba has announced a dividend program which is expected to yield 3.3 percent in 2003. Kumba continues to lower its debt load, and now sports a healthy 24% debt-to-equity ratio, down from 78 percent a year ago. Proving, as always, that any economic event creates both winners and losers, last year's collapse of the rand boosted Kumba's export oriented bottom line by close to \$100 million.

Here's the really exciting news about Kumba. In the short and medium term, iron ore exports are rising fast, at a 20 percent per year pace. Kumba expects exports to top 20 million tons in 2003. This growth is expected to continue until at least 2004.

Then there's the Anglo-American PLC factor. Anglo-American holds an effective 20% stake in Kumba and plans to consolidate the Northern Cape iron ore field. As for Kumba's share price, it fell after the "black empowerment" governmental leak mentioned above. Kumba trades on a forward P/E multiple of 12.8 and remains undervalued versus the other

non-ferrous mining producers. With a current price of \$4.65, expect to see Kumba Resources hit \$6 within the next 12 months. And don't forget the hefty 3.3% dividend yield in the meantime.

South Africa may seem to outsiders like a risky place, and there's no denying its brutal history. But an effective majority of the population seems committed to a pro-business investment climate. The good news here will become apparent to all investors eventually. The goal is for savvy investors to get wind of these opportunities early and to profit from that knowledge.

The author is Senior Advisor and Strategist with Montgomery Asset Management.

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