THE **Traveling Analyst** – SOUTH AFRICA

Investment **Research**

The Traveling Analyst series highlights journeys by Lazard Asset Management's investment professionals and the perspectives such visits have helped them gain.

The insights they gain from company meetings and site visits help generate a coherent picture of companies and the industries in which they operate—insights that simply could not be attained from financial reports, websites, or phone conversations.

THE Traveling ANALYST

LAZARD

THE “CAPITAL” OF

Combining tremendous opportunities with significant risk, South Africa has long

Sub-Saharan Africa

been one of the most fascinating countries to Lazard Asset Management. Our analysts travel there frequently to visit the country's most important and innovative companies, and to stay abreast of the latest developments.

Increasingly, Lazard's analysts are seeing South Africa as the *de facto* capital of sub-Saharan Africa. From an economic perspective, that view is almost irrefutable: while South Africa accounts for only approximately 6% of the continent's population, it produces more than a third of Africa's GDP.[1] The idea of South Africa as a regional capital, though, goes beyond GDP alone. Indeed, South African companies increasingly seem to be the conduits through which foreign governments and investors expand into other countries on the continent.

A Turbulent ECONOMY

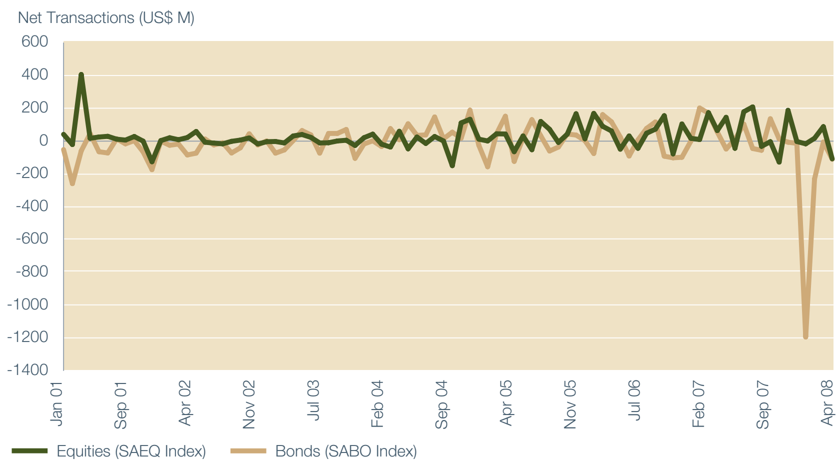
South Africa's economy continues to be highly volatile, with both opportunities and risks around every corner. The country is looking toward 2010, when it is scheduled to host the FIFA (*Fédération Internationale de Football Association*) World Cup; yet many wonder whether its infrastructure can handle such a large event. In addition, the country's vital mining sector has gone through numerous changes over the past decade, and rising commodities prices are providing the companies in this sector both new opportunities and new challenges.

In recent months, much of the news from South Africa has seemed negative. From concerns about new leadership in the African National Congress (the country's largest and most important political party) to the large and growing current account deficit, many investors have been reluctant to look too closely into South African companies, due to risk concerns.

The current account deficit (approximately 7%) is not only high in comparison to those of other emerging markets countries, it is also largely backed by foreign portfolio investment instead of foreign direct investment (FDI). In practical terms, this means the country and its currency are strongly subject to the whims of foreign equity portfolio investors. By comparison, as one Lazard analyst noted, while Turkey's current account deficit issues tend to get headlines in the international business press, Turkey's deficit is backed by both portfolio flows and FDI, the latter of which is less likely to be pulled out of the country rapidly during an economic downturn.[2]

South Africa's current account deficit is unlikely to shrink in the next few years, as the country is in the midst of large-scale infrastructure improvements (as we will discuss in detail later). The effects of this issue were felt in the devaluation of the rand in the fourth quarter of 2007 and the first quarter of 2008, when the South African currency depreciated nearly 20% against the dollar. When one combines these developments with fears of increasing inflation, it is easy to see why many investors are concerned about investing in South Africa.

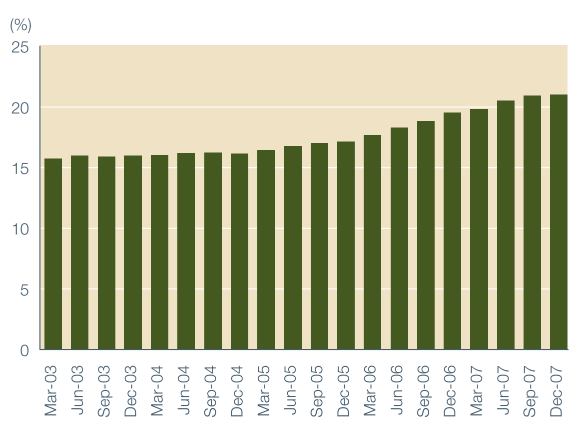
NONRESIDENT ASSET PURCHASES, JANUARY 2001-APRIL 2008



As of 30 April 2008
Source: Bloomberg

While Lazard certainly monitors these and other risks closely, our analysts nonetheless believe that many South African companies present the potential for strong returns in spite of the risks; they point to the strong fundamentals of many companies that appear very attractive when examined through Lazard's valuation screens. We believe that corporate governance standards, which are often a cause for investor concern in emerging markets countries, are relatively high in South Africa. There have been two well-regarded reviews of the country's corporate governance in the past 15 years that have further strengthened the standards. While occasional lapses have occurred, including some transactions that have, in Lazard's view, resulted in unequal rights for minority shareholders, these have tended to be exceptions to the rule. Generally speaking, South African companies sport savvy managements, who tend to focus on precisely those metrics that Lazard considers most crucial for generating value.

FIXED CAPITAL INVESTMENT AS A PERCENTAGE OF GDP, 2003-2007



As of 31 December 2007
Source: South Africa Reserve Bank

Infrastructure: ENSURING THE WORLD CUP DOES NOT GO DARK

Among Lazard's analysts who have been to South Africa lately, there is a consensus that the country's infrastructure is severely inadequate. This was confirmed by the attitudes of companies' managements during the analysts' visits. From stories of nightmarish traffic jams in Johannesburg to the spate of blackouts the country experienced in early 2008, it is clear that South Africa will have to continue investing in infrastructure for many years to come.

In the face of the rapidly approaching 2010 World Cup, the nation has entered a period of feverish infrastructure improvements, hoping to ensure that it can handle the estimated 400,000 fans expected to attend.[3] Overall, fixed investments have risen from an average range of 14-15% of GDP to approximately 20% over the past year.

Our analysts visited what we believe to be some of the greatest beneficiaries of this increased investment, including construction giants Murray & Roberts and Aveng. These established, brand-name companies are in charge of the largest projects in the country. Our analysts are also very interested in the cement industry, as it benefits from high barriers to entry. Unlike in the United States, where domestic cement companies must compete with low-cost providers from Mexico, South African cement companies operate largely without outside competition in the domestic market. That, combined with the fact that domestic capacity is tight, means that these companies are in a position to capitalize on infrastructure spending. One analyst described some firms in the South African fixed-investment sector as "among the most profitable companies in the world."

ROLLING **Blackouts**

While some companies are benefiting from this spike in infrastructure investment, the country as a whole has been reeling from problems caused by an insufficient electricity supply. Eskom, South Africa's government-run electric company, was forced to allow rolling blackouts throughout the country in January 2008 (the height of summer for the Southern hemisphere). In an attempt to stave off future incidents, Eskom has requested a 53% rate increase.

Unfortunately, few people believe that a simple rate hike will solve the problem, since the shortages are largely due to insufficient electricity infrastructure, rather than to increases in oil prices. As Eskom's CEO, Jacob Maroga, noted recently, "If we only rely on [an increase in supply], the numbers are not looking good for many years."[4] However, his proposed solution of reducing energy consumption poses significant problems for many of South Africa's businesses.

In spite of Mr. Maroga's claim that "reducing energy consumption should not slow down the GDP growth,"[5] some analysts forecast that the electricity crisis will help to pull GDP growth

FINDING VALUE AMID THE TURMOIL: **South Africa's Banking Sector**

One area where Lazard believes the conscientious investor can find value is the South African banking sector. While late 2007 and early 2008 saw a sell-off in the sector, there are reasons to believe that this sell-off (at least in the case of some top-tier institutions) may have been overdone.

Over the past several years, loan growth and returns at most South African banks have been sustained by growth in consumer portfolios. However, many observers believe that consumer-led growth could be in jeopardy. Key indicators such as the household debt-to-GDP ratio (which currently stands at approximately 80%) and the ratio of debt payments to disposable income (which has risen to approximately 11%) are worrisome.

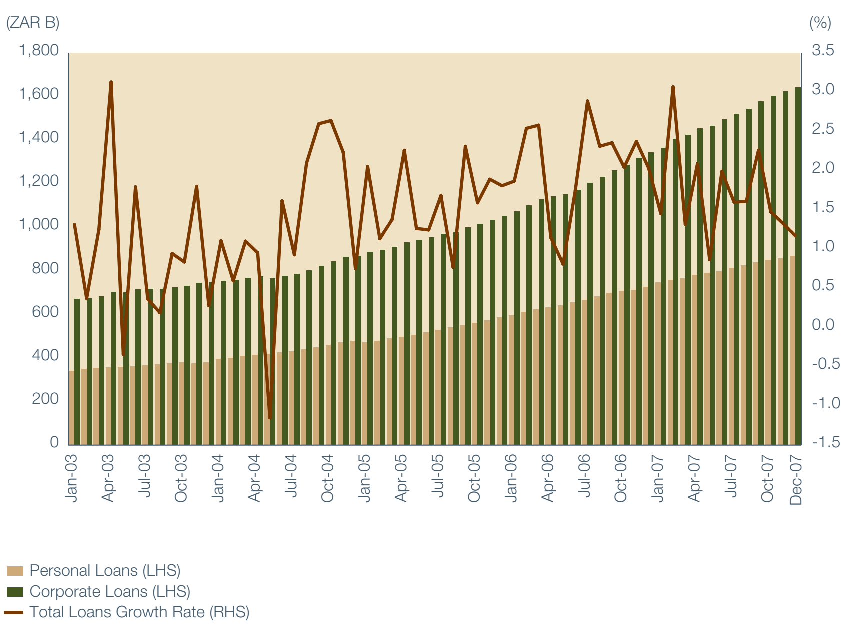
However, corporate loans have shown signs of strength and, in fact, some analysts believe that South African banks may actually be benefiting from the credit crunch that has been affecting global markets. Whereas the largest South African multinational corporations might once have turned to Western lenders for their credit needs, many are now turning to their domestic banks.

This trend, combined with the growth in infrastructure investments that have spurred overall corporate loan demand, indicates that 2008 may well be the year in which growth in the South African financial sector shifts from consumer-led to corporate-led. For this reason, Lazard's analysts are very interested in those banks that are best positioned to take advantage of corporate loan growth. One bank we have been carefully tracking is Nedbank, which is 50% owned by the Old Mutual insurance company. In addition to an attractive ratio of corporate to consumer business, Nedbank has a strong management team, prudent provisioning, and good capitalization. While Nedbank, and others like it, are still subject to risks from a slowing economy and some asset quality concerns, we believe they still represent the possibility for finding value in a potentially troubled sector.

for 2008 down to an estimated 3% (compared to 5.1% in 2007). Lazard's analysts point out another difficulty in the effort to improve South Africa's electricity supply—the country cannot simply tap into its neighbors' electrical grids to boost supply during a crisis, as its neighbors are all developing nations with infrastructure issues of their own.

In addition to the potential complications that would accompany further rolling blackouts (e.g., retailers forced to shutter their stores during certain peak hours), the overall issue of reducing energy consumption is particularly worrisome to the country's huge and vital mining industry. Most of the country's largest mines (including diamond, coal, gold, and platinum) were forced to shut down for five days during the late-January 2008 blackout period, because Eskom could not guarantee their electric supply (or even the times of day when it might not be reliable). Since resuming production, the mines have had to reduce their consumption by 10%.[6] These factors and others provided context for the recent discussions Lazard's analysts had with the major mining concerns in South Africa.

CORPORATE AND PERSONAL LOANS, 2003-2007



As of 31 December 2007
Source: Bloomberg

Mining: BEYOND SILVER AND GOLD

South Africa is a uniquely resource-rich country, and mining has long been the backbone of its economy. For many decades, mining was focused on gold and diamonds. While these industries remain important, our analysts are more interested in some of the other mineral riches that South Africa has to offer.

Platinum production, for instance, has been doing very well over the past several years. Platinum, which has long been vital to the production of both jewelry and catalytic converters for automobiles, has seen its price rise by over 250% since 2003. Given that South Africa is home to over 60% of the world's production of this rare metal, we feel the platinum industry can only grow in importance for the country.

Moreover, platinum's future continues to look strong. While demand for jewelry has softened due to the currently high price of the commodity, we believe the demand for automobiles (especially in growing economies such as China and India) will continue to increase. In addition, there is a political component to the development of the platinum industry. Since increasing amounts of platinum are needed to improve the efficiency with which catalytic converters remove pollutants, more stringent emissions laws in countries around the world should serve as a catalyst for increasing shareholder value in the top-tier platinum mining businesses.

Lazard's analysts were also pleased to note that the platinum production industry has seen a marked improvement in the structure and management of its top companies. To take one example, Anglo American Platinum, by far the largest platinum producer in South Africa, has undergone significant changes over the past decade. One Lazard analyst noted that 10 years ago, Anglo American shared many characteristics with Korea's *chaebol* conglomerates.[7] He described the company as having had many interests outside of its core mining business,

BLACK ECONOMIC **Empowerment**

Black Economic Empowerment (BEE) is one of the most important developments in South Africa's post-apartheid business landscape. BEE is a government policy that addresses historical inequalities that led to white South Africans owning almost all of the shares of South African companies, while the indigenous population was virtually shut out of the stock market.

BEE requires that companies achieve specific targets for percentage of ownership by nonwhite South Africans. Most companies comply by either buying back shares of stock or by issuing new shares. They then provide those shares to black and mixed-race recipients either at a discount or free of charge.

On its face, it might appear that this policy would be bad for investors. However, Lazard believes that "broad-based" BEE can, in fact, be a positive force. In this scenario, analysts expect to see that the required transfer of shares is going to a large number of different individuals and entities, and particularly the company's employees. This provides the growing black middle class in South Africa with the motivation of an ownership stake in the companies they work for, and it tends to align their interests with those of the companies (and hence with those of investors).

On the other hand, some BEE deals have been viewed as sweetheart deals for insiders, where earmarked shares have been transferred to well-connected, already-wealthy people. In our opinion, this sort of implementation offers relatively few clear advantages to investors.

In the end, many implementations of BEE have had some positive aspects, while some have had negative. For Lazard's analysts, determining the degree to which a given company's BEE program is working to the benefit of investors is one of the most important aspects of evaluating South African companies.

which made it hard for analysts to value it as a whole, and also made it difficult for management to run it efficiently. However, the Anglo American Platinum of today has divested itself of many of its noncore interests, and it has expanded its holdings into Latin America and other resource-rich areas of the world.

Conclusion

South Africa's importance as a cultural and economic capital of sub-Saharan Africa seems destined to grow over the next several years. As both developed and developing countries seek to invest in the opportunities available throughout the continent, they are likely to see South African companies as good partners for such endeavors. Recently, ICBC, a Chinese state-owned bank, purchased a stake in South Africa's Standard Bank as a first step toward financing future African acquisitions.

Lazard's research focus is not dictated by current trends in the marketplace; therefore our analysts will continue observing the operations of South African companies during their on-the-ground meetings with managements and site visits. It is by feeding those insights into its global investment platform that Lazard is able to develop a clear and evolving picture of both South Africa's markets and the world's, and to invest accordingly.

NOTES:

1 “The Long Journey of a Young Democracy,” *The Economist*, 1 March 2007.

2 See *The Traveling Analyst: Turkey* for more insights.

3 Attendance estimate from FIFA.com (http://www.fifa.com/worldcup/organisation/media/newsid=638951.html).

4 “Eskom urges more power cuts,” *News24.com*, 2 April 2008 (http://www.news24.com/News24/South_Africa/Power_Crisis/0,,2-7-2335_2298582,00.html).

5 *Ibid*.

6 “The Dark Ages,” *The Economist*, 31 January 2008.

7 See *The Traveling Analyst: Korea* for more insights.

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