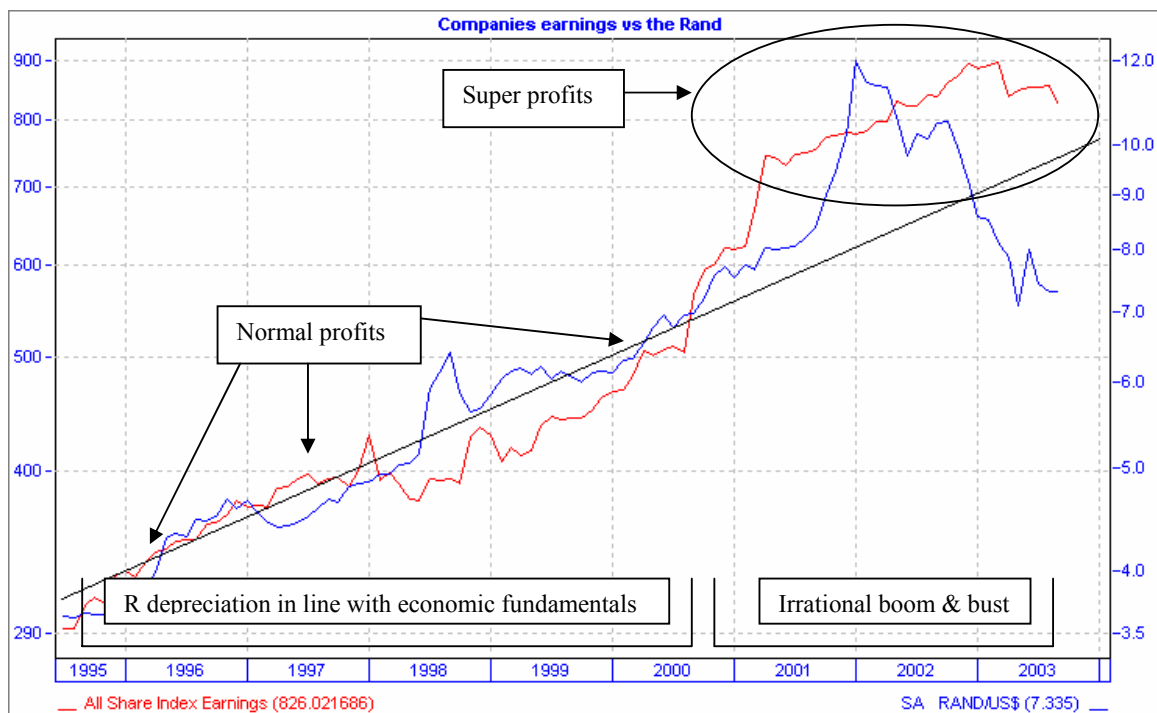


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HIDING BEHIND THE RAND

After 5 years of a moderately declining Rand in real terms, domestic companies experienced a far sharper decline of the Rand in 2001 and 2002. This created highly profitable opportunities in exports and provided pricing power in the local market against imports. Revenue streams became unnaturally high; whilst healthy margins were maintained. “Super profits” and above average returns on equity were reported. As is typical of human nature, the market expected the abnormal trend to continue into the future and too many businesses started to bank on continued Rand weakness.



Source: Inet Bridge

South Africans irrational pessimism towards the Rand not only impacted on the mindsets of investors, but also in the way local businesses has been managed. Many of these actions have and are expected to continue to unwind in the next year. Companies’ profits are expected to revert back to the long-term trend over time. Astute investors should try to understand how this will impact the valuation of these

businesses going forward and how it reflects on management's actions where they are faced with economic factors beyond their control. Here follows some of these reflections.

Most company revenue streams are geared to the exchange rate through global pricing. A weakened Rand has resulted in the typical South African business concentrating on growing the revenue stream. The cost base was expanded, to drive revenue growth higher. Whilst that is a very successful strategy when getting the benefit of "super profits" generated by a weaker Rand, it becomes a problem over the long term if the costs are of a permanent nature. Companies became slack when the going was good, assuming the Rand would always bail them out (taking a one way bet). The consequence is that with a stronger Rand companies are now faced with a high cost base, which makes them uncompetitive in the global market. The strong Rand has made imports cheap in the local market, resulting in companies reducing sales prices and coming under margin pressure as expensive inventory is worked out of the system. Of course management blames the Rand for their current problems, although they conveniently took the glory for the Rand based "super profits".

The drastic fall in the exchange rate also resulted in management not necessarily taking a prudent currency management approach. The typical South African company has a component of expenses directly or indirectly priced in foreign currency. Mostly foreign exchange contracts are bought to protect this cost base against adverse exchange movements. The known cost base is used to price sales in strong currencies. The prudent approach would be to lock in the margin and to ensure a stable profit stream. However in the past few years South Africans have bargained on a continued weaker Rand, not hedging their hard currency incomes. Therefore the current significant Rand strength will result in declining revenues on a relatively fixed cost base, "unexpected" margin squeeze and declining earnings. In some instances management became so confident of continued Rand weakness that they did not even utilise natural hedging, offsetting foreign income streams against foreign costs.

It is very interesting to note that Goldfields took great care in hedging their Australian income stream against Australian Dollar strength against the US dollar whilst the Rand income stream was left exposed to Rand strength. This was done whilst only 16% of earnings are from Australia in comparison to about 70% from South Africa.

Probably the most fundamental impact of the Rand pessimism has been the trend of buying offshore earnings. It became very fashionable to buy foreign businesses to ensure an offshore earnings base. To date there have been extremely few businesses, which have generated even moderate returns on their original offshore investment. In some instances the only reward shareholders have had for financing these offshore forays, is a reduction in dividend payments. It is interesting to note, in the five years after listing offshore, SAB's share price has declined and it has cut its dividend twice! A reasonable investor has to ask what competitive advantage local businesses have in another marketplace and why they should be able to pick up "cheap" offshore acquisitions. It seems to us as if this strategy was

pursued due to businesses bargaining on continued Rand weakness, which would camouflage weak offshore asset returns.

“Super profits” have also resulted in management earning super income streams. This begs the question as to how management are judged and compensated. It does not appear that the local trend has been to compensate management necessarily for their operational skills and business strategy. In the past few years they rather benefited significantly from the weak Rand, which was not within their control. As an aside, it will be interesting to see what happens to remuneration and the performance appraisal process of management when misguided hedging practices come to light.

One finds that the boom and the bust in a cycle bring out the worst or the best in a business. A conscientious investor would try to understand a company’s earnings power through the cycle, judging the resilience of the company through both good and bad times. And so it makes sense to analyse the effect of the recent fluctuations in the Rand on a company’s earnings, management’s approach and the company’s overall position in the market place. This is how we would calculate the intrinsic value of a business, upon which rational long-term investment decisions can be made.

The market will always be subject to different business cycles and companies will continue to be tested by the unexpected. We like to invest in those companies, which are attractively priced, based on performance in a “normal” market environment and have a sustainable business model throughout adversity. If management displays rational behavior, that is an added attraction!

Meirine Giggins

September Market Comment