RE:CM

_REGARDING CAPITAL MANAGEMENT

No 7 West Quay Office Block, West Quay Road, V&A Waterfront, Cape Town 8002
PO Box 51615, Waterfront 8002
_TELEPHONE +27 21 425 7953 _FAX +27 21 425 7956 _WEB www.recm.co.za
_Regarding Capital Management (Pty) Ltd. _REG. NO. 2001/028924/07
_DIRECTORS Piet Viljoen, Theunis de Bruyn, Werner Stals.

ABI AND THE CAPITAL CYCLE

> *"When Bidvest acquires another company it is obliged to treat shareholders equally, but not necessarily to show special consideration to minorities. The purchaser's duty is to further the interests of its own shareholders by concluding the transaction on the best terms.*
>
> *If there is a special duty of care for minorities within the company that is about to be acquired, then that duty falls on major shareholders who are negotiating the sale, especially if they believe the prospective purchaser will ultimately seek full ownership"*
>
> *- Brian Joffe, CEO of Bidvest (extract from the Bidvest annual report, 2004)*

At RE:CM we tend to invest in three types of assets:

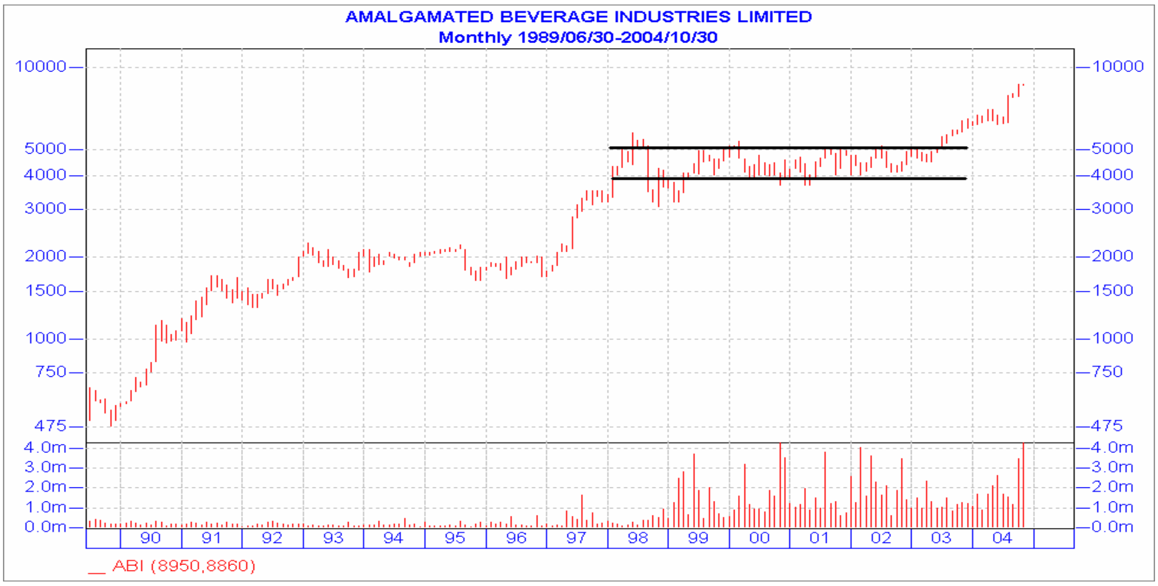
The **first** is where we can buy something which (in our opinion) is worth one Rand for 50 cents or so – i.e. cheap assets.

The **second** is where we can buy something which has superior financial characteristics (i.e. a combination of high margins, strong brands, and good management resulting in high growth in free cash flows) for a fair price – i.e. a high quality asset. In this case, once we have allocated our clients money to such an investment, it looks after itself, and our clients can sit back and enjoy superior returns over a very long time. It is worth noting that the returns from such an investment are merely superior, not supersize.

The **third** type is what we would regard as our ideal investment – where we can buy a superior asset at a cheap price. Here our clients stand to earn supersize returns. Unfortunately, these types of investments do not come around frequently – if they did, our job would be very easy! Over the last few years, we have been able to identify only a few: ABI was one.

This company traded for a very long time between R40 and R50 (see chart 1). During this whole period, it generated superior returns to shareholders, in terms of dividend growth and cash flow. Generally, when one finds an asset of this quality trading at such a low price, it pays to understand why it would be priced as such. It comes as no surprise that the period during which ABI languished coincided with large scale consolidation amongst fund managers in South Africa. The resultant mega-managers were constrained from buying stock in ABI due to their perceived inability to apply meaningful amounts of their clients' money towards the investment. The excuses usually took the form of either "it's too illiquid, we can't buy enough of it", or the even more feeble "due to its low free float, it's not part of the index, therefore we can't buy it."

Chart 1 : ABI share price from 1989



Source : Inet Bridge

This was of course compounded by investors' irrational attempt to apply as much of their capital offshore (at any price) as they could, creating wonderful investment opportunities in South Africa. As they say, one irrationality leads to another – and we think it was exactly these structural problems that caused ABI to be ignored by most institutional fund managers – and created the opportunity for patient, long term investors to buy enough stock at compelling prices for their clients.

Of course, the fact that SABMiller is contemplating taking out the minorities of ABI ties in with the capital cycle on the JSE – and we feel this is something that investors should be aware of. Very simply, the capital cycle comes down to the actions of the smart money. A point we have made repeatedly is that the smart money in the market these days is the corporate money. In a nutshell, what the smart money does is to take advantage of the dumb money – which is by and large represented by institutional fund managers. The way corporates (including investment banks and private equity managers) apply their cash flow is a good pointer to the capital cycle.

The cycle works something like this: the **peak** of the cycle happens when stock prices are unusually high. At this point the smart money sells a lot of stock to the dumb money – evident in a spate of new listings on the stock market. This generally coincides with an economic environment which is conducive to high profitability - as well as being conducive to all kinds of ludicrous extrapolations of the prevailing situation – there is nothing the dumb money likes better than a good story, no matter how improbable!

The **downleg** of the cycle is then evidenced by a lot of the recent listings falling apart, and widespread investor disillusionment with the actions of the dumb money on their behalf. Of course, the smart money, having exited their low quality assets at very high prices, now sits on the sidelines, conserving their cash for the next up leg of the cycle.

The **trough** is normally characterised by a lot of the better quality companies being taken private by the smart money: this generally entails buying out the minorities at a very low price and delisting the company. The dumb money is only too happy to hand over what is left of their original investment, as they now have irate clients, a stock which is trading far below their buying price, and an economic environment which is not conducive to short term profitability. Most delistings during this period of the cycle are perversely welcomed by exactly the people being fleeced. This point was most recently reached in South Africa during 2002/2003 – good companies that were bought at very low prices included Avis, MNet Supersport, Pepkor, Softline, DNA Supply Chain and Mettle (see our newsletter on our website www.recm.co.za dated August 2004). This phase probably ended when Marathon Asset Management (a London based firm of money managers) successfully thwarted the impending buyout of HCI by its controlling shareholders. (The fact that a London based firm was the only one to stand up to this potential abuse of minorities, with all the South African institutions throwing in the towel, is a story in itself!).

The next stage of the cycle, the **upleg**, is then characterised by a combination of the buyout of larger, better quality companies (generally by their controlling shareholders) as well as a dribble of new listings of good quality businesses. This phase is normally reached when the smart money starts recognising that the economic environment has changed for the better, while the dumb money is still trying to hold on to yesterdays heroes. We believe that we are at just such a point here in South Africa.

It therefore comes as no surprise that offshore companies are trying to buy out the minorities of large local listed companies, generally of a very good quality. For example:

- London based mining conglomerate Anglo American bought out the minorities in De Beers
- London based Old Mutual tried to buy Mutual and Federal
- Mittal was successful in gaining control of Iscor, without paying a premium (in addition to extracting large "management fees"!)
- Barclays have confirmed that they are in talks to buy control of ABSA
- And now, London based SABMiller is trying to buy out the minorities in ABI.

Despite the fact that these are generally good signs regarding the investment environment in South Africa, we think that the prices offered in these transactions are far too low.

In the specific case of ABI, to which our clients have a large exposure, we think the offer at R91 undervalues the company for the following reasons:

- Minorities have helped fund capex (expansion and maintenance) to the tune of R2bn over the past four years. This equals around R13 per share. As the economic cycle picks up, and ABI grows their volumes (as indicated in their most recent trading statement, dated 17 September 2004: ***"headline earnings …are expected to be between 40 to 45% higher than for the comparative six month period. The main contributor to the improved earnings is volume growth, expected to be between 5.5% to 7.5% for the period"***), cash flow to the owners will pick up dramatically. And guess what – minorities will no longer own shares in ABI!
- SABMiller has, over the past few years bought out a number of companies. The one most comparable to ABI is a bottler in Central America, for which SABMiller paid a multiple of 8.6 times EV (enterprise value) to EBITDA (earnings before interest, tax, depreciation and amortisation). Regardless of the theoretical correctness in using EV/EBITDA as a measure of value, it can be used to compare transaction values. SABMiller is only offering a 9 times multiple for ABI. We think ABI is a far better investment proposition, and deserves much more than a 5% premium! (see table 1)
- SABMiller paid 11.5 times EBITDA for Miller itself. This is a company that has taken two years of intensive management effort (including the importation of some of SAB's top management to the USA from SA) to turn around, and despite the apparent success of the turnaround, is still years away from delivering an acceptable return on the original investment. Apart from the dubious attraction of Miller as a large US company, we struggle to understand why it would command a premium to the price of ABI. (see table 1)

Table 1 : How ABI stacks up

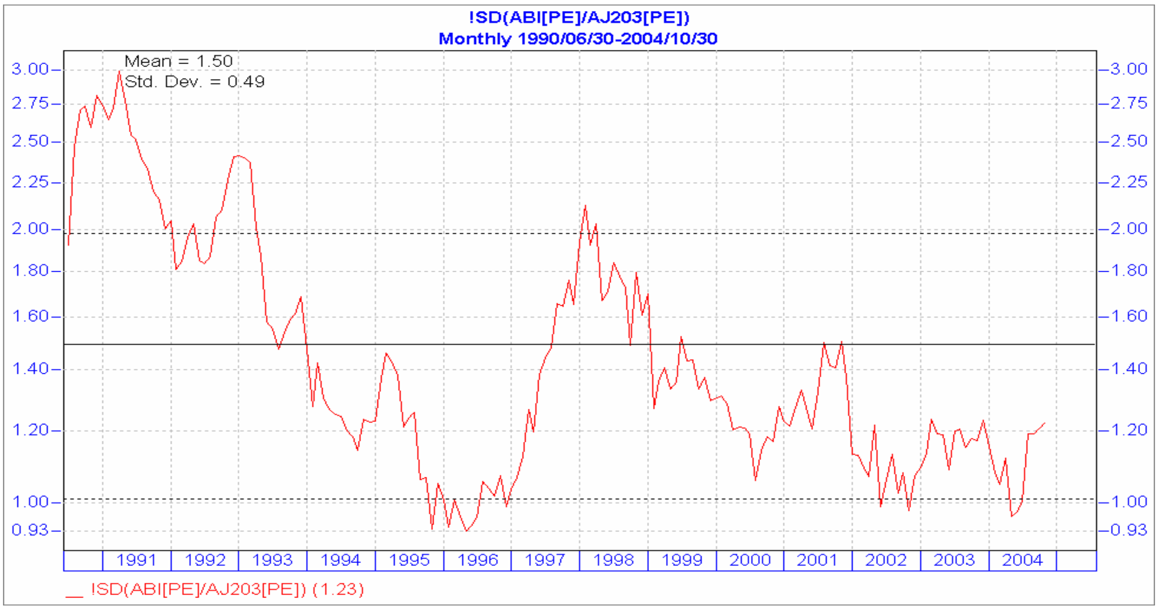
	Sales volume (000's hl)		Turnover (US $ mn)		EBITA Margin	
	FY03	FY04	FY03	FY04	FY03	FY04
ABI	12 063	12 999	594	912	16.5%	17.3%
Miller	54 670*	57 921*	4 544	4 778	7.2%	8.9%
America	10 503	10 513	514	531	10.8%	14.2%

* - *Annualised*

Source : SABMiller Annual Report,2004

- As in the case of De Beers, owning 100% of an unlisted company is a far more valuable proposition than owning a majority stake in a listed vehicle. This is because the 100% owner can utilise the cash flows without regards to minorites sometimes overwhelming short term concerns in a publicly listed environment. The use of financial engineering in a business which generates very strong cash flows, such as De Beers, and, in this case, ABI can add tremendous value. For example, through allowing the owners to take out a huge chunk of equity – thereby immediately reducing the cost of the acquisition.
- Finally, and very simply, the current PE ratio of ABI relative to the All Share index is very, very low – close to historically low levels. The average PE relative for ABI over the last 13 years is 1.5 times – against a current level of 1.2 times, at the proposed take-out price (see chart 2) . ABI is a far superior company than the average company listed on the JSE (see chart 3), and deserves a very high premium. Just on this very simplistic basis alone, one could credibly argue for a price at least 25% higher than the one on offer by SABMiller!

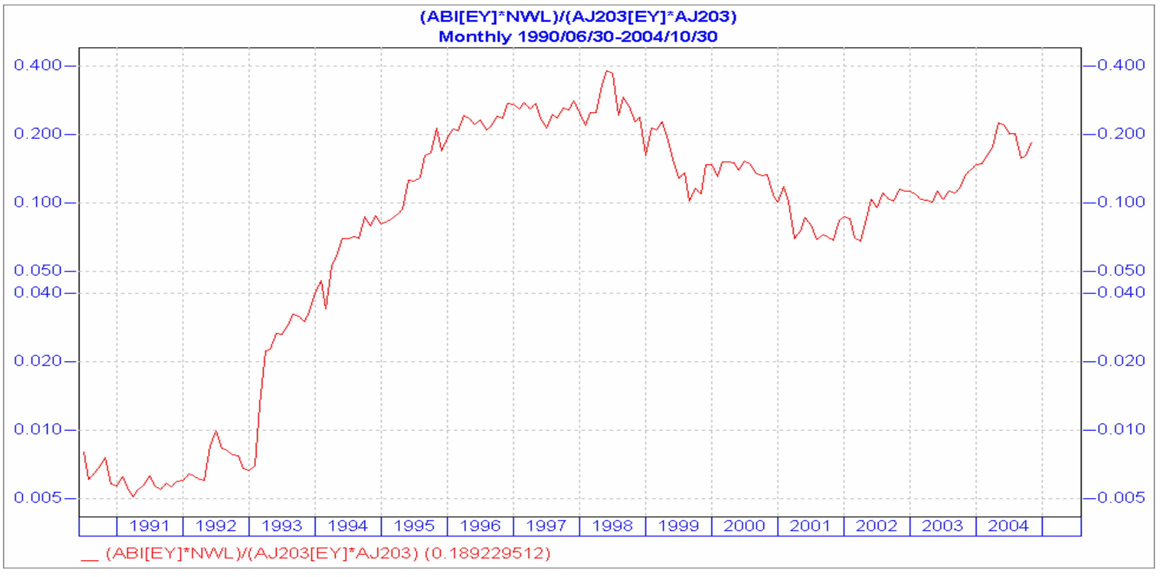
Chart 2 : ABI PE relative to the All Share index – close to historic lows



Source : Inet Bridge

From the above, it stands to reason, that we are not supportive of the proposed transaction by SABMiller, and intend advising our clients to vote against it. We think that minority shareholders should take heed of Brian Joffe's advice. SABMiller is doing this for the benefit of its own shareholders, and the ABI minorities have to look after themselves. The key question then becomes: What is the likely outcome if the bid fails? We see one of two things happening.

Chart 3 : ABI earnings relative to the All Share Index earnings



Source : Inet Bridge

First prize is that SABMiller decides to walk away, and the status quo remains. In this case, there is a strong likelihood that the share price drops – possibly even substantially, to pre-bid levels. We would welcome this outcome, as it would give us a chance to buy more of the stock for our clients – at very attractive levels. It would be as if the Spur announced a massive sale on hamburgers – our favourite food. Our reaction would be similar – we would buy as much as we could eat!

Second prize would be that SABMiller ups its bid to a level where minorities effectively share in the upside of the synergies that will be unlocked by having ABI in an unlisted format – let's just call it payback for helping to fund the capex payments over the past few years.

In short, we see the likely outcome as a win-win situation for ABI minorities. In addition, we think the bid - whether successful or not - indicates a growing confidence in the future of the economic environment in South Africa. This is good for owners of companies operating in South Africa, and points to higher share prices over the medium to long term.

Piet Viljoen **October 2004**