RE:CM
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THE INDUSTRIAL SECTOR – *High Quality Businesses at Cheap Prices*

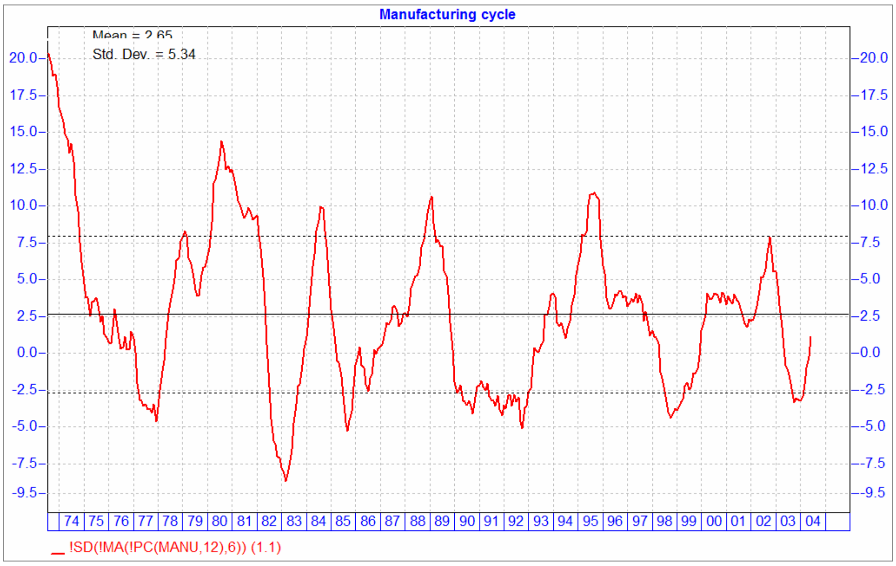
If you have been monitoring our portfolio at RE:CM you would have noted that it continues to be heavily biased towards local industrial stocks - and in particular manufacturing industrial stocks. In our investment team's search for good businesses trading below their intrinsic value, industrial stocks continue to be a fertile picking ground.

Here, we are finding stocks which have had long histories of delivering real earnings growth (i.e. earnings growth above inflation) through the business cycle. These are exactly the kind of businesses we like to invest in over the long term since the prices of these businesses should reflect their earnings growth over time: thus generating capital growth in excess of inflation. As of late these companies' earnings have come under pressure especially with the strong Rand. Imports have become very competitive and deflation is occurring in many products. As a result, although volumes are holding up, and even growing rapidly in some cases, revenue growth has been very difficult to achieve. As a result of these shorter term pressures, the market has become doubtful about the long term earnings growth potential of these businesses.

This is seen as an outstanding investment opportunity for us at RE:CM, whilst the rest of the market gets progressively more disillusioned while concentrating on short term earnings fluctuations. Our investment philosophy demands of us to (or at least attempt to) value a business on its long term sustainable earnings capabilities through the business cycle and ignore short term mood swings. Currently many industrial manufacturing companies are delivering below normal earnings and are therefore delivering lower than normal returns on shareholders capital. When valuing these businesses, we concentrate on the sustainable return on equity the business should generate through both the ups and downs of the economic business cycle. It is important to note, that the success of our investment process is not dependant on our being smarter than the market. (If that were so, we would be doomed to failure!) In essence, our success largely depends on the fact that our investment philosophy allows us to have a much longer time horison.

In addition, while we do take note of where the business cycle is, we do not attempt to forecast where it is going. Instead, we allow the much more powerful force of reversion to the mean to help us. This is one of the very few things upon which market practitioners can rely – as opposed to analyst's forecasts! To see how this works in practice, the platinum sector is a good spot to look at. Two years ago when the Rand was very weak, platinum mines were printing money. As a result, management decided to expand the printing presses, and announced huge mining capacity increases. Analysts agreed with management, and forecast continued massive growth in profits. Share prices got to ridiculous levels. The consequence was unsurprising: higher costs and lower profits, leading to lower share prices. This was classic mean reversion in action.

When (not if!) the manufacturing cycle reverts to its mean, the businesses will benefit from strong volumes. This is currently not being discounted by the short term orientated market participants. The following charts illustrate the strong cyclicality exhibited by the manufacturing cycle over the very long term. Our contention is that the cycle is very much alive and kicking, and will some day turn up again. We just don't know when, and waste no time on forecasting this!



Source: Inet

Due to the past few years of relatively low manufacturing volumes, pressure on the top line and as a results weak earnings growth, businesses have been forced to focus inwards. Working through the numbers it is clear that these tough times have forced management to run very efficient operations with a low cost base. This positions businesses well for any increase in volumes in the future, where increased volumes should be generated off a relatively lean and mean fixed cost base. The past few years of tough times has also sorted the rats from the mice, with the strong surviving.

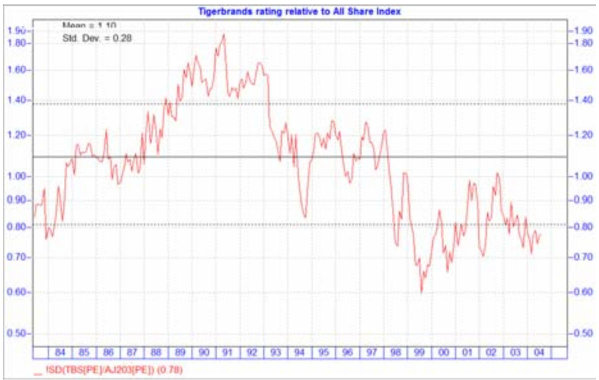
With businesses focusing on operations and low interest rates, one also sees strong balance sheets in these companies with low gearing levels. This enables them to wait out the tough times, whilst still rewarding shareholders with strong dividends. In essence, as a shareholder in these businesses, you are getting paid well to wait for an upturn.

In the charts below, investors can see that we are currently faced with a very good situation: prices for good quality businesses are low – i.e. investors are not expecting much. The charts show the P/E ratios relative to the All Share index for four of our favourite companies. Investors are not paying very much for the earnings generated by these companies, mainly because they are expecting the current poor trading conditions to stay in place indefinitely. It is clear that prices are currently at or near all time lows. If business conditions improve, these companies share prices should improve as well. If conditions stay poor, there does not seem to be much downside.

<u>Selected companies' P/E ratios relative to the market</u>

Nampak

Tiger Brands



Afrox

ABI

Source: Inet

Due to the value being seen in local manufacturing stocks, Nampak, Tiger Brands, ABI and Afrox remain key stock picks in our current portfolio. These companies are all high quality companies with strong brands and have an oligopoly in their markets, yet it is not factored in the price you pay for the business. Furthermore these businesses have a long history of generating real earnings growth resulting in real returns for its shareholders. Yet these businesses with high quality fundamentals continue to trade at very low ratings relative to the rest of the market. They also provide a dividend yield of about 4.6% on average in comparison to the market's dividend yield of 3.2%.

Therefore at RE:CM we are currently very comfortable with our exposure to these high quality stocks at cheap prices. We are patiently waiting for these businesses to be valued at their true worth and in the mean time, are being rewarded with strong dividends.

Meirine Giggins, Investment Analyst
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