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FEBEZZLEMENT: The Functional Equivalent of Embezzlement

Embezzle

To take (money, for example) for one's own use in violation of a trust

[The American Heritage® Dictionary of the English Language, Fourth Edition]

Bezzle

The economist J.K Galbraith used the term "bezzle" to denote the amount of money siphoned (or "embezzled") from the system. Galbraith's prediction was that this goes up and down with the economic cycle. At a macro level, bezzle could be interpreted to cover a range of ethical crimes and misdemeanors - from outright corruption and fraud to self-interested self-deception and greed.

In good times, he remarked, the bezzle rises sharply, because everyone feels good and nobody notices. "In [economic] depression, all this is reversed. Money is watched with a narrow, suspicious eye. The man who handles it is assumed to be dishonest until he proves himself otherwise. Audits are penetrating and meticulous. Commercial morality is enormously improved. The bezzle shrinks."

[Galbraith, The Great Crash, 1955]

Febezzlement

"But suppose you paid a lot of attention to algebra, which I guess Galbraith didn't, and you think, "Well, the fundamental principle of algebra is, 'If A is equal to B and B is equal to C, then A is equal to C.'" You've then got a fundamental principle that demands that you look for functional equivalents, all you can find. By the way, Galbraith invented the word "bezzle" to describe the amount of undisclosed embezzlement, so I invented the word "febezzlement": the functional equivalent of embezzlement.

This happened after I asked the question "Is there a functional equivalent of embezzlement?" I came up with a lot of wonderful affirmative answers. Some were in investment management. After all I'm near investment management. I considered the billions of dollars totally wasted in the course of investing common stock portfolios for American owners. As long as the markets keep going up, the guy who's wasting all this money doesn't feel it, because he's looking at these steadily rising values. And to the guy who is getting the money for investment advice, the money looks like well earned income, when he's really selling detriment for money, surely the functional equivalent of undisclosed embezzlement. You can see why I don't get invited to many lectures"

[Charles T. Munger "Academic Economics: Strengths and Faults after Considering Interdisciplinary Needs" Herb Kay Undergraduate Lecture University of California, Santa Barbara Economics Department, 2003]

It is a well known fact of market psychology that investors are heavily influenced by their most recent experience. If stock prices have risen strongly in the most recent period, investors expect more of the same; if prices have declined, the outlook is negative. We term this "extrapolation bias". It is exactly this bias that enables less-than-ethical market participants to take advantage of investors at great profit to themselves with almost no risk to their reputation. It is during such times that the bezzle is created.

The size of the bezzle is variable, and directly proportional to the amount of greed that accompanies the extrapolation bias. The wonderful thing about embezzlement, described so well by J.K. Galbraith, is that over the short term, it creates a type of a wealth effect. The “embezzlee” does not realize that something of value is being misappropriated, and continues to spend as if original wealth levels are intact. At the same time, the “embezzlor” has received a windfall gain, which normally has attached to it quite a high marginal propensity to consume. In the short term, there appear to be no losers, and the whole system gets a boost.

This pleasant state of affairs can last for a surprisingly long time. During the course of the process, objective analysis which comes to conclusions diametrically opposed to those of the ruling consensus are often ridiculed or worse. If the “extrapolation bias” with its accompanying super-sized bezzle carries on for long enough, some professional money managers might face mandate terminations. Demotions and even job losses are not uncommon. This reality creates an incentive for the gatekeepers (i.e. the fund management industry) to join the party, and if they are “smart” to enlarge the bezzle even further and claim a piece of it for themselves.

At present, we can identify (at least) two different types of febezzlement in South Africa. Our best efforts are applied to quantify these situations in our valuation work, and avoid them as far as possible. Of course, the converse is also possible: there could be cases where the market has recognised the size and scope of the bezzle, and has priced it in – sometimes quite viciously. These can also turn into investment opportunities. As always, the actions of that portion of the business community which is either less-than-ethical, or simply misguided, create risks as well as opportunities.

Febezzlement number one – Black Economic Empowerment deals (BEE deals). Here we are not actually referring to BEE itself, but rather the perverse outcome of an originally well-intended policy. The old saying goes: “Give a man a fish, feed him for a day. Teach a man how to fish, feed him for life”. This saying encapsulates what the empowerment process is about, and we wholeheartedly support it. But....

We are currently in round number two of the empowerment process. Round number one was spectacularly unsuccessfully concluded around the time of the emerging market meltdown in 1998. At this time, many companies had entered into empowerment deals that consisted of using highly leveraged SPV's to buy newly issued shares in existing companies – fish was being handed out (on a leveraged basis). The crash of 1998 caused most of these fish to disappear, leaving just the debt behind. We are now going through a “new and improved” version of earlier events. Leveraged SPV's are out of fashion, option structures are in. The bezzle takes the form of massive dilution in years to come, as options are exercised and shares issued to fund the commitments being made today. Again fish are being given away, but this time shareholders are bearing all the risk – they just don't realise it, yet.

In due course, we will be back to square one - hungry people with no fishing ability. It is only at this point that the size of the bezzle will become clear to investors, with the concomitant penalty to share prices. Make no mistake – we think BEE is vital for the growth prospects of the South

African economy. We also happen to believe that the huge imbalances created during the Apartheid era need to be rectified on a proactive basis. We just think that education, training and mentoring should take precedence over giving away equity stakes in existing businesses. Teaching people to fish should surely lead to a more sustainable outcome.

Naturally, those positioning themselves for free equity are acting quite rationally. The perpetrators of this specific febezzlement are not the BEE recipients; it is the investment bankers taking advantage of a system that is searching for an equitable outcome, and susceptible to the easy way out. As in most febezzlement situations, everyone thinks they are better off. However, one really needs to ask Barclays what they think of the fact that to ensure control of ABSA (i.e. a 50% shareholding) they need to buy 56% of the company. One thing is clear, if anyone knows how large the bezzle has become, it is Barclays. Let's put a number on it: 6% of ABSA is worth close to R3,75bn at today's prices. The combined value of all companies listed on the JSE is R2,5 trillion. A 6% haircut, which could represent the total size of the bezzle if ABSA is anything to go by, is worth R150bn, or around 15% of GDP.

Febezzlement number two – the growth imperative amongst certain listed companies. Now that stock prices are generally high, growth has become the watchword. We've seen this movie before, and it normally doesn't have a happy ending. In practice, the growth imperative means that any free cash flow generated by a business is immediately used to acquire other complementary businesses, usually citing synergistic benefits. We think of this as a form of febezzlement – shareholders think they are better off due to a growing "accounting" earnings stream while management is definitely better off due to options geared to a rising share price, propped up by what is nothing other than massive capex that is not shown on the income statement. In reality, the free cash flows that belong to shareholders are being redirected towards management, and the shareholders of the target companies. Only when the historically smooth acquisition process hits a speed bump – which invariably happens at some point – does the share price eventually reflect the fact that free cash flow generating ability of the company has been substantially diluted on a per share basis. This dilution is a good approximation of the size of the bezzle. The extent of the share price decline in these circumstances will then eventually reflect the accumulated size of the bezzle. Not a pretty sight. Just ask Dimension Data shareholders, who were subject to one of the largest febezzlement exercises in living memory.

In a recent interview with the CEO of SABMiller, it became clear that he interpreted his mandate from shareholders as one of growth. He said that family owned brewers were actually very good businesses – lots of free cash flow, and very little inclination to issue shares for acquisitions that would dilute this strong cash flow. Unfortunately this meant that they were excluded from taking part in the global brewing consolidation process, which, by some twisted logic, apparently makes them less attractive investments. Our clients' portfolios do not hold shares of this company, but we of course immediately started screening our database for "unattractively priced" listed family controlled brewing businesses! To quantify the size of this particular bezzle is slightly more difficult than the BEE example. At the risk of upsetting more than a few "vested interests", here follows our analysis of the situation:

SABMiller used to be a non-acquisitive company when it was still listed on the JSE. This provides us with a convenient starting point. In 1999, the year it moved to the LSE, SAB had a market value of \$6bn. At that time, the business of SAB was dominated by its interests in South Africa – in fact, it could be argued that SAB was a proxy for the South African economy. As a measure of how SAB would have fared, had it not listed in the UK and gone on a massive acquisition spree, one could argue that a group of companies consisting of Rembrandt, Pick ‘n Pay and Tiger Brands could be used as a control group. All are predominantly South African, have strong annuity based income streams and have strong links to the consumer staple area. Over the period 1999 to 2005, these companies have all tripled their value in US\$ terms, without issuing meaningful amounts of new shares. It would therefore probably be safe to say that SAB could have experienced the same tripling in value, had it chosen to forego the acquisition spree that followed its London listing. Following this line of argument would mean that SAB’s market capitalisation today would have been \$18bn. Now for the surprising bit - it turns out that that is exactly what it is! The only problem is that they have issued an additional 329mn shares in the process – an increase of over 40%. Calculating the size of the “bezzle” is now a simple matter of applying the ratio of new shares issued to the total amount in issue (329mn divided by 1103mn), and multiplying the answer with the current market value of the business (\$18bn). Answer: bezzle = \$5,4bn. And that is just for one company! Admittedly, share prices of most South African companies have been too low to entice management into issuing lot’s of new shares for quite a while so the total value of the bezzle will still be on the low side. Going forward however, it seems likely that this will change.

The above analysis is just our view on this situation. As investment analysts, our opinion on the morals of any particular situation should be taken with a pinch of salt. After all, management of SABMiller will have a completely opposing view, and will also be able to motivate their reasoning very, very well. What is far more important is what value we are receiving (or more importantly, what our clients are receiving) for their every Rand invested in SABMiller at the current price. We think there is a whole lot of “bezzle” embedded in the current share price; management will say it is the discounted present value of future benefits from their acquisitive strategy. Be it as it may, we are not prepared to pay for either.

Given the current strong market action, we are sleeping less and less well. Slowly but surely, the febezzlers are once again gaining the upper hand – slowly but surely, rational asset pricing is moving towards irrational share price chasing. In this type of environment, our clients will experience much less excitement than they might otherwise think they should be experiencing. However, just like the over-exuberance of a bunch of four year olds at a birthday party inevitably ends in tears, so will the current bout of febezzlement. Our preferred course of action is to wait until it all comes unstuck; and then sift through the debris for good assets at good prices. As always; we are committed to staying boring, when everyone around us is getting excited.

Piet Viljoen

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