ELECTUS
EQUITY SPECIALISTS

Quarterly Strategy Note | August 2012


Neil Brown &
Richard Hasson | Boutique Heads

Total Returns to end of July 2012	1-month	3-month	6-month	1-year	3-year p.a.	5-year p.a.
JSE SWIX (J403)	3.2%	2.2%	7.9%	18.7%	17.4%	8.4%
JSE All Share (J203)	2.7%	0.9%	4.0%	14.5%	15.7%	6.9%
JSE Resources (J258)	-1.8%	-7.6%	-15.2%	-7.4%	4.4%	-0.6%
JSE Financial (J580)	5.2%	4.6%	15.0%	25.8%	23.8%	13.6%
JSE Industrial (J257)	3.8%	5.8%	15.4%	30.9%	19.5%	7.0%
USA S&P 500 (ZAR)	1.7%	4.6%	10.9%	32.1%	15.2%	3.5%

Economic Indicators	31-Jul-12	30-Apr-12	31-Jan-12	31-Jul-11	31-Jul-09	31-Jul-07
R/$	R8.22	R7.75	R7.80	R6.71	R7.84	R7.10
Prime Interest Rate	8.50%	9.00%	9.00%	9.00%	11.00%	13.00%

Sources: Deutsche Bank and Morningstar

ELECTUS VALUATIONS UNEARTHING OPPORTUNITIES

What really excites us as fund managers is when we find a company that, on a fundamental basis, offers compelling long-term value but is regarded as a "low expectation" company by the market. In this Strategy Note, we briefly review the changes to our investment team. We also provide commentary on two companies that we believe have been overlooked by the market.

ELECTUS' OWN EQUITY RESEARCH TEAM

In constantly striving to improve our business, which will ultimately result in enhanced client outcomes, we have made changes and enhancements to the equity research structures within ELECTUS. As a specialist equity boutique within Old Mutual Investment Group SA (OMIGSA), ELECTUS previously used the centralised equity research team.

While ELECTUS has built a robust investment philosophy and process and has an enviable long-term track record, we realised the need to in-source our research. We requested the changes and enhancements in late 2011 and in February 2012 we hired six investment professionals from within OMIGSA, as well as one external investment professional. This means that ELECTUS now provides its own entire proprietary bottom-up equity analysis.

These investment professionals have an identical investment philosophy to the existing ELECTUS philosophy, while adding the appropriate depth of investment skills and experience across all sectors of the South African equity market. They fit in well with the ELECTUS culture and share a similar passion, focus and desire to be accountable for their contribution to client returns. Another important change is that for the first time the investment analysts' remuneration and incentives are completely aligned with client success and ELECTUS deliverables.

We welcome the following seven highly skilled investment professionals to the ELECTUS team: Feroz Basa, Warren Jervis, Siboniso Nxumalo, Sharief Pansarey, Greg Cort, Gustav Schulenburg and Izak Swanepoel.

The new ELECTUS team is already operating extremely well, delivering high-quality proprietary equity research. As examples of this research, we have included commentaries on **Raubex** and **Investec**, written by two new members of the ELECTUS boutique.

ELECTUS INVESTMENT TEAM


RICHARD HASSON
BCom, CA, CFA
Investment experience: 15 years


NEIL BROWN
Nat Dip Co Adm, MBA
Investment experience: 20 years


ANWAAR WAGNER
BBusSc (UCT)
Investment experience: 14 years


FEROZ BASA
BCom (Hons)
Investment experience: 9 years


WARREN JERVIS
BCom (Hons)
Investment experience: 23 years


SIBONISO NXUMALO
BCom (Hons)
Investment experience: 5 years


GUSTAV SCHULENBURG
BCom, MBA
Investment experience: 1 year


SHARIEF PANSAREY
BCom
Investment experience: 6 years


GREG CORT
BBusSc (Hons), CFA
Investment experience: 6 years


IZAK SWANEPOEL
BAcc (Hons), CA, CFA
Investment experience: 12 years

A PROMISING ROAD AHEAD FOR RAUBEX

Insights by Gustav Schulenburg

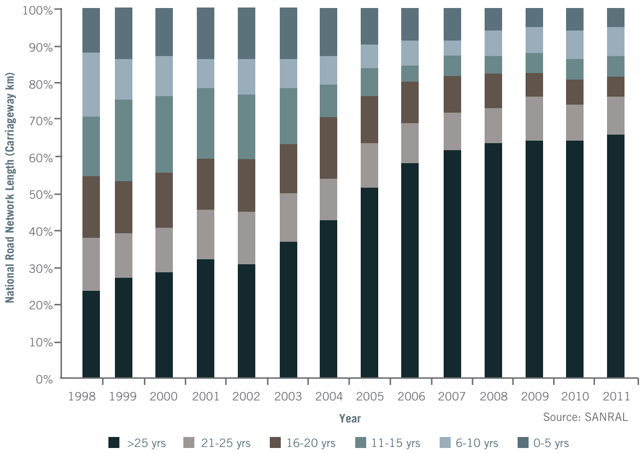
The misguided and negative sentiment surrounding the South African National Roads Agency Limited (SANRAL), and the road construction industry in general, has created opportunities for those investors able to see beyond the short-term noise and focus on business fundamentals and valuations.

"Road building" prospects rock solid

We believe the road construction and aggregates industry is poised for growth, due to numerous prominent factors:

1. Over 80% of our roads are older than 20 years (see chart 1). South African trade and logistics are unlikely to survive without significant expansion and upgrades to our road networks. For this reason, we believe the Government's commitment to developing South African roads, whether upgrading, resurfacing or constructing new roads, remains intact.

Chart 1: Pavement Age Trend



2. National Treasury has allocated R18-20 billion a year to road construction and maintenance for the next three years, predominantly for SANRAL and S'hamba Sonke projects, but this also includes smaller allocations at provincial and municipal levels.
3. The development of rail is unlikely to pose an immediate threat to this budget. In addition to the usual passenger traffic, 87% of South African land freight tonnage currently travels by road. While Transnet aims to drive more road freight to rail, their short- to medium-term focus is on moving commodities, such as coal and iron ore, to the ports.

SANRAL remains on track

We recognise that the industry has not been without its challenges: The decision to roll out an e-tolling system and the first phase of the Gauteng Freeway Improvement Project (GFIP) was taken in 2008. Little did we know that a massive global recession would follow, hitting our pockets and causing a national outcry against the GFIP and e-tolling.

SANRAL is a parastatal with a proven reputation of being a highly-efficient and well-run business. Their roads have been built on time, according to specification and within budget. Many motorists are currently enjoying the benefits of less traffic and fewer potholes, but if Gauteng road users do not pay, it is likely that either the entire country will pay through a national levy or Government will have to use money already allocated to other, perhaps crucial, projects.

We cannot blame SANRAL for this debacle, as reservations to pay toll fees could have been raised before the roads were built. SANRAL simply implements – very efficiently, we might add – government instructions. The reinstatement of SANRAL's highly competent CEO, Nazir Alli, was a positive move for the company. Alli has a solid track record of ensuring that SANRAL delivers the best service to the public.

SANRAL's total road network covers 18 000 km (with toll roads only comprising around 17%). The competence of SANRAL to implement National Treasury's road construction and maintenance budget should bode well for both SANRAL's future and SA's road construction companies, like Raubex.

> Raubex's chairman and executives own more than 17% of the business.

The traction in Raubex

Road construction and aggregates company Raubex (RBX) was founded in 1974 by Koos Raubenheimer, who remains a large shareholder and the non-executive chairman. As part of our investment philosophy, we prefer companies where management own physical shares rather than share options – as we believe that when the management team is aligned with shareholders, it drives the right behaviour and ultimately creates long-term value for our clients. Today, Raubex is a leader in road construction and rehabilitation and a key player in SA's infrastructural development.

Through its vertically integrated value chain, Raubex consistently achieves higher margins relative to competitors. Using its internal divisions, the business gives away less margin to external product suppliers, while also providing competitors with products or services.

Raumix Materials

The Raumix Materials Division focuses on contract crushing, the production of aggregates and asphalt, as well as materials handling and beneficiation for the mining industry.

With a large portion of its work in mining support services, Raumix has profited from increased mining activity. Its asphalt unit, on the other hand, offers different opportunities. The shortage of bitumen (asphalt) in South Africa is a real concern. Oil refineries are either not fully operational or not incentivised to produce the required quantities of bitumen to meet the demand for tar. Raubex is currently importing bitumen from Singapore and Dubai. This shortage will either increase tender prices or reduce competition, as smaller competitors don't have the resources to source their own bitumen.

Raubex Construction

This includes the Road Construction Division (which constructs pavements and on- and off-ramps, does ground reinforcing and earth shaping) and Roadmac, the road surfacing and maintenance division.

International operations

Raubex has also been operating in Zambia, Zimbabwe, Botswana and Namibia for a number of years. These operations have flourished and make up almost 18% of revenue and 22% of operating profit. We believe their business model of establishing local businesses to train and employ people is a sustainable model that will lead to continued success in Africa.

Constructing value

We are confident that from a bottom-up fundamental valuation basis, there is long-term value to be found in Raubex for the following reasons:

Profits: While headline earnings have suffered in recent years, headline earnings per share (HEPS) are still 11.6% higher than in the 2008 financial year* – since then the share price has fallen by more than 65%. Normalised HEPS for Raubex is likely to be 15% to 20% higher than current levels. (*FY 2008 HEPS adjusted for comparative purposes).

Chart 2: Raubex share price relative to earnings

Price earnings and dividend yield: The current share price reflects a price/earnings ratio of 7.6 times, on what is likely to be "trough" earnings, and a dividend yield of 4.5%. In comparison, the FTSE/JSE Shareholder Weighted All Share Index (SWIX) is on a price/earnings ratio of 13.3 times and a dividend yield of 3.3%. Investors can buy Raubex at a very attractive valuation with a significant margin of safety in the valuation.

Balance sheet: Raubex has a healthy balance sheet with R624 million in the bank (equating to R3.40 per share), while all the debt on the balance sheet is asset-backed by their equipment. Therefore, the business has zero effective debt that needs to be settled. On a book valuation, the business has a Tangible Net Asset Value (TNAV) of R10.68 per share.

This means that at the current share price of R13.50, investors are only paying a 26% goodwill premium to TNAV, which we believe is far too low for SA's largest and best road builder. In addition, on a discounted cash flow valuation basis, we believe Raubex is worth R19.85 per share.

Culverts in the road

While more information on the possible Competition Commission fines was not available at the time of writing, we have stress-tested our valuation with significant fines and still remain happy with the outcome. Furthermore, significant fines could lead to consolidation in the construction space, as many financially distressed entities (listed and unlisted) remain vulnerable to cash-flow pressures.

The recent collapse of JSE-listed Sanyati highlights the risk of insufficient cash and cash-flow availability in an uncertain environment marred by delayed payments and questionable government execution.

While there are also risks in working directly with provincial and municipal authorities (around 20% of Raubex's work), its cash underpin, diversification in operations, and lack of debt should ensure that Raubex is less at risk from delayed payments.

On solid ground

Over the last 12 months, Raubex has underperformed the construction sector by 15%, even though they have a stronger balance sheet, more true cash, and higher operating margins.

On this basis, we believe that Raubex is trading significantly below fair value. We are by no means assuming a return to the top-of-the-cycle road building margins, but we do believe, on a normalised basis, that the share is too cheap.

Raubex offers compelling value at current levels. Given the prevailing construction industry sentiment and recent Gauteng Freeway troubles, we believe the market is overly pessimistic. This provides us with an opportunity to buy Raubex below what we believe is a true reflection of the business' value.

CASHING IN ON UNCERTAINTY

Insights by Siboniso Nxumalo

Investec is offering great value as low expectations are being unjustly built into its share price.

ELECTUS has previously written about why, at times, we favour quality cyclical companies over quality defensive companies (see Strategy Note: When does a quality business not offer value?). Due to the high levels of global uncertainty, defensive shares are currently trading at sizeable premiums to their more cyclical counterparts – and investors are willing to pay this sizeable premium for companies with relatively predictable near-term earnings.

At ELECTUS "we strive to buy shares at prices that are low compared to their long-term investment value". This investment philosophy relies on the assumption that, at times, the market's expectations of a particular company (share) differ from our calculation of its long-term value.

> "The future is never clear. You pay a very high price for a cheery consensus. Uncertainty is the friend of the buyer of long-term value." Warren Buffett, 1979

A few years ago I came across a wonderful book by Professor Alfred Rappaport and Michael Mauboussin titled "Expectations Investment". The key concept in this book is that the secret to successful investing is to estimate the level of expected performance embedded in the current stock price. An investor should evaluate the company's competitive position, quality of management and financial position relative to the expectation reflected in the price.

Usually companies trade at discounts to our valuations because something has gone wrong within the business and they have suffered a threat to the perception of their long-term viability. Our skill is identifying those shares, and it is so exciting when such opportunities come to the fore. Investec is one such opportunity!

Earning their stripes

In 1974 a few entrepreneurs launched a small leasing company in Johannesburg. Six years later they had secured a banking licence and by 1986 were listed on the JSE, with a UK listing following in 2002.

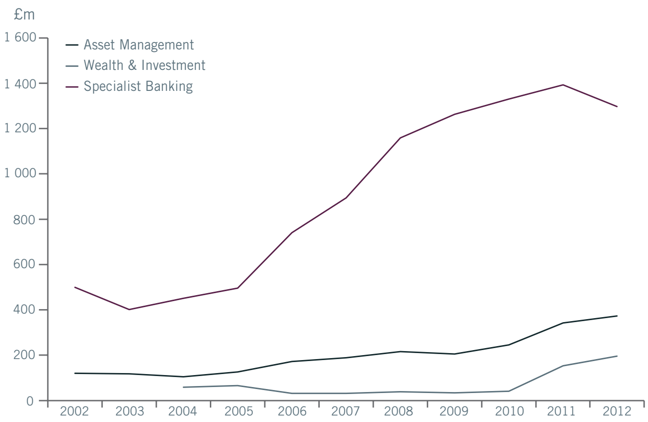
Today, Investec is the fifth largest bank in South Africa, boasting a market capitalisation of over R43 billion. For the year ending 31 March 2012, Investec generated operating profits of £255.8 million from its three business units: asset management, specialist banking and its wealth and investment services. Of these profits, 33% were from the UK and European operations and 84% from Southern Africa (losses in Australia brings the total back to 100%).

What went wrong?

As I've said before, companies generally become "low expectation" shares when something goes wrong, and Investec is one such company.

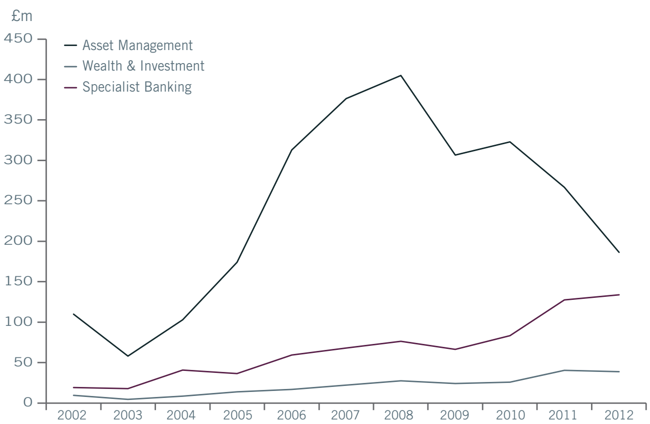
Investec earns the majority of its revenue from its specialist banking division. Over the last decade (since moving to London), Investec has grown its revenue through acquisitions as well as organically. From chart 3, it's clear that revenue growth is not the problem. The real issue lies in the operating profit within their specialist banking division (see chart 4). Profit has halved from 2008 to 2012, largely due to high levels of bad-debt write offs, shown as CLR (credit loss ratio) in chart 5.

Chart 3: Investec's Revenue (per business unit)



Sources: Investec, UBS Securities

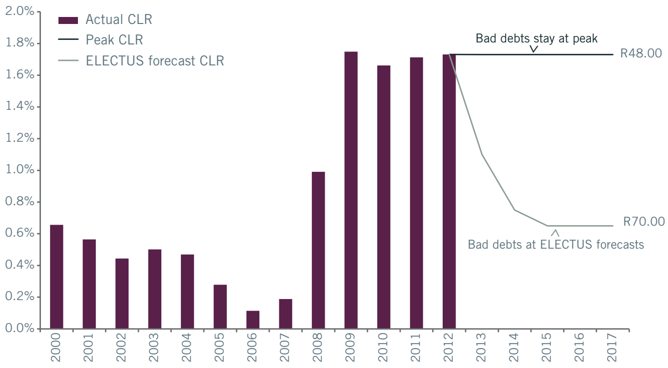
Chart 4: Investec's Operating Profit (per business unit)



Sources: Investec, UBS Securities

It is highly unlikely that credit losses will continue at these high levels for much longer; however, based on the current share price of R49, that is exactly what the market is assuming. (Note: Investec traded at over R80 per share five years ago!) We believe that fair value for Investec is closer to R70, based on normalised earnings through the cycle of bad debt write-offs as well as having built in a significant margin of safety in our valuation. The assumption that bad debts will remain at these levels also disregards management's actions.

Chart 5: Investec: Bad Debts Sensitivity

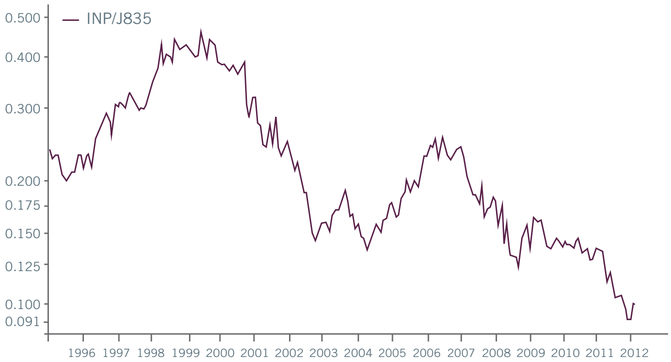


Sources: OMIGSA Research, Company Financial Statements

The appropriate way of looking at Investec's bad debt history is to look beyond the impact of the 2008 global financial crisis and understand the risks that lie in their offshore businesses' loan books, while also taking into account management's responses to these crises.

Over the long term, Investec has been a poor performer relative to the South Africa Banks Index, which benefited from a huge local economic and consumer boom from 2002 to 2007 (see chart 6). It's hard to believe that from the late 1980s to the late 1990s, Investec traded at a premium to SA banks.

Chart 6: Investec relative to the South Africa Banks Index (J835)



Source: I-Net

How could a business that was doing so well end up underperforming its domestic peers and the market as a whole?

Like several other domestic companies, Investec decided to acquire companies internationally to aid their global expansion. As we all know, research has repeatedly shown that mergers and acquisitions have a high failure rate. At ELECTUS, we believe value is created when returns exceed the required cost of capital. Based on this, it's fair to assume that the vast majority of acquisitions are unsuccessful.

Investec has proved no different — management made some value-destructive acquisitions. Since 1992, Investec has made numerous acquisitions totalling £1.1 billion, the largest of which include:

- Israel General Bank, Israel (acquired in stages and sold in 2004)
- Guinness Mahon and Hambros Bank, UK
- Carr Sheppards Crosthwaite, UK
- Ernst & Co, USA (as a subsidiary of Investec, Ernst acquired additional businesses, which were subsequently scaled down and sold)
- Kensington Group, Ireland.

Based on available information, we're able to deduce that the US businesses and Israel General Bank were failures, with Carr Sheppards being the sole success story – as it is the only one of these businesses where returns exceeded cost of capital and shareholder value was created.

In 2007, Investec acquired the Irish sub-prime mortgage lender Kensington for £283 million. We are all familiar with the fate of sub-prime lenders. Seven months later, Investec had already impaired the goodwill by £60 million. In our valuations, we add back all impairments as we seek to judge management's skill over capital allocated.

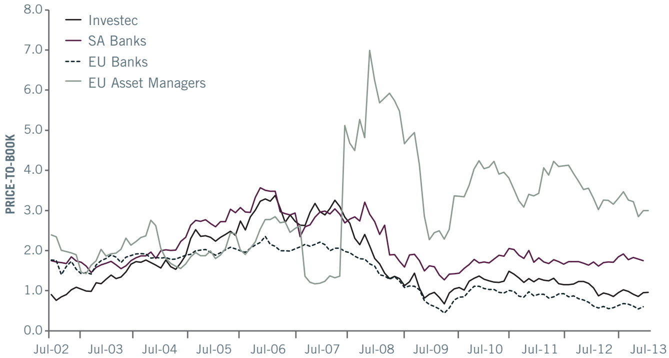
Investec's specialist banking division's return on equity (ROE) is currently 6.1%. While this is totally unacceptable, our research also suggests it's totally unsustainable. Global banks have had a torrid time since 2007, with the European Commission stating that European banks have been recapitalised to the tune of €420 billion since 2008. Despite all its poor acquisitions within a poor business environment in Europe, Investec has not had to raise capital. In fact, Investec has outperformed this selection of global banks.

Valuation: why Investec

Chart 7 shows that Investec is trading at a significant discount on price-to-book value (P/B) relative to both SA banks and European Union asset managers. Considering that Investec is still predominantly a South African business and has a very successful asset management business, this rating is too low. Investec isn't a perfect company, but the market has set such low expectations for the business, it almost assumes the prevailing conditions will continue indefinitely.

We were excited to purchase Investec shares for our clients at what we believe are prices well below its long-term fundamental value.

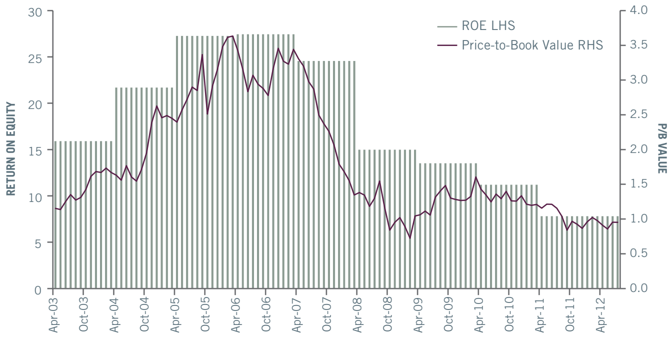
Chart 7: Investec's Price-to-Book Value versus Competitors



Source: ELECTUS

Chart 8 shows the correlation between Investec's return on equity (ROE) and its price-to-book value. When returns are high, investors pay a lot more for the share, as they expect these returns to be permanent. When returns disappoint (as they have over the last few years) investors seem to assume that the returns will permanently remain at these lower levels.

Chart 8: Investec's Return on Equity and Price-to-Book Value



Source: ELECTUS

Investec has some very good businesses that, over time, will earn superior returns. When that happens, the market will adjust the share price to reflect the normalised earnings power of Investec. Until then, we will wait patiently for the market to reflect the appropriate value for Investec.

PORTFOLIO STRATEGY

Within the resources sector, we continue to have a bias towards the large diversified and high-quality mining companies such as Anglo American and BHP Billiton, as they are typically low-cost producers with diversified income streams across various commodities and geographies. We also hold selected single-commodity shares in businesses that we believe have a competitive position in their respective industries.

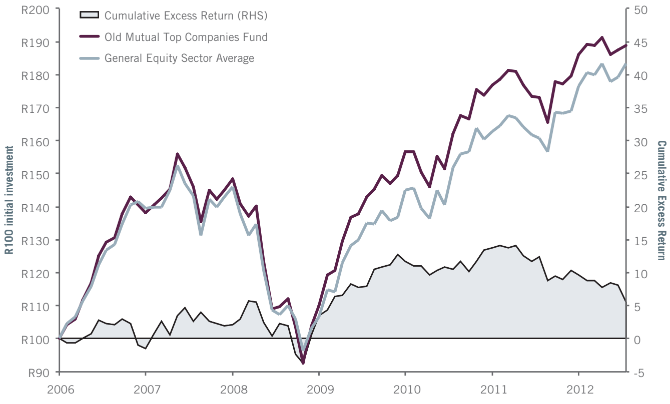
In the South African industrial sector, we have reduced exposure to a few of the domestic consumer industrials, as they have now reached full value. With the proceeds, we have slightly increased exposure to selected, high-quality and better-value rand-hedge industrial shares. We have also purchased some great quality mid- and small cap local industrial businesses that are trading at attractive valuations.

Within financials, based on our company valuations, we retain our preference for selected banks and assurers such as Standard Bank, Investec and Old Mutual as we continue to believe that more upside potential exists in the restructuring initiatives of these three businesses.

At the end of June 2012, our funds remained highly focused, with the top 15 shares comprising over 60% of the funds. The funds all have weighted price:earnings (P:E) ratios below their benchmarks, with good metrics for future earnings and dividends. We believe that the JSE is currently trading at its "fair value", with many defensive industrials being expensive, and several resources and more-cyclical shares offering excellent value. Based on our proprietary equity research, the ELECTUS funds have more than 20% upside relative to their JSE benchmarks, leaving the widest "margin of safety" that we have seen for over three years. This greater than 20% gap relative to the broader market makes us very excited about the potential of future excess returns for our clients. ■

Old Mutual Top Companies Fund vs General Equity Sector average

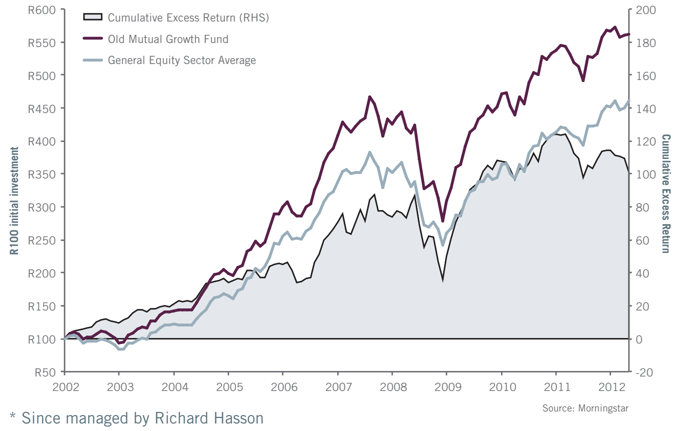
31 July 2006 - 31 July 2012*



* Since managed by Neil Brown and Richard Hasson

Old Mutual Growth Fund vs General Equity Sector average

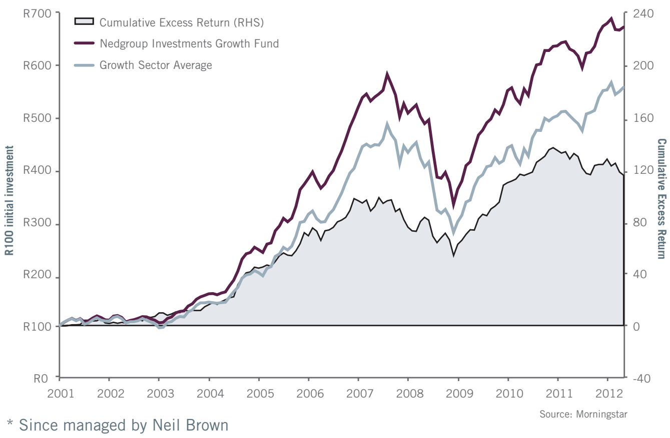
31 March 2002 - 31 July 2012*



* Since managed by Richard Hasson

Nedgroup Investments Growth Fund vs Growth Sector average

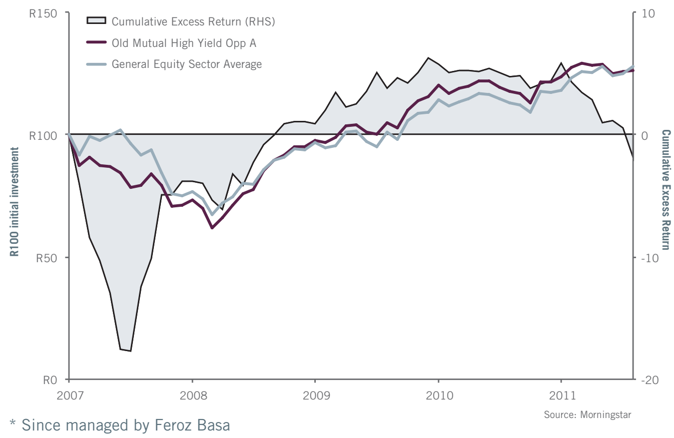
31 March 2001- 31 July 2012*



* Since managed by Neil Brown

Old Mutual High Yield Opportunity Fund vs General Equity Sector average

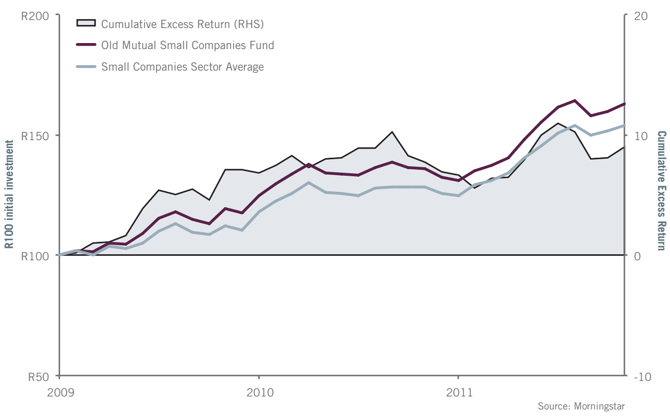
31 December 2007- 31 July 2012*



* Since managed by Feroz Basa

Old Mutual Small Companies Fund vs Equity - Smaller Companies Sector average

31 December 2007- 31 July 2012*



* Since managed by Warren Jervis

For more information on ELECTUS or to read previous editions of our Strategy Notes, visit www.electus.co.za.

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