ELECTUS
EQUITY SPECIALISTS
OLD MUTUAL
Investment Group

Neil Brown &
Richard Hasson | Boutique Heads

Quarterly Strategy Note | December 2012

Total Returns to end of November 2012	1-month	3-month	6-month	1-year	3-year p.a.	5-year p.a.
JSE SWIX (J403)	2.1%	6.8%	15.7%	22.0%	17.4%	8.9%
JSE All Share (J203)	2.6%	8.7%	16.9%	19.8%	15.5%	7.8%
JSE Resources (J258)	-1.8%	10.2%	8.4%	-5.4%	2.5%	-0.9%
JSE Financial (J580)	5.4%	9.6%	23.6%	35.1%	25.5%	15.5%
JSE Industrial (J257)	2.8%	4.6%	14.4%	33.6%	19.1%	8.1%
USA S&P 500 (ZAR)	2.7%	6.7%	13.4%	27.4%	18.1%	6.9%

Economic Indicators	30-Nov-12	31-Aug-12	31-May-12	30-Nov-11	30-Nov-09	30-Nov-07
R/$	8.88	8.43	8.56	8.10	7.43	6.80
Prime Interest Rate	8.50%	8.50%	9.00%	9.00%	10.50%	14.00%

Sources: Deutsche Bank and Morningstar

PROSPECTING FOR BETTER VALUE: DELVING INTO ANGLO AMERICAN

Insights by Neil Brown & Sharief Pansarey

This Strategy Note focuses on analysing the valuation of Anglo American and explaining why Anglo American is the largest share and/or the largest overweight position relative to benchmarks in ELECTUS' client funds.

In analysing the underlying assets that Anglo American owns and manages, we explain how we get to our valuation of US$52 per share (as it is a global company where commodities are forecast in US$, we model the business in US$). This equates to well over 400 00 South African cents per share (cps). With the current share price at around 250 00 cps, it leaves substantial upside to our valuation and a very high "margin of safety" in the valuation for clients. We will also focus on the key areas of disappointment for Anglo American over the past five years: poor capital allocation, poor project management and poor operational performance.

After reading this Strategy Note, we are sure that you will agree with us that, rather than selling the Anglo American shares because we have been frustrated with its recent management and underperformance, the best possible investment decision is to take proactive steps in ensuring that the business is extremely well managed and that "value is unlocked" over the next couple of years as the share price moves towards our 425 00 cps valuation.

Chart 1 shows how we get to our valuation of US$52 per share for Anglo American. As a resources company that is well diversified across several commodities and geographies, Anglo American has a very clear and well-defined strategy regarding its core commodities, assets and projects. It has superb operational assets in coal, iron ore, platinum, diamonds, copper and nickel and the best project pipeline of the leading global diversified resources companies, including BHP Billiton, Rio Tinto, Vale and Xstrata. An example of this project pipeline can be seen in chart 2 overleaf, showing the meaningful forecast growth in Anglo American's copper production.

Chart 1: Anglo American Sum of the Parts valuation

Net Present Value of mining operations	US$m
Net present value of mining operations	68 206
Anglo American Coal	14 543
Kumba Iron Ore	8 783
Minas Rio Iron Ore	6 851
Anglo American Platinum	12 307
Diamonds - De Beers	12 491
Anglo American Copper	6 719
Anglo American Nickel	1 583
Other operating mining assets	4 929
Net present value of investments and other cost	(1 757)
Net cash and investments	2 360
Exploration and head office cost	(4 118)
ELECTUS Fair Value	66 449
Number of shares in issue (m)	1 273
ELECTUS Fair Value per share (US$)	52
Anglo American's fair value using Kumba at market price	54
Anglo American's fair value using Anglo American Platinum at market price	50

Source: ELECTUS

Value of mining assets by division

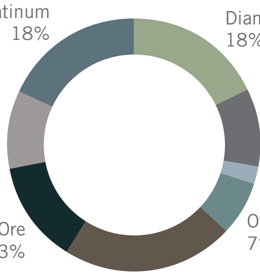
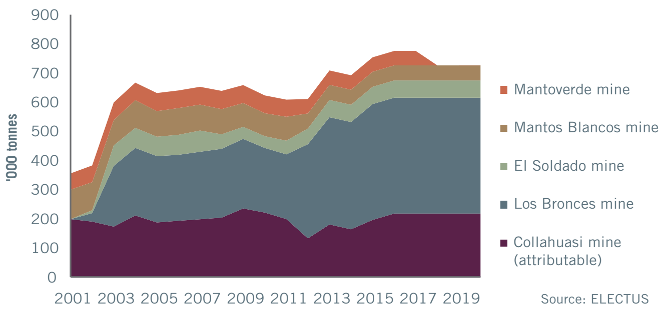


Chart 2: Anglo American copper production volumes



In determining our valuation for the company, we value each asset and project independently on a discounted cash flow (DCF) basis, using very conservative long-term commodity price and currency (rand) forecasts. As you can deduce from our above valuation of US$52, we used a conservative rand/US$ of R8.20 to get to our rand-based valuation of 425 00 cps.

Why then does Anglo American trade at around 250 00 cps?

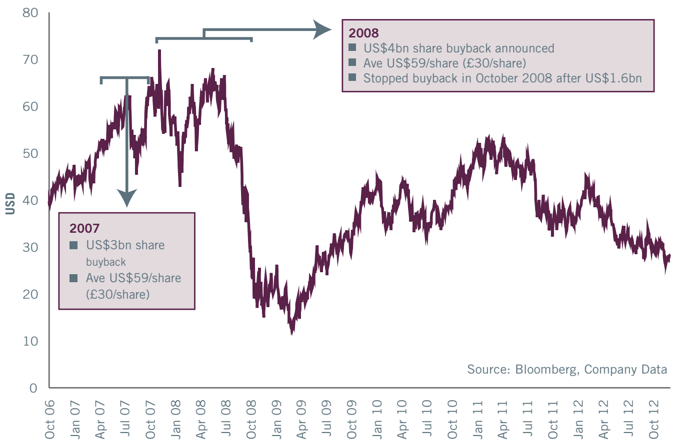
We believe that the answer comes down to three critical areas under the control of senior management: capital allocation, project management and operational performance. Over the past five years, Anglo American has been extremely poor in all of these areas, which is why the share price trades well below our valuation for the company. These are the key areas that must be well managed if a diversified resources company wishes to have an above-average return on equity (ROE).

A company like Anglo American should have a well above-average return on equity (ROE) through time, as it has great assets and operations and an excellent project pipeline. As can be seen in chart 3, Anglo American has had a very low ROE over the past few years, being positioned in the bottom quartile. This has largely been a result of poor decisions relating to capital allocation, project management and operational performance.

Costly Capital Allocation

Anglo American made "super profits" from 2006 to 2008, as a result of the very high prevailing commodity prices. With hindsight, management should have acknowledged that these were "super profits" and been conservative in its capital allocation. Instead, Anglo American made two very costly mistakes regarding capital allocation. The first was to buy back US$4.6bn worth of its own shares at an average price of US$59 (the current Anglo American share price is around US$29).

Chart 4: Anglo American buybacks relative to spot price



Project/company	Number of shares	Average price	Spot price	Difference
US$3bn share buyback programme	51	US$59	US$31	US$-1 443
US$4bn share buyback programme	28	US$59	US$31	US$-796
Total				**US$-2 239**

The second was the purchase of the Minas Rio iron ore resource in Brazil in mid-2007 for US$6.7bn. Anglo American has since spent a further US$6bn on developing Minas Rio, which is still not yet at production and well behind schedule. Minas Rio is potentially a superb iron ore asset, but value has already been destroyed through all the delays and overspending on getting the mine to first production.

Chart 3: Anglo American - The lowest ROEs since the 1932 Great Depression

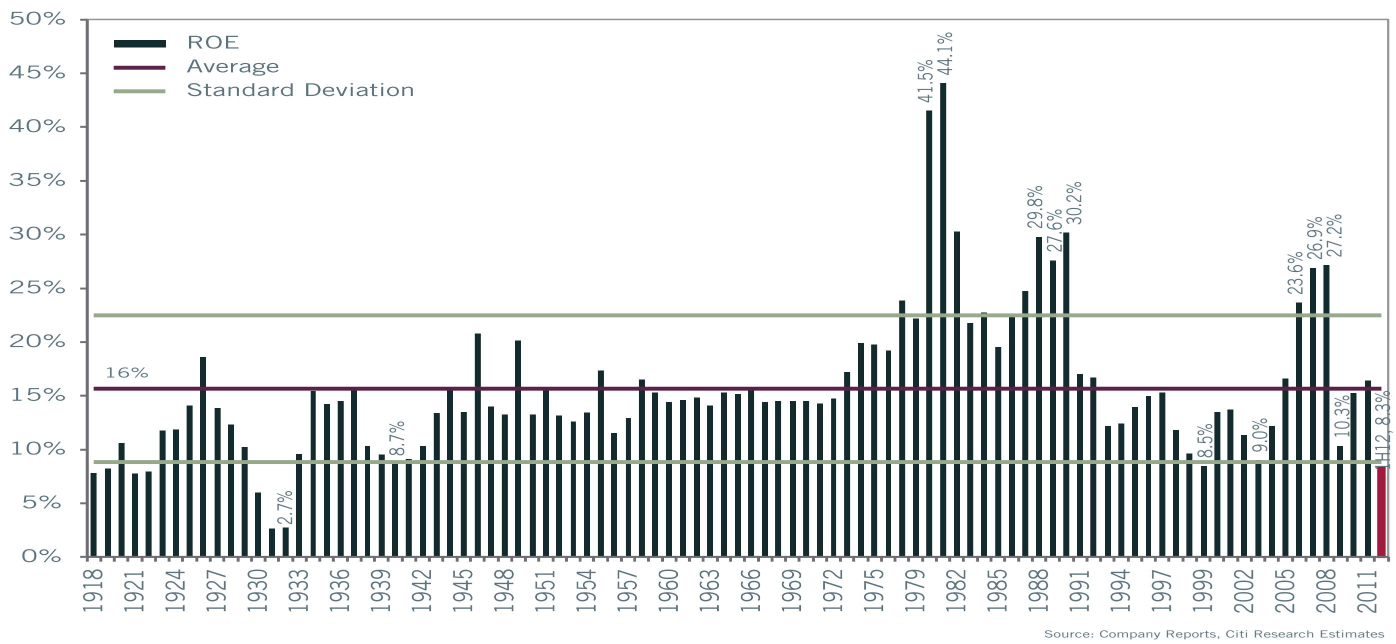
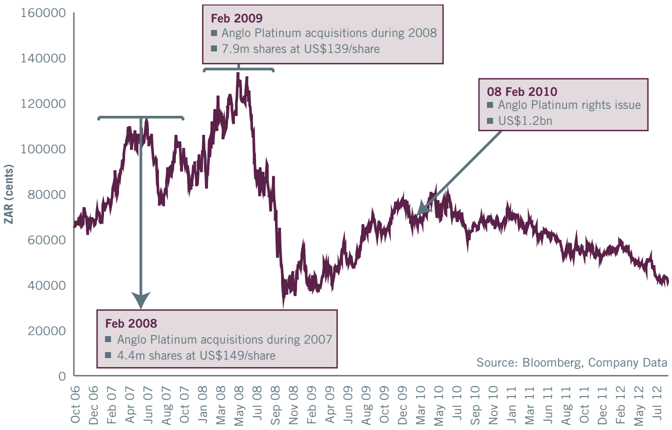


Chart 5: Poor timing of the Anglo American Platinum share buybacks



Project/company	Number of shares	Average price	Spot price	Difference
US$3bn share buyback programme	4 400	US$150	US$50	US$-438
US$4bn share buyback programme	7 942	US$140	US$50	US$-711
Anglo Platinum rights issue	80%	US$1 600		US$-1 276
Total				**US$-2 424**

Anglo American made further capital allocation mistakes by allowing its 80%-owned subsidiary, Anglo American Platinum (Amplats) to buy back its own shares at levels substantially higher than the current share price. Amplats was later forced to have a rights offer at a much lower share price.

Finally, we believe that Anglo American should stop buying any more Kumba shares (it already owns 70%), as better value for iron ore exposure can be obtained by building new mines rather than buying a listed iron ore company such as Kumba. Effectively, Anglo American can build four new iron ore mines for every equivalent Kumba share they buy. As an important aside, the platinum industry, which is under extreme pressure, is the opposite to the above iron ore example, where building a new platinum mine is currently costing twice as much as buying every equivalent Lonmin share in the stock market.

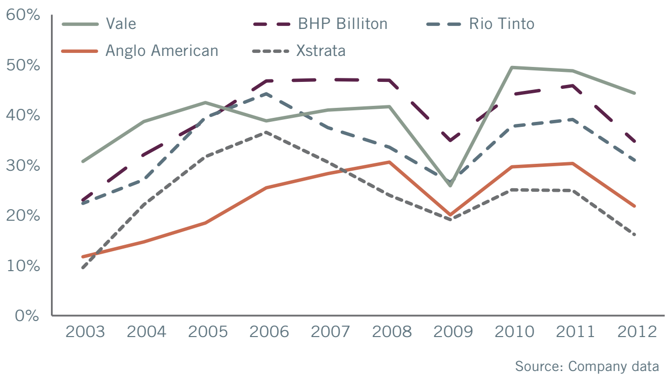
Poor Project Management

Anglo American has been very poor in meeting its own deadlines for starting projects. These project delays, such as Minas Rio, have cost Anglo American a great deal of extra time, capital expenditure and delayed profitability. The poor project delivery is best shown in chart 6, which is taken from Anglo American's own forecasts.

Disappointing Operational Performance

Over the past five years, Anglo American performed fairly well in terms of improving its procurement and asset optimisation, but this has not been sufficient to improve its absolute or relative operating profit (earnings before interest and tax, or EBIT) margins. We believe that, with its superb assets and investments, Anglo American should be able to deliver above-average operating profit (EBIT) margins. Chart 7 shows the disappointing operating margins.

Chart 7: Group EBIT margin relative to diversified peer group

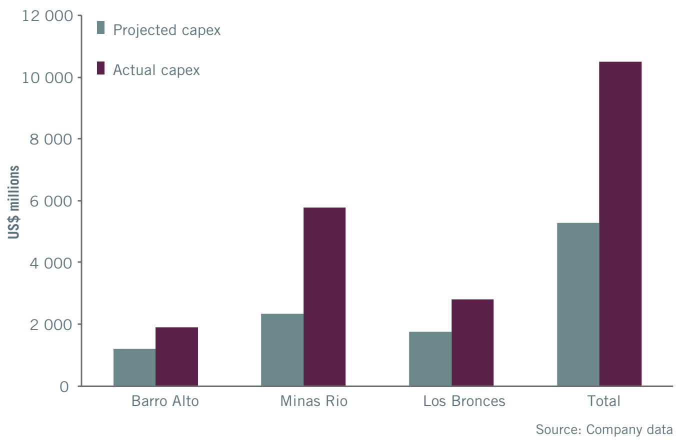


ELECTUS takes proactive steps: Engaging with Executive Management

Based on our extensive valuation work showing substantial upside for Anglo American's share price, we became frustrated with their poor capital allocation, project delivery and operational performance. In mid-2012 we decided to engage with Anglo American's executive management and their board in order to constructively discuss much of the work and research we've outlined in this Strategy Note. We also wanted to discuss how Anglo American could start performing better.

On behalf of our ELECTUS clients, we met with the Anglo American Chief Executive Officer (CEO) and its executive team in mid-September 2012. The next day we sent a formal letter to the Chairman of

Chart 6: Anglo American - Three major projects all experienced capital-cost overruns



Date	Project/company	Project budget (US$)	Actual spend (US$)	Budget overruns	Delay (months)
07-Dec-06	Nickel - Barro Alto	1 200	1 900	700	>12
23-Apr-07	Iron Ore - Minas Rio	2 350	5 789	3 439	60
28-Nov-07	Copper - Los Bronces	1 744	2 800	1 056	18
Total project budget overruns		**5 294**	**10 489**	**5 195**	

the Anglo American board, strongly expressing our concerns and including many of the above charts and facts. At no stage did we request changes to any of the executive directors, but we very clearly showed that Anglo American had not met our expectations over the past five years.

On 26 October 2012, Anglo American CEO Cynthia Carroll announced her resignation and the board started the recruitment search for a new CEO. Cynthia Carroll has been successful as CEO in terms of refocusing Anglo American on its core commodities and also improving its safety record and government relationships. However, we believe that her resignation will enable Anglo American to recruit a new CEO who has strong skills in terms of capital allocation, project management and operational performance. Since Cynthia Carroll's resignation, we have discussed these views with the Chairman of the Anglo American board and we expect the new appointment to be an important "trigger" in ensuring that we see a marked improvement in these key areas of Anglo American.

Based on these developments and our valuation of well above 400 00 cps for Anglo American, we continue to hold large positions in Anglo American within our client funds. We expect that the changes we anticipate happening in Anglo American will lead to better capital allocation, project management and operational performance, which, in turn, should lead to a higher share price and a narrowing of the gap between our valuation of well over 400 00 cps and the current share price of around 250 00 cps.

PORTFOLIO STRATEGY

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

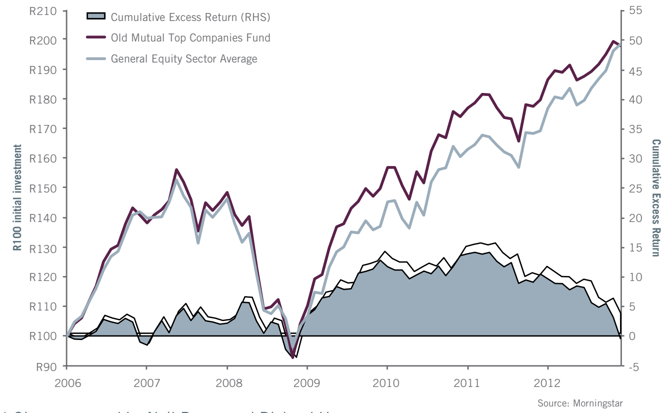
In the South African industrial sector, we have reduced exposure to a few of the domestic industrials, especially if they are not of a high quality, as well as reducing exposure to MTN and Naspers as they have reached fair value. With the proceeds, we increased exposure to selected high-quality and better-value rand-hedge industrial shares, such as Richemont and British American Tobacco. 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.

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 slightly below 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 around 25% upside relative to their JSE benchmarks, leaving the widest "margin of safety" that we have seen for over three years. This 25% gap relative to the broader JSE market makes us very excited for the potential of future excess returns for our ELECTUS clients. ■

Old Mutual Top Companies Fund vs General Equity Sector average

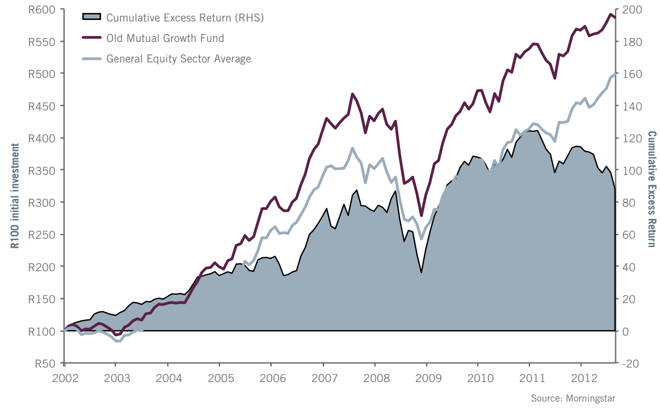
31 July 2006 - 30 November 2012*



* Since managed by Neil Brown and Richard Hasson

Old Mutual Growth Fund vs General Equity Sector average

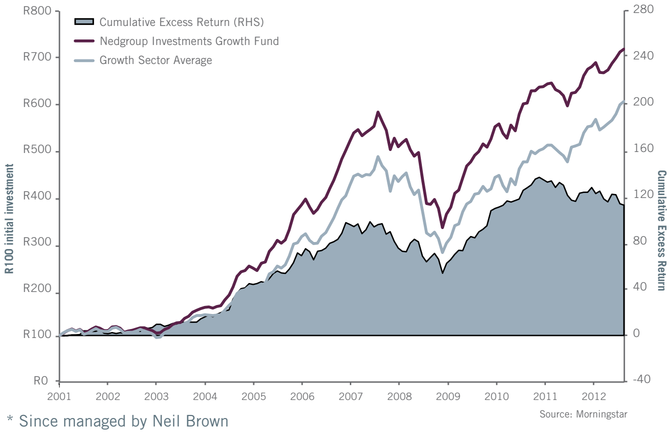
31 March 2002 - 30 November 2012*



* Since managed by Richard Hasson

Nedgroup Investments Growth Fund vs Growth Sector average

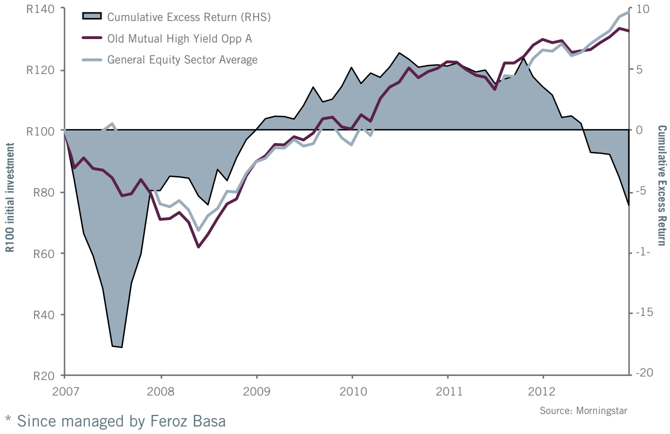
31 March 2001 - 30 November 2012*



* Since managed by Neil Brown

Old Mutual High Yield Opportunity Fund vs General Equity Sector average

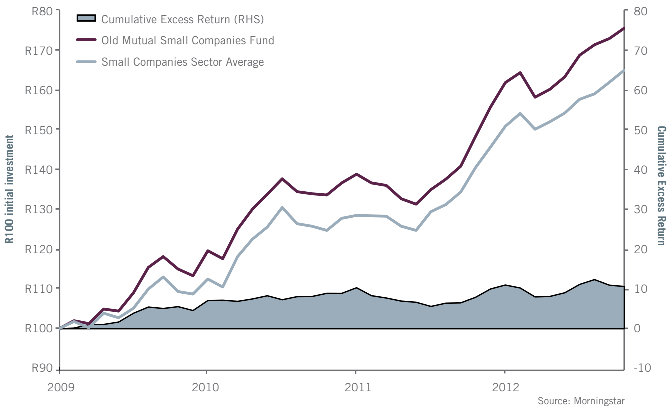
31 December 2007 - 30 November 2012*



* Since managed by Feroz Basa

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

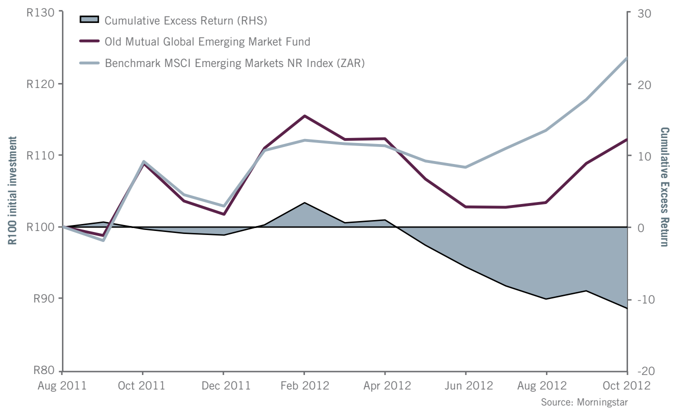
31 December 2007 - 30 November 2012*



* Since managed by Warren Jervis

Old Mutual Global Emerging Markets Fund vs Fund Benchmark

Inception - 30 November 2012*



* Since managed by Anwaar Wagner

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

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