

We still need fertilizer for the green shoots

July saw most global equity markets, South Africa included, being driven by events in the US, where the 2nd quarter US corporate earnings reporting season kicked off. US corporate results in general came in much better than most analysts expected. The banking sector in particular, looked in much better shape than most financial analysts had foretold before the reporting season.

US corporate earnings relieved the markets and alleviated fears that there were no legs for a continued global economic and financial market recovery to stand on. In a sense, the latest US earnings season could be best described as adding some fertilizer to the economic green shoots that commentators have been so desperately trying to look for over the past few months. US stocks showed strong gains in July and local equities followed suit. This in turn continued to provide some support for commodity prices. This applied to oil in particular, which also got a boost from a weaker US Dollar that was weak on an increasing risk appetite.

Locally, Gill Marcus was recently appointed the South African Reserve Bank Governor. There was relief that with this appointment, the Reserve Bank is likely to maintain its independence from third party influences. One only has to look to the immediate north of the border to see the disastrous effects of having a central bank that is too easily influenced and swayed by outside parties. The major area of concern now seems to be what the new central bank Governor's approach to inflation targeting will be.

There will continue to be strong debate about the merits of the current inflation targeting strategy versus disadvantages of formally targeting inflation using monetary policy instruments. The advantages of having a low and manageable inflation rate are self evident, but the problem most critics of inflation targeting have is that the central bank has generally been too inflexible in its approach and in the process has disregarded the bigger picture, which is growth and financial stability.

Locally, another area of concern is the widespread strike action seen in South Africa in July. Many of the strikes eventually ended and unions managed to negotiate wages above the current consumer inflation rate. The gold, platinum, construction, paper and

pharmaceutical sectors were just some of the affected industries. One would hope that this does not become too common an occurrence. It is at the end of the day a vicious cycle, where workers will continuously chase a higher inflation rate that they have partly contributed to. At least inflation continued with its downward trajectory in July and is now close to at least breaking below the upper end of SARB's inflation target range.

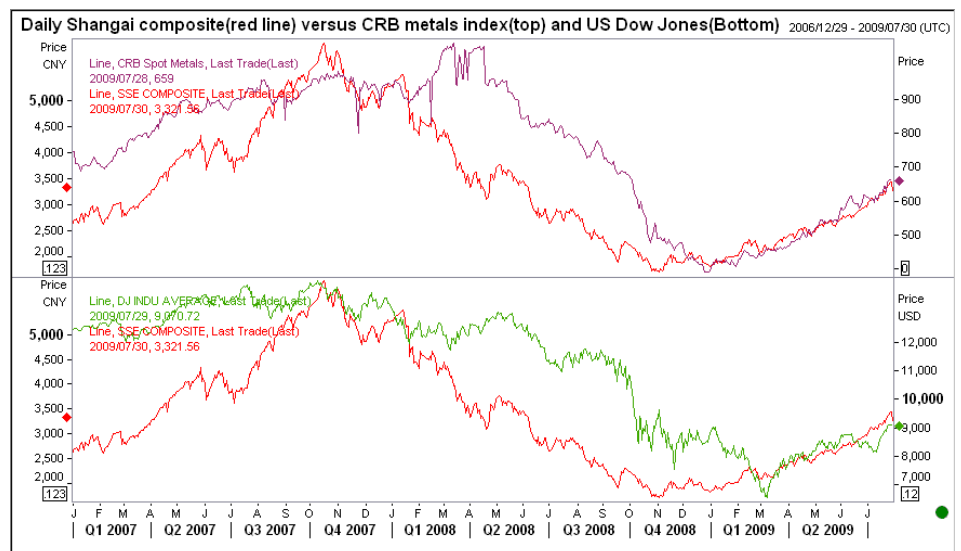
The new Minister of Finance, Pravin Gordhan, said that locally, economic recovery will continue to be experienced in the latter half of this year. Employment growth, as with most other countries, will lag the economic recovery process and local households are likely to gradually increase their spending next year, but consumption growth would lag GDP growth. Something that was also worth noting was that he mentioned that SARS was R19 billion below its benchmark target for revenue collection for the first three months of this fiscal year. If this present trend continues, the revenue authority could be as much as R50-60 billion below its target by the end of the year. South Africa's budget deficit will undoubtedly increase as spending will substantially exceed revenue.

This seriously suggests that government's R787bn infrastructure spending plans may be in danger. This would not support the local infrastructure stocks to the extent that investors have hoped for. Government counters this fear by saying that South Africa's currently low debt

to GDP ratio and strong fiscal position should allow the country to maintain its present spending levels and increase borrowings to offset revenue losses. It still maintains that it will use the counter-cyclical measures such as infrastructure spending to help the economy out of recession. Optimism from such quarters has in the past proven to be overly optimistic and one should probably not get too excited about promises that infrastructure spending will be maintained, at least not at the levels that were indicated in the last budget.

Data released in July showed that South Africa's Purchasing Manufacturing Index (PMI), which measures local manufacturing activity, showed a second positive uptick in June. At 37.9, the positive figure shows that the worst of South Africa's factory recession might be over. However, as it is still below 50, it still indicates that the industry is in recession albeit at a slower pace. As shown in a PMI chart last month, comparing various PMI indicators from China and the USA, the recovery in South Africa seems to be lagging that of some of the more developed countries, China in particular. Chinese equity performance is now proving to be a leading indicator, in and of itself, of the performance of the global economy.

The performance of Chinese stocks has over the past few years proved to be a useful leading indicator of the performance of commodities, other global equity markets and this is visible in the chart below:



Compiled by: Mitchell Gannaway

This publication has been issued by Thebe Securities Ltd and is for the information of our clients only. The information contained herein has been obtained from sources which we believe to be reliable but is not guaranteed for accuracy, completeness or otherwise. All opinions expressed and recommendations made are subject to change. The information contained herein reflects our opinion and recommendations but it does not constitute a solicitation for transactions in any of the securities mentioned herein. We have no responsibility whatsoever arising here from or in consequence hereof.

Securities of companies have various degrees of risk and volatility. The reader of this newsletter must make its own independent decisions regarding any securities or financial instruments. The writers of this newsletter and employees of Thebe Securities may from time to time have positions in the securities that are mentioned herein.

There was talk in the market that the South African Treasury might be interested in changing the classifications of some companies on the JSE that have primary listings overseas. It was rumored that the Reserve Bank was considering reclassifying some of these companies as foreign/inward listings. If these stocks became inward listings, they would be removed from the JSE's benchmark indices and investing in them would then only be allowed as part of an individual/institutional investor's available offshore allowance.

BAT for instance, is classified as an inward listed share and thus investors are subject to exchange controls that limit the value of the investment that they can have in BAT. This also means that the JSE cannot include BAT in any of its indices. The development mentioned in the last paragraph, if it ever materializes, will undoubtedly have negative implications for companies such as Anglo American, BHP Billiton, SABMiller and Old Mutual, and would likely have the very noticeable impact of reducing liquidity on the JSE. Fortunately, this was vehemently denied by the Treasury. Also, this rumour was partly dispelled when **Mondi**, which has its primary listing on the LSE and its secondary listing on the JSE, announced that it was allowed by the SA Ministry of Finance to have its secondary listing on the JSE reclassified as domestic assets in the hands of local investors. This changed an earlier judgment made when it first unbundled from Anglo American and listed, that Mondi PLC shares should be classified as foreign.

BAT has made a similar application and if its shares are granted a similar status, this should be very positive for its shares. 10% of the shareholding is held in South Africa. If such a move is successful, it is likely to prevent forced selling by South African shareholders between now and at the end of October next year. October 2010 is the deadline by which shareholders who got BAT shares from last year's unbundling activities, would have to sell their BAT shares to remain on the right side of the law regarding their offshore allowances. We continue to remain optimistic on BAT in any case.

BAT recently released its first half results and beat the most optimistic of analyst forecasts, in line with its global tobacco peers, Reynolds American (RAI)-(40% owned by BAT) and Altria Group - Phillip Morris (MO), which also recently reported their quarterly results, both beating average analyst expectations for the period. At the same time, all these tobacco companies raised their performance guidances for their full year earnings. BAT has an attractive geographical spread, with its largest operating regions, the Asian Pacific and South American markets, being more attractive than the more difficult, highly competitive developed markets such as Europe. BAT should still be viewed as a good long term buy and should be bought on weakness.

Anglo Platinum released its 2009 interim results. As expected, the positive impact of higher sales volumes were by far outweighed by the lower PGM rand metal prices. Basic earnings per share fell 68% to 1144cps from 3547cps reported in the 2008 interim. Excluding the profit of R2.3bn realized on Anglo Platinum's BEE transaction with Mvelaphanda Resources and Anoroq, HEPS were actually

down 95% to 169c. Judging by the gains in the share price after its results, the market seemed to be relieved that Amplats at least managed to remain profitable.

Anglo Plat's 2nd half should benefit from the modestly higher PGM price averages over the past two months. It is also expected to show the positive effect of cost cutting measures recently undertaken. The latest earnings figures give Anglo Plats rolling 12 month HEPS of 2207c and a PE ratio of 25.37 on a price of 56000c. Forecast consensus HEPS of 401.11c for the 2009 year end gives Anglo Plats a ridiculously high forward PE of 191. It would seem from recent bullish share price movements that the market has already priced in a very large portion of the expected recovery in PGM prices. Although US Dollar spot platinum prices are being viewed in a more optimistic light by analysts, the strength in the rand is likely to offset this to a large extent.

Implats is preferred to Amplats, but in the meantime, both platinum stocks look relatively expensive if consensus forecasts are relied on. PGM prices have picked up in recent months based more on anticipation of a recovery in demand rather than any significant actual physical demand uptick or restocking activities. There are increasing signs that the global auto manufacturing industry decline may have found a bottom, but a V shaped recovery in the auto industry and thus a strong immediate up tick in PGM demand remains very doubtful. The remainder of the 2009 year will likely prove to be irrelevant in the bigger scheme of things. Beyond the current year, the stabilization / normalization of PGM demand should continue to make PGM miners more attractive. Nevertheless, in the near future, it would seem that PGM prices will have to go up much more to justify the recent recovery seen in platinum company prices.

A recent **Grindrod** trading statement said that the group expected its interim HEPS to fall between 50 - 60%, and based on a price of 1500c, this would give the group a forward 12-month rolling PE of between only 3.9 and 4.15. However, the outlook for the full year remains poor, with a full year HEPS forecast of 243c, which places the group on a full year forward PE of 6.21. The weak performance can be attributed to the global economic slowdown, with shipping rates and volumes being hit hard. The strengthening of the rand is also unfavourable.

It gave warnings when it last released results (record numbers were reported) that 2009 was going to be a difficult year. Directors seem to have taken heed of their own warnings, judging by the strong selling from them seen over the past few months. Between November 2008 and June this year, the Baltic Dry exchange index, an indicator often looked at to ascertain Grindrod's fortunes, showed a strong recovery from the 2008 fallout, but between early June and now, the index has plummeted over 22%. It might still be best to avoid Grindrod at its current price.

Kumba Iron Ore reported a 20% rise in its interim HEPS, surprisingly coming in at the upper end of its own expectations. The result was helped by a 12% increase in production over the corresponding interim. Visibility in its market still remains poor and it mentioned that it's still too early to see any substantial recovery,

especially in Europe, Japan and Korea, but it does look as if these markets are close to bottoming out. Lost sales in any of these regions were redirected to China, which it mentioned consumed 80% of its export volumes.

It still has large capex plans (R4bn) for the remainder of the year and is still on track to increase its output by 10% in 2009. Its share price has actually shown a gradual increase since October last year, in the face of most commodity stocks showing wild fluctuations. Kumba Iron Ore is a stock that seems detached from the trend in the local market and is closely following the trend and timeline being set by Chinese equities as shown further above. Needless to say its share price is heavily dependent on what developments will take place in China for the rest of the year.

Naspers also recently released its 2009 final results. Its subsidiary, Tencent, is now the third largest internet company (ranked in terms of US\$ market capitalization) in the world, just behind Amazon and Google in the USA. Reuters places Tencent's historical 12 month rolling PE ratio on 45 and its 2009 forward PE ratio at 35. This PE ratio does seem expensive but when put into perspective and compared to Amazon (historical PE ratio of 55 and 2009 forward PE of 49) it looks reasonable. It trades at a premium to Google's PE ratio (historical PE ratio of 22.8 and 2009 forward PE of 20) but the premium was much higher in prior years. Naspers was mentioned as a strong buy in a recent newsletter, but at present, with the strong run in its price in recent weeks, it would be recommended that investors only buy back into it on weakness. Its long term prospects still remain very promising.

Several construction companies have come out with earnings updates in the past month. It is worth noting that the trading updates were generally all better than expected. **Aveng**, however, hit by the fall in steel prices, will as expected report full year HEPS, 20% - 25% weaker than its 2008 year. **Group Five** (Full year HEPS expected to be 20 - 30% higher) and **Basil Read** (interim HEPS expected to be 25% - 35% higher) had particularly good trading updates. Another positive development in the sector was that Murray and Roberts mentioned that it had been awarded a new contract in Abu Dhabi. Although this one contract comes nowhere close to making up for all the other recently lost contracts, perhaps this can be viewed as the turning of the tide of negative developments in the infrastructure sector in that part of the world.

Of the big 4 construction companies, **Murray and Roberts** remains a favored pick and **Basil Read** also remains a buy recommendation. A frequently ignored stock in the infrastructure sector remains **PPC**, which has since March not enjoyed the same gains as the other construction companies. At its current price level of 2850c there seems to be some significant technical support that makes PPC worth considering.

South African year on year new vehicle sales fell in June by 22.6%. There is however, a clear sign that the speed of the decline is starting to lose momentum. Total new car sales fell 33% year on year in May, from a 44% decline in April. The month on month total vehicle sales figure showed an improvement of 16.5% between May and June. Are these the signs of a sustainable

change in the fortunes of the local automotive industry or is this simply a dead cat bounce?

We are inclined to believe that there is some substance to the recovery and the worst might be over for the auto industry. As NAAMSA said, any improvement in the industry's domestic operating environment will depend on the revival of consumer spending on the back of lower interest rates and also stimulatory government expenditure. Exports still seem to

be in the doldrums, with the year on year new vehicle sales falling 52% in June. Nevertheless, there does seem to be some reason to start looking at the local listed automotive stocks, which have been particularly hard hit over the past two years.

Stocks in this sector that have exposure to a recovery in the automotive sector include **Imperial**, which recently found some upward momentum and touched a new 52 week high.

Combined Motor Holdings (CMH) and **Metair** seem to have found price support levels. All of these companies have had a very rough couple of years and have shown poor results in the face of difficult trading conditions. An unflinching turn in the fortunes of the automotive industry is likely to result in these companies coming off very low bases in terms of earnings and share price growth.

Tongaat Hulett

Tongaat Hulett (Tongaat) released an interim trading update in July and said that it expects its interim headline earnings per share to increase by 74% to 426cps on the prior interim's HEPS. This is mainly a result of the group re-integrating its Zimbabwean operations back into its latest set of results. The total profit from the group's sugar operations totalled R644 million, of which its Zimbabwean operations made up R305 million, a tenfold increase compared to the dividend received of R35 million in 2008 from these operations. The group's various other sugar operations contributed R339 million, compared to R218m in 2008. Tongaat is on a historical PE ratio of 18, but given the release of this trading statement it can reliably be placed on rolling HEPS of 741cps, giving it a rolling PE ratio of 13 based on a price of 9850c. Consensus estimates for its December 2009 year-end results are for HEPS of only 539c, but given the recent developments, this is likely to be revised sharply higher.

The fundamentals for the global sugar industry remain particularly attractive at present. Global sugar prices continue to remain bullish on the back of a weaker US\$, high global energy prices and on strong global demand, which continues to exceed supply mainly due to lower production in Brazil. Brazil is the world's largest sugar producer, but because of capital constraints in the industry there, it is not producing close to its potential. As a pure sugar play, Illovo is actually a strong alternative choice because it is not

active in some of the more unrelated activities Tongaat is involved in, such as its property development activities. However, Tongaat's recent Zimbabwean windfall makes it a company worth looking at right now.

The sustainability of the economic situation in Zimbabwe still remains capricious, but in the short-term, the situation on the ground shows that there is a potentially large profit windfall for companies that are already involved in the country as it goes through a phase of recovery. Tongaat is debt free in Zimbabwe and has a mill and refinery and through the two sugar estates it has in the country, it has a potential production capacity of around 600 000 tons per annum. Tongaat is a South African listed company with some of the largest direct investments in Zimbabwe and through it, investors have strong exposure to whatever growth might take place in that economy. Zimbabwe also currently ranks as one of the lowest cost sugar producers in the world.

The EU, which is currently experiencing a sugar deficit, has allowed qualifying, least developed countries (LDCs) to export sugar to it on preferential trade terms such as duty free and quota free export incentives, until its own market finds an equilibrium level. Tongaat currently realizes sugar prices above the reference price for exports into the European Union from its Mozambique operations and it is possible that Zimbabwean sugar will have the same marketing benefits and preferential access.

Exports from South Africa, are often sold at the much more volatile world sugar spot price.

The consolidation of the Tongaat's Zimbabwean operations comes after the implementation of huge macroeconomic changes that took place when Zimbabwe moved away from its worthless currency to a Rand and US dollar based system, and, in the process, re-established key fundamentals to its economy. This removed many of the distortions that existed in this economy. Some of these distortions included unrealistic local market sugar price realizations due to price controls, not receiving the full benefit of export proceeds, exchange rate uncertainty and foreign currency restrictions, shortages of inputs and the effects of extreme hyperinflation. As a result of these abnormal conditions, Tongaat's operations were accounted for on a dividend received basis.

In addition to the Zimbabwean operations, Tongaat will also be able to look to its expansion activities in Mozambique to add to its growth, although these activities will have no major impact in the interim results. The second half of the 2009 year will show the benefits of a doubling in production on 2008 levels that will come from Mozambique. Sugar production here, is expected to reach 300000 tonnes per annum by 2010. Tongaat can be viewed as a buying opportunity but not without some notable sustainability questions over the longer term. **BUY.**

Banks

Banking stocks have had a strong run over the past two months in particular, outpacing the gains seen on the All Share index. FirstRand will report its 2009 full year results at the beginning of August, while the other three big banks will also report their interim results in the same month. It is thus worth reviewing what to look out for when these results are released in August and considering whether banking stocks are still worth buying given their recent run.

Despite the strong run for local banks over the past few weeks and also regardless of the fact that they are up from the multi year low PE multiples that they were trading at, at the height of the market turmoil not too long ago, a strong investment case can still be put forward for buying into the local banking stocks. This is based on the fact that they are unjustifiably trading at a discount to other global emerging market banking stocks. The local banking index is trading on a PE ratio of 8.82 compared to over

12 times historical earnings for many emerging market banking shares in the BRIC countries, and this is one of the largest discounts local banks have traded at over the past year. The local big four banks remain adequately financed and did not get involved with the toxic loans many other global banks got involved in, partly due to rigid local exchange control restrictions, and thus they can be declared to be undeserving of their lower ratings.

As a result of shielding themselves from their unfavorable trading environment, trading volumes have generally fallen as banks have lent less (FirstRand in particular has been more prudent here). Despite this, bad debts still continue to mount and less interest is being earned on capital, thus putting margins under pressure. Thus the recent negative banking stock trading updates have not really come as a surprise to investors that already seem to have priced in weak earnings over the next year.

Retail banking operations will continue to be the hardest hit of the different banks' divisions. In its 2009 first half period, 80% of FirstRand's bad debts came from its retail operations, with FNB Home loans being particularly hard hit, making a loss of close to R1bn compared to a profit of R200m in the 2008 interim. Its vehicle finance division, Wesbank, also showed the same trend. This situation was not unique to FirstRand. For the December 2008 year end, Nedbank Retail's home loans had a loss of R442m from a profit of R486m in 2007. Its vehicle finance division also increased its losses over the same period. With Standard Bank, a huge increase in mortgage lending impairments saw mortgage loans contributing a huge loss to the group of R922m, from a profitable contribution of R822m in the 2007 year. Absa is the biggest retail bank. A strong increase in impairments naturally followed its continued strong lending practices last year, in the face of strong signs of a

floundering local economy and an increasingly pressurized local consumer. Mortgage loans make up the majority of Absa's advances.

In an easily identifiable trend, it can be observed that across the four big banks, investment banking activities and corporate banking activities continued to limit to some extent the damage to earnings growth. The hit to earnings growth as mentioned above came mainly from weak retail banking performances and weak performances from other divisions linked to investment markets such as Liberty Life under Standard Bank, and FirstRand's Momentum division. At the beginning of the year, there were concerns that the risk from the retail operations would spread to corporate operations. The possible occurrence of such a trend is something that will have to be looked at carefully when the banks start reporting over the coming weeks. The table included with this article shows the make up of the different banking activities of the big four banks, relative to each other.

Standard Bank is exposed to investment banking activities more than any of the other local banks.

Its alliance with the Industrial and Commercial Bank of China (ICBC), which owns 20% of Standard Bank, allows the group to continue gaining unique exposure to China's growing relationship with Africa, which China desperately needs in order to take advantage of the continent's vast resources. Standard Bank is more exposed to the African market than any of the other banks through its hugely synergistic relationship with ICBC.

In June, Standard Bank mentioned that the two organizations were at that time, working on around 60 deals in Africa, involving mainly mining and infrastructure related activities. FirstRand, clearly not wanting to miss out on the Africa - China growth potential, also recently announced that it was partnering up with China Construction Bank, to help both companies win investment, corporate and project finance deals in Africa. FirstRand has recognized the enormous growth opportunities to be gained by expanding into other Africa countries but it has to be mentioned once again that it noticeably lags the pioneer in this area, Standard Bank.

FirstRand in its last results reported strong growth in its African division, but this growth remained much less impressive than that achieved by Standard Bank, considering that most of FirstRand's growth probably came from Botswana. We are thus likely to see the negative effect that the slump in the diamond industry has had on that country when FirstRand's interim results are released. Standard Bank only managed to achieve 8% growth in its headline earnings in 2008. It is however, more important to note that South African operations only showed a 1% growth in headline earnings, indicating the significance of non-South Africa operations and African operations in particular, which showed 46% growth in headline earnings.

Despite the weak bank earnings in general, the top four banks still remain adequately capitalized as shown by their acceptable capital adequacy ratios (one of the best ratios to measure a bank's "cushion" for potential losses) in the table below. They thus remain in a strong position to ride out the possibility of a prolonged recession and a South African consumer who continues to remain under strong financial pressure.

Taking a longer term view, one factor provides a more favourable investment scenario for FirstRand relative to its peers. This is that its higher exposure to vehicle financing and credit cards makes it more highly geared to the benefits of the fall in interest rates relative to its peers. Bad debts in South Africa are expected to continue rising, particularly for mortgage loans, which continue to remain the most worrying feature of retail lending. FirstRand's advantage is that, relative to its rivals, its mortgage loans are the lowest constituent of retail credit out of all the large banks. The table below shows that FirstRand at the end of 2008 had the smallest share of the South African mortgage loans market. This can be credited largely to cautious management action taken by the group over the past few years. The results in the first half of the 2010 financial year (6 months to December 2009) should start to show the fruits of this cautious strategy.

Absa's relatively high exposure to the local mortgage market makes it an investment that would be wise to defer for now, relative to its counterparts. Nedbank was slow off the mark when expanding into the retail market and when it did get off the mark, not too long ago, it did so aggressively at an inopportune time. For the long-term, Standard Bank's African exposure and its stakes in attractive emerging markets around the world, makes it the most attractive long-term buy prospect. In the short-term, FirstRand does seem to offer relatively more attractive earnings recovery prospects than its rivals and thus can also be considered as a buy.

Bank Comparisons	Absa	First Rand*	Nedbank	Standard Bank
Last financial year end	Dec-08	Jun-08	Dec-08	Dec-08
Latest Price	11375c	1520c	10600c	9240c
12 month rolling HEPS	1412.10c	171.2c	1401c	968.10c
12 Month Rolling PE	8.06	8.59	7.64	9.6
2009 Forward HEPS	491.20c	125.1c	1050c	864c
Forward PE based on 2009 HEPS(est)	9.66	11.75	10.19	10.76
Net Asset Value	6950c	750c	8522c	5729
Price/NAV				
Dividends per share	595c	72.25c	620c	386c
Current dividend yield	5.23%	4.91%	5.79%	4.15%
Ratios				
Return on average equity	23.40%	18%	17.70%	18.20%
Advances/loans to deposits	95.70%	91.40%	93%	93.40%
Total Bad debt charge to Average Advances	1.07%	1.23%	1.19%	1.58%
None performing loans	3.50%	4.20%	-	3.40%
Cost to income ratio	49.40%	53.30%	51.10%	49.20%
Capital adequacy ratio	14%	13%	12.40%	12.90%
Segmental divisions				
Retail Banking	37.40%	26.51%	17.40%	33.80%
Corporate Banking	28.30%	28.55%	22%	56.3% (corp and inv banking are combined in the segmental report)
Investment Banking	22.70%	28.90%	50.70%	
Other	11.60%	16.04%	9.90%	9.90%
Total	100%	100%	100%	100%
* 2009 interim data is used for FirstRand above				
Retail banking				
Estimated share of local market in:				
Credit cards	26.20%	21.70%	12.80%	34.80%
Mortgage advances	30.70%	15%	21.30%	26.80%
Installment financing	24%	30%	23.10%	21.80%
Others - e.g. Overdrafts	21.10%	21.50%	19.80%	18.90%
Recommendation	Hold	Buy	Hold	Buy

New Facility on Corporate Actions

We have implemented an electronic system that will deal with corporate actions. Whenever a corporate action requires an investor to make a decision, for example to accept or decline an offer, an e-mail will automatically be sent to you, to which you can respond to select your option. This will only be available to client accounts with valid e-mail addresses. Please supply us with your e-mail address if we do not have it already.

Head Office: 2 Hogsback Road, Quellerina Ext. 4, Roodepoort
 PO Box 418, Bergbron, 1712.
 Tel (011) 375-1000 Facsimile (011) 375-1100
 e-mail : info@thebesec.co.za Web : www.thebesec.co.za