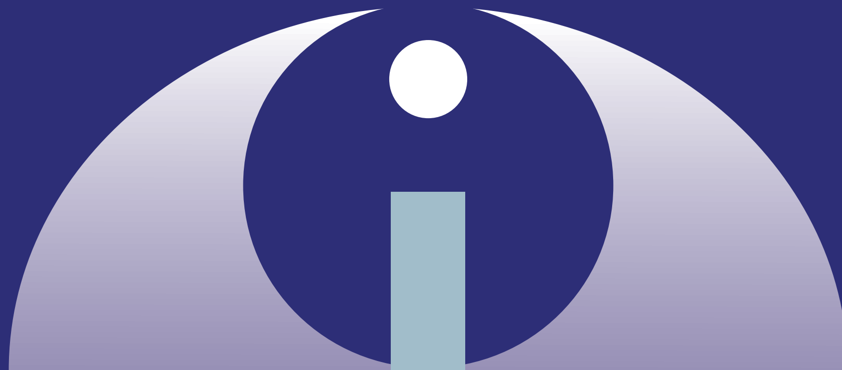
INTUITION



(n: immediate insight; receive knowledge by direct perception)

In this edition:

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- Dividends Withholding Tax: our thoughts

APRIL 2012 VOLUME 9 ISSUE 4

Empowering knowledge and insight exclusively from the Harvard House Group of companies

AFRICA: THE FINAL FRONTIER

Michael Porter

Our January Insight Seminar focused on the relationship between China and Africa, and the perception that China is unfairly exploiting Africa's people and resources for its own gain. Whilst that may well be true in selected circumstances, the conclusion drawn from that presentation was that whilst China stands to benefit hugely from Africa's resources, fortunately it is not a one-way street. Africa stands to benefit enormously too. Owing to strong demand from China and other large, growing economies, commodity prices have rallied. This in turn has fueled exploration and mining activity across the continent. Where resources once lay idle, now those are being brought to account. In our opinion, Africa stands at the brink of a virtuous economic cycle where economic growth gains momentum, which in turn fuels demand for additional infrastructure and growth.

Sceptics might argue that we have stood on the verge of the virtuous cycle before, only for Africans to come away empty handed. After all, Africa is not referred to as the "forgotten continent" for nothing. Why should this time be different? In our opinion, there are a number of reasons, each of which is important in their own right. But when added together, they present a powerful concoction of positive momentum that might be just the tonic our struggling continent requires.

> "There is no clearer indicator of the enthusiasm for Africa than that of the Shoprite Group. It embarked on an African expansion territory in the late 1990s, to much ridicule from investors and competitors alike. Today it has 178 supermarkets spanning 15 countries outside of South Africa. "

1. Economic growth across Africa is gaining momentum, which in itself can become a virtuous cycle. Just look at China! Over the past ten years, six out of ten of the fastest growing countries on Earth were African – a statistic that would have seemed fantastical just a few years ago.

2. In part, faster growth has been fuelled by the emergence of China, India and Asia as economic super-powers. Their growth has fuelled demand for commodities, some of which are becoming increasingly scarce. Investors have realised that resources are finite. New discoveries are required to replenish dwindling supplies from traditional sources. Most of those discoveries are taking place in Africa.

3. However, rising prosperity is also due, in part, to the spread of peace and democracy. Some may scoff at the idea of peace when Mali suffered a military coup just a few days ago. Yet everything is relative. Thirty years ago, Africa was beset by wars – two on our own doorstep. Now Angola and Mozambique offer some of the most exciting opportunities on the continent. Significant oil and gas discoveries in both countries have the potential to transform the region in much the same way that North Sea Oil changed Britain.

4. The global economy is beset by challenges – in a nutshell, western countries have too much debt, too little growth and generally ageing populations that consume more resources than they generate. The impact of these constraints might seem like an insurmountable obstacle for Africa to overcome on the path to success. We have a different view. In our opinion, it is the very challenges facing Europe and The West that open the door to African success. Why? Companies are looking for growth. That is what shareholders demand. Growth is in short supply in Europe and will be for some time. The US is not looking like a bed of roses either. Africa has a combined population of 850 million people – mostly young people who until recently had very little. It is brimming with unbridled economic potential and pent up demand for goods and services that we take for granted. With so little growth on offer in "traditional economies", companies have been forced to take Africa seriously. The second scramble for Africa has begun. But instead of being politically motivated, this time it is all about the money.

There is no clearer indicator of the enthusiasm for Africa

than that of the Shoprite Group. It embarked on an African expansion territory in the late 1990s, to much ridicule from investors and competitors alike. Today it has 178 supermarkets spanning 15 countries outside of South Africa. Last week it announced that it wanted to raise R8 billion from investors to accelerate its expansion plans. It managed to raise the money in just five hours. Five hours! Investors can see the opportunity, and are desperate to get a foot in the door. In our opinion, the enthusiasm is well founded, but as with all investing, it is essential to keep things in perspective.

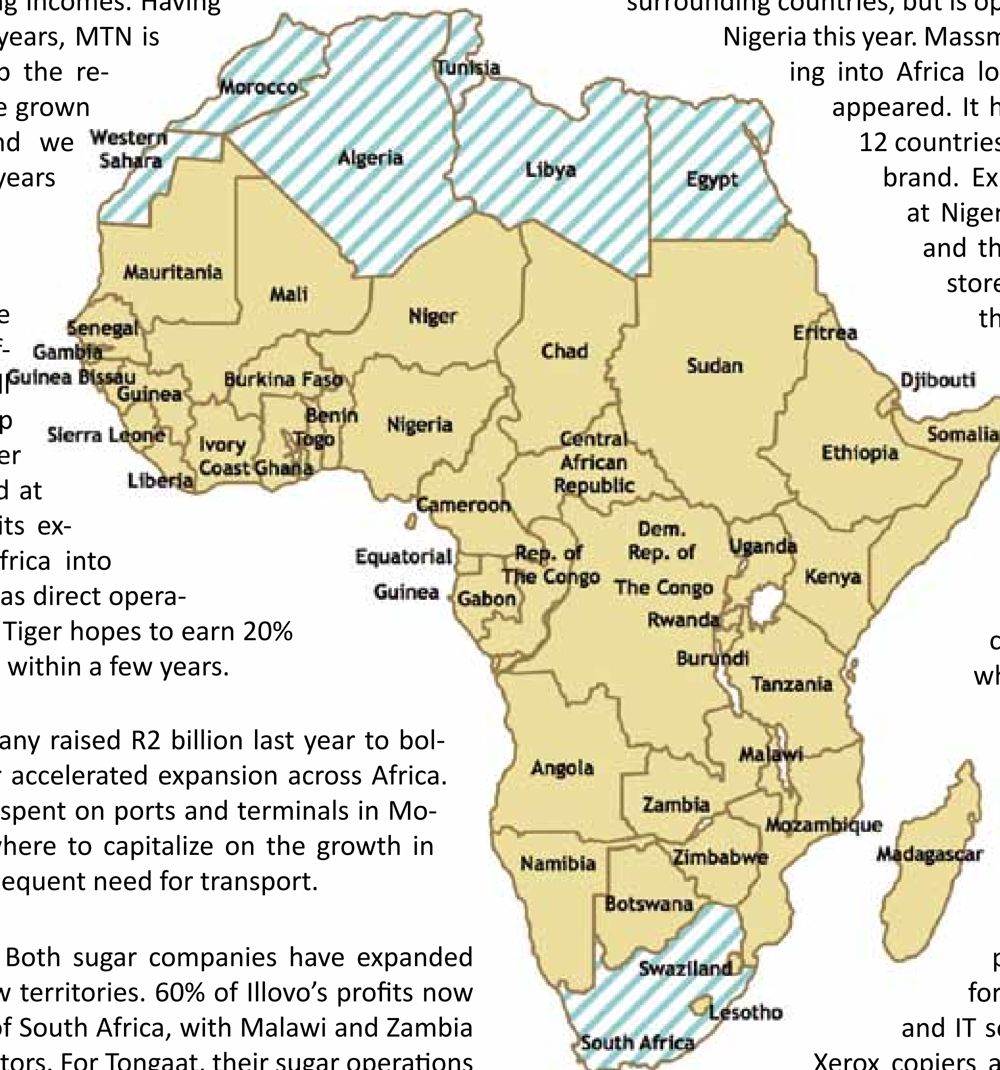
What follows are snippets of companies that we like with strategies for African expansion. In most cases, the contribution to profits from African operations is tiny. But that will change. Importantly, it is our opinion that as the years tick by, the gulf will widen between those companies that have successfully conquered Africa and those that haven't. As the saying goes, fortune favours the brave. Time is running out for those who refuse to believe that Africa is changing.

MTN stands head and shoulders above its peers when it comes to presence across Africa. 50% of its revenues already come from Africa, sourced from 18 different countries. Key markets are Nigeria and Ghana, which offer huge populations and rising incomes. Having invested heavily for years, MTN is now starting to reap the reward. Dividends have grown sharply recently, and we expect more in the years ahead.

Tiger Brands: The contribution to profits from Africa is small at 7%, but the Group has made a number of acquisitions aimed at strengthening both its exports from South Africa into new regions, as well as direct operations on the ground. Tiger hopes to earn 20% of profits from Africa within a few years.

Grindrod: The company raised R2 billion last year to bolster its resources for accelerated expansion across Africa. Much of this will be spent on ports and terminals in Mozambique and elsewhere to capitalize on the growth in coal mining and consequent need for transport.

Illovo and Tongaat: Both sugar companies have expanded aggressively into new territories. 60% of Illovo's profits now come from outside of South Africa, with Malawi and Zambia the primary contributors. For Tongaat, their sugar operations in Mozambique and Zimbabwe hold huge potential to more than double production. We are expecting profits to rise sharply.



Retailers: Shoprite leads the way amongst South African retailers for their African expansion, but others are expanding fast. Woolies operates in 12 countries, with expansion into a further 2 countries imminent. Mr Price has 67 stores, mainly in surrounding countries, but is opening new stores in Nigeria this year. Massmart started expanding into Africa long before Walmart appeared. It has 26 stores across 12 countries – mainly the Game brand. Expansion is targeted at Nigeria, Angola, Senegal and the DRC, with 7 new stores expected over the next few years.

Altron: 8% of profits come from Africa, with much of that focused in East Africa where its subsidiary, Altech, has rolled out fibre telecommunications networks and other infrastructure. But demand for power products (transformers, cables etc) and IT solutions (ATM's and Xerox copiers and printers) is also gaining traction.

SPENDING: THE HEADWINDS ARE GROWING

Michael Porter

America is often referred to as the world's consumer, a reference to the seemingly insatiable demand for material goods and items from its 315 million inhabitants. Whilst we have a far smaller population than the US at approximately 50 million people, South Africans seem determined to earn the same nickname. It is well known that we are a nation of spenders, not savers. A quick look at the composition of our economy shows that household spending accounts for almost 60% of our economy, not very different to that of the USA.

Given that background, it is not surprising that our cities and towns are dotted with endless shopping centres. It is not uncommon to find competing supermarkets within a stone's throw of each other. In fact, in Hilcrest outside Durban, the centre of town has a major supermarket on each corner of the main road intersection! Four shopping centres within 500 meters of each other – we often wonder how they all trade profitably. Yet, amazingly they do. Clearly our penchant for shopping has attracted the interest of foreigners. First it was Walmart, who bought a stake in Massmart. Now it is Zara, a leading Spanish fashion retailer, with stores across the world that is opening new shops. They hope to have 25 – 30 stores across South Africa within the next eighteen months.

Shares in our major retailers (Woollies, Mr Price, Foschini, etc) have soared since the trough reached at the height of the Financial Crisis in early 2009. Indeed, some shares have gained 300-400% in just three years – a remarkable performance. This stellar performance has been driven by buoyant profits and giddy sentiment from local and international investors. Retailers are the "flavor of the month." Can it last?

When analyzing investments and economic trends, often some of the most useful information can be gleamed from chatting with colleagues and associates, rather than poring over annual reports. Nonetheless, we acknowledge that one cannot rely solely on anecdotal evidence, as our sample might not be representative of the country as a whole. But certainly, we (being the investment team) have all been concerned about the longevity of the spending cycle. Chats

JSE GENERAL RETAIL INDEX

"Retailers have shot the lights out since 2009. Can it last?"

with colleagues, store managers, business owners and clients all reveal the same concerns: costs are rising – fast! Whether it is municipal rates, electricity, school fees or food, everyone seems to be feeling the pressure of higher costs. Higher costs on essential items mean only one thing: less money for discretionary spend – dinner out at a restaurant, some new clothes, a weekend away and so on.

As if the costs mentioned above weren't enough, another – possibly the most concerning - needs to be added to the list: fuel. The price of fuel is now well over R11 per litre, higher than the peak reached back in 2008 when oil spiked to $150 per barrel. Why? Petrol has risen steadily on the back of a rising oil price and a somewhat weaker Rand. Oil markets are tight. Libyan oil is taking time to flow again; Syria is fast descending into civil war; and violence has spread across Nigeria - attacks on oil pipelines are a common modus operandi for unhappy insurgents. To top it off, US and European sanctions are starting to bite against Iranian oil. Markets are concerned. Rhetoric in the Middle East is high, and rumours of an imminent attack against Iran are pervasive. Nerves are shot, and it is reflected in high prices.

Ironically, prices should be coming off the boil. Chinese growth is slowing, which implies weaker demand. So in a normal world (do we even remember what normal is anymore?) prices should be falling. But politics is keeping the price well above average. Without a major political breakthrough, which is highly unlikely (there has been no political success

with Iran in the last ten years), it is almost impossible to see prices falling back below $100 per barrel any time soon.

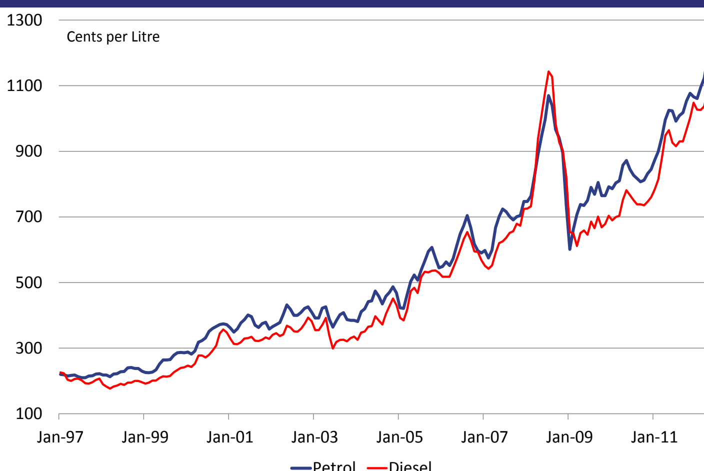
So the oil price is high, the Rand is a little weaker, and our petrol prices are back at record highs. If it were that simple, we would have faith that market mechanisms would, over time, bring prices back down to a more sustainable level. Unfortunately, it's not that simple. The fly in the ointment can be summed up in one simple word: government!

Over the last six weeks, various government departments have announced the following taxes and/or tariffs that will push up the fuel price:

1. An increase in the fuel levy of 28c per litre (see last month's issue of Intuition.)
2. Transnet has been awarded an increase of 32% in its tariffs for the new fuel pipeline from Durban to Gauteng. This will add 4c per litre to the Gauteng fuel price. (The only thing to be grateful for was the fact that Transnet asked for an increase of 84%, which was rejected!)
3. Gauteng's toll road system will go live at the end of April. Although rates have come down, it is still another cost that motorists must bear.

Every day the Department of Minerals and Energy publish fuel price data, showing the extent to which the current monthly price differs from the daily price based on oil price and rand movements. At the time of writing, the under-recovery of prices was approximately 32c per litre. So on the first Wednesday of April, and right before the Easter holiday, consumers are facing a fuel price increase of 64c per litre (32c owing to changes in oil prices and the Rand, 28c from a rise in the fuel levy, and 4c from a rise in the pipeline levy.) That is steep, especially coming off an already inflated level of R11.23 per litre. Fuel prices will be at their most expensive ever in this country!

GAUTENG FUEL PRICES



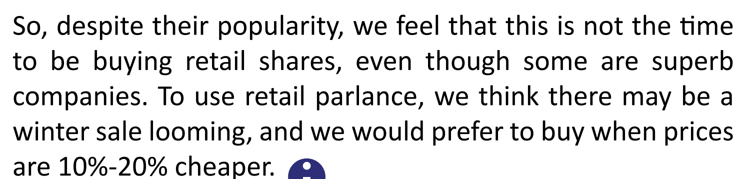
"At record highs. A 65 litre tank now costs R124 more to fill than it did a year ago"

> Shares in our major retailers (Woollies, Mr Price, Foschini, etc) have soared since the trough reached at the height of the Financial Crisis in early 2009.

So what does this mean for our future spending power? Discretionary spend is under pressure – there is simply no doubt about it. Regardless of where you are or what you earn, compulsory costs are rising. It is costing more to do the basics. At the same time, incomes are also under pressure. The introduction of Dividends Tax is imminent (see next article), and the Finance Minister made the clearest hint yet that taxes will rise in the future – to pay for National Health Insurance (as an example.) There doesn't seem to be anywhere to hide.

Back to the markets. We have always argued that investors are not concerned about whether a company is growing its profits or not. Rather, investors are concerned about the rate of growth of those profits. That is an important and crucial distinction. If investors are expecting a company to grow profits at 25%, and the company "only" delivers 15%, then the share price is likely to fall like a stone. The reality is a disappointment relative to expectations, even though a 15% increase might be a commendable performance. That is the markets for you.

Herein lies our concern. We have no doubt that retailers will continue to grow their profits – our spending habits are too deeply ingrained. But given the relentless pressure on incomes described above, we are concerned that the rate of growth will slow this year. In our opinion, this is not a widely held view amongst the investment community.



So, despite their popularity, we feel that this is not the time to be buying retail shares, even though some are superb companies. To use retail parlance, we think there may be a winter sale looming, and we would prefer to buy when prices are 10%-20% cheaper.

DIVIDENDS WITHHOLDING TAX: OUR THOUGHTS

Michael Porter

The introduction of a withholding tax on dividends was first mooted in the National Budget in 2008, but it has suffered numerous delays in implementation, mainly relating to the renegotiation of tax treaties between South Africa and other countries to ensure that investors do not get double taxed on their dividend income. Time passes, and by the time most of our clients read this, the tax (referred to as DWT – Dividends Withholding Tax) will be up and running – the operative date being 1st April 2012.

The Tax has caused much anxiety across many quarters. Press articles have sowed some panic, citing financial planners who report that their clients are liquidating all investments to move their capital offshore. The aim of this article is to spell out the changes, use some real life examples to highlight the impact, and articulate our thoughts on the implications. (Note that our next seminar scheduled for the end of May will delve into some of these topics in more detail – we would encourage all to attend.)

To start, what changes have been made to our tax legislation?

1. The current tax on dividends, called Secondary Tax on Companies (STC) falls away, and is replaced by a new tax, Dividends Withholding Tax.
2. STC was levied at a rate of 10% and was paid by a company every time it declared a dividend. It was a tax liability of the company, not of the shareholder.
3. The surprise in the Budget was the announcement that DWT will be levied at a rate of 15%, and not 10% as previously indicated. It is payable by everyone who receives a dividend, unless that person qualifies for an exemption.
4. Who is exempt? South African companies, retirement funds, and special bodies such as charitable trusts, non-profit organisations etc. Everyone else must pay the tax.

As I mentioned earlier, the introduction of DWT has been in the pipeline for many years, so its introduction was of little concern to us. That was because we assumed, like everyone else, that the tax would be levied at 10%. Instead, government has decided to introduce it at 15%. This does

	Current Regime	New Regime	DWT @ 15%
	STC @10%	No STC Saving	STC Savings Passed on
Dividend declared	100	100	110
STC payable by the company	10	-	-
Total cash required by the company	110	100	110
Dividend received by shareholders	100	85	93.5
Decline in Dividends Received		-15%	-6.5%

make a difference and will impact on those investors receiving income from dividends. To start, the table above highlights the theoretical calculation of how an investor is affected. Much depends on whether the company paying the dividend passes on the "STC saving" as illustrated in the table above. From the simple table above, it is easy to see that depending on how each company treats the saving it will receive from not having to pay STC anymore, an investor's dividend will decline by between 6% and 15%. This is not insignificant.

Let us look at some real life examples of dividends that have been declared recently to make the above example easier to digest, and to highlight how individual companies can ease the burden on its investors.

Sasol		
Item	**Detail**	**Michael's Comment**
Dividend declared	570c	Dividend was raised by 84%, in line with profits. But Sasol has a "progressive dividend policy" which means that it would like to increase the dividend amount each year. In effect, Sasol has adjusted its dividend base to a higher level to compensate for future taxes.
Comparable amount last year	310c	
% Increase over 12 months	84%	
Last day to trade	30 March	This is before 1st April, so no DWT Payable

BIDVEST		
Item	**Detail**	**Michael's Comment**
Dividend declared	280c	Bidvest has dropped its dividend cover slightly, but not enough to compensate for the tax. Shareholders will only receive 238c (280c less 15%), which is higher than last year, but only by 6%.
Comparable amount last year	225c	
% Increase over 12 months	24%	
Last day to trade	5 April	This is after 1st April, so DWT payable

So how does it affect you, the investor? The amount of tax you will pay is directly proportional to the dividends received. Importantly, there is one crucial point to understand: DWT is a stand-alone tax levied on dividend income received only. Your dividends are not added to the rest of your taxable income when determining your total tax liability. What does that mean?

1. For those clients that draw income generated from dividends alone, your tax will rise. Previously dividends were tax-free. Now they are subject to tax of 15%. Your income may fall by between 6% and 15% in future. That assumes all else being equal, which is not necessarily the case if you look at the examples above – some companies have increased their dividends to compensate. So a fall of that magnitude would be a worst-case scenario. For those clients where income is affected, we will relook at the portfolio to see where we can make changes to ensure that incomes remain largely intact. However, there is no doubt that the introduction of the tax will make the generation of monthly income slightly more difficult.
2. Clients who receive interest from listed property companies will not be affected. Listed property companies pay interest, not dividends. So the tax treatment of that income remains unchanged, at least for now.

We have discussed the mechanics of the tax, how it will be implemented and who will be most impacted. So what are our thoughts on the subject? A couple of issues spring to mind.

1. We have often discussed the global search for income. We are living in a world in which investment income is hard to find. Interest rates are at record lows, and don't look set to rise any time soon (at least globally.) Bond yields have fallen to historic lows as well, yet at the same time, more people than ever before are reaching retirement age. Income is scarce and investors are paying a premium for those companies that generate good levels of cash, and then return it to their shareholders. DWT is just another nail in that coffin. Investment income will fall a little further, as some of the dividends we used to enjoy will now be paid away in tax. So our first thought is that companies that generate cash and have generous dividend policies will remain in high demand.
2. That being said, companies might start to get a little more creative. Paying dividends now comes at a higher cost. Companies might rather buy back their own shares than pay large dividends. As a refresher: when a company buys back its own shares, it is essentially cancelling shares which were previously issued. Fewer shares in issue means that profits per share and dividends per share rise faster than what would have been the case if no shares were bought. This usually leads to higher share prices. So dividends might be lower, but capital growth is higher.
3. Under the previous regime (STC), the tax treatment of offshore investments was far more penal than local investments. In particular, dividends received were taxable. Following the introduction of DWT, that difference has fallen away. Local and foreign investments are now treated similarly. In fact, offshore investments now enjoy a sight advantage, although we believe that anomaly will disappear in the future. Nonetheless, foreign investments have suddenly become more attractive, and even more so when one considers that many offshore companies offer dividend yields of between 4% and 6%. That is attractive given that the average dividend yield for the JSE is just below 3%.

When all is said and done, we do not believe that the introduction of DWT is a train smash. Yes, the higher rate did catch us by surprise, and in some cases income levels will be affected. We will be working with those clients affected to chart the most effective way forward. Yet we are encouraged by the pragmatic approach already evident from many companies – that they will be passing on tax savings from the abolishment of STC to compensate for DWT. In the late 1700s, Benjamin Franklin said "There are only two things certain in life: death and taxes." In a world where governments are scratching for every cent they can get, nothing has been more true!

INTUITION

Market Insight from the Harvard House Group

INSIGHT SEMINAR: KZN MIDLANDS & JOHANNESBURG

As mentioned above, our next seminar will delve into the world of taxes, and how that affects your investments. Despite protestations about increasing savings and encouraging citizens to save, our government continues to punish savers through various taxes. In this seminar, we will try to shed some light on the issues and offer reassurance that investing is still not only necessary, but very worthwhile.

Please note the new venue in Howick, which is the Fernhill Hotel. These functions continue to draw a lot of support, for which we are very grateful. All clients are welcome, and please invite friends along if you feel they may benefit from the evening.

	Natal Midlands	Johannesburg
Topic:	Taxes: Are they killing the golden goose?	
Date:	29 May	n/a
Venue:	Fernhill Hotel Midmar / Tweedie Road (almost opp entrance to Midmar)	n/a
Time:	5.30pm for 6pm	n/a
RSVP:	Cathy Maitin-Casalis on 033 330 2164 or cathym@hhgroup.co.za	

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