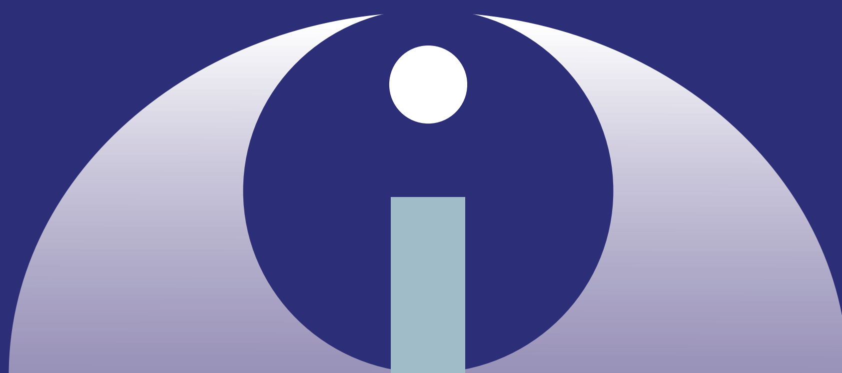
INTUITION



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

In this edition:

- BAT: Still smoking!
- Pallinghurst: Slowly coming of age
- Midcap shares for the bottom drawer
- Company snippets: Aspen, MTN, Sasol

MAY 2012 VOLUME 9 ISSUE 5

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

BAT: STILL SMOKING

Nigel Porter

BAT announced results for the year ended 31 December 2011, on 23 February 2012. If you read the financial press, you will never hear one good word about tobacco or smoking. It seems to be the one area of concern on which politicians worldwide agree - and that is to try and crush the tobacco industry through increased taxation and increasingly onerous legislation. The Supreme Court of Canada has now ruled that smokers who have suffered ill-health from their habits can now sue the major tobacco companies (Imperial Tobacco, Philip Morris, BAT and others) for medical expenses incurred. It would appear that the lawyers who argue the case on both sides are going to have a field day in respect of litigation fees. We now also have Australia and the UK legislating that tobacco products can only be sold in plain packaging, so that the brand of cigarette on offer is hidden from view.

It may then surprise clients to know that the top four shares on the JSE by market capitalization (number of shares in issue x market price per share) are as follows:

Ranking	Company	Market Cap
1	BAT	R793 billion
2	SAB Millar plc	R536 billion
3	BHP Billiton plc	R511 billion
4	Anglo American plc	R386 billion

We humans are a persistent bunch and we enjoy our habits of smoking and drinking far more than the basic minerals which are the cornerstone of the world economy. China cannot live without iron ore, copper, coal, etc. However, we humans cannot live without our vices!

It all boils down to cashflow and we would be hard pressed to find a company with a more impressive cashflow than BAT. The results for the year and comparative years are above right.

£ million	2011	2010	2009	2008
Gross sales (incl taxes)	46,123	43,926	40,713	33,921
Direct revenue (excl taxes)	15,453	14,442	14,208	12,122
Profit from operations	4,721	4,318	4,101	3,572
Earnings per share	194p	175p	153p	129p
Dividends per share	126p	114p	99p	84p

The company defines free cash flow as the cash receipts before the payment of dividends to shareholders, the repurchase and cancellation of shares in issue, and the purchase of investments to enhance the long term growth of the company. In 2010 the free cash flow was £3,229 billion and in 2011 this increased to £3,326 billion. For the financial year ended 31 December 2011 the company bought back 28 million shares at a cost of £750 million. This year the company has allocated the sum of £1.25 billion for the repurchase and cancellation of its own shares. It buys back approximately 270,000 shares every single trading day and these are then either cancelled, which increases the earnings per share for the remaining shares, or they are used to purchase trading investments for the company.

The company has a target of paying out 65% of distributable earnings by way of dividend and this would appear to be sustainable for the foreseeable future.

The following stats make interesting reading. The FT100 Index of companies produced an average return of 13.7% for the period from 1 January 2009 to 31 December 2011. BAT produced a return of 25.4% over the same period. So BAT outperformed the average of the other 99 companies that make up the index by 85% over the three year period.

"Smoking has not gone completely out of style"

BAT SHARE PRICE

"BAT - Delivering value for both UK-based and SA-based shareholders"

The directors comment in their annual report as follows, and I quote:

"The last year has seen considerable success for the group and I am excited when I look to our strengths. We have some great brands and our marketing is based on powerful consumer insights, supported by differentiated and superior products. We have market leading innovations and we are getting better at deploying them. We have a great business mix, with a strong presence in emerging markets, and a balanced product portfolio across all segments. We have a fully integrated supply chain and our systems are becoming more efficient. We have an industry-leading approach to science and harm reduction, and importantly, we have the people capable of tackling the challenges ahead."

Nicandro Durante, CEO of BAT, comments as follows:

"I am confident that we are well placed to take advantage of the substantial opportunities ahead for our business and that we can continue to deliver superior shareholder returns."

BAT remains a core holding for all long term portfolios.

PALLINGHURST: SLOWLY COMING OF AGE

Nigel Porter

Pallinghurst announced annual results for the year ended 31 December 2011 in the last week of March 2012. Clients who hold Pallinghurst shares in their portfolios will know that the performance has been very disappointing over the past 12 months. However, Pallinghurst is one of the few shares which does not pay a dividend and which I have been prepared to buy for clients, thus deviating from the usual importance which Harvard House places on dividend income. I still believe that Pallinghurst has long term growth potential for those who can afford to hold the share without a need for dividend income.

Arne Frandsen, chief executive officer of the company made the following statement: "On the road show for the initial listing of the company in September 2007, we told all prospective shareholders that, for the first round of capital raised, we should allow for a ten year period. Simply put, during the first five years we would plough the fields, sow the grain and attend to the green shoots. During the following five year period we would aim at timing the harvest in a way which would maximize the returns to shareholders. We are now in the fifth year and I am pleased to report that, as per the initial plan, our four investment platforms are indeed entering the predicted harvesting period."

The company has four investment platforms, as follows:

Platmin. Agreement has been reached recently for the consolidation of the three contiguous platinum properties acquired over the past few years. We also welcome the Industrial Development Corporation as a key partner in this consolidated development, with the IDC agreeing to purchase a 16% equity stake for R3.24 billion in the project. This will make Platmin a long life, low cost producer of platinum group metals and is a tangible confirmation of the development of our vision and strategy for Platmin.

Tshipi Borwa. Construction of South Africa's newest open pit manganese mine in the Northern Cape is well under way. This mine is due to start producing manganese before the end of calendar 2012 and is capable of sustaining production for a period of 60 years.

Gemfields. In 2007 we stated that the strategy for Gemfields was to emulate the model used by De Beers for the control of the fragmented diamond industry many years ago. Our vision for Gemfields was met with some scepticism by investors. However, Gemfields has now achieved its position as market leader in the emerald sector. It is also in the process of applying the same business model to rubies, having recently acquired a world class deposit in Mozambique. In just 5 years our plan to become the market leader in gemstones other than diamonds is now close to reality. Gemfields has again delivered record breaking results at auctions of gemstones, earning higher revenues and prices per carat than in previous years. In 2012, Gemfields' share price has climbed significantly as the market has begun to recognize its potential.

Faberge is now a high profile business with a distribution network which includes retail outlets in London, Hong Kong, Geneva and New York. It is also the leading "global flagship" for an online shop window for the luxury jewellery industry. The achievements of the Faberge team confirm our strategy for this valuable brand and positions Faberge attractively for further value creation.

The directors comment further as follows:
"Despite the volatile economic situation we are confident that each investment platform will grow, develop and generate significant value for the company."

The directors have stressed that the company will only raise capital when the directors have specific use for the new funds. In their best judgment, now is the right time to raise further capital for the company. The Board has therefore approved a rights offer of up to R800 million at 224 cents per share. The directors all intend to follow their rights in full.

"An exquisite Faberge egg"

The net asset value of each share was 625 cents on 31 December 2011. The share is currently trading at 315 cents per share which is a discount of 50% to the intrinsic value of the share.

In summary, Pallinghurst has chosen to develop four distinct divisions from scratch, rather than taking the more easy option of buying existing companies. It takes time to build a successful business from scratch and the first five year period is nearly over. Clients should not be too distressed at the current value of their shares, and in our opinion, should exercise patience which will bring significant rewards as these projects come on stream. We intend to follow the rights issue for all our clients.

MIDCAP SHARES FOR THE BOTTOM DRAWER

In May 2011, we suggested that Distell, Trencor and Tongaat were three midcap shares for the bottom drawer.

Distell and Trencor have recently released results, hence the update below. Tongaat will only report at the end of May, so it is excluded, but not for any nefarious reason.

We start with Trencor results on the right:

TRENCOR

Year ended December	Dec'11	Dec'10	Dec'09	Dec'08
Earnings per share	559.3	335.5	134.8	379.2
% growth year on year	66.7%	148.9%	-64.5%	25.5%
Dividend per share	175	140	120	110
% growth year on year	25%	16.7%	9%	37.5%

We comment as follows on these results:

1. Trencor shares trade at 4600c, which equates to a price/earnings ratio of 8.2, which is very low for a company of this calibre. The dividend yield is a healthy 3.8%, which fits in with our philosophy that dividends are a vital component of overall return. Equally important, despite a fall in earnings during the Financial Crisis, Trencor has increased its dividend steadily – a sure sign, in our opinion, that the directors run a tight ship and have immense long-term confidence in their company.
2. Textainer increased the direct ownership of its fleet of sea borne containers to 58.6%, as compared to 50.9% at December 2010. It is more profitable for the company to own the containers rather than to lease them.
3. Utilization of the fleet of containers stands at 97.3%, despite the depressed state of world shipping as measured by the Baltic Dry Index. 78% of the total fleet is committed to long term leases with customers. That is defensive. Even in tough times, they are guaranteed to earn income from these long term commitments.
4. Trencor's sole investment is a 61% in Textainer, which is listed on the New York Stock Exchange. So it remains the only company which is listed on the JSE, and which has a direct investment into the NYSE, and it is a classic rand hedge stock. (Clients with offshore portfolios will recognise Textainer as we have bought those shares directly.)
5. Despite the tough global conditions, Textainer (and therefore Trencor) continue to deliver results. We think the share has enormous potential, and so continue to hold and accumulate.

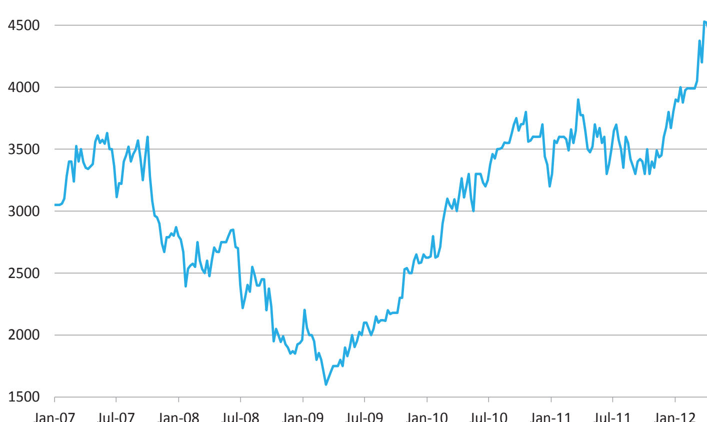
DISTELL

6 months ended Dec	Dec'11	Dec'10	% Change
Surplus Income (Rm)	776.9	630.7	23.7%
Earnings per share (cents)	384.6	312.8	23.0%
Dividend per share (cents)	143	124	15.3%

The directors comment as follows:

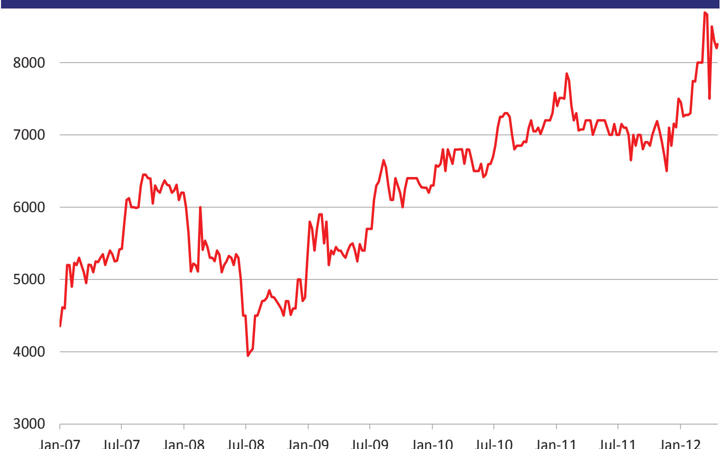
1. Sales increased by 15.9 % to R8 billion.
2. The cider, and ready-to-drink brands continued their strong performance. R116 million will be spent on the expansion of the cider production capacity, to keep up with increased demand.
3. Exports of wine showed sound growth, and the company increased its share of total wine exports from South Africa.
4. The Company remains in a strong financial position, with R942 million in cash balances at December 2011, compared with balances of R580 million at December 2010.
5. Distell is well positioned to take advantage of any improvement in economic conditions.
6. The shares continue to be tightly held with Remgro, Capevin and SAB Miller owing 87 % of all shares in issue. All three are long term shareholders, and with so many shares in long term hands, there are precious few for the rest of the investment community. We continue to accumulate if or when shares become available at attractive prices. But with so few shares to go round, accumulating shares requires patience. We certainly feel that patience will be well rewarded.

TRENCOR SHARE PRICE



"Benefitting from the growth in containerized trade"

DISTELL SHARE PRICE



"A consistent performer"

COMPANY SNIPPETS

Aspen

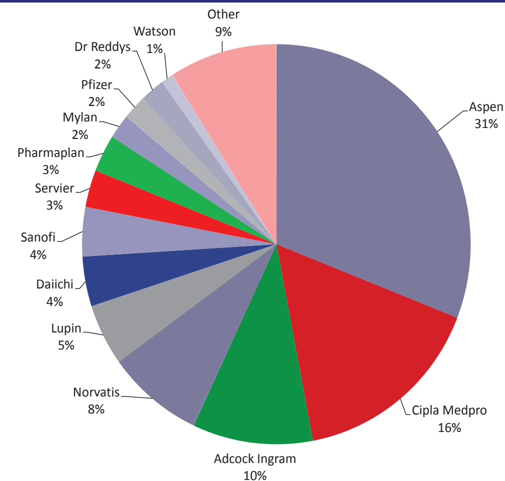
Aspen, the South African pharmaceutical company that is fast becoming a recognised global player, supplies branded and generic pharmaceuticals in over 100 countries, with a smaller offering of consumer and nutritional products in selected emerging markets. Aspen's largest presence is in South Africa, Australia, Latin America (countries such as Brazil and Mexico), and various countries in the Middle East and Africa. Analysts' reviews on Aspen's 18 manufacturing plants have always complemented its state of the art facilities and the high hygienic standards of its sterile operations. After a recent site trip to its Australian operations hosted by the company (which, unfortunately, we could not attend) the overriding feedback on Aspen was: management, management, management! In a nutshell, Aspen's team of senior executives is world class.

Amongst other products, Aspen has proved themselves to be leaders in the field of generic medicines. Their market share, at 31% in South Africa, is well ahead of Cipla's 16% and Adcock Ingram's 10%. Furthermore, Government has also announced its intentions to implement preferential procurement on the purchase of pharmaceuticals from local manufacturers which has positive implications for the listed groups with domestic manufacturing capabilities, such as Aspen.

It is this same management team which has just announced a R2.1 billion acquisition of established over-the-counter products from GlaxoSmithKline (GSK). The deal is positive from two angles. The first advantage is that in the future they will manufacture the products that they have bought from GSK in their own manufacturing facilities. That enhances their economies of scale and efficiencies, driving down costs. Secondly, there is a strong overlap for these new products with Aspen's existing regional presence in South America, Asia and to a smaller extent, South Africa and Africa. The latest transaction is not the first for Aspen. A few years ago they acquired the Australian-based Sigma for R6.1bn. That acquisition has been bedded down quickly and is already impacting positively on the results of the group. Over the last three reporting periods, Aspen has grown revenues by 31%, 29% and 33% respectively. That is an impressive track record.

Aspen has been a stellar performer. Their latest results saw the 27th consecutive reporting period of unbroken profit growth. The five-year compounded earnings growth is 25% versus the average of the market of 11% and in so doing, it has outperformed the broader JSE by a significant margin. The only blot on its largely unblemished copybook is the weak dividend yield. At present the yield is less than 1%, as the company retains cash for its future growth. We like the share, and buy will if it falls, but feel that it is expensive at current levels.

SHARE OF SA GENERICS MARKET



"SA's leading generics pharmaceuticals group, by far"

MTN Group

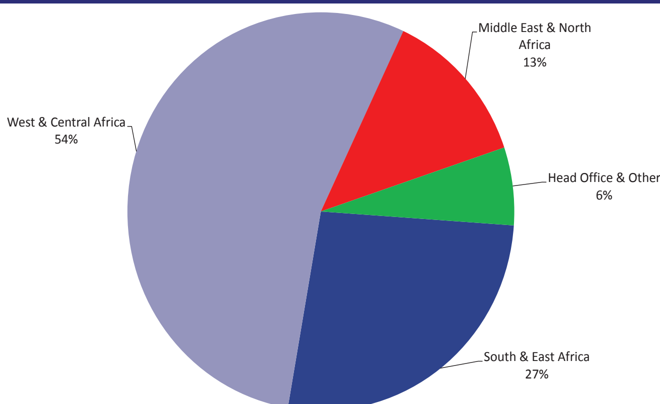
MTN is one of our favorite shares at the moment. In our opinion, the company is poised to offer its shareholders the best of both worlds – strong growth in profits as well as a juicy cash dividend. Normally, shares offer either one or the other. Rarely do they offer both. MTN delivered a good set of results when it reported in March. Its earnings grew by 128% after accounting for the impact of a prior BEE transaction – and 43% if the BEE deal is excluded. More importantly, MTN increased its dividend by 50%, and is now committed to paying out 70% of its annual profits to shareholders. To put that into perspective, just four years ago, MTN paid out only 20% of its profits as dividends. As a result of this change, MTN's dividend has soared, and the share now offers investors an income yield of 6% - one of the highest on the JSE.

MTN is an exciting growth story. It has operations across Africa and the Middle East, and is the dominant operator in a number of highly populated countries – Nigeria being the

most valuable. In many parts of Africa, cell phones are not a luxury, but rather a necessity, as the fixed line operators (equivalents of Telkom) barely exist let alone provide a reliable service. Africa and the Middle East offer enticing returns for investors, but they don't come without their risks. Competition is fierce and running costs are high due to poor infrastructure. (For example, in Nigeria, every base station needs a diesel generator because electricity supply is so erratic.) But these costs are bearable give the potential.

Whilst MTN offers exciting growth, nothing is simple. Some of the company's largest markets are not exactly must-see holiday destinations – Nigeria, Syria and Iran stand out! In particular, MTN was awarded a license to operate a network in Iran about 5 years ago. Given broad-based US sanctions against the country, US shareholders are being forced to sell their shares, as they cannot own shares in companies that do business in Iran. (Remember the large disinvestments from this country in the late '80s!) On top of that, Turkcell, Turkey's largest cellular network, has recently filed a lawsuit against MTN, alleging that MTN bribed officials in order to secure the license. MTN has strongly denied any wrongdoing, and we believe the lawsuit holds little merit. But these issues combined are weighing on sentiment in the short term. It is frustrating that the share price is not higher, given the stellar operating performance. But we believe patience will be more than amply rewarded, and a weak price merely provides us with an extended opportunity to build a holding at excellent valuations.

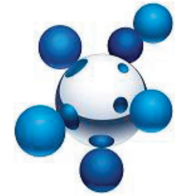
MTN SOURCE OF PROFITS



"SA is no longer the dominant source of profits for MTN"

sasol

reaching new frontiers



Sasol

On the face of it, an increase in profits of 81% seems like a superb performance. After all, not many companies have that claim to fame. Sasol delivered such a performance for the first six months of its financial year, and it raised the dividend by a similar margin – from 310c per share to 570c a share. We did not expect such a large increase. Sasol has a "progressive dividend policy" which means that they like to increase the dividend steadily over time. In such cases, large increases in profits are not normally matched by the increase in dividends, as the directors want to avoid cutting in the dividend in future years when profits normalize. So reading between the lines, Sasol is telling us that they are confident that profits will remain strong, and importantly, that cashflows will also remain strong. This is a welcome signal. At the current share price, Sasol offers a dividend yield of almost 4.5%, one of the more generous amongst our major resources firms.

Yet despite the huge increase in profits, the results were deemed disappointing. You might think the investment community is a hard one to please. But Sasol faces some operational challenges – notably weak volume production (the amount of product they produced was lower than expected) and higher costs. The increase in profits came mainly from factors outside of their control – a weaker Rand and higher oil prices – and those cannot be predicted into the future with any certainty.

That said, it is not all bad. Sasol is pursuing its strategic growth plans – new gas-to-liquids plants (turning natural gas into diesel) in various parts of the world, and it is securing vital gas reserves in the US, where the commercialization of shale gas is revolutionizing the industry. These are exciting ventures that position Sasol well to reap the benefit of its proprietary technology. On the operational front, their performance has improved over the past few months, and management is confident that they will make up for a weaker first half. With new management blowing some fresh air into the group, we believe Sasol has an exciting future. The juicy dividend is the cherry on top.

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:	Tuesday, 29 May 2012	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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