

Beer, Cigarettes and Cell-phones

SABMiller, Remgro (whose major asset is a stake in British American Tobacco), and MTN are now the top three shares in our funds. This does not reflect on our analysts' propensity for a social nightlife, but rather on the quality of each of these businesses! To understand the investment case for each of these shares, it is useful to consider some of their similarities:

1. Stable Demand

While demand for any good or service will exhibit some cyclicity, demand for beer, cigarettes and cell-phone connectivity tends to be more stable (i.e. less cyclical) than the demand for cement, steel, metals, clothing, furniture and credit for example. This results in less cyclical earnings, which is why these companies are sometimes called 'defensive' shares in investment jargon.

2. Competitive Advantage

SAB, BAT and MTN enjoy a very strong competitive position in their markets, where they are typically the number one or two player in a highly consolidated industry. New competition is a relatively small risk for these companies (although new technologies may spark some competition for MTN).

3. Global Diversification

They derive the majority of their profits from operations outside of South Africa. Admittedly, many of these foreign operations are in emerging markets, which share many of the same risks as South Africa, but we would still expect the geographic diversification to provide some protection from South Africa-specific risks such as Rand weakness or political discontent.

4. Long-term Growth Prospects

We believe that SAB can continue to grow volumes in many regions where per capita beer consumption is below global averages (China, India, the Andean cone, Africa). We expect this to be supplemented by further market share gains, productivity improvements and growth in premium brands such as Peroni, Pilsner Urquell and MGD. Despite declining cigarette consumption in the developed markets, volumes continue to grow in the emerging markets, where BAT is well positioned. BAT is succeeding in growing its more profitable drive brands (Kent, Dunhill, Lucky Strike and Pall Mall), and is expected to benefit from productivity gains for some time to come. MTN profits continue to grow in its 'mature' markets of South Africa and Nigeria as network traffic continues to grow, but if MTN can repeat its successes in South Africa and Nigeria in just a few of the many African and Middle Eastern countries in which it operates where cell-phone penetration is less than 20%, we would expect its profits to grow even more strongly.

While we are excited by the business prospects for SAB, BAT and MTN; it must be said that the shares are not outstanding bargains. They all trade on over 15 times forward earnings. But then it is rare to find outstanding bargains, when a stockmarket has increased fourfold in four years as ours has. Are these companies 'growth' or 'value' shares – I think the distinction is artificial and pretty meaningless. The important point is that we have more confidence in their ability to sustain and grow their current profits over the next decade, than we have for many other more cyclical companies, which are currently enjoying boom times. Cheers!

Commentary by Ian Liddle, Portfolio Manager, Allan Gray Limited