HARGREAVEHALE

INVESTMENT BULLETIN

Beer Consumption in Africa and the UK Budget

29 March 2011

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I recently went to a breakfast presentation by Brewer SAB Miller (FTSE100) on its operations in Africa, which mirrors its successful businesses in South America, where it has 17% of the Columbian market and nearly 10% of the Peruvian market.

SAB Miller is not a particularly cheap share, trading as it does on a prospective multiple of 14.7 offering a yield of 2.5% but it has a number of longer term merits, one of which is that getting on for 90% of its sales are within emerging markets. And rather than develop global brands, the management has preferred to concentrate on local brands geared to local markets. This is particularly apt in relation to developing markets where the group has a wide spread of geographies which provides a hedge against specific political risk. This particular presentation related to Sub Saharan Africa where business is booming. The background is of rapidly growing discretionary income triggered by infrastructure, agricultural and mining investment and the breakdown of traditional tribal divisions as a result of information technology and urbanisation.The comparisons with developed economies are startling.

The relationship between disposable income and beer consumption looks simple. Litres per capita consumption of beer in the USA last year was around 77. In Europe, the figure was 60. In Africa, excluding South Africa the figure was 7. A catch-up process is now underway. For example, a recent survey in the Economist, forecasts that between now and 2015, the top ten fastest growing economies in the world will be China and India (averaging 9.5% and 8.2% per annum respectively), Ethiopia with 8.1%, Mozambique with 7.7%, Tanzania with 7.2%, Vietnam with 7.2% and Congo, Ghana, Zambia and Nigeria trailing with between 6.8% and 7% GDP annual growth.

The company provided an interesting chart on the dimensions of the African beer market with the typical cost per serve ranging from a fifteen cents home brew to traditional beer of fifty cents, to "affordable" beer of eighty cents, "mainstream" beer of one dollar and "premium" beer of one dollar fifty cents. With 200 million Africans likely to enter the market for consumer goods in the next five years the message was fairly clear. Instead of the cheap stuff brewed illegally, no tax to pay, the punter is "now evolving to modern alcohol consumption and socialising patterns" in other words going out for a drink, and ordering, for example a local premium brand such as "Laurentina Preta" in downtown Maputo. Being number one or two in these African markets, and with a similar position in a number of South American markets makes SAB Miller an interesting proposition for refugees from the UK economy.

The chart was in the form of a pyramid with the base being cheap homebrews and the apex being premium brews. I wondered what would happen if you applied the same parameters to UK drinkers. Would it just be a case of turning the pyramid upside down, as the UK consumer, increasingly unable to afford premium beer prices, trades down to the UK equivalent of "shabeens", illegal drinking dens in the South African shanty towns. What is happening to UK beer trends?

Global beer trends suggest that Germany, Netherlands, Canada, France and the UK will all experience declining beer volume between now and 2015. Last year, for example consumption of beer in the UK fell 1.9%, and given pricing for a bottle of premium lager equivalent to maybe $5 plus, it is scarcely surprising. In the recent budget, the Chancellor confirmed that the duty on alcohol would rise by 2% above the rate of inflation, (RPI currently 5.5%) in line with "the duty escalator put in place by his predecessor". Beer prices are likely to rise by 10p per pint this weekend. Not good news for the proposed Punch demerger, let alone boozers.

The obvious point being that UK consumers are being subjected to a severe squeeze on their disposable incomes, which you could argue is only just beginning. The average household's "real income", adjusted for inflation will have fallen by 1.6% over the three years to the end of 2011. In contrast, over the previous half century real incomes rose by an average 1.6% a year. The Institute for Fiscal Studies (IFS) suggests that household incomes in 2013 will still be lower than in 2008. Not since the great depression of the 1930's has a fall of such magnitude taken place.

Public sector workers earning between £20,000 and £35,000 in particular will be battered. They will be faced with a 6.6% fall in gross pay between now and 2014 and in addition they will face a 3% rise in pension fund contributions and rises in tax and benefit cuts which will reduce incomes by a further 3% to 4% in real terms. Top earners will lose at least 7% of their net incomes over the same time period. Consumers at the bottom of the pile will also suffer. Payments from the State dominate incomes and here the cut in the generosity of working tax credits for low income families will hit hard. Across the spectrum of earnings things do look dire. It is hard not to feel that in relation to developed markets turning upside down the African pyramid chart might be all too appropriate.

Pressure on earnings is clearly now starting to have a big effect even on non discretionary spend like food. Sainsbury's sales for the 10 weeks to March 19th rose just 1 per cent against analysts estimates of 2.4% and the shares promptly fell 5%. CEO Justin King said shoppers were feeling the pinch from rising food prices and were unsettled by bleaker employment prospects. There has been a “change in shopping habits as consumers buy a little bit less."

CEO Lord Wolfson of Next said yesterday that "things will get worse before they get better with clothing retailers margins likely to be hit by being unable to fully pass through to consumers recent sharp rises in raw material prices such as cotton and fuel”. Li & Fung, the big sourcer of products from China for leading European and US suppliers has called time on the era of cheap products out of China which retailers and consumers in the West have come to take for granted. They said: “A new era in sourcing with higher prices has begun as manufacturers pass on the rising costs of raw materials and Chinese labour to customers”.

Retailers, particularly food retailers have always been perceived by investors as good places to hide in a recession. But no longer. The same can be said with utilities. The trouble with utilities is that they cannot take their plant offshore and they have to sit it out when the Government is looking for cash. Sitting ducks spring to mind. Ofgen is now said to be in the process of appointing an independent firm of accountants to look into the balance sheets of the top six electricity generators. For example, Scottish and Southern might have included £127m of profit as an exceptional item called "portfolio optimisation." It is entirely legitimate in accounting terms but what this means in terms of definitions of return on capital will now be looked at.

Investors in the UK are facing both uncertainty and opportunity. But it is difficult to get into perspective what is happening. There is not necessarily a conspiracy of silence in the media about the prospects for UK economic growth. It is just the scale of the problem to be addressed.

The Office for Budget Responsibility (the OBR), the Government's new independent fiscal watchdog, summed up the situation quite well. As things stand, in 2011/12, the Government is seeking to borrow £122 billion from local and international investors. This figure is the difference between total tax receipts of £589 billion and spending of £711 billion.

Breaking down receipts, the big items are income tax of £158 billion, national insurance of £101 billion, VAT of £100 billion, excise duties of £46 billion and corporation tax of £48 billion. Breaking down spending, the big items are social security £200 billion, national health £126 billion, education £89 billion, debt interest of £50 billion and defence £40 billion.

The OBR says that the UK is on course to reduce its annual budget deficit from a current 11% to 1.5% by 2015 following a strong recovery in GDP growth boosting tax receipts. Growth is anticipated to rise to 2.5% in 2012 to 2.9% in 2013 and 2.9% in 2014. The key changes since the OBR's Report just last November is an unexpected fall in GDP in the final quarter of 2010, and a jump in inflation from the targeted 2.0% to 4.4%.

If nothing else, changes of this magnitude in just four months underline the fragility, to be polite, of all forecasting. The idea that any estimate of the level of GDP growth in 2014 can be taken seriously is patently absurd. This is all about small moves either way in very big numbers.

Investors therefore should sit back and think about the macro environment. In particular, the fact that we are facing something of a first in western economies. We are being assaulted by all the usuals to be expected in a cyclical downturn, rising unemployment, rising inflation, heavy public sector borrowing, underlying portfolio investment write-down’s yet to be recognised by the big banks. But what is novel is that we are also faced with well organised, well educated, well financed, determined competition from emerging nations such as China, Brazil and India.

The crucial fact about this competition is that it does not have the handicap of a heavy ongoing cost of social and medical healthcare that has to be paid for by western taxpayers nor does it have the penalty associated with a higher proportion of an ageing population, again that has to be paid for. These costs in the UK this year are of the order of £320 billion. If nothing is done to reduce these costs there are serious implications for our ability to compete globally. The Government has gone to the brink in trying to increase the tax take rather than address the cost issue but increasing the tax take further is likely to be counterproductive. For example, increasing the tax take on the integrated banks might well be just and popular but it will reduce the tax take as the integrated banks go offshore. Barclays has already threatened to go. The difficult option is cutting costs. There are actions however that would have popular support but which would offend powerful interest groups. One example would be regulation.

Open Europe Research, sponsored by the Government, has recently published a comprehensive study on the cost of regulation to the UK economy, based on over 2,300 of the Government's own impact assessments. Open Europe finds that regulation has cost the UK Economy £176 billion since 1998, well in excess of the UK's existing budget deficit. Since the UK Government launched its "Better Regulation agenda" in 2005, the annual cost of regulation has actually doubled. This is in no small part due to a failure to stem the flow of new, costly EU regulations. Osborne's budget speech hinted at the legal difficulties in closing down quangos and other bodies with statutory rights, particularly in relation to European law. History suggests that it is unlikely that anything much can be realistically achieved. At the end of the Portuguese Empire, one in eight people employed in Lisbon were said to be lawyers.

Investors clearly have to decide whether the current Government will be successful in their existing deficit reduction efforts. The other judgement clearly relates to the issue of inflation. In essence the Government is telling us not to be concerned about the inflation rate exceeding 5% in the shorter term. Cost pressures are "one offs" and deflating demand, oil prices will fall back, harvests will be generous etc, high unemployment will curb excessive wage awards. Inflation will therefore fall back in the second half of this year. Let us hope that the Government and the Governor of the Bank of England is correct in this judgement. The problem is that this is the first time we have had a recession in western economies which has not caused a recession in emerging economies. Unfortunately for us, emerging economies are still growing despite efforts to slow them down via higher interest rates and as a result emerging market consumers are continuing to spend. This means that commodity prices, food prices, cotton prices will be less likely than before to fall. This could impact on the Government's calculation on falling inflation in the second half of 2011. Li & Fung's judgement on the price of goods sourced from China springs to mind. As a result, interest rates might well have to rise which would not augur well for the UK banks and UK property/construction market. The extent of the rise could also be somewhat larger than expected. Negative, inflation adjusted, interest rates are around 4% in the UK. In China, real interest rates are 1% and rising.

In such a scenario, it is not just retailers like Next or supermarket operators like Sainsbury that are in the firing line. Investors should heed recent warnings from well managed contractors such as Severfield-Rowen that the outlook in the UK is not getting any better. In terms of domestic banks, it is clear that the need to write-off bad debts is continuing to impact on their lending programmes. The fact is that domestic banks need to reduce their loan books in order to get their capital adequacy ratios back in order. And of course, being only human, they reduce their loan books where they can do so without write-offs. So the good loans go first and the bad loans stay well locked up, impairment provisions avoided. This means that overall loan books continue to deteriorate in quality making them vulnerable not just to the impact higher interest rates on their loan books but also to sovereign loan write-offs, like those looming in Portugal.

In relation to the banking sector, the failure of the Chancellor to finance the Green Bank start up adequately was bad news. It does not matter which side you are on in terms of the merits or demerits of the integrated banking system. Some, like the Governor of the Bank of England, Mervyn King are in favour of separating the casino activities of banks from their retail and industrial lending responsibilities. Some find the current situation ideal: big bonuses if the punting is successful, too big to fail and smaller bonuses if the punts fail. Underwritten by you and me. Stalemate between the two sides is very bad news. What is needed are new banking licencies for banks concentrating on retail deposits and industrial lending. The Green Bank looked like a good start, but because of Treasury intransigence, the new bank will have only £3billion in funding and more important will not be able to leverage its lending until 2015. The UK needs to auction new bank licences now to deal with the current stalemate, rather than worry about the impact of fresh competition on the nationalised banks and the pricing of pre election IPOs.

The challenge for investors, who feel that the sums might not add up in the UK, is how best now to diversify your way out of the UK. The immediate way is to find UK corporates addressing successfully global markets. And there are very many. SAB Miller would be such a candidate. But in rebooting portfolios for the new tax year, here are some suggestions.

Every portfolio should surely have some representation in the global luxury goods market. It is an industry which to date at least has absorbed rising interest rates in emerging markets with some aplomb and seems likely also to be able to absorb the travails of Japan. This is all about newly found status and the need to impress. It has created a major industry. Burberry is capitalised at £4.8billion, Mulberry is capitalised at £780m, Christian Dior is capitalised at EU 17billion, Hermes at EU 19 billion, LVMH at EU 52 billion, and Richemont at SF 25 billion. The shares are expensive in earnings multiple terms, ranging amongst the majors from 18.3 for Richemont to 31 for Hermes. The multiple for Mulberry is more than 50, which can be looked at in two ways. Either it is very expensive or the rate of growth from a smaller retail base is worth paying up for in the longer term. Obviously there will be ups and downs, for example last week the Chinese authorities put a ban on some billboards advertising luxury brands for social reasons but over a five year view the growth momentum should continue.

The case for investment in Japanese equities and Investment Trusts made in February's bulletin has if anything been strengthened by last month's tragic events. Reconstruction should prove a catalyst to GDP growth aided by a weaker Yen and a higher level of monetary expansion. There are a number of opportunities. We have been buying Komatsu, (market cap £27 billion) the world's second largest maker of construction equipment as demand for excavators, dump trucks and wheel loaders is increasing sharply. This is not just as a result of the earthquakes but it is also driven by construction and mining in China, Indonesia and Brazil. In the very short term, the Group could be affected in terms of production and procurement issues, but the company has stated that the six major plants in Japan have all resumed production with the exception of one assembly line. Some distribution bases in the Tohoku area have been impacted but this is likely to be temporary. Pre the earthquake, demand had been booming with third quarter profits more than tripling. In the three months to December 2010, net income climbed to 36.9 billion Yen, compared with just 10.16 billion Yen in the comparable period of 2009. Its full year profit forecast has been raised to 140 billion Yen, more than quadrupling last years profits, producing a prospective multiple of 19. The shares at 2,790 Yen trade well below a five year high of 4000 Yen and look attractive on a longer term view.

An alternative, indirect Japanese play could be via UK quoted Jardine LLoyd Thomson (Market Cap £1.4 billion). JLT is a global insurance broker, rather than underwriter and it is underwriters that are currently being scrutinised as a result of the Japanese quakes and aftermath. For brokers such as JLT should benefit going forward from the likely increase in premiums being negotiated as a result of last months devastation in North East Japan. Earthquake related claims could be anything between £15 billion and £40 billion depending on who you talk to, but just a 10% increase in premiums can have quite an impact on the profits of a brokerage business such as JLT with high operating leverage. In addition, unlike other equities, insurance brokerages such as JLT tend to benefit from higher interest rates in view of the cash carried on the balance sheet. Last year, for example, investment income fell by over ten per cent to £5.6 m as a result of low interest rates. Insurance broking is primarily about teams of people and the goodwill they do or do not engender and here JLT has well respected teams which must make it of interest to big global operators like AON. JLT trades on a prospective PER of 14.

Let us pray for an extension of son of quantitative easing formally due to end in the US this summer. The US as opposed to the UK can still get away with printing notes because inflation remains low and the housing market seems dead. In February, only 250,000 new homes were built in this US, the lowest since records began in 1963, and interest rates seem destined to remain low as long as China continues to buy US Treasuries to finance the budget deficit.

This means that there is little immediate momentum for dollar strength, possibly the reverse, which again means that continued investment in gold should be rewarded. Investors are not spoilt for choice when it comes to gold shares.

At least an average of three/four explorers for precious and industrial metals come to see us each week. That figure also would include oil explorers. They come for trading updates and for new money. They do have fairly common problems, ranging from electricity, water and general infrastructure issues, JORC (Joint Ore Reserves Committee) compliant reserve issues, political problems, and increasingly with a more powerful Chinese presence, license retention issues. That is on top of success or failure in exploration and cost of production and availability of bank finance. But despite all these problems, it is fair to say that the London market has been financing an extraordinary array of high risk exploration companies over the last years. With some success.

Bitter experience if nothing else has taught us that along with luck, good management with the correct political connections, companies are most likely to succeed with the correct balance between exploration and production. This means that levels of existing production generates sufficient cash flows to at least finance a high proportion of exploration drilling. Surprisingly few managements seem to get this balance right. Hence the need for fresh money. The notion of "risked" reserves is an interesting one and somewhat elastic too, which is why a balance of activities is crucial. All exploration activity is highly speculative and gold companies are not suitable for widows orphans or possibly anybody else for that matter. But occasionally an interesting one comes along primarily because of the right management, political influence and balance of activities.

Avocet Mining (market cap £472m) falls into our preferred category of a business which is well managed and owns a good production/exploration balance. Production in 2010 was 236,000 oz whilst Avocet is also in the middle of a drilling programme in its two preferred geographies of Burkino Faso and Guinea. This programme is extensive, costing over $40m and importantly is being financed out of existing cash and cash flow. The company is targeting a doubling of its Inata Resource in Burkino Faso to 2m oz and a tripling of the Guinea resource to a further 2m oz. Recent drill results have been good and there are a number of secondary deposits which could significantly increase the total. The Group is currently trading at $150/oz for its existing resources, compared to other African producers which trade on a median of $180/oz. The company's most obvious listed peers are African Barrick, Randgold and Centamin which are trading on $375/oz, $226/oz, and $207/oz respectively. In addition, the company could receive over $150m from the sale of its East African assets, over $110m of which is in escrow. An interesting albeit high risk gold play with an estimated net asset value per share of 310p compared with the existing share price of 235p

Summary of Buy Recommendations

Avocet Mining (Higher Risk)
Jardine Lloyd Thomson (Medium Risk)
Komatsu (Medium Risk)
SAB Miller (Lower Risk)

All other stocks referred to in the article should not be classed as recommendations.

George Finlay

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