How has South Africa Inc sought to reduce its high Cost of Capital?

OECD Development Centre Seminar:

"Cheaper Money for Southern Africa - Unlocking Growth"

7 October 2004, Paris

Michael Power,

Strategist,

Investec Asset Management

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Conventional Wisdom uprooted

CW: A company's cost of capital is determined by the locale of its assets, not its place of listing.

"Anglo American cannot change its cost of capital simply by moving its head listing to London.

"Being listed in a developing country rather than a developed country makes no difference to a company's cost of capital."

Wrong! The cost of capital is a price, a price for a 'share' of risk sold by a company.

That price – as with all prices – is determined by the interaction of the supply of risk by the company and the demand for risk from investors.

Moving to London virtually halved Anglo American's cost of capital from about 17% to about 9%.

An Anglo investment previously adding value of 14% return on capital turned from being unprofitable to *truly* profitable as a result of the London listing.

What is the Cost of Capital for SA Inc today?

For an ungeared company:

- **SA Inc: 14.9%** (Risk Free Rate (RFR) of 9.4% + Equity Risk Premium (ERP) of 5.5%)

Compared to:

- **UK Inc: 8.8%** (RFR of 4.8% + ERP of 4%)
- **US Inc: 8%** (RFR of 4% + ERP of 4%)

A South African company needs value added returns that are over *1½* times as high as British or American company to be profitable.

The Cost of Capital Defined

- **It is the blend of a corporation's capital base, its debt and equity, creating its WEIGHTED AVERAGE COST OF CAPITAL or WACC**
- **WACC = equity % of capital base (risk free rate + (beta x ERP)) + debt % of capital base ((risk free rate + lending margin) x (1 - tax rate))**

The modern MNC will aim to create the lowest risk adjusted cost of capital it can by blending that capital base from the world's pools of capital

Why is the WACC so important?

- **It defines the hurdle rate that determines true 'economic profit'**
- **Returns to capital less the Cost of Capital = Economic Value Added if positive, Economic Value Destroyed if negative**
- **A company whose auditors say it is 'profitable' and whose 'profits' are taxed by the Government is not *truly* profitable unless it also covers its cost of capital!**

"It is critical that all operations earn returns in excess of our cost of capital"

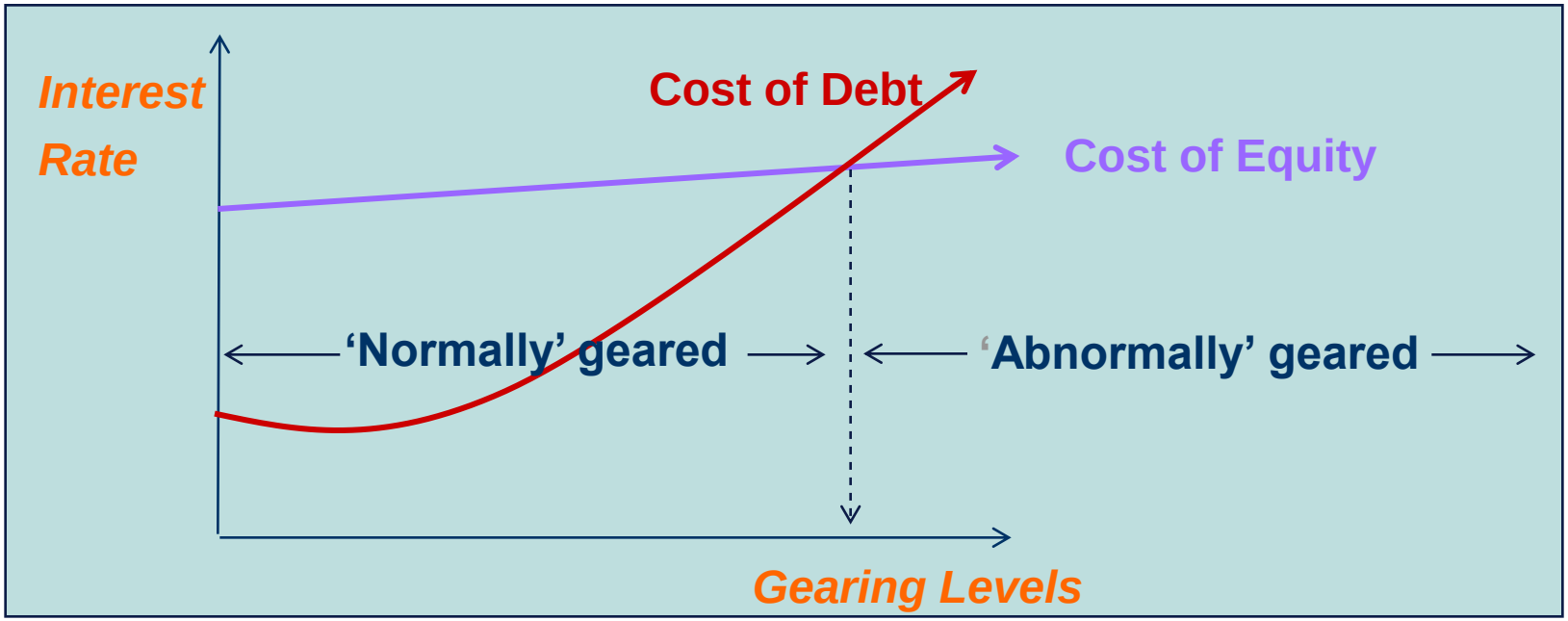
Roberto Goizueta, Former CEO

My focus here is on *'more expensive'* equity not *'cheaper'* debt

Q: Why debt is usually cheaper than equity?

A: Because of tax. The debt part of WACC is calculated as follows:

- ***((risk free rate + lending margin) x (1 - tax rate))***



But when a company's gearing gets 'too' high, the interest rate on its debt tends to rise above the cost of equity as increasingly nervous lenders demand penal lending rates

The Key Variables in determining a Cost of Capital

Common to both Debt and Equity

- **Risk free rate (RFR):** theoretical interest rate that would be returned on an investment which was completely free of risk. The yield on 10 year Treasury Bond is a close approximation, since it is virtually risk-free. **Determinants:** Country risk, including FX risk, investor appetite for sovereign risk

Debt

- **Gearing**
- **Tax Rate**

Equity

- **Equity Risk Premium – ERP** –The extra return that the overall stock market or a particular stock must provide over the rate on Treasury Bonds to compensate for market risk.
  Determinants: Market history and outlook, market character
- **Individual Stock *beta*** – a measure of the stock's volatility vs. its home market

What has SA Inc done about SA's high cost of capital?

Those that could made the Great Trek to London

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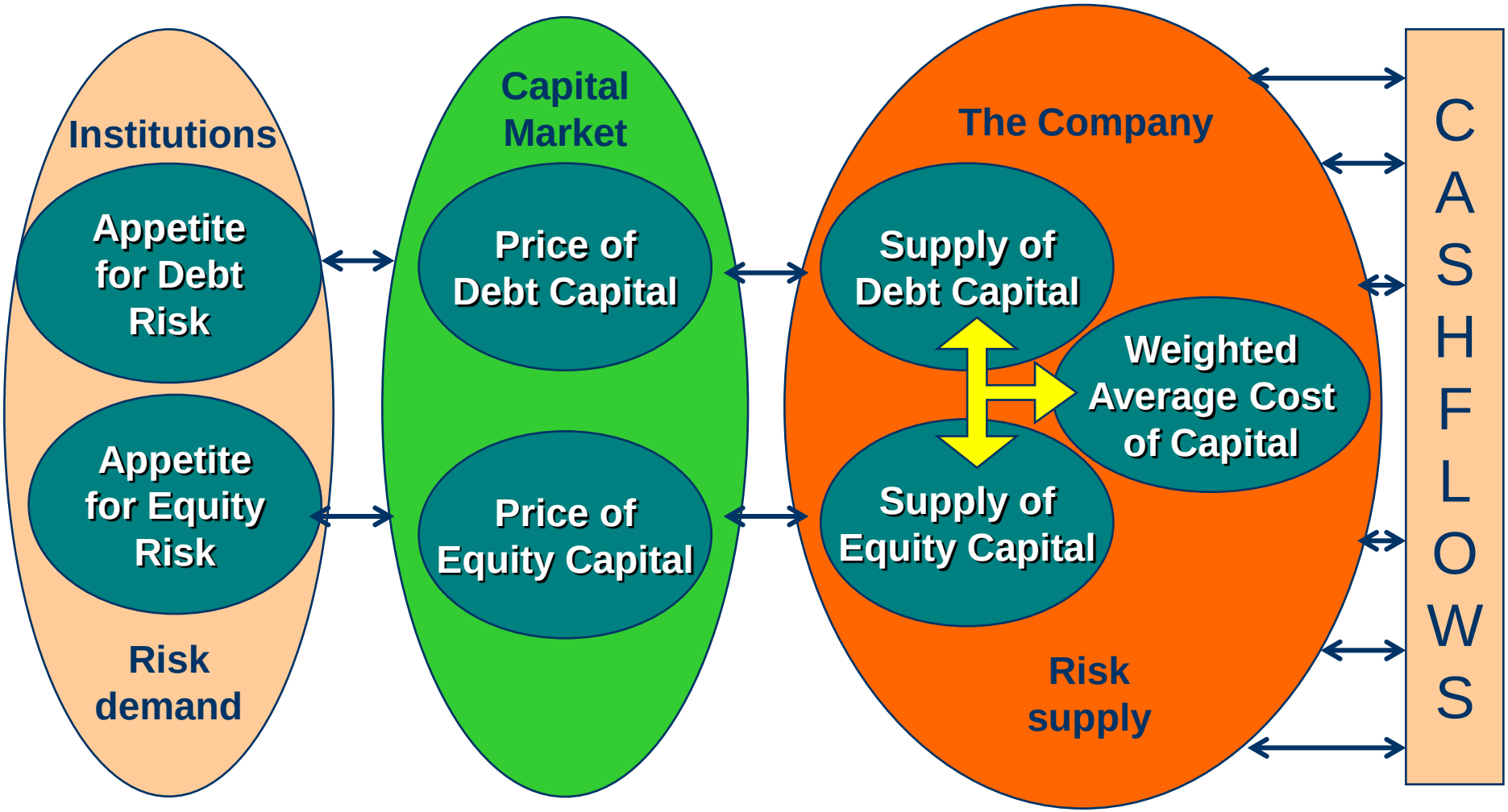
The Two Sides of the Price of Risk:

Corporate Supply and Institutional Demand



The Role the Company plays:

The seller of cash flows, the buyer of capital

- **A company owns the cash flows arising from its investments over future time periods.**
- **A company finances these investments by blending debt with equity to create its capital base.**
- **The capital charge made against that base – calculated via the WACC rate – is its specific hurdle rate for profitable capital employment.**
- **That hurdle rate is usually applied to prospective projects as a discount rate so as to determine their likely financial viability.**

Critically, this hurdle rate is the price of capital determined where:

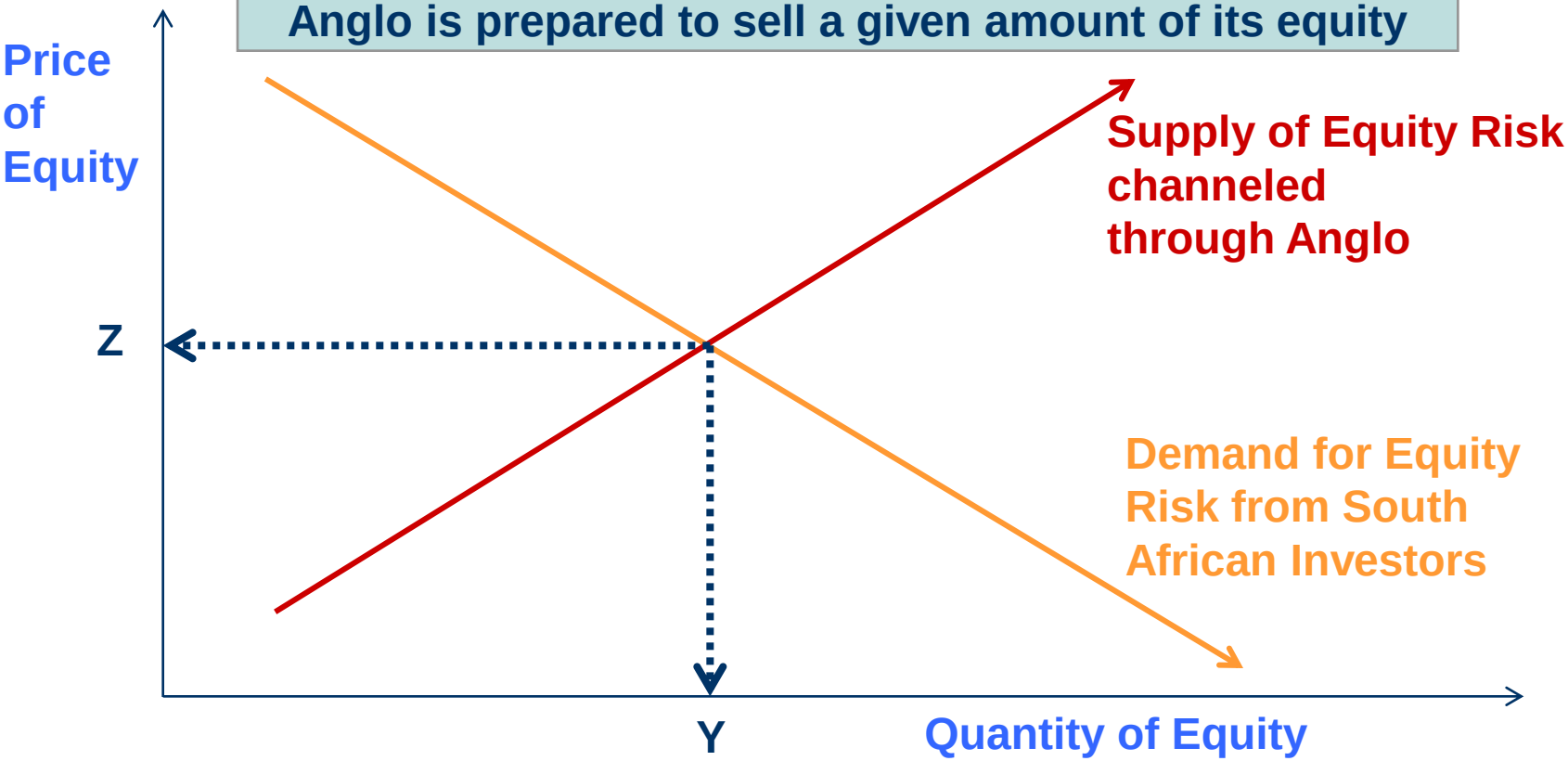
the supply of risk **i.e. those investment activities undertaken by the company**

meets:

the demand for risk **i.e. what investors in debt and equity capital are willing to pay to buy access to those cashflows**

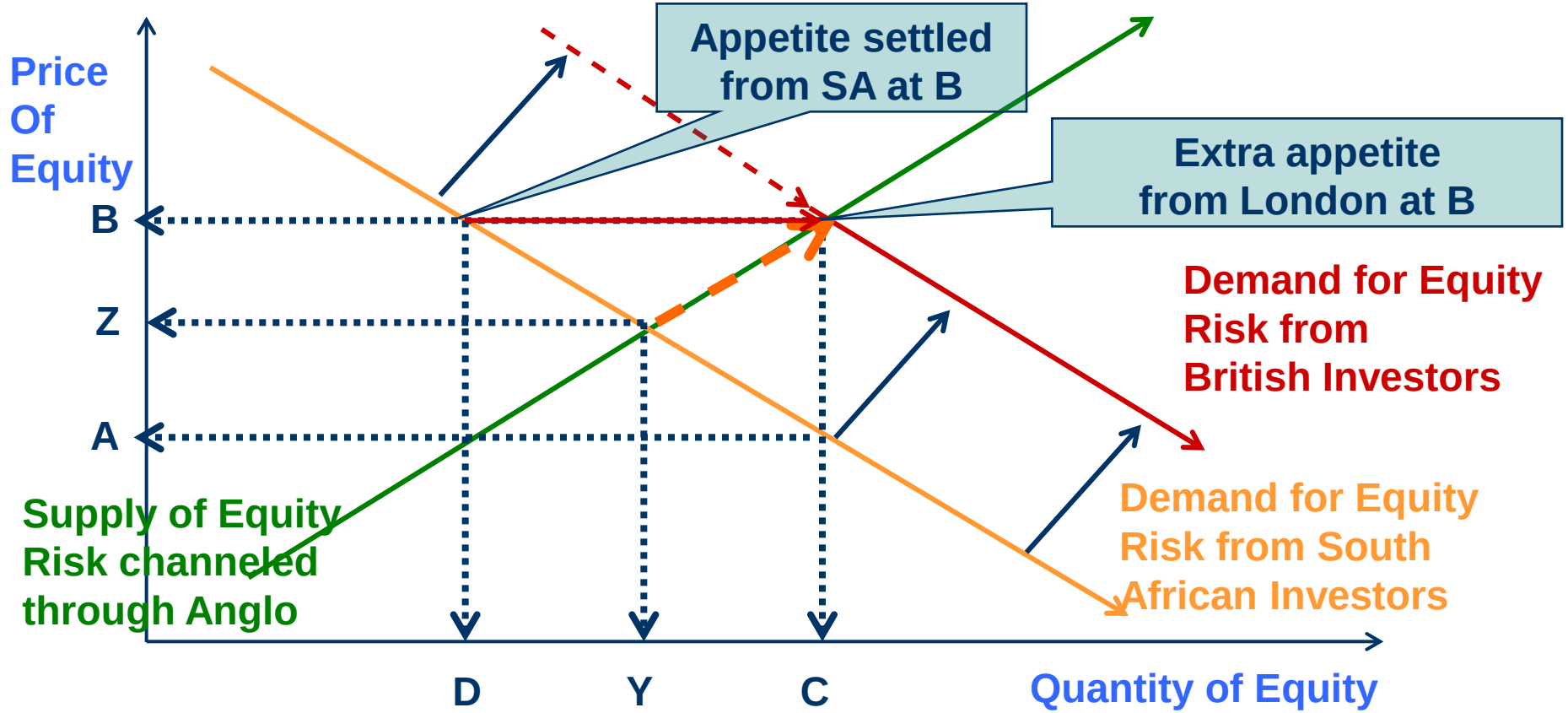
Stage 1: Anglo when its head listing was in Johannesburg

At each level of demand for its risk,
Anglo is prepared to sell a given amount of its equity



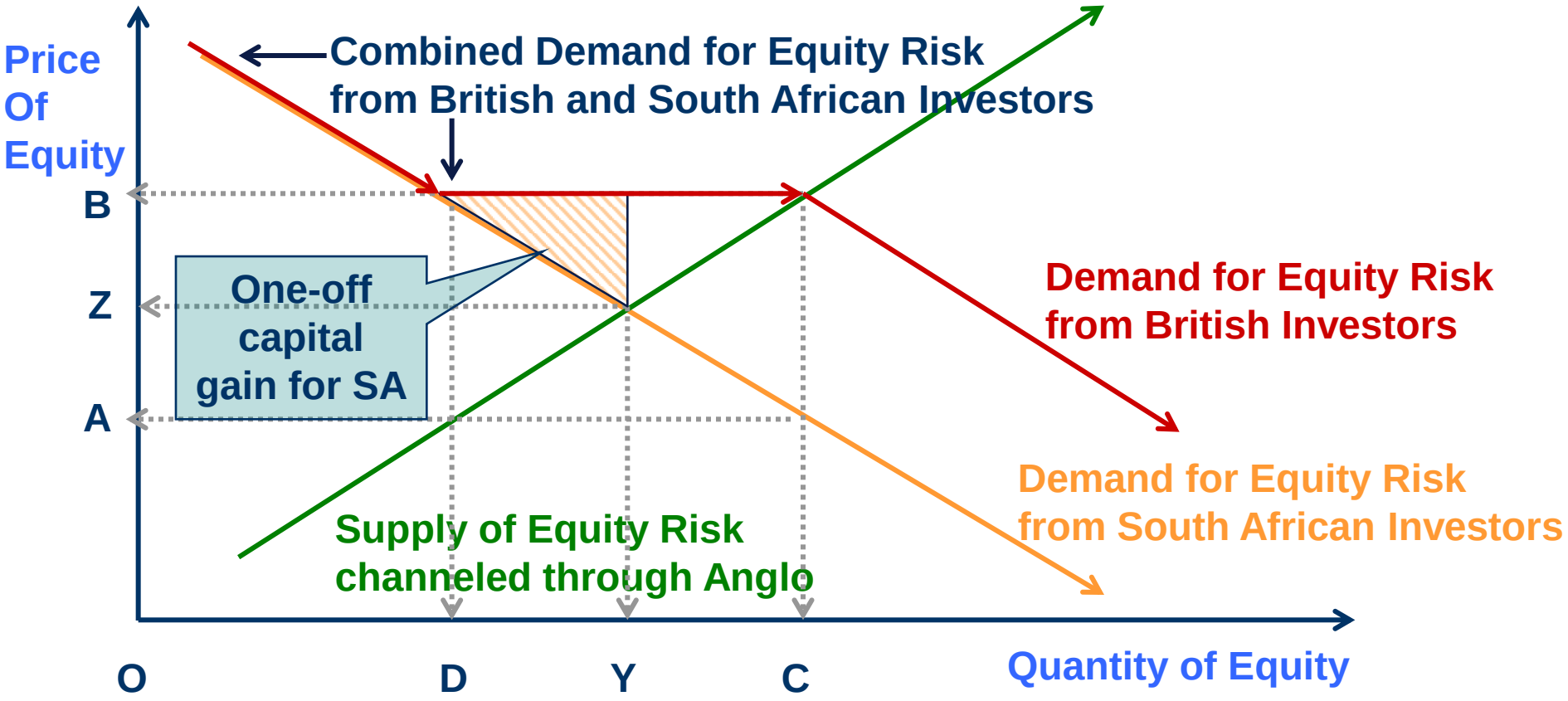
At 'fair value' in SA's equity pool, SA investors would buy Y amount of risk at Price Z and Anglo would sell Y amount of rights to bundled cash flow at Price Z

Stage 2: Anglo moves head-listing to London



Some British investors have a higher tolerance of risk – they pay B where SA's marginal Investor would only pay Z. Those British Investors demand even more risk – C rather than Y – at that higher price B. At price B, SA investors demand only quantity D and so they sell Y-D in scrip, which flows from SA to the UK. In addition, the UK demands C-Y *extra* scrip! To capture this extra demand, Anglo might (and did) issue extra scrip on its London move.

Stage 3: Anglo's move complete



Some existing South African investors (O-D) with a greater willingness to pay more for risk would *not* have sold their Anglo shares in the London move.

The Proof of the Pudding

Chairman's comment covering Anglo American's first earnings release after their move to London:

"Ogilvie Thompson said the group was pleased with its London listing, which had lowered its cost of capital…"

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NEWS WORTH KNOWING

23 March 2000

The Errunza-Miller Study

December 2000

Market Segmentation and the Cost of Capital in International Equity Markets.

Findings: Capital market theory suggests that the removal of barriers to capital flows reduces companies' cost of capital and investors' realized returns. The authors studied the issuance of 126 American Depositary Receipts as a form of company-specific capital market liberalization. They find a significant reduction – an average of 42% – in the cost of capital for companies that issue ADRs for the first time.

Journal of Financial and Quantitative Analysis
vol. 35, no. 4, 577–600

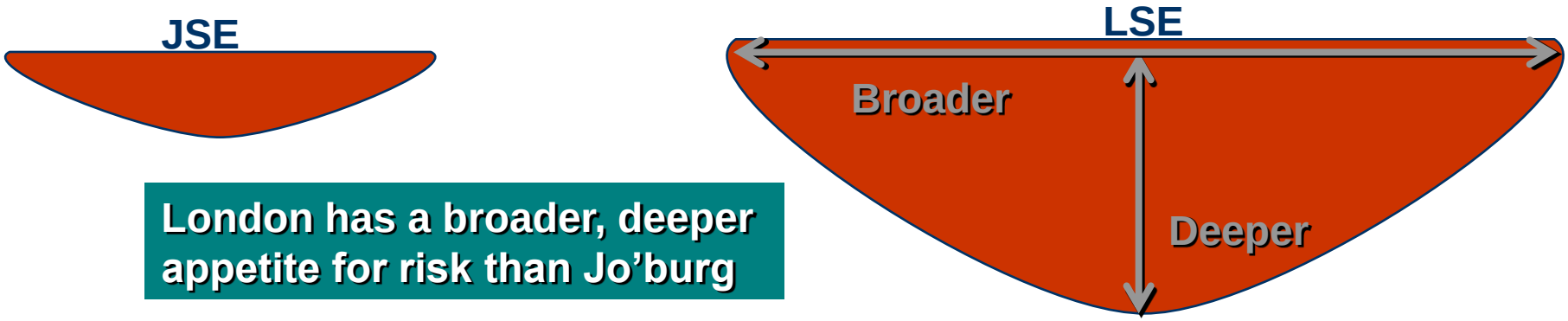
Why would London have a higher risk tolerance?

Suggested Answer:

Segregated pools of capital – each with their own particular supply of risk opportunities as well as appetites for those risk opportunities – have their own specific **TOLERANCES** for risk.

What increases that risk **TOLERANCE**?

1. On the ***supply*** side, ***BREADTH:*** The broader the range of investible risk options open to investors – the greater the capacity for diversification and so the higher the tolerance involved in an individual risk opportunity (either in terms of price or quantity or even both)
2. On the ***demand*** side, ***DEPTH:*** The greater the aggregate amount of capital available for investment – the deeper the appetite for risk

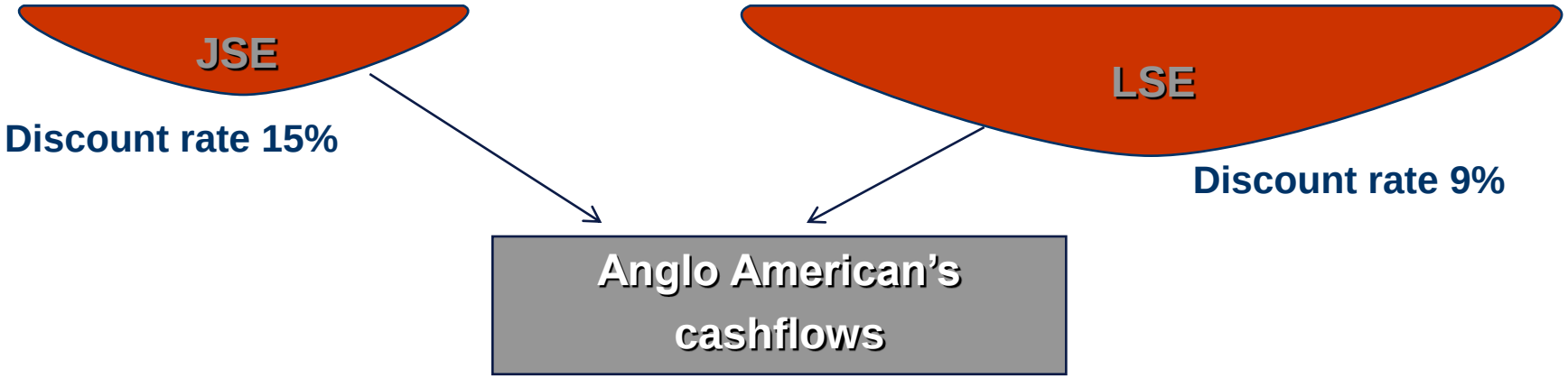


London has a broader, deeper appetite for risk than Jo'burg

How moving Anglo's head listing increased its valuation

Whilst there is no change to the quantum of supply of risk in the form of future cash flows from the assets, what changes is the nature of demand for those cash flows.

If the new place of listing has a higher tolerance of risk and so a lower cost of capital, the discount rate by which the cashflows are discounted is reduced. This means profitability increases and so the company's valuation rises.



Anglo is more valuable to London than it is to Johannesburg

What are the consequences of this for developing nations?

1. **An asset is priced in the market *where the marginal purchase/sale of its shares takes place***
2. **Companies able to access the deeper, broader capital pools of Developed Countries can afford to pay more for assets listed in shallower, narrower capital pools of Developing Countries.**
3. **By 'creaming off' the appetite for higher risk investment from multiple segregated capital markets, the nomadic supranational can create a much lower cost of capital than competitors trapped in an individual capital pool.**
4. **This not only gives such supranationals a huge advantage in their industry, it also may turn previously marginal investments in the developing world into potentially profitable ones.**

Why did Anglo American, Billiton, South African Breweries, Old Mutual and Didata move their head listings to London?

So they could become more profitable

Suggestions for further investigation

- **South Africa's cost of equity capital is high because:**
  - **its RFR is high.**
    - **Are real interest rates too high?**
    - **Have institutional asset allocation decisions over-favoured equities?**

But the cost of capital is not only high because of the RFR:

- **Are companies underleveraged?**
- **Are bank lending margins too high?**

Appendices: ‘Real World’ Ramifications of this Insight

The African Case Studies

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Appendix 1: Why Anglo pays more for Amplats than most South Africans can

Anglo American is slowly but surely buying out the minorities in Amplats – it now owns over 72% of the company – at prices which the South African investment community consider to be too high.

Q: Who's valuation is "Right"?

A: *Both parties* – Anglo and the South African institutions!

Q: Why?

A: Because Anglo has a lower cost of capital than the South African institutions do, say 9% vs. our 15%. With Amplats' current valuation currently discounting a 12% cost of capital, the share *is* expensive to the latter as the opportunity cost of capital they must employ is 15%. But to Anglo American, Amplats *is* showing value as the opportunity cost of capital Anglo can employ is only 9%. Anglo American can 'grandfather' its base cost of capital onto its controlled assets wherever they are located.

Appendix 2: Cazenove's Auction of a Zambian business worldwide

"We were selling a business and approached a number of potential suitors to invite bids for the business. The suitors were from all over the world, including Western Europe, Scandinavia, the UK, Southern Europe, Central America and South Africa. All parties were given identical information and asked to submit indicative bids. What was interesting, and it may have been coincidence, was that the value of the bids correlated exactly with relevant countries' costs of capital – i.e. the country with the lowest cost of capital bid highest, and vice versa. Needless to say, the South African bidder lost out."

Julian Wentzel of Cazenove

The highest price appears to have been determined by the bidder's home cost of capital.

Appendix 3: It works for South Africans too! MTN in Nigeria

- **In the case of valuing MTN's Nigerian assets, MTN is leveraging its lower SA cost of capital when charging out its capital to MTN Nigeria.**
- **In South Africa MTN's cost of capital is currently 16%.**
- **In Nigeria, a stand-alone investment would typically have a cost of capital of at least 25%.**
- **MTN is currently adding a 4% country risk on to its Nigerian operations (which now account for 42% of EBITDA and 68% of its pre-Head office cost profits).**
- **The 20% MTN Nigeria cost of capital is at a 5% discount to the 'normal' rate that would be charged. Why? Because of the appetite for risk available in SA's deeper, broader capital markets.**

Appendix 4: How South African Breweries 'bought' a 7.5% cost of capital

Though London-listed SAB did not realise at the time the full implications of buying Miller, the acquisition had the net effect of reducing their cost of capital by 2% from 9.5% to 7.5%. This was achieved through two methods:

1. ***The Ballast Argument:*** The average risk profile of SABM's cashflows was reduced with inclusion of US-based, US-Dollar earning (i.e. beta-reducing) Miller, thereby reducing the discount rate used by SABM's investors, particularly US-dollar based investors.

2. ***The Tolerance Argument:*** Via Miller, SABM accessed an investor base with a higher tolerance of risk:

- on the **equity side**, this comes from now having at least 37% of their investor base in the US (23.5% of that being Altria); SABM has an ADR facility;
- on the **debt side**, by borrowing cheaply in US dollar corporate bond markets, their August 2003 $2bn bond issue (*admittedly of varying maturities but all of at least 5 year*) was $600m at 4.25% and $1.1bn at 5.5% (an average cost of 5.06%), both secured against Miller whereas SABM Plc – the head company! – was only able to borrowed its $300m at 6.625%. **The US loan cost 157 bps less than the UK loan!**

Appendix 5: How much of the South African market affected by this issue?

Non-SA Head-listings:

Index weight close to 40%

Anglo American
Richemont
BHPBilliton
SABMiller
Old Mutual
Liberty International
Investec UK
Didata

Companies with offshore controlling shareholders: about 4%

Anglogold
Amplats
Kumba
ABI
Iscor
Western Areas

Companies with large offshore registers: about 6%

Goldfields
Harmony
Implats
SAPPI

Nearly 50% of SA's benchmark is affected by this consideration, including *every* Resource company with a benchmark weight over 0.2% except SASOL, and almost 1/3 of the Industrial and the Financials weights. Of the Top 40 FTSE/JSEAfrica Index, the above list constitutes about 2/3.