Newsletter

Absa Asset Management Private Clients

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# Sasol is a strategic holding in our portfolios

By Chris Gilmour, Analyst, Absa Asset Management Private Clients

Sasol is one of the largest holdings in our model portfolio. We took a strategic decision to increase Sasol's weighting earlier this year, as it became evident that the high oil price was sustainable and the rand was likely to weaken. Sasol benefits significantly from both factors.

From an investment perspective, Sasol has what is often described as "durable competitive advantage". In an increasingly energy-hungry world, its tried and tested technology places it in an enviable position of being able to produce liquid fuels very profitably. Unlike its traditional oil company peers, it doesn't have to spend vast amounts of money on drilling exploration wells, nor does it have to bow and scrape to unfriendly governments that take an increasingly large chunk of profits in the form of oil revenue royalties.

And Sasol's fortunes aren't just reliant on the South African market. In recent years it has expanded well beyond this country's borders, supplying technology and industry to a wide variety of countries, including Iran, Nigeria, Qatar, India and China.

## Power in reserve

Sasol's existing coal reserves will last for almost forty years at current depletion rates and beyond that there are plenty more coal-rich areas in South Africa to exploit, notably in the Waterberg region. Currently producing around 37% of South Africa's liquid fuel requirements, the company has committed itself to significant expansion, with its recently announced new R59bn synthetic fuel plant.

At a recent Sasol Investor Day CFO, Christine Ramon, highlighted Sasol's sensitivity to the oil price and the rand/US dollar exchange rate. Every $1 rise in the oil price is worth approximately R300m to Sasol's earnings before interest and tax (EBIT). For every 10c decline in the value of the rand against the dollar, Sasol's EBIT should rise by approximately R600m.

Its latest interim results were in line with expectations but the best is yet to come. We expect very strong earnings growth in the years to June 2009, 2010 and beyond. Sasol's PE rating of around 15x is not demanding, especially considering its strong growth prospects. At the current oil price of just above $100/barrel and rand/US dollar rate of around R8$, analysts have a target price for the share of around R480 to R500. This compares with the current share price of around R410. Our Sasol weighting is thus set to remain high.

## The oil price

It seems likely that the oil price will remain high for the foreseeable future, due to both technical and fundamental factors, unless and until alternative fuels can be developed on a widespread basis and at a lower cost.

Opec's ability to act as a "swing producer" - to boost or curb oil output to balance the market - has waned in recent years. US President George W Bush, on a recent state visit to Saudi Arabia, asked the Saudis to increase output to help lower the oil price. They declined politely. Speculators have seized upon Opec's perceived powerlessness and have dictated the generally upward direction of the oil market in the past few years.

But the high oil price isn't just some sort of spike - if it were, it would have long since subsided. There are far more fundamental factors at play. In its Global Risks 2008 report, the World Economic Forum says that with predictions of a 37% increase in oil demand over current levels by 2030, there could be limited scope for a fall in energy prices over the next decade.

## How long will it last?

There are plenty of oil reserves around the world but the rate at which new reserves are being discovered and brought on stream isn't keeping up with existing well depletion. But unfortunately, with a few exceptions, these oil reserves are in politically unstable areas of the world, like the Middle East.

Unconventional reserves, like those in the Athabasca Tar Sands in Alberta in Canada and the Orinoco Heavy Oil fields in Venezuela, are now much more profitable to exploit, given the current rarefied levels of the oil price.

Opinions vary as to how long crude oil reserves will last. In 2000, the US Geological Survey estimated that reserves from conventional sources (oil found in subterranean reservoirs and brought to the surface by drilling) would last almost 100 years. More recently, Cambridge Energy Research Associates (CERA) estimated that reserves from both conventional and non-conventional sources would last a similar amount of time.

BP's 2007 Statistical Review calculates a reserves/production (R/P) ratio that puts crude oil's longevity at around 40 years. This assumes a static reserve position and no change in current production levels. In reality, both parameters change continuously.

## Emerging demand

Demand from the large emerging market economies, notably China and India, is also having a marked impact on price. As these economies keep on growing, their demand for oil increases, putting further pressure on the oil price. Oil demand is increasing rapidly in oil-producing nations as well, notably the Middle East, as these economies reap the benefits of substantially higher oil prices. In a recent research report, Barclays Capital says: "The significance of the Middle East as a source of additional oil consumption has, until recently, perhaps been somewhat overlooked. Between 2000 and 2007, demand from the region has increased by 35%, three times faster than the overall global demand growth rate".

One of the most contentious issues in oil circles currently is that of oil reserve calculation. The large multinational oil companies listed in the US have been forced by the Securities and Exchange Commission to be more conservative in their accounting for reserves, following Shell's shock admission in 2004 that it had grossly over-stated its reserves.

But it's not just the multinationals that have exaggerated their positions. It has long been suspected that Saudi Arabia, the world's largest oil producer and the country with the greatest reserves, has also been playing games. Saudi production is controlled by Aramco, a notoriously secretive oil company that divulges precious little reserves data of any worth.

If Saudi reserves are indeed inflated, it would explain why that country is so reticent to increase production in order to help reduce prices to more "normal" levels.

Against this background, a growing body of opinion believes that oil production will peak fairly shortly, much sooner than the oil companies and governments believe the case to be. Chris Skrebowski, a researcher for the Energy Institute in Britain, told delegates to the sub-Saharan Oil, Gas & Petrochemicals conference in Cape Town in March that oil supply will peak in 2011 or 2012 at around 93 million barrels a day and that oil supply in international trade will peak earlier than the oil production peak. He forecasts: "There will be supply shortfalls in winter before peak." Current global production is around 86 million barrels per day.

## The rand

The rand has been remarkably steady since 2002, the last time it weakened considerably for any sustained period of time. This has coincided with prudent fiscal and monetary discipline, which resulted in structurally lower inflation.

But in the past few years, a couple of things have changed. Firstly, South Africa's current account deficit has ballooned as the country has embarked upon a profound fixed investment expenditure boom. Secondly, inflation has moved well outside the SA Reserve Bank's targets and seems like staying there for some time.

This has put pressure on the rand, which is the most liquid of all emerging market currencies. As the global economy grapples with the systemic fallout from the sub-prime situation in the US, investors naturally seek safe havens and unfortunately South Africa isn't seen as one at this point.

The rand has slumped by around 20% against the dollar since the beginning of this year and substantially more than that against the Euro. It's unlikely that this trend will reverse any time soon.

## Sasol's Business

In very broad terms, Sasol's business can be divided into three main segments: the South African energy cluster, the international cluster and the chemicals business.

The South African energy cluster is the primary contributor to Sasol's earnings, contributing 86% of Sasol's 2007 earnings. Its main components are mining (6% of Earnings before Interest and Taxation (EBIT)), Synfuels (64% of EBIT), oil (9% of EBIT) and gas (8% of EBIT). The outlook remains highly positive for this cluster, which has the ability to maintain strong operating margins across the various businesses.

The mining division has 1,5bn tons of recoverable coal reserves and has optimised production to meet demand from synfuels. Gas is growing due in no small measure to the pipeline capacity being increased. Synfuels will be expanded significantly in the next few years, with the new project Mafutha coming on stream around 2013 at a cost of about R59bn. Sasol is working with government on this project, which will eventually result in 80 000 barrels per day coming on stream.

And while Sasol's share of the oil market is around 37%, it should be remembered that its main market is inland, not coastal, which is where the main population centre is located. This is a huge advantage for Sasol as its products don't have to be shipped up from the coast as is the case with other oil companies' products. Additionally, its coal to liquid plants are of a highly modular design, allowing easy expansion when required.

Sasol signed a co-generation agreement with Eskom recently, which will provide 280 megawatts of power to the national grid at a capital cost of R2,5bn.

It should be up and running by end 2010 and will initially run on natural gas, with subsequent conversion to flared gas at Secunda.

The main companies in the international cluster are Sasol Synfuels International (SSI), Sasol Chevron (a 50:50 gas to liquid joint venture) and Sasol Petroleum International. Good progress is being made with the Oryx gas to liquid (GTL) venture in Qatar, with production exceeding 16 000 barrels per day in December 2007. Its design capacity of 34 000 barrels per day should be reached this year. Elsewhere, construction on the Nigerian GTL venture continues, though the schedule is under pressure.

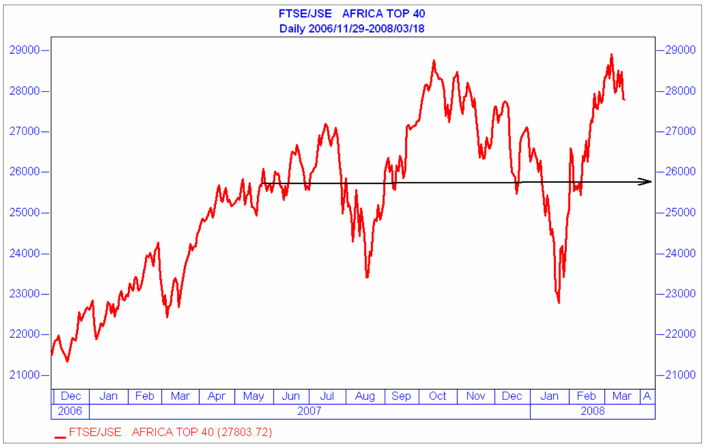
In China, coal to liquid (CTL) feasibility studies are in progress in two separate projects. Design capacity for each project is 80 000 barrels per day and completion is scheduled for the end of 2009.

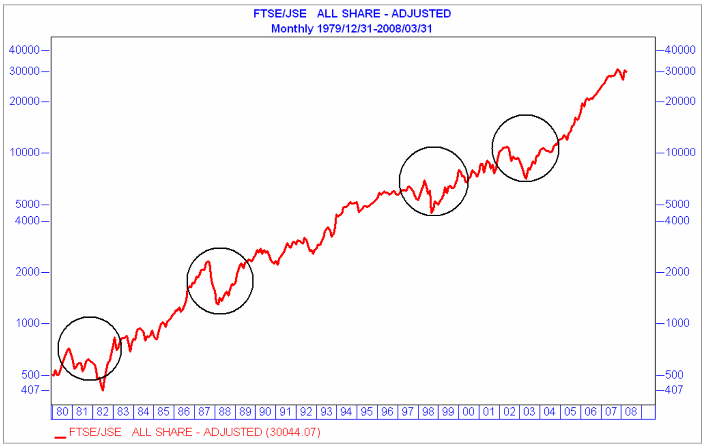
Sasol and Tata received the go-ahead from the Indian government recently to develop India's CTL plant at a cost of $8bn.

There are many more longer term opportunities for Sasol. While CEO Pat Davies acknowledges that at present Sasol is a fringe player, he is confident that the group can become a significant regional player in world alternative energy markets.

# Hedged Equity Portfolios provide insurance cover

By Gary Smith, Portfolio Manager, Absa Asset Management *Private Clients*




The risk event – a sustained downturn in the equity market – continues to be elusive (circled periods on the graph of the All Share Index). Precipitous corrections of 13% and 16% occurred in August '07 and January '08 respectively (see graph of Top40 index) but complete recoveries were made within 30 days! Such volatility is characteristic of mature equity markets, contrasting as it does with the smoothness of the market rise over the preceding four years.

Although there were times in the past year when the portfolio managers considered either exercising or rolling-up the put options, the ever-increasing risk of a "Big One" – a significant and sustained downturn - prevented this. The crosswinds of a global credit crunch and unprecedented demand for commodities blow across the investment horizon and the level of uncertainty is now extremely high, manifesting itself in equity market volatility.

In mid-February the portfolio managers decided to sell the existing March ’08 expiry put options. These were bought in May ’07 at a price of 6% of exposure or 4% of portfolios (as only two-thirds is hedged). The decision to sell was based on the rapidly diminishing time value and the prevailing high prices of the options. The recovery of more than half the original cost provided an unusually high realisation for options so close to expiry. New put options at the same strike level (25 800) were bought to extend the cover to September ’08. The net cost of these was 4% of exposure (or 2,7% of portfolios if two-thirds is hedged). So the “insurance premiums” of 4% in May ’07 and 2,7% in February ’08 totalled 6,7% for 16 months and this equates to approximately 5% per annum. Since the performance of our Hedged Equity Portfolio for the year to February ’08 was 19,6% after accounting for this cost, clients with Hedged Equity Portfolios continue to receive favourable growth with the big downside risk largely hedged away.

The Hedged Equity Portfolios will always carry some measure of protection to the downside. While the cost of this “insurance” may seem unwarranted in a sideways-trending or bullish market, the downside protection will prove invaluable should the market collapse for any reason.

## Portfolio Performance

In the twelve months to end-February 2008, clients of Absa Asset Management Private Clients received the benefit of a dynamic investment process with the portfolio managers committed to managing a portfolio of blue-chip shares to the best advantage. Full weightings in Resource shares delivered outstanding performance and provided the desired (for SA investors) level of rand-hedging. Bank shares performed poorly but continued to be accumulated for being undervalued. Retail and consumer-related shares are avoided – for now.

Our Equity Portfolio achieved 25,7% in the twelve months to end-February ’08. In comparison, the FTSE/JSE All Share Index (incl. dividends) achieved 21,9%. Our Hedged Equity Portfolio achieved 19,6% (after fees and hedging costs), the Balanced Portfolio (no hedging) achieved 23,2% and the Flexible Portfolio (includes hedging) achieved 17,6%. The CPIX inflation rate – the benchmark for many clients - was 8,7% for the period.

Sources: PortCis (Modified Dietz Method, after fees), INetBridge.

**Contact details:**
**Susan Buys 011 647 0874, Bronwen de Klerk 011 647 0827 or Laurna Edwards 011 647 0860**

**www.absa.co.za portfoliomanagers@absa.co.za**

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