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South African platinum companies: a sound long-term investment

EXECUTIVE SUMMARY Despite the very strong performance of platinum producers, driven largely by the appreciation in commodity prices, there is still long-term value to be found in these counters. This view has led Allan Gray Equity Fund to build its platinum holdings to more than 20% of the Fund at 30 June 2006. In this article Delphine Govender provides a detailed analysis of the reasons for the firm's confidence in doing so.

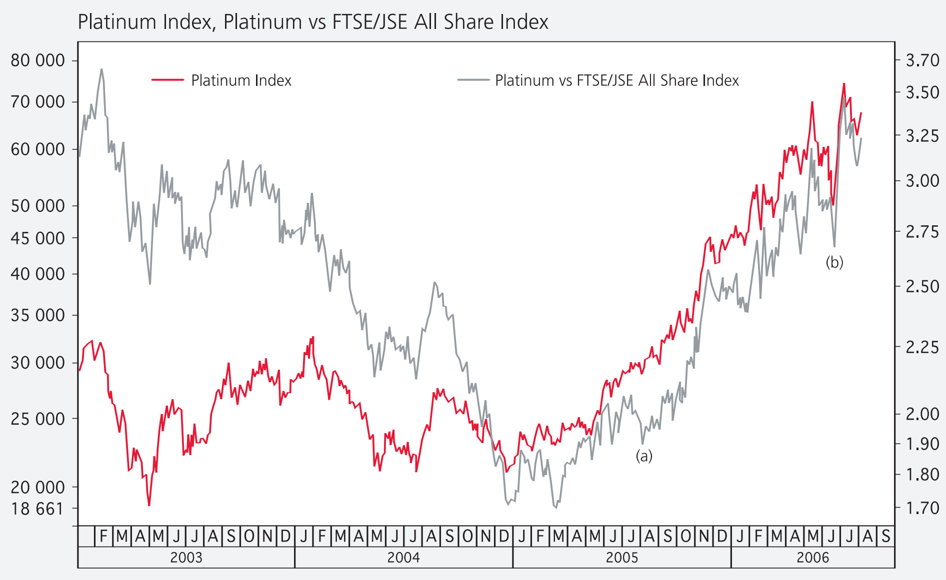
For the year 1 July 2005 (Point (a) on **Graph 1**) to 30 June 2006 (Point (b) on **Graph 1** as shown below), platinum shares (as represented by the Platinum Index), rose 142% and sharply outperformed the FTSE/JSE All Share Index, which rose by 50% over the same period. This made the platinum counters one of the best performing sectors over the past year.

At 1 July 2005, platinum shares collectively accounted for 11% of the Allan Gray Equity Fund while, at 30 June 2006 – 12 months later – they continued to represent one of the largest sectoral exposures in the Fund, being in excess of 20% of the holdings. Clearly, a considerable part of the increase in the holding was as a result of the share price appreciation of the various companies over the period. Despite this price appreciation, we have maintained a large holding in platinum shares as we found that they continue to represent good long-term value in an absolute sense and also superior value when comparing them with other resources shares.

This view is principally based on the following factors:

1. The positive and robust demand fundamentals for the entire platinum group metals (PGM) basket.
2. The highly consolidated supply for the platinum group metals and the state of the supply base.
3. The relative pricing between the PGM basket and other key commodities, in particular base metals.

GRAPH 1



Source: Igraph, United States Geological Survey and Allan Gray research

TABLE 1

Demand Source	Platinum	Palladium
Autocatalysts enable the removal of up to 99% of the pollutants/harmful emission that automobile engines produce.	46%	45%
Jewellery: white metal, pure.	29%	20%
Industrial: platinum is used extensively in the electronics sector as well as in chemicals, refining and glass industries while **palladium** is used specifically in the electronics sector and in the production of dental alloys.	25%	26%
Investment/Other	Not meaningful	9%
	100%	100%

Source: Johnson Matthey

1. Demand fundamentals for the PGM basket

As part of the PGM mining process, the main output is platinum, but the following metals are also produced: palladium, rhodium, nickel, gold and very small amounts of ruthenium, iridium and osmium. Platinum, palladium, rhodium and nickel dominate the PGM basket accounting for almost all the value.

Table 1 above summarises the key sources of demand for platinum and palladium. **Autocatalysts** represent the single biggest demand driver for PGMs. The principal reason for this is the tightening of emission standards across the globe. Ensuring that engine emissions are within these restrictions requires greater use of PGMs in the autocatalyst. Importantly too, the global trend towards increased demand for diesel cars rather than petrol cars (especially in Europe) has created additional demand for platinum as diesel cars use more platinum than palladium in their catalytic convertors.

While the emission standards of less-developed countries are currently less strict than those of developed countries, the generally heightened global emphasis on environmental issues means one should expect developing and emerging countries to impose steadily tighter emission standards going forward.

A point to be borne in mind is that the overall global trend towards tighter emission standards is an autonomous factor in that it is not connected to economic growth or prosperity and hence this trend is likely to continue irrespective of the state of growth of the global economy.

Jewellery demand for platinum and palladium, like the demand for gold jewellery, is price elastic (highly sensitive to changes in price), hence the rally in the platinum price especially has seen some tempering of platinum jewellery demand. An interesting occurrence, however, despite the increase in prices, has been the surge in demand for palladium jewellery, especially in China. Palladium jewellery costs less than platinum jewellery but it is seen by consumers as a superior and purer alternative to white gold rather than an inferior alternative to platinum. In other words, palladium jewellery is particularly popular among less affluent consumers who were not able to afford platinum jewellery in the first place. This phenomenon helps protect against an extended fall in the PGM price as, while platinum jewellery demand growth should remain relatively subdued at current prices, should prices fall the jewellery market should then pick up, creating a renewed support for platinum prices.

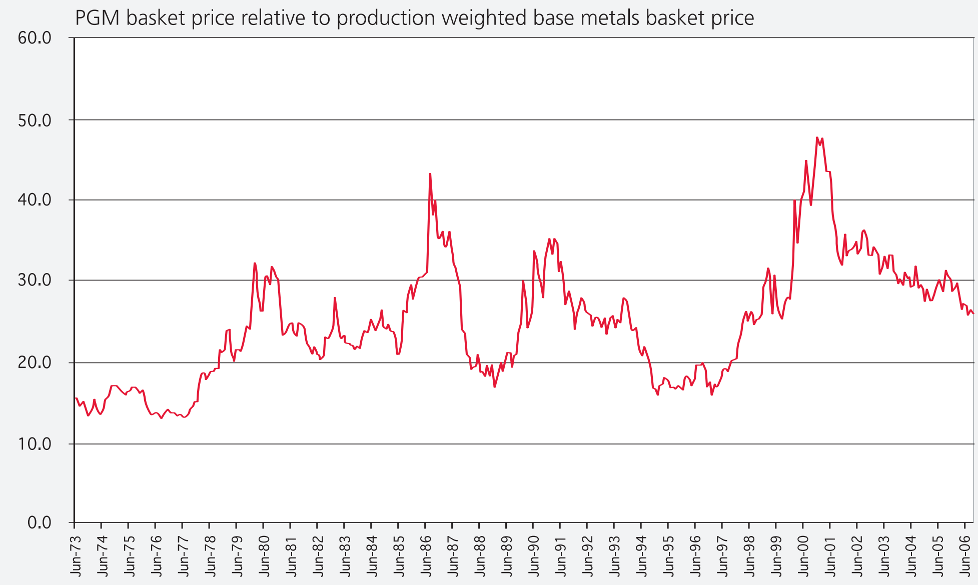
To some extent, **Industrial** demand for PGMs is correlated more closely with overall economic activity. However, the spread in the use of PGMs across various industries (some more defensive than others) reduces some of the risk of industrial demand slowing in the face of slowing global growth.

When considering the key PGM demand drivers on balance, we would conclude that the net impact is that of a solid demand underpin. This ensures that one half of the demand/supply equation is firmly in place.

2. Supply fundamentals

From a supply standpoint, PGM production is highly concentrated with the bulk of production in the hands of four suppliers. Furthermore, approximately 75% of the world's known platinum reserves and resources are located in South Africa, with the key producers here being Anglo Platinum and Impala Platinum (the two main platinum companies we have invested in on behalf of our clients). The key benefit to such a concentrated market – both in terms of number of suppliers and location of the commodities themselves – is that it inherently creates a more responsible marketplace. Suppliers are likely to grow production in a predictable and rational manner which reduces the volatility evidence in several other commodity markets where supply is considerably less consolidated.

GRAPH 2



Source: Igraph, United States Geological Survey and Allan Gray research

3. PGM versus other metals

The supply and demand fundamentals of PGM as outlined, are more robust than those of base metals.

"The supply and demand fundamentals of PGM ... are more robust than those of base metals."

The recent demand for base metals is linked almost entirely to global economic growth, in particular growth in China. While Chinese economic growth is forecasted to remain relatively robust in the medium-term, the base is very high, and a more reasonable expectation is to factor in a slowing growth rate. Accordingly, one should expect the rate of demand growth in base metals to slow down too.

Furthermore, when considering the supply side of base metals, the overall picture is different to that of PGMs. Base metals supply is fragmented across many suppliers and the resources themselves are spread across the globe.

The strong price performance of the platinum companies contained in our clients' portfolios has obviously been mainly caused by the increase in the prices of the PGM basket. However, despite this sharp rise in PGM prices, we have maintained a large holding in the platinum companies largely because we believe the PGM basket price is inherently more robust than the price of a base metals basket. Furthermore these platinum companies are considerable beneficiaries of a weaker US$/Rand exchange rate.

An additional factor to consider is that on a relative basis, despite being at record levels, PGM prices have not risen to the same extent as base metals, as shown in **Graph 2** on page 6, (PGM basket price vs base metals basket price).

Conclusion

The South African listed platinum companies command a unique global competitive advantage in that both the demand and supply fundamentals for their products are particularly sound. While the share prices of these companies have risen to reflect some of this, in our opinion, the full long-term value inherent in these businesses is still to be manifested. We believe that, in the context of investment opportunities available within the South African stockmarket, the platinum shares continue to be attractive long-term investments.