# Africa

## Nationalisation – cheap politics and costly mistakes

by **PETER TOWNSHEND**

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*While our Africa funds are not directly accessible to individual investors, they are used us underlying building blocks in some of our managed funds, namely Coronation Market Plus and Coronation Balanced Plus.*

Mining is in many ways a unique business. For a start, miners exploit finite resources. Once a mineral deposit has been exhausted, it is gone forever. This immediately puts miners in the firing line as what they exploit today is taking from future generations. Mining is also messy. While the actual area affected is often insignificant in relative terms and mines are typically in very remote locations where few will ever see or feel their impact, there is something about a big, untidy hole in the ground that can fire up opposition, even in another continent. Miners can also experience periods of what seems to be obscene profitability. Coca-Cola cannot increase the price of its fizzy drinks by 1 000% over a period of a few short years but this is precisely what has happened to iron ore miners, and their current margins are eye watering. But most of all, mining is possibly unique in terms of the scale of investment required and the time horizon that mining firms must consider.

From initial exploration to discovery, then through construction and to full production is typically measured in decades. And large mining projects can cost tens of billions of dollars. Commodity cycles can be a lot shorter than the mining investment cycle, so mining companies are never sure as to what sort of markets they will be bringing on new projects. And when you have committed billions of dollars to a project with no certainty that your product will sell for $100 or for $10, making big investment decisions is a leap of faith. The last thing a mining executive then wants to worry about is security of tenure or tax and royalty regimes. But, this is exactly what is happening around the world currently.

And Africa is no exception. In many African countries, commodities constitute a significant portion of GDP and dominate export earnings. In addition, the companies that exploit them are often among the only foreign investors of any size. So, whether it is oil in Nigeria and Angola, copper in the Congo and Zambia, gold in Tanzania and Ghana or diamonds in Namibia and Botswana, mining is a high profile business on the continent. Having committed enormous amounts of capital in establishing mines or oil fields and being reliant on the state for mineral rights, mining companies are soft targets for politicians of all stripes. In South Africa, Zambia, Zimbabwe and Tanzania we have seen populist politicians find an eager audience when they start bashing the miners and calling for a bigger slice of the pie – or for outright nationalisation.

Nationalisation does not work. Africa is littered with the corpses of state mining companies that in a few short decades destroyed what were once vibrant private sector-led mining industries. But memories are short. Barely a decade has passed since Zambia privatised its bankrupt state mining firm. In that time, copper output has exploded and recently surpassed the previous peak output levels. But a new (populist) government is now looking to renegotiate the mining tax regime for the second time in less than five years. And a little further south in Zimbabwe, the country's leaders are trying to force mining companies to give up 50% of their assets. Closer to home, calls for the nationalisation of the mining sector in South Africa are growing louder ahead of what is likely to be a bitterly fought leadership race within the ruling party in 2012.

All of this is particularly galling given that the solution is in fact relatively simple – write a fair mining code the first time and then stick to it through thick and thin. Ideally the state should own mineral rights and should retain a carried stake in all mining projects (perhaps between 10% and 20%). Royalties based on revenue also make sense for the state as they are simple and the effective tax take is significant (somewhere between 1% and 3% feels about right). Another possibility is a variable tax rate such as that under which the gold mining industry in South Africa has traditionally operated, where the tax rate moves according to profitability. This gives the miners some relief in tough times and allows governments a bigger slice of the pie in boom times. For the miners, some tax exemption in the early years allows faster recovery of the huge capital invested, as does the ability to write capital off against early profits. The precise levels of taxation need to be debated in each country, but once settled they need to be cast in stone. Certainty has real value and we would argue that for mining companies the absolute numbers are less important than a degree of certainty. Evaluating an investment with a 50% effective tax rate is easily done. Evaluating an investment where you are not certain whether the tax rate will be 50% or 75%, is far more difficult.

The Republic of Mali in West Africa illustrates this point. It comprehensively rewrote its mining laws in the early 1990s, and to the best of our knowledge has not meaningfully tampered with them since. In the decades since, it has come from nowhere to be the third largest gold producer in Africa, is among the top 15 gold producers in the world, and one of the most favoured gold investment destinations on the continent. Unfortunately, common sense seldom dominates political discourse so the current uncertainties are unlikely to be the last that we see. This is just one of the tragedies of Africa and it does very real damage to the industry and has a very real impact on development. The mining industries in the Congo and Zimbabwe, for example, remain a shadow of what they could (and should) be and the mineral wealth of dozens of other African countries remains underutilised.

Despite this rather gloomy picture, Africa does still provide enormous opportunity for commodity companies as it hosts some of the last of the world's great, undeveloped orebodies. In our opinion, markets are not always very good at pricing uncertainty, yet when it strikes it can provide attractive opportunities for the long-term investor. We have significant investments in mining companies that operate in Tanzania, Egypt and Zimbabwe. In all three countries there is significant uncertainty around either politics (Egypt), taxes (Tanzania) or ownership (Zimbabwe). And in all three instances, if we allow for even our most negative potential outcome, there is still a large gap between our fair value and the current market price. There will undoubtedly be further surprises and more negative headlines. But, looking through the noise, we think our investors will be amply rewarded for taking a longer-term view and then showing that rarest of investment skills – patience.