

Understanding the business of an investment holding company

GENERAL

The business of an investment holding company differs substantially from that of an operating company. In the latter case products and/or services are being sold at a certain gross profit margin, thereby creating revenue and cash inflows for the entity concerned. Strong cash flows and shareholder value are accordingly created by increasing revenue, as well as by limiting expenditure and optimising operational efficiencies, thus increasing the net profit from which dividends can be paid to shareholders.

In the case of an investment holding company no products and/or services are being sold. This, together with the specific accounting treatment that is required for different classes of investments in terms of International Financial Reporting Standards, has the effect that the net profit of an investment holding company is not always a fair reflection of its underlying cash flows and financial soundness. Similarly, the variance in net profit between reporting periods will not always be a good indication of the trend in dividends to be paid to shareholders. The value and performance of the underlying investments, rather than the activities at holding company level, will thus to a large extent determine the value created by investment holding companies for their shareholders, although dealmaking at holding company level also adds significant value, if done in a value-enduring method.

CAPITAL ALLOCATION

The most important function of an investment holding company is the allocation of capital. Capital comes in two forms, human and financial. From a human allocation point of view, we must ensure that the best people manage the businesses we invest in. Financial capital needs to be allocated in the most efficient way. Capital is expensive and not infinite.

As we deal with an uncertain future, and inevitably base capital allocation models on certain assumptions about the future, we need a margin of safety in our investment decisions.

We need to be disciplined in our allocation of capital and, if we are wrong, we should act quickly and decisively.

HOW WE MAKE OUR MONEY

In order to understand how Remgro makes its money, one first needs to understand its reported results.

Remgro's statutory reported net profit consists primarily of the following:

- Consolidated results of its operating subsidiaries, i.e. RCL Foods and Wispeco;
- Equity accounted results of its investments in associates and joint ventures, e.g. Mediclinic, FirstRand, RMBH and RMI, the four biggest contributors towards net profit;
- Profits realised on the sale/distribution of investments;
- Dividends received from investee companies not classified as subsidiaries, associates and joint ventures, e.g. the Milestone China Funds and the Pembani Remgro Infrastructure Fund;

- Interest received;
- Interest paid;
- Net corporate costs, including remuneration and other benefits paid to employees; and
- Taxation.

As is evident from the above, the dividends received from operating subsidiaries, associates and joint ventures are not included in Remgro's reported net profit. Furthermore, any profits realised on the sale/distribution of investments are also excluded from reported headline earnings.

Being an investment holding company, however, and contrary to the treatment in terms of accounting standards, the best approximation of Remgro's profit at holding company level ("at the centre") should, in our view, thus comprise the following:

- Dividends received from investee companies;
- Interest received;
- Profit/loss on the realisation of investments;
- Net corporate costs, including remuneration and other benefits paid to employees;
- Interest paid;
- Taxation paid; and
- Foreign exchange movements.

The net result of the above approximates cash generated at the centre in order to make new investments and/or pay dividends to shareholders.

Given its nature as an investment holding company and the substantial amount of cash held and managed, the control of treasury risks are regarded as very important. This includes the management of movements in foreign exchange rates and this area is covered in more detail in the Chief Financial Officer's Report on page 25. Also refer to page 28 for a detailed analysis of "cash movement at the centre" for the year under review. Q

Remgro further measures its performance in terms of the increase in its intrinsic net asset value. This measures the growth in the underlying value of the various investee companies. Refer to the Chief Executive Officer's Report on page 20 for a detailed analysis of Remgro's intrinsic net asset value. Q

DISTRIBUTIONS TO SHAREHOLDERS

Dividends to shareholders are funded from dividend income and interest received at the centre.

In terms of normal dividends to shareholders, it is the Company's objective to provide shareholders with a consistent annual dividend flow which at least protects them against inflation, throughout the economic cycles.

As in the past, in special circumstances, the Company will consider other distributions in the form of special dividends or the unbundling of investments to shareholders.