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FALLEN STARS – A CONTRARIAN'S HUNTING GROUND

EXECUTIVE SUMMARY: In the short term, share prices are affected by market psychology. Over the long term, we believe share prices are always determined by the economic progress of the underlying business. Delphine Govender discusses how Dimension Data is a great example of a share that, at the height of its popularity, was conspicuously absent from our portfolios, but has now become a substantial investment in Allan Gray funds.

While picking winning shares has been key in driving our investment performance, what has been equally important are those that we have intentionally decided not to own because of overvaluation.

Dimension Data (Didata) is a great example of a share that, at the height of its popularity, was conspicuously absent from our portfolios. For a host of reasons, Didata's popularity subsequently unravelled and the share lost favour with the market, falling 97% (**Point A** to **B** on **Graph 1** on page 5) from its peak share price (Point A: 7000c) to bottom (Point B: 180c) in just two and a half years. Avoiding this loss was certainly a contributor to the outperformance of our clients' portfolios at the time.

Didata's extreme share price action presented an opportunity to us

Our research shows that Didata today is a fundamentally better, more sustainable business than it was at the peak of its share price. In our view, the current share price considerably undervalues what we believe the business is worth. Didata currently represents a meaningful investment in our portfolios. It is one of those investments that we believe could add substantial value for our clients – but this time through including it in our portfolios.

That was then…

At the end of the 1990s and the start of this decade, information technology (IT) and internet shares were the darlings of stock markets worldwide. These were businesses that represented the 'new paradigm' in the global economy or as many were convinced, IT itself was the 'new economy'. South Africa was no exception. The share prices of IT companies reached heady levels as the market became supremely optimistic about the prospects for continued high rates of profit growth. By early 2000 many South African IT shares traded at price-earnings (P/E) ratios well in excess of 50x! (Put this in the context of the long-term price-earnings ratio for the overall stock market of 11.5x.)

Didata was South Africa's IT poster child

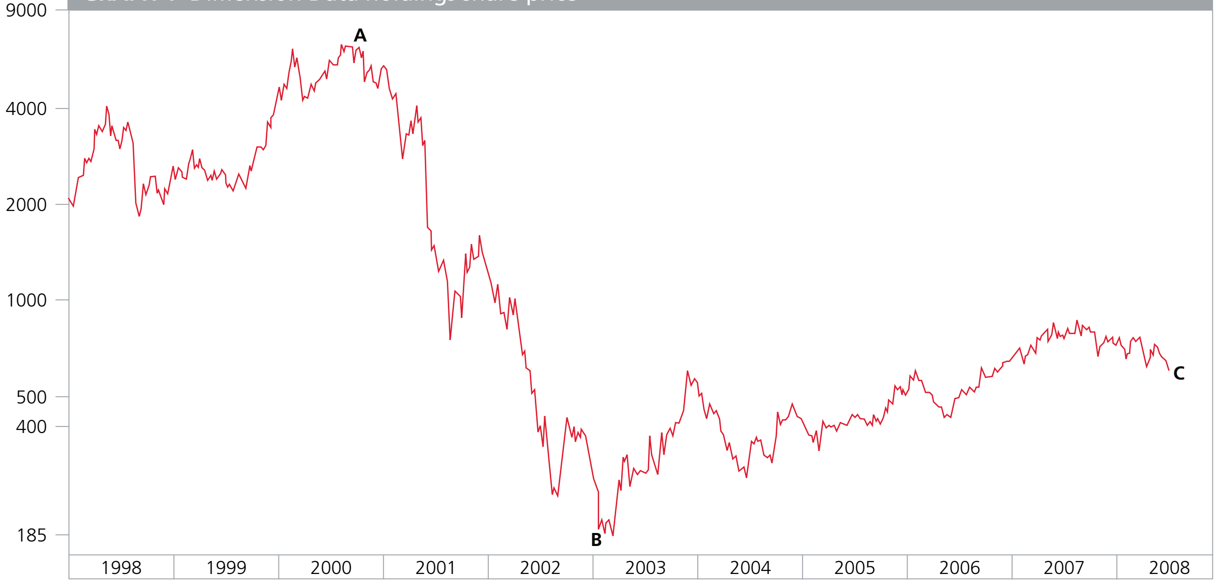
In March 2000 Didata's P/E ratio stood at a hefty 88x (versus the All Share Index P/E ratio of approximately 16x at the time). It was South Africa's largest IT company by market capitalisation.

What is Didata's business about?

Didata's business model is centred on corporate IT networks. It is a reseller of hardware components required to physically build a company's IT network. Didata provides the service of taking all these hardware components and integrating them with each other as well as other existing infrastructure to create both the physical and virtual IT network for its corporate clients.

In addition, Didata also has the expertise to provide several other services to its clients, including connectivity to the internet, securing and storing of company networks and information, and setting up and managing company call centres.

GRAPH 1 Dimension Data holdings share price



Source: I-Net Bridge

In our opinion, the market's optimism that high earnings growth would continue was based largely on the following:

1. Didata's existing client base would need more and more network components. At the same time, Didata could grow its client base aggressively.

2. The margins Didata earned on both its products and services would expand.

3. As a result of the market believing points 1 and 2, Didata could and would continue to raise capital through issuing shares at its very high P/E ratio. Even if there was no need for the cash, it would earn interest in the bank, which would then further boost earnings.

The bubble bursts

However, the market's extremely bullish expectations for the IT sector turned out to be unrealistic. Demand for IT products and services came under pressure as many businesses started pulling back their IT spending post the 'non-event' of Y2K. Then there was the global economic fall-out following the terrorist attacks on the United States in September 2001.

In anticipation of rapidly declining earnings, the infamous IT share price bubble burst and several IT and internet shares plummeted. For Didata, the rest – as they say – is history.

This is now…

Didata's earnings are currently below normal, in our view

Today Didata's share price (**Point C** on Graph 1: 647c) trades at less than one-tenth of its peak share price in 2000 (Point A). However, its last reported revenue (2007) on a per share basis was almost 50% higher than the revenue per share recorded back in 2000. Admittedly, the current profits of the business are some way lower than peak profits achieved in 2000. While we held the view in 2000 that Didata's earnings were then unsustainably high, our opinion now is that the current earnings for this business are below normal.

The core of Didata's business model remains unchanged but the overall picture is quite different:

- **Scale –** Didata has become one of the largest global resellers of Cisco products. Cisco is the world's leading manufacturer and vendor of networking equipment. In Africa, Asia and Australia, Didata commands the number one position in its market share of Cisco product sales.

- **User behaviour –** The IT network has become deep-rooted in our lives over the past decade thanks to mobile telephony and our need to be connected constantly to the internet. The network of the present and future must allow connectivity of any device (mobile phone, laptop, Blackberry) to any application (email, voicemail, documents, Microsoft programmes) and at any location (the office, the home, the airport). With this evolution, companies like Didata that build and customise company networks have a significantly increased load of needs for which to cater. This entrenches Didata's importance to its customers and widens its revenue streams.

- **Regulation –** South Africa's electronic communications environment has been undergoing deregulation. Previously only certain dominant service providers, like Telkom, had the legal right to provide telecommunication services such as 'voice'. This is no longer the case. Private network providers that lease any form of communication lines to their subscribers/clients can now offer a wide scope of telecommunications services. As a result, Didata is able to compete head-on with the likes of Telkom and the other telephony operators, through its subsidiary Internet Solutions – South Africa's largest corporate internet service provider. This is because it may now transmit telephone/voice calls through the computer network and over the internet. We believe Internet Solutions is a source of considerable value within the broader Didata group.

- **Management –** The current CEO has been in place since early 2004. From a loss-making position, he has steered the business through an effective financial turnaround with the right balance of conservatism and progressiveness. Going forward, we believe the management team is likely to carry through this steady approach.

- **Dividends –** For the first time in its history Didata paid dividends in September 2006. In our opinion, this points to a business that has stabilised and signals confidence about the future.

"… there are more reasons to be excited about Didata as a business and as an investment today than ever before."

Prospects for strong revenue growth and improved profitability

We believe these material changes, combined with several other operational and strategic refinements, have improved the sustainability of Didata's business model. We are conservative, however. With its current business mix, we don't believe Didata will ever again earn previous peak profit margins. But in relation to current profitability, our base case expectations are for earnings to increase.

In our opinion, there are more reasons to be excited about Didata as a business and as an investment today than ever before. Ironically, perhaps an element of the market's historic optimism about this company was not unjustified, just premature.

We are happily contrarian

It is common for 'flavour of the month' shares to be missing from our portfolios. When positive market sentiment drives prices up, typically to levels not supported by intrinsic value, we cannot justify investing in those overvalued shares, even if we suspect that the share prices could go up further in the short term.

The way investors over-react – either positively or negatively – is proportionate. Investors become overly optimistic about the prospects for a company or industry and they over-react positively about this; then things might just start to go wrong and they then over-react negatively. Like a pendulum, optimism can swing rapidly to pessimism. This can cause the share price to correct, often extremely, and a 'fallen star' is born.

Owning Didata today is hardly as fashionable as it once was. However, that doesn't concern us too much. If it did, we could not justly claim the description contrarian.