



Monthly Commentary – May 2011

Reduced time between financial market bubbles or crises – the listing of LinkedIn.

One might think that financial market bubbles associated with astronomical valuations, greed, herd mentality and the behavioural bias of regret would be spaced more than a generation apart. Surely the painful lessons learnt from ensuing crashes stay fresh in memories for years afterwards?

Apparently this is not always the case. The recent credit crisis involved different instruments but otherwise it bore a striking resemblance to the savings and loan crisis of the early nineties, which saw 747 of America's thrifts fail. In both cases, ridiculously careless loans were made, jumping on bandwagons was rampant and enormous government support was required, leading to huge budget deficits and massive issuance of Treasury bonds.

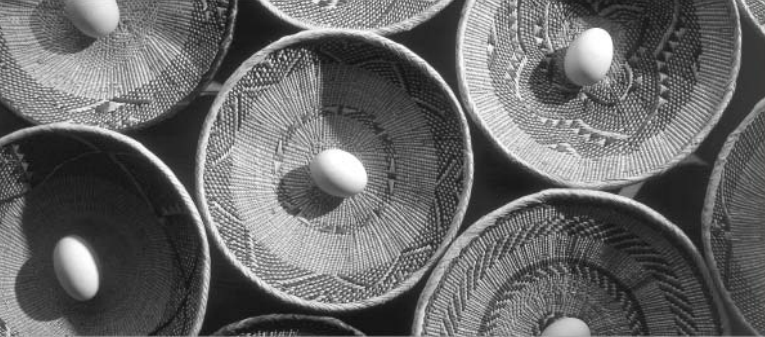
The dot-com or TMT mania peaked in March 2000. Soon after, the fashionable valuation techniques by which it may be characterised, such as price to sales, PEG ratios and ARPU were discredited and tangible assets, positive cash flows and dividends were welcomed back.

So, it was with some incredulity that we noted certain metrics associated with the listing on 26th May 2011 of LinkedIn. The business is described as a social networking group for professionals. Less euphemistically, as far as this writer can see, LinkedIn appears to be a sort of sanitised Facebook for nerdy business people. Anyway, in 2010, eight years after starting up, LinkedIn made its maiden profit, of \$18m. It listed at \$45 a share but soared 173% to \$122.69 on the first day. The underwriters (Bank of America, JP Morgan, Merrill Lynch and Morgan Stanley) therefore seem to have dismally failed the founders of LinkedIn. At \$122.69, LinkedIn's market capitalisation was \$11.6 billion, resulting in a PE ratio of 644! By comparison, the PE ratio of the S&P500 is around 16. In the same week as LinkedIn's IPO, Microsoft paid \$8.5bn for Skype, or 400 times operating profit.

Predictably, huge earnings growth forecasts have been used to try to justify these prices. Is this a case of a new name and a small variation of themes, but actually just a shockingly rapid return to market madness?

Banking sector still showing strain

When Investec Plc reported its interim results in November 2010, we became aware of some of the problems that were brewing in the private banking business, particularly in the lending book in its Irish operations. In May, the full extent of those problems became apparent in a disappointing performance in the private banking business. Impairments were up sharply resulting in a (divisional) loss of £91m which contributed to a disappointing group RoE of 11.2%. This result was mitigated somewhat by a much better result from the Capital Markets and Asset Management business, where Investec's strategy to grow its capital-light businesses started to bear fruit. As shareholders we are naturally disappointed with this turn of events. However, if one places the valuations of the non-private banking businesses on ratings similar to peer operations, the implied value of the private banking business places it at a discount (about 30%) to tangible NAV. We consider this to provide reasonable margin for comfort given the strength of the South African banking franchise.



Reinet Investments : Management continues to grow the investment portfolio

Reinet reported FY2011 results this month. The pace of investments is increasing, with €300m invested up to March 2011. More investments are in the pipeline, of sufficient scale to require Reinet to either leverage the balance sheet or realise some of its investments. The composition of the net asset value of the business has not changed much since last year, with BTI making up just over 85% of the group net asset value (NAV). We see Reinet as offering an attractive discounted entry into BTI (REI trades at a +/- 15% discount to NAV) and we anticipate (given management's track record) positive value to be unlocked in the unlisted portion of the portfolio.

THE ORTHOGONAL TEAM