



Navigating correcting markets: US sub-prime mortgages and South African residential property

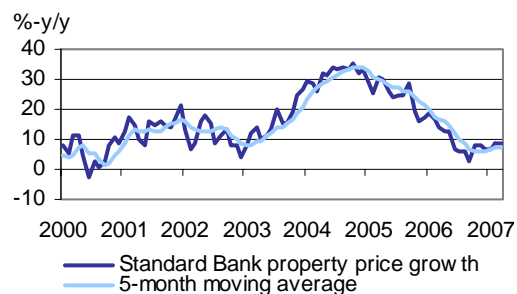
The median house price rose marginally in March to R580 000 from R570 000 in February, recording 1.8% month-on-month growth; year-on-year growth moderated modestly to 8.4% from 8.6% in February. The five-month moving average rate, which is one of the measures that can be used to represent trend growth, remained essentially flat at 7.7% y/y in March from 7.6% in February. The local housing market seems to be reasonably strong amid the moderation in global housing markets and the concerns surrounding the American housing market especially. In this report we take a closer look at the problems in the US sub-prime mortgage market and the potential consequences that it may have for the South African housing market.

When HSBC Holdings announced an earnings restatement recently, setting aside 20% more for loss provisions on sub-prime mortgage loans in the US, tremors were felt not only in the sub-prime market but also in the conventional American mortgage market and beyond. Since then, 30 of America's sub-prime mortgage lenders have closed their doors. Sub-prime loans are extended to weaker borrowers with shakier credit histories. When borrowers are less creditworthy, their loans ordinarily carry higher interest rates, hence, the appeal of such loans to lenders. Now, losses are surfacing and, given the state of the US economy, concerns are being expressed about the possible outcome of the sub-prime meltdown on the wider economy. The root of the problem is clear enough: many homebuyers with low credit scores have nonetheless managed to obtain large home loans. What is not clear is whether sub-prime losses are isolated events or indicative of a deeper malaise in the US economy. More importantly from a South African perspective, however, is the likely consequences of these developments for the local residential property market. In this report we briefly sketch the dynamics surrounding the US sub-prime mortgage market, the transmission mechanisms through which it may impact on the South African housing market, and the likely consequences for the local residential property market.

The US sub-prime mortgage market

Rising loan default is a normal characteristic of any credit cycle. And, in a red hot property market, fuelled by low interest rates, speculation and lax underwriting standards, it is inevitable that some loan providers and loan holders will be scorched when the credit cycle turns. The concern, however, is that the extent of risk taken up during the recent housing boom may be larger than generally perceived. Rising asset (house and stocks) values, combined with historically low interest rates, meant that households were able to greatly extend their indebtedness in recent years. On top of this, lenders began offering many exotic products which may have led to reckless lending and households over-extending themselves. Higher interest rates and slower wealth growth now obviously make it more difficult for households to repay their debt. In some markets like Honolulu, Las Vegas, Southern California, Washington DC, and much of Florida, mortgage payments account for more than 30% of income (the national average is 16%). In California, one in five mortgage holders fork out more than 50% of gross income. Clearly, this is a problem.

Figure 1: House prices – Standard Bank



Source: Standard Bank Group

Table 1: Stats at a glance

Indicator	Period	Data
Median house price	Mar 07	8.4% y/y
Median house price	5m ma	7.7% y/y
Median house price	Mar 07	R580 000
Mortgage advances	Feb 07	29.5% y/y
Private sector credit extension	Feb 07	26.12% y/y
Ratio of household debt to income	Q4 06	73.8%
Prime rate	Mar 07	12.5%

Source: Standard Bank Group, SARB



The sub-prime market

The US mortgage market can essentially be seen as comprising three tiers: the prime, alt A, and sub-prime segments. Borrowers not qualifying for ordinary (prime) loans may be considered for sub-prime mortgage loans. Reasons for not qualifying for prime loans usually include small or no deposits, a poor credit history, and/or insufficient or no proof of income. The “alt A” loans fall between prime and sub-prime loans.

Clearly, the sub-prime mortgage market comprises loans with extraordinarily high risks and, while a deterioration in the performance of most types of loans is to be expected when interest rates rise, this would usually be substantially worse in the higher-risk types of loans such as those in the sub-prime market. Matters are, however, aggravated by the introduction of dramatically lowered standards by some sub-prime mortgage lenders amid the so-called “democratisation of credit”, granting loans that contained many layers of default risk. Some rather exotic products were dreamt up: these include a so-called “stretch loan” where the borrower has to commit more than 50% of gross income to make the monthly payments and a “liar loan” where the borrower is merely asked to state his income without any documentary proof.

Fundamental legal changes in the 1980s contributed to the growth in sub-prime lending. Charging high rates and fees was not possible until the Depository Institutions Deregulation and Monetary Control Act was adopted in 1980. In 1982, the Alternative Mortgage Transaction Parity Act allowed the use of variable interest rates and balloon payments. The Tax Reform Act of 1986 prohibited the deduction for tax purposes of interest on consumer loans, yet allowed interest deductions on mortgages for a private residence as well as one additional home. This made even high-cost mortgage debt cheaper than consumer debt for many home owners.

The sub-prime market is a relatively small part of the overall mortgage market, making up 14% of outstanding mortgage loans (from 6% in 2001). However, this segment has grown rapidly in recent years – in 2006, the sub-prime loans accounted for 20% of all new mortgages, compared to only 5% in 2002. The increased importance of the sub-prime mortgage market suggests increased risk in the total mortgage market, and there has been a decline in the quality of sub-prime mortgages. The “low loc” tier of the sub-prime market, where borrowers don’t have to provide proof of their income, rose to 44% in 2006 from 25% in 2000!

Performance of the US sub-prime mortgage market

The performance of sub-prime mortgages has deteriorated markedly. In the final quarter of last year, 5% of loans were more than 30 days in arrears compared with 4.7% in the previous quarter; late payments for sub-prime loans rose to 13.3% in Q4 from 12.6% in Q3, while sub-prime delinquencies rose to a four-year high of 14.4%.

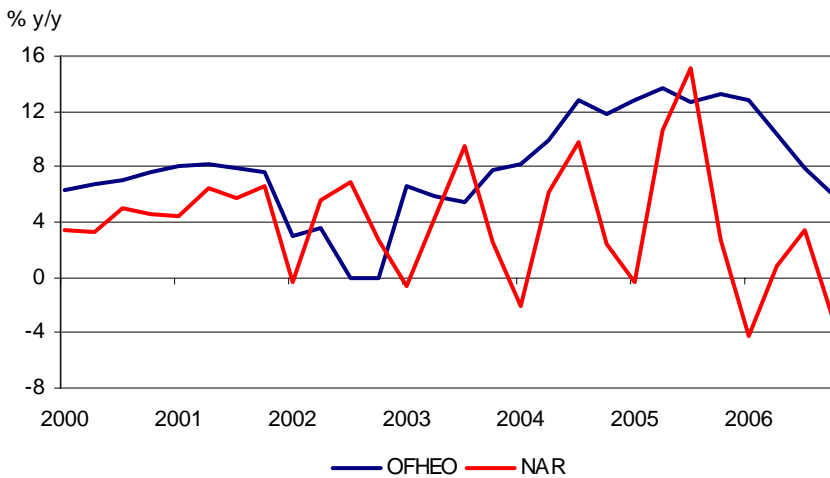
While the performance deterioration is clearly not limited to the sub-prime part of the mortgage market, this tier’s deterioration is aggravated not only by its inherently high risk but also by the comparatively high proportion of it governed by variable, rather than fixed, interest rates. A recent report by the Center for Responsible Lending put the foreclosure risk at 62% to 123% higher for variable than fixed rate loans. Even though some deterioration can be expected in the performance of the conventional mortgage market, this should be muted by the predominance of fixed interest rate loans of which the payments would not be affected by the cumulative 425 basis points rise in interest rates since 2004.

At this stage the problems seem to be contained in the lower priced segments of the market, where the bulk of the sub-prime mortgages were granted. The average value of sub-prime mortgages with variable rates is \$213 000, compared with \$573 000 for prime mortgages with variable rates. The divergent performance of different price segments is aptly captured by the differences between two of the most popular house price indices. The National Association of Realtors’ (NAR) index has occasionally captured negative house price growth last year. The index of the Office of Federal Housing Enterprise Oversight (OFHEO), in contrast, still captured positive house price growth in the final quarter of last year (the most recent data available). OFHEO’s index is adjusted for the mix of houses being sold, whereas the NAR’s index, like most house price indices, does not make this adjustment and is therefore disrupted if there are changes in the mix of houses being transferred. The recent divergent performances of the two indices are therefore probably indicative of increased activity in the lower end



of the price spectrum, which arguably corroborates the view that this segment is experiencing higher turnover on the back of increased stress, while the higher priced segments may still be in better health. The general view seems to be biased towards a continuation of this trend.

Figure 2: US house price growth



Source: SARB, Standard Bank Group

However, the worst may be yet to come. According to *The Economist*, a study by First American CoreLogist estimates that 60% of all adjustable-rate loans made since 2004 will be reset to payments that will be at least 25% higher while a fifth will see monthly payments rise by at least 50%. This will, in due course, underpin further deterioration in loans' performance. The situation is aggravated by the fact that, according to First American CoreLogist, 7% of American homeowners had negative equity (houses worth less than their mortgages) by the end of last year. And Merrill Lynch estimates that the ratio of income to housing costs is still 10% worse than levels at the end of the last housing downturn in the early 1990s. A fall in house prices, if it were to occur, will put further pressure on the already gloomy situation.

Consequences of the sub-prime problems for the US economy

Although questions about sub-prime mortgages have been raised for some time now, it was only in the first few months of 2007 that the scale of the problem became clearer. Fears about contagion spread rapidly. Some argue that the sub-prime crisis will impact on the mortgage market as a whole, slowing housing sales, driving prices down and, through a negative wealth effect, leading to a decline in consumption and GDP. Others see the main contagion effect through equity and capital markets, with fears that the sub-prime crisis will weaken all financial assets, especially the currency market. There is also a view that the sub-prime crisis will resolve itself and have only a muted effect on the US economy.

The sub-prime crisis could impact on the housing market if a flood of foreclosed houses come up for sale and push down prices in areas where the supply of loans is already high because demand has dropped off. Marginal buyers (buyers able to buy when conditions are conducive for buying) are held back, slowing a recovery in the housing market. With consumers under stress, consumption is likely to decline, impacting negatively on GDP and economic growth. Estimates of the direct negative impact on economic growth of the sub-prime crisis are in the order of 1.5 percentage points. This implies a likely scenario where GDP growth can decline from, say, trend-growth of 3.5% to 2% in 2007. A housing slump could place further stress on the already ailing construction sector, thus affecting wage earners from carpenters to attorneys.

The divergence in opinion on the likely consequences of the sub-prime crisis for the US economy is striking. The well-known Morgan Stanley economist Stephen Roach is of the opinion that the sub-prime saga could have greater-than-expected consequences for the US economy, a US-centric global economy, and world financial markets. He argues that the sub-prime crisis today is the equivalent of the dot-com crisis in 1999 and 2000. In 1999, optimists argued that equities, as a broad asset class, were in



reasonably good shape and that failing dot-com companies accounted for only 6% of the total capitalisation of the US equity market, and thus did not constitute a major problem. When the dot-com bubble burst the much broader S&P 500-stock index fell by 49%, while the asset-dependent US economy slipped into a mild recession pulling the global economy down with it.

Roach contends that the US housing bubble has burst, and that the immediate repercussions have been concentrated in sub-prime debt. He suspects that a powerful dynamic has been set in motion by a small, mis-priced portion of a major asset class and that this will have broad macroeconomic consequences for the US economy as a whole. For a number of reasons a political solution could be sought, either by minimising the borrowers' debt service cost by lowering interest rates or by guaranteeing sub-prime credit risk.

Some other commentators argue that the sub-prime problems are likely to affect financial institutions and their investors more than consumer sentiment and the economy at large. Some heavyweights that argue that the US economy will emerge relatively unscathed include Standard & Poor's, BusinessWeek and Goldman Sachs.

In our view, the underlying health of the US economy may hold the key to determining whether the sub-prime crisis will spread to the conventional mortgage market and the economy. If income and employment growth remain strong enough, the deterioration in households' finances may be temporary as households have to deal with higher interest rate payments. At this stage, the cooling-off in the housing market has negatively impacted mainly on output and employment growth in the construction industry. However, despite job losses in the construction industry, overall job creation remains reasonably strong – 100 000 new jobs were created in February 2007 – and the unemployment rate has stabilised at 4.5%. This relationship between economic strength and the housing market's performance is clearly illustrated by the regional spread of non-performing sub-prime loans; the recent surge in non-performing mortgages has been heavily biased towards states suffering from economic shocks, such as job losses and hurricane Katrina.

Transmission mechanisms

Changes in the US financial system

In the last few decades, the US financial system has changed in at least three fundamental ways that will affect the dynamics around the performance of sub-prime mortgage loans:

- **Securitisation.** Banks, insurance companies and savings and loan associations have retreated as direct lenders. Now, mortgages are bundled into bond-like securities and sold to institutional investors (pension funds, endowment funds, insurance companies and banks). More than half of US non-financial debt is currently securitised.¹ This means that the impact of the sub-prime mortgage market's performance will be spread across a broader range of institutions, rather than being limited to the mortgage lenders themselves.
- **The explosion in the number of financial institutions,** including hedge funds, mutual funds and private equity funds. The channels for savings, some of which are not well regulated, have burgeoned in recent years. This lends further support to a wider impact of the deteriorating performance of the sub-prime mortgage market.
- **Globalisation.** Twenty-five years ago most countries, with the exception of the US, had capital controls that restricted investment abroad, and investment by foreign nationals in home markets. In many countries these restrictions have been removed, resulting in global capital flows in excess of \$6tn per annum. This suggests increased risk that problems in the US housing market may spill over to other countries.

Transmission to the SA market

There are three main channels through which the deterioration in the US sub-prime mortgage market can impact on the local economy and on the housing market in particular:

¹ This trend has spilled over to other countries, including South Africa, where securitisation is increasingly popular.

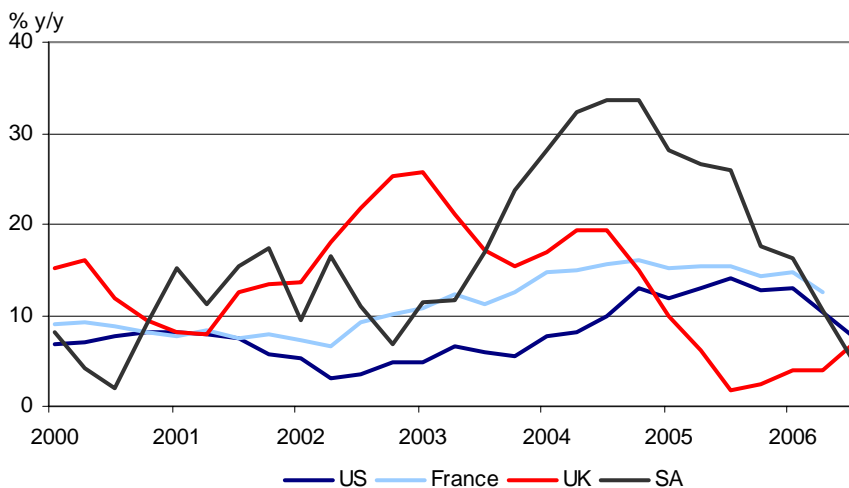


- If the deterioration leads to a slowdown in US economic growth, it could adversely impact on the local economy by reducing the demand for South African exports, which will, in turn, be a drag on local economic growth. In addition, slower US growth, and by extension global growth, will weaken the global demand for commodities, which will cloud the outlook for commodity prices. This, in turn, could adversely impact on South Africa's exports, and by extension its growth and exchange rate.

However, this impact will be mitigated by strong economic growth in Europe, South Africa's main trading partner, and in many developing countries, whose comparatively high commodity intensity may be more important from a commodity demand/price perspective.

- To the extent that global housing markets are seen as an asset class, there may be contagion to other housing markets. Following the global stock market slump in 2000 and the subsequent monetary policy easing, investors swarmed into residential property investments, which played an important role in driving up global property prices. The simultaneous rise in global house prices suggests some linkage between global housing markets, so that it is conceivable that a slump in a large housing market, such as that of the US, may spill over to other countries' housing markets. However, we don't perceive this as a particularly strong transmission channel; features such as immobility mean that housing markets are less interdependent than, say, share markets. The correlation between SA and US house price growth, for example, is only 22%²; the correlation between their equity price growth is markedly higher at 68%. While some element of shared sentiment is undeniable, housing markets are mostly driven by local, rather than global, forces. The divergence in property markets' performances from time to time is illustrated in Figure 3.

Figure 3: Global house price growth — scarce connection



Sources: Standard Bank Group, Bloomberg

- The rise in non-performing loans in the US could adversely impact on the US equity market by denting the share values of not only the lenders of sub-prime mortgages but also the institutions buying the mortgage-backed securities. Given the dominance of US equities in global stock markets, this is highly likely to drag down other share markets too. This is likely to affect the local stock market by contagion as well as possibly through higher risk aversion, which could negatively impact on developing countries' equity markets and currencies.

The South African housing market

Several reasons underpin our view that the pass-through of the current US residential property dynamics to the local housing market will be noticeably partial:

² A correlation coefficient of 100% indicates a perfect positive correlation while a correlation coefficient of 0% indicates no correlation.



- The key reason underlying our view that local house prices are unlikely to be affected materially by the US sub-prime crisis is the belief that local house prices are driven primarily by local economic factors. Linkages between different countries' property markets are typically weaker than the relationships between other types of assets such as shares. The simultaneous increase in house prices across the globe in recent years, for example, was largely attributable to lower interest rates and strong economic and income growth in the respective countries, rather than a predominant herd-like increase in investors' appetite for property investments across all geographies. Locally, the 40% decline in nominal interest rates (between 2003 and 2005), 30% growth in household income (cumulatively in nominal terms between the beginning of 2003 and the end of 2005), and roughly a million newly employed individuals over the past couple of years played a dominant role in the extraordinary strong growth in house prices than any contagion effect of rising global house prices.

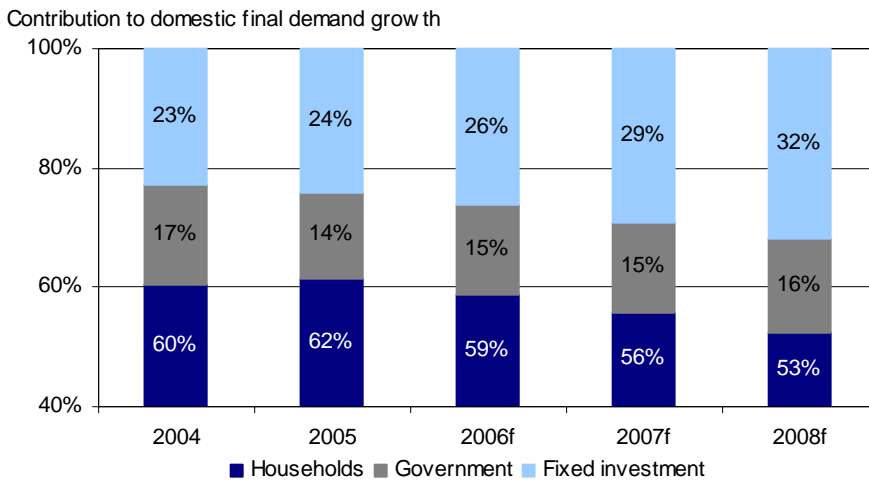
The importance of local economic fundamentals for house price determination is generally larger than in many other asset markets, at least partly because the bulk of purchases are still being made for functional, rather than investment or speculative, purposes. Furthermore, investors generally enter this market for the long-term capital gains and are cognisant of the fact that they are unlikely to profit from these investments in the short term. The average property market investor also tends to be different from the average, say, stock market investor, with less regard for international markets in his/her investment decisions. As noted, the correlation between American and South African house price growth is a mere 22%, compared to an almost 60% correlation between our equity markets.

The local macroeconomic prognosis is more constructive than the US, where interest rates have increased more than fourfold over the past three years and economic growth is expected to remain roughly flat at around 3% (according to the IMF). In South Africa, in contrast, the upward interest rate cycle is expected to be modest, with interest rates expected to rise by about 20% during the current cycle, and economic growth is forecast to remain around 4.5%. This benign economic setting should continue to support the local housing market and will mitigate any spill-over effects from malaise in the US.

- Apart from the possible direct linkages between the local and American housing markets, there is also the risk of an indirect impact on the local housing market if softer US growth hampers local exports. However, although the local growth outlook does to some degree depend on the performance of exports, the dominant force of local economic growth over the next five years is centred on the Accelerated and Shared Growth Initiative for South Africa (Asgi-SA), in particular the infrastructure expansion programme, and hence somewhat less sensitive to American economic growth than usual. Figure 4 illustrates the expected rise in the role of capital formation in local growth.



Figure 4: Composition of domestic demand growth – feverish internal growth dynamic



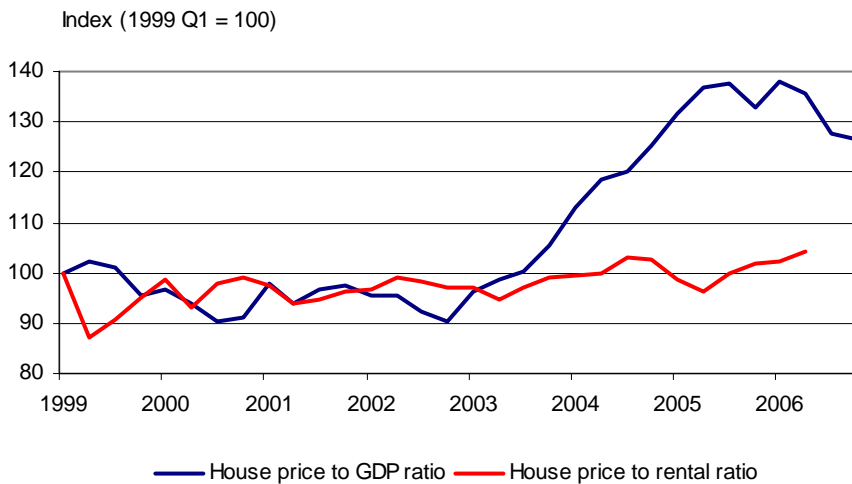
Source: SARB, Standard Bank Group

- The comparatively superior local residential property prognosis stems largely from healthier fundamentals, including firmer household finances, noticeably more responsible lending principles employed by local mortgage-granting institutions, and that the rise in local house prices is consistent with persistently improving economic fundamentals and hence far less likely to have been in bubble-territory than possibly the US.

Analysts make use of several indicators to evaluate whether house prices are overvalued, including the ratio of *house prices to GDP or income* and the ratio between *house prices and rental income*, which is sometimes seen as the equivalent to the price-earnings (PE) ratio used in equity valuation. Admittedly, these indicators can give misleading results, in our view. The rationale for studying the ratio between house prices and GDP or income is that house prices cannot indefinitely outpace income growth if all else remains equal. However, in reality all else hardly ever remains equal, with changes in interest rates being the most important factor that varies over time and critically impacts on the sustainable ratio between house prices and income. If interest rates drop, for example, the ratio between house prices and income is expected to rise since, for a given income, a more expensive house can be afforded. Given the substantial (structural) decline in local interest rates in recent years, and with the expected peak in the current rising interest rate cycle being lower than any of the troughs between 1987 and 2003, it is clearly not meaningful to study the house price-income ratio over time. Also, given global differences in interest rates, among other features, it is not meaningful to make global comparisons of this indicator.

With respect to the ratio of house prices to rental costs, intuitively, if house prices outpace rental costs there is an incentive for individuals to rent rather than buy houses, which will on balance reduce the demand for, and by extension prices of, houses. However, the ratio again doesn't allow for the impact of, for example, changing interest rates.

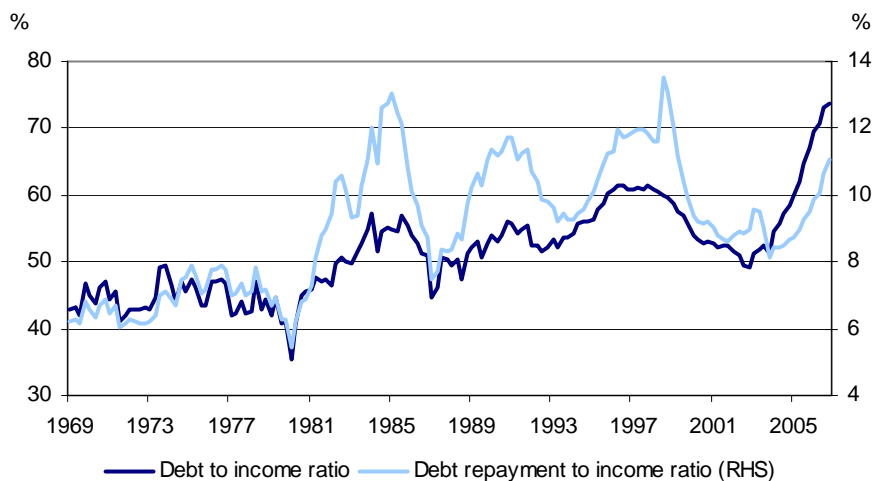
Figure 5: House price fundamentals



Source: Standard Bank Group, Bloomberg

Our favourite indicator of the underlying health of the residential property market, which captures the scope for further house price expansion and the likelihood of house price declines, is the affordability of households' overall debt burden. Ultimately, households' ability to continue repaying their mortgages depends on their total debt. As long as they're able to repay existing debt, they are unlikely to be forced (or willing) to sell their houses for lower prices. Even though South Africans' debt to income ratio (the ratio of households' total outstanding debt to their annual income) reached a record high of 73.8% in the final quarter of last year (the latest official data), their debt instalment to income ratio is still noticeably below historical peaks (see Figure 6) given structurally lower interest rates. This suggests that South Africans are still generally able to repay their existing (mortgage) debt and hence are not compelled to accept lower house prices, which, in turn, suggests that nominal house prices are unlikely to fall.

Figure 6: Household debt



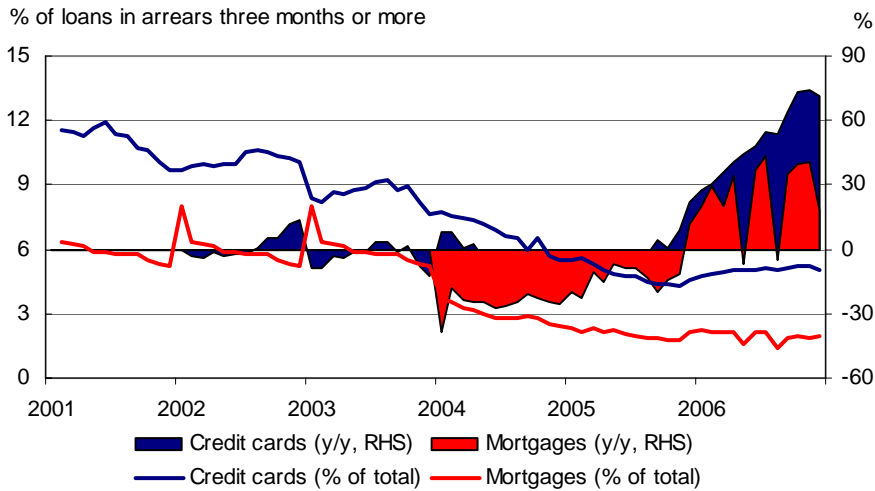
Source: SARB, Standard Bank Group

Aggregated household finances are therefore still reasonably healthy, although some are finding it increasingly difficult to meet their required debt repayments. In December, the value of credit card and mortgage debt in arrears three months or more rose by 71.5% y/y and 18.5% y/y respectively, but this should be seen in the context of the strong growth in credit extension and off a small base: credit card debt in arrears three months or more rose to 5% of total outstanding credit card debt



from a recent trough of 4.3% in November 2005 while the equivalent measure for mortgage advances rose to 1.9% in December 2006 from a near-term trough of 1.5% in May 2006 (see Figure 7).

Figure 7: Non-performing loans



Source: Standard Bank Group, SARB

Apart from a modest deterioration in households' finances in the near term as they absorb higher interest payments and escalating living costs, the longer-term outlook remains very positive. The favourable outlook stems from a very supportive macroeconomic setting, on the back of which high (real and nominal) income and employment growth should continue. Also, local institutions have generally not relaxed their lending criteria nor been "creative" in extending credit. Indeed, exotic mortgages that became popular in the US and are now at the root of their problems are unheard of in South Africa: attempts to get mortgages without proof of income, for example, would be unsuccessful.

Bottom line: It is clear that the sub-prime market has over-extended itself, with nasty consequences for both lenders and borrowers in that segment of the mortgage market. However, whether the impact will extend to the broader US property market and also offshore is less obvious.

The key channels through which the sub-prime market can impact on the South African housing market and economy are:

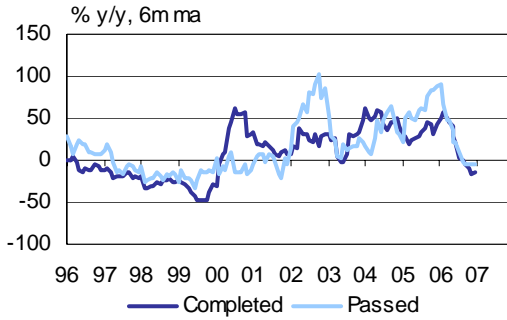
- slower US growth may hamper local exports and commodity prices, which, in turn, may hamper house prices through reduced economic and income growth;
- there may be contagion to global housing markets to the extent that investors regard residential property as a single asset class; and
- equity prices may soften if the mortgage lenders and buyers of their securitised assets experience a further deterioration in their earnings and loss experiences.

In the final analysis, the fall-out in the US sub-prime, as it has occurred so far, is of little observable consequence to local house prices. Moreover, these have been predominantly driven by local economic factors which essentially remain benign. A modest deterioration in non-performing loans is expected, but the prognosis is hardly dire in a relative and historical context.



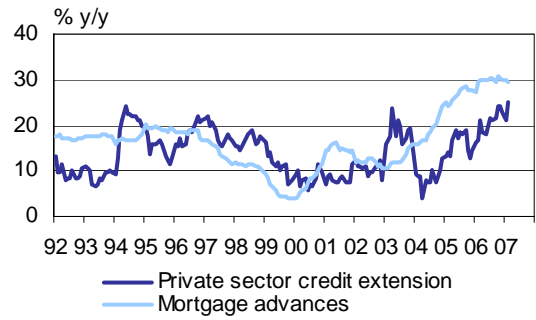
Picture Gallery

Figure 1: Buildings: Flats & townhouses



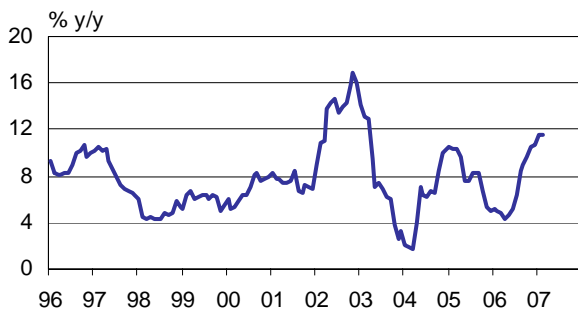
Source: StatsSA

Figure 2: Private sector borrowing



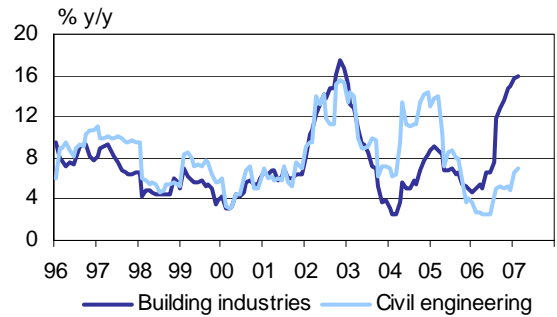
Source: SARB

Figure 3: Building cost: Building and construction



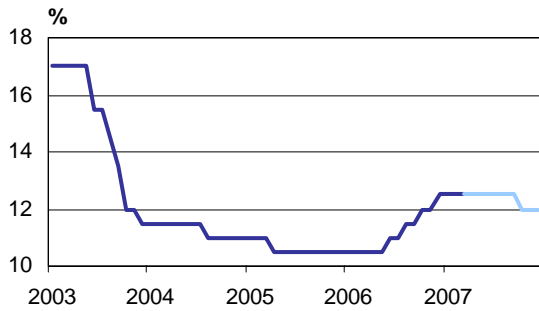
Source: StatsSA

Figure 4: Building cost: Building industries and civil engineering



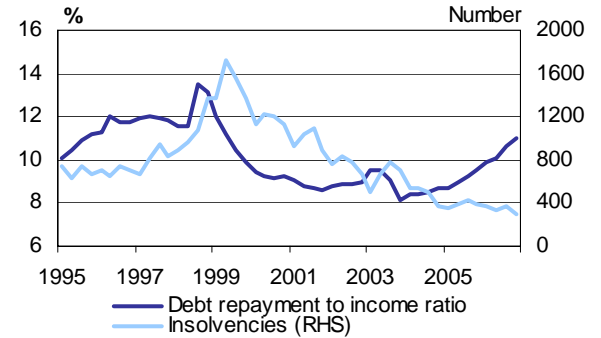
Source: SARB

Figure 5: Prime interest rate



Source: SARB, Standard Bank Group

Figure 6: Debt affordability vs insolvencies



Source: StatsSA, Standard Bank Group

Note on the methodology used in calculating Standard Bank's house price index

The way in which house prices are measured means that they are inherently volatile, not unlike many other economic indicators. Measuring house prices is complicated by the fact that the available data usually stem from the properties sold during a particular period, rather than from a well-designed sample that is representative of all houses. This is aggravated by the heterogeneity of houses. Changes in the measured prices may be the result of actual changes in the general price level; or changes in the distribution of the houses being sold, for example more sales of luxury houses may push up the measured house prices even without changes in general prices; or the changes may simply be random.

Given these data challenges, the international best practice is to use the median or middle price, rather than, say, the average house price. The median is the price such that half of all houses are more expensive and half less expensive than that price. It is substantially less volatile and less sensitive to the typical problems found in house price data. Standard Bank's data are therefore based on the median house price of the full spectrum of houses. Furthermore, national data from the Deeds Office are available only with a relatively long lag of up to nine months, so data from Standard Bank, which has a market share of about 27.7%, and whose data are generally highly correlated with those of the Deeds Office, are a good proxy for the national market.



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