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SOUTH SUDAN

The world's economic "center of gravity" continues to shift from the developed economies to the developing economies, and the economic prospects of the G7 are becoming more intertwined with those of developing countries than ever before. The objective of this research and analysis is to provide our clients with proprietary, ground level, and actionable insights regarding this important economic shift.

Special Macro Report

South Sudan Secession: Newly independent, South Sudan provides investors potentially attractive opportunity although political risk remains high. Risks of civil war and armed conflict over oil in the South create extreme risks in Sudan and will provide significant opportunity for investors seeking inefficiently priced assets in pre-frontier emerging markets. We believe investment opportunities exist in construction, hospitality, and commercial trade. New opportunities include the services industry as banking, insurance, and telecommunications begin to flourish and follow recent economic growth.

REPORT | AFRICA REGION | July 19, 2011

A potential investment opportunity in South Sudan's untapped resources

- South Sudan independence provides opportunity, but extreme risks exist
- Reliance on oil and agriculture threatens survival
- Southern government will need to innovate, look to models that work

South Sudan declares independence. Now what? Lee Iacocca once said, "Leaders are made, not born." This is as true for America as it is for South Sudan. And just like in America (and everywhere for that matter) leaders need to be ***created*** in the new State—and fast. Economic development, stability, and global and regional integration won't happen until this happens. The new leaders ***will need to move the State away from reliance as an agricultural and oil producing country and support construction, hospitality, and commercial trade, as well as critical services like the banking, insurance, and telecom sectors in order to survive***. They will need to attract additional interest from South Korea, Japan, UAE, the U.S. and Spain by supporting co-investment funds with mandates to invest in refineries, hydropower plants, renewable energy systems, information and communications technology, engineering schools (not just general education), and other infrastructure projects—like Scotland and Israel did successfully. They will need to solve the power and energy crisis, the lack of infrastructure crisis, the lack of education crisis, the lack of medicine crisis, the lack of financial services crisis, the lack of information and technology crisis, and the lack of political stability crisis, all plaguing the country.

They will need to deal with chronic corruption by exposing it in the public arena. In short, they will need to do all the things every emerging nation has to do to attract foreign and regional partners in order to not just grow ***but to survive in the new global economy***. ***And, most importantly, they will need to innovate***. For starters, the southern leaders could visit, say, California, like Russia's President Medvedev did last year, to see how business is organized in Silicon Valley? Medvedev, impressed by what he saw, said, "We have much to learn from that experience." The President of Russia going to California to see how things are done? That's innovative. Innovation usually builds on proven models—that is, it is evolutionary more times than it is revolutionary. The southern Sudanese leaders are undisputedly revolutionary; what is needed now, however, is evolution.

Companies Mentioned in this Report:

Petronas
Oil and Natural Gas Corporation
Athi River Mining
East African Portland Cement
SABMiller
East African Breweries
China National Petroleum Company
Greater Nile Petroleum Operating Co.
National Electricity Corp of Sudan
Agricultural Bank of Sudan
Buffalo Commercial Bank
Commercial Bank of Ethiopia
Equity Bank
Kenya Commercial Bank
Nile Commercial Bank
Sudatel
Zain Group

OVERVIEW

Southern secession opens investment opportunities

This report focuses on our outlook for Sudan based on the secession that occurred in the South on July 9th and current trends in oil, construction, hospitality, and the commercial trade industry in Sudan, as well as what this means for the services industry (mainly ***banking, insurance, and telecommunications***) soon to follow.

Construction, hospitality, and commercial trade find a yield

Although we believe the 2005 Comprehensive Peace Agreement was at least a start, opening the door to southern secession, which ignited a boom in construction, hospitality, and commercial trade in southern Sudan's larger cities (e.g., Juba, Wau, Rumbek and Malakal), ***it would be imprudent if we did not point out that extreme political and regional security risks still exist and continue to hamper the potential for explosive growth***, presenting significant hurdles for investors looking to ***pre-frontier emerging markets*** for a yield.

Aggressive growth story is banking, insurance, and telecommunications

Southern Sudan's unprecedented economic growth in ***construction, hospitality, and commercial trade*** was the result of an influx of donors, NGOs, foreign investors, and multinationals, which oftentimes works as a catalyst for growth. But we all know this is not sustainable. The most significant investors in Sudan—from Saudi Arabia, Great Britain, France, Malaysia, China, the Netherlands, and Germany (neighboring African investors include DRC, Uganda, Kenya, Somalia, and Eritrea) - may look to exit because the inflation rate is rising to almost 17% (in May) from 9.8% in November. Additionally, the political risk is significantly high; that is, unless the new government makes serious, actionable changes. Economists say the country's US$68 billion economy will probably grow by 3 percent to 4 percent this year after growing by 3 percent last year. This matters little unless the State's leaders find a way to ***move the State away from reliance as an agricultural and oil producing country and create a sustainable—and diversified-- economic system.***

Oil should be a blessing, not curse

How can they do this? Not by relying on NGOs, the U.N., the IMF or "donors" and the like. Instead, the South's new leaders will need to take this landmark opportunity to experiment and take risk; to <u>innovate</u>. They cannot go down the same "aid supported" path of many of its sister African countries that are still mired in weak, unproductive economies and corrupt and ineffective political systems.

Southern Sudan controls 75 percent of country's oil

FIRST: ANSWER THE OIL QUESTION

Given the abundance of oil in the South, oil should not be a problem but instead should be one (a very big "one"!) answer to building out the South's infrastructure. ***Unfortunately, instead of using the abundance of oil to build-out the country ("blessing"), like many resource-rich but skills-poor regions, to date Sudan has treated the oil question more as a "resource curse."***

Oil provides 45 percent of the country's revenue

We are optimistic (though cautious), however, that the new independent State will not fall into the historical trap Sudan has fallen into—mismanaging the oil revenues—and will take this historic opportunity to leverage its natural resources to its advantage, building out the country's infrastructure from the ground up.

Southern leaders not very clear about future oil split

The South to build regional oil alliances

Juba and Khartoum need an agreement on oil

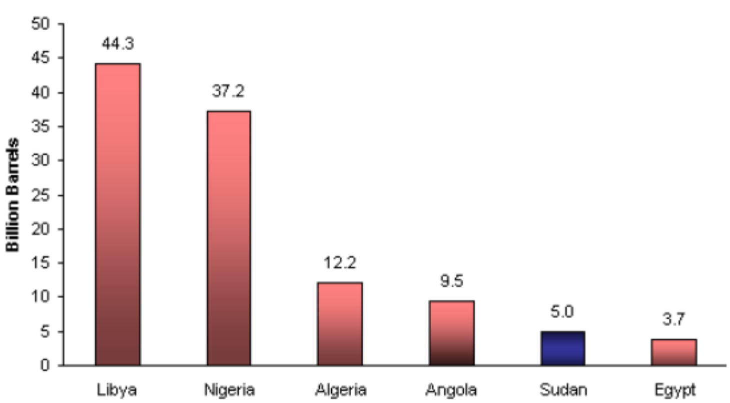
South Sudan will ostensibly assume control of about 75 percent of Sudan's daily oil production of 490,000 barrels when it becomes independent. The crude is pumped mainly by **China National Petroleum Corp**., **Malaysia's Petroliam Nasional Bhd (KL:PGAS)** and India's **Oil & Natural Gas Corp (NSE:ONGC)**. We say "ostensibly" because the northern economy ***will not be able to cope*** with losing real control of almost three-quarters of Sudan's current daily crude production since oil provides about 45 percent of its revenue and most of its foreign currency earnings. Even though the South promises to keep the status quo (and to even pay the North for the use of its export pipeline and port), the government in the North can neither risk losing real control over the oil nor can it impose austerity measures, such as new spending cuts to cope with the revenue loss, without triggering massive civil unrest. ***We expect the southern leaders to look for alternative routes to the coastline and to build a few refineries in the State (which will decrease the South's dependence on the North substantially) given recent statements by the southern government have been evasive and even contradictory. What does this mean? Unless the two sides come to a quick agreement over oil, we will have to wait until 2012 for the pieces of the oil puzzle to come together, by which time the policies of the new government in Juba and Khartoum in the North should be clearer, although we are highly skeptical of how mutually supportive they will be.***

A Few Important Facts

65 percent of Sudanese oil exports going to China means too many eggs in one basket

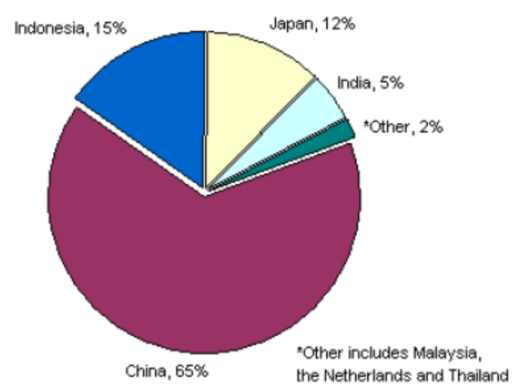
- The Sudanese oil industry represented 90% of export earnings, half of the North's revenues, and 98% of southern Sudan's total revenues for 2010.
- Sudan has the 5th largest proven oil reserve in Africa with five billion barrels of proven oil reserves (2010) up from an estimated 563 million barrels in 2006 (see Fig. 1).
- In 2009, Sudan produced close to 485,000 barrels per day (bbl/d) and consumed around 90,000 bbl/d. The remaining crude was exported almost exclusively to Asian markets with China importing close to 250,000 bbl/d (65 percent of total Sudanese exports and 6 percent of Chinese imports) followed by Indonesia (60,000 bbl/d) and Japan (50,000 bbl/d) (see Fig. 2).

Figure 1. African proven oil reserve holders (2010)



Source: Oil and Gas Journal; Nova Research

Figure 2. Sudan's crude oil exports by destination (2010)



Source: EIA, FACTS Global Energy, Global Trade Atlas; Nova Research

Both North and South must diversify away from China

Both northern and southern Sudan will continue the unsustainable path of courting China, its largest trading partner (it purchases 71 percent of Sudan's global exports) until they realize stability and open markets bring more players to the table (something it appears the leaders on both sides do not yet understand). This means southern Sudan will need to rely on continued Chinese investment in the energy sector and continue selling of more than 60 percent of its oil output to China. Since China is the largest investor in Sudan (that is, in the government of North Sudan), with strong political ties to the northern leaders, these investments present the greatest benefit to Khartoum and greatest risk to an integrated and truly self-sufficient South Sudan and the region. ***How can approximately 80 percent of Khartoum's revenue coming from oil, which is produced and bought by the Chinese, be good for peace and stability in the region? It can't.*** To further complicate things, the Chinese state-owned oil company, China National Petroleum Company (CNPC), is the largest stakeholder in Sudan's biggest energy consortium, the **Greater Nile Petroleum Operating Company**, through its 40 percent stake. ***Both governments need to cooperate to bring regional and international companies (instead of focusing on the same perennial NGOs, government agencies, donors, etc.) to the area, which will create real activity in other energy-related sectors of Sudan's economy, including the construction of oil pipelines, electricity and hydropower facilities, as well as infrastructure development.***

China strong political ties with North, not the South

CNPC stake creates risk

With the establishment of the southern State, ***and with China giving continued support and assistance to Khartoum*** (to protect its interests), ***<u>the South needs to genuinely innovate</u>,*** specifically in the areas of local development (including environmental protection), improving local medical conditions, supporting local education ***(i.e., committing capital toward creating engineering schools)*** infrastructure construction, privatization efforts, and creating jobs.

South needs engineers, innovation, and capital

SECOND: BUILD RELIABLE HOUSES AND ROADS - WITH QUALITY CEMENT

With few industries outside the oil and agriculture sectors - and with an almost non-existent infrastructure in southern Sudan - many international and regional investors can look to the construction industry for a yield. ***We expect to see a substantial increase in demand for cement manufacturers in the South as the region develops its infrastructure over the coming years - with cement's role being central to the building out of the country. Sudan's neighbors will need to establish a strong market presence in southern Sudan first before foreign companies can be expected to venture in.*** Kenya's **Athi River Mining (ARM:NR)**, producer of the Rhino cement brand, is one example and expects to expand into the southern Sudan market with its increased production capacity (to cover that market) and is expected to establish a plant in the new country. Kenya's largest cement producing company, **East Africa Portland Cement (EAPC:KN)**, has increased production to meet the demand in southern Sudan. The company has already penetrated the State, supplying over 100,000 tons a month to Rumba, Kapoeta, and Juba under a German development agency sponsored program (GTZ).

Cement in demand

Southern government in Juba to set the tone for investments in infrastructure

Hospitality industry dominated by food & beverages

SABMiller the first multinational to invest in southern Sudan

Beer, pure drinking water, and soft drinks for the southern Sudanese

Power sector, an innovative solution

Biomass accounts for 75 percent of Sudan's primary energy supply

Extreme shifts expected in the power sector

THIRD: HAVE A BEER OR A GLASS OF WATER OR SODA

The hospitality industry in southern Sudan, although still in its infancy, ***can't flourish until a middle class emerges***. The southern leaders will need to create a marketing plan - call it **"Invest in Sudan" -** in order to bring an influx and growth of an international community in southern Sudan. This will add to the development of this industry in several sub-sectors including ***Food & Beverage***, Leisure & Entertainment, and luxury Residential Properties. Many businesses in this industry continue to adopt a wait-and-see approach while a few have ventured into the market early. Although it is very hard to predict the growth of this industry as a whole because of the civil strife, ***we can look to a few companies for precedence***. One of the few major foreign investments in southern Sudan over recent years, for example, has been **SABMiller's (LSE:SAB)** Southern Sudan Beverages Ltd (SSBL) brewery in Juba. The brewery produces White Bull lager and Chairman's Extra Strong Beer as well as the Club Minerals Sparkling Soft Drinks range and Source Pure Drinking Water. SSBL has also announced it will also start production of two of SABMiller's existing brands Nile Special Lager and Club Pilsner. The company is set to produce in southern Sudan, stating in its annual report that the market size had the potential to support the local production of beverages and the investment climate was right to invest in southern Sudan. The company was the first major multinational company to invest in southern Sudan ***and should be used as a case study*** for investors and multinationals looking to set up shop in the State. Kenya's **East African Breweries Ltd (EABL:KN)** is also set to establish a brewery in southern Sudan. EABL last year said that it plans to build a 700,000 hectolitre (hl) plant in Juba, which can be expanded to 1 million hl.

INVEST IN A CURE - RENEWABLE ENERGY SYSTEMS (RES)

The Ministry of Commerce and Industry of the Government of Southern Sudan (GOSS) is in charge of "stimulating, facilitating, and playing a regulatory role in building, strengthening and promoting the country's commercial trade development to accomplish a twofold goal: one, building, supporting, and regulating trade and investment and, two, establishing a solid base for the development of a sustainable industrial sector that has linkages with the dominant agricultural sector." ***In order to do that, they will need to begin working closely with the Ministry of Energy and Mining to aggressively build out the region's power sector***. The power sector in southern Sudan suffers from poor infrastructure and frequent outages. More than 70 percent of the population lives in rural and isolated communities with limited economic activities. Although oil plays a major role in the economy, biomass accounts for almost 75 percent of the country's primary energy supply because the large rural population is not connected to the grid, and are also by-passed by the petroleum supply pipe lines and thus rely mainly on biomass. Many villages connect small generators to the ubiquitous diesel-powered irrigation pumps. This way of generating electricity is inefficient and expensive, and causes environmental problems, which hinders more than fosters trade. The national power utility is the **National Electricity Corporation of Sudan (NEC)**, which is responsible for electricity generation, transmission and distribution, and three main regulatory bodies have been established to deal with petroleum, electricity, and mining:

Renewable Energy Master Plan needed in South

Billions needed in power sector

Renewable energy systems (RES) acts as hedge against oil dependence

U.S. lifts sanctions on South Sudan's central bank

Southern banking system ready for a "bank grab"

Conventional insurance industry potential boom in South

- **Electricity: Electricity Regulatory Authority (ERA)**
- **Petroleum : Sudanese Petroleum Cooperation (SPC)**
- **Mining: Public Geological Research Authority (PRA)**

The government wholly owns the utility. Regions not covered by the utilities grid rely on privately owned small diesel-fired generators. Now that the South is independent, a new system must be created by the southern government. ***The most obvious solution to the power problem in the South is renewable energy systems (RES).***

We expect the southern Sudanese government to adopt a Renewable Energy Master Plan (like the one created in Khartoum in 2005), giving priority to construction of electricity distribution networks (including in the form of inter-connecting power grids with neighboring countries) and rural electrification projects to promote sustainable economic development, as well as capacity building within institutions, and to aggressively promote the use of RES, including priority project—such as solar PV installations, biomass co-generation in sugar factories, wind energy systems for pumping water, and hydropower in order to avoid dependence on an oil-based market in the sector development.

This will require large investments by both the southern government, which includes sorting out the regulatory framework, and foreign investors (who are standing ready to pump billions into the medium and low voltage distribution grids) in order to promote cooperation and trade in the region.

EINSTEIN SAID COMPOUND INTEREST WAS THE BEST INVENTION EVER

South Sudan's new central bank is now clear of U.S. sanctions, according to the U.S. Treasury Department. The former Bank of Southern Sudan is now the central bank of South Sudan and is no longer part of the Government of Sudan." The move allows U.S. financial institutions to do business with the bank without seeking permission from the U.S. government, as long as the transactions do not benefit Sudan. Located in Juba, the **Bank of Southern Sudan (BOSS)** ***is now the central bank of southern Sudan, completely autonomous from Sudan's central bank,*** and in charge of regulating operating banks in southern Sudan's banking system, primarily the **Agricultural Bank of Sudan, Buffalo Commercial Bank, Commercial Bank of Ethiopia, Equity Bank, Kenya Commercial Bank,** and **Nile Commercial Bank**. ***We think South Sudan's financial system will grow geometrically as U.S. financial institutions will be able to do business with the bank without seeking permission from the U.S. government (as long as transactions do not benefit the North). The central bank of South Sudan will strengthen the new State's conventional banking system***, furthering a sustainable regulatory framework differentiated from the north's banking system which must adhere to Islamic law. Neighboring country banks are also waiting for some stability but ***we believe a potential "bank grab" is on the horizon***. **Kenya Commercial Bank (KCB)**, for example, expects to double its branches in southern Sudan if the region manages to conduct a successful southern devolution.

Insurance industry set to expand as U.S. lifts sanctions

THE "LAW OF LARGE NUMBERS" IS A LAW, NOT GAMBLING

Similar to the banking system, the insurance industry in the South is set to expand rapidly as sanctions are lifted. ***The South will open the new State to U.S. and other foreign investors seeking incremental returns in the country's aggressive growth insurance markets while*** the North will continue to operate under Sharia law and U.S. sanctions.

Engine of the southern economy will be telecom

ICT MEANS "I CAN TALK" TO THE WORLD

The telecom industry in northern Sudan has been established for quite some time with only the major towns of Juba, Wau and Malakal in the South enjoying the benefits of telecom through the telephone line and the Sudanese television service providers.

Sudatel and Zain continue gaining market share

Information and communication technology infrastructure is desperately needed in the South—that is, ***we argue it is fundamental to the development of the new State and/or any sustainable economy,*** creating an exchange of information through political and economic routes; and creating thousands of jobs as small businesses expand outwardly from the cities to sell units of airtime, set up call centers, internet cafeterias, and sell and repair communication device (like mobile phones). Making telecom infrastructures and communications services available to the southern population will empower southerners to connect and stay abreast of critical information provided by their government and the world.

Multinationals set to support growth of telecom in South

The ICT revolution in the South has great potential, creating a sense of interconnection, as people share ideas on matters, such as new medicines, new farming techniques, financing opportunities (e.g., microfinance), and techniques for bringing cheap and clean power sources to towns across the region. Several companies are rushing the risky land grab in telecom rather than adopting the wait-and-see policy. **Sudatel (ADX:SUDATEL)** is expanding aggressively into the southern markets, recently stating independence will serve as a catalyst to buy more mobile licenses to expand its business in the South. **Zain (KK:ZAIN**), which currently enjoys a 55 percent market share in Sudan, recently stated it will proceed in building out a mobile network in southern Sudan, having already invested US$300 million building a broadband network in the landlocked State.

Regulatory regime in South to work with foreign investors

ICT will be the engine of all the sectors of the southern Sudanese economy as it is in all countries in the modern world (***especially in New Frontier emerging economies like Sudan)*** because of its impact on education, health, housing, agriculture, power, finances, and transportation. Good reliable communications services in the new State will attract investments from multinationals looking for raw materials and cheap labor. However, the ***southern government and the private sector will need to work together to develop a cohesive ICT policy for southern Sudan***, allocating additional funds for the development of the sector in order for all the other pieces of the economic engine (mentioned in this report) to come together to create a sustainable and regional and global integrated economy.

Cohesive ICT policy needed

CONCLUSION:

We suggest that the leaders of South Sudan take four game-changing steps.

Step 1 – Have Courage. Southern leaders have plenty of this; that is certain. But they will need to tone down the rhetoric with their northern counterparts immediately, stop pointing the finger at the North, take responsibility for creating a future, and forget about the past (who did what to create this mess over the last fifteen hundred years) and simply solve the (oil) problem by doing what needs to be done. ***This is no longer a North versus South issue. It is a global issue and the world cares nothing of the politics any more. The world wants to see change – real change. Sustainable change. Period.***

Step 2 - Innovate. The southern leaders need to acknowledge and embrace the creators of jobs and wealth: ***privatization and entrepreneurs***. This is not theory; it is fact. Why is it so difficult to understand that ***privatization creates entrepreneurs that create the ideas - that create the companies - that create the jobs - that create the wealth*** (even American politicians struggle to understand this fact)? This area deserves more than lip service. This issue needs to be a regional imperative, as important to the fabric of southern Sudan's first President, Salva Kiir Mayardit, and his government as John F. Kennedy's "New Frontier" ideology was to America in the 1960's. The world needs commitment, not talk. ***We would like to see an executive and legislative focus on this initiative that becomes the foundation of the southern government***, the pillar of economic stability and the fabric of all legislative, policy and monetary initiatives going forward. We believe that every politician in the new State should be talking about this every day of the week and the media to push this as a national priority in every broadcast.

Step 3 - Investment not Stimulus. Southern officials and ***President Mayardit needs to invest at least US$300 million in young Sudanese companies, start-ups and entrepreneurs.*** We have written about the importance of this before in earlier commentaries but would like to see US$30 million put to work in each of the 10 states across the country. But these funds must stay out of the hands of government officials. Rather, it should be invested directly into each state in the three historical provinces—Bahr el Ghazai, Equatoria, and Greater Upper Nile - in the form of a local Silicon Valley style growth capital fund. This should be managed and run by a team of U.N.-selected serial entrepreneurs, VCs, and private equity investors. This will provide a base level of scrutiny that can guide the selection of companies for investment. ***A Sudanese Development Board will need to be created and, in order to bring a global perspective to the State, this group will be composed of western business leaders (Steve Jobs, Warren Buffet, etc…), former politicos (Bill Clinton, Tony Blair, etc...) infrastructure specialists, bankers (from commercial banks, not Investment Banks), as well as a UN representative who should get a seat on the board***. This US$300 million investment from the southern leaders will result in more economic activity than any NGO initiative could ever accomplish. And, it will result in substantial investment returns to the Sudanese people.

Step 4 – Focus on educating engineers. One of the most important things the leaders in the South can do to establish the country's infrastructure is to encourage as many Sudanese as possible to enter Juba's College of Engineering at the University of Juba. Engineering schools beget engineers. Engineers beget ideas. Ideas beget companies. Companies beget jobs and taxes. Jobs and taxes beget growth and a middle class. A middle class begets more engineers. It's that simple. America has Silicon Valley in California, which has led to the creation of thousands of jobs, companies, and billions in tax revenues, because the region aggressively recruited the world's best engineers. What do professors at engineering schools in America make (in salary)? Find out—and double it! Find other ways of recruiting engineers to the new State. Be clever. For example, many qualified engineers in America are unemployed because of the economy. Hire them and put them to work. Not only will they help establish the infrastructure in South Sudan but this will create a political and economic link between America and South Sudan because those American engineers will have to pay U.S. taxes on income earned in South Sudan, which will strengthen geopolitical ties between the two countries.

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