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SA Equities: Chasing the Sun 3

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An overview of net flows between asset classes in the South African collective investments industry is evidence that local investors have favoured the safety of fixed income over the potentially higher albeit more volatile returns on offer from SA equities over the last 12 months. Investors that may have missed out on the rebound in SA equities in the 36 months following the Covid pandemic, when the SA market rebounded over 90% from its lows, may now be wondering, given the low valuations of the SA market, which asset class will deliver the best returns over the next 12 months?

The South African economic environment has been challenging, hamstrung by a low-growth environment that has been exacerbated by loadshedding and logistical issues on the Transnet network. This is reflected in the single-digit P/E multiples of South African companies that are pricing in an environment of low earnings growth for the foreseeable future. As seen in the chart below, the South African market has derated dramatically from 2018 and now trades at a material discount to both developed and emerging market peers.

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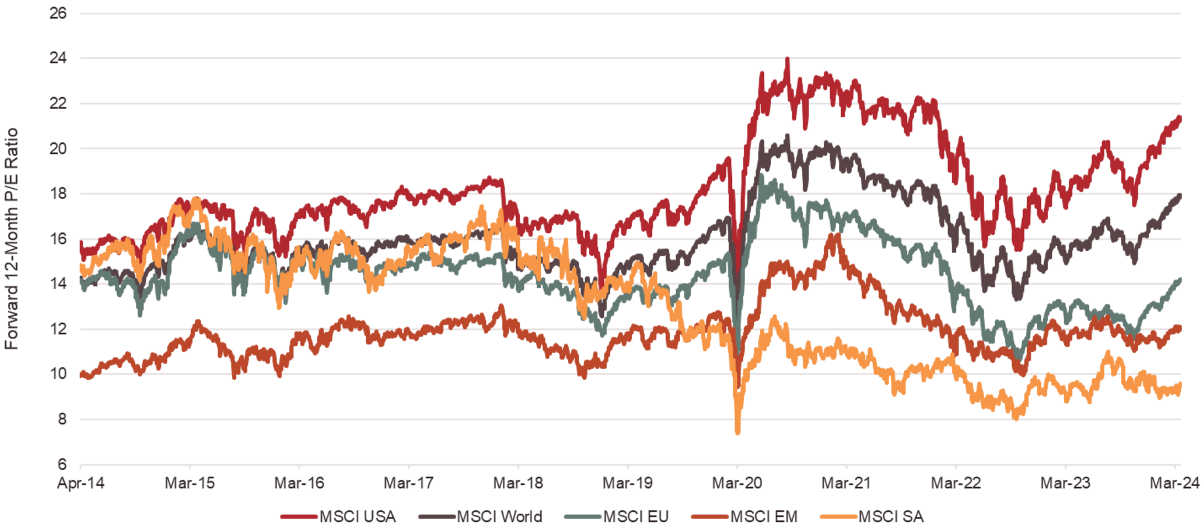
Chart 1: Valuation of MSCI South Africa versus other MSCI Markets



Source: Bloomberg

As we look out over our investment horizon, we believe the local equity market presents an attractive investment opportunity. It trades at depressed valuations, and several of the forementioned headwinds are expected to turn into tailwinds. On top of this, we believe South African management teams have been resourceful and innovative when navigating their businesses in the face of these headwinds. This has resulted in a more resilient business landscape for multiple listed companies going forward.

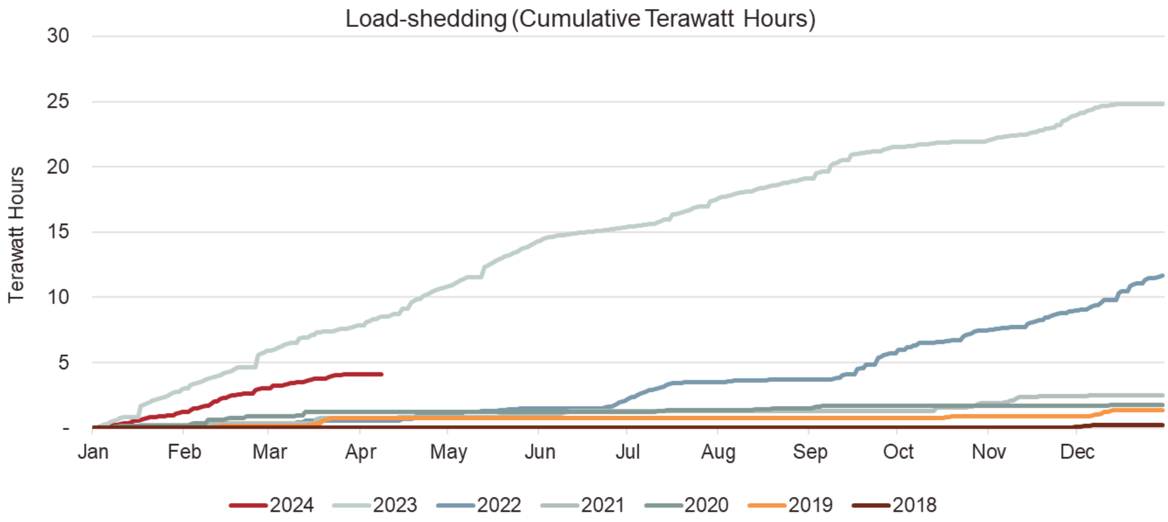
Key drivers for the SA market

We believe that amongst the many drivers the market is currently focussed on in South Africa, there are three key drivers that could affect the market in the medium term being loadshedding, logistics and the all-important national elections.

Loadshedding

We saw a marked increase in the level of load shedding mid-way through 2022, with unprecedented levels of load-shedding in 2023 that not only affected investor sentiment to the local market but had a very negative impact on local consumer and business sentiment.

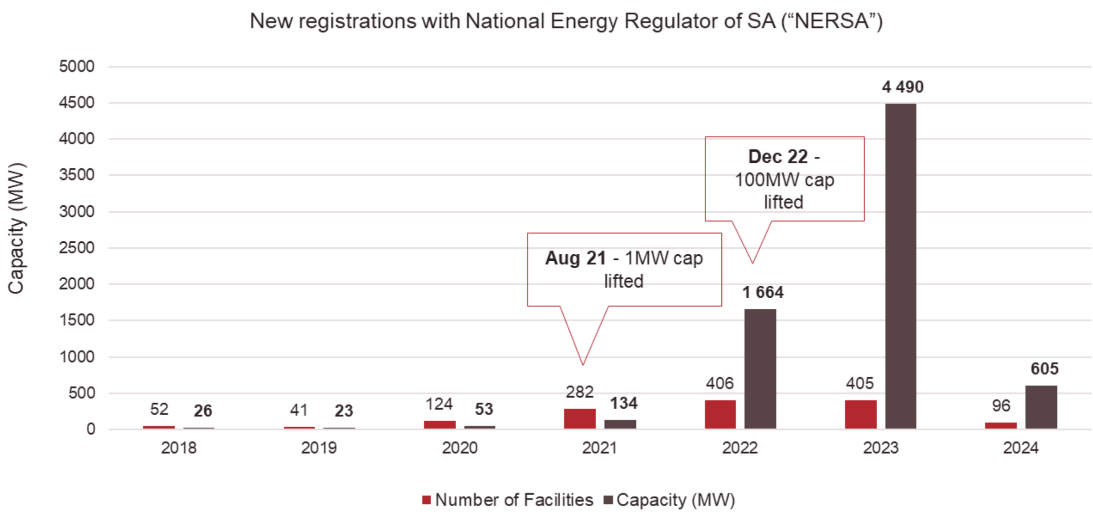
Chart 2: Cumulative loadshedding per annum, an improving picture



Source: Navigare

This resulted in the government having to continue to deregulate the energy sector. In December 2022, the cap for setting up private power generation systems without licensing was scrapped – this had been pegged at 100MW. After the removal of the cap, the market has seen a surge of new private-sector energy projects being registered with NERSA (National Energy Regulator of South Africa). Since 2022, over 900 independent energy projects with an estimated capacity of over 6.5 GW have been registered, and we have now seen those projects starting to come online.

Chart 3: Electricity: Private sector to the rescue



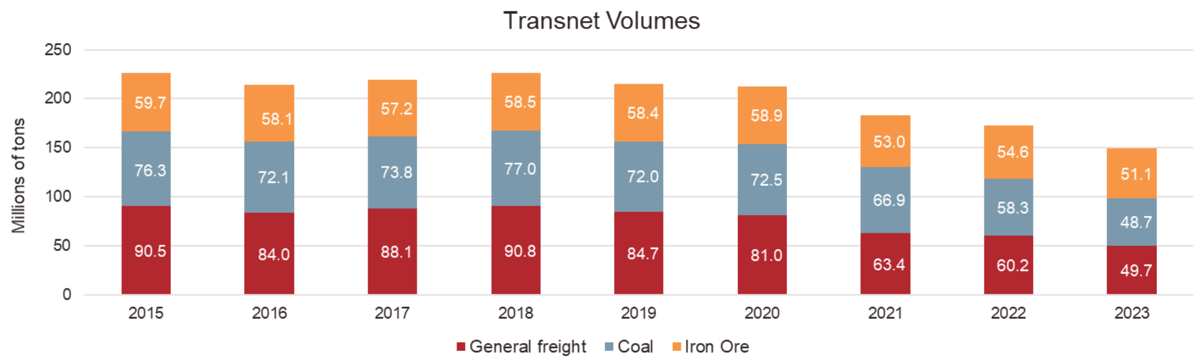
Source: NERSA

This capacity, together with a large amount of residential rooftop solar capacity that has been installed since 2022, is helping to curb the demand Eskom has experienced for electricity in 2024, resulting in lower stages of load-shedding with the month of April load-shedding free. We continue to forecast that by the end of 2024, we will have seen the end of material load-shedding. This could be a great driver for GDP growth as it is estimated that every stage of load-shedding costs the economy approximately 0.3% of GDP.

Transnet plans and reforms

Logistics constraints have had a materially negative impact on the local economy through decreased exports of commodities and increasing costs of transport for local businesses. This has been driven by the state-owned entity Transnet facing many challenges on its network of railways and ports across the country. In the chart below, the drop in volume across the Transnet network can be seen on an annual basis between the general freight, iron ore and coal networks.

Chart 4: Transnet volumes



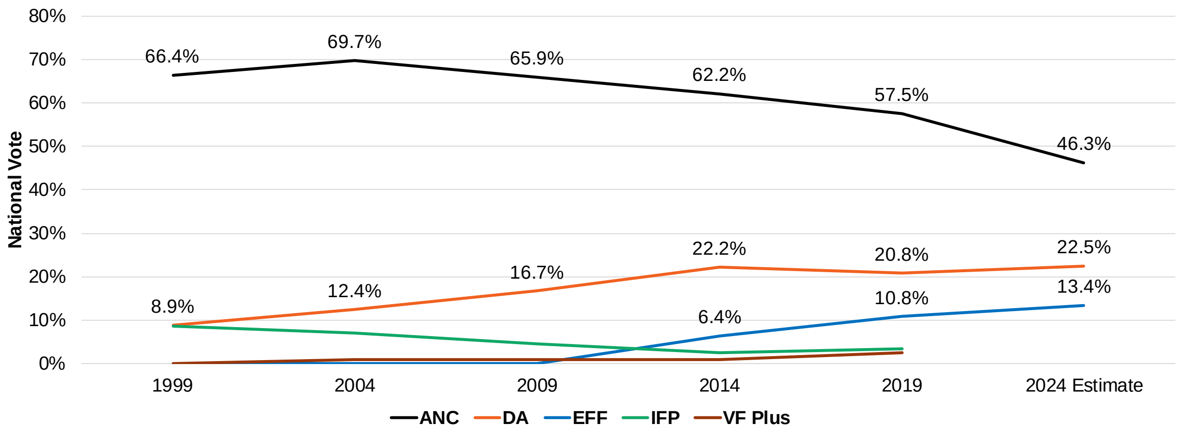
Source: RMB

The government has established the National Logistics Crisis Committee (NLCC) to tackle the problem, with many initiatives being executed jointly with the private sector to help sort out the crises. One of these, for instance, is a selection of ICTSI (largest independent terminal operator across 6 continents) in July 2023 as the preferred bidder and private sector partner to run the Durban container port Pier 2. The port accounts for approximately 46% of South Africa's container traffic and introducing a private sector partner should result in a material improvement in terminal productivity and throughput. This, along with multiple other initiatives involving private sector partners, including a focus on areas such as the coal and iron ore railways, could have a material impact on the GDP growth for the country going forward, with some experts estimating that more than 5% of GDP is lost due to the network problems. While we estimate that it will take 3 – 5 years to get Transnet back to its previous levels of operation, the ongoing improvement will be another tailwind for GDP growth in the country.

SA Elections - The removal of election uncertainty

Election uncertainty has been an overhang on the market, with polls sending mixed signals on potential outcomes for the ruling ANC and possible coalition scenarios that would form the government. Firstly, we need to recognise that our democracy is only 30 years old. When examining the chart below, we can see that the dominant ruling party had consistently lost voter support since 2004, when it won 70% of the national vote. This points to a functioning democracy, of which we should be proud, in which a ruling party that does not deliver the required outcomes and services to the population loses support.

Chart 5: Historical election results vs. average of recent polls



Source: JPMorgan / Laurium

If we average the latest poll results, it points to the ANC winning approximately 46% of the vote in the upcoming election (keeping in mind that an average of historic polls has had approximately a 3 - 4% margin of error and that many of the polls were performed before the emergence of the MK party in December 2023). We maintain that there is a very low probability of an ANC coalition with the likes of EFF or MK and an overwhelmingly higher probability of a government of national unity or ANC coalition with the DA or IFP. These latter results would result in the worst case being the status quo for structural changes in the country, or in the best case, an acceleration of the structural changes, two examples of which we have highlighted above, being electricity and logistics.

Conclusion

Currently, the South African market is trading on what looks like attractive valuations from a historical perspective. We believe the market is pricing in a large amount of risk and a low growth environment into the foreseeable future.

Chart 6: Compelling Value in SA Equities – Domestic SA Blended one-year forward P/E

Source: Bloomberg

A positive election result, combined with continued momentum around structural changes implemented by the government in conjunction with the private sector, could drive an increasingly positive GDP growth trajectory for South Africa. This would result not only in growing earnings prospects for listed companies, but also increasingly positive investor sentiment towards the local market. We believe that the local equity market thus currently presents a very interesting opportunity for investors to generate attractive returns going forward.

Glacier Research would like to Dwayne Dippenaar for contributing to this week's *Funds on Friday.*

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Dwayne joined Laurium in May 2015. Prior to joining Laurium, Dwayne, worked at Electus, a boutique asset manager which is part of the Old Mutual Investment Group, where he was a research analyst for their GEMs and South Africa equity funds. Dwayne also spent time working for Berman Capital, a US retail long/short fund based in New York before joining Electus. Dwayne worked at PricewaterhouseCoopers (PwC) on the audit and financial due diligence teams where he was involved in over 30 buy/sell side deals. Dwayne holds a CA(SA) and CFA. Dwayne was promoted to a Co-Portfolio Manager of the Laurium Equity Fund in 2019.