FUNDS ON FRIDAY
by Glacier Research

glacier
by Sanlam

23 February 2024
Volume 1216

What can catalyse a structural re-rating in SA equities

Authors: Ann Sebastian, Head of Equities and Senior Portfolio Manager, Terebinth Capital
Athenkosi Mjebeza, Equity Analyst, Terebinth Capital

SA equities: Structural re-rating depends on enabling earnings growth

South African (SA) equity market valuations are at their cheapest levels since the Global Financial Crisis (GFC), with the FTSE/JSE All Share Index (ALSI) and MSCI South Africa having derated by c.45% over the past decade. Investor sentiment and fundamentals play a crucial role in determining the valuation of equities. If investors have a negative perception of domestic economic prospects or are concerned about governance issues, they may be hesitant to invest in the market, leading to lower valuations.

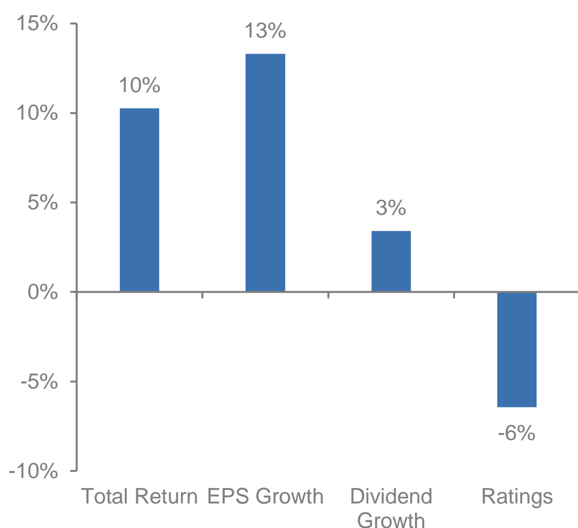
The key drivers of share price performance in the SA equity market over the long term have been: growth in earnings; dividends and cash flows; and changes in the rating or valuation commonly proxied by multiples like Price to Earnings (P/E). Of these, earnings growth is the primary factor in total returns, as illustrated by the attribution of the local equity market over the past 17 years (Figure 1). Even so, a change in the rating also plays a key role, with SA's structural ailments having detracted from total returns in recent years.

Glacier Financial Solutions (Pty) Ltd, I A member of the Sanlam Group | Private Bag X5 I Tyger Valley 7536 I Email: client.services@glacier.co.za | Tel +27 21 917 9002 I
Fax +27 21 947 9210 I Web www.glacier.co.za | Reg No 1999/025360/07 I Licensed Financial Services Provider
Glacier Management Company (RF) (Pty) Ltd is a registered and approved Manager in Collective Investment Schemes

This document is intended for use by intermediaries. The information contained in this document has been recorded and arrived at by Glacier Financial Solutions (Pty) Ltd in good faith and from sources believed to be dependable, but no representation or warranty, expressed or implied, is made as to its accuracy, completeness, or correctness. The information is provided for information purposes only and to assist the financial intermediary to submit an investment proposal to the client and should not be construed as the rendering of investment advice to clients.

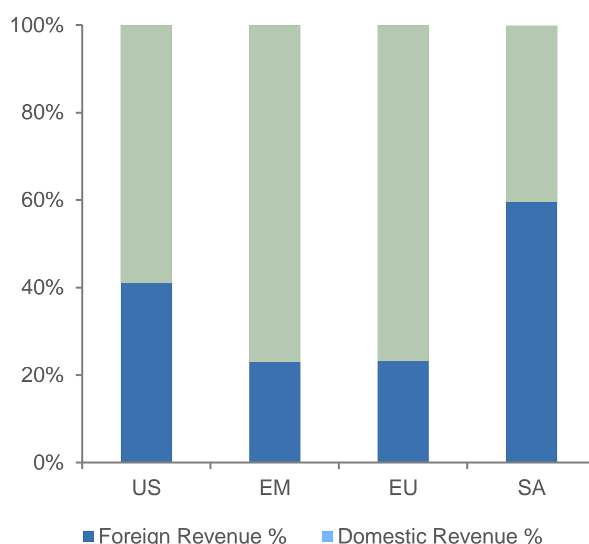
It is often perceived that SA companies can only structurally grow their earnings through the revenue they derive from the domestic economy. The reality is that companies listed on the Johannesburg Stock Exchange (JSE) do not rely only on the local economy for their fortunes. A look at the revenue exposure of JSE listed counters reflects that the market is less domestically focused than other exchanges across the globe (Figure 2). As a result, the local equity market is not as exposed to South Africa's economic woes as one might expect. However, there are companies - commonly referred to as "SA Inc." - where local economic factors do have a significant impact on financial performance because they derive most of their revenue within the borders of the country. SA-specific catalysts are essential for investors to become more constructive in sectors such as Banks, Telecoms, Retailers and Consumer Services.

Figure 1: Primary drivers of equity return



Analysis covers the period 31 December 2006 to 31 December 2023; Annualised return.
Source: FactSet, Terebinth Capital

Figure 2: Revenue split of companies by regions



Latest company disclosure for listed companies in the United States, Emerging Markets, Developed Europe, and South Africa
Source: FactSet, MSCI, Terebinth Capital

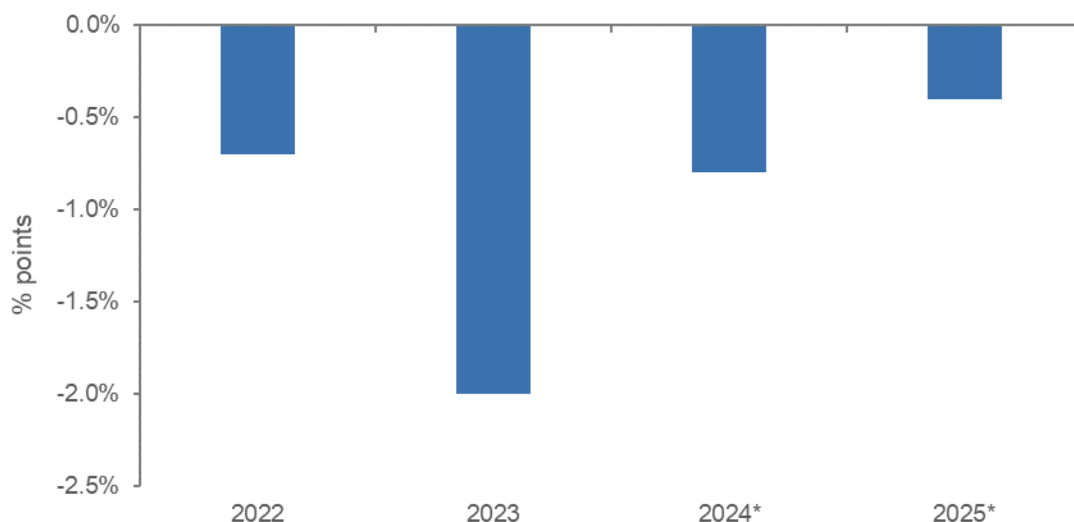
What can catalyse a structural re-rating in SA inc.?

SA companies need the domestic energy crisis to improve. The drag on SA's GDP from higher stages of load shedding is significant and was most visible in 2023 (Figure 3). Frequent and prolonged electricity outages prevent businesses, industry, and households from functioning optimally.

The 2023 reporting period of many JSE listed companies, particularly SA Inc., highlighted this negative impact on company earnings. The impact stretched from high capital expenditure bills for backup generators, and higher diesel running costs, to lost sales during load shedding. Some of these costs are passed onto the consumer, despite an environment where disposable incomes did not have much of a buffer to begin with.

Investing in the grid is critical to stabilising SA's electricity supply and meeting the growing demand for electricity. Energy reforms were prioritised under Operation Vulindlela and several milestones have been achieved. These include the procurement of new generation capacity and a pipeline of private sector generation projects that continue to increase. Renewable energy capacity expected to come online is encouraging: the South African Renewable Energy Grid Survey estimates that 18 GW of projects are in advanced development. In the near term, these should deliver some improvement. Unfortunately, the process is gradual, but a step in the right direction.

Figure 3: Estimated direct impact of loadshedding on GDP



**Analysis from the SARB uses estimates for 2024 and 2025*
Source: SARB

The green shoots on the electricity front are being offset by failings in another critical infrastructure area. The poor performance of South Africa's freight logistics system is now the most important constraint on growth after the electricity shortfall. The decline in rail freight volumes, with firms switching to road and air freight, is weighing on SA companies' domestic operations and adds to their operational costs.

The National Logistics Crisis Committee (NLCC) has been formally established, with its goals being to improve the operational performance of freight rail and ports, restructure Transnet, and modernise the freight transport systems to ensure efficiency and competitiveness. While this is a positive step, it is likely going to take some time before it bears fruit, therefore prolonging the logistics challenge and its impact on domestic companies.

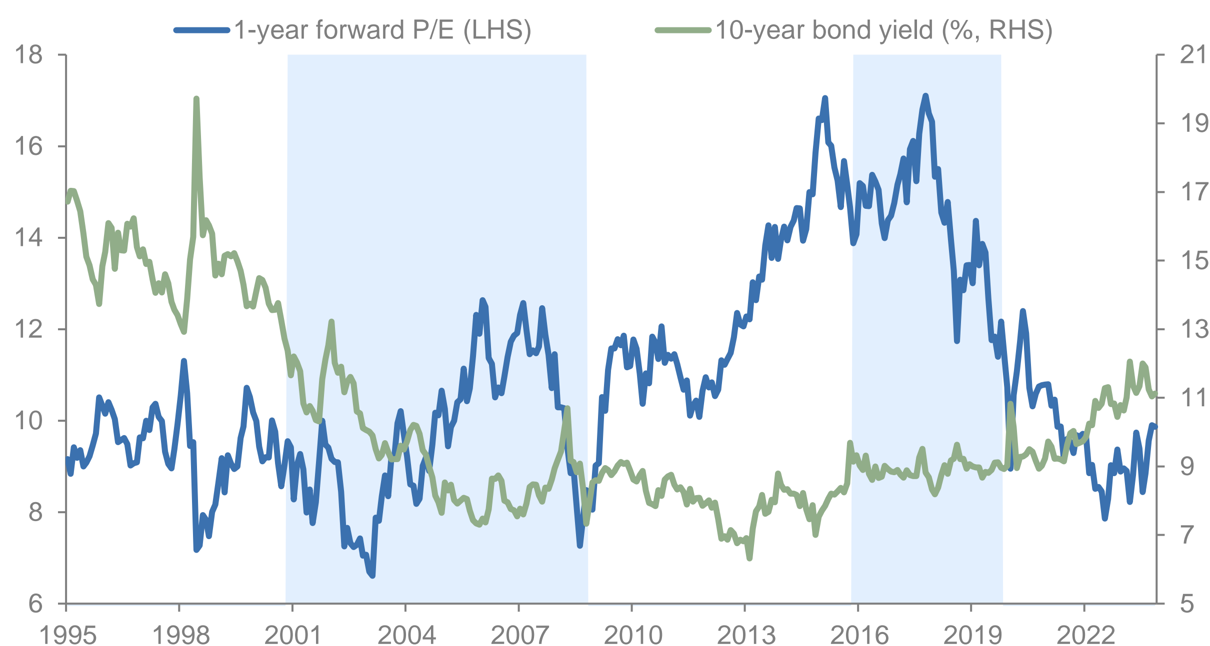
This year's elections may be slated to be the most competitive since the end of apartheid. It is widely expected the results will provide more evidence of the ANC's inexorable decline, but the party will probably be able to cobble together a coalition with minor rivals and thus retain power. President Cyril Ramaphosa is considered an asset for the ANC. He may be the first ANC President to finish two terms in office until 2029, accelerate structural reforms, and assist with the ANC's succession plan. Since 2000, SA equities have always recorded positive returns (average returns of >20%) in an election year, albeit with a weak first half performance in the run-up to the elections.

More than global risk-on needed for a sustained re-rating

Equity markets are cyclical in nature and the SA equity market is no exception. During times of great fortune and exuberance the market will ascribe higher ratings (higher P/E or a lower discount rate because of a lower risk premium - proxied by South Africa's 10-year bond yield). The opposite can be observed when the economy/equity markets are experiencing great difficulties.

The SA equity market has experienced notable shifts in its rating and discount rate over the past 30 years (Figure 4). From 1995 to 2000, low structural ratings were reflected in high discount rates and low P/E as the uncertainty of economic policies implemented by a new ANC-led government led to nervousness in the markets. The early 2000s were a mix: they saw the commodity boom, which fuelled economic growth and provided a boost to the profitability of mining and resource companies. In addition, there were positive spillovers from the terms of trade boost to income and house prices, which led to lower interest rates and stronger credit growth. This led to a positive re-rating but ended with the GFC in 2008–2009.

Figure 4: South African forward P/E ratio versus 10 year bond yield



Analysis plots the PE against the Bond Yield

Source: Iress, JP Morgan, Terebinth Capital

South Africa remains a small, open economy that is affected by global developments. A constructive global backdrop of easy monetary policy and rebounding commodity prices was good for the SA economy, with a higher rating ascribed to domestic equities between the periods 2009 to 2015 (Figure 4). However, the rating started to deteriorate from 2016 amid lower commodity prices, domestic "state capture", and lower potential growth. This derating continued through Covid alongside an increase in the discount rate.

The current starting point seems low from a valuation perspective given the P/E (9.89 times) and bond yields (11.1%). Improving global market sentiment, with investors adopting a more risk-on stance and seeking higher

returns, can lead to an increased demand for SA equities, resulting in a positive re-rating. Key global considerations include: US growth/Fed outlook; US elections; China growth/markets; commodity market outlook; and easing geopolitics. A US soft landing, which was more likely at time of writing, or an accommodative monetary policy stance would be conducive for EM equities to experience a positive re-rating.

The SA equity market's valuation provides an attractive starting point relative to other emerging markets. Globally, a soft landing in the US alongside a cyclical recovery in China would be supportive of sentiment. However, in the absence of an acceleration in structural reforms, the domestic market may continue to underperform. A national election result that raises expectations of enhanced structural reform of SOEs would be paramount in driving an internally driven structural re-rating.

Glacier Research would like to thank Ann Sebastian and Athenkosi Mjebeza for contributing to this week's *Funds on Friday.*

Ann Sebastian
Head of Equities and Senior Portfolio Manager
Terebinth Capital

Ann joined Terebinth Capital as Head of Equities from STANLIB Asset Management where she held the title of Senior Portfolio Manager. Her investment capabilities cover the management of listed local and global equity, property, and local nominal and inflation linked bonds, as well as Reg 28 compliant high- and low-equity multi-asset funds. In her previous role, she was the lead Portfolio Manager on multi-billion active equity portfolios, where she consistently achieved top quartile returns. Her experience in portfolio management and research includes the utilisation of best-of-all principles approach using fundamental, macroeconomic, quantitative and data principles in fund management. Ann holds a Master of Science in Statistical Sciences from the University of Cape Town. This follows the completion of a BSc Honours in Advanced Mathematics of Finance and Bachelor of Science in Mathematical Sciences from the University of Witwatersrand..

Athenkosi Mjebeza
Equity Analyst
Terebinth Capital

Athenkosi joined Terebinth Capital from PSG Wealth and previously worked for Kagiso Asset Management – now known as Camissa Asset Management – and Sanlam. He has a master's in investment management from the University of Cape Town and an honours in finance from the University of the Western Cape. As an equity analyst he is responsible for assisting with portfolio management and conducting fundamental research. His focus is on interrogating stock selection considering a bottom-up and top-down, communication of findings, recommendations and assist in expanding the process.