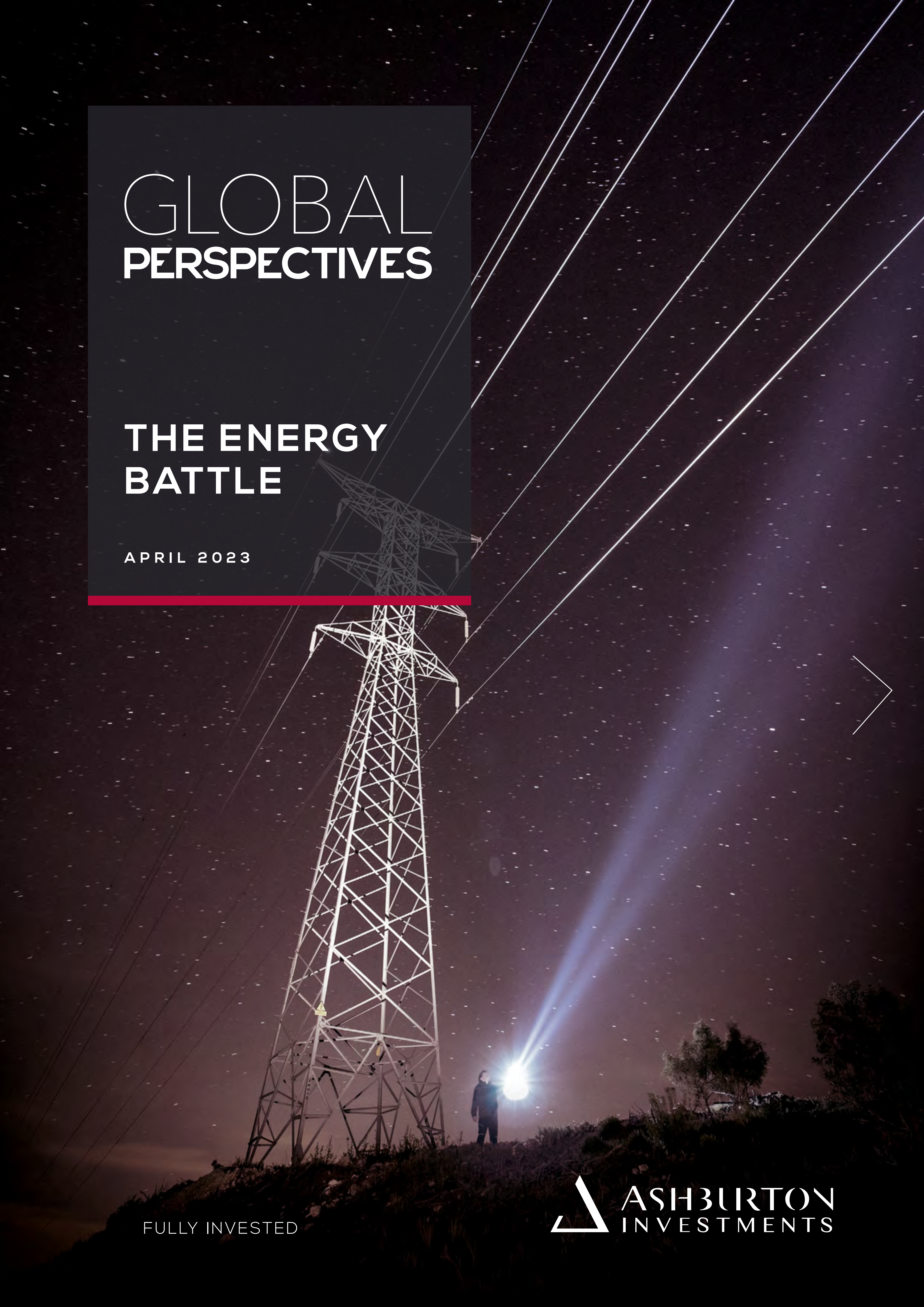
GLOBAL PERSPECTIVES

THE ENERGY BATTLE

APRIL 2023



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ASHBURTON INVESTMENTS

IN THIS ISSUE /

DUZI NDLOVU
Chief Executive Officer

LET'S GET TO GRIPS WITH LOAD-SHEDDING

INTRODUCTION

Load-shedding is like that renegade family member who disrupts holiday get-togethers, keeps borrowing money from friends and acquaintances, and shows no sign of changing his ways.

LIKE THE REST OF THE WORLD, SOUTH AFRICA IS TURNING TO RENEWABLES AS THE SOLUTION.

While parents, siblings, aunts and uncles have tolerated this behaviour in the past, the situation has now become so untenable that it's time for an intervention.

South Africa is just such a battered family, and load-shedding is the troublemaker, dragging down the country's economy.

Fortunately, we've started to see some concerted movement of late to rein in the troubled power utility, and a few green shoots are emerging around private power production. However, such is the complexity of the Eskom system and model, that even this raises issues for the future.

In this issue of Global Perspectives, we set out to unpack the Eskom load-shedding crisis from different perspectives, including exploring the damage that the deteriorating energy supply has inflicted on the economy. Towards the end of March, the FNB/Bureau for Economic Research Survey affirmed in hard data what the person in the street already knows in their gut, that South African consumer confidence has dropped. This is a direct result of the power crisis, coupled with rising inflation and the rising cost of living. Finance Minister, Enoch Godongwana, slashed South Africa's economic growth forecast for the year due to the load-shedding factor and according to the RMB/BER Business Confidence Index business confidence is notably lagging.

South Africa is not alone in battling an energy crisis. Kathy Davey explains in her contribution that the world is seeing ever more expensive energy costs which are absorbing a relatively high proportion of the consumer basket – around 7.5% in the United States (US).

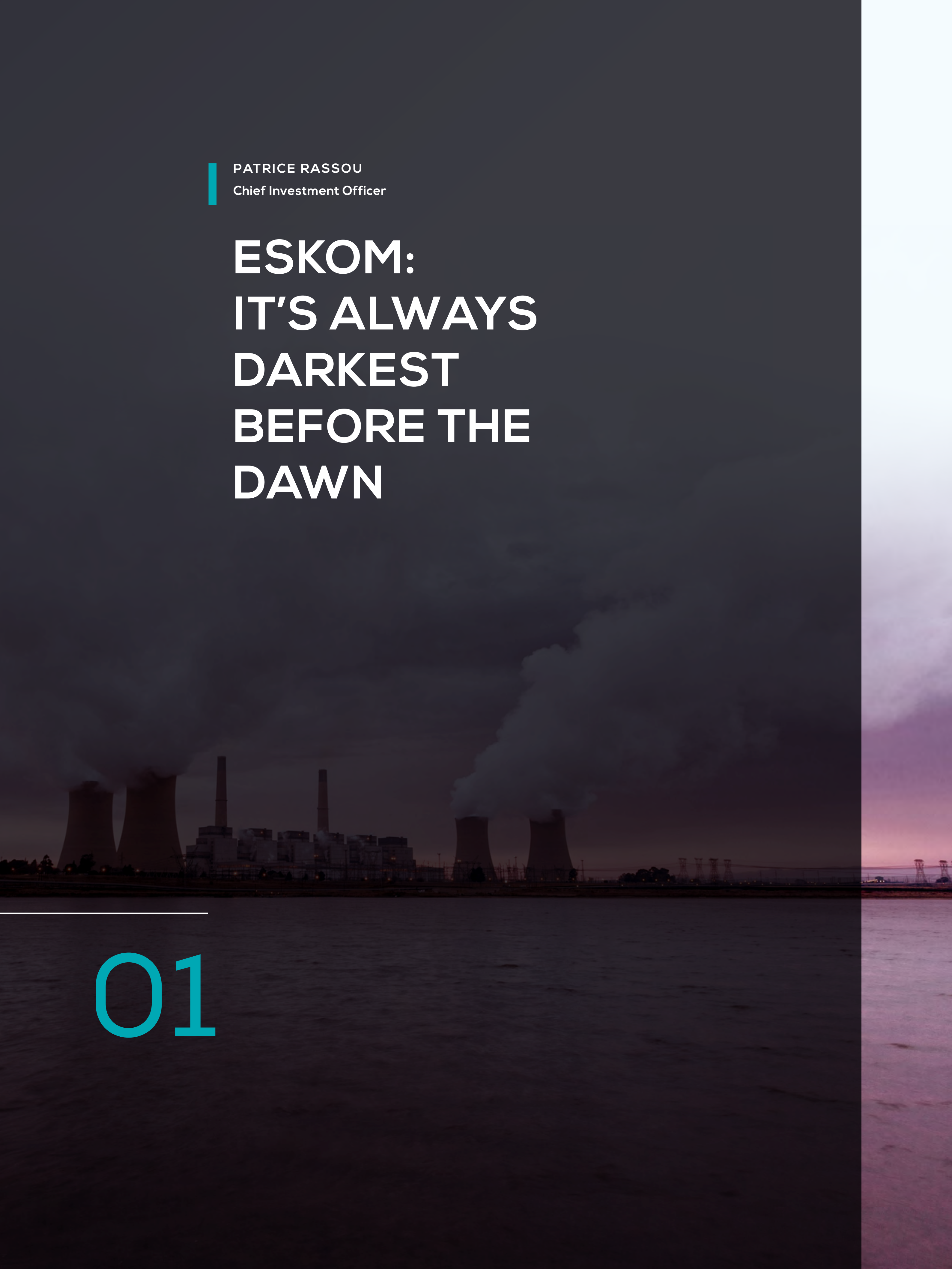
Like the rest of the world, South Africa is turning to renewables as the solution, but Santhuri Thaver poses an important ethical and social question about overlooking our country's staggering inequality in our pursuit of a long-term solution. As she writes:

"It is well noted and accepted that improved environmental outcomes do lead to social justice, but this tilted approach is more appropriate for a developed country."

Luresha Chetty looks at the impact on big, listed companies and how they are responding to the need to keep their lights on while keeping a close eye on the bottom line. Turning to one specific sector, Lesiba Ledwaba goes into more detail about the response from shopping centres and malls, while noting how the office sector is seeing more employees returning to the workplace to avoid power cuts at home.

Albert Botha asks some questions about the impact on Eskom's future bottom line, considering the shift by corporate South Africa towards self-generation and the concerted effort being made by the City of Cape Town as well. But we ask, what happens when Eskom runs out of paying customers?

Finally, in his in-depth contribution, Patrice Rassou tells us that in 2001 Eskom walked away with a 'power company of the year' award. The logical response to this: How the mighty have fallen. And yet, there are still opportunities to be had.



PATRICE RASSOU
Chief Investment Officer

ESKOM: IT'S ALWAYS DARKEST BEFORE THE DAWN

01

IN 2022, WE SUFFERED

157

EQUIVALENT DAYS OF LOAD-SHEDDING.

Incredible as it seems now, Eskom was awarded the 2001 "power company of the year" award at the Global Energy Awards – high praise for a company which, at that stage, was providing more energy per capita than any other power utility in the world, at one of the lowest rates.

How things have changed! Eskom's prices have more than trebled in the last decade and its erratic power supply is now costing the country billions a day.

Still, there is light at the end of the tunnel. Changes in legislation have effectively shifted South Africa's power generation landscape.

But let's backtrack a little and take a good hard look at where we are now and what we are dealing with.

THE CRUMBLING MONOLITH

Eskom, established in 1923, is a vertically integrated utility operating 30 power stations, 14 of which are coal-fired, and 16 of which use gas, nuclear, hydroelectric or pumped storage.

Coal-powered stations last only about 40 years, on average, and with Eskom's inability to maintain its facilities, we have seen a steady deterioration in performance.

Last year unplanned outages exceeded the number of planned ones with the average unplanned outage being three times the length of planned ones, adding further to grid instability. Labour action by Eskom workers and allegations of sabotage have not helped the situation. The two newest coal-fired stations, Kusile and Medupi, also suffer from design flaws.

Despite these challenges, the state-owned power producer still has an aggregate generation capacity of 46 466 Megawatts (MW).

Eskom also has 33 000km of transmission lines across the grid and serves close to seven million households and businesses via its distribution business.

It generates almost 45% of all electricity produced on the African continent and emits 42% of South Africa's total greenhouse gas emissions.

In the recent budget, National Treasury cut its growth forecast for 2023 from 1.4% to 0.9% – largely a result of the impact of load-shedding on the economy. In the final quarter of 2022, our gross domestic product (GDP) declined by 1.3%, also largely attributable to load-shedding. The country's economy is now smaller than it was pre-Covid, despite our population having grown by some two million.

The adverse effect on businesses and households is increasingly crippling. For instance, shopping centres are spending an additional R500 000 to R1 million per month in fuel costs to keep the lights on. In heavy industry, we are also witnessing growth capital expenditure being diverted to projects to source alternative energy sources. In addition, the Energy Availability Factor (EAF) for the country dropped from 76% in 2016 to under 50% – the first time this has occurred – as the graph below shows.

FIGURE 1:

THE WEEKLY ENERGY AVAILABILITY FACTOR (EAF) IN SOUTH AFRICA FROM 2016 TO 2022

Source: CSI

SHOULD WE EXPECT MORE POWER CUTS?

In 2022, South Africans suffered through 157 equivalent days of load-shedding, compared to a cumulative 152 equivalent days over the previous 15 years.

We are well on track to break this ignominious record in 2023. Also, in the past 15 years, stage one or two load-shedding was the norm, but in 2022, for the first time, most of the country's load-shedding comprised stage four to stage six events.

At stage two, the country needed to save 2000MW, but at stage four it needs to save 4000MW, equivalent to the entire capacity of Medupi. The increased intensity of moving from stage two to four has translated into far more power interruptions. While the country used to have an average of six two-hour power cuts over four days, we now have an average of 12 such cuts in the same period. Industries such as mining are shielded from load-shedding up to stage four but have no protection beyond that level.

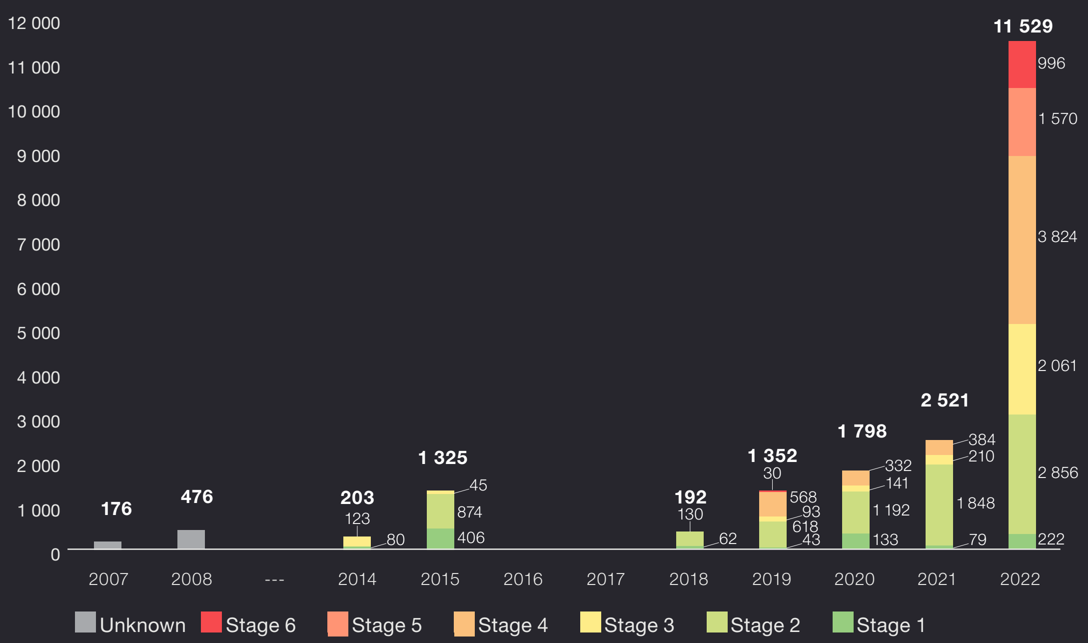


FIGURE 2:

INCREASES IN LOAD-SHEDDING FROM 2007 TO 2022

Source: Council for Scientific and Industrial Research

To make matters worse, Eskom expects to close six of its coal-fired power stations in Mpumalanga by the end of the current decade. These represent 11 000MW – about a quarter of its current generating capacity. It is therefore essential that Kusile and Medupi, which cost a combined R380 billion to R300 billion over the original budgeted costs, become fully operational.

STEPS TO CURB THE ROT

Government has taken several steps in an attempt to bring some relief to embattled South Africans. In this year's budget, Finance Minister Enoch Godongwana announced a R254 billion debt relief package for Eskom for the next three years. Eskom had already been issued R350 million in government-guaranteed debt relief, but since the parastatal has not had the financial wherewithal to invest in maintenance or transmission capacity, it has seen its debt balloon to unsustainable levels since 2005.

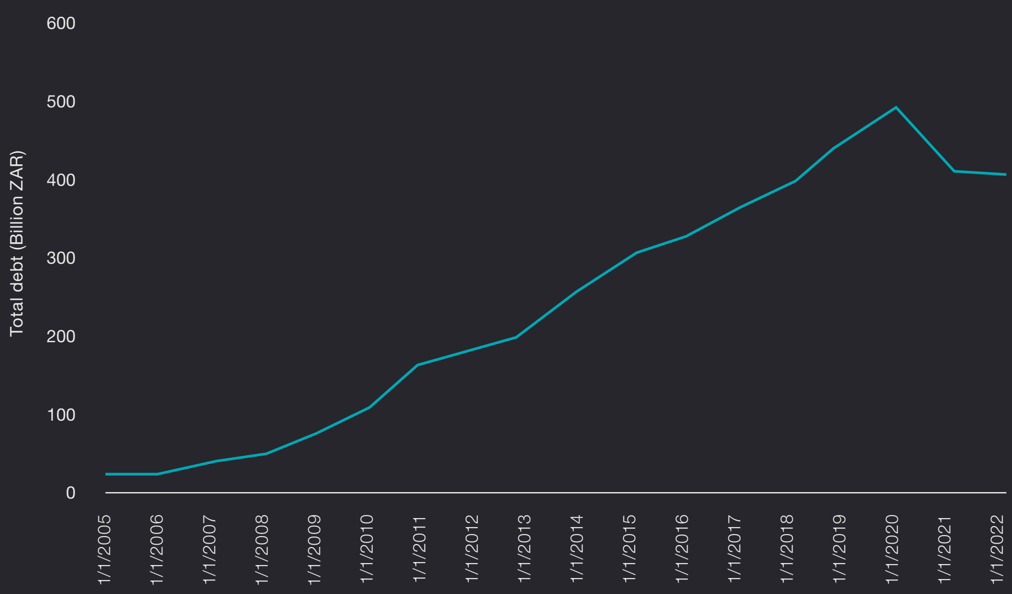


FIGURE 3:

ESKOM'S DEBT FROM 2005 TO 2022

Source: Bloomberg

Another positive move has been the appointment of an international consortium to recommend measures for improving the operational efficiency of Eskom's coal-powered stations by the middle of this year. This assessment will include a decision on which plants could be resuscitated to their original capacity and then privatised.

In March, President Cyril Ramaphosa created a new Minister for Electricity post and appointed Kgosientsho Ramokgopa, who will be responsible for tackling load-shedding, developing an electricity crisis response plan and coordinating responses across ministries.

THE LANDSCAPE FOR ENERGY PRODUCTION IS EFFECTIVELY CHANGING; ESKOM WILL BECOME MORE OF A DISTRIBUTOR, WHILE THE PRIVATE SECTOR WILL BE RESPONSIBLE FOR NEW POWER GENERATION.

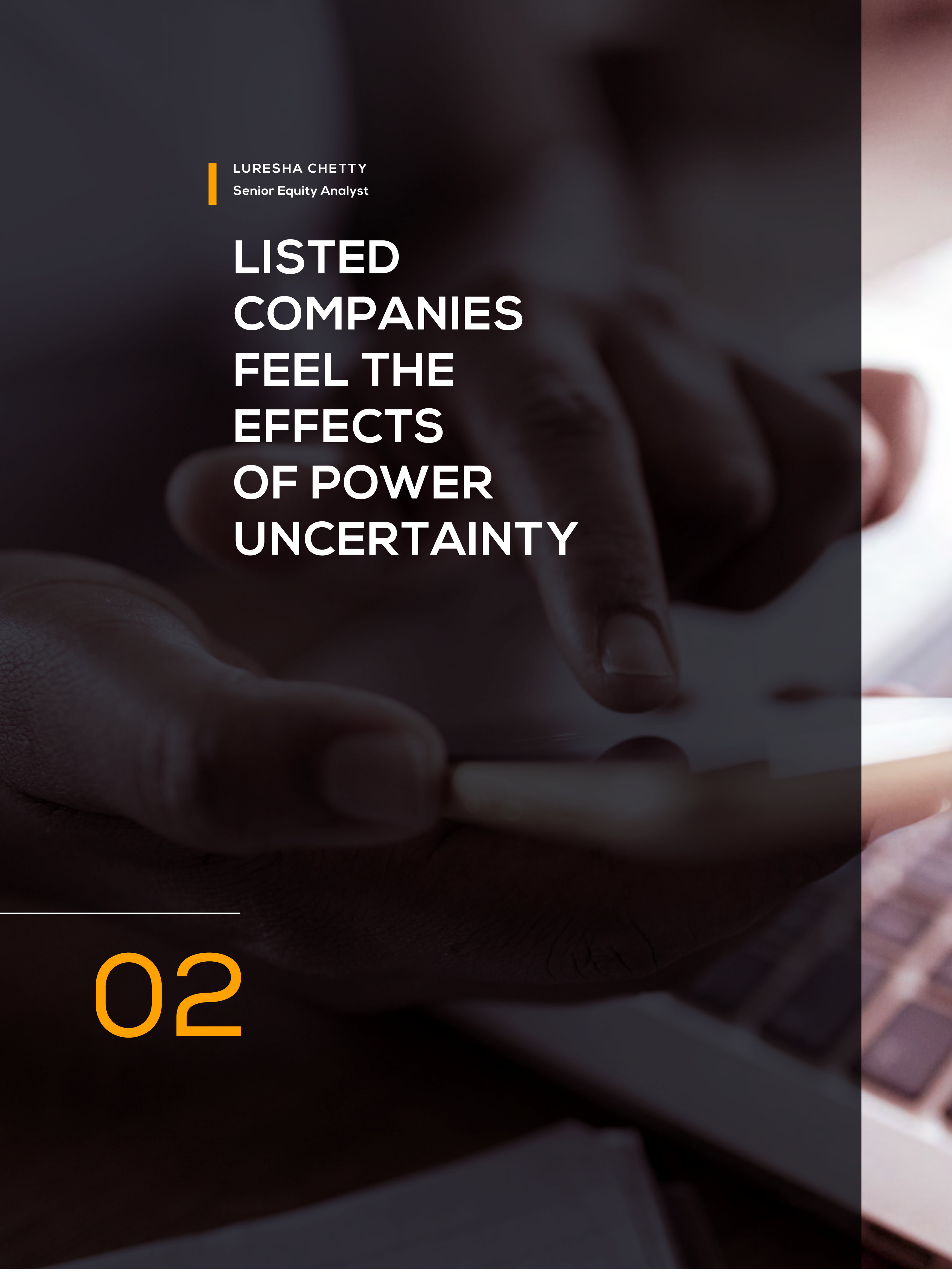
Also on a positive note, in 2021 government raised the licensing threshold for embedded generation projects from 1MW to 100MW. By removing the need to apply for a license and requiring registration only with the National Energy Regulator, government is hoping to drive the green energy build programme.

Last year, green energy increased to 7% of the mix, increasing its energy output by 50% over the past five years. It is, in fact, the first time that coal has fallen below 80% in our energy mix. This year alone, some 70 private sector projects with a combined output of 5000MW are planned. Government is also providing incentives for households to install solar photovoltaic (PV) panels, with individuals now being able to claim a tax rebate of 25% of new panels, up to the value of R15 000. The future of power is decentralised with smart grids. Corporates will be allowed to claim tax deductions of 125% of renewable energy investments brought into use for the first time over the next two years. This, of course, presents a risk for many municipalities whose principal source of revenue is from electricity sales.

It is always the darkest before dawn – and most South Africans have been yearning to see the light at the end of the Eskom tunnel. There are, of course, challenges ahead. The supply shortage of some 6000MW will have to be addressed through several interventions, and unplanned outages will have to be reduced. Renewable energy procurement will need to be stepped up to fill the energy gaps, but with the proliferation of independent power producers, this could well be manageable.

The landscape for energy production is effectively changing; Eskom will become more of a distributor, while the private sector will be responsible for new power generation. In 2018, some 2200 MW was procured via Bid Window four and a further 6800MW is planned via Bid Windows five to seven from late 2023. In addition, gas and battery storage capacities are planned.

South African ingenuity always comes to the fore when we have our backs against the proverbial wall. Once again, this will be required to find a lasting solution to our electricity supply problem over the years to come.



LURESHA CHETTY
Senior Equity Analyst

LISTED COMPANIES FEEL THE EFFECTS OF POWER UNCERTAINTY

02

THE TRANSFORMATION FROM RELIANCE ON STATE-PRODUCED POWER TO RENEWABLE AND ALTERNATE SOURCES OF BACK-UP GENERATION HAS BENEFITTED SOME COMPANIES.

From mining to telcos, food producers to retail, the depth of the load-shedding impact on listed companies in South Africa is becoming increasingly evident. Fortunately, there are bright spots.

South Africans have become great event planners. Previously ordinary tasks such as mealtimes, homework and Netflix-and-chill time have become "events" that we plan as we diligently check our load-shedding schedules. We have had to adapt to the intermittent power provision from Eskom's ailing fossil-fuel generation stock. We have seen a similar trend across the Johannesburg Stock Exchange (JSE).

Despite challenges, there have been some bright spots and South African companies have shown resilience.

INTENSIFYING LOAD-SHEDDING IMPACTS

There has been a negative impact across most sectors from the intensifying load-shedding.

The country's gross domestic product (GDP) shrank 1.3% year-on-year in the fourth quarter of 2022, led lower by agriculture and mining. Negative growth across these two sectors is concerning, given their high labour intensity – together, they employ more than 1.2 million people. There is a high risk that continued production inefficiencies will lead to cost-cutting and job losses.

Mining and pharmaceutical companies are somewhat insulated at load-shedding stages one to four, however, during stages five and six these companies are not immune to the load reduction measures. The higher stages of load-shedding during the last quarter of 2022 added to the logistics challenges experienced by the coal and iron-ore producers, translating into a 3.2% decline in mining industry output for the period. Other industries are more fully exposed to rolling blackouts.

Mobile network operators and the food supply chain have also been hard hit, both of which have a direct impact on the lives of South Africans.

MOBILE NETWORK OPERATORS HARD HIT

Telco operators face increased diesel and maintenance costs as they run backup generators longer than expected. They have also incurred additional security expenses to secure their alternate sources of power generation at tower sites. Network towers are reliant on electricity supply to operate, and network availability declines as load-shedding intensifies. Telkom noted an increase of 154% in diesel costs and consequent higher roaming costs in their interim result. This contributed to a 17% reduction in EBITDA (earnings before interest, taxes, depreciation and amortisation). Telkom's network availability drops as low as 70–75% during stages five and six.

MTN's operations in South Africa have also experienced a negative impact on the group's topline and costs owing to load-shedding, which reduced the EBITDA by R695 million in 2022, or 3.5%. MTN plans to deploy longer-life batteries and power generation sets to critical sites during the current year. However, this additional capital expenditure was not part of their previous capital allocation programme. Consumers will need to brace themselves, as all three telcos' operators are set to increase prices in the current year to recoup additional power-related costs.

TOUGH TIMES FOR THE FOOD VALUE CHAIN

Tiger Brands, the owner of Albany bread and several other South African staples disclosed a R27 million additional cost to run back-up generators, partially offset by investments into alternative power in prior years and some local advantages, in the four months ending 31 January 2023. Despite these benefits, Tiger Brands is guiding to R1.5 million in load-shedding costs per day at stage six.

Chicken producers Astral and RCL Foods have been battling higher feed prices since 2022 and rising cost inflation. The situation has intensified with higher stages of load-shedding. Astral reported chicken production costing R2/kg above the selling price and being unable to pass on the cost inflation to consumers, who are already under pressure due to high cost-of-living increases. Astral's share price is down 20% over the past six months. RCL Foods spent R96 million in direct load-shedding associated costs for the six months to December 2022 to keep chicken production and bakeries operational. All three companies – Tiger Brands, Astral and RCL Foods – have plans for longer-term backup generation from renewables.

Further down the value chain, the country's retailers are also finding it hard to deal with the erratic electricity provision. Retailers entered the high trading month of December 2022 amid record levels of load-shedding, which started in the fourth quarter of 2022 and persisted into the first quarter of 2023.

However, not all retailers are impacted equally. Those with perishable offerings are far more reliant on a stable supply of electricity, suggesting a higher cost. As tenants, and not owners of their floor space, retailers face challenges in trying to invest in their own renewable backup power generation at many stores. Shoprite spent R560 million on diesel to run generators in the six months to December 2022. Pick n Pay's recent trading update guided for an approximately R60 million increase in costs per month on diesel to run generators for the same period.
These additional direct costs and indirect increased product wastage costs reduce profits and cash returns to shareholders.

SOME LIGHT IN THE DARK

Despite the gloom, there are bright spots. The transformation from reliance on state-produced power to renewable and alternate sources of backup generation has benefitted some companies. While the latest bid windows (five and six) for renewable energy procurement have experienced challenges, the removal of the 100MW licensing threshold has spurred growth in private sector projects for renewable energy generation.

Media reports note that the National Energy Regulator of South Africa received just over 1000MW collectively, mostly solar power registrations, in February 2023. This is an encouraging figure given that it received only 1664MW for the entire year in 2022.

Additionally, distribution networks owned by Eskom and municipalities require investment to unlock further solar and wind power from key renewable energy locations, to where it is consumed.

SECTORS BENEFITING FROM RENEWABLES EXPOSURE

In the midcap sector, Reunert and Hudaco have outperformed the JSE All Share Index in the year-to-date, increasing 10% and 7% on a relative basis, respectively. Reunert has exposure to turnkey renewables solutions and electrical cables used in electricity distribution. Hudaco's sales have benefitted from the importation of renewables components, batteries and generators for both residential and commercial use.

In the larger cap space, Bidvest has also made the most of the opportunity, commenting on exponential renewable energy growth in the six months to December 2022. Similarly, banks will benefit from private sector credit extension, as many private renewables projects and some projects from bid windows five and six reach financial close.

Our unloved and forgotten construction sector has seen an increase in requests for renewable project pricing from the private sector, and their order books have seen some benefits. WBHO is investing in an additional precast concrete manufacturing facility for components for the wind energy sector. Energy infrastructure now contributes approximately 20% of WBHO's South Africa order book. As a labour-intensive sector, the construction sector is poised for increased activity in renewable energy projects, with wide-reaching positive second-round effects and social benefits.

MEDIA REPORTS NOTE THAT THE NATIONAL ENERGY REGULATOR OF SOUTH AFRICA RECEIVED JUST OVER

1000MW

COLLECTIVELY, MOSTLY SOLAR POWER REGISTRATIONS, IN FEBRUARY 2023.

WHERE TO FROM HERE?

The outlook for power security remains uncertain, with negative consequences expected for the entire economy. The additional costs and capital expenditure required to reduce reliance on the national grid appear to be part of the new reality for SA companies. Unfortunately, these costs are likely to increase in 2023.

Energy-related costs, coupled with rising interest rates and inflation, currency volatility and logistics bottlenecks, are a burden for local companies. However, with Eskom tariffs likely to increase by double digits over the next few years, and renewable energy component costs declining, those companies investing in sustainable and reliable alternative sources of energy will benefit from both predictable operations and reduced energy costs in the long run.

At Ashburton Investments, we remain focused on implementing our investment process, which relies heavily on bottom-up valuation and scenario analysis.

We are still finding value in some local companies. Companies, with attractive valuations despite the local headwinds, which are also nimble enough to adjust to the current operating environment and others which can benefit from opportunities brought about by the power disruptions.

LESIBA LEDWABA
Property Portfolio Manager

ENERGY CHALLENGES, OPPORTUNITIES FOR PROPERTY OWNERS AND LISTED PROPERTY COMPANIES

03

ON THE UPSIDE FOR RETAILERS, ESPECIALLY THOSE IN NON-URBAN CENTRES, LOAD-SHEDDING HAS INCREASED FOOTPRINT IN SOME SHOPPING CENTRES.

Expect margin contractions as load-shedding sustains the pressure on tenants. Although a switch to renewables may offer the best long-term solution.

Over the past couple of years, the listed property sector has withstood quite a few challenges which have caused plenty of volatility in share prices and led to a derating of the sector.

Covid-19 was especially difficult to navigate, but thankfully most of its challenges are now behind us. A huge bump in the road to recovery was the civil unrest of July 2021, along with localised flooding in KwaZulu-Natal in April 2022. The Russia-Ukraine war threw another curveball at global markets, leading to high inflation and an increase in interest rates.

The sector has shown resilience in the face of these challenges, evidenced by continued recovery in its market capitalisation and the FTSE/JSE SA Listed Property TR benchmark. However, prices and absolute dividend levels have not yet fully recovered to pre-Covid levels. The big challenge on everyone's lips now, of course, is load-shedding.

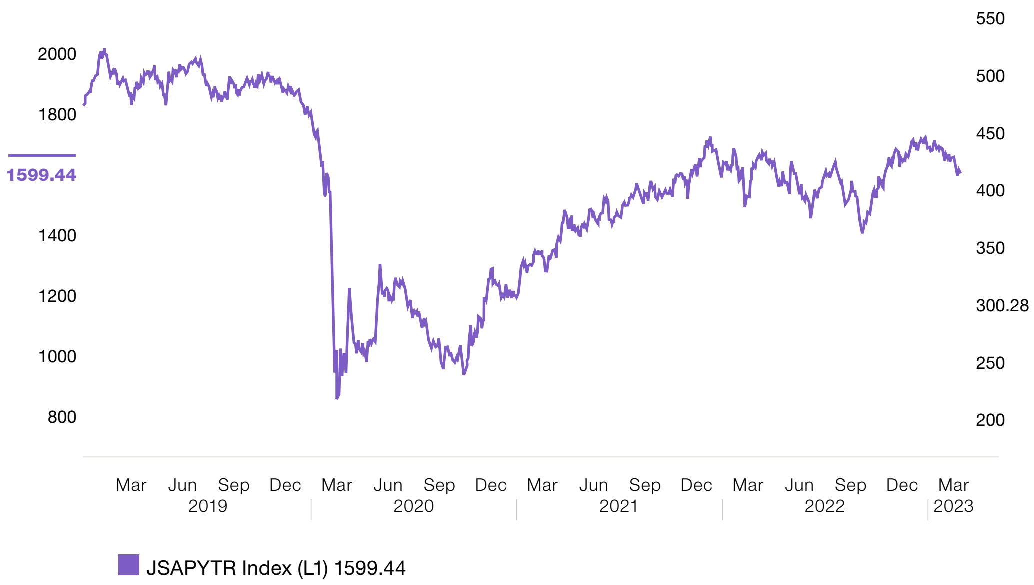


FIGURE 1:

PERFORMANCE OF THE FTSE/JSE SA LISTED PROPERTY INDEX (2019-2023)

Source: Bloomberg

According to the Council for Scientific and Industrial Research, South Africa experienced 3 773 hours (157.2 days) of load-shedding in 2022, a 223% increase over the 1 169 hours of disruption recorded in 2021. The report noted that 2022 was also the first year in which most load-shedding came in at stage four, rather than stage two. December 2022 alone was subject to more load-shedding than any other year.

So far in 2023, this high-intensity load-shedding has continued.

The impact on the economy and the sector is undoubtedly negative. In January 2023, the South African Reserve Bank (SARB) downwardly revised its gross domestic product (GDP) forecast for 2023 to 0.3% and 0.7% for 2024 partly as a result of extensive load-shedding. Listed companies have recently been reporting eye-watering costs related to increasing diesel consumption as they grapple with the energy crisis. The cost of low-sulphur diesel in rands per litre increased by about 35% in 2022.

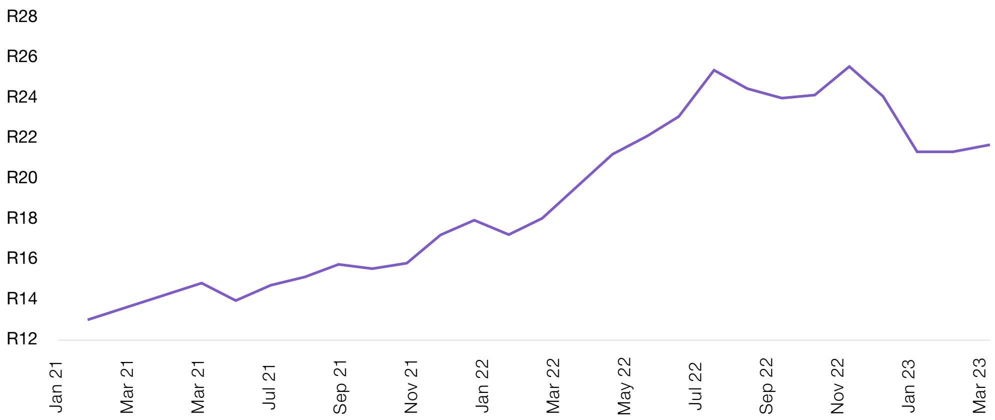


FIGURE 2:

COST OF LOW-SULPHUR DIESEL PER LITRE

Source: Automobile Association South Africa

Coupled with higher fuel consumption as load-shedding intensifies, these snowballing costs will lead to some degree of margin contraction or negative impact on profitability.

One sympathises with small- and medium-sized enterprises which cannot afford this financial outlay and do not have the luxury of tapping into alternative power sources. Many will end up on the casualty list of businesses that have been forced to shut their doors. The average person on the street will also bear the brunt, as there will be an attempt to pass on these costs to consumers.

Apart from the financial consequences, the increasing collective reliance on diesel generators will increase carbon emissions as the energy consumption mix shifts away from renewables in the short term. Unfortunately, this will undo some of the progress made in addressing South Africa's environmental sustainability.

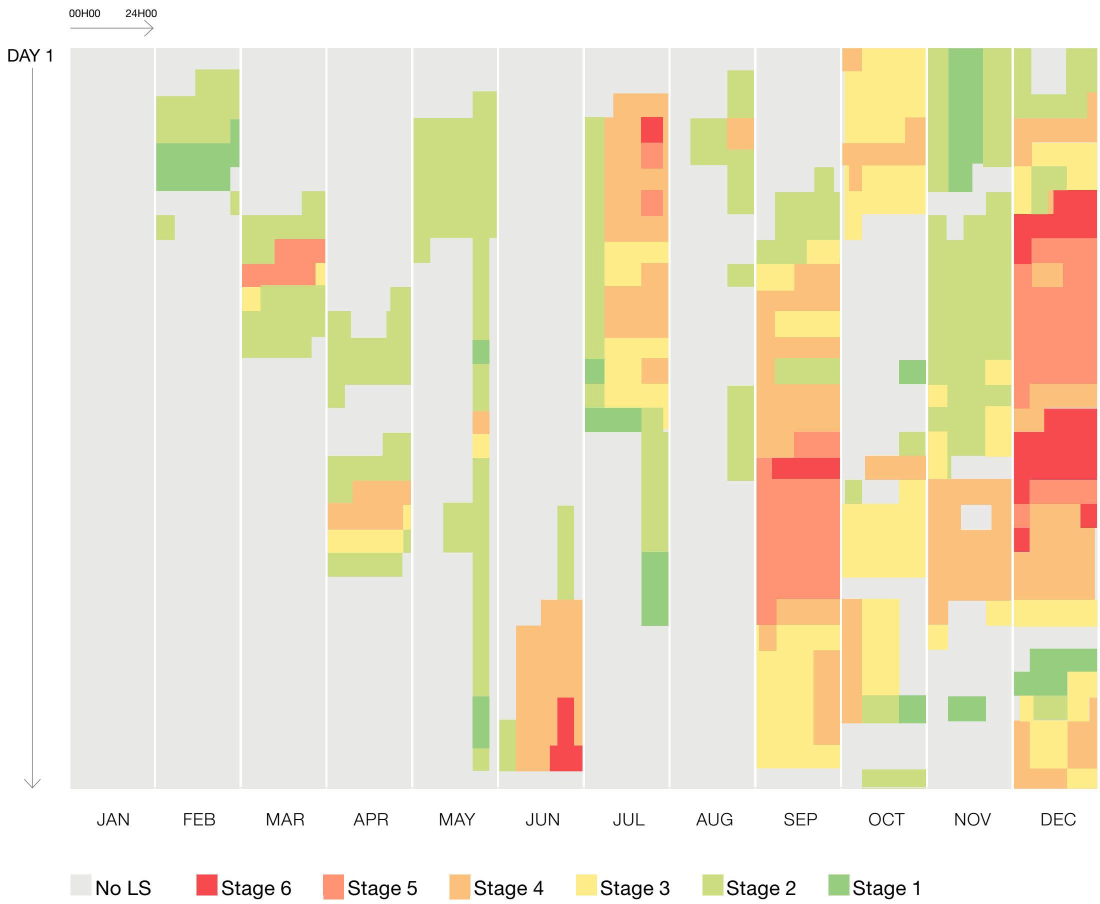


FIGURE 3:

HOURLY DISTRIBUTION OF LOAD-SHEDDING JANUARY - DECEMBER 2022

Source: Council for Scientific and Industrial Research

RETAIL SECTOR BEARS THE BRUNT

In the listed property sector, the largest impact of load-shedding is likely to be felt in the retail sector.

Management teams have indicated that diesel cost recovery rates are around 50%, with non-recovery mostly due to the existence of common areas in shopping centres which are not lettable and therefore generate no revenue. This represents a lower recovery than that of the office and industrial sectors, which achieved higher recovery rates from tenants.

In Hyprop Investments' recent results presentation for the interim period to 31 December 2022, the company reports that the fund's average cost of diesel through load-shedding came in at R8.83p/KWh, compared to the Eskom/local authority cost of R2.44 p/KWh. This high cost is certainly unsustainable.

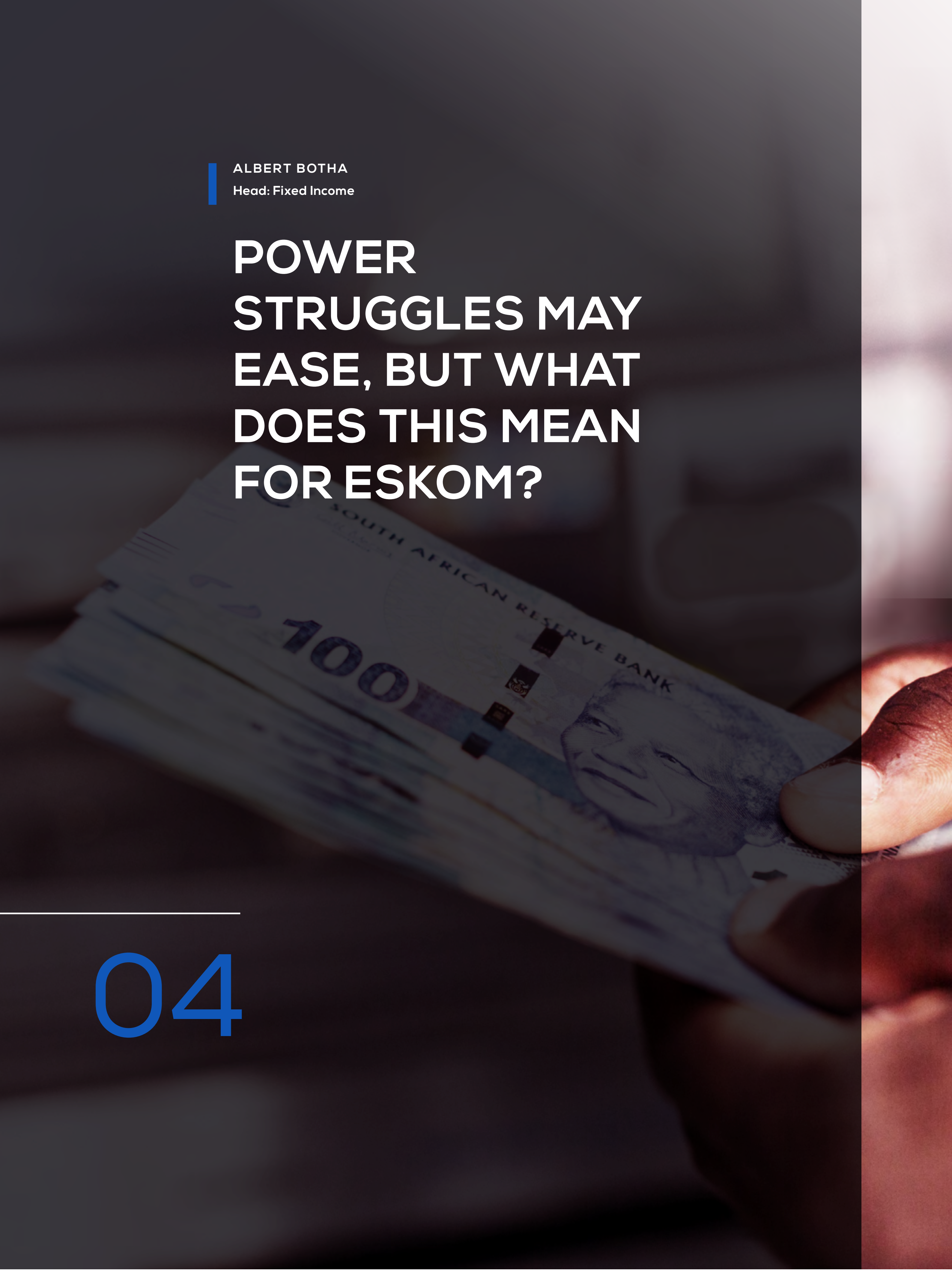
Apart from the negative margin impact, passing on these costs to tenants will lead to an increase in their occupancy costs in the absence of improving trading revenue. Given current macroeconomic headwinds, the growth in trading revenue within shopping centres will be benign and occupancy costs will inevitably rise. This will likely lead to pressure on rental reversions or negotiated rentals at lease expiry, which could reverse some of the improved metrics recently reported. Rental reversions on retail leases remain negative, although to a lesser extent than in 2020.

On the upside for the retail sector, especially for non-urban centres, load-shedding has increased footprint in some shopping centres since these are some of the few places with sufficient energy to remain operational, at least during trading hours. As consumers turn to shopping centres as a respite from the gloom, centre tenants may be able to entice increased sales.

The impact on the office sector, meanwhile, is positive in the respect that offices are no longer standing half empty as staff stream back to the workplace to avoid load-shedding at home. Most office buildings catering for large corporates have backup power, offering a welcome alternative to homes without electricity. Many companies also now require employees to spend more time at the office.

Although the effects of load-shedding are undesirable, the situation presents an opportunity for the sector to reduce its reliance on the grid and fast-track the use of renewables or green energy. More capital expenditure is being allocated to solar projects that offer property owners attractive yields on cost and will be accretive to their earnings in the medium to long term. There will also be cost savings flowing through to tenants, which will provide some relief related to occupancy costs. Property owners and tenants' energy mix will shift away from diesel and towards renewables, which is a much more desirable outcome in the long run.

LISTED COMPANIES REPORT EYE-WATERING COSTS FOR DIESEL CONSUMPTION AS THEY GRAPPLE WITH THE ENERGY CRISIS.



ALBERT BOTHA
Head: Fixed Income

POWER STRUGGLES MAY EASE, BUT WHAT DOES THIS MEAN FOR ESKOM?

04

SOUTH AFRICA'S POWER OUTLOOK IS MUCH BETTER THAN IT WAS ONE YEAR AGO.

Details of the new Eskom debt relief package are good news for independent power producers in the country and have hugely improved our prospects of keeping the lights on in the medium term.

To understand how the debt relief package affects the fiscus and, in turn, all of us, we need to grasp some of government's position when it comes to state-owned enterprises (SOEs).

Some SOEs, such as Eskom and Transnet, are systemically important to the continued functioning of South Africa, while others, like Denel and South African Airways (SAA) are "nice to haves" but are not of strategic importance to the country's very survival. There are also two other types of SOEs – those with guaranteed debt (such as Eskom and SANRAL) and those without guaranteed debt (such as Rand Water).

This gives us four types of SOEs in South Africa, which we can view in light of where they fall in a matrix, as shown below.

	Guaranteed debt	No guarantee
Systemically important	Eskom SANRAL	Rand Water
Non-systemic	SAA	Denel

Knowing where an SOE falls in this matrix helps us to understand how the various market participants view SOE debt and its impact on the fiscus. Given the strategic importance of Eskom, its explicit guarantee and the complications that would result from an Eskom debt default, few market participants would not view Eskom's contingent liability as part of the state's debt load. Eskom and the state have been joined at the hip for years.

This is quite evident when you consider that the announcement of the debt-relief package has had no noticeable effect on our bonds. South African government bond yields are trading below the average for second half of 2022, and the spread relative to the US 10-year for our local 10-year is similarly lower. This does not mean that the 2023 Eskom-National Treasury deal is without consequences.

The details of the debt package contain both capital and interest repayments totalling R254 billion over the next three years. There are, however, provisos.

- Eskom is prohibited from building new generation capacity – it must focus on transmission, distribution and maintenance
- All sales of assets must be used for debt relief
- No new borrowing from 1 April 2023
- Debt relief is to be used only for the settlement of existing debt and interest payments
- No remuneration adjustment is allowed that negatively affects its financial position

In essence, all new power generation is in the hands of the private sector, and Eskom is on the road to being primarily a distributor of electricity. This new direction of travel is one of the strongest indicators that the state is being forced to confront the weakness of its centralisation of production and control strategy.

THE COMPLEX WEB OF PRIVATE POWER PRODUCTION

Being given free rein and the prospect of an uncertain energy future, the private sector and households have jumped at the opportunity to increase their energy independence. Not a week goes by without an announcement of another power project initiated by some corporation.

In early March, the City of Cape Town (CoCT) released numbers showing that 10% of all solar installations since January 2018 were implemented in the first two months of 2023.

WHAT HAPPENS TO ESKOM WHEN IT RUNS OUT OF PAYING CUSTOMERS?

FORTUNATELY, THIS HAS BEEN CONSIDERED.

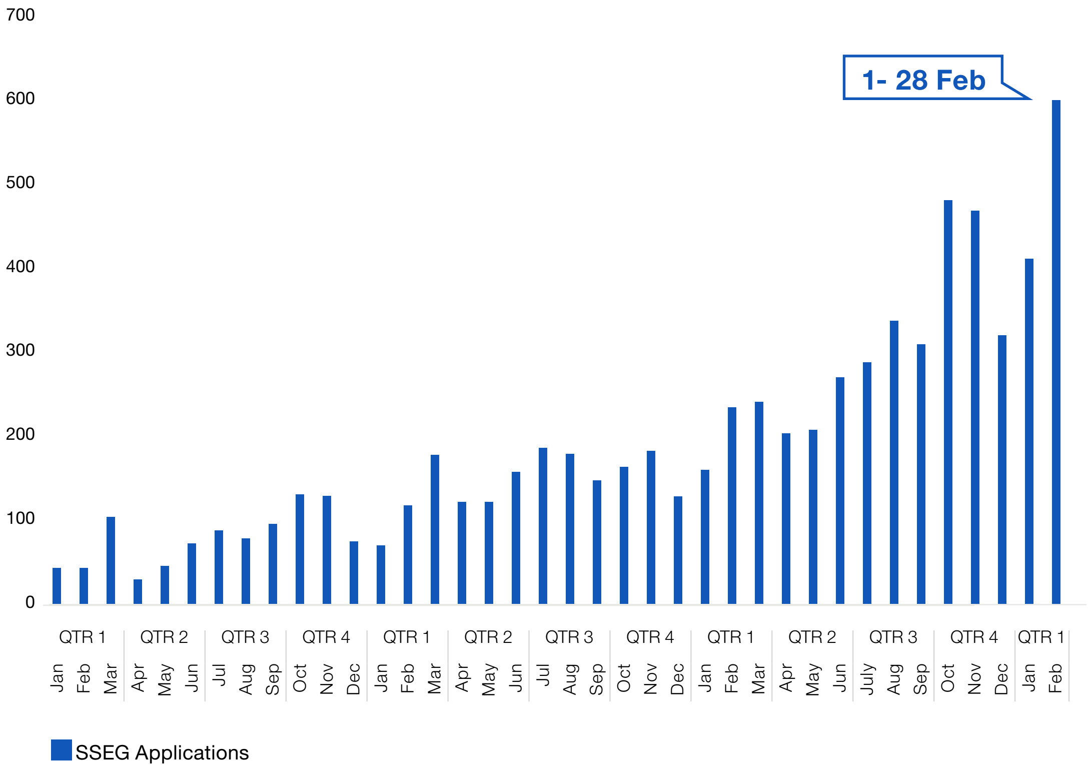


FIGURE 1:

SOLAR INSTALLATION APPLICATIONS IN THE CITY OF CAPE TOWN (2020-2023)

Source: City of Cape Town

SSEG key stats

- SSEG commissioned **= 5078**
- SSEG applications received **= 9700** (since 2018)
- SSEG 2023 applications so far **= 1040 (1 March 2023)**

SSEG applications

- Experiencing exponential growth
- Majority of application are **residential**
- Majority of installed capacity is **commercial**

This, of course, is great news for the medium-term power outlook in the country, as the less power Cape Town and the large corporations need, the more power becomes available for the rest of the country – or so you would think. However, things are not always as simple as they seem.

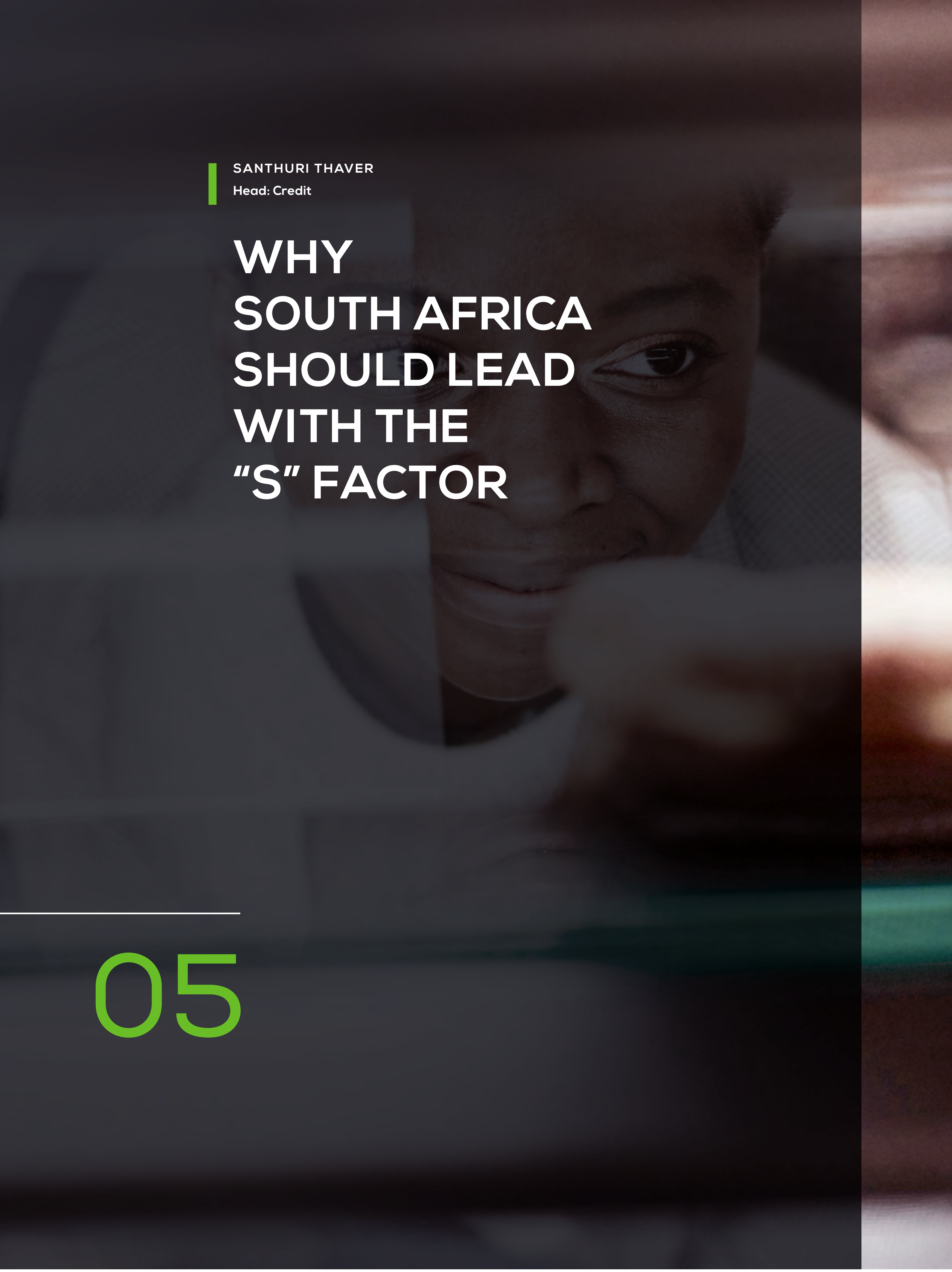
Eskom's accounts show that its best payers, who buy directly from the parastatal, are the CoCT, Anglo American, BHP, Sasol, other large miners and corporations. They have no debt outstanding, they pay promptly and without the need for encouragement. Looking five to 10 years ahead, one can easily see that the balance of users paying Eskom for power will shift away from these prompt-paying entities towards those who have historically caused Eskom's accounts department headaches. Between the Free State and Mpumalanga alone, 26 municipalities owe more than R30 billion.

This begs the question: What happens to Eskom when it runs out of paying customers? Fortunately, this has been considered.

As Eskom moves from a generation to distribution and transmission entity, it will make money the same way that municipalities have for years. Most municipalities have been making a large portion of their annual revenue from the on-sell of power they buy from Eskom. As an example, the CoCT has an annual revenue budget of R48.8 billion, of which R16.1 billion (33%) is from electricity sales. So, what does Eskom's move to distribution and transmission mean for the viability of municipalities?

As both Eskom and the CoCT shift towards increased independent power generation, this model is still viable. City of Cape Town's budget is safe as they are now able to make similar margins from residential and corporate power producers, and the same could be true for Eskom if transmission and distribution is properly maintained and developed.

South Africa's power outlook is much better than it was one year ago. There is a viable path forward, with a more decentralised model and fewer catastrophic failure points. It did take a crisis to get us here, but you know what Britain's war-time prime minister, Winston Churchill, used to say: "Never let a good crisis go to waste."



SANTHURI THAVER
Head: Credit

WHY SOUTH AFRICA SHOULD LEAD WITH THE "S" FACTOR

05

THE MULTIPLIER EFFECT OF CREATING A SINGLE JOB MEANS THAT THE INCOME OF JUST ONE EMPLOYEE HAS THE POTENTIAL TO UPLIFT MANY LIVES.

South Africa's official unemployment rate in the fourth quarter of 2022 stood at 32.7%, according to Statistics South Africa. If you include discouraged job seekers, this sobering statistic rises to a staggering 41%.

Africa's most advanced economy currently holds the global title of being the most unequal society in terms of income distribution. One would thus expect a spotlight on social outcomes when considering ESG (Environment, Social and Governance) factors. Why then is the Social or "S" factor so overlooked in the local context?

Social considerations include how a counterparty interacts with its employees, clients and wider stakeholders. Part of the challenge in addressing these matters is the wider and undefined arena. How a company's social footprint impacts society and how this can be measured is challenging versus more clearly defined and quantifiable environmental outcomes.

One can argue that it is easier to measure a targeted reduction in carbon emissions or reduced water usage versus an improvement in the quality and health of your workforce or how a product may be received by target markets. It certainly is easier to build a power plant than address the gender pay gap.

There is, however, a measurable and easily quantifiable social outcome to address the inequality within the country and reduce the risk of social upheaval, and that is job creation.

TO FOCUS ON ENVIRONMENTAL OUTCOMES AT THE COST OF SOCIAL IMPACT WOULD NOT BE APPROPRIATE IN OUR CONTEXT.

ONE JOB IMPROVES MANY LIVES

The multiplier effect of creating a job speaks to the ability of one income to uplift many lives. Anecdotally, I recently made an online purchase and was pleased to receive a complimentary Khayelitsha Cookie. Khayelitsha Cookies creates one meaningful job for every 1000 cookies sold per day, employing previously unemployed women from informal settlements in the greater Cape Town region.

These women are taught to bake and are provided with a food safety-accredited factory. This reduces the level of unemployment faced by women, with the income providing independence and the ability to support at least five dependents. A real-life example of the multiplier effect.

EVERY COMPANY HAS A ROLE TO PLAY

To address the high unemployment levels in South Africa, Ashburton Investments have partnered with the National Treasury Jobs Fund through our Impact Funds, the first initiative of its kind in the southern hemisphere to provide a measurable positive impact on society through investments that support job creation targets. Since the first fund inception in 2015 and the second in 2018, our Impact Funds have successfully delivered financial returns in excess of its benchmark of CPI +3% along with social outcomes.

Over 17 000 local permanent jobs have been created to date exceeding 100% of the target, with jobs created weighted towards underserviced provinces and black African females who remain the most vulnerable in terms of unemployment. In addition to the above, investments have unlocked funding to small-medium enterprises (SMEs) via intermediaries and which traditional fund providers considered risky, enabling the growth of this sector.

WHAT MAKES THE 'S' IMPACT SO IMPORTANT?

Employment not only increases economic output but also reduces social disorder. The ability to earn an income, provide for oneself and dependents gives humans much-needed dignity and improved quality of life. While the impetus towards addressing climate change is noble and which has our support, it is important to recognise that the solution for a developing country cannot only be based on developed metrics. A developed country is not plagued by the social inequalities facing Africa, parts of Asia and South America. South Africa remains afflicted by the effects of apartheid. The focus on environmental outcomes at the cost of social impact is not appropriate in our context.

The ESG factors are playing an increasing role in investment decisions. As primary allocators of capital, the ESG analysis should be embedded in the fabric of an investment process as an overarching framework. Ultimately a sustainable investment creates greater and more stable returns for investors over the long term.

Governance is the glue that holds environmental and social considerations together, without this foundation, the E and S factors will likely fall by the wayside. Environmental and social considerations, however, should not and cannot always receive equal weighting and are bespoke to externalities.

Integration of ESG in an investment process is not black or white and should not be mistaken for an outright rejection of an investment scoring low on any factor but rather used as a tool to highlight the increased risk profile which could be mitigated for. A company with a high environmental footprint may be one of the largest employers in the country, but the latter cannot be ignored. ESG is a journey, an outright decline or an immediate divestment is unlikely to achieve the economic and social impact that could result from being an agent of change. It is a journey that investors need to walk with counterparties to effect change for good.

A CASE IN POINT: GREEN SOUTH AFRICA

In 2022, we saw a rise in the South African listed credit market issuance in terms of green, social and sustainability-linked instruments, with R17.6 billion issued, up 29% on 2021 issuances. This is positive, however, research from Standard Bank Credit shows that green bonds dominated this area with 64% issued. The investment industry has supported these instruments in both the listed and unlisted credit markets. It is positive to see momentum in this space and we continue to engage with issuers around business as usual versus stretch targets to achieve environmental goals with greater positive impact and introduce more social goals.

Our intention is not to say that we should neglect a cleaner, greener future, it is well noted that improved environmental outcomes do lead to social justice, but this tilted approach is more appropriate for a developed country. Below two degrees Celsius, green energy, decommissioning of the coal industry, and so forth, are concerns of the privileged and cannot be considered in isolation locally. A hungry nation teeters on the edge. If people are starving, the level of clean energy generated does not matter. Let us focus on the greatest positive economic and social impact in a measured manner for the benefit of all South Africans. In the words of Hubert Humphrey: "There is no such thing as an acceptable level of unemployment, because hunger is not acceptable, poverty is not acceptable, poor health is not acceptable, and a ruined life is not acceptable."

KATHY DAVEY
Investment Manager

A TWO-PRONGED APPROACH TO ENERGY INVESTMENT

06

ENERGY COSTS ARE A RELATIVELY HIGH PROPORTION OF CONSUMER EXPENDITURE, MAKING UP JUST OVER 7% OF THE US CONSUMER PRICE INDEX BASKET.

The face of global energy supply is shifting as renewables attract increased attention and oil and gas continue to experience underinvestment. Yet, right now, we see value in investing in both sources of energy.

It is hard to believe that nearly three years ago, oil producers ran out of space to store the oversupply of oil left by pandemic shutdowns and were forced to pay buyers to take barrels they could not store. The recent spike in global energy prices makes this event a distant memory. Recently, energy prices reached five times what they were at that point.

The strong global economic rebound following the Covid-19 pandemic led to a rapidly rising demand for energy, which was compounded by underinvestment in the production of oil and gas. These commodities make up almost 60% of primary energy consumption globally. Underinvestment in the oil and gas sector has been ongoing for several years. However, 2020 saw a particularly huge drop in global investment – 35% in US dollar terms. No doubt this was a direct result of the uncertainty surrounding the Covid-19 pandemic and its implications for the industry.

To compound the situation, Russia's invasion of Ukraine in February 2022 resulted in a further increase in energy prices, as Russia is a major exporter of energy fuels. Energy prices have dropped since the peak in the second half of 2022, but remain elevated, as shown in the chart below.

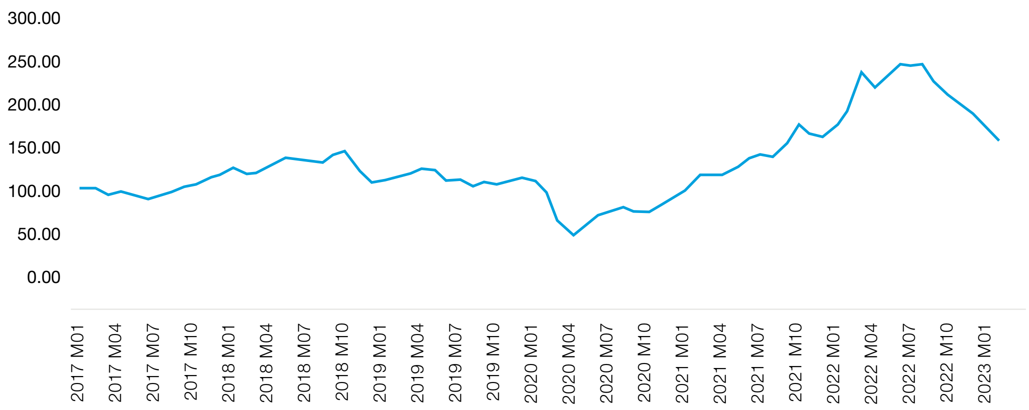


FIGURE 1:

GLOBAL ENERGY PRICES FROM JANUARY 2017 TO JANUARY 2023

Source: World Bank

The war in Ukraine has highlighted that energy security is of paramount importance in a world where geopolitical tensions are on the rise. However, we need to be cognisant that this has not been the sole factor driving energy cost inflation.

The global community has not invested enough in renewable or clean energy sources to meaningfully slow down our reliance or investment in hydrocarbons without risking an energy crisis in the process.

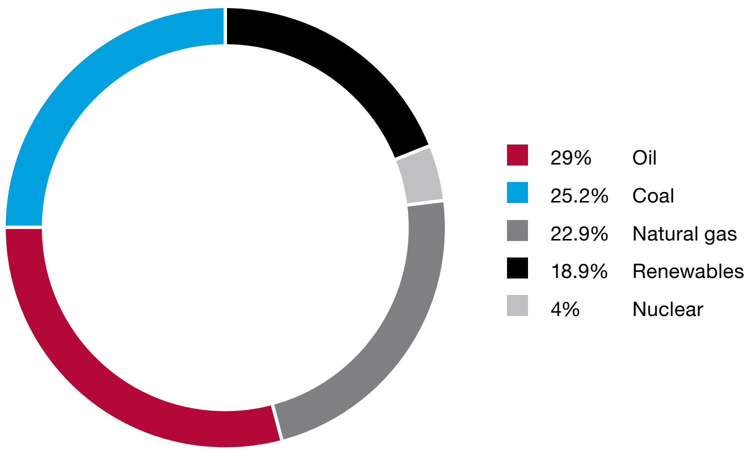


FIGURE 2:

GLOBAL PRIMARY ENERGY CONSUMPTION BY SOURCE (2021)

Source: Our World in Data

RIPPLE EFFECTS

High energy prices have both a direct and indirect effect on inflation. We feel the direct effects of energy inflation in heating, cooling, cooking and mobility. Indirectly, the costs of goods and services increase where energy is an input into the final product. Energy costs are a relatively high proportion of consumer expenditure, making up just over 7% of the US consumer price index basket. They have therefore contributed meaningfully to the overall high levels of inflation we have seen globally, as the chart below indicates.

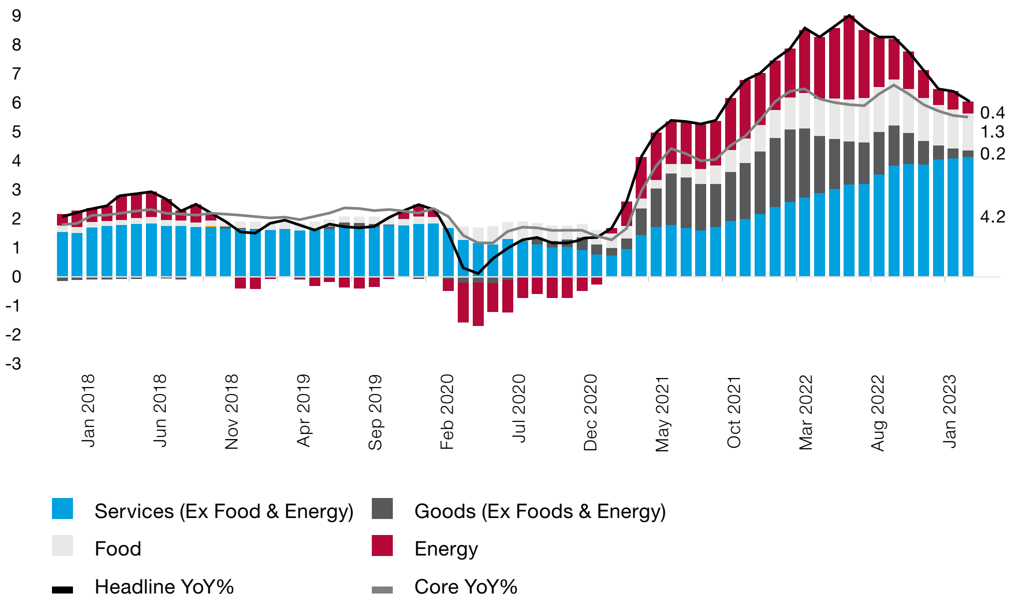


FIGURE 3:

FACTOR CONTRIBUTION TO OVERALL US CONSUMER PRICE INFLATION (2018-2023)

Source: Bloomberg

LOW GROWTH EXPECTED

Inflation has a negative effect on global growth, as it erodes household purchasing power, thereby reducing economic activity. The World Bank has reduced its global growth forecast from 3.0% to just 1.7% in 2023. This lower prediction is a direct result of inflation, along with the tighter monetary policy. Rising energy costs have a profound effect on the global economy. Hence why central banks around the world are increasing interest rates, a measure taken to reduce currently elevated levels of inflation.

THE WAR IN UKRAINE HAS HIGHLIGHTED THAT ENERGY SECURITY IS ALSO OF PARAMOUNT IMPORTANCE IN A WORLD WHERE GEOPOLITICAL TENSIONS ARE ON THE RISE.

PROMOTION OF CLEAN ENERGY

On the positive side, the crisis has encouraged the introduction of new policies by countries and regions such as the US and Europe, with the intention of speeding up investment in renewable energy. The goal is to reduce energy costs and encourage local production of renewables to improve energy security.

On 16 August 2022, US President Joe Biden signed the Inflation Reduction Act into law. This is the most significant commitment that US Congress has taken with regard to promoting clean energy to date, with planned investments also aimed at lowering energy costs for families and small businesses. The new policies announced will support energy efficiency too, which will play a large role in reducing overall household energy costs.

The Act should go a long way in promoting the use of renewables in the US, the world's second-largest energy consumer after China.

It offers new tax credits and deductions to homeowners who introduce energy-efficient home upgrades such as heat pumps or better insulation. It also offsets the cost of residential clean energy sources such as solar panels and battery storage and gives rebates for energy-efficient retrofits and the electrification of home appliances.

Biden's Inflation Reduction Act has been successful in attracting global investments which might otherwise have gone to other countries. For instance, electric vehicle (EV) manufacturer Tesla had planned to produce batteries at its Berlin car plant in Germany, but the EV maker recently changed course and has now prioritised US production as a direct result of tax incentives in the new Act. Management at Volkswagen (VW)* have also recently reported that they are considering the US as a location for their next cell factories. For Europe to remain competitive, it needs to introduce similar incentives.

* Ashburton Investments owns VW as part of the Ashburton Global Leaders Equity Fund

LOOKING AHEAD

Our expectation for 2023 is that energy prices will remain at somewhat higher levels, owing to dynamics in the oil sector which will support oil prices this year.

We believe the effect of a weaker global economic environment on oil demand will be negated by the re-opening of China after a severe Covid-19 lockdown, growth in India and continued increase in global travel. However, we do not expect energy costs to be as inflationary as they were last year, which should offer some respite for households.

Looking beyond 2023, it is encouraging to see world powers being proactive and making more meaningful investments in clean energy and energy efficiency. If successful, we have a much greener future to look forward to, one characterised by lower energy costs and usage.

FOR INVESTORS

For investors, we believe opportunities in energy lie in a two-pronged approach. Investing in hydrocarbons and renewable energies are not mutually exclusive – we see value in both. Underinvestment in the oil and gas sector is likely to keep oil prices at levels where producers generate decent cash flows thereby offering attractive investment opportunities. Growing investment in renewable energies makes this sector attractive too, although we find that the future growth potential is often already priced into share prices here. Better returns may be realised by looking at a broader range of companies that will benefit from the green energy transition, for example, electrical companies.

The world needs to transition to low-carbon fuels, no doubt. But as we have recently witnessed, this needs to be done in a measured way to avoid future energy crises and further punitive energy costs.

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