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South Africa – A Cautious Stance

Our specialist Emerging Markets investment partner, Northcape Capital, recently revisited South Africa, their first visit since before the COVID pandemic. Here the team examines the country's current political, social and economic challenges, and why Northcape retains a zero exposure to the nation, despite its 3.5% weighting of the Emerging Markets index.

This information has been prepared by Northcape Capital, the underlying investment manager for the Warakirri Global Emerging Markets Fund.

South Africa, a 3.5% constituent of the emerging markets index, has a long sovereign history dating back to the Union of South Africa in 1910. Modern South Africa began with the first democratic elections in 1994 and the election of Nelson Mandela as president. Well endowed with natural resources, a population of 60 million, US$7,000 per capita GDP, and a stock market capitalised at US$1.1 trillion, yet our portfolio has zero exposure. We recently revisited South Africa, our first since before the COVID pandemic, in line with our research effort to regularly review emerging markets for attractive investment opportunities.

Economic and energy challenges

Inflation is problematic, but at 7% is not deviating materially from global conditions, while the Reserve Bank of South Africa continues to exercise monetary policy independence, raising the cash rate to a recent 7.75% high.

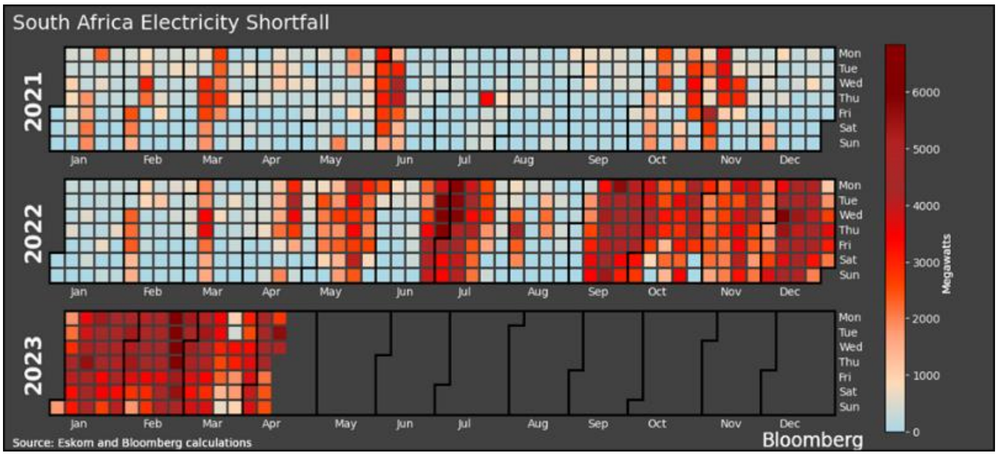
Other challenges include persistent fiscal deficit and a return to deficit for the Current Account, placing renewed pressure on the Rand, depreciating 7% CYTD. The economy contracted at a faster than expected -1.3% in the December quarter, and with GDP expected to have fallen over the March quarter, South Africa is likely already experiencing a technical recession.

South Africa exited COVID benefitting from higher commodity prices on recovering economic activity and spiking energy prices, notably coal and palladium, the latter aided by its crucial role in lowering vehicle exhaust emissions, with South Africa a leading producer. Activity fell away towards the end of 2022, due to falling exports, a result of fading global growth, exacerbated by lower domestic production and infrastructure supply constraints.

South Africa's dysfunctions are increasingly apparent, notably the deteriorating energy market, resulting in nationwide power supply reductions, known as load-shedding, by electricity public utility Eskom. Energy problems led the Reserve Bank of South Africa to reduce forecast annual GDP growth by an astonishing absolute -2%. Load-shedding is an outcome of multiple energy generation failures from the country's ageing coal-fired electricity plants, unable to meet electricity demand.

Measured in Stages (Stage 3 effectively takes out 3GW of energy from the national grid, Stage 7 removes 7GW) load-shedding seeks to better balance supply and demand, to avoid potential system collapse. Eskom's installed capacity is approximately 44GW, yet operational capacity is around half that number, falling well short of an estimated 30GW peak demand. Load-shedding frequency increased over the past decade as Eskom, 90% supplier of South Africa's energy, implemented higher stages in response to worsening electricity conditions (**refer Exhibit 1**).

Exhibit 1: National Daily Electricity Shortfall



(Source: Bloomberg)

Problems jeopardising the fundamental supply of adequate and reliable energy is a litany of at best bad management (underinvestment and poor planning), at worst criminality (vandalism and corruption) over recent decades. Putting the utility's decline in context is Eskom's award for Power Company of the Year at the Global Energy Awards back in 2001. Stage 6 load shedding was implemented in 2022, with up to 6 hours a day of lost electricity supply. More than half of Eskom's power plants are over fifty years old and insufficiently maintained. New facilities (Medupi and Kusile plants) have been beset by extensive construction delays and massive cost overruns.

Dissecting Eskom is beyond this brief but rotating through thirteen CEOs between 2007 and 2022 is indicative of a broken enterprise. Former CEO Andre de Ruyter, resigning in December 2022, estimated that around one billion Rand had been being stolen from Eskom each month, with crime and corruption deeply entrenched and highly organised. Disturbingly, De Ruyter made corruption accusations directly at the ruling political party, the African National Congress. Hyperbole? His attempts at combatting organised crime and corruption resulted in being poisoned with cyanide at his office, coinciding unsurprisingly with his resignation.

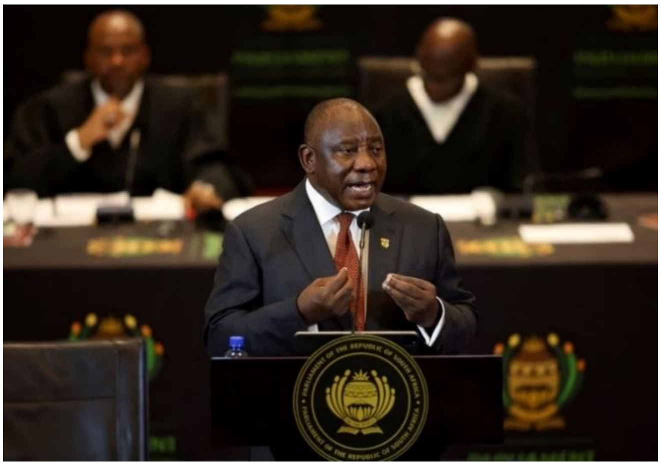
Political and structural problems

Eskom's failings are symptomatic of largely political shortcomings. The ANC party has held absolute rule since 1994, increasingly displaying characteristics of patronage, with unqualified political actors placed in senior cabinet and public sector positions, contributing to an erosion of governance standards and decision-making paralysis. Current president Cyril Ramaphosa (**refer Exhibit 2**) while perceived as an improvement on the prior Zuma presidency, is not action oriented and is compromised in his ability to enact direct change due to the blurring of ANC and government authority. Ramaphosa followed the established path to country president by first becoming deputy president of the ANC, and subsequently ANC president. Ramaphosa's cabinet Minister of Mineral Resources and Energy is Gwede Mantashe, also holding the position of ANC National Chairperson. Mantashe was supportive of Ramaphosa's ascendancy to ANC president, potentially compromising the South African president's autonomy.

The government, along with the ANC, faces an existential crisis ahead of the 2024 general election. The central bank's daily cost estimate from lost energy supply is estimated at close to nine hundred million rand (US$50m), with extensive load-shedding and logistical constraints expected to reduce 2023 economic growth close to zero. Economics and politics are bringing social problems to the fore. National unemployment is over 30%, and remarkably youth unemployment more than 60%, a toxic level when combined with elevated inflation, especially in energy and food prices.

Unfortunately, there is no quick fix. Power supply is failing at a faster rate than generation is being added. Over the next few years around 11GW of installed capacity is expected to be decommissioned due to obsolescence. During our meetings with officials and industry representatives, the most optimistic energy solution appears at least two years away, and more likely closer to three years. Ironically the country possesses significant potential solar and wind resources, but meaningful renewables investment has been slow, due to the politics of the dominant coal industry in terms of employment and northeast location, both important sources of ANC support.

Exhibit 2: President Cyril Ramaphosa, 2023 State of the Nation Address



(Source: Reuters)

The ANC approaches the general election next year facing for the first time the probability the party will need to rely on forming a coalition to govern, with polling consistently showing ANC support below 50%. The centrist Democratic Alliance attracts 23% support and if in collation would represent a major improvement in governance via increased transparency and accountability, but its conservative voter base is likely unappealing to ANC supporters.

The Economic Freedom Fighters is a far-left party, led by expelled former leader of the African National Congress Youth League Julius Malema with around 10% support, is not favourably disposed towards either the ANC or DA, whose presence in a coalition government wouldn't be received well by investors. A workable governing coalition is difficult to imagine, given philosophical distances between major political parties, representing significant uncertainty expected to persist well into next year.

Evidence of positive policy initiatives though modest are emerging, with incentives for private sector renewable energy investment allowing households and businesses with rooftop solar panels to sell excess solar power to Eskom an encouraging development (**refer Exhibit 3**).

Exhibit 3: Solar panels - Johannesburg Mall rooftop

(Source: Northcape Capital)

Though more visible, the energy crisis is not South Africa's sole major structural headwind. Transnet, owner of the country's railway, ports and pipelines infrastructure, operates at around half capacity, resulting in foregone valuable national export revenue and corporate sector earnings. Worryingly, the transport dysfunction is a culmination of yet more corruption, incompetence and criminal activity.

Recovery or evolving crisis?

The World Economic Forum warned last year that South Africa risked state collapse, due to record unemployment, high crime rates, unsustainable state spending, mismanaged institutions and corruption. Energy problems are indeed acute, with load-shedding in place to reduce potential grid failure, and though grid collapse risk is low, if an outage occurred, could last from days to weeks and according to Eskom, risk looting, vandalism and public unrest. More prosaic, but equally relevant for investment consideration, is the economy's decelerating growth trend since 2008, from 5% to less than 1% currently.

A key observation is the political nature of the social and economic challenges. South Africa has confronted structural problems in the past, successfully implementing necessary reforms, notably in 1994 when policy makers identified around a dozen problems requiring policy fixes.

Critically all reforms were endorsed as urgent by then President Mandela, and by 2001 the country had returned to fiscal surplus and regained its investment grade rating. South Africa now faces another 1994-type crisis. Is the political leadership of the calibre, integrity, and does it attract the following of a statesman such as Nelson Mandela? Mandela's image and admiration remain omni-present in South African society.

South Africa also possesses noteworthy structural positives. The corporate sector is financially solid, possesses quality management and consists of numerous businesses generating high returns on capital. The financial sector and capital markets are well regulated and function soundly. The South African Reserve Bank, Treasury and judiciary remain independent and robust, while the media appears independent offering objective coverage. Government debt is typically long dated with minor foreign currency exposure. One must also acknowledge the resilience of the South African people; however, the question remains, have the country's economic prospects degraded to an extent where investment gains are confiscated by poor returns on capital and persistent currency depreciation?

Conclusion

South Africa's political and social landscape is not encouraging, meanwhile flagrant corruption persists, rule of law is at risk of material erosion, and government debt is elevated. Time is not on South Africa's side as global growth slows and the commodity cycle weakens, problematic as close to half the population is supported by the government. Meanwhile the nation's brain-drain from skilled labour emigration persists.

Northcape's zero country portfolio weight is a result of significant sovereign risk identified and discounted in South Africa's high cost of capital exceeding 20%, reflecting the firm's disciplined investment process applied to capital investment in emerging markets.

For more information, please contact us on 1300 927 254 or visit warakirri.com.au