INTUITION
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The Case for SA

Two weeks ago, Willie shed light on the SA economy, highlighting the benefit that we have enjoyed from buoyant commodity prices and the importance of reform to improving the outlook for growth. As I write this, we are mired in Stage 6 loadshedding, hardly conducive to economic growth and improving business sentiment. Yet, as dark (literally) as it is, we believe that the base is being laid for better times ahead. This article will reiterate some of the points from our recent Insight seminar and argue the case for not giving up on SA equities just yet.

SPEED READ

- **The SA economy has performed better than expected recently, thanks to commodity windfalls and resilient consumer spending.**
- **Higher rates of growth in the future rely on the implementation of reform. We believe this is gaining traction, despite headlines to the contrary.**
- **Loadshedding epitomises the worst of times, yet in it lie the seeds of hope.**
- **SA equities are almost as cheap as they have ever been – hardly pricing in a golden future, or even a future at all!**

Two weeks ago, Willie outlined some of the factors at play within the SA economy. Buoyant commodity prices have reaped an export windfall, which has propped up government spending. Consumer spending has been remarkably resilient, thanks to overall debt levels that are well under control (relative to historic standards), and fixed investment is improving. Willie articulated the upside from a successful reform program – the potential for SA to raise its growth rate from 1.5% per annum to 3.5% - 4.5% per annum. That is significant and would be a game changer for local investors. But given that I write this in the shadow of Stage 6 Loadshedding, one can be forgiven for feeling frustrated. We never seem to find the pot of gold at the end of the rainbow.

Over the past week, we have been presenting our Insight seminar series. For those who joined us (in person and online), forgive me the repetition. But there are a few points worth highlighting.

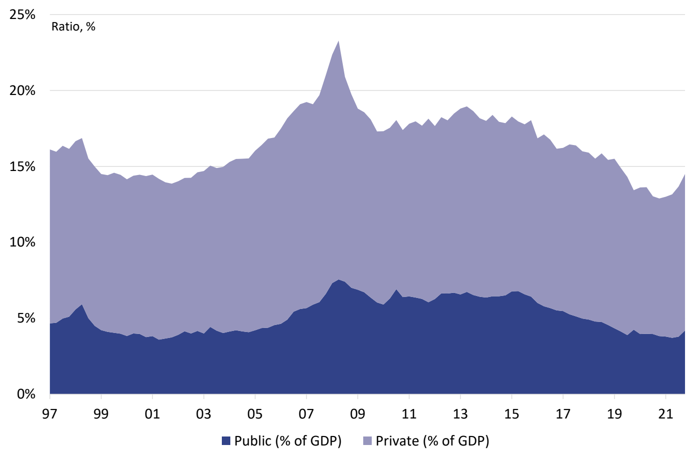
> "These included removing the limit on own generation completely, allowing municipalities to procure their own power."

The first sounds like a contradiction in terms – that the best thing to end loadshedding is more loadshedding. What I mean is that the more that the electricity crisis intensifies, the more pressure government is under to deliver meaningful reform. This is already evident. Last year, various reforms were announced, and they seemed significant at the time. These included raising the cap on embedded "own generation" from 1MW to 100MW, including wheeling legislation. That was meant to unleash a wave of new investment, but all it did was highlight the raft of other rules and hurdles that still had to be met. In June, we suffered Stage 6 Loadshedding again. The outcome was a raft of further reform designed to remove outstanding obstacles. In brief, these included removing the limit of own generation completely, allowing municipalities to procure their own power, removing onerous "local content" requirements (including BEE) and allowing commercial and industrial renewable installations to feed surplus power back into the grid. There were others, but these are the ones that will drive investment over the next five years.

Importantly, there is already evidence that these reforms are unleashing the intended investment into new infrastructure. Since those reforms were announced in July, we note that five projects totaling 740MW have reached financial close and construction is now already underway. These should be contributing to the national grid within the next 18 months. Our research indicates that this is just the tip of the iceberg. There is an avalanche of projects still to come.

The chart below shows the ratio of Fixed Investment to GDP in our economy. We have frequently commented on this. A ratio above 25% is required to improve a country's infrastructure. The ratio touched a low of 12.9% last year – all the evidence required to support the notion that our country is falling apart. But the ratio now stands at 14.5% - far from ideal, but a definitive move in the right direction.

SA GFCF / GDP RATIO



The level of fixed investment has turned decisively for the better. Equally important is that it is largely being driven by the private sector, where both capital and skills are available.

What is equally important, and is also illustrated in the chart above, is that the improvement is largely being driven by the private sector. This should not be understated. The reason why reforms are so crucial is that they are opening up key markets (such as electricity, rail and ports) to the private sector for the first time, and there is no shortage of capital to pursue opportunities. Reform is akin to opening the flood gates. The private sector has often been criticized for embarking on an "investment drought" but this is simply not the case. In fact, had it not been for the private sector, then fixed investment would have been even weaker. Thanks to electricity, port and rail reform and the successful spectrum auction, corporates are opening the taps on new investment. Furthermore, despite having record cash balances, corporates are borrowing money, with credit growth back to levels that prevailed in the years before Covid. Indeed, most of the banks have commented in their results that they are seeing buoyant demand for corporate credit.

The above are just two examples of statistics that suggest

SA CORPORATE CREDIT GROWTH

Corporates are borrowing money for new investment, contrary to the perception that SA is uninvestable.

a gradual turning of the tide. Yet the press remains full of pessimism and scepticism that any improvement is possible. This in turn informs the national mood and the notion that SA has no future. Nowhere is this more evident than in the valuation of SA stocks. Over the past 27 years – itself a period that has seen wild swings in both global and SA fortunes – valuations have, on average, ranged between a low of 12x and a high of 19x. Seldom do they fall out of this range, In 2017, valuations were expensive, peaking at 23x on the back of a surging Naspers. That now seems like a long time ago. Ever since (apart from the Covid-induced anomaly), SA shares have been in a steady derating, to the point where valuations, at 10.5x earnings, are now well below the lower 12x threshold. This can be compared to valuations of close to 20x in the US and 15x in Europe. It's a rather technical discussion but shares that trade on lower valuations are far less susceptible to higher interest rates than those on excessive valuations. Nonetheless, we continue to be buffeted by global factors and the trend in US inflation and interest rates.

Reform in the power generation sector will be felt soon, even though Stage 6 loadshedding is being felt now.

JSE ALL SHARE PE RATIO

Local shares have derated steadily since 2017 and are now below the lower bound of their valuation range.

Despite many companies reporting record profits and paying near-record dividends, share prices are far from the highs reached 5 years ago. Readers will remember that four weeks ago, we articulated the case for Standard Bank, which had just reported exactly that – record profits and a record dividend. I want to close this article with a practical example of the impact of sentiment on the price of an investment.

Without repeating what I wrote last month, let me just remind you that Standard Bank reported significant profit growth for the 6 months ended June 2022, driven by rising net interest income, strong growth in fees and commissions, a reduction in bad debts and good cost control. That allowed the Bank to declare a record dividend, bringing the rolling 12-month dividend to its highest level ever. An investor might expect the share price to be trading at a record high given this result. Far from it. The share first reached this price in 2014 and is now lower than during the initial few weeks of Covid. Why? It is all due to sentiment.

The chart below is the Price/Book (PB) ratio for Standard Bank – a popular valuation method for banks. Since the GFC, Standard Bank has, on average, traded at a PB Ratio of 1.6x. As I have already demonstrated, corporate credit is gaining momentum and we believe the banks are ideally positioned to finance the rollout of critical infrastructure. The outlook is solid if nothing else. Yet presently, Standard Bank trades on a PB multiple of 1.13x – well below pre-Covid levels. If it were merely to return to its average valuation that has prevailed for the past 12 years, that would imply a share price of R203 – versus the current price of R144. That alone would deliver a return of 41%, before taking the dividend of 7% into account. Essentially, a change in sentiment alone could drive a return of 50%, before even acknowledging better growth prospects.

STANDARD BANK PRICE/BOOK RATIO

Standard's valuation is well below historic norms, despite record profit and dividend growth. That can be blamed squarely on poor sentiment.

I can perform the same analysis on dozens of local shares – companies that are trading at deeply discounted valuations despite rising profitability and strong cash flows. I want to close by para-phrasing Willie's closing remarks from two weeks ago. "The only challenge – from an investor's point of view – is to remember that sentiment will not change overnight. Headlines will continue to scream about a failing state. We suggest you ignore those headlines and stay the course. Even a modest uptick in either growth or sentiment will translate into solid, inflation-beating returns."

The topic of our next Insight Seminars shall be confirmed in due course.

Thank you to all clients who have attended our recent editions in Howick and Johannesburg.

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Topic: **TBC**

Natal Midlands	
Date:	To Be Confirmed
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg	
Date:	To Be Confirmed
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am

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