M&G **Insights**

M&G Investments

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Finding investment opportunities amid SA's energy crisis

Loadshedding continues to negatively impact on South Africa's already frail economy, further dimming the lacklustre economic growth prospects. The recent higher intensity of power supply disruptions has caused material damage to companies through lost manufacturing time, trading hours and sales, not to mention contending with the extra expense of running generators to ensure business continuity. Further to this, companies seeking to build supplemental energy infrastructure are faced with a hefty bill. It's a balancing act between keeping operations running at present versus investing in renewable or alternative energy sources over the medium term. The impact of loadshedding differs across sectors and companies, depending largely on how energy intensive the company is and whether it has easy access to backup or alternative energy sources. For some companies, loadshedding results in operations grinding to a complete halt for hours, while others can continue to operate and benefit from their competitors' inability to do so.

From an investment perspective, the question is: how does one navigate the risk that loadshedding presents? And what are the investment opportunities in the midst of the energy crisis?

Considering valuations first, then impact on cash flows

Many JSE-listed companies have reported very different levels of revenue losses and erosion of profit margins resulting from the energy supply disruptions. Yet we must look beyond these basic measures. Companies are all at different stages of mitigating these losses, some being well-advanced in sourcing alternate power supplies. At the same time, some have opted for cheaper, shorter-term solutions and others for more costly, longer-lasting alternatives, and of course some are more exposed to Eskom than others. Which would be best to invest in?

At M&G Investments, when deciding whether to invest in a company, we first assess the quality of a company and the robustness of its cash flows. We then use our long-standing valuation-based process to consider whether the company is over or undervalued. It is then important to carefully consider how the country's energy supply challenges might affect the company's future cash flows over, say, the next five to 10 years. For some companies there might be a permanent effect on cash flows and for others only a temporary impact.

We recognise that companies with strong balance sheets could be well-placed to take advantage of the opportunity presented by loadshedding, since they are able to invest in alternative energy sources to mitigate the risks, and ultimately benefit from this competitive edge by taking market share from companies with weaker balance sheets. Equally, they are more likely to be able to continue with any planned projects to expand or improve efficiencies, gaining more advantage. In our view, this period of loadshedding is likely to see the stronger companies only get stronger and the weaker companies weaker. A disproportionate burden may be placed on smaller businesses or those with fewer options than well-capitalised businesses.

Omnia: Taking its opportunities

A locally listed company that we believe is cleverly making the best of the current situation is Omnia, which specialises in mining explosives, agricultural fertilisers and industrial chemicals and has a presence in over 25 countries. Internationally known for its research and innovation, Omnia aims to replace its carbon dioxide-intensive, conventionally produced ammonia with "green" ammonia from a new ammonia production plant based in

South Africa that will eventually be powered by renewable energy from hybrid sources, namely wind and solar power. This will help de-carbonise its operations, as well as reduce its ammonia imports, leading to cost reductions and a lower reliance on Transnet for transport. Although the project is in its infancy, the company is currently expanding its solar plant at its Sasolburg operations and is aiming to add 11,000 solar panels over 6.5 hectares.
In our view, these projects will give Omnia further competitive advantage. And importantly, we believe the company currently represents exceptional value for investors, trading around a 7.0X price-earnings multiple which we think already largely reflects market concerns about the country's energy shortages. We see strong upside potential over time, believing it should be trading on around double this rating.

MTN Group: Experience, diversification and capital
As with other SA companies, mobile communications provider MTN South Africa is having to face the challenge of loadshedding and ensuring its mobile network remains up and running during the periods of power disruption. Fortunately, MTN has extensive experience of running its mobile networks in a number of other African countries where regular grid power is unreliable and the mobile network towers need to be powered using generators, with battery back-up. This experience provides us comfort that MTN will be able to implement back-up power solutions locally, albeit coming at an additional cost. Two positive factors improving its ability to manage the impacts of higher energy costs include the company's strong balance sheet, which is helping it to cover an increased pace of investing in new infrastructure, as well as the limited contribution of energy to its total costs, at between 5%-7%.

It is worth noting that last year MTN South Africa concluded the sale of its SA tower assets to IHS Holding Limited (IHS Towers), with the sale including a service level agreement that incorporates *"power as a service"*. The power as a service forms part of a requirement on IHS Towers to ensure network availability is maintained above 95% up to Stage 4 loadshedding. MTN have confirmed the agreement does not cover loadshedding at Stages 5 and above, levels we have experienced in late 2022 and into 2023.

MTN's South African mobile network has sufficient battery power back-up to deal with loadshedding up to Stage 4, such that network availability is

maintained at an average of 98%. During loadshedding Stages 5 and 6, currently network availability falls to as low as 90%, with the need to increase the battery storage capacity at key towers to ensure the network remains up during the longer periods of no grid power. Within its capital spending program, the group is prioritising addressing this shortfall, having rolled out a comprehensive network resilience plan which includes deploying additional back-up power solutions. The Group's balance sheet is strong enough to fund the additional costs and capital expenditure required to keep its network operating optimally but this ultimately leads to an increase in the cost to communicate.

To mitigate the higher costs of keeping the network up and running, MTN South Africa have already announced increases to its post-paid bundled tariffs. Other positive factors include experiencing higher mobile data demand during periods of loadshedding, as well as increased roaming revenues from Telkom, given that the roaming partner's network does not have the same backup power as MTN.

Lastly, while loadshedding is expected to have a marginally negative impact on costs and potential lost voice revenue, it is worth noting that MTN South Africa currently only accounts for 28% of Group profitability. This compares to SA contributions of 60% for Vodacom and 100% for Telkom, making MTN the least negatively impacted.

Given all the above factors, we therefore do not see loadshedding as being materially negative to our original investment case for holding MTN – we remain confident in the underlying growth prospects from increased mobile data consumption and the potential for mobile money adoption across Africa.

Apart from Omnia and MTN, there are other companies also set to emerge stronger from the current crisis which we've included in our portfolios. As always in such tricky times, "cash is king", so apart from valuation measures, investors should look to those businesses with strong balance sheets and the cash to invest to navigate the conditions best.

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