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South African Retailers: Is load-shedding weighing too heavily?

Key take-aways

- Retailers are among the SA companies worst impacted by load-shedding.
- Food retailers are particularly hard-hit, needing more power and having more to lose due to their cold chains.
- There is considerable differentiation between companies and their abilities to manage the crisis based on balance sheet strength, exposure to SA, costs and margins, among other factors. Investors should be selective.
- We believe retailers' share prices are reflecting over-pessimistic views of the crisis and there are selective opportunities for to take advantage of.

Load-shedding reached a record high during the first two months of 2023, and if the frequency and severity persists, is on track to exceed the record set in 2022 within the first six months of 2023. Its impact on the economy has been severe and is being written about extensively. In this article we turn our focus to the impact it is having on JSE-listed retailers, which are among the companies worst affected by load-shedding, and whether the recent sell-off induced by the negative news flow could be presenting a buying opportunity for long-term investors.

Load-shedding has ramped up!

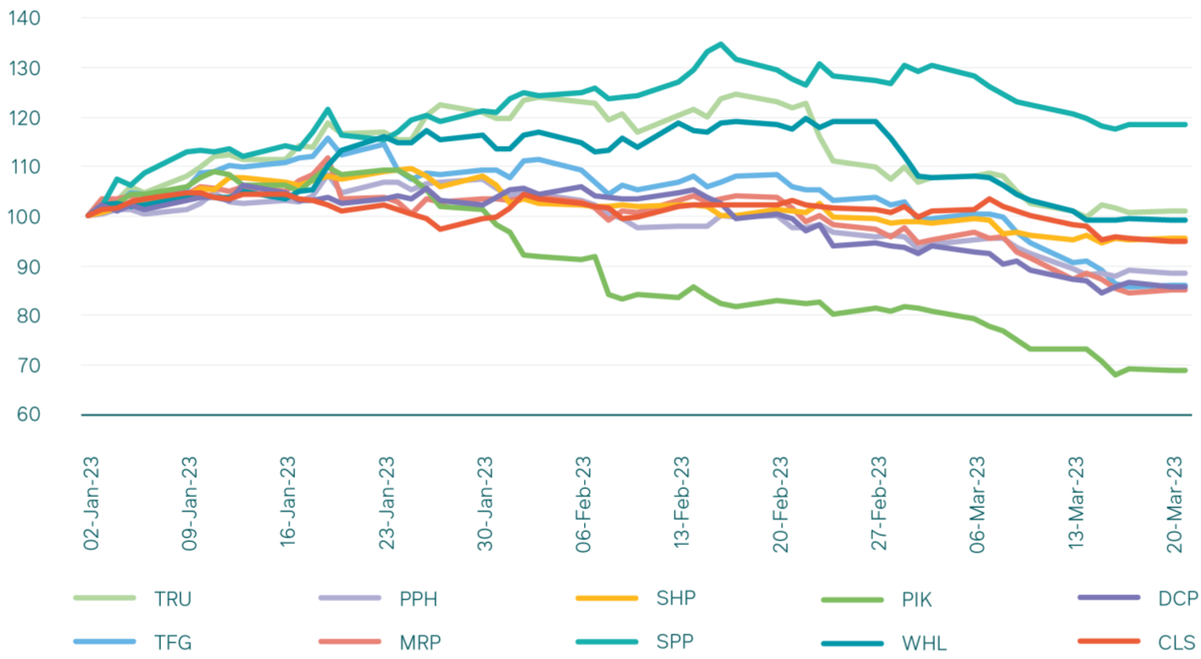
Load-shedding has ramped up substantially in the last six months, something to which both consumers and businesses are rapidly trying to adapt. For retail companies, load-shedding has had a substantial impact on their operations, leading to decreased sales, increased costs and potential damage to their brand reputations. The additional burden on the consumer from having to fund alternative power sources for home also reduces consumers' spending ability.

In their most recent trading updates, covering the key festive trading period where South Africa was frequently experiencing Stage 5 or 6 (the highest level of load-shedding thus far), the retailers have provided more granular details of the effect on their earnings.

As Graph 1 shows, these negative updates have weighed on retailers' share prices, as the market grapples with the impact this high level of load-shedding is going to have on consumers' disposable incomes and companies' earnings prospects, capital allocation decisions and valuations going forward.

Graph 1: Retailer Share Prices in 2023

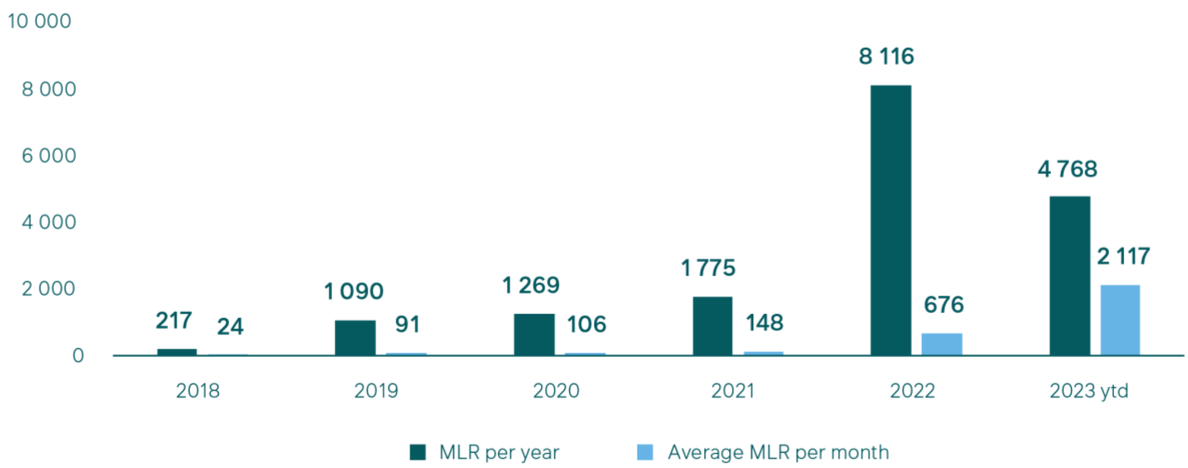
(Re-based to 100 at 1 Jan 2023)



Source: Refinitiv

Concerningly, load-shedding has remained at the elevated levels experienced in November and December 2022 for the bulk of the first quarter of 2023. Graph 2 indicates that in 2023 the average quantum of load-shedding in South Africa is 3.1X 2022's level and 14.3X 2021's level.

Graph 2: Manual Load Reduction (load-shedding) per year
(gigawatts)



Source: Eskom, Investec

How does load-shedding impact retailers?

While all retailers are impacted by load-shedding, food retailers are far more energy-intensive than apparel and drug retailers (such as Clicks and Dischem), as they need to maintain their cold chains in both their distribution centres and store networks 24/7. One food retailer has described the impact of load-shedding as "10% a revenue problem and 90% a cost problem". All retailers are experiencing slower sales growth, higher costs, lower margins and either higher capital spending (capex) or are having to re-allocate capex from growth initiatives to installing alternative power solutions.

Slower sales growth

Load-shedding is changing consumer's purchasing behaviour and due to the frequency of purchase, food retailers are most impacted. Consumers are adapting where they shop depending on load-shedding schedules, shopping more regularly and shifting the mix in their baskets from fresh to more ambient food products to avoid food waste at home. Consequently, food retailers known for their superior cold chain management are gaining market share. The inconvenience load-shedding poses to shopping in stores is also accelerating the use of online shopping, which is in turn shifting market share to those businesses with superior e-commerce offerings, namely Checkers with Sixty60 and The Foschini Group with Bash (their recently launched online marketplace, consolidating for the online stores of all their SA brands in to one online store).

Demand-planning becomes substantially harder due to the variability of load-shedding stages, as retailers try to ensure they have the right products, in the right quantity, at the right stores. Mistakes with demand-planning lead to both missed sales opportunities and higher wastage (which impacts gross profit margins). In addition, suppliers' production abilities are being hampered, restricting the volumes and range they can manufacture and results in less product on shelf. Small suppliers are requiring financial assistance to invest in backup power solutions, which retailers are providing to ensure supply.

While food retailers use generators, apparel retailers typically use inverter and battery solutions for backup power. Most of the apparel retailers' systems are designed to cover Stages 3-4. At higher levels of load-shedding, the batteries don't have enough time to re-charge between outages, requiring the retailer to either stop trading or trade out of a dark store. Not all apparel stores have backup systems, hence load-shedding has a greater impact on their revenue generation. For example, Mr Price has the lowest coverage of backup power of the listed apparel retailers, which we believe was a key contributor to them delivering the worst festive period trading update.

Lower gross profit margins

Both food and apparel retailers are experiencing gross profit margin pressure. Almost all apparel retailers increased inventory levels in the lead-up to the festive period in 2022 as they were trying to avoid a repeat of the supply chain challenges of late 2021. Combining higher inventory and a reduced ability to trade is likely to lead to higher promotional activity and increased markdown levels, both of which are negative for gross profit margins.

Maintaining the integrity of the cold chain is non-negotiable for food retailers to ensure that products are safe for consumption. Disruptions to these cold chains are leading to higher wastage. In addition, the Food sector is experiencing high input inflation (suppliers have seen substantial raw material inflation and increases in production costs) and is not fully passing this inflation on as they try to preserve their value offering in a constrained consumer environment. Despite this price investment, food retailers are experiencing negative volume growth (except for Shoprite). All the above impacts are negative for gross profit margins.

Elevated operating costs

While apparel retailers have not experienced a significant increase in operating costs due the mix of backup power solutions being heavily skewed to inverter and battery solutions, food retailers have reported substantial increases in operating costs.

Food retailers must use generators given the energy intensity of their cold chains. The cost of doing so is reported to be at least five times higher than the cost of grid-supplied power. The rapid escalation of load-shedding has seen Shoprite's average monthly diesel spend increase from R16 million in the first half of financial 2022 to R93 million in the first half of financial2023 and most recently in January 2023 to R150 million. If load-shedding continues at a similar rate in Shoprite's fourth quarter (April – June 2023), they will spend approximately R1.5 billion on diesel in their 2023 financial year, reducing their operating margin by just under 1.0%. The increased utilisation of the generators is also increasing maintenance and repair expenditure.

Our concern with the food retailers is that operating margins are relatively low (mid-single digits); hence the negative leverage impact from materially higher operating costs on their earnings will be substantial. Retailers are likely to pass these higher costs on to customers, increasing the risk of high inflation being stickier and volume growth being even more negative. This is likely the key driver of why Pick n Pay's share price has fallen 30% in 2023 (see Graph1), as they have the thinnest margin.

Capex is being re-prioritized

Retailers, like all businesses in South Africa, are having to accelerate their roll-out of backup power solutions. Retailers with strong balance sheets (including Shoprite, Woolworths, The Foschini Group and Truworths) are able to fund this in addition to their current capex plans. However, retailers with weaker balance sheets (like Pick 'n Pay) are having to re-allocate capex from growth projects (such as the rollout of their Ekuseni strategy) to this energy expenditure, thereby protecting current sales at the expense of future growth.

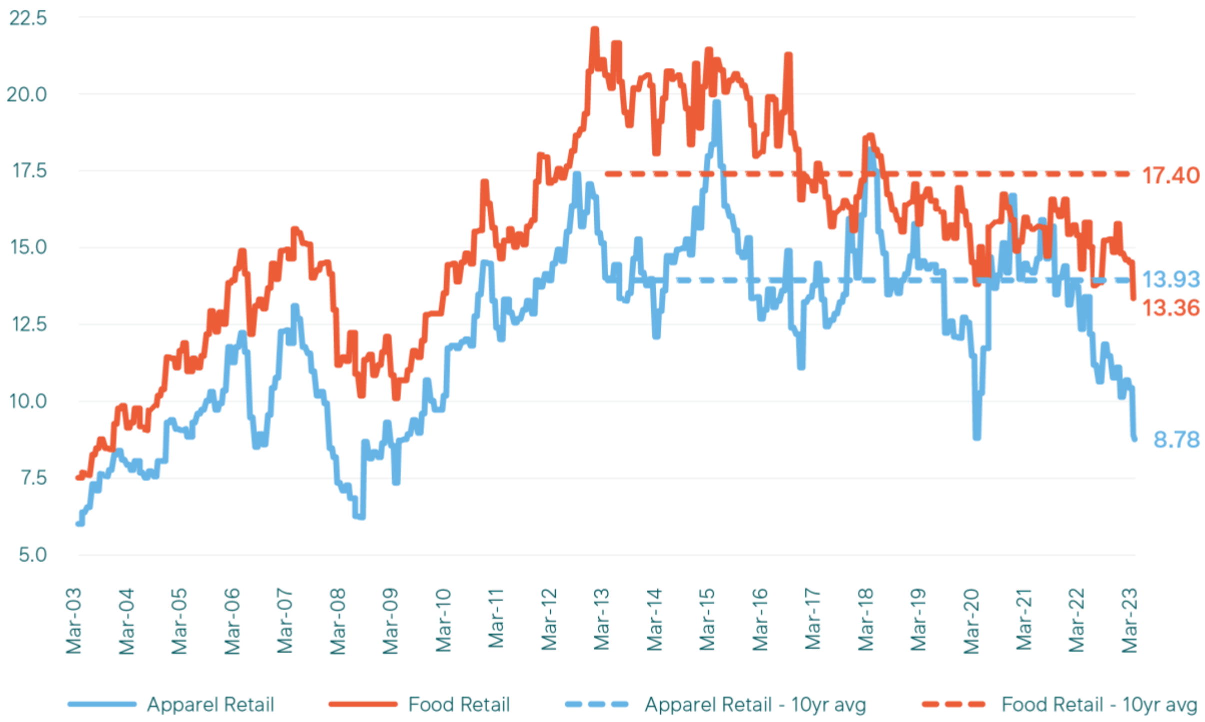
Is the market too pessimistic?

The entirety of the impact of load-shedding on retailers' sales growth, costs and margins is difficult to forecast due to the fluidity of the level of load-shedding being implemented and the uncertainty of how long it will persist. What we do know is that these high levels of load-shedding are negative for retailers' earnings prospects and that the risk of load-shedding getting worse over winter 2023 is high.

While the near-term outlook does look dire, we think the load-shedding challenges will ultimately prove transitory given the amount of investment in alternative power sources by the private sector (both businesses and households), combined with Eskom supply improving when units at Koeberg and Kusile are brought back online post maintenance/repairs being completed later in 2023.

Valuations of retailers seem to be pricing in the current poor conditions into perpetuity, rather than expecting the load-shedding challenges to be overcome in the medium term. Graph 3 illustrates that both the SA Food and Apparel sectors are trading below the forward price-earnings (PE) multiples they traded at during the height of Covid (when stores were closed and earning zero revenue). In our view, this is overly pessimistic on a medium-term view and hence provides a good buying opportunity of select retail stocks.

Graph 3: Food & Apparel sectors forward PEs below Covid lows & 10-year averages (X)



Source: Refinitiv

Graph 4: SA Retailers 12-month forward PEs (X)

Source: Refinitiv

The market has also sold off all retailers indiscriminately because of the challenges the SA operations are experiencing. Yet several of the listed retailers have material exposure to geographies other than SA, which are unaffected by our load-shedding issues. Although the operations in the UK (where Spar, The Foschini Group and Truworths have exposure) are operating in a constrained consumer environment, the Australian retail market is booming thanks to high pent-up demand and substantial excess savings accumulated during the stringent Covid lockdowns. Both Woolworths (Country Road Group & David Jones) and Foschini (RAG) have reported exceptionally strong revenue growth and a near-doubling of profit margins to record levels in their most recent results. The growth in these offshore earnings streams should more than offset any weakness in the SA division's earnings streams.

With valuations currently low versus their long-term average and the market pricing in what we believe are pessimistically high risks over the medium term, especially for Apparel retailers, we believe the risk-adjusted return potential is very attractive for select retailers, and we hold certain retail shares in our top-quartile performing portfolios like the M&G Equity and Balanced Funds. While there are likely to be more hard times for the sector ahead, especially over the winter when electricity demand is at a high and reliable power sources remain in short supply, retailers will expand their alternative power supplies and improve their ability to manage through load-shedding in the not-too-distant future. For valuation-based investors like us, it is important to invest with a view to the medium- and longer term and seize episodes of mis-pricing when they arise. This approach, plus investor patience, should lead to fund outperformance over time.

https://www.mandg.co.za/insights/articlesreleases/south-african-retailers-is-load-shedding-weighing-too-heavily/