Exxaro traverses the energy transition

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Exxaro is a highly cash-generative low-cost coal miner, with quality iron ore mining assets and a growing renewable energy business. It faces unique challenges as a large supplier to troubled Eskom and as the world moves away from using its carbon-emitting primary product in the long term. We set out Exxaro's medium-term prospects and how they aim to use a portion of cash flow to transform the business in the future.

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Coal for electricity

Thermal coal remains the world's single largest source of fuel for electricity generation. The International Energy Association (IEA) anticipates that this will continue to be the case for the foreseeable future, as indicated in the *chart below*. This forecast is even higher in developing economies due to economic expansion and the lack of resources to fund alternatives. In South Africa, coal currently supplies over 80% of the electricity generated by Eskom and will continue to be their dominant fuel source well into the 2030s.

The irrefutable need to move towards zero emission energy sources is causing global energy production to change. Coal will ultimately be phased out - albeit more slowly in some regions - in a transitory period that will see huge investment into alternative sources of electricity. The unit costs of these alternatives will decline with the increase in scale and the evolution of energy technology.

Coal will continue to power growth

Electricity usage is expected to increase significantly over the coming decade as the global economy continues to expand and become more electricity-intensive, especially given the expected rapid increase in the electrification of vehicles.

As *shown below*, the share of coal in electricity production will decline, to be replaced by cleaner renewable energy sources. This will be particularly challenging as coal provides baseload electricity - power that is constantly available - versus renewable energy sources that are intermittent by nature. This is likely to be solved by storing renewable energy for later use and by using alternative baseload sources such as nuclear.

Environmentalist pressures on corporates to reduce carbon emissions and constrain the activities of coal miners, has resulted in difficulties in them securing financing and insurance. This is constraining coal supply, thus raising coal prices, as demand largely continues and will realistically only decline gradually during the energy transition.

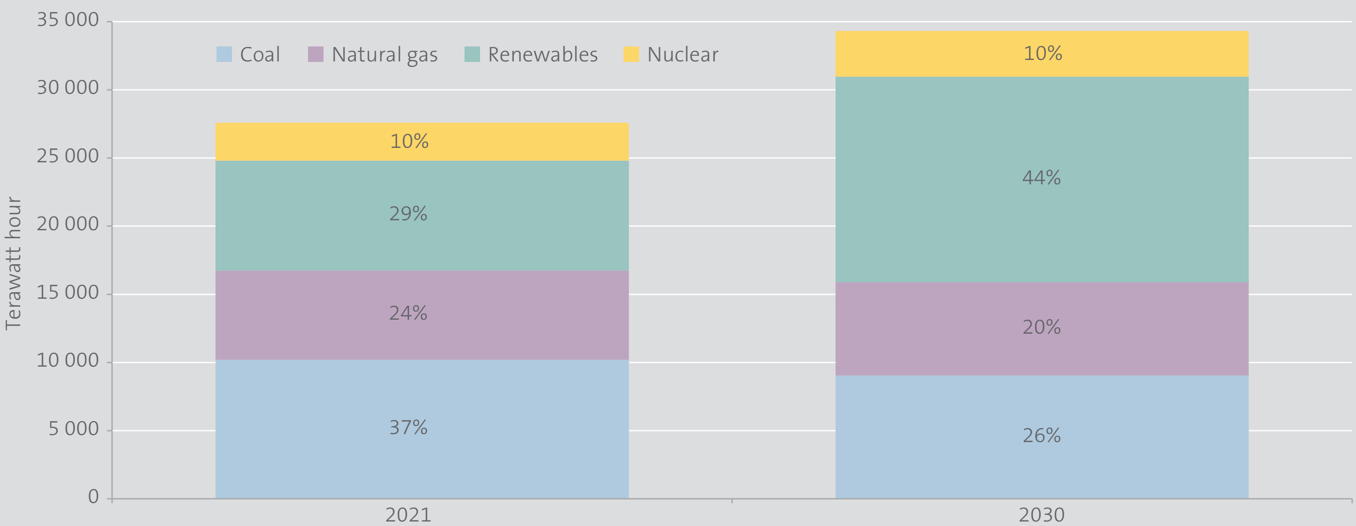
Other uses for coal

Metallurgical coal is the primary source of carbon used in the making of steel, with no alternatives or substitutes available. In addition, coal is the most widely used source of fuel in the manufacturing of other energy-intensive materials such as cement, aluminium and lime.

Exxaro's coal business

Exxaro produces over 40 million tonnes of coal per annum from five South African mines, over 70% of which is supplied to

Global electricity production by source



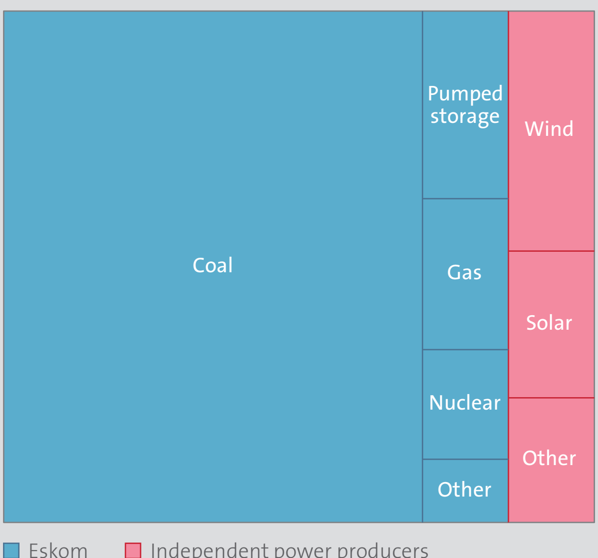
Source: IEA 2030 scenario refers to the stated policies by global governments

Eskom through long-term contractual agreements. These contracts are a source of stable cash flow for the company as they are based on a pre-set coal price, as opposed to the fluctuating export market price.

Such pre-determined or fixed price supply contracts are long-term in nature and ensure the delivery of agreed volumes to Eskom. The coal price is set at the start of the contract, including an annual escalation formula, with inflation as a key input. The costs to run the operation are borne by the mine owner, along with the capital needed. Eskom compensates the miner for the coal, with a margin that should include compensation for operational and capital costs, however, there is pricing risk borne by the miner.

The bulk of Exxaro's cash flow is generated from its largest mine, Grootegeluk, that produces over 28 million tonnes of coal per annum. 25 million tonnes of this is supplied to the Medupi and Matimba power stations. Grootegeluk has a considerable resource base that will enable it to supply Eskom's power stations for the next 20 years. Importantly, it is one of the lowest cost mines in the world, which ensures profitability at a wide range of potential coal prices.

South Africa's current electricity generation



Source: Eskom

Exxaro has invested to expand the capacity of this mine to additionally supply the export market, bringing in new sources of revenue at market prices. Grootegeluk is also one of the largest metallurgical coal suppliers to ArcelorMittal South Africa, the largest South African steel producer.

Exxaro's Matla mine has a cost-plus contract with Eskom, supplying six million tonnes of coal to the Matla power station. Cost-plus contracts differ from fixed price contracts in that Eskom is responsible for ensuring the sustainability of the coal mine, with no pricing risk borne by the miner. Its other three mines are largely focused on the export market, supplying high value coal to the Southeast Asian markets. Notably, recent operational challenges at Transnet Freight Rail have caused a 40% decline in export volumes from 2020 levels, resulting in substantially reduced revenues. Any improvement in rail performance will be massively positive for Exxaro's export earnings.

Iron ore-derived dividends

Exxaro has a 20% investment in the Sishen Iron Ore Company (SIOC), a subsidiary of Kumba Iron Ore. SIOC produces high-quality iron ore that commands a premium price as it lowers carbon emissions in the steel making process, relative to standard quality iron ore. Exxaro has committed to pay out all dividends received from SIOC to Exxaro shareholders.

Investing in renewables

South Africa's current electricity sources are *shown here*. The share of electricity production from renewable sources is set to grow very strongly as independent power producers' limitations on electricity generation have been lifted. In 2019, Exxaro invested in a renewable energy business based in the Eastern Cape, Cennergi, to capitalise on the growing demand.

Cennergi is a highly cash-generative business with good returns, producing electricity at an operating profit margin of 80%, with very low ongoing capital requirements. It comprises of two wind farms collectively supplying over 700 megawatts of electricity per annum. Cennergi will be growing electricity production and Exxaro anticipates that it should be producing three gigawatts of electricity per annum by 2030.

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Investing in new mines

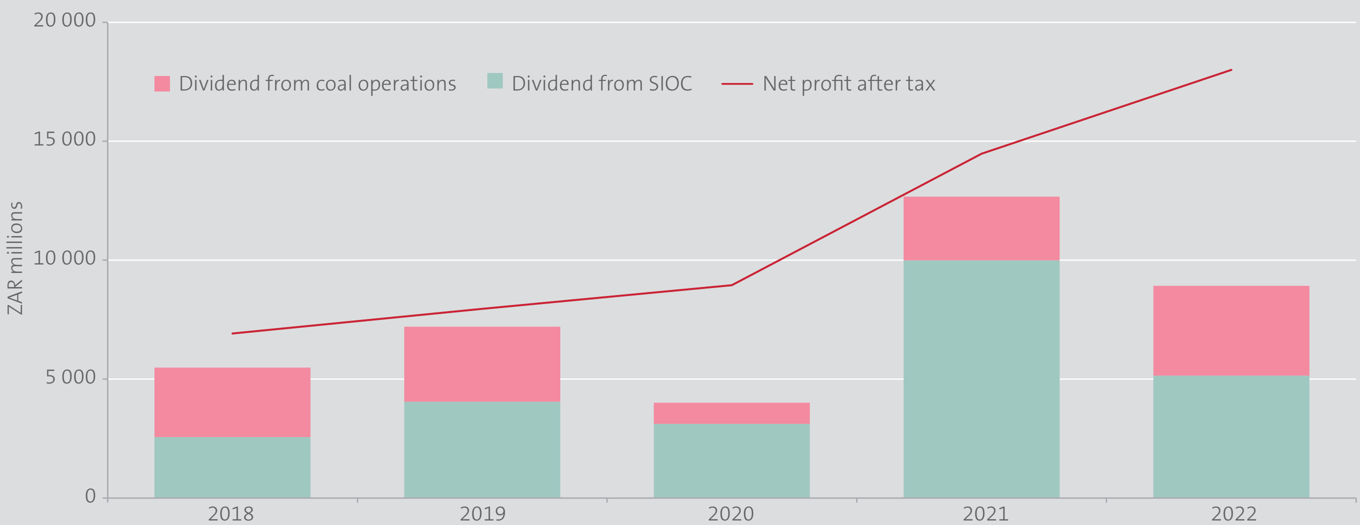
Exxaro has also chosen to invest a portion of its coal-derived cash flows in new mining operations, with a focus on producing commodities that will be used in green electrification applications, namely copper, manganese and bauxite. Their aim is for 50% of earnings (before interest, taxes, depreciation and amortisation) to flow from these new exposures by 2030. This introduces a considerable risk of value-destructive capital allocation as Exxaro moves away from its core competency, coal mining, into unfamiliar jurisdictions, commodity exposures and mining operations or projects. Market apprehension in this regard seems to be particularly high, given that Exxaro has incurred large capital losses in past such investments - albeit under different executive management.

A highly cash-generative future

Exxaro has paid out around 70% of earnings to shareholders over the last four years, while still investing in its coal business - showcasing a strong cash generating ability (*charted below*).

Although decarbonisation will inevitably see a decline in coal demand, it will continue to be used (particularly in developing countries) during the energy transition. Environmentalist constraints on coal supply during this time should create a supportive environment for coal prices and, hence, cash flows for Exxaro's export mines, especially given the low-cost nature of its mines. Stable cash flows will be generated from Eskom under long-term contracts. SIOC will deliver dividends and the diversification into renewable energy, and the potential production of other metals supports additional cash generating opportunities. Exxaro's prospective cash flow yield is very significant at its current share price. UP

Total dividends paid by Exxaro



Source: Exxaro, Camissa Asset Management

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Footnote: [1]Annualised (ie the average annual return over the given time period); [2]TER (total expense ratio) = % of average NAV of portfolio incurred as charges, levies and fees in the management of the portfolio for the rolling three-year period to 30 September 2023; #over 12 months to 30 September 2023. [3]Transaction costs (TC) are unavoidable costs incurred in administering the financial products offered by Camissa Collective Investments and impact financial product returns. It should not be considered in isolation as returns may be impacted by many other factors over time including market returns, the type of financial product, the investment decisions of the investment manager and the TER. This is also calculated on the rolling three-year period to 30 September 2023 #over 12 months to 30 September 2023. [4]Source: Morningstar; net of all costs incurred within the fund and measured using NAV prices with income distributions reinvested; [5]Source: Camissa Asset Management; gross of management fees; [6]Median return of Alexander Forbes SA Manager Watch: BIV Survey; [7]Median return of Alexander Forbes Global Large Manager Watch.