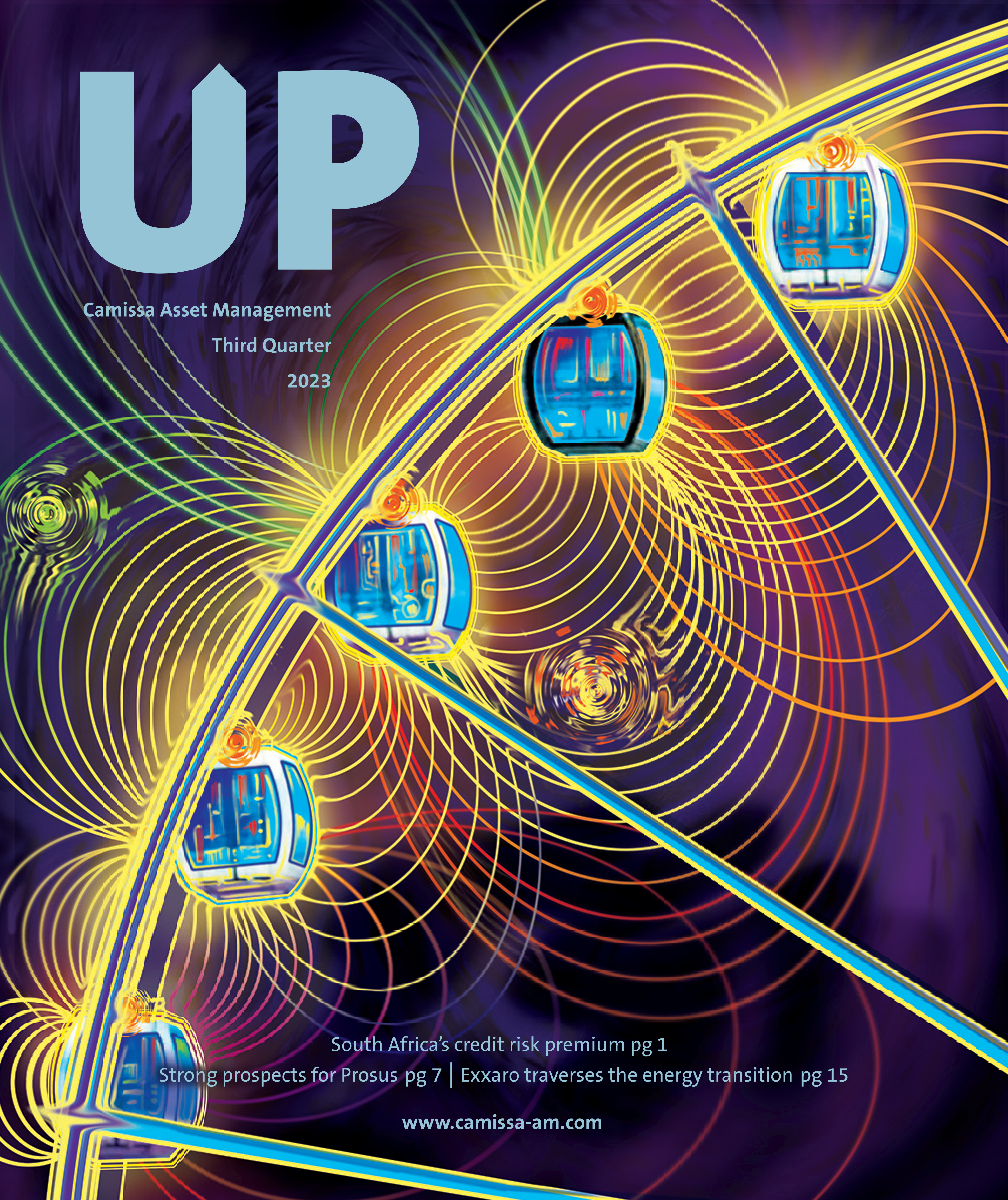
UP

Camissa Asset Management

Third Quarter

2023



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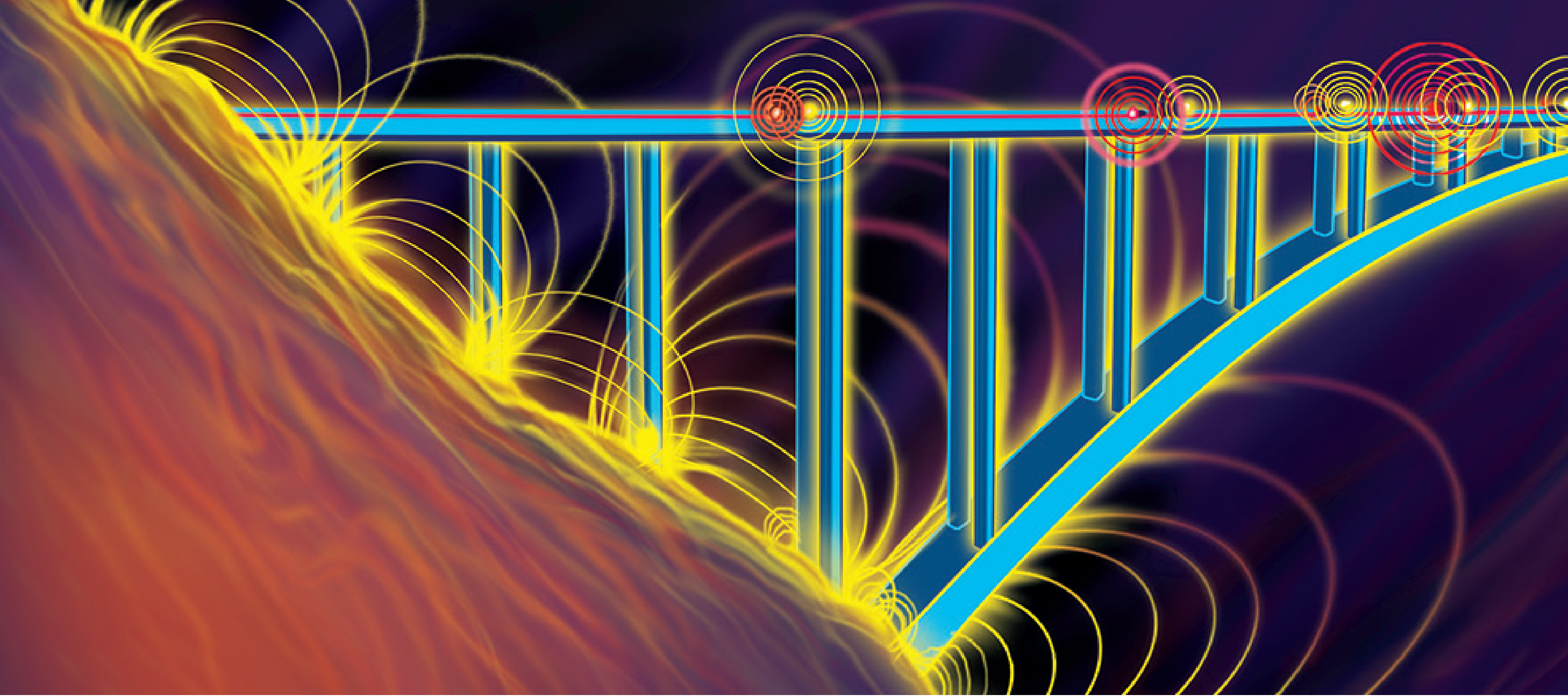
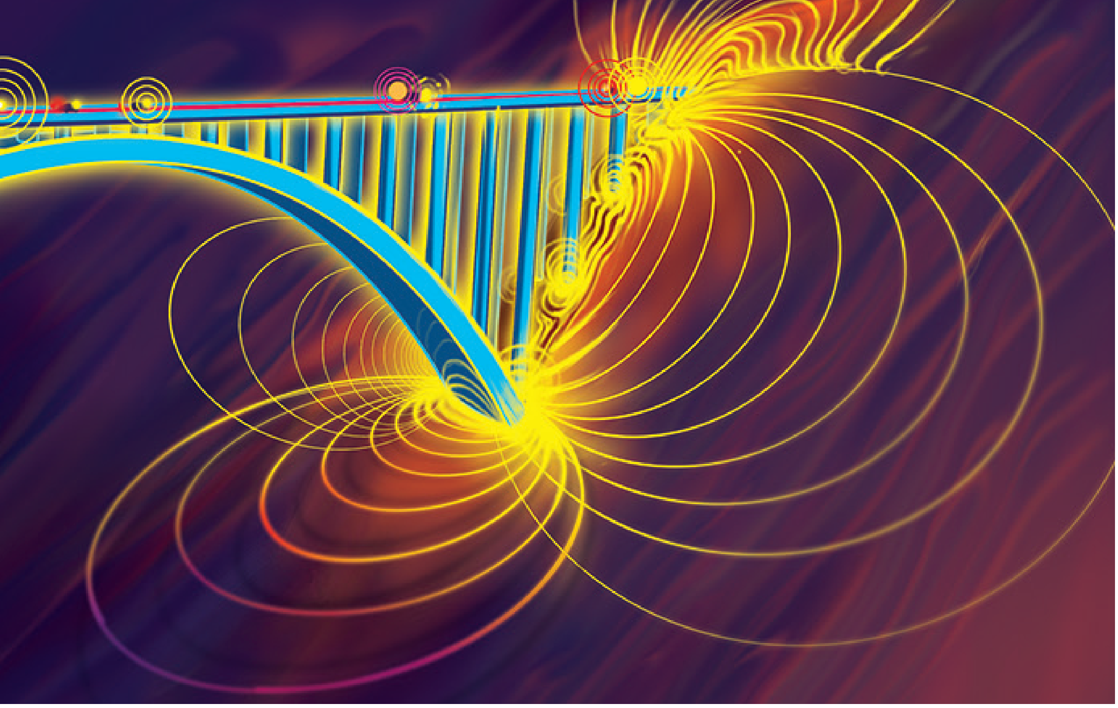




South Africa's credit risk premium

Satish Gosai - Head of Fixed Income and Derivatives

"Governments borrow to fund their fiscal deficit, that is any shortfall from their tax revenue received relative to their expenditure incurred, primarily by issuing debt securities to the private sector. These sovereign bonds have a variety of terms to maturity, from months ahead to many decades into the future, and may have interest rates that are fixed, floating or linked to a fixed real rate over future realised inflation."

South Africa's credit risk premium

We focus on fixed-rate long bonds and assess the appropriateness of the current market pricing of the part of their yield that compensates investors for taking on South African government long-term credit risk.

Decomposing fixed-rate bond yields

Prospective yields to maturity of fixed rate government bonds may be decomposed into three components: (i) a risk-free rate, (ii) a sovereign credit risk premium - the additional premium in the rate that is compensation for taking on the relevant country's government credit risk, and (iii) the currency risk premium[1], which compensates investors for the risks stemming from the fact that the loans are denominated in the currency of the borrowing country.

Current market pricing of the South African credit risk premium

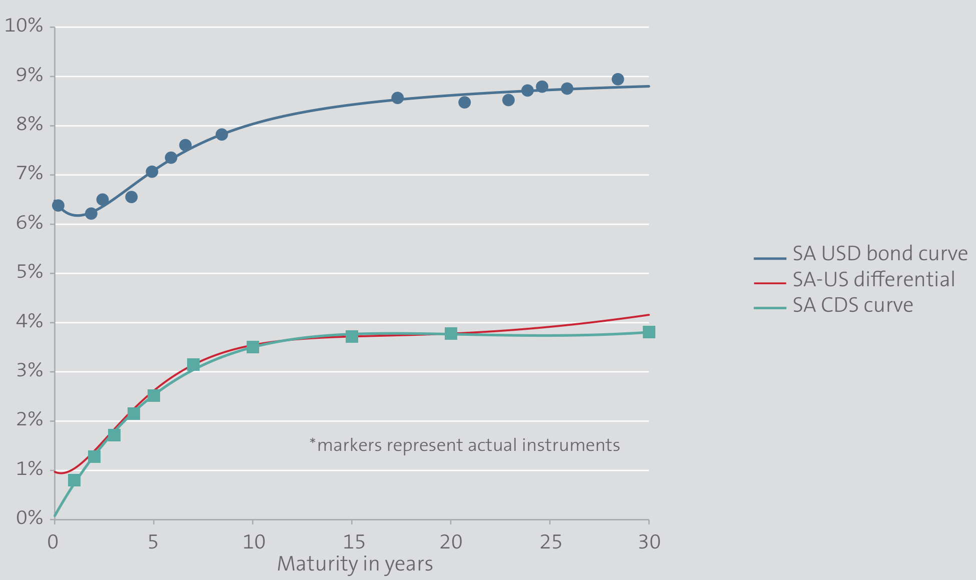
Sovereign credit risk relates to the issuing government's ability to meet their debt obligations, interest and principal, over the term of the borrowing. To simplify the analysis, we assume that US government bonds issued in US dollars (US Treasuries) represent a risk-free alternative and therefore, the SA credit risk premium is the excess yield of a US dollar-denominated SA government bond over the equivalent term US Treasury. The additional risks posed by the rand currency are eliminated by comparing bonds both issued in dollars. South Africa currently has 15 US dollar-denominated bonds in issue, ranging in maturity from 2024 to 2052. These bonds are exchange-traded, liquid and exhibit transparent pricing and available data on value traded.

An alternative measure of the South African credit risk premium is the price of a credit default swap (CDS), which is a derivative instrument used to mitigate such risk by transferring the credit risk from the debt holder to the counterparty of the CDS (ie effectively the price of insuring against a South African government default in dollars). Credit default swaps are traded over the counter directly between two parties. CDS instruments exhibit less liquidity (than equivalent term SA dollar bonds) for maturities longer than 10 years and are consequently less reliable pricing indicators beyond 10 years to maturity.

The *chart below* shows that current market pricing of South Africa's credit risk premium is similar between the bond differential and CDS spreads, except at longer durations. Given the greater market liquidity in the former, the gradual upward slope in the credit risk premium (implied by the bond differential) seems the more accurate market price at this stage. This risk

[1] The currency risk premium attempts to price for the expected loss of purchasing power of the currency relative to liquid, stable developed economy currencies, and the risk of potential variability around these expectations (ie the expected inflation differential and a premium for the variability of this differential).

A better representation of sovereign risk



Source: Avior, Camissa Asset Management

premium rises from around 1% pa at the short end, to about 3% pa from five years out, and then to around 4% pa for longer terms to maturity[2].

South Africa's sovereign rating

Sovereign credit risk is assessed through an analysis of various country-specific criteria including economic outlook, political stability, fiscal position and the strength of a country's legal and financial regulatory framework.

Moody's, Standard & Poors (S&P) and Fitch are the three most influential rating agencies that assess sovereign creditworthiness. Currently, all three agencies have assessed South Africa's sovereign rating as below investment grade, with a stable outlook. The trajectory of ratings has been negative over the last few years as South Africa's fiscal position has deteriorated. The drop below investment grade happened in 2020 for Moody's and 2017 for S&P and Fitch.

Concentrating specifically on the Moody's rating framework in this analysis, its' country rating is built up from sub-factors. These include ratings and assessments for economic strength and resiliency, institutional strength, depth of capital markets, offshore liabilities, banking and political risks and fiscal strength (the most important component).

According to Moodys' assessment, the overall country rating is two notches below investment grade. Importantly, all sub-category ratings for South Africa are above investment grade, a notable positive, relative to comparable countries - except for the fiscal strength sub-category rating, which is five notches below investment grade and clearly the major credit risk issue for the country. Increasing risks to the government debt level and debt affordability metrics are key concerns to the agency and evidently South Africa's major weakness at present.

South Africa has both economic and structural strengths. It is a sizable economy with diversified GDP contributors, which implies good economic robustness. The quality of its institutions and governance is assessed as investment grade, with the judiciary system and monetary policy effectiveness as key areas of strength. An example of this would be the South African Reserve Bank, which is technically effective at delivering on its mandate and credibly independent in monetary policy implementation. Additional positive attributes highlighted by Moody's include having adequate levels of foreign exchange reserves, the low level of external debt, the depth of South African capital markets and the diversification of governments' lenders - debt is readily raised across banks, insurers, asset managers and non-residents.

An analysis of the country's fiscal position and how it could evolve is therefore crucial in assessing South Africa's credit risk premium. To do this, we need to start with the current debt position and then assess how it is likely to evolve, given the probable growth in government income and outlays.

Current position

The current debt position relative to the size of the economy, the debt-to-GDP ratio, is currently 72.7%. This is a substantial deterioration from 24% in 2008, when South Africa last ran a fiscal surplus. National Treasury (who have consistently been overly optimistic in their projections) currently forecasts this ratio to peak at 77.7% in 2026 and then decline to 73.6% by 2031. The *chart on the next page* shows the significant deterioration of the fiscus and economic growth since 2003.

Government revenue outlook

South Africa's revenue is largely derived from income tax on corporates (20% in 2022) and individuals (35% in 2022), with the third major component being VAT. However, these three categories offer extremely limited scope for increases from tax rate hikes.

Personal income tax rates in South Africa are very progressive and among the highest in the world, tapping a very small proportion of the population. The previous increase to the upper tax bracket from 41% to 45% resulted in lower than anticipated revenue collections. South Africa is therefore arguably at maximum personal tax rates and any further increases would be counterproductive. The tax base is also small and very concentrated with high income earners being material contributors - this base is also declining due to emigration, tax evasion and avoidance.

[2] Strictly speaking, this rise beyond a 20-year term is due to the counterintuitive fact that, currently, the US yield curve declines after 20 years (ie a 30-year Treasury yields less than a 20-year comparative bond).

South Africa's credit risk premium

Corporate tax rates in South Africa are also comparatively very high in the global context. Increases to corporate tax rates will most likely result in lower domestic corporate investment, less direct foreign investment, business closures and relocations. This will therefore ultimately cause negative trends to revenues as South Africa becomes less favourable in which to operate. Increasing corporate tax rates to grow revenues seems unlikely to be a lever that government can pull.

The other meaningful revenue source is VAT. It is a logical taxation source to increase via raising the tax rate, but politically this is not a possibility as it is the one tax that lower income and unemployed South Africans (a vast number of voters) pay. The consequence of a VAT increase would negatively impact the broader population in a country that has a very high unemployment rate of 32.9%.

Government expenditure outlook

Fiscal improvement could also conceivably be achieved by a reduction to government expenditure. The large components of government's spending are debt servicing costs, public sector wages and social grants. The ability to materially reduce spending in these areas is severely limited.

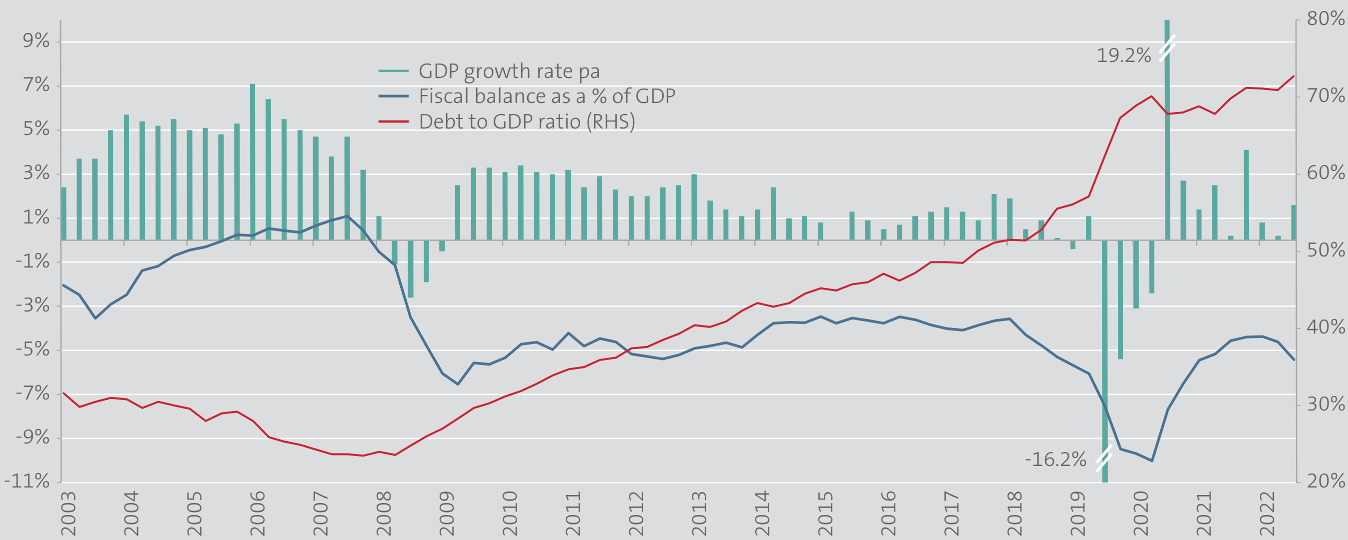
Interest payments, which are a function of rates and debt levels, are contractually immovable.

Social grants similarly cannot be significantly reduced as they are low and meet only the most basic needs of the unemployed, old and poor. Social instability would inevitably arise from reducing this for these people who have nothing else to lose.

The public sector wage bill is very high in a global context, compared to even developed economies that have large public sector service provision to their populations. This is the result of years of wage settlements above those of the private sector and an arguably inefficient use of this work force. These workers are represented by strong unions, who routinely threaten to withhold essential services as a bargaining tool. These workers do provide critical services to the country, such as healthcare, teaching, police and armed forces. While more efficiency and potentially lower future wage increases are possible in a crisis, the reduction in government expenditure from this source is likely to be very slow.

Capital expenditure on infrastructure is another essential government cost. In recent years, the South African government's allocation to the capital stock of the country has

The deterioration of South Africa's fiscal position



Source: Bloomberg, Camissa Asset Management been too low. This is now being revealed by the material inadequacies in the state provision of the country's energy and logistics needs (acknowledging the most material two). These inadequacies are causing the country to grow vastly below its potential and therefore need to rise in future, rather than be reduced. This is in addition to the vast sums of money the government needs to inject into state-owned companies to achieve their debt sustainability.

The economy has to grow faster

Given the inability to raise tax rates and the inflexibility of government expenditure, the only solution to improve our fiscal position and ultimately improve our credit rating is for the economy to grow faster.

A larger economy, ie higher GDP, would progressively increase the denominator of the debt/GDP ratio, improving this key measure of fiscal strength. Tax revenues would increase without a rise in tax rates as more people are employed, wages rise in real terms and people pay more VAT via increased consumption. Corporates will earn more and consequently pay more tax. If government spending is managed well and more is allocated to infrastructure investment, a self-reinforcing cycle of improving growth will result.

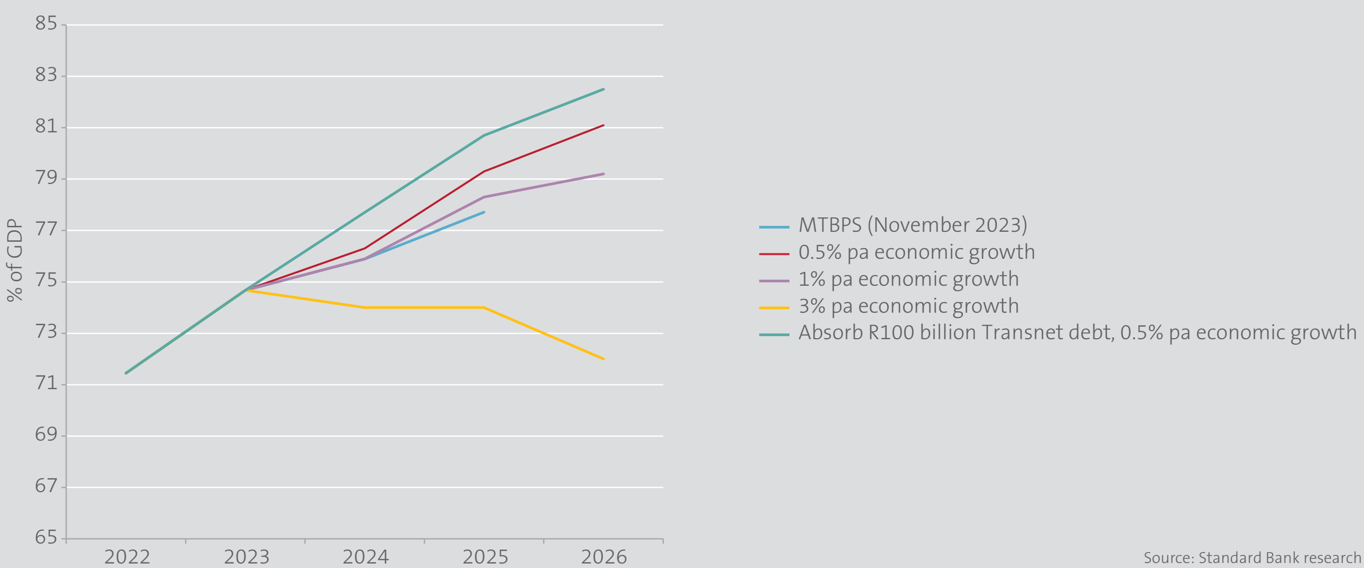
As the country's fiscal deficit shrinks, government debt balances can be reduced and another virtuous cycle is created as the annual interest burden declines.

It is beyond the scope of this article to propose solutions to foster faster growth, but reforming the economy's constraints and inefficiencies most likely reside in many domains and primarily involve freeing up the private sector and improving government service delivery. The *chart below* shows potential outcomes based on different growth and spending scenarios and the quantum of higher growth levels' impact on improving the debt/GDP metric.

A comparison of spreads to other countries

Assessing sovereign credit risk across similar countries can be done by comparing credit ratings to CDS spreads. South Africa's CDS spreads currently trade at levels slightly higher than similar rated countries. However, as important as the current country rating is, it is the trajectory of that rating that is more significant in the analysis. South Africa's stable outlook compares to the stable outlook of Brazil, Columbia, Thailand and Mexico, all of which have lower CDS spreads and higher credit ratings. Additionally, countries like Brazil have a higher debt/GDP ratio than South Africa, yet sovereign risk spreads are

Debt to GDP scenarios

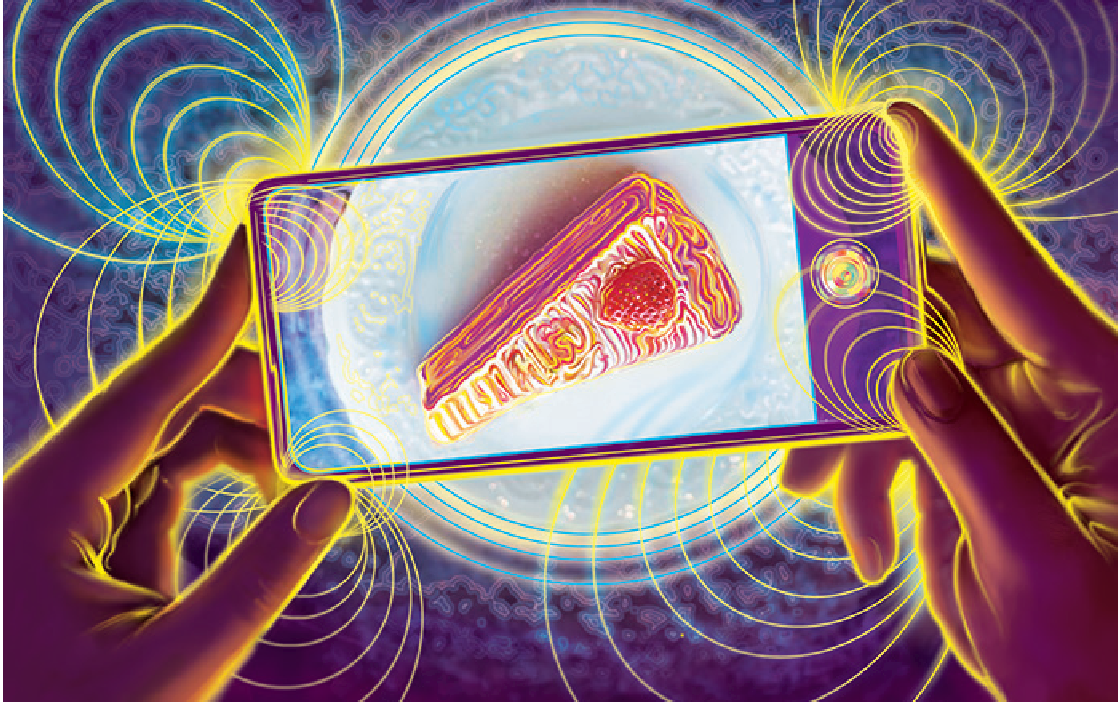


Source: Standard Bank research

much lower, indicating that a better path to fiscal improvement is being envisaged by markets and priced into its CDS spread.

If economic growth can accelerate, South Africa could see its rating outlook improve and forward-looking market CDS spreads move lower.

The key weakness relating to South Africa's sovereign credit risk is its fiscal position. The potential outcomes for fiscal consolidation have many constraints but a higher economic growth trajectory over the medium term is critical. We view the sovereign credit risk premium component to be fairly priced, given the weak fiscal position and risks to the outlook, yet an improving situation is possible. We therefore see substantially more value in buying rand-denominated government bonds. These are pricing in a very high currency risk premium, therefore offering rich real yields. The US Treasury yield curve should also move lower as inflation is brought under control in the US, boosting returns. UP



Strong prospects for Prosus

Aslam Dalvi - Portfolio Manager

"The value in Naspers now consists almost exclusively of its holding in Amsterdam-listed Prosus. Prosus holds a large stake in Tencent - a Chinese online media giant - and a variety of online businesses (the rump). Over the past decade, the group has made a number of investments across emerging markets in online businesses, with very little success to date, incurring substantial cumulative losses."

Strong prospects for Prosus

More recently, the group has changed strategy towards one of realising value for shareholders and pursuing value-adding share buybacks. We unpack the key rump investments and explore the very strong future prospects for shareholders from Prosus (and in turn Naspers).

Visionary early success

Naspers boasts a rich history of investing in emerging technology industries with significant growth potential. The company enjoyed early success, pioneering South Africa's first pay TV operator, M-Net, and making strategic investments in South Africa's second-largest mobile network, MTN. In 2001, Naspers acquired a 46.5% stake in Tencent for a mere $32 million - its most successful investment to date.

Recent history

Tencent has since become the world's largest digital gaming company and China's pre-eminent digital platform, boasting over 1.3 billion active users. It has one of the most expansive advertising platforms in China and dominates the digital payments sector. Since its listing in 2004, Tencent has grown its revenue and profits by an estimated 33% and 27% per annum respectively, with its market value growing to over $350 billion. Naspers' investment in Tencent has consequently been the primary driver of value creation for its shareholders, with the Naspers share price compounding at over 30.5% per annum over the last two decades.

Naspers, now via Prosus, has strived to replicate its initial success by venturing into a broad spectrum of high-growth markets encompassing online retailing, online classifieds, digital payments, food delivery and online education. While these ventures have indeed yielded substantial revenue growth, few are profitable and it seems that the group substantially overpaid for them (returns on invested capital have fallen well short of expectations).

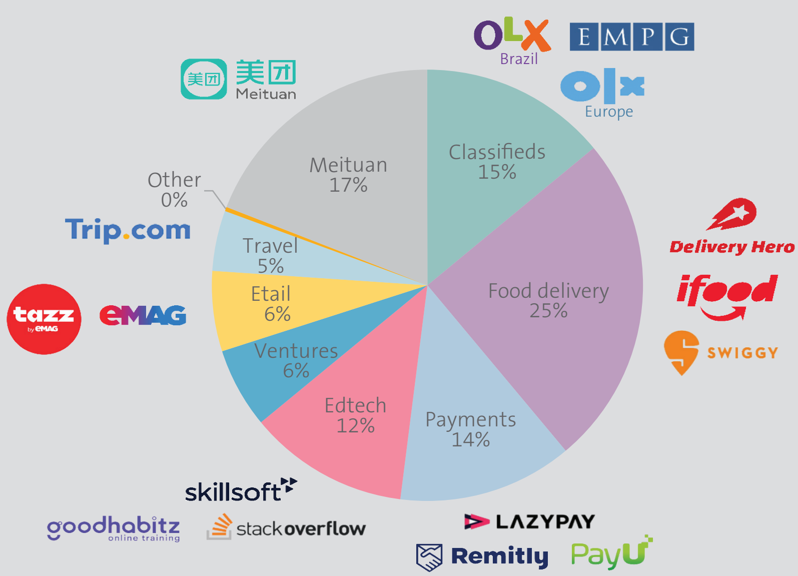
A diverse portfolio of growth assets

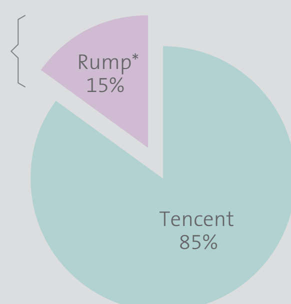
Prosus's net asset value (NAV) is predominantly composed of Tencent, which accounts for roughly 85% of the group's NAV. The remaining portion, the rump, encompasses a diversified array of online enterprises, as *illustrated below*.

The strategy has been to invest early in online businesses in developing economies, with substantial addressable markets and therefore significant growth potential. Prosus has spent over $32 billion since 2008, enlarging its footprint across various online and digital industries.

Approximately 25% of the rump's value is in the food delivery sector. Notable holdings include a 29.9% stake in the world's

Breakdown of Prosus's net asset value excluding its stake in Tencent





*Rump valuation based on current prices for listed assets and Camissa estimates for unlisted assets
Source: Bloomberg, Camissa Asset Management

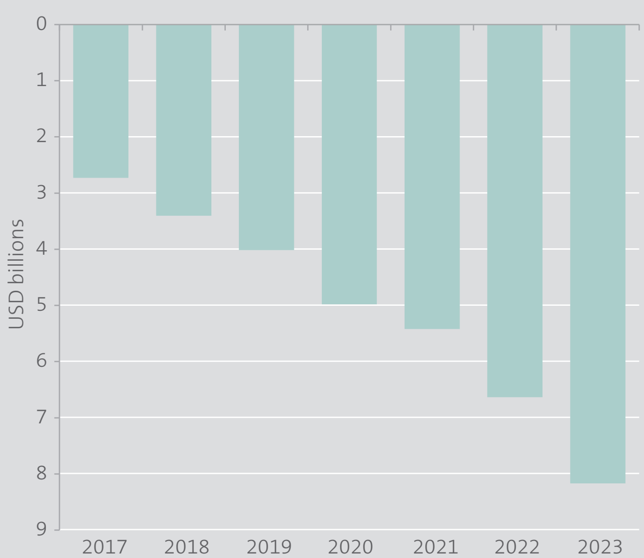
largest food delivery company, Delivery Hero, and a 33% stake in the leading Indian food delivery firm, Swiggy. Additionally, Prosus owns and operates ifood, a dominant and rapidly growing food delivery platform in Latin America.

Meituan, a Chinese-listed digital services conglomerate, contributes another 17% to the rump's value. It encompasses diverse interests in food delivery, online hotel booking, third-party delivery and various niche online services such as pet care, tutoring, home maintenance and home cleaning. Over the past five years, Meituan has impressively delivered a 45% growth rate in revenue. It also stands out as one of the few profitable food delivery businesses globally, capitalising on China's high population density in urban areas and a fragmented restaurant landscape that affords the group strong pricing power. The future appears promising for Meituan, with profits expected to more than double in the next five years as the food delivery and hotel booking businesses scale up, while losses diminish across the rest of its portfolio.

Prosus's investments in classifieds, online education and digital payments constitute the remaining pillars, each representing around 15% of the rump. Among these, the digital payment business, PayU, is particularly well-positioned in India. It stands to benefit from several regulatory changes aimed at supporting the digital economy and the growing acceptance of digital transactions among Indian consumers and merchants. Payment volumes in India have surged at a rate exceeding 50% annually since 2015, with expectations of payment volumes doubling again in the coming years.

The residual portion of the rump comprises online e-commerce in Europe, online travel and Prosus's Ventures portfolio, which houses a collection of smaller investments in early-stage startups.

Prosus's cumulative rump losses



Source: Bloomberg, company financials

Elusive profitability

Despite achieving profitability in a few early investments, Prosus's strategy of frequently entering new markets has resulted in mounting aggregate losses over time. Our estimates indicate that the portfolio has incurred cumulative losses exceeding $8 billion since 2017 *(shown below)*. Furthermore, the estimated return on capital since 2008 for its portfolio - a critical measure of capital allocation effectiveness - has been a disappointing 4-6% per annum. This falls well below the returns attainable from other, less risky equity asset classes during the same period. This subpar performance is extremely disappointing, particularly considering the roughly $1.5 billion in additional cumulative corporate costs incurred to deliver these lacklustre results.

Investing has been poor

The global private equity market has witnessed explosive growth during this time, expanding from approximately $3 trillion in 2012 to over $7 trillion in 2022[1]. Investors have sought to replicate the incredible success of the prior generation of venture capital investors that invested early in today's tech giants. This has ushered in heightened competition, with the number of private equity managers more than tripling over the past decade.

A cash flush private equity market and abnormally low interest rates in the decade prior to 2022 have led to increasing private market valuations and seen the extensive funding of business models with questionable long-term economics. Against this backdrop, we've witnessed a widening gap between the best and the least successful private equity investors. Prosus's performance unfortunately ranks very poorly against the competition, with its estimated return since 2008 well below

[1] Source: BlackRock

Strong prospects for Prosus

the median return for private equity managers of around 15%[2]. Despite making well over 60 investments since 2008, we estimate that fewer than five have delivered an internal rate of return above the company's cost of capital.

Changing focus

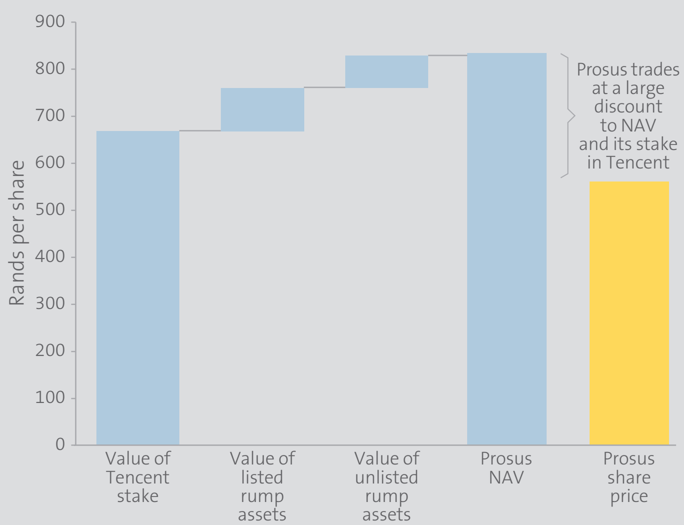
Prosus recently unveiled a shift in its investment strategy, announcing a clearer path to profitability for its larger businesses. Management has committed to shorter investment cycles and is prioritising value realisation for shareholders through the divesting of assets.

Prosus is also now pursuing a multi-year share buyback program while it trades at a discount to the value of its underlying assets. This will generate significant shareholder value as Prosus sells Tencent and repurchases its own shares - securing substantial profit with each trade due to the currently large discount to underlying assets. We estimate that the buyback alone holds the potential to grow Prosus's value per share by approximately 5-7% annually. Naspers is pursuing a similar program, selling Prosus shares and repurchasing its own.

Prosus currently trades at a 35% discount to its net asset value and a 20% discount to the value of its Tencent stake alone *(shown below)*, indicative of the market attributing a negative

[2] Source: JP Morgan Asset Management (2008 to 2022)

Estimated value of Prosus NAV



Note: The value of Tencent and listed rump assets are based on current share prices and the value of unlisted assets are Camissa estimates
Source: Camissa Asset Management

value to the rump. In our view, this is unjustified based on the prospects of these businesses and considering that over half of the rump assets are listed with readily observable market values.

Tencent is also independently pursuing a share buyback program, given that its share price is substantially too low.

Promising prospects

The Prosus strategy of the last 10 years - to invest in a broad range of high growth online businesses and replicate its early success - has failed. Profitability across its investments remains elusive, with estimated returns considerably below its cost of capital. Despite this, Prosus is a very compelling long-term investment.

Its largest asset, Tencent, has a promising long-term future through its exposure to online Chinese economic activity and rapidly expanding incomes in the Chinese middle class. Nascent businesses including cloud services, mobile payments and video advertising are scaling rapidly, thereby diversifying revenue beyond the core domestic gaming and social network segments. Additionally, its international gaming business is now substantial and growing very rapidly. Tencent currently trades at a substantial discount to our estimate of its intrinsic value.

The shift in strategic focus toward rump profitability coupled with improved capital allocation and recent management changes are all positive developments. The combination of growth at Tencent, NAV accretion from buybacks and potential recognition of value across its e-commerce assets as the new strategy unfolds, positions Prosus for material outperformance. UP

Santam: South Africa's pre-eminent insurer

Edward Mtsweni - Investment Analyst

"With a history spanning the last century, Santam (the South African National Trust and Assurance Company) has weathered many storms and remains South Africa's leading short-term insurance business. Its massive success stems from strategic adaptability and remarkable operational execution in evolving its client-centered service offering that caters for individuals, business owners and institutions. We unpack Santam's history, the business and its strong market position today."

Santam: South Africa’s pre-eminent insurer

Early origins

Santam was founded in 1918 in the aftermath of World War I and the Spanish flu pandemic. Within months, they had established a subsidiary focusing specifically on life insurance, namely Sanlam (the South African Life Assurance Company). Santam remained the largest shareholder in Sanlam until 1953 when Sanlam converted to a mutual insurer. Subsequently, Sanlam became Santam’s largest shareholder.

Santam’s early focus was on insuring risks related to agriculture and it later expanded into offering various forms of personal (ie motor and home), business and liability insurance. The company revolutionised the insurance industry in the 1970s by launching the first all-risks policy (Multiplex) that enabled South Africans to consolidate the insurance of all their assets under a single policy. The yellow umbrella brand icon, reinforcing their positioning, was incorporated into Santam’s logo in 1981.

Growing and adapting their position

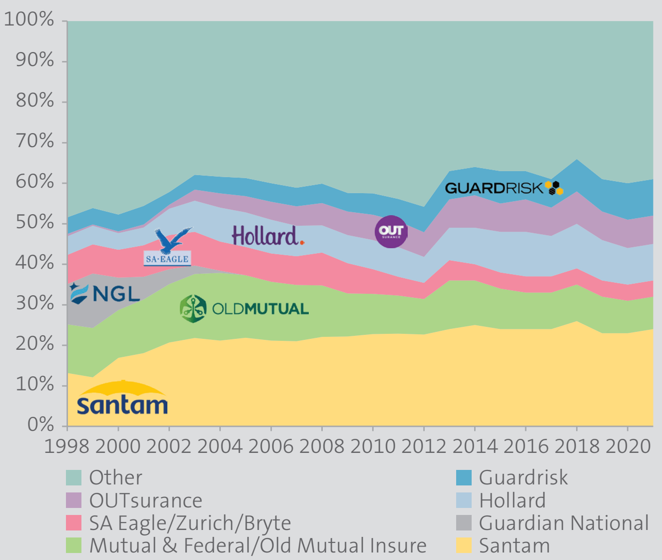
Santam’s 1999 acquisition of Guardian National (the third largest insurer at the time) for R1.6 billion, was a huge success. It was transformational for Santam as it secured a 25% market share of the local insurance industry (*below left*), thereby achieving material economies of scale and reducing market competition. It significantly increased the company’s presence in the commercial insurance market. The complimentary combined market offerings of the two companies created immediate benefits from risk diversification and capital optimisation, and longer-term cross-sell opportunities.

In 2003, Santam (in conjunction with Sanlam) established insurance businesses outside of South Africa (particularly in other developing countries). They later also established Santam Re and Santam Specialist, offering business insurance.

In the late 2000s, direct[1] insurance competitors emerged and began rapidly gaining market share from intermediated[2] insurers such as Santam. To counteract this threat, MiWay - a direct insurer separately branded from Santam - was launched in 2008 by Santam, Sanlam and PSG. MiWay was acquired in full by Santam in 2012 and has been a remarkable success, capturing a large portion of the move to direct insurance without disrupting Santam’s relationships with its intermediated distribution channel.

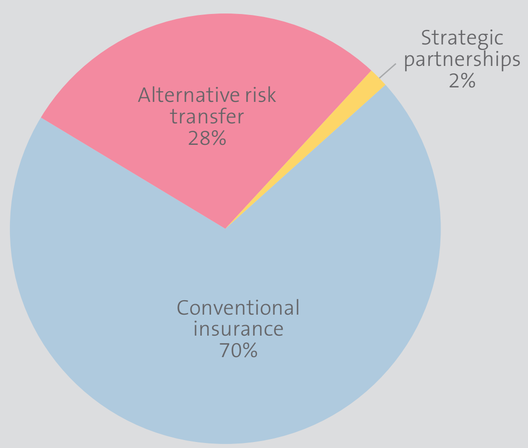
[1] Online and call center-based personal lines insurers that deal directly with customers, rather than via intermediaries such as brokers.
[2] Insurance sold and serviced via intermediaries such as insurance brokers. Client interactions are primarily face-to-face, with more of a personal touch than can be offered by a call center.

SA short-term insurance market shares



Source: KPMG, Camissa Asset Management

Santam gross written premium split (2022)



Source: Swiss re, company reports, Camissa Asset Management

Substantial competitive advantages

Santam's competitive advantages stem from its decades of experience, broad geographical footprint, massive scale, brand strength, business diversity, specialist skills and capabilities, and distribution networks. Currently, it offers short-term insurance solutions under three divisions (*right chart previous page*):

- **Conventional insurance** comprising Santam Commercial and Personal in South Africa and Namibia, along with MiWay, Santam Re (wholesale reinsurance) and Santam Specialist for business (eg crops, liability, engineering);
- **Alternative risk transfer** offerings are tailored solutions for business clients to enable them to insure their own operational risks. These comprise a separate legal entity (cell) operating under Santam's insurance licence; and
- **Strategic partnerships** outside of South Africa in countries including Malaysia and India.

Personal lines - large and very competitive

Personal lines insurance (mostly motor and household insurance for individuals) comprises 50% of total industry premiums. This market has seen direct insurers rapidly gain substantial market share, with their penetration seeming to now stabilise at around 40%. Direct insurers include Outsurance, Miway, Telesure (with brands such as DialDirect and 1st for Women) and King Price.

Santam Personal (41% of Santam's gross written premium[3]) has exhibited sector-leading growth that accelerated post 2016 - largely aided by strong growth in MiWay (*left chart below*). Although the growth rate has eased due to the tough economy, Santam still sees significant growth potential for MiWay. This should be boosted by the launch of its fully digital offering that will compete with new digital competitors such as Pineapple and Naked.

Commercial lines - the growth driver

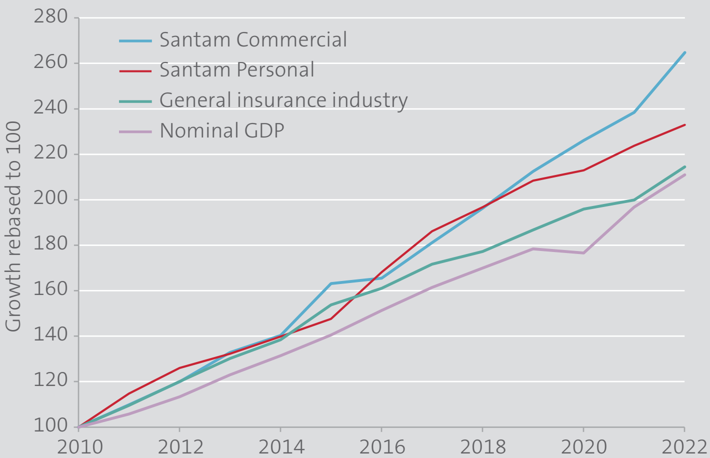
Commercial lines insurance (*below right*) contributes approximately 30% of the industry's premiums. Santam Commercial has exhibited above-industry growth and holds the largest market share. This leading position stems from Santam's deep experience and expertise in specialist risk insurance across a far broader range than competitors.

The commercial market has three segments, with a specific distribution model for each:

- **Small corporate** - a mix of direct and broker-led with many new entrants. Discovery and Outsurance are growing well in this segment and competition is high.
- **Medium corporate** - broker-led, where Santam is the largest player with fewer competitors.

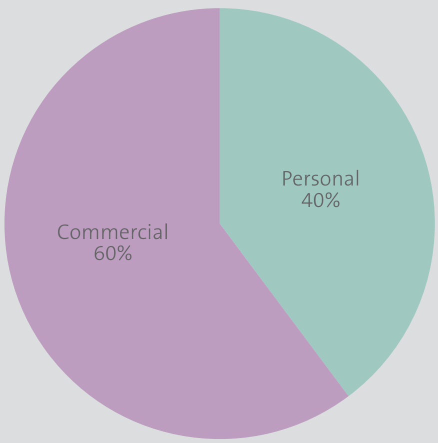
[3] The total premium written by an insurer before deductions for reinsurance and commissions.

Santam's premium growth



Source: Swiss re, company reports, Camissa Asset Management

Conventional insurance gross written premiums



Source: company reports, Camissa Asset Management

Santam: South Africa's pre-eminent insurer

- **Large corporate** - broker-led, where Santam dominates and has more than 3 000 established broker relationships. Growth opportunities in this segment will come from:
  - asset growth and related protection needs as these businesses grow and the value of their assets increase in real terms.
  - new risks that are emerging, for example cyber-crime, terrorism and climate change.

Cell captive solutions

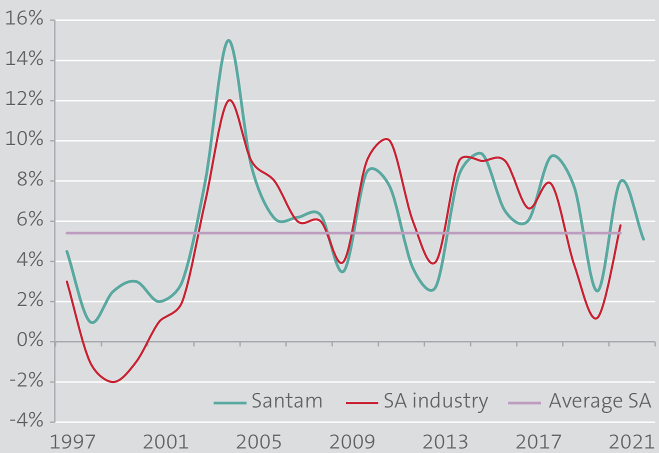
Cell captive insurance, whereby a business entity self-insures its assets by setting up its own insurance subsidiary administered by an insurer and written on that insurer's licence, is expected to grow in the coming years. An increasing number of companies are seeking to manage their risks more effectively and reduce their insurance costs. Santam's alternative risk transfer business is a relatively small profit contributor (8% of total profits) now but is expected to grow fairly rapidly.

Dominance in a difficult market

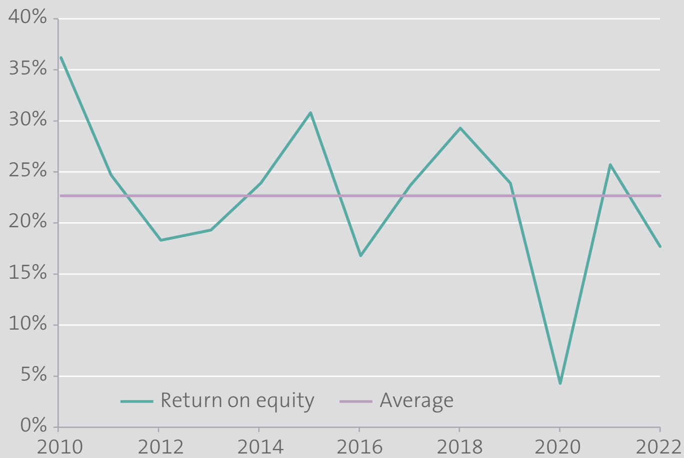
Santam's margins and return on capital have been excellent over the long term (*charted below*). Their robust long-term underwriting margin signature results primarily from outstanding risk selection and pricing. They have also effectively managed their capital requirements by diversifying their portfolio of risks and applying internal risk capital models that result in higher returns on equity than competitors.

As a market leader with a history of financial stability and solid risk management, Santam has immense scale, operates with efficiency and deploys leading underwriting skills that enable it to achieve high margins and provide a compelling competitive edge. This will serve shareholders well in the years to come. UP

Santam vs industry underwriting margins



Santam: high normalised returns



Source: company reports, Camissa Asset Management

Exxaro traverses the energy transition

Mandi Dungwa - Portfolio Manager

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.

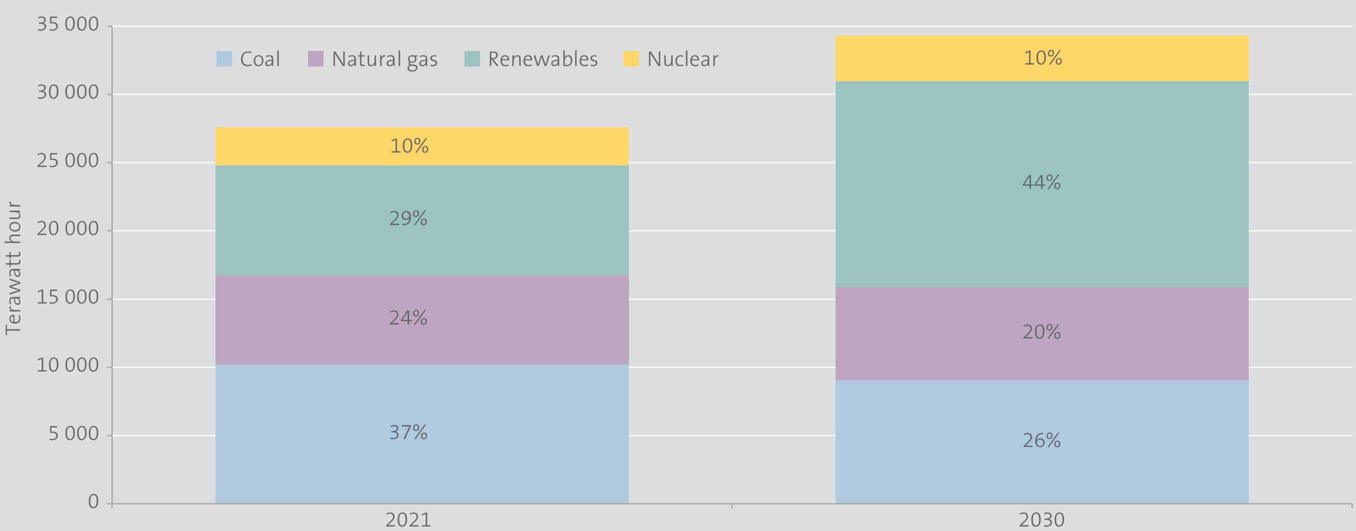
Other uses for coal

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



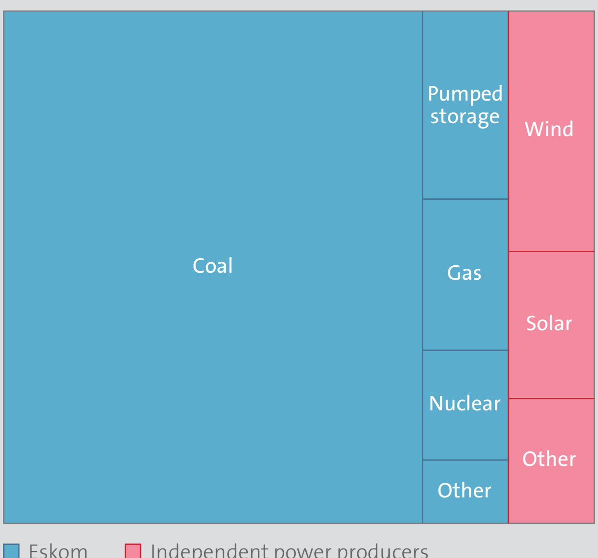
Source: IEA 2030 scenario refers to the stated policies by global governments

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

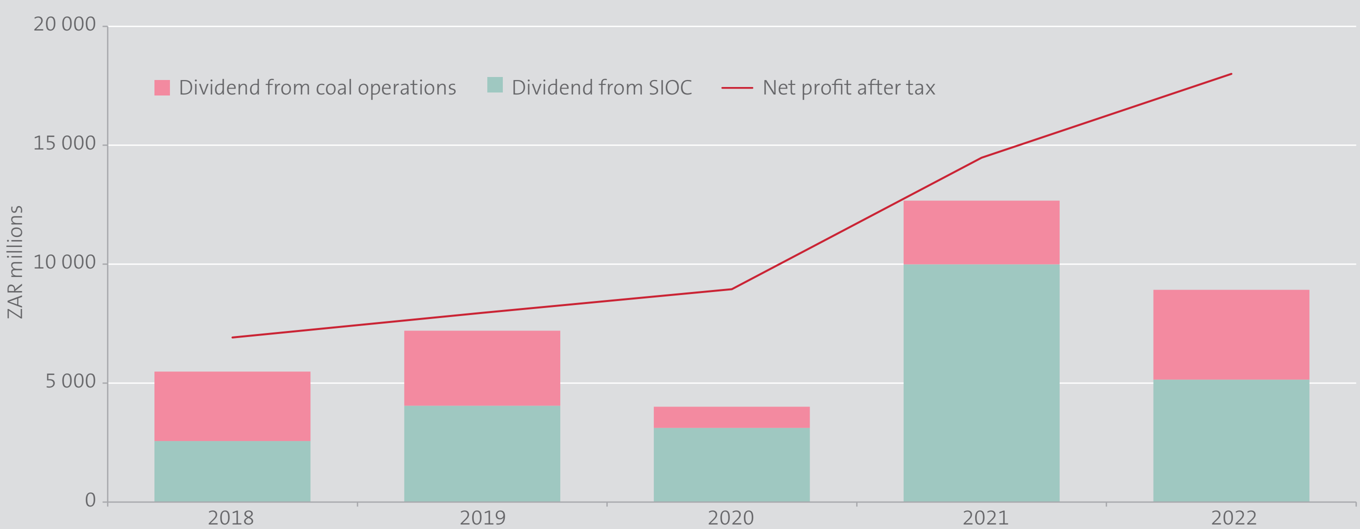
Exxaro has also chosen to invest a portion of its coal-derived cash flows in new mining operations, with a focus on producing commodities that will be used in green electrification applications, namely copper, manganese and bauxite. Their aim is for 50% of earnings (before interest, taxes, depreciation 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

Camissa Asset Management Funds

Performance to 30 September 2023	1 year	3 years[1]	5 years[1]	10 years[1]	15 years[1]	Since launch[1]	Launch	TER[2]	TC[3]
Unit trust funds[4]									
Equity Alpha Fund	4.7%	14.4%	10.0%	7.7%	10.7%	14.7%	Apr-04	1.78%	0.35%
SA Equity General funds mean	11.8%	13.2%	6.8%	6.1%	8.7%	11.5%			
Outperformance	-7.1%	1.2%	3.2%	1.6%	2.0%	3.2%			
SA Equity Fund#	1.9%	-	-	-	-	-2.9%	Sep-22	1.64%	0.55%
SA Equity General funds mean	11.8%					7.0%			
Outperformance	-9.9%					-9.9%			
Global Equity Feeder Fund	33.9%	9.6%	-	-	-	6.5%	Nov-19	1.94%	0.21%
FTSE World Index	28.2%	13.3%				14.5%			
Outperformance	5.7%	-3.7%				-8.0%			
Balanced Fund	12.7%	12.0%	8.3%	7.5%	-	8.6%	May-11	1.51%	0.28%
SA Multi Asset High Equity funds mean	13.0%	10.2%	6.8%	6.8%		8.0%			
Outperformance	-0.3%	1.8%	1.5%	0.7%		0.6%			
Protector Fund	8.0%	11.6%	7.8%	7.3%	7.4%	9.3%	Dec-02	1.57%	0.23%
CPI + 4%	9.6%	9.9%	8.9%	9.6%	9.8%	10.2%			
Outperformance	-1.6%	1.7%	-1.1%	-2.3%	-2.4%	-0.9%			
Stable Fund	4.0%	13.1%	7.5%	7.5%	-	7.9%	May-11	1.48%	0.31%
CPI + 2%	7.6%	7.9%	7.0%	6.5%		6.3%			
Outperformance	-3.6%	5.2%	0.5%	1.0%		1.6%			
Institutional funds[5]									
Managed Equity Fund	3.6%	15.4%	10.5%	7.4%	10.8%	10.8%	Sep-06		
FTSE/JSE Capped SWIX Index	11.9%	13.8%	6.8%	7.4%	10.6%	10.3%			
Outperformance	-8.3%	1.6%	3.7%	0.0%	0.2%	0.5%			
Domestic Balanced Fund	4.0%	13.8%	9.8%	7.5%	9.7%	8.6%	May-07		
Peer median[6]	9.9%	13.0%	7.0%	7.2%	9.8%	8.6%			
Outperformance	-5.9%	0.8%	2.8%	0.3%	-0.1%	0.0%			
Global Balanced Fund	14.2%	13.7%	9.8%	8.8%	-	9.6%	Jul-13		
Peer median[7]	14.2%	11.9%	7.8%	8.3%		8.9%			
Outperformance	0.0%	1.8%	2.0%	0.5%		0.7%			
Bond Fund	5.4%	8.1%	7.5%	7.5%	8.1%	8.0%	May-07		
BESA All Bond Index	7.2%	7.0%	7.2%	7.2%	8.1%	7.8%			
Outperformance	-1.8%	1.1%	0.3%	0.3%	0.0%	0.2%			
Money Market Fund	9.3%	7.1%	7.4%	7.5%	7.4%	7.7%	Jan-04		
Alexander Forbes STeFI Composite Index	7.5%	5.3%	5.9%	6.3%	6.5%	7.0%			
Outperformance	1.8%	1.8%	1.5%	1.2%	0.9%	0.7%			
Shariah unit trust funds[4]									
Islamic Equity Fund	3.1%	13.5%	7.9%	7.6%	-	10.3%	Jul-09	1.49%	0.19%
SA Equity General funds mean	11.8%	13.2%	6.8%	6.1%		9.6%			
Outperformance	-8.7%	0.3%	1.1%	1.5%		0.7%			
Islamic Global Equity Feeder Fund	28.8%	7.4%	-	-	-	9.3%	Jan-19	1.84%	0.12%
Global Equity General funds mean	23.7%	8.0%				13.7%			
Outperformance	5.1%	-0.6%				-4.4%			
Islamic Balanced Fund	6.3%	12.1%	8.0%	7.3%	-	7.5%	May-11	1.50%	0.13%
SA Multi Asset High Equity funds mean	13.0%	10.2%	6.8%	6.8%		8.0%			
Outperformance	-6.7%	1.9%	1.2%	0.5%		-0.5%			
Islamic High Yield Fund	6.1%	7.8%	-	-	-	6.9%	Mar-19	0.59%	0.04%
Short-term Fixed Interest Index (STeFI)	7.5%	5.3%				5.8%			
Outperformance	-1.4%	2.5%				1.1%			

Highest and lowest monthly fund performance	High	Low	High	Low	High	Low	High	Low	High	Low	High	Low
Equity Alpha Fund	11.7%	-4.1%	11.7%	-4.1%	12.6%	-21.6%	12.6%	-21.6%	12.6%	-21.6%	12.6%	-21.6%
SA Equity Fund	11.5%	-5.9%	-	-	-	-	-	-	-	-	11.5%	-5.9%
Global Equity Feeder Fund	14.5%	-6.8%	14.5%	-8.2%	-	-	-	-	-	-	18.1%	-15.6%
Balanced Fund	7.5%	-3.6%	9.1%	-4.5%	9.1%	-15.7%	-	-	-	-	9.1%	-15.7%
Protector Fund	5.1%	-2.8%	7.4%	-3.7%	7.4%	-13.9%	7.8%	-13.9%	7.8%	-13.9%	9.5%	-13.9%
Stable Fund	4.9%	-4.4%	6.1%	-4.4%	6.1%	-11.4%	6.1%	-11.4%	-	-	6.1%	-11.4%
Islamic Equity Fund	5.3%	-3.3%	9.6%	-8.9%	9.6%	-14.3%	9.6%	-14.3%	9.6%	-14.3%	9.6%	-14.3%
Islamic Global Equity Feeder Fund	10.6%	-6.8%	10.6%	-7.4%	-	-	-	-	-	-	14.6%	-8.4%
Islamic Balanced Fund	4.5%	-2.0%	8.0%	-6.2%	8.0%	-9.3%	8.0%	-9.3%	-	-	8.2%	-9.3%
Islamic High Yield Fund	1.4%	-0.4%	2.7%	-1.2%	-	-	-	-	-	-	2.7%	-2.4%

Footnotes and disclaimer follow overleaf.

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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.