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BAYAKHA INVESTMENT PARTNERS INVESTMENT UPDATE

Fitch SA Downgrade, Cabinet Reshuffle and The Renewable Energy Sector

On Friday, the 31st of March 2017, South Africans woke up to the news of a cabinet reshuffle. The following Monday, Standard & Poor's (S&P) took a decision to downgrade South Africa's (SA's) foreign currency denominated debt to non-investment grade. As I'm writing this, news has just broken that Fitch has become the first ratings agency to downgrade SA's foreign *and* local denominated debt to junk status. Naturally, citizens and investors have since sought to understand what these events mean for them. For Bayakha specifically, the question relates to the continued viability of the clean energy sector.

In a nutshell, Bayakha remains positive about the sector, but we expect financial close delays given changes in the Energy Ministry.

This update has thus been compiled to share the facts and rationale underpinning Bayakha's view. A letter I received from a prospective investor this week revealed 2 key concerns that have been common to the communications we've handled since the reshuffle:

1. What is the impact of the downgrades on project returns?
2. How does the "nuclear agenda" impact Bayakha's investment universe?

<u>The Impact of The Downgrades on Project Returns</u>

The impact of the S&P and Fitch downgrades are negligible at present as revenues of the independently owned power projects that Bayakha invests in are inflation-linked and therefore, protected. Importantly, we forecast that the South African Reserve Bank's (SARB's) monetary policy will probably alter course from price stability to pro-growth in accordance with the counsel of the ratings agencies. In this scenario, investors are likely to benefit as inflation increases will outpace interest rate increases, therefore resulting in improved returns at the project level.

<u>The Impact of the "Nuclear Agenda" On Bayakha's Investment Universe</u>

It is important to note that nuclear is not new to South Africa's energy plans. Thus, as an energy investor, we have always been aware of its presence alongside other technologies in the planned energy mix. Given that renewable energy is now the cheapest form of energy, there is no rational case for its exclusion in the energy mix in favour of nuclear. In other words, renewable energy is not in competition with nuclear. We therefore expect renewables to remain firmly on the agenda, in tandem with other technologies, nuclear being just one of them.

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In Detail...

Below is the detailed analysis underpinning Bayakha's views.

S&P & Fitch Downgrades – Impact on Asset Prices Muted for Now

Ratings agency Standard & Poor's (S&P's) decision to downgrade South Africa's foreign currency denominated debt, on its own, was not going to have a material effect on the cost of capital because the decision currently only affects 10% of South Africa's issued debt.

It is important to highlight that, only *foreign* currency denominated debt has been downgraded to junk status by S&P. South Africa's investment grade rating on rand denominated debt is still intact.

For context, 90% of SA debt is rand denominated and the remaining 10% is foreign currency denominated debt. S&P is also the only rating agency that differentiates between foreign and local currency debt ratings.

In its statement, the S&P advised that it "could revise the outlook to stable if they see political risks reduce and economic growth and/or fiscal outcomes strengthen compared to their base projections."

Fitch is the first ratings agency to downgrade South Africa's local currency denominated debt to sub-investment grade since 2000. South Africa's local currency debt needs to maintain an investment grade rating by two ratings agencies to remain in major global bond indices.

What this demonstrates is that the downgrades haven't affected South Africa's eligibility in global bond indices at present.

The figure below graph indicates South Africa's current local currency debt rating across the three major rating agencies.

Figure 1: South Africa's local currency debt rating

	Moody's rating scale	S&P rating scale	Fitch rating scale
Investment Grade	Aaa	AAA	AAA
	Aa1	AA+	AA+
	Aa2	AA	AA
	Aa3	AA-	AA-
	A1	A+	A+
	A2	A	A
	A3	A-	A-
	Baa1	BBB+	BBB+
	Baa2	BBB	BBB
	Baa3	**BBB -**	BBB -
Non-Investment Grade	Ba1	BB+	**BB+**
	Ba2	BB	BB
	Ba3	BB-	BB-
	B1	B+	B+
	B2	B	B
	B3	B-	B-
	Caa1	CCC+	CCC+
	Caa2	CCC	CCC
	Caa3	CCC-	CCC-
	Ca	CC	CC
	C	C	C

Our Macro- Economic Forecast

Given the S&P & Fitch downgrades, we forecast that the ZAR is likely to depreciate. This will result in increased inflation. However, we believe that the typical SARB response to target inflation through increased interests rates will be less aggressive in an effort to support GDP growth. Therefore, we forecast that the South African Reserve Bank's monetary policy will probably alter course from price stability to pro-growth.

Given that renewable energy power purchase agreements are structured to ratchet to CPI rates, we expect nominal returns to projects to increase as inflation rises.

The probable movement in the forex costs of projects is covered by the PPAs standard adjustment mechanism to adjust tariffs for forex movement at financial close. This should mute the impact on project viability and risk.

In conclusion, our forecast of a muted SARB response to inflation risk implies that bottom-line profits are expected to increase due to a CPI linked tariff.

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Nuclear Allocation & Impact on Bayakha Investible Universe

One of Fitch's concerns listed in the downgrade statement is that under the new Cabinet, including a new energy minister, the nuclear programme is likely to move relatively quickly.

The government's official stance on South Africa's nuclear capacity is as follows:

1. Department of Energy has indicated the path to a diversified energy mix
2. President Zuma, in his State Of The Nation Address, committed to Eskom signing outstanding renewable energy preferred bidder PPAs
3. President Zuma has said SA will take up nuclear based on what the country can afford. Said differently, "at a scale and pace South Africa can afford."

South Africa's policy has been clear in having a diversified energy mix. Nuclear has been part of this mix reflected in the State's energy policy planning documents since 2010. The Integrated Resource Plan (IRP) 2010 and the new updated Draft IRP 2016 include nuclear.

To our investors

Clients are reminded that Bayakha's intended portfolio is based on Bid Window 1 to Bid Window 4.5 projects i.e. all *existing* independent power producers. 112 projects to date have been awarded preferred bidder status. Of these:

- 54 projects have reached commercial operating date.
- 40 projects have been operational for longer than a year.
- Energy generated in 2016 by these 40 projects was 5 087 GWh, which was 94% of their annual energy contribution projections (P50) of 5 401 GWh over a 12-month delivery period.
- 24 projects (60%) have individually exceeded their P50 projections

Bayakha's Renewable Energy Fund is currently fund-raising. Please do not hesitate to contact us should you require further details.

Sincerely,

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