Driehaus Emerging Markets Small Cap Equity Strategy Summary

FEBRUARY 2023

"Load shedding..." my driver in Cape Town simply said with a sheepish shrug as we pulled out of the parking lot after dinner. As I glanced over my shoulder at the terrain that overlooks some of the most spectacular views in the world, all I could see at this time of night was darkness. Without even the glimmer of a streetlight, it was akin to being shut inside of a windowless room with all of the lights off.

The strategy has maintained zero exposure to South Africa since May 2021. While the market possesses a number of well managed companies with consistent growth profiles, the escalating power crisis has deterred us from investing. A recent trip to the country provided a glimpse at the ongoing challenges and opportunities on the ground.

Load shedding is by no means a new phenomenon. Throughout the world, although most prevalent in emerging market countries, the term refers to the periodic curtailment of power due to a bottleneck in the system. However, in South Africa, load shedding has reached an extreme, currently on so-called Stage 7, which implies that most people will be without electricity for ten hours per day, spread over two different increments. During my visit, rumors swirled that parts of the country may soon move to Stage 8, which would mean no electricity for 12-14 hours per day.

What once began as a band-aid to ease in the mending of a struggling power sector has gone on to resemble a slow-motion train wreck, impacting households, creating an additional cost of doing business, and resulting in health concerns.

How did we get here? The epicenter of South Africa's power woes resides with Eskom, the state utility company. Ironically, the Financial Times named Eskom its global power company of the year in 2001. Things went downhill for the company around the Global Financial Crisis in 2008 and spiraled over the last decade. In 2010, as South Africa hosted the World Cup, the top priority for Eskom was to keep the power running at all costs, hence grid maintenance took a back seat to power generation. The ongoing aging of the system and operational missteps of the company have created a vicious circle, as South Africa's credit rating, cost of capital, and currency are inevitably tied to Eskom's fate.

South Africa is a country with a rich endowment of natural resources. In addition to platinum (where South Africa accounts for approximately 80% of the world's reserves), the country is a large producer of gold, iron ore, and coal. As a result of South Africa's resource base, the country relies heavily on coal-fired power generation, with some 80% of Eskom's capacity linked to thermal power. This is despite much of the world seeking to phase out coal plants in search of greener alternatives. Eskom has been a laggard in that regard, although in conjunction with the COP-26 summit in Glasgow in 2021, South Africa received $8.5 billion in climate finance to bolster its renewable energy capacity.

During my visit, more than half of Eskom's installed power generation capacity of 48 gigawatts (GW) was out of service, representing a new record. Of the nearly 25GW of outages, some 3.5GW were due to planned maintenance, while a staggering 21GW was due to unplanned breakdowns of multiple power stations.

In a stunning twist, Eskom's CEO suffered an attempted poisoning in December, drinking cyanide-laced coffee. He has been outspoken against the influences of organized crime and corruption in various levels of the government, which have perpetuated the power crisis in the country. The CEO went on local television during my visit, issuing a scathing rebuke against the corrupt influences throughout the country. Having already submitted his resignation at this point, his departure date was unsurprisingly moved up following this outspoken public appearance.

What could the path forward look like? One idea that has been proposed is a partial privatization or separation of various business units of the company. For example, private sector operators could take over parts of the generation capacity that Eskom is unable to effectively operate, leaving the company with a more manageable asset base. Another possibility is the separation of generation, transmission, and distribution, which would ideally streamline the company.

This pivotal moment may also represent an opportunity for South Africa to establish itself within the global energy transition, underscoring the need for conventional power to coexist with the growth of renewables. While the strategy carries no direct exposure to South Africa, one of the strategy's top holdings is a Taiwanese company that supplies off-grid solar inverters, which are used in developing countries facing unstable power supplies. South Africa is one of the company's largest and fastest growing markets.

Toward the end of my visit, an emotional trip to the Apartheid Museum in Johannesburg served as a reminder of the legacy of this painful era in South Africa's history. President Cyril Ramaphosa served as the ANC's chief negotiator as apartheid drew to an end. One can only hope that Ramaphosa and other leaders in South Africa will summon the will to confront the power crisis, which pales in comparison to the devastation and tragedies faced under apartheid.

Performance Review

At the sector level, the most significant contributors to returns were information technology and utilities. Consumer discretionary and industrials detracted the most value. At the country level, Saudi Arabia and the US were positive contributors to performance for the month, Hong Kong and China were notable detractors from performance.

Positioning and Outlook

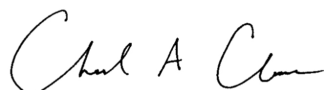
After carrying an overweight position to cyclicals for much of the last two years, the strategy has incrementally shifted exposures into dynamic and consistent growth stocks in the first two months of 2023. While we expect continued tight supply in a number of commodities, namely those associated with a shifting global energy mix, we currently observe muted demand signals. The strategy continues to maintain a significant underweight to the financials sector, where we see cyclical pressures emerging related to asset quality in certain markets, following meaningful increases in interest rates over the last two years.

After a sharp pullback in information technology and health care stocks in 2022, as well as a valuation de-rating in longer-duration stocks with consistent growth profiles, we are starting to see attractive opportunities emerge. The strategy has moved closer to a neutral position in the information technology sector relative to the MSCI Emerging Markets Small Cap Index, while reducing the magnitude of the underweight position in the health care sector.

We remain positive on the dynamics associated with energy transition and believe that favorable supply/demand dynamics could persist for the better part of the decade in key minerals such as lithium, copper, and aluminum. However, these remain cyclical areas, and with slowing demand in much of the developed world, alongside a muted recovery in Chinese demand thus far following the relaxation of zero-COVID policy, we have reduced exposure to these areas.

That said, we retain a significant overweight position in China, with the view that the incremental growth in the domestic economy will be best captured in local beneficiaries, along with thematic exposures in the mainland equity market, rather than so-called "China derivative" exposures. Chinese equities recently exhibited their first meaningful pullback since the market bottomed last November, and we expect that as more clarity on the economic outlook emerges post the National People's Congress meetings in early March, investors will discount an economic recovery with a greater degree of conviction.

Until next month,



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