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DIGGING INTO SA'S SOARING FOOD PRICES

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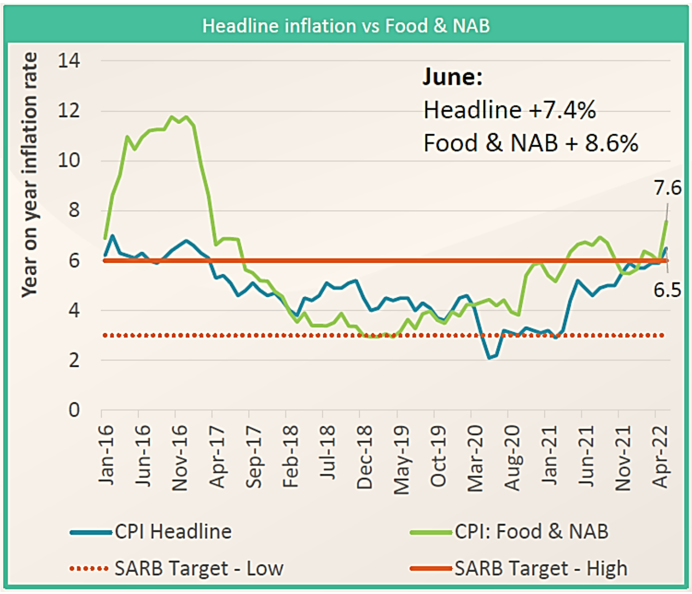
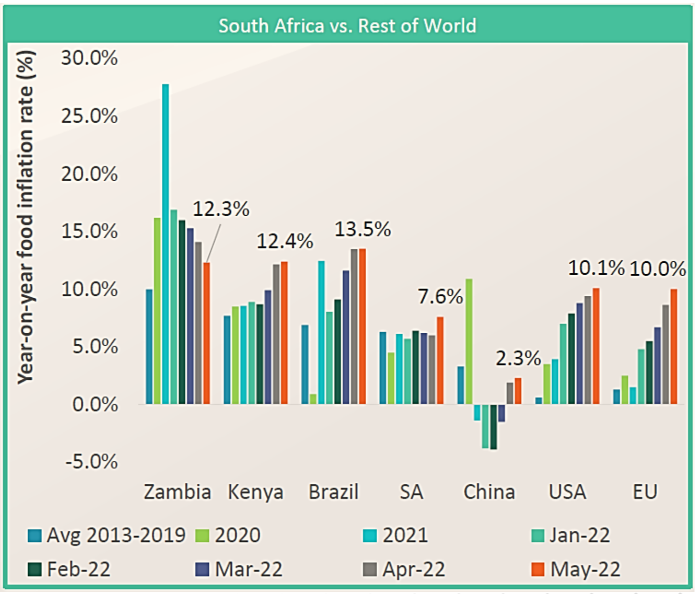
It will come as no surprise to most readers that the economy has, in recent months, been ravaged by rising food prices off the back of various drivers including climatic factors, geopolitical factors and, in the local context, South African-specific structural weaknesses, to name a few.

Inflation generally (and food inflation specifically) has seen a sharp increase over the past 12 to 18 months. South Africa's overall rate of inflation (headline CPI) in June 2022 (compared to June 2021) was 7,4%. The rate of increase in the prices of food and non-alcoholic beverages was higher – at 8,6% over the same period. Interestingly, South Africa is not among the worst affected countries globally, nor is this the highest level of food inflation seen by the country in recent years (see graphs below). However, the effects can be directly felt by consumers, with the most vulnerable members of society being hardest hit as they typically spend a higher portion of their income on food. Food inflation has consequently been attracting a lot of media attention locally and beyond, as concerns grow about people's ability to afford basic foodstuffs.





Source: Bureau for Food and Agricultural Policy ("BFAP") presentation titled "Food inflation in South Africa", July 2022 (www.bfap.co.za)

In this article, we unpack the themes driving the agriculture, agro-processing, and food production sector ("Agri and Food sector"), delving into some of the headwinds that triggered the recent inflationary environment, and considering the outlook for the sector, for food inflation, and for South African food security.

Global and geopolitical factors

The past couple of years have seen a perfect storm, in that the global economy has been hit by two significant humanitarian and geopolitical events directly following one another. These are the COVID-19 pandemic and then the Russian invasion of Ukraine. Both events weighed negatively on global economic growth, created logistics and supply-chain issues, and drove up the cost of transport and the direct prices of certain key agricultural commodities - with the downstream effects being complex and interconnected.

Coronavirus pandemic

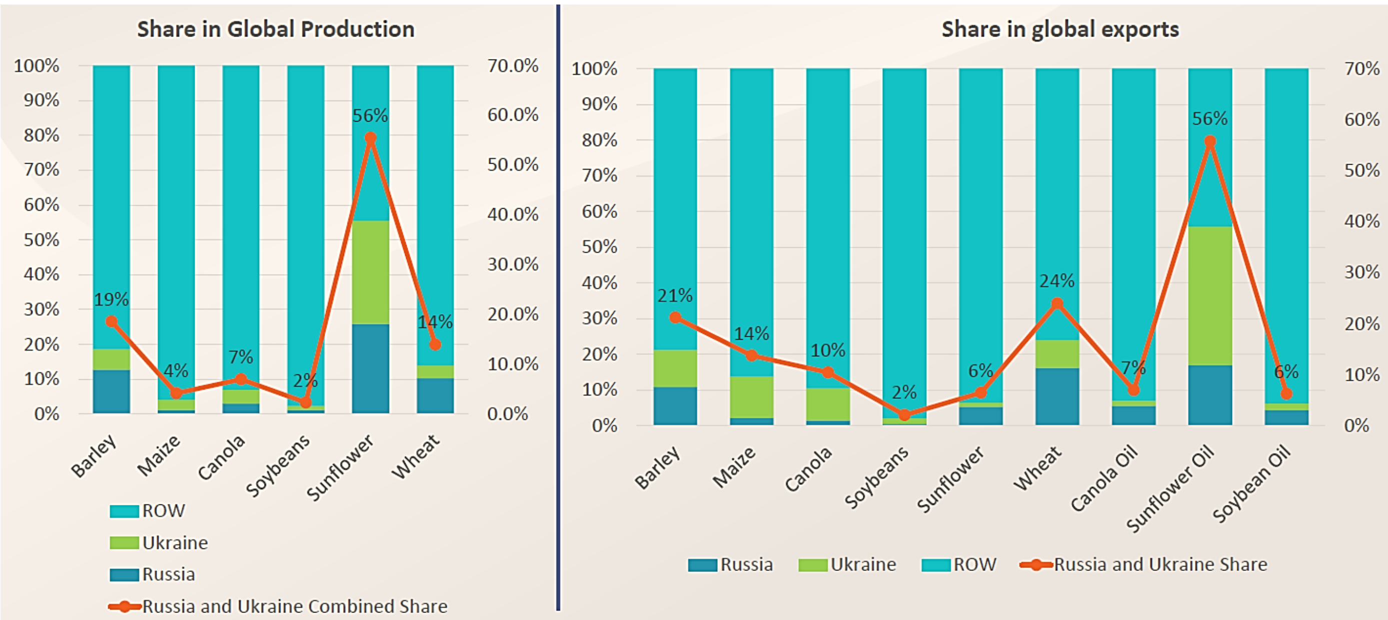
- The pandemic and associated lockdowns around the globe resulted in substantial supply chain and logistics disruptions and delays, and drove up the cost of transport for various agricultural commodities.
- The supply chain challenges caused by COVID also created a pent-up demand in certain products, thereby driving their prices up even after lockdowns ceased and borders reopened.

Russian invasion of Ukraine

- Russia is a major supplier of gas to the EU, and a major exporter of petroleum oils. The ongoing war and sanctions against Russia drove up energy and fuel prices. According to Statistics South Africa, fuel prices were up 45.3% in June, the largest annual increase for fuel since the agency's consumer price index series began in 2009.
- Both Russia and Ukraine are major suppliers of key agricultural commodities (see graphs below). The conflict has therefore adversely affected international supply and consequently the prices of various commodities, including wheat, as an example, which is a staple food in many countries.
- Russia is a leading exporter of chemical fertiliser. South Africa is a net importer of fertiliser, so we are heavily impacted by global pricing pressures. SA has seen a

roughly 60% increase in fertiliser prices this year to date (on top of a roughly 50% increase that had already been absorbed in 2021 due to COVID-related factors).

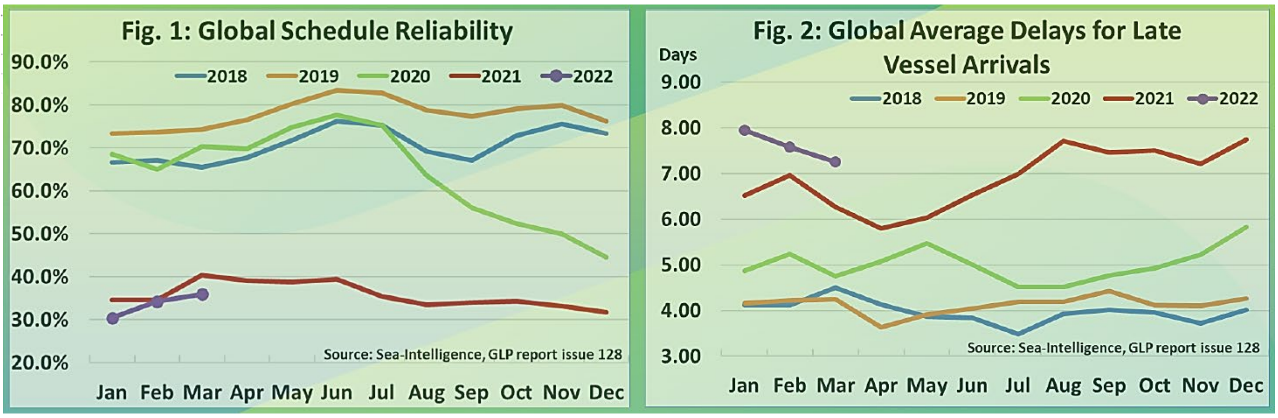
- The war has affected shipping routes as many major shipping lines stopped routing produce to Russia, furthering supply chain and logistics issues and disrupting international trade. Some trade to Russia has since resumed, including from SA, but significantly reduced volumes are expected.



Source: BFAP compiled from USDA & ITC Trademap, 2022 (www.bfap.co.za)

Shipping and logistics costs and reliability:

- Overall, shipping and logistics costs have increased exponentially in recent years, with the global container freight rate index having increased by more than 100% in 2021. Although we seem to have seen the peak, prices remain far above historical levels.
- Logistical challenges such as container shortages, port inefficiencies and congestion have also characterised the past few months, with delays and weak global schedule reliability continuing to plague agricultural producers who need to transport agricultural commodities to key markets.



Source: BFAP compiled from Sea-Intelligence (www.bfap.co.za)

Other factors

In addition to the devastating effects of the geopolitical events discussed above, the global agricultural sector has also been affected by other headwinds.

- There have been multiple regional livestock disease outbreaks in recent years, including foot-and-mouth disease and bird flu, amongst others. Notably, China’s recovery from African Swine Flu materially impacted global pork supply. China supplies roughly 50% of the world’s pork.
  - This increased global demand for other protein (substitution effect), pushing up the prices of other meat products.
  - This is also said to have driven investment in intensive meat production facilities (in other words, large industrial scale feedlots replacing smaller, more dispersed farming operations). These change the rate at which animal feed is consumed, and we can expect animal feed prices to increase in response to this higher overall demand.
- Globally, we have also seen severe cooking oil shortages, and a consequent spike in prices. Palm oil supply has been hugely constrained, with Indonesia having banned all exports of a range of palm oil products. Palm oil is the most highly used edible oil in the world, and Indonesia is by far the world's biggest palm oil producer, generating about 60% and exporting more than 50% of the world's supply. This shortage compounds a global sunflower and canola oil shortage due to the Ukraine war and earlier droughts in some oilseed producing regions (e.g., Canada and Argentina), as well as a surge in demand due to increasing biofuel operations worldwide.

Climatic factors

Extreme weather events have exacerbated the challenges posed by the pandemic and the Ukraine war. Globally, these events were multiple: the Derecho Storm in Iowa in 2020; flooding in China in 2020; Hurricane Ida in Louisiana in 2021; a drought in South America and Canada in 2021; flooding in Malaysia in 2021; and, more recently, the heat waves in the Northern Hemisphere this year (2022). Weather-related USA planting delays in 2022 also meant that the USA could not pick up some of the demand created by the Ukraine war, exacerbating supply-demand mismatches for certain key commodities.

Some of the above weather events may be linked to the La Niña weather pattern that occurred between 2020 and 2021, causing varying weather patterns across the world. South Africa typically benefits from La Niña weather patterns due to good rainfall, whereas other regions such as South America and North America suffer weaker rainfall. A challenge our producers faced with this occurrence, however, is that in recent seasons it led to excessive rainfall which persisted during harvesting and planting times. Rainfall during a harvesting period makes it difficult to harvest, causing delays and, in some instances, in lower quality produce being harvested.

There are predictions that another La Niña is forming towards the end of this year. Whilst this may bode well for South African producers (assuming the rainfall is not too excessive or prolonged), it could have adverse effects on the global supply of various agricultural commodities produced elsewhere in the world, and therefore on global food prices.

South African-specific factors

In South Africa, there is added uncertainty and upside risk to other input costs, including energy and labour costs. We recently saw Eskom applying to increase their tariffs by as much as 34% in April next year. NERSA is due to rule on this in November. SA also suffers particularly weak transport and logistics infrastructure, including our rail networks and ports. Our ports reflect productivity levels that are far below international benchmarks due to weak and ageing port infrastructure and equipment. The recent floods in parts of the country (notably in KwaZulu Natal) also damaged key infrastructure, and there is the added challenge of vandalism and theft destroying the rest.

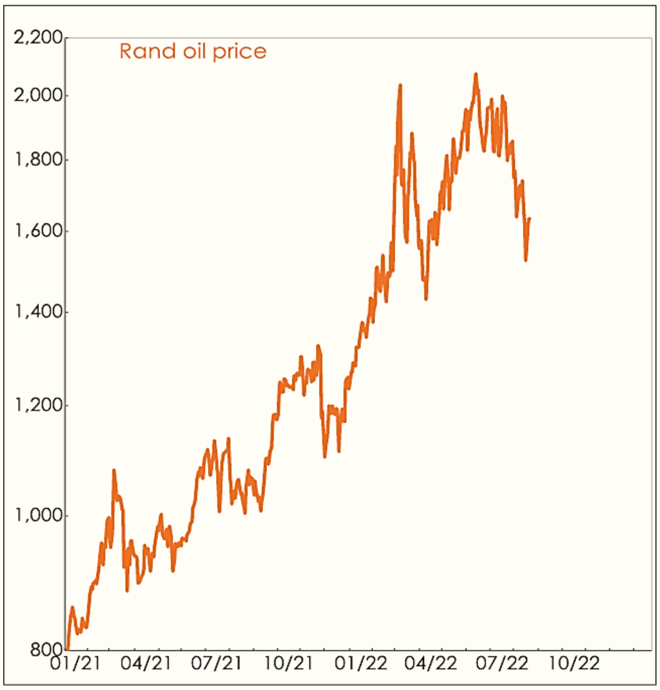
In the wake of the Land Bank saga - which in April 2020 saw the biggest agricultural funder in the country default on its debt, precipitating a severe liquidity challenge – South African agricultural producers also face difficulties in obtaining the necessary funding to support their ongoing working capital and capital expenditure needs. Land Bank once funded close to 30% of agricultural debt in the country. Whilst the large, commercial agricultural operations are easily able to obtain alternative funding from commercial banks, the smaller agricultural producers will struggle.

Outlook

If anything is certain, it is that we are living in very uncertain times. Agricultural producers face an array of challenges, including an ongoing war and the ripple effect that various governments' policies will have on the global and local economy.

The economic damage from the war poses a material risk to global growth projections, with the IMF, World Bank and OECD all recently having revised their global growth forecasts for 2022 sharply downwards. Elevated inflation in this low growth environment complicates the tradeoffs to be managed by central banks, who must balance the risks to growth and inflation, creating a material risk of entering a cycle of stagflation. We have seen most central banks tighten monetary policy by increasing interest rates, which, in turn, places pressure on emerging markets and developing economies like South Africa. A weaker Rand makes agricultural imports more expensive in Rand terms, which could place upward pressure on local food prices.

Encouragingly, crude oil and natural gas prices seem to have stabilised, albeit at levels higher than the historical average. According to Bloomberg consensus estimates, energy prices are expected to remain elevated in the near term but are expected to normalise by late 2023. Linked to this, fertiliser costs are also expected to ease over the next 12 to 24 months, but at levels higher than the historical norms. In other words, when it comes to these key input costs (being fuel and fertiliser), although we seem to have seen the peak, we are not expected to be back at pre-2020 levels any time soon.



Source: Old Mutual Investment Group compiled, Factset data, August 2022

The risk of extreme weather events around the world will persist as the world battles the ever-increasing effects of climate change. This will continue to impact the supply of key agricultural products, and consequently the price of food in years to come.

Positively, in the short term, agricultural producers should respond to higher agricultural commodity prices, hopefully leading to increased production. According to data released in August 2022 by the Crop Estimates Committee, South African producers have increased their plantings of winter crops (notably wheat, barley, and canola) for the 2022/2023 season, to take advantage of higher prices. Production conditions will be critical, and stocks must replenish, but we could expect to see higher supply leading to normalisation in prices in the medium term.

Notwithstanding the various complexities and headwinds, agriculture is widely accepted to be a key engine of economic growth both locally and internationally. Within a troubled global economy, the agriculture and food value chain sectors will continue to be driven by population growth, urbanisation, and the rise of the middle class. The demand for food will continue to grow over the next decade and this growing need must be met by supportive government policy, decisive action, and continued investment in the sector, to ensure that the country avoids an emerging food crisis.

The Agri and Food sector is one that we, at Futuregrowth, are eager to support through responsible investments that yield appropriate risk-adjusted returns. We continue to pursue a strategic initiative of growing our presence in the sector from both a debt and an equity perspective, as part of a broader strategy to support infrastructure investment across various critical sectors of the economy.

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