Portfolio Committee on Public Enterprises Presentation - Financial oversight of SOCs

Presenter: ALM; National Treasury**| September 2014**

national treasury
Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

PUBLIC FINANCE MANAGEMENT ACT (PFMA)

OBJECTIVE OF THE PFMA

- Secure transparency, accountability & sound management of revenue, expenditure, assets and liabilities of institutions*(management of REAL)*

UNDERLYING PRINCIPLES OF THE PFMA

- Responsibility
- Accountability
- Promotion of transparency, efficiency, effectiveness and economy
- Effective management of revenue, expenditure, assets and liabilities
- Governance structures
- Improved service delivery

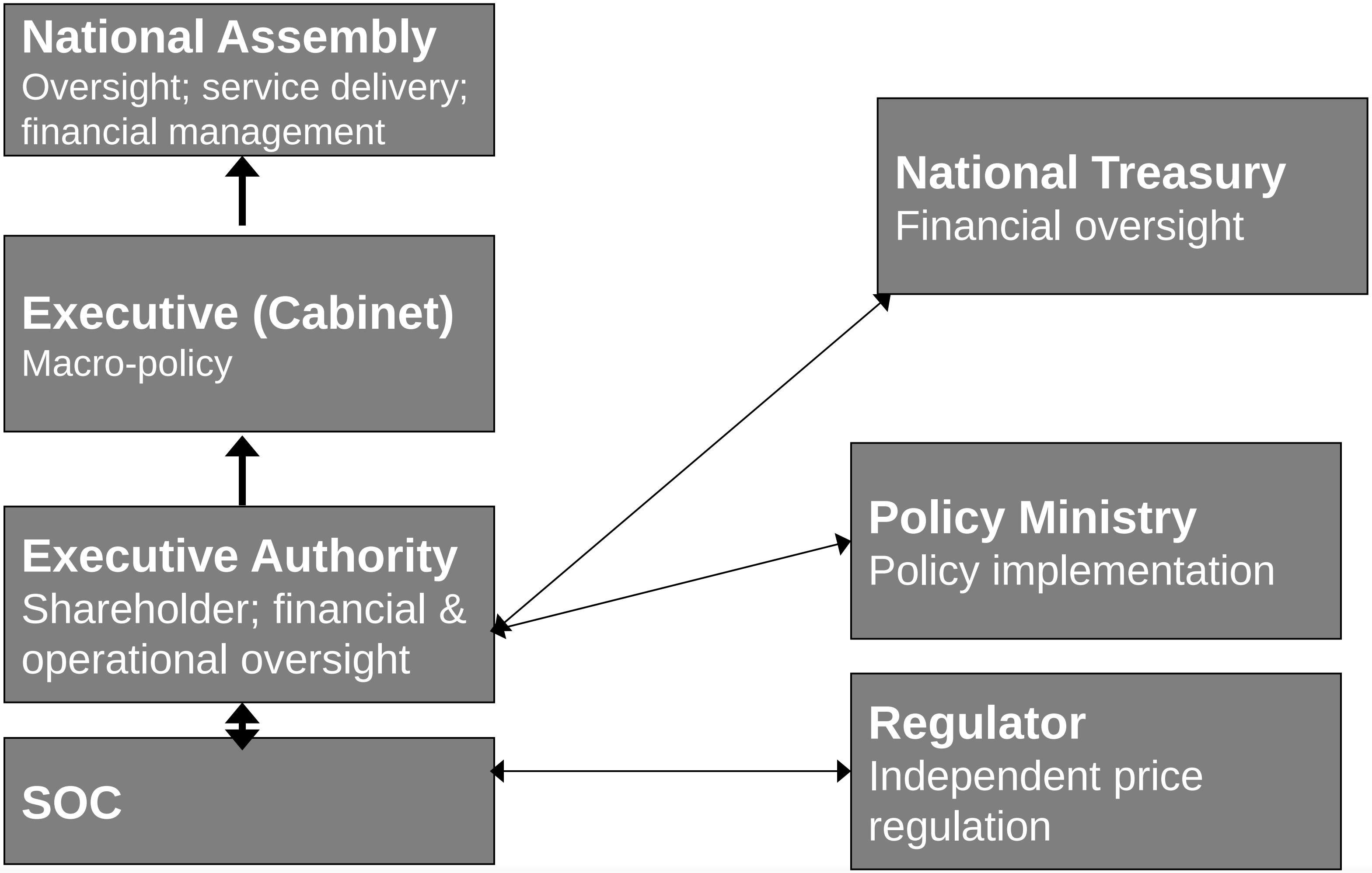
Key provisions of the PFMA

- Section 52 and 53 – Corporate plans and annual budget must be submitted to Executive Authority and National Treasury one month before the start of the financial year
  - Treasury Regulations specify that the Corporate Plans must include:
    - Strategic objectives
    - Strategic and business initiatives
    - Key performance measures and indicators
    - Risk management plan
    - Fraud prevention plan
    - Materiality and significance framework
    - Financial plan addressing projections of revenue, expenditure and borrowings; asset and liability management; cash flow projections; capital expenditure programmes; and dividend policy
  - Executive Authority and Accounting Authority (Board) of SOCs required to conclude a shareholder compact ("performance agreement") and to agree on a process for quarterly reporting to the Executive Authority
  - Parliament requires that Corporate Plans be tabled by the Executive Authority in Parliament

Key provisions of the PFMA

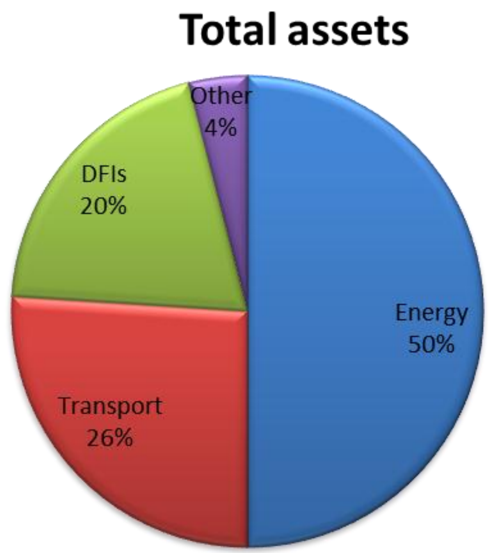
- Section 58
  - SOCs financial statements to be audited by the Auditor General or other registered auditor in consultation with the Auditor General
- Section 55
  - Unaudited financial statements to be submitted to the National Treasury within 2 months after the end of the financial year
  - Annual report, audited financial statements and report of the auditors to be submitted to the Executive Authority, National Treasury and Auditor General within 5 months of the end of the financial year
  - Executive Authority required to table the annual report and financial statements in Parliament within one month of receipt
- Section 66
  - All public entities must annually submit borrowing plans to the Minister of Finance
  - Schedule 2 public entities need approval from the Minister to borrow in a foreign currency or from a foreign entity
  - Schedule 3B SOCs require approval of all borrowing from the Minister of Finance
  - Schedule 3B SOCs require the approval of the Executive Authority in concurrence with the Minister of Finance to issue guarantees or indemnities

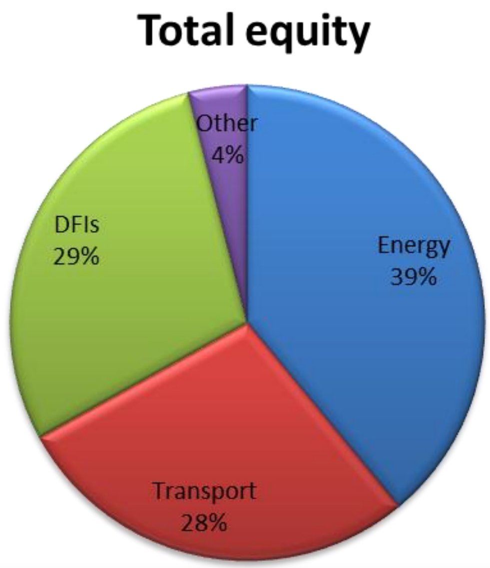
Oversight of SOCs



Relative Size of SOCs 2013/14

- Revenue streams ≈ R260 billion vs. Governments revenue ≈ R810 bil
- Interest bearing debt ≈ R467 billion vs. Governments debt ≈ R1.4 tril
- Infrastructure spend R110 bil. vs. Governments R104 bil
- Total asset value ≈ R1 005 tril
- Net asset value ≈ R374 bil





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Corporate plans & Annual report Focus Area

Financial Analysis

- ✓ Income statement
- ✓ Balance sheet
- ✓ Cash Flows analysis
- ✓ CAPEX
- ✓ Dividend policy

Income statement
- ✓ Revenue and costs growth
- ✓ Profitability and efficiency analysis

Balance sheet
- ✓ Solvency and liquidity analysis

Cash flow statement
- ✓ Generating sufficient cash from operations
- ✓ Relationship between earnings and operating cash flow

Corporate Governance

- ✓ Board composition
- ✓ Risk management framework
- ✓ Materiality & Significant framework etc

Board composition
- ✓ Evaluation of board composition – board committees

Risk management framework
- ✓ Evaluation of key risk management framework

Fraud prevention framework
- ✓ Describe key fraud components

Materiality and significant framework
- ✓ Materiality levels set and agreed with the shareholder

Strategy and Policy

- ✓ Alignment to Government objectives
- ✓ Execution of strategy
- ✓ Skills development
- ✓ Risks to strategy etc

Alignment to Government objectives
- ✓ How is the strategy aligned to the SOC's mandate NDP

Execution of the strategy
- ✓ What are the KPIs

Challenges faced by the strategy
- ✓ What are the challenges
- ✓ What is the SOC doing to address these challenges

Skills development
- ✓ Employment equity plans
- ✓ Creating sustainable skills

Treasury Operations

- ✓ Quantum of debt (guaranteed; unguaranteed; domestic; foreign; on and off-balance sheet debt)
- ✓ Debt maturity profile (Refinancing; Interest rate risks)
- ✓ Weighted average cost of debt (Finance Costs) etc

Quantum of debt
- ✓ Summary of the contingencies and commitment made by government on behalf of the SOC

Debt Capacity
- ✓ Evaluate Debt to Equity ratio given planned funding
- ✓ Evaluate interest cover and debt service ratio (current and future)

Debt maturity profile
- ✓ Evaluate how well the SOCs manage refinancing risk over time

Impact of credit rating downgrade on SOC

Financial Analysis Focus Area

Income statement

- Is the business generating sufficient operating profit to cover the operating expenses
- Evaluate the efficiency of the SOC by calculating profitability ratio e.g cost to income ratio, EBIT margin
- Calculate the employee costs as percentage of total expenditure
- Analysis the quality of the earnings i.e. real profits or accounting profits

Balance sheet

- Evaluate the solvency of the SOC by calculating the gearing ratio and interest cover ratio
- Evaluate the liquidity position to determine whether the SOC will be able to service the short term obligations – working capital management

Cash flow

- Ability of the SOC to generate sufficient cash from operations
- Calculate free cash flow for capital investments and dividends
- Analyse the dividend policy
- Review the CAPEX spending in relation to the budget/target

Strategy Policy Focus Area

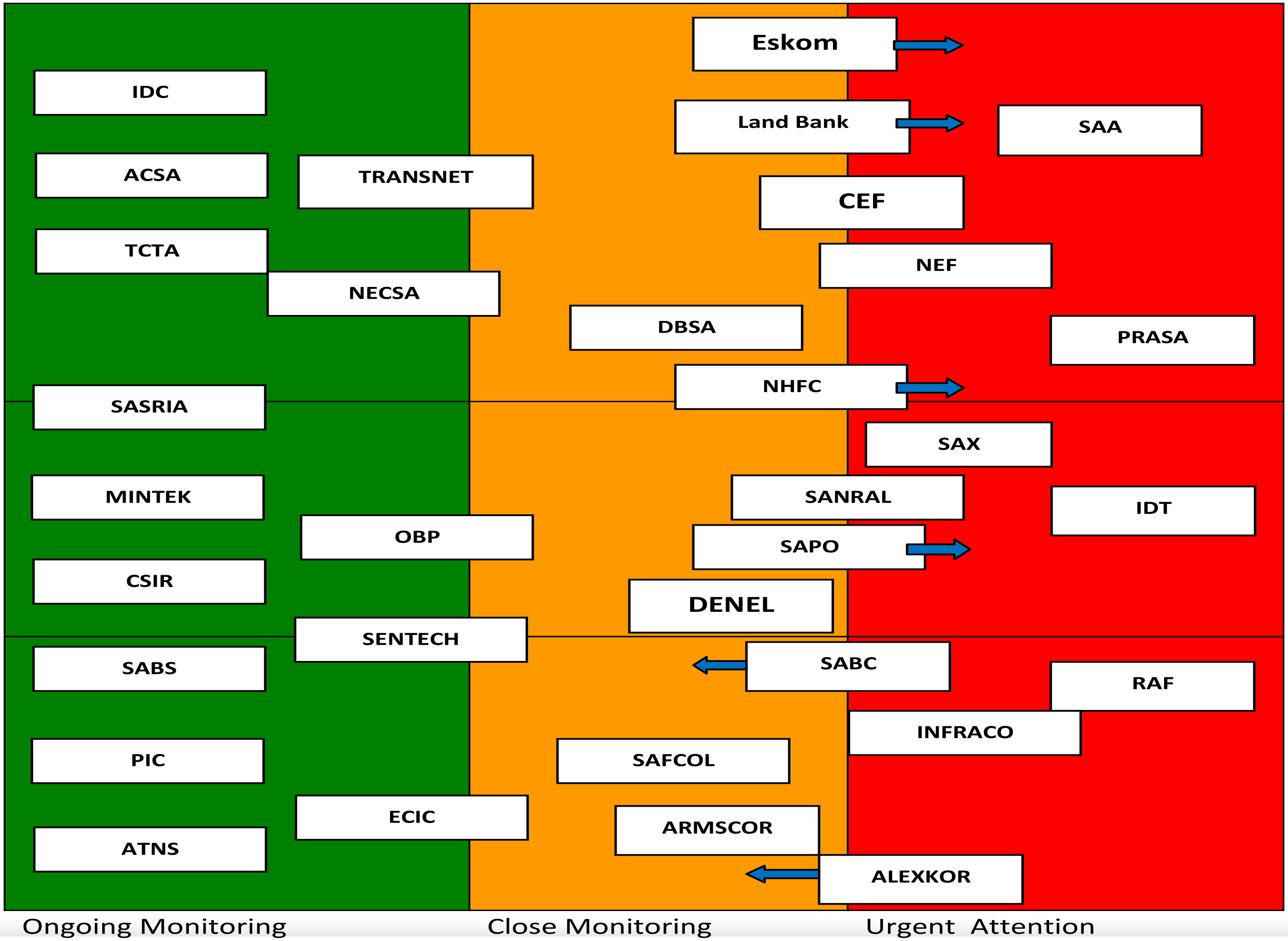
Analysis revealed:

Majority of SOCs achieved less than 60% of KPIs

Committee Oversight Focus Area:

- **Has the SOC properly interpreted its mandate and in line with NDP?**
- **Are the SOC's objectives, strategies and targets appropriate and do its performance indicators provide a strong basis for holding it to account?**
- **Are trade-offs by the SOC between commercial objectives and developmental objectives reasonable?**
- **Do performance targets sufficiently "stretch" the SOC?**
- **Has the plan taken government priorities into account?**
- **Is the SOC capitalized appropriately, and are targets for dividends and return on equity appropriate?**
- **Has the SOC met past performance targets?**
- **Is there a need to assess whether the SOC's mandate is still relevant**?

Status of SOCs



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Consolidated key financials of SOCs

Consolidated key fiancial indicators of Schedule 2 SOCs	2011/12 R'bil	2012/13 R'bil	2013/14E R'bil	2014/15B R'bil	2015/16B R'bil	2016/17B R'bil
Total income	231.7	263.4	286.9	316.3	350.7	388.1
Net earnings	18.0	10.4	9.3	9.5	3.5	14.3
Total assets	708.0	793.9	894.1	982.6	1 054.9	1 138.0
Total liabilities	470.5	541.8	620.8	703.9	770.2	836.8
Net asset value	237.5	252.2	273.4	278.7	284.7	301.2
Total income growth	19.8%	13.7%	8.9%	10.3%	10.9%	10.7%
Total costs to revenue	*88.4%*	91.7%	92.7%	91.8%	91.5%	86.6%
Net earnings margin	*8.2%*	4.1%	3.3%	3.0%	1.0%	3.7%
Return on equity (ROE)	*7.6%*	4.1%	3.4%	3.4%	1.2%	4.7%
Return on assets(ROA)	*2.5%*	1.3%	1.0%	1.0%	0.3%	1.3%
Debt ratio	*66.5%*	68.2%	69.4%	71.6%	73.0%	73.5%

Source: Schedule 2 SOCs Annual reports & Corporate plans (excluding DFIs)

Infrastructure spend

CAPEX	2011/12 Budget	2011/12 Actual	% Expenditure of Budget	2012/13 Budget	2012/13 Actual	% Expenditure of Budget	2013/14 Budget	2013/14 Actual	% Expenditure of Budget	2015/16 Annual Budget
Total of Top 5	**127,681**	**91,256**	**71.5%**	**131,669**	**107,626**	**81.7%**	**120,699**	**117,834**	**97.6%**	**118,404**
Other SOES	4,012	1,408	35.1%	5,887	2,228	37.8%	4,557	2,497	54.8%	5,458
Total	**131,693**	**92,664**	**70.4%**	**137,556**	**109,854**	**79.9%**	**125,256**	**120,331**	**96.1%**	**123,862**

- Ensuring that capital spending yields intended outcomes and service delivery improvements as per NDP
- Significant improvement in CAPEX spend over past 3 years, SOCs spent approximately R322 billion, representing average of 82% against budget
- Main reasons for under - spending on CAPEX

    - Contractors delays
    - User requirement specifications
    - Change of work scope
    - Material shortages

Borrowings Focus Area

- SOCs have to submit their borrowing program in the Corporate Plan
- On a quarterly basis, SOCs are required to report progress on their borrowing programme:
  - Quantum of new borrowings for the quarter
  - Funding sources broken down into instrument type
  - Profile of foreign vs. domestic borrowings
  - Profile of tenure for the outstanding debt

Analysis reveals:

- Delays in planned funding may indicate delays in rolling out of planned capital/infrastructure projects
- Changes in funding instruments indicate how well entity has diversified funding sources
- Changes in foreign vs domestic mix in funding indicates capacity of domestic market to fund domestic investment
- Debt maturity profile point out areas of increased refinancing risk for the entity

Borrowings Focus area

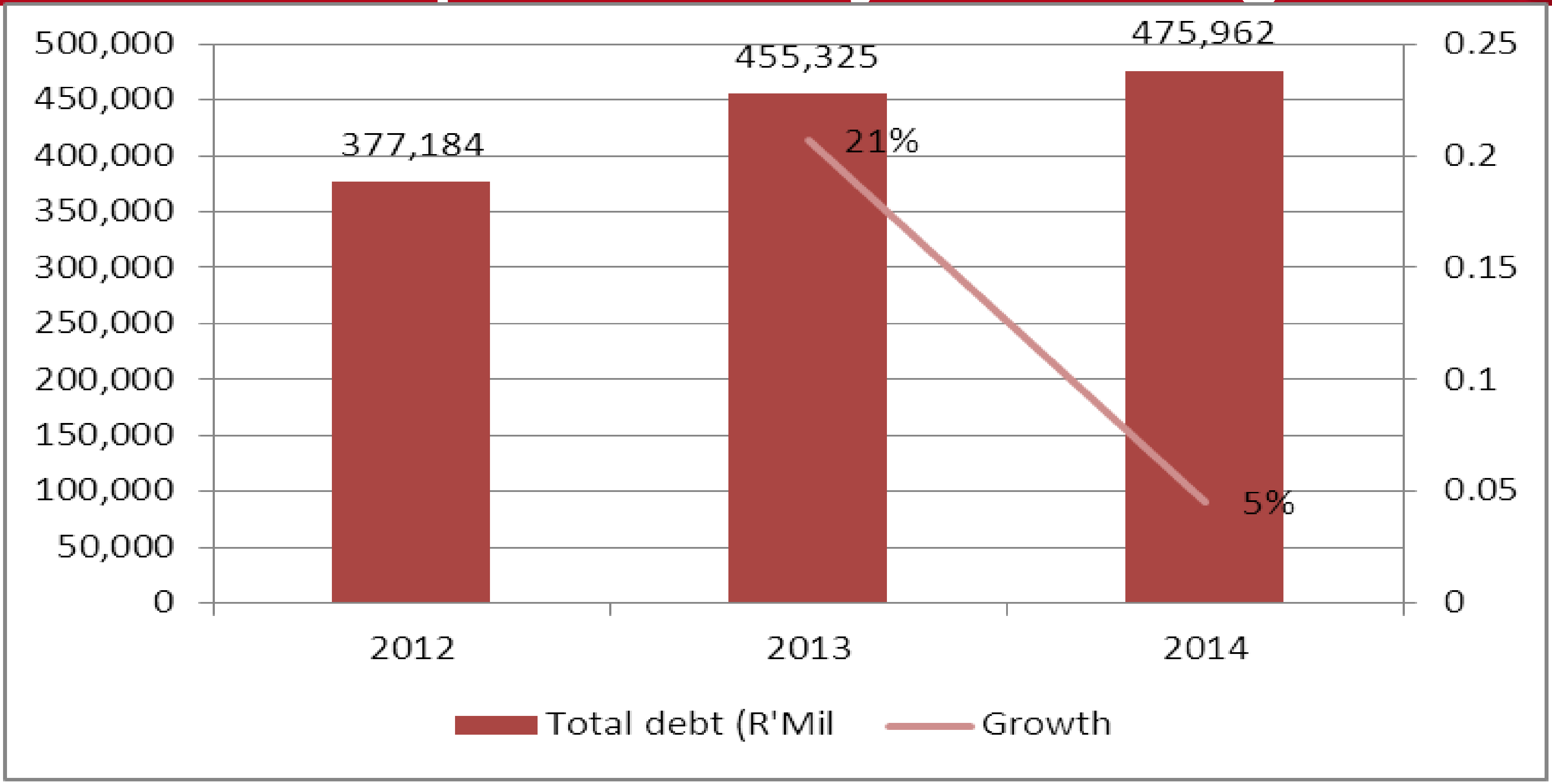
Borrowing requirement of state-owned companies, 2013/14

	2012/13	2013/14	
R million	Actual	Budget	Actual
Domestic loans (gross)	40,500	51,200	64,900
Foreign loans (gross)	29,400	40,800	37,500
Total	69,900	92,000	102,400
As percentage of total:			
Domestic loans (gross)	58 %	56 %	63 %
Foreign loans (gross)	42 %	44 %	37 %

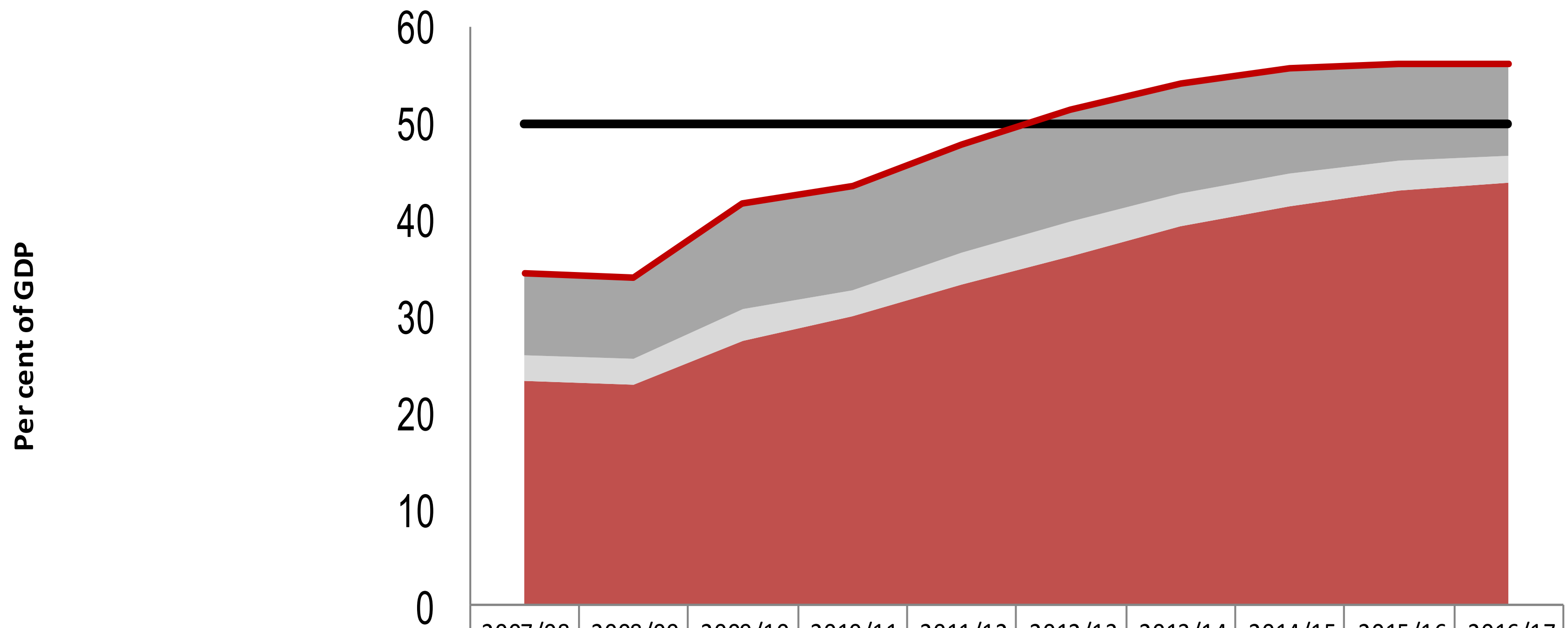
- Delays in planned funding may indicate delays in rolling out of planned capital/infrastructure projects
- Changes in foreign vs domestic mix in funding indicate the capacity of the domestic market to fund domestic capital expenditure
- Risks to meeting funding requirements
  - Downgrade of a major SOC or downgrade of the sovereign
  - Increases in interests rates and the depreciation of the Rand make funding more expensive

Committee Oversight Focus Area
SOCs ability to attract and service debt – gearing ratio/interest cover ratio and credit rating

Top 7 SOC's by Borrowings



Net debt, provisions and contingent liabilities (% of GDP) has exceeded the prudency threshold



	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17
Contingent liabilities	8.54	8.51	10.96	10.77	11.28	11.53	11.39	10.86	10.11	9.56
Provisions	2.66	2.69	3.30	2.69	3.32	3.62	3.41	3.41	3.11	2.80
Net debt	23.28	22.89	27.44	29.99	33.29	36.23	39.34	41.41	43.05	43.87
Tolerance benchmark	50.00	50.00	50.00	50.00	50.00	50.00	50.00	50.00	50.00	50.00
Net debt + Provisions + Contingent liabilities	34.48	34.09	41.71	43.46	47.89	51.38	54.14	55.69	56.27	56.22

Source : National Treasury

Guarantees

- Net debt, provisions and contingent liabilities are expected to stay above prudency benchmark going forward.
- SOCs guarantee as at 31 March is R466 billion against exposure of R209 billion
- Some guarantee conditions may include:
  - Monthly or quarterly monitoring task teams formation, consisting of National Treasury (NT) and Executive Authority (EA) with Terms of reference
  - NT to approve the terms of financing against the guarantee
  - Concurrent approval by both Ministers on Section 54 applications
  - Submission of monthly management reports to both NT & EA
- Concerns regarding unattainability of contingent liabilities and contagion impact of SOCs default on sovereign credit rating.

Committee Oversight Focus Area
Adherence by SOCs to guarantee conditions

REMUNERATION OF THE EXECUTIVE DIRECTORS

BONUSES MUST LINKED TO PERFOMANCE

- Shareholder Compact signed by shareholder and Board must stipulate Key Performance Indicators (KPIs)
- Organisational performance must be measured (and audited) against KPIs
- Bonuses payments must be linked to actual performance achieved
- State Owned Remuneration Guidelines (SOERG) recommends 50% of Guaranteed Packages (GPs) for CEOs and 35% of other executives
- Review revealed that more than 50% of SOCs pay executives bonuses above the recommended percentages (some as high as 78% above 50% norm)
- Increases in annual salaries are contained but compensated by high incentives/bonuses

Committee Oversight Focus Area:

- **Bonuses must be linked to performance and guided by SOERG recommendations**

KEY GOVERNANCE ISSUES

BOARD COMPOSITION

- The size, diversity(academic qualifications, technical expertise, relevant industry knowledge, experience, race and gender) and demographics makes the Board effective

- Handbook for the appointment of persons to Boards of state and state controlled institutions recommends 75% representation of Black people (African, Coloureds, and Indians) and 50% women
- Review shows:
  - majority of the Board are dominated with financial expertise
  - lack industry/technical expertise
  - 45% of SOCs have not met 50% target regarding gender representation

Thank you