sefa

Small Enterprise Finance Agency

Accessible Development Finance

Forensic Audit Report: Poultry Co-operatives Project in Limpopo & Mpumalanga

*Presentation to the Portfolio Committee of Small Business Development on 13 September 2017 by Ms. HN Lupuwana-Pemba, Chairperson of the **sefa** Board*

PC 171309

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Background

- Following Portfolio Committee's visit to one Chicken Co-operative funded by **sefa**, concerns were raised suggesting corruption and non-payment of Co-Operatives in terms of standing Legal Agreements.
- **sefa** Internal Audit was requested to perform a Forensic Investigation into various allegations and address some of the Portfolio Committee's concerns.
- **sefa** approved R20 million for four Chicken Co-Operatives 2 in Limpopo and 2 in Mpumalanga at R5 million each. (R4,2m – Instalment Sale Agreement (ISA) & R800K – Working Capital)
- Funding was for construction of additional Chicken Houses for each Co-Operative, the supply of Day-Old-Chicks and feed.
- The transaction was based on an Off-take Agreement by Kroon's Abattoir which Super Grand presented to **sefa**. The Co-Operatives were already growing chickens for Super Grand before the **sefa** loan.

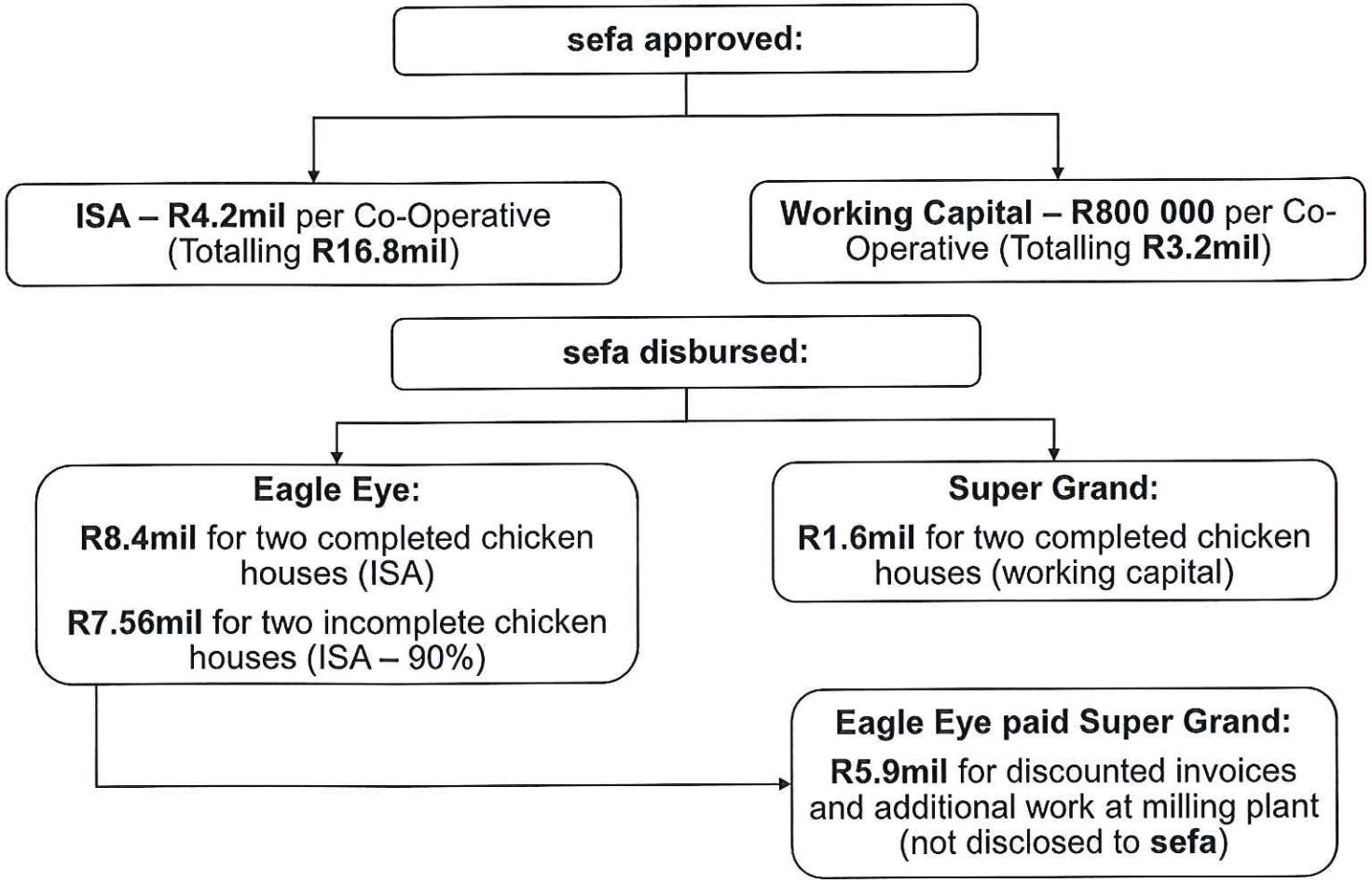
Summary of Findings

- **Material deficiencies and irregularities** which related to sefa internal control weaknesses.
- Evidence of **fraud, forgery and possible collusion** between the Supplier and the Technical Partner.
- The Technical Partner has been paid an amount totalling at least the **R4 240 818** by the Off-taker during the period August 2016 until 31 January 2017. **However, no payments were** made to Co-Operatives during this period.
- Alleged **intimidation** and enticement of Co-Operatives by the Technical Partner to take sefa loans.
- **Misappropriation** of funds earmarked Co-Operatives working capital.

Status of the Project

- All Co-Operatives' loan facilities are currently placed on repayment moratoriums.
- The Technical Partner owes the Co-Operatives payment for several completed cycles. Actual amount still in dispute.
- There is no business activity at all within the Co-Operatives due to disputes with the Technical Partner. Therefore, no revenue is currently being generated.
- Two Chicken Houses in Mpumalanga remain incomplete.
- The Technical Partner is not servicing any of the Co-Operatives by providing Day-Old-Chicks and feed being consequence of existing disputes and non-payment by the Technical Partner.
- The Technical Partner has closed three (3) of its bank accounts.
- The Technical Partner has indicated that the key person is "Absent Without Leave" and have not been able to communicate with him recently.
- Resuscitation of the project to arrive at the initially intended socio economic impact . CEO to provide details

Funds Flow Summary



Main Findings - Summary

– Impt 2 find out what was going on b/c SEFA was caught on both sides

#	Finding	Level of Significance
1	Fraud and Embezzlement of funds by Eagle Eye and Super Grand.	Critical
2	Alleged Forgery by Super Grand as Claimed by Co-Operatives.	Critical
3	Fraud and Theft by Super Grand of funds intended for Working Capital.	Critical
4	Allegations of Intimidation and Misinformation by Super Grand according to the Co-Operatives.	Critical
5	Breaches identified in the Super Grand Co-Operation Agreement.	High
6	Co-Operatives rushed into signing Legal Agreements without appropriate perusal and consultation.	High
7	Inadequacies in the Due Diligence.	High
8	Approval of Loan Facilities without a Credit Risk Report.	High
9	Inaccurate information presented to EXCO.	Medium
10	Lack of Resolution from Super Grand.	High
11	Key Legal Agreements and Conditions not effected prior to disbursement.	Critical
12	Failure to comply and fulfil Conditions of the Legal Agreements.	Critical
13	Inconsistencies and inadequacies in the Legal Agreements.	Medium
14	Lack of effective Post Investment Monitoring (PIM) efforts.	High

Critical = Significant W extensive impact

. Mgt could've been implicated & thus board the change

Status of Co-operatives Loans

Co-operative Name	Loan Type	Loan - Approved	Loan - Disbursed	Arrears 30/06/2017
Hitsakile Primary Co-operative Ltd	Instalment Sale Agreement	R 4 200 000.00	R 3 780 000.00	R 341 514.91
	Developmental	R 800 000.00	R -	R -
Khayalethu Masakhisane Skills Farming Primary Co-operative	Instalment Sale Agreement	R 4 200 000.00	R 3 780 000.00	R 344 453.01
	Developmental	R 800 000.00	R -	R -
Tsebere Mphempe Farming and Projects Primary Co-operative Ltd	Instalment Sale Agreement	R 4 200 000.00	R 4 200 000.00	R 815 280.21
	Developmental	R 800 000.00	R 800 000.00	R 149 214.56
Mzanzi Agricultural Co-operative Ltd	Instalment Sale Agreement	R 4 200 000.00	R 4 200 000.00	R 815 280.21
	Developmental	R 800 000.00	R 800 000.00	R 149 214.56
TOTAL		**R 20 000 000.00**	**R 17 560 000.00**	**R 2 614 957.46**

Conclusion

- **Significant deficiencies were noted within the Due Diligence, Disbursement and Post Investment Management processes within sefa**, which contributed to the demise of the project.
- The **lack of "Systems and Procedures" within the Wholesale Lending** presents material vulnerabilities and compromise the Control Environment.
- The manner in which the signatures of Legal Agreements by Co-Operatives were effected, **denying members an opportunity to peruse and obtain counsel**, may affect the validity of the respective contracts.
- **Super Grand intentionally siphoned sefa funds amounting to at least R5.9 million out of the project for their own benefit.** This act can be singled out to have compromised the project and finalisation of the construction of the Chicken Houses.

Conclusion (Continued)

- There is evidence to suggest that the Technical Partner manipulated the Disbursement Request Forms, in a fraudulent manner and was able to effect disbursements without the knowledge of the Co-Operatives.
- There were areas of negligence during the Due Diligence process, poor consultation with the Co-Operatives which affected the assessment and the nature in which the loan facilities were structured and implemented. This was further evidenced during the implementation of the deal, particularly the Disbursement process as well as the overall management of the project.
- Management transgressed the Credit Policy by approving the loan transaction without a formal Credit Risk Report. This may have exposed **sefa** and the stakeholders of the project to risks which could otherwise have been mitigated.

Conclusion (Continued)

- There is evidence to suggest that the Co-Operatives were unduly influenced into entering into the Loan Agreements with **sefa.**
- Key Legal Agreements were omitted and not concluded. These had a significant impact on the rights and obligations of the Co-Operatives as well as **sefa's** security position.
- Key Conditions were not fulfilled and allowed the inappropriate disbursement of **sefa** funds.
- Management failed to ensure effective monitoring of the project. Effective monitoring would have ensured early detection of problem areas, at least, between the Co-Operatives and the Technical Partner, where appropriate interventions would have been formulated in order to ensure the success of the project.

Detailed Findings

- The Technical Partner embezzled at least R5.9 million through dubious discounts related to the construction of Chicken Houses by Eagle Plant Hire. The discounts were not disclosed to sefa or the Co-Operatives.
- Allegations by all the Co-Operatives that the Technical Partner forged signatures on the Disbursement Request Forms submitted to **sefa** on drawdowns. Primary evidence generally supports the allegations.
- **R1.6 million** paid by **sefa** to the Technical Partner for the supply of Day-Old-Chicks and feed, yet did not provide chicks, but only some of the feed to the Co-Operatives.
- Tsebere Mphempe Co-Operative was allegedly given an ultimatum by the Technical Partner to accept the terms of the **sefa** deal or loose doing business with the Technical Partner.

Detailed Findings (continued)

- Amongst several breaches of the Co-Operation Agreement by the Technical Partner, the following were key:
  - Failure to provide Guarantee for the underlying debts of the Co-Operatives, as security to **sefa.**
  - Steering Committee not set-up for the project.
  - Mentor not appointed to monitor performance of Co-Operatives.
  - Failure to pay Co-Operatives upon delivery of fully-grown chickens to the Off-taker.

- Co-Operatives were rushed into signing Legal Agreements without appropriate perusal and consultation.
- Inadequacies in the Due Diligence performed by **sefa:**
  - **sefa** concluded the deal with the Technical Partner on the basis of a Off-take Agreement. However, the Technical Partner had no legal rights to the Off-take Agreement.
  - Lack of consultation with the Co-Operatives. Engagements focused on the Technical Partner.
  - Co-Operatives' Agreements with Super Grand were never reviewed and aligned to the terms of the sefa loan and implications of the project.

Detailed Findings (continued)

- **sefa** EXCO approved the R20million loan facilities for Co-Operatives without submission of a formal Credit Risk Report as required by the Credit Policy.
- The **sefa** Wholesale Team submitted that the Technical Partner had purchased a Chicken Hatchery, which was to supply the Co-Operatives, whereas, this was not the case.
- No resolution was obtained from the Technical Partner, authorising the signatory to do business and contract with **sefa** and Co-Operatives on their behalf.
- Key Legal Agreements and Conditions not effected/fulfilled by sefa prior to disbursement:
  - A Guarantee by the Technical Partner to cover the Co-Operatives' loans.
  - A Supplier Agreement for the management of the supply of chicken houses for the Co-Operatives.
  - A Maintenance Agreement between the Co-Operatives and the Equipment Supplier.
  - The appointment of a mentor to provide oversight over the Technical Partner.

Detailed Findings (continued)

- **sefa failed to fulfil several Security and Conditions Precedents as per Legal Agreements:**
  - Incomplete, invalid and inappropriate suretyships from the Co-Operatives.
  - Guarantee from the Technical Partner not secured to cover Co-Operatives loans.
  - Non-compliance with FICA regulations.
  - Signed Service Level Agreement between the Technical Partner and individual Primary Co-Operatives not obtained.
  - Mismatch between the dates of the Off-take Agreements, namely that the old agreements for some Co-operatives with the Technical Partner expired in 2015 while the agreements for others expired in July 2017.
  - The signed Off-take Agreement is between the Off-taker and an associated company of the Technical Partner but not with the Technical Partner as such.
  - Non-compliance with National Water Act of 1998 and National Environmental Management Act of 1998.
  - Supplier Agreement between Co-Operatives and the Equipment Supplier of chicken houses was not drafted and signed.
  - Maintenance Agreement between the Co-Operatives and the Equipment Supplier of chicken houses was not drafted and signed.

Detailed Findings (continued)

- Lack of Post Investment Monitoring by **sefa:**
  - Poor Project Management resulting in failure of the project.
  - Failure to monitor the application of approved funds, resulting in successful fraud/embezzlement by the Technical Partner.
  - Failure to monitor implementation of the project.
  - The Technical Partner's conditions and undertakings were not monitored to ensure compliance. This resulted in multiple breaches of Legal Agreements.

Recommendations

Recommendations	Status
Management should consider laying criminal charges against the Technical Partner and the key person of the Technical Partner for the alleged forgery of Disbursement Request Forms. These charges will have to be supported by the Co-Operatives.	Complete
Management should consider criminal and civil action against the Technical Partner and the Equipment Supplier for the recovery of funds unjustifiably directed to the Technical Partner through the undisclosed discounts from the Equipment Supplier	Complete
The Co-Operatives should also consider legal action against the Technical Partner for outstanding payments due to them. sefa to assist in this regard.	In progress
Corrective action should be taken with respect to the approval of the loan transaction without a formal Credit Risk Report. Management should review the submission of inaccurate information presented during the approval of the Co-Operatives' loans and determine appropriate action in this regard.	Complete

Recommendations (Continued)

Recommendations	Status
Wholesale Lending Division should ensure that the requisite "Systems & Procedures" are formulated, approved and implemented to ensure that there is an effective Control Environment for the mitigation of associated risks.	In Progress
Corrective action should be taken with regards to the negligence identified during the Due Diligence process as well as finalisation and signature of Legal Agreements by the Co-Operatives. This relates to other affected areas/processes as well.	Complete
Appropriate corrective action should be taken for the failure to ensure appropriate fulfilment of the Drawdown Conditions, Security Conditions as well as Other Conditions.	In progress
Appropriate corrective action should be taken for the failure to ensure that all Legal Agreements are drafted and finalised, including the Technical Partner Guarantee, which was key to **sefa's** security against the Co-Operatives' loans.	In progress

Recommendations (Continued)

Recommendations	**Status**
Management should review the Legal Agreements concluded with various parties to ensure that all are valid, complete and appropriate for all intents and purposes of the Technical Partner / Co-Operatives project.	In Progress
Continuing probe into the possible collusion and corruption by **sefa** staff in the transaction through criminal investigation with Commercial Crimes Unit of the South African Police Services.	Complete

Possible additional investigations

- Based on the current findings of Super Grand investigation, Internal Audit was requested to review the Wholesale Lending portfolio in order to determine if there any transactions which may be affected in ways similar to the Super Grand/ Co-Operatives transaction. The scope of the review will focus on the Loan Approval process, including the Due Diligence as well the Application of Funds.
- Internal Audit has identified three transactions which may be potentially investigated. A complete summary of the review will be presented to the Board by December 2017. Appropriate action will be taken based on the results of the review.
- As per Internal Audit Annual Plan, grants approved by sefa in the form of Institutional Support will be reviewed in terms of the specified scope. This area has been rated as a high-risk. The review will be concluded by the end of the 2018 financial year.

Developmental Impact

- **sefa to develop innovative solutions/products** - **sefa** is challenged by all its stakeholders to come up with innovative solutions to address the triple challenges and to develop products for the unbankable. These innovative product solutions should be radically different from the normal commercial sector and traditional DFI funding. It should also change the existing policies as well as systems and procedures of **sefa**.
- **Shift towards co-operative** - With the transfer of **sefa** from EDD to DSBD the mandate shifted to include focus on rural co-operatives and intense deliberations with various stakeholder took place on the correct funding model. Our value chain model was generally accepted by the **sefa** stakeholders.
- **A pilot is not a final product offering** - In order to introduce new solutions it is required that products are piloted. The objective of these pilot projects is to learn (develop lessons' learnt), refine the product offering, develop systems and procedures, adjust policies (if required) and to ultimately launch the product. The development of systems and procedures usually follows the conclusion of the pilot.

Developmental Impact (Continued)

- sefa's involvement with the Technical Partner and the group of Co-operatives in Limpopo and Mpumalanga provinces was aimed at advancing economic inclusivity of these participating Co-operatives, thus generating jobs and income for them.
- The project was at a pilot stage, with the ultimate goal of rolling it out to other areas upon successful completion.
- A structured Finance Solution (SFS) product was identified as an appropriate tool to execute this project and the Co-operatives were to participate fully in the poultry value chain.
- The partnership with the Technical Partner was supposed to provide both downstream (i.e. one day old chicks, feed and medicine supply, training and technical support) and upstream linkages in the form of access to market, (i.e the off-take agreement with Kroon's).
- However, this did not materialise and the intended developmental impact could not be fully realised as only two of the four chicken houses were completed.

Developmental Impact (Continued)

- As a result, **25 direct jobs from the four co-operatives** were created during the active operation of the Co-Operatives.
- **sefa** is **mandated to address market failure in the provision of finance to small businesses, including start-ups**, thus it essentially operates in a highly risky market.
- **Agriculture Co-operatives are a high risk business** that exceptionally few institutions are willing to fund.

Lessons Learned

- **sefa** team acknowledges that there were some gaps in controls in respect of the due diligence and implementation phases of the project.

Outlined below are some of the identified gaps and remedies taken:

a) Addressing vulnerability of Co-operatives

Remedies:

- To address the vulnerability of the co-operatives, **sefa** undertakes to partner with other government agencies such as SEDA, Department of Agriculture, Local Economic Development and other active players in the Co-operative sector,
- The Steering Committee to appoint a site manager who will communicate and report on all aspects of the project to all stakeholders,
- **sefa** representatives will explain terms and conditions of the loans and roles and obligations of the members in terms of the loan agreements.

Lessons Learned (Continued)

b) Involvement of the Provincial government departments

Remedies:

- The provincial departments will be consulted and form part of the due diligence process.
- A project plan to be developed by the Steering Committee, with the approved project plan incorporating key milestones against which the implementation of the projects will be measured.

c) Financial commitment of the Technical Partner

A technical partner did not commit financially to the project to ensure its successful implementation.

Remedies:

- The future technical partners must share the loan liability of at least 10% of each Co-operative loan and /or inject 10% equity in the project.

Lessons Learned (Continued)

d) Comprehensive review of the legal agreements

All Technical Partner agreements relating to the projects were not reviewed by **sefa** Legal Department.

sefa did not enter into a direct legal agreement with the constructor of the chicken houses.

Remedies:

- All legal agreements between our partners and their related counter parties who are neither part of the loan agreements nor security arrangements, will be reviewed by **sefa**'s Legal Department to ensure that the interests of **sefa** and the Co-operatives are safeguarded.

e) Implementation of the projects

Remedies:

A Steering /Technical Committee consisting of **sefa**, Co-operatives, Provincial representative, Seda, DSBD) has been set up to monitor project's progress, track challenges and address them.

Action Plan

sefa Management has approved the following as an interim measure:

- An initial moratorium of 6 months on the capital and interest repayments to be reviewed after the final restructure has been concluded; and
- A financial services company to provide cash management services and bookkeeping for 12 months and procurement processes will be followed.
- Conclusion of Wholesale Lending processes and procedures which are currently being reviewed by the Internal Audit.
- Resuscitation of the project
  - The Steering Committee has engaged the Off-taker which in turn has indicated that they would give the Co-operatives another chance to work with them without the Technical Partner
  - The market access and other services will be provided through a Secondary Co-op and Seda will provide the mentorship.
  - The Steering Committee and the **sefa** Legal Department are reviewing the new off-take agreement, which will be directly between the Co-operatives and the Off-taker,
  - **sefa** will conduct additional investigations to establish the actual value of the liabilities of the Co-operatives, and
  - **sefa** will consider restructuring the existing facilities with Co-operatives.

Action Plan in collaboration with Seda/DSBD

- Internal Audit forensic investigation and institution appropriate legal action
- Restructuring of partnerships and Co-operatives loans
- Appoint technical advisor in collaboration with SEDA, DSBD and provinces
- Register secondary co-operatives for the two provinces.

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- Provide business support and training
- Assist with market access
- Governance training

SEDA

- CIS grant funding for primary co-operatives-working capital e.g. repairs and maintenance
- CIS grant funding for secondary co-operatives e.g. marketing

DSBD

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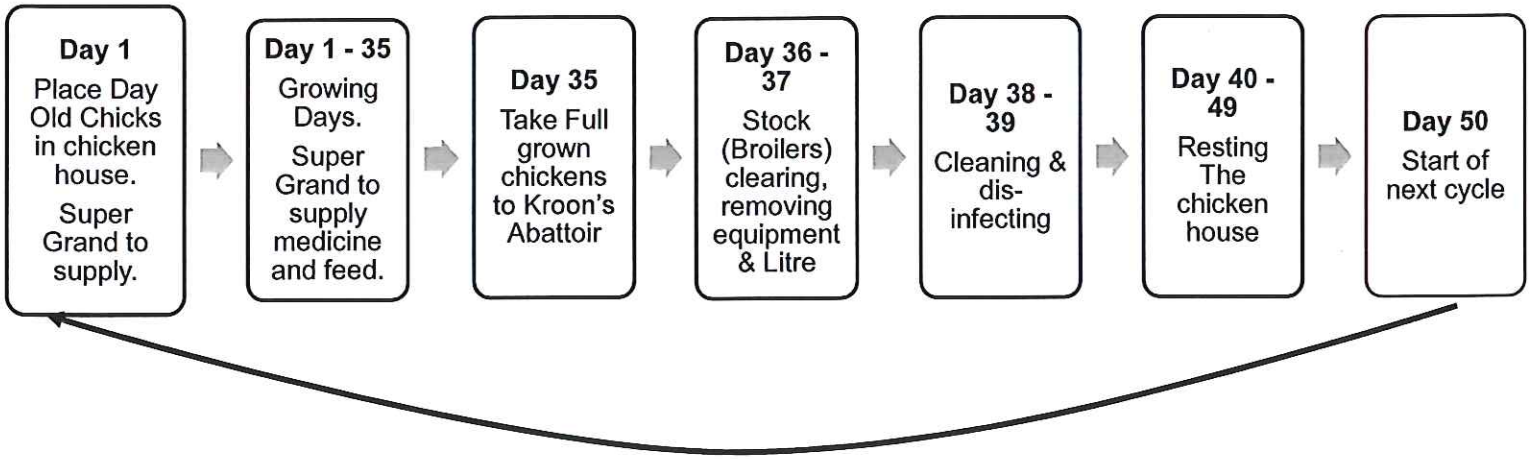
Chicken Growing Process Summary



Role Players Summary

Role Player	Responsibilities
Co-Operatives: Mzanzi Agricultural Co-operative Ltd Tsebere Mphempe Farming and Projects Primary Co-operative Ltd Hitsakile Primary Co-operative Ltd Khayalethu Masakhisane Skills Farming Primary Co-operative	• Growers of Day-Old-Chicks in **sefa** built chicken houses. • Already in business with Super Grand.
Technical Partner: Super Grand (Pty) Ltd	• Provides the Day-Old-Chicks, medicine and feed to Co-Operatives. • Provides technical support to the operations of the Co-Operatives including training. • Already supplying 40 000 chickens per Co-Operative as per the Kroon's Off-take Agreement.
Supplier: Eagle Eye Plant Hire	• Constructed the four chicken houses at the Co-Operatives
Off-taker / Abattoir: Kroon's Abattoir (Pty) Ltd	• Off-take Agreement with Super Grand for the supply of 500 000 chickens at the end of each broiler cycle (35 days)
Financier: **sefa**	• Provided R5mil to each Co-operative for the construction of a chicken house and working capital

THANK YOU.