



PRESENTATION TO THE PORTFOLIO COMMITTEE ON PUBLIC ENTERPRISES



06 November 2019

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INTRODUCTION

1. INTRODUCTION

- The Board is confident that Denel has core technological products, basic systems and skills which form the critical and required base for an effective business turnaround, and a view on the Denel Future State.
- However, key challenges faced included investigating the nature, extent and underlying causes of the liquidity constraints faced by the business with following outcomes:
 - unprofitable sales, loss making contracts, including onerous contracts;
 - higher costs with declining revenues;
 - poor inventory and cash management;
 - High dependency on a large and complex contract which did not proceed as planned;
 - lack of basic financial discipline and internal controls;
 - poor governance;
 - mismanagement;
 - overzealous and expensive acquisitions; and
 - general corruption as we are seeing in the case of State Capture currently before the Zondo Commission (e.g. Denel Asia and VR Laser Group).



1. INTRODUCTION (cont.)

- Since its appointment in May 2018, the new Board has focused on improving governance, with an executable and viable turnaround strategy developed by the Board, with the plan continuing at a steady pace;
- Interim measures were implemented with the appointment of an Interim GCFO to deal with governance and the integrity of numbers;
- Since Jan 2019, subsequent appointments of a full executive team has been completed (GCEO, GCOO, GHR, GCFO);
- With the recap received from the shareholder, compilation and execution of a liquidity management plan together with a strategy to deal with liquidity challenges are in place; and
- Denel is tax compliant.



DENEL – AT A GLANCE



ECONOMIC

Revenue
R3.8bn
2017/18 | R5.8bn

Cash
R575m
2017/18 | R1.3bn

Debt: Equity
-2.05:1
2017/18 | 7.39:1

Borrowings
R3.4bn
2017/18 | R3.3bn

Net profit/loss
(R1 749m)
2017/18 | (R1053m)

R&D
R108m
2017/18 | R769m



SOCIAL

Skills
development
R32m
2017/18 | R52m

Corporate
social investment
R593k
2017/18 | R9.4m

Employee Numbers
3 968
2017/18 | 4 629

Black-Owned *Spend
R417m
2017/18 | R614m



TRANSFORMATION

B-BBEE
Level 6
2017/18 | Level 6

Female
appointments
58%
2017/18 | 44%

ACI* appointments
83%
2017/18 | 83%



GOVERNANCE

2. GOVERNANCE

Improving corporate governance and oversight – core pillar of the Denel turnaround plan.

- Comprehensive governance framework and turnaround plan being implemented
 - GCEO, Danie du Toit, appointed in Jan 2019
 - GCOO – William Hlakoane and GHR Executive, Mercia Ngema appointed in Jul 2019
 - GCFO, Carmen Le Grange appointed beginning Sept 2019
 - Internal audit outsourced to E&Y, appointed in Sept 2019
 - With all EXCO positions now filled, determined effort by new Management team and the Board to address the performance culture and consequence management
 - New Delegation of Authority to enable effective management and accountability in Denel
- Co-operating with State Capture Inquiry and SIU
 - Addressing irregular and fruitless & wasteful expenditure through investigations and criminal and civil litigation to recoup and claw back financial losses emanating from state capture
 - Supply Chain Policy being reviewed to be relevant for Denel and Supply Chain to report to GCFO



PROGRESS ON TURNAROUND

3. TURNAROUND PLAN: Progress to Date

- 2019/2020 FY to date order intake of R7.8bn compared to R509mn in FY 2018/19
- Winnable order pipeline of R30bn in 24 month window. Solid base to secure Corporate Plan
- A solid order backlog (R17.4bn) covering roughly 4 years of sales revenue
- Largest Export Contract received – R6.3bn
- Excellent potential in target markets. Denel brand is well-respected and our products are highly sought after in the market
- Solid support from our local customer, continued order intake
- Exited onerous contracts of ~R250m (Recurring cost per year)
- Mitigated Parent Company guarantee risk of R 1.6bn
- Reduced Operating costs by R500m
- Reduced Head Office costs by R15m
- Solid skills base of **620 Development Engineers and technicians** in current work force, avg. experience of 15 years
- **1740 Technicians and Operators** in Manufacturing and Support Operations



3. TURNAROUND PLAN: Progress to Date (cont.)

- Potential to **generate cash from divesting non-core assets of R1.56bn**. First result in 3-6 month window
- Potential to **generate cash from SEP activities of R2.0bn**
- Further **operating cost reduction potential of R500m** through Supply Chain etc
- **~40 expressions of interest to partner** with Denel businesses and to acquire parts of the businesses
- **Excellent return on investment potential and cash generation potential on recap**
- **High probability to unlock Hoefyster Programme**. Requires political will and support
- Good potential to **improve Programme Delivery precision** led by new GCOO
- Good potential to **improve our Human Capital and capability** led by newly appointed GE: HR
- Plan to improve financial function effectiveness and build a strategic finance function led by experienced GCFO
- **Motivated and capable Management team**, led by GCEO with strong military, defence industry and international background

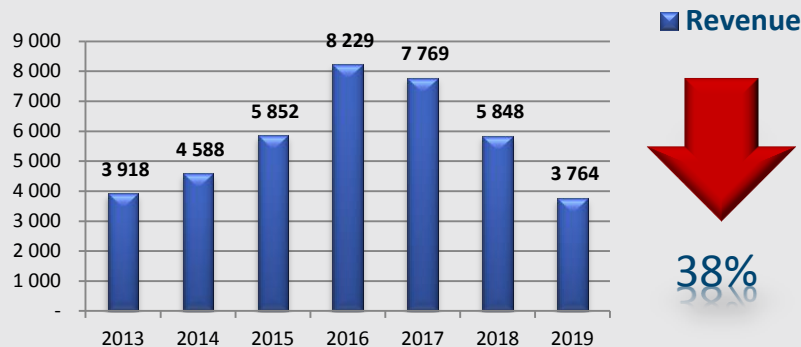




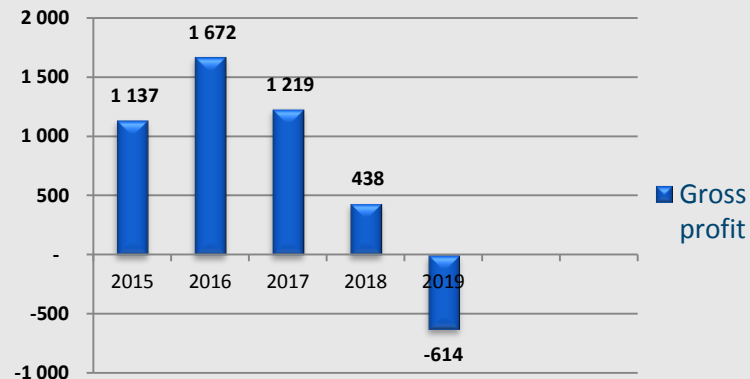
2018/19 FINANCIAL RESULTS

4. 2018/19 FINANCIAL RESULTS

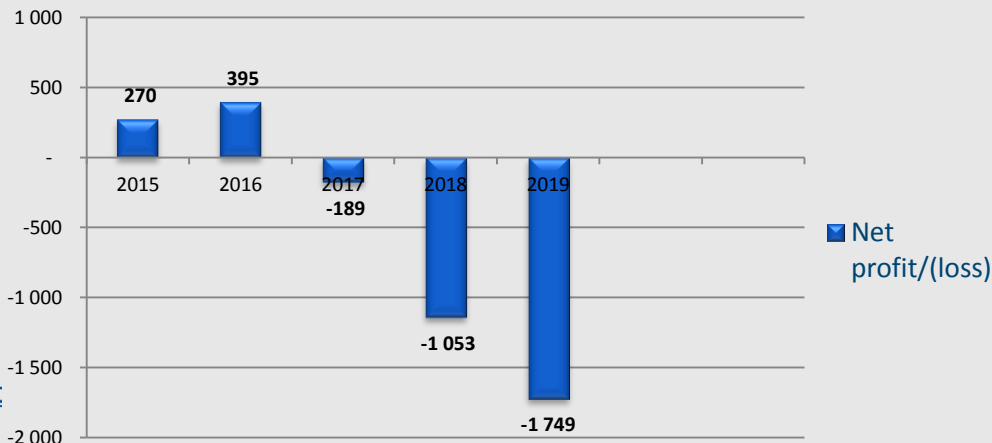
Revenue



Gross profit/(Loss)



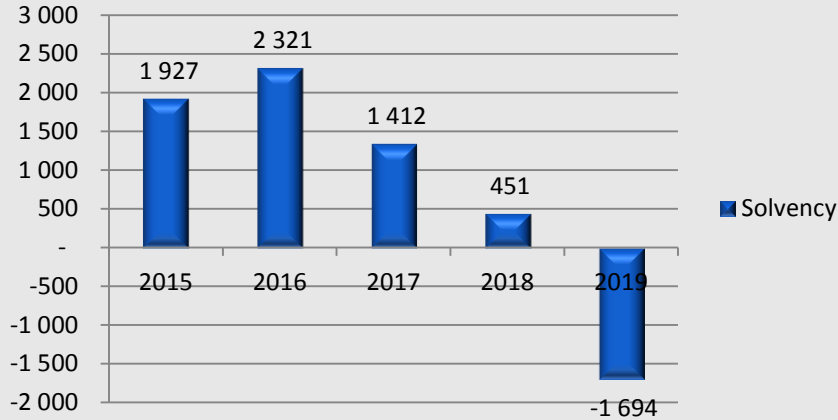
Net profit/(loss)



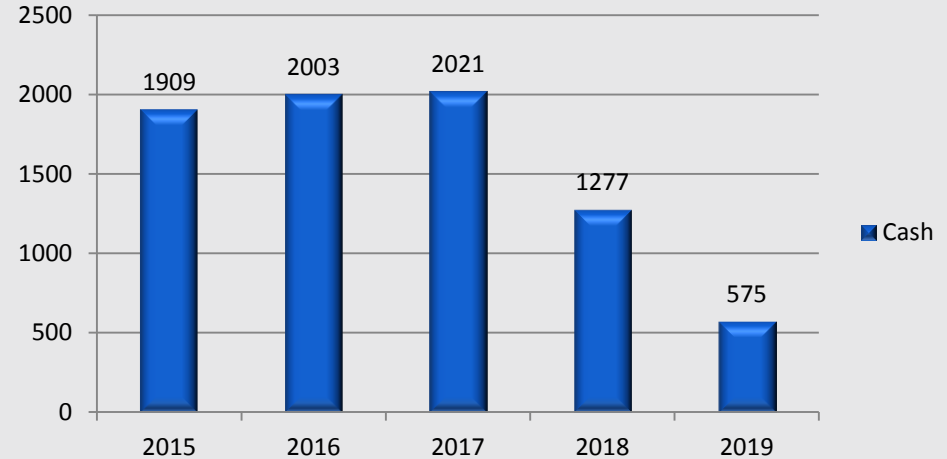
- Revenue – low production activity
- GP loss – Labour under-recoveries despite headcount reductions
- Net loss – High interest expense, exit of loss-making divisions and onerous contracts
- Poor financial performance mainly due to continued liquidity challenges
- Expected improvements in future years due to the capital injection from government

4. 2018/19 FINANCIAL RESULTS (cont.)

Solvency



Cash



- R3.0bn deterioration of reserves since 2016/17
- R1.8bn recap received on 31 Aug 2019 will improve equity whilst solvency is still under risk in 2019/20
- Cash balance at it lowest levels



EXTERNAL AUDIT OPINION 31 MARCH 2019

5. BASIS OF DISCLAIMER

- **Revenue** – Incorrect IFRS application (IAS 11 and IFRS 15) and translation of prepayments
- **Property, plant and equipment** – Assets understatement valued at zero, inadequate evidence for properties and impairment of assets
- **Trade and other Receivables** – **Incorrect application of IFRS 9 Financial Instruments**
- **Trade and other Payables and Financial Liabilities** – **Recording of accruals due to cut off year-end controls**
- **Investment in subsidiaries** – Fair value on acquisition of Turbomeca and the impairment valuation of DVS
- **Non-current assets held for sale** – Sale of Hensoldt not adequately disclosed
- **Retirement benefit obligation** – Service costs and net interest not adequately disclosed
- **Operating expenditure and Contingent liabilities** – Inappropriate supporting evidence for expenditure
- **Disclosures** – Inadequate disclosure for change in accounting policies, prior periods, related parties, statement of cash flows, financial risk management and related parties
- **Deferred tax and income tax** – tax implications due to the prior year period errors that could not be quantified at conclusion of audit
- **Irregular and fruitless and wasteful expenditure** – Additional expenditure identified by AG

5. ROOT CAUSES FOR DISCLAIMERS (Both Years) – (cont.)

- The AG identified the following root causes as contributing to the disclaimers:
 - Repeat audit findings – Revenue and related accounts, PPE and disclosures
 - Vacancies and instability of key management positions
 - Inadequate skills/ knowledge of the accounting standards
 - Lack of accountability and commitment towards improving internal control environment
 - Lack of consequence management
 - Lack of sufficient review by senior management
 - Slow pace in addressing root causes of findings raised
- Given what is emerging at the Zondo Commission and based on some of the outcomes from our own forensics investigations, Denel is not only seeing the impact of state capture being reflected in our poor financial results but is also experiencing its impact on our control and supply chain environment, with Management having to focus on re-energizing and motivating our workforce.

5. KEY OUTCOMES FOR DENEL FINANCE GOING FORWARD

- **Addressing prior year audit findings** to move Denel from a disclaimer to a qualified and then an unqualified audit opinion over the next 2-3 years
- **Liquidity Plan** for the next 5 years, including monthly cash flows, simultaneously restructuring the Balance Sheet
- **Building a credible Finance function** to enable consequence management through IFRS training and building skills, capacity and capability
- **Improving integrity of the numbers** by working with the AG to document position papers on the IFRS Standards, getting sign-off on interpretation of Standards so that implementation is achieved, documenting business processes and controls and adequately preparing for interim and final audits
- **Improving internal controls and the control environment** by working with Internal Audit

5. HIGH LEVEL PLAN TO ADDRESS DISCLAIMER OPINION

Improving credibility of financial reporting through re-configuration of SAP and Bridge

Develop SAP Security Management Policies and Procedures and configure SAP and Bridge system maps to meet business needs and improve controls and reporting.

Setting up an internal audit function

Internal Audit to assist with overseeing and auditing the financial information as well as performing interim audits of information before it is submitted for the year-end audit to the AG. Ernst and Young were appointed and started their work in Sept 2019.

Finance Function Effectiveness

Building a strategic finance function that adds value to the business and its stakeholders in respect of the quality of its people, the operating model and a finance architecture that enables a fit-for-future organisation.

ICT Audit and Supply Chain

ICT and Supply Chain to be audited as part of final audit. Internal Audit to assist with General Computer Control Reviews. ICT Consolidation project to continue to identify cost-savings & efficiencies. Supply Chain policy and processes under review to ensure clear understanding of PFMA in respect of irregular, fruitless and wasteful expenditure with relevance to Denel as a commercial business competing in global markets.

Mandatory assessed IFRS training & appointment of IFRS Specialist to improve adherence to Standards

Mandatory for all Finance teams to keep abreast of technical accounting developments that impact the preparation of key accounts and accounting records.

Develop documented business processes

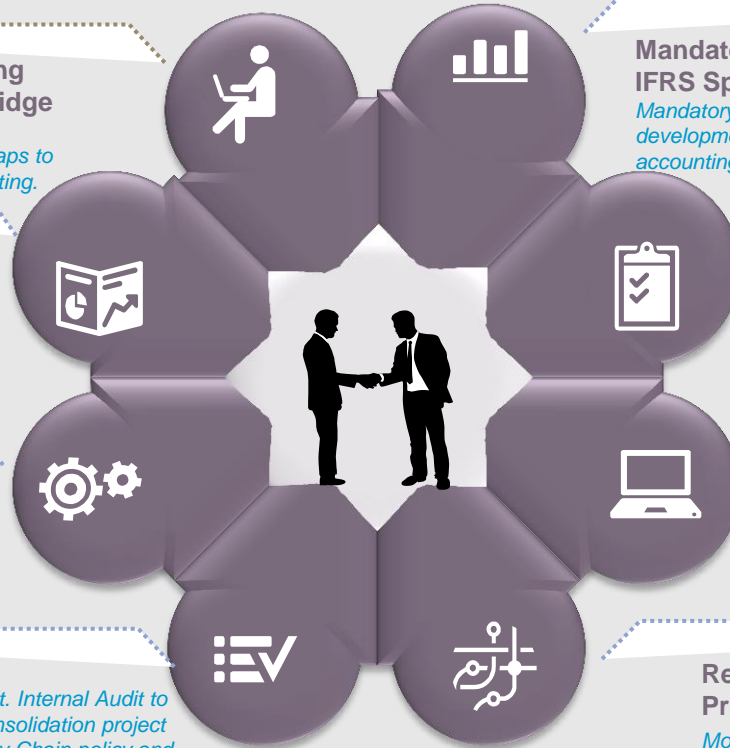
Develop business processes that are readily available and regularly updated. Business processes should be supported by key internal controls, which must be adequately designed and operate effectively. Business transformation process must include communication, monitoring, performance and consequence management.

Quarterly Walkthroughs by each division of Accounts

Each division to set up quarterly presentation of key account reconciliations and accounts prepared to date with management to test implementation of Standards timeously.

Recurring Review of Key Accounts & Key Program Reviews

Monthly review of key accounts to be performed by management to review, standardise and supervise work performed by the various finance staff members.





IRREGULAR EXPENDITURE

6. IRREGULAR EXPENDITURE

	Mar-17	Mar-18	Mar-19
Opening Balance	999.9	1,496.6	1,901.4
Irregular expenditure incurred in current year	563.7	404.7	199.9
*Non-compliance to PPPFA	494.0	327.2	196.8
Contracts - Inadequate approvals (Policy/Process/DoA)	4.9	43.9	
Single source/sole – approval process not followed	64.8	33.6	3.0
Less: Amounts condoned	(67.0)		
Irregular expenditure awaiting condonation	1,496.6	1,901.4	2,101.2

Prior year irregular expenditure identified in the current year amounted to an additional R1.389m (compared to previously reported amount of R510m) as a result of investigations on transactions from 2016 to 2018 financial years

* Non-compliance to PPPFA

- Contained within this line item are matters handed over for forensic investigations, with regard to the following:
 - VR Laser Holdings
 - ENNE 7
 - CHAD contract
 - EML Engineers and Construction
 - Landward Mobility Technologies (LMT) loan

- Additional investigations are currently being conducted by the Special Investigations Unit

IRREGULAR EXPENDITURE (cont.)

- Reviewed all procurement transactions since 2015/16 financial years
- Re-stated the disclosure for irregular, fruitless and wasteful expenditure
- Reviewed and updated the policy and processes to prevent and detect transactions leading to irregular expenditure e.g. :
 - In instances involving OEM's and sole suppliers, prior approval must be obtained from the Group SC Manager prior to placement of any order; and
 - In conjunction with this, the Group SC Manager works closely with National Treasury to ensure compliance with regard to Industrialised and Client Prescribed Suppliers.



RESPONSE TO QUESTIONS FROM PREVIOUS MEETING

7.1 RESPONSE TO QUERIES – Executive remuneration

- Executive remuneration 2018/19:

2019/20 Annualised remuneration

THE FOLLOWING AMOUNTS WERE EITHER PAID OR ACCRUED TO THE EXECUTIVES DURING THE YEAR:

Amounts paid or accrued to executives of the group	Salaries	Pension Fund contribution	Medical Aid contribution	Other ⁷	Company contribution	Short-term Incentive	Lump Sum/ Loss of office	Total 2018/19
	R'000	R'000	R'000	R'000	R'000	R'000	R'000	R'000
EXECUTIVE DIRECTORS								
Mr D Du Toit ^{1 and 6}	885	37	31	74	66	-	2 124	3 218
Mr Z Ntshope ²	721	22	15	109	40	-	-	907
Mr ZM Mhtwana ³	1 746	62	66	187	111	-	-	2 172
Sub-total	3 352	122	112	370	217	-	2 124	6 296
PRESCRIBED OFFICERS								
Ms VQ Qinga	2 239	82	102	187	146	-	-	2 756
Mr T Klaynhans	2 463	96	146	531	170	-	-	3 406
Mr DTT Mbele	2 198	80	64	183	142	-	-	2 667
Mr V Xaxa ⁴	1 406	50	53	288	88	-	-	1 885
Mr O Mothudi ⁵	1 155	50	72	96	89	-	-	1 463
Ms N Davies	-	-	-	-	-	-	-	-
Sub-Total	9 462	357	437	1 285	635	-	-	12 176
Total	12 815	479	549	1 655	852	-	2 124	18 472

POSITION ^α	COMMENCEMENT DATE ^α	ANNUAL PACKAGE ^α
Group Chief Executive Officer ^α	January 2019 ^α	°R5°000°000.00 ^α
Group Chief Financial Officer ^α	September 2019 ^α	°R3°500°000.00 ^α
Group Chief Operating Officer ^α	July 2019 ^α	°R3°000°000.00 ^α
Group Executive: Human Resources and Transformation ^α	July 2019 ^α	°R2°500°000.00 ^α
Group Executive: Communication and Public Affairs ^α	Vacant ^α	^α

0.8% of Total Labour Cost 2018/19

7.2 RESPONSE TO QUERIES – Supply Chain

Key areas of concern:

- Governance weaknesses;
- Weak controls enabling state capture related events to occur; and
- Ineffective and inefficient processes in place for a commercial business to compete in the global market.

Improvements:

- Investing in capable leadership, capacity building, training and development;
- Implementing processes that will address proper demand setting, planning for procurement and stock control;
- Review of the policy is underway to:
 - Improve governance;
 - Meet the Constitutional requirements of Accountability, Transparency, Effectiveness, Efficiency, Competitiveness, Equitability, Integrity, Uniformity and Risk Avoidance; and
 - Enable efficient execution of contracts for the local and international markets.

7.3 RESPONSE TO QUERIES – Lessons learnt



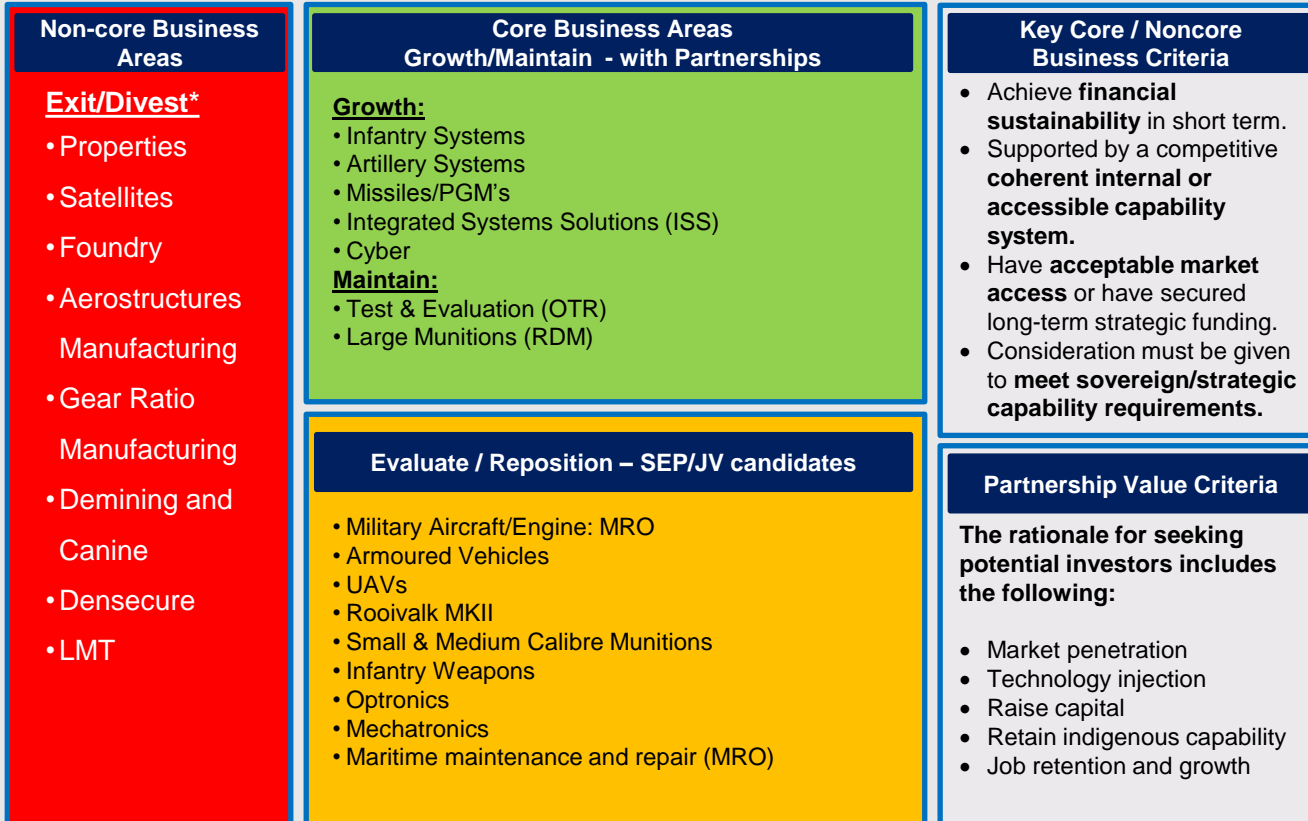
STRATEGIC CHALLENGES	IMPROVEMENTS
<p>POOR Governance Practices & Financial Management including:</p> <ul style="list-style-type: none"> - Undermining of Denel EXCO in decision-making - Inappropriate investment decisions - Weak Supply Chain 	<p>Appointment of credible and independent BOARD</p> <ul style="list-style-type: none"> - Appointment of experienced executive management and reinstatement of the EXCO - Implementation of a Governance Framework
<p>POOR Programme Execution</p> <ul style="list-style-type: none"> - Poor risk management - Lack of consequence management - Low productivity 	<p>New GCOO and Divisional CEO's focussed on improving PERFORMANCE including:</p> <ul style="list-style-type: none"> - Programme management to identify: <ul style="list-style-type: none"> - Technical risks - Cost overruns - Resource allocations and availability - Risk management and schedule performance - Programme management controls and their effectiveness
<p>LIMITED Market Access and DECLINING order book with some Markets e.g. NATO having barriers to entry</p>	<p>Refocused marketing strategy and intelligence resulting in improved ORDER INTAKE and LARGEST EVER EXPORT ORDER secured</p>

7.3 RESPONSE TO QUERIES – Lessons learnt (cont.)



STRATEGIC CHALLENGES	IMPROVEMENTS
UNSUSTAINABLE Cost Base	R500m cost reduction over the last 12 months
SEVERELY CONSTRAINED Liquidity	Improving working capital management including ring-fencing cash for major contracts
HIGH Debt	Awaiting Additional R1bn RECAP to normalise Capital Structure; Disposal of non-core assets, securing SEP's and expecting to improve the solvency position; and Increase of funding of R&D required to maintain core capabilities
UN-FOCUSSED & FRAGMENTED Operational Structure leading to fragmented overhead costs	New Operational Structure finalised and implemented leading to cost reduction and skills optimisation at DCO, operations structures are being reviewed in line with corporate strategy
WEAK SUPPLY CHAIN MANAGEMENT leading to weak controls, inefficient procurement, irregular and fruitless and wasteful expenditure and non-adherence to legislation.	STRENGTHENING Supply Chain leadership; and UPDATING policy and processes for improved governance and efficiency
MIS-ALIGNED Stakeholder Environment – DoD – DPE – NT, other	Better Alignment through regular consultation and communication with our stakeholders

7.4 RESPONSE TO QUERIES – Private Sector Partnerships



Cost to run non-core is R375m annualised

*This process must follow PFMA S54 requirements.

7.4 RESPONSE TO QUERIES – Private Sector Partnerships



Objective	Qualifying Criteria
Capital	The Interested Party's ability to invest in equity at a value based on Denel's offering of intellectual property rights, products, facilities, existing markets, etc.
Markets	Access to additional markets and / or the growth of Denel's existing markets.
Expertise / Technology	A track record and specific expertise and / or technology together with leadership to support and / or expand Denel's portfolio.
Jobs	Protection of existing jobs, as well as growth through applying strategic / core capabilities in Denel and the South African Aerospace and Defence industry at large.
Indigenous Capability	Positive impacts, constraints and benefit relating to the sustainability and supportability of capabilities, technologies and products that are considered strategic or require sovereign control.

