PRESENTATION TO THE STANDING COMMITTEE ON PUBLIC ACCOUNT (SCOPA)

ANNUAL FINANCIAL RESULTS FY2019/20

10 March 2020

INDEX

DENEL

1. INTRODUCTION – DENEL'S NATIONAL INTEREST ROLE

DEFENCE REVIEW 2015
(Section 15 - Paragraph 95)
Denel is a national security asset, with the primary purpose of designing, developing, manufacturing and supporting defence matériel. *In addition thereto, Denel is charged with:*
*a. The **custodianship of assigned sovereign or strategic defence capabilities, technologies and abilities**, inclusive of those that may be at risk, the loss of which would threaten South Africa's required defence capability.*
*b. The **design, development, manufacture and support of important capabilities** which may **not** be **commercially viable**.*

DOD - NATIONAL STRATEGIC PERSPECTIVE ON DENEL

The SANDF cannot afford to lose the skills vested within the employees at Denel. A concerted effort is warranted to find a mechanism to retain employees with scarce skills that forms part of the manufacturing of arms for the SANDF. *This requires interventions from Government and the wider South African Defence Related Industry (SADRI).*

August 2020

National Defence Industrial Council (NDIC): ***the liquidity challenges facing Denel as having the potential impact of:***

a. Compromising South Africa's national security*;*
b. Collapsing the entire defence industry *irretrievably;*
c. Exposing RSA to a mass exodus of skilled personnel in sensitive defence domains *to countries that are not necessarily aligned to our country's national interests;*
d. Loss of critical defence capabilities*, including sovereign and strategic capabilities.*

A&D MASTERPLAN

Without the technology developed by the industry*, we will not transition optimally through the interregnum between the 3rd and 4th waves (into 4IR);*

- *We will **become technology takers** (and price takers);*
- *We will be **vulnerable to sovereign pressure**;*
- *We will **not diffuse competitive technology** throughout South Africa industry;*
- *Our citizens will **not benefit** as they must, **from the Fourth Economy Wave** – inequality and poverty will increase and;*
- *We will be **less able to protect ourselves***

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1. INTRODUCTION – DENEL'S DEFENCE CAPABILITIES (ii)

Artillery
- 155mm G6 self-propelled Guns
- 155mm G5 Towed Guns
- 105mm Leo Guns
- Charges and Propellants
- Laser Range Finders

Security and border control
- Seeker 200 and 400 UAVs
- Light Weapons
- Ammunition
- MEDDS
- Casspir Vehicles
- Surveillance Equipment
- Mine Clearing

Naval
- 20mm Guns
- Umkhonto Missile
- DPS-35 Guns
- Ammunition
- Periscopes

Aerospace
- Inflight testing
- Aircraft Systems Integration
- Aircraft & Engine MRO
- Air-to-Air Missiles
- Precision Guided Bombs
- UAV Systems
- Ejection Cartridges
- Aircraft Bombs
- Stabilized Gimbals
- Space

Infantry
- Anti-Armour Missiles
- Active Missile Protection
- Air Defence Systems
- Combat Vehicles
- Vehicle Turrets
- Machine Guns
- Ammunition
- Anti Materiel Rifles
- Automatic Grenade Launchers
- Casspir Vehicles
- Pyrotechnics
- Laser Range Finders

Training and other
- Artisan Qualification
- Engineering Training
- Mine Clearing Training
- Mining Drill Bits
- Rocket Motors
- Warheads
- Energetic Materials

Jobs Impact
Denel: +/- 4000
Local Industry: +/- 15 000

2018 SADI Exported products worth R4bn to 66 countries

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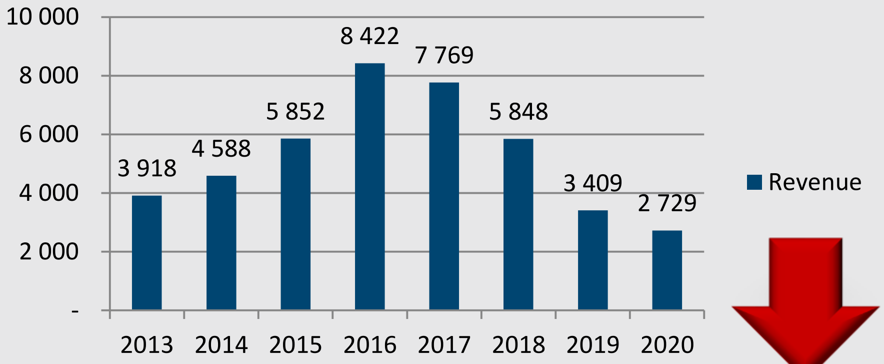
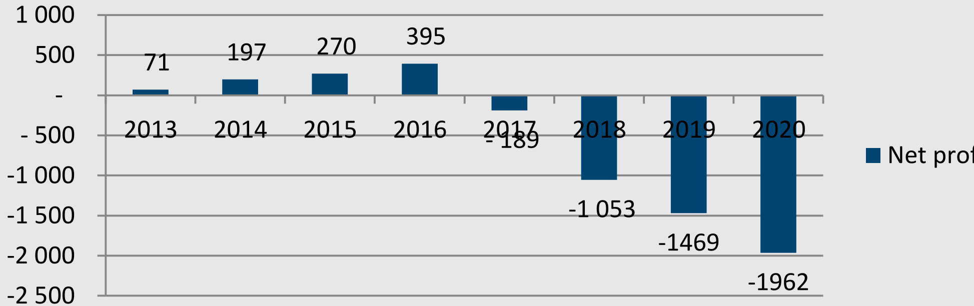
2. FY2019/20 RESULTS

2.1 FY2019/20 FINANCIAL RESULTS

Revenue



Net profit/(loss)

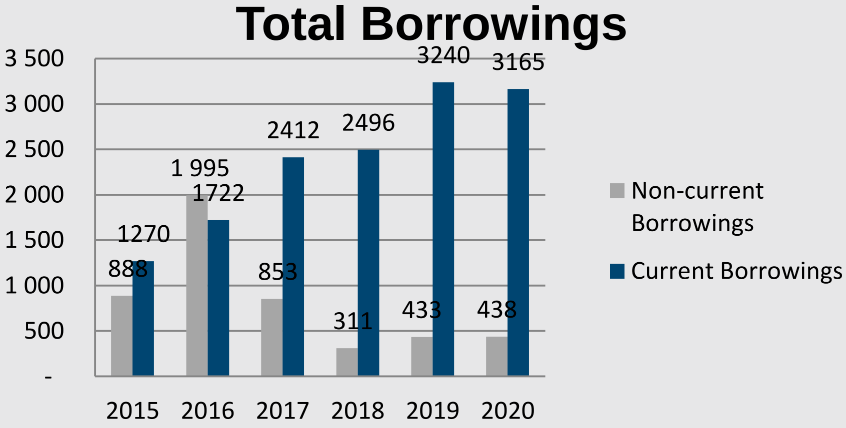


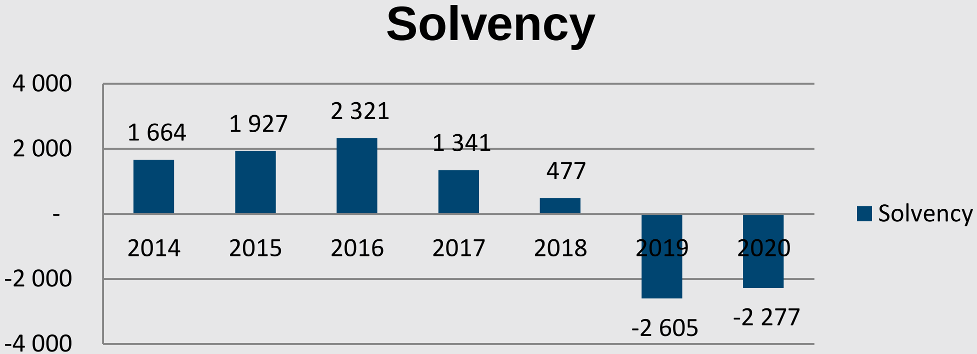
20%

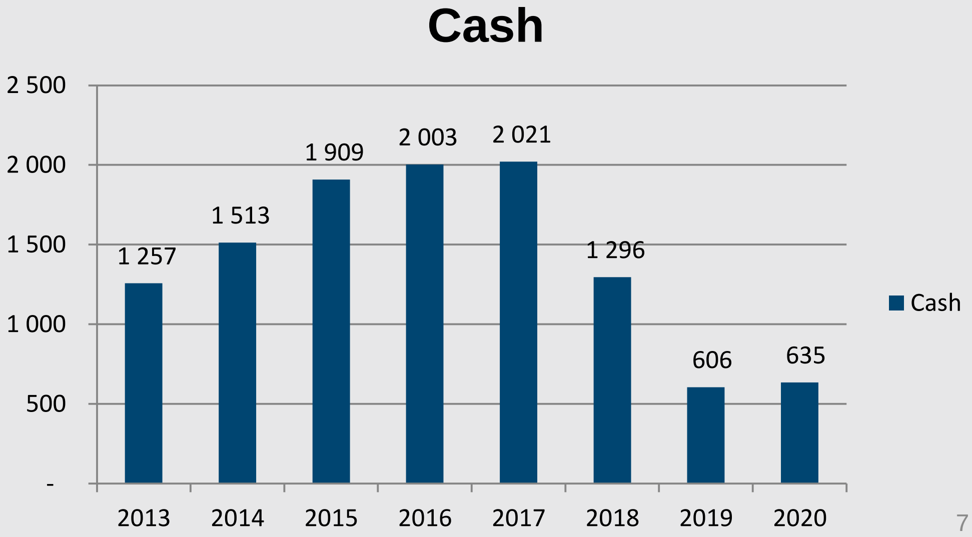
- Reduction in revenue over the last three years and at low levels of R2,7bn in FY2020. Primarily due to reductions at DAe, PMP, Dynamics and DVS.
- R4,4bn losses in the last three years due to revenue decline, contracting and export permit related issues with NCACC during Covid-19 pandemic lockdown in FY2019/2020, high cost structure including labour under-recoveries, interest, legacy obligations and inability to secure new business and execute on existing work due to liquidity constraints.

Prior year numbers have been restated

2.2 FY2019/20 FINANCIAL POSITION (ii)



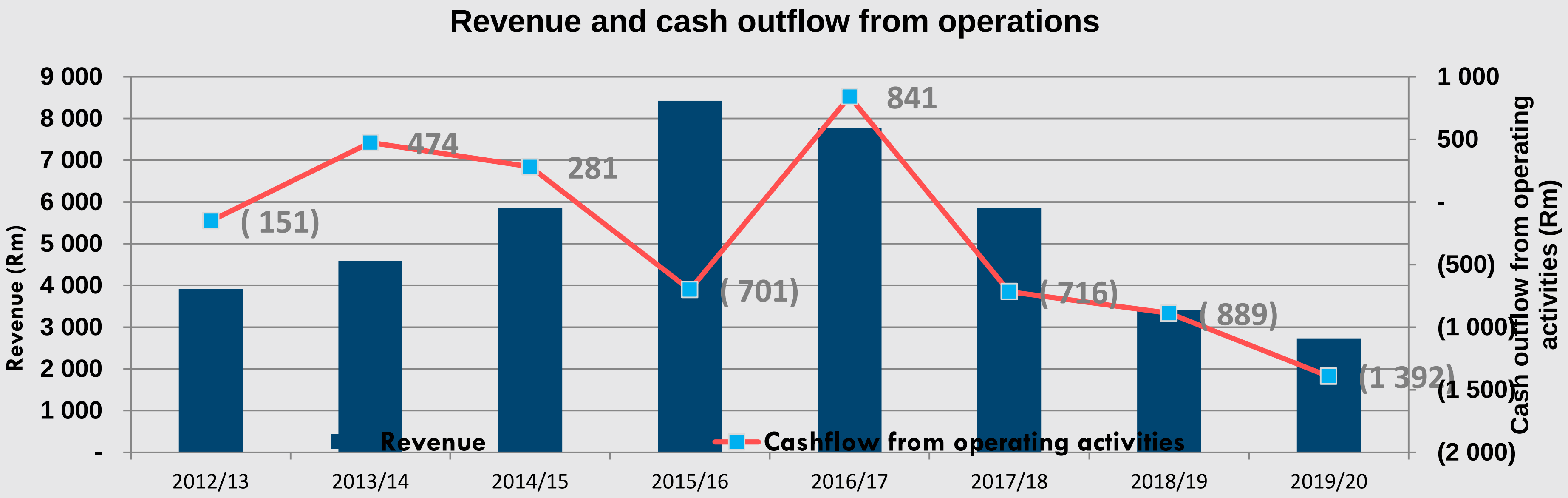




- Denel is insolvent with an increased debt position in the short term; DMTN – R3,4bn at 31/3/2020 (Today: R3,2bn)
- Cash at R635m (with R331m ring-fenced)
- Advance Payments Received – R3bn (R1,945bn – Hoefyster of which R800m in stock, contract assets and trade receivables)

Prior year numbers have been restated

2.3 FY2019/20 FINANCIAL RESULTS – CASH FLOW (iii)



- Cash generated from operations has reduced significantly as increased investment in inventories, trade receivables and contract asset persists due to delays in contract execution.
- Prepayments received from clients at c. R3bn reported, whilst R331m ring-fenced cash remains, with the rest utilised in working capital and operational requirements.
- 576m allocated in FY2020/21 MTEF cycle; R305m allocated to debt and interest. NT waived conditions in Sep 2020, R271m received mid-Nov 2020. Consequence: short-term liquidity position has steadily worsened.

DENEL

Prior year numbers have been restated

2.4 SEVERE FUNDING ISSUES (iv)

Despite the turnaround, **Denel remains rooted in a liquidity crisis;** its order book significantly exposed to risk. **Consequently, it has seen:**

- **Denel was downgraded by Fitch to ‘CC(zaf)’** due to **delayed and insufficient support from the Shareholder,** resulting in a weakened Standalone Credit Profile. **Banks / Financial institutions are no longer willing to provide facilities** critical for operations and winning new business. In fact, Banks are reducing facilities.

- **Reducing order backlog and pipeline and business exposed to significant risk** as reputational damage influences customers and markets.

- **Local defence budget continues to shrink and impacts Denel and the rest of the SADI. Geo-political landscape rapidly transforming. Treaties signed in the Middle East with the USA changing Denel’s traditional export advantage where access has been limited for Western suppliers.**

- **Denel Balance Sheet** reflects short-term debt of R3.2bn, <12 months; and negative equity of R2.3bn.

- **Debt profile has worsened;** Whilst Government guarantee extended to Sept 2023, Lenders have invested short-term

- **NT waived conditions for balance of recap (R271m of R576m as part of the FY20/21 MTEF)**; allocated to restart operations with priority on projects that can deliver a significant return and be cash generative to deal with creditors backlog and outstanding salaries.

- **Domestic Medium Term Note (DMTN) Programme – Risk of potential call on Notes** – Key investors agreed to roll over notes investment due for redemption on 11 Dec 2020 for R290m, **Denel’s disclaimer from the AG on the going concern poses a risk** with market regulation and could prevent us from rolling the Notes further, posing cross-default risks.

- **Slow progress on sale of non-core assets and exit from loss-making businesses** continue to put strain on already poor liquidity position.

- **Ring-fencing of funds due to Customer demands does not allow efficient allocation of resources.**

- **Under-funding for projects of strategic national importance.**

3. FY2019/2020 – IRREGULAR EXPENDITURE

3.1 IRREGULAR EXPENDITURE SUMMARY

Irregular Expenditure- R3.17bn

Includes LMT R0.77bn (24%)

Prior to FY17/18- R1.54bn (*E&Y to submit report to indicate any form of corruption, fraud and/or other criminal activities*)

FY17/18 to FY19/20 R1.63bn

Deviation from Competitive Bidding

R1.74bn (55%)

Expansions/ Variation of Orders

R0.41bn (13%)

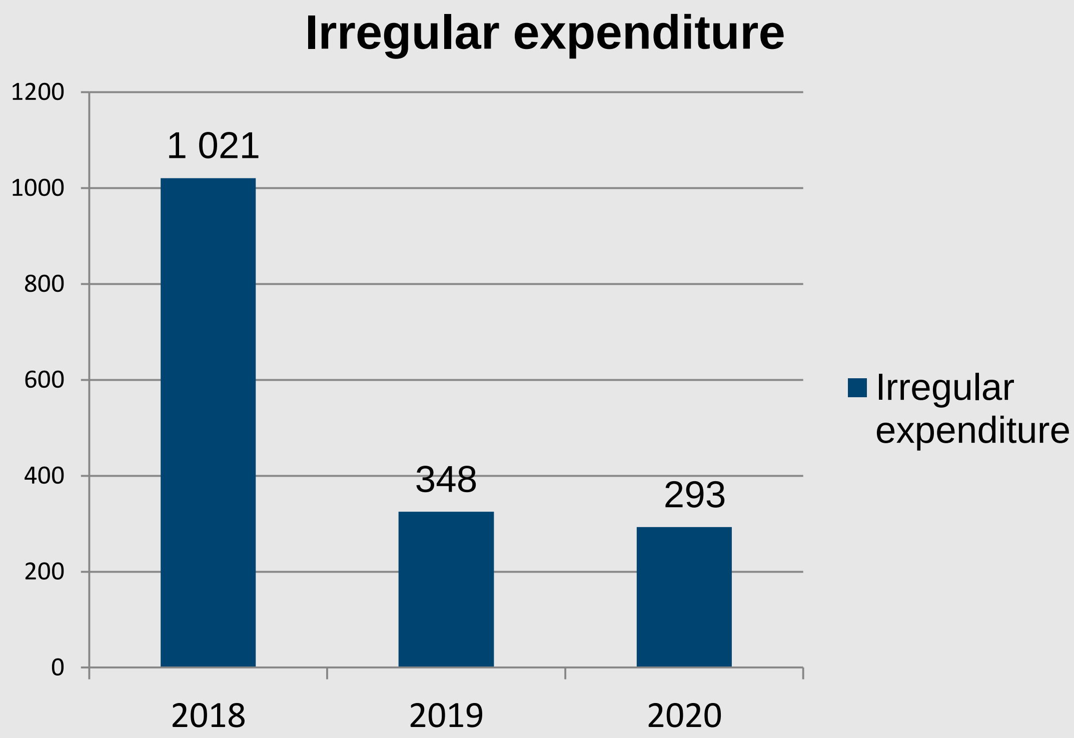
Evaluation criteria not adequately specified or applied

R0.36bn (11%)

Other

(Bids not adequately approved, Contracts not signed, Declaration of interest, Tax Clearance, AG Findings) (R0.66bn (21%)

3.2 IRREGULAR EXPENDITURE INCURRED – R3,1bn (PY: R2,9bn)



- Annual incurred irregular expenditure decreased by 80% since April 2018.
- Backlog of expenditure under investigation for possible condonation/recovery- R1,5bn.
- AG identified a further R119m (2019: R23m; 2018: R111m) due to Supply Chain Policy misalignment with PFMA and inability to prove fair, equitable & competitive process followed for certain historical suppliers, especially OEMs.
- Appointed SCM Head on 17/2/2020 and implemented improved SC Policy on 26/3/2020 aligned with legislation – however, improvements must include change in performance culture, knowledge & accountability.
- Consequence management requires significant improvement as well as processes for reviewing all potential IE.

4. EXTERNAL AUDIT MATTERS

AUDITORS REPORT

4.1 Response to 2018/19 audit findings

4.2 FY 2019/20 audit report

4.1 RESPONSE ON 2018/19 AUDIT FINDINGS

NATURE OF FINDING	COMMENT	STATUS
1. Revenue - Incorrect IFRS application IFRS15 and translation of prepayments	Insufficient audit evidence submitted and technical disagreements with the auditors.	Not resolved
2. Property, plant and equipment – Assets understatement valued at zero, inadequate evidence for properties and impairment of assets	Insufficient audit evidence submitted and technical disagreements with the auditors.	Not resolved
3. Trade and other Receivables– Incorrect application of IFRS 9 Financial Instruments	Contract assets taken into account as per previous findings. New findings raised regarding COVID-19 consideration.	Not resolved
4. Investment in subsidiaries - Fair value on acquisition of Turbomeca and the impairment valuation of DVS	Fair value on acquisition of Turbomeca resolved, however impairment of valuation still incorrect.	Not resolved
5. Non-current held for sale – Sale of Hensoldt not adequately disclosed	Hensoldt, correctly disclosed.	Resolved
6. Retirement benefit obligation – Service costs and net interest not adequately disclosed	Insufficient audit evidence submitted.	Not resolved

4.1 RESPONSE ON 2018/19 AUDIT FINDINGS (ii)

NATURE OF FINDING	COMMENT	STATUS
7. Operating expenditure and Contingent liabilities – Inappropriate supporting evidence for expenditure submitted	Insufficient audit evidence submitted.	Not resolved
8. Disclosures – Inadequate disclosure for change in accounting policies, prior periods, related parties, segment reporting, financial risk management and related parties	Closing this matter will be dealt with in closing the prior period errors and reporting tool.	Not resolved
9. Deferred tax and income tax – tax implication due to prior year period could not quantified at conclusion of audit	Closing this matter will be dealt with in closing the prior period errors and reporting tool.	Not resolved
10. Irregular and fruitless and wasteful expenditure – Additional expenditure identified by AGSA	Improvements in processes have been noted by AGSA but not fully resolved.	Not resolved

4.2 EXTERNAL AUDIT REPORT (i)

- AGSA has concluded on a **Disclaimer audit opinion** due to various matters including:

NEW FINDINGS:

- **Going concern** due to **material uncertainties** in cash forecast and liquidity assumptions;
- **Preparation of consolidated financial statements** Inappropriate audit evidence provided relating to the elimination of intercompany journals;
- **LMT – Preparation of consolidated financial statements** – Non-submission of financial statements by LMT for audit;
- **Inventories** – Non submission of sufficient audit evidence information for audit in relation valuation of stock;
- **Cost of sales** – Incorrect allocation of provisions for an onerous contract at Denel Aerostructures and non-submission of sufficient audit evidence to the auditors;
- **Provisions** – Insufficient audit evidence submitted to support amounts recognised as warranty provisions;
- **Non-current assets held for sale** – Incorrect application of IFRS 10 for the assets held for sale relating to the transfer of assets by Denel Aerostructures (auction stock);
- **Investment in associates** – Incorrect applications of IAS 28 in accounting for gains and losses on intragroup transactions between associates; and
- **Right of use of assets and lease liability –** Incorrect application of new Accounting Standard IFRS 16 (Deniprop only).

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4.2 EXTERNAL AUDIT REPORT (ii)

- AGSA has concluded on a **disclaimer audit opinion** due to various matters including:

REPEAT FINDINGS:

- **Revenue** - Incorrect of IFRS 15 application
- **Trade and other receivables and contract assets –** Incorrect application of IFRS 9(ECL);
- **Investment in subsidiaries –** Incorrect application of IAS36 Impairment of investments;
- **Retirement benefit obligation -** Service costs and net interest not adequately disclosed;
- **Operating expenditure and Contingent liabilities -** Inappropriate supporting evidence for expenditure;
- **Property, plant and equipment and Intangible assets** - Did not adequately review the useful lives, residual values and impairment of property, plant and equipment at each reporting date;
- **Disclosures** – Inadequate disclosure for change in accounting policies, prior periods, related parties, financial risk management, segment reporting and related parties;
- **Deferred tax and income tax** – Tax implications due to the prior year period could not quantified at the conclusion of audit; and
- **Irregular and fruitless and wasteful expenditure** – Additional expenditure identified by AGSA.

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5. HUMAN RESOURCES & SOCIO-ECONOMIC IMPACT

DENEL

Human Resources Dashboard

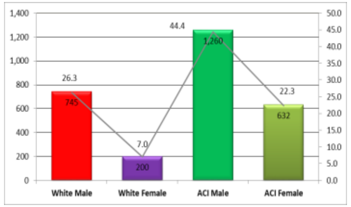
Headcount Current Month : 31 January 2021

2,837

Current Headcount

-14.9%

over Financial Year



832 29.3%

Total Female

-13.3%

over Financial Year

1,892 66.7%

ACI

-11.7%

over Financial Year

Employee Movements : 1 April 2020 to 31 January 2021

Entrants

1

Transfers

1

Exits

498

Contract Type	1 April 2020	31 January 2021
Permanent	3,054	2,617
Students	193	162
Contractors	85	58
Total	**3,332**	**2,837**

832
29.3%

2,005
70.7%

Entrants	
1 Jnr Eng (Re-Appoint)	

Exists	
1 Legal & Comm Exec	25 x SupCh/Planners/Conf
73 x Management 498	20 x Fin/HR/Market/IT/Train
99 x Engineers / Project Managers	7 x Security/Emergency
249 x Techn/Artisans/Operators/Train	25 x Admin/General Worker

Metric	KPA	YTD Achievement %		YTD Achievement Number		Exist Reasons	
		Actual	Target	Achieved	Target	Regretted Loss	Other
EE Plan	Designated	66.3%	72%	1,979	2,329	60 Better Salary/Benefits	61 x Contract Terminations
	People with Disabilities	1.1%	5%	43	52	77 x Better Career Opportunities	59 x Retirement
	Females	29.3%	33%	885	970	9 x Better Working Conditions	28 x Early Retirement
BBEEE	Level	Level 6	Level 5	Level 4	Level 5	2 x Company Culture	17 x Death
Female in Leadership	Top Management	29.8%	33%	3	5	4 x Emigrate	3 x Medical Unfit
	Senior Management	16.9%	32%	14	25	24 x Personal/Family Circumstances	2 x Dismissal / 3 x Abscondment
	Middle Management	26.7%	17%	107	130	14 x Not Disclosed	6 x Voluntary Retrenchment
	Junior Management	0.0%	33%	359	501	7x Self Employment / 3 x Studies	119 x Forced Retrenchment

HR & SOCIO-ECONOMIC IMPACT: B-BBEE/CSI

TRANSFORMATION

B-BBEE:	Level 4	ACI* appointments:	90%
2018/19:	Level 6	2018/19:	83%

Female appointments:	43%
2018/19:	58%

- Improved B-BBEE status to level 4;
- Appointments both for ACI and female still aligned to the social mandate.

SOCIAL

Black-owned spend*	R602 m	Skills development:	R21 m
2018/19:	R417 m	2018/19:	R32 m
Corporate social development:	R-	Employee numbers:	3 332
2018/19:	R593 k	2018/19:	3 968

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6. FY2020/21 – Q3 FINANCIAL RESULTS & PERFORMANCE

6.1 FINANCIAL RESULTS – DECEMBER '20

	Year-end							
	Actual * Dec-20 Rm	Budget Dec-20 Rm	Actual Dec-19 Rm	Variance Dec-20 Rm	Forecast Mar -21 Rm	Budget Mar -21 Rm	Variance Mar -21 Rm	Actual Mar-20 Rm
Income statement								
Turnover	1 474	3 388	1 614	(1 914)	2 819	3 640	(822)	2 729
Gross profit	186	587	29	(401)	(189)	730	(919)	582
Operating expenditure	(1 286)	(855)	(1 208)	(431)	(1 280)	(789)	(491)	(2 229)
Net (loss)/profit	**(1 234)**	**(378)**	**(1 361)**	**(855)**	**(1 565)**	**(184)**	**(1 381)**	**(1 962)**
Balance sheet								
Cash on hand (incl. escrow)	752	1 820	173	(1 068)	514	2 427	(1 913)	635
Net equity	(3 677)	(1 020)	(1 463)	(2 657)	(2 835)	(311)	(2 524)	(2 277)

- December sales was 56% behind budget with a the full-year forecast of R2.8bn that is 23% behind the budget.
- Due to the delays in resolving the liquidity issues and Covid-19 lock down impact, there was reduced operational activity resulting in reduced sales.
- The forecast has indicated a decrease in revenue of R822m and an increased net loss of R1 565m. This was partially as a result of the delay in the recapitalisation funds receive leading to delayed operational activities.
- Operational activities is at low levels throughout the organisation.

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6.2 CASH PRIORITIES

Besides the servicing of long term loans and settling of legacy debts, **Denel manages its cash with the following priorities:**

- **Assets & Liabilities:** commitments and expenses in this regard have been **prioritised according to necessity and contribution to Denel's operations**.

- **Creditors:** suppliers have been prioritised and **paid in order to allow daily operations to continue** to preserve +/- 4000 jobs and the expediting of projects that can deliver a rapid return.

- **Salaries:** Since the decentralisation of salaries and cash management, **the divisions with contracted productive workload have been able to recover, meet their obligations and begin to repay outstanding employee salaries and statutory payments.** Some divisions, such as Denel Dynamics and Denel Vehicle Systems continue to experience severe constraints.

- **Restructuring:** a **Section 189 process** was approved by the Board and initiated. Lack of funds to pay severance packages may delay the exit of impacted employees.

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7. FY2021 – IRREGULAR EXPENDITURE YTD

DENEL

IRREGULAR EXPENDITURE FY2021 Year to date

AERO R4.30m

DVS R0.03m

TOTAL R25.45m

DD R6.42m

DLS R9.30m

DIP R5.40m

The main contributor/transgression category for Irregular Expenditure is attributed to Order Variations Exceeding 15% and participating in expired contracts.

- These are related to
    - Freight Forwarding & Clearing contracts. This was resolved during December 2020 with the appointment of 2 Service Providers. Will be expanded during Q1 of FY22
    - ERP contract extension. Approval from NT did not cover preceding expenses

Other matters related to PPE which went through a quotation process but prices were not compared to NT pricelist

No fraud, corrupt and/or other criminal activities related to these transactions were reported.

Divisional CEOs were requested to submit reports around consequence managements which will be considered by the Loss Control Committee during the Determination tests for Irregular Expenditure

Refer to Annexure A for Irregular Expenditure Schedules for FY21

8. QUESTIONS


THANK YOU