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PARLIAMENT
OF THE REPUBLIC OF SOUTH AFRICA

16 March 2021

SOUTH AFRICAN FORESTRY COMPANY 2019/20 ANNUAL REPORT ANALYSIS

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1. INTRODUCTION

After three consecutive years of receiving qualified audit opinions, the **South African Forestry Company (SAFCOL)** managed to achieve an unqualified audit opinion, although with findings. It is reported that irregular and wasteful and fruitless expenditure increased for the year, however this was due to previous year's contracts. The entity is ensuring that all irregular and wasteful and fruitless expenditure be accounted for and corrected. The entity's financial position also improved slightly, where another operational loss occurred, it was lower than the previous year. **Earnings before interest, taxes, depreciation and amortisation (EBITDA)** also improved from a loss of R66 million in 2018/19 to a profit of R35 million in 2019/20. However, the entity achieved **56.0 per cent of its performance targets**, achieving 14 of the 25 performance targets. The entity did not achieve any of its financial sustainability and strategic initiative targets, which is a concern. Overall, SAFCOL's performance for the 2019/20 financial year was an **improvement** on the previous year

The brief seeks to provide an overview of SAFCOL's annual report for the 2019/20 financial year, highlighting matters for further consideration by the Portfolio Committee on Public Enterprises.

2. COMPANY BACKGROUND

SAFCOL is wholly owned by the South African Government, an entity within the mandate of the Department of Public Enterprises. The South African Forestry SOC Limited was established in 1992 through the Management of State Forests Act. SAFCOL has a 100 per cent stake in **Komatiland Forests (KLF)**, KLF in turn owns 80 per cent of **Industrias Florestais de Manica, SARL (INFLOMA)** in Mozambique. SAFCOL conducts its primary business within the forestry industry, ensuring the sustainable management of forests and other assets within the SAFCOL Group, to enhance value for the shareholder. SAFCOL also plays a catalytic role in the realisation of the state's afforestation, rural development and economic transformation goals. SAFCOL maintains its status in the forestry industry by continuously developing its understanding of and striving for innovation throughout the full forestry-sawmilling value chain. Revenue is generated through the sale of forest products, sawn timber and other value added products.

2.1 Government Strategy

Government recognises State-owned enterprises (SOEs) as strategic instruments of industrial policy. This among other things means that SOEs' key programmes must be integrated into the broader industrial policy and economic cluster programme of the government both in terms of funding and policy support.[1] State-owned enterprises are to reflect in their mandates the socio-political objectives of governments. To do so, they will need to create a delicate balance between SOCs' strategic purposes and SOCs' commercial viability.[2]

[1] Hogan, B. (2010).
[2] Boskati. (2012).

Thus SOCs need to reach towards the twin goals of attaining the country's socio-economic developmental goals and maximising operational efficiency and financial sustainability. SAFCOL is well positioned to contribute to the following priorities of government, as indicated in the National Development Plan, by speeding up growth and transforming the economy to create decent work and sustainable livelihoods, by a comprehensive rural development strategy linked to land and agrarian reform and food security, strengthening the skills and human resource base, and by sustainable resource management and use. Furthermore, the utility will commit itself to the strategic role of advancing government's policy objectives as outlined in the **Industrial Policy Action Plan (IPAP)** and the **New Growth Path**, by aligning its strategy, goals and objectives to these priorities.

3. CORPORATE GOVERNANCE

SAFCOL is governed by its board of directors. The board is accountable to the shareholder for determining strategy and the overall performance of the company which needs to adhere to the Public Finance Management Act (1999) for financial management. A formal Shareholder Compact determining strategic objectives of the company was concluded between the Board and its shareholder for the year under review. The board has the ultimate responsibility for the strategic management and performance of the company.

On 01 October 2018, the Minister of Public Enterprises, Pravin Gordhan, appointed an entirely new board on the basis that the entity needed to be turned around. The board members are: Mr. Mpho Makwana as Board Chairperson, Ms. Zimkhitha Zatu, Adv. Lentswe Mokgatle, Ms. Buhle Hanise, Ms. Lahlane Mnisi, Mr. Neeshan Balton, Ms. Joanne Yawitch, Ms. Portia Derby, Mr. Frans Baleni, Mr. Yershen Pillay. The new board was appointed for a three year term ending on 30 September 2021. In the financial year under review, Ms. Portia Derby resigned as a board member on 03 February 2020. The Chief Financial Officer (CFO), Mr. D Hlatshwayo, resigned effective 29 February 2020, after being CFO for only 6 months. Mr. John Maruma was once again appointed as acting CFO, as he was acting CFO before Mr. Hlatshwayo was appointed. The Chief Executive Officer (CEO) is M. Tsepo Monaheng.

The board held 10 board meetings, with the following board committees taking place: human resources and remuneration (five meetings held); Finance, Investment and Transaction (nine meetings held); Audit and Risk (seven meetings held); Safety, Health, Environment and Quality (four meetings) and Social and Ethics (four meeting held).

4. PERFORMANCE OVERVIEW[3]

The vision is stated as being a leader in sustainable forests and commercial forest products. The mission is to strive to:

[3] SAFCOL (2021). This section is taken directly from this report.

- Grow the business in the forestry value chain;
- Maximise stakeholder value through strategic partnerships;
- Maintain practises that are economically viable, environmentally acceptable and socially beneficial;
- Facilitate sustainable economic transformation of the forestry industry and thereby uplifting communities.

The Strategic Intent Statement states[4]:

a) Leveraging State capabilities to improve sustainability and economic viability;
b) Securing the economic future of the community and stakeholders it serves;
c) Enhancing co-ordination between SOC's to unlock real value in support of the NDP goals;
d) Optimising the social and economic impact of all interventions undertaken in the SOC in the achievement of these objectives;
e) Horizontal Integration: to increase the management of plantation areas to ensure the sustainable supply of sawlogs to the country;
f) Vertical Integration: participation in processing activities within the timber value chain; and
g) IFLOMA: optimisation of the existing operations and investment for growth.

SAFCOL is currently implementing a turnaround strategy, entitled SAFCOL's 50:50 Strategy. The vision is to increase lumber processing and value-adding activities to contribute 50 per cent of the revenue over five years, reducing the dependence on log sales and ensuring sustainability of the business. Various initiatives are being deployed to achieve growth, including but not limited to, acquisitions and partnerships with the industry. This is to ensure commercial sustainability to contribute to GDP growth and national developmental objectives focused on communities.[5]

The core values of the company are: respect and value employees; passionate about forests and the communities; conduct themselves with honesty and integrity; strive for customer satisfaction; and to strive for excellence and innovation in the business.[6]

The entity achieved 14 of its 25 key performance indicators, achieving 56.0 per cent, while 11 indicators were not achieved. The targets not achieved mostly concerned Financial Sustainability; Strategic Initiatives; and Socioeconomic impact. Specific targets not achieved are: trade receivable days of 60 days; EBITDA margin of 5 per cent; revenue per employee; Timbadola reinvestment; IFLOMA Fibre Project; total local content as a percentage spend; procurement spend on people with disabilities owned entities as a percentage of total measurable procurement spend; annual value of all enterprise development and supplier

[4] SAFCOL (2021). This section is taken directly from this report.
[5] Ibid
[6] Ibid

development contributions made by SAFCOL; spend on BEE compliant companies; fatalities index; Temporarily unplanted percentage (TUP) Mozambique.[7]

4.1 Operational Performance[8]

According to the CEO, the industry entered into its third consecutive quarter of negative growth. The saw mills were unable to get an increase in selling price for structural lumber products from the retail customers, as a result, customers demand for higher priced class logs remained very poor. SAFCOL had to decrease the price of logs for the year against increased operating costs. Timber volumes amounted to 975 669 logs with market prices weighted average per cube at R646.67.[9]

Maintained Plantable area in South Africa amounted to 120 870 hectares, while in Mozambique (IFLOMA) amounted to 16 317[3] hectares, both meeting their targets. Temporarily Unplanted Area in the South African operations achieved 3 per cent, meeting its target of 3 per cent. However, 7.0 per cent of temporarily unplanted area was achieved in Mozambique, not meeting the target of 4 per cent as the 2019/20 financial year was due to lack of rain experienced throughout the year.[10]

The Timbadola Reinvestment project was not achieved. This involved the approval of a bankable business case, the section 54 (of the PFMA) approval process concluded and a turnkey provider appointed, with construction commencing. The bid was advertised but was unsuccessful. SAFCOL received approval from the National Treasury to re-advertise the bid again. The bid specifications and evaluation criteria were reviewed.[11]

The IFLOMA Fibre Project was also not achieved. This involved the board approval of a bankable feasibility study/business case with implementation plan. SAFCOL states that an award was made for the updating of the Bankable Feasibility Study (BFS) and the development of a Bankable Business Plan (BBP) in February 2020. Due to capital management initiatives, projects will start in the new financial year 2020/21.[12]

IFLOMA has invested in a new sawmill, which will be commissioned during the 2020/21 financial year and this will increase the lumber sales. This subsidiary is fully operational and achieved a breakeven performance.[13]

Land claims on the land on which SAFCOL operates, being 61 per cent, is the entity's biggest business risk. A committee has been put in place with member from the beneficiaries, SAFCOL and the Department of Rural Development and Land Reform to work on the Mmamahlola land

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[7] SAFCOL (2021). This section is taken directly from this report.
[8] Ibid.
[9] Ibid
[10] SAFCOL (2021). This section is taken directly from this report.
[11] Ibid
[12] Ibid
[13] SAFCOL (2021). This section is taken directly from this report.

claim. Parties have agreed to work together post settlement. A draft Lease Agreement has been developed.

Of the 7 targets set for the key performance area Productivity, under the strategic objective Operational Excellence, the entity achieved 4, while 3 was not achieved, as discussed above.

The target with respect to research and development was met, the company spending 1.69 per cent of total expenditure on R&D as a percentage of revenue, against a target of 1.5 per cent.

Issues to Consider

- **The Committee should request an update on the model for the settlement of claims on SAFCOL operations.**
- **SAFCOL should update the Committee its engagements with its customers. What has the entity learned from these engagements and what is being implemented to ensure customer satisfaction?**
- **What is the delay in the Timbadola upgrade? In the 2018/19 financial year, the bid request was also unsuccessful. Has SAFCOL considered entering into a Public-Private Partnership to fund this project?**
- **What was the amount spent on R&D?**
- **What progress has been made regarding SAFCOL's request to manage government forests, which was part of the entity's turnaround strategy?**
- **In the Board Chairperson's statement, he says that in response to the COVID-19 disease the entity undertook a scenario planning project to identify if the current strategy was still relevant. The entity should inform the Committee on what this scenario planning project entailed?**
- **When will the vacant board position be filled?**

4.2 Transformation and Human Capital[14]

SAFCOL spent R423 million on employment costs, an increase of 10.7 per cent from the R382 million spent in the previous financial year, attributed to the increase in regulated minimum wages. During the year, SAFCOL had a total of 1 472 permanent employees and 447 employees at IFLOMA compared to 1 546 permanent employees at SAFCOL and 606 employees at IFLOMA in the previous year. SAFCOL has 248 vacancies, against an approved 1 720 positions. Total Employee costs amounted to R395.8 million compared to R422.6 million in the previous financial year.[15]

The entity does not provide the overall demographic profile of the company. Representation is given for Black Top and Senior Management at 77 per cent (target 79 per cent), Black Top

[14] SAFCOL (2021). This section is taken directly from this report.
[15] Ibid

and Senior Female managers at 26 per cent (target 36 per cent), Black Middle Managers at 74 per cent (target 69 per cent), Black Middle Female Managers at 30 per cent (target 30 per cent) and Black persons with disabilities at 2.6 per cent (target 2 per cent).[16]

Unfortunately there were two fatalities during the year, from no fatalities in the previous year, with the Disabling Injury Incident Rate (DIFR) at 1.62, against a target of 1.8.[17]

SAFCOL invested R26.5 million in training during the 2019/20 financial year to promote higher levels of productivity and engagement. Additionally, a total of 3 701 forestry specific and safety training were implemented to build capacity within SAFCOL operations and Contractors upskilling. A total of 511 employees underwent external training to enhance the pool of skills available to the company's future business needs.[18]

A total of 170 graduate programmes were implemented to promote community development in line with the Shareholder Compact, which include implementation of learnerships, internships, bursaries and apprenticeships. The number of apprenticeship trainees amounted to 14, with 100 sector specific learnerships. Thus the targets relating to percentage of training spend, number of apprenticeship trainees and number of sector specific learnerships were all achieved.[19]

With regard to local procurement, the following was achieved[20]:

- Spend on BEE compliant companies achieved 51 per cent against a target of 80 per cent (not Achieved)
- Procurement spend on 51 per cent Black-owned entities as a percentage of total measurable procurement spend (TMPS) achieved 40 per cent against a target of 40 per cent (achieved)
- Procurement spend on 30 per cent Black Women-owned entities as a percentage of TMPS achieved 18 per cent against a target of 12 per cent (achieved)
- Procurement spend on Black Youth-owned entities as a percentage of TMPS achieved 8 per cent against a target of 6 per cent (achieved)
- Procurement spend on People with Disabilities owned entities as a percentage of TMPS achieved zero per cent against a target of 2 per cent (not achieved)
- Procurement spend on Qualifying Small Enterprises (QSE) or Exempt Micro Enterprises (EME) entities as a percentage of TMPS achieved 36 per cent against a target of 30 per cent.
- Total local content as a percentage spend achieved 8 per cent against a target of 55 per cent.

The reason given for the achievements not meeting its targets is given as cost containment measures.

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[16] SAFCOL (2021). This section is taken directly from this report.
[17] Ibid
[18] Ibid
[19] SAFCOL (2021). This section is taken directly from this report.
[20] Ibid

A budget of R7.5 million was targeted where R7.8 million spent on Corporate Social Investment (CSI) initiatives while R3 million was spent on Enterprise Development and Supplier Development contributions against a target of R4 million.

Issues to Consider

- **The Committee should request the entity to give a breakdown of their workforce, by demographic.**
- **What is the entity doing to ensure it meets its preferential procurement spend targets?**

5. FINANCIAL PERFORMANCE[21]

The entity's revenue decreased by 20.9 per cent from R1.042 million in 2018/19 to R824 million in 2019/20. The decrease was as a result of the entity deciding to discontinue standing sales in the 2019/20 financial year. Log sales of R587 million was achieved, while lumber sales amounted to R204 million, in the year under review.[22]

In the year ending March 2020, the entity incurred an operating loss of R13.7 million in comparison to the operating loss of R130.7 million in the previous year. This was a reduction of 89.5 per cent year-on-year as a result of cost containment measures implemented. Cash generated by the entity amounted to R161.2 million, an improvement on the R49.9 million achieved on the previous year due to prudent working capital management. The overall loss for the year amounted to R54 million, a further improvement on the R72 million loss made in the previous financial year.[23]

The company's major asset is its biological assets which are the plantations within the forest operations. Biological assets increased year-on-year from R3.6 billion to R3.8 billion. Total assets increased from R4.991 billion in 2018/19 to R4.648 billion in the 2019/20 financial year. Total equity decreased marginally to R3.2 billion from R3.1 billion in the previous year, with total liabilities increasing to R1.852 billion from R1.456 billion in the previous year. The cash and cash equivalents at the end of the financial year amounted to R252.4 million, an increase of 61.7 per cent on the R156.1 million balance in the previous financial year.[24]

[21] SAFCOL (2021). This section was taken from this report.
[22] Ibid
[23] Ibid
[24] SAFCOL (2021). This section is taken directly from this report.

Irregular expenditure amounts to R626.5 million, an increase from the R443.3 million spent on this item in the previous year while fruitless and wasteful expenditure amounts to R2.6 million an increase on the R496 000 spent in the previous financial year.[25]

5.1 Auditors Opinion[26]

SAFCOL received an unqualified audit opinion with findings after three consecutive years of qualified audit opinions.

5.1.1 Emphasis of Matter

The corresponding figures for 31 March 2019 were restated as a result of an error in the consolidated and separate financial statements of the group at, and for the year ended, 31 March 2020.

5.1.2 Compliance with Laws and Regulations

The auditor highlighted the following issues relating to compliance with laws and regulations:

- **Expenditure management:** Effective and appropriate steps were not taken to prevent irregular expenditure of R9 071 000 as required by section 51(1)(b)(ii) of the PFMA. The majority of the irregular expenditure was caused by non-compliance with supply chain management processes. (Repeat finding)
- **Annual Financial Statements:** The financial statements submitted for auditing were not prepared in accordance with the prescribed financial reporting framework, as required by section 55(1)(b) of the PFMA. Material misstatements of disclosure items identified by the auditors in the submitted financial statement were corrected, resulting in the financial statements receiving an unqualified opinion. (Repeat finding)
- **Procurement and contract management:**
  - Some goods, works or service were not procured through a procurement process which is fair, equitable, transparent and competitive, as required. (Repeat finding)
  - Some of the tenders that achieved the minimum qualifying score for functionality criteria were not evaluated further in accordance with the 2017 preferential procurement regulation 5(7).
- **Consequence management:** Inability to obtain sufficient appropriate audit evidence that disciplinary steps were taken against officials who had incurred irregular expenditure and fruitless and wasteful expenditure as required by section 51(1)(e)(iii) of the PFMA. This was due to proper and complete records that were not maintained as evidence to support the investigations into irregular expenditure and fruitless and wasteful expenditure. (Repeat finding).

[25] Ibid
[26] SAFCOL (2021). This section was taken from this report.

- **Governance and oversight:** Approved audited financial statements for the 2018-19 financial year were not filed with the annual return, as required by section 33(1)(a) of the Company Act and section 30(2) of the Companies Regulation.

5.1.4 Internal Control

The auditor highlighted the following issues relating to internal control:

- Executive management **did not exercise oversight responsibility regarding financial reporting and compliance** with legislation as well as related internal controls relating to the prevention of irregular expenditure. Effective and appropriate measures were not implemented in a timely manner to prevent and detect material errors in the submitted annual financial statements, as well as to prevent and detect non-compliance with legislation. (Repeat finding)
- The **year-end review and reconciling processes were not always effective** to detect and correct misstatements in the financial statements.
- The public entity developed an **audit action plan** to address internal and external audit findings; however, **actions implemented were not always effective** to prevent non-compliance with supply chain management legislation.
- The **financial statements lacked an in-depth review** as a number of errors were identified in the financial statements submitted for audit.

5.1.5 Investigations

An **independent firm was appointed** to investigate allegations of improper conduct in supply chain management, at the request for the public entity, covering the period 26 February 2018 to 21 September 2018. The investigation was concluded on 26 May 2020. The Auditor-General (AG) stated that at the date of reporting, disciplinary action as recommended has not commenced.

Although the entity received an unqualified opinion, **some of the areas of concern in the previous year have not been resolved**, when comparing the findings from the previous financial year.

Issues to Consider

- **SAFCOL decided to discontinue standing sales contracts. Why was this decision taken and how has this impacted on the operations of the entity?**
- **What processes has SAFCOL put in place to address the above matters? What support is DPE offering to capacitate SAFCOL to overcome these matters?**
- **SAFCOL should update the Committee on all findings into investigations of alleged financial mismanagement and the consequence management mechanisms instituted against those found guilty of mismanagement.**

- **What processes are being put in place to reduce and overcome irregular expenditure and fruitless and wasteful expenditure?**
- **The auditor stated that the effects of the COVID-19 disease did not impact the entity on its 2019/20 annual financial statements. How is the entity going to mitigate the effects of the COVID-19 disease on its operations for the 2020/21 financial year?**
- **SAFCOL still holds minority shares on behalf of communities. When will these shares be transferred to the communities?**

6. CONCLUSION

SAFCOL received an unqualified audit opinion with findings. The entity's performance for the year, achieving 53.0 per cent of its targets. Overall, the entity improved on its performance from the previous year, coming off three consecutive years of qualified audit opinions. The entity also improved on its preferential procurement targets achieved, given that it did not meet any of these targets in the previous financial year. It seems as if the **turnaround strategy** implemented by the board is yielding results. The turnaround strategy was conceived by the entity to ensure it fulfils its potential in the forestry industry and thereby creating much needed employment in the rural areas in which it operates. However, the **upgrading of the Timbadola Sawmill should be prioritised** if the entity wishes to become financially sustainable. The entity is currently depend on log and lumber sales. The company needs to diversify its revenue streams. The Committee will have to ensure that the board fulfils this mandate.

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7. REFERENCES

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