PARLIAMENT
OF THE REPUBLIC OF SOUTH AFRICA

RESEARCH UNIT
PO Box 15 Cape Town 8000 Republic of South Africa
Tel: 27 (21) 403 8273 Fax: 27 (21) 403 8118
www.parliament.gov.za

23 August 2021

DENEL: STATUS OF THE ENTITY

TABLE OF CONTENTS

1. INTRODUCTION

This paper provides an update on the current operations at Denel, the state owned armaments company. The purpose of this paper is to provide the Portfolio Committee on Public Enterprises (hereafter, the Committee) with an update on the developments regarding the company. The Committee was last briefed on the status of Denel on 09 June 2020 by the entity. The paper will focus on recent developments with regards to the entity.

2. BACKGROUND

Denel provides military independence and security of supply to the country by developing high-end technology, and conducting research and development. It is also involved in advanced manufacturing of niche defence products and solutions, which are also supplied to global markets. Denel is a significant global defence and security equipment manufacturer, as well as a provider of related services, with more than 50 per cent of its revenue earned from exports. Denel has presence in South Africa, Africa, the Middle East, Southeast Asia, South America and Europe.

During 2009/10, after a decade of posting financial losses, a turnaround strategy aimed at bringing Denel to profitability was launched. The turnaround strategy included rightsizing and decentralisation to improve financial performance and accountability. Denel entered into selected equity partnerships with the aim of accessing funding, best practice business

processes, new technology and securing new markets. Non-core, loss-making assets and businesses were disposed of. Various initiatives were implemented, including strategies focused on significantly improving business development, enhancing capabilities, leadership and transformation, as well as improving efficiencies to start posting profits in 2010/11. The company also received R700 million from the National Treasury for recapitalisation of the company to restore its balance sheet in the 2011/12 financial year. The company experienced improved stakeholder relationships and enhanced support in its marketing efforts. The entity continued to post profits from the 2011/12 financial year, securing an order book in excess of R35 billion in the 2016/17 financial year.[1]

However, during the 2016/17 financial year, Denel entered into an unsanctioned transaction with RV Laser to create Denel Asia. This caused reputational damage to the entity. The creation of Denel Asia without the appropriate approvals brought to light governance irregularities at the entity, which resulted in the entity's 2017/18 financial statements not being tabled due to liquidity challenges.[2]

Denel was unable to table its 2019/20 Annual Report and financial statements by the due date of September 2020 to Parliament, as happened with the 2017/18 Annual Report and financial statements, due to uncertainty regarding its going concern status. Despite receiving R1.8 billion from National Treasury in August 2019, the entity still reported a comprehensive loss of R1.962 billion compared to a loss of R1.469 billion in the previous year. Due to the recapitalisation received from National Treasury, the entity was able to submit its 2019/20 annual report in February 2021.[3]

The entity received a disclaimed audit opinion for the 2019/20 financial year, for a third consecutive year, citing insufficient audit evidence to verify the figures in the financial statements.

A new Board was appointed at Denel in April 2018. The new Board was tasked with investigating the allegations of fraud and corruption at the entity as well as bringing the entity back to financial and operational sustainability. The turnaround strategy addressing the governance and operational issues was approved by the Board and shareholder and is currently being implemented.[4]

2.1. TURNAROUND STRATEGY

The turnaround plan introduced by the Board remains at the core of the entity's strategy to ensure the long-term sustainability of the organisation. The key strategic drivers are:

[1] Denel SOC Ltd (2016)
[2] Bramwell (2021)
[3] Ibid.
[4] Ibid.

- To maximise the value of the core business areas
- To deliver on strategic partnerships
- To exit non-core business areas
- To improve corporate governance and combat fraud, corruption and wastage
- To drive cost reduction and optimise the utilisation of assets
- To secure funding and high-level support from the shareholder
- To grow the order book
- To ensure the retention of core skills and capabilities
- To restore Denel's reputation and improve employee morale and loyalty.

As part of Denel's turnaround strategy approved by the Board in February 2019, the company embarked on a process to exit unprofitable, non-core businesses. This created an opportunity to acquire strategic equity partners, which enabled Denel to secure market access and generate cash, thereby restoring its financial sustainability. Denel was also engaging with interested parties for equity injections.

The rationale for the new look Denel was the following factors:[5]

- Declining local budget and decline in defence spending (Armscor reduced budget by over 40 per cent)
- Non-alignment and expectations from key stakeholders
- Unsustainable cost structure versus revenue
- Unsustainable debt
- Poor programme management
- Poor working capital management (stock, debtors and cash)
- Lack of appropriate commercial skills
- Sub-optimal relationship with Strategic Equity Partners (SEPs)

The turnaround strategy suggested the following:[6]

The **exit or disposal** of the following businesses:

- Aerostructures
- Pretoria Metal Pressing (PMP) Foundry
- Properties
- Gear Ratio
- S3
- Mechem
- Spaceteq
- LMT

[5] Du Toit (2021)
[6] Ibid.

- Densecure
- Optronics

Strategic Partnerships will be created with the following businesses:

- Aircraft and Engine Maintenance, Repair and Overhaul (MRO)
- Maritime MRO
- Rooivalk
- UAV's
- Infantry weapons
- Mechatronics
- Armoured Vehicles

No change will be made to the following businesses:

- Overberg Test Range
- S & M Munitions (PMP)
- Large Munitions (Rheinmetall Denel Munitions (RDM))

Growth will be sought in the following businesses:

- Missiles and Platinum Group Metals (PGMs)
- Artillery Systems
- Infantry Systems
- System Integration
- Cyber

However, Denel still faced risks to its future sustainability. These included:[7]

1. Recall of advance payments received on Hoefyster
    a. Denel received R2.8 billion in advance payments, of which R2 billion relates to the Hoefyster project.
    b. Denel has only approximately R800 million in stock and work-in-progress against this prepayment and cannot repay this prepayment if the contract is cancelled or executed at negative margins.
2. Programme Management – penalties on projects delayed or cancelled:
    a. Potential penalties of R857 million, mostly on Hoefyster (R653 million)
    b. Exit onerous contracts as follows:
        i. Chad prepayment of R104 million; DRC prepayment of R54 million; Venezuela prepayment of R18 million.
        ii. Airbus parent company exit cost of R121 million.

[7] Ibid.

3. High debt levels and debt servicing costs include;
    a. The high quarterly debt servicing costs eroding operating profits on turnaround plan that could be used for growth and settlement of debt. The conditions of the DMTN programme is quite onerous with cross default conditions on interest payments and other creditor related defaults.
    b. The debt remains short-term and cannot be repaid by Denel if investors decide not to renew terms.
4. Liquidity constraints include;
    a. Denel requires an average working capital requirement of R370 million per month to ensure operations run smoothly.
    b. Covid-19 may further delay strategic actions of the turnaround plan, leading to further liquidity constraints.
    c. Low levels of liquidity open Denel to the possibility of litigation and business rescue proceedings from debt providers, creditors and even employees for non-payment of salaries.

The key achievements made by June 2020 were the following:[8]

- Cumulative cost savings in excess of R1bn since April 2018, driven mainly by 27 per cent reduction in employee numbers.
- Exit of Aerostructures with an annualised benefit of R260m from 30 June 2020 going forward.
- Exit of loss-making and onerous contracts, i.e. Venezuela, DRC and Chad.
- Closure of the loss-making LMT subsidiary, LMT Products (Pty) Limited which is in business rescue and in its final stages of closure. It is anticipated that Denel will save another annualised R48m in support costs.
- Good progress made with the establishment of the production baseline on the Hoefyster Section Variant, which will open the way for the re-set of the production baseline and enable delivery of the vehicles to the SANDF.
- Significant future business potential exists with an order pipeline in excess of R40bn.
- Concluding the Hensoldt transaction – Transaction finalised. However, delayed due to COVID19 impact.
- Overdue creditors have been reduced by more than 80 per cent and payment plans for the remainder are in place.
- The progress made on strategic actions and the support received from the shareholder was acknowledged when Denel was moved from a rating of Negative Watch to Stable Outlook in the latest Fitch Agency review. The recent downgrade from Fitch of RSA from BB+ to BB will effect Denel's next rating review as Denel's rating is largely based on the support it receives as a government owned entity.

[8] Ibid.

In the Departments presentation on the state-owned entities dated 03 February 2021, the progress made in resolving the challenges facing Denel was given as follows:[9]

1) Financial Challenges
   a) Discussions with National Treasury on the optimal capital structure are underway. An application for recapitalisation has been made.
   b) A majority of the Commercial Papers (Guaranteed Debt) have been rolled over to September 2021. Ideally these should be extended for a period longer than 12 months.
2) Operational challenges
   a) The operations are struggling to catch up due to the liquidity challenges.
   b) The staff morale issues and resignation of key personnel are putting more risk to the sustainability of the operations.
3) Leadership
   a) The Board has been instructed to look into the depth of leadership in the SOC and to fix the gaps that may exist.
4) Strategy/Regulatory aspects
   a) Consultation with the relevant State players is underway. The options were presented to the Justice Crime Prevention and Security Cluster in the later part of 2020.
   b) National Convention Arms Control Committee (NCACC) process turnarounds on export permits, end user certificates, and other authorisation has improved. However, there is a need for additional resources to improve on the responsiveness of the regulatory structures.

2.2. LIQUIDITY IMPACT ON SALARIES

The Covid-19 pandemic necessitated a hard lockdown in March 2020, which severely impacted on Denel's already struggling operations. Due to a significant decline in productivity, Denel was unable to pay full salaries for May to July 2020, including third party statutory obligations. Employees were paid a cash portion of their salaries on a sliding scale with the lowest earning employee receiving the highest percentage compared to the highest earning employees. statutory employee contributions and third party contributions were deferred, for the period April to October 2020, due to Covid-19 relief measures and negotiated agreements. Arrangement were put in place to restore compliance. No salary sacrifice or short-time was implemented to align with reduced productivity levels.[10]

On 4 August 2020 the Labour Court ruled in favour of trade unions UASA and Solidarity ordering Denel to pay members of the Applicant Unions outstanding cash portion of their salaries and payment of all deductions made in their salaries for third party payments (statutory deductions and third party payments). Denel was ordered to make payments within 7 days. However, Denel failed to honour the Labour Court order and the unions launched an Ex Parte Application for Denel and its Board of Directors to be held in contempt of court. The Labour Court gave Denel a return date of the 3rd of December to show cause why it and its Board of

[9] Department of Public Enterprises (2021)
[10] Denel (2021a)

Directors should not be held in contempt of court for the failure to comply with the court order to 4th August 2020.[11]

On 16 August 2020, Denel decentralised the financial control and cash management to the operating divisions and subsidiaries to take full responsibility for their own revenue and operations to meet clients' contracted obligations. Divisions with contracted workload, unencumbered by unproductive divisions, managed to restart operations and meet customer obligations while others were challenged due to insufficient workload. Currently, the average productivity across the group remains very low.[12]

In November 2020, R271 million of the R576 million recapitalisation received from National Treasury, was released on condition that, "Denel should deploy these proceeds in priority activities that will allow the business to restart operations with immediate cash generation". R167 million was allocated to projects that can deliver a return in the short term - R753 million planned to be generated to deal with creditors' backlog.[13]

On 3rd December 2020, Denel and the applicant unions appeared in the Labour Court and the matter was adjourned to the 28 January 2021 when the matter was heard and judgement reserved. PMP was the first division to meet its salary payment obligations in terms of the Court Order of 4 August 2020. Medical Aid arrear contributions for April to September 2020 were settled with the medical aid service providers save for Discovery and for which a final settlement payment will be made by March 2021. Employee Risk benefits were maintained throughout the period and continues to remain in place.[14]

3. CURRENT OPERATIONS

The following section details the recent developments with the entity.

3.1. LIQUIDATION THREAT

Denel is currently facing an application in the High Court by SAAB Grintek Defence, for the liquidation of the state-owned company. SAAB Grintek is a South African based military defence products and services company[15]. It says Denel's affairs should be handed over to a liquidator to allow its creditors to file claims according to the Insolvency Act. The matter relates to a contract for SAAB to produce 211 Fire Control Computers for the Badger Infantry Combat Vehicles, also known as the Hoefyster Project. In terms of the contract, Denel was supposed to supply SAAB with specific equipment which would have enabled SAAB to fulfil its side of the deal. However, Denel never supplied these parts. SAAB is filing a R126 million claim against Denel. According to the court documents, SAAB has been requesting Denel to supply the

[11] Ibid.
[12] Ibid.
[13] Denel (2021a)
[14] Ibid.
[15] SAAB (n.d)

required components since 2016 and has been sending legal letters and letters of demand since 2020, however, Denel never responded to the company.[16]

Denel is struggling financially, with reports stating that only 20 per cent of salaries were paid in the month of May 2021. Trade union UASA has stated that Denel owes its employees R500 million in unpaid wages, full salaries last being paid in May 2020. Denel has experienced a loss of critical skills to domestic and foreign companies due to this inability to pay salaries. The union argues that the current liquidity struggles the entity is facing could have been avoided if the State had intervened when requested.[17]

However, the entity has stated that it will defend the liquidation bid from SAAB Grintek Defence if necessary, but will seek to resolve the payment dispute amicably.[18]

3.2. NEW OPERATING MODEL

On 11 August 2021, the entity issued a statement on the steps it will be taking to ensure the sustainability of the business. It stated that a streamlined and refocused Denel will be able to be a sustainable business and return to profitability within the next five years. This would be done through a comprehensive restructuring of the defence technology company. Part of the plan includes reducing Denel's current operating divisions (plus one subsidiary) from six to two. One division will focus on engineering, while the other focuses on manufacturing and maintenance, of which the latter is the core business of the entity. Denel's campuses will be optimised to reduce their footprint and contain costs. However, there is still an immediate need for significant cash injections to support current operations and implement the new operating model.[19]

The statement further said that the Department of Public Enterprises (DPE), as shareholder representative, is fully supportive of this comprehensive five-year plan put together by the Denel board and management. The DPE has also acknowledged that there is a need to assist Denel with regards to its financial situation. DPE is in discussions with the Department of Defence and the National Treasury with regards to this.[20]

In a presentation to the Committee on 18 August 2021, the Director General of the DPE, Mr. Kgathatso Tlhakudi, stated that Denel plans to exit its Spaceteq, Mechem and Denel Gear Ratio (DGR) businesses. It is engaging with the Department of Science and Innovation (DSI) to transfer Spaceteq to the Department as the business has capabilities that are critical to the Square Kilometre Array project. Mechem's services which include de-mining, mine protection vehicles and specialised canine products and services, is facing more competition in the market it operates in and is putting pressure on the business. DGR provides mechanical

[16] Bateman (2021)
[17] Campbell (2021)
[18] Gernetzky (2021)
[19] Denel (2021b)
[20] Denel (2021b)

components for military vehicles, mining and earthmoving equipment, traction locomotives and industrial machinery. Mr. Tlhakudi further states that they will consolidate its property assets to reduce its footprint accordingly.[21]

In the new model, there are two divisions, namely, Engineering and Manufacturing.

The engineering divisions will comprise research and design (R&D), innovation, design and integration. This will focus on new business and diversification. The engineering division will include the following:[22]

1. Land Systems
    a. Infantry systems
    b. Artillery Systems
2. Vehicle Systems
    a. Armoured Vehicles
    b. Mechatronics
3. Dynamics
    a. Missiles
    b. Precision Guided Munitions (PGM's)
4. Integrated Systems Solutions (ISS)
    a. GBADS, as well as other complex integrated ICT Systems and Cyber Solutions

The Maintenance and Manufacturing division will include the following divisions.[23]

1. Aeronautics
    a. Military Aircraft and Engine – MRO
    b. Systems integration and upgrades
    c. Rooivalk Helicopter
    d. Unmanned Aerial Vehicles (UAVs)
2. Pretoria Metal Pressing (PMP)
    a. Small and Medium Calibre Munitions
    b. Infantry Weapons
3. Vehicle Systems Maintenance
4. Dynamics production

These businesses will be strengthened as its core business. The new business model will be built on a foundation of standardised governance, policies, practices, standards and business management systems, which will be supported by centralised services for human resource management, supply chain management, financial management and ICT.[24]

[21] Tlhakudi (2021)
[22] Ibid.
[23] Ibid.
[24] Ibid.

4. KEY ISSUES FOR CONSIDERATION BY PARLIAMENT

- Negotiations regarding the future of Denel was discussed between DPE, the Department of Defence and National Treasury. What has these discussions yielded regarding the future of the entity?
- According to news reports SAAB Grintek Defence sent letters to Denel regarding the contract since 2016. Why did Denel not respond to the company? Why is it only engaging the company when there is a threat of liquidation?
- How far are the negotiations with SAAB Grintek regarding its application to the High Court for Denel to be liquidated?
- Denel is implementing a new 5-year corporate plan. How much will it cost to implement the new plan? Where will the funding come from? How far are negotiations with the National Treasury for the recapitalisation of the company?
- With regards to the new corporate plan, has the unions' buy-in been sought? As well as its stakeholders'? What has been their input on the new model?
- Denel stated that with regards to strategy/regulatory aspects consultations with the relevant State players is underway. Were these stakeholders consulted on the new 5-year model for Denel? What were their inputs?
- According to Minister Gordhan, "The board continues to make efforts to secure funding to pay salaries and implement its turnaround strategy to restructure Denel into a far more effective organisation."[25] Where will the entity receive funding to pay the unpaid salaries?
- Of the total staff complement, how many have not been paid and what is the DPE's Plan of Action in this regard?
- Denel stated that Medical arrear contributions to Discovery would be settled in March 2021. Has this settlement been paid?
- How many employees remain at the entity? Does the company still retain their capabilities with the loss of so many of its employees?

5. CONCLUSION

Denel has been struggling financially even before the Covid-19 pandemic effected South Africa, however, the effect of the pandemic worsened the situation. The Board, appointed in 2018, approved a turnaround strategy for the company. However, the implementation of this turnaround strategy was affected by the pandemic as well as by a lack of funds. Denel has been unable to pay its employees full salaries since May 2020, and the company owes employees R500 million in unpaid salaries, with employees only receiving 20 per cent of salaries in the month of May 2021. This situation was worsened when one of its contract partners, SAAB Grintek Defence, approached the High Court for the liquidation of Denel. This was in respect of a contract for SAAB to produce 211 Fire Control Computers for the Badger Infantry Combat Vehicles, also known as the Hoefyster Project.

[25] Magubane (2021)

In response to its worsening financial situation, the entity unveiled a new 5-year business plan for the business. It stated that a streamlined and refocused Denel will be able to be a sustainable business and return to profitability within the next five years. This would be done through a comprehensive restructuring of the company.

The company is in dire straits at the moment with the loss of critical skills and its future sustainability in question. The Committee on Public Enterprises must exercise its oversight over the entity and the Department and decide whether the entity is worth saving and if so, efforts must be made accordingly.

6. REFERENCES

Bateman, B. (2021) *SAAB bid to have SOE liquidated.* (05 June 2021) eNCA. Available from: <https://www.enca.com/videos/exclusive-denel-faces-liquidation-bid-saab-grintek-defence> (Accessed 05 August 2021)

Bramwell, L. (2021) *Denel 2019/20 Annual Report Analysis.* (22 February 2021) Parliamentary Research Unit. Cape Town, Parliament of the Republic of South Africa.

Campbell, R. (2021) *Uasa reassures its members at Denel as group faced liquidation threat.* (7 June 2021) Engineering News. Available from: <https://www.engineeringnews.co.za/article/uasa-reassures-its-members-at-denel-as-group-faces-liquidation-threat-2021-06-07> (Accessed on 19 August 2021)

Du Toit (2020) *Denel Progress Made on Turnaround Actions.* (09 June 2020) Denel. Presentation made to the Portfolio Committee on Public Enterprises. Virtual Meeting. Parliament of the Republic of South Africa.

Department of Public Enterprises (2021) *Progress Made in Addressing Challenges Facing State-Owned Companies.* (03 February 2021) Presentation made to the Portfolio Committee on Public Enterprises. Virtual Meeting. Parliament of the Republic of South Africa.

Denel SOC Ltd (2019) *Denel Twenty 18/19 Integrated Report.*

Denel (2021a) *Financial and legal challenges regarding a court order to pay outstanding employee's salaries.* (17 February 2021) Presentation made to the Select Committee on Public Enterprises. Virtual Meeting. Parliament of the Republic of South Africa.

Denel (2021b) *Far-reaching steps to ensure Denel's sustainability.* (11 August 2021) Available from: <http://www.denel.co.za/press-article/Far-Reaching-Steps-To-Ensure-Denels-Sustainability/235> (Accessed on 15 August 2021)

Gernetzky, K. (2021) *Denel says it will defend liquidation threat if necessary.* (08 June 2021) Business Live. Available from: <https://www.businesslive.co.za/bd/national/2021-06-08-denel-says-it-will-defend-liquidation-threat-if-

necessary/?utm_term=Autofeed&utm_medium=Social&utm_source=Twitter#Echobox=1623135890> (Accessed on 13 August 2021)

Magubane, K. (2021) *Denel vows to defend itself from SAAB Grintek liquidation bid.* (08 June 2021) News24. Available from: <https://www.news24.com/fin24/companies/industrial/denel-vows-to-defend-itself-from-saab-grintek-liquidation-bid-20210608> (Accessed on 18 August 2021)

Tlhakudi, K. (2021) *Presentation to PCPE Department of Public Enterprises* (18 August 2021) Presentation to the Portfolio Committee on Public Enterprises. Virtual Meeting via Zoom. Parliament of the Republic of South Africa.

SAAB (n.d) *Who we are.* Internet. Available from <https://www.saab.com/about> (Accessed on 20 August 2021)