8

Financial position of public-sector institutions

In brief

- The Public Finance Management Act (1999) requires major state-owned companies to generate sufficient financial resources from their operations to meet their obligations to employees, the public and debt holders. Several state-owned companies are not in a position to meet these obligations, and are in financial distress.
- Beginning with a restructuring of the electricity sector, government is initiating a series of major reforms at state-owned companies. These reforms will adjust business models in response to changed economic conditions, restore good governance, bolster operational efficiency, and strengthen financial controls and planning.
- To achieve their mandates, which include funding economic and social development, the development finance institutions need to be financially sustainable and supported by efficient governance structures. The combined net asset value of the Development Bank of Southern Africa (DBSA), the Industrial Development Corporation (IDC) and the Land Bank increased to R133.1 billion in 2017/18, with allowance for credit losses at 7.5 per cent of the gross loan book.
- The financial positions of the Unemployment Insurance Fund (UIF) and Compensation Fund are strong, but they are more than offset by the liabilities of the Road Accident Fund (RAF). By 2021/22, the combined net asset deficit of the social security funds is expected to reach R167.6 billion.
- The Government Employees Pension Fund holds assets in excess of R1.8 trillion, which will help it to meet future pension obligations.

Overview

This chapter discusses state-owned companies, development finance institutions and social security funds. Their mandates include building and operating economic infrastructure, financing social and economic development, and augmenting the country's social security system. To meet their objectives, these institutions need to be well governed, operationally sound and financially sustainable.

Public institutions must be well governed, operationally sound and financially sustainable

As the *Budget Review* and the *Medium Term Budget Policy Statement* have noted for several years, the deteriorating financial position of some institutions, particularly several large state-owned companies, is a major risk to South Africa's economy and its public finances.

Several state-owned companies face negative cash flows and are financing operations from debt, which has become increasingly difficult to raise. This

moves them perilously close to default unless they receive some form of recapitalisation. Apart from financial problems, Eskom has experienced serious operational failures, forcing a temporary return to intermittent power cuts across the country. The mounting liabilities of the RAF, expected to reach R413.8 billion in 2021/22, more than offset the accumulated surpluses of the other social security funds.

Widespread pattern of corruption alleged at state-owned companies

Over the past 12 months, government has taken the first steps to address governance problems in several public institutions. The Commission of Inquiry into Allegations of State Capture has exposed an apparent pattern of widespread corruption across major state-owned companies. Inquiries into the performance of the South African Revenue Service and the Public Investment Corporation, both of which have a large impact on the health of the public finances, have raised additional concerns.

Far-reaching programme of reforms to start immediately with separating Eskom

Government will initiate a series of far-reaching reforms at state-owned companies over the period ahead. These reforms are aimed at restructuring sectors in response to changed economic conditions, restoring good governance, bolstering operational efficiency, and strengthening financial controls and planning.

The immediate focus is Eskom, which is discussed in Chapter 1 and Annexure W3: *Fiscal support for electricity market reform*, available on the National Treasury website. Reforms affecting the other institutions discussed in this chapter will be shaped by robust engagements with a broad range of parties in the months ahead. The discussion below focuses on the current financial position of these entities.

State-owned companies

Return on equity has deteriorated to -0.3 per cent as result of weak revenue growth and overstaffing

The Public Finance Management Act requires state-owned companies listed in schedule 2 of the act to generate sufficient financial resources from their operations to meet obligations to employees, the public and debt holders. Several entities cannot meet these obligations. As Table 8.1 shows, return on equity has deteriorated to -0.3 per cent. This is largely the result of weak revenue growth and high compensation costs associated with overstaffing. Growing debt-service costs from a decade-long debt accumulation phase also weigh heavily on profitability.

Table 8.1 Combined balance sheets of state-owned companies[1]

R billion/per cent growth	2013/14	2014/15	2015/16	2016/17	2017/18
Total assets	910.9	1 037.5	1 178.6	1 224.2	1 266.8
	14.1%	*13.9%*	*13.6%*	*3.9%*	*3.5%*
Total liabilities	636.3	739.2	818.2	868.7	898.5
	17.3%	*16.2%*	*10.7%*	*6.2%*	*3.4%*
Net asset value	274.6	298.3	360.4	355.5	368.3
	7.4%	*8.6%*	*20.8%*	*-1.4%*	*3.6%*
Return on equity (average)	*1.7%*	*-2.5%*	*0.6%*	*-0.0%*	*-0.3%*

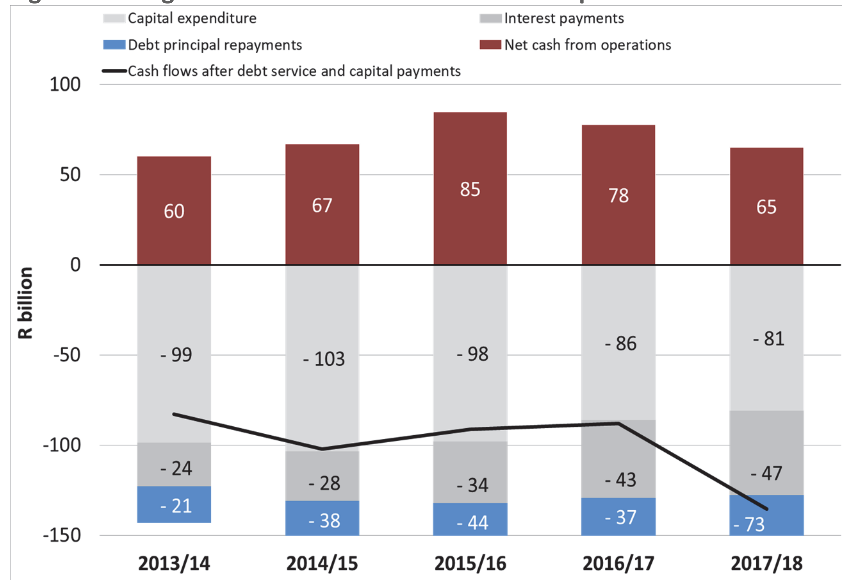
1. State-owned companies listed in schedule 2 of the PFMA, excluding development finance institutions
Source: National Treasury

Cash flows, assets, debt and borrowing

Assets have grown in line with capital investment, asset revaluations and capitalised interest. In most cases, however, growth in net asset value has not been matched by an improvement in cash generation. As Figure 8.1

shows, after capital investment and debt servicing, most institutions show negative cash flows.

Figure 8.1 Negative cash flows at state-owned companies*



**Eskom, Transnet, Airports Company of South Africa, Denel, South African Airways, South African National Roads Agency Limited and Trans-Caledon Tunnel Authority*
Source: National Treasury

In 2017/18, state-owned companies spent 85.9 per cent of the R83.8 billion budgeted for capital projects. Eskom accounted for 66 per cent and Transnet for 30.2 per cent of infrastructure spending. Most of Eskom's expenditure was on the Medupi and Kusile power stations. Transnet reported that 40 per cent of expenditure was for acquisitions of locomotives and pipelines, 31 per cent was for maintenance and 29 per cent for other projects.

Some state-owned companies using debt to fund operations

Some state-owned companies are financing their operations with debt. Capital spending is also financed primarily by debt, with little contribution from operating cash flows (instead of a more conventional mix of debt and equity).

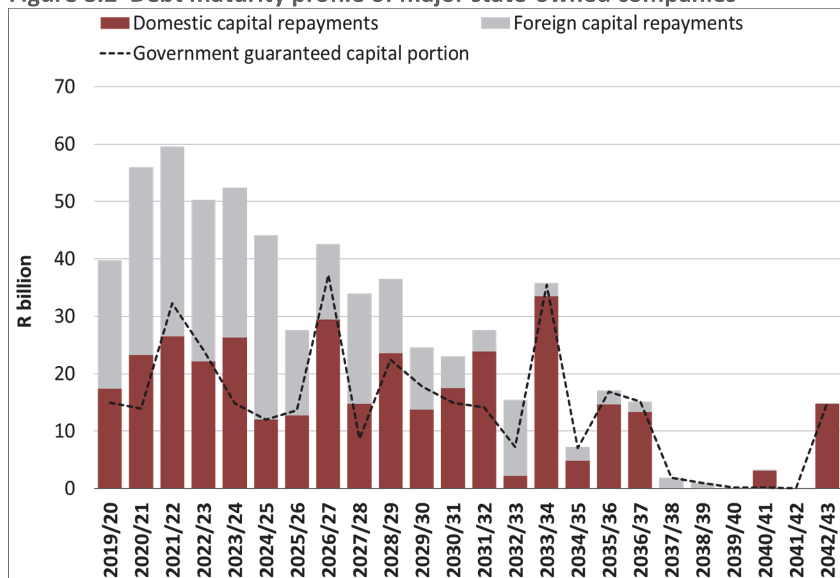
Figure 8.2 shows debt falling due for seven of the largest state-owned companies, totalling R630 billion over the next 23 years. Government guarantees 54 per cent of the total debt. Over the medium term, R155 billion in debt falls due, of which government guarantees R61 billion. Given the poor financial condition of several state-owned companies, a substantial share of the debt may need to be refinanced.

In the event that the entities are unable to refinance debt, government may be called upon to honour guarantees, with major consequences for the public finances.

Increased credit risk raises funding costs for state-owned companies

Increased credit risk has contributed to the high cost of funding for state-owned companies. Interest rates payable on short- to medium-term debt range from 8.4 per cent to 9.8 per cent, even where state guarantees are in place.

Figure 8.2 Debt maturity profile of major state-owned companies*



**Eskom, Transnet, Airports Company of South Africa, Denel, South African Airways, South African National Roads Agency Limited, Trans-Caledon Tunnel Authority*
Source: National Treasury

In 2017/18, state-owned companies could raise only 76 per cent of the R135.1 billion they expected, mostly from domestic sources. Financing of long-term capital investments should ideally attract long-dated debt, because the infrastructure is expected to generate positive cash flows over the life of the investment. Given the poor financial position of the borrowing entities, however, most of the new debt was in short-term instruments.

Medium-term borrowing estimates have been revised lower in recognition of state-owned companies' funding difficulties. Most of this borrowing is for refinancing. Eskom accounts for 62 per cent of the planned borrowing.

Table 8.2 Borrowing requirement of selected state-owned companies[1]

	2016/17		2017/18		2018/19	2019/20	2020/21	2021/22
R billion	**Budget**	**Outcome**	**Budget**	**Outcome**	**Revised**	**Medium-term estimates**		
Domestic loans (gross)	**52.8**	**56.2**	**70.1**	**54.4**	**61.8**	**39.5**	**49.5**	**39.3**
Short-term	35.0	22.7	17.9	29.4	20.1	14.8	21.5	16.5
Long-term	17.8	33.5	52.2	25.0	41.7	24.7	28.0	22.8
Foreign loans (gross)	**49.5**	**43.5**	**65.0**	**48.8**	**52.0**	**43.4**	**34.2**	**39.8**
Long-term	49.5	43.5	65.0	48.8	52.0	43.4	34.2	39.8
Total	**102.3**	**99.7**	**135.1**	**103.2**	**113.8**	**82.9**	**83.7**	**79.1**
Percentage of total:								
Domestic loans	*51.6%*	*56.4%*	*51.9%*	*52.7%*	*54.3%*	*47.6%*	*59.1%*	*49.7%*
Foreign loans	*48.4%*	*43.6%*	*48.1%*	*47.3%*	*45.7%*	*52.4%*	*40.9%*	*50.3%*

1. Airports Company of South Africa, Eskom, SANRAL, SAA, Transnet and Trans-Caledon Tunnel Authority
Source: National Treasury

Eskom

Eskom, which produces and transmits most of South Africa's electricity, reported a loss of R2.3 billion in 2017/18 following a profit of R0.9 billion in 2016/17. The loss was mainly a result of the increase in net finance costs, lower revenue and high operational costs. The utility's debt-service coverage ratio fell from 1.3 to 0.85 in 2017/18, meaning it could only

service 85 per cent of capital and interest payments from operating cash flows.

Delays and cost overruns in Eskom's build programme have contributed to higher debt

Delays and cost overruns in Eskom's build programme have contributed to higher debt. The poor performance of existing and new generation plants constrained sales volumes and revenue. High municipal arrears continue to weaken liquidity. Eskom has been able to raise 93 per cent of its funding for 2018/19 and about 22 per cent for 2019/20 has been pre-funded. Inadequate maintenance, along with serious operational problems at Eskom's two large new coal-fired power stations (Medupi and Kusile), has led to power cuts in early 2019.

Chapter 1 sets out initial steps for a major reconfiguration of Eskom, and more detail is provided online in Annexure W3.

Transnet

Transnet's net profit has increased, but procurement controls are a serious concern

Transnet operates South Africa's port, freight rail and pipeline infrastructure. The group's net profit increased to R4.9 billion in 2017/18, up from R2.8 billion in the prior year, largely as a result of increases in the volumes of export coal, railed automotive and port containers. Volumes, however, still fell short of targets. Cash generated from operations increased by 12.6 per cent from R31 billion in 2016/17 to R34.9 billion in 2017/18. Total assets improved from R353 billion in 2016/17 to R369 billion in 2017/18, mainly due to the revaluation of rail and port infrastructure. Equity remains healthy at R156 billion.

Transnet's procurement governance and controls have broken down, resulting in a qualified audit report for 2017/18. The new board has hired forensic specialists whose responsibilities include reviewing the contract for the acquisition of 1 064 locomotives.

Denel

Denel's cost structure is unsustainably high and it faces severe liquidity problems

Denel, a producer of military and aerospace equipment, reported a net loss of R1.8 billion in 2017/18. This resulted in negative operating cash flows of R717 million, compared with a positive R376 million in the previous year. Denel financed the shortfall by increasing its borrowing. The group's gearing ratio increased from 122 per cent to 361 per cent, meaning that its debt is more than triple its equity. Denel's cost structure is unsustainably high. Since 2017, it has faced severe liquidity problems. Negative operating cash flows have affected the company's ability to deliver on projects and meet creditor obligations. In September 2018, government provided Denel with a R3.4 billion guarantee to address its liquidity problems and support a turnaround plan.

South African Airways

South Africa's national carrier incurred net losses of R1.5 billion in 2015/16 and R5.6 billion in 2016/17. The airline is not generating sufficient cash to repay its maturing debt or cover its working-capital requirements. SAA will have to address its short- and medium-term funding needs to finalise its 2017/18 financial statements on a going-concern basis.

SAA has secured a R3.5 billion working capital facility for 2018/19 and will require an additional R4 billion facility for 2019/20. This funding will be acquired through a mix of government-guaranteed debt and

recapitalisation. About R12.7 billion in guaranteed debt matures on 31 March 2019. SAA is negotiating with lenders to refinance this debt.

South African Post Office

SAPO forecast to continue incurring losses over medium term

In 2017/18 the South African Post Office (SAPO) incurred a loss of R908 million – a slight improvement from the R987 million loss reported in 2016/17. It continues to implement measures to control costs, but expects to continue incurring losses owing to declining customer numbers and ageing infrastructure. SAPO remains reliant on debt to fund operations.

In 2017/18 government recapitalised the Post Office with R3.7 billion to settle maturing debt. In the current year, government provided SAPO with a R2.9 billion recapitalisation to extinguish its entire debt, and ensure continued operations. An additional R1.5 billion is allocated to SAPO over the MTEF period. As of October 2018 SAPO has taken over responsibility for distributing social grants.

Development finance institutions

Development finance institutions support inclusive economic growth and the objectives of the National Development Plan by providing loan and equity funding for industry, infrastructure and agriculture. These institutions need to be well governed, developmentally focused and financially sustainable.

Table 8.3 Financial position of selected development finance institutions

R billion	2015/16	2016/17	2017/18
IDC			
Total assets	**121.3**	**129.8**	**137.0**
Loan book	23.9	26.7	30.7
Equity and other investments	97.4	103.1	106.3
Total liabilities	**36.5**	**41.5**	**44.9**
Net asset value	**84.8**	**88.3**	**92.1**
DBSA			
Total assets	**82.3**	**83.7**	**89.2**
Loan book	70.8	76.6	75.0
Equity and other investments	11.5	7.1	14.2
Total liabilities	**53.1**	**51.6**	**54.9**
Net asset value	**29.2**	**32.1**	**34.3**
Land Bank			
Total assets	**41.4**	**45.4**	**49.5**
Loan book	36.4	41.0	43.4
Equity and other investments	5.0	4.4	6.1
Total liabilities	**35.3**	**39.0**	**42.8**
Net asset value	**6.1**	**6.4**	**6.7**

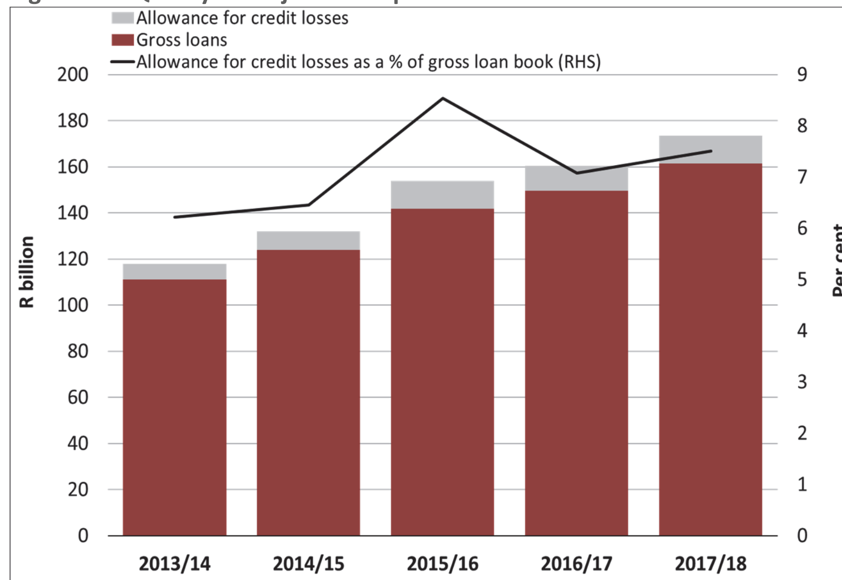
Source: National Treasury

The three largest institutions – the DBSA, the IDC and the Land Bank – increased their total net asset value to R133.1 billion in 2017/18, a 5 per cent increase relative to a 5.6 per cent increase in the previous period, owing to subdued economic growth, a reduced repurchase rate and delayed infrastructure projects.

In addition to data on loan disbursements, a useful way to assess development finance institutions' loan portfolios is to track the allowance for credit losses. This accounting metric captures the expected proportion of capital and interest payments that will not be repaid. The cumulative measure allows lenders to assess borrower repayment patterns over time. As Figure 8.3 shows, the percentage of allowance for credit losses is 7.5 per cent in 2017/18.

Development finance institutions' allowance for credit losses at 7.5 per cent

Figure 8.3 Quality of major development finance loan book assets*



**Land Bank, IDC and DBSA*
Source: National Treasury

The IDC had R5.2 billion in cumulative credit losses associated with its R35.8 billion gross loan portfolio in 2017/18, owing to higher-than-expected losses by two manufacturing subsidiaries. Improvement in the Land Bank's allowance for credit losses, which totalled R2.1 billion in 2017/18, resulted from higher agricultural production and favourable exchange rate movements, which boosted export revenues. The DBSA's allowance for credit losses has steadily increased over the past two years, reaching R4.8 billion in 2017/18, as a result of weaker municipal finances.

Borrowing by the three major development finance institutions in 2017/18 (see Table 8.4) was in line with budgeted amounts. The majority of the debt obtained was short term, which increases refinancing risk.

Reliance on short-term borrowing increases refinancing risk

Land Bank

The Land Bank supports development and transformation of the agricultural sector. It disbursed new loans of R2.4 billion in 2017/18. Over the medium term, the Land Bank anticipates that the average tenure of its liabilities will increase from the current base of less than two years, reducing liquidity risk. Developmental loans are expected to increase from 11.8 per cent to 24.2 per cent of the total loan book by 2020/21.

Industrial Development Corporation

The IDC finances industrial development. Over the medium term, it will focus on financing and facilitating the adoption of emerging technologies and creating new industries. IDC profits grew by 45.5 per cent, from R2.2 billion in 2016/17 to R3.2 billion in 2017/18, mainly as a result of

IDC disbursed R15.4 billion in loans and investments during 2017/18, mostly to black-owned companies

capital gains. The corporation disbursed R15.4 billion in loans and investments during the year, the majority to black-owned companies. The loan book grew by 15 per cent to R30.7 billion.

Development Bank of Southern Africa

DBSA disbursed R11.9 billion in developmental loans in 2017/18

The DBSA provides financing for infrastructure projects – including water, sanitation, energy and school infrastructure. It assists clients with project preparation and implementing infrastructure programmes. The DBSA's profit declined from R2.8 billion in 2016/17 to R2.3 billion in 2017/18, mainly due to interest rate movements, project delays and slow municipal processes. In 2017/18, it disbursed R11.9 billion in developmental loans, and the development loan book increased from R72 billion to R75 billion.

Table 8.4 Borrowing requirement for development finance institutions[1]

	2016/17		2017/18		2018/19	2019/20	2020/21	2021/22
R billion	**Budget**	**Outcome**	**Budget**	**Outcome**	**Revised**	**Medium-term estimates[2]**		
Domestic loans (gross)	**23.4**	**58.0**	**51.1**	**54.0**	**36.2**	**44.4**	**38.2**	**19.7**
Short-term	17.8	47.7	36.2	39.0	23.9	27.7	22.7	11.8
Long-term	5.6	10.3	14.9	15.0	12.3	16.7	15.5	7.9
Foreign loans (gross)	**6.5**	**9.4**	**9.3**	**5.6**	**9.2**	**12.1**	**10.7**	**4.5**
Long-term	6.5	9.4	9.3	5.6	9.2	12.1	10.7	4.5
Total	**29.9**	**67.4**	**60.4**	**59.6**	**45.4**	**56.5**	**48.9**	**24.2**
Percentage of total:								
Domestic loans	*78.3%*	*86.1%*	*84.6%*	*90.6%*	*79.7%*	*78.6%*	*78.1%*	*81.4%*
Foreign loans	*21.7%*	*13.9%*	*15.4%*	*9.4%*	*20.3%*	*21.4%*	*21.9%*	*18.6%*

1. Land Bank, DBSA and IDC
2. Forecast numbers for 2021/22 relating to DBSA were not available
Source: National Treasury

Social security funds

Social security funds provide support for unemployed workers and those involved in road and workplace accidents. Over the medium term the funds will collect R239 billion in contributions and pay R194.3 billion in benefits.

Table 8.5 Financial position of social security funds

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
R billion		**Outcome**		**Estimate**		**Medium-term estimates**	
Unemployment Insurance Fund							
Total assets	124.7	139.5	160.1	174.0	185.1	198.1	213.6
Total liabilities	4.6	6.4	13.4	16.5	18.8	23.0	27.9
Net asset value	120.1	133.1	146.7	157.5	166.3	175.1	185.7
Compensation Fund							
Total assets	55.2	62.5	67.3	53.6	56.5	59.6	62.9
Total liabilities	34.7	35.5	34.3	12.2	12.8	13.5	14.3
Net asset value	20.5	27.0	33.0	41.4	43.7	46.1	48.6
Road Accident Fund							
Total assets	9.8	9.2	9.8	10.8	11.6	11.8	11.9
Total liabilities	155.0	189.2	216.1	252.6	295.4	348.6	413.8
Net asset value	-145.2	-180.0	-206.3	-241.8	-283.8	-336.8	-401.9

Source: National Treasury

The financial positions of the UIF and Compensation Fund are strong and expected to improve over the medium term. However, they are offset by the liabilities of the RAF. By 2021/22, the combined net asset deficit of the social security funds is expected to reach R167.6 billion.

Financial positions of UIF and Compensation Fund are strong, but offset by RAF

Detailed income and expenditure data for the social security funds is published in the *Estimates of National Expenditure*.

Unemployment Insurance Fund

The UIF provides benefits to workers who are out of work due to retrenchment, illness or maternity leave. The fund's projected benefit payments are expected to grow from R9.3 billion in 2017/18 to R15.9 billion in 2021/22. However, its net asset value continues to grow, and is projected at R185.7 billion in the outer year.

Compensation Fund

The Compensation Fund provides financial support to employees who have been injured at the workplace or have a work-related illness. The net asset value of the fund is expected to grow from R33 billion in 2017/18 to R48.6 billion in 2021/22. Contributions are projected to grow from R11.8 billion in 2018/19 to R13.6 billion in 2021/22 due to administrative improvements, which will finance higher benefit payments. The fund has also budgeted for an increase in cases of post-traumatic stress disorder, orthotic support and medical rehabilitation to help beneficiaries transition back into the workplace.

Compensation Fund's net asset value expected to reach R48.6 billion in 2021/22

Road Accident Fund

The RAF's accumulated deficit is expected to deteriorate at an average annual rate of 18.5 per cent over the medium term to R402 billion in 2021/22. On an accrual basis, the fund will have an average annual deficit of R53.3 billion, mainly as a result of claims awarded but not paid. In 2019/20 the RAF fuel levy will increase by 5c/litre.

Government Employees Pension Fund

In 2017/18, the Government Employees Pension Fund (GEPF) paid out R95 billion in benefits to about 1.3 million employees and 450 000 beneficiaries.

In 2017/18, the Minister of Finance approved a pension increase of 5.5 per cent, exceeding consumer price inflation for the same period. Assets invested on behalf of the fund returned 8.5 per cent compared with 4.3 per cent in 2016/17.

Table 8.6 Selected income and expenditure of GEPF

R billion	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
Revenue						
Employer contributions	30.8	33.5	36.1	38.6	42.1	45.3
Employee contributions	17.1	18.7	20.3	21.7	23.4	25.1
Investment income[1]	49.9	54.0	68.5	69.0	69.5	72.0
Expenditure						
Benefits paid	43.2	57.9	85.8	83.1	88.3	94.9

1. Dividends on listed equities, interest on bonds and money market instruments and income from unlisted properties and unlisted investments excludes adjustments for value of financial assets

Source: Government Pensions Administration Agency

On best-estimate basis, GEPF remains fully funded

An actuarial valuation completed in December 2018 showed that the GEPF held R1.8 trillion in assets. This is sufficient to cover 108.3 per cent of liabilities on a best-estimate basis, which measures the present value of future pension liabilities. On a stricter liability measure, taking into account the reserve the fund has to hold to make pension payments and remain solvent, assets cover 75.5 per cent of liabilities. On both measures, the GEPF's position has deteriorated since 2016. The contributing factors are lower-than-expected investment returns, the introduction of new benefits and improvements to existing benefits. In addition, contributions to the fund were lower than actuarial assumptions.

The Public Investment Corporation (PIC) manages the financial assets of the GEPF and the social security funds. At the end of March 2018, the PIC had R2.08 trillion in assets under management.

Table 8.7 Breakdown of assets under management by PIC, 2017/18

R billion	Government Employees Pension Fund	Unemployment Insurance Fund	Compensation Fund[1]	Other	Total
Asset class					
Equity	1 029.5	37.1	13.6	0.3	1 080.4
Bonds	571.0	88.4	39.5	13.3	712.2
Money market	54.3	16.1	9.5	32.3	112.3
Property	101.3	5.5	1.1	0.2	108.1
Unlisted investments	58.8	9.7	1.6	–	70.1
Total	**1 814.9**	**156.8**	**65.3**	**46.1**	**2 083.1**

1. Includes the Compensation Pension Fund
Source: Public Investment Corporation and National Treasury

The Commission of Inquiry into Allegations of Impropriety Regarding the PIC is expected to submit a final report on 15 April. The PIC's board resigned on 1 February to allow for an investigation of the fund's investments. The current board will serve until the Minister of Finance appoints a new board – a process that is under way.

Conclusion

Broad reforms to be designed to strengthen governance, financial management and operations of public entities

A number of public-sector institutions, particularly large state-owned companies and the RAF, face serious financial and administrative difficulties, and pose a risk to the public finances. Government is working on a broad reform programme to strengthen the governance, financial management and operations of these entities.