

Creating a Viable Denel

Presentation to:
Portfolio Committee on Public Enterprises

May 17



Agenda



- Key Events
- Overview of the Global Defence Industry & Denel
- Strategy Imperatives
- Recapitalisation
- Strategy Implementation Process & Status
- Transformation
- Head Office Developments & Changes
- Non-Core Disposal

Key Events



- India withdraws business 04/05
- Excessive losses – Announcement of Section 20(5) 05/05
- Strategy presented to Board 05/05
- Defence procurement & policy workshops with stakeholders 08/05
- Engagement of Treasury for recapitalisation 09/05
- Potential equity partners identified & discussions commenced 09/05
- Section 189 process commences (corporate, DLS) 10/05
- Initial non-core disposals 12/05
- Treasury recapitalisation announced 02/06
- NewCo strategy approved by Board 02/06
- 1st tranche recapitalisation announced 02/06
- Internal audit to PwC 03/06
- Transformation program initiated 03/06
- New corporate office location 04/06

Key Events



- Financial year end results being finalised
- Current financial projections and challenges

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DEFENCE INDUSTRY AND DENEL [NOT A NORMAL COMPETITIVE MARKET]



Characteristics of the Defence industry

Long business cycle

- Many platforms developed for over 30 years of use
- Consequently industry takes a holistic, long-term perspective when making investment and technology decisions
- This requires close alignment and transparency with the national customer

Development intensive

- A large part of programme cost is upfront R&D – which gets pre-paid or repaid through a minimum order quantity

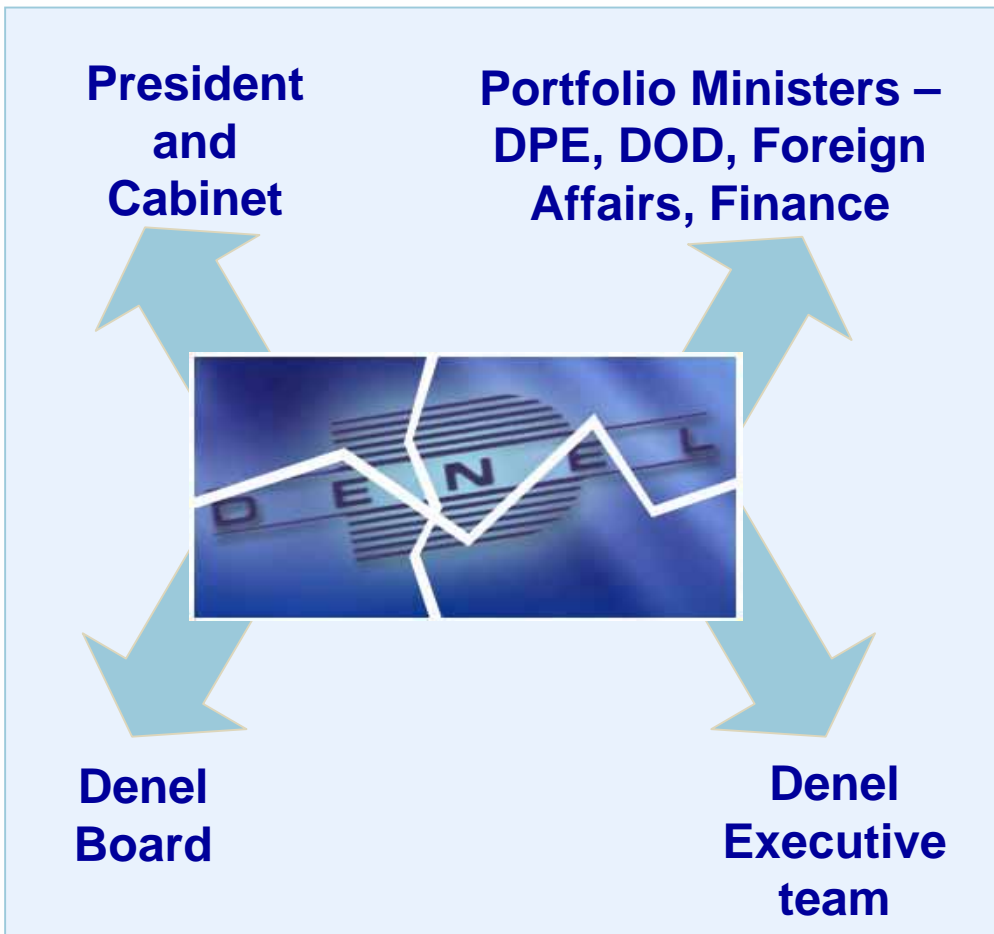
Strategic

- Bulk of military spend kept in the country – governments will support own industry, even when imported technologies are cheaper
- Hence, much of global market not directly accessible for exporters
- Political support often a prerequisite for securing export contracts

Implications for defence contractors

- Players reliant on captive markets
- Must have guaranteed breakeven business from domestic customer
- Domestic upgrade and maintenance revenue is an important, stable income source
- R&D is a core part of the revenue model, and is largely funded by:
 - Government agencies
 - Guaranteed minimum order quantities
- Scale is essential
- Allows for different revenue sources across industry cycle
- Allows partial self funding of R&D
- Pure export businesses seldom viable
- Export margins are low and business is only pursued once initial development and industrialisation costs funded
- Major markets only accessible through alliances and with consistent political support

THE WORLDWIDE DEFENCE INDUSTRY WORKS ACCORDING TO A SPECIFIC MODEL WHICH NEEDS TO BE UNDERSTOOD BY STAKEHOLDERS IF THEY ARE TO ALIGN APPROPRIATELY



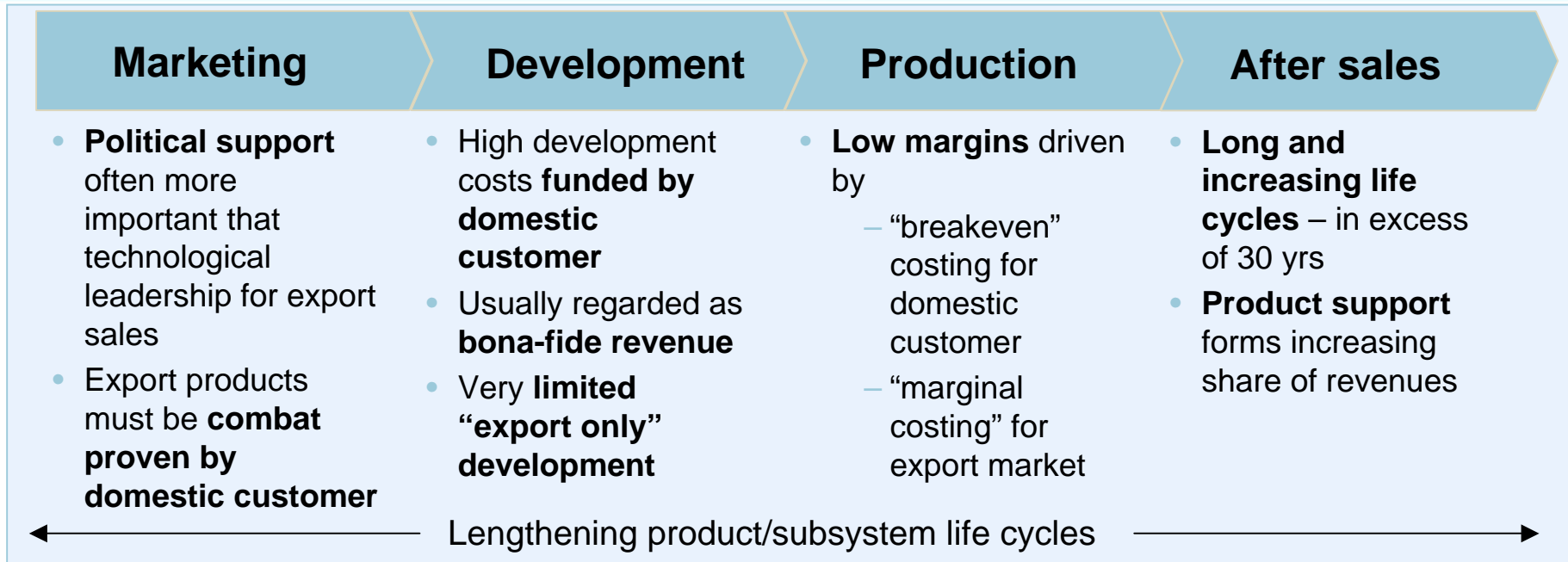
McKinsey Findings

Domestic demand is the nucleus for success in the defence market – This includes a secure source of domestic R&D funding

Although the international defence market is very large, only a small part is accessible and this can only be grown through **alliances**

Denel needs to play in the **second and third supplier tiers** (apart from select national programmes) and find its place in an **international alliance network**

ALIGNMENT PROFILE



Hurdles to reach alignment

- Government Capacity to Support
- Response Time to Issue Resolution
- Long-term Planning & Commitment
- New Culture from all Stakeholders Required

Outcomes:

- **Strategic Requirements Better Defined**
- **Economic Growth**
- **Viable Domestic Defence Industry**

Denel

AMD

Government Workgroups – Develop Alignment

SINGLE VISION ANYTHING ELSE WILL NOT HELP



From: Misalignment amongst stakeholders

President
and
Cabinet

Portfolio Ministers –
DPE, DOD, Foreign
Affairs, Finance



Denel
Board

Denel
Executive
team

To: Single vision and purpose



One team

- President and Cabinet
- Portfolio Ministers
- Denel Board
- Denel Executive team

OEMs DRIVE VALUE ALONG FIVE KEY CRITERIA



Value drivers for global sourcing

- 1 – Sales support/market access through off-set type agreements
- 2 – Driving procurement savings by leveraging low cost production advantages
- 3 – Accessing new/relevant technology in specific areas of excellence
- 4 – Accessing cheap raw materials supply
- 5 – Currency hedging

South African characteristics

- Small market for any product
- Business limited to off-set ratio of SA acquisitions
- South Africa unable to compete with low labour costs of India and China or high capital productivity of Japan and Asia
- South Africa still retains an innovative engineering capability and a base of relevant technologies in areas (e.g. design engineering, composites)
- No particular cost advantage
- Specific patented alloys produced in insufficient scale cannot make SA competitive
- OEMs not interested in hedging in minor market currencies i.e. ZAR

Attractiveness to OEMs



Is SA more competitive than other emerging markets?

Does this driver provide a sustainable advantage in the long-term?

KEY MESSAGES



1. Much of the global defence spend is inaccessible to independent contractors, making players highly reliant on their domestic markets. Furthermore, changes in the industry are forcing players to consolidate, build alliances and carefully focus their businesses
2. Denel is facing a funding crisis, and there is significant risk associated with the current financial projections
3. Denel is not viable under the current model. It no longer has the domestic market and scale to succeed as an independent systems integrator and exporter of a broad range of products
4. To succeed, Denel should pursue a strategy based on prime contracting in the domestic market and the export of systems and components through selective equity partnerships and alliances with global prime contractors
5. A process is underway to evaluate alliance opportunities and drive internal improvements across all business units

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Strategy Imperatives



Engage State Agencies

Secure Privileged Access

Evaluate Commercial Viability (Fix or Exit)

Create Equity Partnerships / Alliances

Raise capabilities and Productivity to World Standards

Transformation & People

Strategy Imperatives – Guiding Principles

Engage State Agencies

- Initiate and participate in forums to ensure stakeholder alignment (DPE, DoD, Armscor, Industry) in areas of Industry Structure, Acquisition Policy, Industrial Participation
- Initiate, guide and participate in the formulation of a Defence Industrial Sector Strategy
- Appropriately communicate strategic principles and plans to ensure buy-in of all stakeholders

Secure Privileged Access

- Secure 70 % local spend of the defence acquisition budget as a policy decision (via a defence council)
- Visibility of the defence budget to enable long term planning for industry

Evaluate Commercial Viability (Fix or Exit)

- Evaluate business viability: capacity utilisation, sales, margins, overheads, markets, strategy
- Exit unviable businesses & product lines
- Restructure viable business: consolidate & right-size (focus on efficiencies, costs, overheads, productivity)
- Define acceptable hurdles: gross profit, EBIT (productivity, capacity utilisation)
- Business plan: “low risk” budgets & plans
- Creation of NewCos to ensure risk mitigation, governance and business focus

Create Equity Partnerships / Alliances

- Identify potential partners and engage to find synergies
- Conclude equity transactions
- Identify strategic alliances to increase market share

Raise Capabilities and Productivity to World Standards

- Identify, initiate and coordinate management interventions to ensure capability & productivity gains

Transformation & People

- Transform Denel’s people into a motivated, innovative and empowered workforce with a commercial and performance-based mindset within a truly representative and diverse environment

Strategy Unfolded



Denel Turnaround: 6 Pillar Strategy

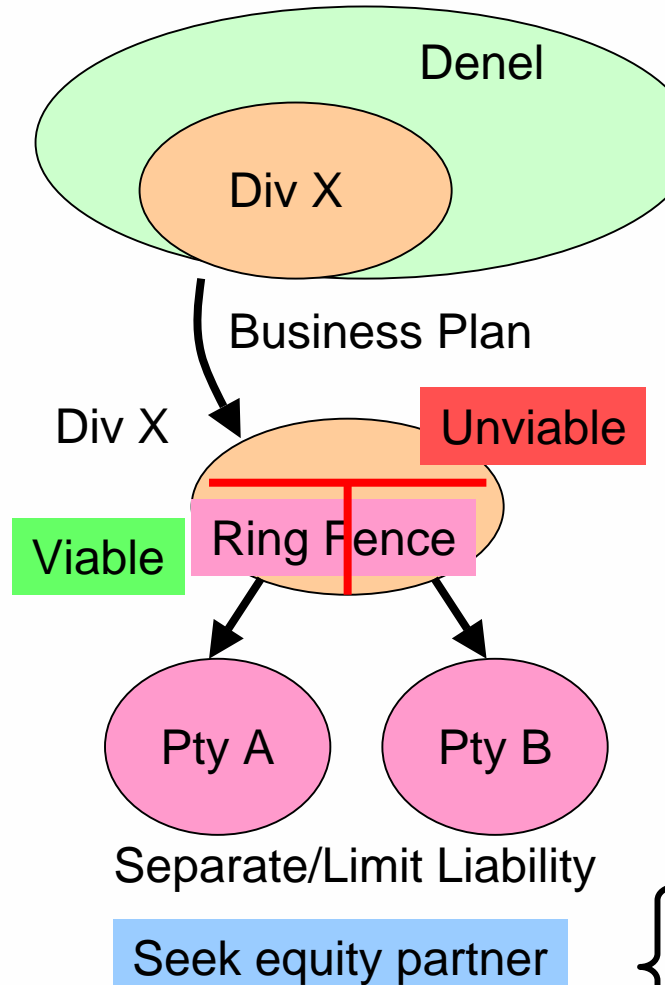
- Secure privileged access
- Engage state agencies
- *Evaluate commercial viability*
- *Develop partnerships*
- *Raise capabilities & productivity*
- Transformation & people

Analyse divisions (Viability)

- Low risk business case
- Unviable: exit business
- Viable: consolidate, restructure & right-size – efficiencies, overheads, costs
⇒ Business Plan (GP & EBIT hurdles)

Separation into NewCos

- If A fails, B not affected
- Unrelated business – focus on core
- Risk mitigation
- Governance



Recap requirement

- Cannot fix without recap
- Fix RYbn, Exit R3Y bn

Requirement for survival:

- Restructure – focused business
- Recap – sins of past / investment for future
- Skills
- Markets
- Technologies
- Attract capital

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Recapitalisation Requirements “SINS OF THE PAST”



Division/BU Restructuring	2006/7	2007/8	2008/9	2009/10	Total
Denel Corp	547	825	0	0	1379
Non-Core Proceeds	-447	0	0	0	-450
India Guarantee	170	0	0	0	170
Aviation	803	0	0	0	803
DAS Rooivalk	65	300	250	0	615
Munitions	80	91	348	125	644
LIW	528	0	0	0	528
Total	1750	1216	598	125	3689

Recapitalisation Requirements (Restructuring, Limited Exit and Investment)



Investment Company	Potential Partners	2006/7	2007/8	2008/9	2009/10	2010/11	Total All Years	Accu Total
Sins of the past		1750	1216	598	125	0	3689	3689
Aerostructures	Saab A	482	245	0	0	0	727	4416
Dynamics	Saab BD	315	175	63	40	26	619	5035
Dynamics	Debt		127	72	70	2	271	
Optronics	Zeiss/Flir	20	20	20	20	20	100	5135
Logistic Support	SAT, Saab, E/C	0	0	0	0	0	0	5135
Munitions	TBD	0	25	10	0	0	35	5170
Integrated Systems	GRIDS/ ADS	0	0	0	0	0	0	5170
DLS Lyttelton	BAES	0	0	0	0	0	0	5170
Rooivalk	TBD	0	0	0	0	0		5170
Total – All BU's		2567	1681	691	185	46	5170	



Legal liability for Government

- **Government Guarantees** R 1.515 billion
- **Letter of support for corporate bond** R 0.825 billion

Possible impact should Government allow Denel's legal limited liability to define the funds available for closure

- **Credit rate listing of country**
- **Industrial reputation – especially impact on A400M**
- **Employee loss of benefits**

Denel “Properly Managed” Closure Estimated Financial Impact



Major Items	Total	Business groupings								
	R m	Aero-structures R m	Logistic Support R m	Dynamics R m	Integrated Systems R m	Rooivalk R m	Optronics R m	Munitions Group R m	DLS -L Group R m	Other R m
Liabilities exceed assets	1,470	365	108	-	475	622	(71)	(113)	360	(276)
Loss of assets probably not realisable	2,332	236	93	212	97	239	166	524	98	667
Prepayments/ performance bonds	1,689	33	14	199	201	-	155	827	175	85
Personnel lay-off costs	806	95	95	56	14	46	62	319	56	63
Rehabilitation costs	1,004	20	20	25	25	-	30	824	60	-
Counter trade obligations	966	1	-	202	87	-	-	220	456	-
Contractual obligations (Guarantees, maintenance etc)	1,147	23	23	25	25	-	135	681	236	-
Potential claims against contracts (Rooivalk, A400M, Augusta)	3,619	1,119	-	-	-	2,500	-	-	-	-
Total estimated impact	13,032	1,890	352	719	925	3,407	477	3,280	1,442	539

Total would reduce by the revenue collected on forced sale of assets – net total estimated at R 12 billion

Recapitalisation (1)



- A large portion of the recapitalisation request (R3.7 billion) relates to Denel's legacy and represents a sunk cost in economic terms (although the cash outflows occur over four years).
- The remainder (R 1.4 billion) is required for property plant and equipment and product development to access future markets – which would allow Denel to achieve the sustainable turnover level of R 4 billion and an EBIT of 8% (achievable after year 3 when the restructuring will be concluded).
- The future cash flow funding for Denel as a going concern cannot be subdivided as Denel does not have separate legal entities. Therefore separate actions cannot be taken for individual business units without those actions affecting Denel as a whole.

Recapitalisation (2)



- First tranche of recapitalisation received in Mar 06 (R2bn)
- R600m still outstanding for current financial year
- R2bn utilised to repay loan of R1.5bn and certain restructuring activities
- Monthly reports on cash flow provided to DPE and National Treasury
- At financial year end 2006/07 Denel is forecast to be technically insolvent therefore Government commitment required to meet going concern status and avoid Section 20(5) insolvency act
- Certain major contracts require performance guarantees that Denel (given its potential technical insolvency) cannot provide – these may require Government guarantees on a case by case basis



Recapitalisation (3): Government Performance Monitoring

- Approval of and submission of Corporate Plans to DPE and National Treasury in accordance with PFMA and National Treasury regulations
- Monthly performance evaluation of businesses and progress on strategy implementation - reports submitted to DPE and National Treasury
- Half yearly review of future cash flow requirements with DPE and National Treasury and effect on recapitalisation request – current estimate that R5.1bn still required over the 5-year period

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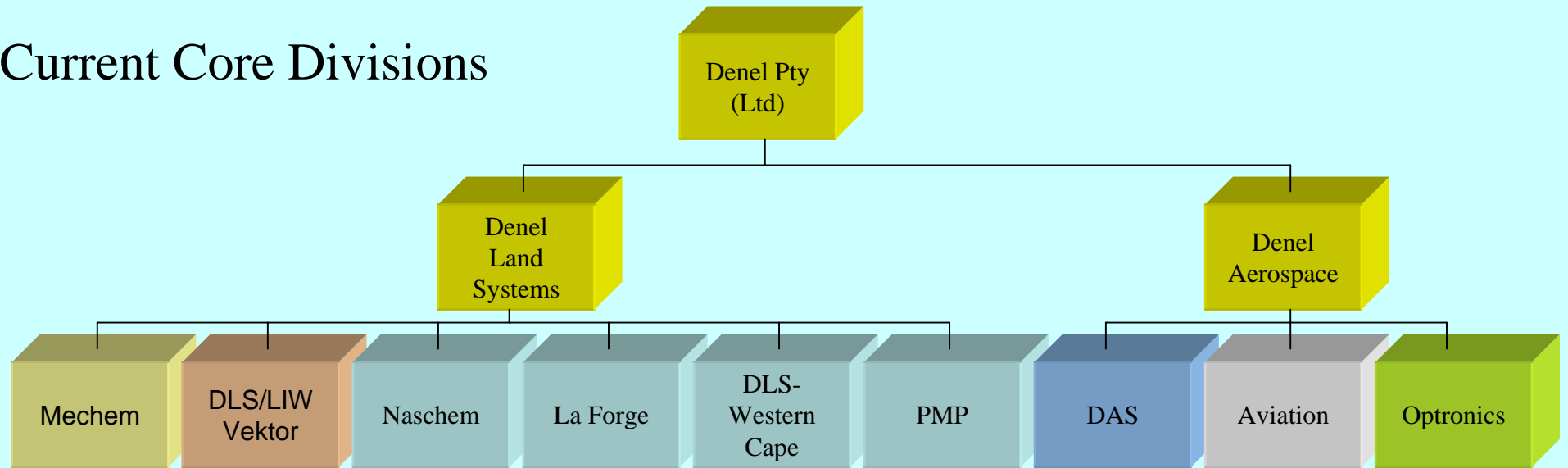
Engage State Agencies



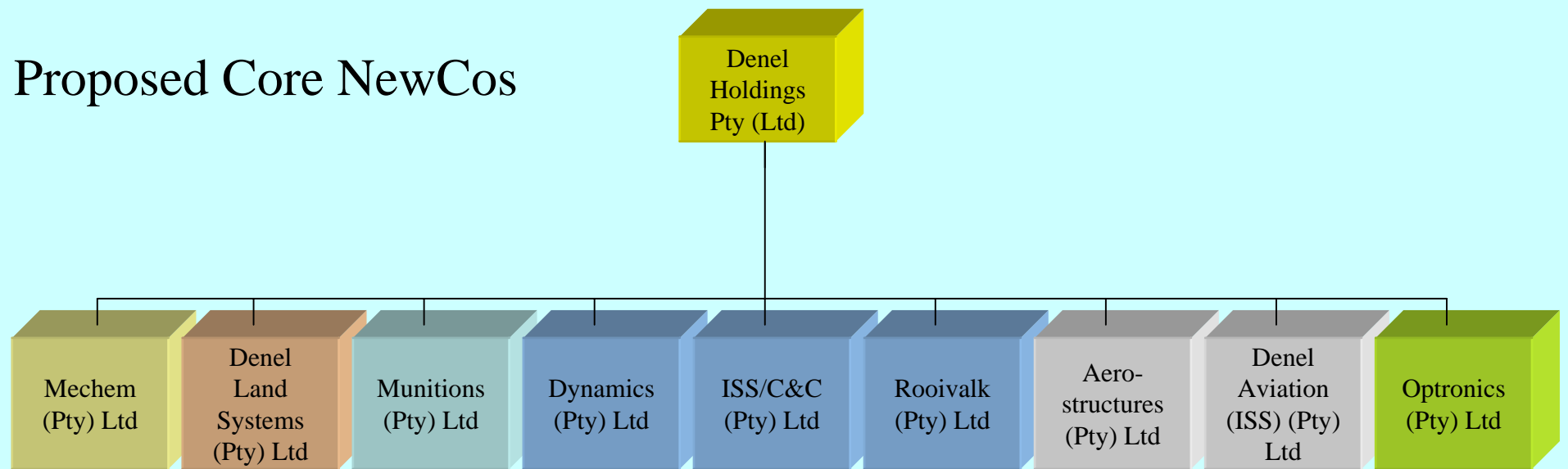
Area	Outcomes	Target
Acquisition Policy and Capex	Defence Council (DoD, Armscor, Industry represented by AMD) to address defence spend Transparency of DOD budget Improved cooperation on system tenders	30 Jun 06
DIP / NIP	Changes proposed to policies for more effective leverage on IP commitments for industry capability establishment Investments in DIP projects to carry NIP credits	1 Apr 07
DERI	Establish Research, Development, Test and Evaluation structure.	1 Apr 07
Defence Sector Strategy	Draft Sector Strategy Document	1 Oct 06

Restructuring Overview

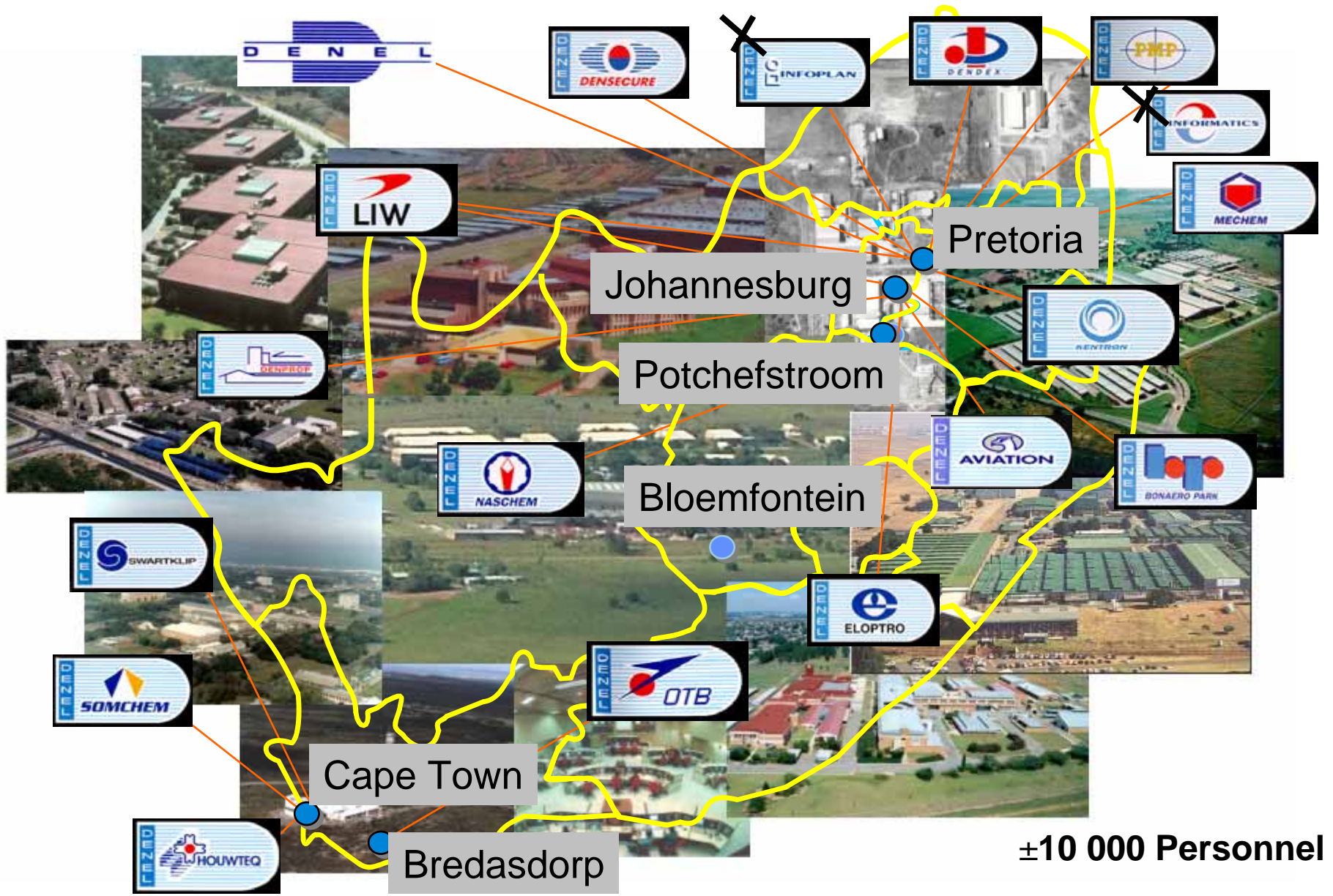
Current Core Divisions



Proposed Core NewCos



Denel Divisions



±10 000 Personnel

Denel's Technology Campuses



Irene Campus

- Denel Head Office
- Dynamics Pty Ltd
- Optronics Pty Ltd
- Land Systems Pty Ltd ?
- Mechem Pty Ltd



Aviation Campus

- Aerostructures Pty Ltd
- Logistics Support Pty Ltd

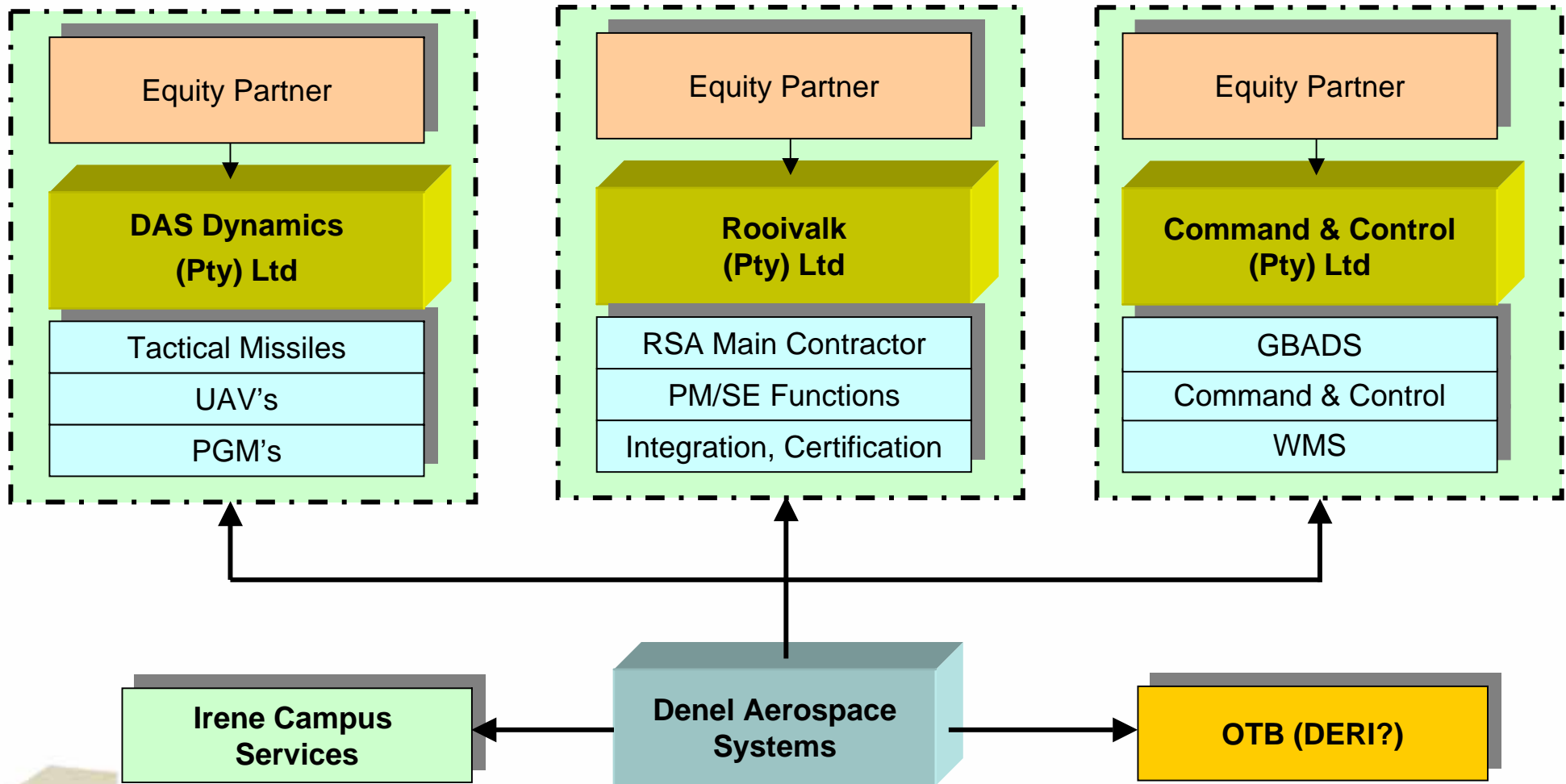


Potchefstroom Campus

- Munitions Pty Ltd



Strategic Roadmap: DAS



Dynamics NewCo (1)

A niche global competitor and local technology provider in the areas of tactical missiles, guided weapons and UAV systems



A-Darter Air-to-Air Missile



Ingwe & Mokopa Anti-Armour Missiles



Umkhonto Surface-to-Air Missile



Raptor & Umbani Stand-off Weapons



Seeker UAV Surveillance System



Skua High Speed Target Drone



Bateleur Surveillance UAV

Dynamics NewCo (2)



A niche global competitor and local technology provider in the areas of tactical missiles, guided weapons and UAV systems

Item	Notes/Status	Plan %	Status %	Target
1 yr Budget & 5 yr Forecast	Turnover de-risked, efficiencies identified, costs reduced	✓	✓	21 Feb 06
Ring Fence Business Operations	Ring fence for separate reporting	✓	✓	1 Apr 06
Reduce Overheads	At DAS level prior to transfer. Initiated, R40m savings (DAS).	✓	50 %	15 June 06
Transfer to NewCo	Due diligence process , Legal steps to transfer operations to NewCo	✓	40 %	1 Oct 06
Equity Partner	Secure equity partner	✓	50%	1 Nov 06

Command & Control (ISS) NewCo (1)



*A local main contractor for integrated level 5 air defence systems,
and a specialized local and international supplier of C3 products
with GBADS as flagship program*



WMS



GBADS

Command & Control (ISS) NewCo (2)



A local main contractor for integrated level 5 air defence systems, and a specialized local and international supplier of C3 products with GBADS as flagship program

Item	Notes/Status	Plan %	Status %	Target
1 yr Budget & 5 yr Forecast	Turnover de-risked, efficiencies identified, costs reduced	✓	✓	21 Feb 06
Ring Fence Business Operations	Ring fence for separate reporting	✓	✓	1 Apr 06
Transfer to NewCo	Due diligence process , Legal steps to transfer operations to NewCo (pending equity discussions)	✓	0 %	Nov 06
Equity Partner	Secure equity partner	✓	30%	Jan 07