07 11 06 JC BUDGET

public enterprises

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REPUBLIC OF SOUTH AFRICA

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Dear

WRITTEN REPONSE TO MATTERS RAISED BY JBC 2 NOVEMBER 2007

The presentation made to the Joint Budget Committee (JBC) by the Department of Public Enterprises refers.

The Department appreciates the opportunity given to provide further information regarding its Medium-Term Estimates for Funding. As a consequence of time constraints on 2 November 2007, the purpose of this letter is to:

(a) provide the JBC with a written reply to the four outstanding questions posed by members of the JBC;
(b) present verified data on staff vacancies; and
(c) provide a summary of the salient shareholder management initiatives of the Department to bolster shareholder oversight and enterprise accountability.

1. **QUESTIONS: DENEL**

Three questions were raised in respect of Denel:

(a) What is the full extent of re-capitalization required by Denel and what measures were being introduced to manage the risk in this regard;
(b) How is the solvency risk of the munitions business being managed; and
(c) What is the status of SPP in relation to Denel's restructuring, capitalization and risk management?

The Management of Risk and Denel's Recapitalisation

The management of Denel's risk needs to be seen within the context of the following legacy issues:

- Denel was a major systems developer, without having the requisite scale, locally and globally, to ensure its viability. For example domestic defence spend declined by 54% in real terms since 1990. In addition, much of global defence spend is inaccessible to independent contractors such as Denel. For example, an amount of only $55bn, out of a total spends of $360bn, in the global land systems market is accessible to non-NATO suppliers, with competition being fierce for this portion of spend.

- The Group diversified its business in an effort to survive. This included the diversification of manufacturing and investing in non-core businesses including protein (Specialised Protein Products, SPP), IT (Co source and Arivia.kom), plastics and electronics (Irenco), properties (Bonareo Park, Dendustri), and electrical accessories (Voltco). The Group also embarked on an export drive which achieved mixed results as exports were too diverse (over 100 products were exported to 60 countries), were mainly focused on price with no long term repeat order business and markets were targeted that are fragmented and generally not politically stable.

- A high cost base, both in terms of direct and indirect overheads.

- Poor contracting and contract management skills and legacy contractual and legal issues.

- Weak internal governance and risk management systems.

- Numerous labour issues.

The Department commissioned defence industry experts to develop a new strategy for Denel in 2005. The strategy set Denel on a new course whereby it will no longer be a major systems developer, but a producer of niche sub-systems and components. The key pillars of the strategy are as follows:

- Securing privileged access to a guaranteed minimum portion of South Africa's development and procurement spend. This includes entering into multi-year orders to smoothen cash flows and ensure the long-term sustainability of Denel's business units. This includes partnering with state agencies to undertake joint planning.

- Focus on growing commercially viable businesses where Denel has real technological leadership. This includes ring-fencing businesses to isolate risk and thereby manage exposure, exiting non-core and the potential exit of defence businesses that are not viable (where a sustainable solution cannot be found).

- The securing of equity partnerships with major global players to ensure access to stable developed markets and the transference of skills to Denel.

The raising of capabilities and productivity to world class standards. This includes the reduction of costs and the improvement of profit margins.

- A cross-cutting pillar includes the implementation of effective transformation and people management throughout the organisation.

Further detail on progress with regard to implementation in the above areas can be provided if needed.

In addition to the implementation of the above strategy pillars, Denel has made significant progress in improving governance systems and managing risk exposure:

- Governance structures have been put into place to continuously improve accountability, integrity and the standard of reporting to facilitate informed decision-making.

- The primary risk management objective is to protect the interests of the stakeholders and to ensure sustainability. The Board Audit and Risk Committee is responsible for oversight of risk at enterprise level, whilst management is responsible for implementation.

- Safety, Health, Environment and Quality (SHEQ) policies and practices in place. Denel adopted the OHSAS 18001 for occupational health and safety.

- The appointment of key financial management staff at group and at the core business units and monthly financial reviews.

- The implementation of performance contracts and the appointment of expert external service providers to review its contract management and supply chain systems and processes.

- Latest developments include the rolling out of a performance management system which will be followed by training, the completion of a business continuity assessment as the foundation for the development of a business continuity programme, a programme management process evaluation and the appointment of a champion for PFMA compliance.

From a Shareholder perspective, the Department monitors risk exposure and institutes measures to address significant risks.

In terms of Denel's recapitalisation requirements, the Department assesses Denel's working capital, borrowing and investment requirements, to ensure that Denel remains competitive but at the same time does not over indebt itself. Denel will be issuing Corporate Paper in 2008 and to manage the risk of Denel not being able to meet its interest payment requirements, the Department applied for the interest to be paid on Denel's behalf for the first 3 years, out of a total of 5 years, of its intended borrowings in the 2007 MTEF. Due to the fragile market that Denel operates in, sales are unpredictable and this could negatively affect Denel's ability to service its interest obligations. Denel will require a Government guarantee to support its borrowing programme. The Department has included debt monitoring ratios in the 2007/08 Shareholder Compact to monitor Denel's gearing.

Certain consolidation and costs of exit will emerge as the strategy unfolds and the future of Denel's ring-fenced businesses becomes clearer. The Department will assess such funding requirements.

Denel's Munitions business

Denel's Munitions business faces the following challenges:

- Annual break-even turnover amounts to R 1.2 billion. Local orders from SANDF were R120 m in 2006/07. In addition, there is a significant focus on exporting to developing markets which are unstable, with inconsistent orders that carry low to negative margin. Developed markets are largely inaccessible to Denel.
- The business also has a high a fixed cost base as evidenced by the low gross profit margins over the period (which dipped to 5.4% in 2006).
- The industry benchmark for indirect overheads is 10% - 11%, with Denel's costs at 24% and 30%. This is mainly due to large under-utilised facilities.
- Plant and equipment is outdated and is 20 years old in some cases.

To ensure the sustainability, Denel is in negotiations with a major European defence company to increase access to the NATO and other high spend markets, to invest in right-sizing the business and new plant and equipment and transfer skills and manufacturing know-how to Denel Munitions. Should this partnership be successful, then the capability will be retained in South Africa and the business will be returned to profitability.

Disposal of Specialised Protein Products (SPP)

There have been numerous attempts since 2003 to sell the business which failed due to the buyers not being able to either come up with payment guarantees or sufficient funding. Denel is therefore currently planning to pursue an open public auction strategy. Denel hopes to sell SPP before the end of 2007/08 financial year.

2. **QUESTION: SOUTH AFRICAN EXPRESS AIRWAYS (SAX)**

It was enquired whether current capitalisation requirement would be sufficient to ensure that it meets its objective of provide regional services.

The amount of R104 million contained in the MTEF for 2008/2009

The amount of R 104 million relates to the funding of existing bullet payments due to Standard Bank during April and May 2008 under existing aircraft financing commitments of SAX that have been guaranteed by Transnet. This amount is the last of a series of such commitments associated with the transfer of SAX from Transnet to DPE.

The amount has to be provided by means of re-capitalisation of SAX as a result of its historic under-capitalisation resulting in its total dependence on its holding company, Transnet, for the funding of its operations.

Other amounts pertaining to the transfer of SAX from Transnet to the Government

The DPE has requested amounts to be included in the adjusted estimates pertaining to the transfer of SAX from Transnet to the Government that precede the abovementioned amount. These were however excluded from the adjusted estimates and will now be requested as a special appropriation in order to finalise the transfer of SAX to the Government.

Purchase Price of shares and claims of Transnet in/to SAX at 31 March 2007	**140**

Re-capitalisation requirements for SAX	
Working capital requirements for the future	**40**
Scheduled payments of existing financing transactions before closing date (Nedbank and Standard Bank)	**301**
Total re-capitalisation requirements for SAX	341

Purchase Price and Re-capitalisation requirements	**481**

Submissions will be made to the GCC pertaining to the following guarantees, letters of comfort and indemnities currently issued by Transnet that has to be taken over by the Government as part of the transfer of SAX to the Government:

Guarantees and letters of support required pertaining to acquisition of SAX	
Transnet Guarantees and Letters of Support	753
Air Traffic Liability Guarantees	180
Guarantees and letters of support required pertaining to transfer of SAX to DPE	**933**

Funding of the future African Development of SAX

The priority for the Government is to transfer SAX from Transnet to DPE as soon as possible. This transaction will require the recapitalisation of the amounts stated above. Such recapitalisation would have a beneficial effect on the balance sheet of SAX which should improve the ability of SAX to make provision for growth in its existing and future operations.

However, should such recapitalisation not be granted, SAX will remain undercapitalised, in which case, separate requirements for the recapitalisation of SAX would have to be considered on a case by case basis for future expansion of SAX.

At the end of a SOE's financial year, they must submit an annual report and
... The SOE's annual performance against targets

It is possible that future expansion of SAX in Africa may be of a co-operative nature. SAX is also expected to remain profitable and together with the recapitalisation by the amounts required for the bullet payments as stated above would result into a healthy balance sheet. These factors should enable the investment required for such African expansion to be able to be absorbed to a large extent, therefore not requiring further funding by the shareholder.

The future African expansion of SAX is expected to be on a sound financial basis of profitability and customary investment criteria.

3. QUESTION – VACANCY TURNOVER

Staff turnover is 8.9% and vacancy rate is 13%. The size of the department means that any resignation affects the vacancy rate tremendously. Professionals leave the organisation for opportunities both personal and in the private sector. Retention of employees is difficult due to highly attractive private sector packages. The revised figures reflect a vacancy rate of 13%.

4. QUESTION – SHAREHOLDER MANAGEMENT

Shareholder management of SOE that fall within the DPE portfolio is primarily conducted by means of performance and oversight tools provided for in the Companies Act and the PFMA.

All SOE are required to submit a corporate plan annually. The corporate plan details a 3 year horizon budget, borrowing plan and corporate strategy for the SOE. DPE determines Key Performance Areas ("KPAs") and Key Performance Indicators ("KPIs") from the corporate plan and identifies additional KPAs and KPIs as may be required. KPAs ordinarily include, at least the following:

1. Capital and financial efficiency;
2. Commercial and operational efficiency;
3. Environment, health and safety;
4. Developmental objectives;
5. Skills development;
6. Broad Based Black Economic Empowerment; and
7. Strategic Supplier Development.

The mandate, strategic intent statement, KPAs and KPIs for a SOE's financial year are negotiated with the SOE. Upon finalisation of the negotiations a shareholder's compact setting out the agreed upon mandate, strategic intent statement, KPAs and KPIs is concluded.

The SOE reports to DPE on its performance against the criteria in the shareholder's compact and on its borrowings on a quarterly basis. SOE receiving capitalisation report to DPE on a monthly and quarterly basis. DPE evaluates these reports and determines whether corrective action is required and advises the shareholder Minister accordingly.