South Africa: Government support for Eskom could prove costly

Government support for state-owned utility Eskom would mean job cuts, rising tariffs and an increase in the government's debt/GDP ratio

Following recent plans to turn around Eskom, the fully state-owned utility, the focus has turned to South Africa's credit ratings. Concerns have risen that a downgrade by Moody's (currently Baa3) would see forced selling of South African domestic government bonds as a result of an exit from portfolios following the FTSE World Government Bond Index (WGBI) or other portfolios requiring an investment grade rating. According to the IMF, this could result in forced outflows of around US$1.5 billion (or 0.5% of GDP) directly linked to the WGBI although actual outflows could be higher on negative market sentiment. We expect more clarity from Moody's after the February budget. Our call is for USD/ZAR to trade close to 15/USD in 1Q19 although a combination of a weak external environment and downgrade concerns could see an overshoot potentially to even 16. However, we believe that South Africa is well positioned to weather the storm.

Eskom troubles: a problem long in the making

Specifically, Eskom is reported to have proposed that the government take over ZAR100 billion (or around US$7.1 billion) of currently government-guaranteed debt, representing around a quarter of its total debt outstanding. This would result in a 2 percentage point increase in the government's debt/GDP ratio which stands at c.56%. The plan would also see an increase in tariffs and potential job cuts of a third of its 48,000 strong workforce. However, the utility has repeatedly delayed the presentation of its turnaround plan, which is now scheduled for early 2019.

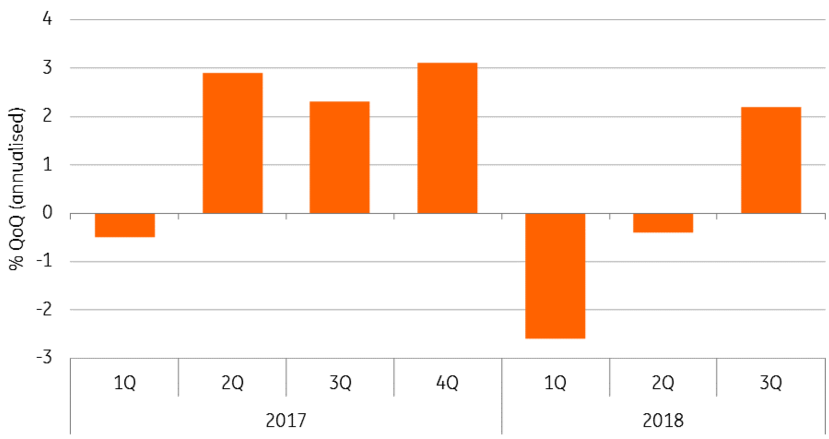
Moody's yesterday commented on those plans, saying that its fiscal strength assessment accounts for the likelihood of government support for state-owned enterprises (SOE). While debt levels would increase, the amount of guarantees provided to Eskom would similarly decrease from a current 7% to 5% of GDP (and from 5% to 3% if based on guarantees drawn). Therefore, the credit implications will depend on whether the transfer would also come along with an improvement in Eskom's financial profile, effectively reducing potential future contingent liability risks.

These are however anything but certain. Aside from the above-mentioned delay in its turnaround strategy, tariff hikes and a labour force reduction are contentious issues and have faced tremendous opposition in the past. Moreover, Eskom continues to be dragged by municipality arrears and large capex required in the next few years. Board and management changes as well as bridge loans by public institutions have provided Eskom a lifeline, its financial and operational profile has deteriorated due to the high debt burden (gross debt/EBITDA 16.6x in Sep 2018), increasing debt servicing costs (ZAR45 billion between Apr-Sep 2018 vs ZAR 23 billion a year ago) and high operating costs.

There is little wriggle room for the government

While Eskom's dire state and need for a fix is well-known, it's nonetheless a setback for the new leadership around President Cyril Ramaphosa as South Africa comes out of a technical recession (GDP contraction of 0.7% and 0.2% QoQ annualised in 1Q and 2Q 2018, respectively) which saw the National Treasury readjusting the fiscal trajectory. The Medium Term Budget Policy Statement in October sees debt/GDP stabilising at 59.6% in 2023/24 only vs 56% in 2012/22 in the previous budget.

GDP growth (% QoQ, annualised)



Source: Statistics South Africa, ING

However, we note that the government remains committed to reviving growth, stabilising government debt and pushing for structural reforms. While the National Treasury has not received a formal proposal by Eskom yet, a spokesman said that the policy for the funding of state companies has to be "deficit neutral" while Finance Minister Tito Mboweni suggested that Eskom should return to debt markets.

February budget will be key for rating agencies

Without doubt, the National Treasury is aware of the risks of simply writing Eskom a blank cheque, but there is a chance that the government will play a part in a potential turnaround strategy. Moody's comment that a broader strategic plan including a debt transfer could indeed have a neutral credit impact under some circumstances and might provide some relief here.

We therefore believe that the rand and South African government bonds might remain volatile over the first half of next year. Key events to watch out for include the February budget statement, the regulator's decision on Eskom's requested tariff hikes by March and the company's strategic plan. The downside risks are further exacerbated by the upcoming general elections that will take place sometime between May and August, despite expectations that the African National Congress and President Ramaphosa will retain a majority.

Rating concerns could see USD/ZAR overshoot 15 area

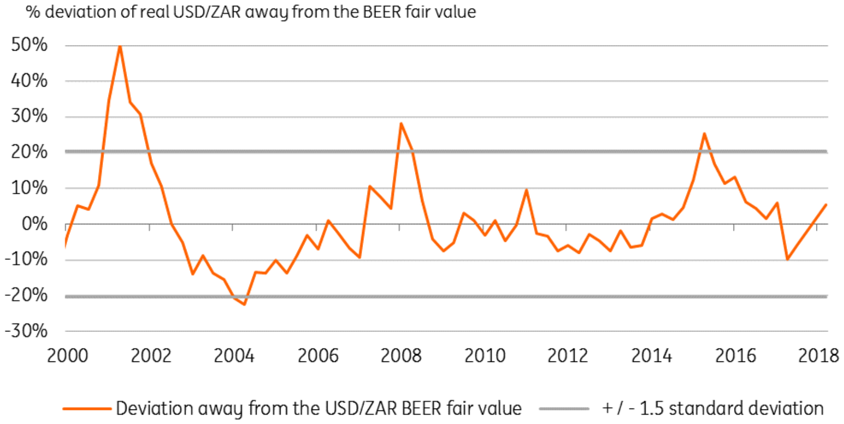
In addition to domestic developments, slowing growth in China and the expected decline in world trade creates a soft backdrop for the rand into early 2019. Our baseline forecasts published in our 2019 FX Outlook: Peak Dollar assume that USD/ZAR trades close to 15/USD in 1Q19, before recovering to the 13/USD area by the end of 2019 once it becomes clear that US rates have peaked and that the dollar trend has turned.

That call of USD/ZAR at 15 in 1Q19 is largely driven by the external environment - including US rates rising back to their highs as the Fed continues its late cycle tightening. But that profile does not incorporate a view of South African local debt losing its investment grade rating from Moody's. That issue had been a hot topic in March/April 2017, when President Jacob Zuma had removed his respected Finance Minister Pravin Gordhan.

If the issue of a downgrade were to re-surface in South African markets early next year – especially when the external environment is still challenging – USD/ZAR could certainly over-shoot the 15 area – potentially even to 16.

And unlike March 2017, when we calculated that the ZAR was 18% undervalued against the dollar, the ZAR has less of a cushion now. Results published in our FX outlook suggest the ZAR is currently a mere 5% undervalued against the dollar. So valuation looks unlikely to provide much support to this currency pair, which trades on an 18% annualised volatility.

South African rand is a mere 5% under-valued against the dollar

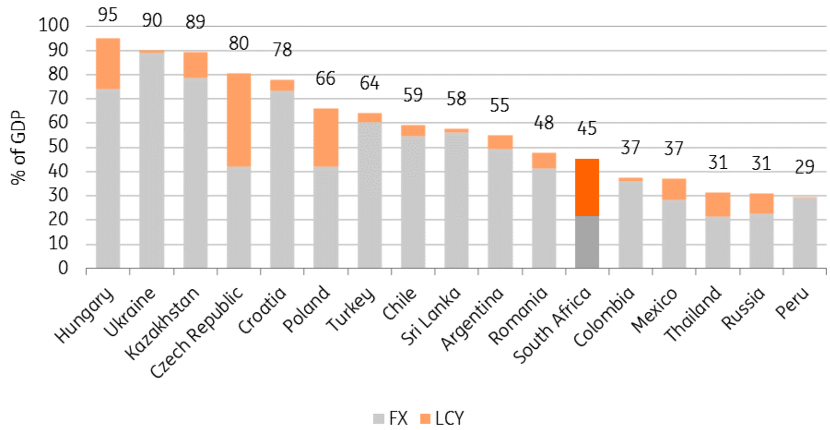


Source: Bloomberg, ING

South Africa is well positioned to weather the storm

While Argentina and Turkey have gone through a more extreme sell-off earlier this year, we think that South African corporates and the government are in a good position against a weaker rand. This is because they are mainly borrowing in rand which limits the fallout on balance sheets and lowers the dollar value of local-currency denominated debt, effectively reducing drawdown on FX reserves. Moreover, South Africa is a net external creditor which acts as an important buffer. Lastly, exchange controls limit outflows by residents and corporates/banks.

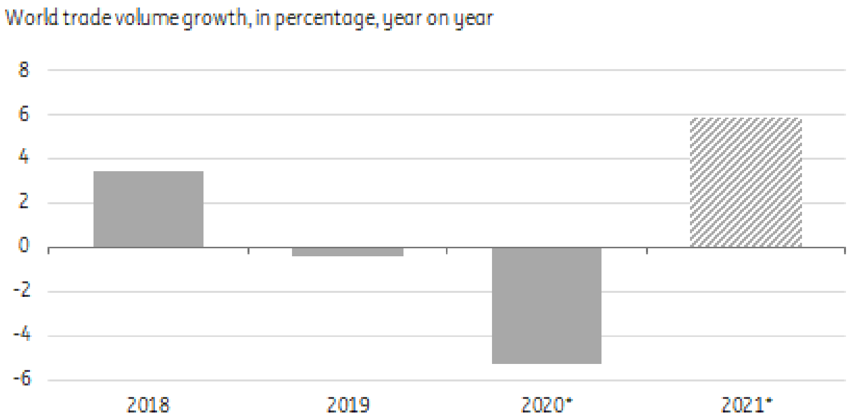
South Africa's total external debt is mainly rand-denominated



Source: World Bank, ING

With regards to government debt, only 10% of total debt is FX-denominated. Moreover, the average tenor is long at around 15 years and funding needs are low (11% of GDP according to Moody's). That said, non-residents hold 38% of South Africa's foreign and domestic government debt which leaves it vulnerable to external drivers. This has recently seen South African USD-denominated government bonds (SOAF) underperforming vs the wider market. Here, we note that SOAF bonds now trade wide in comparison to Brazilian and Russian sovereign bonds, but still meaningfully inside those of Turkey.

South African $ sovereign bonds trade wide to peers aside from Turkey



Source: Bloomberg, ING

Author

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Disclaimer