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Briefing by the Financial and Fiscal Commission on the SAA Debt Relief and Recapitalisation

Wednesday, 15 November 2017

For an Equitable Sharing of National Revenue

PRESENTATION OUTLINE

1. Background to the Aviation Sector
2. Assessment of SAA's Financial Position
3. Implications of Debt Relief on 2017 Budget and MTBPS
4. Measures to Improve Sustainability and Profitability of SAA
5. Way Forward

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1. BACKGROUND TO THE AVIATION SECTOR

1.1 HIGH LEVEL INDUSTRY AND MARKET ANALYSIS

- The airline industry is one of the biggest facilitators of trade and yet highly sensitive
  - Sensitive to competition, national pride, currency movements, oil prices, geo-political risks, travel volumes
- The local airline industry has been experiencing growth in travel volumes and entry of low cost carriers
- The Johannesburg – Cape Town route is highly competitive and ranks among the 10 busiest in the world

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1.2. Competitive Environment

- SAA operates within a highly competitive market domestically, regionally and internationally
- The airline however maintains domestic market dominance with a 36% market share – or 56% including Mango
  - Mainly dominates the busiest routes with the help of mango as a Low cost carrier
- Private airlines account for 46% market share and mostly dominant on less busier routes
  - Kulula makes up 53% of market share on JHB to George route

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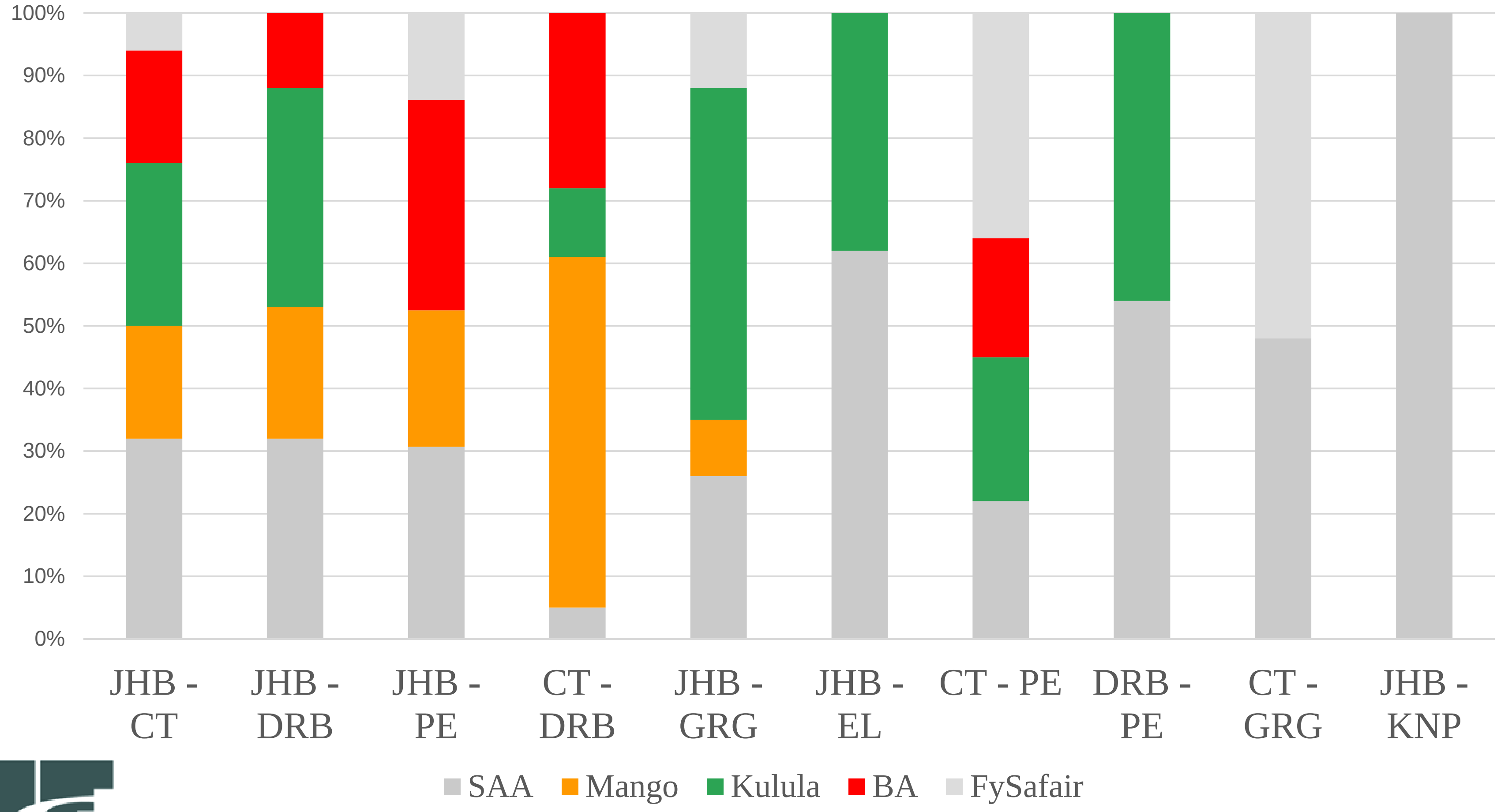
1.3. Market Share on 10 busiest Routes (based on Seat Capacity)



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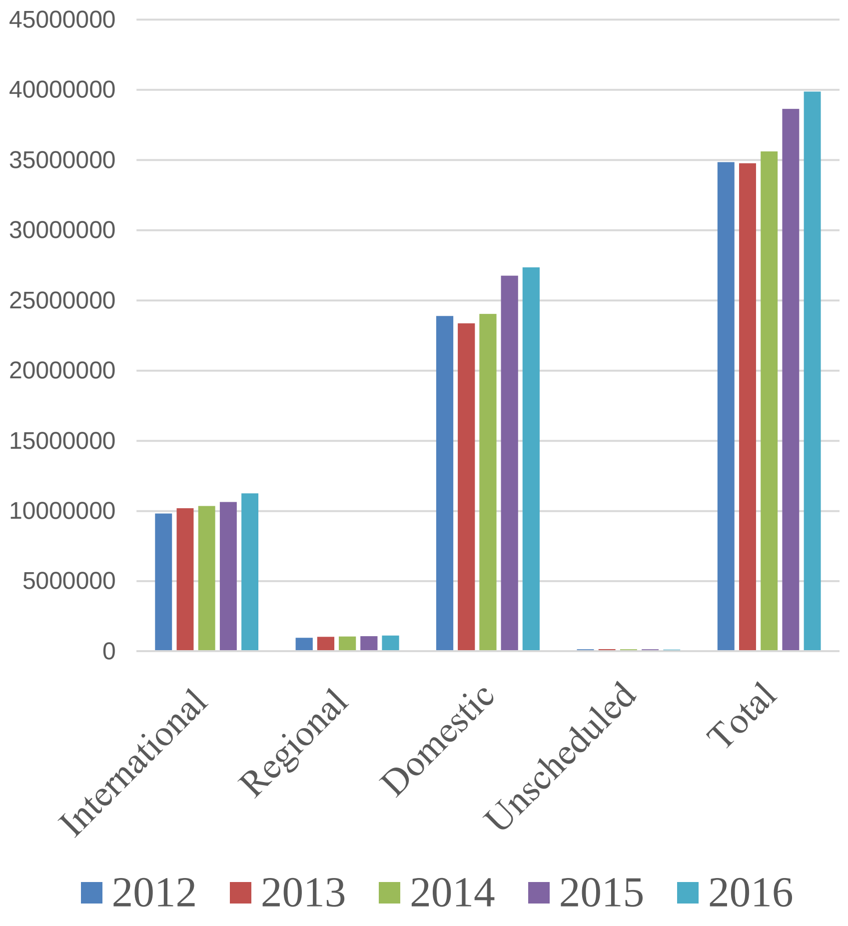
1.4. South African Airline Travel Volumes

- Demand for air travel remains strong with passenger traffic reaching 50 million departures and arrivals
- The domestic market constitute 69% of SA travel volumes
- International market accounts for 28% of traffic while regional is very small



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1.5. SECTOR CHALLENGES

- The slowdown of the Chinese and Brazilian economies placed downward pressure on commodity prices
    - Has impacted negatively on SAA's revenue
- Despite sharp decline in jet fuel prices between 2014 and 2015, the weak rand meant that SAA did not benefit from lower operating expenses
- The Ebola epidemic in 2014/15 affected key routes to East Africa and America
- New visa rules enacted pertaining to children travelling resulted in a decline in international travellers coming to South Africa
- In context of lower economic growth, poor airline margins and bailouts may lead to lower investor confidence
- SAA has also been accused of anti-competitive behaviour in South African aviation market

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2. Assessment of South African Airways Financial Position

2.1. Overview of South African Airways

- In 2006/7, SAA experienced significant losses which led to a major restructuring programme at the airline. An assessment found the operations at SAA was unsustainable
- During same period, Public Enterprises took over SAA from Transnet after the latter considered the airline as non-core
- Restructuring programme led to improved performance, with the company turning in profits for three consecutive years (i.e. 2008/9 – 2010/11)
- In 2013, SAA developed a long-term turnaround strategy after incurring losses in two consecutive years (2011/12 & 2012/13)
- Shareholder oversight was moved to the Ministry of Finance in December 2014 as a measure to address the financial and governance crisis at SAA
  - A 90-day Action Plan was implemented to address implementation failure at SAA
- In 2016, Ministry of Finance extended further guarantees to SAA with conditions attached, despite persistence of poor performance

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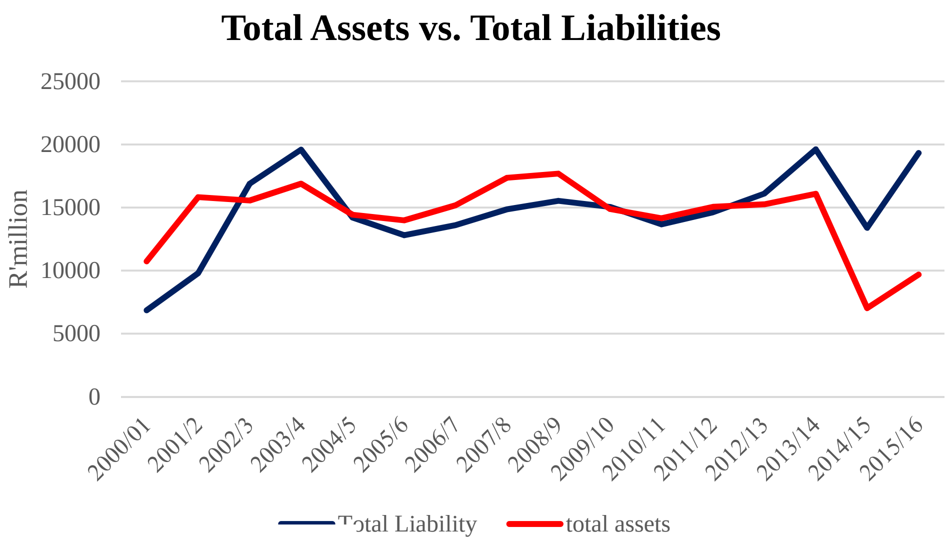
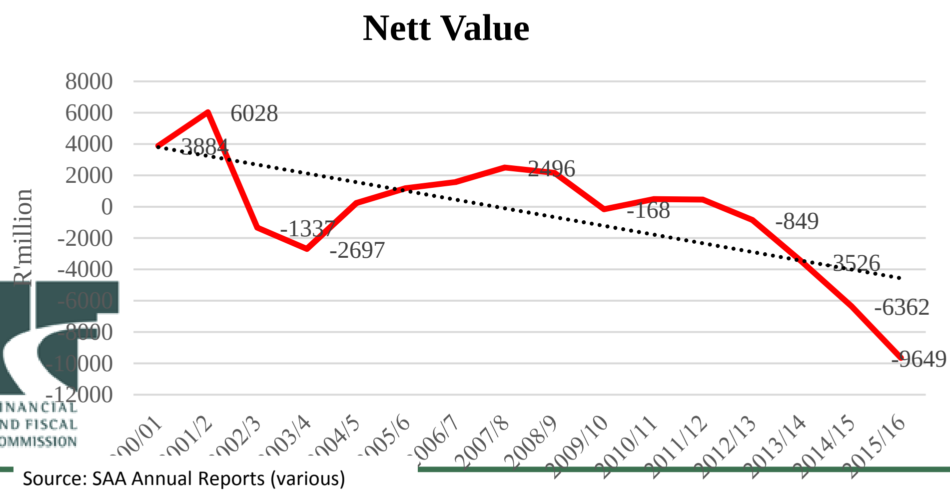
2.2. Assessment of SAA's Financial Position



Source: SAA Annual Reports (various)



Source: SAA Annual Reports (various)

- Since 2012/13, total liabilities have outstripped total assets, with the gap growing increasingly wider
  - By 2015/16, the nett value (difference between total assets and liabilities) reached –R9.6 billion
  - Note though that since 2001, there has been previous episodes where SAA experienced a negative nett value on its balance sheet (e.g. 2002/3 - 2003/4), but the size and duration is unprecedented
  - The rapid rise in liabilities and decline in assets imply SAA is required to pay a larger share of revenue generated to service debt costs thereby negatively influencing cash flow position of the company

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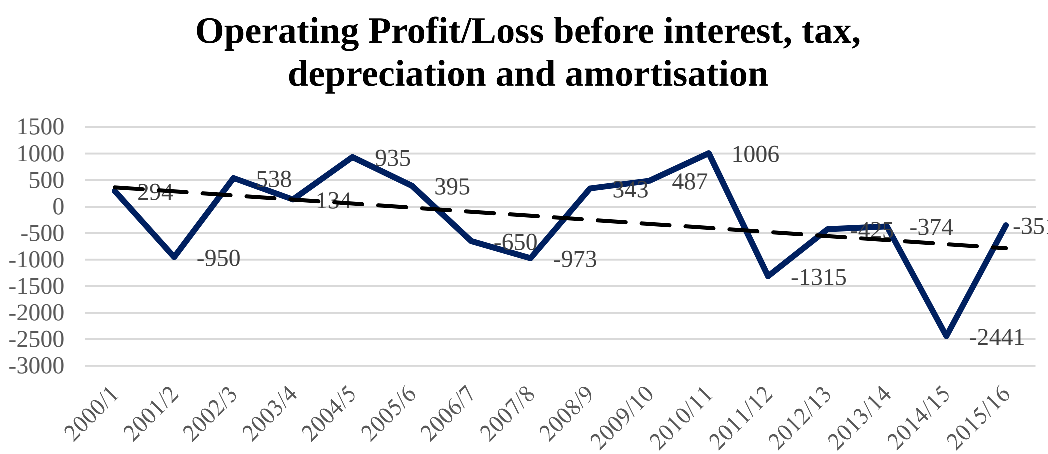
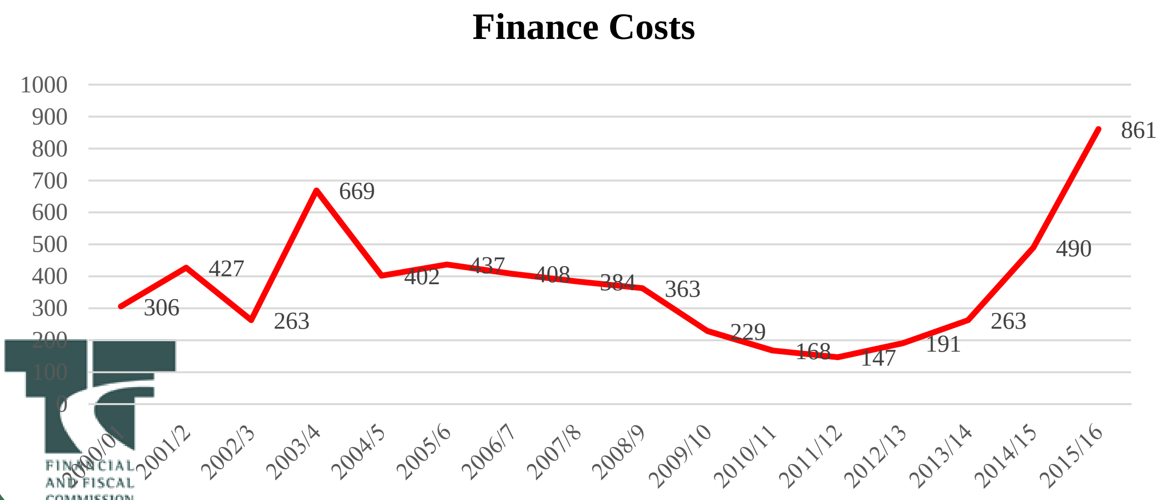
2.2. Assessment of SAA's Financial Position [cont.]





- SAA incurred an operating loss in five consecutive years (2011/12 – 2015/16), while finance costs have escalated alarmingly over the same period
- Instability in leadership, flawed governance and inefficient operations have been attributed as reasons for poor performance at SAA

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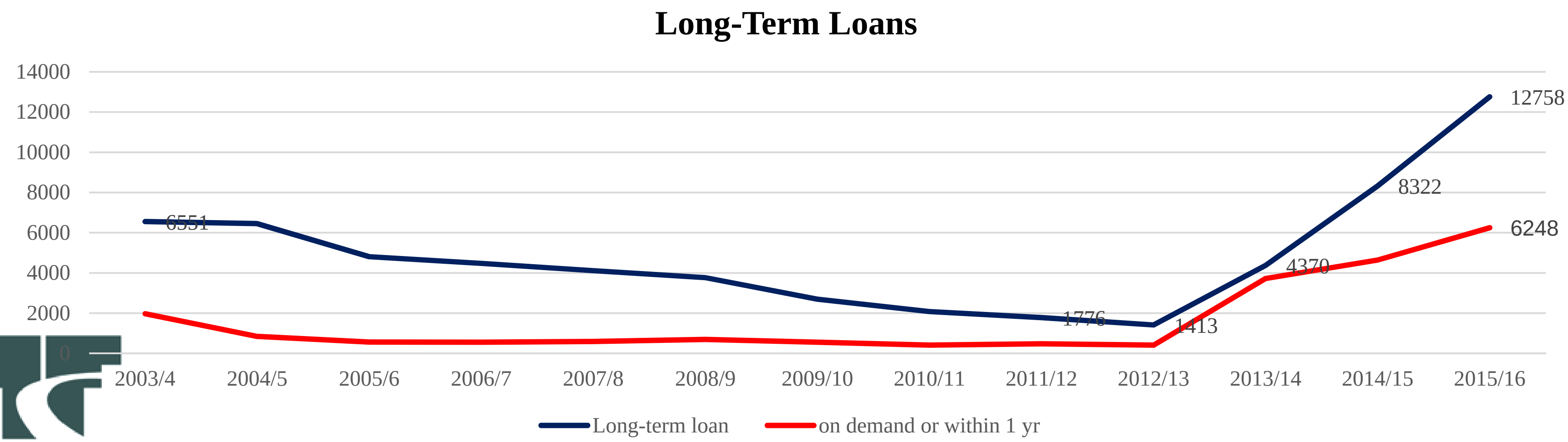
2.2. Assessment of SAA's Financial Position [cont.]

- Long-term loans reached R12.7 billion in 2015/16. Worryingly R6.2 billion of total long-term loans were expected to reach maturity immediately or within a year
- Given the poor financial health of SAA, financiers have been reluctant to extend the maturity date of loans, resulting in government intervention to keep SAA afloat



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3. Implications of Debt Relief on 2018 Budget and MTBPS

3.1. Details of Government's support strategy

- The Minister of Finance invoked S16(1) of the PFMA to settle SAA's debt obligation with lenders and financed it through the National Revenue Fund (NRF)
  - An amount of R2.2 billion was authorised to be paid to Standard Chartered Bank on the 30th of June 2017 and R1.76 billion to Citibank on the 29th of September 2017 in respect of outstanding debt owed to these lenders
  - SAA also received an injection of R1.2 billion for immediate working capital requirements

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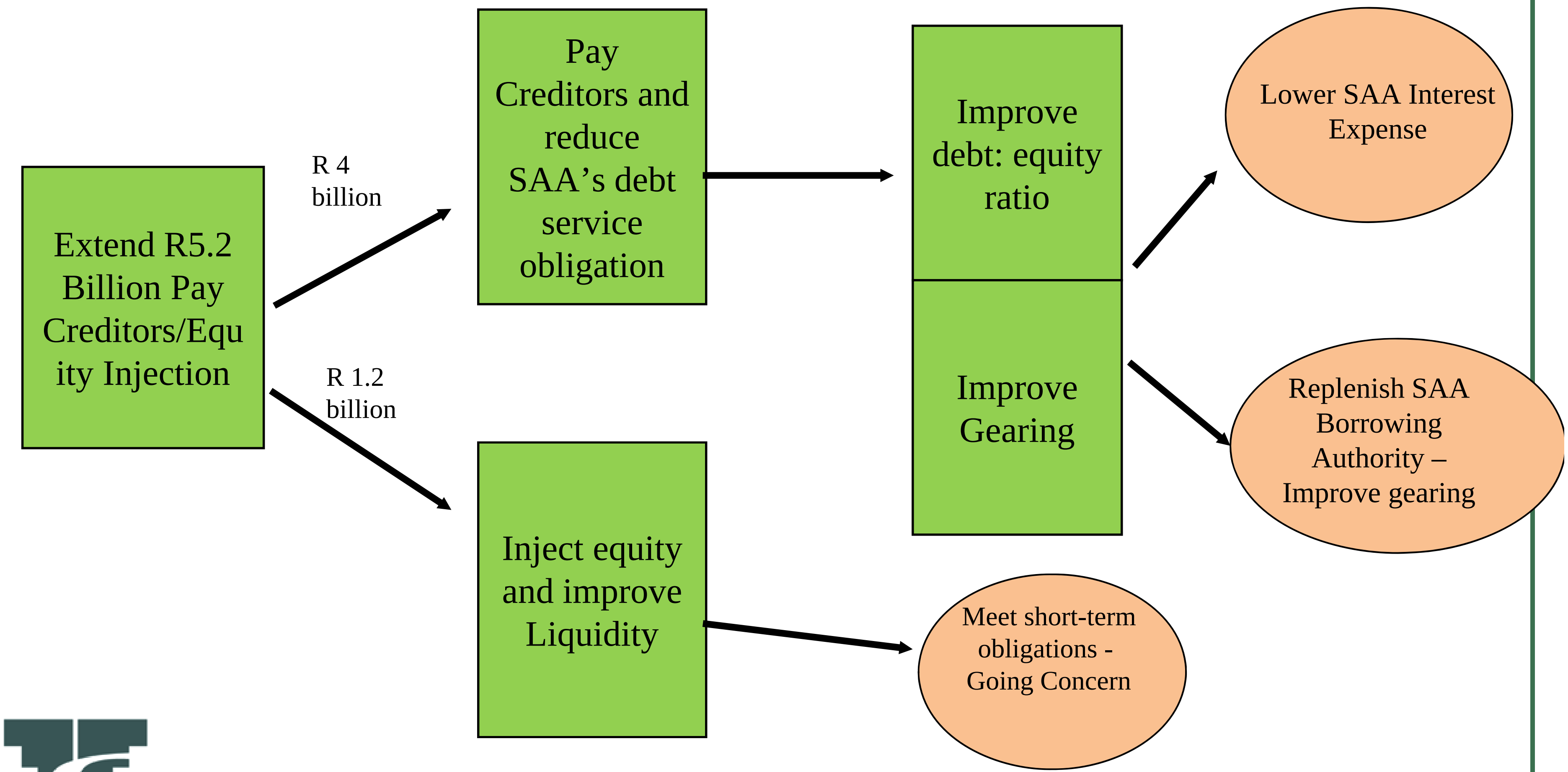
3.2. Mechanics of R5.2 Billion Appropriation



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3.3. Implications of support package on 2017 budget and MTBPS

- Government is funding the R5.2 billion (R4 billion debt repayment and 1.2 billion equity injection) to SAA directly from the NRF
  - This will likely increase the budget deficit and further push back fiscal consolidation over the medium term
- Should government follow through on plans to dispose state assets to offset expenditure incurred, this will have a neutral impact on the budget, but government's balance sheet will still be negatively affected
  - Details with respect to selling state assets will only be announced at the time of the 2018 Budget
  - The sale of state assets is a once off cash injection and cannot be called upon again to balance off future expenditure needs
- Given SAA's existing loan commitments, the equity injection into SAA may not be sufficient to secure its long-term viability

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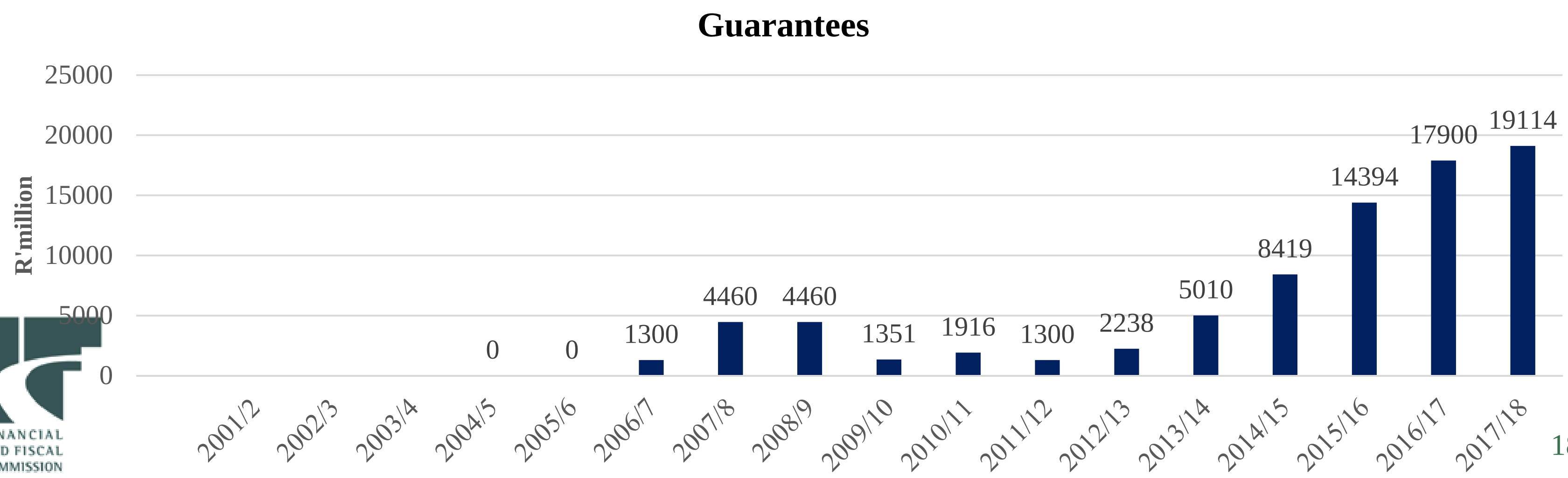
3.4. Additional Government Measures to improve fiscal sustainability of SAA – Guarantees

- To reduce costs of borrowing and manage its credit ratings, government has progressively extended guarantees to SAA over time
- Guarantees imply government commits to making loan repayments on behalf of SAA should it default. This exposes the budget to undisclosed risks and is recorded as a liability on government's balance sheet
  - If SAA had defaulted on its loan repayments to Citibank and Standard Chartered, this would have triggered a call on the government guarantee, including loans received from other lenders totalling R13.75 billion



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3.4. Additional Government measures to Improve Fiscal Sustainability of SAA – Guarantees [cont.]

- The Commission is of the view guarantees should not be viewed as an easy option to avoid managing risks as now appears the case
  - In other words Guarantees should not be taken for granted and become a default response position
- Given that guarantees are not exposed to the same level of scrutiny in the budget process as regular spending, the Commission advises oversight mechanisms of guarantees should be strengthened to reduce the risk of unintended consequences from materialising particularly at National Treasury Assets and Liabilities Oversight Division

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4. Measures to Improve Sustainability and Profitability

4.1. Losses in Times of Plenty

- SAA's ongoing financial woes occur in stark contrast to thriving domestic and international competitors
  - Comair turned 297 million profit (2016)
  - Ethiopian air R3.4 billion profit (2016)
  - Emirates R4.4 billion profit (2016/17)
- SAA losses are however not isolated internationally
  - Malaysian and Kenyan airlines have been struggling to turn profit in recent times
- Reasons underlying losses vary: tough competition, poor fleet fit for purpose, operational inefficiencies and managerial
- SAA continue to make losses despite endless interventions
  - Interventions seem to be superficial and not addressing underlying core reasons

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4.2. Proposed Interventions for Profitability

- The Commission proposes that SAA should take the following actions to improve its operations and return to profitability:
  - Renegotiate contracts – network arrangements, leases and fleet structure
  - Sell non-strategic assets such as Airlink stake which undercut SA Express
  - Continue to aggressively pursue outsource of non-core services
  - Halt operations on non-performing routes
    - plans to cut 37%, 11% and 4% of domestic, regional and international routes
  - Diversify income away from ticket sales – catering, lounges and technical services

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4.2. Proposed Interventions for Profitability [cont.]

- Strict procurement controls
  - Consider using Chief Procurement Office services to maximise procurement efficiency
- Staff right sizing
  - High staff component relative to airline size
  - Address salary perks in amicable ways
  - Re-engineer employee benefit structures
- Aggressive cost containment on major cost drivers
  - Finance cost, letters of credit
  - Set up day to day operations unit/centre for cost control
- Stabilise executive and senior management
- Swift decisions on routes termination
- Recommit to aggressive expansion on strategic domestic and international routes
  - Require improved value proposition to the international market

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4.3. Sector-wide interventions

- SAA's future growth is poised to rely on domestic travel and other ancillary services (Cargo)
  - Serve few domestic destinations relative to fleet size
  - Airplanes may be stuck in costly international routes
- International travels are predominantly driven by Big Full Service Carriers relying on LCC for regional carriage
  - International airlines account for 82% of traffic into and out of Africa
- Regional travel is hamstrung by restrictions on open-sky policies, bilateral agreements and fragmentation
  - Africa has 227 airlines but only account for less than 5% of global air traffic

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4.3. Sector-wide interventions [cont.]

- The sustainability of SAA will not only depend on market dominance but also fair competitive practices
  - The airline industry thrives on competitive prices which enables passenger growth
  - Entry of FlySafair resulted in reduced fares on certain routes
- Deal with risks associated with exchange rate fluctuations
- Deal with oil price fluctuations
- Deal with fleet fit for purpose issues

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5. Overall Assessment and Next Steps

- Most successful businesses seek to minimize interest expense and optimize the mix of debt instruments within their total portfolio
  - Government’s repayment of SAA’s debt and injecting equity into the company is a step towards managing SAA’s debt and minimizing its interest expense
- However, the Commission is concerned that this bailout will create the perception that SAA (and other public entities) can count on government to support it when faced with financial troubles
  - This may create perverse incentives that undermine basic principles of fiscal irresponsibility

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5. Overall Assessment and Next Steps [cont.]

- The Commission believes to mitigate the risk of SAA's liquidity position weakening in the future and the likely implication on loan repayment, government should:
  - Speed up policy clarity and implementation on finding an equity partner for SAA
  - Use guarantees sparingly and as a last resort in managing risks
  - Clarify if future government financial support will be required from SAA and the extent thereof as of now to enable future planning
  - Implement proposed cost saving and revenue enhancement measures, improve leadership stability and enhance governance at SAA

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