InvestSense

April 2021

Make Eskom Great Again

In 2001, Eskom was named as the global power company of the year at the Global Energy Awards hosted by the Financial Times in New York. The utility was commended for its technological innovation, effective maintenance, and low-cost electricity. In the two decades since then, however, a lack of maintenance, rampant corruption and deliberate maladministration has turned the jewel in the state's crown into a noose.

Eskom's current CEO, Andre De Ruyter, was appointed in 2020 to turn the ship around. He impresses with his business minded approach and no-nonsense attitude in dealing with Eskom's issues. The narrative is that Eskom is in very deep trouble, but that we must bite the bullet now because the consequences of inaction will be far worse.

In grappling with this reality, we tend to overlook the significant positive changes that have been made in the face of immense adversity. De Ruyter's turnaround strategy is incredibly detailed and affects almost every part of the organisation. It also requires the buy-in from a wide range of government stakeholders, which is no easy task, and is being implemented at an impressive pace. In our opinion these efforts go a long way to show why having a sense of hope and optimism for the future is not entirely misplaced.

In our opinion, Eskom's troubles are primarily operational and financial in nature. In this month's article we discuss these issues and highlight the cornerstones of De Ruyter's strategy to make Eskom great again. The focus here is not on Eskom's journey into its current predicament. We'll leave the revelations to the investigative journalists who are doing a good job of unearthing Eskom's skeletons.

Operational Issues

Issue	Solution
Old and poorly maintained fleet	Prioritise critical maintenance
Design flaws at Medupi & Kusile	Identify issues and fix them
New generation capacity	Independent Power Producers (IPP)

Table 1: Operational Issues

Ageing Fleet of Power Stations

The first operational issue to attend to is the maintenance backlogs at the utility's ageing fleet of power stations. The average power station is 39 years old and the lack of maintenance has further taken its toll on the plants. The populist mindset of the past was to minimise load-shedding as far as possible and hence critical maintenance was deferred. De Ruyter has prioritised a catch-up maintenance program to provide the much-needed TLC that the plants have been lacking, with as much as 12% of installed capacity out on long term maintenance. Eskom has warned that this translates into a higher risk of load-shedding until the project is completed, however, it is imperative in extending the shelf life of plants to keep existing capacity in the grid.

Design Flaws at Medupi and Kusile

Secondly, design flaws at Eskom's two new plants, Kusile and Medupi, mean that the plants are unable to operate at full capacity and provide the planned relief to the grid. Eskom has identified the issues and is modifying the designs of units under construction, while it will start fixing the flawed operational units from mid-2021. Medupi's final unit is expected to come online later this year while Kusile is expected to add units through May 2024.

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New Generation Capacity

The third operational issue is about future generation capacity. Eskom acknowledges that it can't afford to build sufficient generation capacity for the country's needs going forward especially considering government's goal of generating 60% of our energy from renewable sources by 2030. They therefore welcome and encourage independent power producers (IPPs) to supply electricity to the grid.

The problem is that IPPs need to be guaranteed that they will compete on a level playing field against Eskom's own generation capability, which is difficult to demonstrate when Eskom also owns the transmission lines. To facilitate investor confidence, Eskom is reorganising its operations into three distinct units: generation (i.e. the power plants), transmission (i.e. the power lines), and distribution (power lines to consumers). This is expected to spur investment in the sector and bring more capacity online.

Eskom is an anomaly when compared to global peers with its vertically integrated organisational structure, so the separation also brings the business in line with global best practice. The separation is expected to be completed towards the end of 2021.

Financial Issues

Issue	Solution
Increasing revenue	Higher tariffs, payment culture
Cutting Costs	Efficiencies, root out corruption, cut staff, reduce interest
Dealing with debt	Transfer debt to government

Table 2: Financial Issues

Increasing Revenue

The primary financial issue is that Eskom needs to make more money and they are pushing hard for tariff increases. Eskom must get approval from the national energy regulator, NERSA, to increase tariffs. NERSA tends to act in the best interests of consumers and has been a major obstacle to Eskom obtaining approval for tariff hikes in the past. The result is that Eskom has under-earned around R370bn over the last decade. Consumers have also moved off the grid as the power supply has become more unreliable which, combined with weak economic growth, has resulted in electricity sales declining by 1% per year since 2014. At the same time, Eskom's expenses have increased significantly on the back of corruption and maladministration, which has made the financial situation completely unsustainable. As shown in Chart 1 below, the utility is currently losing around R20bn per year.

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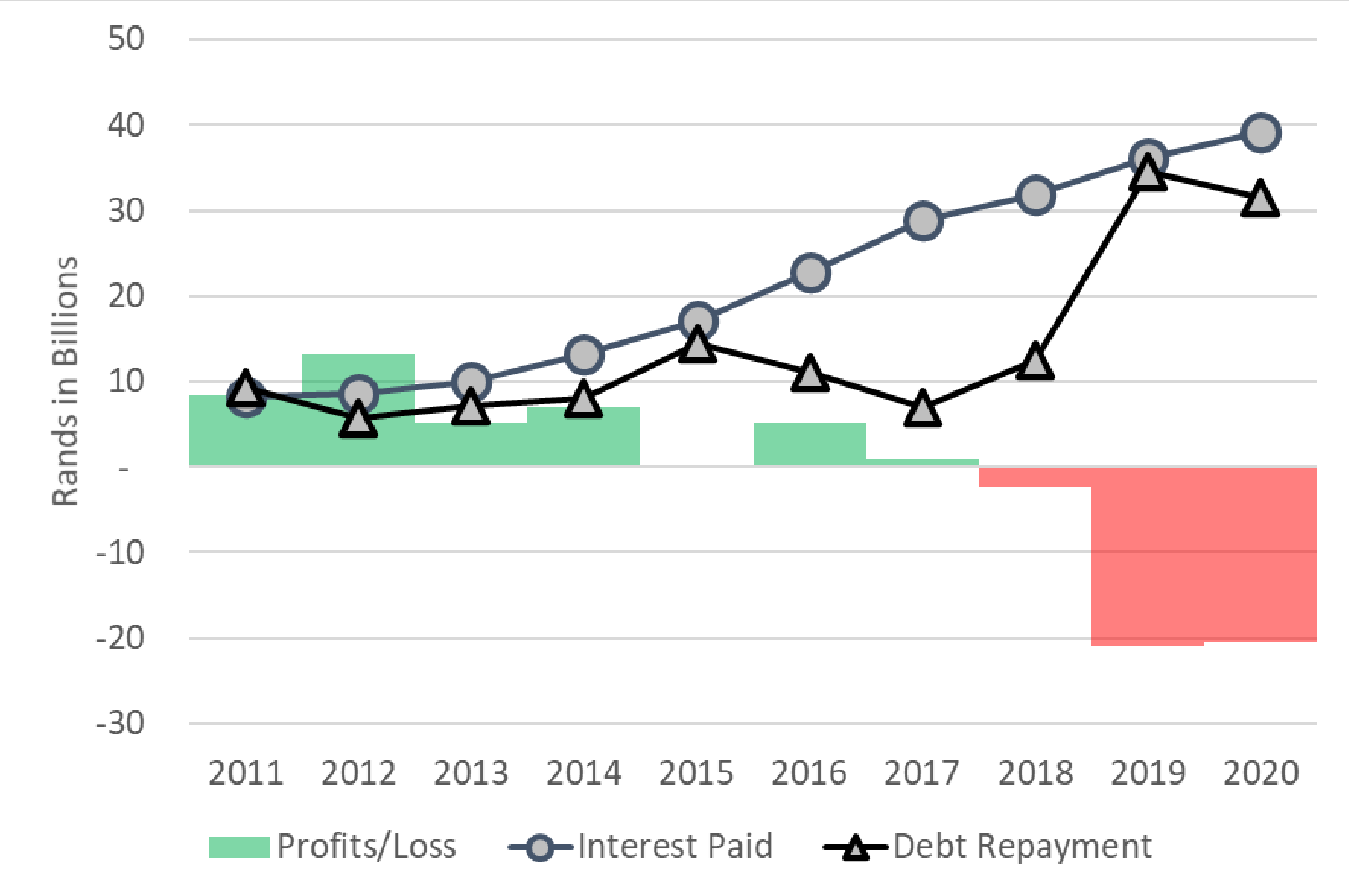

Chart 1: Eskom's financial dilemma (Source: Refinitiv)

Eskom's efforts have paid off as NERSA granted a 15% tariff increase in the 2021/2022 financial year and requested another 15% in the following year to reconcile the price of generating electricity with the cost of supplying electricity.

An additional issue for Eskom is non-payment by distressed municipalities, with accounts in arrear exceeding R35bn. Eskom recently started responding more aggressively to non-payment, cutting off electricity to municipalities, attaching bank accounts and movable assets, taking over distribution and rolling out pre-paid meters. They acknowledge that this has led to hardship in some of these areas, but that it has started to foster a culture of payment.

<u>Cutting Costs</u>

The second financial issue is to cut costs. Eskom spends R140bn per year on procurement, with horror stories of paying over R200 000 for a mop or R30 for a roll of toilet paper. Eskom's chief procurement officer has been suspended for non-performance and tenders are being scrutinised. The two main costs Eskom is targeting are staff and interest costs.

1. Staff cost is a big-ticket item that Eskom is addressing. The solution has been to reduce the headcount by 2000 staff to reduce the payroll. This has been done through attrition and voluntary severance packages (no retrenchments) in the last financial year, with a further reduction of 6000 expected over time. They are also implementing a high-performance culture for remaining staff, with consequence management for non-performance, to shift the mindset from non-profit to profit-driven service delivery.

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2. Periodic taxpayer funded government bailouts are used to pay R40bn in annual interest (see Chart 1), so reducing Eskom's massive interest bill is a priority. One of the ways that it can be achieved is by paying a lower interest rate. The utility as a whole is considered risky, so interest rates are high. An objective of the planned separation as discussed before is to distinguish the stronger business units from the troubled ones in the eyes of investors. This allows the more sustainable business units, like transmission, to access cheaper financing for its R180bn in capital projects over the coming decade.

Dealing with Debt

The third financial issue is dealing with Eskom's debt, which has escalated to over R400bn and costs R30bn per year in repayments (see Chart 1). One of the ways to address this has been to dispose of non-core assets, for example selling off parts of their property portfolio. If its property portfolio was listed, it would be the 2nd or 3rd largest property company on the JSE. So far, they have disposed of R250m worth of property in the last financial year, with more to follow.

Eskom states that it needs to reduce debt by around 35-50% to function properly. Their argument is that the business is unsustainable at these debt levels and that a large percentage of the debt is guaranteed by the government anyway. So why keep Eskom in a stranglehold while providing periodic taxpayer funded bailouts when the government can take over the debt? The government is also considered lower risk and will likely be charged less interest. Eskom has proposed to transfer around R150bn-R200bn of government guaranteed debt to the state, as shown in Chart 2, with discussions still ongoing.

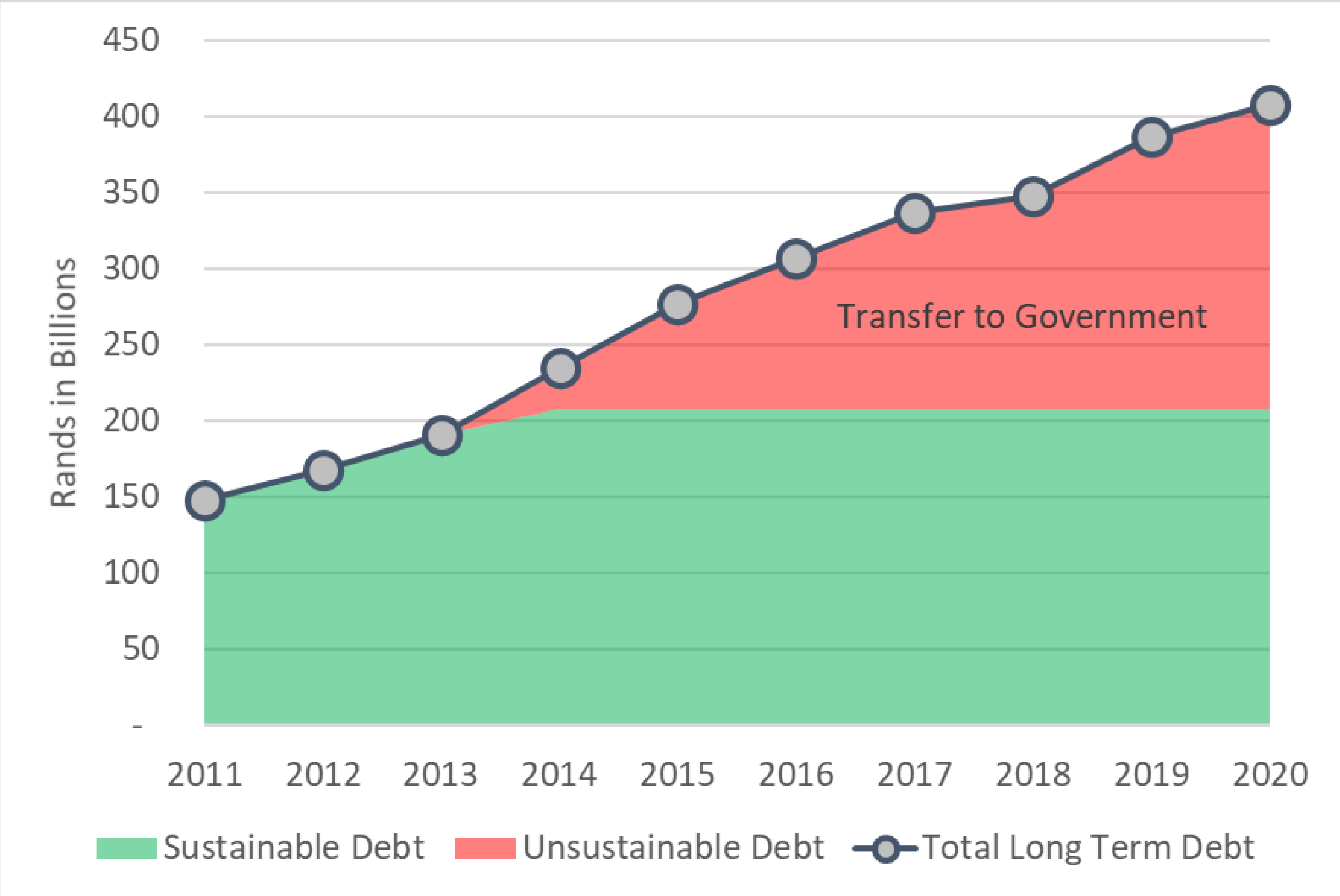

Chart 2: Eskom's debt journey (Source: Refinitiv)

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Eskom is confident that increasing tariffs, working with municipalities to improve collection, rationalising expenses and transferring the debt to the state, will enable them to return to financial sustainability.

Despite all the bureaucratic hoops that needed to be jumped through, De Ruyter has buy-in from the government. Corruption and incompetence are being driven out, and the changes so far are sensible and seem to be implemented reasonably well. We don't always appreciate how much more damage Eskom would have caused if allowed to continue its destructive path. A ship turns slowly and there is still an immense amount of work to be done, but much progress has been made and there is a clear pathway to recovery.

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data provided by Reuters and Datastream

MARKET REPORT

30/04/2021

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	8.6%	14.2%	36.4%	8.1%	8.0%	10.7%	15.2%	13.4%
FTSE/JSE SA Listed Property	ZAR	22.8%	18.8%	40.3%	**-11.8%**	**-7.4%**	5.2%	25.9%	20.9%
SA All Bond Index (ALBI)	ZAR	**-0.6%**	0.1%	14.7%	6.4%	8.7%	8.2%	8.2%	7.9%
SA Cash Index (SteFI)	ZAR	0.9%	1.2%	4.3%	6.2%	6.8%	6.3%	0.4%	0.3%
Balanced Benchmark	ZAR	5.9%	9.1%	23.3%	8.8%	8.2%	11.1%	10.5%	8.9%
SA Inflation (1 month lag)	ZAR	1.7%	1.7%	3.2%	4.1%	4.4%	5.0%	1.2%	1.3%
GLOBAL MARKET INDICES BASED TO USD									
Global Equity (Datastream World)	USD	11.1%	10.0%	46.0%	14.7%	14.7%	10.5%	14.7%	14.0%
Emerging Markets Equity (Datastream EM)	USD	1.8%	4.9%	49.2%	7.9%	12.9%	4.0%	16.4%	17.7%
Global Property	USD	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Global Bonds (Barclays Global Bond Index)	USD	**-3.4%**	**-4.6%**	1.8%	3.1%	2.1%	1.4%	5.4%	5.0%
Global Cash	USD	0.0%	0.1%	0.2%	1.6%	1.4%	0.9%	0.2%	0.2%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	8.6%	14.2%	36.4%	8.1%	8.0%	10.7%	15.2%	13.4%
Global Equity (Datastream World)	ZAR	7.0%	8.6%	15.3%	20.6%	15.2%	19.6%	16.8%	14.5%
Emerging Markets Equity (Datastream EM)	ZAR	**-1.9%**	3.6%	17.9%	13.4%	13.4%	12.5%	14.3%	13.4%
Global Property	ZAR	9.6%	11.7%	2.4%	14.8%	8.2%	16.4%	16.7%	14.3%
SA All Bond Index (ALBI)	ZAR	**-0.6%**	0.1%	14.7%	6.4%	8.7%	8.2%	8.2%	7.9%
Global Bonds (Citigroup)	ZAR	**-6.9%**	**-5.8%**	**-19.6%**	8.4%	2.6%	9.8%	16.3%	14.5%
COMMODITIES									
Gold (US Dollars)	USD	**-4.7%**	**-6.7%**	3.9%	10.5%	6.5%	1.4%	13.2%	16.0%
Gold (Rands)	ZAR	**-8.2%**	**-7.9%**	**-18.0%**	16.1%	7.0%	9.8%		
CURRENCIES									
Rand / Dollar	ZAR	3.6%	1.2%	21.0%	**-5.1%**	**-0.5%**	**-8.2%**	16.7%	15.5%
Rand / GBP Pound	ZAR	2.8%	**0.0%**	13.3%	**-5.3%**	0.7%	**-6.2%**	17.7%	14.7%
Rand / Euro	ZAR	4.5%	2.8%	13.2%	**-5.0%**	**-1.5%**	**-6.0%**	15.4%	13.7%

Spot Rates		30-Apr-21	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US$	Rand	14.51	14.69	18.37	14.18	6.59	8.02
Rand/GBP	Rand	19.94	19.88	22.74	20.78	11.03	12.16
Rand/EUR	Rand	17.46	17.97	20.12	16.24	9.77	7.11
RATES							
Libor 6m $	US$	0.20	0.26	0.76	0.90	0.43	4.30
Repo Rate	Rand	3.50	3.50	4.25	7.00	5.50	12.00
Prime	Rand	7.00	7.00	7.75	10.25	9.00	14.50
All Bond Index Yield	Rand	10.10	9.62	11.64	9.38	8.50	9.74
COMMODITIES							
Gold ($/oz)	US$	1 770.46	1 897.77	1 704.81	1 292.34	1 535.80	263.85
Platinum	US$	1 218.00	1 068.00	767.00	1 065.00	1 835.00	594.00
Oil (Brent Crude) $	US$	67.35	51.89	25.52	47.49	126.11	27.37
INFLATION							
SA Inflation	%	3.2	3.1	3.0	6.2	4.4	9.4

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