

AFRICA RISK CONSULTING

South Africa Monthly Briefing February 2015

South Africa Summary 27 February 2015

Finance minister Nhlamhla Nene delivers his first budget, which revises growth forecasts downwards and raises income tax. However it fails to impress business or the markets and does not address South Africa's underlying economic problems. The removal of opposition Economic Freedom Fighters (EFF) by public order police overshadows President Jacob Zuma's state of the nation address. This raises questions over the credibility of parliament and the state of the nation's governance. South African mining companies announce 2014 losses and take action to return to profitability. This includes selling off underperforming assets and building power plants to avoid power-cut related disruption to business. The government confirms its \$1.9 billion cash injection into power facility Eskom and hints at cogeneration deals with independent power plants in the future to solve South Africa's power crisis.

Nene's first budget identifies South Africa's problems but offers no solutions

Finance minister **Nhlamhla Nene** presented the 2015/2016 budget to parliament on 26 February, predicting low growth and hard times for the South African economy and the first tax raise in 14 years. However many of the budget cut plans announced in October did not feature, leaving the markets and business community underwhelmed.

Nene lowered the national forecast for GDP growth by 0.5%, predicting 2% growth in 2015, 2.4% in 2016 and 3% in 2017. The programme of reducing the fiscal deficit, begun in 2014, will continue. The government will reduce the deficit to 3.9% of GDP in 2015/2016, falling to 2.6% in 2016/2017 and 2% the year after that.

Nene presented the continuing electricity crisis as the largest barrier to South African growth. The ongoing load shedding due to a series of technical faults and inadequate electricity supply has increased business costs as businesses have to find alternatives in high cost generators. Several small businesses – on which South Africa's future depends – have had to shut operations. The electricity crisis is adding to the list of deterrents to investment. In the 2014 budget the then finance minister, **Pravin Gordhan**, outlined projected investment expenditure in the economy in 2015/2016 of 5.6% of GDP. The national treasury cut this projection to 2.2%. The low rate of investment means that there will be no increase in real terms in private sector investment in South Africa. This will affect the country's growth rate as well as job creation.¹

There was little information in the budget on how the government planned to tackle the energy crisis. Nene said that national power utility **Eskom** would be raising the cost of electricity to move towards "cost reflective" tariffs. Growth will come from "low energy" industries including tourism, agriculture, light manufacturing and property development.² Sources in the business sector were unconvinced:

"What Nene got right was that the economy is not going to get better until the energy crisis is fixed, what he got wrong was a belief that any industry will be able to profitably grow in a country with indefinite load shedding."³

¹ Business Day, 26 Feb 2015

² Mail and Guardian, 26 Feb 2015

³ Source: consultant, Johannesburg

In order to finance government expenditure in this low growth, low investment environment the government will raise income tax by 1%. This will raise R9.4 billion (\$814m) for the public purse, R8.5 billion (\$736m) of which will be re-circulated as tax relief for low earners to compensate for the effects of inflation on tax brackets. Those earning under R450,000 (\$39,000), roughly 90% of the tax paying population, will pay less tax, while the top 10% of earners will pay more.⁴ The government will also raise a further R6.5 billion (\$562m) through increasing the general fuel levy by 30.5 cents/litre, bringing the total levy to R2.25/litre of petrol.⁵ He announced some budget increases for the education ministry (for school books), and health ministry (for purchasing medicines). Nene also announced tax incentives for small businesses with the top rate of corporation tax reduced from 6% to 3%.⁶

Plans that Nene outlined in October to sell off non-strategic assets of state-owned enterprises in order to fund their budget shortfalls were absent from the budget. South Africa has a highly efficient revenue collection system – income tax, corporation tax and VAT account for 80% of the budget. However, inefficient state-owned enterprises are a huge drain on the public purse (see *ARC South Africa Briefing* November 2014-January 2015) and the budget presented no plans to decrease their spending. National wage negotiations are also taking place in 2015 and the unions will push for a salary increase well above inflation. The public wage already accounts for 40% of non-interest public spending. To increase it above inflation will necessitate the state borrowing additional funds. South Africa's national debt is already at 40.5% of GDP. Keeping borrowing down in a low growth environment will be difficult, raising the risk of further public debt.

There was also no mention of policy outlined in President **Jacob Zuma's** (2007-present) state of the nation address (see below), such as how the government was planning to fund large capital expenditure projects including nuclear energy. Nor was there mention of how to fund the overhaul of national health insurance that the government promised in 2012, or how to address structural inequality, poverty or unemployment. Opposition parties and the **Congress of South African Trade Unions (COSATU)** criticised the budget for failing to address these issues while raising taxes across the board.⁷

The speech failed to inspire confidence in the markets. The rand fell marginally from R11.45 to R11.48 to the dollar, and local bond markets also fell incrementally. The view from observers in South Africa and abroad was that while the budget was able to contain some of South Africa's fiscal problems, it offered no real solutions and ambitious deficit reduction targets.

*"Unless economic growth picks up across 2015 it will be very difficult for the government to reduce the deficit to 2.5% of GDP."*⁸

Observers were also disappointed that Nene had not implemented the far-reaching budget reduction promised in his October budget statement:

*"The medium term budget statement in October showed lots of promise.... but he (Nene) has failed to deliver...there is no real plan in place to rebuild the economy."*⁹

Some sources argue that Nene lacks the political influence to enforce major budget cuts to departments and state-owned enterprises (SOEs).

*"This budget was a test of Nene's political clout.... now we can see that he can't push budget cuts on either the departments or the SOEs."*¹⁰

⁴ City Press 27 Feb 2015

⁵ Mail and Guardian, 27 Feb 2015

⁶ Moneyweb, 26 Feb 2015

⁷ Daily Maverick, 27 Feb 2015

⁸ Source: currency trader, London

⁹ Source: investment banker, Johannesburg

¹⁰ Source: financial journalist, Johannesburg

Zuma's SONA speech raises questions about state of the nation's governance

The ruling **African National Congress (ANC)**'s mishandling of the minority opposition **Economic Freedom Fighters (EFF)**'s planned disruption of President Zuma's 2015 state of the nation address (SONA) sparked widespread discussions about South Africa's political governance. In breach of parliamentary rules, armed police in non-regulation white shirts forcibly removed from parliament all EFF members. The main opposition **Democratic Alliance (DA)** then walked out in protest at the presence of armed police. This followed protests from journalists over the ANC security cluster's attempt to jam phone signals.

Zuma delivered his SONA speech to parliament on 12 February 2015. However, it was the actions of the opposition, rather than the content of the speech, that dominated the press coverage and debate. Prior to Zuma beginning his speech, EFF secretary general **Godrich Gardee** rose on a point of order and asked the speaker, **Baleka Mbete**, to ask the president when he was going to "*Pay Back The Money*" – the EFF's insistence that Zuma repay the nation for the money spent upgrading his **Nkandla (KwaZulu Natal province)** home. There followed orderly but repeated points of order from EFF members of parliament. Mbete asked them first to quiet down, and then asked for them to be removed from parliament. Members of the **South African Police Service (SAPS)** public order police dressed in plain clothes forcibly removed the EFF MPs. The DA then staged a walkout in protest, leaving only ANC MPs and other minority parties to listen to Zuma's speech. During this period of time the official video footage of the speech was turned off.¹¹

Journalists in the viewing gallery noticed prior to the session starting that the government had blocked their phone signal. They vocally complained until state security minister **David Mahlobo** left the chamber and restored the signal. Mahlobo has since conceded this was an "*operational error*" that was part of government's counter-terrorism strategy, and has blamed an intelligence official on duty that night.¹²

Zuma's speech contained a number of policy promises. The president:

- spoke at length about electricity and promised that the government would fund Eskom's budget shortfall, pledging to build an unspecified number of nuclear power stations to solve the power crisis;
- announced new land reform laws, limiting land ownership to 12,000 hectares per person and preventing foreign nationals from owning land. Zuma has since clarified that this would not apply to owning property, or non-agricultural purchases of businesses' land;
- promised that companies who won state tenders would have to purchase 30% of all goods and services from South African small and medium enterprises (SMEs);
- unveiled government plans to centralise applications for water and mining rights, which would also function as a 'one-stop-shop' for investor complaints.¹³

However, the response to the speech has focused on the EFF's expulsion, calling police into the chamber, and ANC MPs' response to the eviction: cheering and clapping as they celebrated their 'victory'. One media outlet captured Zuma laughing as EFF party leader **Julius Malema** was forcibly ejected. The media, business community, non-ANC politicians and South African public expressed disappointment on social media with the state of the nation. Former president **Thabo Mbeki** (1999-2007) was quoted in the media as disapproving of Zuma's actions during the debate, but later insisted he was quoted out of context.¹⁴

¹¹ Business Day, 12 Feb 2015

¹² Mail and Guardian, 18 Feb 2015

¹³ Daily Maverick, 12 Feb 2015

¹⁴ Business Day, 15 Feb 2015

*"It is a sad day for South Africa when the president announces that the state has to bail out its power supplier and the media coverage focuses on how he had the opposition beaten up."*¹⁵

*"The EFF got what they wanted – to be the media highlight of the night.... the DA appeared the serious opposition....and Zuma got to give his speech without interruption and carry on as normal....only South Africa loses."*¹⁶

Disruptive interactions between the ANC and the EFF continued at the debate on the SONA speech on 18 February. It went a small way towards mitigating the reputational damage to parliament: Zuma and Malema had a rapprochement of sorts, with Malema raising points relevant to policy and Zuma thanking him for participating in the SONA debate. However, ANC, EFF and DA MPs soon fell into a familiar pattern of personal attacks.¹⁷

*"Zuma's presidency has created a culture where the only way to critique government policy is to disrupt parliamentary process...this fundamentally undermines."*¹⁸

South African mining companies take measures to mitigate poor operating conditions

South African mining companies are taking action to ensure profitability as the commodities market continues to be unpredictable. Mining companies are taking steps to reduce expenditure and increase liquidity in order to weather low prices and an uncertain operating environment in South Africa.

Gold miners have been badly hit. The price of gold has regularly dropped below \$40,000/kg since October 2014, despite recovering to \$44,000/kg in March 2014. The price has not shown any signs of increasing to its 2011/2012 prices of over \$50,000/kg and was, at time of writing, \$39.043/kg.¹⁹

Johannesburg Stock Exchange (JSE)-listed **Anglogold Ashanti** is planning to sell off assets and claim early redemption of its \$1.25 billion bond due in 2020.²⁰ The company is trying to cut \$1 billion of its debt. It is also reducing its workforce through offering voluntary redundancy packages. The company cited the falling price of gold and rising costs globally as the reasons for the repositioning.²¹

South African **Sibanye Gold** announced that its profits in the second half of the 2014/2015 financial year had increased by 14% due to increased production.²² However it posted an overall decline in profits year-on-year, with \$132m profits in 2014 compared to \$145m in 2013. Sibanye said that the major contributing factors to the decline in profits were a fire at its **Dramfontein** mine and electricity cuts that contributed to 16,000 fewer ounces being mined in 2014 than the previous year. The company now plans to spend \$257m on a 150MW solar plant and is considering building 500-600MW coal power plants in an effort to make itself entirely independent of Eskom. CEO **Neal Froneman** said that electricity costs now make up 20% of the company's expenditure.²³

*"Sibanye's plan to move away from state power is a good indication of how the private sector will address poor infrastructure provision in the future – they will do it themselves."*²⁴

Declining commodities prices and high operating costs have also hit more diversified mining houses. **United Kingdom (UK)**-headquartered **Anglo American** is attempting to sell \$3.9 billion of assets after profits for 2014 fell 17%.²⁵ The company is in negotiations with the South African government to

¹⁵ Source: businessman with ANC connections, Johannesburg

¹⁶ Source: senior financial journalist, Johannesburg

¹⁷ City Press, 18 Feb 2015

¹⁸ Source: political journalist, Johannesburg

¹⁹ Goldprice.org

²⁰ Ventures Africa, 24 Feb 2015

²¹ Bloomberg, 23 Feb 2015

²² Business Day, 18 Feb 2015

²³ Business Day 19 Feb 2015

²⁴ Source: financial journalist, Johannesburg

²⁵ Bloomberg, 16 Feb 2015

sell its stakes in three coal mines (**Kriel**, **New Denmark** and **New Vaal**) in order to cut its exposure to underperforming assets in the company. The mines produced 31m tonnes of coal in 2014, much of which supplies Eskom's power plants. The South African government is requiring Anglo American to sell to black-owned South African businesses and work to ensure that Eskom receives good value for money on coal.

Anglo-American subsidiary **Anglo-American Platinum** is also looking to divest its **Rustenburg** and **Union** platinum mines by mid-2015 following the five month platinum strike in 2014.²⁶ The strike hit platinum miners hard. South African **Impala Platinum** announced the sale of its **Marula** platinum mine in Rustenburg. The company saw its headline earnings drop by 53.5% year on year due to the five month platinum strike in early 2014, and safety stoppages in the second half of 2014. The sale is part of a strategic review the company has undertaken to reduce its capital expenditure and bring it back into profit.²⁷ The company will invest \$2.5 billion in operations in the next five years, but will cut spending by \$180-\$380m over the next two years. It will also reposition and modernise the rest of its platinum mining operations in South Africa.²⁸

*"There is some interesting potential for new players to enter the mining industry with all of these assets up for sale, however without an improvement in operating conditions operating any mine profitably will be a challenge."*²⁹

Power crisis update: bail-out and co-generation

Power generation has been the focus of government policy as South Africa's power crisis continues. The government will go ahead with a R23 billion (\$1.9 billion) bail-out of Eskom, in order to fund Eskom's upgrade programme to improve its generation capacity, and to complete the construction of the **Medupi** and **Kusile** power plants. The injection was originally supposed to be funded through the sale of non-essential assets, however it will go ahead before any such sales have gone through. Nene has announced the government will sell its 13.9% stake in telecoms company **Vodacom** for approximately \$2.9 billion, part of which will go towards covering the Eskom injection.³⁰

The government has given Eskom permission to raise its electricity tariffs to bring in more money. Tariffs in 2014/2015 have risen by 5% already, but having "cost reflective" tariffs gives Eskom leeway to raise them further.³¹

Former finance minister **Trevor Manuel** criticised the bailout and accused the state-owned enterprise of being a "burden on government coffers" due to mismanagement. Observers from the business community have also doubted whether the bailout will improve profitability:

*"Giving Eskom R23 billion is throwing money out of the window."*³²

The government is also considering bringing in independent power producers (IPPs) to co-generate power with Eskom. However, they have not released details of how co-generation would work. Sources in the power sector are sceptical about the ease and profitability of such a scheme:

*"Working in a joint-venture with any government is a risk, but working with Eskom....which has a poor track record....would be a major concern."*³³

²⁶ FT, 11 Feb 2015

²⁷ Business Day, 23 Feb 2015

²⁸ Financial Times, 24 Feb 2015

²⁹ Source: commodities analyst for a major bank, Johannesburg

³⁰ Bloomberg, 2 Feb 2015

³¹ Business Day, 26 Feb 2015

³² Source: businessman with ANC connections, Johannesburg

³³ Source: international power company, London

Implications

Nene's budget shows that he is a sensible steward of South Africa's economy, but not one with the ability to turn it around. In an economic downturn raising taxes to increase expenditure and revising down growth forecasts and deficit reductions targets is sensible. However, it is not possible to turn South Africa's economy around without first addressing the power crisis and curbing inefficiency and overspending SOEs. It may be that Nene lacks the political pull to be able to do this or it may be that he believes that the SOEs are unable to survive budget cuts. Whatever the reason, without tackling major drains on government expenditure that underlie the economic problems, raising revenue can only do so much.

Zuma's SONA speech epitomises his time in office – the opposition makes lots of noise while he is able to sit apart and act without reasonable checks and balances. The entire parliament has been drawn into this system – the EFF are a product of it; the DA, in trying to be aloof from it, are also participating, and the media add fuel to the fire. The EFF's use of parliamentary procedure has had the ironic effect of strengthening institutions. However, Zuma has succeeded in removing the ability of the elected legislature to appear to be doing their jobs. This allows him to portray any opposition to his government's decision making as part of an ineffective institution. The ANC have closed ranks once more to defend Zuma, but this does not mean that the party stands united behind him. The opposition is gaining in momentum to challenge traditional "liberation" parties, but the real threats to Zuma are within the ANC. However, the damage done to the credibility of South Africa's hard-won democratic institutions may last longer than he does.

South Africa's mineral wealth is a key sector for improving its economic performance. The poor conditions for mining have contributed to the country's economic slowdown. The fact that mining companies are divesting assets in the country will have a broad impact on the economy. The industry is not abandoning South Africa, but is less willing to work with the state due to the hostile operating conditions. The sale of assets allows other companies the opportunity to enter into a space dominated by a handful of key players. However, until South Africa's infrastructure improves and the commodities market picks up it will be difficult to make mines profitable.

The budget, SONA speech, and mining announcements have all referenced South Africa's ongoing power crisis. It is causing an incalculable amount of damage to South Africa's economy and is still months, if not more, from a solution. The government has no choice but to throw money at Eskom because the need for power trumps the need for an efficient power producer. However, if the country is to build long-term sustainable power generation then the government needs to come up with a coherent energy plan. Once a plan is in place and underway, the operating environment will become more attractive for IPPs who can be part of a permanent solution.