



CORPORATE CREDIT INSIGHT | SOUTH AFRICA MOODY'S POST-BUDGET CREDIT IMPLICATIONS

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EXECUTIVE SUMMARY

SA Budget – Implications of Moody's rating

- As we had expected, Moody's response to the budget is that it was credit-negative for the country's **fiscal strength**, but the agency remains noncommittal about the rating outlook.
- We still see little scope for an affirmation of South Africa's "stable" credit outlook in the current economic circumstances.
- Our baseline assumption is a high likelihood of South Africa's **outlook being revised to "negative"** in March 2019. However, the **rating level could still be affirmed at "Baa3"**, at the bottom rung of investment grade.
- There is nothing preventing Moody's from downgrading South Africa to speculative grade from a "stable" outlook without first transitioning the outlook to "negative". This is the very essence of credit risk: rating transitions are often driven by unexpected events.
- In this report, we unpack what a credit outlook suggests about rating transition risk, as this concept has more technical connotations in the ratings world than its more colloquial use in other economic disciplines.
- We also consider the fact that an **outright downgrade is not clear-cut** in terms of Moody's rating scorecard. Moody's is not beholden to its model for credit rating decisions. The scorecard is indicative and informs the final opinion. This is why this next credit committee rating level outcome will be a difficult one to call.
 - The rating transition decision, in our opinion, is dependent on Moody's credit committee opining negatively on South Africa's complicated **domestic political climate**, which may constrain the government's ability to execute its budget promises and implement a credible and sustainable corporate turnaround at Eskom (mainly cost cutting). These are the **root causes of the fiscal slippage** we are now observing.
 - In other words, a change in Moody's opinion about South Africa's **"Susceptibility to Event Risk"** score could induce a downgrade, according to Moody's scorecard model. Therefore, it is not simply a case of assessing fiscal slippage alone, with reference to some pre-defined fiscal thresholds incorporated in Moody's sovereign methodology. According to our assessment of the model, the **current fiscal outcomes are not sufficient to induce an automatic credit downgrade** (all other factors remaining the same).
 - The big picture is that South Africa's credit story has changed from the last time Moody's credit committee sat and reviewed the country's credit position. Eskom is now the main story, overshadowing the country's credit standing.
 - While the Treasury has now provisioned R69bn in financial support to Eskom over the Medium-Term Expenditure Framework (MTEF), the financial support extends to 10 years, which is present-valued at R150bn. The need for further extraordinary support remains undiminished, in our view, considering the size and scale of the company's ongoing liquidity needs and the inflexibility of its cost structure. Moody's may take into account the government's willingness to support Eskom, but may doubt its **ability and capacity to support Eskom** sufficiently.

MOODY'S CREDIT STORY – OVERVIEW

We expect an affirmation of the rating at ‘Baa3’, with a revision of the outlook to ‘negative’



Date	Rating Action	Rationale
03 April 2017	Baa2/Watch Neg	<ul style="list-style-type: none">Policy uncertainty due to changes in leadership could undermine the sovereign's economic and fiscal strength
09 June 2017	Baa3/Negative	<ul style="list-style-type: none">A weakening of the institutional frameworkPolicy uncertainty and slow progress on structural reformsRising public debt and contingent liabilities
24 November 2017	Baa3/Watch Neg	<ul style="list-style-type: none">Widening budget deficitLack of progress on structural reforms and policy implementationWeakening institutions
23 March 2018	Baa3/Stable	<ul style="list-style-type: none">Slow growth and lack of debt stabilisationLack of concrete structural reformsSOC financial support
29 March 2019	Baa3/Negative (Nedbank CIB Estimate)	<ul style="list-style-type: none">Rising debt levels and slow growthLack of implementation of structural reformsSignificant execution risk in the budget and at Eskom may have outsized fiscal outcomes – more than what is currently provisioned

Source: Moody's, Nedbank CIB

UNDERSTANDING CREDIT OUTLOOKS

An indication of credit trajectory rather than proximity to an upgrade/downgrade

- There are four long-term rating assignments: (1) positive, (2) stable, (3) negative and (4) developing.
- A rating outlook is accompanied by a **bi-directional outlook statement**. This states the scenarios of what could move the rating. For instance, a stable outlook would have an upgrade and downgrade scenario statement, while a negative outlook would have a downgrade scenario and a scenario of what would revert the outlook to stable – it is incorrect to talk of upgrade scenarios with a negative outlook.
- The **outlook is time-bound**: about an 18- to 24-month horizon for investment-grade issuers and 12-18 months for speculative-grade issuers. Hence, outlooks are assigned to long-term ratings.
- The **rating level itself represents the baseline expectations of the credit** on a forward-looking basis (a year or two). The outlook speaks to a high-impact, low-probability alternative scenario where the baseline expectations are not met. It does not speak to the eventuality of that alternative scenario obtaining and therefore inducing a rating transition over the outlook horizon. Therefore, it represents a low probability (typically a one-in-three chance) of credit conditions that could be beyond the baseline expectations and in the direction of a lower or higher rating category, but not a deterministic eventuality of the rating actually shifting.
- As such, a **“stable” outlook implies a lack of conviction about a credit trajectory** in any one direction and, therefore, a low likelihood of a rating change. Usually, this can happen if the drivers of risk balance each other out or are not meaningful enough to shift credit metrics away from the baseline expectations. A **“negative” outlook would imply a marginally higher likelihood of credit deterioration** away from the baseline assumptions (with only a 33% conviction), which could lead to a downgrade if the deterioration is high-impact and accelerates way beyond the baseline.
- In light of this, we have for a while now questioned the rationale for and timing of Moody’s “stable” rating outlook on South Africa, especially if there was a conviction that political risk and fiscal outcomes could be materially worse than the baseline assumptions. Since South Africa entered the “Baa3” rating category in June 2017, it was assigned a “negative” outlook. It was only after the ANC elective conference that a “stable” outlook was assigned, but credit conditions and the credit trajectory remained fundamentally unchanged, with still a fairly good chance of further slippage.
- Credit metrics have been consistently revised in a negative direction, and materially so, and the **chance of slippage beyond expectations remains elevated**. This would be consistent with a “negative” outlook, in our opinion. The **proximity to a lower rating category is a sufficient but not necessary condition to assign a negative outlook**.

RATING TRANSITIONS IN CONTEXT

If Moody's is consistent with its credit story, political risk has been at the heart of rating transitions over the past 18-24 months and could continue to be

Sensitivity Analysis of the Rating Pillars

- **Economic Strength:** The key drivers are the long-term real GDP growth rate and per capita wealth levels in USD terms. Currently, GDP growth is anaemic, but the long-term trend takes into account historically higher growth rates and recovery assumptions for the future. The 10-year average real GDP growth rate (t-4; t+5) is taken between FY2012 (when real growth was 2.1%) and FY2021 (when growth is estimated to peak at 2.1% from the current low of 0.7% estimated for FY2018). **The National Treasury would be pressured to estimate growth rates above 2% in outer years (which is not credible without structural reforms), to avoid slippage in the long-term real GDP growth trend.** The GDP growth rate in the trailing years from FY2015 to FY2018 is 0.8%. This would imply a structural breakdown in the growth trend within Moody's outlook horizon, but may not be severe enough to shift the rating level to speculative grade on its own.
- **Institutional Strength:** This depends on the World Bank's Governance Indicators dataset, which is backward-looking. Moody's can adjust these index scores to capture the current and forward-looking reality, but we do not see a meaningful revision in this rating factor currently. On 9 June 2017, Moody's downgraded South Africa from "Baa2" to "Baa3" by revising its "Institutional Strength" score to "Moderate(+)" from "High(-)", taking into account the political ramifications of former President Zuma's cabinet reshuffles on the sustainability of economic growth expectations and the stabilisation of the country's debt-to-GDP ratio (50-55% at the time). Currently, fiscal and growth concerns remain, but much of the **risk around institutional strength is baked in already – particularly the lack of "political will" to embark on structural reforms** or the independence of the National Treasury and the Reserve Bank. However, political risk around state capture and low-income-related social unrest are captured elsewhere – in the "Susceptibility to Event Risk" pillar.
- **Susceptibility to Event Risk:** For the six months from 9 June 2017 to 24 November 2017, Moody's maintained a negative outlook on the sovereign; thereafter, it changed its outlook to CreditWatch Negative in the run-up to the ANC's 54th Elective Conference. The negative outlook was premised on rising domestic political risks – reflecting protracted political infighting in the ruling ANC, which was generating policy uncertainty and structural reform inertia and inhibiting investor confidence. Consequently, the "Susceptibility to Event Risk" score was rated "Moderate(-)". When President Ramaphosa emerged victorious at the Elective Conference, the "Political Risk" score was revised and the "Susceptibility to Event Risk" pillar rated "Low (+)" from "Moderate(-)" on the back of an improvement in the political landscape, which was expected to slow the erosion in institutional strength and policy uncertainty and revive the impetus for structural reform. In our view, these expectations have not materialised. **Political divisions in the ruling party persist in the run-up to the 2019 general elections as does policy uncertainty, and reform implementation is slow.** There is political will on the government's part, but the party is unwilling to act in unison. This time, the impact is not so much on "Institutional Strength" – which is slowly improving with some key appointments at the National Prosecuting Authority, SARS and the boards of state-owned companies – although some matters persist, especially around the independence of the Reserve Bank. This time, the impact of political risk is manifesting itself in the "Fiscal Strength" pillar. In our view, **the fiscal slippage we are now witnessing is driven by political risks that encumber the government's ability to intervene effectively and timeously at Eskom and balance the fiscus.** Therefore, we wonder whether Moody's has the appetite to revise the "Susceptibility to Event Risk" score back to "Moderate(-)" or to at least attribute a "negative" outlook to it and its effect on fiscal uncertainty, rather than waiting until after the elections. We believe the political landscape and policy environment are structurally more complex and uncertain over the longer term and alliances in the ruling party would take a while to rehabilitate and are not poised to shift dramatically after the elections.
- **Fiscal Strength:** South Africa's "Fiscal Strength" has been assessed as "Moderate(+)" since 1Q16, when the debt-to-GDP ratio was around 45-50% and was expected to peak at 51% by the end of 2017/18. Over this period, the ratio deteriorated by almost 600bps and is expected to peak at 60.2% by 2023/24. Still, its fiscal strength is scored "Moderate(+)". In fact, we believe that **the "Fiscal Strength" score is fairly insensitive in the model and that debt to GDP could reach nearly 80% ("Low"), before the scorecard grid indicates a change in the final credit rating** (all other factors remaining equal). We think that above 60%, the debt overhang would start to become unmanageable and would justify a deviation from the scorecard in order for the ratings to reflect the current and future reality. If this were not the case, Moody's would not be concerned about fiscal flexibility. The current score of "Moderate(+)" reflects the rise in government debt levels and contingent liabilities, and a deterioration in debt affordability. On the other hand, the sovereign's fiscal strength benefits from a favourable debt structure, where debt is denominated primarily in local currency (suggestive of a deep and liquid domestic capital market) and the average maturity profile is 13.5 years for local-currency debt.

Moody's indicative rating-grid scenarios: Susceptibility to event risk is more likely to induce a rating downgrade



**Scenario 1 rating
score grid**

Our conclusion is that the path to a downgrade is not clear-cut. The emphasis on fiscal slippage and reduced fiscal flexibility is not consistent with the mechanics and sensitivity of the scorecard model in Scenario 1. However, the scorecard model is not the final arbiter of the rating opinion. In our view, **the proximate risk to a downgrade is in Scenario 2**, where political dysfunction is identified as the root cause of persistently poor fiscal and economic outcomes.

SCORECARD PREVIEW

Final Factor Score	
Economic Strength	M+
Institutional Strength	M+
Economic Resilience	M+
Fiscal Strength	M-
Government Financial Strength	M+
Susceptibility to Event Risk	L+
Rating	Baa1-Baa3 range* Baa3 (Unchanged)

*Moody's has applied one notch of flexibility based on deliberations by the committee rather than a mechanical mapping of the scorecard indicative grid

Economic Strength								
Sub-Factor	Sub-Factor Indicator	Indicator	Ranking Category	Indicator Score (Mid-Point**)	Indicator Weighting	Indicator Weighted Outcome	Sub-Factor Weighting	Sub-Factor Weighted Outcome
Growth Dynamics	10yr Average Real GDP Growth	1.49%	L	37.5	50%	18.75	50%	26.88
	Volatility in Real GDP Growth	1.5	VH	82.5	25%	20.63		
	WEF Global Competitiveness Index	4.3	M+	57.5	25%	14.38		
					Sum of Indicators	53.75		
Scale of Economy	Nominal GDP	401.28	VH-	77.5	25%	19.38	25%	19.38
National Income	GDP per Capita	13 775	M	52.5	25%	13.13	25%	13.13
							Score:	59.38
							Final Alpha Score:	M+

Institutional Strength								
Sub-Factor	Sub-Factor Indicator	Indicator	Ranking Category	Indicator Score (Mid-Point**)	Indicator Weighting	Indicator Weighted Outcome	Sub-Factor Weighting	Sub-Factor Weighted Outcome
Institutional Framework and Effectiveness	World Government Effectiveness Index	0.28	H-	62.5	50%	31.25	75%	47.81
	Worldwide Rule of Law Index	-0.01	M+	57.5	25%	14.38		
	Worldwide Control of Corruption Index	-0.01	H-	72.5	25%	18.13		
					Sum of Indicators	63.75		
Policy Credibility and effectiveness	Inflation Level	5.42	H-	62.5	50%	31.25	25%	16.88
	Inflation Volatility	1.9	H+	72.5	50%	36.25		
					Sum of Indicators	67.5		
							Score	64.69
							Indicative Alpha Score Final Alpha Score	H- M+

**The criterion uses mid-point scores, but the Moody's committee would deliberate on whether a credit factor is further away from or closer to the mid-point. For analytical simplicity, we have not presented our opinion on these.

Source: Moody's, National Treasury, Nedbank CIB

SCORECARD PREVIEW

Fiscal Strength

Sub-Factor	Sub-Factor Indicator	Indicator	Ranking Category	Indicator Score (Mid-Point**)	Indicator Weighting	Sub-Factor Weighting	Sub-Factor Weighted Outcome	Sub-Factor Weighted Outcome
Debt Burden	Total Debt/GDP	56.2%	M+	57.5	50%	28.75	50%	30
	Total Debt/Revenue	216.8%	H-	62.5	50%	31.25		
					Sum of Indicators	60		
Debt Affordability	Interest Payments/Revenue	14.4%	L+	42.5	50%	21.25	50%	21.25
	Interest Payments/GDP	3.7%	L+	42.5	50%	21.25		
					Sum of Indicators	42.5		
							Score:	49.25
							Final Alpha Score:	M-
Adjustment Factors	Debt Trend (6-year average)	3.6%			0-3		0-6 max	
	Foreign Currency Debt/Total Debt	10%			0-6			
	Contingent Liabilities/GDP	17%		-2	0-3			

Susceptibility to Event Risk

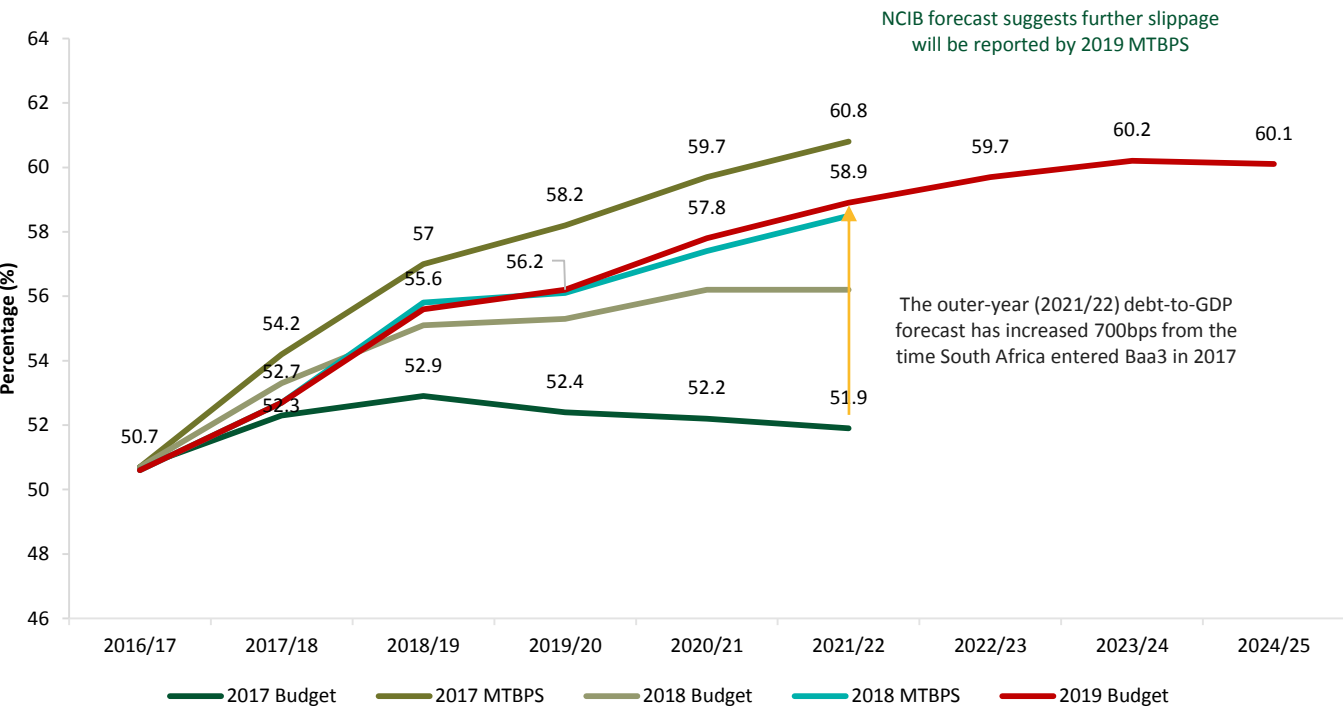
Sub-Factor	Sub-Factor Indicator	Sub-Factor Indicator Component	Indicator	Ranking Category	Indicator Score (Mid-Point**)	Indicator Weighting	Indicator Weighted Outcome	Sub-Factor Weighting
Political Risk	Domestic Political Risk	Worldwide Voice and Accountability Index	0.64	L+	42.5			
		GDP per Capita (percentile)						
	Geopolitical Risk	Geopolitical Risk						
Government Liquidity Risk	Fundamental Metrics	Gross Borrowing Requirements/GDP	6%	VL	22.5	50%	25	Max Function
		Non-Resident Share of General Government Debt (%)	38%	VL+	27.5			
	Market Funding Stress	Moody's Market Implied Rating	B1	H-	62.5	50%	31.25	
						Sum of Indicators	56.25	
Banking Sector Risk	Strength and Size of Banking System	Average Baseline Credit Assessment	baa3	L+	42.5	80%	34	
		Total Domestic Bank Assets/GDP (%)	112%	H	67.5			
	Funding Vulnerabilities	Banking System Loan-to-Deposit Ratio	93%	L+	42.5	20%	8.5	
						Sum of Indicators	42.5	
External Vulnerability Risk	(Current Account Balance + FDI Inflows)/GDP	(Current Account Balance + FDI Inflows)/GDP	-3.10	L	37.5	25%	9.375	
	External Vulnerability Indicator	External Vulnerability Indicator	83.9	L	37.5	50%	18.75	
	National International Investment Position	National International Investment Position/GDP	8.3	L	37.5	25%	9.375	
						Sum of Indicators	37.5	
							Final Alpha Score:	L+

**The criterion uses mid-point scores, but the Moody's committee would deliberate on whether a credit factor is further away from or closer to the mid-point. For analytical simplicity, we have not presented our opinion on these.

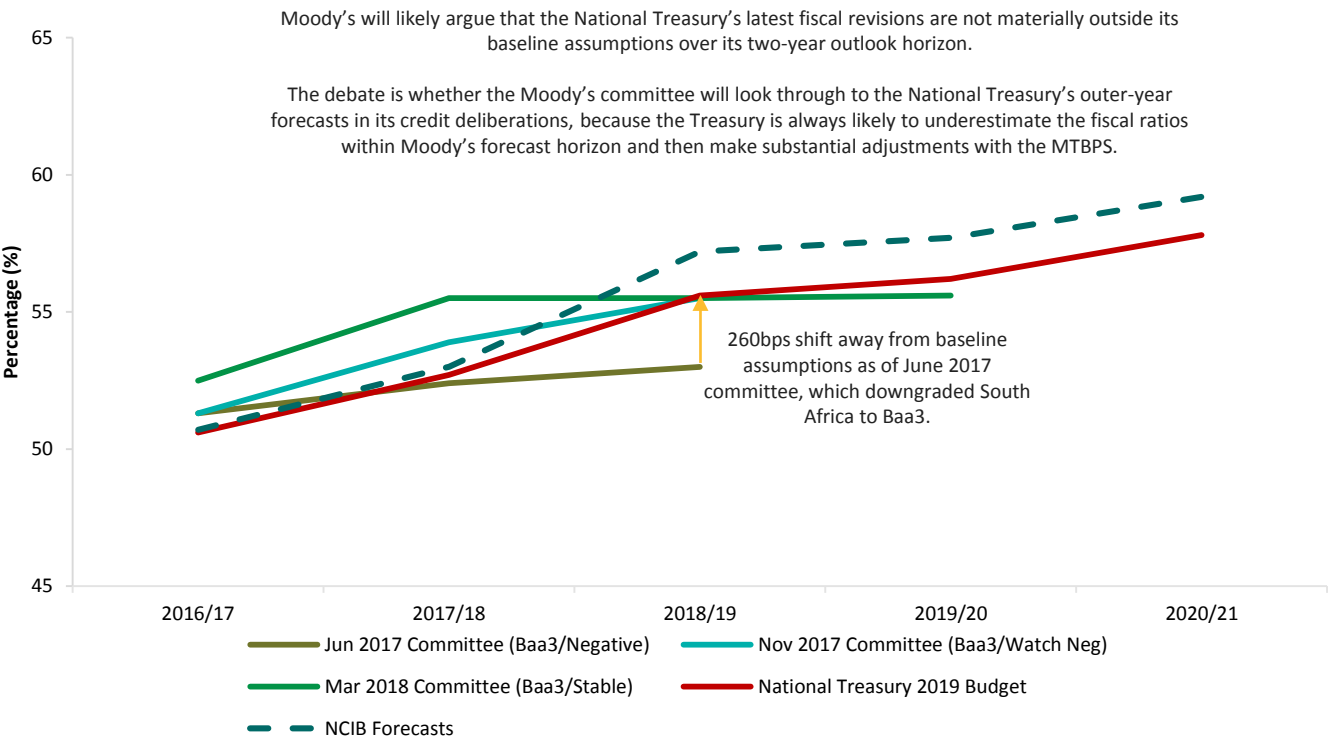
Source: Moody's, National Treasury, Nedbank CIB

EVOLUTION OF FISCAL STRENGTH

The National Treasury’s revised debt-to-GDP forecasts have deteriorated since South Africa entered the Baa3 rating category



Moody’s debt-to-GDP forecast evolution



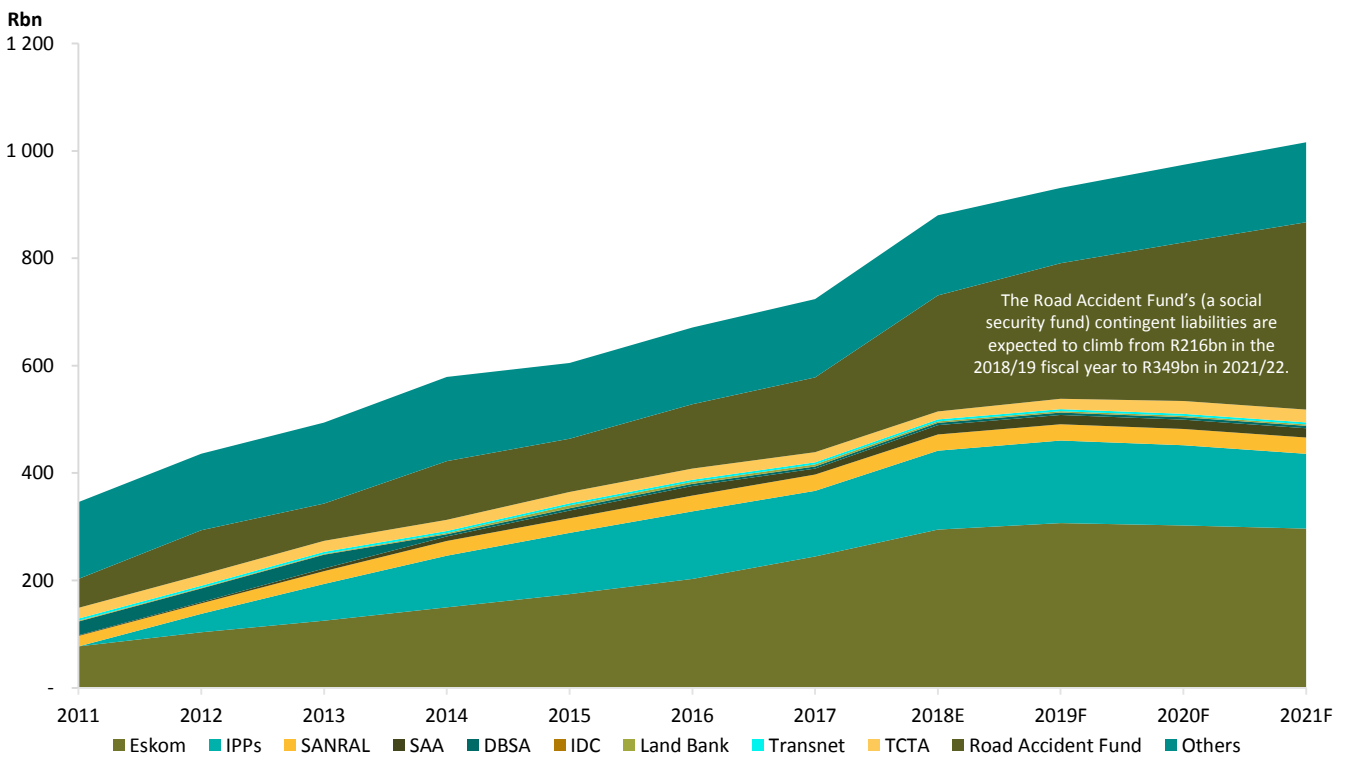
Source: Moody’s, National Treasury, Nedbank CIB

CONTINGENT LIABILITIES

Contingent liabilities are expected to continue to rise; SOC reforms have been governance-focused and have yet to impact financial health

- A rise in contingent liabilities signals a failing SOC sector. Reform efforts thus far have been focused on replacing errant boards and executives. It might be too early to expect financial and operational turnaround after years of mismanagement. Nevertheless, the risk of fiscalisation is at its highest point, and the capital markets are not entirely open to some SOC, despite the government's support by way of additional guarantees. The concern debt investors had was about governance; now, it has more to do with the financial viability of the business model.
- The rise in contingent liabilities is driven primarily by an increase in Road Accident Fund (RAF) liabilities and an increase in the TCTA's guarantee headroom. The RAF is operating a net deficit, increasing the likelihood of the government having to step in and fund claims if the social security fund is insufficient.
- We think Moody's understands that the government is willing to support Eskom and other distressed SOC but that it may doubt the government's capacity to support these institutions timeously and in full (without conditionality). It may also doubt the government's ability to execute swift and diligent turnaround plans, especially at Eskom, which has conflicting stakeholder interests due to intractable political divisions in the governing party and among its alliance partners.
- The R69bn (R23bn/pa over the MTEF) bailout received by Eskom has not reduced the risk of the government's contingent liabilities crystallising. The National Treasury has not completely ruled out further financial support beyond the MTEF period, citing that the size of support beyond the medium term would depend, among other factors, on the NERSA's tariff outcome and the implementation of the utility's turnaround strategy.
- Eskom's liquidity crisis persists (uses of cash still outweigh sources), and we think its ability to successfully fill the gap using debt capital markets is still uncertain. The proposed split of the company into three units has also done very little to improve investor confidence in the utility. More clarity on concrete steps is expected once the Chief Reorganisation Officer is appointed by the Ministers of Finance and Public Enterprises. Talk around an eventual debt migration will likely continue to worry investors, as this is extremely complex legally and is likely to be disorderly, if not a breach of promise. At the same time, concerns about structural subordination of senior creditors in the new capital structures would also need to be dealt with.

Chart 1: Total Government Contingent Liabilities by Public Entity



Source: National Treasury

CONTINGENT LIABILITIES

Chart 2: Total Government Debt and Contingent Liabilities to GDP

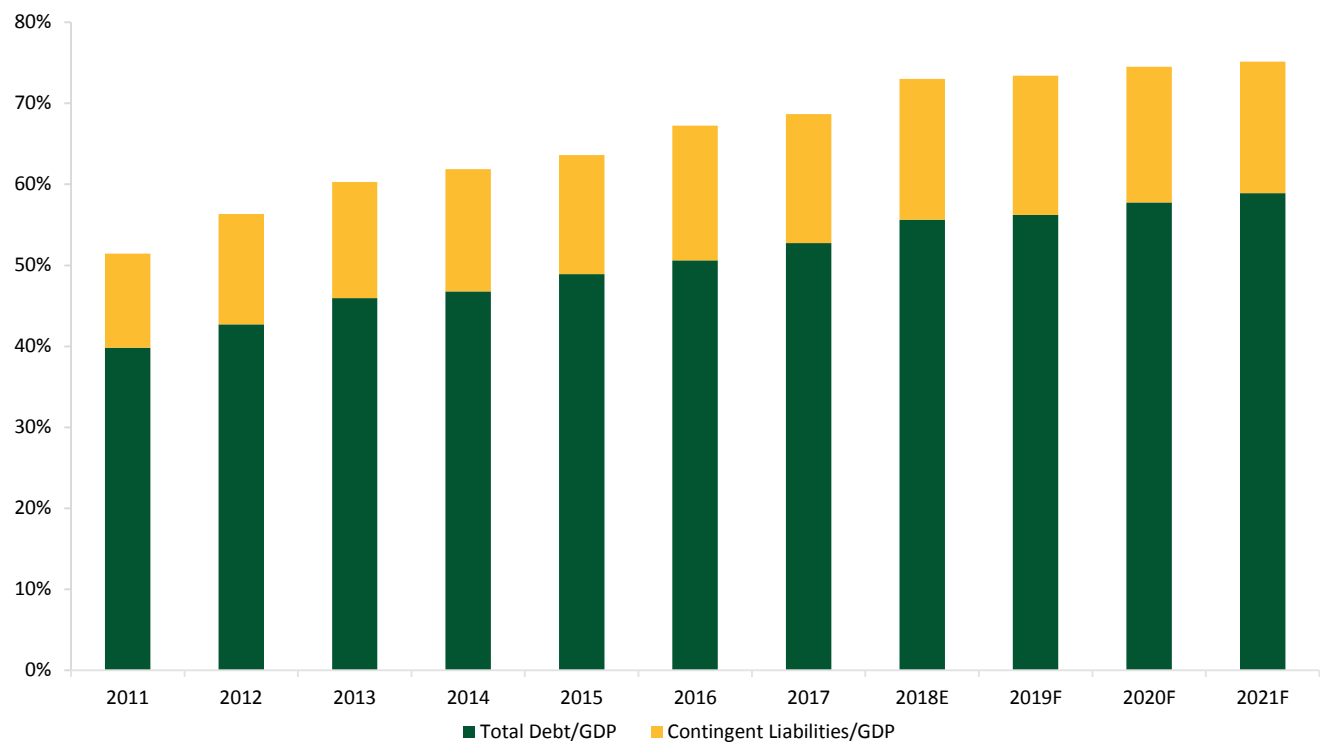
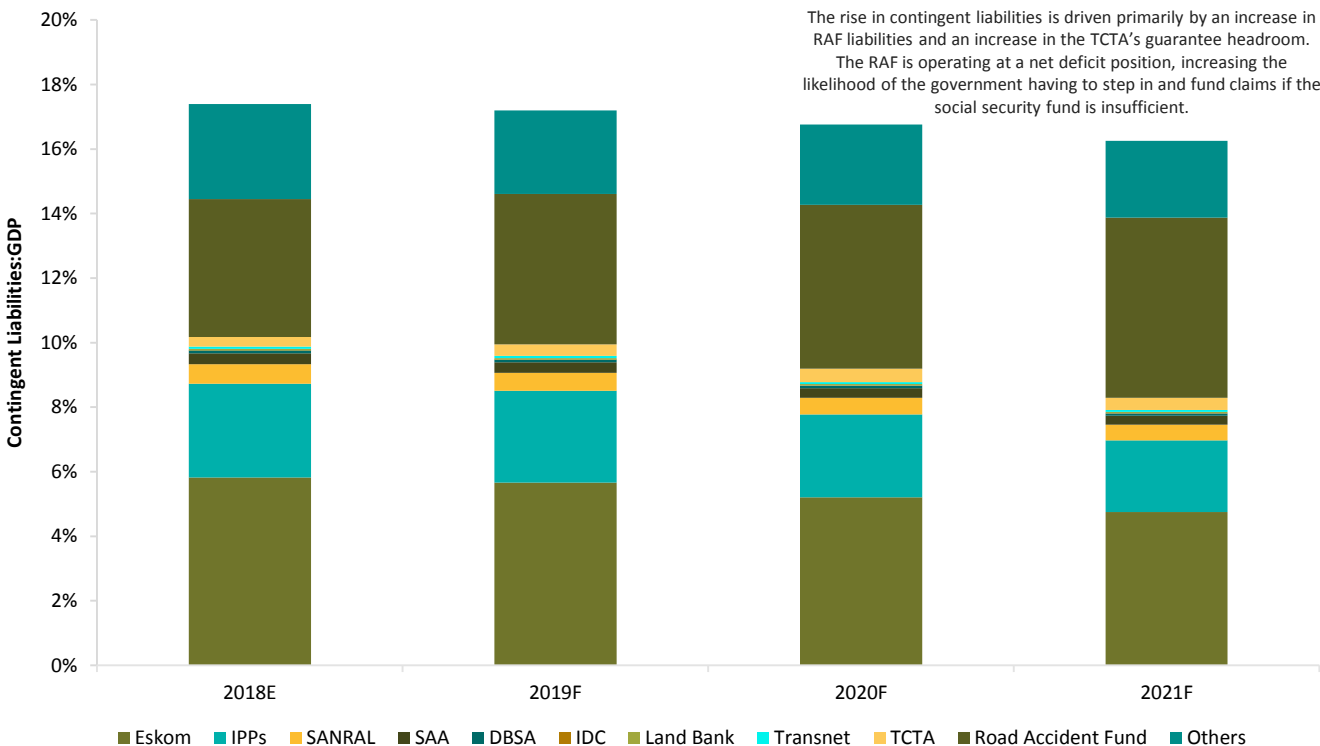


Chart 3: Contingent Liabilities by Public Entity to GDP



Source: National Treasury

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- Corporate Credit Insight: [Eskom](#), Published 24 January 2019
- Fixed Income Credit Insights: [Eskom Holdings Downgraded – A Story of Waning Implicit Support](#), Published 29 March 2018
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