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MARKET UPDATE

Eskom Holdings SOC Ltd

Going, Going, Gone?

Speculation is rife that Eskom may very well be insolvent and that the delay in releasing its latest interim results (as at 30 September 2017) is due to the Company's Board, Management and Auditors needing to sign-off on its interim financial statements (ie on a going- or on a gone-concern basis of accounting). In the meantime, the Johannesburg Stock Exchange (JSE) has indicated that it may suspend Eskom bonds from trading on its interest rate market if the interim results are not submitted by the end of the month.

At the end of 2017, the National Energy Regulator of South Africa (NERSA) approved a lower than anticipated tariff increase of 5.23% compared to the 19.9% applied for by Eskom. This added pressure on Eskom's already constrained cash generating capacity, and since then it has had to rely on alternative funding sources to stay afloat. What is often missed (and as Fitch points out) is that the lower tariff increase was partly due to delays in implementing outstanding Regulatory Clearing Account[1] (RCA) applications due to legal challenges against NERSA itself; in terms of its price determination methodology. Over the past few years Eskom has come to depend upon regulatory clawbacks to make up its tariff or revenue shortfalls – ultimately this is an unreliable method and makes forecasting the Company's financial viability difficult for the market. Certainly Eskom's Board, Executive and Auditors will be discussing this.

The rating agencies have already sounded the alarm about Eskom's severe liquidity constraints and their concerns around prompt and full emergency liquidity support from the Sovereign. Consequently, the rating uplift Eskom receives from its links to the Sovereign is tenuous. An overview of the various rating actions is detailed below:

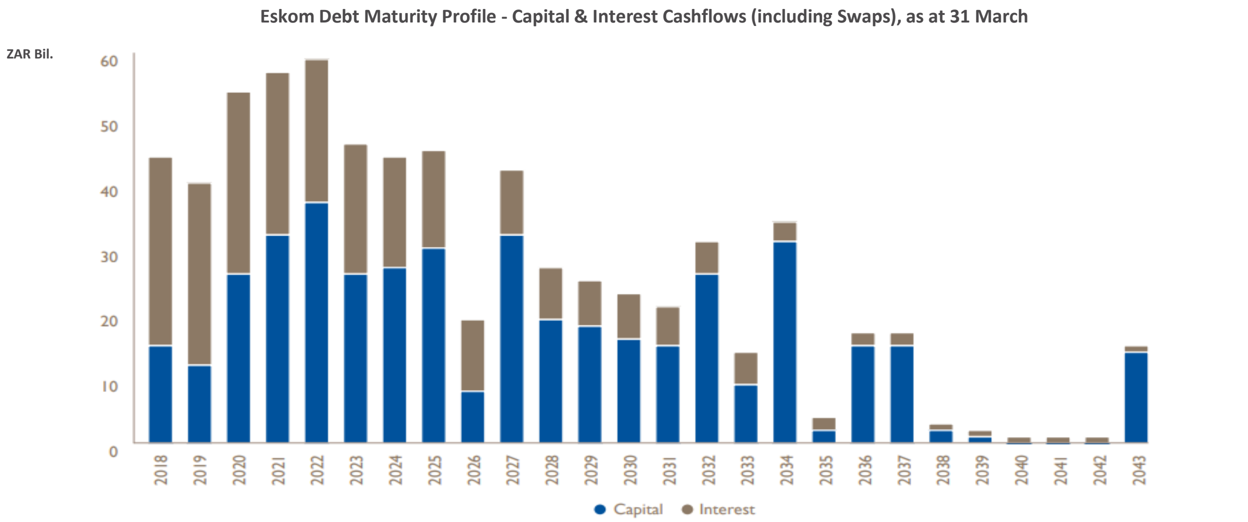
- **Fitch** placed Eskom's unguaranteed local currency and national scale issuer ratings on "Rating Watch Negative"; (BB+/Watch Neg) and (AAA(zaf)/Watch Neg/F1+(zaf) respectively. The Guaranteed Debt was affirmed. Fitch was specifically looking to re-assess Eskom's link to the Sovereign (ie the support framework which allows its issuer rating to be lifted above its stand-alone assessment). In the worst case scenario, this could result in Eskom's unguaranteed ratings tumbling five notches or more, towards its stand-alone rating of "B-".
- **Moody's** downgraded its Corporate Family Ratings on Eskom by one-notch to "Ba3" from "Ba2" on the global scale; it's global medium term note (GMTN) programme (unguaranteed) was lowered to "B1" from "Ba3"; and its national scale ratings went down to "A3.za" from "A2.za". Moody's noted that the entity's stand-alone creditworthiness had deteriorated (assessed at "caa1") due to liquidity constraints and corporate governance deficiencies. It further noted that the likelihood of timely government support may have reduced. The ratings are on "Ratings Watch Negative", the same as the Sovereign.
- **S&P** lowered its stand-alone assessment by two-notches to "ccc-" from "ccc+" and revised its local and foreign currency global scale ratings by two-notches to "B-" from "B+". The outlook is negative. Eskom's national scale ratings were downgraded four-notches to "zaBB" from "zaBBB" and the short-term ratings to "zaB" from "zaA-

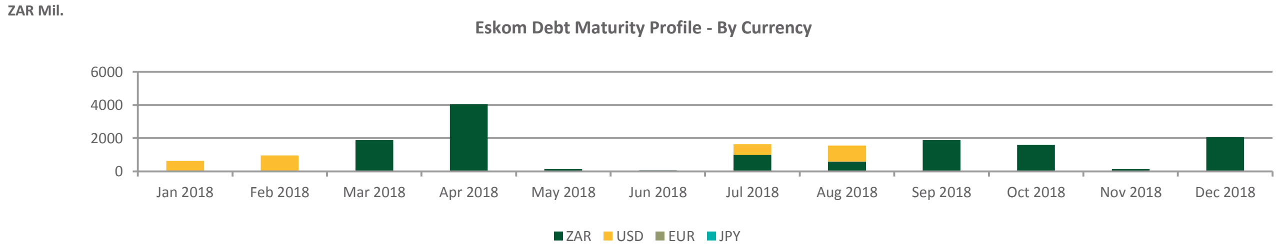
[1] The Regulatory Clearing Account (RCA) is a monitoring and tracking mechanism that compares certain uncontrollable costs and revenues assumed in the MYPD decision (made by the National Energy Regulator of South Africa (NERSA)) to actual costs and revenues incurred by Eskom. This is to allow for changes in the actual conditions for specifically identified cost items when compared to assumptions made when the MYPD application was considered.
Should there be a difference between the decision and actual costs and revenues; the difference is subject to RCA rules. The RCA rules applicable to a MYPD decision are informed by the approved regulatory framework applicable to the MYPD decision period.
This results in a RCA balance that should either be recovered by Eskom (if overspent) or be given back to the customers (if underspent). Once the RCA balance has been determined by NERSA, a separate process is followed to decide on the liquidation thereof, which would take place through implementation of adjustment in tariffs.

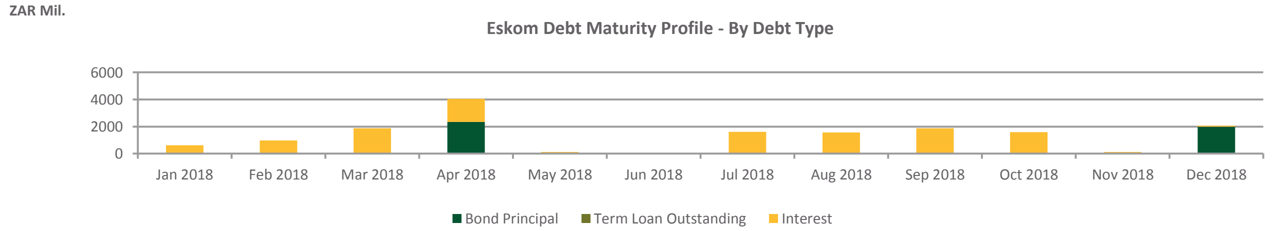
2”. S&P’s view is similar to its peers: that Eskom has lost the support of local banks and investors and that default was a real possibility over the six months to May 2018 (without direct Sovereign liquidity support).

According to Bloomberg, Eskom has approximately ZAR16.5bn in listed debt falling due in 2018 (74% of which is interest payments, and the rest principal). Its corporate plan puts the total debt (interest plus principal) closer to ZAR45bn in 2018. With severe cashflow constraints at Eskom, and a lack of access to traditional sources of funding, the concern is that 1H18 will be a particularly onerous time for Eskom with 45% of its listed debt repayment falling due by April 2018 (perhaps more, if bilateral debt is considered). If the entity is unable to implement its near-term funding plans; which primarily involves a Eurobond issuance mooted for early 2018 (a market it cannot access without publishing its interim results and demonstrating progress in resolving its latest audit findings), then we see very few options for Eskom in the short-term. One option might be a direct Sovereign injection or a DFI/ECA emergency funding (perhaps from the Far East). In July 2017, Eskom secured a US$1.5bn loan from China Development Bank. This was the second tranche of its US$5bn facility with the bank, which was secured in 2016. The first tranche was US$500m after signing.

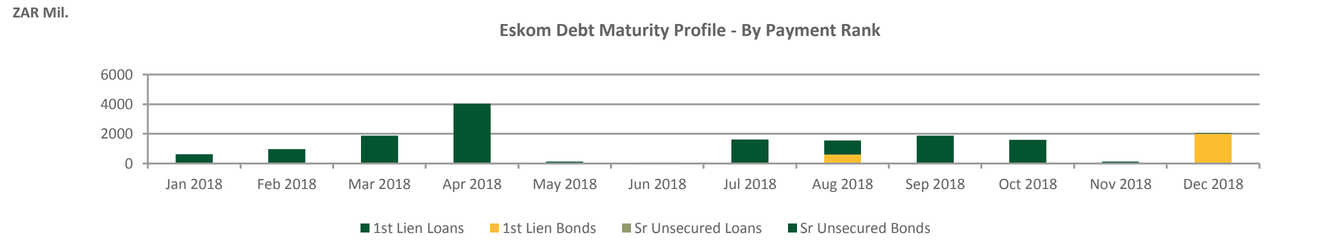
Chart 1: Monthly Debt Repayment Profile – 2018







We think that the domestic market is bracing for the worst (i.e. a default). What is important for local creditors is to pay attention to is the Sovereign guarantee terms and conditions (T&Cs) in the DMTN Programme, as well as the “Early



Source: Bloomberg, Eskom

Redemption" and "Events Of Default" conditions contained therein. From a credit point of view, it is near pointless to begin by analysing typical credit factors such as Eskom's future business prospects and financial/leverage profile. What is critical (and is consistent with how rating agencies approach near-defaulting cases in the "CCC", "CC" and "C" categories) is to look at the possible near-term sources of liquidity support, and how much time these could buy the entity (as well as the description of the likely path to default).

Default Scenarios

Generally, we think that Eskom has a number of things to consider (all at the same time) to avert a default. We discuss our thoughts on default and early redemption possibilities. Public information informs us that:

- Typically, bond indentures in South Africa state that Early Redemption, triggered by noteholders, could take place if (i) An issuer's bonds are delisted from the JSE and/or (ii) The issuer loses its credit rating and does not replace it within 30 days. However, in this case things could be different:
    - Eskom is no ordinary corporate issuer. In our reading of its bond DMTN programme, there is no mention of the above triggers. While the JSE has threatened suspension of the bonds if the interim financials are not submitted, this (in our opinion) is not the same as delisting the notes. Delisting would be the final step for the JSE. Nevertheless, even if they were delisted, we do not see how noteholders could have an explicit right to put the bonds back to Eskom as per the T&Cs in the bond programme, unless other clauses are triggered as a consequence.
    - Further to this, Eskom does not have any ratings-based triggers for Early Redemption or for the Event of Default.
- **Qualified Audit:** Disclaimers in the audit opinion do not trigger default or Early Redemption in the DMTN. However, we learnt in 2017 that DBSA did have a "clean audit" requirement in its covenant package with Eskom. We think that Eskom's Board and its Auditors will certainly be debating the progress made to address outstanding opinions on governance and controls. We think that this time around, the DBSA is likely to condone a breach of "clean audit" requirements if the actions by the new Board are seen as being "slow but sure" to effect reform. Of course the solvency state of Eskom could be another risk for lenders, including the DBSA (i.e. to call their funding lines).
- **Debt Standstill/Restructure:** While it might be feasible for Eskom to negotiate a payment holiday or a rescheduling of its bilateral bank lines, this probably would not go down well with bondholders. Clause 15.1.6 describes an Event of Default to include "*compromises or attempts to compromise with creditors generally or a significant class of creditors a meeting of creditors convened by Eskom of any of its cores subsidiaries to consider a proposal for an arrangement of compromise with its creditors*".
- **Insolvency**: Bankruptcy is noted as an Event of Default in the DMTN, and this is probably also the case forin all other funding lines; hence the concern over Eskom's going-concern status. This would certainly be the Sovereign's primary concern (as Shareholder and Guarantor), as it would necessarily require an outright bail-out.
- **Missed payment and failure to perform (without cure within the stated grace period):** We must remember that the DMTN is guaranteed by the Sovereign and it is important to note that the Sovereign (as Guarantor) is

entitled at any time (whether in anticipation of an event of default occurring or while an event of default is continuing) to pay any amounts due under the DMTN on behalf of Eskom. Noteholders would then be required to consider this a full and punctual payment by Eskom. What this means is that the Sovereign can intervene prior to a missed payment and notice of default by noteholders, and therefore Eskom would never really technically default.

- **Cross-default:** Eskom has no explicit cross-default clauses in the bond programme. This makes sense because the programme is guaranteed. However, it could be a different case for its bank facilities. Typically, Multilateral/DFI funding is guaranteed, but does not include cross-default (and these lenders are preferred creditors in a liquidation scenario). The benefit of not having cross-default clauses is that the Sovereign (as Guarantor) is able to cure each missed payment, without worry that the entire debt structure would collapse and require bail-out. This reduces the actual fiscal burden on the Sovereign.

  Some of the Event of Default clauses (particularly 15.1.3) refer to the material obligations of Eskom and its core subsidiaries (including guarantees assumed) and it is unclear whether a default on these actually imply cross-default or cross-acceleration of all other obligations issued under the DMTN.
- **Asset Sales, Full/Partial Privatisation:** Eskom could look to sell assets or pursue partial or full privatization. This would effectively inject new capital into Eskom. In our opinion this would be problematic in a couple of respects. First, any resultant organisational restructuring, demerger, consolidation, material encumbrance or material indebtedness could be construed as adverse to creditor rights and could be seen as an Event Of Default. Second, from a Sovereign support perspective, privatisation proves a lack of Sovereign support and Eskom would be completely de-linked from the Sovereign (in the same way as Telkom's rating strength is based on its stand-alone credit profile only). At this stage, the ratings would not really matter if privatization was the optimal way to recapitalize and stabilize Eskom and recover its stand-alone credit profile.

Our conclusion: We believe that Eskom is unlikely to default due to missed payment. We base this on the premise that Eskom still could secure sufficient cashflow to pay its upcoming debt obligations through alternative facilities; as was recently suggested by the Company Spokesperson in the media. Furthermore, we believe the Sovereign would be able to make punctual and full payments if needed. We think the Sovereign would in this instance activate its right under the guarantee to pay obligations in anticipation of an event of default, rather than waiting for notice of default.

We believe that the most likely way that Eskom could reach a default scenario is if it is declared insolvent, and we think that this would be the worst case scenario. Our opinion is that having its bonds delisted or suspended, because it has failed to submit its financials, is not the worst case scenario.

Appendix

Government support

It is useful for creditors to have a means to determine whether the quality of a guarantee provided to any issuer is robust and meets the standard for full versus partial credit substitution/enhancement (in other words, to look through to the Guarantor's creditworthiness). Applying S&P's Guarantee Criteria, we look at the checklist of conditions which need to be met for an issuer to qualify for full guarantee benefit.

Table 1: S&P Guidelines for assessing full vs partial credit substitution

Eskom R150bn DMTN programme is guaranteed by the Government of the Republic of South Africa; represented by the Minister of Public Enterprises in terms of Sect. 66(2) of the Public Finance Management Act, 1999 -- acting with the concurrence of the Minister of Finance in terms of sect. 70 of the PFMA (the "Guarantor")
→ **FULL CREDIT SUBSTITUTION**
See Guarantee Document for Eskom

1	Is the guarantee one of payment and not collection? (i.e. guarantor promises to pay the guaranteed obligation rather than covering any deficiency remaining after the beneficiary has exhausted all remedies against collateral and main obligors)	**YES –** Clauses 2 (Guarantee) & 3 (Demands)
2	The guarantor agrees to pay the guaranteed obligations on the date due (as applicable eg. After grace period) and waives demand, notice, marshalling of assets?	**YES –** Clauses 6.5 (Renunciation of Benefits) & 6.6 (Exercise of Rights)
3	The guarantor's right to terminate or amend the guarantee is appropriately restricted?	**YES** Cancellation/amendment requires Extraordinary Resolution of Noteholders; written consent of noteholders holding > 75% of nominal amount outstanding
4	The guarantee is unconditional, irrespective of value, genuineness, validity, or enforceability of the guarantee obligations. The guarantor waives all other circumstances or conditions (eg. Sovereign default or T&C restriction; suspected fraud or malfeasance) that would normally release a guarantor from its obligations. The guarantor also waives its rights of set-off, counterclaim etc?	**YES** - Clause 6 (Preservation of Rights)
5	The guarantee provides that it reinstates if any guaranteed payment made by the primary obligor is recaptured as a result of the primary obligor's bankruptcy or insolvency?	**YES** Clauses 6.3 (Guarantor's Obligations Not Discharged) & 6.4 (Reinstatement)
6	The holders of the rated notes or other obligations are beneficiaries of the guarantee?	**YES –** Clauses 1.6 & 8 (Benefit of Guarantee) & 6 (Recourse Against The Issuer)
7	How are potential risks around withholding tax dealt with in terms of cross-border payments to ensure payment in full?	**YES –** Clause 9 (Taxes & Withholdings)
8	Consider the guaranteed obligation's payment rank or subordination and does it rank pari passu with similar ranking obligations of the guarantor?	**YES –** Clause 6.9 (Pari Passu)
9	If the issuer has an unguaranteed rating -- then the issuer or note benefitting from the credit enhancement will be assigned a rating that is the higher of the guarantor's rating and the primary obligor's or note's unenhanced rating. If joint guarantors without proportional undertakings, then the rating of the higher-rated guarantor is used.	**YES –** Eskom has a stand-alone credit rating and its guaranteed notes would be rated higher than those without guarantee/credit enhancement.
10	In cases of several guarantees (i.e., where each guarantor only guarantees a proportional amount of the obligation), S&P typically rates to the lowest guarantor rating to rate the obligation--though not below that of the rating on the transaction if it were unenhanced by guarantees	N/A
11	If the primary obligor is not rated or have a stand-alone credit profile from S&P, then the obligation can still be rated using the guarantor's rating.	N/A

Source: Nedbank, Eskom, S&P

In our view, the Government guarantee provided to Eskom is robust. This is a very different kind of credit support assessment to that conducted by rating agencies specifically around the likelihood of extraordinary government support. The former is part of ongoing government support (budgeted in the contingent liabilities of the sovereign). The latter has to do with a qualitative assessment of how a crisis would induce the Sovereign to provide unbudgeted support, mainly because the supported entity plays too important a role in policy implementation on behalf of the sovereign and that it is inextricably linked to the sovereign's reputation, fiscal trajectory or simply via shareholding. This link is what is being put into doubt by the ratings agencies Fitch and S&P. We discuss the role and link framework of Eskom next using S&P's methodology.

The Role and Link of a Government-Related Entity – S&P Framework Approach

- S&P measures the Stand-Alone Credit Profile (SACP) of Eskom because the entity's rating transition risk could change the government's ability and willingness of supporting Eskom (either on an ongoing basis or in terms of timely extraordinary support).
- In our view, many unguaranteed lenders depend on the government support framework as the key credit mitigation against default. This speaks directly to government's commitment and ability to provide extraordinary liquidity support, in full and on time, in all or most circumstances of distress.
- S&P has some doubts about government's commitment and ability to provide timely extraordinary liquidity support to Eskom given the sheer size of support that could be needed to extinguish the near-term liquidity strain. In other words, Eskom support would likely transition the Sovereign's own creditworthiness.
- We do not think that government's commitment to support Eskom has diminished – rather, its ability to do so has, especially given its fiscal circumstances. The rating agencies can only forecast Eskom's cash position when liquidity sources are predictable or certain, hence their conservative stance. We still believe that the Sovereign would likely commit to more support once the NERSA Regulatory Clearing Account Assessment is concluded by NERSA, or should the Audit opinion of going-concern prompt them to inject capital into Eskom.

Chart 2: Role and Link Matrix For Assessing The Likelihood Of Extraordinary Government Support

Role-Link Matrix For Assessing The Likelihood Of Extraordinary Government Support

Likelihood of Extraordinary Government Support		Importance of the GRE's **Role** to the Government			
		CRITICAL	VERY IMPORTANT	IMPORTANT	LIMITED IMPORTANCE
Link between the GRE and the Government	INTEGRAL	Almost certain	Extremely high	High	Moderately high
	VERY STRONG	Extremely high	Very high	High	Moderately high
	STRONG	High	High	Moderately high	Moderate
	LIMITED	Moderately high	Moderately high	Moderate	Low

Determining A GRE's Issuer Credit Rating: Very High (VH) Likelihood Of Support

	--Government's local currency rating--															
SACP	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B+	B	B-
aaa	AAA															
aa+	AAA	AA+														
aa	AAA	AA+	AA													
aa-	AA+	AA+	AA	AA-												
a+	AA	AA	AA	AA-	A+											
a	AA	AA-	AA-	AA-	A+	A										
a-	AA	AA-	A+	A+	A	A	A-									
bbb+	AA-	AA-	A+	A	A	A-	A-	BBB+								
bbb	A+	A+	A+	A	A	A-	BBB+	BBB+	BBB							
bbb-	A	A	A	A	A-	A-	BBB+	BBB	BBB	BBB-						
bb+	A-	A-	A-	A-	A-	BBB+	BBB+	BBB	BBB-	BBB-	BB+					
bb	BBB+	BBB+	BBB+	BBB+	BBB+	BBB+	BBB	BBB	BBB-	BB+	BB	BB				
bb-	BBB+	BBB+	BBB	BBB	BBB	BBB	BBB	BBB-	BBB-	BB+	BB	BB-	BB-			
b+	BBB+	BBB	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	BB+	BB	BB-	BB-	B+	B+		
b	BBB	BBB-	BBB-	BBB-	BB+	BB+	BB+	BB+	BB+	BB	BB-	BB-	B+	B	B	
b-	BBB-	BBB-	BB+	BB+	BB	BB	BB	BB	BB	BB	BB-	B+	B	B-	B-	B-
ccc+	BB-	BB-	BB-	BB-	BB-	BB-	BB-	B+	B+	B+	B+	B+	B-	B-	B-	*
ccc	B+	B+	B+	B+	B+	B+	B+	B+	B+	B+	B+	B	B-	*	*	*
ccc-	B+	B+	B+	B+	B+	B+	B+	B+	B+	B+	B	B-	B-	*	*	*
cc	B+	B+	B+	B+	B+	B+	B+	B	B	B-	B-	*	*	*	*	*

*These combinations may suggest an issuer credit rating in the 'CCC' or weaker rating categories. As per paragraph 43, we only assign issuer credit ratings for GREs in these rating categories based on "Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings," published Oct. 1, 2012. SACP--Stand-alone credit profile.

<u>**Very important role:**</u> Eskom is government's main electricity provider, thereby meeting the state's key socio-economic objectives. Eskom is a profit-seeking enterprise and a default would lead to disruption of its activities and would have a significant systemic impact on the local economy. The capacity for private electricity production exists (especially in the renewables space) and NERSA's role in tariff determination limits Eskom's monopolistic pricing power somewhat; to levels that would (in principle) be reflective of competitive cost economics. This negates Eskom from having a "critical" role, as defined in the criteria.

<u>**Very strong link:** We believe Eskom's "link" to the Sovereign was re-assessed to "very strong" from "integral", resulting in the likelihood of extraordinary government support falling to "very high" from "extremely high". This has the effect of lowering the indicative rating by two notches to "B" from "BB-" (before applying any discretionary notches of adjustment.</u> The reason Eskom is no longer considered "Integral" (in our opinion) is the "doubt" S&P now incorporates around timeliness of extraordinary support in <u>all</u> circumstances.

Eskom is 100% owned by the government and there is an explicit legal framework through which the entity receives ongoing government support (eg Guarantee framework and contingent step-in rights by the Sovereign in case of distress to avert default and support senior unsecured, unguaranteed creditors). The government support track-record also underpins the view that timely support would be forthcoming in <u>most</u> circumstances. Government has a strong influence over the capex program (given the level of support) and privatization is not yet contemplated in the medium-term. A default at Eskom would significantly affect the Sovereign's reputation. Furthermore, the state acts strictly as shareholder and not manager (by ceding managerial control and monitoring to an independent board of directors and executive management).

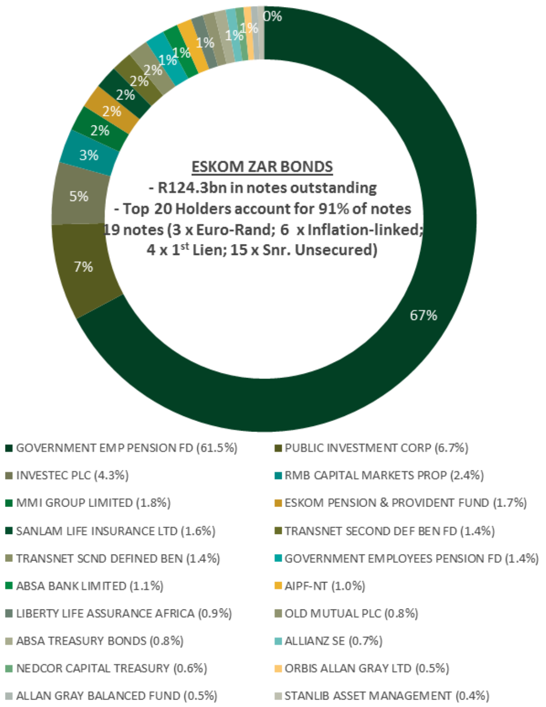
<u>**Extremely high → Very high likelihood of extraordinary government support:**</u>

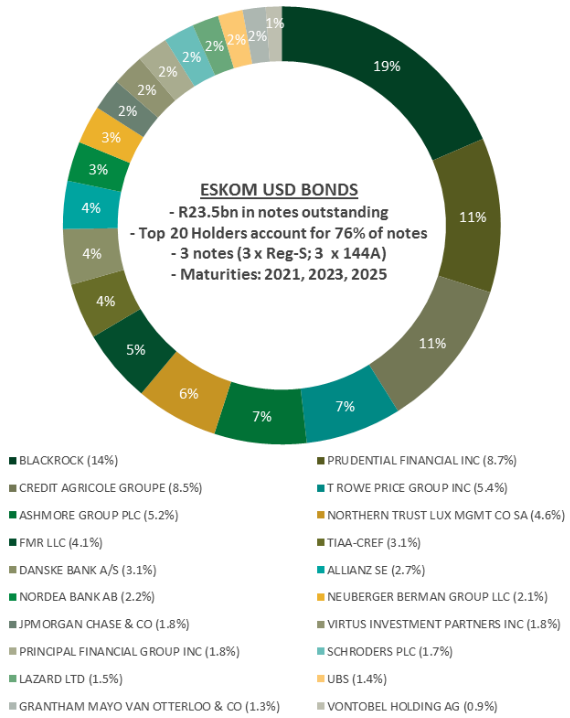
- Government local currency global scale rating: **BBB- → BB+**
- Eskom SACP: **ccc+ → ccc-**
- Grid indicative rating: **BB- → B**
- (Rating might vary from the grid by one notch up or down when a gradual deterioration in the GRE's role or link leads to a weakening or strengthening of the likelihood of extraordinary government support over time).
- Final issuer credit rating (after downward discretionary adjustments): **B+ → B-**

Source: Nedbank, S&P

Top 20 Holders Analysis

Chart 3: ZAR- vs USD-denominated Noteholders (December 2017)





Source: Bloomberg, Nedbank

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