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Gearing for Growth 2019

Restructuring SOEs for improved governance and performance

Outcomes report

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Welcome and context

Sihlalo Jordan, Deputy CEO, Deloitte Africa

Deloitte Africa's *Gearing for Growth* series, now in its fourth instalment, prides itself in making an impact that matters by focussing on the issues driving the South African economy.

The state and health of State-owned Enterprises (SOEs) in South Africa remains a top priority for President Cyril Ramaphosa as he contemplates the future of the country following his 2019 presidential victory.

The comparative state of South Africa's SOEs to those of other governments offers some insight: despite the current challenges that exist, the country's SOEs have a solid base from which to recover and grow.

The elimination of these challenges and the subsequent recovery of South Africa's SOEs will be instrumental in powering domestic economic growth toward the 5-6% GDP growth rate that is required to significantly reduce poverty and reverse the current unemployment rate of 27%.

Keynote presentation

Restructuring and revitalising SOEs – The experience of Singapore

Lee Hwee Hua, Former Minister in the Prime Minister's Office, Republic of Singapore

It is clear that there is a global spotlight on SOEs – the result of the various challenges and problems they face. These interrelated challenges include over-indebtedness, rampant corruption, as well as distress and insolvency that often lead to inevitable financial bailouts at the expense of public coffers. Some of these challenges have intensified in degree in recent times, and as vast consumers of public funds, SOEs continue to be viewed as ineffective users of both financial and human capital. These challenges can be better understood by observing examples.

1) Over-indebtedness of SOEs

Unlike their private sector counterparts, SOEs continue to be funded by governments as well as state banks. Brazil's state-run oil giant Petróleo Brasileiro (Petrobras) continues to hold in excess of US$69bn in debt (down from the over US$100bn it had accumulated in 2014). In China, SOEs took on close to 9% more debt in 2018 compared to the previous year – resulting in aggregate debt of US$16trn. The Chinese State-owned Assets Supervision and Administration Commission (SASAC) has called on SOEs to cut their collective debt ratio by two percentage points by 2020. The South African Broadcasting Corporation (SABC) has close to R700m in debt owed to creditors, which has placed the national broadcaster under much publicised financial stress.

2) Rampant corruption

The scale of corruption within SOEs continues to astound, with misappropriations running into the billions, denting public finances to such an extent that many governments are unable to function properly. Malaysia's 1Malaysia Development Berhad (1MDB) investment fund, Brazil's Operation Car Wash, as well as investigations into fraud at South Africa's Transnet, highlight the high degree of corruption that has occurred within various state-linked enterprises.

3) Distress and insolvency

The airline industry is an inherently difficult business to run, mostly because of heavy regulations as well as the politicisation of airlines – particularly those that are national airline carriers. These factors aggravate the financial distress that many airline companies face. Air India was repeatedly provided bailouts from state funds until the government could no longer justify doing so. In Malaysia it is estimated that the state has injected over US$7bn so far in a series of bailouts for Malaysia Airlines. South African Airways (SAA) has been loss-making since 2012 with no clear route out of the turbulence.

4) Mega bailouts

Financial bailouts extended to SOEs are getting bigger and the timelines associated with such recoveries are becoming increasingly long and complicated. In the UK, US$2.2bn was dispersed to the state-owned Cross Rail in a bid to get the line operational and revenue generating so as to stem further losses. In South Africa, Eskom, which has a high debt-to-equity ratio, requires an estimated US$1.6bn (R23bn) per year for the next three years to stay afloat, as well as significant restructuring.

Given the above challenges, it is not surprising that the narrative around SOEs has not changed significantly in the past. Common perceptions associated with SOEs include: drain on public resources, lacking in financial accountability, crowding out of private sector investment, inefficient, corrupt, and lacking in governance. In short, "SOE" remains a "dirty" term.

There is an increasingly loud call for SOEs to be transformed, not only to stem the financial bleeding, but also as a measure to return such entities to their original mission. Adding to this, the process of SOE transformation is a long and challenging one because of the political nature of these entities.

Factors cited in opposition to the much needed transformation of SOEs include social considerations such as the role of SOEs as significant employers, heavy unionisation, and the impossibility of retrenchments. Political considerations include the growth of some SOEs into national icons that cannot simply be allowed to fail, as well as the essential services they provide, which carry a political cost should there be a disruption in the delivery thereof.

Nonetheless, the following guiding principles – which authorities in Singapore adhere to – should be observed by governments when deciding what to do with SOEs:

1) Clarity of purpose

There must be a justifiable case for government participation, whether directly or indirectly, in the business. Such justifications may include strategic and security concerns (military and defence sectors), as well as social concerns (particularly with social services such as healthcare, education, public transportation, and public housing). In the case of Singapore, where there is a goal of housing more than 80% of the population, the Singapore government itself undertakes the provision of public housing.

2) Management of SOEs

Most SOEs flounder because of a lack of definition of roles, particularly where the split between shareholder, board, and management is concerned. In some cases, even where these roles are clearly defined, there still exists a persistent lack of accountability. SOEs succeed or fail depending on the political will and accountability that governments have to take hard decisions for underperformance.

3) Importance of capital management

The reality is that many governments, given the short-term nature of political terms, are unwilling or unable to financially plan for the long term. Furthermore, revenue collections are inherently difficult to be boosted, resulting in the taking on of more national debt. These factors provide for a strong case to take on private sector capital, or private sector partners, in big projects to ensure sustainable fiscal health.

4) Fiscal health

A SOE that has been allowed to become bloated over time, and purportedly of national importance, may present a future need for a bailout outside of the economic cycle.

Given the inherent political nature of SOEs, it is important for the sake of restructuring that top level support be ascribed, one clear change agent be appointed, and that the conflation of roles be disallowed at all costs. China recognised this in the early 2000s when SASAC was set up to report directly to the State Council – the highest decision making body – on SOE policies.

In Singapore, Temasek Holdings was established in 1974 to hold all government linked companies under the Minister for Finance. The elected Presidency of Singapore serves an additional layer of governance to ensure that past reserves are adequately protected. Temasek serves as a clear change agent on issues pertaining to Singapore's fully-owned SOEs, challenging any change in regulation that leads to unfavourable economics for SOEs.

There are a number of policy decisions that may be made when deciding the future of an SOE. These include reviews of the criticality and relevance of the SOE's existence, the SOE's vision and mission in comparison to the industry structure, the commercial viability of the SOE against Key Performance Indicators (KPIs), the state's position on bailouts, changing market and societal conditions, and lastly the scope for privatisation.

From the early 2000s, Temasek intensified its stewardship role in helping government-linked companies build capacity to respond to changing market and societal conditions, by spearheading an exercise to ensure that Singaporean SOEs had the best talent. Companies like Singapore Airlines are regularly benchmarked against global standards to ensure that they remain relevant to global industry norms and structures.

If privatisation of a SOE becomes the likely outcome, consideration should be given to the state of the domestic economy – particularly the current stage of the economic cycle; the contribution and dominance of the SOE in its respective sector; the private appetite for divestment; as well as the availability of talent to assume leadership of the newly privatised organisation.

Panel Discussion

Restructuring SOEs for improved governance and performance

Mohan Vivekanandan, Group Executive: Origination & Client Coverage, Development Bank of Southern Africa (DBSA)

Ravesh Rajlal, Chief Director: SOE Oversight, National Treasury

Mark Barnes, CEO, SA Post Office

Bongiwe Mbomvu, Acting CEO, Airports Company South Africa (ACSA)

Vuyani Jarana, Group CEO, South African Airways (SAA)

Moderated by Dr Martyn Davies, Managing Director: Emerging Markets & Africa, Deloitte Africa

A number of SOEs have gone through a process of systemic degradation, which has contributed their ongoing underperformance, thus attracting public attention.

Although South African SOEs have received bouts of support from the state, SOEs need to look into alternative ways of improving their overall performance. The key element is to draw a line between history and the future and reviewing existing policies, while considering the current state of the SOEs.

The idea is thus to restructure existing SOEs, to improve governance and overall performance. This is achievable through a transformation roadmap which outlines the mandate of SOEs, and by creating a clearly defined strategy in order to implement alternative reforms.

It is also essential for SOEs to consider creating a clear structure and focus on stabilisation in terms of liquidity and cash flow. This can be achieved by improving the capital structure and utilising existing state assets to replace state dependency.

This is where development banks may assist and provide development capital which is inherently collaborative and may be useful for the SOE stabilisation objective. The primary focus of development financing is on infrastructure and unlocking the value of "lazy assets" in SOEs, by identifying opportunities in infrastructural developments.

The playing field between SOEs and the private sector has not yet been equalised, thus placing strain on SOEs confronted by open market competition. SOEs have the potential to perform equivalent to the private sector by resetting the cost base to open up the market for SOEs. SOEs need to create strategic value by addressing market failures and eliminating social instability, while making profit (or breaking even) to reduce state dependence.

Looking at South Africa's growth and technical capabilities, part of the economic strategy should be focused on opening new frontiers. South African SOEs have the potential and capacity to perform better by tapping into international markets through equity and infrastructure. Essentially, well-structured SOEs can be established by going beyond local borders and investing in regional and global infrastructure.

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Summary and close

Thiru Pillay, Managing Director, EXCO: Consulting, Deloitte Africa

SOEs continue to face challenges and thus remain a concern for citizens. The objective of improving SOE performance is not based on finding solutions for the sake of the SOEs. However, the aim is to restructure existing SOEs for the best interest of the country as a collective.

This requires moving away from admiring the problem and instead taking meaningful action to find strategic solutions to the challenges. Meaningful action starts by getting the basics right and defining the purpose of SOEs.

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