South Africa’s downgrade increases volatility in an already uncertain economic environment

The recent uptick in political uncertainty and subsequent downgrades of South Africa’s long-term foreign currency sovereign debt rating by S&P Global Ratings and Fitch Ratings have rocked the South African economy and markets. The ratings, which were previously ‘BBB-’ with a negative outlook, were lowered to ‘BB+’ in the week of 3rd April 2017 in the wake of the cabinet reshuffle, bringing South Africa’s rating into sub-investment territory. This could spell severe economic repercussions for our country and business.


S&P and Fitch downgrade rationale

S&P noted in its press release that the reasons for the unscheduled adjustment (the next official review was set for June 2017, which is still in place) included “heightened political and institutional uncertainties that have arisen from the recent changes in executive leadership”. Similarly, Fitch stated that “recent political events, including a major cabinet reshuffle, will weaken standards of governance and public finances”.

Consequently, the downgrade stemmed from a rise in risks to policy continuity, which in turn increases the probability of lower economic expansion and slowing fiscal consolidation. Regarding the fiscal outlook, the rating agencies’ concern is that state liabilities (particularly in the energy sector) are set to rise, while they also assume a higher risk of fiscal slippages.

Downgrade – long time coming

The downgrade to so-called ‘junk status’ has been on the cards for a while. S&P first placed South Africa’s investment grade rating on a negative outlook back in December 2015.
Pressures on South Africa’s sovereign credit rating included weak real GDP growth, public sector underperformance, twin deficits showing a shortfall both in the fiscus and the current account, waning investor confidence also seen by a reduction in foreign direct investment (FDI) inflows, an unsettled labour force, and the continued issue of addressing the triple problem of high unemployment, inequality and poverty.

Russia was downgraded to sub-investment grade in 1996, with the economy contracting by an average of 2.5% over the 1996-98 period. Russia took eight years to regain its investment grade rating, before being cut to junk again in January 2015. Again, the economy contracted by 2.8% and 0.2% in 2015 and 2016, respectively, with the economic growth outlook set to remain under pressure this year.

Similarly, Brazil took more than 12 years to regain its investment grade status after being cut to junk in 1994, before being downgraded again to sub-investment grade in September 2015. In contrast to South Africa’s relatively expected downgrade to junk status, the Brazil relegation took most investors by surprise.

As a result, the market reaction in the wake of Brazil’s downgrade was much more severe than seen in South Africa directly following it’s downgrade. In line with the Russian case, the Brazilian economy contracted by an estimated 3.6% in 2016 and has since been downgraded further into junk territory.

What about other ‘junked’ economies?
South Africa is by no means the first economy to have lost its investment grade status in recent years amongst emerging markets. Within the BRICS grouping, only China (‘AA-‘) and India (‘BBB-‘) have investment grade ratings. That said, India had been cut before (in 1991) to junk status, and was only upgraded to investment grade in 2006. It has managed to hold onto investment-grade since then.

Apart from the downgrades by S&P and Fitch, Moody’s Investor Services has also issued a press release indicating that the agency has placed their ‘Baa2‘ rating on South Africa on review. While another downgrade would not be a positive development, a downward adjustment by Moody’s would likely not have such a severe effect on domestic financial markets as the downgrades already announced by the other two major rating agencies, given that a single-notch downward adjustment by Moody’s would mean they still rate South Africa as investment grade.

Delayed consequences
Divisions within the ruling ANC have ostensibly widened in the wake of the cabinet reshuffle, which S&P and Fitch believe could delay fiscal and structural reforms.

An additional consequence of the widening rift within the ruling party is the likely erosion of trust between the ANC and business leaders and representatives of labour unions. This erosion of trust, in turn, could potentially see a delay in both foreign and domestic investment that could otherwise have been a boon to economic expansion.
Monetary policy consequences
Despite the downward adjustment to South Africa’s sovereign debt rating, S&P noted that the country still boasts several rating strengths, particularly the flexibility of the South African Reserve Bank’s (SARB) monetary policy. The apex bank, along with its track record of achieving price stability, operational independence, and transparent and credible policies are viewed as important credit strengths.

In that vein, SARB Governor Lesetja Kganyago stated during the latest Monetary Policy Committee (MPC) meeting that “the MPC is of the view that we may have reached the end of the tightening cycle”. Consequently, the central bank elected to keep the repo rate steady at 7% during the MPC meeting that was held at the end of March.

However, the central bank also cited a high degree of exchange rate uncertainty, with the MPC also concerned about the impact of political uncertainty.

Given the sharp depreciation of the rand following the downgrade, and the likelihood that the local currency will remain under pressure as markets continue to adjust to the downgrade, there is a strong possibility that the central bank may be forced to re-evaluate its inflation outlook. Rising interest rates in the United States (US) also make it unlikely that the SARB will ease its monetary policy stance any time soon.

In a worst-case scenario, the economic environment has now been put on course that leads to a downward spiral. An important caveat is that the downgrade itself is not the cause of South Africa’s woes, but rather confirmation of the economic, but more importantly, political path the country is on. Even if S&P and Fitch had elected to ignore the cabinet reshuffle, the fiscal, monetary and investor confidence consequences that followed would arguably have placed the economy on a downward path even without a downgrade.

Nevertheless, the two immediate consequences of the downgrade, i.e. a weaker currency and higher government borrowing costs, both place pressure on what is already a slow to no-growth environment, which in turn could lead to further pressure on South Africa’s sovereign debt rating.

Inflation & repo rate (%)

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<th>Date</th>
<th>CPI % chg, y-o-y</th>
<th>Repo rate (%)</th>
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<tbody>
<tr>
<td>01 Jan</td>
<td>3.50</td>
<td>5.50</td>
</tr>
<tr>
<td>01 Sep</td>
<td>5.00</td>
<td>6.00</td>
</tr>
<tr>
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<tr>
<td>01 Jan</td>
<td>7.00</td>
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Source: StatsSA, 2017; SARB, 2017

What happens next?
Once the immediate effects of the sovereign debt rating downgrades (and those stemming from the further potential downgrade by Moody’s) have been incorporated into domestic and financial markets, the question moves on to what is next on the agenda.

This downward spiral, however, can be avoided. First and foremost on the list would be for the ruling ANC to make abrupt changes in order to address its myriad of challenges. These include addressing: a lack of internal unity; policy uncertainty; a lack of transparency within the structure of the ANC and the reality of corruption; a lack of clarity surrounding plans to deal with ill-performing state-owned enterprises (SOEs); concerns pertaining to fiscal slippages; and concerns regarding rising external debt levels.

While a downgrade to sub-investment grade is certainly not a favourable development, there are some rays of light going forward. The South African economy has begun to show signs of green shoots, with data releases prior to the downgrade pointing to a possible recovery, although still under considerable pressure. Headline inflation moderated on the back of lower food prices, the rand had previously strengthened to its strongest level since September 2015, and the current account deficit narrowed significantly in the last quarter of 2016.

Additional rating strengths previously lauded by rating agencies include South Africa’s prudent debt repayment history, robust banking sector, sound fiscal and monetary policies, and adequate portfolio inflows helping to finance the current account deficit. These strengths still remain, although some doubt has been cast on the future of the government’s fiscal policies with the dismissal of Minister Gordhan.

If government, with private sector support, addresses its shortcomings in an effective and timely manner, then South Africa should be able to once again achieve an investment-grade sovereign debt rating.

How long before a return to investment grade?
It is not a simple process to regain investment status, and the timeframes to do so vary widely. For example, South Korea and Thailand took just over one year and one-and-half years, respectively. Indonesia, however, took 13.5 years to regain its investment grade rating in 2011, before being reduced to junk status again last year. As mentioned, India took 15.3 years to regain its investment grade rating. Overall, the emerging market average is eight years to regain investment status.
Managing volatility in uncertain times

South Africa now faces the possibility of a deteriorating economic environment over the medium term – the extent and magnitude of which are still to be seen across companies and organisations. While the scope of potential volatility can appear to be daunting, it requires renewed focus by management and boards of directors to address and manage these uncertainties.

Our Volatility Response Framework

Deloitte has developed a Volatility Response Framework (VRF), which assists organisations in navigating through the challenges, approaches and company responses, to doing business in volatile times.

The VRF focusses on the most relevant priorities and challenges facing companies in an uncertain and volatile economic environment; these being margin management, revenue growth, balance sheet strength and expectations management.

Margin Management

The primary goal of margin management in the context of the VRF is to contain costs in a period of increased volatility through a framework of robust cost discipline. This includes, for example, the digital transformation of companies, which is increasingly necessary in order to manage the cost of doing business, as well as moving to infrastructure-light and cost effective cloud investments. Additional key focus areas include:

- value chain re-engineering and optimisation
- spend optimisation
- turning fixed costs into variable costs
- leveraging partnerships to manage selling, general and administrative expenditure
- proactively managing revenue leakages
- use a low cost offshore provider to outsource costs.

Revenue Growth

In addition to margin management, companies should position themselves to optimise revenue growth and increase market share. One way of achieving growth is through the introduction of new products and by penetrating new markets in order to win customers and accelerate growth. Management will need to clearly define their revenue retention and growth strategy, including which customers and markets to focus on and the most optimal product mix.

Long-term planning for the ‘new normal’ will take up increased time and can include digital innovation / transformation of products and services to create modern, dematerialised and competitive products and services, as well as leveraging consumer insights and analytics to drive growth.

Growth can also be achieved by expanding the company through acquisitions. To create value through acquisition and divestitures, the board and management need to carefully consider:

- the company’s mergers, acquisitions and divestitures strategy and what support they will require to successfully conclude on transactions
- whether vertical and horizontal consolidation in the industry is relevant to their business or if the company should rather venture into new products or markets
- who will lead the project management of the deal process and how this will impact on the ‘normal’ management duties of running the business
- how to drive consolidation and synergies post M&A (including divesture and merger IT planning) to ensure the targeted synergies are achieved to create shareholder value.

Balance Sheet Strength

Balance sheet strength is even more critical during volatile economic times to create a buffer against potential creditor calls. When assessing balance sheet strength, focus should be on increasing operating cash flow and balance sheet recapitalisation, respectively.

Increasing operating cash flow can result in the improvement of working capital and increasing the sustainability of working capital levels, as well as the improvement of short-term cash flow and liquidity. This inadvertently results in reduced funding costs and increased headroom in financial covenants.

The key areas of achieving sustainable cash and working capital improvements include:

- medium-term planning and forecasts to determine minimum and maximum funding requirements
- optimising the deployment of working capital (including banking facilities) and arranging or accessing additional working capital
- improving working capital cycle and efficiency
- improving asset utilisation.

When considering how to improve short-term cash flow and liquidity, management should include:

- strategies to reduce trapped cash
- capital efficiency analysis and determining ‘best use’ of capital
- detailed cash flow budgeting and management
- tax efficiency and planning
- distress and/or crisis management.

During times of increased economic volatility, the number of companies needing to recapitalise their balance sheets, automatically increases. The majority of balance sheet recapitalisation, constitutes raising of new equity, effective debt funding and management, and the disposal of non-core and unprofitable assets.

When raising new equity, the sourcing and introduction of a new strategic equity partner is typically a key consideration; and when done correctly, can have a significant value add to the company.
and shareholders, despite the seemingly counter-intuitive reason for doing so in a sub-investment grade economy.

While equity is the most expensive form of recapitalisation, management should first consider ways to effectively manage and extend debt funding. This can include:

- amending and extending the debt of the company
- how creditor resilience can be utilised to support the company through times of volatility
- putting mechanisms in place to continue servicing your debt obligations
- effective and timely communication in times of stress
- drawing up a realistic, robust business recovery and debt rescheduling plan targeted at creditors, investors and suppliers.

**Expectations Management**

As for balance sheet strength, managing stakeholder expectations and reducing financial risk and exposure of unforeseen spikes in volatility and the management of strategic and commercial risks increase in priority during times of volatility.

Management should focus on matching financial risk exposure to appetite by:

- clearly defining the company’s business (trading) model
- identifying transparent financial risk reduction methodologies and tools
- defining clear risk hedging policies, procedure and exposure limits
- detailing performance and financial reporting requirements.

Managing strategic and commercial risks includes improving transparency in financial reporting, risk management, governance and compliance and ensuring supply chain continuity for customers.

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**How Deloitte can help**

In what are undoubtedly uncertain times, organisations need trusted advisors more than ever.

Deloitte, one of Africa’s leading professional services firms, provides Audit, Tax, Consulting, Risk Advisory and Corporate Finance services.

Deloitte’s Corporate Finance Division and Restructuring Services team are well positioned to assist organisations in thinking through the challenges, approaches and company responses, to doing business in volatile times.
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