FUTUREGROWTH
/ ASSET MANAGEMENT

Can Eskom unbundle itself out of its debt overhang?
Author: Sithembiso Garane, Head of Listed Credit @ Futuregrowth
Published: September 2021

Eskom results continue to expose its mountain of debt

Eskom released its FY20/21 financial results on 31 August 2021. These were characterised by the persistent strain on the liquidity and profitability position, high gross finance costs and some challenges to operational efficiency. The group incurred a loss after tax of R18.9 billion, a slight uptick from the previous year's loss of R20.7 billion. The audit opinion was qualified owing to irregular expenditure and going concern risk. The government injected R56 billion to assist in reducing the debt burden. Eskom current debt maturities reduced to R44.9 billion from R128 billion in FY20. The group's cash generation capacity has continued to deteriorate since its 5-year peak in FY17 at R47.4 billion, and is currently sitting at R30.0 billion.

The prevailing theme remains Eskom's unsustainable debt, despite the recent equity injection and reduction in capital expenditure. Operating expense increases offset the revenue surge. Primary energy cost pressure and the inability to contain employee costs continue to pose a significant challenge in the utility expenditure reduction programme.

The energy availability factor decreased from 66.64% to 64.19%, largely attributed to increased maintenance. During the year, two Kusile power stations were added to the grid, contributing 1 500 MW, and Medupi's final unit was handed over to Eskom in July 2021. Investigations into the recent Kusile explosion are ongoing, with the damage estimated at R2 billion. Eskom expects to incur an additional R38.4 billion in environmental project costs on Medupi, as part of its loan conditions with the World Bank.

Financial highlights FY20/21

1. **Revenue was up** 2.38% year-on-year, solely owing to the 8.76% tariff increase. Sales volumes significantly declined by 6.7% (from 205 635 GWh to 191 852 GWh) off the back of the COVID-induced slump in demand across all customer categories. Management noted that sales volumes are expected to rebound in FY21/22, albeit not to pre-COVID levels. Revenue is expected to be aided by 15.06% tariff increase in the medium term.

2. **Interest bearing debt (IBD) reduced** from R483 billion to R401 billion, assisted by the R56 billion equity injection from the government. The reduction in the capital expenditure programme over the reported period also contributed to the net redemption of debt. Finance costs remained very high, despite the slight decrease from R48 billion to R45 billion. As a result, the effective cost of debt spiked from 9.58% to 9.66%. This remains a concern for the issuer, as it seeks to extricate itself from this debt overhang.

3. **Primary energy costs continued to rise** in spite of the lower demand: 3.4% year on year, due to a combination of coal and import cost escalation, higher utilisation of open cycle gas turbine (OCGT) and renewable energy independent power producers (IPPs). The IPPs contributed 24.0% in total primary energy costs and accounted for 6.0% of energy generation. The growth in contribution was stunted by the force majeure on wind energy procurement during the hard lockdown. Coal contribution, which currently accounts for 85% of energy generation (and 65% of the cost base), is expected to decrease as Eskom rolls out its decarbonisation strategy.

Energy Costs	FY21 (R bn)	FY20 (R bn)	FY21 (R/MWh)	FY20 (R/MWh)
Nuclear	R1 040	R1 330	R105	R100
Coal	R74 908	R73 664	R406	R384
OCGT	R4 125	R4 350	R2 778	R3 231
OCGT IPPs	R2 911	R3 579	R3 250	R4 049
RE-IPPs	R27 921	R24 810	R2 178	R2 206
Imports	R4 998	R4 716	R567	R550
Total	**R115 903**	**R112 119**	**R532**	**R494**

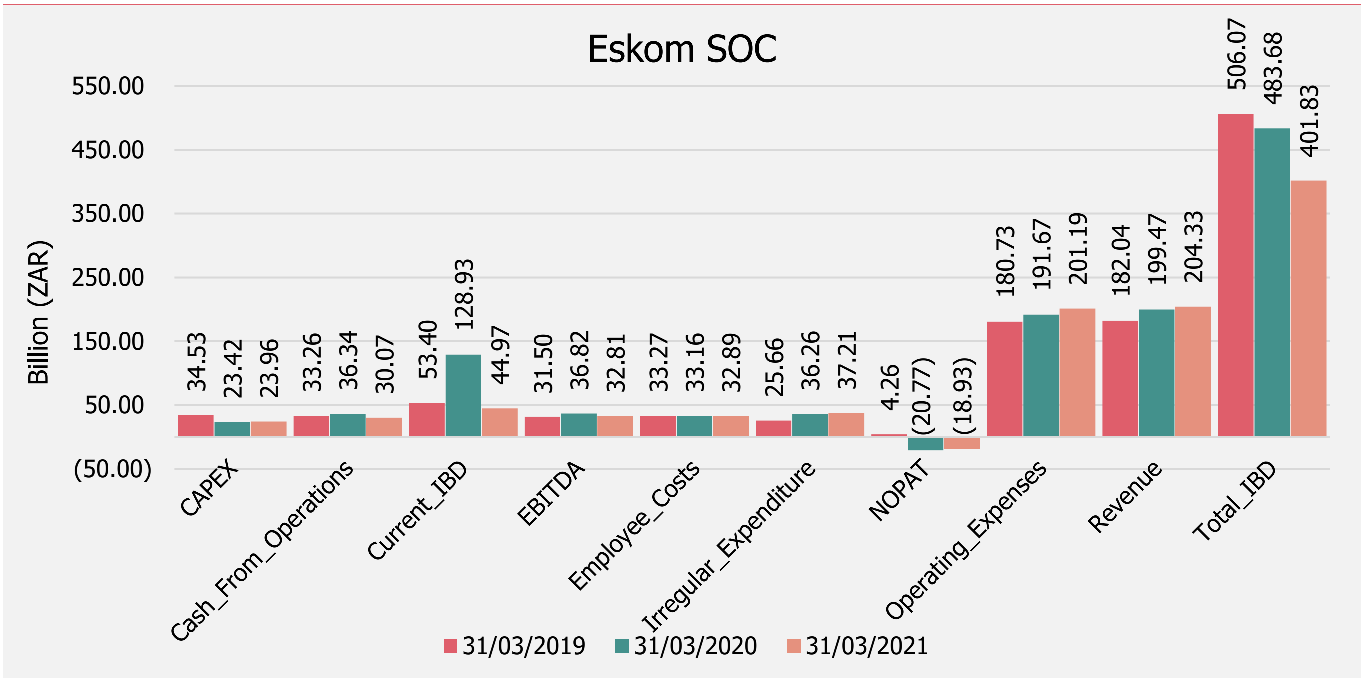
Source: Futuregrowth, Eskom

4. **Eskom's average employee cost decreased** from R775 000 to R735 000 as a result of the slight reduction of headcount from 44 000 to 42 000 and a management salary freeze. This is expected to be dampened by the 7% wage increase settlement over the next three years. Employee costs remain the Achilles heel for the counterparty as it grapples with its cost base. A 42 000 headcount is still a far cry from the 35 000 optimal level as noted by management. The total employee cost accounts for 16.35% of Eskom's revenue.

5. **Municipal debt arrears increased** by 26% year-on-year from R28.0 billion to R35.3 billion (including interest accrued over time). This figure was R6 billion in FY16 and is escalating very fast. Efforts to address collections from the top 20 defaulting municipalities continue to be questionable. Eskom has entered into a payment agreement with 12 of the 20 defaulting municipalities in an effort to increase recovery; however, 10 of the 12 are yet to comply with the agreement.

6. **The utility remains completely reliant on its R350 billion government guarantee** programme to raise debt in the market. Currently, the guarantee headroom is R47 billion, inclusive of the R32 billion committed drawdown. The expected debt service costs for FY22 are R71 billion (FY21 103 billion), R31 billion of which are finance costs. Eskom generated R30 billion from operations, hardly covering its net finance costs (R33 billion in FY21). The total funding requirement for FY22 is R39 billion which can be fully absorbed by the guarantee headroom.

7. **Eskom recorded a net loss for the year of R18.9 billion and R37.2 billion in irregular expenditure** which is the main driver for its audit qualification. The reduction in debt does give some reprieve on debt service costs; however, the entity's failure to generate sufficient cash from operations remains a significant risk. This is evident in the chart below:



Source: Futuregrowth, Eskom results

Eskom unbundling does not solve the core problem
Eskom expects to fully unbundle the transmission division by December 2021, followed by the generation and distribution divisions in December 2022. This is subject to all regulatory and legislative compliance. It is our view that management may be somewhat overly optimistic with these timelines, given potential political impediments. The functional separation of the three entities is said to be complete, and plans are afoot to create legal entities that will be operated independently. Some efficiencies may be unlocked through this exercise, but this will not address the core problem of debt spiraling out of control.

The chart below depicts the initial split into the different divisions. The majority (60%) of Eskom's employee costs come from distribution and shared services – a low-margin division and a cost centre. Other high operating expenses from the generation division are due to the provision for the decommissioning costs of coal generation and are not expected to remain at current levels in the medium term. The third-party generated energy (IPPs and imports) forms part of the transmission division cost base.

R million	Generation	Transmission	Distribution	Other	Eskom group
INCOME STATEMENT					
Total revenue	136 566	42 975	24 975	(190)	204 326
Primary energy	(80 073)	(35 818)	(12)	–	(115 903)
Employee benefit expense	(10 942)	(2 347)	(11 583)	(8 015)	(32 887)
Other expenses	(24 016)	(1 824)	(9 566)	11 388	(24 018)
Profit/(loss) before depreciation and amortisation expense and fair value adjustments (EBITDA)	**22 371**	**3 123**	**4 644**	**2 675**	**32 813**
Depreciation and amortisation expense	(19 342)	(3 063)	(3 977)	(634)	(27 016)
Profit before net finance cost	**3 135**	**432**	**272**	**2 841**	**6 680**
Net finance cost	(23 350)	(5 206)	(2 769)	(184)	(31 509)
(Loss)/profit before tax	**(20 215)**	**(4 774)**	**(2 497)**	**2 728**	**(24 758)**
BALANCE SHEET					
Total assets	542 661	78 969	115 931	44 087	781 648
Total liabilities	82 494	19 116	47 458	416 744	565 812
Additions to property, plant and equipment and intangible assets	16 722	3 160	6 249	(3 292)	22 839

Source: Eskom results FY20

Management now has to grapple with the IBD split amounting to R416 billion (as at FY20) across the entities, which requires bondholder consultation and approval. Our expectation is that this will not be a swift process. Further details are yet to be revealed, including how the R350 billion guarantee will be segregated, and business cases for each division so that investors can assess each division's investability.

More importantly, all these interventions do not address Eskom's core problem: the debt trap. The utility's management has alluded that more government assistance to the tune of R200 billion will still be needed. It is our view that, regardless of the divisionalisation and liberalisation of the energy sector, a debt solution is still required. Failing this, the debt problem will be inherited by all or some of the soon-to-be established entities.

Some encouragement but concerns remain
Futuregrowth is encouraged by Eskom's accelerated execution of its long-communicated divisionalisation strategy and government's equity injection. However, these interventions are barely scratching the surface when it comes to extinguishing Eskom's solvency risk. The remaining operational inefficiencies and unsustainable debt burden patently require further extra-ordinary support. We are cautiously optimistic that a decisive debt solution will be found, and we are of the view that comprehensive divisional business cases will determine the success (and/or duration) of the debt separation process. Government's recent intervention does indicate that Eskom remains important to the state, and that the likelihood of government support is still high. However, these intermittent interventions do not solve the

going concern risk status of Eskom, and its high dependency on the shareholder. Eskom needs more than just unbundling to address its solvency and liquidity risk.

Published on www.futuregrowth.co.za/insights.