DBSA & THE URBAN AGENDA: CAPITAL MARKETS AND LONGER TERM MATURITIES

by

Nico Bruwer

3 June 2009
“Restoring balance to our world will not happen unless there are serious efforts to build greater public understanding about the importance of poverty end inequity ... we must rebalance our world to give everyone the chance for a life that is secure... and the right to development”

James D Wolfensohn: President: World Bank Group
Overview of presentation

1. Introduction
2. Issues for DBSA
3. MFMA and other challenges
4. Capital markets and other funding instruments – aspects for consideration
5. Developmental state
6. Longer term maturities
7. Infrastructure Funding Gap as viewed by the DBSA
8. Maintenance
9. Way forward
1. INTRODUCTION

- Intention to provide some thoughts for consideration
- Based on experienced of myself in the DBSA
- Market failures certainly experienced
- DBSA but one player
- Need for co-operation
- Not exhaustive list of aspects but rather major aspects
2. Issues for the DBSA

- Urban vs rural: Metro’s containing same elements of poverty as rural
  Biggest need in Metro areas
  Continued focus on municipalities
- Transformation in sources of revenue: Reds for electricity, Reds for water?, rates & taxes and implications
- Cross-subsidization
- Retaining AAA rating
- Challenges in delivery or implementation due to capacity on local level
- Maintenance aspects
Partnerships with private sector
Crowding out argument: DBSA experience competition with bids: Important to retain a presence in municipal market
Impact of Basel II: Risk increasing important
Metro’s and major municipalities account for major portion of investment
Bank Industry average exposure to Government 8.7% (As at 11/08)
Off balance sheet or PPP’s, etc
3. MFMA AND OTHER CHALLENGES

- MFMA and:
  - Bids: Based on price as main consideration
  - Bids: Development impact limited
  - Does it support the developmental state?
  - Risk for Muni’s if not following MFMA

- Request for proposals (RFP)- Challenges
  - Not linked to appropriate instruments
  - Security aspects
  - Equitable share and its use
  - MIG funding: Accelerated implementation and resultant interest charges

- Proposed tariff increases and affordability: Next slides
## Tariff increases in 5 biggest Metro’s on 1 July 2009

<table>
<thead>
<tr>
<th>Metro</th>
<th>Electricity %</th>
<th>Water %</th>
<th>Sewerage %</th>
<th>Refuse %</th>
<th>Rates &amp; taxes %</th>
<th>Inflation BER forecast 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>JHB</td>
<td>30</td>
<td>11</td>
<td>10</td>
<td>8.5</td>
<td>10</td>
<td>6.8</td>
</tr>
<tr>
<td>Cape Town</td>
<td>33</td>
<td>10</td>
<td>10</td>
<td>7</td>
<td>8.5</td>
<td>6.8</td>
</tr>
<tr>
<td>Tshwane</td>
<td>30</td>
<td>13</td>
<td>13</td>
<td>17</td>
<td>10</td>
<td>6.8</td>
</tr>
<tr>
<td>Ekurhuleni</td>
<td>30</td>
<td>9.3</td>
<td>15.8</td>
<td>10</td>
<td>10</td>
<td>6.8</td>
</tr>
<tr>
<td>ETThekwini</td>
<td>25</td>
<td>10</td>
<td>10</td>
<td>8.5</td>
<td>5.57</td>
<td>6.8</td>
</tr>
</tbody>
</table>

Source: Rapport 31 May 2009
# TABLE ON SOME MUNICIPAL SERVICES

<table>
<thead>
<tr>
<th>Service</th>
<th>No of households: million</th>
<th>Free: million</th>
<th>Paying: million</th>
<th>% Paying</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electricity</td>
<td>11.7</td>
<td>5.7</td>
<td>6.0</td>
<td>51</td>
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<tr>
<td>Water</td>
<td>10.4</td>
<td>7.3</td>
<td>3.1</td>
<td>30</td>
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<tr>
<td>Sewerage</td>
<td>8.6</td>
<td>4.2</td>
<td>4.4</td>
<td>51</td>
</tr>
</tbody>
</table>

Source: Rapport 31 May 2009
4. Capital markets and other funding instruments – aspects for consideration

- Considerations on bond issues
  - Size of bond issues
  - Presence in the market and strategy
  - Credit ratings
  - Sound borrowing practices & programme: i.e. policy not to exceed 50% of total revenue
  - Above should be in line with forecasts
  - Liquidity aspects and secondary market for municipal bonds
  - Pricing market related
  - Not many municipalities that qualify
  - Initial bond issues expensive
  - Total strategy more important
## Debt and Liquidity

<table>
<thead>
<tr>
<th>Short term debt Rm</th>
<th>Long term debt Rm</th>
<th>Total debt Rm</th>
<th>Cash Holdings Rm</th>
<th>Cash coverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>210.9</td>
<td>2,038.1</td>
<td>2,249.0</td>
<td>2,956.0</td>
<td>1.3</td>
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<td>54.6</td>
<td>1,167.1</td>
<td>1,221.7</td>
<td>2,881.4</td>
<td>2.4</td>
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<td>236.6</td>
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<td>4,581.7</td>
<td>3,657.7</td>
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<td>173.7</td>
<td>6,113.7</td>
<td>6,287.4</td>
<td>1,764.1</td>
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<td>18.8</td>
<td>213.8</td>
<td>232.6</td>
<td>1,715.0</td>
<td>7.4</td>
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<td>295.5</td>
<td>3,137.5</td>
<td>3,433.0</td>
<td>1,281.8</td>
<td>0.4</td>
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<tr>
<td>990.1</td>
<td>17,015.3</td>
<td>18,005.4</td>
<td>14,256.0</td>
<td>2.1</td>
</tr>
</tbody>
</table>

## Financial Statistics

<table>
<thead>
<tr>
<th>Total income Rm</th>
<th>Days cash on hand Rm</th>
<th>Net capex: Total income %</th>
<th>Total debt: Income %</th>
<th>Net debt: Income %</th>
</tr>
</thead>
<tbody>
<tr>
<td>9,996.3</td>
<td>115.1</td>
<td>19.1</td>
<td>22.5</td>
<td>-7.1</td>
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<td>9,488.1</td>
<td>132.0</td>
<td>10.8</td>
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<td>11,539.1</td>
<td>143.1</td>
<td>20.1</td>
<td>39.7</td>
<td>8.0</td>
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<td>15,755.2</td>
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<td>20.4</td>
<td>39.9</td>
<td>28.7</td>
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<tr>
<td>4,636.2</td>
<td>162.6</td>
<td>18.5</td>
<td>5.0</td>
<td>-32.0</td>
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<tr>
<td>8,639.4</td>
<td>56.1</td>
<td>15.4</td>
<td>39.7</td>
<td>24.9</td>
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<tr>
<td>60,054.3</td>
<td>109.3</td>
<td>17.4</td>
<td>26.6</td>
<td>6.2</td>
</tr>
<tr>
<td>Capacity</td>
<td>Existing</td>
<td>Total</td>
<td></td>
<td></td>
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<tr>
<td>----------</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>2,749</td>
<td>2,249</td>
<td>4,998</td>
<td></td>
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</tr>
<tr>
<td>3,522</td>
<td>1,222</td>
<td>4,744</td>
<td></td>
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<tr>
<td>1,188</td>
<td>4,582</td>
<td>5,770</td>
<td></td>
<td></td>
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<tr>
<td>1,590</td>
<td>6,287</td>
<td>7,878</td>
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<tr>
<td>2,086</td>
<td>233</td>
<td>2,318</td>
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<tr>
<td>887</td>
<td>3,433</td>
<td>4,320</td>
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<td>12,022</td>
<td>18,005</td>
<td>30,027</td>
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<td></td>
</tr>
</tbody>
</table>
5. DEVELOPMENTAL STATE: THOUGHTS

- Private sector and free market principles
- Hybrid required to deliver: Market does not cater for every aspect
- MFMA constraints for DBSA
  - Pricing main emphasis
  - Mandate to alleviate poverty, etc negatively impacted
  - Any conditions imposed may disqualify bid
- Aggressive tariffs and affordability
6. Longer term maturities

- Important considerations
  - Stability (Peace index) & certainty
  - Assumption underlying: Proper maintenance of asset
  - Risk of default important consideration

- RFP should be based on useful economic lifespan of underlying assets: Not always true

- Example: RFP request 15 years: Submission for 10 years: Considerations by issuer? Price/Cash flow pressure/Assets not sufficiently in categories

- Mismatch of terms as seen above: Roll over?

- Policy and forecasts not consistent: Example – Policy 40%: Forecasts up to 2012: 56%

- DBSA: Perceive to curb prices in RFP’s

- Credit assessment: See next slide
Objective: Any assessment aim is to form an opinion on the ability and willingness to pay its debt obligations on a full and timely basis.

Differently stated: A credit assessment measures the risk of default over the life of the debt instrument.
Differently stated

Credit: “A system whereby a person who can’t pay gets another person who can’t pay to guarantee that he can pay.”

-Charles dickens, (1820-1870< 19th – century English novelist
Credit ratings

- Two broad categories
  - Investment grade: Up to Baa (Moody’s)
  - Speculative grade: From Ba (Moody’s)

- Probability of default by rating category – See next slide – Empirical evidence over 70 years

- Important aspects
  - 1/1000 for Aaa in 5 years
  - Much higher in speculative grade: 1 in 10
## Cumulative default rates: Percentages after......

<table>
<thead>
<tr>
<th>Rating</th>
<th>5 Years</th>
<th>10 Years</th>
<th>20 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aaa</td>
<td>0.1</td>
<td>0.8</td>
<td>2.2</td>
</tr>
<tr>
<td>Aa</td>
<td>0.4</td>
<td>1.1</td>
<td>2.6</td>
</tr>
<tr>
<td>A</td>
<td>0.5</td>
<td>1.7</td>
<td>4.8</td>
</tr>
<tr>
<td>Baa</td>
<td>1.7</td>
<td>4.5</td>
<td>11.4</td>
</tr>
<tr>
<td>Ba</td>
<td>11.4</td>
<td>20.9</td>
<td>37.7</td>
</tr>
<tr>
<td>B</td>
<td>28.6</td>
<td>43.9</td>
<td>51.5</td>
</tr>
<tr>
<td>Investment</td>
<td>0.8</td>
<td>2.4</td>
<td>6.4</td>
</tr>
<tr>
<td>Speculative</td>
<td>17.7</td>
<td>28.3</td>
<td>43.0</td>
</tr>
</tbody>
</table>

Source: Moody’s
Other aspects

- Standard and Poors and Fitch IBCA
- DBSA in line with Fitch and grading categories
- Credit ratings only one of many factors that should ultimately influence investment decisions
- Focus of ratings is on default risk
- DBSA rating locally: AAA, challenge to retain
- Price of money influenced by ratings
- Highest rating in country: Sovereign i.e. South Africa as risk of default lowest
7. Infrastructure Funding Gap

- Municipalities face huge backlogs in infrastructure and services (particularly to the poor).

- Backlogs relate to the:
  - Infrastructure for growth (roads, storm water, water, water and sanitation).
  - Maintenance and refurbishment backlogs (notably roads, storm water, water and sanitation).
  - Housing backlogs (housing and infrastructure project top-ups).
  - Most municipalities are growing rapidly (in population and business activities).
  - Accordingly municipalities have to grapple with the requirements for growth and dealing with poverty.
Annual capital requirements and provision: investment and funding gap

<table>
<thead>
<tr>
<th>Current annual expenditure</th>
<th>Additional annual required</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td></td>
</tr>
<tr>
<td>R130bn</td>
<td></td>
</tr>
<tr>
<td>R120bn</td>
<td></td>
</tr>
<tr>
<td>R300bn</td>
<td></td>
</tr>
<tr>
<td>R83bn</td>
<td></td>
</tr>
<tr>
<td>R140bn</td>
<td></td>
</tr>
</tbody>
</table>

Government budget
SOE's budget
Private budget
Backlogs
Required for growth
Total investment gap
Funding gap on current expenditure
Total funding required

Total estimated expenditure
R550bn

Based on 2%-5% growth in economy

Approx 51% of total current expenditure funded from debt

Economic
Enabling
Social

Primary involvement of DBSA

Assume additional investment requirements to be fully debt funded

Infrastructure Funding Gap
Infrastructure Funding Gap contd

- Minimum of R700bn required per annum
- Current unfunded gap estimated between R220bn and R280bn per annum
- Current investment level below required levels for growth and to alleviate backlogs
- Funding gaps exist: domestic funding shortage
- Infrastructure funding needs to be accelerated
- DBSA only provides a fraction of this funding
Need for investment: Huge backlogs in all sectors and current provision not sufficient

• Social:
  ▪ 22% of total population requires services
  ▪ Housing, education and health needs acute.
  ▪ Current eradication in backlogs by government 2.2% per annum
  ▪ Current annual expenditure by all institutions estimated at R105 billion.
  ▪ Current estimated annual funding gap of R35 billion to reach Government 2016 targets.

• Enabling environment, all sectors require support to accelerate development.
  ▪ Priority sectors: roads, electricity and water.
  ▪ Current government and SOE expenditure R150 billion per annum.
  ▪ Annual funding shortfall estimated at R90 billion.

• Economic infrastructure:
  ▪ 20 million people in poverty
  ▪ 12.5 million people unemployed
  ▪ Priority sectors those with high employment creation multipliers.
  ▪ Current annual expenditure by private sector and government R295 billion.
  ▪ Estimated funding gap of R95 billion per annum.
Overview of infrastructural development requirements

a) Desired levels of investment and position for DBSA’s funding

• Current investment levels still below required levels for growth and to alleviate backlogs.
• Funding gap exists: domestic funding shortage.
• Infrastructure funding needs to be accelerated.

[Graph showing the ratio of gross fixed capital formation to GDP and the ratio of gross savings to GDP from 1980 to 2008.]

Space for the Division to add additional funding

Contributors:
- Private: 62%
- SOE’s: 18%
- Gov: 20%
- Economic: 11%
- Enabling: 9%
- Social: 3%

Funding gap: Funded from cumulated surpluses and foreign sources

Ratio GFCF/GDP 25% target

Backlog creation
8. MAINTENANCE OF INFRASTRUCTURE

- Existing infrastructure not properly maintained
- Sanral roads study on cost of maintenance delay:
  
  Repair cost
  1-2 years: x/km
  3-5 years: 6x (Ratio 1:6)
  5-8 years: 18x (Ratio 1:18)

  Typical costs for 11,4m wide road in flat terrain

- Programmes or conditions difficult through RFP and bonds
- Maintenance budgets insufficient
- Capacity constraints
9. Way forward for DBSA

- Continued focus on main business regarding municipalities
- Increase staff in the rollout of the Siyenza Manje Programme in conjunction with National Treasury
- Provide assistance pertaining to the DBSA LED Fund
- Explore assistance in project planning and preparation
- Explore DBSA financing mechanisms to fast track infrastructure development, capacity building, operations and maintenance of infrastructure
- Identification and addressing of additional areas for capacity building
Radical Innovation by Wolfgang Grulke stated:

Never confuse activity with progress. Especially when it comes to the future.
Deepening and broadening development impact

Thank You