PRUDENTIAL **INSIGHTS**

PRUDENTIAL
INVESTMENT MANAGERS

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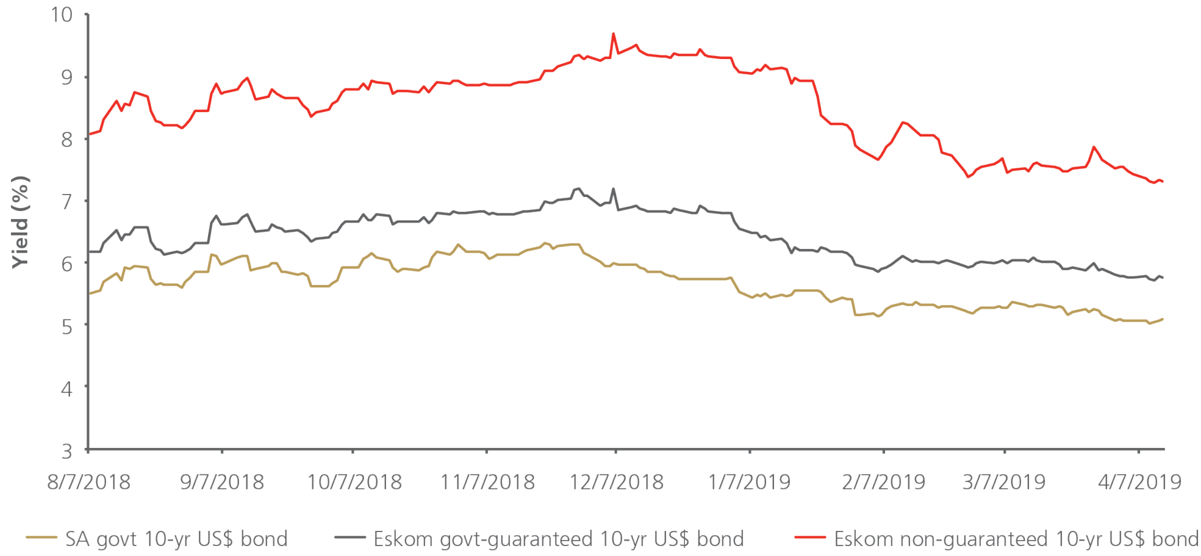
SOE debt: Avoid or invest?

Given the steady stream of bad news regarding the financial state of South Africa's state-owned enterprises (SOE's), it's understandable that investors might be inclined to consider SOE debt as simply uninvestable. But our analysis of SOE debt shows that while there are risks, there are also some opportunities to earn attractive risk-adjusted returns.

Can you actually avoid exposure to SOE's? It isn't easy. SOE debt represents 7% of the All Bond Index (ALBI), and you will have indirect exposure if you hold government bonds or bank shares, among others. The government explicitly guarantees almost half of the nearly R300bn in outstanding SOE debt, while at the end of 2018 banks had 10% of their equity exposed to SOE's on average. Banks also package SOE exposure within debt instruments (credit linked notes) which they issue, giving investors exposure to both the risk of the bank and the underlying SOE.

How can you identify the opportunities? Our credit analysts make a detailed assessment of the standalone risk of the relevant SOE, and then determine what level of support might be inferred from the government. This ranges from an explicit guarantee to none whatsoever, and is based on the government's previous actions when an important SOE has been in trouble. This risk assessment drives the compensation (yield) we require over and above government debt. This additional return is made up of two components: extra compensation for the lack of liquidity (liquidity risk); and the additional default risk (or credit risk) one assumes.

Higher Eskom bond yields reflect higher investor risk



Source: Bloomberg as at 12 April 2019

This difference is best illustrated by observing the returns available on Eskom US$ debt. The graph shows the additional compensation for investing in both guaranteed and non-guaranteed Eskom instruments as of mid-April 2019. For an investor in the guaranteed debt, the additional return above that of the SA government (approximately 0.7%, or 5.8% vs 5.1%) is compensation for the lack of liquidity – it is more difficult and therefore more costly to trade than government debt. The debt is explicitly guaranteed, so there is no additional credit risk assumed. Eskom's unguaranteed debt, meanwhile, at 7.3%, offers extra compensation over and above this as investors are assuming some additional risk of default – they need to make an assessment as to this risk, as well as the compensation they are willing to receive for assuming it.

For those SOE's which we consider to have not adequately addressed prevalent governance concerns – be that as a result of State Capture allegations or other factors – we have chosen not to invest in any new issues. These issuers would include Transnet, Denel, ACSA, Umgeni Water and SANRAL. The latter remains in an uncertain state as the E-Tolling saga remains unresolved. We do think there have been significant changes implemented at Eskom and are prepared to consider further investments – but only in its fully government-guaranteed instruments.

We prefer to hold a diversified portfolio of exposures, and as such Prudential funds have holdings in a number of names within the sector. These would include: the Industrial Development Corporation; the Development Bank of Southern Africa; Eskom (government-guaranteed only); Land Bank and the Trans-Caledon Tunnel Authority, among others. This reflects our view that the SOE sector, despite the recent headlines, can offer investors some attractive risk-adjusted returns with the use of careful analysis.

For more information, please feel free to contact our Client Services Team on 0860 105 775 or email us at query@prudential.co.za.