

MUNICIPAL BORROWING

BULLETIN

ISSUE 11

December 2018

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SOL PLAATJE MUNICIPALITY

Upgrading of Carters Glen 66/11Kv Substation

PURPOSE

The purpose of the Municipal Borrowing Bulletin (MBB) is to advance transparency, responsibility, and the prudent and responsible utilization of municipal borrowing to finance infrastructure. The MBB is a tool for sharing developments and analyses regarding the municipal borrowing market. Comments and suggestions on topics for inclusion are welcome!

CONTEXT

The MBB is issued by the National Treasury on a quarterly basis. This issue covers long term municipal borrowing up to 30 September

2018, corresponding to the first quarter of the 2018/19 municipal financial year.

Sources used for this MBB include data submitted by municipalities to National Treasury as required by Sections 71 and 74 of the Municipal Finance Management Act of 2003; data acquired from lenders; information published by the South African Reserve Bank (SARB); and data from the Johannesburg Stock Exchange (JSE) sourced from STRATE.

HIGHLIGHTS

- Municipalities reported aggregate long-term debt of R63.5 billion while lenders reported an aggregate of R57.7 billion, reflecting a variance of about R5.8 billion

between municipalities side and lender-side. This is largely caused by that one of the banks which holds a significant stake in municipal debt, has not provided us with the borrowing data relating to this reporting.

- In addition to the issues indicated in the previous bulletins as causes of the discrepancy; we have identified the Public Investment Corporation (PIC) as a significant lender to municipalities, holding a sizeable amount of municipal obligations that should substantially reduce the discrepancy between borrower-side and lender-side data. Moreover, it has been identified that there are a number of long term contractual



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arrangements which municipalities are incorrectly reporting as finance leases also inflating the outstanding LT debt balance.

- National Treasury will issue a directive in the form of a circular to advise both lenders and municipalities on how to consistently report on municipal borrowing.
- Municipalities' aggregate borrowing budgets for the 2018/19 financial year were increased by 22 percent from the prior financial

year, while their capital expenditure budgets were raised by 25 percent, compared to the previous year.

- Actual new borrowing for the first quarter stood at R756 million, representing only 5 percent of budgeted borrowing thus far.
- Most of the loans to municipalities are from the public sector while most of the securities are held by the private sector.
- Compared to the metros and secondary cities, the nation's other municipalities have to serve a higher proportion of the population with fewer resources.

DATA AND ANALYSIS

1. Analysis of long-term debt as reported by municipalities

Table 1: Outstanding long term debt as at 30 September 2018

Municipal Category	Municipality	Total debt Q1 2018/19 R'000	Share of total debt	Actual Revenue 2018/19* R'000	Debt to revenue ratio	Budgeted Borrowing 2018/19* R'000	Actual Borrowing Q1 2018/19* R'000	Population	Total Debt per capita
A	BUF	389 219	1%	6 517 222	6%	69 000	0	781 026	498
	NMA	1 207 753	2%	10 363 386	12%	148 290	16 303	1 152 114	1 048
	MAN	1 061 361	2%	6 304 424	17%	33 188	2 894	775 184	1 369
	EKU	5 846 834	9%	35 317 657	17%	3 590 944	61 031	3 178 470	1 839
	JHB	19 883 211	31%	53 046 409	37%	2 849 726	230 074	4 434 827	4 483
	TSH	10 628 857	17%	32 530 207	33%	1 500 000	43 028	2 921 488	3 638
	ETH	8 871 159	14%	35 175 463	25%	1 000 000	0	3 476 686	2 552
	CPT	6 756 849	11%	39 735 877	17%	4 000 000	237 504	3 740 031	1 807
	Total Metros	54 645 243	86%	218 990 645	25%	13 191 148	590 834	20 459 826	2 671
B	B1 (19)	5 884 695	9%	52 038 248	11%	2 141 645	140 530	7 592 443	775
	Other Municipalities	2 361 190	4%	123 802 164	2%	26 977	4 264	28 469 631	106
C	Districts	658 272	1%	20 719 333	3%	835 897	20 332		
	Total all municipalities	63 549 400		415 550 390	15%	16 195 667	755 960	56 521 900	1 124

*excluding capital transfers

Source: National Treasury Database, Municipal Money and Stats SA

Table 1 above, shows that the metros' stake in the total outstanding long term municipal debt has fallen by 1 percent since the end of the 2017/18 financial year, while the share for secondary cities has risen by 1 percent in the same period. This does not mean that the total long-term debt for the metros has declined, but rather that it has not increased at the same rate as that of the secondary cities. The City of Johannesburg's share of long term municipal debt has also shrunk by 1 percent, while that of eThekweni metro grew by the same percentage. The aggregate revenue for the "other municipalities" category makes up about 30 percent of total municipal revenues, while their share of long term municipal debt represents only 4 percent of total municipal debt.

The overall debt to revenue ratio for all municipalities has dropped by 3 percent since the fourth quarter end of FY2017/18. Notably, this ratio for the City of Johannesburg has decreased from 45 percent to 37 percent during the same period, because of the City's increased revenue projections for the 2018/19 financial year.

The start of the 2018/19 financial year saw municipalities increase their planned long term borrowing budgets by over 21 percent from R13.3 billion in the previous financial year to almost R16.2 billion in the current year. This is a step in the right direction as far as enhanced capital investment by municipalities is concerned, considering that the last

time municipalities grew their borrowing budgets by over 20 percent was four years ago during the 2014/15 financial year. Table 2 below, shows that only R755.9 million in new borrowings, which is about 5 percent of the budgeted borrowing, has been incurred as at the end of the first quarter of the 2018/19 financial year. New borrowing was 7 percent of the budget during the first quarter of the 2017/18 financial year, 7.9 percent in quarter one of FY2016/17 and 9 percent at the end of the first quarter of the 2015/16 financial year.

The 8 metros are home to roughly 20.5 million of South Africa's population. About 7.6 million South Africans live in the 19 secondary

cities, while the smaller and more rural municipalities are home to half of the population (28.4 million). These smaller municipalities have to serve a higher proportion of the population with fewer resources. On average the metros are currently incurring about R2 671 in long term borrowing in order to address the infrastructure needs of one person as illustrated by the outstanding debt per capita in table 1. The city of Johannesburg has the highest debt per capita amongst the metros followed by the City of Tshwane. The secondary cities and the other municipalities have lower per capita debt owing to their minimal borrowing activities.

Table 2: Capital Expenditure, new borrowing and outstanding debt

R million	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	Full Year 2018/19	2018/19
	Actual	Forecast	1st Quarter									
Capital expenditure	39 577	39 625	30 945	33 239	41 679	47 932	53 241	54 682	54 411	58 756	73 411	6 588
New Borrowing	9 463	8 226	6 401	6 211	6 490	7 583	9 357	9 222	8 099	8 750	16 196	756
New borrowing as a % of CAPEX	24%	21%	21%	19%	16%	16%	18%	17%	15%	15%	22%	11%
Outstanding debt	32 366	35 388	43 190	45 640	48 078	51 431	53 493	60 903	62 043	62 512	67 286	63 549

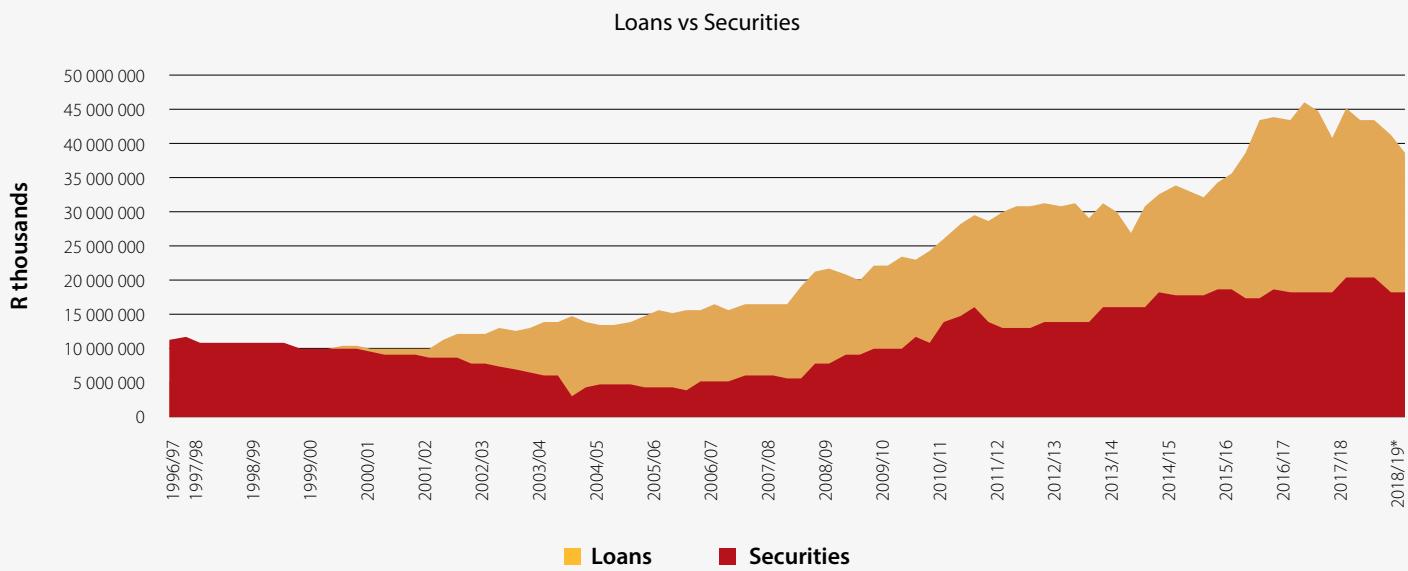
Source: National Treasury Database

Municipalities raised their planned capital expenditure budget by 25 percent from R58.7 billion in FY2017/18 to R73.4 billion in the 2018/19 financial year. 22 percent of the total budget is planned to be funded from new borrowings. If these ambitious plans are realized, this would be a positive development, reflecting that municipalities are taking more responsibility for funding the required infrastructure investments. As shown in table 2 above, the actual spend on the capital budget stood at R6.5 billion by the first quarter end of the 2018/19 financial year and new borrowings funded about R756 million of this expenditure. Outstanding long term debt, as reported by municipalities, has so far only increased by approximately R1.04 billion from the R62.5 billion reported at the close of the last quarter of the preceding financial year.

2. Analysis of long term debt as reported by lenders

So far, we have received borrowing data, in the required format, from three of the identified additional municipal lenders. Many other lenders have reported some form of contractual arrangements they have with the municipalities which may not be finance leases and therefore should not be classified as long term borrowing. Municipalities are reporting long term service contracts, property rentals and fleet hire arrangements as finance leases when in actual fact they are not. We believe that this possible misreporting by municipalities contributes to the over-reporting of long-term debt from the municipalities' side that has been observed over the previous bulletins.

Figure 1: Split between debt instruments

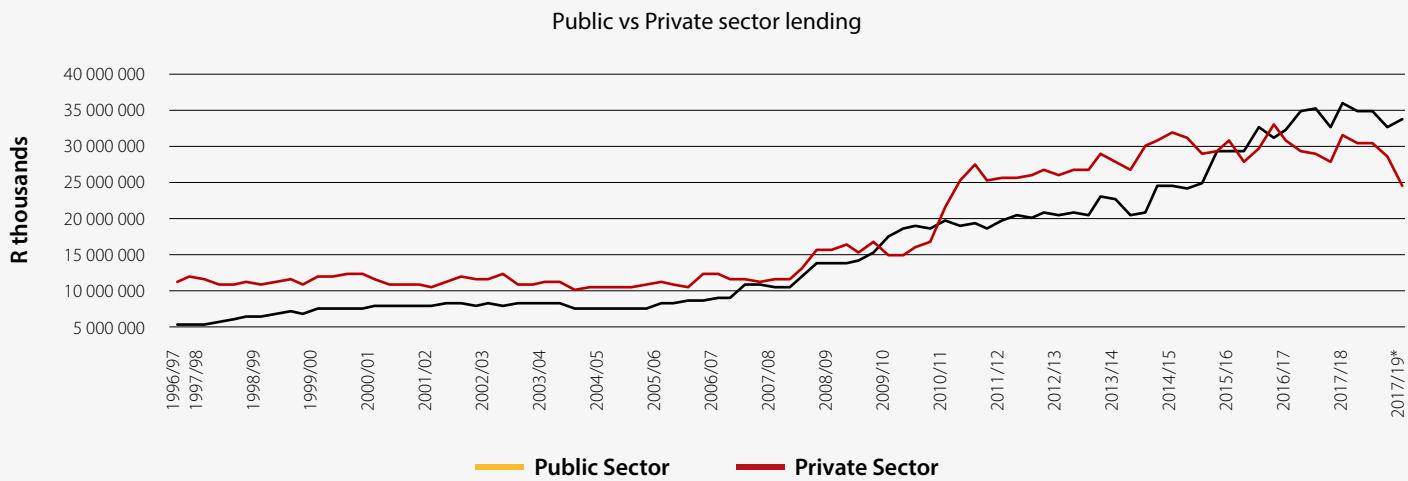


The most popular long-term debt instruments used by municipalities are loans and municipal bonds. Although municipalities do borrow utilizing other instruments, such as finance lease agreements, figure 1 only shows the proportion of loans and bonds in long term municipal debt. Loans account for 68 percent of outstanding long term municipal debt and the remaining 32 percent is attributable to municipal bonds.

The proportion of loans has risen by 1 percent since the end of FY2017/18, compared to a slump of 1 percent for securities over the same timeline. There have not been any new bond issues so far in the current year. This is, at least in part, related to the growing dominance of public sector lenders, whose financing has been almost exclusively in the form of loans.

3. Holders of municipal loans and bonds

Figure 2: Public and private sector lending to municipalities



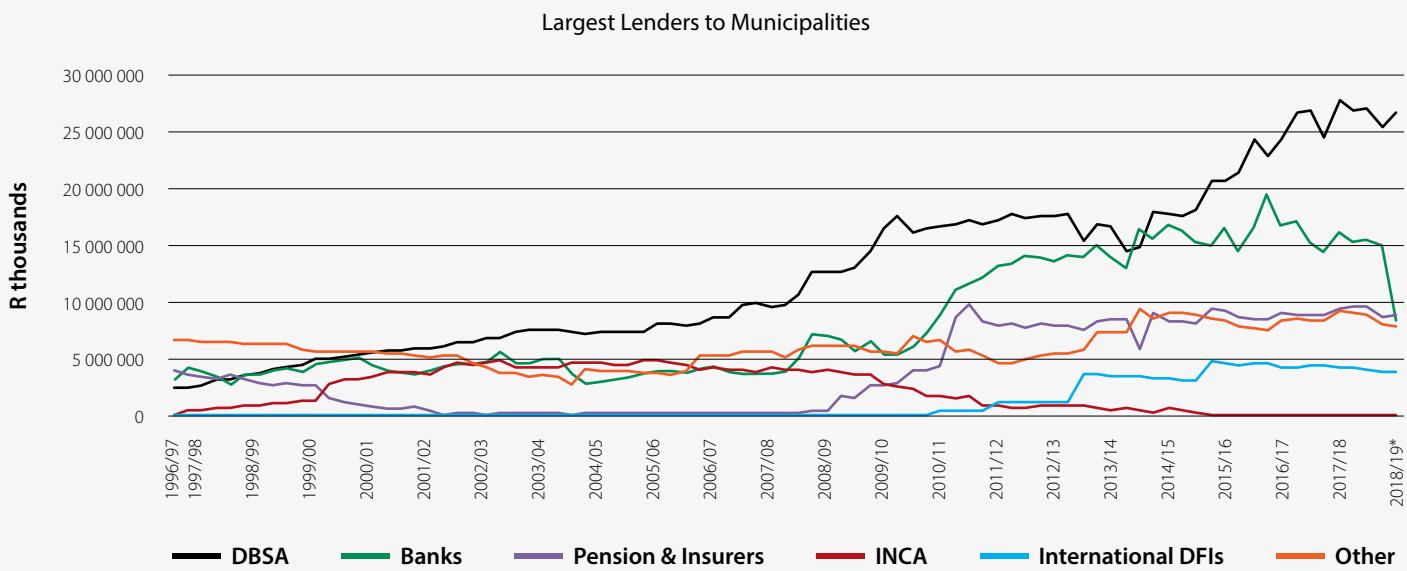
*Incl Q1

Data sources: Banks, DBSA, INCA, DFIs, STRATE, SARB

Figure 2 above, shows that most of the outstanding municipal long term debt obligations have been sourced from the public sector. The public sector's holding in long term municipal debt grew to 58 percent, against a drop for the private sector to 42 percent, since the start of the 2018/19 financial year. The majority of loans are held by the public sector while the majority of securities are held by the private sector.

Public sector holders of municipal debt obligations include the DBSA; the Public Investment Corporation; public enterprises and international development finance institutions such as the Agence Française de Développement and the International Finance Corporation. For the purpose of Figures 2 and 3, private sector holders comprise commercial banks and pension and insurers.

Figure 3: Largest lenders lending to municipalities



*Incl. Q1

Data sources: Banks, DBSA, INCA, DFIs, STRATE, SARB

DBSA loans are shown by the black line in Figure 3 above. The DBSA has seen its share of long term municipal debt increase by 5 percent since the start of the year under review. Accounting for the majority of public sector lending, the DBSA alone is responsible for 42 percent of the total long term municipal debt as at the first quarter end of the 2018/19 financial year. The aggregate holding for the commercial banks has dropped by 16 percent over the first three months of the 2018/19 financial year. The shares for the international DFIs, pension funds, and insurers have also declined since the beginning of FY2018/19.

DISCUSSION

Secondary market research

Readers will recall that since the White Paper on Local Government (1998), Government has been pursuing a vision for the financing of local government infrastructure which includes a vibrant secondary market for municipal debt. When Cabinet adopted the original Policy Framework for Municipal Borrowing (2000), the idea was to reinvigorate the capital market and help creditworthy municipalities access capital via a competitive market which is appropriately priced and reflects the differential creditworthiness of various municipal borrowers. The policy goal is restated in the updated borrowing policy framework (2017) that now governs municipal borrowing. These policies have been somewhat successful with respect to South African banks, who are investing significantly in municipal loans and bonds but only to a limited extent with institutional investors.

National Treasury conducts ongoing market research aimed at understanding the municipal borrowing market, and specifically the barriers to a more vibrant and liquid secondary market for municipal

bonds. Since the adoption of the MFMA it can be noted that only four metropolitan municipalities (City of Johannesburg, City of Tshwane, City of Cape Town and Ekurhuleni) have issued municipal bonds that, in principle, can be readily bought and sold in the capital market. However, there is not yet a critical mass of municipal bonds sufficient to support a liquid secondary market. One challenge is that much of municipal borrowing that is done is in the form of loans rather than tradable securities. As a result, municipal borrowing instruments are not as liquid as hoped, because a liquid market provides an exit ramp for an investor whose investment needs change. An illiquid market also affects the term of years for which municipalities are able to borrow.

The objectives of our research are, to identify and evaluate the policy options to support the further development of the municipal credit market. On an ongoing basis, interviews are conducted with various fund managers, insurers, banks and other supply-side actors in the credit market.

AMONG THE ISSUES IDENTIFIED BY OUR RESEARCH ARE THE FOLLOWING:

Politicization of management: Investors have become concerned about the degree to which a political change impacts on professional municipal management, especially after the 2016 elections. They have limited confidence that long-term municipal capital investment programs will be sustained. Creditworthiness is affected by management stability, in addition to the obvious need for clean audits and good financial ratios.

Municipal bonds as government obligations: despite the Constitutional status of local government as a distinctive sphere of government, with its own financial and borrowing powers, many investors see sovereign

(RSA) bonds as government obligations, but tend to think of municipal bonds as different in kind. This is unfortunate, as high quality municipal obligations can be sound investments. Prudential regulations and investment mandates will need to be re-thought, if we are to achieve an active secondary market for municipal debt obligations

Credit ratings: Investors have mixed feelings about rating agencies. Many do not have great confidence in the credit ratings because they are perceived to be more reactive than proactive. As a result, most investors do their own due diligence. This is obviously impossible for smaller, individual investors. Some investors do consider credit ratings, in part because their customers' mandates require high quality investments.

Debt service structures: Investors had differing views on the amortization structures of the bonds that Cape Town and Ekurhuleni issued in July 2017. Some struggled to figure out the place of such bonds in their overall investment portfolios, as compared with "plain vanilla" structures. These investors prefer a vanilla bond structure because it is easier to price and to fit into their portfolios. Other investors were happy with these structures, which return the bulk of the lent capital to the investors in a relatively short time frame, reducing the risk to investors (as well as the utility to borrowers).

Pricing: Pricing varies between issuers and over time. With respect to the July 2017 bond issues from Ekurhuleni and Cape Town, several investors observed that the spread as between the two similarly structured issues seemed reasonable and a typical sentiment was that Cape Town has a longer history of engagement with the capital markets, as well as long history of unqualified audits but Ekurhuleni has only recently gotten there. With the involvement of DFIs in the municipal credit markets, it is difficult to know whether pricing that reflects differences in credit quality can be maintained.

Relationship management: Several investors spoke of the need for municipalities to maintain their market presence, if they want to be of interest to the broader range of investors. One aspect of this is regular road shows, even when there is no imminent need for borrowing. Some investors said they would advise municipalities to come to the market often even if it is for relatively shorter term debt. This keeps lenders and potential lenders in touch with the management and the financial condition of the municipalities and makes it easier for lenders to assess them when there are large capital needs.

Diversification: Currently, only a limited number of metros are actively accessing the debt market but even these are not aggressively borrowing. Investors would be interested to see other creditworthy borrowers come to the market. There is strong appetite for high quality municipal debt obligations, but there need to be more issues from the rest of the metros and other financially sound municipalities.

Liquidity: Many potential investors indicated that they would only feel comfortable buying municipal paper if they knew that there was a way to sell it if they needed liquidity, or if a municipality's credit rating drops.

In November 2018, the above findings were presented in the quarterly Urban Finance Working Group meeting (involving metros, banks, institutional investors, rating agencies, DFIs and others). The presentation was well received and sparked a lot of debate.

AMONG THE POINTS OF DISCUSSION:

- Investors have capital and are keen to lend it to cities, though they do worry about creditworthiness and governance in some cases. Investors noted that they pay a lot of attention to the management team in municipalities. There was a feeling that national government needs to do more to ensure that municipalities are creditworthy and well governed. Several participants noted that it is important to understand what happens when municipalities violate the MFMA – clear consequences will boost the credibility of national and local government.
- With many secondary cities, investors are concerned about treasury capacity and the quality of financial management, as well as credit metrics and instruments are big issues. A concern with secondary municipalities is to have a first layer of protection that warns when things are going wrong. There must be triggers and maintenance covenants.
- Banks and rating agencies agreed that now would be a good time for municipalities to talk with ratings agencies and see what they need to do to prepare for borrowing in 6 months or a year. A rating agency indicated they see the path to creditworthiness as a progression. Municipalities that have not yet engaged in significant borrowing might look into borrowing first from DBSA to get used to borrowing and managing debt service. Those secondary cities that already have DBSA or commercial loans could consider moving to bond issuance if their credit needs are substantial.
- The discussion emphasized that municipalities should not only come to lenders and investors in times of need, but that they should stay in touch and borrow regularly even if it is minimal. It is important that municipalities communicate regularly with potential lenders and investors. They should visit investment managers, introduce themselves, start borrowing in the short-term market and gradually increase the size and the tenor. This will assist in developing a relationship - it takes time to build confidence.

Our research is ongoing and more interviews will be conducted in order to try and understand the capital market better. One area for further research is to identify what worked well, or went right, for the big four metropolitan metros already in the bond market, as a way of assisting the other metros and large cities with better financial management to tap into the market.