

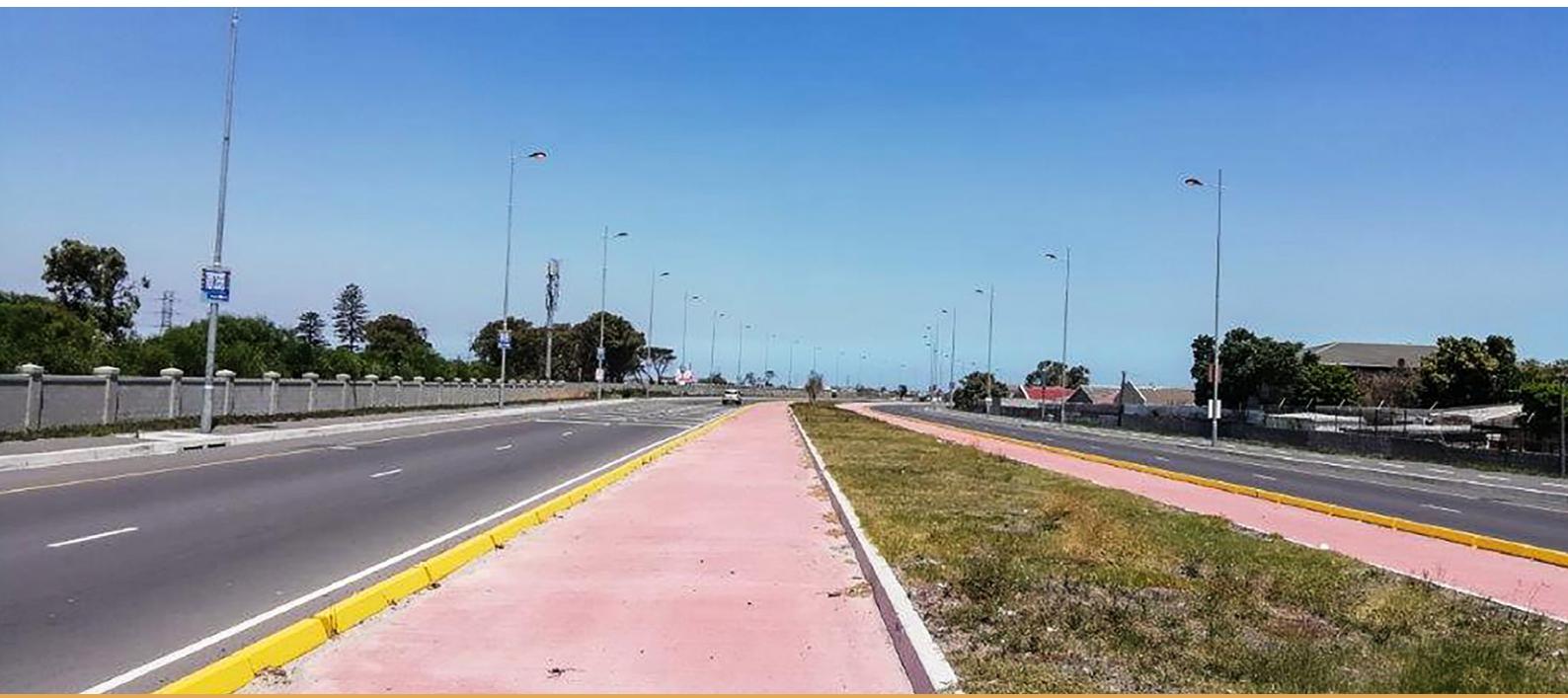
MUNICIPAL BORROWING

BULLETIN

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INSIDE

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CITY OF CAPE TOWN Stock Road BRT

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 achieves this purpose by informing interested parties on developments in the municipal borrowing market. The MBB aims to add value to better understanding of developments and patterns in municipal borrowing through information sharing, analysis, and exchange of topical content relating to municipal borrowing.

CONTEXT

The MBB is issued by the National Treasury on a quarterly basis. This issue covers long term borrowing information up to 30 June 2019, corresponding to the fourth quarter of the 2018/19 municipal financial year.

Data used for this MBB include data submitted by municipalities to National Treasury as required by Sections 71 and 72 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

- The outstanding long-term debt reported by municipalities rose sharply from R62.5 billion to R70.6 billion while lenders reported a total of R69 billion, resulting in a difference of R1.6 billion between the two reporting sides. This is a slight decrease from the R2 billion variance reported in the previous issue of the bulletin. While we cannot expect to completely eliminate the variance between the two reporting sides, it can be reasonably expected that the variance will be lower in the upcoming issues owing to our recent engagements with the lenders whose data were highly inconsistent with that of municipalities.



national treasury

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National Treasury
REPUBLIC OF SOUTH AFRICA



These lenders have committed to providing more accurate data in the next batch of reports.

- New borrowing incurred amounts to R8.0 billion and it only financed about 14 percent of the aggregate capital budget for all municipalities.

- The secondary cities became more visible in the current financial year after raising about R1.5 billion in new borrowing.
- Outstanding long-term debt held by private sector lenders has surpassed the debt held by the public sector and was mainly provided by commercial banks.

DATA AND ANALYSIS

1. Municipal borrowing budgets

Borrowing is a powerful tool, which if used appropriately can allow a municipality the use of its future revenues to address its infrastructure requirements now, albeit at a price. And if used unwisely, it can compromise the financial sustainability of the municipality. It follows then that borrowing should be undertaken only by those municipalities that are well run and such borrowing should be solely on the strength

of local revenues, which include both own source revenues and intergovernmental transfers.

Borrowing should never be used as a tool to close an existing fiscal gap. Rather, it is essential that municipalities borrow only when they are able to realize consistent operating cash surpluses.

Table 1: Budgeted borrowings

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
Original Budget	9 631 795	9 728 855	12 038 295	12 155 568	12 015 730	13 327 264	16 195 667
Adjusted Budget	9 273 438	9 747 836	12 033 281	11 674 332	11 602 644	13 572 036	12 241 682
Actuals	6 490 000	7 583 000	9 357 000	9 222 000	8 099 900	8 749 729	8 004 007
	70%	78%	78%	79%	70%	64%	65%

Source: National Treasury Database

Table 1 above indicates that the aggregated borrowing budgets for all municipalities amounted to R16.2 billion at the beginning of the 2018/19 financial year. Municipalities revised their borrowing budgets downward to R12.2 billion at mid-year. By 30 June 2019 municipalities had only borrowed R8 billion, which is about 65 percent of the revised

borrowing budgets. The underutilisation of the borrowing budgets should not always be viewed as a bad thing. Municipalities shouldn't borrow just because they can, or had planned to. They should borrow only if they can spend the money wisely and if their financial conditions allow.

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

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	2018/19
	Actual										
Capital expenditure	39 577	39 625	30 945	33 239	41 679	47 932	53 241	54 682	54 411	58 756	55 417
New Borrowing	9 463	8 226	6 401	6 211	6 490	7 583	9 357	9 222	8 099	8 750	8 004
New borrowing as a % of CAPEX	24%	21%	21%	19%	16%	16%	18%	17%	15%	15%	14%
Outstanding debt	32 366	35 388	43 190	45 640	48 078	51 431	53 493	60 903	62 043	62 512	70 627

Source: National Treasury Database

Municipalities will always need to make investments in infrastructure for several reasons, i.e. for the renewal/replacement of dilapidated infrastructure; to respond to increased demand on existing infrastructure as a result of population or enterprise growth; to lay a foundation for economic growth; and to eradicate infrastructure backlogs in the interest of adequate and inclusive service delivery. It is therefore imperative that municipalities know at any point in time what their infrastructure investment needs are, not only at present but over the medium to long term, and these should be clearly articulated in their strategic plans such as the Integrated Development Plans, Built Environment Performance Plans and the overall budget. The optimum funding mix for the required infrastructure investment should be determined considering the available funding options. Infrastructure forms a significant part of

a municipality's capital budget, making successful infrastructure investment dependent on the effective implementation of the capital budget.

During the period under review, the aggregated capital budgets for all municipalities was adjusted marginally to R73.5 billion from an original R73.4 billion, but municipalities only realized an actual expenditure of R55.4 billion by the end of FY2018/19. This is 75 percent expenditure on the adjusted capital budget and is less by 7 percent than the previous financial year's 82 percent expenditure on the capital budget. Fourteen percent of the capital expenditure for the 2018/19 fiscal year came from the R8 billion incurred in new borrowing. Municipalities are urged to pay closer attention to their expenditure forecasts, which are chronically unrealistic.

Table 3: Outstanding long term debt as at 30 June 2019

Municipal Category	Municipality	Total debt Q4 2018/19 R'000	Share of total debt	Actual Revenue 2018/19* R'000	Debt to revenue ratio
A	BUF	345 554	0,5%	5 903 053	6%
	NMA	1 151 863	2%	9 299 835	12%
	MAN	967 818	1%	6 682 457	14%
	EKU	8 497 509	12%	34 340 908	25%
	JHB	21 982 991	31%	52 028 010	42%
	TSH	11 606 751	16%	32 282 996	36%
	ETH	9 272 314	13%	35 196 133	26%
	CPT	6 740 805	10%	40 204 516	17%
Total Metros		60 565 605	86%	215 937 908	28%
B	B1 (19)	6 267 498	9%	48 059 119	13%
	Other Municipalities	3 236 797	5%	67 268 159	5%
C	Districts	557 333	1%	18 035 706	3%
Total all municipalities		70 627 233		349 300 892	20%

*excluding capital transfers

Source: National Treasury Database

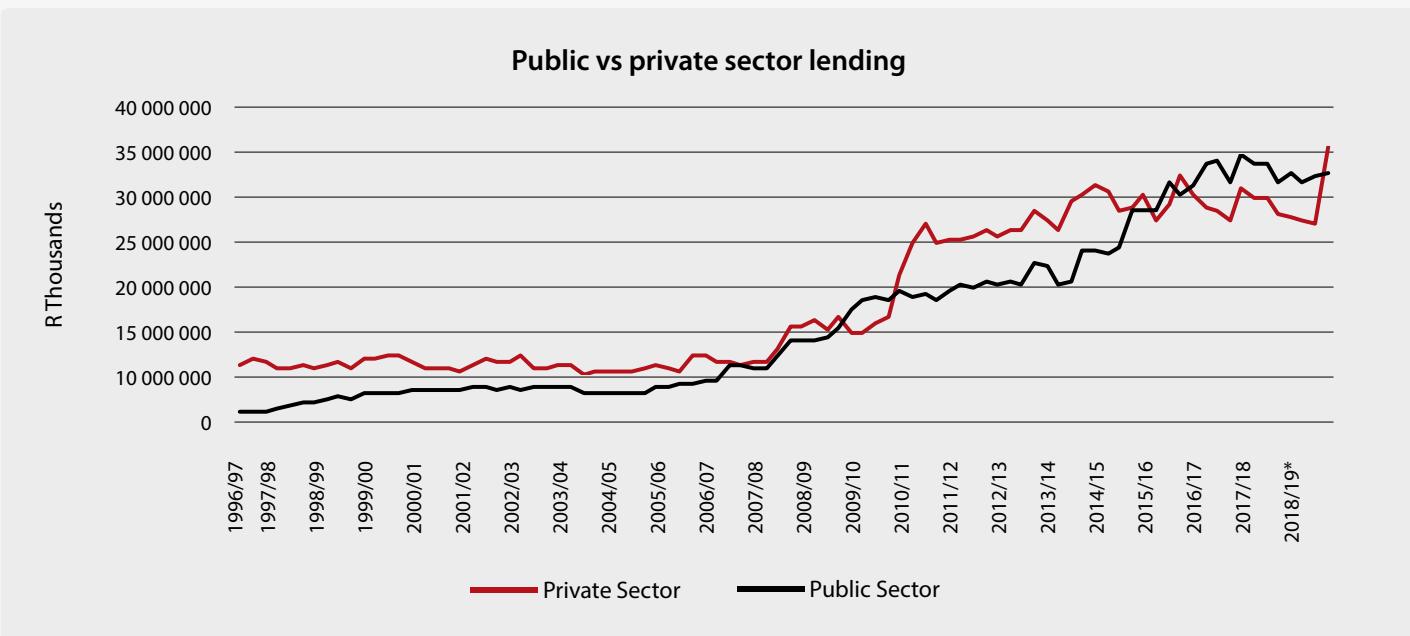
The aggregated outstanding long-term debt for all municipalities grew significantly by about R8.1 billion during the 2018/19 financial year and now sits at R70.6 billion as shown in Table 3 above, compared with R62.5 billion at the end of the 2017/18 financial year. This is a year on year increase of about 13 percent and is largely attributable to the metros, who were responsible for R6.3 billion of the R8.1 billion increase in total municipal long-term debt. This raised the aggregate long term debt balance for the metros to R60.5 billion. The metros' proportional share of total municipal long-term debt is however down from 87 percent to 86 percent over the one-year period. Of the metros, Ekurhuleni and Johannesburg were the biggest borrowers in the current financial year,

having each increased their outstanding long-term debt by at least R2 billion. Tshwane and eThekweni both raised new borrowings of at least R1 billion each. Outstanding long-term debt owed by the secondary cities rose by R1.5 billion from R5.7 billion to R6.2 billion, with the other local municipalities also raising their long term debt balance by about R400 million from R2.8 billion to R3.2 billion

Although outstanding long term debt for all municipalities has risen considerably during the course of the reporting period, total municipal long-term debt as a percentage of total municipal revenues is calculated at 20 percent after it grew from 18 percent in the previous year.

3. Analysis of long-term debt as reported by lenders

Figure 1: Public and private sector lending to municipalities



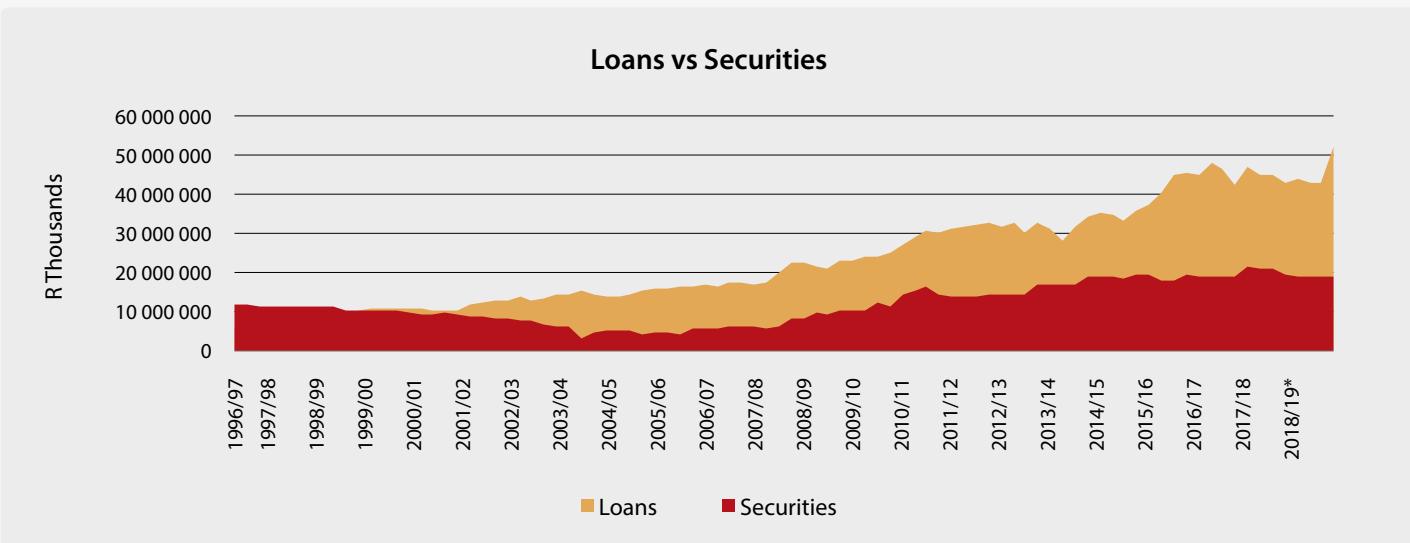
*Incl QIV

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

From Figure 1 above, we see, for the first time since June 2016, the amount of long-term debt owed to private sector lenders has surpassed that owed to the public sector. The R8 billion new borrowing has almost exclusively been from private financiers and as a result, municipal long-term debt from the private sector now stood at R35.8 billion, above the R33.2 billion in municipal debt belonging to public sector lenders. Note that as at 01 July 2018, which marked

the beginning of the financial year, public sector held long term debt amounting to R32.1 billion against R28.2 billion for the private sector. This growing private sector-based financing reflects private sector confidence in well-managed municipalities, and could lead to even more private sector lending. As more creditworthy municipalities access more commercial financing, this will free up DFI resources to focus on their developmental roles.

Figure 2: Municipal long-term debt instruments



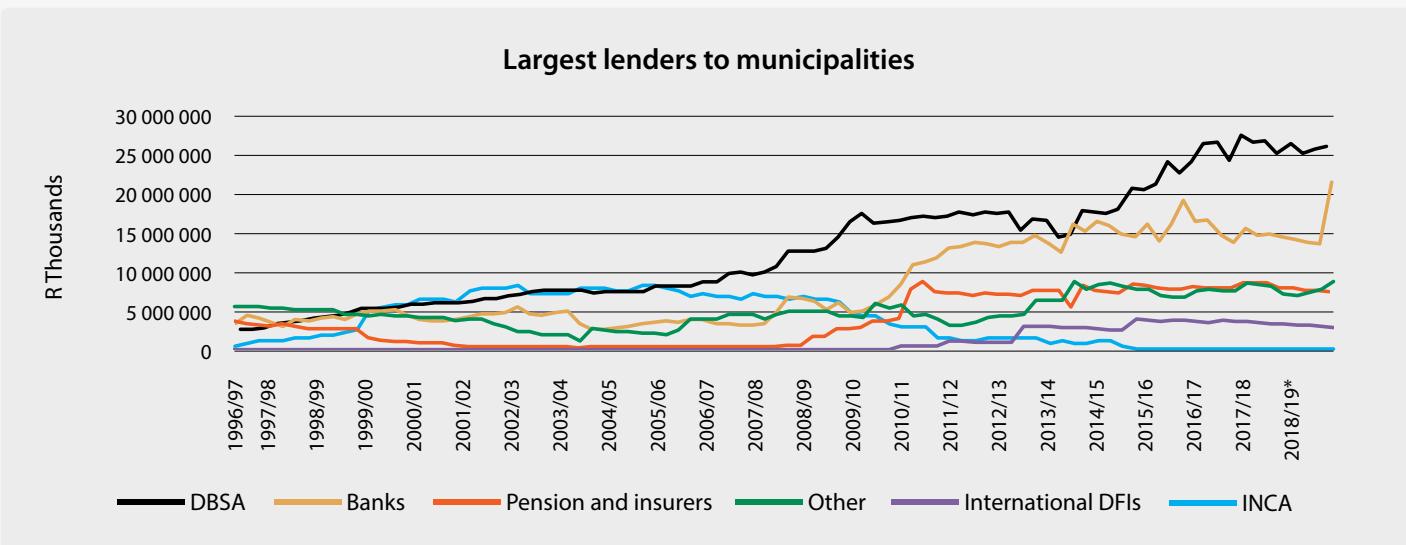
*Incl QIV

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

The increased private sector lending reported above was entirely in the form of loans. Figure 2 shows a sharp increase in loans from R41.7 billion to R50.8 billion during the twelve-month period between 01 July 2018 and 30 June 2019 while long-term debt in the form of municipal bonds has declined from R18.6 billion to R18.2 billion. Although private sector investment is positive, we would like to see more of such investment in

the form of instruments, such as municipal bonds, with longer terms, ideally 20 years and above. Ultimately, it will be important that long-term borrowing should be reflective of the economic lives of the assets that are being financed. Municipal bonds can provide the required tenors, if municipalities (especially the metros) seek longer maturities. So far, most municipalities have not shown significant interest in longer-term debt.

Figure 3: Largest lenders to municipalities



*Incl QIV

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

The commercial banks are at the centre of the growth in private sector lending and Figure 3 shows just how their exposure in municipal long-term debt has risen sharply by almost 50 percent to R21.8 billion from R14.7 billion this time in the previous financial year. The DBSA's exposure is slightly up from R25.4 billion to R26.4 billion in the same period. Municipal debt held by pension funds and insurers is down by R452 million since the start of the 2018/19 fiscal year while international DFIs are now owed R3.3 billion from R3.7 billion at the beginning of the year under review.

Another issue that seems to be contributing to an illiquid secondary market is the perception that many fund managers have of municipal bonds. Some see municipal debt issues as being similar to corporate issues. While municipal bonds may be somewhat riskier than sovereign issues, local government is more similar to national government than to corporations. The powers and functions of municipalities, including their fiscal powers, are founded in the Constitution. Unlike corporations, they have permanent existence, and cannot be liquidated in the event of bankruptcy. They have constitutionally mandated own revenue sources which they can use to meet their debt obligations.

According to Global Insight, South Africa's metropolitan municipalities account for 58.4% of national GVA and 40.5% of the population. With their constitutional status and fiscal powers, these municipalities are in a position to structure and issue bonds similar to sovereign bonds. Given this, National Treasury has been exploring how municipalities might replicate sovereign RSA bonds, in order to better fit into investment portfolios and thus improve the liquidity of secondary markets. This is also in line with the objectives of the updated Municipal Borrowing Policy Framework which advocates various strategies to support a liquid secondary market. There are various approaches to the issuance of sovereign bonds that might also be of use to municipal bond issuers as we pursue a more liquid municipal bond market. Some examples include:

TOPICAL ISSUES

EXPLORING REPLICA BONDS

During 2017 and 2018 National Treasury undertook a study of the secondary municipal bond market to better understand why the secondary market for municipal securities has remained underdeveloped. The outcomes of the research were highlighted in the 11th issue of the Municipal Borrowing Bulletin. One of the key issues raised by investors was the manner in which municipal bonds are structured (some recent issues have been amortized, unlike sovereign bonds which use bullet structures). Some portfolio managers indicated that they found it difficult to include amortized bonds in their portfolios. This greatly limits the potential secondary market for such bonds.

1. Expanding investor supply base and relationship management strategy

The South African municipal bond market is largely a “buy and hold” market. Most purchasers of municipal bonds hold them to maturity and the universe of primary market purchasers is limited. To foster a robust secondary market, municipalities need to be exposed to a wider variety of potential investors and there will need to be a significantly higher volume of municipal bonds available.

Many investors and potential investors consulted during our municipal securities secondary market study spoke of the importance of a municipality's relationship management strategy. They want to get to know the municipality through road shows and other interactions, in advance of and in between any actual bond issues. By going to potential investors and presenting a clear long-term financial strategy, municipalities can build investor confidence and increase the chances that they will participate in primary issues as well as in the secondary market. It is wise to keep potential investors aware of the municipality's financial condition, investment plans and bond issuance plans, if a municipality wants to expand its investor base.

2. Exploring the possibility of using the sovereign's auction system

Private placement of bond issues, as is the current practice, cannot guarantee that a municipality is getting the lowest borrowing cost. We would like to explore the possibility of a municipality utilizing the RSA auction system, or a similar system, whereby participants would be

bidding for the municipality's bonds. This is one way that a municipality could determine the actual market value of their debt instruments, and hopefully attract a broader set of investors.

3. Increased collaboration between national government and local government in creating municipal bond market awareness

Several fund managers told us that if municipalities want to attract their interest, they need to be more visible through frequent engagements with investors and potential investors. We would like to explore ways in which municipalities can partner with the National Treasury on roadshows and other relationship management efforts.

In the next issue of the Municipal Borrowing Bulletin we will go into detail with regards to the strategies. National Treasury would like to solicit inputs from any municipality that would like to pursue the possibility of a replica bond.