Turnaround & Restructuring

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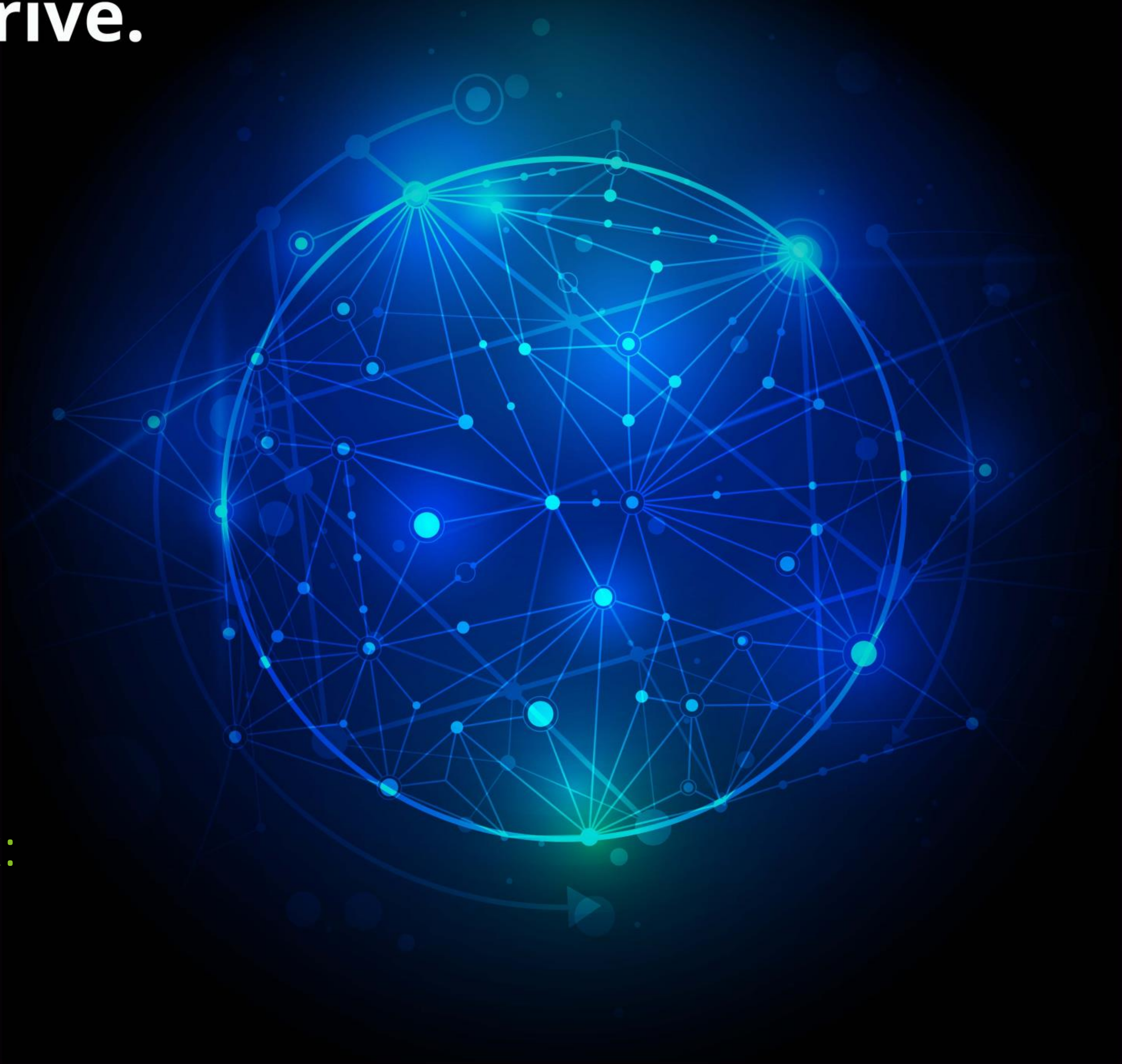

Deloitte Stability Index:

H2 2021 update

March 2022

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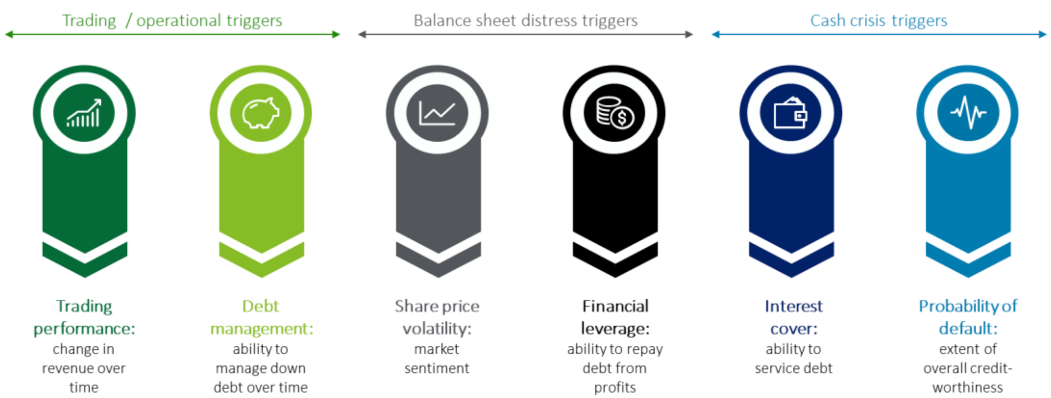
Deloitte Stability Index

The Deloitte Stability Index ("**DSI**") measures the extent to which a company is financially stable based on a granular model that converts leading indicators into a composite score.

The Deloitte Stability Index tracks six leading indicators



We take a four-step approach to arrive at a DSI score

Ratio analysis 1	The six ratios opposite are calculated for each listed company in the dataset for the defined time periods.
Scoring 2	Each ratio is assigned a score based on boundaries that have been set.
Aggregation 3	The six ratios are aggregated to form an overall score out of 100, where 100 is the highest level of stability.
Categorisation 4	We assign each company a sector classification based on Deloitte's industry taxonomy, and banking relationships are derived from AFS.

Key themes for H2 2021:

Pent up demand buoys the index

As lockdowns eased worldwide, demand for goods spiked while interest rates remained low. The accompanying surge in trade fuelled a commodity boom and price inflation.

Well-run companies are leaner

Companies with the highest DSI scores did not waste a good crisis: cost control measures improved profitability and diversification reduced their reliance on challenging SA markets.

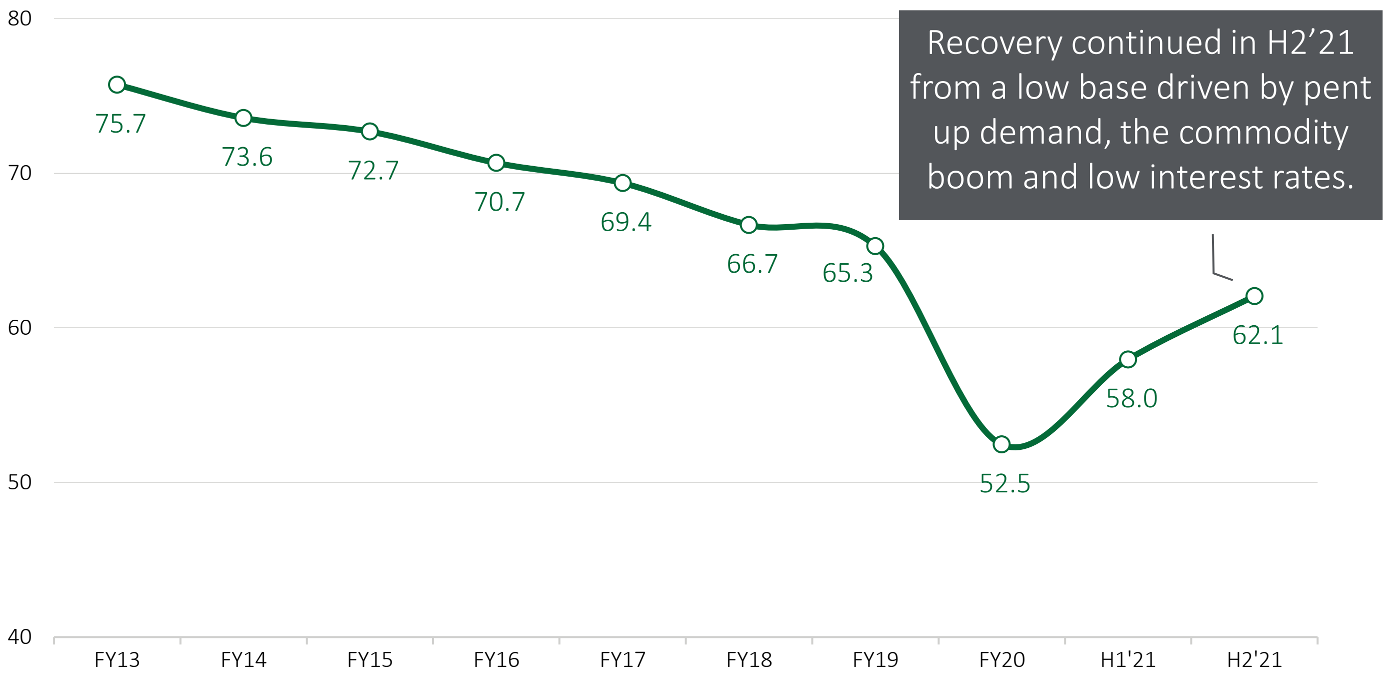
Interest rate reversion will bite

Global inflation fears that were thought to be temporary will be prolonged by war in Ukraine, and a more than 100bps repo rate increase is likely to follow in 2022.

Consumers will be under pressure

Unemployment in SA is the highest in the world, real wages have been falling since 2010 and consumer default rates are at a peak last seen during the global financial crisis. As inequality widens, consumer spending patters will polarise: B2C businesses must either adapt or die.

Figure 1.1: Deloitte Stability Index Score (score is stated out of 100)

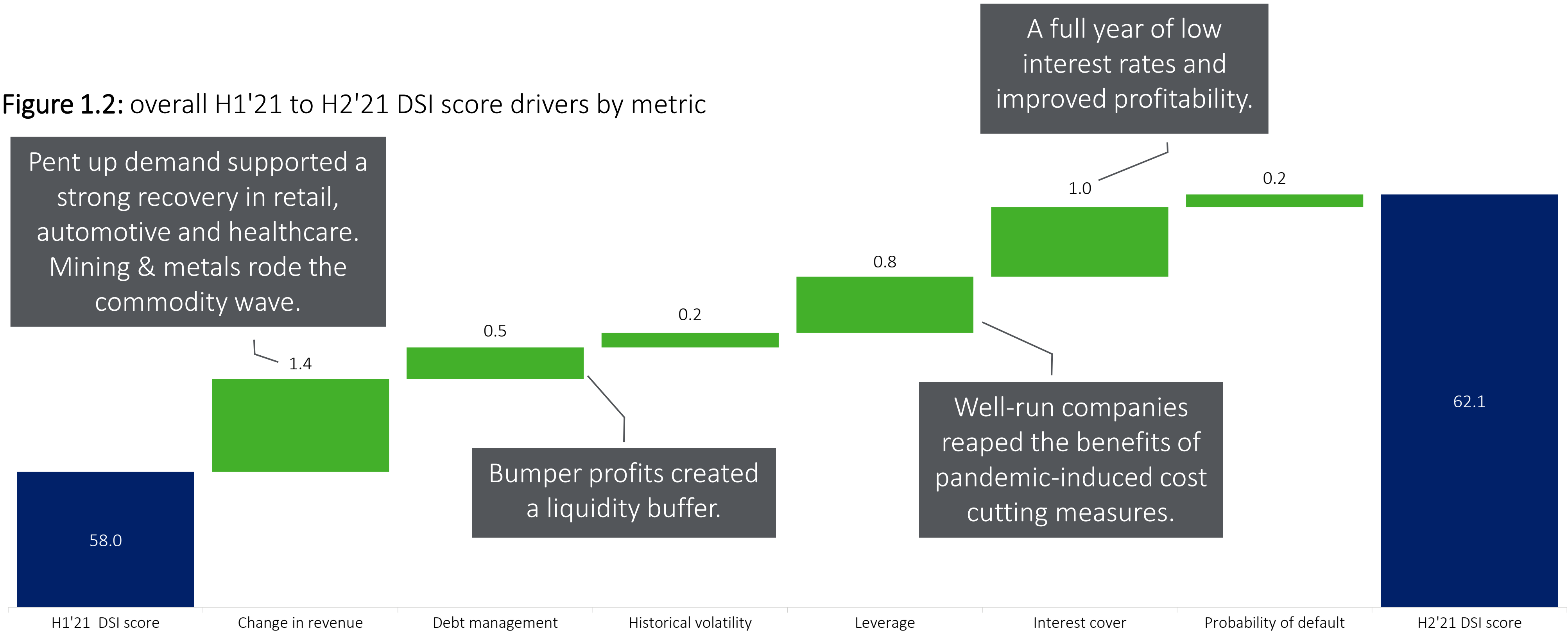


Key assumptions and limitations

- DSI data is based on publicly available information for listed JSE companies as reported on Capital IQ. We have not sought to audit, verify or reconcile this data to original annual financial statements.
- Detailed DSI information is available on request.

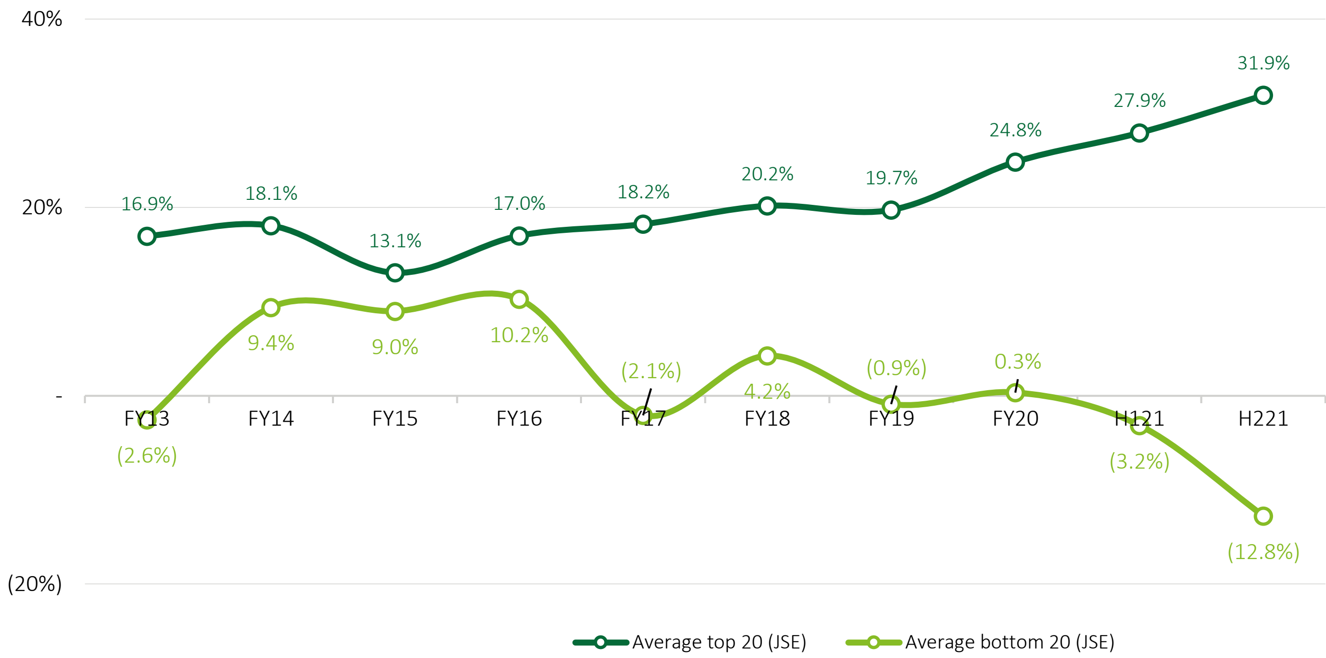
The improvement in the overall DSI can be attributed to one off post-pandemic effects: pent up demand as consumers emerged from isolation, and price inflation as supply chains struggled to cope. Low interest rates and Covid-induced cost cutting measures further supported profitability, driving the DSI close to pre-pandemic levels.

Figure 1.2: overall H1'21 to H2'21 DSI score drivers by metric



For the best-run companies, the pandemic was an opportunity to create leaner, more competitive organisations that not only survived, but thrived when the market turned. Weaker companies are increasingly loss-making and are particularly exposed to challenging markets, e.g. inbound international tourism.

Figure 1.3: EBITDA margin for the average top 20 vs bottom 20 companies in the DSI



More profitable sectors

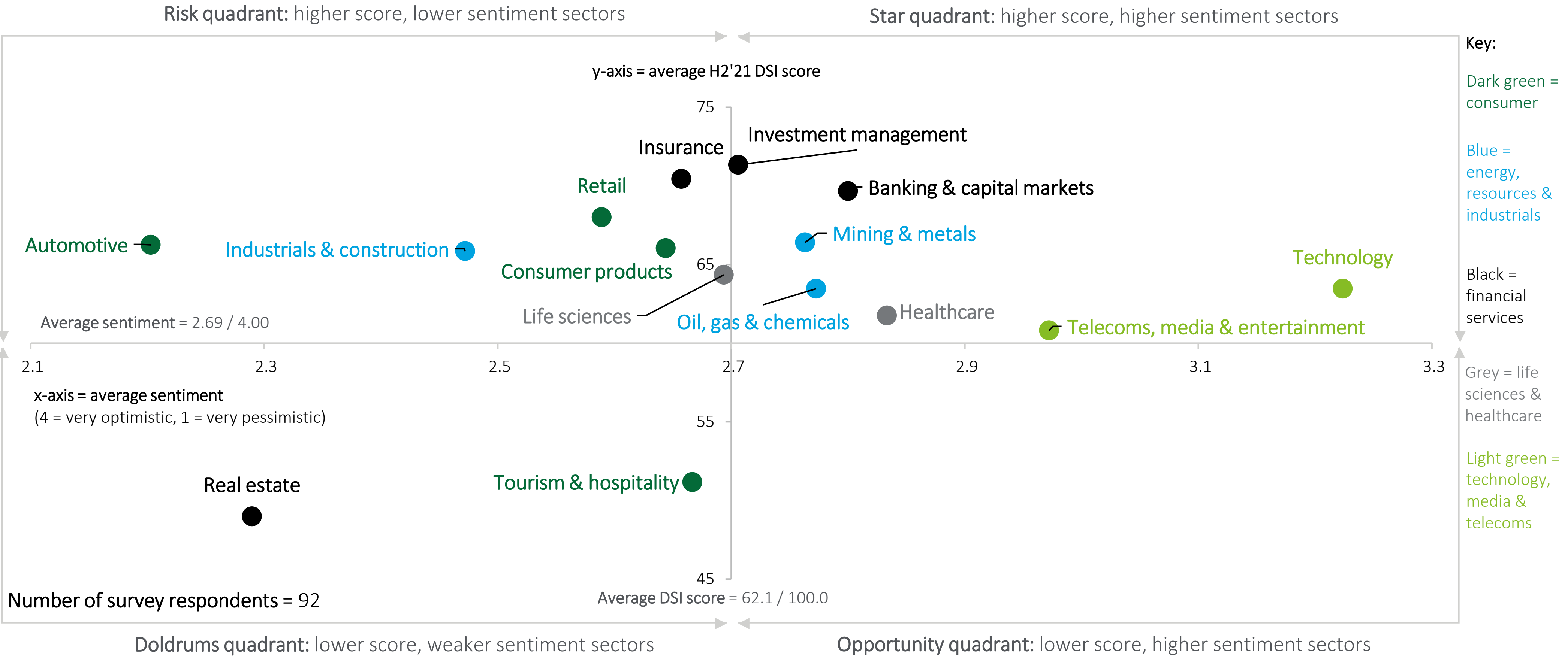
- Life sciences
- Mining & metals
- Oil, gas & chemicals
- Healthcare
- Industrials & construction

Less profitable sectors

- Insurance
- Consumer products
- Tourism & hospitality
- Retail
- Technology

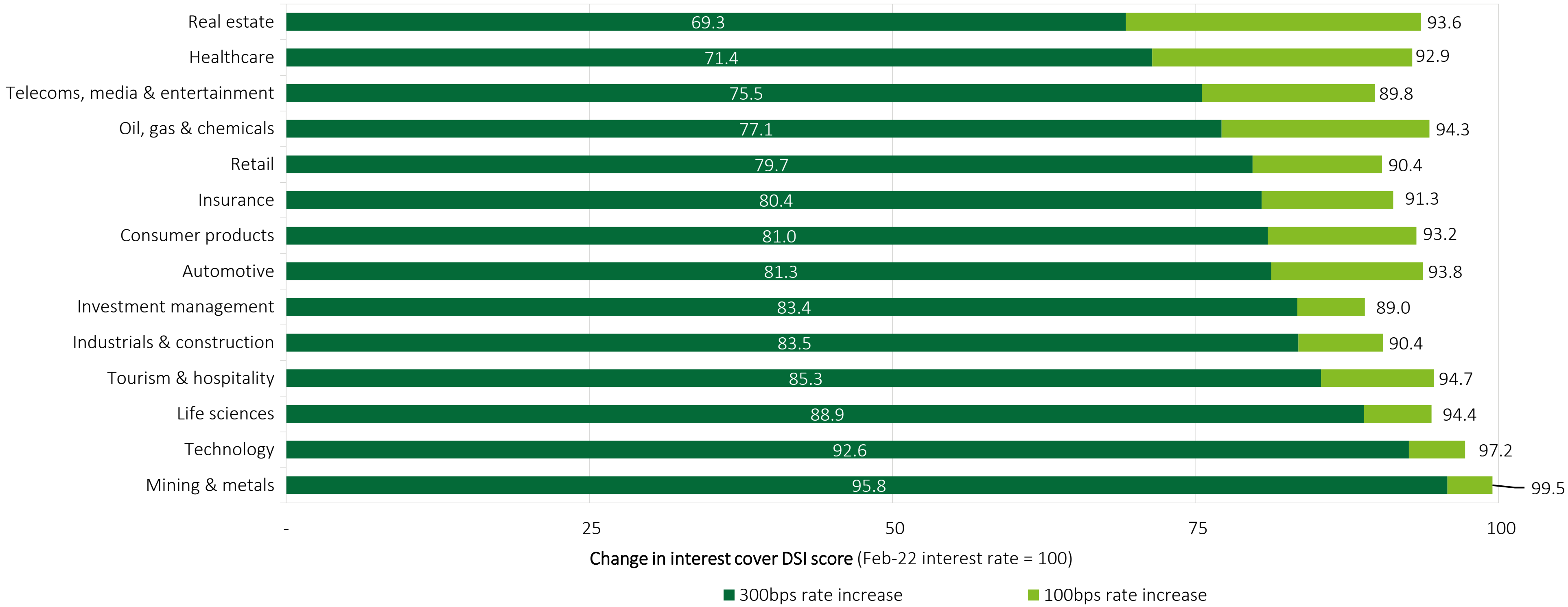
When average sector growth sentiment across the 92 South African respondents to the 2022 Deloitte Restructuring Survey is compared to current average DSI scores, the sectors most at risk of contraction appear to be automotive (shift to EV & near-shoring), construction (lack of infrastructure spend) and retail (SA consumers under pressure).

Figure 1.4: Average H2’21 DSI score per sector ↑ vs average optimism for growth in the sector in the next 12 months by 2022 Deloitte Restructuring Survey respondents →



A 100bps increase in interest rates appears manageable across the JSE, particularly in the context of strong 2021 profitability. However, if interest rates revert to pre-pandemic levels (300bps), highly leveraged sectors such as real estate, oil & gas and healthcare would see a rapid deterioration in debt serviceability. As we move through the interest rate cycle, proactive and more regular monitoring of these exposures will become critical.

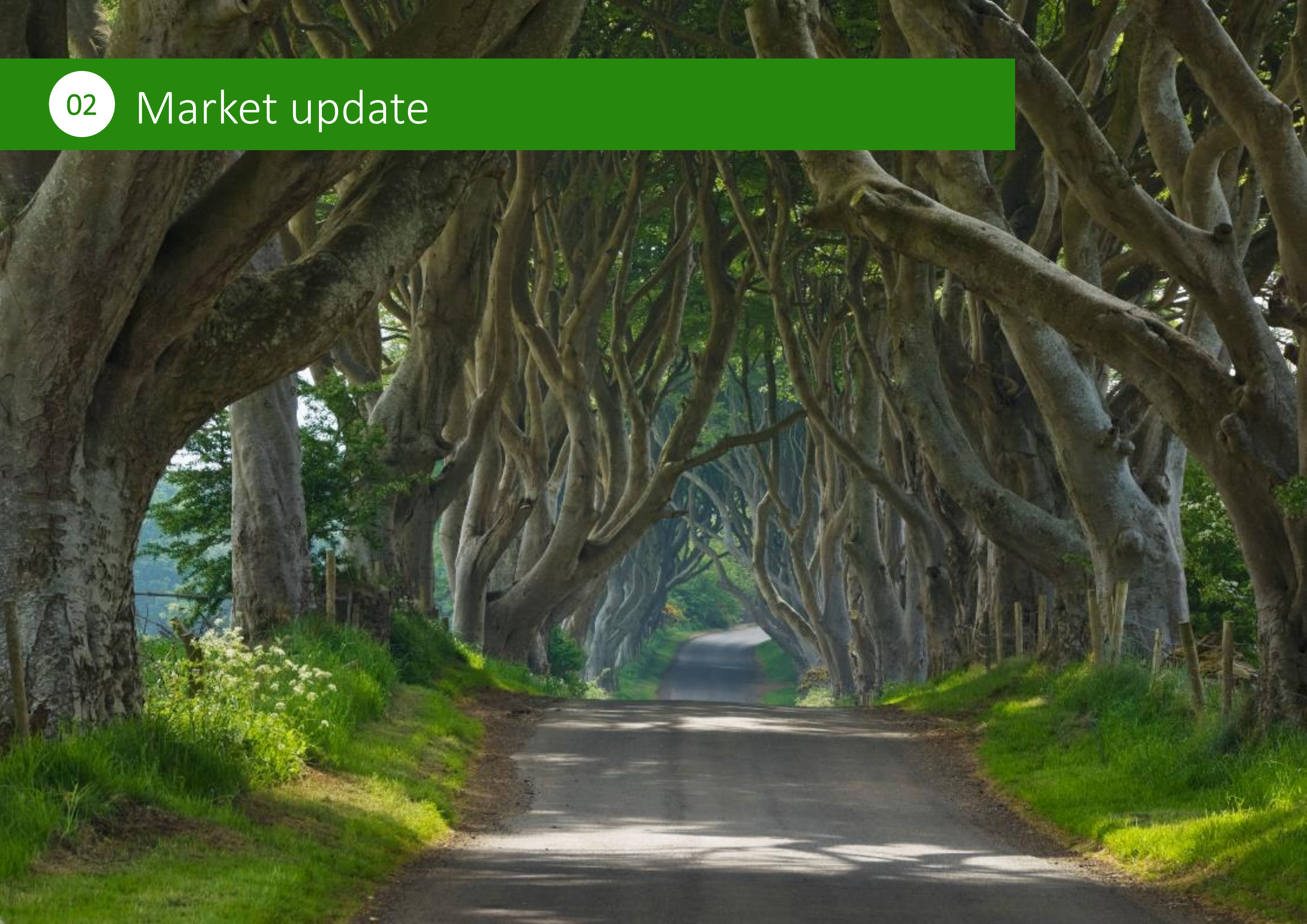
Figure 1.5: Illustrative impact of an interest rate rise on SA sectors



The graph shows the impact of an increase in interest rates on average sector interest cover, where current interest cover has been rebased to 100. For real estate, for example, a 100bps increase in interest rates will illustratively reduce interest cover to 93.6% of baseline, while a 300bps increase will reduce it to 69.3% of baseline.

N.B. We have assumed that all debt attracts a variable interest rate referenced against the South African Prime rate.

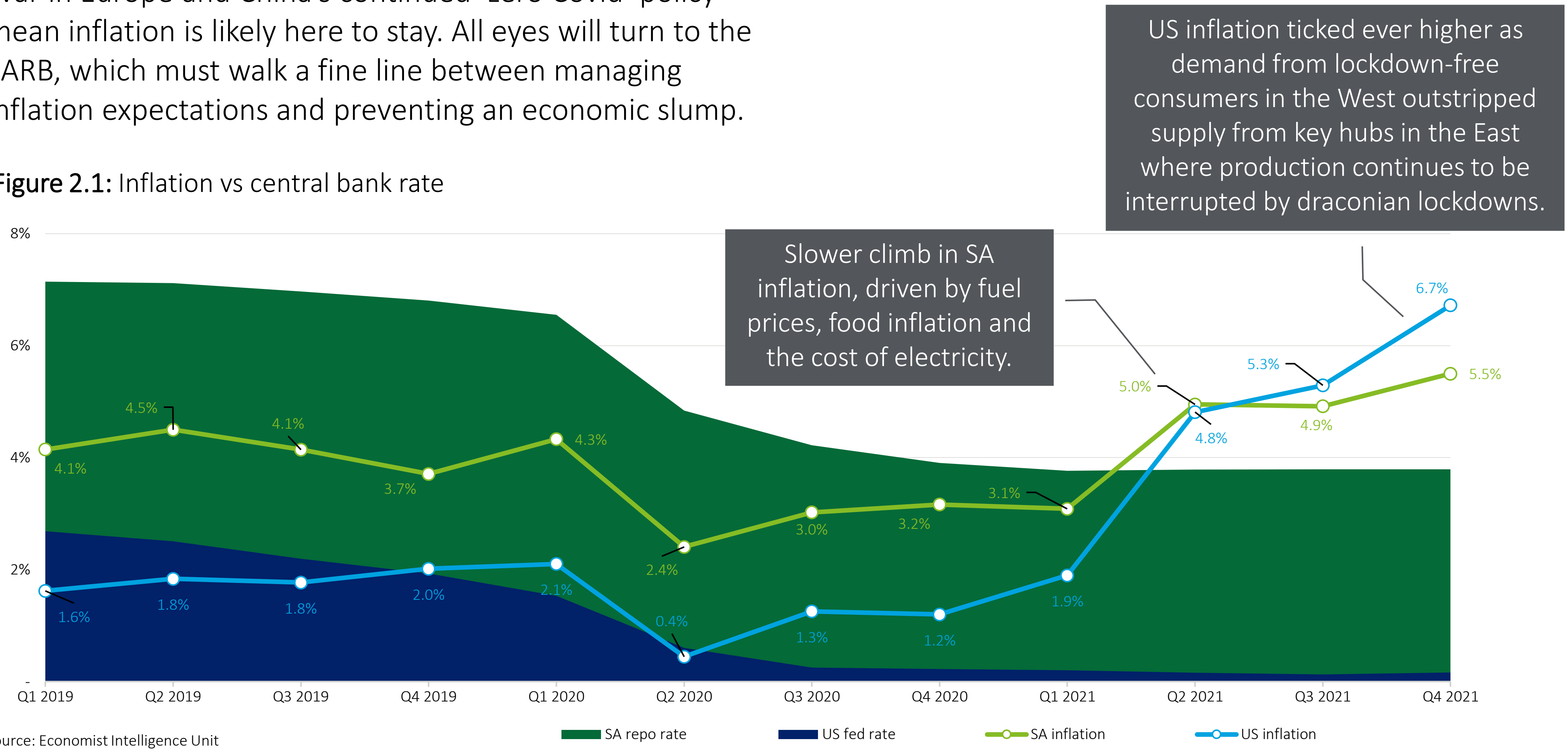
02 Market update



Interest rate reversion: all eyes on SARB

War in Europe and China's continued 'zero Covid' policy mean inflation is likely here to stay. All eyes will turn to the SARB, which must walk a fine line between managing inflation expectations and preventing an economic slump.

Figure 2.1: Inflation vs central bank rate



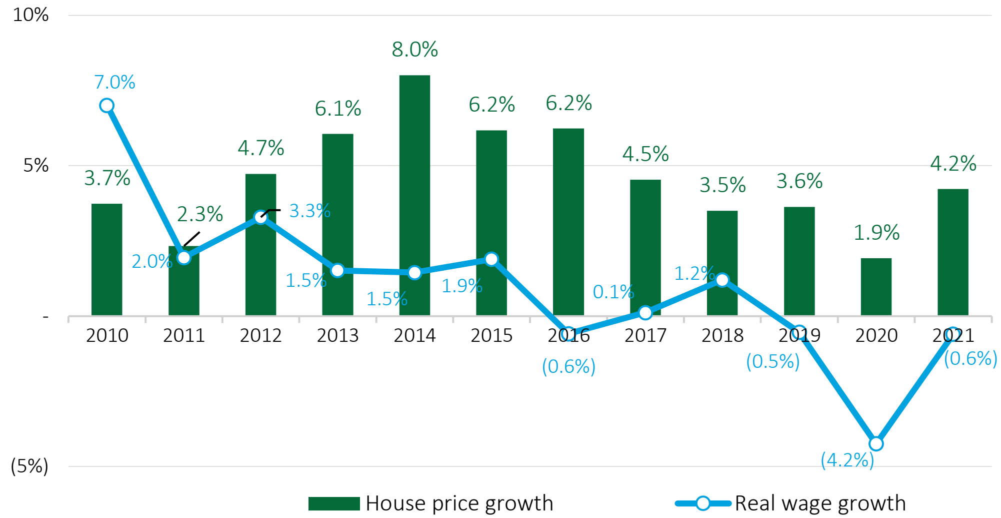
Source: Economist Intelligence Unit

Consumers under pressure

Looking ahead, consumers are set to be flanked on all sides by a range of risk factors. Interest rate reversion could send consumer debt defaults (already at global financial crisis levels) to record highs, and if pay does not keep up with high inflation, real wages will fall. Should asset prices continue to show resilience, the gap between the asset-owning rich and wage-earning poor will widen.

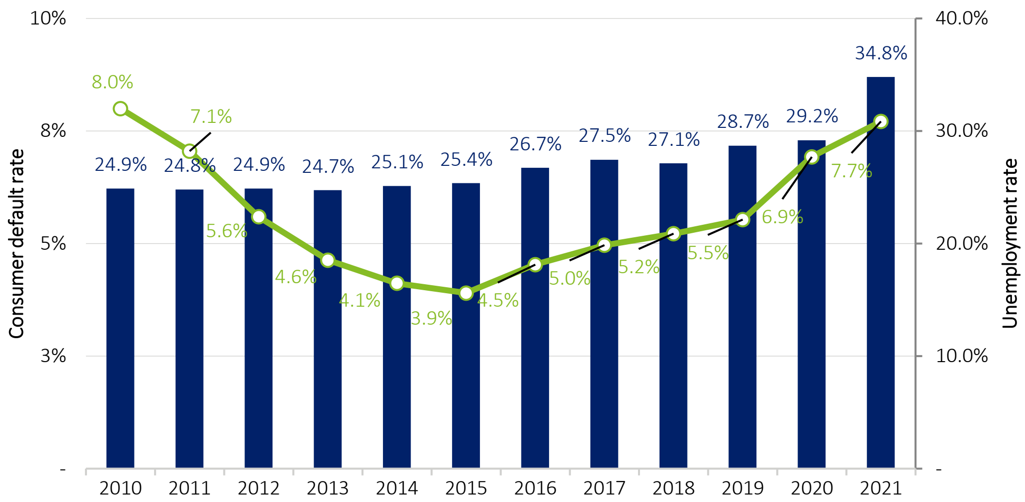
Setting aside the societal ramifications of an increasingly unequal society, what does this mean for consumer-facing businesses? Spending patterns are likely to polarise, and companies positioned at the top or bottom end of the market will thrive, while those that refuse to adapt will struggle for survival.

Figure 2.2: House price vs real wage growth in South Africa



Source: Economist Intelligence Unit

Figure 2.3: Unemployment vs consumer debt default rate in SA

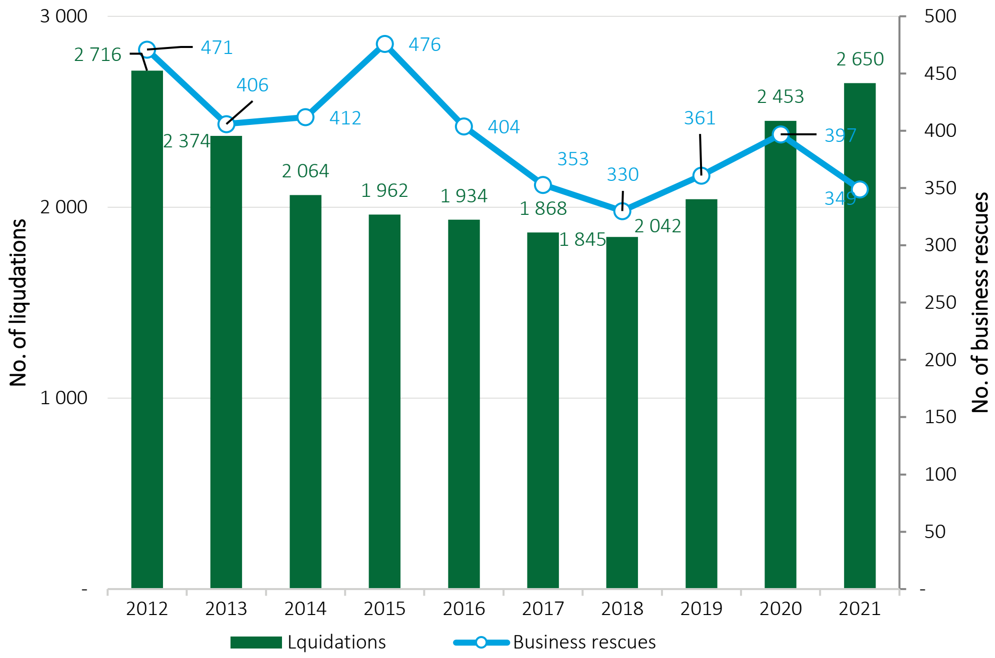


Source: Economist Intelligence Unit

Distressed M&A opportunity

The number of business rescues fell in 2021 despite an increase in corporate failures, reflecting stakeholders' scepticism of BR. We believe that this trend will continue in 2022, and that informal restructurings with a distressed M&A component will take centre stage.

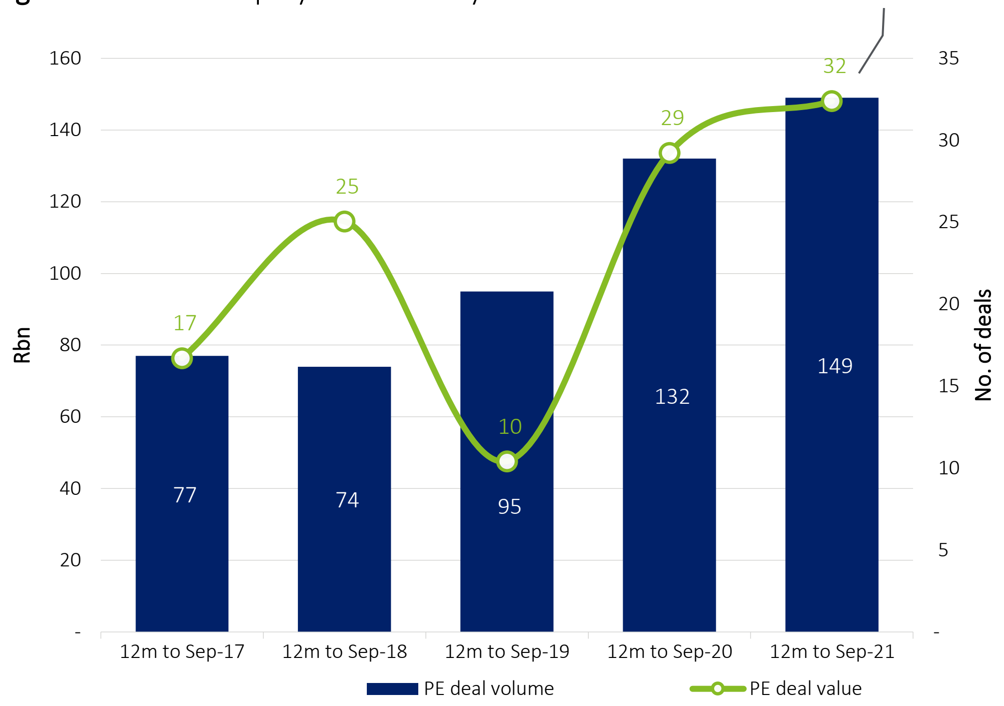
Figure 2.4: No. of liquidations vs total business rescues in SA



Source: Stats SA, CIPC

Figure 2.5: Private equity M&A activity in SA

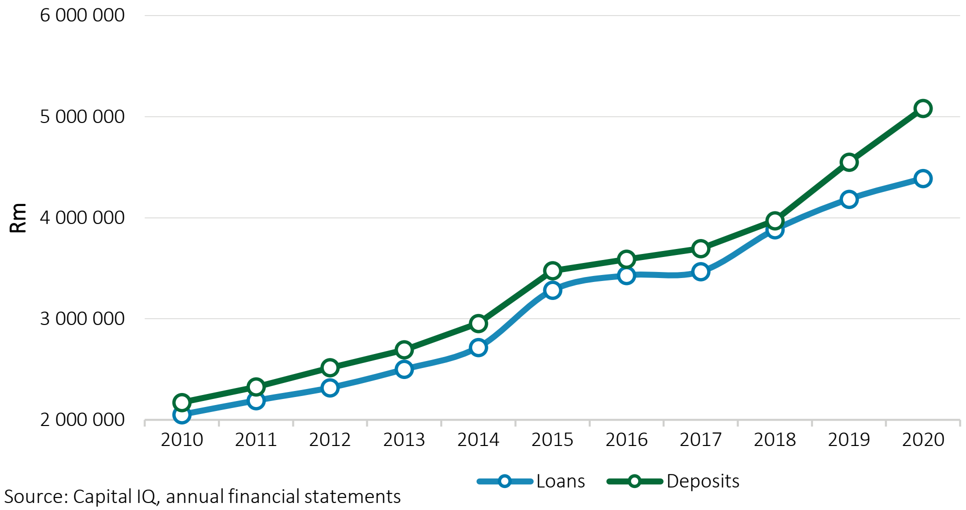
Small reduction in average deal size suggests pressure on valuations.



Source: Dealmakers South Africa

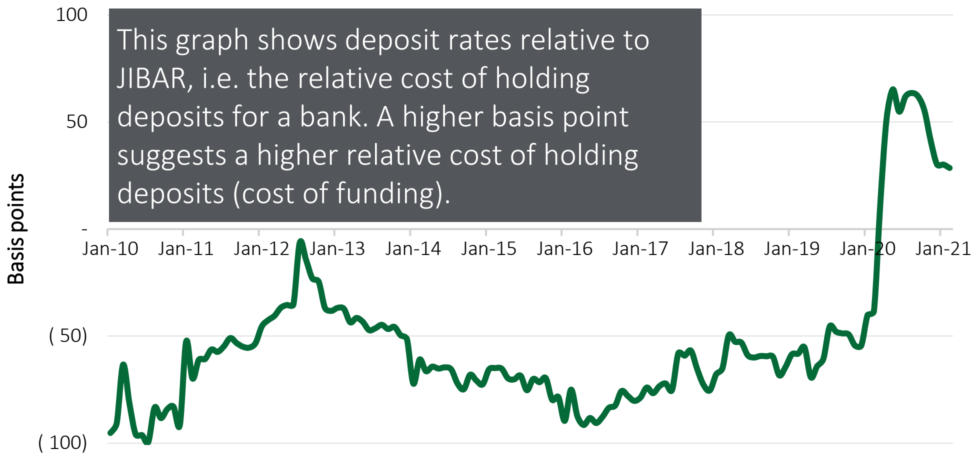
Banks have capital to deploy and the cost of not putting it to work is increasing. Companies with a clearly articulated investment case supported by robust forecasts should be able to secure funding for acquisitions on favourable terms.

Figure 2.6: Total deposits vs loans for the big four SA banks



Source: Capital IQ, annual financial statements

Figure 2.7: Weighted average cost of funding for SA banks



Source: SARB

03 Our Turnaround & Restructuring team

Our Turnaround & Restructuring team

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Key highlights:

- Almost 50 years of collective restructuring experience
- Over 25 years of European experience
- Almost 20 years of banking and private equity experience
- Full team membership of SARIPA / TMA
- Four SARIPA Insolvency Law & Practice certifications
- Four chartered accountants
- Global insolvency / cross border expertise

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