Research Update:

South African Power Utility ESKOM Holdings SOC Downgraded To 'BB+' Following Management Suspensions; Outlook Negative

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Table Of Contents

Overview
Rating Action
Rationale
Outlook
Ratings Score Snapshot
Related Criteria And Research
Ratings List
Research Update:

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Downgraded To 'BB+' Following Management
Suspensions; Outlook Negative

Overview

• The recent announcement of ESKOM Holdings SOC Ltd.'s board regarding the
  suspension of the company's CEO and three senior executives has led us to
  have less confidence in the company's corporate governance arrangements
  as well as in its stand-alone credit profile (SACP).
• We continue to assume there is an extremely high likelihood that ESKOM
  would receive extraordinary state support if needed, which currently
  leads us to add six notches of uplift to our assessment of the company's
  SACP.
• Consequently, we are lowering our long-term ratings on ESKOM to 'BB+'
  from 'BBB-' and national scale ratings to 'zaA/zaA-2' from 'zaAA-/zaA-1'.
• The negative outlook reflects our opinion that material execution risk
  remains associated with the government's support plan, and that ESKOM's
  operating performance has not yet stabilized due to rising costs and the
  very tight generation capacity margin in South Africa.

Rating Action

On March 19, 2015, Standard & Poor's Ratings Services lowered its long-term
local and foreign currency ratings on South Africa power utility ESKOM
Holdings SOC Ltd. to 'BB+' from 'BBB-'. The outlook is negative.

At the same time, we lowered our long- and short-term South Africa national
scale ratings to 'zaA/zaA-2' from 'zaAA-/zaA-1'.

Rationale

The downgrade reflects our reassessment of ESKOM's management and governance
to "weak" from "fair." Also, we have revised down our assessment of ESKOM's
stand-alone credit profile (SACP) to 'ccc+' from 'b-', leading us to lower the
long-term rating to 'BB+' from 'BBB-'.

Our view of ESKOM's "weak" business risk profile factors in our assessment of
a "weak" regulatory advantage under the framework supervised by the national
energy regulator of South Africa. The business risk profile also reflects our
opinion of important execution and operational risks associated with ESKOM's
very large capital expenditures program, which has been subject to successive
delays at a time when South Africa's reserve margin remains stretched.
Our assessment of ESKOM's "highly leveraged" financial risk profile incorporates our opinion that the company's stand-alone credit metrics will remain weak over the medium term, due to continued delays in implementing tariffs that reflect its real-time costs, investment needs, and the rising debt associated with its large capital expenditures. We apply our standard volatility table to ESKOM, as per our corporate methodology criteria, because we assess its regulatory advantage as "weak."

Our revised view of ESKOM's management and governance as "weak" is based on the following observations:

• The recent announcement of ESKOM's board regarding the suspension of the company's CEO and three senior executives, pending an inquiry, leads us to question the corporate governance arrangements at the company.
• We think the suspension of such senior members of the executive introduces a gap in the leadership at the company at an important time, given that the entity still has material operational and liquidity management issues to overcome.
• ESKOM has a track record of high turnover at the senior executive level, with a number of changes in CEOs and CFOs in recent years.
• The suspension also leads us to question the timing of the delivery of new power plants and the cost of project completion.
• The pending inquiry is expected to last three months, and the results—if they reveal further cost overruns, delays in the delivery of power, or cash flow weaknesses—could lead to a further deterioration in the company's credit quality.

However, we could reassess our view of ESKOM's management and governance if the company implements practices to counteract management's shortcomings.

We consider ESKOM to be a government-related entity (GRE). Under our criteria for GREs, we believe there is an "extremely high" likelihood that the Republic of South Africa would provide timely and sufficient extraordinary support to ESKOM in the event of financial distress. This is based on our view of ESKOM's:

• "Very important" role for South Africa, since it is the nation's dominant electricity provider. The government considers ESKOM to be a strategic asset and, in our view, privatization is unlikely in the medium term. ESKOM provides an essential commodity to municipalities and large industrial customers; and
• "Integral" link to the South African government, reflecting its full ownership by the government and the explicit government support.

Also, ESKOM obtained a dividend waiver from the government during the build program.

Moreover, the South African government has a strong track record of providing extraordinary support to critical GREs, including ESKOM, which has received
capital injections and large guarantees from the government in the past.

Our assessment of an "extremely high" likelihood of government support leads us to apply six notches of uplift to the SACP, resulting in our 'BB+' long-term rating on ESKOM.

**Liquidity**

Our "less than adequate" assessment of ESKOM's liquidity reflects the pressure ESKOM faces, based on our assumptions of negative working capital, higher capital expenditures, and the continued challenging operational environment. In addition, we think that the company has a relatively high dependence on what we consider to be uncommitted sources of funding to support its debt maturity profile.

In our calculation of the company's liquidity sources, we include sovereign-guaranteed domestic bond issuances amounting to about South African rand (ZAR) 12 billion-ZAR15 billion from Jan. 21, 2015, to Jan. 21, 2016, along with committed facilities amounting to ZAR13 billion from development finance institutions (DFIs) and export credit agencies (ECAs). We note that ESKOM may choose to draw down close to ZAR41 billion under the ZAR150 billion sovereign-guaranteed domestic medium-term note (DMTN) program over March 2014-March 2018, of which currently ZAR51 billion are still available for issuance. But these amounts could change, depending on discussions with the government regarding how to utilize the remaining ZAR200 billion in government-guaranteed issuances.

However, we assume that ESKOM is unlikely to tap more than ZAR12 billion-ZAR15 billion under its DMTN program in any given year, based on potential constraints on the domestic market's capacity to absorb such issuances. We note that ESKOM currently continues to tap issuances of between ZAR1 billion and ZAR2 billion per month under its commercial paper (CP) program, and is currently exploring alternative funding sources by way of banks and capital markets, as well as the announced equity contribution from the government through the government's asset disposal program. ESKOM's liquidity position could benefit if the company executes these initiatives successfully. However, we do not include potential future sources of CP program issuances as liquidity sources, as per our criteria, nor do we include potential future sovereign-guaranteed issuances (beyond our one-year outlook horizon) or any other potential issuance. This is because we do not assume that companies are able to borrow in the future unless such lines are committed. Furthermore, we do not include the government's expected equity contribution from future asset disposals.

We forecast that ESKOM's sources will cover its liquidity uses by less than 1.2x over the 12 months started Jan. 21, 2015.

We calculate that ESKOM has the following liquidity sources for the 12 months started Jan. 21, 2015:
- Cash and marketable securities of about ZAR19.4 billion;
• Estimated funds from operations (FFO) of between ZAR18 billion and ZAR22 billion;
• Committed lines of ZAR1.4 billion; and
• Debt of about ZAR25 billion to be raised from committed or reliable sources such as DFIs and ECAs, and the domestic bond market.

We calculate the following liquidity uses for the same period:
• Capital expenditures of about ZAR60 billion;
• Negative working capital of about ZAR5 billion–ZAR15 billion; and
• Loans and interest due of about ZAR30 billion.

Outlook

The negative outlook reflects our opinion that considerable execution risk remains associated with the government’s support plan. ESKOM’s operating performance has not yet stabilized due to rising costs combined with a doubtful interim tariff regime reprieve, a very tight capacity margin in South Africa, and a less than effective executive management team. Moreover, we think that there is a risk that ESKOM’s financing needs may exceed what is currently covered in the government’s additional support package.

To revise the outlook to stable, we would need to believe that ESKOM could sustain adjusted FFO to debt of at least 5% in the medium term, with no additional strain on liquidity. ESKOM’s management needs to demonstrate a track record of effective control of major projects and a restored relationship with key stakeholders, such as the ESKOM board and the South African government.

Downside scenario

We could lower the ratings on ESKOM if we were to revise our SACP assessment to ‘ccc’ or lower, or if we saw a reduced likelihood of extraordinary government support for the company. A deterioration of the SACP could result if we consider that, over the next 12 months, ESKOM may be about to experience a near-term liquidity crisis, violation of financial covenants, or is likely to consider a distressed exchange offer or redemption.

A deterioration in the SACP could occur, for example, if the regulator does not grant additional tariff increases during the current regulatory period (MYPD3), as it did for the fiscal year ending April 2016, that are sufficient to allow Eskom to adequately manage ongoing debt service requirements. A deterioration in the SACP could also occur, due to other elements, such as the announced equity contribution from the government’s asset disposal program or conversion of government loans to equity, or if ESKOM's operating performance deteriorated further because of additional cost overruns or a lack of progress in planned efficiencies, without offsetting government support. A weakening of the SACP by one notch would, all else being equal, likely result in a one-notch downgrade of ESKOM to 'BB'.

We could also lower the ratings if we were to revise downward our assessment
of the likelihood of extraordinary support from "extremely high." This could occur if ESKOM develops additional funding requirements that are not explicitly covered by government support, or if the announced support program is not implemented on time or in full. All else remaining equal, this could lead us to downgrade ESKOM by three notches, to 'B+'.

Finally, we could lower the ratings on ESKOM if we lowered the sovereign rating on South Africa, all else remaining equal. Under our criteria for GREs, a one-notch downgrade of the sovereign would result in a one-notch downgrade of ESKOM.

Upside scenario
We consider an upgrade unlikely in the foreseeable future given the current pressures on the SACP. Under our GRE criteria, an upward revision by one notch in our assessment of ESKOM's SACP would result in an upgrade of ESKOM by one notch, assuming unchanged government support.

However, an upgrade could materialize if we believed the likelihood of government support had increased to "almost certain," which would result in us equalizing the ratings on ESKOM with the sovereign rating. That said, we consider this unlikely in light of the government’s finite resources and the actions it has taken to support ESKOM to date.

Ratings Score Snapshot

Corporate Credit Rating: BB+/Negative/--

Business risk: Weak
- Country risk: Moderately high
- Industry risk: Very low
- Competitive position: Weak

Financial risk: Highly leveraged
- Cash flow/Leverage: Highly leveraged

Anchor: b-

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Less than adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Weak (-1)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: ccc+
- Long-term sovereign rating: Foreign currency BBB-; local currency BBB+
- Likelihood of government support: Extremely high
Related Criteria And Research

Related Criteria

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Standard & Poor's National And Regional Scale Mapping Tables, Sept. 30, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings, Oct. 1, 2012
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Corporate Methodology: Rating Each Issue, April 15, 2008

Ratings List

<table>
<thead>
<tr>
<th>Downgraded</th>
<th>To</th>
<th>From</th>
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<td>BB+/Negative/--</td>
<td>BBB-/Negative/--</td>
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<td>Corporate Credit Rating</td>
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<td>BBB--</td>
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<tr>
<td>Senior Unsecured</td>
<td>BB+</td>
<td>BBB--</td>
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