Transnet SOC Ltd
Registration Number
1990/000900/30

Carlton Centre
150 Commissioner
Str. Johannesburg
2001

P.O. Box 72501
Parkview
South Africa, 2122
T +27 11 308 2250
F +27 11 308 1269

TRANSNET

MEMORANDUM

www.transnet.net

To : **Garry Pita**, Acting Group Chief Financial Officer

From : **Phetolo Ramosebudi,** Group Treasurer

SUBJECT : R12 BILLION CLUB LOAN INTEREST RATE RISK EXPLANATION

PURPOSE:

1. The purpose of this memorandum is to obtain approval from the Acting Group Chief Financial Officer to:

   1.1. Hedge the interest rate risk exposures from a float for fixed basis for the amount of R12 billion.

   1.2. Instruct Regiments Capital as per the 1064 Locomotives mandate to execute the hedges with Transnet approved counterparts.

   1.3. The execution cost of hedges by Regiments Capital will be all inclusive in the rate of the interest rate swap.

BACKGROUND:

2. A club loan to the amount of R12 billion was recently entered into to fund the locomotive payments to CSR and CNR as well as redemption of loan maturities in February 2016.

3. The club loan was done on a floating rate basis at a cost of 3 month Jibar plus 270 basis points to manage the pricing divergence from all parts.

DISCUSSION:

4. The current floating rate risk exposure of the total debt portfolio is 29% after the inclusion of the hedges and 71% fixed.

5. If the full amount of the club loan is included as fixed, the floating rate portion will decrease from 29% to 26%, which is still within Board approved limit in FRMF. This is

well in line with the FRMF that allows a floating rate portion that may be managed between 10% and 50%.

6. High level calculations done by our Traders have indicated that to swap the club loan to fix, the mid-rate will be around 11.50% (NACQ), all inclusive of execution cost by Regiments Capital. This excludes the cost of the bid offer spread which needs to be determined in market.

7. The annual interest rate cost of 9.217% on R12 billion is R1.106 billion which is likely to be volatile due to the high inflationary environment ahead, whilst the annual interest cost is R1.38 billion on 11.50%. This eliminates the interest uncertainty for the loan and fixed the commitments for the duration of the loan.

8. The latest 3 month Jibar forecast from BER is reflected below to give an indication of what may happen with floating interest rates over the medium term.

Q4 15	Q1 16	Q2 16	Q3 16	Q4 16	Q1 17	Q2 17	Q3 17	Q4 17
6.50%	6.50%	6.70%	6.71%	6.89%	6.86%	6.84%	6.82%	6.81%

MOTIVATION

9. As per the interest rate forecast above, the short term interest rates are expected to increase over the medium period, the poses a serious risk to Transnet debt portfolio which is currently 29% floating;

10. In addition, to this, the volatile currency has a consequential risk to the short term rates too, which will be a double whammy to the rates;

11. The interest rate expense line is expected to increase in line with the increase in the short term rates;

12. This will have a negative impact to the Cash interest Cover ratio to the detriment of Transnet ratings;

13. Therefore it is important to manage the volatility of interest rate risk to contain its negative impact to the cash interest cover ratio.

14. The implementation of the identified financial risk initiatives such as Float for fixed swaps, CPI bond and Swaps will results in the 50% proportion of fixed for floating as illustrated in the figure below.

CPI LINKED SWAPS:

15. As part of the progression to relieve pressure on the CIC ratio, thereby managing the cost of interest expense and short to medium term liquidity, a conversion of R15 billion fixed rate debt (bonds) need be swapped to CPI linked debt early in the new-year. This should be in line with the appropriate accounting treatment.

16. The net savings achieved from converting fixed bullet bonds to CPI linked will be positive initially, but will result in large cash outflows at redemption of each bond and Transnet will need to meet liquidity demands as the redemptions of the bonds fall due. The Treasury is developing a solution related to the redemption portfolio to cater for the balloon payments of the CPI bond and swaps.

17. The above will result in lower interest payments over the majority of the life of the bond, but will increase closer to the bond redemption dates.

18. The above action will furthermore increase the duration of the debt portfolio to manage assets and liabilities.

ACCOUNTING:

19. Any interest rate swap entered into will have to be hedge accounted for to minimise volatility of fair value movements in the Group's income statement.

20. PWC has been appointed a while ago to test system capability to apply either cash flow and or fair value hedge accounting on interest rate swaps and the cash flow hedge accounting process is almost completed.

BUDGET AND FINANCIAL IMPLICATIONS:

21. Interest is budgeted for in corporate plan for 15/16 financial year.

DELEGATION OF AUTHORITY (DOA):

22. The DOA makes provision for the acting GCFO to approve interest rate risk hedging with an unlimited amount and tenors exceeding 5 years.

23. An extract of the DOA is reflected below for ease of reference:

"Interest Rate Risk Hedging

Approval Authority →	Notional Amounts	Group Treasurer	GCFO
Group	Notional amount of hedge expressed in USD or equivalent in RAND (FX loans and leases)	Up to but not exceeding $100m or equivalent in RAND	Exceeding $100m or equivalent in RAND
Tenure		Not exceeding 5 years	Exceeding 5 years

All breaches of the above limits to be reported to the Audit Committee.
Note: Where no specific limit is mentioned, the FRMF policy on interest rate risk will apply.
The above limits are applicable per hedging submission.

24. The amount of R12billion and tenor of 15 years are within his delegation.

RECOMMENDATION:

24. It is recommended that the Acting GCFO approves the hedging of the interest rate, risk exposures on a float for fixed basis for all the R12 billion club loan drawdowns.

Compiled by:

Phetolo Ramosebudi
Group Treasurer
Date: 3/12/15

Approved/Not Approved:

Garry Pita
Acting Group Chief Financial Officer
Date: 3/12/15

5.2.6 Foreign Exchange Hedging Transactions: Extensions, early take ups (expressed in USD equivalent)

Approval Authority	Traders	Chief Trader	Deputy Treasurer: Front Office	Group Treasurer
Group	Not exceeding an aggregate equivalent of $20m per day (desk total)	Not exceeding an aggregate equivalent of $50m per day (desk total)	Not exceeding an aggregate equivalent of $100m per day (desk total)	Exceeding an aggregate of $100m per day (desk total)

All breaches of the above limits to be reported to the Audit Committee.
Note: Where no specific limit is mentioned, the FRMF policy on foreign exchange rate risk will apply.

5.2.7 Approval of FX hedges to be hedged by external suppliers on their balance sheet for goods/services to be delivered to Transnet in respect of Rand agreements involving foreign content

Approval Authority →	Traders	Chief Trader	Deputy Treasurer: Front Office	Group Treasurer
Group	Not exceeding $10m	Not exceeding $25m	Not exceeding $50m	Exceeding $50m

All breaches of the above limits to be reported to the Audit Committee for noting.
The above limits are applicable per agreement.
Note: The Business Units must always obtain quotes on FX forward rates and liaise with the Treasury Trading desk that will verify the rates to ensure it is market related. The Business Units can only enter into the FX hedges with the supplier once the rates are accepted by the Treasury Trading desk via e mail. Once the above approvals are obtained, the Treasury Traders will provide sign off on the rate acceptance.

5.2.8 Interest Rate Risk Hedging

Approval Authority →	Notional Amounts	Group Treasurer	GCFO
Group	Notional amount of hedge expressed in USD or equivalent in RAND (FX loans and leases)	Up to but not exceeding $100m or equivalent in RAND	Exceeding $100m or equivalent in RAND
Tenure		Not exceeding 5 years	Exceeding 5 years

All breaches of the above limits to be reported to the Audit Committee.
Note: Where no specific limit is mentioned, the FRMF policy on interest rate risk will apply.
The above limits are applicable per hedging submission.

5.2.9 Hedging of fuel risk exposures (RAND and USD)

Approval Authority →	Group Treasurer	GCFO
Tenure	Not exceeding 6 months	Not exceeding 18 months
Notional hedge expressed in USD or equivalent in RAND	Not exceeding $25m or equivalent in RAND	Exceeding $25m or equivalent in RAND

All breaches of the above limits to be reported to the Audit Committee.
Note: The maximum hedge should not exceed 75% of annual budgeted consumption inclusive of energy levy income. The first priority will be to fix the contract through ZAR based agreement. If not then exposure to be taken on Balance Sheet, subject to hedged accounting. This will limit volatility and bring certainty in terms of the Rand.
~~The above limits are applicable per hedging submission.~~
Note: Where no specific limit is mentioned, the FRMF policy on commodity (fuel) risk will apply.

5.2.10 Hedging of commodity risk exposures in supply agreements, including escalation (other than fuel) in FX or RAND

Approval Authority →	Group Treasurer	GCFO
~~Tenure~~	Not exceeding 24 months	Exceeding 24 months
Notional hedge expressed in RAND	Not exceeding R100m	Exceeding R100m
Notional hedge expressed in USD	Not exceeding $10m	Exceeding $10m

All breaches of the above limits to be reported to the Audit Committee.
The above limits are applicable per hedging submission.
Note: Where no specific limit is mentioned, the FRMF policy on commodity risk will apply.

BLOOMBERG NEWS

May 11, 2016 14:53:08

Transnet Moving to Fixed-Rate Debt as Credit Downgrade Looms

By Liezel Hill and Antony Sguazzin

(Bloomberg) -- Transnet Holdings SOC Ltd., South Africa's state-owned transport company, is cutting its proportion of floating-rate debt to hedge against a rise in borrowing costs in the event of a downgrade of the country's credit rating to junk, Chief Executive Officer Siyabonga Gama said.

The possibility of South Africa's national sovereign debt rating being cut to junk by S&P Global Ratings next month is "a big concern for the country, it's going to affect everybody," Gama said in an interview on the sidelines of the World Economic Forum conference in Kigali, Rwanda, on Wednesday. "We have spent the last couple of months trying to buttress our balance sheet against that kind of eventuality."

Transnet has increased its ratio of fixed-rate to floating-rate debt to about 80-20, from 65-35, "in the last few months," Gama said. The company has about 70.7 billion rand ($4.7 billion) of bonds, of which 5.8 billion rand is floating-rate debt, according to data compiled by Bloomberg. It also has 73.3 billion rand of other loans.

S&P is reviewing the debt rating of Africa's most-industrialized country on June 3. It rates South Africa's debt BBB-, the lowest investment-grade level, with a negative outlook. A cut to junk may raise borrowing costs for state-owned companies, which are benchmarked against government debt.

Transnet, South Africa's third-biggest borrower after the government and the state-owned electricity company, Eskom Holdings SOC Ltd., has studied covenants attached to its bonds and is "comfortable" none of the loans would be recalled in the event of a downgrade, Gama said.

To contact the reporters on this story:
Liezel Hill in Johannesburg at lhill30@bloomberg.net;
Antony Sguazzin in Johannesburg at asguazzin@bloomberg.net
To contact the editors responsible for this story:
Robert Brand at rbrand9@bloomberg.net