FITCH DOWNGRADES SOUTH AFRICA TO 'BB+'; OUTLOOK STABLE

Fitch Ratings-Hong Kong-07 April 2017: Fitch Ratings has downgraded South Africa's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) to 'BB+' from 'BBB-'. The Outlooks are Stable.

The issue ratings on South Africa's senior unsecured foreign- and local-currency bonds have been downgraded to 'BB+' from 'BBB-'. The rating on the sukuk trust certificates issued by RSA Sukuk No. 1 Trust has also been downgraded to 'BB+' from 'BBB-', in line with South Africa's Long-Term Foreign-Currency IDR.

The Short-Term Foreign-and Local-Currency IDRs and the rating on the short-term local-currency securities have been downgraded to 'B' from 'F3'. The Country Ceiling has been revised down to 'BBB-' from 'BBB'.

KEY RATING DRIVERS

The downgrade of South Africa's Long-Term IDRs reflects Fitch's view that recent political events, including a major cabinet reshuffle, will weaken standards of governance and public finances.

In Fitch's view, the cabinet reshuffle, which involved the replacement of the finance minister, Pravin Gordhan, and the deputy finance minister, Mcebisi Jonas, is likely to result in a change in the direction of economic policy. The reshuffle partly reflected efforts by the out-going finance minister to improve the governance of state-owned enterprises (SOEs). The reshuffle is likely to undermine, if not reverse, progress in SOE governance, raising the risk that SOE debt could migrate onto the government's balance sheet.

Differences over the country's expensive nuclear programme preceded the dismissal of a previous finance minister, Nhlanhla Nene, in December 2015 and in Fitch's view may have also contributed to the decision for the recent reshuffle. Under the new cabinet, including a new energy minister, the programme is likely to move relatively quickly. The state-owned electricity company, Eskom, has already issued a request for information for nuclear suppliers and is expected to issue a request for proposals for nuclear power stations later this year. The treasury under its previous leadership had said that Eskom could not absorb the nuclear programme with its current approved guarantees, so the treasury will likely have to substantially increase guarantees to Eskom.

This would increase contingent liabilities, which are already sizeable. According to the 2017/18 budget, the government's guarantee exposure to public institutions was ZAR308.3 billion at end-March 2017, up from ZAR255.8 billion a year earlier. The main SOEs had additional liabilities of ZAR463 billion in 2016 with no explicit guarantee but with a significant probability that the government would step in should SOEs be unable to service the debt. The government has repeatedly needed to support SOEs, including Eskom, which is responsible for a large share of liabilities.

The new finance minister has stated that he does not intend to change fiscal policy and remains committed to expenditure ceilings that have been a pillar of fiscal consolidation. However, Fitch believes that following the government reshuffle, fiscal consolidation will be less of a priority given the president's focus on "radical socioeconomic transformation". This means that renewed shortfalls in revenues, for example as a result of lower than expected GDP growth, are less likely to be compensated by expenditure and revenue measures. This could put upward pressure on general

government debt, which at an estimated 53% of GDP at end-March 2017 was already slightly above the 'BB' category median of 51%.

The tensions within the ANC will mean that political energy will be absorbed by efforts to maintain party unity and fend off leadership challenges and to placate rising social pressures for addressing inequality, poverty and weak public service delivery. The Treasury's ability to withstand departmental demands for increased spending may also weaken.

Political uncertainty was already an important factor behind weak growth last year, as in Fitch's assessment it has affected the willingness of companies to invest. The agency believes that the cabinet reshuffle will further undermine the investment climate. Fitch forecasts GDP growth of 1.2% in 2017 and 2.1% in 2018, but the reshuffle has raised downside risks.

South Africa's ratings also reflect the following key rating drivers:

The current account deficit narrowed to 3.3% of GDP in 2016 from 4.4% in 2015, on the back of import compression reflecting weak domestic demand, low oil prices and increasing investment income from abroad. This improvement, together with the flexible exchange rate, will contain pressures should external financing dry up. The government's low reliance on foreign-currency financing, which accounted for just 11.3% of debt at end-March 2017, is also helping to contain external pressures.

Most indicators of economic development are in line with 'BB' category medians. GDP per capita at market prices is estimated at USD5,207 for 2016, compared with a median of USD5,007. The World Bank's governance indicator, at the 59th percentile, is well above the 'BB' median and more in line with the 'BBB' median. However, this may not adequately reflect governance issues that were highlighted in the recent state of capture report by the public prosecutor and governance may deteriorate as a result of the reshuffle. The rating is supported by a sound banking sector, which has a Fitch Bank Systemic Risk Indicator of 'bbb'.

SOVEREIGN RATING MODEL (SRM) and QUALITATIVE OVERLAY (QO)
Fitch's proprietary SRM assigns South Africa a score equivalent to a rating of 'BBB' on the Long-Term FC IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to rated peers, as follows:
- Macroeconomic Performance, Policies and Prospect: -1 notch, to reflect South Africa's weak growth prospects relative to the 'BBB' category median, with important repercussions for public finances.
- Structural Features: -1 notch, to reflect the expected deterioration in governance standards, particularly related to SOEs.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three year centred averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

RATING SENSITIVITIES
The following risk factors could, individually or collectively, result in negative rating action:
- A failure to stabilise the government debt/GDP ratio or an increase in contingent liabilities.
- Failure of GDP growth to recover sustainably, for example, due to sustained uncertainty about economic policy.
- Rising net external debt to levels that raise the potential for serious financing strains.

The following risk factors could, individually or collectively, result in positive rating action:
- An improvement in governance standards that is supportive of a stronger business and investment climate and a sustained upturn in economic growth.
- A marked narrowing in the budget deficit and a reduction in the government debt/GDP ratio.
- An improvement in the country's net external debt/GDP ratio.

KEY ASSUMPTIONS
Fitch expects global economic trends and commodity prices to develop as outlined in Fitch's March Global Economic Outlook.

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Applicable Criteria
Country Ceilings (pub. 16 Aug 2016)
https://www.fitchratings.com/site/re/885997
Criteria for Rating Sukuk (pub. 16 Aug 2016)
https://www.fitchratings.com/site/re/885806
Sovereign Rating Criteria (pub. 18 Jul 2016)
https://www.fitchratings.com/site/re/885219

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