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Let's be MDS Agile Admired Digital United

# Transnet Properties Structured Solutions

## Executive Summary

April 2016

# Introduction

## Supporting the MDS strategy

- ❑ The Market Demand Strategy ("MDS") forms the centrepiece of Transnet's growth strategy through investment in rail, port, and pipeline infrastructure.
- ❑ It is an essential component in assisting in the shift from road to rail, thereby reducing the cost of doing business in South Africa.
- ❑ The MDS is fine-tuned to expand and modernise the country's ports, rail and pipelines infrastructure with the intention of meeting capacity ahead of demand to promote economic growth in South Africa.
- ❑ Transnet is spending approximately R380bn on its MDS in a depressed economic climate, and because of weaker commodity outlooks and South Africa's lower growth performance Transnet is experiencing a short-term funding gap.

## Trillian has been tasked with implementing solutions to address these concerns are required

- ❑ Balance sheet optimisation
- ❑ EBITDA enhancement
- ❑ Cash unlocking

***Trillian's strategy seeks  to leverage off Transnet's existing property portfolio to optimise its Balance Sheet and enhance its long-term EBITDA uplift through creating sustainable income streams while at the same time enabling Transnet to benefit from cash upfront.***

# Identified opportunities

***Trillian appointed FPG to analyse and investigate the Transnet property portfolio to ensure that the proposed Property Fund solution could be implemented.***

## Findings

### FPG high level findings

- Sufficient property exists within the portfolio with a gap between book value and market value to provide Transnet with the EBITDA uplift it required.
- Property earmarked for transfer to the Fund was sufficiently valuable and of sufficient quality to ensure the commercial viability of the Fund.
- The Fund structure meets the required legislative and accounting requirements to ensure it is ability to be implemented
- Implementation of the Fund will not result in the properties being consolidated back onto Transnet's Balance Sheet.
- The Fund structure was tax efficient.
- There is potential for cash unlocking.

### Opportunities available to Transnet

| | |
|---|---|
| **EBITDA Enhancement** | Transnet's properties should be developed, and buildings managed to maximise their potential.<br>❑ Historically, Transnet has alienated land parcels too early in the value chain or left them underdeveloped and underutilized.<br>❑ The proposed solution maximises possible value extraction such that Transnet and not third party developers are the beneficiaries of the bulk of the development profits.<br>❑ There are properties within the portfolio that are only suited to specialised developers in areas where they have a distinct advantage. Those properties should be purchased by the Fund and flipped to the logical buyer. This will provide the Fund with the ability to provide Transnet with cash out. |
| **Cash unlocking** | ❑ Trillian has developed a cash unlocking solution that will enable Transnet to receive cash upfront in the short term. |
| **Hostel portfolio** | ❑ FPG has also proposed an innovative solution to manage the Hostels housed within the portfolio. |

# Benefits to the suggested solutions

BENEFITS

## EBITDA Enhancement

### Property Fund Structure

- Positive balance sheet impact:
  - Replacing a portion of Transnet's property assets with an asset that will be re-valued as the property value in the Fund increases with annual increases in revenue
  - Off balance sheet funding for the proposed developments and redevelopments
- Ring fence risk
- No cash flow impact to Transnet
- Sustainable participatory returns
- Third party has ability to expedite delivery of the solution
- Ensured compliance with all governing legislation, tax and accounting standards

## Cash Unlocking

### Securitization structure

- Off-balance sheet financing
- Improves capital structure
- Extends credit pool
- Reduces credit concentration
- Enhanced risk management due to isolated risk transfers
- Potentially lowers cost of funding
- Not regulated as a typical loan
- Liquidity enhancement
- Opportunity to potentially earn a higher rate of return on low risk investments
- Opportunity to invest in an isolated pool of high-quality credit enhanced assets
- Portfolio diversification

## Hostel Portfolio

### Hostel fund structure

- Avoidance of long term reputational damage
- Reduction in exposure to long term costs associated with operational expenses
- Development of a master plan for the Hostels providing a safe, secure and healthy living environment.
- Increased provision of accommodation
- Enhancement of the general standard of living
- Local community engagement through the enhancement of the Hostel precinct and surrounds
- Improvement in accommodation offering (i.e. including recreational facilities)

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# The characteristics of the proposed solutions

| EBITDA Enhancement | Cash Unlocking | Hostel Portfolio |
|---|---|---|
| **Property Fund Structure** | **Securitization structure** | **Hostel fund structure** |
| ❑ An off-balance sheet property fund will be established into which land and properties will be exchanged for participatory debentures into the property fund<br>❑ Transnet will contract with a FPG creating a management agreement over the property fund, development and properties<br>❑ FPG will classify properties into Rental Pool, Sales Pool & Development Pool for either renting or selling<br>❑ FPG will continuously mobilise development funding from multiple funding sources, develops properties and manages all post-development processes | ❑ Through securitization an entity ‘securitizes‘ cash flows and transfers the cash flows through the issuance of marketable securities backed by the expected cash flows from specific receivables.<br>❑ The claim is on the lease cash flows and not the entity, on a mutually exclusive basis<br>❑ The cash flows are isolated from the underlying operational risk of the entity as a whole<br>❑ Securitization places investors at the top of the stacking order (in terms of claims) by isolation (defined pool of cash flows) through selling the rights to cash flows from leases<br>❑ The underlying assets are selected by the originator to be considered for securitization | ❑ Trillian proposes that the Hostel properties be sold into a structure, separate from the Fund.<br>❑ This alternative structure, unlike the Fund, will have no participatory return to Transnet.<br>❑ FPG will purchase the Hostels at zero value from Transnet.<br>❑ Transnet will pay for three years on-going operating expenses or until turnaround is achieved, whichever comes sooner |

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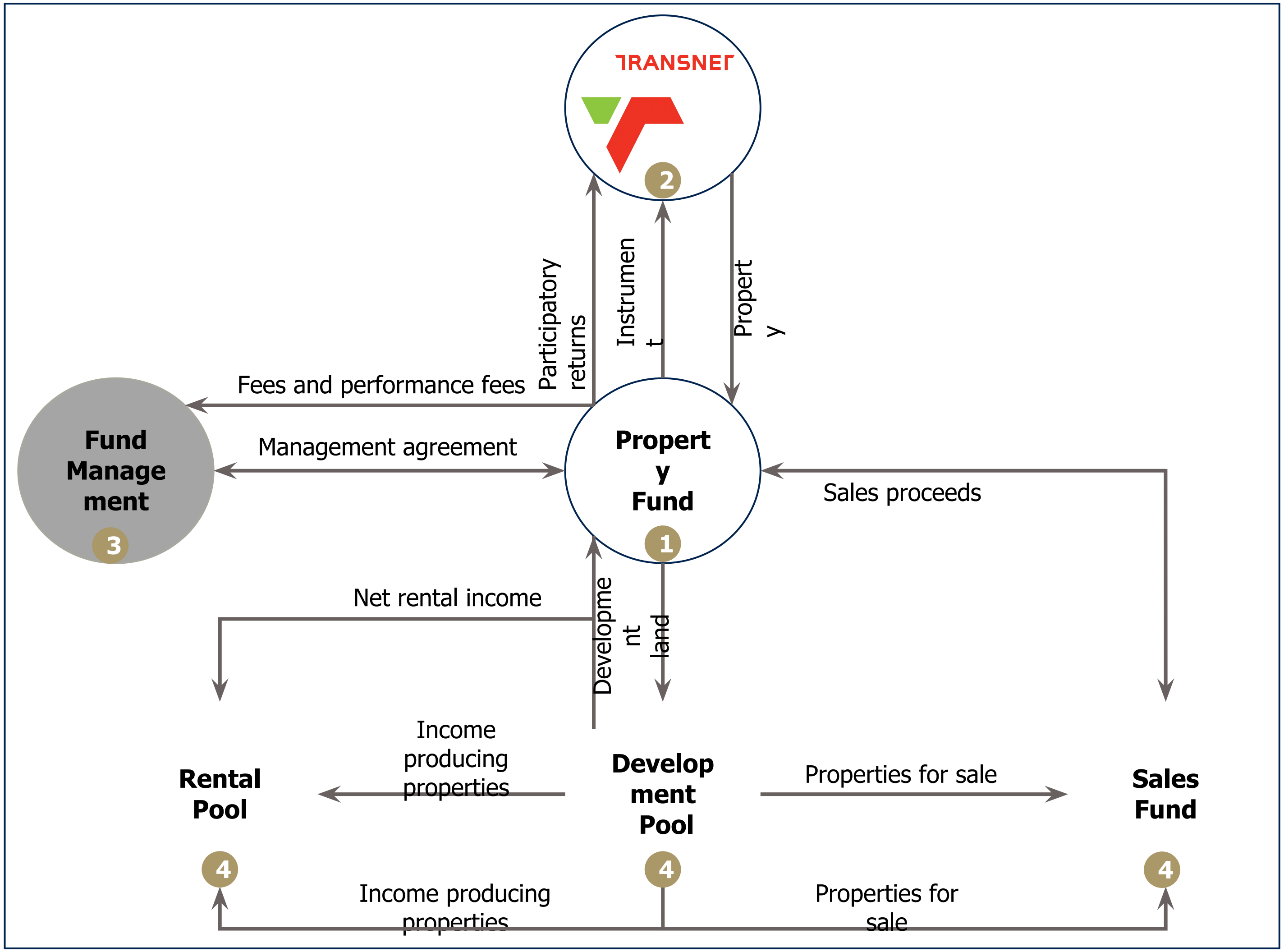
# An illustration of the proposed property fund structure and process for EBITDA enhancement

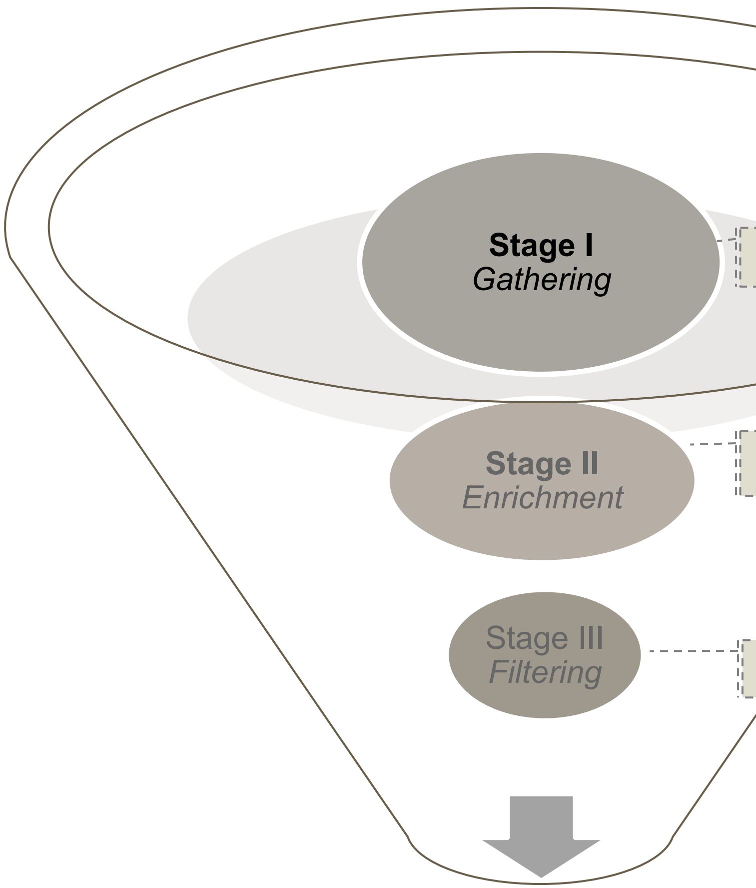
1. Establish Property and Funding “SPV”
2. Exchanges land and properties into the “SPV” for participatory debentures in the Funding “SPV”
3. Receive returns based on Property Fund profits
4. Contract with a Management Company creating a management agreement over the “SPV”, development and properties
5. Management Company manages the “SPV” to meet the SOE’s objectives and all net proceeds from the “SPV” used for stakeholder needs
6. Management Fund classifies properties into Rental Pool, Sales Pool & Development Pool for either renting or selling
7. Mobilise development funding from multiple funding sources
8. Develop land and properties and manages all post-development processes



# An outright sale of the properties will not fully address Transnet's needs

| Fund Structure | Factors to consider | Outright Sale |
|---|---|---|
| Transnet sells land and buildings into a Fund. Payment consideration is in the form of a financial instrument/s, where the benefit from the upside created in the Fund accrue to the Instrument holder | **Description** | Land and Buildings are sold. Proceeds are received in full, and ownership is transferred |
| Higher – Receive on going benefit from upside created in the Fund | **Returns** | Lower – Likely to receive prevailing market value at best |
| Higher – Fund structure assumes some property centric risk for the Instrument holder | **Risk** | Lower – Payment date and amount are fixed when a buyer is found |
| Shorter – Fund purchases land and buildings from Transnet in large tranches | **Time Period** | Longer – Properties sold on the open market are sold on a property-by-property basis and sales are dependant on the buyer market within the property cycle |
| Less – PFMA required to sell to the Fund, but can deviate from open tender because of the specialist nature of the transaction | **Legal Issues** | More – PFMA required to sell to the open Market, but difficult to deviate from an open tender as transaction is vanilla |
| Complex – Careful consideration needs to be given to tax during the lifespan of the Fund | **Tax** | Simple – Profits taxed at the CGT rate |
| Recommended if Transnet wishes to maintain its economic interest in the properties while benefitting from the potential upside arising from developing the properties | **Suitability** | This is a good option if cash is required immediately and a buyer can be found. However, this is done at the risk of losing out on the upside potential from property development |

# Background to work performed on proposed property fund structure




**Identified property solutions**

**Stage I:** Gathering information from various Transnet sources on properties with potential for EBITDA uplift.

**Stage II:** Enriching the information available on the aforementioned properties with a view to establishing their commercial viability.

**Stage III:** Filtering out properties that were not suitable for inclusion in a final master list.

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# Three structural scenarios can be implemented, depending on Transnet's specific requirements

| Scenario 1 | Scenario 2 | Scenario 3 |
|---|---|---|
| *Transnet wants the optionality to subscribe for Preference shares at some point in the future.* | *Transnet wants equity in the form of Preference shares upfront and if Transnet want a dividend return alongside the interest return on the debenture.* | *Transnet wants an interest return only.* |
| *Set up entity* | *Set up entity* | *Set up entity* |
| *Asset transfer/ acquisition* | *Asset transfer/ acquisition* | *Asset transfer/ acquisition* |
| *Agreement between Transnet and the Fund* | | |
| *Agreement between the Fund and FPG* | *Agreement between the Fund and FPG* | *Agreement between the Fund and Manco* |
| *Profit share arrangement* | *Profit share arrangement* | *Variable rate participatory debenture arrangement* |

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# Estimated EBITDA should the property structure be implemented

| Financial Year | EBITDA | Cumulative Earnings |
|---|---|---|
| FY16/17 | | |
| FY17/18 | | |
| FY18/19 | | |
| FY19/20 | | |
| FY20/21 | | |
| FY21/22 | | |
| FY22/23 | | |
| FY23/24 | | |
| FY24/25 | | |
| FY25/26 | | |

***Implementation of the Fund structure will result in an estimated Rxxbn in EBITDA for the FY16/17 financial year. FPG estimates that Transnet will benefit from ongoing EBITDA between FY17/18 and FY25/26 of Rxxbn.***

***NPV of the transaction equates to Rxxbn***

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# An illustration of the proposed securitisation structure and process for cash unlocking

1. The underlying assets are selected by the originator to be considered for securitization (these need to be homogeneous in terms of the underlying asset and cash flow profile)
2. Initiate packaging of pools of lease cash flows
3. Explore methods of credit enhancement (guarantees, insurance, swaps and hedges)
4. Assigning assets (lease cash flow) to the SPV in return for an upfront cash payment
5. Design and structure the conversion of the lease cash flows into divisible securities
6. The SPV sells these divisible securities through capital markets in return for cash
7. Investors receive income and return on capital from the assets over the lifetime of the securities
8. The risk on the securities owned by the investors is minimised as the securities are collateralised by the lease cash flow
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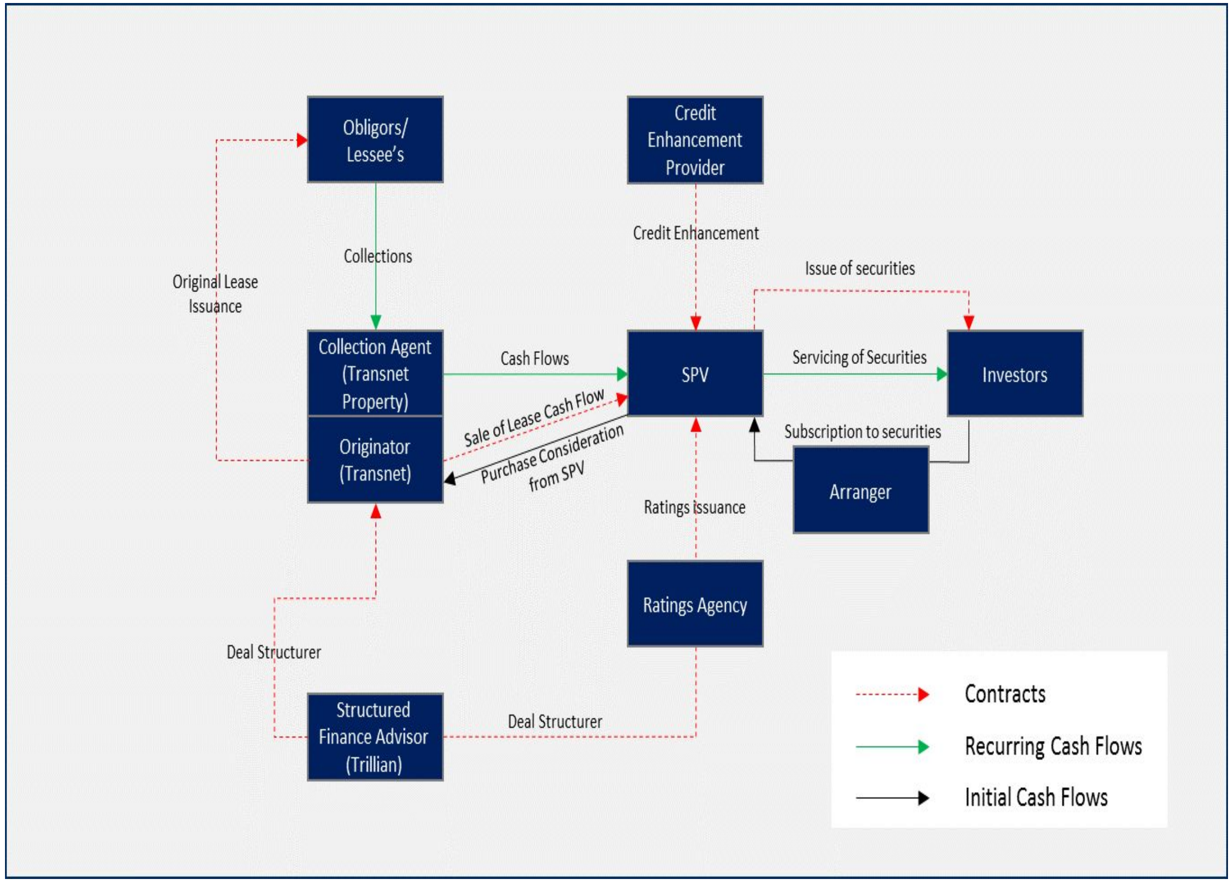


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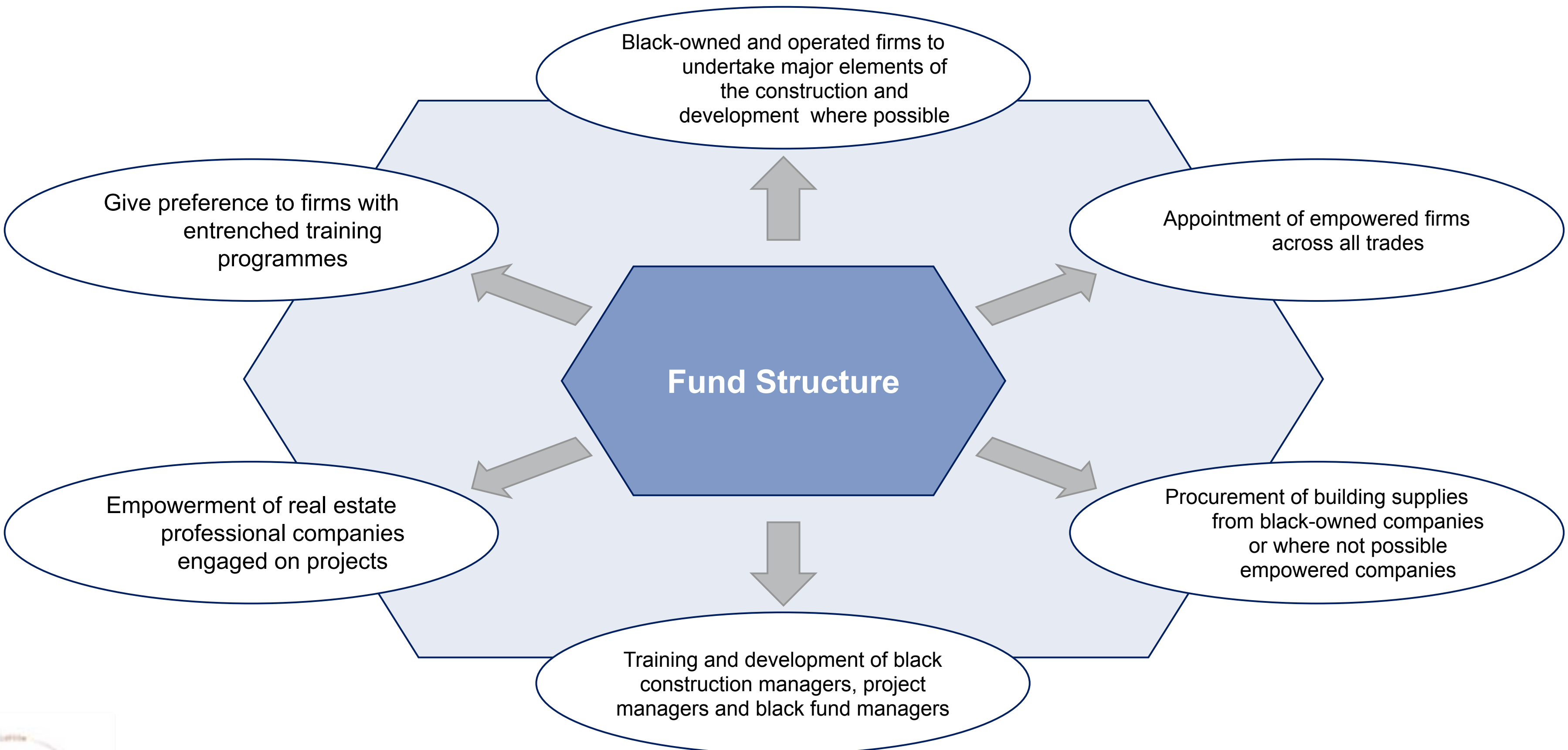
# Estimated economic benefit to the proposed hostel portfolio solution

To be included

# Socio-economic benefits from implementing the proposed solutions

***The benefits from the development that will occur will accrue to as broad a base of historically disadvantaged South Africans as possible.***



# Considerations