Denel's rating revised from negative to stable

Fitch Ratings has retained Denel's rating and revised its outlook from negative to stable which displays confidence in the company's ability to restructure the business and ensure its viability.

The group financial director, Fikile Mhlontlo, says the Fitch report recognises the progress already made to turn around the company from its loss-making position over a more than a decade to reporting modest profits in the past two financial years. The rating recognises Denel's position as a strategic asset for South Africa and the commitment displayed by the government to provide support through guarantees and capital injections.

In its statement released Fitch Ratings has affirmed Denel's national long-term rating at 'AA(zaf)'. The agency also affirmed the state-owned defence company's national short-term rating at 'F1+(zaf)'. The outlook revision reflects the renewed demonstration of tangible financial commitment and support received from the South African government, in the form of an imminent R700m equity capital injection and the renewal of the R1.85bn DMTN guarantee for another five years.

Doubt remains

"Fitch understands that management plans to replace outstanding commercial paper with a five year state-guaranteed corporate bond. A successful execution of Denel's turnaround strategy and the capacity of the business to achieve a sustainable operating and financial profile remain in doubt," the report notes.

The affirmation primarily reflects Fitch's view that Denel remains a strategic asset for the country, given its status as a wholly state-owned company and as a strategic defence supplier to key South African security forces. As such, the ratings incorporate Fitch's top-down assessment of the company in relation to South Africa's sovereign ratings (long-term foreign currency IDR 'BBB+'/negative; long-term local currency IDR 'A'/Negative) reflecting an expectation of timely support being provided to Denel by the state to service and repay its debts.

The report says Fitch recognises the efforts of management to restructure and reposition Denel to help the business achieve sustainable viability. Exposures to loss making contracts have been materially reduced and this has helped the business to materially reduce reported losses. Nevertheless, the business needs to achieve and sustain revenue, profitability and cash flow improvements against a background of arguably the most challenged market environment ever for the defence industry to achieve a sustainable profile.

New contracts

Denel has entered into some new international contracts that may support profitability and cash flow generation over the next three or four years, however market conditions remain challenging. Fitch notes that the recent draft South African defence review has reaffirmed the importance the government attaches to Denel and its position within the local defence industry, although local defence spending remains under pressure.

The ratings continue to be supported by Denel's position as the largest manufacturer of defence equipment in South Africa and its strong strategic ties with its ultimate shareholder. As such, Fitch notes that any change in Denel's strategic and/or legal ties with the South African government could have a potential impact on its ratings.

"We have embarked on a comprehensive turnaround strategy that is starting to deliver results. The company is on the road to sustainability based on improved operational performance, significant containments in costs and an aggressive move into new markets for Denel's quality products and services - especially in Africa and the Middle East," says Mhlontlo.