SIKELELO

White Paper
Removing forex risk from your procurement portfolio
February 2019

1. Introduction

The South African Rand remains volatile and is sensitive to emerging market events, global events, US monetary policy and domestic concerns. Most anticipate the general downward trend against the major currencies will continue over the next 3-5 years. Operational budget requirements have been difficult to predict where a large percentage of software license spend is exposed to forex risk. This an increasing challenge for operating divisions, yet the management of forex exposure is only addressed at the end of the generation of commitments.

Using historical data a $10m per annum ICT procurement package over the five years would have reduced incurred exposure of 170m ZAR (28%) over the term.

This document describes how this forex risk may be mitigated and provides detail regarding 1) net benefits 2) balance sheet considerations 2) SARB treatment and 3) tax treatment.

BUSINESS AND ICT TRANSFORMATION ✓ FINANCIAL BENEFITS REALISATION ✓ CRUCIAL SKILLS PROVISION

✓ TURNKEY PROJECT DELIVERY ✓ FOREX RISK MITIGATION ✓

2. The Solution

Vika is an approach that suggests a procurement strategy including financing of purchases in order to negate forex risk downside over a 5-10 year term. This approach is without the use of derivative products (options or forwards) and without the associated derivative counterparty risks and costs.

Vika is designed to provide predictability of ZAR spend on forex exposed commitments invoiced in ZAR, GBP, USD and Euro's.

Overall value may be achieved through one or more of the following.

- Reduction of overall spend exposed (value at risk).
- Reduction of direct and indirect hedging costs and opportunity costs.
- Negation of any counterparty risk associated with financial hedging using derivative products.
- Secondary options for management of FX provision.
- Discount on product purchases through aggregation (optional).

Usage patterns.

- Rolling to keep certainty locked on a 5 - 10 year horizon.
- Ability to wind down should fundamentals change.
- Annual top up option to increase term or value.
- Flexible Bill of Materials.

Figure 1 - Conceptual Overview

Forex risk is backed out over the term of the contract.

- **As a service**

Vika can be delivered as a service assisting in structuring your portfolio of FX flows and removing FX risk.

- **As a product**

Vika can be offered as a turnkey product with our Banking and OEM partners.

- **Scale**

Economies of scale are required with ICT procurement in order to achieve financial benefits.

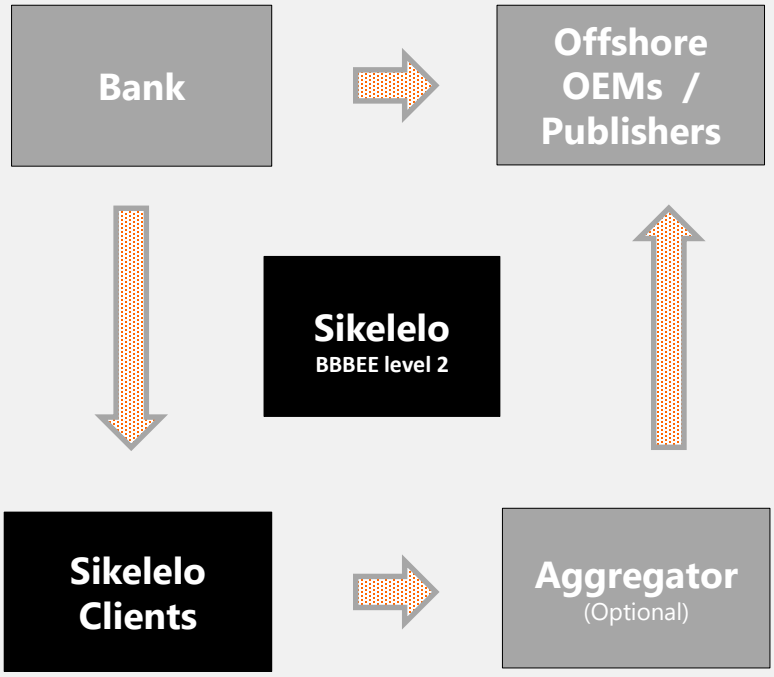
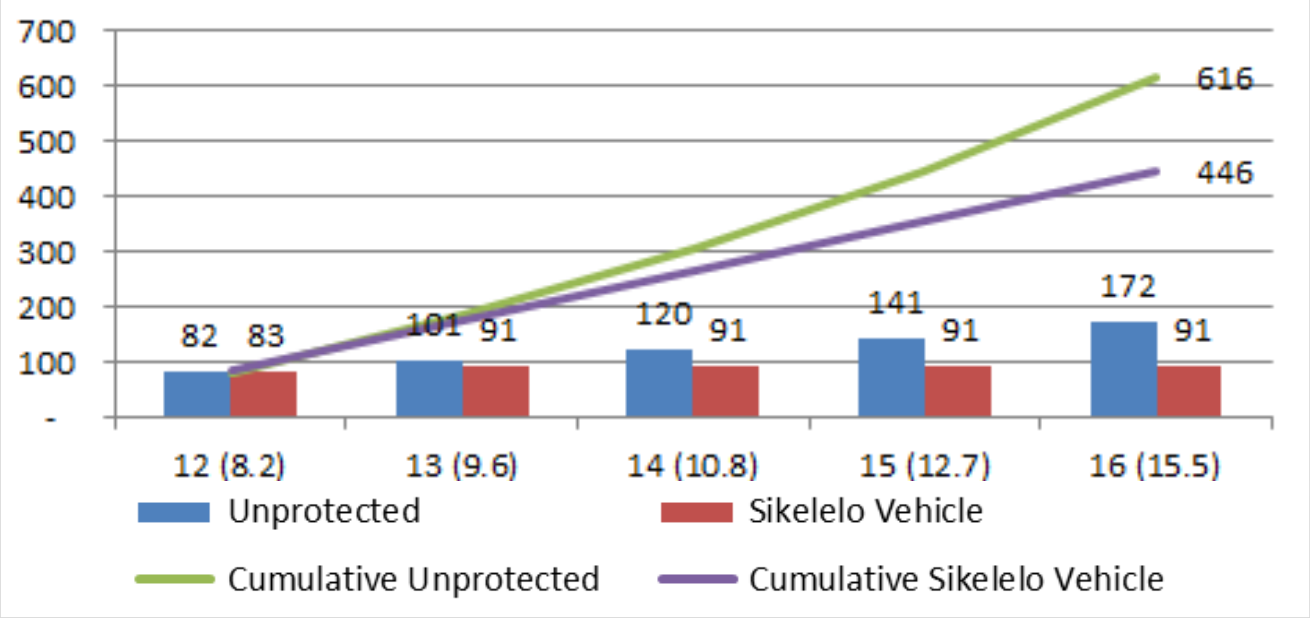


Figure 2

Using historical data a $10m per annum contract over the last five years would have reduced exposure by 170m ZAR (28%) at the end of the term.



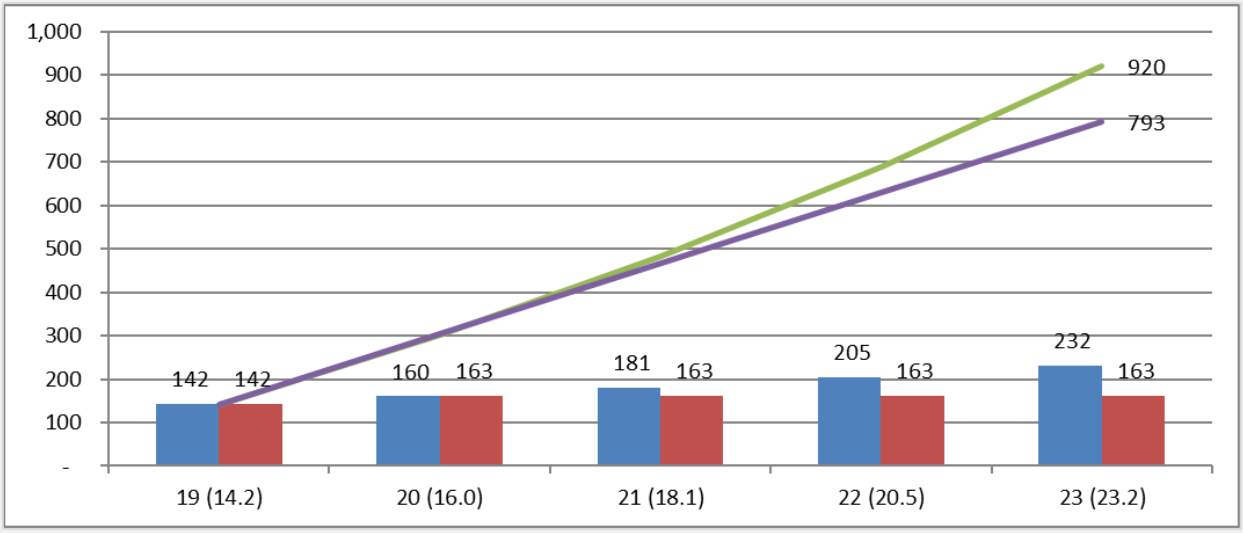
3. Benefits Hypothesis.

The rationale is based on packaging forex exposed commitments over the medium term (five to ten years) as opposed to short term (less than one year). In this section we address the benefits.

The figures below will provide a view of the benefits using two scenarios.

- The first scenario carries forward the trend of depreciation of the rand against the dollar for the last five years over the term for the facility. It assumes unchanged and continued behavior and performance of the local economy, continued negative emerging market sentiment and unchanged US interest rate policy.
- The second scenario assumes significant local macro-economic improvements, improved global emerging market sentiment and ZAR favorable US interest rate policy.
- The models use an amortized loan with monthly annual payments with an interest rate of 8.25 %.
- The models are structured so the first year's payment is made from an existing budget, immediately after the first payment is effected, the loan is activated to lock the exchange rate for the remaining four calendar years.
- The interest earned in the USD deposit account discounts the loan amount from USD 40 000 000 to USD 37 600 000.
- Excluded are transactional banking fees.
- The models are structured so the first year's payment is made from an existing budget, immediately after the first payment is effected, the loan is activated to lock the exchange rate for the remaining four calendar years.

Figure 3
Scenario One – Unchanged outlook over the next five years , net benefits of ZAR 127 M.



Item	Year 0	Year 1	Year 2	Year 3	Year 4	Total
USD annual licence cost	USD 10,000	USD 10,000	USD 10,000	USD 10,000	USD 10,000	USD 50,000
Exchange rate year one day one	14.2					
Annual exchange rate depreciation %	13	13	13	13	13	
ZAR amount licence cost per annum	ZAR 142,000	ZAR 160,460	ZAR 181,320	ZAR 204,891	ZAR 231,527	ZAR 778,198
ZAR licence cost including vika cost	-	ZAR 162,648	ZAR 162,648	ZAR 162,648	ZAR 162,648	ZAR 650,593
Net benefit	-	(ZAR 2,188)	ZAR 18,672	ZAR 42,243	ZAR 68,879	ZAR 127,606

All USD and ZAR figures 000's

Figure 4
Scenario Two – Scenario Two – A vastly improved outlook over the next five years, net benefits of ZAR 55 m.

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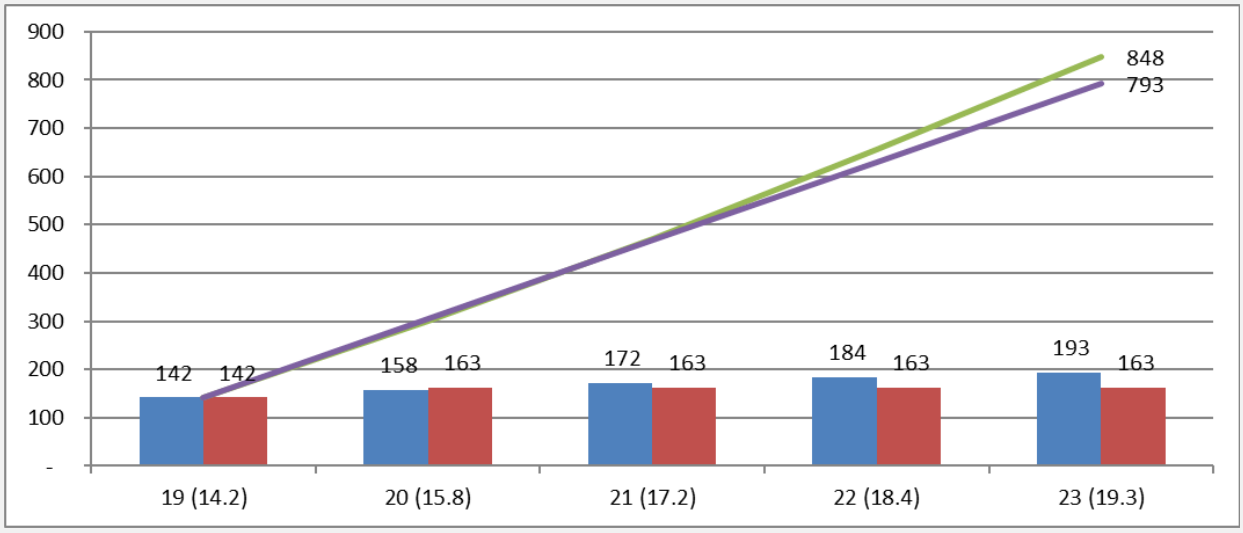

Item	Year 0	Year 1	Year 2	Year 3	Year 4	Total
USD annual license cost	USD 10,000	USD 10,000	USD 10,000	USD 10,000	USD 10,000	USD 50,000
Exchange rate year one day one	14.2					
Annual exchange rate depreciation %	13	11	9	7	5	
ZAR amount license cost per annum	ZAR 142,000	ZAR 157,620	ZAR 171,806	ZAR 183,832	ZAR 193,024	ZAR 706,282
ZAR license cost including Vika cost	-	ZAR 162,648	ZAR 162,648	ZAR 162,648	ZAR 162,648	ZAR 650,593
Net benefit	-	(ZAR 5,028)	ZAR 9,158	ZAR 21,184	ZAR 30,376	ZAR 55,689

All USD and ZAR figures 000's

4. Balance Sheet Impact.

IFRS standards oblige recognition of the liability and a corresponding asset on balance sheet. This has a bearing on debt/equity ratios, and debt service coverage ratios.
Should the Vika facility be embedded in a service contract with an ICT service provider or OEM the asset and liability will be held by the service provider then there will be no balance sheet impact for the procurer of the service contract. Similarly, there are other opportunities to structure the facility off balance sheet in compliance with IFRS policies.

5. The SARB guidelines that apply are held below.

- **Business entities may import computer software and specific custom-made computer software products, including any license fees which may be payable, against the production of documentary evidence confirming the purpose and amount payable.**
- **Royalty payments to non-residents, including any license fees that are payable from the local reproduction or copying of computer software packages may be effected provided that the licensor is an unrelated party (i.e. none of the parties have any direct and/or indirect interest or shareholding in each other) and the application is accompanied by documentary evidence confirming the purpose and amount payable.**
- **Where applicable minimum payments, advance payments and down payments are permissible, provided that the advance payments and down payments are recoupable from future royalties or fees payable. Payment of percentage based fees are permissible provided that the client confirms it is normal in the trade concerned.**

- **Maintenance payments applicable to computer software packages, in advance and/or retrospectively, against documentary evidence confirming the purpose and amount payable may be affected. Extension of agreements previously authorized must be referred to an Authorized Dealer for approval.**

6. Tax treatment.

The number of provisions contained in the Income Tax Act of 1962 (the Act) which deal with the tax treatment of interest income and interest expenditure has gradually increased over time.

Interest expenditure may be allowed by the Commissioner on the basis that the expense has been incurred in the production of income. Sections 11(a) and 23(g) of the Income Tax Act No. 58 of 1962 are commonly referred to as the "general deduction formula". As the name suggests, it is in terms of these sections of the Act that tax deductions in general are sought to be claimed by taxpayers. The Act does, however, contain provisions which are specially tailored for the deduction of specific expenditure. Section 24J of the Act is one such provision and allows taxpayers to claim a deduction specifically for interest expenditure. Section 24J of the Act applies to qualifying "instruments" and contains the principle that an amount of interest expenditure is incurred by a taxpayer by applying a constant compound rate of interest over the term of an instrument in terms of various formulas contained in section 24J of the Act.

No deduction of interest is permitted if the interest is not incurred in the production of "income" as defined. Section 24J defines "interest" to include, inter alia, the gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement irrespective of whether such amount is i) calculated with reference to a fixed rate of interest or a variable rate of interest; or ii) payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement."

Recently the Supreme Court of Appeal interpreted the word "related" very widely and included such items as guarantee fees, facility fees, and so on, and even went so far as to include the fees paid to attorneys for drafting the financing documents.

Citations:

1. Johan Kotze, Tax Executive Shepstone & Wylie Attorneys. Related Finance Charges vs Similar Finance Charges: How Broadly Will the New Definition of Interest Be Interpreted? May 4, 2017.

2. SAICA'S Taxation Newsletter. Taxation of interest. September 2015, Issue

3. IFRS Foundation. International Financial Reporting Standards, Sections 8F, 8FA, 23M, 23N, 24J, 24JB , 24O, 45, 47, 50A to 50H, IAS 39.

4. Currency and Exchanges guidelines for business entities 2019-03-05. South African Reserve bank. March 5, 2019.