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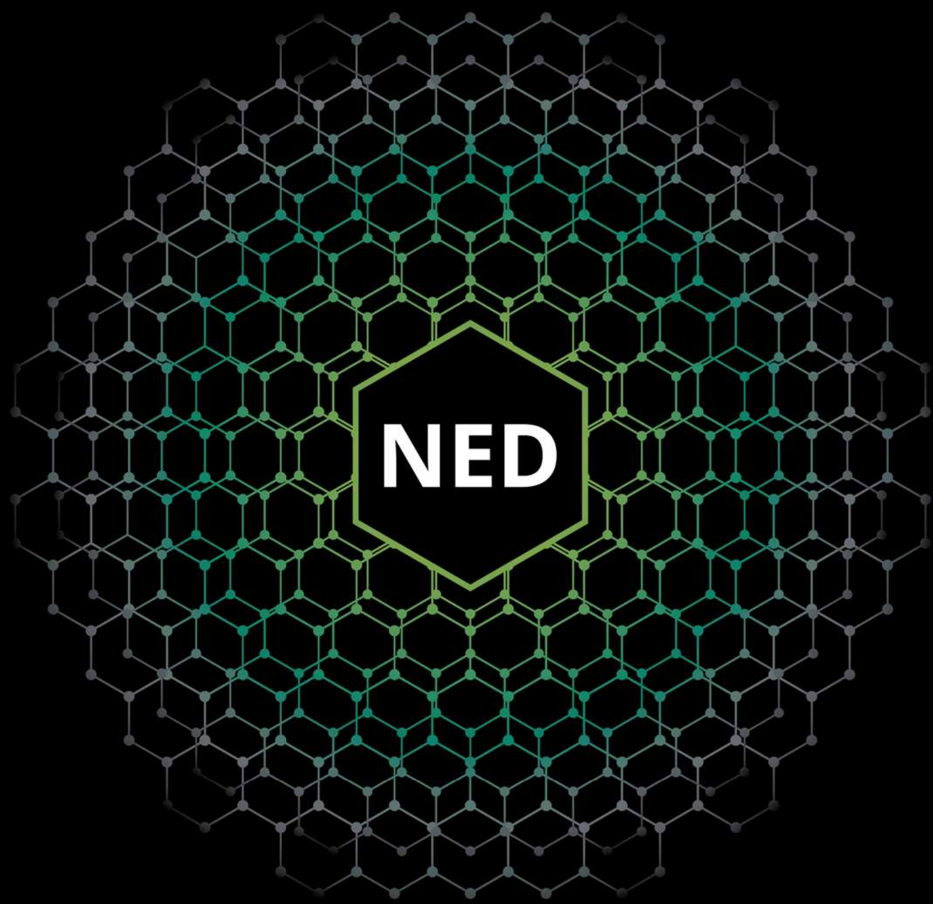


Executive pay – trends and challenges arising

Summary of discussions post virtual event (15 minute read)

23 June 2020

MAKING AN IMPACT THAT MATTERS since 1845

Executive Pay: is the 'perfect storm' brewing?

"The priorities of the country are changing to respond to address the pandemic, its social impact and the related consequences of managing the crisis. These changes will create significant cultural shifts in terms of what is considered appropriate, socially responsible and supportive of a new economy post COVID-19."
 - *IoDSA guidance paper*

"If a company cancels dividend payments or makes significant changes to their workforce's pay, IA members support boards and remuneration committees that demonstrate how this should be reflected in their approach to executive pay."
— UK Investor Association Letter to FTSE 350 Chairs

Setting the scene: global trends emerging

The reality is that executive performance frameworks and Key Performance Indicators (KPIs) have been evolving, but COVID-19 has accelerated the pace of change.

In a new global research project by Deloitte we have found the following emerging trends:

- Whilst there are differences amongst organisations, generally, CEOs have accepted that they will face some reduction in pay. Their concern, however, is that the short term reduction may evolve into a longer term trend which will in turn create a lower base against which future performance metrics will be set.
- There is a transatlantic divide between trends in the UK and USA: for example, the UK has adopted a much more philosophical approach in trying to understand what it is that companies are trying to reward and the purpose of pay. The UK also sees a much lower threshold and acceptance towards high levels of executive pay, relative to that of the general workforce.
- Shareholders are consistently telling us that they expect to see greater alignment between executive pay and shareholder returns, despite a recognition that CEOs may be expending heroic efforts which may not translate into financial performance during the crisis.
- Some European REMCO Chairs interviewed expressed concerns around the reset of targets and KPIs, at a time when the CEO needs to have laser focus on leading the business through the recovery phase of the crisis.
- There was recognition of the direct correlation of government assistance schemes on executive reward.

“Remuneration has always been a sensitive topic, but has now become a ‘hot potato’ requiring clear, fair and ethical decision making”.

-Remco chair of a JSE Top 40 company

Perspectives from a Non-Executive Director

The role of the REMCO Chair is to apply the broader strategic decisions and deliberations of the board and apply those outcomes to remuneration policies and decisions. COVID-19 presents an opportunity to reset remuneration philosophies and redefine what the organisation aims to achieve through reward. Ultimately, the REMCO Chair will need to stand to account for the company’s decisions, and recognise that there is a trade off within the myriad of stakeholders.

Whilst most organisations have seen temporary reductions and contributions to the Solidarity Fund (by Executives and Non-Executives), there will be a need to balance short term and long term incentives. For example, traditional models have seen greater weighting towards guaranteed pay, but has the crisis required this to change?

Many investors and shareholders adopt a fairly formulaic approach to executive pay, however, the reality is that reward is complex and REMCO Chairs will have the impact of the pandemic on the broader society top of their mind. In particular, we expect Remuneration policies to have stronger links to the policies and objectives of the Social and Ethics Committee.

Alignment to shareholder value creation is crucial and any future approaches will need to adapt to these rapidly changing circumstances. Key questions to test and to obtain shareholder opinion on are:

- What is the greater societal impact of our approach?
- What will the impact be relative to the minimum wage and the widening pay gap?
- What message will executive pay give to the market and our wider stakeholder group?

The social context is crucial for the South African market, and the approach needs to be fair and equitable to all. Do REMCO Chairs take the approach of a ‘little for everyone’ or a ‘lot for a few’?

Key considerations:

- *Are our pre-COVID "Single Figure" values still appropriate?*
- *Is the mix between guaranteed pay and variable pay appropriate?*
- *Are the targets, quanta and architectures of our variable pay schemes still appropriate?*

Local trends and challenges arising

Whilst we have seen many organisations announce salary reductions and contributions to the Solidarity Fund, many of those reductions seem to be temporary – typically three to five months. If we learn from the UK experience, companies have experienced a tremendous amount of negative coverage once pay cuts have been reversed, particularly if the organisation that have furloughed staff, are looking to implement headcount reductions and/or are relying on government support. Other short-term tactics applied have been the reduction or termination of bonuses and deferrals or waivers of share-based payments.

The next challenge for REMCO Chairs will be changes which will need to be made in the medium and long-term. Of course, the question around the shape and timing of the economic recovery brings additional uncertainty.

Predictions for each organisation will mean a different approach to target setting and potentially the architecture and quanta schemes adopted. The two main issues shareholders and stakeholders focus on when it comes to executive pay:

1. Quanta: it is already noted that shareholders are expecting pay reductions post COVID; and
2. Structure: where there is general criticism that schemes are opaque and complex. In South Africa we have seen a 24% increase in non-binding votes against remuneration policies over the last year at AGMs.

"We have seen companies cut or terminate bonuses, despite the performance period being before the onset of COVID and often where a robust financial performance was achieved".
- Deloitte Reward and Well-being leader

Annual cash incentive considerations

Two frameworks dominate in the JSE top 100: the *distributed scorecard* and the *funding and distribution* models. In the case of first model, a bonus is paid subject to the achievement of a balanced scorecard of financial, operational, customer and ESG metrics. Although financial metrics are usually dominant – a portion of the bonus can be paid even when financial performance is below target.

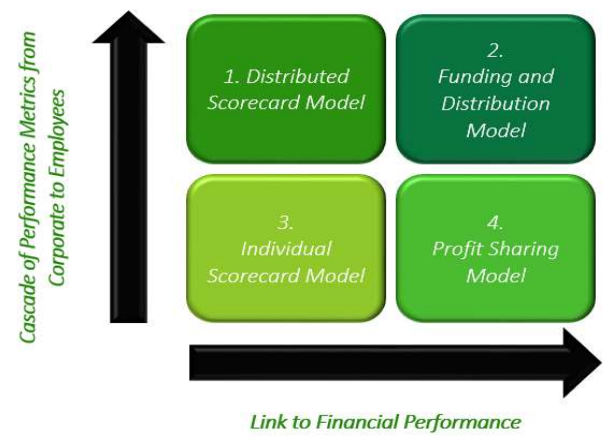
In the case of option two, a bonus pool is funded based on one or a number of financial metrics and performance against key metrics is used to modify and distribute the pool.

In 2020 we expect to see almost no pay-outs from funding models and modest pay-outs from scorecard models.

Options of the Remuneration Committee future decisions include: if a prolonged recovery is anticipated then REMCO Chairs may want to consider a scheme structure closer to option one with a combination of metrics that focus on the recovery of the business. Another consideration is reducing the target bonus potential, a tactic we have seen adopted in the UK.

If a faster recovery is anticipated, option two may be more appropriate. However, we do recommend that a degree of conservatism is applied when setting targets. We also strongly suggest that consideration is given to the potential quanta of the target and maximum bonus potential during the crisis.

In both cases, we strongly recommend that the committee apply the necessary discretion at vesting to moderate any extreme outcomes. It is important that this approach is clearly communicated to your key investors at inception and over term of the scheme.



Long-term incentive considerations

Full value schemes are dominant, and the majority have performance metrics linked to vesting. A few key considerations are:

- **Averaging period:** Investors typically expect a 'haircut' in award size where grants are made following a significant share price fall, to prevent 'windfall gains' to executives. Consider using the VWAP over a longer period to prevent a "windfall" gain at vesting.
- **Discretion at vesting:** Review of outcomes at vesting, ensuring they reflect business performance and broader stakeholder impact. Consideration could be given to extending the vesting period.
- **Performance conditions:** Performance conditions cannot be altered for awards that have already been made. Future performance conditions of three to five years' time should consider business recovery and should avoid "windfall" gains.
- **Restricted/Forfeitable Shares:** Consider issuing Forfeitable Shares instead of salary increases or annual cash incentives. These shares would vest in three to five years.
- **Minimum shareholding:** Are policies still applicable in light of significant share price drops?

Key discussion points

Can Non-Executive Directors expect a similar reduction in their pay packets?

Whilst the volume of board meetings and required support has significantly increased for NEDs, we have seen globally and locally, a reduction in NED pay which mirrors that of the executives.

Clearly, for NEDs who conduct their roles as a professional career, this will be a challenging time whilst all leaders are expected to navigate their organisations through the crisis whilst also having a critical role to play in supporting broader society.

Some of the experience in managing pay during COVID-19 is that not all employees can continue to work and add value to companies. How are Remuneration Committees managing this?

In many ways, COVID-19 has teleported us forward and the fourth industrial revolution under the umbrella of 'future of work' is becoming a reality. Whilst the immediate focus should be to steady the ship and ensure sustainable financial performance, businesses now have the opportunity to actively review what the future of work means for their business and employees

Specifically companies will need to re-imagine a preferred future through evaluation of how the work itself, the supporting workforce, and workplaces are changing. Key questions to ask are:

- How / what work is done: How the nature of work is changing to achieve new business goals, requiring new skills and capabilities given automation and augmentation.
- By whom is the work done: Who can perform the work as it changes and how organisations can close skills gaps by tapping into alternative talent pools or upskilling.
- And where is the work done: Where the work can get done physically and how we can maximize collaboration, productivity, and consistency with physical design and enabling technologies.

This is important because businesses can actively start to look at the skills they require for the future and then can upskill employees in the right manner so that they can continue to provide value.

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This summary is based on a virtual event with the same title that was hosted by Deloitte Africa's Deputy Chief Executive, Sihlalo Jordan, on 23 June 2020. Speakers included:

- Sarita Martin, Remuneration Committee Chair, Reunert Limited
- Dan Konigsburg, Senior Managing Director, Corporate Governance & Public Policy, Deloitte
- Leslie Yuill, Reward and Well-being leader, Deloitte Africa

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