CORPORATE GOVERNANCE PRINCIPLES

South Africa

Hermes EOS
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For professional investors only

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HERMES
INVESTMENT MANAGEMENT

ENDORSEMENT OF THE KING CODE OF GOVERNANCE PRINCIPLES

We generally endorse the recommendations of the King Code of Governance Principles and encourage companies to comply with them or to explain their reasons for non-compliance.

However, these recommendations do not sufficiently cover all the issues we regard as important. In our South African Corporate Governance Principles, we therefore address additional issues, highlight certain points and set out our preferred approach to particular matters. We outline priorities that will assist companies in taking concrete steps to improve their corporate governance, thus attracting investment and contributing to sustainable company performance.

We seek to work with companies and regulators to help them move towards and enhance best practice. The following sections intend to assist South African companies and their directors in understanding our views on these issues.

BOARD OF DIRECTORS

Composition and independence

We place a strong emphasis on the overall balance in the composition of a board. The board should be made up of members with an appropriate and diverse range of attributes, competencies, knowledge and experience to enable it to discharge its duties and responsibilities effectively. These include leadership skills to move the company forward, expertise to make decisions, as well as sufficient character and independence to hold executive management to account. We encourage companies to introduce mechanisms to assess board performance and to promote appropriate board refreshment where long tenures may compromise the independence of directors and as the needs of the company evolve.

Availability

We remain concerned about the ability of some directors to devote sufficient time to the boards of which they are members. In some cases, this is because they are over-committed and cannot dedicate sufficient time to each of their boards. We would welcome reassurance from boards that particularly heavily committed non-executives have the appropriate time for board matters. Where this is not done to our satisfaction and the board attendance of individuals is poor, we are unlikely to support their re-election. We believe that over-commitment by directors reflects a failure to draw candidates from a wide enough pool.

Board committees

We encourage the implementation of formal, independently chaired, audit, remuneration and nomination committees and for the majority of their members to be independent. If this is not the case, companies should explain how potential conflicts of interest in respect of audit and remuneration are dealt with.

Board diversity

Boards are most effective when they have access to the knowledge and experience of a wide range of backgrounds that are relevant to the company, including its long-term strategic direction, suppliers, employees, customers and geographic footprint. In addition, a wide variety of viewpoints and perspectives will make for better debate and challenge. Boards that have too much commonality of backgrounds run the risk of groupthink and even hubris, both clear signs of governance failure. We believe that boards should take account of diversity in its broadest sense, including gender, nationality, ethnicity, as well as skills, experience, character and other attributes, when considering candidates for the board and other senior positions.

Importance of board and shareholder engagement

Dialogue between boards and serious, committed long-term shareholders on strategy, finance, corporate governance and risk management – including the management of risks and opportunities stemming from environmental and social issues – is essential. Through this exchange of views, shareholders can better comprehend, and if necessary, attempt to influence, the boards of companies in which they are invested, developing relationships of trust based on improved mutual understanding. Our experience has shown that constructive engagement between shareholders and directors in these areas can lead to improvements in the performance and value of companies, as well as help to prevent value destruction. Chairs and other non-executive directors, in particular board committee chairs, should make themselves available for meetings and teleconferences with minority shareholders as an essential part of their responsibilities. Developing relationships of trust with long-term shareholders can be invaluable to boards. We therefore expect boards to welcome more and better quality engagement between long-term investors and directors and for independent directors to participate in engagement.

Evaluation of the board

We welcome greater transparency on the work of the board and the rules and procedures in place to facilitate its functioning. Annual evaluations of the performance of the board and its members, either by self-assessment or by an external consultant, are beneficial to companies, as they help to identify potential weaknesses so that they can be addressed before they cause problems. We therefore encourage companies to implement a formal process for these evaluations and to communicate on the areas identified for improvement. At least every other year, the board should use an external independent reviewer to assess its performance.

EXECUTIVE REMUNERATION

Executive remuneration continues to be an area of concern for Hermes EOS. While requirements for additional disclosure have led to improved transparency, experience shows that, in many cases, remuneration still fails to align the interests of executives with those of long-term shareholders. In particular, it often fails to safeguard against excessive risk-taking or be sufficiently reflective of long-term performance.

We do not consider stock price appreciation on its own to be an appropriate performance metric. We expect long-term remuneration plans to employ specific metrics with rigorous targets that are closely linked to a company's long-term strategy. This nexus should be clearly explained in the discussion on pay and analysis within the company's annual report. Most variable remuneration should be explicitly linked to these performance targets and not simply vest over time.

Our interest is not limited to executive-level remuneration. In particular at organisations where staff pay makes up a high portion of the overall costs, we have concerns that levels of pay and performance criteria may create perverse and short-term incentives for employees.

We therefore encourage companies to improve their disclosure on how incentives for individuals with the ability to materially affect the performance of the business are linked to the interests of long-term shareholders, including the effective management of risk.

With a number of pension funds, we developed our Remuneration Principles for Building and Reinforcing Long-Term Business Success,[1] which provide high-level guidance to companies regarding our expectations of their pay structures and practices. They are:

1 Remuneration committees should expect executive management to make a material long-term investment in shares of the businesses they manage.
2 Pay should be aligned to long-term success and the desired corporate culture throughout the organisation.
3 Pay schemes should be clear, understandable for both investors and executives and ensure that executive rewards reflect long-term returns to shareholders.
4 Remuneration committees should use the discretion afforded them by shareholders to ensure that awards properly reflect business performance.
5 Companies and investors should have regular discussions on strategy and long-term performance.

The full version of our Remuneration Principles, along with a number of other policy documents on remuneration and other topics which Hermes EOS has produced, can be found at https://www.hermes-investment.com/ukw/stewardship/eos-literature/

EQUITABLE TREATMENT OF SHAREHOLDERS

Multiple-class share structures

Multiple-class share structures disenfranchise minority shareholders and often increase the power of one shareholder for a disproportionate economic stake. We encourage issuers with multiple-class share structures to adopt the concept of one-share one-vote. We are unlikely to support the issuance of shares with reduced or no voting rights or capital raising exercises that discriminate against minority shareholders.

TRANSPARENCY AND DISCLOSURE

Meeting notification and proxy documents

For minority shareholders, the annual general meeting is a formal opportunity to obtain information about management's and the board's stewardship of their investments and, if necessary, to request clarification of any decisions taken during the year. The annual general meeting is thus an important accountability mechanism, and the communication of detailed information on all agenda items at least 30 days in advance of the meeting is a pre-requisite for its effectiveness. All documents should be readily accessible on the company's website.

AUTHORISATION TO ISSUE SHARES FOR CASH AND TO PLACE UNISSUED SHARES UNDER THE CONTROL OF THE DIRECTORS

These types of resolutions tend to be the most controversial ones proposed by South African companies. This is because investors believe that the maximums placed on these resolutions by regulation and practice insufficiently protect the interests of shareholders. In order to protect the ownership interests of our clients, we believe that it is inappropriate to grant boards significant discretion over the issuing of shares for cash or other purposes. We strongly prefer that boards seek approval from shareholders for specific transactions instead of seeking a blanket authorisation for the next year. We believe that the small delay in carrying forward intentions that this might engender is more than compensated for by the scope for transparency and dialogue with shareholders which such specific approval would enable, allowing companies to gain endorsement of their strategies instead of creating discontent among investors. At most, we are willing to grant general authorisation to issue shares for cash up to 10% of the existing issued capital and to place no more than the same amount under the control of the directors.

ENVIRONMENTAL, SOCIAL AND ETHICAL RESPONSIBILITY

Companies should effectively manage environmental, social and ethical factors that are relevant to their business, with a view to enhancing long-term sustainability. They also ought to disclose to shareholders on a regular basis how they identify and manage the relevant risks and provide evidence that these structures are effective and that environmental, social and ethical factors are embedded in their culture. Companies should clearly define board and senior management responsibilities for environmental, social and ethical issues. We believe that directors of companies are accountable to shareholders for the management of environmental, social and ethical risks and opportunities in the same way they are accountable for the company's financial performance.

Bribery and corruption

We expect companies to have best practice anti-bribery and corruption policies and processes in place and robust compliance mechanisms to enforce them. However, on their own these are not enough. We expect boards to oversee the anti-bribery and corruption controls and – as importantly – to set the tone from the top, as well as to outline the highest ethical standards and expectations and the values of the organisation. This is to ensure that the culture does not allow corruption to thrive and has the necessary organisational measures in place to provide the best possible defence against corruption. We seek to enter dialogue where we judge the culture and values of a company to be lacking or the effective oversight, management of or reporting on bribery and corruption, company values and ethics to be insufficient.

Climate change

Climate change is a systemic risk to the value of the portfolios of our clients because of its economic and geopolitical consequences. We therefore support the ambition of the 2015 Paris Agreement of 195 countries to limit global warming as a result of climate change to below 2°C. This historic commitment was helped by the intervention of companies globally, which encouraged political action in the run-up to and during the 2015 UN climate change conference.

Because of the systemic risk to the global economy, we encourage all companies to publicly support the ambition of the Paris Agreement and to have this commitment as a central tenet of their public policy and sustainability activity. To support this, boards should ensure that they have climate change on their board meeting schedules at least annually and that they expose themselves and senior management to experts who can challenge them on the strategic risks and opportunities that climate change brings.

[1] https://www.hermes-investment.com/wp-content/uploads/2017/09/Remuneration-Principles.pdf

Task Force on Climate-related Financial Disclosures

We welcome the recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures. As a representative of long-term shareholders, we expect companies to assess and report on possible future climate change risks, not just those that have already emerged. Therefore, we expect companies to respond positively to the recommendations and to report against them. For companies in sectors where the risks from climate change are most material, this should include identifying potential material issues by testing the performance of their strategies against a range of low-carbon scenarios and demonstrating that these are effectively monitored and managed.

Importance of good quality reporting

We believe that the quality of narrative reporting reflects how well the board thinks about its strategy and indicates how able it is to execute it. Moreover, effective reporting means that engagement between shareowners and boards is more productive. For this to be most effective, boards must report openly and transparently on the performance of the company and their stewardship of it over the year. It is also fundamental that risk is reported on in a way that allows investors to understand the main risks that the board has identified for the business and the management and mitigation of these by the company. We encourage companies to adopt the International Integrated Reporting Framework.[2]

Sustainable Development Goals

We expect companies to assess the relevance of each UN Sustainable Development Goal (SDG) to their business and to consider how best to incorporate those which may be material into their business models and strategies. We encourage companies to report on how they support the SDGs and to engage with civil society to find out how best to respond to them.

Tax

We expect companies to:

- Comply with all tax laws and regulations in all countries of operation
- Recognise the importance of taxation to the funding of good public services on which they and their stakeholders rely and their commitment to pay their fair contribution
- Ensure that their tax policies and practices do not damage their social licence to operate in all jurisdictions in which they have a presence
- Disclose the taxes paid by or collected by them in each country.

[2] http://integratedreporting.org/wp-content/uploads/2013/12/13-12-08-THE-INTERNATIONAL-IR-FRAMEWORK-2-1.pdf

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HERMES INVESTMENT MANAGEMENT

We are an asset manager with a difference. We believe that, while our primary purpose is to help savers and beneficiaries by providing world class active investment management and stewardship services, our role goes further. We believe we have a duty to deliver holistic returns – outcomes for our clients that go far beyond the financial – and consider the impact our decisions have on society, the environment and the wider world.

Our goal is to help people invest better, retire better and create a better society for all.

Our investment solutions include:

Private markets
Infrastructure, private debt, private equity, commercial and residential real estate

High active share equities
Asia, global emerging markets, Europe, US, global, and small and mid cap

Credit
Absolute return, global high yield, multi strategy, global investment grade, real estate debt and direct lending

Multi asset
Multi asset inflation

Stewardship
Active engagement, advocacy, intelligent voting and sustainable development

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Why Hermes EOS?

Hermes EOS enables institutional shareholders around the world to meet their fiduciary responsibilities and become active owners of public companies. Hermes EOS is based on the premise that companies with informed and involved shareholders are more likely to achieve superior long-term performance than those without.

For more information, visit **www.hermes-investment.com** or connect with us on social media:

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