CORPORATE GOVERNANCE PRINCIPLES

South Africa

Hermes EOS
2020

For professional investors only

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HERMES
INVESTMENT MANAGEMENT

INTRODUCTION

Hermes EOS represents a broad range of long-term investors, who seek to be active stewards of their beneficiaries' assets and owners of shares or debt of the companies in which they invest. Hermes EOS engages with companies around the world in which our clients are invested to promote long-term, sustainable value. These Principles express our expectations of companies across a number of important governance, environmental and social topics.

COMPANY PURPOSE AND LEADERSHIP

It is our strong belief that companies can only create and preserve long-term value if they profitably provide goods and services that solve societal needs.

To achieve this, we expect companies to be guided by a purpose that serves not only shareholders, but also other stakeholders, society and the environment. This helps protect the long-term interests of the savers and pensioners – current and future – invested in companies, who require sustainable financial returns and an economy, society and environment capable of providing a secure future.

The board should be ultimately responsible for articulating this purpose. It should identify those stakeholders most critical to long-term value creation and articulate the timeframe over which it guides the company's strategy, values and culture, which is expected to transcend the tenure of individual members of corporate management. The board should assess the company's culture to ensure it is aligned with the purpose, strategy and stated values, as well as providing an environment in which employees are respected, motivated and engaged.

STEWARDSHIP AND ENGAGEMENT

Investors must also act as responsible stewards and promote long-term value through constructive engagement with companies and their directors. All substantive correspondence from institutional investors should be shared with all board members. Our experience has shown that dialogue between companies and committed, long-term investors on strategy, finance, risk management and material environmental, social and governance (ESG) issues can improve the governance, performance and value of companies. Developing relationships of trust with long-term shareholders can be invaluable for boards, and we encourage chairs and other independent directors to make themselves available for engagement.

Our model of engaging on behalf of a collective of investors aims to make the engagement process more efficient and effective, for companies and investors, by pooling resources and assets. We also aim to reduce potential conflicts of interest through a collective focus on long-term, sustainable value, shaped with input and agreement from our clients.

ENDORSEMENT OF THE KING CODE OF GOVERNANCE PRINCIPLES (KING IV)

We generally endorse the recommendations of the King Code of Governance Principles (King IV or the "Code") and encourage companies to comply with these 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 address additional issues and set out our preferred approach to particular governance matters. We outline priorities that will assist companies in taking concrete steps to improve corporate governance, thereby helping to increase investment and improve sustainable company performance. We seek to work with companies and regulators to help them move towards best practice, or to further enhance existing practices. The following sections are intended to assist South African companies and their directors in understanding our views on key corporate governance issues.

We expect all companies to comply with the principles contained in the Code. However, when implementing the principles, companies may choose to adopt practices different from those recommended by the Code, in order to suit their circumstances. In this case, we expect companies to explain, carefully and clearly in their disclosures, which recommended practices are not being adopted and the reason for not adopting them, as well as how their actual practices are consistent with the Code's principles, and how they will contribute to good governance.

BROAD-BASED BLACK ECONOMIC EMPOWERMENT

We recognise the need to address the inequalities which persist in South Africa because of its past and the need therefore to improve the economic position and financial inclusion of historically disadvantaged South Africans. We are therefore supportive of Broad-Based Black Economic Empowerment (B-BBEE), understanding that the greater involvement in the economy of people disadvantaged by the country's past is essential to South Africa's development and future prosperity.

We expect transparency from companies on how they are improving their ownership structure, board and management composition (including in relation to black women), employment practices, workforce training and skills development, procurement and social investment to promote and to help to achieve Broad-Based Black Economic Empowerment and socio-economic development.

BOARD EFFECTIVENESS AND COMPOSITION

Boards should ensure they comprise members with strong and diverse skills, experience, perspectives and psychological attributes, as well as sufficient independence and strength of character to challenge, advise and support executive management teams. They should ensure membership of the board is frequently reviewed and refreshed, and that directors are elected and re-elected by shareholders on a regular basis to ensure accountability. Biographies for all directors should be provided to shareholders, indicating which are considered independent and the value that they bring to the board. This should be accompanied by an analysis of how the board as a whole displays the necessary skills, independence and other attributes to meet the company's evolving needs.

Independence and tenure

On all boards, we expect a strong core of independent directors, including an appointed lead independent director, to ensure that all stakeholder interests are protected, to exercise objective judgement and, if necessary, to act as agents for change. This group should play an important role in guiding the boards' decision-making and in the recruitment of directors. It should be empowered to meet independently, including before and after board meetings, and should do so in practice. It should be granted access to members of management, information and resources as required.

Ensuring sufficient levels of independence is particularly important for founder-led companies, those with executive chairs, significant shareholder representatives (which we believe can be useful and justified, provided minority shareholder interests are protected) or strong management representation on the board. We expect at least half of the board directors to be independent in companies with a dispersed ownership structure, and at least one third to be independent in controlled companies. In their disclosures, companies should clearly state which directors they consider to be independent and the criteria for determining this.

We consider the overall composition of boards and recognise the value that long-serving directors can contribute. However, too many directors serving concurrently can increase the risk of groupthink and complacency. We expect a healthy mixture of tenures on boards, including regular board refreshments.

Diversity and inclusion

Boards should seek diversity in its broadest sense to support high-quality debate and decision-making Considering diversity of skills, experience, networks, psychological attributes and demographics (including gender, ethnicity, nationality, sexual orientation and age) will equip the board to effectively serve the company and its stakeholders.

Diverse perspectives are also likely to more accurately reflect employees, customers, and suppliers across the company's geographic footprint. As such, we support the aspiration that board members, together with all levels of management, should broadly reflect the diversity of society.

It is important to promote diversity at board and executive level, but companies should also focus on promoting a diverse and inclusive workforce. We encourage boards to monitor key indicators to assess how the culture of the company is inclusive and aligned to its strategy and purpose. Where diversity is found to be lacking – for example, the under-representation of women or ethnic minorities in leadership positions or elsewhere across the organisation – we expect companies to develop time-based targets and initiatives to address it.

Director attendance and commitment

We expect board directors to be able to devote sufficient time to fulfil their duties, including to build and maintain a good understanding of the company and to fully absorb and be able to challenge the information presented to them by management. We will consider recommending voting against a director who has missed a material number of board meetings without a satisfactory explanation being disclosed to shareholders, such as illness or compassionate leave.

Whether a director may be over-committed depends on a range of factors beyond the number of other roles they hold, including the size and complexity of the company and additional responsibilities, such as being a committee chair. As a broad guideline, we do not support directors holding more than five directorships at public companies and consider a non-executive chair role to be equivalent to two directorships. We encourage executives to take on non-executive roles to bring current experience to boards and build a pipeline of future board directors. However, we do not expect executives to hold more than one non-executive role.

Succession planning

Effective succession planning at board and senior management level is essential for safeguarding the long-term value of all companies. It should involve contingency planning for the sudden loss of key personnel, as well as planning for foreseeable change such as impending retirement. It should include consideration of the diversity of skills, experience and other attributes required at board and senior management level.

Overseen by the board, senior management should create a pipeline of suitable candidates from within the organisation to become senior managers and executive directors. We also encourage companies to make their senior management and executive directors available to serve as non-executive directors at other companies as part of their development. This helps to develop a deep pool of suitable talent for companies to draw from when selecting candidates for board positions.

EXECUTIVE REMUNERATION

We are increasingly concerned that executive remuneration structures and practices around the world are not fit for purpose, neither serving long-term investors nor aligning properly with the core long-term objectives of companies. Markets where pay practices are more restrained are at risk of importing poor practices from others. Some of these practices, such as introducing structures which gear the majority of pay towards 'performance-based' pay may have been well-intentioned but have proven to be ineffective, with unintended consequences such as escalating quantum and encouraging short-termism or financial engineering.

Our views and expectations of executive pay, including a suggested alternative model, can be found in our paper, *Remuneration Principles: Clarifying Expectations*[1].

They can be summarised as follows:

1 Simplicity: Pay should be simple; for example, fixed pay (mix of cash and long-term shares) plus a single incentive scheme (an annual bonus).

2 Alignment: Pay should incentivise long-term value creation, including wider social and environmental outcomes. Where metrics and targets are used in incentive pay, they should reflect strategic goals, rather than focus attention on total shareholder return, stock price appreciation or earnings per share.

3 Shareholding: Management should become long-term stakeholders in the company's success through substantial shareholdings. Significant shareholding requirements should remain in place for at least two years following departure from the company.

4 Accountability: Pay outcomes should reflect outcomes for long-term investors and take account of falls in company value or reputation. The board should intervene and apply discretion whenever formulaic outcomes do not achieve this. The potential pay outcomes under a policy should be rigorously scenario tested in advance, with a cap on the total possible pay published, to help reduce the risk of unintended consequences.

5 Stewardship: Pay outcomes should be communicable to all stakeholders, including employees and the public. Boards should take into account wider workforce pay practices and ratios when judging the appropriateness of pay opportunities and outcomes. Boards should then write to employees each year explaining the outcomes of executive pay and the alignment to long-term value, and the company's strategy and purpose. Companies and investors should regularly discuss strategy, long-term performance and the link to executive pay.

We ultimately want to see far simpler pay schemes based on fixed pay as a majority of the total, combined with long-term share ownership. However, we recognise that typical current practice models in many markets are not in-line with our vision for pay, such as those based on lower fixed pay with both short and long-term incentive schemes.

We strongly encourage companies to consider fundamental, rather than incremental, change when reviewing their pay schemes and are ready to support those willing to do so.

PROTECTION OF SHAREHOLDER RIGHTS

We rigorously defend shareholder rights on behalf of institutional investors, including the right to receive good quality corporate reporting and material information on a timely basis, to propose shareholder resolutions and to vote at shareholder meetings.

We support a single share class structure, with one share one vote, and oppose any measures that deviate from this.

SOCIAL, ETHICAL AND ENVIRONMENTAL RESPONSIBILITY

Taking a responsible and long-term approach to social, environmental and ethical issues is critical to the creation and preservation of long-term value, and should be reflected in the company's purpose, strategy and culture. Companies must identify and disclose the most material social and environmental issues for the company and its significant stakeholders. They must seek to address the associated risks and opportunities through their core business strategy and value proposition, rather than through adjacent initiatives which can feature in traditional corporate social responsibility programmes.

We expect boards and management to have oversight of material sustainability issues and to be accountable to shareholders for effectively managing the associated risks and opportunities. Boards should consider the issues in this section, although the list is not exhaustive.

UN Sustainable Development Goals

We support the UN Sustainable Development Goals (SDGs) and believe that the private sector has an important role to play in achieving them by 2030. Companies should assess the relevance of each SDG, identifying those that they can make a direct contribution to, and incorporate the most material SDGs into their strategies. We encourage companies to go beyond highlighting any SDG that the company could be connected to and to be purposeful in selecting those which it intends to make an active, direct contribution to, including through the allocation of resources and setting targets. We urge companies to report on their approach to the SDGs and to engage with its shareholders and civil society on how best to contribute to the SDGs.

Climate change

The breakdown of the climate is a systemic risk to the value of our clients' portfolios, due to the economic and political consequences, as well as the physical impacts of climate change.

We strongly support the goal of the 2015 Paris Agreement – to limit global warming to well below 2°C and pursue efforts to reach 1.5°C of warming – and expect companies to publicly do the same, as well as encouraging any third-party organisations they support or are members of, such as trade bodies or lobbying organisations, are aligned to achieving this.

We urge companies not already doing so to:

- Establish strong governance of the risks and opportunities presented by climate change. Boards should ensure that climate change is included on the board agenda at least annually. We recommend that the board and senior management engage with outside experts who can advise on strategic risks and opportunities that climate change presents, including challenging the company's approach if necessary.
- Set science-based targets to reduce greenhouse gas emissions in-line with the goals of the Paris Agreement. This should include consideration of 'Scope 3' emissions associated with a company's supply chain or use of products, wherever feasible.

[1] https://www.hermes-investment.com/wp-content/uploads/2018/10/remuneration-principles-clarifying-expectations.pdf. The principles contained in this paper are global in nature, but some of the specific references to structures are more applicable to certain markets such as the UK.

- Integrate climate change into the forward-looking strategy for the company. This includes conducting scenario analysis to establish the potential financial and other impacts of climate change on the business at different levels of warming.
- Adopt the framework set out by the Task Force on Climate-related Financial Disclosures (TCFD) for the management and reporting of climate-related risks and opportunities.

We support the work of The Transition Pathway Initiative (TPI), which assesses companies' management of greenhouse gas emissions and risks and opportunities related to the transition to a low-carbon economy. It also assesses how companies' current and future carbon performance might compare to the international targets and national pledges made as part of the Paris Agreement. Company ratings can be accessed via the publicly available TPI tool[2]. We will consider recommending voting against the chair of the board or other responsible directors of companies which we do not believe to have demonstrated sufficient management of climate risks, for example, those scoring below a Level 3 management rating from TPI.

Resource efficiency – circular economy

As the global population and consumption levels continue to rise, it is vital to find ways to use resources more efficiently, to tackle environmental challenges such as climate change; pollution to air, water and land; and soil erosion and loss of biodiversity. We expect companies to strive for the most efficient use of resources possible, and to consider how they can introduce circular economy approaches to their business model and operations.

One highly visible example is the urgent need to reduce plastics consumption and waste. We expect companies in exposed sectors to develop strategies and set targets for the reduction of, and optimal and balanced use of plastics in products and packaging; to end reliance on 'single-use' plastics wherever practicable; and to invest in developing more circular supply chains which consider the most sustainable use of plastics or alternative materials throughout their lifecycles.

In the face of looming resource scarcity, another example is the need to shift to more sustainable sources of food, including reliance on inefficient animal and livestock-based proteins. Boards in relevant sectors should consider the potential for healthy, sustainable foods, ingredients and agricultural practices, such as plant-rich dietary options, plant-based proteins, and animal proteins which do not exacerbate further deforestation or fisheries depletion, and which avoid excessive use of antibiotics in rearing.

Human rights

We endorse the UN Guiding Principles on Business and Human Rights and the UN Global Compact and expect companies to do the same. We expect companies to use the reporting framework of the Guiding Principles to disclose how they assess and manage human rights issues that are salient to their operations and supply chain.

Companies' licences to operate are increasingly affected by reputational factors, including their approach to human rights. As a minimum, we expect companies to comply with all legal requirements and to respect all internationally recognised human rights.

Human capital management

For many companies, employees are one of their most valuable 'assets', yet it is often unclear from disclosure or engagement with boards how companies invest in or manage their people effectively. Companies should set strategies and supporting objectives for the management of their human capital which reflect the importance of employees to long-term value creation and are overseen by the board. We encourage companies to provide qualitative contextual information describing their approach, as well as annual disclosure of key performance indicators used to manage human capital.

Ethical conduct, bribery and corruption

As a minimum, we expect companies to set and adhere to standards of ethical conduct through relevant policies and process, including enforcing best practice anti-corruption and anti-bribery policies and processes. These should be overseen by the board with robust action taken where issues are identified.

Policies and processes cannot be fully effective without the right cultural context and leadership. We expect the board not only to oversee the company's culture and conduct but also to set the tone from the top, to encourage the highest ethical standards, and to drive company values. The goal is to ensure that the culture is one in which employees are engaged and motivated, corruption cannot thrive and organisational measures provide the best possible defence against corruption and other unethical behaviour.

Tax

Our main expectations of companies are to:

- 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;
- Publish a global tax policy that describes their approach to tax risk, controls and oversight, including any material variations across the entity. This should include policy on corporate structuring in low tax jurisdictions, transfer pricing and the use of tax incentives from public authorities;
- Ensure tax, including policy, risk, and controls, is sufficiently covered in the board and board-committee agenda;
- Pay tax in line with where economic value is generated and in line with the legislative intention of tax law; and
- Disclose taxes paid in each country, including for each a description of the purpose of the corporate entity and comparative business data such as revenue, profit before tax and number of employees.

[2] http://www.lse.ac.uk/GranthamInstitute/tpi/the-toolkit/

TRANSPARENCY AND REPORTING

We believe that the quality of narrative reporting reflects the board's strategic thinking, its line of sight into operations and how well it oversees the company. Boards must report openly and transparently on the performance of the company and their stewardship of it over the year, acknowledging the challenges, as well as the achievements, the state of the market and the competitive landscape. It is also fundamental that each company reports in a way that allows investors to understand the main risks that the board has identified for the business, along with how the company manages and mitigates them. This includes environmental, social and governance, as well as financial and strategic, risks.

Audit

We remain concerned about the audit market and audit quality. As such, we will hold the audit committee responsible for the quality of a company's audit. The audit process should objectively examine a company's financial position and ensure the integrity of company reporting on essential matters, such as the solvency of the company and its long-term financial prospects. We expect audit committees to provide meaningful reporting for shareholders on the key aspects of their work.

COMMERCIAL TRANSACTIONS

Most merger and acquisition transactions are not as successful as the acquiring party expects. When considering our voting recommendation on a commercial transaction, we will consider a range of factors, in the context of seeking to protect and promote long-term, sustainable value. The underlying expectation is that due process is followed, with information made available to shareholders. Considerations include:

- Consistency with strategy: whether the transaction is consistent with the prior stated strategic aims of the company or whether any change in strategy appears coherent and sensible.
- Risks and opportunities: the key risks and opportunities to the business from the transaction and the extent to which these appear to have been considered and managed. This includes factors such as cultural fit, human capital management implications and the post-transaction integration plan.
- Conflicts of interest: any conflicts of interest which may affect the alignment of the interests of directors or particular shareholders with those of long-term outside or minority shareholders. This includes considering whether the proposal is a related party transaction and, if so, whether appropriate disclosures and safeguards are in place; whether the transaction erodes any shareholder rights; and any potential conflict of interest concerning the directors' duty to act in the interests of shareholders, in particular, as these may arise from either existing or newly revised remuneration arrangements.

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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, small and mid-cap and impact

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

Stewardship
Active engagement, advocacy, intelligent voting and sustainable development

Offices

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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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