Executive remuneration in SA

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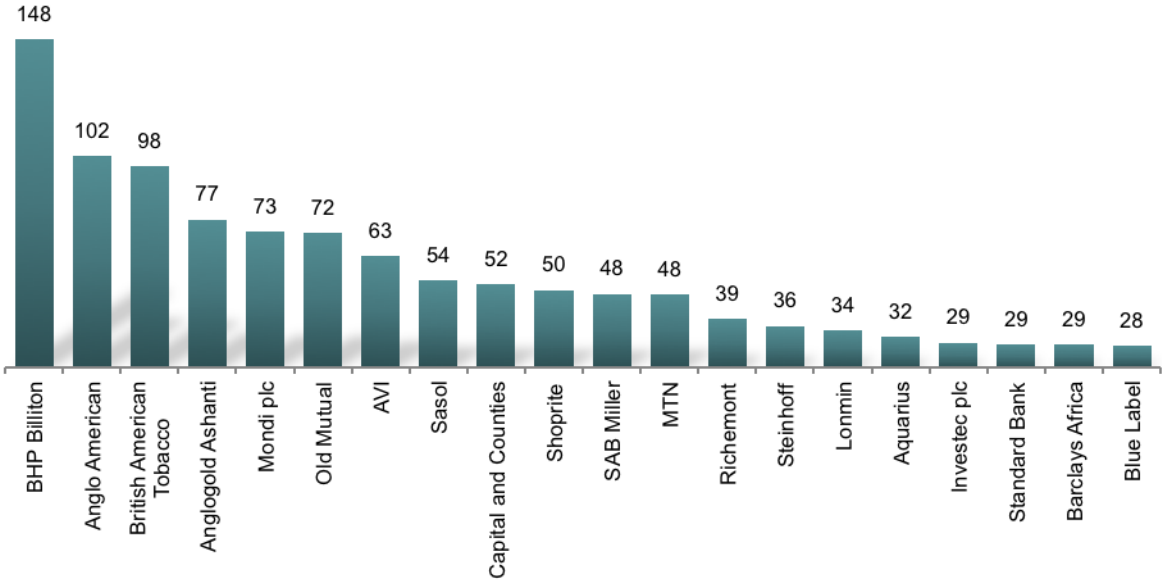
As investment managers representing shareholder interests we aim to maximise our clients' wellbeing in the long term. The wellbeing of our clients at retirement is driven by how much we are able to grow their retirement savings, but also by the society and environment that they retire into. We are responsible for ensuring that our clients' capital is invested in the companies and with the management teams that will generate the best returns on their capital over the long term. At the same time we are responsible for ensuring that the companies and management teams that we allocate our clients' capital to be conducting business in a way that does not have a negative impact on the broader society or environment in which they operate.

Against this backdrop we are concerned by the high level of inequality within South African society and so we need to approach the topic of remuneration within the companies that we invest our clients' savings, with great care and thought. We wish to invest capital in the best quality companies managed by world class management teams and we know that compensation is an important tool to attract and incentivise highly skilled management to these companies. At the same time extreme or unwarranted levels of executive remuneration and income inequality within the companies that we invest in and the societies that they operate in pose long-term risks to the capital that we have allocated to them and to the broader society as a whole. As a result we spend time thinking about how managers should be remunerated and incentivised and conduct analysis to understand the topic of executive remuneration and income inequality. Given the level of interest in this topic within the public debate currently we present some of the findings of our research with the hope that we can add some useful insight and data to what is a complex, opaque and emotive discussion

Highest paid executives on the JSE

We start by simply examining the largest pay packages for CEOs of JSE listed companies in 2013 which show that the highest earners on the JSE are dominated by CEOs of multinational companies, with seven CEOs receiving total compensation of over 60 million rand respectively during 2013. According to the Stats SA Quarterly employment report the average total compensation earned by non-agricultural workers in South Africa during 2013 was just below R180 000 a year. This means that the seven highest paid CEOs on the JSE earned more than 300 times what the average employed South African made during the year.

Figure 1: Top 20 largest total CEO compensation 2013

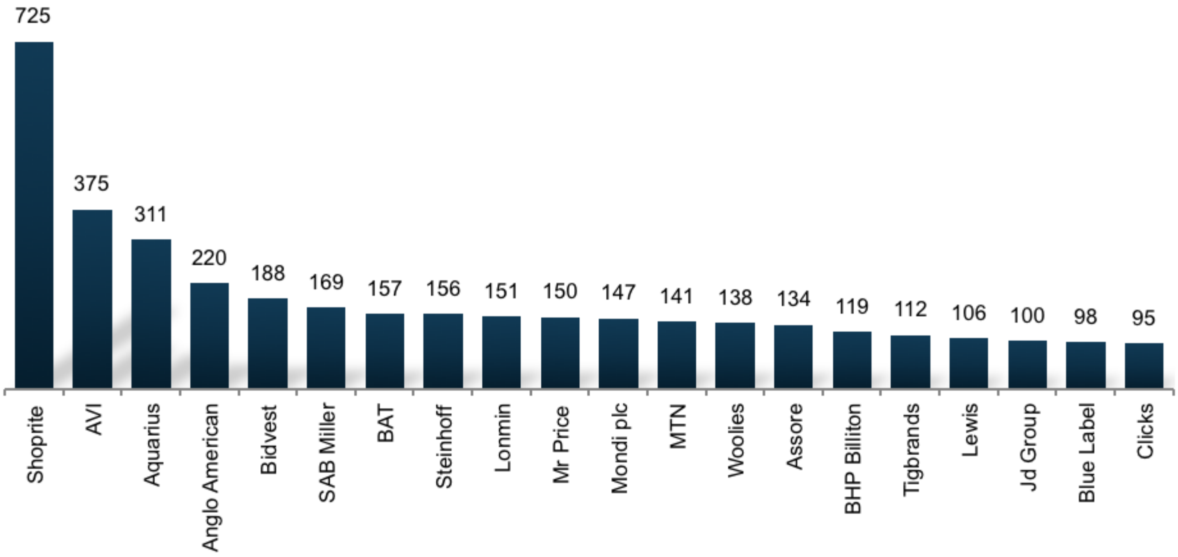


The remuneration committees of these companies would argue that large multinational companies such as BHP Billiton, Mondi and British American Tobacco are globally diversified and so it is not necessarily relevant to compare their CEO compensation to the average salary within South Africa and so next we examine the pay gap between CEOs and the employees within their own companies.

Largest wage gap on the JSE

Calculating the gap between the highest and lowest paid workers in a company is often difficult due to lack of disclosure but for most listed companies it is possible to estimate the average salary per employee and compare that to the total compensation paid to the CEO.

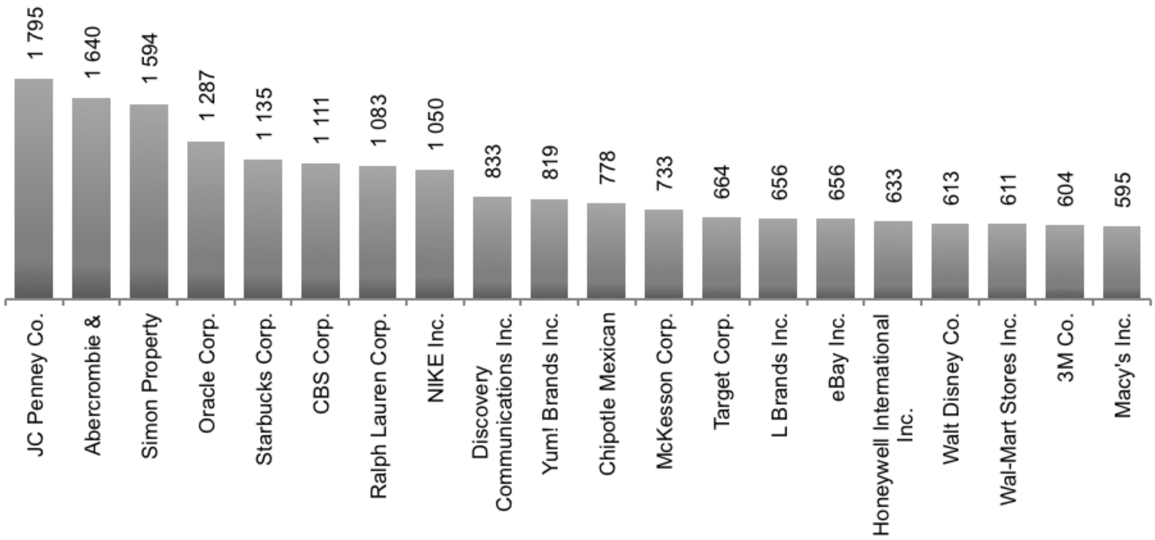
Figure 2: Top 20 largest pay gap (CEO to average Salary Pay Gap)



This analysis shows that Shoprite has the highest gap between total CEO compensation and the average wage per employee, with four JSE listed companies showing a gap of more than 200 times. It is also important to note that this measure may vary over time as CEO compensation may be quite volatile from year to year driven by bonuses and share awards. In this case however the 2013 remuneration paid to the Shoprite CEO is largely made up of guaranteed compensation and so this pay gap is reflective of a long-term average rather than a one-off anomaly.

It is interesting to compare these numbers to international examples to gain some perspective. The chart below shows the top 20 US listed companies with the largest CEO to average worker pay gap as estimated by Bloomberg. While the highest gap in this sample set is higher than that of Shoprite, Shoprite would still be comfortably within the top 20 companies in the US with the largest pay gaps.

Figure 3: Top 20 largest pay gap US listed companies



The US is widely regarded to have the most extreme examples of the gap between CEO and employee remuneration. An example closer to the other end of the spectrum is Switzerland. In 2013 the Swiss population voted against a proposed pay cap on CEO salaries at 12 times the salaries of the lowest paid employees in the company. The supporters of the law claim that the average salary of Swiss CEOs reached 43 times the average wage in 2011. In 2012 the Swiss trade union Travail Suisse published the CEO to worker pay ratios of the top five Swiss companies, with ratios between 195 and 261 times.

While these examples above show individual companies it is also useful to look at aggregate country level data to see how high average wage gaps are across different countries.

We calculate an average gap between CEO compensation and average wages at the companies in question across a sample of stocks in a number of countries where we are able to find sufficient data. We also include a different measure of the wage gap by calculating the gap between the average compensation paid to a CEO within a country compared to the average wage earned within that country, rather than the average wage earned at that the companies where the CEOs serve.

	Average CEO compensation to average company wage	Average CEO compensation to average country wage	Gini Coefficient
United States	164.4	331.0	45.0
Hong Kong	115.2		53.3
Germany	102.2	147.0	28.3
United Kingdom	93.2	84.0	34.0
South Africa	73.1	144.6	63.1
Malaysia	63.2		46.2
Australia	54.7	92.0	30.5
Japan	53.8	67.0	38.1
Italy	51.9		36.0
France	48.0	104.0	32.7
Switzerland	47.5	148.0	33.7

	Average CEO compensation to average company wage	Average CEO compensation to average country wage	Gini Coefficient
India	32.1		33.4
Norway	30.1	58.0	25.8

Source : Mergence calculations, American Federation of Labor and Congress of Industrial Organisations.

Due to the fact that many SA listed companies have international operations where wages and salaries may be higher than in SA, the ratio of CEO pay to the average wage in SA is significantly higher than the pay gap calculated versus company employees. While this data shows that high levels of income inequality between executives and workers is a global phenomenon, it is concerning to see that South Africa ranks above a number of developed and developing market peers on these measures. It is also important to note the difference between the wage gap in the US compared to other countries. Due to the global dominance of US companies, and data availability, the US is often cited as an example to justify large executive pay packages in SA, based on the argument that a local executive is earning less than a comparable US executive. As shareholders we are aware that large companies are competing globally for talent, but it is also important to note that US compensation is not necessarily reflective of global norms.

Changes in wage gap over time

An important question that arises is how the wage gap has progressed over time. The best historical data on pay gaps exists for the US. Two separate reports conducted by PWC and the AFL-CIO, the largest US trade union federation, show that the pay gap in the US has increased at least five-fold since the 1980s.

Figure 4: US CEO– worker wage gap [AFL-CIO data]

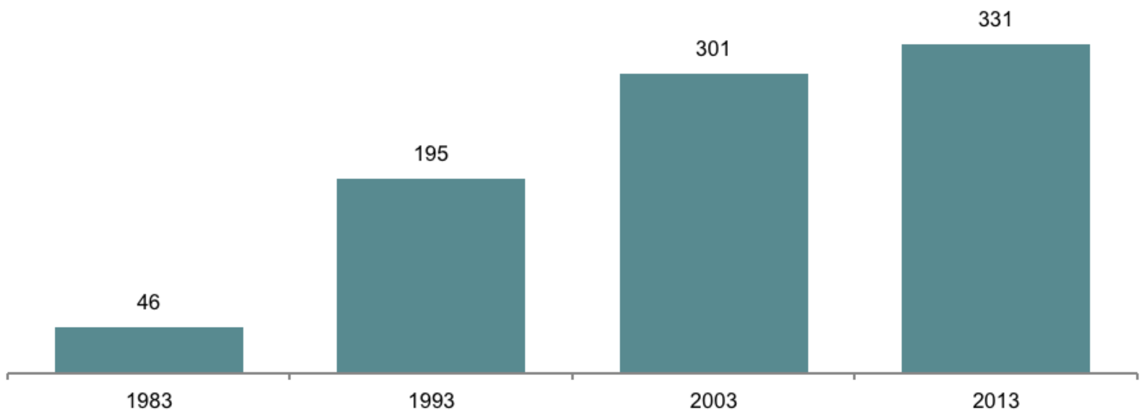
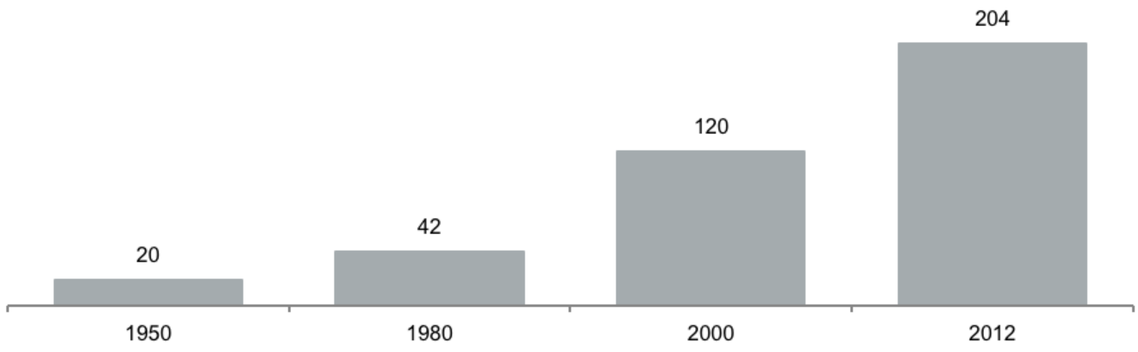


Figure 5: US CEO– worker wage gap [PWC data]



While these two reports arrive at quite different numbers for the pay gap within the US due to different methodologies and sample sets, the long-term trend in the wage gap is very clear from both of these charts. While consistent data is more difficult to find for other countries, the upward trend seems to be quite consistent across the globe, although the US is the most extreme example.

We measure the progression of the wage gap for South African listed companies over the past five years. We include the top 100 largest JSE listed companies where we have sufficient data available. We track the average of CEO and employee compensation over time across the universe of stocks in our data set. We also compare the average CEO compensation to the average wage earned within South Africa as published by Stats SA. The data seems to suggest that there is still an upward trend in the pay gap within our universe over the past five years, with the gap between CEO total compensation and average employee compensation increasing from just under 120 times in 2009 to over 140 times in 2013. The same trend appears when comparing the average CEO base salary for CEOs against average employee compensation, indicating that the move is driven by actual increases in packages rather than just variability in bonuses and share grants.

Figure 6: Average CEO total compensation to average company wage and average country wage

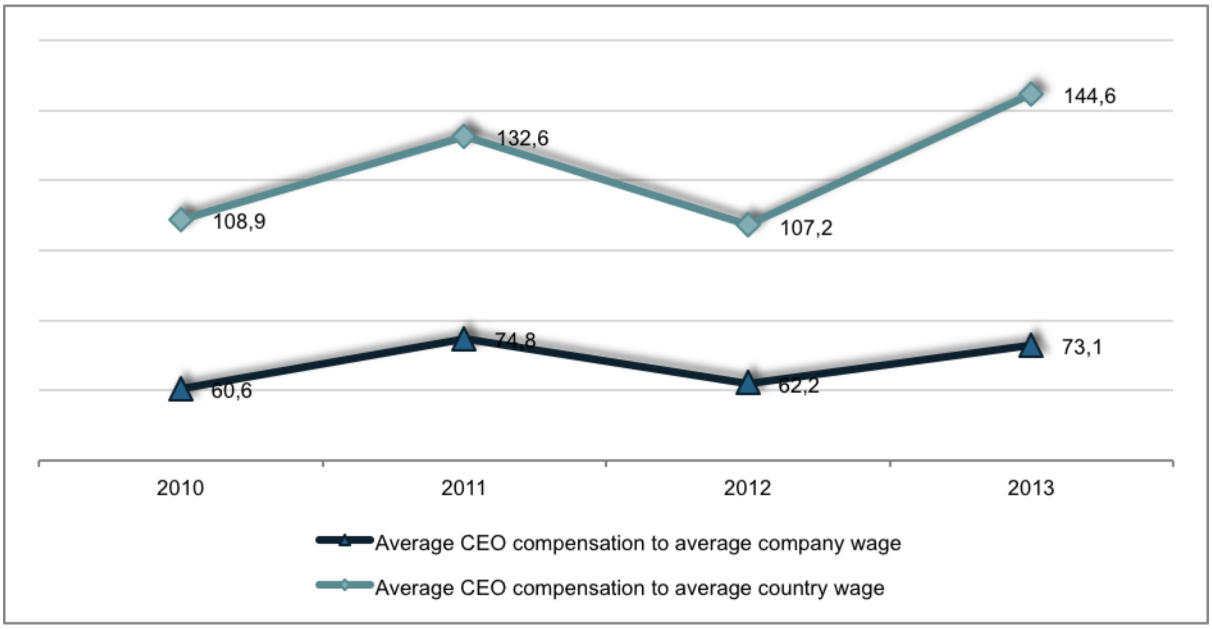
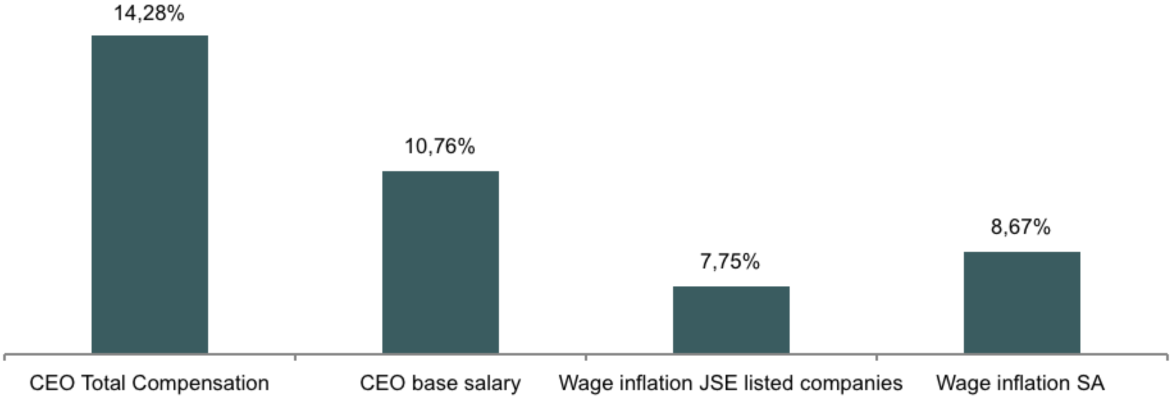


Figure 7: Average CEO base salary to average company wage

Our data suggests that since 2009 the average annual inflation rate of CEO base salary packages was above 10% per annum while average salaries across all employees within the companies in our sample increased by under 8% per annum.

Figure 8: Average annual inflation rates [2009-2013]



Comparing CEO pay to company fundamentals

To gain some insight into how executive packages can continue to rise faster than average remuneration, it is useful to compare executive remuneration to some company measures to see how much companies are spending on their executive teams. For the 20 companies with the highest wage gap we show the proportion of the total salary bill that is paid to executives as well as the proportion of total operating expenses that is spent on executive remuneration.

	CEO Total Compensation (R'000)	Average Employee Compensation (R'000)	Wage Gap	Total Executive Remuneration as % of Total Salaries	Total Executive Remuneration as % of Total Operating Expenses
SHP	50 001.00	68.97	725	1.52%	0.13%
AVI	63 084.00	168.36	375	4.90%	1.13%
AQP	31 632.71	101.70	311	4.28%	0.87%
AGL	102 141.10	464.02	220	0.29%	0.06%
BVT	27 378.00	145.72	188	0.50%	0.05%
SAB	48 417.98	285.91	169	0.46%	0.08%

	CEO Total Compensation (R'000)	Average Employee Compensation (R'000)	Wage Gap	Total Executive Remuneration as % of Total Salaries	Total Executive Remuneration as % of Total Operating Expenses
BTI	98 033.71	623.93	157	0.61%	0.15%
SHF	36 060.82	231.54	156	0.57%	0.10%
LON	34 098.52	225.94	151	0.53%	0.26%
MPC	11 522.00	76.72	150	1.78%	0.23%
MNP	72 595.25	494.07	147	1.28%	0.21%
MTN	48 077.00	341.02	141	0.71%	0.06%
WHL	27 094.00	196.96	138	1.69%	0.25%
ASR	20 363.00	152.24	134	5.71%	0.99%
BIL	147 640.61	1 236.71	119	0.72%	0.10%
TBS	17 661.00	157.33	112	1.71%	0.19%
LEW	11 394.33	107.06	106	2.63%	0.53%
JDG	14 287.11	143.37	100	0.75%	0.10%
BLU	28 214.00	287.73	98	14.09%	0.26%
CLS	21 595.00	227.43	95	2.08%	0.23%

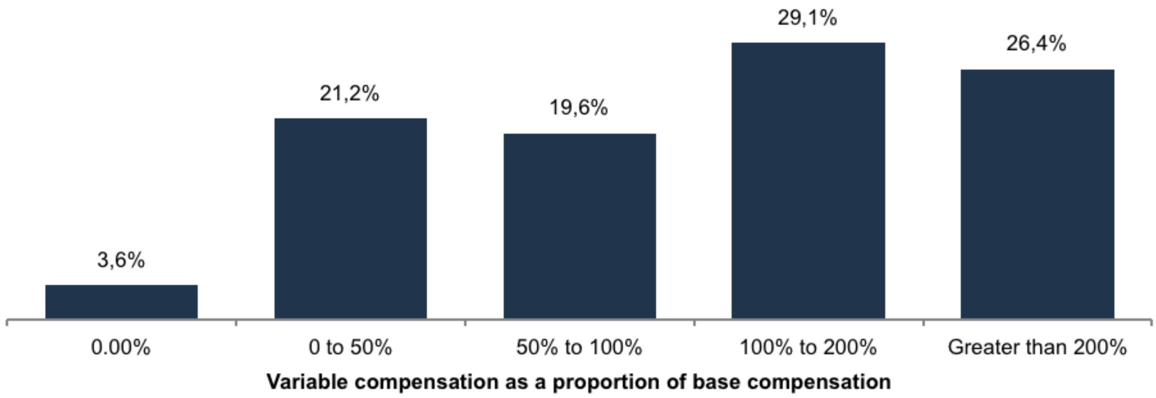
Source: company annual financial statements; Mergence calculations

Given the size and scale of the companies on this list, the amounts that are paid to executives are small relative to the total salary bill of the company and to the operating expenses of the company. This incentivises corporate boards and shareholders to spend to obtain the best management teams. Consider for example a company where the total compensation paid to executives makes up 0.1% of operating expenses. If the board believes that a new executive team can cut costs within the company by 1%, but they would need to double their executive pay packages to attract the desired team, the result would still increase profits, given that the 1% reduction in costs would be 10 times the increase in executive remuneration.

Variable pay

As shareholders, variable performance based compensation is an attractive approach to some of these concerns. Management teams that are incentivised to generate value for shareholders and are only compensated generously if they achieve those targets are attractive to shareholders. But given the large potential rewards offered to executives for good performance it is important to ensure that variable pay is being awarded appropriately and that the performance hurdles for variable remuneration is not too low.

Figure 9: Distribution of variable compensation [2011-2013]



Across our universe of stocks for the period 2011 to 2013 less than 5% of CEOs did not receive bonus payments; more than 70% of CEOs received variable compensation that was greater than 50% of their base salary with almost 50% receiving variable pay higher than 100% of base salary. This seems to suggest that the performance targets set for CEOs are low enough to ensure that at least some level of variable pay is awarded and that a CEO with average performance versus peers can expect to receive 100% of their base salary in variable rewards. Given the complex structure of executive incentive schemes and the poor disclosure by some companies of the targets that executive performance is measured against, shareholders need to play a more active role ensuring that executive remuneration policies are set appropriately.

Say on Pay

Currently South African shareholders have a non-binding vote on a company's executive remuneration policy. It is considered best practice for companies to put their remuneration policy to shareholder vote, but the company has no legal obligation to abide by the outcome of that vote. Globally, a number of companies have made moves to give shareholders more control over executive remuneration. Australia instituted a law in 2011 stating that if in two consecutive meetings over 25% of shareholders vote against the directors' remuneration package, the directors have to stand for election again in 90 days and may face the prospect of not being re-elected. In 2013 the Swiss government implemented a law that gives shareholders control of executive remuneration. Spain has recently presented a bill that would require companies to get approval from shareholders for their remuneration plan once every three years.

Conclusion

Executive remuneration is a complex and sensitive issue, especially in South Africa. South African companies and their stakeholders face the challenge of having to compete in a global marketplace but also having to confront the enormous levels of inequality within South African society. We believe that the current level of income inequality within listed South African companies should be a concern for shareholders, as well as the fact that in some companies this inequality is rising.

The short-term incentives for large companies and their shareholders lead to increasing executive remuneration and income inequality, but in the long run these increases potentially lead to negative social consequences and fuel popular support for regulatory and political responses that may pose a risk to the ability to obtain skills and allocate capital optimally. There are increasing moves globally to limit executive remuneration through various means, in some cases through increased disclosure and control by shareholders and in other instances through legislation. We believe that it is important for shareholders to engage company management seriously on this issue to attempt to mitigate the risks posed by the high levels of income inequality with in South Africa, both to the long-term safety of their capital as well as to South African society as a whole.

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