The Journey in South African Executive Reward

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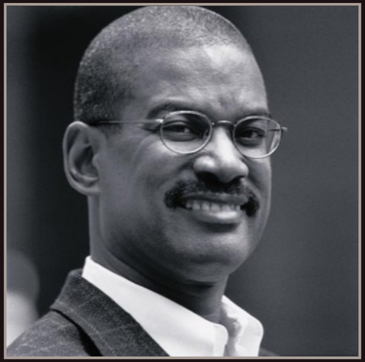
By Martin Hopkins,
Executive Chairman, Value Analytics,
Specialist Advisor, PricewaterhouseCoopers



The Journey

The late 20th Century …

The dawn of the 21st Century …

Breaking News …

The late 20th Century

Cash salary and bonuses more frugal

- No disclosure of Executive Pay
- Remuneration more pedestrian and less differentiated from senior management
- Bonuses paid to reward exceptional performance, not viewed as variable pay

The Halcyon Days of Share Options

- Almost all schemes were simple Share Options or Share Purchase Trusts
- No performance vesting requirements
- Large initial awards on appointment or promotion
- No tax on gains until awards after June 1969 (introduction of S8A of the Income Tax Act)
- Prevalence of Deferred Delivery Schemes, which avoided S8A Tax
- No capital gains tax
- No income statement expense for Share Options

The Dawn of the 21st Century - Events

- Major collapse in equity markets the .com bubble – Executives profiting from ballooning share prices without underlying profitability
- Disclosure of Executive Reward
- High profile Corporate Governance failures – Enron and Worldcom – more scrutiny of executive reward
- South African Tax changes – S8C (2004 and amendments thereafter)
- Accounting expense – IFRS 2 (2005) and FAS 123

The Dawn of the 21st Century – Reward impact

- Cash remuneration increases – disclosure results in “keeping up with the Jones’s
- Bonuses are viewed as part of variable pay, not an exceptional payment
- Investor activism leads to imposition of Performance Vesting Conditions
- Tax and accounting changes lead to introduction of new instruments:
    - Performance shares
    - Cash- and equity-settled Share Appreciation Rights
    - Deferred Bonus Plans

Share Appreciation Rights

New generation "Options"

Participant receives a benefit equal to the increase in the Share Price from grant to exercise.

Settled in Equity or Cash.

May be exercised after vesting (3-5 years) but before lapse (5-10 years).

May be subject to Performance Vesting Conditions

Can be more tax-effective and better for dilution.

Performance Shares

Vesting of Performance Shares are linked to critical value drivers.

For Listed Companies these are usually Financial Drivers (Shareholder returns and Profit Growth).

For State Owned Enterprises these can be Non-financial Measures linked to Capacity building, Empowerment, Environmental impact and Operational Efficiency.

Performance Vesting Conditions in SA

Type of Plan	Comments	Examples
Options (including Share Appreciation rights and Phantoms)	Real Growth in HEPS Cumulative HEPS between Threshold and Target	2% (Anglo Platinum, Tongaat Hulett, Kumba, Highveld Steel, Datatec, Johncom, Sun International) 3% (Investec, Old Mutual) 5% (Super Group) Threshold/Target (Dimension Data)
LTIP or Conditional Shares	Total Shareholder Return vs Peer Group. 30% vesting at Median and 100% Vesting at Upper Quartile. Return on Capital Employed	Dimension Data, Datatec, Anglo Platinum, Tongaat Hulett, Kumba, Highveld Steel, Datatec, Johncom, Sun International

Deferred Bonus Plans

Invest portion of the annual bonus in Company shares or Assets under Management (Investment managers).

Matching share awarded after three years if still in the Company’s employ and ledged shares are retained.

Or increased Annual Bonus with compulsory deferral and co-investment for 2-3 years.

GOOD FOR RETENTION

Co-investment and Purchase Plans

Similar to Deferred Bonus Plans.

Funds may come from other resources than the Bonus.

Funds can be loaned from Company or Third Party.

Investments can be in shares or more leveraged instruments – eg convertible shares or prefs.

Investment can be Economic Interest in participants Business Unit – GOOD FOR RETENTION

Common in private equity deals.

Matching shares or conversions reward tenure and performance.

GOOD FOR RETENTION

Sizing the Prize

Quantifying and valuing award instruments is important for calibrating and benchmarking grants, assessing affordability and accounting cost.

Two concepts are important:

- Face value
- Expected value

Face value is the market value (at grant) of all the shares involved in the grant.

Expected value is the probability weighted present value (at grant) of the instruments taking all attributes and performance conditions of the instruments into account.

Breaking News …

- Under-water markets, tough local conditions, emigration and the skills shortage …
- … leads to the introduction / resurgence of:
  - Restricted shares
  - Forfeitable shares

- The credit crunch has lead to focus on financial service company Bonus practices …
- … is likely to lead to:
  - Lower cash bonuses
  - Higher Guaranteed Pay
  - Higher Deferred or long term incentives

Restricted Shares

- Similar to Performance Shares, but are only subject to continued employment, not Company Performance Conditions
- Usually require 3 years of employment from date of grant to vest
- Good for retention, because they are “in the money” from day one
- Reasonably tax effective since they are taxable in Participant hands but can be structured to be dedutible in Company’s hands

Forfeitable shares

Share granted up-front, but may be forfeited if employment requirements and other conditions are not met.

Qualify for dividends and voting rights immediately.

GREAT FOR RETENTION – IMMEDIATE LOCK)IN / NEVER “OUT OF THE MONEY”

INSTITUTIONAL INVESTORS DON’T PERMIT SUCH AWARDS TO DIRECTORS + EXCO

MAY SET CONDITIONS UP FRONT FOR AWARD AND MAKE THEM PART OF BONUS DEFERRAL

Thank you