Benguela's Active Engagement on ESG

Massmart Case Study

BENGUELA GLOBAL
FUND MANAGERS

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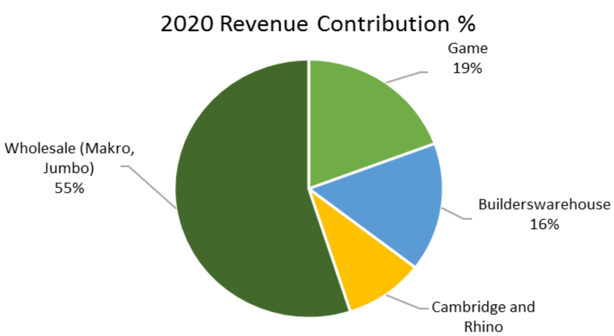
Introduction

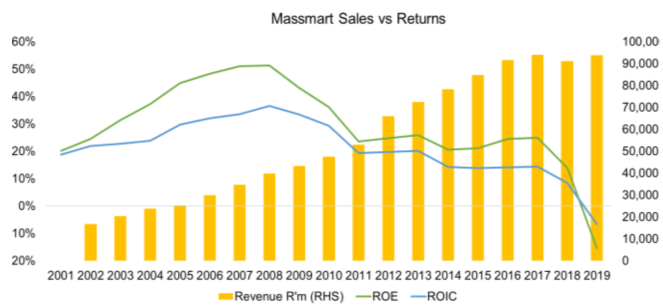
Massmart and its retail brands are prevalent in every South African's life. Being one of the largest retailers, it contributed 10% to national retail sales in 2019. Game alone accounts for one in every three TVs sold in the country, it sells one in every three large appliances, and is the seller of the most laptops of all retailers in South Africa. Yet, this retail giant has destroyed so much value for its Shareholders. Massmart's share price has fallen 65% over the last five years versus the FTSE/JSE Food & Drug Retail index that has returned 12% over the same period. We, at Benguela, believe a significant contributor to this underperformance has been the historically misaligned remuneration incentive model.



Source: MSM, Benguela

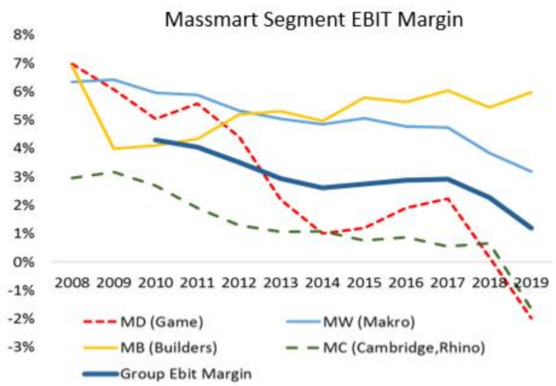
Owner Manager Conflict: A Misaligned Remuneration Policy

Massmart's management team have historically been incentivised to prioritise earnings and sales over returns. 80% of Massmart's Executive Short-Term Incentive Scheme is based on meeting a profit before tax target, with their Long-Term Incentive weight split 50/50 between sales and ROI.

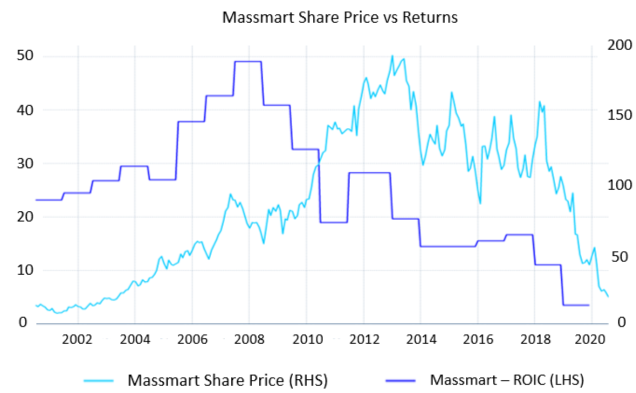


Source: MSM, Benguela

The graphs above and overleaf (*top of page*) clearly show the impact of a management team which prioritised unprofitable sales. In 2019, Massmart reported their first Profit After Tax loss since listing on the JSE in 2000.



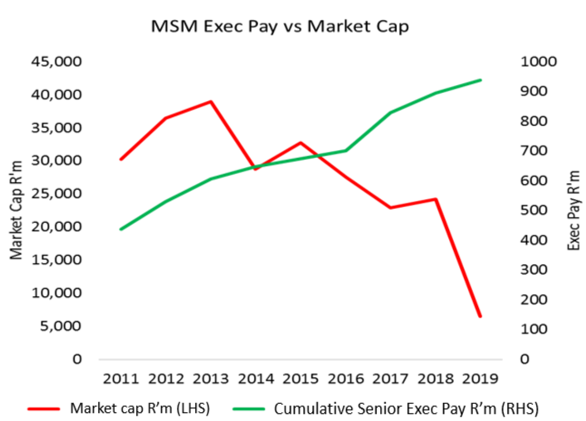
Source: MSM, Benguela



Source: Refinitiv

Well Rewarded Executives

By the start of 2021 Massmart's share was down by c.65% over the last five years, yet Massmart's previous executive team were handsomely rewarded over this time. This incentivisation scheme was approved by independent non-executive directors of Massmart. Through diligent research Benguela found that in 2014 Massmart's ROI target was adjusted lower, this allowed for Massmart's executive management to be **awarded greater than 100% of the total award for targeting lower returns.**



Source: MSM, Benguela

Weak Governance Structures: Lack of Board Independence

Figure 1 (*last page*) highlights the growth in fees for three of Massmart's independent non-executive directors. **Fee growth averaged c.19% over the last five years while Massmart's earnings declined by more than 100% over this time.** Furthermore, figure 2 highlights the tenure of two of the directors who have served for greater than 10 years on the Board. This goes against King IV's best practices to rotate directors who have served for more than nine years.

Director Emoluments R'000	2012	2013	2014	2015	2016	2017	2018	2019	5Yr CAGR
Mrs Gwagwa	183	451	512	543	600	738	845	1,141	17%
Mr Dlamini			892	1,440	1,621	1,961	2,262	2,313	21%
Mrs Langeni	296	689	758	795	852	1,106	1,541	1,702	18%
MSM Net Income Rm	1,031	1,343	1,137	1,168	1,340	1,508	869	-862	
MSM Net Income yoy%		30%	-15%	3%	15%	13%	-42%	-199%	-100%

Figure 1

Independent Non-Executive Director Tenure	
Mr Kuseni Dlamini (Chairman)	6-years
Mrs Nolulamo Gwagwa	14-years
Mrs Olufunke Ighodaro	2-years
Mrs Phumzile Langeni	16-years
Mrs Lindiwe Mthimunye	1-year

Figure 2 – Source: Massmart REM Reports, Benguela

It is for these reasons that Benguela strongly questioned the true independence of Massmart's board.

Benguela approached Massmart on three separate occasions between August and September 2020 in the form of letters to the Board, a presentation to the Board and a one-on-one conversation with the Chairmen and Massmart's remuneration committee – raising these findings and providing action items to remedy our concerns.

Benguela's Recommendation to Massmart's Board and Call to Action

In these engagements with Massmart we recommended the following and included empirically backed evidence for our recommendations:

- Given the importance of the turnaround cost savings initiative and getting Game back to profitability, the short-term incentive (STI) should explicitly include details prioritising SG&A (Selling, general and administrative expenses) cost savings and the Game turnaround;
- Include ROIC as the primary return measure in the Remuneration Policy;
- ROIC should hold the largest single weighting in the long-term incentive scheme (LTI); and
- The resignation of long-standing non-executive board members whose independence has been compromised due to tenure and who presided over the value destruction at Massmart over many years without taking action, as well as the reconstitution of the Board

Conclusion

Massmart released its 2020 Remuneration Report on 16 April 2021. We are pleased that Massmart has made the following changes to their Remuneration Policy:

- The STI scheme now includes SG&A expenses as a ratio of net sales at a 20% weighting – this will allow turnaround cost savings to be prioritised by explicitly measuring executives on SG&A expenses rather than Earnings Before Interest and Tax (EBIT) alone.
- The STI now includes a "Game modifier" – Massmart executive's STI will be adjusted 10% lower or 25% higher depending on the EBIT performance of Game versus target.
- In line with our engagement regarding focusing on profitable sales, Massmart's LTI now includes comparable store sales which prioritises life-for-like annual sales rather than nominal sales.
- Massmart has removed the retention component for executives – Massmart's LTI is now a 100% performance-linked share scheme versus 25% prior. The removal of the retention component effectively creates a 100% pay for performance link at senior level.
- ROIC has now been included in the Remuneration Policy; it is included at a 45% weight and is the single largest metric in Massmart's LTI.
- Headline earnings per share (HEPS) has been introduced at a 35% weight.
- The breakdown of the LTI weights now encouragingly favours returns and profitability over sales:

	New LTI weights	Previous LTI weights
ROIC	45%	0%
ROI	0%	50%
HEPS	35%	0%
Nominal Sales	0%	50%
Comparable Sales	20%	0%

- There were no resignation announcements made regarding the long-standing non-executive directors that we flagged to Massmart. We intend to re-engage with Massmart in this regard.

We are encouraged by the swift and material changes made to the Remuneration Policy, as well as Massmart's willingness to engage throughout the process. Benguela believes that the improvements in Massmart's remuneration structure will drive a performance-based culture focused on driving profitable sales, thereby enhancing Shareholder returns.

The changes to the Board should allow for improved governance at Massmart as they create the opportunity to improve the Board's independence.

Benguela is proud to have had ESG integrated into our investment process since inception, allowing us to identify the governance risks in Massmart, in addition to risk at many other JSE listed companies over the years.