

## The clash of judging a federation by normal corporate governance

<b>Company/ASX Code</b>	Sonic Healthcare (SHL)
<b>AGM date</b>	Thursday 12 November, 2020
<b>Time and location</b>	10am VIRTUAL meeting entering in your web browser <a href="https://web.lumiagm.com/357926886">https://web.lumiagm.com/357926886</a>
<b>Registry</b>	Computershare
<b>Webcast</b>	Yes
<b>Poll or show of hands</b>	Poll on all items
<b>Monitor</b>	Allan Goldin assisted by Patricia Beal & Karin Hickman
<b>Pre AGM Meeting?</b>	Yes with Chair Professor Mark Compton, Kate Spargo Chair of the Remuneration and Nomination Committee and Paul Alexander Deputy Chief Financial Officer and Sonic's Company Secretary

### **NOTE: ASA WILL BE ATTENDING THE VIRTUAL MEETING VOTING ALL PROXIES WE RECEIVE AND ASKING QUESTIONS AS NORMAL**

Please note any potential conflict as follows: An individual (or their associates) involved in the preparation of this voting intention have a shareholding in this company.

	<b>Consideration of accounts and reports</b>
<b>ASA Vote</b>	No vote required

Sonic sees itself as a federation, not a normal corporation. This vision has undoubtedly provided some financial success but is it a reason not to follow normal corporate governance? Later we will discuss that issue but first:

Due to COVID-19, initially, the base business revenue was severely impacted by social restrictions and fear of infection in March, April and May 2020, with accompanying margin contraction. But Sonic swiftly moved on to the front line with now more than 9 million COVID-19 PCR tests completed globally to date. Staff working 24/7 to provide COVID-19 testing internationally and COVID-19 swab collections in Australia.

Sonic also received the national contract to service Aged Care Facilities, which is a massive logistics exercise supporting aged care residents and staff. In addition to manning the normal collection centres with the requirement for initial cleaning after each test. In Australia there was also having to set up and operate drive through facilities including new data entry challenges.

Yes, Sonic is making money from this, but this is a company with a total belief in the importance of medicine, so they also saw it as part of their civic duty. Remember when you talk about front line that is exactly where many Sonic staff were and still are.

During the downturn Sonic received no JobKeeper or any other Australian COVID-19 relief funds But it did get a US \$20million grant to maintain essential services, plus a UK 6.5 Million pound grant and in the USA there was a pre-payment of \$AUS 63 million Medicare charges. Looking at Sonic's overall revenue these are not overly substantial amounts, but the timing of when this money was received must have generated a sense of relief inside the company at a time (March to May) when routine pathology and radiology had slowed down dramatically.

The overall 2020 financial figures for Sonic appear to show a very minor hit from COVID-19, this is because in addition to all the testing that was being done for COVID-19, the normal business came back strongly from the middle of May. The acquisition of Aurora Diagnostic in the USA was also a major help as 7 months of this move accounts for 11% of overall group revenue.

The first quarter of FY2021 has compared to first quarter FY2020 seen revenue growths of 29% and unaudited EBITDA growth of 71%. These amazing figures have resulted from a combination of both COVID-19 testing and with the exception of the UK and USA resumption of pre COVID-19 levels of business. Although it is not reported it is likely that margins have also returned to pre-COVID-19 levels. The company knows it is not reasonable to expect a continuation of this growth and for that reason is offering no forecasts.

Because of Sonic's significant share of the Australian market, the company will not be making any Australian moves therefore future acquisitions are most likely to occur in the USA and Germany, given the size and fragmentation of those markets, although opportunities will also be targeted in Switzerland and Belgium

Sonic Healthcare has a management and operational philosophy of medical leadership. The impact of this approach has been to develop a company whose services are optimally aligned with physicians and the needs of their patients. Medical leadership encompasses a management commitment to the maintenance of professionalism and 'good medicine' at all times. It fosters an understanding of the doctor-patient relationship and it puts quality first. Sonic's operations are structured as a federation, with individual subsidiaries or geographical divisions working in a synergistic network to achieve best practice outcomes in terms of service and business excellence

The question firstly is, does this federation model result in outperformance? We are unsure. The federation model appears to be the catalyst for the successful bedding down of more than 150 acquisitions, however if we look at the last 10 years Sonic has very much tracked the ASX 100 up and down, with very little variation, it is only in March of this year it has moved away from the pack. Who knows if this performance level will continue and if it does, is this a result of benefits accruing more from the advantages that size, than a unique federation model and as the company acknowledges the acquisition of Aurora Diagnostic, its largest takeover, was a normal commercial move.

Importantly, does the federation model exempt a listed Australian company from normal corporate governance? Is the fact that there are only two Executive KMPs and that those two uniquely are also on the board of directors, stem from the structure of the federation model or rather is it the result of the two individuals being in their roles for so long, that they are seen internally and externally as the company.

Sonic has world class medical oversight but what sort of board oversight does this merging of executive and management allow. In a continuation of this blurring of roles they have another director who until a few months ago was a Sonic executive. In addition, another director has been on the board for 15 years, although he may seem to act with an independent mind, there seems to be little concern as to the perception of him staying on the board and being classified as independent.

Last year we struggled with this federation concept and the belief that this excused the company from normal corporate governance. As we further examine the company, we can't help but be drawn to the fact that the federation model helped Sonic grow in the manner they have, but this does not exempt them from the normal corporate governance practices.

(As at FYE)	2020	2019	2018	2017	2016
NPAT (\$m)	528	549.7	476	428	451
UPAT (\$m)	552	524	467	442	440
Share price (\$)	30.43	27.10	24.53	24.22	21.55
Dividend (cents)	85	82	78	75	71
TSR (%)	15.6	14.1	4.9	16.3	4.6
EPS (cents)	110.6	122.1	112.2	102.1	109.3
CEO total remuneration, actual (\$m)	5.671	11.873*	9.978*	5.092	4.403

For 2020, the CEO's total actual remuneration was **61.65 times** the Australian Full time Adult Average Weekly Total Earnings (based on May 2020 data from the Australian Bureau of Statistics).

<b>Item 1</b>	<b>Re-election of Professor Mark Compton as a Director</b>
<b>ASA Vote</b>	<b>For</b>

Professor Mark Compton joined The Sonic Healthcare board in October, 2014. He has extensive senior executive experience in healthcare services. He is currently Adjunct Professor in Management (Healthcare Leadership) at Macquarie University (Macquarie Business School) and Non-executive Director of ASX-listed Next Science Limited (since 2018).

His previous experience includes Chief Executive Officer of each of St Luke's Care, Immune Systems Therapeutics Limited and the Royal Flying Doctor Service of Australia and a number of Nonexecutive Director roles. In recommending his re-election, the Board recognized that he brings to the position broad experience and expertise in healthcare services and governance.

Professor Mark Compton is aligned with shareholders as he personally holds 459 shares and beneficially a further 8,807 Sonic shares. ASA will vote its undirected proxies in favour of him.

<b>Item 2</b>	<b>Re-election of Mr. Neville Mitchell as a Director</b>
<b>ASA Vote</b>	<b>For</b>

Mr Neville Mitchell joined the Sonic Healthcare board in September 2017. He is a qualified Chartered Accountant with international healthcare and finance experience. He was Chief Financial Officer and Company Secretary of ASX-listed Cochlear Limited, a key member of Cochlear's executive team, responsible for the setting and execution of the company's growth strategy from its listing in 1995 until his retirement in 2017.

Mr Mitchell currently holds non-executive director roles with ASX-listed healthcare companies Fisher and Paykel Healthcare Corporation Limited and Osprey Medical Inc.

He has also previously performed roles with a number of industry and government committees, including Chair of the Group of 100 (Australia's peak body for senior finance executives), and chair, Standing Committee (Accounting and Auditing), for the Australian Securities and Investments Commission (ASIC). In recommending his re-election, the Board recognised that he brings a wealth of international healthcare and finance experience to Sonic's Board.

In holding beneficially 9,770 Sonic shares Mr. Neville Mitchell is aligned with shareholders and ASA will vote our undirected proxies in favour of his election.

<b>Item 3</b>	<b>Election of Professor Suzanne Crowe as a Director</b>
<b>ASA Vote</b>	<b>For</b>

Professor Suzanne Crowe was appointed to the Sonic Healthcare board in April 2020. She is a qualified medical specialist and physician-scientist, holding medical and MD degrees from Monash University, and an internal medicine specialist qualification in Infectious Diseases from the Royal Australasian College of Physicians.

Professor Crowe's current positions include Nonexecutive Director of ASX-and NASDAQ-listed Avita Therapeutics Ltd.

Suzanne Crowe during her 30 years at Burnet Institute playing an integral role in its development as a global research organisation, she was also a Principal Specialist in Infectious Diseases at The Alfred Hospital, Melbourne.

In recommending her election, the Board recognised that she brings to the position specialist medical expertise and a diverse range of medical leadership experience. Professor Suzanne Crowe personally holding 856 Sonic shares, in her short time on the board demonstrates alignment with shareholders and ASA understands that her medical speciality was particularly useful during this unique Covid-19 times we will be voting it undirected proxies in her favour.

<b>Item 4</b>	<b>Re-election of Chris Wilks as a Director</b>
<b>ASA Vote</b>	<b>For</b>

Mr Wilks became Finance Director and Chief Financial Officer of Sonic Healthcare in 1993. He has a background in chartered accounting and investment banking and was previously a partner in a private investment bank. Mr Wilks has held directorships in a number of public companies and is currently a Non-executive Director of Silex Systems Limited (since 1988), a listed company divested by Sonic in 1996.

In recommending Mr Wilks' re-election, the Board has acknowledged the role he performs within Sonic is broader than the usual Chief Financial Officer role and Mr Wilks' strategic input, experience and reputation in the market are considered extremely valuable to Sonic.

Mr Wilks is aligned with shareholders as he holds (personally) 547,368 Sonic Shares and (beneficially) 94,760.

Normally ASA would be opposed to having on the board someone who reports to another director, at the same time having more than one executive on the board tends to give greater

weight to executive opinions. However, we recognise that Chris Wilks has a unique place in Sonic's operation and therefore ASA will be voting its undirected proxies in favour of him.

<b>Item 5</b>	<b>Adoption of Remuneration Report</b>
<b>ASA Vote</b>	<b>Against</b>

### Summary of ASA Position

CEO rem. framework	Target* \$m	% of Total	Max. Opportunity \$m	% of Total
Fixed Remuneration	2.397	31.28%	2.397	25.86%
STI - Cash	1.320	17.22%	1.760	19.71%
STI - Equity	.880	11.48%	1.320	14.78%
LTI	3.066	40.02%	3.450	38.65%
<b>Total</b>	<b>7.663</b>	<b>100.0%</b>	<b>8.927</b>	<b>100%</b>

The amounts in the table above are the amounts that are envisaged in the design of the remuneration plan.

\*Target remuneration is sometimes called budgeted remuneration and is what the company expects to award the CEO in an ordinary year, with deferred amounts subject to hurdles in subsequent years before vesting.

The Board, including the Managing Director and Finance Director, and other executives proactively volunteered to sacrifice a proportion of their salaries in response to the COVID-19 pandemic. All KMP sacrificed 50% of their 2020 fees/fixed remuneration from the early days of the pandemic, when the potential impact of social restrictions on Sonic Healthcare was uncertain, for an approximate eight week period.

Because the company received a strike (25% of the vote cast was against the Remuneration Report last year) they have been prodded into making some changes.

### Short Term Incentive (STI)

On the STI, Sonic have increased the financial threshold performance hurdle and also increased the earnings performance target. Plus a hurdle of, achievement of 80% of target EBITDA growth, must occur before any contribution can be included from acquisitions which are unknown at the time of setting the target. The amount which can be included as a result of such acquisitions is

capped at 1% of any additional earnings. It should be noted this is not creating a financial hurdle to the issuing of an STI as many others have done, it simply forms part of the STI scorecard.

Virtually every company in the ASX 200, is basing an increasing proportion of their Short Term Bonus on non-financial measures. This is a trend ASA agrees with, provided the proportion is small in the overall total, the non-financial criteria are able to be measured and are for areas above and beyond what you would anticipate being part of the executives normal day to day job.

In a reversal of this trend Sonic has decreased the proportion of non-financial. Somewhat surprising in this case, we don't totally disagree because the two executive directors have received a 100% of the non-financial portion of this bonus ever since it was introduced. The reason for this again appears to be as the two gentleman are seen as virtual founder status and that they live and breathe the company, which we are sure is probably true but why give them bonus for doing that.

Most companies now base their STI on a scorecard containing some financial criteria and some non-financial criteria. That scorecard is treated as a whole paying a proportion as equity, hopefully at least 50%, and a proportion as cash, but not Sonic, which results in the highly confusing following scenario.

Reading a combination of the Annual Report (AR) and the Notice of Meeting (NOM) it appears that CEO's Fixed Annual Remuneration (FAR) is \$2,397,634 and the STI at target is 91.8% of FAR, which is \$2,201,368. 80% of the STI is based on the EBITDA Hurdle so that would be \$1,761,094 of which 50% (\$880,547) is awarded as cash and 50% as Equity (\$880,547). The other 20%, \$440,274 is paid in cash. We now move into the great unknown as according to the NOM stretch STI is 128.5% of FAR, which is \$3,081,915 but as Non-Financial has no Stretch that leaves EBITDA with \$2,641,641, which is 110 % of FAR.

### **Long Term Incentive (LTI)**

In a very welcome move the company has increased the threshold Earnings per Share (EPS) Compound Annual Growth Rate (CAGR) target from 4% to 5% per year and reduced the proportion available to vest at reaching threshold performance from 40% to 30%.

Then somewhat surprising the LTI has a stretch element so that if the EPS CAGR is above 10% it provides the executives with the opportunity to earn up to 150% of the target rather than 100% for performance above 10% EPS growth. Basically this means that if over the three years the total growth is 1 cent more an extra \$450,000 is awarded.

The other two LTI measures are Relative Total Shareholder Return (RTSR) compared to the S&P ASX 100 Accumulation Index (excluding Banks and Resource companies) and Return on Invested Growth (ROIC).

The measures are both fine although it is very unfortunate that 50% of the RTSR bonus is paid when performance is just slightly more than average. Also we have great difficulty in seeing a three year measurement term as long term as opposed to a 4 or 5 year term. Like the STI there is added complications in the ratios used in this award, which we will go into on Resolutions 9 & 10.

Last year we very reluctantly voted in favour of the remuneration report. We thought this year after receiving a first strike there was a good opportunity to significantly reform the remuneration report, this has not happened. We think the changes are slight are not addressing some of the core problems and as we have said through this item and in later resolutions Sonic has also added

complexity that is not required. Thus, ASA will be voting their undirected proxies against this resolution.

<b>Item 6</b>	<b>Increase in Available Pool for Non- Executive Directors Fees</b>
<b>ASA Vote</b>	<b>For</b>

Although Sonic has never used their allocation it is understandable that they want additional capacity. For a company of this geographic spread it is surprising that all the directors are based in Australia we would expect to see at least one from the USA or UK. We are happy to note that the board has travelled to some of their major international operations and intends to do more. This travel will frequently result in the awarding of a travel allowance.

The pay rate of the Directors is more or less in line with other companies with a similar market capitalization, but the chair's fee is noticeably underweight, compared to his corporate peers which may be a legacy of the federation model concept.

For the above reasons and because ASA believes that directors should be paid a fair amount for their work and will vote our undirected proxies in favour of this resolution.

<b>Item 7</b>	<b>Approval of the issue of securities under the Sonic Healthcare Limited Employee Option Plan</b>
<b>ASA Vote</b>	<b>For</b>

Options are appropriate for a start-up or a new company with only limited ability to fund proper incentives. At the same time those companies are blue sky with potential to grow into real companies or just as likely to fail.

In a well-established profitable company there is no reason to offer options. However this is not a reason to vote against the plan.



<b>Item 8</b>	<b>Approval of the issue of securities under the Sonic Healthcare Limited Performance Rights Plan</b>
<b>ASA Vote</b>	<b>For</b>

While there are many aspects of the remuneration report that we do not like and are voting against it, that is not a reason to vote against the Performance Rights plan.

<b>Item 9</b>	<b>Approval of long term Incentives for Dr Colin Goldschmidt Managing Director and Chief Executive Officer</b>
<b>ASA Vote</b>	<b>Against</b>

This is for a bonus worth \$3,449,251 which was calculated as being 143.9% of Dr. Colin Goldschmidt's FAR of \$2,397,634. That is a maximum amount that will be awarded 50% in Performance Rights and 50% in options. We will call this one Bonus 1.

Then there is a smaller bonus called a target bonus which we will call Bonus 2. This bonus is calculated by taking 127.9% of FAR or \$3,006,573.

There are three performance criteria PC1 – Total Shareholder Return (TSR), PC2 – Earnings Per Share (EPS) Growth and PC3 – Return on Invested Capital (ROIC).

If on the TSR component Sonic beats or equals 75% of the S&P ASX 100 Accumulation Index (excluding Banks and Resource companies) over the cumulative 3 year period 50% of Bonus 2 or \$1,533,001 is awarded.

On the EPS component if the aggregate growth over 3 years is 441 cents 25% of Bonus 2 or \$766,500 is awarded.

If on the ROIC component over the three years 110% of target average ROIC is achieved 25% of Bonus 2 or \$766,500 is awarded.

To get the difference between Bonus 1 and 2 of \$442,678 the EPS aggregate growth over 3 years has to be just a further one (1) cent to be awarded.

Outside of the maximum bonus (Bonus1) and the FAR none of the other actual dollar values are disclosed you have to attempt to do the calculations that we have done.

We are voting against this resolution for the reasons stated in Resolution 5, plus the stretch target that has been thrown in for no particular reason. The lack of actual numbers in the NOM and the use of options.

<b>Item 10</b>	<b>Approval of long term incentives for Mr. Chris Wilks, Finance Director and Chief Financial Officer</b>
<b>ASA Vote</b>	<b>Against</b>

This is for a bonus worth \$1,314,449 which was calculated as being 120.6% of Mr. Chris Wilks's FAR of \$1,089,740 .That is a maximum amount that will be awarded 50% in Performance Rights and 50% in options. We will call this Bonus 1.

Then there is a smaller bonus called a target bonus we will call Bonus 2. This bonus is calculated by taking 107.2% of FAR or \$1,168,201.

There are three performance criteria PC1 – Total Shareholder Return (TSR), PC2 – Earnings Per Share (EPS) Growth and PC3 – Return on Invested Capital (ROIC).

If on the TSR component Sonic beats or equals 75% of the S&P ASX 100 Accumulation Index (excluding Banks and Resource companies) over the cumulative 3 year period 50% of Bonus 2 or \$584,200 is awarded.

On the EPS component if the aggregate growth over 3 years is 441 cents 25% of Bonus 2 or \$292,100 is awarded.

If on the ROIC component over the three years 110% of target average ROIC is achieved 25% of Bonus 2 or \$292,100 is awarded.

To get the difference between Bonus 1 and 2 of \$146,248, the EPS aggregate growth over 3 years has to be just a further one (1) cent to be awarded.

Outside of the maximum bonus (Bonus1) and the FAR none of the other actual dollar values are disclosed you have to do the calculations that we attempted to have done.

We are voting against this resolution for the reasons stated in Resolution 5, plus the stretch target that has been thrown in for no particular reason. The lack of actual numbers in the NOM and the use of options.

<b>Item 11</b>	<b>Amendment to the Constitution</b>
<b>ASA Vote</b>	<b>For</b>

As most of the changes are technical in nature and as it allows for a hybrid meeting as opposed to a virtual one we will vote our undirected proxies in favour of this resolution.

<b>Item 12</b>	<b>Spill motion (contingent resolution)</b>
<b>ASA Vote</b>	<b>Against</b>

ASA virtually always votes against the spill motion as this draconian penalty would cause total chaos in a company and in most cases hurt shareholders more than help them.

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