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Solid Profit in a Volatile Market

Company/ASX Code	**Australian Foundation Investment Company /AFI**
AGM date	Tuesday 4 October 2022
Time and location	10am AEDT Clarendon Auditorium, Melbourne Convention & Exhibition Centre, 2 Clarendon St. Southbank
Registry	Computershare
Type of meeting	Hybrid
Poll or show of hands	Poll on all items
Monitor	Jason Cole assisted by Dennis Shore and Frank Thompson
Pre AGM Meeting?	Yes – with John Paterson (Chair), Mark Freeman (Manging Director), Andrew Porter (Chief Financial Officer / Company Secretary)

Monitor Shareholding: Some individuals involved in the preparation of this voting intention have a shareholding in this company.

Summary of issues for meeting

An assessment of the company against ASA guidelines reveals a high degree of alignment. There are only three resolutions requiring a shareholder vote with the ASA supportive of all three. Given this, the ASA will direct its focus this year on the proposed changes to the executive incentive plan to ensure that AFI are aware of ASA preferences before any changes are implemented. A more detailed examination of the remuneration structure from an ASA perspective will be required once full details are provided next year.

Proposed Voting Summary

No.	Resolution description	
2	Adoption of Remuneration Report	For
3	Re-election of Director – Ms Rebecca Dee-Bradbury	For
4	Amendments to the Constitution	For

Summary of ASA Position

Consideration of accounts and reports - No vote required

Governance and culture

AFI remains well aligned with ASA guidelines from a governance and culture perspective.

- The board has a majority of independent directors and now contains at least 30% male and female representation.
- The chair is not considered independent under the ASA guidelines for tenure having been on the board since 2005. However, he has only been chair since 2018. As discussed in previous year's voting intentions, the company consider director longevity to be a crucial part of their investment strategy.
- There has been ongoing board renewal over the past three years, with three new directors having been appointed during this time.

Financial performance

- AFI recorded a profit of $360.6m in FY22, up 53.4% on the previous year, whilst the dividend remained steady at 24cps (fully franked).
- Ten cents of the final dividend were sourced from taxable capital gains on which AFI has paid tax. Previous years has seen this within a range of two cents to five cents. The company advised that the reason for this was due to having more taxable capital gains this year. AFI is committed to paying 'Listed Investment Company (LIC) capital gains' where possible, as it enables some shareholders to claim a tax deduction on their tax return.
- Total Shareholder Return (TSR) for the year was 0.1% when including franking in the calculation.
- The portfolio returned -6.8% for the year compared to the S&P ASX200 Accumulation Index (Index) return of -5.1% for the same period. This was explained by the portfolio being underweight in the better performing sectors. Both figures are inclusive of franking credits, but the AFI return is calculated after costs, whereas the index is not.
- The AFI return over three and five years is slightly ahead of the index, whilst over 10 years it is slightly lower.
- The Management Expense Ratio (MER) increased from 0.14% to 0.16% in FY22. The increase was due to higher incentive vesting last year due to outperformance, the value of the portfolio being down and some additional expenses relating to the international portfolio. Should the international portfolio become a standalone LIC in future, then expenses relating to this would be attributed to that LIC.

Key Board or senior management changes

- Non-Executive Director (NED) Peter Williams will retire from the board at the completion of the AGM, having been on the board since 2010. At this stage there is no intention to replace him. AFI generally prefer an eight-person board, occasionally rising to nine persons to assist the board renewal process.

ASA focus issues

ESG

- AFI's main concern with environmental, social and governance (ESG) issues is to have consideration for the ESG credentials of the companies that they choose to invest in. AFI has added additional commentary to their approach to ESG issues in this year's annual report, including that they *"are closely monitoring the development of international standards for ESG reporting, as these may further inform our approach going forward".*
- The company has also added a table to the AFI website outlining AFI's voting record on resolutions. It is not particularly easy to find (search under Our Company / Corporate Governance) and outlines the total number of resolutions voted on and the total number voted against over the 2020/21 financial year. As this table does not specify the individual companies involved, its informational value is perhaps limited.

Summary

(As at FYE)	**2022**	**2021**	**2020**	**2019**	**2018**
NPAT ($m)	360.6	235.1	240.4	406.4[1]	279.0
UPAT ($m)	360.6	235.1	240.4	272.2[1]	279.0
Share price at end FY ($)	7.51	7.82	6.09	6.25	6.16
Dividend (cents)	24	24	24	32	24
Simple TSR (%)	-0.9	32.35	1.28	6.66	10.15
EPS (cents)	29.4	19.3	19.9	34	23.6
CEO total remuneration, actual ($m)[2]	1.47	1.35	1.12	1.08[3]	

Simple TSR is calculated by dividing (change in share price plus dividend paid during the year, excluding franking by the share price at the start of the year.

[1] *Profit increased due to several one-off factors including participation in the Rio Tinto and BHP off-market share buy-backs, special dividends and a receipt of a dividend because of the Coles demerger from Wesfarmers.*

[2] *The quoted amount is the total remuneration received by the Managing Director (MD) across the four related companies (AFI, Amcil, Mirrabooka and Djerriwarrh). For the first time, this year's Annual Report states the amount borne by AFI which was $793,649 (54%).*

[3] *2019 was the first full year for the current MD who took over on 1 January 2018.*

Election or re-election of directors Rebecca Dee-Bradbury

- Ms Dee-Bradbury was appointed to the board in May 2019 and was elected by shareholders at the AGM later that year. She is a member of the investment and nomination committees.
- She is a NED of listed BlueScope Steel Limited (BSL) and a director of Energy Australia Holdings.
- Her equity holdings in AFI are the equivalent of one year's base NED fee.

Ms Dee-Bradbury is appropriately qualified and an important member of the board in terms of being able to satisfy the ASA's guidelines regarding independence and gender diversity. Her workload is considered manageable, and the ASA will vote open proxies in support of her re-election.

Adoption of Remuneration Report

The AFI remuneration structure is generally well aligned with the outcomes sought by the ASA. A pleasing addition to the report this year is a breakdown of the total of executive remuneration borne by AFI and the total borne by the other related LIC's (as explained in footnote #2 of the above summary table).

Positives aspects of the remuneration package include:

- The Managing Director's (MD) actual remuneration, as well as the target and maximum opportunity are clearly disclosed.
- The quantum of the MD remuneration package does not exceed the Godfrey Remuneration Group report benchmarks, although it must be considered that the structure of a LIC is somewhat different to that of other companies in the financial sector.
- 50% of the MD's potential remuneration is at risk through the annual incentive (STI) and long-term incentive (LTI)
- Both the STI and LTI require the executives to acquire AFI shares on market. (See Appendix 1 for further information.)

As noted last year, an area of concern is that the LTI plan from 2020-2024 onwards will only be based on one hurdle, that being TSR.

Additionally, the directors are proposing a simplification of the executive incentive schemes that would involve merging the LTI and STI into a single incentive plan. The details provided in the annual report are brief at this point, but the company has highlighted that "*50 per cent of the available incentive under the new scheme will be long term in nature*".

The ASA sought further clarification about the reasoning. The company wanting to simplify the incentive structure being given as the main one. Currently the incentive schemes for the management and investment teams are different and the goal is to have these structured the same.

It is possible that TSR will not be used as a performance measure in future, with AFI considering the measures currently in place for the annual incentive to be the best indicator of shareholder return. These would remain assessed over a 1-, 3-, 5-, and 10-year period.

The company believes that the performance of a LIC, and its alignment with shareholder value, is more clearly measurable than the performance of other companies who may need to use share price as a measure of this. It is considered that LIC performance is best determined through measuring the return on the portfolio and the movement of the net asset backing of the company against benchmark indices. A more thorough assessment of any new remuneration structure will be required once full details are known.

Of benefit to AFI shareholders will be future incentives being attributed to the relevant company in which they are earned. Currently the LTI is only based on the performance of AFI and all costs associated with the performance incentive are borne by AFI.

Overall, it is considered that the current remuneration outcomes are sufficiently aligned with shareholder reward and the structure is appropriately enough aligned with ASA guidelines to warrant the ASA voting in favour of this resolution this year.

Adoption of new or amended constitution

Proposed changes include

- New rule to give ASX listing rules priority in the event of conflict with the company constitution
- Update the number of joint holders that may be registered from 3 to 4.
- New rule regarding instances when the company is required to make payments to a taxation authority or government on behalf of any holder of the company's shares.
- Updating the provisions relating to voting at General Meetings. (Must be poll rather than show of hands).
- Updating notice provisions, including the use of electronic notices.
- Miscellaneous changes considered of a minor and technical matter that would benefit from amendment.

The changes are considered to be routine. Open proxies will be voted in favour of this resolution.

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Appendix 1

Remuneration framework detail

CEO rem. Framework for FY22	Target* $m	% of Total	Max. Opportunity $m	% of Total
Fixed Remuneration	0.884	50%	0.884	50%
STI - Cash	0.53[1]	30%	0.53+[2]	30%
STI - Equity	0.177[1]	10%	0.177+[2]	10%
LTI	0.177	10%	0.177	10%
Total	1.768	100.0%	1.768+	100%

*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.*

[1]*The Annual Incentive is paid as cash, but 25% of the pre-tax amount received is used by recipients to acquire shares in AFI or related subsidiaries which must be held for at least 4-years.*

[2]*Where stretch levels of performance are achieved above target, then higher amounts may be paid at the discretion of the board. To date, annual incentives paid to each Executive have never exceeded target.*

Fixed Annual Remuneration (FAR)

- 50% of target remuneration (50% is at risk)
- FAR is well below Godfrey's Remuneration Group report benchmark for a market cap of $9.5b
- No change in FAR for FY22. The MD's remuneration package was increased through an increase in the amount of 'at risk' remuneration.

Annual Incentive (STI)

- Target is 80% of FAR.
- 80% of performance measures are quantifiable (20% Company performance, 60% investment performance) with the remaining 20% based on personal objectives.
- Performance is measured at 1,3,5 and 10 years with measures clearly outlined.
- The relative weighting of AFI on the outcome is 40%
- The incentive is paid in cash, but 25% of the pre-tax amount must be used to acquire AFI shares to be held for a minimum of four years.
- Outcome for 2022 was 66% (Previous 5-year average 61.2%)

Long Term Incentive

- Target is 20% of FAR
- Performance is measured after four years, with only outperformance or performance better than the median rewarded.
- Current LTI has 2 hurdles (Total gross TSR and total portfolio return (TPR)). From 2020 only TSR will be measured.
- The incentive is paid as the right to receive cash that must then be used (after tax) to acquire AFI shares on market.
- The performance rights are calculated on a 30-day Volume Weighted Average Price (VWAP) from 1 July each year.
- For the 2017-2021 award, 88% vested. (50% based on TSR which was 20% better than benchmark, and on 38% based on TPR which was better than the benchmark, but below the 75th percentile).
- Vesting results for the previous 5-years were

- 2021 25.5%
- 2020 0
- 2019 0
- 2018 0
- 2017 34.1%