Australian Shareholders' Association

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This Aussie icon is beginning to show its age

Company/ASX Code	Harvey Norman Holdings Ltd/HVN
AGM date	Tuesday 27 November 2018
Time and location	11.00 AM Tattersalls Club Sydney
Registry	Boardroom Pty Ltd
Webcast	No
Poll or show of hands	Poll
Monitor	Pamela Murray-Jones assisted by David Jackson
Pre AGM Meeting?	Yes with directors Christopher Brown, Kenneth Gunderson-Briggs and Graham Paton

Item 1	**Consideration of accounts and reports**
ASA Vote	No vote required

Summary of ASA Position

It is unusual (and indeed unique in our experience) that a company would choose to release the ASA questions provided in preparation for a pre-AGM meeting to the ASX, along with its pre-prepared answers, yet Harvey Norman chose to do this on 29 October. The directors notified us of the release at the beginning of the pre-AGM meeting and we were read a formal statement of non-disclosure, thus setting the tone for the meeting.

The level of defensiveness of the Harvey Norman board and its confrontational approach to small shareholders reveals a board that is out of touch with current concepts of board accountability and shareholder engagement. It is also a board on uncertain ground when it comes to supporting its recent failed and failing non-core investments, declining earnings per share and shareholder return. When asked how the board came to some of its investment decisions such as in mining accommodation, the answer was, “It was a board decision.”

For a board that prides itself on being business savvy, many of its recent decisions seem to have been flawed and have resulted in negative media. The board also revealed flawed decision making when the October 2018 capital raising went wrong.

Shares were issued at $2.50 at 1 for every 17 shares held (a generous discount to the closing price of $3.54 on the date of the announcement). However, the $164m raised is less than the estimated $183.3m in dividends paid out on 2 November (which was an increase of 6c on the previous two distributions).

All shareholders were offered a top-up option. When it came time to decide the amount of shares individual shareholders would receive, an arbitrary minimum of 300 shares was required to be eligible. Moreover, in offering the directors of the company shares through the top-up facility the company found itself in breach of Listing Rule 10.11 and has had to take corrective action. The profit earned from the shares was donated to a scholarship fund, but shareholders who missed out on the bonus shares because of the actions of the directors were not compensated.

This is a board stacked with members of the Harvey family, HVN executives and large HVN shareholders. It is also a long-tenured board where there has been not one new non-executive director appointed since 2005. Yet despite this, the directors at the pre-AGM (including Mr Paton who is the Chairman of the Nominations Committee) established that the company has no board succession plan nor any intention to renew the board.

And herein lies the conundrum for the company. Are those who have served it well in the past the right people to take it into the future? With no fresh blood; no new ideas; no willingness to challenge or be challenged on its decision-making, this retail icon is beginning to suffer the effects. This is revealed in its declining earnings per share; its declining share price and the subsequent decline in total shareholder return.

<u>Positives</u>

- Sales revenue from company-operated stores was up 8.8% from $1,8133.12m in 2017 to $1,933.76m in 2018
- Sales revenue from overseas company-owned stores grew by 8.6% to $1.99billion with profitability up 15.1%
- Cash flow remains strong with a 6.8% increase in operating cash flows from $425.14m in 2017 to $454.17m in 2018

<u>Negatives</u>

Net profit after tax declined by 17.1%. and earnings per share declined by 16.5%. Some significant items were:

- The franchising segment was down 7.2% due to a combination of lower fees and higher "tactical support" required from the company. (It was explained this tactical support consisted of updating systems and providing marketing support.)
- The property segment was down 23.8% before tax partly as a result of the Coomboona write-down.
- Borrowings have increased from $386,651m in 2017 to $422,191m in 2018
- Non-trade debts receivable +90 days and impaired have increased from $48,305m to $63,008m. +90 days receivable, but not impaired, increased from $57,368m in 2017 to $106,794m in 2018 (a growth of 86%)
- Total trade receivables have increased from $82,166m in 2017 to $103,315m in 2018. The +90 days past due but not impaired grew by 37%
- Loans to joint ventures and unrelated parties have increased by $87.29m

<u>Early warning signs</u>

At the pre-AGM meeting the directors remarked that Harvey Norman was as much a property developer/manager and general investor as a retailer. However, where it has strayed from its core business, its investments have been less than successful:

- The investment in Coomboona dairy farm (through a 49.9% share in a holding company) has had to be written off with losses of $5,945m in 2017, compounded in 2018 with a further loss of $4,565m. On 31 October the company announced the property had been sold with the debt exceeding the recoverable amount by $5.9m so it appears there will be a further $1.3m to be written off in 2019.
- The Byron Bay investment has suffered losses in the residential/convention segment of $734,000 in 2017 and $741,000 in 2018
- There have also been losses recorded in the past two years on land held in Bundaberg.
- At the pre-AGM, the directors were unwilling to share the total profit and losses from its non-core investments in the KEH partnership in school apparel and educational supplies, nor in the mining camp joint venture. It was remarked on a number of occasions that the company was under no obligation to make any further disclosures apart from what is required by law and can be found in the Annual Report. This leaves us to speculate that the nature of the losses are such as to be an embarrassment, reflecting badly on the board and directors.

Lack of transparency is always an early warning sign of a company in trouble. And the lack of transparency is in conflict with its renumeration principles for key management personnel (including directors), which refer to the need for integrity, stating “Integrity requires a level of fundamental honesty, candour and frankness in dealing with colleagues, regulators and other third parties.” Frankness and candour were noticeably lacking at the pre-AGM meeting.

Financial Summary

(As at FYE)	**2018**	**2017**	**2016**	**2015**
NPAT ($m)	375.38	452.9	351.3	268.9
UPAT ($m)	377.03	448.9	348.6	268.1
Share price ($)	$3.26	$3.85	$4.61	$4.50
Dividend (cents)	30	26	30	20
TSR (%)	(9.0)	(11.49)	8.09	60.16
EPS (cents)	33.71	40.35	31.36	24.51
CEO total remuneration, actual ($m)	3.13	3.41	3.08	2.93

For 2018 the CEO’s total actual remuneration was 34.5 times the Australian Full time Adult Average Weekly Total Earnings (based on May 2018 data from the Australian Bureau of Statistics).

Note - For May 2018, the Full-time adult average weekly total earnings (annualised) was $85,831 (http://www.abs.gov.au/ausstats/abs@.nsf/mf/6302.0, “Full-time adult average weekly total earnings”, Trend(a)).

<u>Key events</u>

October 2018: Issue of 65,547,679 ordinary shares issued under the terms of a pro-rata renounceable rights offer and a Top Up facility available to those owning 300 shares or more. Although we would have preferred a PAITREO, the fact that it was a renounceable pro-rata was a plus.

<u>ASA focus issues</u>

Board composition: The board at Harvey Norman fails the test for diversity and independence. ASA guidelines state that companies should have an independent chairman, a majority of independent directors, only one executive director, and boards should be comprised of at least 30% female directors and at least 30% male directors.

The Harvey Norman board has an executive chairman; no directors that could be considered to be independent; five executive directors out of a total of nine directors, and only one woman on the board. Its Board Diversity Policy does not make any reference to board diversity but relates only to employees. As noted earlier, it has no plans for board renewal.

Item 2	**Adoption of Remuneration Report**
ASA Vote	**Against**

Summary of ASA Position

Harvey Norman provides shareholders with clarity around remuneration in the Annual Report and their directors told us in our meeting they believe their remuneration structure has worked well over the years. Whether this is the case or not, reviewing incentive schemes on a regular basis is part of the board's role in undertaking its supervision of management (difficult when half the board consists of those same managers and is therefore conflicted).

The current scheme has a number of perceived weaknesses and for this reason ASA has voted against the Remuneration Report for the past two years. It will do so again this year.

<u>Short-Term Incentive (STI)</u>

We have no issue with the criteria for awarding the STI: 50% financial – return on net assets (RONA) - and 50% on non-financial. The non-financial measures are clearly spelt out as is the achievement against each of the KPIs. The amount of the bonus is also reasonable. However, the STI is awarded 100% in cash and all four executive directors receive the exact same percentage as a bonus. This was explained as being a team-based approach which has a feel-good sound to it but leaves open the question of individual responsibility and accountability at a senior level.

However, one positive outcome from discussions was that ASA monitors were told that the board might be prepared to consider awarding some of the STI as equity in future to align it better with ASA guidelines and shareholder interests

Long-Term Incentive (LTI)

This is an award of performance rights that on vesting converts into shares. The major problem is that the criteria is the same as for the STI, namely RONA. The only difference is STI is measured over one year and the LTI is an aggregate over three years. So if a key manager is awarded their STI they are virtually certain to get the LTI. Conversely if they miss the STI in one year, they are likely to feel that there is little chance that they will get the aggregate over three years so it becomes a disincentive. This is the reason that ASA recommends at least two separate measures for LTI and a period of four years or more as a reasonable time for measurement.

Inequitable Treatment of KMPs

We note while there are thirteen Key (Executive) Management Personnel listed, not all are treated equally with only four (those on the board) apart from the CEO, able to take part in the LTI scheme.

This appears to be an inequitable arrangement and contrary to the team-based remuneration espoused to us by the directors at the pre-AGM.

Item 3	**Re-election of Michael John Harvey as a Director**
ASA Vote	**Against**

Summary of ASA Position

The concept of retiring directors by rotation when there is no intention of renewing the board at any time now, or in the future, is a cynical exercise designed only to tick the compliance box.

Mr Harvey is a member of the Harvey family. He has been on the board since 1993 and his continued presence on the board only serves to reinforce the notion that the board operates the business as a private family company with no regard to the spirit of the ASX Corporate Governance Council's Corporate Governance Guidelines and the interests of all shareholders.

Item 4	**Re-election of Mr Christopher Herbert Brown as a Director**
ASA Vote	**Against**

Summary of ASA Position

Mr Brown has been on the board since 1987. When asked at the pre-AGM meeting how he ensured "independence of mind" he referred to his owner orientation (he controls 17% of the shares in the company) and his competence as a business person. He asked whether we would prefer an independent who did not know the company.

ASA believes directors can be both independent and competent. While we do not doubt Mr Brown's competence or experience, we believe the board would benefit from some fresh thinking.

Item 5	Re-election of Mr John Evyn Slack-Smith as a Director
ASA Vote	Against

Summary of ASA Position

Mr Slack-Smith is an executive director. He has been on the board since 2001.

Good governance requires a division between the roles of management and board; otherwise the board is conflicted and cannot maintain its independence and do the job it is entrusted to undertake on behalf of the shareholders, which is to hold management accountable. A board with nearly half of its members being executives cannot oversee management or make the tough decisions that are often required.

Item 6	Approval of LTI grant to Executive Chairman, Mr Gerald Harvey
ASA Vote	Against

Summary of ASA Position

The resolution provides for up to 196,500 performance rights to Mr Harvey.

Mr Harvey is Chairman with special responsibility for strategy and property investments.

We spelt out in item 2 the reason that we are opposed to the LTI incentive component of the remuneration structure and therefore are voting our open proxies against this item

Item 7	Approval of LTI grant to CEO, Ms Kay Leslie Page
ASA Vote	Against

Summary of ASA Position

The resolution provides up to 549,000 performance rights to Ms Page.

We spelt out in item 2 the reason that we are opposed to the LTI incentive component of the remuneration structure and therefore are voting our open proxies against this item.

Item 8	Approval of LTI grant to Mr John Evyn Slack-Smith
ASA Vote	Against

Summary of ASA Position

The resolution provides up to 327,000 performance rights to Mr Slack-Smith.

Mr Slack-Smith is the company's COO.

We spelt out in item 2 the reason that we are opposed to the LTI incentive component of the remuneration structure and therefore are voting our open proxies against this item.

Item 9	Approval of LTI grant to Mr John David Matthew Ackery
ASA Vote	Against

Summary of ASA Position

The resolution provides up to 327,000 performance rights to Mr Ackery.

Mr Ackery has responsibility for managing relationships between Harvey Norman home appliances, home entertainment and technology franchisees and strategic partners

We spelt out in item 2 the reason that we are opposed to the LTI incentive component of the remuneration structure and therefore are voting our open proxies against this item

Item 10	Approval of LTI grant to Mr Chris Mentis
ASA Vote	Against

Summary of ASA Position

The resolution provides up to 249,000 performance rights to Mr Mentis.

Mr Mentis is the Chief Financial Officer

We spelt out in item 2 the reason that we are opposed to the LTI incentive component of the remuneration structure and therefore are voting our open proxies against this item.

The individual (or their associates) involved in the preparation of this voting intention has no shareholding in this company.