Australian Shareholders' Association

Australian Shareholders' Association Limited
ABN 40 000 625 669
Suite 11, Level 22
227 Elizabeth Street, Sydney NSW 2000
PO Box A398, Sydney South NSW 1235
t (02) 9252 4244 | f (02) 9071 9877
e share@asa.asn.au

South32 faces major challenges

Company/ASX Code	South32 Limited/S32
AGM date	29 October 2020
Time and location	Virtual meeting via LUMI, 12 noon AWST/3pm AEDT
Registry	Computershare
Webcast	As above, video webcast
Poll or show of hands	Poll on all items
Monitor	John Campbell assisted by John Ferguson
Pre AGM Meeting?	Yes with Chair Karen Wood and Chair of the Remuneration Committee Wayne Osborn

An associate of an individual involved in the preparation of this voting intention has a shareholding in this company.

Item 1	**Consideration of accounts and reports**
ASA Vote	No vote required – **all amounts in USD unless otherwise stated**

Summary of ASA Position

S32 is a diversified miner/metal refiner whose assets are spread around the globe. The onset of the pandemic Covid-19 has been a challenge for everyone around the globe and few more so than for S32 with its dispersed and varied international operations. For companies such as S32, it prevents directors and executives from making site visits ahead of important decisions on the allocation of resources. It stops technical experts in geology, engineering and every aspect of business skill from making visits to sites to prevent or remediate problems. It impedes the normal precautions taken to control risks such as those involving inaccurate or fraudulent accounting. The pandemic's continued disruption of international travel and commerce threatens the very business model of companies such as S32. It is evidently essential that these disruptions are minimised in time and extent.

However, S32 has discharged well the difficult task of compressing reports of its varied activities and responsibilities into the annual report. The report discloses a loss of $65m, a poor result by comparison with profits in the preceding 3 years (note: S32 reports in US dollars so all amounts in this section of our voting intentions are stated in that currency unless otherwise indicated). However, S32 performed well as regards factors it could control – it met guidance as regards increased production and reduced costs in most operations but commodity prices were in general decline and slumped after Covid-19's financial implications were factored into world markets. Shareholders seeking the reasons for the fall in value of its shares from $3.18 (AUD) at 30 June 2019 to $2.04 (AUD) at 30 June 2020 should study the chart on page 38 of the annual report showing the factors responsible for the fall in underlying EBIT from $1,440m in FY19 to $446m in FY20.

Our main concern is with the $1,858m Hermosa Project. We note that few details have been provided by S32 of this project which was acquired in 2018. South32 released a JORC compliant resource for the first time in FY2019 for the Taylor deposit at Hermosa which South 32 believed provided higher confidence in the measured resource and de-risked early production from the project, albeit at about 17% lower zinc grades than the original Arizona Mining pre-feasibility study. S32 told us last year that a new pre-feasibility study would be completed in FY20 but now says this has been delayed by Covid-19. During FY20, S32 released some results of drilling the Clark deposit adjacent to the Taylor deposit but, with only 2.3% zinc, we do not see this deposit as being a major factor in the economic viability of Hermosa. The annual report contains very little information about it beyond its segment net assets of $1,858m. We have seen none of the usual information provided by mining companies about new projects such as projections of production costs, schematics of declines in place and planned, details of existing infrastructure in its remote location near the Arizona/Mexico border and plans for ore processing and product transport. Instead we have a single paragraph on page 7 about the project.

There is an AUD $3,000m gap between S32's market capitalisation of about AUD $10,000m (at time of writing) and its net asset value in the annual report which would convert at USD/AUD 0.72 to AUD $13,300m. We assume that this gap is in part due to the stock market doubting the viability of Hermosa and its concern about the 2020 decline commodity prices for coal, aluminium/alumina and base metals generally. Whilst many of the relevant price indices have shown improvement since the decline following the spread of Covid-19, many are still to regain their pre-Covid price levels and others such as metallurgical coal and manganese are dependent upon continued high levels of Chinese steel production about which there are obvious concerns. We note that the auditors considered whether adequate allowance had been made for asset impairment as a key audit area and evidently satisfied themselves in this regard. We hope their confidence in management's assertions and projections of future profits is not misplaced.

We understand that there are material conditions outstanding for completion of the sale of South African Energy Coal to Seriti Resources, an unlisted South African company, involve approval of the sale by the equivalent of our ACCC and by the main South African electricity generating entity, Eskom. Eskom, the South African power generating authority, currently takes most of SAEC's coal and while SAEC is fully empowered and more than meets the current black-empowerment ownership criteria, it will struggle to compete for future domestic coal opportunities. As disclosed in our FY19 voting intentions, the board has determined that the SAEC business is not a good fit in its portfolio of assets and accordingly has resolved to sell it to a company which is a preferred Eskom supplier and has the financial ability to meet current group standards as regards safety and capital replacement at the same time as being capable of accepting the existing rehabilitation requirements. No doubt in negotiating the completion of the sale, S32 is missing the involvement of former director, Dr Xolani Mkhwanazi, who sadly passed away after a short illness in late 2019. Doubts about the ability of S32 to transfer the loss-making business to Seriti are also likely to be a factor in depressing its share price on the ASX.

These circumstances highlight the current risks associated with investment in South Africa by Australian listed companies. Our concern remains as to the remaining South African assets, South African manganese and the Hillside aluminium smelter, with reported segment net asset values of $1.03 billion. We understand that there is less pressure on the company with Hillside subject to differing black-empowerment objectives and because products of each segment are primarily headed for export to world markets rather than for domestic use. SAEC is a much larger employer than either of the other two businesses and coal has a more challenging unionised labour market.

Sustainability and conservation of natural and heritage assets are a major focus of community and investor concern in FY20. S32 has published a comprehensive sustainability report as a separate document but whilst the annual report contains references to that document, we would have preferred to see a short and succinct summary of the report in a chapter of the annual report. S32 has a well established risk management framework and uses Global360 software to collect real time data to determine materiality of risk. The data is used to make adjustments to the way thirteen identified strategic risks are addressed. In addition, the company's Sustainability Report lists fourteen material sustainability issues but their relationship to the risk management framework is unclear. As a further comment on what the already long annual report does NOT contain, we would like to see a five year financial summary, comprehensively covering all financial and remuneration measures.

We are concerned that S32 has declared a final dividend having incurred a consolidated loss for the year and without having any net retained profits from which to declare it – the parent entity shows a 'profits reserve' of $1,719m whilst also reporting accumulated losses of $4,607m in Note 30. Whilst paying dividends out of capital used to be prohibited under the Corporations Act, this was removed from the legislation about a decade ago and we are noticing a trend in companies, particularly listed investment companies, to continue to pay dividends whilst incurring losses. Shareholders whose taxable income exceeds their imputation credits are paying tax on these dividends which are to all intents and purposes a return of capital and an implication that the management of the business believes that shareholders can earn a better return on these funds than can be earned from the business. The chair told us that S32 was paying the dividend in the belief that shareholders would rather receive a dividend, albeit 1 US cent, than none. It is a pity that we are not able to vote on the adoption of the annual report which might help directors assess shareholder views on such matters.

Governance and culture

The board is chaired by Karen Wood, who succeeded David Crawford in 2019. She is classified by S32 as an independent non-executive director (see comments under resolution 2 below). There are 6 other independent non-executive directors and a single non-independent director, the CEO, Graham Kerr. All directors have significant skin-in-the-game.

Financial performance

The impact of reduced commodity prices was responsible for wiping out last year's underlying earnings before finance costs and tax – it cost the group $1,628m, whereas other factors outside S32's control such as foreign exchange and sales volume improved underlying EBIT by $547m. Equity accounting adjustments less a small increase in controllable costs took the underlying EBIT to $446m whilst finance costs and tax of $253m resulted in group underlying earnings of $193m, compared to FY19's $992m. Note 4(b) on page 100 of the annual report shows the profit adjustments between underlying earnings and NPAT comprising items such as currency restatements and derivative revaluations – the adjustments took underlying earnings from a positive $193m in FY20 to a loss of $65m and totalled $258m in FY20 compared to $603m in FY19.

We have commented on the decision to pay a final dividend of US 1c per share above; the interim dividend was US 1.1c per share. In aggregate, these total about AUD 3c per share and ameliorate the reduction in share price between 30 June 2019 (AUD 3.18) and 30 June 2020 (AUD 2.04) to yield a total shareholder "reward" of minus 34.9% for the year.

Key events such as restructures, acquisitions, buy backs and capital raisings
Without a significant turnaround in prospects for commodity prices, there seems little upside in existing operations so hope for improved results rests on the Arizona zinc/lead/silver and the Eagle Downs metallurgical coal acquisitions in 2018 together with the Trilogy copper prospect in Alaska. All three of the above prospects are unlikely to affect FY2021 to any great extent although the prospects for each of them should be clarified further.

Key board or senior management changes
We have referred above to the sad death of Dr Xolani Mhkwanazi during FY20. S32 appointed a new independent non-executive director, Mr Guy Lansdown, an American mining engineer resident in Mexico. There were a number of changes in the executive leadership group, but not in KMP.

ASA focus issue – virtual AGM
The company's 2020 AGM is being held on 29 October as a virtual AGM using the LUMI platform. Shareholders will be able to listen in via the webcast through their internet browser or via downloading the LUMI app, which will enable you to ask questions by typing in a question in advance of or during the meeting. Whilst being concerned with a number of matters mentioned in these voting intentions, we have provided the company with a copy of them and therefore expect that any response to our concerns will be provided in the address at the meeting if not before. Accordingly we do not intend to submit questions at the meeting unless prompted to do so by information disclosed during the meeting.

Summary

(As at FYE)	**2020**	**2019**	**2018**	**2017**	**2016**
NPAT (USDm)	(65)	389	1,332	1,231	(1,615)
UPAT (USDm)	193	992	1,327	1,146	138
Share price (AUD)	2.04	3.18	3.61	2.68	1.54
Dividend (US cents)	3.2	9.6	13.5	10.0	1.0
TSR (%)	(34.9%)	(7.65%)	41.99%	78.0%	(13.97%)
EPS (US cents)	(1.3)	7.7	25.8	23.2	(30.3)
CEO total actual remuneration, (AUDm)	3.216	13.195	7.839	5.008	4.199

For FY20, the CEO's total actual remuneration was **36 times** (2019 – 155 times) the Australian Full time Adult Average Weekly Total Earnings (based on May 2020 data from the Australian Bureau of Statistics).

Item 2	**Re-election of directors:** **2(a) Frank Cooper, AO** **2(b) Xiaoling Liu** **2(c) Ntombifuthi (Futhi) Mtoba** **2(d) Karen Wood**
ASA Vote	**For**

Summary of ASA Position

Mr Frank Cooper is a chartered accountant with a distinguished professional background in Perth and is a director of Woodside Petroleum Ltd. He has a number of unlisted non-executive roles including chair of the State Insurance Commission, a director of St John of God, and a member of the UWA Senate. He is also state president of AICD. Mr Cooper is the Chair of the Risk and Audit Committee.

Ms Xiaoling Liu is a metallurgist with mining and processing experience. She has held senior executive roles with Rio Tinto during a 26-year career at that company running integrated mining, processing, and supply chain operations in different continents.

Dr Futhi Mtoba is also a distinguished accountant having chaired the board of Deloitte in South Africa. She was awarded Business Woman of the Year in 2004 and is a past board member of United Nations Global Compact. She is a director of two other companies and a member of a number of not-for-profit boards including University of Pretoria and the Nelson Mandela Foundation.

Ms Wood succeeded David Crawford as chairperson in 2019. She is a lawyer with a strong governance background who has held roles as group company secretary, chief people officer and president, public affairs for BHP Billiton at various times during 2001 to 2014. Ms Wood left BHP in August 2014, three years before commencing as a South32 director and she is classified by S32 as an independent non-executive director. We have queried this status due to her long career as a BHP executive, remembering that S32 was a spin-off from BHP in 2015, but the 3-year period between her leaving BHP and joining S32 meets ASX guidelines for independence. She has assured us of her real independence from S32's management. She is a director of one listed company and vice-president of the Melbourne Cricket Club.

All four directors were last elected or re-elected at the November 2017 AGM. Mr Cooper and Dr Mtoba have been directors since the time of the company's demerger from BHP in 2015. Dr Liu and Ms Wood were first appointed in 2017. With the price of S32's shares falling from over AUD$3 to less than AUD$2 during FY20, the value of some of the directors' shareholdings are falling a bit short of one year's fees when including committee fees with board fees – all are over the minimum of one year's board fees in value. None of these directors are over-committed in terms of governance guidelines about the number of directorships which may be held. They all bring varied and appropriate skills to the board and bring its female component above the ASA guideline of 30%. We support their appointment.

Item 3	Election of director – Guy Lansdown
ASA Vote	**For**

Summary of ASA Position

Mr Lansdown is a civil engineer who was appointed as an independent non-executive director in December 2019; he is a member of three committees – Nomination & Governance, Risk & Audit, and Sustainability. He has had 20 years' experience as an executive at Newmont Mining Corp serving in a number of different countries and brings relevant skills and experience to the S32 board. He runs his own consulting business in the United States. He has no other listed company directorships or onerous commitments. We support his appointment.

Item 4	Adoption of Remuneration Report
ASA Vote	**For**
Currency	**The remuneration report is stated in Australian currency and all amounts below are AUD**

Summary of ASA Position

We commented last year that the remuneration report is to be commended for its clarity and layout, making it comparatively easy for the reader to assess the nature and fairness of the remuneration structure. It has been improved this year by the provision of information on page 72 of the annual report comparing the CEO's fixed and total remuneration with peer groups. The structure of executive remuneration follows well-established precedent of a fixed salary, short-term incentive split between cash and deferred equity on a 50/50 basis, and a long-term incentive on a 4-year appraisal period.

The following table shows the components of Graham Kerr's (CEO & MD) target remuneration package for 2020:

All amounts are in AUD	Target A$m	% of Total	Max. Opportunity A$m	% of Total
Fixed Remuneration	1.815	29%	1.815	17%
STI - Cash	1.089	18%	1.6335	15.5%
STI - Equity	1.089	18%	1.6335	15.5%
LTI	2.178	35%	5.445	52%
Total	6.171	100%	10.527	100%

His remuneration expense calculated under accounting standards for 2020 was A$7.3m, aggregating his fixed salary with his cash STI of A$0.69m and accrued equity (STI and max LTI on the AAS fair value basis) of A$4.689m. His actual pay for 2020 was A$3.216m (FY19 $13.195m).

Total executive KMP remuneration on the accounting standards basis (ie accruing equity awards at fair value over their duration between grant and vesting) was A$17,053m for FY20 compared to A$16,173m as reported in last year's annual report. Adjusting to make the remuneration table comparable on an individual KMP basis, FY19's expense is reduced to $13.751m.

As regards the overall level of executive pay and the CEO's pay in particular, we recognise that S32 is a global mining company with high risk operations with respect to both employees and neighbouring communities, and with its terms of trade basically out of management's control because of their reliance on commodity prices and currency exchange rates. S32 justifies the level of executive remuneration on the basis of the nature of its business and international competition for executives of their calibre and the disclosed information as to peer group comparison provides support for S32's position. Our other concerns over the remuneration structure are of a relatively minor nature as follows:

- the lack of a second hurdle to TSR as the yardstick for the LTI incentive – we prefer to see a second absolute hurdle such as growth in earnings per share;
- LTIs should only vest if S32's performance exceeds the median performance of the comparator groups; S32's LTI starts vesting if it achieves 40% of the comparator indices result (note that in 2020 it failed to achieve this threshold so awards lapsed);
- travel allowances paid to non-executive directors which we still view as inappropriate and excessive (the total allowances paid is not disclosed but is presumably the major factor in the "Other allowances and benefits" paid to non-executive directors totalling $323,000 in FY20 (FY19 - $495,000). We are cognisant that both BHP and Rio Tinto have similar methods of compensating their non-executive directors for board travel and that there are significant calls upon their time involved in meeting their obligations.

Item 5	**Approval of share rewards for the CEO, Graham Kerr**
ASA Vote	**For**

Summary of ASA Position

The resolution seeks to approve the grant to Graham Kerr of 2,695,544 (FY19 -1,696,261) share rights which had a face value on grant date 1 July 2020 of A$5.445m (FY19 - A$5.445m), being his maximum opportunity for long-term incentive for 2020, together with share rights with a face value of A$0.689882m (FY19 - A$0.92394m) for the equity component of his 2020 short term incentive. The STI share rights will be granted as determined by the average face value of S32 shares for the relevant period in December 2020 if approved by shareholders. The awards are in accordance with the remuneration structure set out in the remuneration report and commented upon by us in these voting intentions.

Item 6	Renewal of proportional takeover provisions
ASA Vote	**For**

Summary of ASA Position

We support the proposed provisions intended to prevent a predator from bidding for a proportion of a shareholders' interest. We prefer full takeovers so that shareholders are not left with a controlling shareholder.