Australian Shareholders' Association

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Brown coal smothers result

Company/ASX Code	South32 Limited/S32
AGM date	24 October 2019
Time and location	10.30am at Pan Pacific Hotel, 207 Adelaide Terrace, Perth
Registry	Computershare
Webcast	Audio webcast
Poll or show of hands	Poll on all items
Monitor	John Campbell assisted by Geoff Read
Pre AGM Meeting?	Yes with Chair Karen Wood

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

Summary of ASA Position

S32's share price has been quite volatile during 2018-9, peaking at over A$4 in October last year and dropping to $3.18 at year-end before falling to a low point of A$2.45 in August 2019, responding to changes in commodity prices and market expectations. Perhaps the shock has been to see that the probable sale of South African Energy Coal (SAEC) assets resulted in an impairment of $504m, mainly responsible for the fall in NPAT (Net Profit After Tax) down from $1,332m in FY18 (Financial Year 2018) to $389m in FY19. Putting the SAEC impairment of US$504m aside, the FY19 NPAT difference with FY18 is $439m. Generally lower commodity prices, partly offset by foreign currency movements, and higher controllable costs weakened the underlying result leading to the poor result after impairment. The S32 FY19 financial performance displays the bumpy outcomes typical of the mining/resources sector which is dependent upon global commodity pricing and exchange rates. The circumstances surrounding the possible sale of SAEC highlight the current risks associated with investment in South Africa by Australian listed companies.

Whilst precise terms of the SAEC sale are still being negotiated, the write-down of $504m, referred to above, is intended to reduce the carrying value of the SAEC assets, net of rehabilitation provisions, to the expected present value of proceeds of sale expected to occur late in FY20. This also considers FY20 capex (capital expenditure) (in excess of $200m) and operational cashflows and an upfront and deferred payment mechanism as part of a likely sale agreement. 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 government's Broad-Based Black Economic Empowerment (BBBEE) ownership criteria, it will struggle to compete for future domestic coal opportunities. 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. It is hoped that the precise terms of sale can be released to the market before the end of the calendar year.

We are concerned about the country risk associated with the remaining South African assets, South African manganese and the Hillside aluminium smelter, capitalised at approximately $1,300m in S32's balance sheet. We will ask about these at the meeting but we understand that these assets face fewer regulatory pressures with regards to the BBBEE criteria as they are more oriented towards the export market as opposed to the domestic market. SAEC is a much larger employer than either of the other two businesses and coal has a more challenging unionised labour market which could affect performance to some degree.

Despite the poor result, shareholders have benefitted from dividends in FY19 of $657m and on-market buy-backs of $281m. S32 has negative retained earnings at year-end so dividends at these levels can only be maintained if profits improve. S32's FY20 guidance indicates improved production volumes.

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. We queried this status due to her long career as a BHP executive, remembering that S32 was a spin-off from BHP in 2015, but there was a period of some years between her leaving BHP and joining S32 meeting ASX guidelines for independence. She has assured us of her real independence from S32's management. There are five other independent non-executive directors and two non-independent directors, the CEO, Graham Kerr and Dr Xolani Mkhwanazi, also previously a senior BHP executive who joined S32's board directly from his employment. All directors have adequate skin-in-the-game except Dr Mkhwanazi who has increased his shareholding subsequent to balance date to reach 75% of a year's fees.

Financial performance There has been a 12% reduction in share price during FY19 and the price has weakened significantly since 30 June. Declining profitability is due to increasing costs, and to changes in commodity prices and exchange rates, and also to the proposed sale of SAEC which contributed EBIT (Earnings Before Income Tax) of $276m in FY18 compared to an impairment charge of $504m and an EBIT loss of $46m in FY19.

Key events
Without a significant turnaround in prospects for aluminium 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. S32 released a JORC compliant resource for the first time in FY2019 which South 32 believes provides higher confidence in the measured resource and de-risks early production from the project, albeit at about 17% lower grades than the original Arizona Mining pre-feasibility study. A new pre-feasibility study is being undertaken to assess commerciality. All three of the above acquisitions are unlikely to affect FY2020 to any great extent although the prospects for each of them should be clarified further.

Key Board or senior management changes
S32's spin-off from BHP was guided by David Crawford, a BHP non-executive director since the mid-1990s, who took the chair at S32 at the time of the demerger. He retired and Karen Wood, who was appointed a director in November 2017, took over as chairperson commencing 12 April 2019. There have been no other changes in the directorate since then. Brendan Harris, who had been the Chief Financial Officer (CFO) since demerger, was appointed chief marketing officer in

May 2019 and ceased to be classified as a key management person from that date. He was succeeded by Katie Tovich as CFO.

Summary

(As at FYE)	2019	2018	2017	2016	2015
NPAT (US$m)	389	1332	1231	(1615)	S32 was spun off by BHP in May 2015 so 2015 comparative information is neither comparable nor relevant
UPAT (US$m)	992	1327	1146	138	
Share price (A$)	3.18	3.61	2.68	1.54	
Dividend (US cents)	9.6	13.5	10.0	1.0	
TSR (%)	(7.65%)	41.99%	78.0%	(13.97%)	
EPS (US cents)	7.7	25.8	23.2	(30.3)	
CEO total actual remuneration, (A$m)	13.195	7.839	5.008	4.199	

For FY2019, the CEO's total actual remuneration was **149 times** the Australian Full time Adult Average Weekly Total Earnings ($1695.20.80 based on May 2019 data from the Australian Bureau of Statistics).

Item 2	**Re-election of Wayne Osborn and Keith Rumble as Directors**
ASA Vote	**For**

Summary of ASA Position

Mr Osborn is an electrical engineer, former CEO of Alcoa in Australia and has served as chair of the remuneration committee since demerger. He is also a non-executive director of Wesfarmers Ltd and is located in Perth. Keith Rumble is a geologist, had a 40-year career in the mining industry primarily in southern Africa and was CEO of a number of mining companies. He is the chair of the sustainability committee. Both were appointed directors prior to demerger in 2015 and have adequate skin in the game.

Item 3	**Adoption of Remuneration Report**
ASA Vote	**For**

Summary of ASA Position

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. The structure itself 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) remuneration package for 2019:

All amounts are in A$	Target A$m	% of Total	Max. Opportunity A$m	% of Total
Fixed Remuneration	1.770	29%	1.770	17%
STI - Cash	1.062	18%	1.593	16%
STI - Equity	1.062	18%	1.593	16%
LTI	2.124	35%	5.310	52%
Total	6.018	100.0%	10.266	100%

His remuneration expense calculated under accounting standards for 2019 was A$6.979m, aggregating his fixed salary with his cash short-term incentive (STI) of A$0.924m and accrued equity (STI and maximum long-term incentive (LTI) on the Australian Accounting Standard (AAS) fair value basis) of A$4.264m. His actual pay for 2019 was A$13.195m after he waived entitlement to a grant of shares valued at A$4.733m arising from his replacement BHP LTIP grant as negotiated with him at demerger. His take-home pay would have been A$17.928m if he had not waived this entitlement. Not that we are complaining as we would have considered the level of pay grossly excessive at that level as we see it excessive at the A$13m level.

Total executive key management Personnel (KMP) remuneration on the accounting standards basis (i.e. accruing equity awards at fair value over their duration between grant and vesting) was A$16.173m in 2019 compared to A$16,588m in 2018. 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. Whilst we think that the pay levels are excessive, S32 justifies them on the basis of the nature of its business and international competition for executives of their calibre. The remuneration committee has the benefit of expert advice on this subject and we think it would be inappropriate to vote against the remuneration report because of this factor. Our other concerns over the remuneration structure are of a relatively minor nature as follows:

- the lack of a second hurdle to total shareholder return (TSR) as the yardstick for the LTI incentive – we prefer to see a second absolute hurdle such as growth in earnings per share;
- LTI's should only vest if S32's performance exceeds the median performance of the comparator groups, not if it is merely achieved;
- travel allowances paid to non-executive directors which we still view as inappropriate and excessive (total value in 2019 – A$0.543m). 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.

Shareholders should consider directing their vote against the remuneration report if they disagree with our view of its reasonableness.

Item 4	Approval of LTI grant to CEO/Managing Director Graham Kerr
ASA Vote	**For**

Summary of ASA Position

The resolution seeks to approve the grant to Graham Kerr of 1,696,261 share rights which had a face value on grant date 1 July 2019 of A$5.445m, being his maximum opportunity for long-term incentive for 2020, together with share rights with a face value of A$0.92394m for the equity component of his 2019 short term incentive. The STI share rights will be granted as determined by the face value of S32 shares in December 2019 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.

The individual(s) (or their associates) involved in the preparation of this voting intention have a shareholding in this company.