Capex Growth Challenges Management

Company/ASX Code	NEXTDC Ltd/NXT
AGM time and date	11.00am AEDT Friday, 22 November 2024
Location	S3 Data Centre, 2 Broadcast Way, Artarmon, NSW 2064.
Registry	Link Market Services
Type of meeting	Hybrid https://meetings.linkgroup.com/NXT24
Monitor	Mike Sackett assisted by Alison Prentice
Pre-AGM Meeting	With Chairman, Doug Flynn; Stuart Davis, Chair of Remuneration & Nomination Committee and Simon Guzowski, ESG Investor Relations Manager.

Monitor Shareholding: The individuals, or their associates, involved in the preparation of this voting intention have shareholdings in this company.

1. How we intend to vote

No.	Resolution description	
1	Remuneration Report	For
2	Re-election of Mr Douglas Flynn, as a Director	For
3	Increase in the maximum aggregate annual remuneration of Non-executive Directors	For
4	Ratification of issue of shares under institutional placement	For
5	Approval of grant of Rights to Mr Craig Scroggie under the FY25 Long Term Incentive Plan	For

2. Summary of Issues and Voting Intentions for AGM

- After 14 years strong earnings before interest tax and depreciation growth in Australia, NEXTDC last year announced expansion plans overseas, initially Malaysia and New Zealand. Is it equipped to successfully carry out this ambition?
- No LTI was paid to any key manager in FY24. This was due to the fact that NEXTDC's TSR over the three year period to 28 August 2023 of 12.4% fell short of the ASX200 TSR "gateway" requirement, despite the business growth. Essentially this under-performance was a market quirk rather than a reflection of underlying company performance. Non-payment of any LTI bonus potentially affected the company's ability to retain key managers.

3. Matters Considered

Accounts and reports

NEXTDC is a data centre services company with an expanding set of operating data centres in major Australian cities and high growth areas such as the Pilbara and the Sunshine Coast. In May 2023 the development of NEXTDC's first offshore data centres in Kuala Lumpur and Auckland was announced. In May 2024 a $1.3 billion capital raising was undertaken to finance further major investment in Australia as well as this overseas expansion. Four months later there was a further $750 million capital raising, mainly to be applied to the acquisition of data centre sites in Asia, such as Bangkok and Johor, Malaysia.

NEXTDC first listed on the ASX in 2010. Through organic growth the company rapidly expanded to be included in the ASX200 index in 2016, and the ASX100 index in June 2020. It has recently entered the ASX top 50 companies by capitalisation ranking. The company describes FY24 as being the year Artificial Intelligence (AI) emerged as a "truly transformative technology, revolutionising economies and communities". This underpins the recent growth spurt for NEXTDC as AI comes with complex power, security and interconnection requirements, in all of which the company claims to have competence.

A significant feature of FY24 was capital expenditure of $1,003 million compared with guidance of $850-900 million and actual FY23 capex of $695.7 million. This was queried in our pre-AGM meeting when we were told that additional investment opportunities arose during the course of FY24.

Financial performance

(As at FYE)	**2024**	**2023**	**2022**	**2021**	**2020**
NPAT ($m)	(44.1)	(22.0)	9.1	(23.6)	(45.0)
UPAT ($m)	(41.5)	(21.6)	34.7	(24.4)	(45.1)
Share price ($)	17.63	12.58	10.64	11.86	9.88
Dividend (cents)	0	0	0	0	0
Simple TSR (%)	40	18	(10)	20	52
EPS (cents)	(8.3)	(4.8)	3.9	(4.5)	(12.6)
CEO total remuneration, actual ($m)	2.8	4.5	5.7	4.7	3.2

Positive factors:

- FY24 revenue grew by 11.6% to $404 million;
- Built NEXTDC data centre capacity increased by 110% between June 2020 and June 2024;
- Contracted utilisation as a percentage of built capacity increased from 89% to 105% between 2020 and 2024;
- Long term debt having grown in FY23 to $1.435 billion (an increase of 68% over the previous two years) stabilised somewhat in FY24 when it was $1.448 billion.

Negative factors:

- After making a profit of $9 million in FY2022 NEXTDC had an increased negative NPAT in FY24 of $44 million;
- Total sold capacity (billing utilisation) as a percentage of built capacity fell from 67% to 52% between 2020 and 2024, and has in fact fallen in each of the past three years. A key challenge for the company is to ensure contracted customers transform to billing customers as early as possible.

Governance and culture

The Board has comprised eight directors since August 2023. Seven directors are listed as independent in the company's Corporate Governance Statement and generally meet ASA criteria. Three (37.5%) directors are female. The company is committed to a goal of 40% male: 40% female: 20% flexible across employees, management and board by 2030. Currently the percentage of female staff stands at 31%, which we were told compares favourably with the 8% female staff proportion for the data centre sector overall.

NEDs are "encouraged to accumulate shares on their own behalf, over a three year period, of equivalent value to their average annual director fees". With the exception of US-based Stephen Smith, who owns no shares despite having been on the Board since 2019, all directors meet this expectation. Apart from the CEO the other six share-holding NEDs all participated in the May and September 2024 capital raisings.

Key events

Successful capital raisings were held in May 2024 and September 2024 generating a total of $2.05 billion in new capital. The May raising was via a pro-rata accelerated non-renounceable entitlement, and the September raising was a placement with a share purchase plan where all eligible applications were accepted at the discount to VWAP price. At the time of the latter capital raising FY25 capex guidance was revised from $900-1,100 million to $1,300-1,500 million. In October 2024, NEXTDC announced the purchase of land for its future Sydney S7 data centre at a cost of $353 million plus taxes and transaction costs (prompting the question whether NEXTDC is as much a real estate investor as data centre operator?).

Sustainability/ESG

Data centres consume staggering amounts of electrical energy. NEXTDC Annual Reports in previous years have always highlighted the company's relatively low Power Usage Effectiveness (PUE) which was 1.38 in FY22 and 1.39 in FY23 (a lower figure indicates greater energy efficiency). In FY23 and FY24 achieving a PUE less than 1.40 was a specific STI operational metric. It came as a surprise therefore when in FY24 the PUE achieved deteriorated to 1.42 with no explanation in the Annual Report. This was queried at our pre-AGM meeting when it was explained that reduced energy efficiency was the result of opening new data centres initially operating at a fraction of their eventual capacity.

4. Rationale for Voting Intentions

Resolution 1 - Remuneration Report - FOR

While complex, the Remuneration Report is clear, logical and comprehensive. In FY24 senior executive remuneration appeared appropriate and was structured as follows:

- Fixed remuneration (29% of potential total) said to be set with reference to domestic and international benchmarks.
- The Short Term Incentive (STI) Plan (29% of potential total) provides an at risk incentive for performance against annual objectives. It is paid 50% in cash at year-end and 50% is deferred for one year and payable in either cash or shares.
- The Long Term Incentive (LTI) Plan (42% of potential total) provides an at risk securities-based reward for performance and on-going service. Half of the LTI is awarded in Performance Rights based on achieving a positive TSR with respect to the ASX 100 Accumulation Index. These vest equally after three and four years. The other half of the LTI is awarded in Restricted Rights vesting equally after three, four and five years. Performance conditions for these include the same positive relative TSR, plus a behavioural assessment and on-going service, the latter being intended as a significant retention inducement.

The FY24 STI plan had the following gateway requirements:

- underlying EBITDA achieved be at least 95% of the midpoint initial guidance range given;
- fulfilment of the company's uptime obligations to its customers;
- no breaches of code of conduct.

Weightings given to specific key performance indicators were:

- Underlying EBITDA – up to 40% of total STI;
- Total revenue – up to 35% of total STI;
- Major project delivery (four equally-weighted projects cited) – up to 15% of total STI;
- ESG and operational metrics – up to 10% of total STI.

The Total Revenue target was only 64% achieved with actual FY24 revenue of $404.3 million compared to the initial guidance range of $400 million (50% payable) to $415 million (100% payable). The operational target of achieving a Power Usage Effectiveness of less than 1.40 was not achieved and nothing was paid. All other STI targets were met in full.

As mentioned in the summary above, no LTI payment was made in FY24. This was because the NEXTDC TSR over the measurement period from 27 August 2020 to 28 August 2023 at 12.4% was below the growth in the ASX200 Accumulation Index of 31.2% over that period.

The level of Board remuneration is reviewed under Resolution 3.

Resolution 2 - Re-election of Mr Douglas Flynn, as a Director – FOR

Mr Flynn was appointed to the Board in September 2013 and as Chairman in April 2014. ASA guidelines state that a director "should not serve more than 10 years as chair, subject to exceptional circumstances". Mr Flynn has exceeded that period of tenure and has not yet reached 12 years tenure which ASA guidelines considers impinges on independence. Arguably NEXTDC is an exceptional company with exceptional circumstances. The NEXTDC of today with a $10 billion capitalisation and on the cusp of expanding into south-east Asia, bears little resemblance to the minnow it was in 2014, four years after going public. In the writer's view, NEXTDC shareholders are best served by retaining Mr Flynn with his experience and longevity being a virtue in this context.

Mr Flynn's only other corporate responsibility is as Chairman of IMEXHS, a medical imaging technology microcap ($21 million) company. In our contacts with Mr Flynn, including the FY24 pre-AGM meeting, he has been helpful and constructive.

Resolution 3 - Increase in the maximum aggregate annual remuneration of Non-executive Directors – FOR

It is proposed to increase the aggregate fee limit from the current $2.0 million to $2.2 million. The FY23 AGM had approved an increase from $1.6 million, which had been unchanged since the FY20 AGM, to the current level.

Total FY24 remuneration for Chairman Doug Flynn was just over $466,000, which extrapolating from last year's analysis is about 10% above the median for companies of comparable capitalisation. Directors received between $188,000 and $228,000 which was close to the median.

Given the rapid increase in the size and geographical focus of the company the proposed increase is acceptable.

Resolution 4 - Ratification of issue of shares under institutional placement – FOR

This seems to be a prudent, routine piece of house-keeping for a company undergoing rapid expansion.

Resolution 5 - Approval of grant of Rights to Mr Craig Scroggie under the FY25 Long Term Incentive Plan - FOR

It is proposed to grant the CEO 97,206 Performance Rights and 97,206 Restricted Rights under his FY25 LTI award. These numbers have been calculated based on the prevailing market price of the company shares in the 10 days following the release of the FY24 audited accounts and the maximum LTI award which has been set at 200% of annual base salary. The Board has proposed this increase from 150% to 200% of base salary in order to "adequately incentivise" the CEO for his ongoing service to the company. Another proposed change is the testing of Restricted Rights in equal tranches over three, four and five years. ASA particularly welcomes the extension to five years, for the first time, for part of the LTI. We consider the size and structure of this grant of rights to be appropriate.

Appendix 1
Proposed Remuneration Framework Detail for FY25

CEO Remuneration Framework (FY25)	Target	% of Total	Max. Opportunity	% of Total
Fixed Remuneration (1)	$1,676,809	25%	$1,676,809	25%
STI – Cash (2)	$838,405	12.5%	$838,405	12.5%
STI – Equity (2)	$838,405	12.5%	$838,405	12.5%
LTI Performance Rights 50% Years 3 & 4 (3)	$1,676,809	25%	$1,676,809	25%
LTI Restricted Rights 33.3% Years3, 4 & 5 (3)	$1,676,809	25%	$1,676,809	25%
Total	$6,707,236	100.0%	$6,707,236	100%

Notes:

1) It is proposed to increase base (fixed) salary by 10% in FY25 from the FY24 level, after a 15% increase in FY24 after a review which included benchmarking.
2) Maximum opportunity under the Short term Incentive Plan represents 100% of base salary.
3) Maximum opportunity under the Long Term Incentive Plan represents 200% of base salary, a proposed increase from 150% in FY24.