Australian Shareholders' Association
Australian Shareholders' Association Limited
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Vale COVID

Company/ASX Code	Sonic Healthcare/SHL
AGM time and date	10:00am AEDT Tuesday, 19 November 2024
Location	The Heritage Ballroom, The Fullerton Hotel, 1 Martin Place, Sydney NSW
Registry	Computershare
Type of meeting	Hybrid
Monitor	Sue Howes
Pre-AGM Meeting	Yes, with Mark Compton (Chair), Kate Spargo (Chair Remuneration) and Paul Alexander (Co Sec)

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

1. How we intend to vote

No.	Resolution description	
1	Re-election of Ms Kate Spargo	For
2	Adoption of the Remuneration Report	Against
3	Increase in the available pool for Non-executive Director's Fees	For
4	Approval of LTI for Dr Colin Goldschmidt, MD and CEO	Against
5	Approval of LTI for Mr Chris Wilks, Finance Director and CFO	Against

2. Summary of Issues and Voting Intentions for AGM

- Re-election of Ms Spargo, who has tenure of 14 years at the commencement of this term.
- The use of "fair value" in the remuneration plan.
- Financial results and acquisition profitability.

See ASA Voting guidelines and Investment Glossary for definitions.

3. Matters Considered

Accounts and reports

Financial performance

(As at FYE)	**2024**	**2023**	**2022**	**2021**	**2020**
NPAT ($m)	511	685	1,461	1,315	528
Net cash flow from ops ($m)	1,072	1,471	2,226	2,043	1,360
Share price ($)	26.30	35.57	33.01	38.4	30.43
Dividend ($)	1.06	1.04	1.00	0.91	0.85
Simple TSR (%)	(23.1)	10.9	(10.8)	29.1	15.6
EPS (cents)	107	145	303	273	110
CEO total remuneration, statutory ($m)	5.162	5.969	7.685	6.733	4.494

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.

Revenue and NPAT fell this year due to an 87% reduction in COVID-related revenue. COVID-related revenue for the year totalled $62m. Non COVID-related revenue grew 16%, including 6% organic growth, the remainder from acquisitions.

Despite this result, and the operating cash flow falling by 27%, the dividend increased "continuing our long-standing progressive dividend strategy" rather than the usual strategy relating dividend to results or payout ratio.

We quizzed the Board on these results and the explanation is that while COVID was a large and profitable event in the business, scaling back from that has taken time to do in an orderly fashion so that good staff can be retained and redeployed within the business. FY24 sees a rapid reduction in COVID related flows to the extent that this is now largely business as usual.

Acquisitions are generally performing well, although there are some large acquisitions in more recent years (including FY24) that will take longer to realise synergies.

There are several well-advanced initiatives in progress to improve the profitability of the business overall.

The coming together of these disparate factors effectively means that FY24 is an inflexion point for the company and FY25 going forward should see cost reductions, improvement in profit margins and thus profitability. Guidance has been provided for FY25 of:

- EBITDA: A$1.70B to A$1.75B on a Constant Currency basis
- Net interest expense is expected to increase by ~25% from the FY2024 level, due to the business acquisitions completed in FY2024, and higher interest rates on refinanced long-term debt
- The effective tax rate is expected to be 26-27%.

The company has increased the payout ratio this year to reward shareholders with an increased dividend. In light of guidance, the payout ratio should move back to within the usual 70-80% range as the financial situation shifts.

Governance and culture

This company has a very strong culture, promulgated by the Board, but spread through the organisation. It rests on the premise that if they offer top service to medicos, then medicos will refer more tests. This is monitored throughout and seems to work both in organic growth as well as attracting investment opportunities.

The company engages in slow integration of acquisitions to improve profitability over time. The value of this with past acquisitions is not evident in this year's accounts due to the working out of additional COVID expenses but is expected to be apparent in FY25.

The Board has a high proportion of people with medical backgrounds, and we questioned the Board on this. The last two additions have been medical in nature, but the Board was careful to ensure early-stage investment, technology and business skills. Having said that, they are in a process of continuous Board renewal and are targeting business skills in the next appointments to round out their skill set.

One item we asked about was the IT systems and facilities upgrades flagged in the annual report. We were interested in the reporting lines and the visibility of the Board over these issues given the problems several other large companies have had in this area. The Board were obviously on top of what was happening in the firm and gave us confidence. The CIO reports directly to the Board from time to time and the Board receives regular updates in the Board reporting. It also receives specific reports on the AI projects being run and has recently undertaken a tabletop exercise on cyber security that allowed Board members to raise a number of questions to the IT team. The company also undertakes regular testing of systems, and the Auditor has oversight into the systems to give further assurance.

Key events

The company has made a very large acquisition in Europe that has resulted in considerable goodwill being added to the balance sheet. This acquisition is a more mature business producing considerable revenue. SHL is continuing to look for acquisition opportunities in pathology worldwide and radiology and general practice in Australia.

Key board or senior management changes

The key changes this year are the retirement of Mr Panaccio and the re-election of Ms Spargo. Mr Panaccio has served 19 years on the Board and thus the average tenure reduces with his exit.

Ms Spargo has 14 years on the Board and has indicated this will be her final term.

Sustainability/ESG

The Company issues a sustainability report in November of each year. We asked whether this could be brought forward to be released prior to the AGM so that shareholders would have an opportunity to review it and then ask questions at the AGM. The company is in the process of annual improvement to this report and expanding metrics and it takes time to pull together. However, in FY26 will align with the annual report timing.

The report itself is well written, clear and comprehensive. The largest issue for a company such as Sonic is how do they maintain quality while reducing waste and using more climate sensitive packaging. They also have to deal with medical waste and a range of other issues. Having said this, the company has targets for reduction, measures these and monitors the results.

4. Rationale for Voting Intentions

Resolution 1 Re-election of Ms Kate Spargo (for)

The ASA does not consider a director who has served for over 12 years to be sufficiently independent of the company and its management. SHL clearly has a different view and has listed Ms Spargo as independent in their annual report. The company uses the yardstick of independence of thought.

Having said this, Mr Panaccio is retiring this year and the Board therefore will comprise two executives, 5 independent directors and Ms Spargo.

The Board has indicated that they are in the process of renewal, are actively searching for new directors and that Ms Spargo has indicated this will be her final term.

Ms Spargo is clearly actively involved in Board work and holds considerable corporate knowledge.

ASA will be voting any undirected proxies for Ms Spargo's re-election.

Resolution 2 Adoption of the Remuneration Report (against)

ASA have had discussions with Sonic over several years around the clarity of reporting in the remuneration reporting and the use of options in the LTI. The company indicated to our monitors that it would take on our feedback. There has been no change to the remuneration plan or its reporting for this year and the company does not expect to change any aspect of the plan in the near future but will again take on our feedback.

We give a thorough run down on remuneration in the appendix to this report, but draw shareholders attention to this excerpt from ASA guidelines re the use of options:

> "As the company matures, we expect they will move away from using options in their incentive schemes. We acknowledge the equity-based rewards for companies at an early stage of evolution may comprise options, which being unlisted will be valued using fair value methodology. Boards should be mindful of the potential for windfall gains and consider how to cap excessive awards."

When discussing this issue with the company we indicated that our view was that their use of options meant that the true effect on the remuneration for senior staff was not apparent and often confusing for retail shareholders. The company is of the view that the company and staff really like the incentivisation effect of the options and that the company does not see why owners being able to understand how senior executives are remunerated should impact on the remuneration plan of the company.

A detailed description of the remuneration plan and its workings are given in the appendix to this report. For the reasons described therein, we will be voting any undirected proxies against this resolution.

Resolution 3 Increase in the available pool for Non-executive Director's Fees (for)

Director fees are not excessive, and the Board is undertaking a period of renewal. The fee pool has not been increased since 2020 and the increase is reasonable. We will be voting all undirected proxies for this resolution.

Resolution 4 Approval of LTI for Dr Colin Goldschmidt, MD and CEO (against)

This resolution relates to the issue of the LTI options and performance rights for the current year. Given the options under the Remuneration plan are a large part of the vote against the remuneration plan we will also be voting against this resolution.

Resolution 5 Approval of LTI for Mr Chris Wilks, Finance Director and CFO (against)

This resolution relates to the issue of the LTI options and performance rights for the current year. Given the options under the Remuneration plan are a large part of the vote against the remuneration plan we will also be voting against this resolution.

Appendix 1
Remuneration framework detail

CEO rem. Framework for FY25	Target* $m	% of Total	Max. Opportunity $m	% of Total
Fixed Remuneration	2.398	31%	2.398	26%
STI - Cash	1.321	17%	1.849	21%
STI - Equity	.881	12%	1.233	14%
LTI	3.067	40%	3.451	39%
Total	7.666	100.0%	8.931	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. Some remuneration framework set a maximum opportunity amount, but not all.

The framework is typical of most ASX companies in that it has a Fixed Annual Remuneration (FAR), a Short-Term Incentive (STI) and Long-Term Incentive (LTI).

STI

Consists of two components: 80% based on EBITDA and 20% based on Strategic Objectives. At the Target level STI is awarded 60% cash and 40% equity, with equity held for minimum of two years. ASA prefers that this is split 50% / 50%.

EBITDA component (80%):

The target for EBITDA was based on guidance given at the beginning of the year, but the actual hurdle and calculation method for partial performance are not disclosed in the remuneration report. We consider this a shortcoming in the company's reporting. The actual result this year was 0% awarded due to the poor result.

Given the potential for significant uplift in remuneration of maximum over target for outperformance (Maximum is 140% of target, which is 92% of fixed) we believe the full calculation and hurdles should be fully disclosed.

Strategic Objective (20%):

The strategic component vested 100% again.

50% of this component relates to sustainability objectives. These are disclosed in the annual report, but it is difficult for shareholders to identify whether they would have been met and must be quite subjective for the Board to determine outcomes of.

The other 50% relates to a range of factors that are disclosed in the report, but are again very subjective. We questioned the company on the first three of these as they seem to relate to simply doing the job. The response indicated that the company doesn't consider STI to require stretch targets and that these items are very important to the company. While we do agree that culture and adherence to it is very important, particularly in light of the range of spectacular failings seen in ASX listed organisations in recent times, greater disclosure and measurability would be ideal for the annual report.

LTI

The LTI is composed of 50% options and 50% performance rights. There is a 3-year performance period before vesting occurs and this applies to both the options and the rights.

The proportionate components of the LTI vary depending on the level achieved on the EPS item.

Relative TSR

This vests on a sliding scale from 50% vested at the 51st percentile to 100% at the 75th percentile and above and is weighted at 45% of the awarded LTI.

Aggregate EPS

Is calculated using total EPS over the 3 years commencing the beginning of the year the LTI is being awarded. There is no hold period. ASA would prefer a longer vesting and a holding period post vesting.

This is then awarded on the following scale:

% vesting	2024 Aggregate EPS (cents)	2025 Aggregate EPS (cents)
0	<457	<355
30	=457	=355
Pro-rata 30 to 100	457 to 480	355 to 390
100	480	390
Pro-rata 100 to 150	480 to 504	390 to 428
150	504	428

EPS for the most recent three years is 555 cents, two years of which involved years of underperformance.

It can be seen from the table above that this component of the LTI can ramp higher than one is led to believe looking at the issue of rights and options given this performance feature.

We also note that the FY25 hurdles are significantly lower than the FY24 hurdles, this could indicate expected continuing lack lustre performance or it could be the company wants to ensure outperformance on the remuneration plan. This aspect of the remuneration plan does not align with shareholder experience when the targets are adjusted down for staff when results disappoint.

This measure has been added to the mix in the last couple of years. It can be seen that it does not apply to the vesting of LTI for the 1/7/21 to 30/6/24 performance period, which comprised 75% Relative TSR (nil vesting as 10th percentile was achieved) and ROIC, which was 100% vested.

Our view is that this mechanism is confusing, it takes a good deal of effort for a shareholder to understand the workings of this and that the hurdles are not sufficient hurdles given the quantum of remuneration involved, the level of ramping up of remuneration from the 150% in the table above and the interaction of the option grants, discussed further below.

Average ROIC

ROIC is calculated as:

> "tax effected (using the effective tax rate and adjusted for the tax benefit of goodwill amortisation) EBIT (pre-AASB 16), less minority interests, divided by invested capital. Invested capital is measured as total pre-AASB 16 equity (excluding minority interests) plus net interest bearing debt (excluding lease liabilities under AASB 16). Invested capital is the average of the opening and closing position"

While this is presented in the annual report, an individual shareholder has no access to the adjusted information required to complete this calculation and little hope of replicating it in any way.

The average ROIC vests according to the table below:

Average ROIC over 3 years	% vesting
< Target	0%
Target	40%
Target to 110% target	Pro-rata 40% to 100%
>110% of target	100%

The Board sets an average ROIC target for each year and publishes it in that year's annual report. A shareholder therefore needs to review three annual reports to determine the target for any given vesting year. The target for 2024 was set at 9%, which seems soft based on the outcomes over recent years in the table below, the fact that the last two years have shown notable poor performance and the fact that Total average ROIC for the 1/7/21 to 30/6/24 period came in at 115.2% of target.

Statistics					
Diluted earnings per share (cents)[5]	107.2	145.0	302.5	273.1	110.6
Dividends declared per ordinary share (cents)[2]	106.0	104.0	100.0	91.0	85.0
Dividend payout ratio[2]	99.4%	71.7%	32.5%	33.1%	76.7%
Gearing ratio[3]	22.3%	9.9%	9.7%	12.5%	26.1%
Interest cover (times)[3]	12.0	29.4	47.3	33.8	11.5
Debt cover (times)[3]	1.9	0.6	0.3	0.4	1.8
Net tangible asset backing per share ($)	(2.19)	0.28	0.14	(0.44)	(2.72)
Return (after tax) on invested capital (ROIC)[4,5]	6.5%	8.8%	19.7%	18.7%	8.5%
Return (after tax) on equity[5]	6.4%	8.9%	21.0%	21.6%	9.5%

[1] Net interest bearing debt excludes lease liabilities under AASB 16.
[2] Dividends declared and payout ratio relate to the dividends declared out of the profits for the relevant year, rather than when the dividend is paid.
[3] Calculated using debt facility covenant definitions, which exclude AASB 16.
[4] ROIC is calculated as tax effected (using the effective tax rate and adjusted for the tax benefit of goodwill amortisation) EBIT (pre-AASB 16), less minority interests, divided by invested capital. Invested capital is measured as total pre-AASB 16 equity (excluding minority interests) plus net interest bearing debt (excluding lease liabilities under AASB 16). Invested capital is the average of the opening and closing position.
[5] 2024 includes a non-recurring gain relating to the sale of West division in USA.

Options and fair value

We discussed the use of options in the remuneration framework with the Company.

Our view is that it makes it difficult for owners (shareholders) to determine how much executives are really being paid due to complexity of understanding the scheme and that the options ramp up the remuneration in a way that means that the remuneration being granted under the LTI is generally not what shareholders believe it to be.

The company's response was that they think their level of disclosure is reasonable, that they get varying feedback from proxy holders and fund managers about the clarity and working of the plan, that the Board and management like the additional incentivisation of the options in the rem plan and that shareholders not being able to comprehend the remuneration plan should not be a criterion for changing what they consider to be a good plan.

So, let's consider an example how this part of the remuneration plan works and how it looks when put next to the performance rights part. Data for these calculations comes from page 48 of the annual report.

Target LTI for FY24 is stated as 128% of fixed remuneration. This equates to $3.068m. There are two separate places in the annual report identifying LTI for FY24. Page 48: $2,012,401 and Page 46: $2,285,975 (value of rights and options issued under the LTI).

This resulted in 313113 options and 69913 rights being issued.

The rights were issued using a 5-day VWAP of $17.81. The rights calculation should be (using the page 48 figure)

($2,012,401 x 50%)/$17.81 = 56,496

The performance rights actually issued were 69,913, which relates to a third LTI value of $2.490m. We have no idea why the difference.

Each right translates directly into a share, so at 30/6/24 (share price of $26.30) are worth a face value of 69,913 x 26.3 = $1.8m.

The options, on the other hand are priced using a Black Scholes methodology that takes into a range of factors including market volatility, interest rates, time to exercise and the difference between the share price and the exercise price. The calculation is:

($2,012,401 x 50%)/$3.03 = 332,079

$3.03 is the fair value option price reported in the annual report, and the actual number issued was 313,113. Again, we are not sure why the calculation does not match that reported.

The exercise price for these options is $28.89 and these options, should they vest, can be exercised for one share each. They expire on 29 November 2028.

This means that if the share price were to be above $28.89 after vesting (29/11/26) and before expiry, which is pretty likely, the CEO would be able to pay the option premium and acquire 313,113 shares. The value to the CEO would be the difference between the share price at the time and the exercise price multiplied by the number of options. Using the 52-week high ($32.57) as a yardstick. These would be worth:

313,113 x (32.57-28.89) = $1.152m.

Any share price increases above the yardstick in the next four years would increase the value of this holding by $313,113 for each $1 increase in share price. It is this potential for ramping up the remuneration outcome and the difficulty of shareholders understanding how this works that ASA does not like about this aspect of the remuneration.

CEO actual remuneration calculation for FY24

	$m
Fixed incl super and LSL	2.436
STI	0.440
LTI vested rights 39,409 x 26.3 (price at end FY24)	1.036
LTI vested options 248,622 at an exercise price of 38.9 until 29/11/28. The exercise price would be payable to convert but the underlying shares are worth 26.3 at end FY24	0 to ?
Total	3.912 to ?

To our point re complexity: it is very difficult to figure out what the actual remuneration is during the year given the probabilistic nature of the value of the options and the payment of the exercise price by the holder if exercised.

To our point on disclosure: we had to look up the Appendix 3Y announcements "Change of Director's Interest Notice," on the ASX to verify we had the numbers correct.