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"Clear SkinCare" to the rescue

Company/ASX Code	Australian Pharmaceutical Industries/API
AGM date	Wednesday 22 January 2020
Time and location	2:00pm Four Seasons Hotel, 199 George St, Sydney
Registry	Boardroom Pty Ltd
Webcast	No
Poll or show of hands	Poll on all items
Monitor	Stewart Burn assisted by Mike Robey
Pre AGM Meeting?	Yes with Chair Mark Smith, 2 directors and the company secretary

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

Summary of ASA Position

API is one of two major distributors to pharmacies of pharmaceutical, medical, health, beauty and lifestyle products in Australia. It purchases and sells various health, beauty and lifestyle products within the retail industry and also provides retail services to pharmacies. It is predominately an Australian business with a small New Zealand operation. Priceline and Soul Pattinson are the two well-known company brands, with an emerging interest in the area of skin care.

Company performance for the year ended 31 August 2019 was slightly ahead of the previous year. Revenue was up 3.3%, net profit after tax (NPAT) rose a whopping 17.4% to $56.6m, earnings per Share (EPS) increased significantly 9.7 cents to 11.2 cents while dividends increased from 7.5 cents to 7.75 cents (up 3%). Net debt has increased significantly to $199m with the investment in Sigma Healthcare ($85.9m) and the investment of $35.7m in "Clear Skincare" network of clinics.

The number of Priceline Pharmacy stores increased by 13 to 488. Pharmaceutical Distribution and Supply made a decreased contribution from previous years being down 1.8%. At our pre-AGM meeting, we asked the directors about potential issues associated with structural changes to the PBS in the coming three years, however they appear confident that the situation will not change significantly from that at present. The Sister Club Loyalty program has a large number of members and marketing to these members is now achieved via the website and social media. The company is very happy with the growth in membership and analysis shows that in store spend by Sister Club members is significantly above the norm (34%).

The bid for control of Sigma appears to have been opportunistic and API have now completely exited their holding, which at year end amounted to 12.95% of the Sigma shares on issue. The board sees "Clear Skincare" as the major growth opportunity for the company, with revenues now at $45.6M up from $2.9M in 2018. At year end there are 52 "Clear Skincare" clinics in Australia/NZ up from 44 at 31 August 2018.

Summary

(As at FYE)	**2019**	**2018**	**2017**	**2016**	**2015**
NPAT ($m)	56.6	48.2	52.4	51.7	43.1
UPAT ($m)	55.1	48.05	54.2	51.4	43.6
Share price ($)	1.32	1.85	1.47	1.77	1.62
Dividend (cents)	7.75	7.5	7.0	6.0	4.5
TSR (%)	(28.6)	25.9	(15.8)	9.9	168
EPS (cents)	11.2	9.8	10.7	10.6	8.8
CEO total remuneration, actual ($m)	1.119	1.044	1.091	1.41	1.455

For the 2019, the CEO's total actual remuneration was **12.7 times** the Australian Full time Adult Average Weekly Total Earnings (based on May 2019 data from the Australian Bureau of Statistics).

Item 2	**Re-election of Mr Kenneth Gunderson-Briggs as a Director**
ASA Vote	**For**

Summary of ASA Position

Mr Gunderson-Briggs was appointed as an independent director in 2014 and is chairman of the "Audit and Risk" committee. He also serves on the board of Harvey Norman with whom the ASA has had some transparency issues. Mr Gunderson-Briggs is a chartered accountant and appears to have a skill set that adds value to the board, he does have a shareholding in API, but at a level lower than that recommended by the ASA. This is also the case with regards to his holding in Harvey Norman. We discussed this with the directors at the pre-AGM meeting, and they agreed to raise the issue with Mr Gunderson-Briggs, we will keep a watching brief on this for 2020. We requested that Mr Gunderson-Briggs give a presentation on the value he brings to the board at the AGM. The chairman stated that this is standard practice for API.

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

Summary of ASA Position

The company tightly manages remuneration and both non-executive director (NED) and key management personnel (KMP) rewards are at the lower end of comparable companies. The KMP short-term incentive Plan (STIP) is based on a STIP pool which is calculated as a percentage of target earnings before interest and tax (EBIT). It is a requirement that company performance must pass an acceptable minimum gateway of net profit after tax (NPAT) before any payment is earned.

The minimum STIP pool is established if 90% of the group performance gateway is met and the maximum STIP opportunity is 110% of fixed remuneration for the CEO and 40% for other KMP. The STIP is paid as 50% cash and 50% performance rights. The number of STIP rights to be issued is calculated by dividing the value of the deferred component of the award by the VWAP of shares over the 10 days following the announcement of final results. For 2019 no STIP awards were granted.

The long-term incentive plan (LTIP) is for three years with no re-testing. Market value is used to determine how many rights are to be issued using the same approach as for the STIP. The LTIP uses both return on equity (ROE) (50%) and EPS growth (50%) in its calculation. The LTIP provides for performance rights equivalent in value to 60% of fixed remuneration for the CEO and 30% for KMP. Only 31.84% of the rights ending in 2019 were vested because the aggregate ROE was only 29.45%, whilst the EPS compound annual growth rate (CAGR) was 3.04% resulting in 0% of his tranche vesting from this component.

The actual remuneration is included in the report, but the table is difficult to understand, and the company has been asked again to provide better detail in 2019. No policy is in place requiring directors and KMP to hold a minimum level of shares, although the company does encourage this. However, MOST directors either meet ASA guidelines and the ASA will continue to raise this with the board and ask that such a policy be implemented.

The total shareholder return (TSR) for the year has declined due to a falling share price and continues to fluctuate over a longer period, but shareholder returns in the form of dividends has continued to increase. With the expansion of “Clear Skincare” the board anticipates that TSR will increase as the added value to the company is recognised.

CEO rem. framework	Target* $m	% of Total	Max. Opportunity $m	% of Total
Fixed Remuneration	1.093	97.6%	1.093	52%
STI - Cash	0	0%	0.178	8%
STI - Equity	0	0%	0.178	8%
LTI	0.027	2.4%	0.657	32%
Total	1.119	100.0%	2.106	100%

The amounts in the table above are the statutory 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.

Item 5	Approval of LTI grant to CEO/Managing Director - Mr Vincent
ASA Vote	For

Summary of ASA Position

It is intended to grant Mr Vincent 495,711 performance rights as part of his long-term Incentive plan. This represents 60% of Mr Vincent's fixed remuneration calculated using the 10-day volume weighted average price at announcement of the 2019 full year results. The rights are subjected to a 3-year performance period and will vest on 31 of August 2022. At the pre-AGM meeting we raised our preference for a 4 or 5-year performance period with directors, and they stated that they will consider this in the future. Half of the performance rights are subject to a ROE hurdle and the other half to EPS performance. We discussed ASA's preferred position of including TSR as a component in calculating LTI's and the board will consider this in the future.

For the ROE component of the rights, for any rights to be granted a ROE of not less than 26.48% over the period must be achieved with 100% being granted if a ROE of 43.03% is achieved. For the EPS rights the performance condition requires a CAGR of 3.65% over the three years for any reward and a 5.92% rate to earn 100%. We note that the performance requirements have been reduced to those from previous years and those detailed in the annual report. But considering the level of competition in the industry and the low level of granting in 2019 we believe the conditions to be reasonable at this stage.

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