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Acquisition & possible takeover to drive future growth

Company/ASX Code	Australian Pharmaceutical Industries Limited (API)
AGM date	Wednesday 23 January 2019
Time and location	2.00pm Rydges Parramatta Hotel, 116-118 James Ruse Drive, Rosehill, NSW
Registry	Boardroom Pty Limited
Webcast	Yes
Poll or show of hands	Poll
Monitor	Ian Curry
Pre-AGM Meeting?	Yes with Chair Mark Smith & Company Secretary Peter Sanguinetti

Item 1	**Financial Statements 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-know company brands.

Financial Performance

Net profit after tax (NPAT) was down 8% to $48.2m while underlying NPAT was flat at $54.7m. Business acquisition and restructuring costs explain the difference between the two numbers. Dividend increased from 7.0 cents to 7.5 cents a share, a 77% payout ratio. Debt was reduced by $55.9m. An interest bearing loan of $65m was negotiated to fund the acquisition of Clear Skincare. ASA will ask that a five-year financial history is included in the Annual Report, as well as advice that compliance with ASX Corporate Governance Principles, particularly a skills matrix for directors, can be found on their website.

Key Events

The acquisition of 42 (Australia) and 2 (NZ) Clear Skincare clinics is a transformative move into a complementary service and product sector. Clear Skincare is a leading provider of non-invasive services such as cosmetic injectables (eg wrinkle fillers), laser hair removal, skin treatments and an exclusive skin care product range. None of these services are subject to Government funding or influence. The acquisition cost of $127.4m will be paid over three years with the first payment of $49.650m for a 50.2% interest in July 2018 and two further payments of $32.9m in 2020 and 2021.

Other minor costs are incurred. There may be further cash required of up to $20m if certain performance hurdles are met.

In December 2018 the company announced a takeover offer for 100% of Sigma Healthcare (SIG), a listed company, by means of a Scheme of Arrangement. The terms of the offer are 0.31 shares in API and $0.23 cents for each Sigma share. The offer will be subject to regulatory approval and shareholder voting. It is not expected that any conclusion will be reached before the middle of 2019.

Key Board Changes

Mr Mark Smith succeeded Mr Peter Robinson in the role of Chair on 24 January 2018, following the retirement of Mr Robinson.

Summary

(As at FYE)	**2018**	**2017**	**2016**	**2015**
NPAT ($m)	48.2	52.4	51.7	43.1
UPAT ($m)	54.7	54.2	51.4	43.6
Share price ($)	1.85	1.47	1.77	1.62
Dividend (cents)	7.5	7.0	6.0	4.5
TSR (%)	25	(15.8)	9.9	168
EPS (cents)	9.8	10.7	10.6	8.8
CEO total remuneration, actual ($m)	1.491	1.091*	1.410	1.455

*New CEO

For the 2018 financial year, the CEO's total actual remuneration was **17.4 times** the Australian Full Time Adult Average Weekly Total Earnings of $85,831.

Item 2	**Adoption of the Remuneration Report**
ASA Vote	**For**

Summary of ASA Position

The company tightly manages remuneration and both non-executive directors (NED) and key management personnel (KMP) rewards are at the lower end of comparable companies. There have been no changes to remuneration in 2018. 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 NPAT before any payment is earned.

Performance conditions set by the board are 80% related to NPAT and 20% on other financial and non-financial measures. These may include EBIT, return on capital employed (ROCE) and individual measures. The maximum STIP opportunity is 100% of fixed remuneration for the CEO and 40% for other KMP. Target is 65% and 20% respectively. 50% of any reward is paid in cash and 50% in deferred rights. The number of STIP rights to be issued is calculated by dividing the value of the deferred component of the award by the volume weighted average price (VWAP) of shares over the 10 days following the announcement of final results. For 2018 no STIP awards were granted. (2017 Nil)

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. For 50% of rights to be granted, a target measure of three years earnings per share (EPS) compound annual growth (CAGR) is used. 50% of the rights are based on a return on equity (ROE) measure. The LTIP provides for performance rights equivalent in value to 60% of fixed remuneration for the CEO and 30% for KMP. 17.2% of the 2015 rights vested in 2018. For any rights that vest the dividends which would have attached to them over three years are paid in cash.

ASA is pleased that finally the company has provided a table of actual remuneration. There is still no policy requiring minimum shareholdings for directors and KMP although ASA guidelines are met or being worked towards.

Mr Robinson received a retirement benefit of $220,000 on his retirement in addition to superannuation. This benefit now only applies to Mr Millner.

Total shareholder return (TSR) for the year increased by 25% following an increase in the dividend and a higher closing share price. The report is easy to understand.

Item 3	**Election of Director Mr Robert Millner**
ASA Vote	**Against**

Summary of ASA Position

Mr Millner is an experienced company director appointed to the Board in 2000. He is not regarded as independent by the company or ASA given his length of service or association with another listed company having a significant shareholding in API. ASA also regards Mr Millner as having an excessive workload. He chairs five listed companies and is a director of another two giving him a score of 12 using ASA guidelines. This recognition of his ability does not alter the position that challenges in one or more of these companies impinges on his ability to perform his duties elsewhere. He holds 1.755m shares in API.

Item 4	**Grant of Performance Rights To Mr Richard Vincent MD & CEO**
ASA Vote	**For**

Summary of ASA Position

It is intended that Mr Vincent be granted a total of 416,954 performance rights under the Long Term Incentive Plan (LTIP). The number of rights to be granted was derived by calculating a value representing 60% of Mr Vincent's fixed remuneration and dividing that value by the 10 day VWAP of API shares immediately after the announcement of 2018 results which was $1.58. Half the performance rights are subject to a Return on Equity (ROE) condition and half subject to an Earnings per Share (EPS) condition. For any rights to be granted under the ROE condition a return of 32.96% must be achieved over the three years of the performance period. 100% can be achieved if the return is greater than 53.56%. The EPS CAGR required for any reward is 7.5% and at 100% it is 10% over the three years. These are challenging targets which will be influenced by the Clear Skincare acquisition and possibly the Sigma Healthcare takeover if it eventuates. Re-calculation of these numbers may be required. The terms for this grant of rights under the LTIP are consistent with the detail of the remuneration report.