Australian Shareholders' Association

Australian Shareholders' Association Limited
ABN 40 000 625 669
Suite 11, Level 22
227 Elizabeth Street, Sydney NSW 2000
PO Box A398, Sydney South NSW 1235
t (02) 9252 4244 | f (02) 9071 9877
e share@asa.asn.au

Calendar Year 2019: An Annus Horribilis Year

Company/ASX Code	Costa Group Holdings
AGM date	29 May 2020
Time and location	11.00am on-line at: agmlive.link/cgc20
Registry	Link Market Services
Webcast	No
Poll or show of hands	Poll on all items
Monitor	Henry Stephens and Mike Robey
Pre AGM Meeting?	Yes with the Chair, Neil Chatfield

The individuals (or their associates) involved in the preparation of this voting intention do not have a shareholding in this company.

Item 1	**Consideration of Reports**
ASA Vote	No vote required

<u>Financial performance</u>

2019 has been an exceptionally difficult year for Costa Group due to the drought, forest fires and numerous operational issues discussed below. The company is reporting earnings on a calendar year for the first time, and for the 12 months to 31 December 2019 net profit after tax and before SGARA and material items (“NPAT-SL”) declined 49.6% to $28.5 million, in line with the earnings update in October 2019. Earnings before interest, tax, depreciation, amortisation, SGARA (a particular accounting standard for agricultural products, self-generating and renewable assets, to deal with assets which increase in value over time) and material items declined 21.5% to $98.3 million on a 5.8% increase in sales revenues to $1.05 billion. The company declared a final dividend of 2 cents fully franked resulting in an annual dividend of 5.5 cents.

The year began poorly with a trading update in January that advised earnings would be significantly lower than the prior comparable six-month period to December 2018 due to subdued demand in the tomato, berry and avocado categories, slower trading conditions and an ‘off year’ citrus crop in which volumes were lower.

At the AGM in May, management forecast a NPAT-SL range of $57 - $66 million which was lower than earlier expectations (as a comparison CY18 NPAT-SL was $56.6 million). The operating environment had deteriorated due to a variety of factors including: 1) the raspberry crop suffered from a condition called “crumbly fruit” that results in low yields and poor quality fruit; 2) fruit fly affected Costa’s citrus crop at Stuart’s Point; 3) in Morocco the blueberry crop season extended later into the season, and as a result, pricing was lower because of competition from Spanish fruit; 4) unseasonably warm weather in May resulted in weaker demand and lower prices for Costa's mushrooms, and 5) the commissioning of the new mushroom facility at Monarto resulted in significant additional costs. Costa's half year results in August revealed that NPAT-SL was at the lower end of the company's guidance and that "forecasting remains challenging with potential further downside risk."

At the end of October the company issued its second Trading Update. CY2019 guidance was further reduced to NPAT-SL of $28 million and $56.6 million for CY2020. In addition, the company announced a fully underwritten renounceable entitlement offer to raise $176 million of equity capital. The reason for the lower earnings forecast was the effect of the multi-year drought on the company's operations and in particular the lower fruit sizing and yield in the citrus, avocados and blueberry categories.

As the year progressed, the impact from the multi-year drought became more pronounced. The hot and dry conditions, particularly in the second half led to smaller fruit and lower yields in the late season citrus, berry and avocado crops; and higher water usage across the citrus farms resulted in increased costs. Demand for mushrooms was subdued resulting in low pricing and blueberry demand was also weaker than expected. Various one off issues such citrus fruit fly and raspberry crumble issue also resulted in additional unplanned costs. Operations in China were very solid with strong demand for blueberries (hectares under production more than doubled to 110ha), particularly the jumbo variety. However, this strong growth was partly offset by the blueberry operations in Morocco due to late harvesting, which resulted in lower prices (down 15%) as the crop competed with peak Spanish production despite a 20% increase in volumes on the prior year.

For the 2020 year, Costa is forecasting the produce categories and the international segment are expected to improve, supported by ongoing investments in the business, operational initiatives and for some categories more normalized market conditions.

Key events

Costa has invested over $400 million in capex and M&A in five expansion programs since the company's IPO. The capital raising mentioned above will strengthen Costa's balance sheet and ensure there is sufficient capital in place to continue the growth strategy in light of the recent trading and market conditions. Of the $176 million raised at $2.20 per share, $66 million came from retail shareholders. This represents a 74% participation rate by retail investors. The balance of the funds raised was institutional money.

Key Board or senior management changes

Early in the year Mr. Kevin Schwartz resigned from the Board and was replaced by Dr. Jane Wilson. Jane is currently a non-executive director of Transurban Ltd and Sonic Healthcare Ltd. She holds a medical degree from the University of Queensland and an MBA from Harvard Business School. She is currently Co-Chair of the Federal Government's Australian Advisory Board on Technology and Healthcare Competitiveness and a director of the General Sir John Monash Foundation.

Frank Costa retired from the Board effective 4 July 2019. He will retain his involvement with the company as an advisor to the Board. Frank spent a lifetime building Costa into a very successful company that is highly respected as a major force in Australia's fresh produce industry.

In December, the company's Chief Financial Officer Linda Kow resigned effective 1 May 2020. Linda has been with the company for almost 10 years and she has played a major role in helping to transform and build the Costa business from family ownership to public ownership.

<u>Summary</u> (Note: Calendar results available for last 2 years only)

(As at CYE)	**2019**	**2018**
NPAT - SL ($m) stat	$(35.4)	$45.0
UPAT after Abnormals ($m)	28.5	56.5
Share price ($)	$3.47	$7.65
Dividend (cents)	5.5	13.5
TSR (%)	(55%)	
EPS (cents)	8.6	16.4
CEO total remuneration, actual ($m)	$1.16	Not available

For CY2019 the CEO's total actual remuneration was **13.2 times** the Australian Full time Adult Average Weekly Total Earnings (based on May 2019 data from the Australian Bureau of Statistics).

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

Summary of ASA Position

The table on the next page shows the target remuneration and the maximum stretch targets the company expects to pay the CEO in the CY2020 year (and it is the same as the CY2019 year).

CEO rem. framework	Target* $	% of Total	Max. Opportunity $m	% of Total
Fixed Remuneration	$1,022,000	55.6	$1,022,000	48.8
STI - Cash	308,133	16.8	479,318	22.9
STI - Equity	151,767	8.3	236,082	11.3
LTI options*	357,700	19.4	357,700	17.1
Total	$1,839,600	100.0	$2,095,100	100

*An option scheme where the upside is unbounded

The remuneration package for the CEO, CFO and the COO (Key Management Personnel or "KMP") includes a combination of fixed remuneration, short term incentives and long-term incentives in the form of options over shares. For 2019, the CEO's fixed remuneration was 49% of his total package and the balance was "at risk" remuneration (i.e. including STI and LTI).

The 2019 STI plan covered an 18 month period ending the 29th of December 2019 (which reflects the company's new calendar year reporting period). At the end of the 18 month period, the KMP's had not met their STI performance hurdles which were based on meeting certain statutory EBIT hurdles (as disclosed in the Annual Report on page 31). As the KMP's achieved less than 90% of budgeted group EBIT for the period (EBIT actually declined 41% to $51 million), no STI payments were made and the CEO's mix of fixed versus variable at risk remuneration increased to 90% for 2019.

The CY2019 LTI Plan that governs the LTI options issued during CY2019 is designed to reward the KMP and selected senior executives for long term performance and long term value creation for shareholders. The LTI is an options based scheme based on a certain percentage of an executive's total fixed remuneration, which is 35% for the CEO and CFO, and 30% for the COO (for a full explanation see page 32 of the Annual Report). The number of options granted is determined by an independent external valuer (Ernst & Young). The exercise price of the options is $7.42 per share and the performance period is over three years from 31 December 2018. 75% of the options granted are subject to a performance hurdle based on the company's Earnings per Share compound annual growth rate ("CAGR") over the performance period. The table from the Annual Report shows that if CAGR is at or above 22% per year then 100% of options will vest. Likewise, if the company's CAGR is less than 18% then no options will vest.

The balance of the options (25%) are subject to a performance hurdle based on geographic and category diversification and growth designed to support sustainable long term value creation linked to return on capital. The number of options that vest is determined by the Board (with the Managing Director not voting) based on an assessment of the Company's performance during the Performance Period against the growth and diversification targets set by the Board. Costa Group considers the performance targets for this hurdle to be commercially sensitive, and as a result the Company will not reveal this information until the end of the performance period as it may be prejudicial to the interests of Company.

The performance period for the FY2017 LTI Plan ended on 30 June 2019. 75% of the options issued under the plan were subject to a performance hurdle based on an EPS CAGR of a minimum of 8%. Since the company did not meet this hurdle, these options lapsed. 25% of the options issued under the FY2017 Plan were subject to a performance hurdle based on the company's geographic and category diversification and growth designed to create long term value creation. The Board determined that 80% of these options would vest because the China berry business was highly successful with a return on investment greater than Costa's after tax target of 15% and growth in the avocado business was also projected to be in excess of the company's target return. The Board deemed that 20% of the options would lapse because of the longer ramp up in timing of the avocado investment returns.

The ASA did not vote for the 2018 Remuneration Report and we will not vote for the 2019 Remuneration Report for the same reasons we explained last year. Our concerns are twofold. First, we do not like the options based nature of the long term incentive scheme. The target LTI is notionally 35% of the CEO's fixed remuneration. This requires the calculation of a fair value in order to determine the number of options granted.. The calculation of the options value is difficult for shareholders to understand, and more importantly, it is completely opaque - Ernst & Young do not provide any information to shareholders on how the options are valued. Options are often used in the early stages of a company existence, prior to it becoming profitable, which does not apply here. We believe that a performance rights structure, as used by the majority of ASX companies, would be more suitable and more understandable by retail shareholders.

Second, under the Costa LTI scheme 75% of the options granted will be subject to a performance hurdle based on the company's earnings per share compound annual growth rate over the performance period (3 years). The ASA strongly prefers a Total Shareholder Return ("TSR") hurdle as the principal measure for executive performance. The TSR hurdle reflects the share price performance of the company plus dividends paid over the performance period which in our opinion ideally should be over a five year period. We would have thought that for an agricultural company, a five year performance period would be much better the current three years given that company earnings are quite cyclical (for example, the citrus crop yields are typically heavy in one year and weak in the following year).

Item 3	Re-election of Neil Chatfield as a Director
ASA Vote	**For**

Summary of ASA Position

Neil Chatfield has been a director of the company since October 2011 and Chairman since June 2015. He currently serves on Costa's Remuneration and Human Resources Committee and the Nominations Committee.

The ASA supports the re-election of Neil Chatfield. We regard him as being a very experienced company director and Chairman of the Board. We note that if he is re-elected for a further three years he will have been a director for a total of 12 years which will mean that the ASA will no longer regard him as being independent. We also note that Neil is a non-executive Chairman of Aristocrat Leisure and a non-executive director of Transurban, two major Australian companies listed on the Australian Stock Exchange. This means that his workload in terms of directorships is now in line with what the ASA regards as the maximum number of board seats (five board seats) he can take on and not over burden himself with work as we regard a Chairman role as being the equivalent of two directorships.

In terms of Neil's business experience he has very broad experience across a range of companies at a very high level. He was previously executive director and Chief Financial Officer of Toll Holdings from 1997 to 2008. In addition, he has been Chairman and non-executive director of Seek Ltd, a non-executive director of Iron Mountain Inc, Recall Holdings Ltd and Chairman and non-executive director of Virgin Australia Holdings.

The Costa Board has six members of which five are independent and two are women (equivalent to 33% of the Board) so the Costa Board complies with the ASA's best practise governance guidelines. Neil has attended all the Board meetings except for one. The ASA strongly supports his re-election, but due to his length of service, expect him to stand down from the Board at the completion of this three year term

Item 4	Managing Director's Calendar Year 2020 STI Performance Rights
ASA Vote	**For**

Summary of ASA Position

The CEO is entitled to an STI award equal to 45% of his total fixed remuneration ("TFR") with a stretch target equal to 70% of his TFR. The cash amounts are $459,900 with a maximum of $715,400 if stretch targets are achieved. Two thirds of the award is to be paid in cash following the end of the performance year and the balance will be deferred for 12 months in the form of performance rights. Each performance right is a right to receive an ordinary share in the company upon vesting (on 1 March 2022) plus a cash payment equal to any dividends paid by the company. The exact amount of the payment is dependent on whether the CEO meets certain financial and individual targets set by the company. Financial measures are EBIT and cashflow generation. The individual measures relate to key business drivers which will be set by the Board and may include measures related to safety, quality, people, risk management and execution of key projects. The specific EBIT hurdle target and individual targets set by the Board are not disclosed in the Notice of Meeting (although they should be disclosed in the 2020 Remuneration Report). The ASA supports the granting of STI performance rights to the Managing Director although we would prefer the incentive structure to comprise a maximum of 50% of the STI being paid in cash and 50% deferred for 12 months.

Item 5	**Managing Director's Calendar Year 2020 LTI Options**
ASA Vote	**For**

Summary of ASA Position

Under the CY2020 LTI scheme, the CEO is entitled to receive 35% of his TFR ($357,700) in the form of options that are convertible into shares in the company. The options are independently valued by Ernst & Young, and are valued at $0.96 per option, which means that the CEO is entitled to 372,604 options. The number of options that vest at the end of the three year performance period (ending 31 December 2022) will depend on whether the company meets the performance hurdles set by the Board. There are two performance hurdles, namely an **earnings per share** ("EPS") hurdle and a **strategic growth** hurdle that drives sustainable long term value creation. The exercise price of the options is $2.44 per option. Vesting of 75% of the options is subject to an EPS performance hurdle over the performance period. The EPS performance hurdle is not disclosed because the Company regards such information as being commercially sensitive although it will be disclosed in the Remuneration Report when the options are tested (i.e. in three years' time). Vesting of 25% of the LTI options is subject to a performance hurdle based on certain geographic and category diversification criteria.

We have voted against the Remuneration Report because we do not like the use of options (especially for an agricultural company) and we prefer a TSR measure, but we will vote for the 2020 LTI scheme for the Managing Director because we want to support him in these very difficult times and we recognise that he is doing an outstanding job in spite of all the terrible events that Mother Nature has thrown at the Company over the last year!

Item 6	**Amendment To The Constitution**
ASA Vote	**For**

Summary of ASA Position

The ASA does not see any reason to oppose the proposed amendments to the constitution. The changes are being made to give the Company greater flexibility to adapt its general meeting procedures to respond to unexpected events such as Covid-19 and to clean up some legacy issues to do with Frank Costa's original shareholding.

ASA Disclaimer

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