## Buonasera SRX!

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| **Company/ASX Code** | **Iluka Resources Ltd - ASX: ILU** |
| **AGM date** | **10 May 2023** |
| **Time and location** | 9.30 am, Karri Room, Parmelia Hotel, Mill Street, Perth |
| **Registry** | Computershare |
| **Type of meeting** | Hybrid meeting (https://meetingnow.global/M4RTYQU) |
| **Poll or show of hands** | Poll on all items |
| **Monitor** | John Campbell assisted by Leanne Harrison |
| **Pre AGM Meeting?** | Yes with chair Rob Cole & People & Performance Committee chair Andrea Sutton |

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

**Summary of issues for meeting**

Iluka has had a stellar year with good prices for its zircon and rutile products used in the production of ceramics, pigment for paints and other industrial uses. It also demerged its often-loss-making former subsidiary, Sierra Rutile Ltd (ASX: SRX), an action which the ASA had been promoting for several years. In addition, Iluka announced in advance of its 2022 AGM that it had committed to build a Rare Earth (RE) Refinery at Eneabba, obtaining a $1.25bn non-recourse loan from Export Finance Australia (a government agency) for its construction. Iluka will contribute $200 million and the company's large stockpile of rare earths containing neodymium, praseodymium, dysprosium and terbium, the elements for high-performance magnets needed particularly for electric vehicles and wind-turbines.

A critical question is whether the estimate made of the total project cost of $1.2bn for the RE Refinery remains materially accurate on current information. We will ask about this at the meeting, but, overall, we will congratulate board and management on a successful year.

The company's Capel synthetic rutile production facility is covered under the Australian Government's Safeguard Mechanism scheme, being one of the 215 largest emitters and will be subject to legislated reductions in $CO^2$ emissions. We have been told that Iluka cannot reduce its level of emissions under current technology because coal is necessary as a reductant in the processing of ilmenite to synthetic rutile. The Federal Government recently struck a climate deal with the Greens which will force these 215 big-emitters to reduce emissions by nearly 5% each year out to 2030, prompting warnings that the scheme could force companies to spend billions on offsets and low-emissions technologies. It is probably too early to expect a detailed response but we will ask what implications this has for Iluka in reducing output or acquiring carbon offsets.

**Proposed Voting Summary**

| No. | Resolution description | |
|---|---|---|
| 1 | Re-election of Ms Susie Corlett as a director | For |
| 2 | Re-election of Ms Lynne Saint as a director | For |
| 3 | Adoption of Remuneration Report | For |
| 4 | Approval of 2022 equity grant to Managing Director Tom O'Leary | For |
| 5 | Approval of 2023 equity grant to Managing Director Tom O'Leary | For |

## Governance and culture

The company has a small board with a good cross-section of skills and 50% female membership. We have no criticisms except that the annual report is light on environmental impacts and plans to achieve carbon neutrality. There is a volume of details in the sustainability databook but we think that should be better summarised and commented upon in the annual report itself. We would like to see more detail on the company's rehabilitation obligations and its plans to discharge them. The company did not engage its auditors to provide assurance on its sustainability reporting.

## Financial performance

Better average prices achieved for products resulted in a 45% improvement in earnings before interest, tax, depreciation and amortisation (EBITDA) and a 61% improvement in net profit after tax (NPAT). The average revenue per tonne of product sold increased 39% in 2022 whereas costs increased only 13%. Prices have been maintained into 2023. Basic earnings per share were 139.3c in 2022, compared to 86.7c in 2021, a 61% improvement. In addition to a 2022 interim dividend of 25cps and a 2022 final dividend of 20cps, shareholders also received a demerger dividend in the form of a 1 for 1 issue of Sierra Rutile Ltd (SRX) shares for each ILU share held. After initial listing at 43c, the shares in SRX traded at around 30c for some weeks after listing, before declining to their current price of around 23.5c at the time of writing.

## Key events

As mentioned above, the key events in 2022 have been the decision to go ahead with the RE Refinery at a projected cost of $1.2bn and the demerger of Sierra Rutile Ltd.

**Key Board and senior management changes**

In March 2022, Andrea Sutton was appointed a non-executive director and after the AGM took over as chair of the People and Performance Committee in place of Rob Cole. In April 2022, the former chairman, Greg Martin, retired from the board and Rob Cole took over as chairman. Greg Martin remained as chairman of Sierra Rutile after its demerger. There were no other changes to the Board. There were no changes to executive KMP during the year, but Kerrie Matthews was appointed to the executive as Project Director for the RE Refinery Project and subsequent to balance date, Colin Nexhip has been appointed chief technology officer.

**Summary**

| (As at FYE) | **2022** | **2021** | **2020** | **2019** | **2018** |
|---|---|---|---|---|---|
| NPAT ($m) | 589 | 366 | 2410 | (276) | 304 |
| UPAT ($m) | 597 | 315 | 151 | 279 | 301 |
| Share price ($) | 9.53 | 10.10 | 6.46 | 9.30 | 7.62 |
| Cash dividend (cents) | 37 | 14 | 2 | 13 | 29 |
| Simple TSR (%) see below | -9.7 | 58 | 34.1 | -15.8 | -22 |
| EPS (cents) | 139.3 | 86.7 | 24.5 | -71 | 72.2 |
| CEO total remuneration, actual ($m) | 3.760 | 4.515 | 4.280 | 2.644 | 3.386 |

For 2022, the CEO's total realised remuneration was 40 times the Australian average full time adult weekly total earnings ($94,000.40 per annum in November 2022).

Simple TSR is calculated by dividing the change in share price plus dividend paid during the year, excluding franking by the share price at the start of the year. This ignores the demerger dividend of 1 Sierra Rutile share additional to the cash dividends shown above. Sierra Rutile shares (ASX: SRX) traded at about 30c per share for a period of in excess of a month after initial listing so if this was used to calculate total shareholder return, the return would have been 5.7%. The price of SRX shares at the time of writing is 23.5c per share. Whilst the price of Iluka shares declined from $10.10 to $9.53 during 2022, the ASX all ordinaries also recorded a 7.1% decline for the calendar year so, taking into account the demerger dividend, the total shareholder return has been better than the AOX index and was at least marginally positive.

**Re-election of directors**

Two directors are standing for re-election, Ms Susie Corlett (appointed June 2019) and Ms Lynne Saint (appointed October 2019). Ms Corlett is a geologist by training with 25 years' experience in mining and related finance and investment. She is well qualified and is a director of Aurelia Metals Ltd and Mineral Resources Ltd so is not over-committed. Ms Saint has an auditing background and was CFO of the Bechtel Mining & Metals Group for a period. She is also well qualified and she is a director of Nufarm Ltd and Ventia Services Group and is similarly not over-committed. We will support the re-election of these two directors.

The board has three male members and three female members, 5 independent directors and a single non-independent director (the managing director), and has an appropriate balance of skills supported by an executive team with wide-ranging skills. All directors have met the normal standard of 'skin in the game'.

**Adoption of Remuneration Report and approval of equity grants to the Managing Director**

The remuneration structure is well described in the Remuneration Report and is not dissimilar to many other companies. Disclosure is made of take-home pay – the MD's is shown as $3.76m which includes $771,000 from the vesting of his 2019 long-term incentive performance shares together with $43,000 in accumulated dividends thereon. The 2019 long-term incentive vested in full for all executive key management personnel as the company's total shareholder reward for the four year period to 31 December 2022 of 152% equalled the 72nd percentile of the comparator group of ASX200 Resources companies, which was better than the 100% vesting hurdle of 50th percentile.  The MD's realised pay compares with $3.38m determined under the accounting standard's complex method of determining the value of incentives, and with his 2022 target total remuneration of $3.36m as shown in the table in the appendix at the end of these voting intentions.

As in prior years, and continuing to apply to the changes made to the remuneration plan for 2023, we have two concerns with the plan:

- There is only one hurdle for the long-term incentive performance rights – that is to achieve a level of total shareholder reward comparable to or better than a comparator group of resource companies.  The ASA prefers there be two hurdles, one of which is TSR and the other is an absolute measure such as return on capital or earnings per share.  In Iluka's circumstances of commencing a new and innovative activity in rare earth refining, it would be tough call to expect executives to achieve such a hurdle in the appraisal period.  Iluka is also dependent upon commodity prices in the rutile/ilmenite business which also makes this hurdle difficult to set.
- There is little transparency in terms of the goals set for targets in financial performance hurdles.  Iluka claims this is because of commercial confidentiality and we have no reason to dispute that assertion. We note the reporting of the long term performance rights vesting outcomes against the TSR for the executive incentive plan period shows variability in the award - see p 74 for the annual report.

The company's performance for the year as shown above was good in terms of net profit and earnings per share.  Total shareholder reward was negative on a simple basis but the return on the ASX's all ordinaries index for the calendar year was also negative 7%, and shareholders who sold their SRX shares after the demerger would have made a positive return whilst those who retain the shares would be better than breaking even on current prices.  Taking into account the opportunity that the company has to generate significant returns in future from its rare earth refinery and management's achievement in arranging the financing of its construction with a government loan, our assessment is that management has earned the remuneration awarded.

Resolution 4 asks shareholders to approve the grant of 142,502 restricted rights and 95,001 performance rights to the MD, Tom O'Leary. This represents the award of $1,487,640 in restricted rights and $991,760 in performance rights (using the average value of Iluka shares $10.43 in March 2023) being in aggregate 84% of the outcome of the 2022 maximum opportunity for Mr O'Leary. The MD's total 2022 remuneration therefore comprises his base pay of $1,400,000 plus the combined incentive above of $2,479,400 to equal $3,879,400.  The restricted rights will vest in 4 equal instalments commencing 2023 and the performance rights will vest to the extent hurdles are passed as at 31 December 2026.

Resolution 5 asks shareholders to approve a further allocation of 160,928 performance rights to Mr O'Leary as a part of his 2023 remuneration package which will vest to the extent hurdles are passed in the four year period to 31 December 2026 (the same appraisal period as for the 2022 performance rights).  Effectively, the company's performance appraisal period under the 2022 remuneration plan was a five year period, commencing on 1 January 2022 and concluding on 31 December 2026 with the number of rights determined at the end of year 1, whereas the 2023 arrangement is to be a 4-year appraisal period ended on the same date.  The effect of the change is to double-up the incentive available in March 2027 when the hurdle for the two years' incentive is determined.

This is not a desirable situation from our perspective as we would prefer to see the rewards to executives flow evenly with shareholder rewards, and it is doubtful that this will occur. However, it will not be easy for executives to maintain shareholder rewards at level commensurate with the comparator group of companies during the period that the rare earth refinery is built and commissioned. There will be extra payroll and other overhead costs and a period during which losses may occur until commercial productivity is achieved.

Further, the five-year appraisal period that has been used to date is longer that most WA-based companies operating in this sector which use a 4-year appraisal period. Whilst the ASA would prefer all companies to adopt a 5-year period, Iluka operates in a competitive environment where it is necessary to remunerate at market rates to attract and retain skilled and experienced executives, particularly when entering a new field of endeavour – ie rare earths. Taken as a whole, we accept the need for change and inevitable consequence of a doubled-up benefit in calendar 2027 for existing executives.

## Appendix 1
## Remuneration framework detail

The 2022 Executive Incentive Plan provided for the managing director to earn benefits to the value of $3.36m at target (240% of base) and $4.34m at maximum (310% of base) from a base pay of $1.4m as shown in the table below.

Non-executive directors' fees were unchanged in 2022 except that members of the Sustainability Committee received a fee additional to base board fees for the first time – the level of this is the same as for the People & Performance (remuneration) Committee. Executive KMP salaries were increased by an average of 15% in March 2022 for the named executives other than the managing director – the increases reflected expanded roles and market rates. The managing director's fixed remuneration remained unchanged.

| MD rem. framework for FY22 | Target $m | % of Total | Max. Opportunity $m | % of Total |
|---|---|---|---|---|
| Fixed remuneration | 1.400 | 41.7% | 1.400 | 32.3 % |
| STI - cash | 0 | 0% | 0 | 0% |
| STI – restricted rights | 1.176 | 35% | 1.764 | 40.6% |
| LTI – performance rights | 0.784 | 23.3% | 1.176 | 27.1% |
| Total | 3.360 | 100.0% | 4.340 | 100% |

Other executive key management personnel had a remuneration structure of a similar nature to the managing director but to a target of 110% and a maximum of 165% of base pay, but including a bonus cash element of up to 12% of base pay (the MD does not get a cash bonus).

The amount of the allocation of restricted and performance rights is based on assessed performance in the 2022 financial year as determined by a scorecard for each executive as commented upon in the voting intentions paragraph on the remuneration report. The company-wide performance achieved was assessed to be 121% of target then further modified by individual performance factors leading to the MD's award being 126.5% of target, and other executive KMP between 117.5% and 126.5% of target.

The incentive element of remuneration is split between restricted rights (to vest in equal instalments over 4 years commencing in 2023 without further testing) and performance rights (to be assessed against a TSR objective of minimum 50% and maximum 75% of a comparator group of companies based on the S&P 200 Resources Index over the 5 years commencing in 2022 and concluding at 31 December 2026). Both types of rights are awarded using average actual share prices to determine the number of rights allotted. They carry dividend rights paid to the extent of and at the time of vesting. The allocation of restricted vs performance rights is as to 60/40 for the managing director and 50/50 for other executive KMP.

The company is changing its Executive Remuneration Plan for 2023. The main changes are:

- the level of performance rights allocated in 2023 will not be based on performance in 2023 as it was in 2022, but will be a pre-determined percentage of base pay, and
- The appraisal period for the performance rights will commence at 1 January 2023 and run for just 4 years to 31 December 2026.

The MD's maximum incentive is set at 120% of base for his short-term incentive and 120% of base for the long-term incentive aggregating 240%, or an increase of 14.3% on the 2022 plan. There is to be no change to the performance hurdles for both short and long-term incentives, or to the manner in which the incentives are determined and realised.