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Coal knocks South32 results

Company/ASX Code	South32 Limited/S32
AGM date	28 October 2021
Time and location	Virtual meeting, 12 noon AWST
Registry	Computershare
Webcast	Yes, accessible via Lumi
Poll or show of hands	Poll on all items
Monitor	John Campbell assisted by Alan Dickson
Pre AGM Meeting?	Yes with Chair Karen Wood and Chair of the Remuneration Committee Wayne Osborn

An associate of an individual involved in the preparation of this voting intention has a shareholding in this company.

Item 1	**Consideration of accounts and reports**
ASA Vote	No vote required – **all amounts in USD unless otherwise stated**

Summary of ASA Position

Financial performance

Being a diversified miner/metal refiner, South32 is a price-taker at the mercy of international commodity prices, exchange rates and international tensions such as those between China and Australia. Most of those factors were kind to South32 in FY21, with prices yielding a $401m increment to underlying EBIT, partially offset by movements in price-linked costs and the strengthening of the currencies of Australia and South Africa, netting to a $143m increment.

(Note: South32 reports in US dollars so all amounts in this section of our voting intentions are stated in that currency unless otherwise indicated.) Better prices for aluminium and base metals (Ag-Zn-Ni) have been sustained since balance date and metallurgical coal prices have risen strongly in recent months. During FY21, South32 increased production of most of its commodities and achieved cost savings in units of production which accounted for a further $353m increment to underlying EBIT. Overall South32 nearly doubled underlying EBIT from $446m in FY20 to $844m in FY21, which resulted in underlying earnings after finance costs and tax of $489m (FY20 $193m).

However, the results were impacted by two significant items

- a decision by the NSW Independent Planning Commission to refuse an application to expand the Dendrobium metallurgical coal mine near Wollongong led South32 to impair the carrying value of its mine property and associated equipment to the extent of $728m pre-tax/$510m after tax, and
- South32 incurred a loss on disposal of its South African Energy Coal (SAEC) operations near Johannesburg of $159m pre-tax; together with operating losses at SAEC for the year of $194m after tax, SAEC cost the group $337m in 'bottom line'.

Together with other adjustments, South32 recorded a loss of $195m compared to FY20's loss of $65m. Cash flow was strong with $1405m generated by operations (FY20 $1365m), reduced by capex and other investing activity $608m (FY20 $873m), but South32 continued its share buy-back programme spending $346m (FY20 $269m) and paid dividends of $115m (FY20 $246m) leaving an increment to net cash of $296m (FY20 decrease $70m). At balance date, South32 had net cash of $406m (FY20 $298m) - its final and special dividend payable in October will cost $257m (FY20 48.5m). No longer burdened by SAEC and with predicted production levels likely to be constant and strong commodity prices continuing into FY22, there is hope for a positive increment to shareholders' funds, but uncertainties with China and Covid have not allowed a profit projection to be given.

South32 is a diversified miner/metal refiner whose assets are spread around the globe – many along the 32nd parallel of latitude – hence its name. The Covid-19 pandemic has been a challenge for everyone around the globe and few more so than for South32 with its dispersed and varied international operations. For companies such as South32, it prevents directors and executives from making site visits ahead of important decisions on the allocation of resources, and virtual media can only compensate to an extent. It stops technical experts in geology, engineering and every aspect of business skills from making visits to sites to prevent or remediate problems. It impedes the normal precautions taken to control risks such as those involving inaccurate or fraudulent accounting although South32 has used IT and local resources to a greater extent in compensation. The pandemic's continued disruption of international travel and commerce threatens the very business model of companies such as South32. The fact that the pandemic has restricted these activities for more than 18 months is a concern.

As in FY20, our main concern remains with the $1,925m Hermosa Project. South32 released a JORC compliant resource for the first time in FY19 for the Taylor deposit at Hermosa which South32 believed provided higher confidence in the measured resource and de-risked early production from the project, albeit at about 17% lower zinc grades than the original Arizona Mining pre-feasibility study. South32 told us in FY19 that a new pre-feasibility study would be completed in FY20 but this has been delayed by Covid-19. During FY21, South32 released resources for the Clark deposit adjacent to the Taylor deposit but, with only 2.3% zinc, we do not see this deposit as being a major factor in the economic viability of Hermosa. The annual report contains very little information about it beyond its segment net assets of $1925m. We look forward to seeing the pre-feasibility study with projections of production costs, mining plans, details of existing infrastructure in its remote location near the Arizona/Mexico border and plans for ore processing and product transport. The delayed pre-feasibility study, now also waiting for a scoping study on the Clark deposit, should overcome our concerns that this project might be a lemon.

Recent civil unrest and its effect on competitor operations highlight the current risks associated with investment in South Africa by Australian listed companies. Our concern remains as to the remaining South African assets, South African manganese and the Hillside aluminium smelter, with reported segment net asset values of $0.9 billion. However, both are export industries which South Africa relies upon to maintain its budget so are better protected than other foreign-owned enterprises.

We are concerned that South32 has declared a final dividend having incurred a loss for the year and without having any net retained profits on consolidation from which to declare it – even the parent entity shows a 'profits reserve' of $1604m whilst also reporting accumulated losses of

$5401m (FY20 $4607m) in Note 30. Whilst paying dividends out of capital used to be prohibited under the Corporations Act, this was removed from the legislation about a decade ago and we are noticing a trend in companies, particularly listed investment companies, to continue to pay dividends whilst incurring losses. Shareholders whose taxable income exceeds their imputation credits are paying tax on these dividends which are to all intents and purposes a return of capital and an implication that the management of the business believes that shareholders can earn a better return on these funds than can be earned from the business.

ESG, governance and culture

Sustainability and conservation of natural and heritage assets are a major focus of community and investor concern in FY21. South32 has a well established risk management framework and uses Global360 software to collect real time data to determine materiality of risk. The data is used to make adjustments to the way twelve identified strategic risks are addressed. South32 has published a sustainability report and databook as separate documents but whilst the annual report contains references to them, we would have preferred to see a short and succinct summary of emissions and waste management results in the divisional reports within the annual report.

The sustainability report discloses that South32 generated 21.6m tonnes of carbon dioxide equivalent emissions from its operations in FY21 comprising those generated from its own operations and from the generation of purchased electricity, whilst its Scope 3 (value chain) emissions total 106m tonnes CO_2-equivalent, making it a sizeable contributor to global totals. This would have been reduced to 61m tonnes if disposed operations were excluded. We see a shortcoming in that the company's Sustainability Report does not address emissions on a divisional basis with the short and longer-term targets for each division and progress towards meeting them. As a further comment on what the already long annual report does NOT contain, we would like to see a five year financial summary, comprehensively covering all financial and remuneration measures.

The board is chaired by Karen Wood, who succeeded David Crawford in 2019. She is an independent non-executive director with a long history of employment with BHP. Karen retired from BHP in 2014 and joined the board of South32 in November 2017. There are 6 other independent non-executive directors and a single non-independent director, the CEO, Graham Kerr. All directors have significant skin-in-the-game.

Key events such as restructures, acquisitions, buy backs and capital raisings

Apart from finalising the disposal of SAEC in June 2021, the only other corporate event of note was the sale of the Temco manganese alloy smelter in Tasmania, which occurred as at 31 December 2020 – profit or loss on sale has not been disclosed. South32 has more than 20 greenfield exploration projects targeting base metals in the Americas and Australia. Apart from Hermosa, probably the most exciting one is the Arctic copper zinc deposit being explored by the Trilogy joint venture with Ambler Metals, which has entered into an agreement with an Alaskan government authority to jointly fund development activities including road access.

Key board or senior management changes

There were no changes to the board in FY21 or since. There were a number of changes to the leadership group during FY21 and Jason Economidis was appointed acting Chief Operations Officer Australia from 1 July 2020 to replace Paul Harvey in the list of key management personnel listed in the remuneration report. Subsequent to year-end, the company has announced that its experienced and long-serving chief operating officer-Africa, Mike Fraser, is leaving.

Summary

(As at FYE)	2021	2020	2019	2018	2017
NPAT (USDm)	(195)	(65)	389	1,332	1,231
UPAT (USDm)	489	193	992	1,327	1,146
Share price (AUD)	2.93	2.04	3.18	3.61	2.68
Dividend (US cents)	6.9	3.2	9.6	13.5	10.0
TSR (%)	48.1%	(34.9%)	(7.65%)	41.99%	78.0%
EPS (US cents)	(4.1)	(1.3)	7.7	25.8	23.2
CEO total actual remuneration, (AUDm)	3.600	3.216	13.195	7.839	5.008

For FY21, the CEO's total actual remuneration was **39 times** (FY20 – 36 times) the Australian Full time Adult Average Weekly Total Earnings (based on May 2021 data from the Australian Bureau of Statistics - $93,444 pa).

Item 2	**Re-election of directors:** **2(a) Wayne Osborn** **2(b) Keith Rumble**
ASA Vote	**For**

Summary of ASA Position

Both directors were last elected or re-elected at the October 2019 AGM. Wayne Osborn is an electrical engineer, former CEO of Alcoa in Australia and has served as chair of the remuneration committee since demerger. He has been a non-executive director of Wesfarmers Ltd (retiring at its October AGM) and is located in Perth. Keith Rumble is a geologist, had a 40-year career in the mining industry primarily in southern Africa and was CEO of a number of mining companies. He is the chair of the sustainability committee. Both were appointed directors prior to demerger in 2015 and have adequate skin in the game.

Neither of these directors is over-committed in terms of governance guidelines about the number of directorships which may be held. They bring appropriate skills and experience to the adequately diversified board. We support their re-appointment.

Item 3	**Adoption of Remuneration Report**
ASA Vote	**For**
Currency	**The remuneration report is stated in Australian currency and all amounts below are AUD**

Summary of ASA Position

Whilst long, we commented last year that the remuneration report is to be commended for its clarity and layout, making it comparatively easy for the reader to assess the nature and fairness of the remuneration structure. We commend the provision of information on page 75 of the annual report comparing the CEO's fixed and total remuneration with peer groups. The structure of executive remuneration follows well-established precedent of a fixed salary, short-term incentive split between cash and deferred equity on a 50/50 basis, and a long-term incentive on a 4-year appraisal period.

The following table shows the components of Graham Kerr's (CEO & MD) target remuneration package for FY21:

All amounts are in AUD	Target A$m	% of Total	Max. Opportunity A$m	% of Total
Fixed Remuneration	1.815	29%	1.8150	21%
STI - Cash	1.089	18%	1.6335	19%
STI - Equity	1.089	18%	1.6335	19%
LTI – his FY22 allocation	2.178	35%	3.6300	41%
Total	6.171	100%	8.7120	100%

His remuneration expense calculated under accounting standards for FY21 was A$6.4m, aggregating his fixed salary with his cash STI of A$0.879m and accrued equity (STI and max LTI on the AAS fair value basis) of A$3.544m. His actual pay for FY21 was A$3.600m (FY20 $3.216m), with the main difference being LTI. In FY20, Mr Kerr would have been eligible to benefit from FY17 LTI award of 3.3m shares and, in FY21, his FY18 LTI award of 2.0m shares, but neither of these awards vested due to South32's TSR falling short of the comparator indices.

By contrast, remuneration expense under accounting standards as shown on page 90 of the AR accrues the anticipated cost of the awarded shares for the FY19-FY21 LTI awards of 5.8m shares over the period to their future vesting dates. Against this will have been a credit for previously accrued costs of the FY18 award which lapsed, accounting for the LTI expense of $2.7m (FY20 $3.9m).

Total executive KMP remuneration on the accounting standards basis (ie accruing equity awards at fair value over their duration between grant and vesting) was A$13,635m for FY21 compared to A$13,020m as reported in last year's annual report. A number of changes were made to the remuneration plan for the CEO for FY22 of which the largest is to reduce the multiple for the maximum long-term incentive from 3 times fixed pay to twice fixed pay.

The maximum LTI award followed BHP's remuneration plan in the early years of South32, and we were always concerned with the consequent quantum of maximum earnings; accordingly, we are pleased to see this change take effect. Another change to the LTI was to introduce performance measures for climate change and portfolio management, with each being given a 10% weighting in the total assessment of the incentive. There were consequential adjustments to STI weightings of short-term performance measures.

As regards the overall level of executive pay and the CEO's pay in particular, we recognise that South32 is a global mining company with high risk operations with respect to both employees and neighbouring communities, and with its terms of trade basically out of management's control because of their reliance on commodity prices and currency exchange rates. South32 justifies the level of executive remuneration on the basis of the nature of its business and international competition for executives of their calibre and the disclosed information as to peer group comparison provides support for South32's position.

We have two concerns over the remuneration structure of a relatively minor nature as follows:

- the lack of a second hurdle to TSR in the financial yardsticks for the LTI incentive – we prefer to see a second absolute hurdle such as growth in earnings per share;
- travel allowances paid to non-executive directors which we still view as inappropriate. We are cognisant that both BHP and Rio Tinto have similar methods of compensating their non-executive directors for board travel and that there are significant calls upon their time involved in meeting their obligations. There were no travel allowances paid in FY21 due to covid travel restrictions.

Item 4	**Approval of share rewards for the CEO, Graham Kerr**
ASA Vote	**For**

Summary of ASA Position

The resolution seeks to approve the grant to Graham Kerr of 1,267,015 (last year - 2,695,544) share rights which had a face value on 1 July 2021 of A$3.63m (last year - A$5.445m), being his maximum opportunity for long-term incentive, together with share rights with a face value of A$0.879m (FY20 - A$0.689882m) for the equity component of his FY21 short term incentive. The STI share rights will be granted as determined by the average face value of South32 shares for the relevant period in December 2021 if approved by shareholders. The maximum value of the current year LTI award of $3.63m is reduced from the maximum opportunity under last year's LTI arrangements ($5.445m) to reflect changes in peer group remuneration arrangements and to better align with South32's strategies in moving to a low carbon future. The awards are in accordance with the remuneration structure set out in the remuneration report and commented upon by us in these voting intentions.

Item 5	**Approval of termination benefits**
ASA Vote	**Against**

Summary of ASA Position

The Corporations Act places a limit of 12 month's fixed pay on termination unless otherwise approved by shareholders. ASA opposes pre-approval of termination benefits which exceed 12 months' fixed pay except where payment of vested STI or LTI awards are likely to push a termination payment in excess of the 12 month limit. The approval sought is generalised and not restricted to the vesting of incentives or to particular employment conditions applicable to death or disablement of an executive. New contracts should not contemplate such pay outs in excess of 12 months' fixed pay, and specific (not generalised) approval should be sought before the event if such payments are considered necessary. If boards are concerned a termination payment will not be approved by shareholders, they will be less likely to approve them in the first place.

Item 6	**Resolutions requisitioned by shareholders:** **6(a) Amendments to constitution to allow shareholders to make resolutions expressing an opinion or making a request or information about the way in which a power has been or should be exercised.** **6(b) A request by shareholders for South32 to strengthen its review of industry associations to identify inconsistency with the Paris Accord and to suspend membership if so.**
ASA Vote	**6(a) – Against** **6(b) Undecided**

Summary of ASA Position

We do not support resolutions seeking to limit a board's power to govern the affairs of the company in the manner in which it regards to be in shareholders' best interests. Accordingly, we are firmly against resolutions of the nature of 6(a). As regards 6(b), we note that the resolution states that it is not to be read as limiting the Board's discretion to take decisions in the best interests of the company. However, despite the board deciding to support the resolution, we are concerned that its passing may in fact create a limitation on the board being able to take decisions as it sees fit so we leave it up to shareholders to direct our vote on this matter.