



A good year for Sonic Healthcare

Company/ASX Code	Sonic Healthcare / SHL
AGM date	Thursday 17 November 2022
Time and location	10am Acacia Room, InterContinental Sydney Hotel, 117 Macquarie Street, Sydney NSW 2000 or online https://meetnow.global/M6AUYS6
Registry	Computershare
Type of meeting	Hybrid
Poll or show of hands	Poll on all items
Monitor	Helen Manning assisted by Richard Williams and Gareth Eastwood
Pre AGM Meeting?	Yes. With Mark Compton (chair), Paul Alexander (company secretary), Kate Spargo (chairs remuneration and nomination committee, member of the audit committee) ASA: Helen Manning, Richard Williams, Gareth Eastwood

Monitor Shareholding: The individuals (or their associates) involved in the preparation of this voting intention have a shareholding in this company.

Summary of issues for meeting

COVID and the effect of Sonic's COVID testing services on the business.

Cybersecurity.

Remuneration.

Proposed Voting Summary

No.	Resolution description	
2	Election of Christine Bennett as a Director	For
3	Election of Katherine Giles as a Director	Undecided
4	Adoption of Remuneration Report	Against
5	Approval of Long Term Incentives Dr Colin Goldschmidt	Against
6	Approval of Long Term Incentives Chris Wilks	Against

See [ASA Voting guidelines](#) and [Investment Glossary](#) for definitions.

Summary of ASA Position

Consideration of accounts and reports - No vote required

We have nothing to note on this.

Governance and culture

The annual report has a corporate governance statement from pages 53 to 65. This is well laid out and has had thought put into it.

Financial performance

- Sonic recorded a net profit of \$A1.5b (an 11% increase) on record revenues of \$A9.3b (a 7% increase, comprising 5% organic growth with base business organic growth of 2.1%.)
- Surprisingly COVID related revenues grew by 13%, but both future revenue and the margins are hard to predict.
- \$A1.00 per share dividend, fully franked (up 10%).
- Balance sheet is very strong, after 2 years of exceptional profit and cash flow generation.

DEBT: Net interest bearing debt decreased by \$A128m in the year even after \$A628m of acquisitions and joint ventures. (p5 AR). Have repaid all bank debt and currently have no exposure to interest rate rises as remaining debt is fixed rate and long term.

With record low gearing and a strong balance sheet the company is set for further growth through acquisitions and other opportunities.

FUTURE GROWTH: continue to identify and assess synergistic acquisitions and outsourcing contracts. At our meeting with Sonic they said there were plenty of opportunities in the market place and they mentioned the United States, and not doing anything in Asia, in particular. The point was made by the chair, that it is often the things that are looked at, but don't proceed, which guarantee success.

Key events

BUY BACK: Commenced first ever share buy back. By 30 June 2022 had bought back A\$294m of stock on market, out of a 12 month target of up to A\$500m

ACQUISITIONS: \$A6238m includes acquisition of Canberra Imaging Goup (strengthened radiology division) and ProPath (strengthened USA anatomical pathology operations). Acquisitions are seen as not only contributing financially but also enriching culture and talent pool of our people.

- ThyroSeq test in the USA, which is an exclusive thyroid cancer genomic test
- Oncotype DX breast cancer gene expression test for which Sonic is the exclusive provider in Germany and the only laboratory performing this test in Europe.

Acquired 20% strategic equity stake in Harrison.ai and established the joint venture Franklin.ai to develop best in class AI diagnostic tools for pathology. Targeting first product release within two years.

Key Board or senior management changes

Dr Philip Dubois retired. Dr Dubois was appointed to the Board in 2001 following the acquisition of Queensland X-Ray (Sonic's largest radiology practice), where he was the practice leader. His

presence on the Board played an important role in consolidating Sonic’s radiology businesses into a cohesive group. Dr Dubois retired from his executive role as CEO of Sonic’s Radiology division on 30 June 2020, having facilitated seamless succession from both his previous role as CEO of Queensland X-Ray, and then as CEO of Sonic Radiology

Dr Jane Wilson retired. Dr Wilson, a registered medical practitioner, joined the Sonic Board as a non-executive director in 2010, bringing broad experience in governance and company oversight. Her role as the Chair of the Risk Management Committee since 2010 has been invaluable, never more so than during the COVID-19 pandemic.

ASA focus issues

2022 Sustainability Report to be released in November 2022.

Cyber-security was topical at our meeting with them, as both Optus and Medibank had reported data breaches of their customers. We sought assurances on the state of cybersecurity controls within Sonic. Whilst not in a position to elaborate on specific capabilities, Sonic representatives noted that in order to win the government bowel cancer screening contract for example, Sonic were required to demonstrate that their cybersecurity controls aligned to standards set by ASD (Australian Signals Directorate). Querying if Sonic held a cyber insurance policy (most relevant for funding recovery from a ransomware incident), Sonic representatives observed that cyber insurance policies often include a clause that prohibits policy holders from publicly revealing the existence of such a policy.

Summary

(As at FYE)	2022	2021	2020	2019	2018
NPAT (\$m)	1.461	1.315	528	549.7	476
UPAT (\$m)	1.461	1.315	552	524	467
Share price (\$)	33.01	38.40	30.43	27.10	24.53
Dividend (cents)	95	87	85	82	78
Simple TSR (%)	-10.8	29.1	15.6	14.1	4.9
EPS (diluted, cents)	302.9	273.1	110.6	122.1	112.2
CEO total remuneration, actual (\$m)	10.996	8.939	5.671	11.873*	9.978*

For FY22, the CEO/MD’s total actual remuneration was **115.7 times** (vs 96 times in FY21) the Australian Full time Adult Average Weekly Total Earnings (based on May 2022 data from the Australian Bureau of Statistics).

Note - For May 2022, the Full-time adult average weekly total earnings (annualised) was \$95,030.00

Simple TSR is calculated by dividing change in share price plus dividend paid during the year, excluding franking by the share price at the start of the year.

Election or re-election of directors

The Sonic Healthcare board has 7 non-executive directors and 2 executive directors in a remarkably stable, and long-time, serving board. Dr Philip Dubois and Dr Jane Wilson AO are retiring. With the appointment of Emeritus Professor Christine Bennett AO and Dr Katharine Giles, there will now be a majority of board members whose length of tenure, can now be described as 'independent'. With the successful election of the two nominees, there will be five male board members and four females. Eight of the nine board members will have Australian institute of company director qualifications. Five will have medical qualifications, one legal and three with finance qualifications.

In our meeting with Sonic, we discussed board skill matrices and the selection process that went into the board selection. The chair told us that they used internal matrices in the selection process and that the process was rigorous. In the announcement of the two new board appointments to the stock exchange, the appointments '*will continue to strengthen Sonic's unique culture of Medical Leadership. In addition, their appointments will also bring further diversity to our board given the skills and experience both Christine and Katharine bring across a broad base, all relevant to Sonic and its future*'. We note that in the corporate governance statement in the annual report under board renewal a list of desirable characteristics is given. A meaningful board matrix in the annual report would simply be a visual aid to show skill sets and how they align with the company's business and strategy.

The new appointees have impressive medical qualifications and impressive experience as follows:

Election of Emeritus Professor Christine Bennett as a Director

Professor Bennett was appointed to the board in September 2022. Her qualifications and experience are well laid out in the notice of meeting and are impressive.

The board looks to her 'broad range of skills and deep experience in healthcare leadership, policy and governance'. We trust to the selection process, that this is what is required for Sonic at this time.

We are pleased that she has bought 1000 Sonic shares. In starting to have a meaningful shareholding, we see shareholder alignment. We see an expression of confidence in the company.

We support her election and will vote all our undirected proxies to that aim

Election of Dr Katherine Giles as a Director

Dr Giles was appointed to the board in September 2022. Her qualifications and experience are well laid out in the notice of meeting and are impressive.

The board looks to her 'medical expertise, investment experience and a strong background in medical innovation and healthcare technology.' We trust to the selection process, that this is what is required for Sonic at this time.

We are pleased that she has bought 1000 Sonic shares. In starting to have a meaningful shareholding, we see shareholder alignment. We see an expression of confidence in the company.

Dr Giles is currently managing director and chief executive officer of OncoRes Medical, a venture partner at Brandon Capital Partners and a member of the Curtin University commercialisation advisory board. We are concerned that her workload will preclude her from giving the board the attention it needs, particularly should there be unforeseen events arising. We will ask her to talk to the meeting about her workload and commitments, and decide on our vote from her response.

Undecided.

Adoption of Remuneration Report

The remuneration report forms a part of the directors' report and is found from pages 32 to 50 in the 2022 annual report. It has sections from a to h, which are then further sectioned with roman numerals. Tables are included with blue headings that stand out to the reader. Sometimes this obscures what heading the table is under. The statutory remuneration table on page 46 has no heading at all. More attention to numbering could be made, along with ensuring that table headings are associated with the tables. Then, you can say, that it is logically set out.

See Appendix 1 below for details of Sonic's remuneration arrangements.

The arrangements are complex and difficult to interpret from the remuneration report – a fact acknowledged by the Chairman at the pre-AGM meeting. The Company Secretary advised that the report doesn't seek to be all things to all people. It should aim to be as clear as possible to the average person.

Sonic's remuneration arrangements contain two changes compared to last year (one relates to an additional qualitative strategic performance condition and the other to the removal of EPS growth as an LTI performance measure – see Appendix 1 for more detail)

Outcomes

The annual report states that the Board did not exercise discretion to adjust any variable remuneration targets or outcomes for 2021 or 2022.

STI outcome

EBITDA growth of 11.5% resulted in the maximum payout under the EBITDA growth performance condition.

The remaining 20% of the target STI award is subject to qualitative strategic performance conditions relating to seven criteria (one more than last year, which relates to sustainability and governance initiatives). No objective measures such as a balanced scorecard is used however **all performance conditions were met in full**. In coming to its assessment, the Board relies on detailed reports against all the criteria from the KMP concerned, as well as information from other sources. The maximum STI was given.

LTI outcome

The annual report says that the options and performance right issued as LTI are subject to challenging vesting conditions. Of those with a performance measurement of 3 years to 30 June 2022, 100% vested.

The ASA intends to vote against the Remuneration Report for the following reasons:

- The actual remuneration amounts for the executives aren't stated clearly in the annual report although we note the intrinsic value of options and rights on date of exercise is

shown at p47 and can be added to the fixed remuneration and cash STI on page 46. The fixed remuneration is described as not having changed since 2017 on p34, and it would be helpful to state unchanged at "\$". But you need to head to p46. On reading the notice of meeting you can see that the CEO has a fixed annual remuneration of \$2,397,634 and that Mr Wilks received a 10% increase, effective from 1 July 2022 to bring it to \$1,200,000. The incentive parts of the remuneration flow from the fixed remuneration amount. You cannot get to the total remuneration without doing the maths. We think the total dollar amounts for STI and LTI should have been in the notice of meeting.

- STI: The actual EBITDA growth performance condition is not revealed. In fact, the growth metric is somehow tied to guidance (and therefore reaching guidance). Due to no guidance being given last year, they based the metric on market expectations. No figure for market expectations was given. And the maximum payout was given on an EBITDA growth of 11.5%. There should be clarity on how the outcome was reached.
- STI: The percentages for the framework and the outcomes are confusing. The percentages are represented differently in the annual report and in the notice of meeting. For the CEO, the notice of meeting says the current framework is 91.8% of fixed remuneration is target and 128.5% is maximum. The outcome as described in the annual report is 140% of target on page 35 of the annual report (so 140% of 91.8% which is 128.5% - ie maximum). Confusing.
- The STI was paid at the maximum amount. The ASA guidelines state that: STIs should not be paid beyond target remuneration levels unless a financial gateway is met.
- the STI award comprises 40% equity – the ASA guidelines prefer that at least 50% should be in equity.
- LTI awards were paid out despite simple TSR being negative (-10% this year). ASA prefers that no performance bonuses should be paid if TSR is negative whether absolute TSR or rTSR is the measure.
- There is no graphical representation of the company's TSR performance against the comparator group in the Annual Report – the ASA guidelines recommend this.

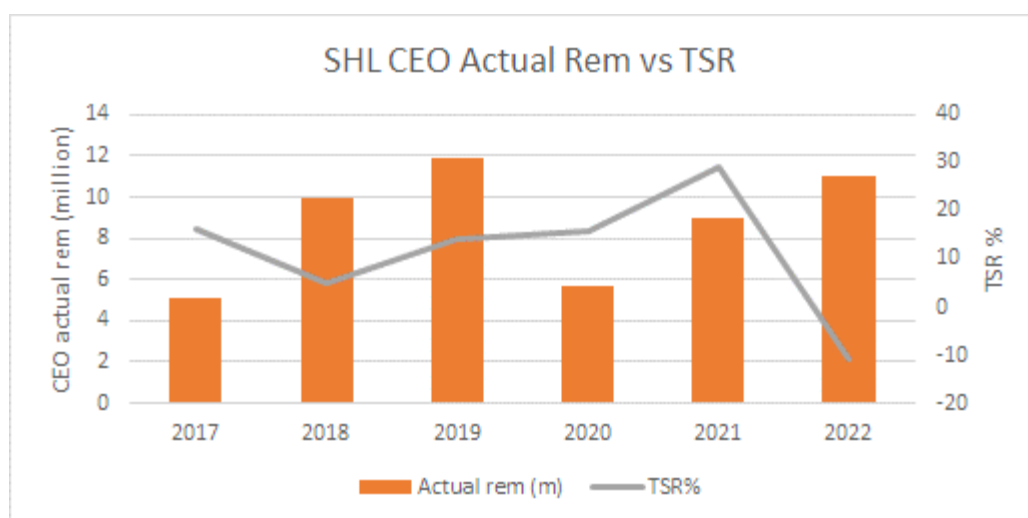
We note the following:

- The actual values of the aggregate EPS and ROIC components of the LTI are only mentioned as a footnote in fine print. It is a hurdle. It should be described better.
- The rTSR component of the LTI is not mentioned at all, apart from being achieved at the 80th percentile over three years to June 2022 (ASA guidelines recommend achievement over four years). On querying this, the ASA was advised that the calculation is performed by a third party (Crichton and Associates) – this fact is not mentioned in the Annual Report. You would need to read p41 to see that rTSR is measured against the S&P ASX100 accumulation index, excluding banks and resources companies.
- An explanation of how LTI options over ordinary shares work is not provided. For example, it is not clear for investors unaccustomed to reading remuneration reports with options, that they are unlisted and that the KMP use their own funds to exercise the options. This means the options have to be valued using fair value methods and lift in value at the time

of vesting is greater in percentage terms (ie leveraged) than the rise in the share price itself.

- An explanation as to why LTI share options are used in a mature company such as Sonic is not provided. LTI share options are typically used in small growth companies. At the pre-AGM meeting the Chairman advised that their use is partly historical and partly that the CEO/MD and CFO back themselves to achieve the necessary hurdles.

Sonic's CEO/MD's actual remuneration vs simple TSR



Source: ASA Voting Intention values

- The above chart illustrates that there is very little relationship between the CEO/MD's actual remuneration and simple TSR in any one year. The rolling three-year TSR provided in the Annual Report might be considered a better guide as it is longer term, but the relationship is similarly unclear. For each year from 2018 to 2022, it is 23.1%, 40.7%, 40.7%, 68.4% and 32.0%, respectively.
- There is no remuneration table for take home pay shown in the Annual Report. Most ordinary people want to know this without having to add up the different amounts themselves.

Items 4 and 5 on the notice of meeting

The proposed LTI options and performance rights will vest three years from grant date, if challenging performance conditions (appendix 1) are met for the period of three years to 30 June 2025. They will expire 5 years from grant date. Options can only vest when the market price of Sonic shares is higher than the exercise price.

If shareholder approval is obtained under Resolutions 4 and 5, it is intended that the options and performance rights will be granted to Dr Goldschmidt and Mr Wilks on the date of the 2022 AGM Meeting or shortly after that date (but not later than 3 years after the AGM or any adjournment of it).

The number of options to be issued to each executive will be calculated based on a Black Scholes methodology valuation at the date of issue (proposed to be the date of the 2022 AGM or shortly after), and the exercise price of the options will be determined using the Volume Weighted 5 day Average Market Price (**5 day VWAP**) for Sonic shares preceding the date of issue. The valuations will not allow for any discount relating to the performance conditions.

The number of performance rights to be issued to each executive will be calculated at the date of issue by dividing 50% of the maximum value of LTI by the 5 day VWAP for Sonic shares preceding the date of grant. Therefore, the number of options and performance rights aren't known at the time the notice of meeting was written.

The options and performance rights will not be listed on the ASX. Upon exercise, the shares issued or acquired will be held on trust by the trustee of the Trust until withdrawn in accordance with the terms of the applicable Plan.

Approval of Long Term Incentives Dr Colin Goldschmidt

It is acknowledged that Dr Colin Goldschmidt's very long experience (since 1993), plus his dedication to the company have no doubt been crucial to the success of the company. This is particularly true during the last two years in navigating Sonic's successful and profitable response to the challenges posed by COVID-19. Dr Goldschmidt has built up a significant shareholding in the company, with a value of approximately \$28m as at 30 June 2022 providing a pleasing alignment with the interests of fellow shareholders.

The notice of meeting states that the maximum value approved will be to the dollar value of \$3,066,001. 50% will be as options and 50% performance rights. This is 127.9% of fixed annual remuneration at target

The ASA will vote undirected proxies against resolution 4 for the following reasons:

While the ASA acknowledges that the LTI performance rights and unlisted options over Sonic shares are subject to two performance conditions;

- both are measured over three years rather than four years or more as stipulated by the ASA guidelines.
- In addition, the LTI RTSR measure has a 75% weighting this year while ASA guidelines prefer a maximum of 50%.
- Relative TSR: The ASA prefers the component to vest at 30% at the 51st percentile and then rise in a straight line to the 85th percentile. Over the 85th percentile 100% vesting will occur. Sonic is more generous.

Approval of Long Term Incentives Chris Wilks

Resolution 5 - Approval of long-term incentives for Mr Chris Wilks Finance Director and CFO

Along with Dr Goldschmidt, Mr Wilks' long experience (also since 1993) and dedication has been similarly crucial to the success of Sonic over the years. Mr Wilks has also built up a material shareholding in the company valued at approximately \$21.8m as at 30 June 2022, again providing a pleasing alignment with the interests of fellow shareholders.

The notice of meeting states that the maximum value approved will be to the dollar value of \$1,286,618. 50% will be as options and 50% performance rights. This is 107.2% of fixed annual remuneration at target.

The ASA will vote undirected proxies against resolution 5 for the following reasons:

While the ASA acknowledges that the LTI performance rights and unlisted options over Sonic shares are subject to two performance conditions;

- both are measured over three years rather than four years or more as stipulated by the ASA guidelines.
- In addition, the LTI RTSR measure has a 75% weighting this year while ASA guidelines prefer a maximum of 50%.
- Relative TSR: The ASA prefers the component to vest at 30% at the 51st percentile and then rise in a straight line to the 85th percentile where 100% vesting will occur. Sonic's performance condition conveys 50% at the 51st percentile, rising in a straight line to 100% vesting at the 75th percentile.

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Appendix 1

Remuneration framework detail

CEO rem. Framework for FY22	Target* \$m	% of Total	Max. Opportunity \$m	% of Total
Fixed Remuneration	2.398	31.3%	2.398	n/a
STI – Cash (60%)	1.321	17.2%	1.761	n/a
STI – Equity (40%)	0.881	11.5%	1.321	n/a
LTI (50% performance rights – 39,409 @ \$38.90)	1.533	20%	1.533	n/a
LTI (50% share options – 248,622 with intrinsic value of \$5.27)	1.533	20%	Unknown	n/a
Total**	7.666	100.0%	Unknown	n/a

The amounts in the table above are the 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.

** **Max. opportunity of LTI share options is unknown** because even if the 248,622 unlisted LTI options over ordinary shares vest – it is only the gain above the exercise price of \$38.90 which will accrue to the CEO/MD. The options can be exercised up to two years after vesting (five years after grant).

Sonic healthcare has a 3 part remuneration structure of fixed remuneration, short term incentive (STI) and a long term incentive (LTI)

Fixed remuneration (FR)

Paid in cash

STI framework

STI is allocated 60% to cash; 40% to equity. To align with performance of the company, 80% is based on an EBITDA growth condition, while 20% is based on a qualitative assessment of the KMP's performance. The qualitative component is described as:

- Promotion of, and adherence to, Sonic Healthcare's Core Values and Foundation Principle
- The exercise and promulgation of Sonic's Medical Leadership culture
- The Federation model employed at Sonic Healthcare, and its effective management
- Risk management within the Company
- External standing and reputation (including stakeholder management, brand and quality)

- Progress with the Company’s sustainability governance and initiatives
- Financial leadership and innovation (for C.D. Wilks)

50% of the EBITDA related component is delivered as rights to shares, which must be kept for at least 2 years. The rest is delivered as cash with no deferral.

LTI framework

LTI makes up 40% of the available remuneration at target and is awarded half as unlisted options over ordinary shares, half as share rights.

In recent years LTI performance measures have been split 50% on Relative TSR, 25% on aggregate EPS and 25% on average ROIC. These are averaged over rolling three-year periods and awarded on sliding scales.

However, this year the Board determined that EPS growth was not a suitable performance measure for the 2022 LTI because of the difficulties in predicting the level of future COVID-19 PCR testing volumes versus those achieved in the 2021 year and the potential for anomalous remuneration outcomes.

Hence this year LTI performance measures have Relative TSR with a 75% weighting while average ROIC remains at a 25% weighting.

Relative TSR (Performance Condition 1 – PC1)

Relative TSR is measured against the ASX100 accumulation index minus banks and resources on the following scale.

TSR Ranking achieved	Percentage of Options and Rights that vest
Below the 51st percentile	Nil options and rights to which PC1 applies
51st percentile	50% of options and rights to which PC1 applies
Greater than 51st and less than 75th percentile	Pro rata between 50% and 100% of options and rights to which PC1 applies
75th percentile and above	100% of options and rights to which PC1 applies

Return on invested capital ROIC (Performance Condition 2 – PC2)

ROIC is calculated as Earnings before Interest and Tax, less related tax and minority interests, divided by average capital employed. It is expressed as a percentage. ROIC has been chosen as a performance hurdle as the Board believes that a primary focus in coming years should be improvement in the return from the substantial investments the Company has made into its businesses.

The Board sets a ROIC target at the beginning of each measurement year, taking into account market conditions and company-specific factors at the time. After completion of the three year measurement period, the average of the actual ROIC over the three years will be compared to the average of the three ROIC targets (**Target Average ROIC**).

Measurement of the average actual ROIC will exclude any significant uncontrollable or one off events, and the initial impact of business development initiatives, as approved by the Board.

The percentage of options and performance rights subject to PC2 that vest will be as follows:

Average ROIC for FY2023 to FY2025	Percentage of Options and Rights that vest
Less than Target Average ROIC	Nil options and rights to which PC2 applies
Equal to Target Average ROIC	40% of options and rights to which PC2 applies
Greater than Target Average ROIC and less than 110% of Target Average ROIC	Pro rata between 40% and 100% of options and rights to which PC2 applies
110% of Target Average ROIC or greater	100% of options and rights to which PC2 applies

If necessary to avoid an anomalous result, the Board may make adjustments in measuring performance under PC2 to ensure the intent of the incentive plan is maintained.

Options and performance rights for which the performance conditions are not satisfied will be forfeited immediately after the performance measurement is finalised. There will be no retesting.

Following vesting of options and/or performance rights, ordinary shares in Sonic may be provided either by way of an issue of new shares or the purchase of existing shares on market by the trustee of the Sonic Healthcare Employee Share Trust (the **Trust**) in accordance with the relevant Plan rules. Options and performance rights are not eligible for dividends.