Austal's future depends on Defence review

Company/ASX Code	**Austal Limited (ASB)**
AGM time and date	2pm AWST, Thursday, 26 October 2023
Location	Fremantle Sailing Club, 151 Marine Terrace, Fremantle
Registry	Link Market Services
Type of meeting	Physical meeting with passive webcast
Monitor	John Campbell
Pre-AGM Meeting	Requested

Monitor Shareholding: The individual involved in the preparation of this voting intention has no shareholding in this company.

1. How we intend to vote

No.	Resolution description	
1	Adoption of the Remuneration Report	For
2	Re-election of John Rothwell AO	For
3	Re-election of Michael McCormack	For
4	Election of Lee Goddard	For
5	Approval of issue of share rights to Sarah Adam-Gedge	For
6	Approval of issue of share rights to Chris Indermaur	For
7	Approval of issue of share rights to Lee Goddard	For
8	Approval of issue of LTI rights to Patrick Gregg	For

2. Summary of Issues and Voting Intentions for AGM

- The central issue for Austal is survival – it has insufficient orders for new work to keep its Philippine and Vietnamese shipyards open and it is running out of work for its Henderson shipyards. Its US shipyards had a marginal result in FY23. An announcement on 6 June 2023 referred to media speculation about 'corporate activity' involving Austal which said it would keep shareholders informed in accordance with its continuous disclosure obligations. No more news has been provided on this matter so we assume that the potential suitor has decided to hold off from any bid at this stage.
- The loss in its US shipyards was due to its new steel ship construction contract for US Towing, Salvage & Rescue vessels (T-ATS) for the US Navy. The program encountered changes in specification and cost inflation pressures as well as incorrect efficiency assumptions on the commissioning of Austal's then new steel production line and in

constructing the first vessel. This has led to the need for an onerous contracts provision. The T-ATS order has been followed by orders for steel-hulled patrol vessels from the US Coastguard. Estimating percentage completion and costs to complete is an essential skill for shipbuilders and doing so for contracted future vessels must be doubly difficult. Accuracy of and therefore adequacy of such estimates is far from assured. Given marginal profitability of overall US operations in 2023, and loss-making steel operations, Austal needs profitable shipbuilding contracts at Henderson at the least for its future prosperity.

- Austal has been on the wrong side of law enforcement in both the US and Australia. In October 2022, it was levied a fine of $650,000 for contravention of the continuous disclosure provisions of the Corporations Act in Australia, whilst, in the USA, three unnamed former employees are being prosecuted for fraud involving activities leading up to and including 2016. The annual report discloses a contingent liability for the consequences of these prosecutions on its compliance with the requirements of the US Exchange Act administered by the US Securities and Exchange Commission. In the meantime, Austal is engaging with the ATO and the Inland Revenue Service in the US as regards its treatment of cross-border transactions.

3. Matters Considered

Accounts and reports

Austal's share price has been quite volatile during FY23 – it started the year at $1.80 climbed to $2.76 in August 2022 following the announcement of the US Coastguard OPC contract, dropped back to around $1.80 for some months then climbed again in May to peak at $2.74 in July 2023, since returning to about $1.80. The 'simple TSR' shown in the table below reflects a price no longer obtainable in the market and may have been driven by hopes of a takeover as referred to above.

Revenue increased 10.9% in 2023 when Austal delivered 9 vessels, 4 of which were patrol boats ex Henderson, a large ferry from the Philippines, another ferry from the Vietnam shipyard, and 2 littoral combat ships and a large ferry-like vessel 'Expeditionary Fast Transport' for the US Navy. It commences 2024 with an order book of $11.6 billion which seems to be all from the US Navy and Coastguard in terms of a mix of aluminium and steel vessels. As mentioned above, there is no reference in the AR to any orders for Australian or Asian shipyards whilst three patrol boats are under construction at Henderson and another 3 are completed awaiting handover.

Profitability suffered at the US shipyards with earnings before interest and tax falling to just $5.2m from $133.7m in FY22, this on revenue of $1,225m (FY22 $1,056m). Australasian operations resulted in EBIT of $15.8m compared to $14.6m in FY22. Unallocated costs were $26.4m in FY23, compared to $27.9m in FY22, and net interest cost was $10.7m in FY23 compared to $8.2m in FY22. The US result was impacted by provisioning against the T-ATS contract of $171m, but this was partially offset by the release of contingency provisions relating to LCS and EPT contracts totalled $114m. So the drop in EBIT of $128.5m is only accounted for as to $57m by these identified factors and we therefore assume that more recent contracts are being undertaken at a lower level of profitability than in the past.

The lack of orders for the two Asian shipyards is a significant concern given delivery of their last orders during FY23. Closure will give rise to losses but these would not be as significant as if the Australian shipyard at Henderson was forced to close through lack of work. Austal awaits the outcome of the Australian Defence Strategic Review, claiming that it is the only shipbuilder in

Australia that is actually delivering vessels in accordance with contracts at the moment. Based on comments from the Commonwealth government about the strategic importance of Henderson as a shipbuilding precinct, and of developing sovereign shipbuilding capability, Austal is hopeful that the outcome of the DSR - and in particular the surface fleet review - will provide a clear pathway forwards. This is expected in Q1 2024. Meanwhile we assume it has opportunities for more commercial contracts through tenders with potential customers awaiting determination.

Austal has had negative free cash flow for the last two financial years resulting in an FY23 decrease in cash held of $54m (FY22 decrease of $128m). Earnings guidance is that earnings before interest and tax will be between 3% and 4% of shipbuilding revenue (unstated) ex total revenue for FY24 of $1.98bn. Overall, its results are disappointing and little encouragement is provided in the narrative to suggest a major turnaround is expected.

Financial performance

(As at FYE)	**2023**	**2022**	**2021**	**2020**	**2019**
NPAT ($m)	(13.8)	79.6	81.06	88.98	61.38
UPAT ($m)	(13.8)	79.6	81.06	88.98	61.38
Share price ($)	2.37	1.80	2.05	3.23	3.41
Dividend (cents)	7	8	8	8	6
Simple TSR (%)	35.6	-8.3	-34	-3.6	86.6
EPS (cents)	(3.8)	22	22.6	25	17.6
CEO total remuneration, actual ($m)	1.009	1.673	0.989	3.03	3.15

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.

For 2023 the CEO's total actual remuneration was 10.2 times the annualised Australian Full time Adult Average Weekly Total Earnings (based on May 2023 data from the Australian Bureau of Statistics.)

Governance and culture

The non-executive chairman is John Rothwell AO who founded the company in 1988 and remains a substantial shareholder with 9% of the company. He is no longer classified as independent because of his tenure having previously served as managing director and then executive chairman up to 2008. Having a non-independent chair is not in accordance with governance recommendations. The rest of the board comprises the CEO, and four independent non-executive directors. The Board continues to have only one female and had targeted 30/6/23 to have increased representation to 40% - this has been extended to 30 June 2024.

The Board skills matrix provided in the Corporate Governance Statement does not evaluate directors against the designated skill requirements. It contains a list of desirable qualities without indicating those directors possessing them. This makes it impracticable for shareholders to evaluate whether directors standing for election possess skills considered necessary for management of the company.

Key events

The annual report draws attention to the US Navy commissioning a littoral combat ship, USS Canberra, in Sydney Harbour in July 2023.

Key board or senior management changes

In April, Austal announced the appointment of a new CFO to replace the previous CFO, Greg Jason who resigned in 2021. A recent appointment to the board is Mr Lee Goddard, a rear-admiral in the Australian navy reserve following 34 years' fulltime service. He is CEO and an executive director of the Australian Missile Corporation. It was announced on 31 August 2023 that the president of Austal USA Mr Rusty Murdaugh had resigned, and we assume that, with no reason given, this was to do with losses from steel shipbuilding activities.

Sustainability/ESG

Austal set emission reduction targets in FY22 to reduce missions by 50% by 2030 from FY21 baselines. The move to fabricating steel-hulled vessels has made this target more difficult with emissions rising in FY23 for scope 1 from 8.5kt to 10.5kt, and in scope 3 from 47.8kt to 66.4kt CO_2e, whereas scope 2 emissions remained at similar levels. The ESG report is well laid-out and comprehensive.

4. Rationale for Voting Intentions

Resolution 1 - Non-binding resolution to adopt the remuneration report

A summary of the remuneration framework is set out in Appendix 1. The Report is clear and comprehensive and includes a table of take-home pay. The main exception to ASA guidelines continues to be the Long Term Incentive (LTI) measurement period of 3 years and not the minimum of 4 years required by ASA. However, we do not see this as a sufficient reason to vote against the report so we will support it.

Performance during FY23 failed to meet threshold levels to activate the short-term incentive, so none was awarded to the CEO and other KMP executives. Similarly, the threshold levels for the 2021 long-term incentive hurdles were not achieved as to TSR, return on equity or earnings per share growth and accordingly no LTI share rights vested.

Resolution 2 & 3 - Re-election of directors Rothwell & McCormack

Mr Rothwell has been a director of Austal for more than 40 years and is a substantial shareholder. Whilst non-independent as a result of this long period of involvement in Austal, he is a very experienced shipbuilder and there are 4 other independent directors to offset the disadvantage of not having an independent chair. Mr McCormack was appointed a director in 2020 and is the former CEO of APA Group. He has qualifications as a surveyor and engineer and is an experienced director. Overall the Board is well structured for a company of Austal's size and considering that there is a separate advisory board with a majority of independent directors for Austal USA. The board's weakness is its lack of diversity but there are stated plans to increase female representation in FY24.

Resolution 4 - Election of Mr Lee Goddard

The addition of Admiral Goddard to the board makes good sense in terms of his experience in the Navy and his contacts with government and the defence industry will be useful to Austal. His appointment was announced in December 2022.

Resolutions 5 to 7 - Approval of the issue of share rights to non-executive directors

The share rights are proposed under an existing incentive scheme which enables Non-executive Directors of the Company to progressively acquire a shareholding in the Company with a value equal to his/her total annual base Board remuneration (excluding committee fees). The scheme is an 'employee incentive scheme' for the purposes of the ASX Listing Rules although in order to preserve Director independence, it is not subject to Company performance measures or thresholds.

The issue of Share Rights under this scheme has been approved by Shareholders at each consecutive Annual General Meeting since the 2018 Annual General Meeting. Resolutions 5 to 7 seek Shareholder approval for Ms Sarah Adam-Gedge, Mr Chris Indermaur and Mr Lee Goddard to acquire rights to the value of 25% of their base fees on a salary-sacrifice basis.

These share rights proposed for the three non-executive directors form part of the NED remuneration plan and assist these directors to build a stake in the Company up to the target shareholding equal to annual base Board fees. Shares are purchased at market prices. ASA supports this resolution.

Resolution 8 - Approval of LTI share rights to the managing director Mr Patrick Gregg

In 2019 the Company established the Austal Limited Rights Plan (the Plan). The Plan is used to grant equity to eligible employees under the STI and LTI provisions. The Plan was approved at Company's 2019 Annual General Meeting. This resolution is required to enable the Company to continue with the grant of Rights under the Plan without using up any of its 15% Placement Capacity under ASX listing rules.

Approval is sought for the grant of up to 446,244 (FY22 416,862) rights to the CEO/MD in respect of the LTI for the 3 years ending 30/6/26. The grant is based on Mr Gregg's fixed remuneration of $1,054,200 for FY24 (FY23 $1,008,800) at the maximum opportunity of 100% and the relevant market-based share price of $2.36 (average July 2023 market price). The share rights vest if performance conditions relating to total shareholder return, earnings per share growth and return on equity are met over the above three-year period. ASA supports this resolution.

Appendix 1
Remuneration framework detail

The framework is the traditional mix of fixed and at-risk remuneration. A summary of the framework is as follows and the table below sets out the exposure mix for the CEO:

Fixed pay (FR)

Short term incentive (STI)-awarded for the achievement of annual hurdles (set out in AR pages 35-36), paid equally in cash and performance rights, with the equity component subject to a 12 month holding period (the USA President is paid wholly in cash)

Long term incentive (LTI) - awarded with performance rights against hurdles over a 3-year period, with a 12-month holding period. The 3 equally weighted hurdles are Indexed Total Shareholder Return, Earnings per Share Growth and Return on Equity

The incentive awards are determined as a percentage of FR and share entitlements are calculated at market price.

No STI is paid unless EBIT is at least 85% of budget.

CEO rem. Framework for FY23	Target $m	% of Total	Max. Opportunity $m	% of Total
Fixed Remuneration	1.009	51.3%	1.009	37.4%
STI - Cash	0.227	11.5%	0.340	12.6%
STI - Equity	0.227	11.5%	0.340	12.6%
LTI	0.504	25.6%	1.009	37.4%
Total	1.967	100.0%	2.698	100%

The amounts in the table above are the amounts that are envisaged in the design of the remuneration plan.