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US$1.3 billion write down "non-cash" – not so!

Company/ASX Code	South32 Ltd (S32)
AGM time and date	12 noon AWST on Thursday 26 October 2023
Location	Perth Convention and Exhibition Centre, 21 Mounts Bay Road, Perth WA
Registry	Computershare
Type of meeting	Hybrid via https://meetnow.global/S32AGM2023
Monitor	John Campbell assisted by Alan Dickson
Pre-AGM Meeting	Yes with Chair Karen Wood and Wayne Osborn, chair REM committee

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

All amounts in this document are stated in US dollars unless indicated otherwise.

1. How we intend to vote

No.	Resolution description	
2(a) & (b)	Re-election of Dr Xiaoling Liu and Ms Karen Wood	For
3(a) & (b)	Election of Mr Carlos Mesquita and Ms Jane Nelson	For
4	Adoption of remuneration report	Against
5	Grant of awards to executive director	Against
6	Renewal of proportional takeover provisions	For

2. Summary of Issues and Voting Intentions for AGM

- We will ask why the Chief Executive and Managing Director, Mr Graham Kerr, has not been asked to resign over recommending to the board that the company acquire Arizona Mining and its Hermosa project in 2018 which has led to a $1.3 billion impairment described as "non-cash". It might not be his cash, but it most certainly is the shareholders. We were surprised when the acquisition was announced because of its high cost (initially reported as $1.3bn but later determined to be $1.7bn), as its grades were not exciting and we were aware of the difficulties of permitting mines in Arizona – so was Ms Wood as a former BHP executive where its Resolution copper project has been held up for more than 12 years over access to native title lands. Since 2018, the company has spent a further $0.6 bn on the project and we think that the board may have prevaricated over the need for impairment for the last 4 years.

- We will vote against the remuneration report because executives were awarded short-term incentives despite the company's net loss for the year after the Hermosa impairment. We think that if underlying earnings are used as the hurdle for short-term incentives, there should be a threshold hurdle of an increase in statutory profit after tax (NPAT) before executives qualify for STIs. We will also vote against the allocation of share rights to Graham Kerr because they include rights derived from his STI award.

3. Matters Considered

Accounts and reports

After buoyant commodity prices which drove a record result for South32 in FY22, reduced prices in FY23 were primarily responsible for the reduction in underlying earnings before interest and tax from $3,967m in FY22 to $1,616m in FY23. Increased finance costs and tax expense further reduced its underlying EBIT to net underlying earnings of $916m. Adjustments to underlying earnings were dominated by the $1,300m impairment to Hermosa with other adjustments primarily relating to joint venture accounting, foreign exchange variances and tax adjustments reducing the impact of the impairment to $1,089m and taking the net result after tax to a loss of $173m. South32 reduced its dividends paid ex FY23 results, with its interim dividend of 4.9c (US) and a final dividend payable in October 23 of 3.2c, totalling 8.1c, compared to 25.7c ex FY22 results.

Being a globally diversified mining and metals company, South32 is a price-taker at the mercy of international commodity prices, exchange rates and international events such as the war in Ukraine and tensions between China and Australia. The earnings analysis chart on page 43 of the annual report provides a graphic illustration of the impact lower commodity prices (in all but nickel -see page 40) had in driving the year's underlying EBIT from $3,967m in FY22 to $1,616m in FY23. Although production had increased in most commodities the revenue from group operations achieved this year was down $1,519m from $10,030m to $8,511m.

The cash flow from operations of $1,814m was almost swallowed up by capital expenditure, interest and tax leaving free cash flow from owned operations of $57m (FY22 $2,240m).

Metallurgical coal had a significant reduction in underlining revenue (coal revenue was $2,338m in FY22 but reduced to $1,643m in FY23) but accounted for almost 43% of the Group's Underlying EBIT. The Board is to pay a final dividend of $145m (FY22 $784m) which will be paid in October.

As in FY20, FY21 and FY22, our main concern remains with the approximately $1 billion net assets of the Hermosa Project (after impairment). As foreshadowed last year, we note that, prior to a final investment decision, the Taylor zinc-lead deposit of Hermosa project has been impaired by $1300m. The final investment decision for Hermosa is now due by the end of 2023 including appraisal of the Clark manganese deposit.

Financial performance

(As at FYE)	2023	2022	2021	2020	2019
NPAT ($m)	(173)	2,669	(195)	(65)	389
UPAT ($m)	916	2,602	489	193	992
Share price ($A)	3.76	3.94	2.93	2.04	3.18
Dividend (US cents)	21.9	14.2	2.4	5.0	13.0
Simple TSR (%)	3.7%	47.1%	48.1%	(34.9%)	(7.65%)
EPS (US cents)	(3.8)	57.4	(4.1)	(1.3)	7.7
CEO total remuneration, actual ($Am)	3.377	4.287	3.600	3.216	13.195

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. The dividend is converted to 32.46 Australian cents for this purpose.

For 2023, the CEO's total actual remuneration was **35 times** (FY22 46 times) the Australian Full time Adult Average Weekly Total Earnings (based on May 2023 data from the Australian Bureau of Statistics).

Governance and culture

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 7 other independent non-executive directors and a single non-independent director, the CEO, Graham Kerr. All pre-May 2023 directors have significant skin-in-the-game.

Key board or senior management changes

The changes to the board in FY23 occurred in May 2023 when Mr Guy Lansdown stepped down from the board and Mr Carlos Mesquita and Ms Jane Nelson were appointed. Ms Sandy Sibenaler was promoted to Chief Financial Officer and the then CFO, Ms Katie Tovich, was appointed Chief Human Resources and Commercial Officer.

Sustainability/ESG

Sustainability and conservation of natural and heritage assets remain a major focus of community and investor concern. 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. 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 sustainability report is light on detail of how planned emission reductions will be achieved as a lot depends upon the ability of electricity suppliers in the various locations converting their generating capacity from coal or gas to renewable sources.

The sustainability report discloses that South32 generated 21.0m (FY22 21.0m) tonnes of Scope 1 and Scope 2 CO_2-equivalent emissions from its operations in FY23 comprising those generated from its own operations and from the generation of purchased electricity, whilst its Scope 3 (value chain) emissions total 65.6m (FY22 67.4m) tonnes CO_2-equivalent, making it a sizeable contributor to global totals. We see a shortcoming in that the company's Sustainability Report does not address emissions on an operational basis with the short and longer-term targets for each operation and progress towards meeting them.

We recommend that shareholders read the sustainability report which incorporates information about South32's steps to combat climate change. Many of the group's operations inevitably cause detriment to the environment because mining and refining operations produce emissions and waste. Minimisation of these impacts and subsequent rehabilitation of the environment is fundamental to sustainability and there are concerns about South32's damage to native forests in Australia and Brazil and its legacy of toxic tailings from bauxite operations in particular.

4. Rationale for Voting Intentions

Resolution 2 (a) & (b) - Re-election of Dr Xiaoling Liu and Ms Karen Wood (For)

Dr Liu, appointed in 2017, is a metallurgist. After completing her PhD, she joined Rio Tinto Group and had many roles in her 26 years there including several very pertinent to South32's operations. Prior to retirement she was President and Chief Executive Office for Rio Tinto Minerals. She has also served as Vice President of the Board of the Australin Aluminium Council, a Director of Melbourne Business School and Chancellor of Queensland University.

Ms Wood has been an independent director since November 2017 and Chair of the Board since April 2019. She has both legal and business experience and joined BHP in 2001 and held several global executive positions including Group Company Secretary, Group Governance Officer, Chief People Officer and President People and Public Affairs (Corporate Affairs).

As stated in the opening paragraphs of the voting intentions, we are concerned with the board's judgement in approving the acquisition of the Hermosa Project in 2018 and its subsequent spending on the project. The Board's key role is selection of the chief executive responsible for proposing this acquisition to the board. Whilst both of these directors were on the board when the Hermosa acquisition was approved, Karen Wood was not the chairman at that time.

Resolution 3 (a) & (b) - Election of Mr Carlos Mesquita and Ms Jane Nelson (For)

The board skills matrix set out on pages 13 to 15 of the Corporate Governance Statement does not identify which directors possess the various attributes listed in the matrix. It is therefore impracticable for us to determine whether the new directors possess attributes that are complimentary to existing skills or fill gaps therein. However, both incoming directors seem well qualified for the role.

Resolution 4 - Adoption of the remuneration report (Against)

As stated in the opening paragraphs of the voting intentions, we will vote against the remuneration report because executives were awarded short-term incentives despite the company's statutory loss for the year after the Hermosa impairment. We think that if underlying earnings are used as the hurdle for short-term incentives, there should be a threshold hurdle of an increase in statutory profit after tax (NPAT) before executives qualify for STIs. Generally the remuneration plan meets our criteria for approval with relatively minor exceptions stated in the appendix but the foregoing represents a serious shortcoming in a year in which there is a material impairment expense excluded from underlying earnings.

Resolution 5 - Grant of shares to Mr Graham Kerr, CEO & Managing Director (Against)

The resolution seeks to approve the grant to Graham Kerr of 1,047,894 (last year – 934,313) share rights which had a face value on 1 July 2023 of A$3.98m (last year A$3.81m), being his maximum opportunity for long-term incentive, together with share rights with a face value of A$0.719m (FY22 A$1.215m) for the equity component of his FY23 short term incentive. If approved by shareholders, the STI share rights will be granted as determined by the average face value of South32 shares for the relevant period in December 2023 if approved by shareholders. The awards are in accordance with the remuneration structure set out in the remuneration report and commented upon by us in these voting intentions.

There is no performance hurdle for the deferred STI share rights, will vest at the end of the two-year deferral period, subject to service, dealing and forfeiture conditions. Vesting of the STI rights is expected to occur following the release of the Company's full year results for FY25 (i.e. in August 2025). Vesting of the LTI rights will be determined at the time of the release of the Company's full year results for FY27 (i.e. in August 2027). The LTI rights will only vest to the extent performance conditions have been satisfied as to 80% being TSR vs two comparator indices, and 10% as to climate change achievement, and 10% as to portfolio management. The rights will vest based on South32's achievement of an adequate TSR as specified for the two indices and performance at least meeting targets on climate change and portfolio management.

We do not object to the principles by which these awards have been determined, but, as stated above, we do not believe that Mr Kerr should have been granted any short-term incentive in FY23 due to the $1,300m impairment of the Hermosa project. Accordingly, whilst accepting the allocation of LTI share rights is appropriate, we cannot support this resolution as it stands.

Resolution 6 - Renewal of proportional takeover provisions (For)

The ASA prefers full takeovers so that shareholders are not left with a controlling shareholder and we therefore support the resolution to renew articles preventing proportional takeovers. These proposals prohibit a predator only bidding for a proportion of a shareholders' interest.

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Appendix 1
Remuneration framework detail

The remuneration report is stated in Australian currency and all amounts below are AUD

The amounts in the table below are the amounts that are envisaged in the design of the remuneration plan. Target remuneration is what the company expects to award the CEO in an ordinary year, with deferred amounts subject to hurdles in subsequent years before vesting. Maximum opportunity is the capped amount (based on share price at date of grant) which would be earned if all targets were well-exceeded. In the event, only part of the STI was approved and no LTI vested in 2023.

CEO rem. Framework for FY23	Target $m	% of Total	Max. Opportunity $m	% of Total
Fixed Remuneration	1.906	29.4%	1.906	20.8%
STI - Cash	1.144	17.7%	1.715	18.7%
STI - Equity	1.144	17.7%	1.715	18.7%
LTI	2.287	35.3%	3.812	41.7%
Total	6.481	100.0%	9.148	100.0%

Whilst long, 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 particularly commend the provision of information on page 86 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. There has been no change to the plan for FY23.

Fixed remuneration was increased for both FY23 (generally 5%) and FY24 (generally 4.5%). Cumulatively the increases give Mr Kerr close to 10% over the two years and bring his salary to just under $2m. Whilst at the top of the range for WA-based companies, this must be gauged against other large mining companies and reflects Mr Kerr's length of service in the role. Based on the information in the annual report and the fixed remuneration of BHP and Rio Tinto CEO's, Mr Kerr's package seems reasonable. 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.

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$12.6m for FY23 little changed from last year's annual report if changes in personnel are excluded. There were no significant changes to the terms of executive remuneration apart from fixed pay increases and a 3% lift to non-executive directors' fees. Travel and other allowances for non-executives increased from $105k to $240k reflecting board ability to travel to operations after covid issues declined.

For the short-term incentive, executives were assessed as having performed on target for sustainability and a little better than target for strategic achievements (including Hermosa), and below target for financial and production measures and return on invested capital, with an overall outcome on business measures of 83.8% (FY22 99.6%) of target. Financial measures use a form of underlying earnings as the basis of calculation, applying budget commodity prices and exchange rates to actual outcomes to remove the non-controllable effect of these factors from the calculation which also excludes impairments such as the $1,300m Hermosa impairment. The remuneration plan allows for a board modifier to adjust the amount of short-term incentive to reflect overall business outcomes.

This year, the board considered the Hermosa impairment and the death of two employees at the Mozal aluminium refinery to be relevant in assessing the modifier. A negative business modifier was applied by the board of 25% to the CEO, 20% to the COO Africa/Colombia, and between 5% and 10% for other KMP, whereas a personal performance rating of 85% to 140% was applied (CEO's factor was 100%). The overall outcome was that the total STI awarded was $3.724m compared to a target of $5.163m (see page 92). As stated earlier in the voting intentions, we think that if underlying earnings are used as the hurdle for short-term incentives, there should be a threshold hurdle of an increase in statutory profit after tax (NPAT) before executives qualify for STIs. In South32's case, the board could have used the modifier to make an adjustment to that effect but chose to do so to just a small extent. We are voting against adoption of the remuneration report for this reason and because we do not believe it appropriate to reward the CEO in these circumstances.

As regards the long-term incentives eligible to vest in FY23, the company's TSR fell short of the hurdle represented by comparator indices. The global mining company index, against which two-thirds of the award was based, achieved a TSR of 86% over the 4 years to 30 June 2023, whereas the general MSCI index (one-third of the award) achieved TSR of 53%. South32's TSR for that period was 41% so the LTI benefits lapsed.

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.