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2018 ANNUAL GENERAL MEETING SEASON PREVIEW

REMUNERATION & DIRECTORS UNDER THE SPOTLIGHT

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Foreword

by Michael Chandler - Governance Director

The scene has been set for an eventful annual general meeting (AGM) season. The Hayne Royal Commission into the Banking, Superannuation and Financial Services Industry has already claimed a number of scalps with trust substantially eroded and the question of 'social license to operate' and 'corporate conduct' heavily weighing on the minds of shareholders, proxy advisors and the community.

One of the knock-on effects we have observed is how shareholders are choosing to vote on resolutions in relation to remuneration and director elections/re-elections. There appears to be little sympathy or appetite for perceived 'offenders' and a number of shareholders are considering tightening up director election voting policies as a direct result of the revelations flowing from the Commission.

It has never been more challenging for Australian public companies to respond to the growing diversity of opinion amongst global asset owners and fund managers as to what constitutes good corporate governance practice and performance. The conversation with shareholders that has most recently focused on executive remuneration structures and pay outcomes has markedly widened to involve considerations relating to non-executive director accountability, board succession planning, diversity, environmental and social 'sustainability' management, and most recently, aspects of corporate culture.

Nevertheless, remuneration will continue to feature in shareholder conversations and across media outlets this annual general meeting season. Of particular note is the recent introduction of hybrid remuneration structures across a number of companies that have been met with mixed views from investors. Consistent with previous years and leveraging the provisions of the 'two strikes' rule, shareholders will continue to voice their opinion on pay for performance alignment and therefore those companies with strong financial and share price growth remain best placed to receive favourable voting support.

Of equal importance is the ability for companies to provide assurance to shareholders around their management of long term environmental and social risks and opportunities, a trend perpetuated by the mainstreaming of responsible investment mandates globally. Environmental and social research, ratings and survey groups are of growing influence in Australia, whilst activist groups continue to publicly agitate their advocacy positions to both companies and superannuation funds. Most significantly, many of the largest institutional investors are now signatories to the United Nations-supported Principles for Responsible Investment (UNPRI) or publicly back the recommendations of the Task Force for Climate-Related Financial Disclosures (TCFD).

What is particularly noteworthy is the emphasis that shareholders are putting towards how intangible assets such as brand recognition, intellectual property and human capital contribute to investment value. The result has been a growing expectation that companies provide more information relating to the management of people, culture and reputation. At the same time, companies are being challenged with how to meaningfully assess, monitor and quantify these aspects.

Irrespective of changing shifts in concerns and voting sensitivities, a comprehensive shareholder engagement program supported by detailed and meaningful corporate governance disclosure remains the most effective approach to managing the expectations of shareholders and other company stakeholders.

All of these topics are explored in this edition of Lighthouse.
Michael Chandler - Governance Director

Remuneration & Directors Under The Spotlight

Dissent has noticeably increased across all types of resolutions voted on thus far in 2018 when compared to the first half of 2017, but most markedly for remuneration related resolutions.

Of the 46 companies that put their remuneration report up for a vote, three companies received a 'first strike' (incurred by receiving more than 25% of votes cast against approval of the remuneration report). Another eight received more than 15% of votes cast against and a further four received more than 20% against the remuneration report.

The upward trend is significant, representing more than a 50% increase in remuneration-related voting dissent, when compared to the same period in FY17.

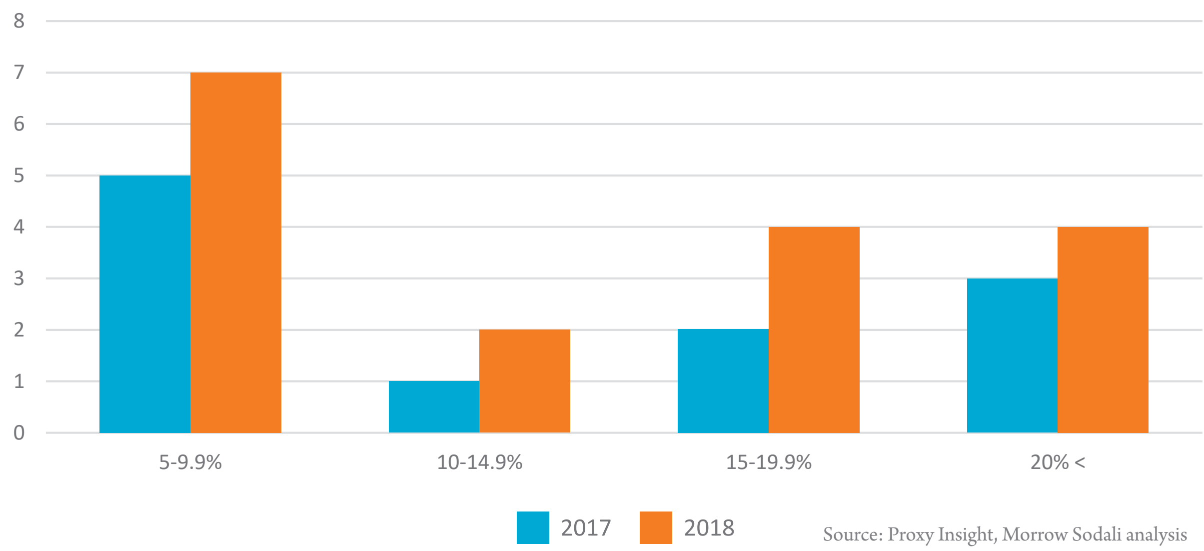
More than a third (38%) of resolutions that attracted over 10% of votes cast against during the first half of 2018 were in relation to the approval of the remuneration report.

The next highest level of dissent was shared equally by resolutions relating to equity based plans and director elections. These categories each represented 27% of resolutions attracting more than 10% of votes cast against during the first half of 2018.

It's noteworthy that directors up for election for the first time were hit the hardest, with six attracting more than 10% dissenting votes compared to only one director up for re-election.

In reviewing voting outcomes and proxy advisor recommendations over the 12 months to September 2018 for resolutions seeking the (re)election of directors for S&P/ASX 200 listed companies, Morrow Sodali observes that approximately 9.8% of directors that were up for (re)election faced significant levels of dissent (defined as more than 10% of votes cast against their (re)election), up from 7.5% in the prior year.

ASX300 REMUNERATION VOTING DISSENT (H1 2017 VS H1 2018)

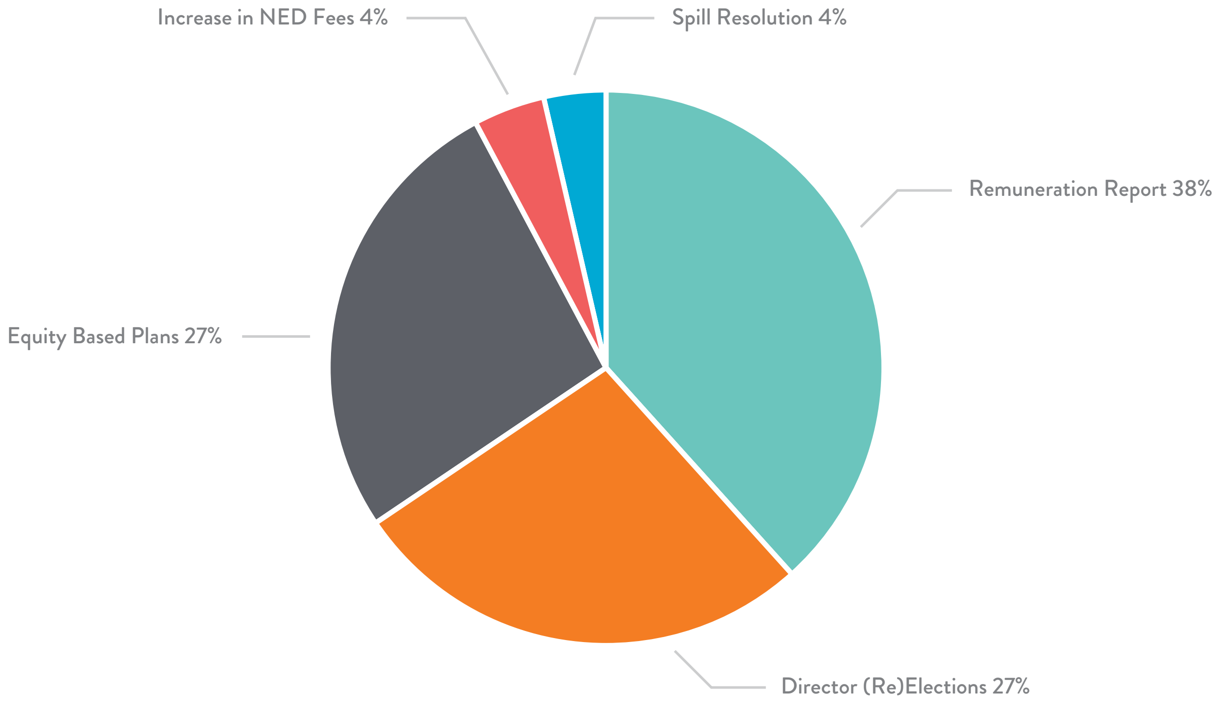


Source: Proxy Insight, Morrow Sodali analysis

The main drivers of negative votes and/or recommendations were concerns about board composition and levels of independence, with many shareholders voting against the (re) election of non-independent directors on boards that are not majority independent. Further, shareholders are less inclined to support the election of non-independent directors that are also members of key committees, for example the audit committee. Concerns around external directorships and potential overboarding continue to play a significant role in assessing the capacity of directors to discharge their duties effectively and act in the best interests of shareholders. An increasing proportion of investors are applying lower thresholds around external commitments for directors, with some choosing to vote against directors serving on as few as three or more boards.

PROPORTION OF RESOLUTIONS WITH >10% OF VOTES CAST AGAINST THE BOARD'S RECOMMENDATION (H1 - 2018)

Source: Proxy Insight, Morrow Sodali analysis



Hybrid Incentive Plans Set To Create Friction

An emerging trend in Australian remuneration practice has been the shift towards combined incentive plan structures. Companies implementing these frameworks are transitioning away from the traditional short-term incentive (STI) and long-term incentive (LTI) structure to create one 'hybrid' incentive plan.

Under these plans, the performance period is typically measured over one year, with a portion of awards vesting in the form of cash at the end of the year, and the rest of the award (rights, shares and/or restricted shares), vesting over a number of years. The equity portion may be subject to long-term performance, however, in most cases these awards vest only subject to continuous employment. The total LTI opportunity is typically reduced to account for the significantly lower risk of forfeiture compared to traditional LTIs.

In most cases, the rationale presented by companies for switching to this modified structure is to help create greater alignment between key management personnel and shareholders by getting shares into the hands of senior executives. The key reason described for the shift is to address the situation where LTIs fail to vest for a number of years and therefore are not incentivising performance. When combined plans were initially adopted by a number of companies, proxy advisors and shareholders were generally receptive to the concept and rationale, albeit with a level of scepticism and subject to seeing how they paid out in future years.

As with traditional remuneration structures, the 'devil is in the detail' and companies need to be aware that the opinions and expectations of their asset manager and asset owner investors about 'what good looks like' when assessing plan structures and performance measures varies widely and with little consensus. In fact, there are several institutional funds who are not prepared to support combined remuneration plans under any circumstances. It is therefore essential that

Pratiksha Hebbandi – Governance Associate

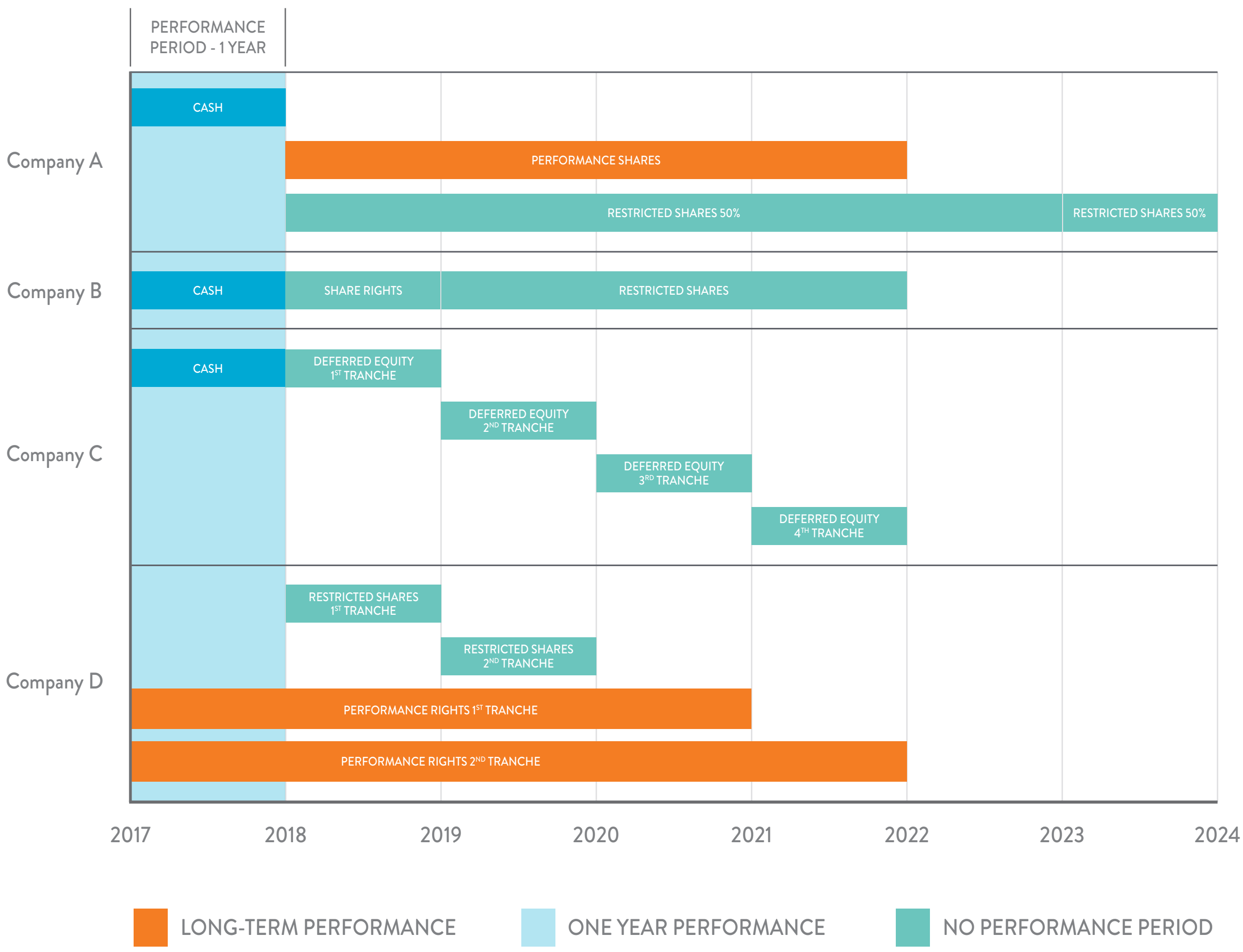
companies that have adopted these plans or are contemplating these plans clearly understand the views and expectations of their shareholders and other stakeholders.

Rolling forward to the present, there has been a shift in sentiment with this new hybrid incentive approach being met with mixed reviews from proxy advisors and institutional investors, particularly investors with a long-term investment horizon. As a starting point, it is expected that the LTI opportunity under a traditional plan should be discounted appropriately under a hybrid plan to reflect the increased likelihood for vesting.

Below is a summary of the 'pros and cons' of recently published combined incentive plans as seen from the lens of proxy advisors.

EXAMPLES OF HYBRID INCENTIVE PLANS

Source: Company Annual Reports, Morrow Sodali analysis



SUPPORTIVE ASPECTS

- Simplicity in disclosure and structure.
- Clarity in valuation.
- Enhancing executive share ownership.
- Reduction in total potential remuneration.

AREAS OF CONCERN

- Disclosure and transparency around annual performance targets is most critical, whereby any opaqueness is met with considerable shareholder scrutiny in the absence of long term performance hurdles.
- Removal of long-term performance metrics - total award vests based on annual performance hurdles, which may not translate to long term shareholder experience.
- Relatively higher financial benefit to the recipient can be paid for similar or lower levels of performance, by virtue of the time vesting component.
- Increased certainty of vesting by virtue of service based equity being granted, in addition to a significantly lower risk of forfeiture when compared to traditional remuneration structures.

Sustainability Reporting Expectations Continue To Rapidly Evolve

One of the most challenging issues we're hearing from companies is trying to keep up with the huge increase in demand to provide and respond to Environmental, Social and Governance (ESG) related requests. These requests are being sent from associations, shareholders and other agencies seeking sustainability data, with many requiring a substantial investment of resources and time to complete. However, companies are at times uncertain about the relevance or importance of participating in these surveys, understanding the methodology applied and what impact the research and ratings may have on their existing and prospective investors.

The appetite and demand however is not abating, and some of the world's largest index and active funds have updated their stewardship codes to articulate and strengthen their narrative on the importance of ESG risk management and how it feeds into their engagement strategy and the exercise of their votes, particularly relating to director elections.

This is also manifesting in an increase in the number of, and level of support for, shareholder resolutions.

We therefore note that ESG topics remain at the forefront of shareholder considerations with responsible investing increasing significantly in Australia. According to the findings of the Responsible Investment Association Australasia's (RIAA) 2018 Responsible Investment Benchmark Report, as at 31 December 2017, responsible investment constituted $866 billion in assets under management, up 39% from $622 billion in 2016, representing approximately 55.5% of total assets professionally managed in Australia. This is the first time responsible investment has constituted the majority of managed investments in Australia.

Initiatives such as the Task Force on Climate-related Financial Disclosures (TCFD) and the UN Sustainable Development Goals (SDGs) continue to gather support from companies and investors. Indicative of the support received from third parties and organisations, is the revised guidance published in June 2018 by the World Federation of Exchanges, suggesting that stock exchanges should include the UN SDG's and the TCFD recommendations in their listing rules. Organisations such as the Carbon Disclosure Project (CDP) and the Global Reporting Initiative (GRI) have also introduced important changes affecting reporting organisations.

Frida Panayi – Governance Senior Associate

THE TCFD'S GROWING INFLUENCE

As at August 2018, more than 390 organisations have officially expressed their support for the TCFD and its voluntary recommendations including Australian listed companies, investors and other organisations. In a report published in June 2018, the Australian Council of Superannuation Investors (ACSI) identified 22 S&P/ASX200 companies that have already adopted or committed to adopt the TCFD recommendations. ACSI stated in its report that the framework "appears to be becoming the 'gold standard' for climate-related disclosure".

The past year has also seen an increasing number of Australian investors express their support for the TCFD recommendations through updates to their stewardship or voting policies and their engagements with listed companies.

THE UNITED NATIONS' SUSTAINABLE DEVELOPMENT GOALS

The UN SDGs are a set of 17 global goals established by the United Nations in 2015 aiming to "end poverty, protect the planet and ensure prosperity for all" by 2030.

According to a report jointly published in July 2018 by the GRI, the Principles for Responsible Investment and the UN Global Compact, investors are increasingly expecting companies to report on the SDG's relevant to their operations and their impact on company strategy and financial performance. The report also stressed the importance of engagement between companies and investors as "understanding how investors use information to inform their decision making should support companies to make their disclosures more relevant and to attract the kinds of investors they seek".

In August 2018, the trio released an additional report offering companies more specific guidance on SDG reporting.

UPDATES TO THE GRI FRAMEWORK

The GRI reporting framework remains one of the most popular ESG reporting frameworks in the Australian market. According to ACSI, the "framework provides a good guide of what leading companies tend to disclose". ACSI also found that in 2017, 72 S&P/ASX200 companies used the GRI framework to report on their ESG impacts. Out of those 72 companies, 48 were constituents of the S&P/ASX100.

The GRI has issued various versions of its guidelines over the years. In 2016, the GRI published the GRI Standards, which replaced the G4 GRI Guidelines of 2013. Organisations preparing reports under the G4 Guidelines were required to transition to the new GRI Standards by 30 June 2018. The consequences are material where a company fails to disclose in accordance with the GRI Standards, with the GRI stating that, "if a report is published after this time that is not prepared using the GRI Standards, it will not be considered a GRI-based report".

OFFICIAL SUPPORTERS

Recognised by the TCFD
as at August 2018 (Australia)

COMPANY

AGL
APA Group
Aurizon
ANZ Banking Group Limited
BHP Billiton
BlueScope
Commonwealth Bank of Australia
Downer EDI
Mirvac Group
National Australia Bank
Origin Energy
Qantas Airways
South32
Stockland
Suncorp Group
Sydney Airport
Wesfarmers
Westpac Banking Group
Woolworths Group

INVESTORS

AustralianSuper
BT Financial Group
Cbus Super
Intrinsic Investment Management
Local Government Super
Perennial Value Management
VicSuper

OTHER

Australian Prudential Regulation Authority
CPA Australia

Source: TCFD website, TCFD Supporters as of August 2018

As part of its new Standards, the GRI introduced further changes to two key ESG reporting indicators ('occupational health and safety' and 'water and effluents'). In a June 2018 statement, the GRI advised that the indicators were updated to "ensure reporting on these issues is done according to current best practice". Companies reporting on these two indicators will need to update their reporting by no later than 31 December 2020.

THE CDP SURVEY

The CDP, which has over 650 signatories representing more than USD $87 trillion in assets under management, operates a global disclosure system that requires organisations to report annually on key environmental topics and metrics. Each year, the CDP invites organisations to participate in its surveys. Organisations are then rated by the CDP based on the information submitted. Companies invited to participate in the survey that decide not to respond to the CDP's request will receive the lowest score in the scale: 'F'.

The CDP's 2018 survey was designed to reflect the TCFD recommendations, with new questions introduced covering more forward-looking metrics. The CDP also introduced questions specific to high-impact sector activities across its climate change, forests and water programs 'in response to market needs'.

An administrative fee for companies responding to their survey was also introduced in 2018. The fee applies to companies listed, incorporated or headquartered in North America, Latin America, Western Europe, South Africa and parts of Asia-Pacific. In discussions with top ASX listed companies, Morrow Sodali is aware that the introduction of an administrative fee has resulted in previous survey respondents forgoing participation in 2018. Companies who forego participation need to be aware that this may trigger a 'penalty' resulting in a downward impact to their ESG score.

Jana Jevcakova - Governance Manager

Director Accountability & Corporate Culture Under Intense Scrutiny

Where to start!

The Royal Commission hearings in the first half of 2018 have broken the mould of traditional board-related governance considerations, and has resulted in the overhaul of several boards in the financial services industry. Whilst the hearings remain ongoing, we expect that shareholders and proxy advisors will be highly attuned to the Royal Commission's findings and are expected to apply an even greater level of scrutiny on directors up for election during the 2018 AGM season than in previous years.

Consequently, the discussion around corporate culture and the importance of managing it effectively has reached considerable momentum. Companies and investors alike are still grappling with the concept, seeking a clear explanation as to what exactly constitutes corporate culture so that such concerns can be addressed with relative uniformity. Irrespective of the challenge in standardising how corporate culture is defined, valued and measured, the need for a system of checks and balances, and the ability to demonstrate how companies manage risks and opportunities arising from their existing and/or desired culture, have been acknowledged by institutional investors, proxy advisors, ESG research providers and other governance stakeholders including the Australian Council of Superannuation Investors (ACSI).

In response, the consultation draft of the proposed 4th edition of the ASX Corporate Governance Principles and Recommendations released in May 2018, proposes to replace Principle 3 'Act ethically and responsibly', with a more specific 'Instil the desired culture'. This includes a recommendation to develop policies that focus beyond shareholders to include employees, customers, suppliers, creditors, regulators, consumers, taxpayers and the local communities in which a company operates. The draft also implies shared responsibility with a recommendation that companies only deal with business partners who demonstrate similar lawful, ethical and socially responsible business practices.

ACSI suggests that as a starting point, the design and implementation of a Code of Conduct and an effective whistleblowing system encourages ethical performance and provides protection against inappropriate behaviours. It is therefore noteworthy that only 11 of S&P/ ASX200 companies satisfy ACSI's definition of leading practice, with less than a half of S&P/ ASX200 constituents addressing key business risks, including cyber-security, anti-money laundering and human rights. With the introduction of modern slavery laws expected later this year, companies with a minimum annual revenue of A$100 million will be required to publish annual statements detailing their actions to address modern slavery and control of their supply chain.

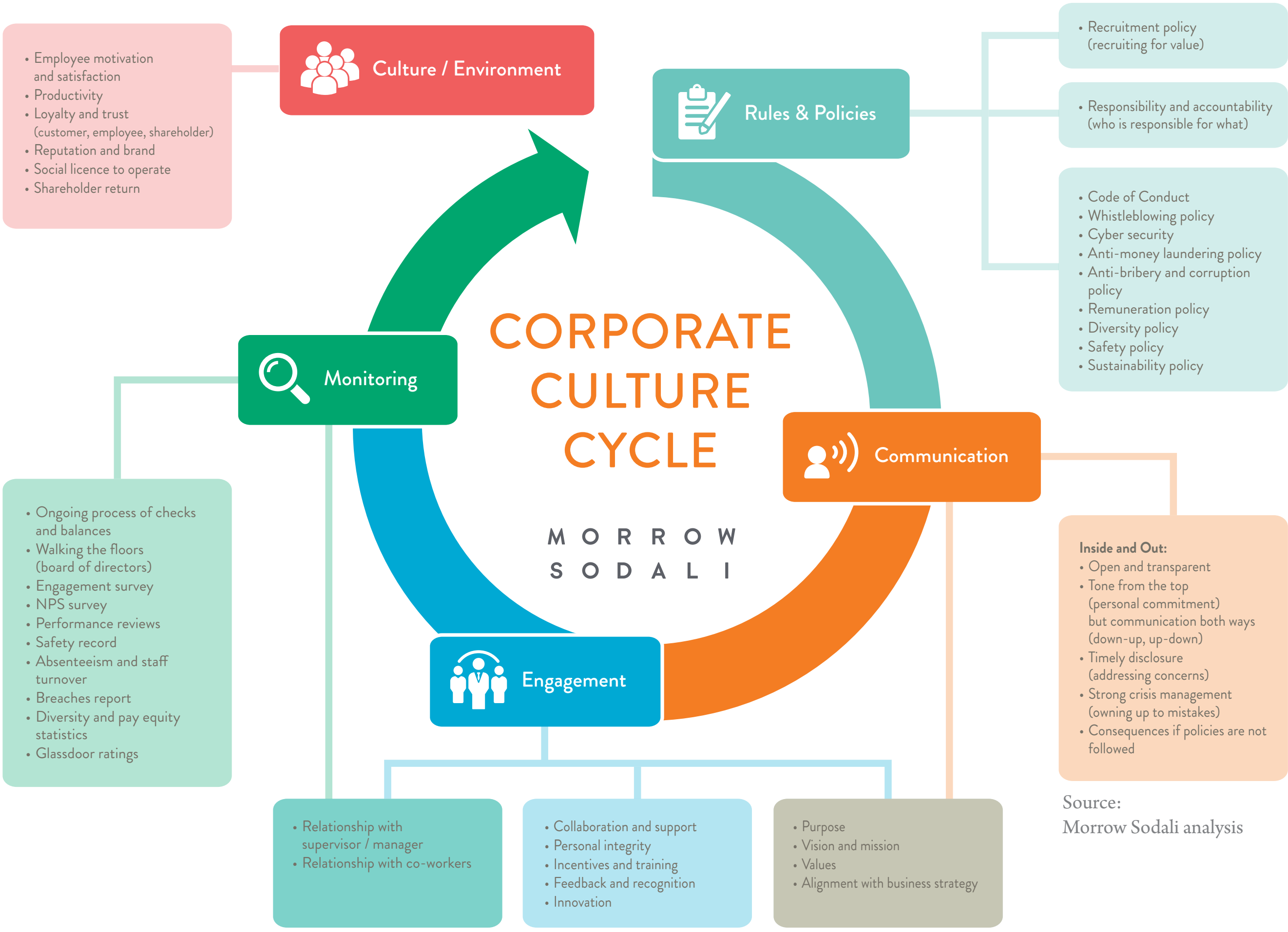
The Australian government proposes that for the purpose of the reporting requirement, modern slavery will encompass slavery, servitude, forced labour, debt bondage and deceptive recruitment practices for labour or services.

Diversity is an integral part of a company's culture and gender diversity remains firmly at the forefront of shareholder engagement topics. ACSI has implemented a policy to recommend a vote against the chairperson or the chair or a member of the nominations committee for S&P/ ASX200 boards with no female directors. Amongst superannuation funds, HESTA is a strong advocate for gender diversity on corporate boards and votes against the most senior director seeking re-election on an all-male board; and Australian Super has a Socially Aware option for its members, which excludes the securities of companies with single-gender boards (S&P/ ASX200 companies only), amongst other ESG considerations.

Diversity policies are most effective when a listed entity sets numerical targets to be achieved within a specified timeframe, outlines the initiatives it is introducing to help meet those targets and then reports regularly on its progress in achieving those targets. Non-numerical objectives such as "introducing a diversity policy" or "establishing a diversity council", and aspirational objectives such as "achieving a culture of inclusion", are unlikely to be effective in improving gender diversity unless they are reinforced with meaningful numerical targets.

Policy approach alone does not guarantee a healthy culture, nor does it automatically solve a problematic culture. In fact, our research shows that there is little correlation between the quality of disclosure of policies and cultural 'identifiers' (i.e. values, vision, purpose) and the perception of actual culture within an organisation or indication of cultural deficiencies.

As discussed at the recent Governance Institute's National Conference in Sydney, some of the practical things that boards and directors can do to promote a more positive culture in their organisation include considering how they are modelling the firm's desired behaviours and values when



Source:
Morrow Sodali analysis

interacting with management and staff; having more robust interaction with staff across the organisation and creating good relationships with key employees; having periodic engagement with all stakeholders to get a broad perspective on issues impacting customers, suppliers, regulators and the community; and including culture as a regular feature on the board and audit committee agenda. Lastly, a board should consider monitoring the composition and behaviour of the board on a regular basis to see how this is impacting the culture of the organisation.

A board skills matrix is a useful tool that can help the board identify any gaps in its composition that should be addressed through providing professional development opportunities to existing directors or recruiting new director candidates. A board skills matrix should address the full range of skills that the board considers desirable in its membership. In this regard, boards are increasingly being called upon to address new or emerging issues including culture, conduct, risk, digital disruption, cyber-security, sustainability and climate change. The board should regularly review its skills matrix to ensure that it reflects the skills needed to address existing and emerging business and governance issues.

Disclosing the board skills matrix gives investors useful information and helps to increase the board's accountability in ensuring it has the skills to discharge its obligations effectively and to add value. In 2017 Morrow Sodali identified 14 S&P / ASX200 companies without a board skills matrix disclosure, 70 with poor disclosure and 95 with a very basic disclosure. Among the ASX companies that provide detailed disclosure of their BSM and break out director specific information are ANZ Banking Group, Caltex Australia, Janus Henderson Group, Mineral Resources, Regis Resources, Invocare and Greencross.

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MORROW SODALI BOLSTERS CORPORATE GOVERNANCE EXPERTISE OF SYDNEY TEAM WITH THE APPOINTMENT OF JANA JEVCAKOVA

Morrow Sodali is delighted to welcome prominent Sydney-based governance specialist, Jana Jevcakova, to its Sydney governance team. Jana's appointment further strengthens our position as Australia's leading Shareholder Engagement and Corporate Governance Advisory firm.

Jana is recognised as one of Asia-Pacific's leading experts in corporate governance and proxy research, having spent the last seven years advising domestic and global institutional investors whilst engaging with company boards around ESG matters.

Together with our regional head of Corporate Governance, Michael Chandler, Jana's knowledge of executive remuneration frameworks and environmental and social issues will enable us to provide deep, strategic governance advice to our growing portfolio of ASX listed company clients to help them manage engagement and voting risks for both routine and M&A situations.

"I'm very excited to be joining Morrow Sodali at a time when investors are taking a more hands-on approach towards Environmental, Social and Governance (ESG) related issues and the market is buzzing with the word culture. I look forward to supporting Morrow Sodali's clients and further building on our reputation as trusted advisors," says Jana.

ABOUT MORROW SODALI

Morrow Sodali, is a global consultancy firm specialising in shareholder engagement and corporate governance advisory services. From headquarters in New York and London and seven offices in major capital markets, we serve more than 700 corporate clients in 40 countries, including many of the world's largest multinational corporations. Our in-house Sydney-based corporate governance advisory team comprises governance and sustainability professionals, including former governance research leads from ISS and CGI Glass Lewis with over a decade of proxy advisory and engagement experience and expertise. Morrow Sodali's global governance team is made up of more than 15 professionals and specialists providing corporate boards and executives with strategic advice and disclosure based solutions relating to a broad range of activities, including mergers and acquisitions, annual and special meetings, shareholder activist initiatives, multinational cross-border equity transactions and debt restructuring services.

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