Quarterly stock commentary February 2020

That which gets rewarded, gets done……..

At Celeste one of the things we assess in companies is the Management that run them and the Board that governs them. This is a crucial step to help us understand the culture of the company, the appetite for risk and the desire to work in shareholders' best interests.

We assess the Board first as the Board appoints Management, they hold Management accountable for the execution of the strategy, the operation of the company, adherence to all the required regulatory frameworks and they oversee the corporate culture. They are a vital part of the governance framework that leads to good corporate behaviour and strong execution, which creates value for employees, the community and shareholders. Most importantly, the Board remunerate the Management for their performance against an established criteria.

At Celeste, we like to read Annual Reports for both companies that we own or ones we are thinking of buying. The Annual Report is a treasure trove of information on the company. Typically the Annual Report contains a discussion of the corporate strategy, an assessment of the year's performance against this strategy and a view to longer term opportunities and risks. Added to a strategic roundup is a full set of financial accounts. The financial accounts are the once a year opportunity to dive into the numbers in far more detail. The ability to read the detailed notes and assess the numbers in the context

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of the performance against the strategy makes the Annual Report a meaningful piece of information.

Inside the Annual Report is one further vital piece of information that we use when assessing the Board and Management - the Remuneration Report. The Remuneration Report we see as the annual report card for the Management team and how they performed against their set milestones.

We think of the Remuneration Report as the most visible form of the natural tension that exists between the Board and the Management. Simplistically, the Board wants to make the hurdles for the Management team challenging, in order to achieve the best possible outcome for the company. Alternatively, Management desire easier milestones so they have a higher level of certainty in achieving them.

The appointment of Remuneration consultants has, over the years, made the process slightly more complicated, but in essence the Remuneration Report is an iterative discussion between the Board and Management around remuneration terms, conditions, timeframes, vesting periods and hurdle rates. It's a little like solving a Rubik's Cube. Every move works to a conclusion point, where the final turn delivers 6 full colour faces. Eventually the Board and the Management iterate to the final remuneration terms and conditions and in most cases both don't get exactly what they want.

The agreed terms highlight the hurdles and return criteria that both parties are willing to accept as reasonable. The Board believes the agreed terms will meet the demands of shareholders and allow Management to perform their jobs, stay true to strategy and be financially rewarded. On the flip side, Management feel the remuneration terms are appropriate for them to do their jobs, grow the business while ensuring they get an opportunity to earn both short term (STI) and longer term incentives (LTI).

Over a year as we see companies we always try to vary who we meet. Company meetings are usually with a mix of Management, operational executives, the Chairperson and also other Non-Executive Directors. We like to meet each separately to reconcile their individual responses to help us form a mosaic view on the day-to-day operation of the business, reporting lines, operational processes, Board reporting, strategy setting and corporate culture. In each of these meetings we also discuss the Remuneration Report and try to understand why each party, from their perspective, thinks the terms and conditions are reasonable. Understanding what they think, helps us best frame the business risks contained in the STI and LTI hurdles.

Often, aggressive remuneration hurdles promote poor Management practices. For example, overly ambitious earnings per share growth targets can result in poor, off-strategy acquisitions and aggressive application of accounting standards, including: increased cost capitalisation, aggressive revenue recognition criteria and changed depreciation/provisioning schedules. Conversely, excessive hurdles may lead to higher Management turnover and a loss of talent and corporate memory.

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How human beings act and behave is complex and difficult to try and predict. Typically people will work hard to achieve the things that they know will be rewarded. Understanding what Management and the Board see as an acceptable remuneration hurdle rate helps us to dimension some of the operational risks for the business. What we aim to better understand at Celeste is how people are being rewarded, if they think targets are reasonable and achievable and what unintended consequences these targets may promote. Sensible targets constructed logically around company and industry growth rates can promote strong companies, great cultures and long term wealth creation for all stakeholders.

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