Why management incentives matter - in the resource sector

Nick Pashias and Winston Chong December 2022

Nick is Head of Equities and Portfolio Manager of the High Growth Shares Fund and Elite Opportunities strategy. Nick is responsible for researching stocks in the Metals & Mining sectors. He has 24 years industry experience and previously consulted on efficiency improvement & process streamlining in the mining industry. Nick holds a Ph.D. in Chemical Engineering and a Master of Applied Finance. Winston is Deputy Portfolio Manager of the Ex-20 strategy and leads the team's ESG and Sustainability initiatives. He has 12 years industry experience and holds a Bachelor of Law & Bachelor of Commerce, is a CFA Charterholder, and is currently undertaking Master of Social Impact (Swinburne).

Why management incentives matter in the resource sector

Berkshire Hathaway's Charlie Munger is famously quoted saying "show me the incentive, I'll show you the outcome". In this note, we show why scrutinising incentive structures forms an important part of our company analysis, delve into the incentive structures across the resources sector and discuss how Antares uses this information to assess and potentially influence a company's ability to create long term shareholder value.

Antares Equities has long considered non-financial indicators as part of our investment process. Over the last few years we have consolidated this work into our Sustainability Scores (these are explained in Figure 6). A key input to the score is the strength of alignment between management and shareholders. As investors who take a long-term view of a company's prospects, it's critical there is a strong alliance between shareholders and those responsible for overseeing the management of the business.

There are many reasons why we believe this is important:

1. As shareholders there are only two paths to generate a return on our investment, through dividends or capital appreciation. Because management have an integral role to play in determining these returns it's critical that there be some nexus between management incentives and shareholder outcomes.

2. As advocates of Discounted Cashflow Analysis (DCF) we recognise that, generally, the majority of the value resides in the terminal value (ie greater than 10 years into the future). As such we need to ensure, as best as possible, there is strong alignment to do what's best for the long-term prospects of the company and hence shareholders.

3. Over the long term, exogenous, black swan (unforeseen) events are inevitable; we need to be confident that management are not taking undue risk in pursuit of short term returns that may wipe out shareholder returns should adversity arise.

4. We also recognise that employee safety, community support, climate change and other license-to-operate concepts are critical to the long-term prospects of any company.

As part of our research process, we look deeply into management incentive structures in order to assess which are best practice and if any are flawed or lack critical components. We are not overly concerned about the quantum of remuneration but more focused on the structure. Given the problems posed by **agency theory***, the wrong behaviours, as a result of a poorly designed incentive plan, often have a detrimental impact on shareholder outcomes that may be far greater than the impact of excessive remuneration. Conversely, our expectation is that well designed incentive plans seek to reduce losses and conflicts of interests associated with agency theory.

Note: ***Agency theory** is a theory that explores the relationship between principals and agents to whom principals delegate work. In the context of a publicly listed company, this relates to the relationship between shareholders (the owner principals) and management (the delegated agents). Principals and agents can have different priorities because of a difference in interests – this can often manifest in differences in risk tolerance, focus on different time horizons of profitability, and differing views on executive compensation and appropriate capital structures. Companies often seek to reduce agency risk and loss through well designed incentive structures that align management with shareholders' interests over the long term.

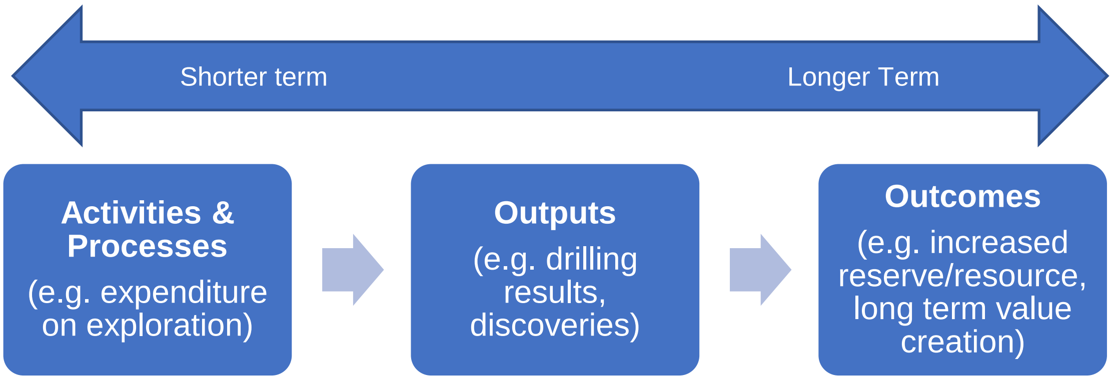
We do note that excessive remuneration can be an indicator of poor governance and can point to an imbalanced relationship between the Board and management and / or a complacent Board culture.

What we look for in a well-designed incentive framework

Designing an incentive plan that enables and encourages long term shareholder value can be both an art and science. Boards need to strike a balance between making remuneration packages attractive enough to retain talent through setting achievable goals, whilst also ensuring the path to those goals does not jeopardise the company long term.

Hence, we believe it is important that companies employ a mix of measures that encompass critical processes, expected outputs and long term outcomes to ensure the sustainability of shareholder value creation. This is particularly important in the resources sector where commodity prices are volatile and can test management's long-term commitment to shareholder value if incentives are not structured well.

Figure 1: Sound incentive structures cover various time horizons and incentives process, outputs and outcomes.



Source: Antares Equities; November 2022

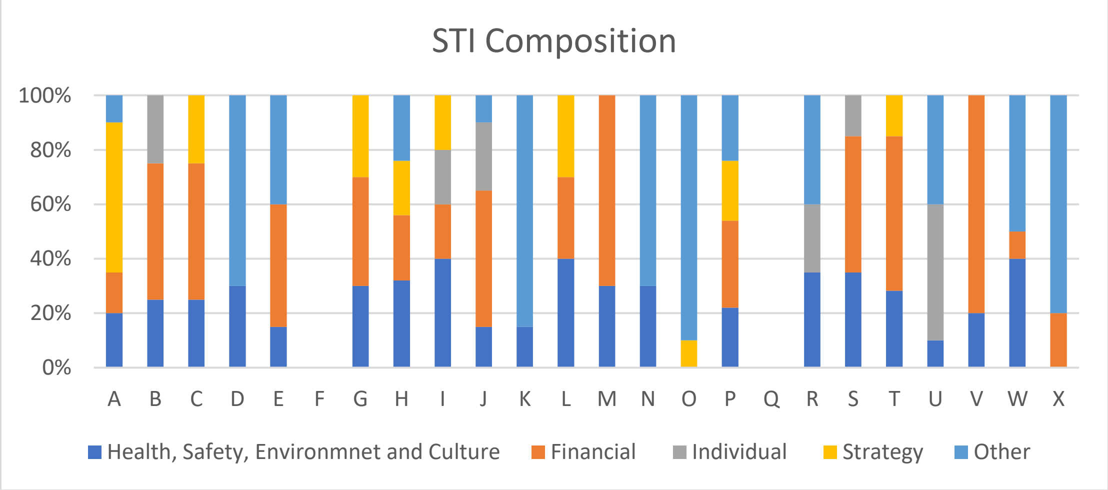
Deconstructing incentives in the resources sector

We have evaluated the structures of the 24 resource companies under our coverage (See Appendix 1). Illustrated in Figure 2 is a summary of the Short-Term Incentive (STI) plans, grouped by us into homogenous clusters to make comparison easier.

Of the 24 companies, two do not have any STI. The greatest number of companies have STIs that include three of the following five categories:

- Health, Safety, Environment and Culture
- Financial
- Individual
- Strategy
- Other

Figure 2: STI composition



Source: Antares equities, company reports; October 2022

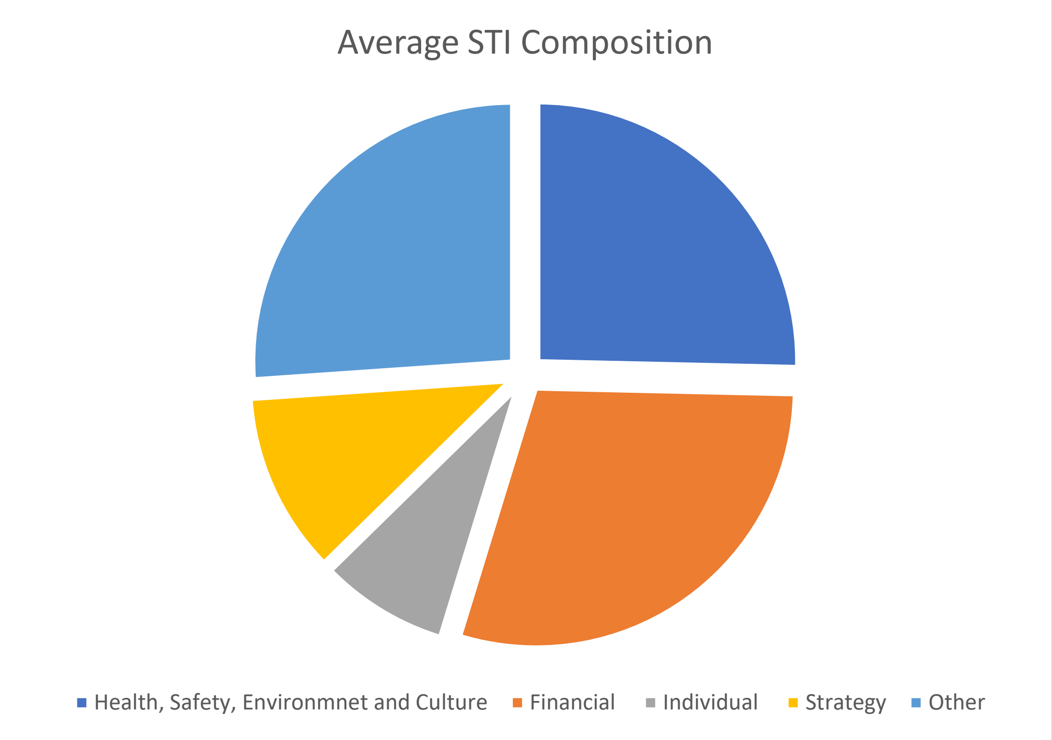
When we look at the “average” company we can see that roughly speaking, STI breaks down to 25% in each of:

- Health, Safety, Environment and Culture,
- Financial, and
- Other (generally relates to a cost or production target for many of the companies under coverage)

The final 25% is split between Individual (typically relating to a Key Management Personnel’s individual performance criteria) and Strategy (typically associated with the company’s strategic agenda).

It is pleasing that many of the companies have a significant allocation to Health and Safety, with Environment and Culture an increasing contributor to the cluster. The reason Antares views these categories as important is they indicate an understanding of the critical nature of these areas with regard to a resources company’s license to operate – these companies operate in dangerous environments and draw on natural capital to create value. Hence, protecting a company’s human and natural capital and aligning managers incentives is of critical importance.

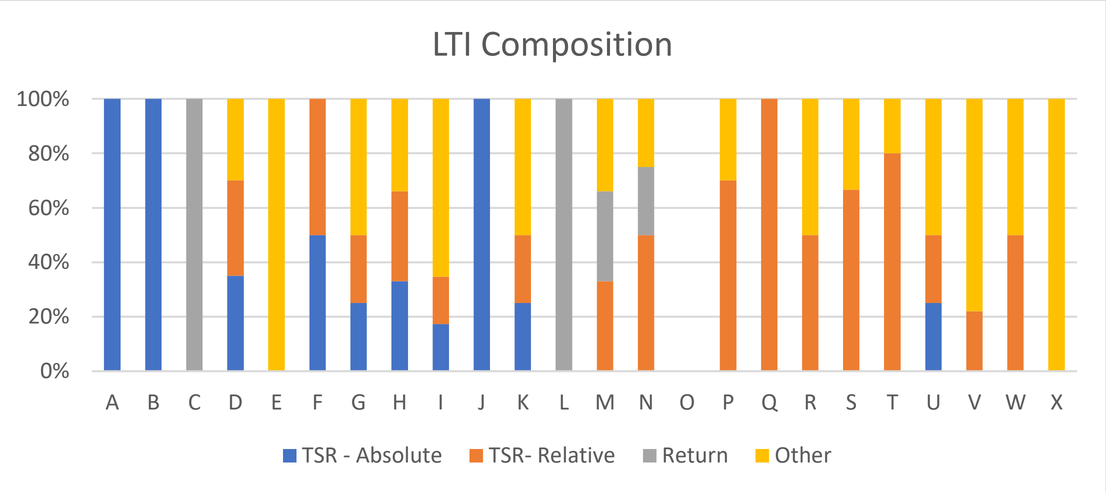
Figure 3: Average STI composition (%)



Source: Antares Equities, Company reports; October 2022

Figure 4 is a summary of Long-Term Incentive (LTI) structures across our resources’ coverage. One company under our coverage does not have any LTI in place and many include some form (absolute or relative) of shareholder return (TSR). Only four companies under our coverage do not have this as part of their LTI.

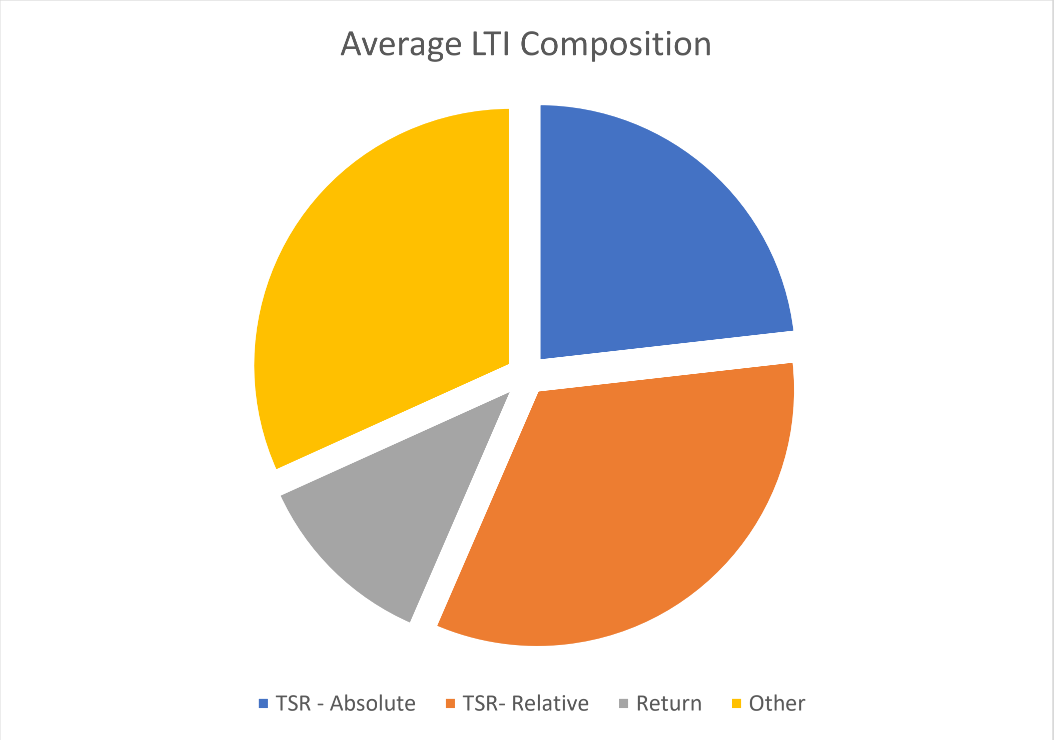
Figure 4: LTI composition (companies A-X)



Source: Antares Equities, Company reports; October 2022

The LTI breakdown of the “average” company is presented below. Shareholder returns make up the majority of the incentive. The “other” component is made up of reserve/resource metrics, climate change objectives or other health and safety targets; all of which are useful when used in conjunction with shareholder returns.

Figure 5: LTI composition (%)



Source: Antares Equities, Company reports; October 2022

The inclusion of shareholder returns in LTI structures is one way in which Boards seek to resolve conflicts of interest that arise from agency theory in aligning remuneration incentives with the returns that shareholders receive. This is often done over staggered time frames. In addition, the inclusion of resource and reserve metrics demonstrate the importance of maintaining and developing a resource company’s natural capital for future value creation. Lastly, with the advent of net zero targets being announced, the inclusion of climate related metrics is becoming increasingly important in ensuring integrity behind those targets to avoid virtue signalling without action (“greenwashing”).

How Antares uses this information

At an individual company level, looking at management incentives and their alignment is one of the inputs into Antares’ proprietary Sustainability Scores across our coverage universe. This reflects our view that management and governance structures are an important component of a company’s ability to create long term shareholder value. It also ensures Antares analysts are systematically scrutinising management incentives on an ongoing basis.

Antares Sustainability Scores
In practice, our Sustainability Scores are used to express analyst conviction. They play a role in how stocks are designated in portfolio construction and are one element of our risk management framework at the portfolio level. Our analysts score each company under coverage using a score card approach across four categories and 12 subcategories per below. The scorecard consists of four key factors that Antares believes underpins the ability for a company to sustainably create value over the long term: management, industry, financial and non-financial. Each category is scored 1 (poor) to 5 (good). The score is then aggregated to a percentage and the coverage universe is then ranked.

Figure 6: Antares Sustainability Scorecard criteria

Management	Industry	Financial	Non Financial
Alignment/Remuneration	Industry structure	Return on Equity	Relationship management
Capability	Opportunity size	Predictability/Dispersion	License to operate
Strategy	Capital flows	Leverage	Human capital & culture
Integrity/Disclosure	Disruption & innovation	Financial sustainability	Other non financial capital e.g. environmental, intellectual

Source: Antares Equities

The Sustainability Scores can be understood as a quality overlay for each stock under coverage. In addition to valuation upside, the sustainability score provides information to the portfolio manager about the enduring quality (or lack thereof) of a company's ability to create value, and therefore confidence around long term value.

Poor incentive structures can also be an indicator of governance issues. Where material governance issues are identified, our analysts are required to consider introducing a governance discount (via our ESG Traffic Lights System) into their valuations and target prices to reflect this heightened risk.

In this ESG Traffic Lights System, analysts assign a Red, Amber or Green Rating for each of Environmental, Social and Governance factors for each stock under coverage. The diagram below describes our rating system and the impacts.

Figure 7: Antares ESG Traffic Lights System

Traffic light	Green	Amber	Red
Issue	No material issues identified	Potential issue identified	Material issues identified
Impact		May impact valuation, cash flows, shareholder returns or multiple	Expected or current impact on valuation, cash flows, shareholder returns or multiple
Change			MUST be reflected in analyst's target price

Source: Antares Equities

Target price discounts for red ratings typically range from 5-20% informed by the materiality of the issue, with the average discount being 10%. Where investment recommendations contain amber or red ratings, analysts are required to discuss the reasons behind why and closely monitor these risks. These are refreshed every time a new target price is posted for a stock. Our ESG Traffic Lights System is the primary way in which we account for ESG related downside risk. This analysis also assists us in our ongoing dialogue and engagement with Board and management teams. This type of analysis enables us to identify deficiencies in remuneration frameworks and can often assist in putting forward our case towards adjusting frameworks. For example, where Antares has observed a low or zero weighting towards safety in a company's remuneration framework, we have been able to present benchmarking information to the board and management as part of our advocacy for the introduction of a greater weighting to safety into management's incentives.

Ultimately our aim in looking at remuneration structures and frameworks is to understand the incentives driving management decisions as stewards of shareholder capital. Unsurprisingly, our observation over time is that poring through the often ignored remuneration reports can provide insight into the decisions management are likely to make over the coming years – in short, as Charlie Munger asserted, the incentives do tend to drive the outcomes.

Appendix 1: List of resource companies covered by Antares Equities

Stock Code	Company Name
AWC	ALUMINA LTD
BGL	BELLEVUE GOLD LTD
BHP	BHP GROUP LTD
CHN	CHALICE MINING LTD
CIA	CHAMPION IRON LTD
DRR	DETERRA ROYALTIES LTD
EVN	EVOLUTION MINING LTD
FMG	FORTESCUE METALS GROUP LTD
GMD	GENESIS MINERALS LTD
IGO	IGO LTD
ILU	ILUKA RESOURCES LTD
LTR	LIONTOWN RESOURCES LTD
MCR	MINCOR RESOURCES NL
MIN	MINERAL RESOURCES LTD
NCM	NEWCREST MINING LTD
NHC	NEW HOPE CORP LTD
NST	NORTHERN STAR RESOURCES LTD
OZL	OZ MINERALS LTD
PDN	PALADIN ENERGY LTD
PLS	PILBARA MINERALS LTD
RIO	RIO TINTO LTD
S32	SOUTH32 LTD
SFR	SANDFIRE RESOURCES LTD
WHC	WHITEHAVEN COAL LTD

Important information

Get in contact

antarescapital.com.au

Toll free: 1800 671 849
Email: investorservices@antaresequities.com.au
Mail: GPO Box 2007 Melbourne VIC 3001