# Questions and answers – DuluxGroup short and long term incentive arrangements

## Short term incentive (STI)

The DuluxGroup STI plan is the Group's annual at-risk incentive programme for the executives whose remuneration we disclose in the Annual Report to shareholders. It also applies to other senior managers within the Group. Details of how the STI plan operated in 2016 are set out below.

### Form and purpose of the plan

#### What is the STI?

The STI is an annual cash incentive plan that links a portion of the executives' reward opportunity to specific performance measures. All executives participate in the STI.

#### Why does the Board consider the STI plan an appropriate incentive?

The STI is designed to put a meaningful proportion of executives' remuneration at-risk, to be delivered based on the achievement of targets linked to DuluxGroup's annual business objectives.

#### Does the STI comprise a deferred component?

In 2016 there was no deferred component, and all 2016 STI awards will be provided in cash.

As a result of a benchmarking exercise undertaken by the Board during 2016, the Board intends in 2017 to defer 15% of all executive STI awards into DuluxGroup shares with forfeiture applying during the two year deferral period. This is intended to enhance shareholder alignment and retention. The maximum STI opportunity for each executive will increase by 10% of fixed annual remuneration (FAR) in 2017 as a result of this change.

### Governance

#### When are targets set and reviewed?

Targets are set at the beginning of each financial year, while performance against these targets is reviewed at the end of the financial year. Any payments are then made in December following the end of the financial year.

#### How are performance conditions and outcomes approved and assessed?

All performance conditions under the STI are clearly defined and measurable.

The Chief Executive Officer (CEO) sets the targets and determines the extent to which the targets have been met for the Chief Financial Officer (CFO) and other executives, taking into consideration the advice of the Remuneration and Nominations Committee (RNC) of the Board. These outcomes are approved by the Board.

The Board, on recommendation from the RNC, approves the targets and assesses the performance outcomes of the CEO.

The Board has adopted a rigorous process for assessing performance under the STI plan which includes external verification of the calculation process and payments.

The Board has discretion to adjust STI outcomes up or down to ensure that they accurately reflect the achievement of results that are consistent with the Group's strategic priorities, are in line with Group values, and enhance shareholder value.

The Board retains complete discretion to adjust any STI award (e.g. such discretion may be exercised in the event of a fatality).

### Gateway and performance conditions

#### Is there an STI plan 'gateway' and how is it determined?

Yes. The Board considers it important that, in general, the Group should achieve a minimum acceptable level of profit before any payments are made under the STI plan.

No STI is awarded (upon achievement of either financial or non-financial metrics) if minimum performance across DuluxGroup does not achieve a threshold NPAT performance level.

The NPAT gateway for the STI plan is determined by the Board each year, with reference to a range of factors. While prior year NPAT is referred to as a starting point, economic conditions, industry trends and practices and other relevant circumstances are also factored in to the Board's decision.

For the purpose of the 2016 STI plan, the minimum performance level was set at the prior year NPAT before non-recurring items of $124.7 million.

#### What are the STI performance conditions and why were they chosen?

The performance conditions for 2016 included both financial and non-financial targets.

Performance conditions are chosen in order to align with the Group's annual budget, targets and longer term plan and therefore, reinforce and drive business strategy. Details of the 2016 performance conditions and the strategic objectives that they support, are set out in sections 2.1 and 3.3 of the 2016 Remuneration Report.

In setting the Hurdles for the STI (that is, the minimum level of performance required for any award to be payable), the RNC is conscious to ensure that all targets are measurable and provide a challenging but meaningful incentive to scheme participants.

The Board also considers it important that executives have a clear line of sight to the targets and are able to affect results through their actions. Accordingly, performance conditions and weightings are directly linked to individual executives' responsibilities.

The Board considers the 2016 performance conditions to be appropriate as they are ultimately aligned with the Group's objectives of delivering profitable growth and shareholder return.

The Board believes that the largest component of an executive's STI award should be affected by the financial performance of the Group, and accordingly generally 70 per cent of executives' awards are financial metrics.

Performance conditions are set at both a DuluxGroup and business unit level, and for those executives with business unit responsibility, STI is directly linked to the performance of their business.

Non-financial metrics are based on performance against core values – including safety and sustainability. In the event of a fatality, The Board retains complete discretion to adjust any STI award (e.g. such discretion may be exercised in the event of a fatality).

Non-financial metrics also include other individual measures such as the successful implementation of specific Group or business unit strategies, achievement of specific customer or consumer based measures and the delivery of targeted, sustainable growth objectives. An overview of the non-financial metrics for executives during 2016 is set out in section 3.3 of the Remuneration Report.

## Cessation of employment, clawback or change of control

### If an individual ceases employment during the year, will they receive a payment?

The individual will not be eligible for a payment if terminated due to misconduct or poor performance nor in general, if they resign.

In certain appropriate circumstances (such as redundancy), the Board may consider eligibility for a pro-rata payment in respect of the current performance year.

### Is there ability to claw back awards in appropriate circumstances?

Yes. The Group has a formal Clawback Policy that provides the Board with broad discretion to ensure that no unfair benefit or detriment is derived by any participant in the case of a material misstatement in Group financial results or serious misconduct by a participant, including where the Group suffers material reputational damage. This includes discretion to reduce, forfeit or reinstate unvested awards, or reset or alter the performance conditions applying to any award.

### How would a change of control of the Group impact on STI awards?

The Board has absolute discretion in relation to STI awards on a change of control, which it would exercise in the best interests of the Group.

Unless the Board determines otherwise, the STI awards will be considered to have been met at the midway point between Hurdle and Stretch for the full performance year, notwithstanding the date of change of control.

## Long Term Equity Incentive Plan (LTEIP)

The DuluxGroup LTEIP is the long term at-risk incentive component of remuneration for the executives whose remuneration we disclose in the Annual Report to shareholders. It also applies to other specified senior managers within the Group. Details of how the LTEIP operates in respect of the grant made during 2016 are set out below.

### Form and purpose of the plan

#### How does the LTEIP operate?

Under the LTEIP, executives are provided with a non-recourse loan from DuluxGroup for the sole purpose of acquiring DuluxGroup shares. The shares are granted upfront but are restricted and subject to a risk of forfeiture until the end of the vesting/performance period and while the loan remains outstanding.

Subject to the achievement of an earnings gateway, part of the loan may be forgiven at the end of the loan period based on the achievement of a relative Total Shareholder Return (TSR) performance condition (described in more detail below). To gain access to the shares, the executive must repay the outstanding loan following testing of the performance condition.

#### How does the LTEIP drive performance?

The LTEIP facilitates immediate share ownership by executives and links a significant proportion of their remuneration to the Company's ongoing share price and returns to shareholders over the performance period. It is designed to encourage participants to focus on the key performance drivers which underpin sustainable growth in shareholder value.

The Board believes the LTEIP promotes behaviour that should achieve superior performance over the long term through both an earnings gateway that must be achieved before any shares vest and a TSR performance condition. The performance condition provides for a portion of the loan to be forgiven where DuluxGroup performs well against its market comparators.

#### How does the plan align participants' interests with shareholders?

The immediate share ownership aligns a participant's interests with those of shareholders from the outset.

Annual grants subject to a three year performance period, combined with the minimum shareholding requirements, mean that executives have a direct holding in the Company that is directly aligned with the outcomes delivered to shareholders.

#### How does a participant derive value from LTEIP?

Participants can derive value from LTEIP in three ways:

- through appreciation of DuluxGroup's share price over the loan period; and/or
- the value of after-tax dividends applied in repaying the loan thereby increasing their equity over the loan period; and/or
- through potential loan forgiveness of a portion of the loan as a reward for superior performance against the Group's market comparators.

### Vesting and performance condition

#### What is the 'gateway'?

The Board has implemented a 'gateway' level of minimum acceptable growth in Earnings Per Share (EPS) performance below which no shares vest.

The EPS gateway in respect of the offer made during the 2016 financial year is for compound annual growth over the three year period from 1 October 2015 to equal or exceed 4% per annum. Where the EPS gateway is met, at the end of the performance period there is potentially value to participants if the value of their shares is greater than the outstanding loan balance that must be repaid.

#### Why does the Board consider the gateway appropriate?

While the Board considers share price growth to be the primary indicator of DuluxGroup's success at present, the EPS gateway is designed to ensure that the quality of share price growth is supported by Group performance, not market buoyancy alone.

For this reason, the Board considers that it is appropriate to set a minimum level of operating performance, and that EPS growth is an appropriate measure for this purpose.

During the year the Board considered that the 4% level for EPS growth remains appropriate, noting that it is set as a minimum level of growth. The real benefit to LTEIP participants is achieved through superior performance against the relative TSR condition that determines the level of loan forgiveness.

#### What is EPS and how is it calculated?

EPS growth measures the growth in earnings on a per share basis.

EPS is calculated by dividing DuluxGroup's net profit after tax (NPAT) by the weighted average number of ordinary DuluxGroup shares on issue during the relevant period.

The Board retains discretion to adjust EPS for individually material non-recurring items on a case by case basis when determining whether the EPS performance gateway condition has been met. In this way the Board is able to ensure that the EPS measurement correctly reflects the underlying performance of the Group.

### How is the relative TSR performance hurdle applied to the plan?

If the EPS gateway is met and the shares vest, a portion of the outstanding loan may be forgiven in order to reward superior performance.

The level of loan forgiveness (if any) depends on the Company's TSR performance against the comparator group.

### How is the forgiveness amount determined?

There is no loan forgiveness amount if the Company's TSR is below the 51st percentile relative to the comparator group.

If DuluxGroup TSR is equal to the 51st percentile, participants become entitled to 10 per cent loan forgiveness which increases to a maximum of 30 per cent based on the Company's relative performance on the 'sliding scale' shown in the table below.

*Loan forgiveness*

| Relative TSR Ranking | Loan forgiveness – proportion of initial loan balance forgiven |
|---|---|
| Less than 51st percentile | 0% |
| 51st percentile | 10% |
| Between 51st percentile and 75th percentile | Between 10% and 30% (determined on a straight-line basis) |
| 75th percentile or above | 30% |

### What companies are in the relative TSR comparator group?

The comparator group comprises peer companies in the ASX 200 at the date of grant which remain listed throughout the performance period. The Board has approved the exclusion of companies that operate in very different markets (mining, financial services, listed property trusts and overseas domiciled companies) from the peer group. These approved exclusions from the comparator group enable the performance of DuluxGroup to be compared to those companies that most relevantly compete with DuluxGroup for capital (Australian industrial, retail, manufacturing and distribution businesses included in the ASX 200).

The Board has considered the reasonableness of the comparator group given the Group's growth over recent years, and believes that it remains appropriate for assessing relative TSR performance. The Board will continue to monitor this, as for all aspects of the LTEIP awards. The performance condition is only tested once at the end of the performance period.

### Is the performance condition re-tested?

No, the performance condition is only tested once at the end of the performance period.

## Nature of the loan

### Is the loan 'interest free'?

The loan is 'interest free' in that there is no annual interest charge to the participant on the loan. An interest component, however, is taken into account in determining the level of performance based debt forgiveness benefit that may be awarded to participants.

### Are dividends applied to the loan balance?

Yes. A portion of the dividends paid on the shares during the loan period is paid to the participant (after withholding tax) to fund their tax liability on the dividends received. The remainder is applied in part repayment of the loan.

### As the loans are non-recourse, do participants have to repay their loans?

Yes, to access the shares, participants must repay their loan. Following the end of the vesting period, assuming the earnings 'gateway' is achieved, the participant can either repay the loan directly or sell some or all of their shares and apply the proceeds to repay the loan. Shares remain restricted until the loan is repaid.

If the value of the shares is less than the outstanding loan balance at the end of the performance period, or if the 'earnings gateway' is not achieved, the participant surrenders and forfeits the shares to the Company in full settlement of the loan balance and no benefit accrues to the participant. This is known as a 'non-recourse loan'.

Further details about vesting of the 2012 and 2013 LTEIP allocations can be located in section 3.5 of the Remuneration Report.

### Why is a non-recourse loan provided?

The Board has structured the remuneration policy for participants to include a significant proportion of 'at risk' pay under the LTEIP. Accordingly, where the outstanding loan at the end of the performance period exceeds the value of the shares, or if the 'earnings gateway' is not achieved, the Board believes the loss of any remuneration value from the LTEIP in these circumstances is a sufficient penalty to participants.

## Structure of awards

### How are the participation levels for executives determined?

The amount of the loan offered to each participant is based on the relevant long term incentive component target amount of their remuneration multiplied by an externally determined 'value' (calculated using an adjusted Black-Scholes option pricing valuation model).

### How are shares acquired for allocation to Executive Directors under the LTEIP?

The Company has the flexibility under the LTEIP rules to acquire shares on-market, issue new shares or reallocate forfeited shares to participants in the LTEIP.

DuluxGroup proposes to acquire shares on-market for the offer to the CEO and the CFO under the LTEIP to be made in December 2016 (which is subject to shareholder approval at the 2016 AGM).

## Cessation of employment or a change of control

### What happens if a LTEIP participant ceases employment prior to vesting and repayment of the loan?

In general, all shares are forfeited and surrendered in full settlement of the loan if a participant ceases employment prior to the end of the performance period. The Board, however, has absolute discretion in appropriate circumstances to determine that some or all of a participant's LTEIP shares may vest, and that some or the entire loan forgiveness amount may be granted.

### Is there ability to 'claw back' in appropriate circumstances?

Yes. The Group has a formal Clawback Policy that provides the Board with broad discretion to ensure that no unfair benefit or detriment is derived by any participant in the case of a material misstatement in Group financial results or serious misconduct by a participant, including where the Group suffers material reputational damage. This includes discretion to reduce, forfeit or reinstate unvested awards, or reset or alter the performance conditions applying to the applicable award.

### How would a change of control of the Group impact on LTEIP entitlements?

The Board has absolute discretion in relation to LTEIP entitlements on a change of control, which it would exercise in the best interests of the Group. If the Board does not exercise its discretion, the LTEIP rules provide that all shares vest and all loans become immediately repayable, with the outstanding loan balances reduced by the default level of debt forgiveness (which is currently set at 20 per cent).

## Hedging policy

### Do any restrictions apply on LTEIP shares prior to vesting?

The Group has a policy that prohibits executives from entering into an arrangement to limit the risk (i.e. hedging) attached to LTEIP shares prior to vesting or while they continue to be subject to restrictions under the LTEIP.

DuluxGroup treats compliance with this policy as a serious issue and takes appropriate measures to ensure policy adherence.

## Illustrative example of how LTEIP works

The following example is designed to illustrate a range of Company performance outcomes, and how the LTEIP remuneration outcomes for the participant are aligned to that performance in each case.

Assumptions:

- The participant is a resident in Australia throughout the performance period.
- The initial share price at grant date is $5 and 15,000 shares are allocated (i.e. initial loan of $75,000).
- Total dividends paid are $2,400 less 46.5 per cent to cover the participants' individual tax obligations (note that as dividends are fully franked, participants receive the difference between the 46.5 per cent to cover the tax and the actual tax payable).

- Case A – EPS gateway achieved and relative TSR ranks at the 60th percentile (i.e. 17.5 per cent loan forgiveness), share price at the vesting date is $8.
- Case B – EPS gateway achieved but relative TSR ranks below the 51st percentile (i.e. no loan forgiveness), share price at vesting date is $6.
- Case C – EPS gateway not achieved and relative TSR ranks above the 75th percentile, share price at the vesting date is $8.

*LTEIP examples*

| | Case A $ | Case B $ | Case C $ |
|---|---|---|---|
| Initial Loan | 75,000 | 75,000 | 75,000 |
| Less net dividends applied to loan balance | (1,284) | (1,284) | (1,284) |
| Less loan forgiveness (1,2) | (13,125) | - | - |
| Outstanding Loan Balance | 60,591 | 73,716 | 73,716 |
| Value of Shares awarded at vesting | 120,000 | 90,000 | NIL |
| Less outstanding loan balance | (60,591) | (73,716) | NIL |
| Value of LTEIP to the executive as at valuation date | 59,409 | 16,284 | NIL |

(1) This amount is determined net of interest charges.
(2) In addition the Group incurs fringe benefits tax on the loan forgiveness.