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ACTIVISTS PUSH THE ESG AGENDA

Listed companies are feeling the heat from big super funds and global investors to embrace action on issues such as climate change and diversity. It's become a critical issue for listed companies and this ASX roundtable discussion explores the best way to respond to this pressure.

Alan Deans, moderator, *Listed@ASX*: What are the hot button issues for corporates in relation to environmental and social reporting?

Michael Chandler, governance director, Morrow Sodali: Responding to activists and their requests is taking up corporates' time. The primary request we're seeing revolves around the impact of climate change. The broader expectation, consistent with recommendations from the Task Force on Climate-related Financial Disclosures (TCFD), is providing more foresight into, and forward modelling and scenario analysis around, the resilience of asset portfolios over the long term. Companies we work with are struggling to gather the data and then figure out how transparent they wish to be in disclosing and quantifying their environmental impact over the long term.

***Listed@ASX:* How are boards reacting to that situation?**

Michael Chandler: Boards are having difficulty interpreting information for the investment community. There's a disconnection between what's important to shareholders and how focused directors are on these issues.

I encourage activist groups to front up to directors. There was an impression activists can't access boards, but that's changing. There's a generational shift taking place on boards and attitudes are shifting. But shareholders want to track performance and they need multiple years of data to assess how these risks and opportunities are being managed. Lots of companies in the ASX 50 still don't have a dedicated sustainability expert. So, responding to environmental, social and governance (ESG) surveys and engaging with shareholders has been difficult. But, that's changing.

Jana Jevcakova, director of research at CGI Glass Lewis: I'm curious to see whether you've come across any boards that are well prepared on ESG?

Michael Chandler: A mere handful of companies for which we have done sustainability work over the last 18 months have been really on top of it.

Ian Woods, head of ESG investment research, AMP Capital: BHP Billiton has stakeholder involvement at board and senior management levels. The company is trying to give the board external input on the issues that are coming. So some businesses are thinking about this at the board level. But, based on discussions with some directors, their appreciation of some issues is patchy.

Michael Salvatico, executive director, MSCI ESG Research: The hot topics are remuneration and diversity. Those are the issues investors are looking at closely. We see human capital as an undervalued asset in an organisation. We recently published a report, *Trends to Watch 2018*, which shows how diversity and human capital management can combine to result in higher growth in revenue per employee. Tax transparency and Climate Change are issues increasingly on ESG investor's radars.

Jana: Governance is currently taking priority over environmental and social factors because investors can vote on governance issues, so there is a voting outcome that issuers need to deal with. There is no option for investors to cast their votes specifically on environmental and social issues.

"The connection between ESG and the remuneration report, voting and accountability is insufficient."

Michael Chandler: The connection between ESG and the remuneration report, voting and accountability is insufficient. There is some discussion on director liability around foreseeable ESG risks. This should be linked to conversations around the potential for reputation damage and the recourse investors have if directors don't meet their ESG obligations.

Ian: This includes staff and their intellectual property. That is how businesses develop their IP and build relationships with customers and suppliers.

Susheela Peres da Costa, head of advisory, Regnan: For many companies, 80 per cent of market value is made up of intangibles. Investors want reports that can show how these are being protected and cultivated. Good boards will focus on these issues anyway. What's new is investors being vocal about their interest in seeing it reported.

***Listed@ASX:* How do investors know what companies should be reporting so they can assess those risks?**

Susheela: Investors need to understand the company's business model; consider what its share price already reflects, and what the price should reflect but doesn't. Those same foundations apply to ESG information investors use to understand a company's future prospects. This varies by company, and can be quite specific. For instance on climate change, investors are concerned whether some companies are addressing the potential for more frequent extreme weather events. For other companies it's more important to check how they're hedging against a more challenging market for carbon-intensive products. For some, climate change might not be a focus at all.

Jana: Investors need to be assured companies have a framework in place to manage risk. But the issue is that some companies don't clearly understand the risks and opportunities they face from the environmental and social perspective, or they do not consider them material.

"One of the reasons investors are thinking about human capital is most of a company's value is in its intangible assets, not what sits on the balance sheet."

***Listed@ASX:* Are companies receptive to this?**

Ian: Some are and some are not. We once asked companies about the 10 issues on which senior management should focus. Then we asked investment analysts what they thought and compared the two. There was surprisingly good overlap, but the number one issue for both was different. For analysts, it was cost control, whereas management said it was human capital.

Susheela: Communicating with investors saves guesswork. Many larger companies make good use of investors' willingness to engage, either directly or via groups like Regnan. Activism is often just the visible tip of a much larger base of longstanding, ongoing engagement. There are also plenty of resources for companies to tap into if they are starting the process and want to know what to prioritise. The Integrated Reporting Initiative is worth looking at for peer examples.

Jana: It's important companies know to whom to talk. Management or the board is used to meeting with fund managers who want to know about how they manage costs and focus on financial performance, often in a time horizon of less than one year. There are asset owners who are environmentally and socially conscious and often look at a much longer time horizon. Issuers also need to be aware that people in different roles within the same organisation may have different views and it is not always the portfolio manager who has the voting power.

Michael Chandler: The investor road show and governance road show have different audiences. During the first you talk to the portfolio manager, during the second you talk to the ESG analyst. You need to have the right conversation with the right individual or you are wasting your time.

***Listed@ASX:* Are there particular issues companies are better at reporting than others, for instance the impact of climate change on operations or diversity?**

Jana: Companies' diversity disclosures are pretty good because of workplace gender requirements.

Michael Salvatico: Diversity is well measured at a board level with reports such as the *MSCI Women on Boards Progress Report 2017* showing an increase in directorships held by women in the past year. The next step is to understand diversity in the C-suite. Carbon emissions are the easiest metric for measuring climate change impacts, and should be the starting point for companies and investors. Surprisingly 40 per cent of companies still don't report carbon emissions, which then requires a research house such as MSCI to calculate estimates.

"Activism is often just the visible tip of a much larger base of longstanding, ongoing engagement."

Ian: When companies ask me what they should report, I ask them what do directors want reported to them. They represent shareholders. They are supposed to look after long-term and short-term strategy and risks. So they should look at the same things as investors do. If you want to know what should be disclosed, start with what the board thinks is important.

Jana: Often, I hear really good stories about managing risks in engagement meetings. But then we read the annual report and other disclosures and they are nowhere to be found. So, at engagement meetings we encourage companies to improve their disclosure and tell their stories where this can add value to investors and other stakeholders.

Michael Salvatico: We look at it clinically and make an assessment based on two aspects: risks and management of risks. Companies can't control all their risk exposures. You are exposed to certain risks through your operations, location and size. But companies can control how they manage risks and we look closely at that. But, we don't necessarily apply a penalty if businesses are not disclosing information well. We'll take information from other sources to fill in the gaps. We recently performed an analysis that showed on average 65 per cent of the information used to assess a company's ESG rating does not come through voluntary disclosures, but rather specialised data sources.

Michael Chandler: But not disclosing is a huge risk for companies because their situation is open to interpretation. You are better off being on the front foot.

Susheela: These disclosures can seem like an optional extra. But when the market falls, companies that have strong information on record benefit from the trust that is created through that transparency, and do relatively better than their peers. So companies benefit from providing this extra, high-quality information.

***Listed@ASX:* How does ESG impact the way MSCI compiles indices and decides whether a company is included or excluded?**

Michael Salvatico: The inclusion of ESG in indices is in response to investor demand. They want ESG overlaid on standard and factor indexes, which includes information about involvement in areas such as weapons, tobacco or alcohol, their exposure to material risks such as climate risk, and their behaviour relative to global norms. That's coming throughout the investment value chain from consultants to superannuation funds. We work with clients such as super funds to identify companies with better carbon emission management, right through to designing ESG strategies for passive exchange-traded funds (ETFs). Some ETFs exclude or include companies based on their behaviour, or ESG ratings. This is a motivator for companies to disclose information about their ESG profile.

Susheela: Some investors are making more active choices about which index their funds should follow. So although they are not selecting which stocks to buy, they are choosing what methodology is used to select them.

***Listed@ASX:* AMP Capital is a veteran in ESG. What's your view, Ian?**

Ian: I want to know what the company thinks is important to disclose. That tells me about what the company thinks is important. Then we'll have a discussion about the issues we think are important. That's how we look at it. But some companies don't know what and how to report ESG information. Some businesses report what they think stakeholders believe is important. But what stakeholders think is important and what is material to the company is not necessarily the same. So when you talk about an issue tell me why you think it is important to the company. Articulating why data is important and how it's used provides the colour investors want.

Susheela: There are different types of investors – and investment decisions. Marginal investors aim to evaluate the company's prospects better than their peer analysts. In contrast, long term owners are looking for evidence that today's business initiatives are not coming at the expense of future returns.

Michael Salvatico: In defence of companies, proactive ones tell me they understand how we are looking at ESG now and are working towards resolving the issues that are identified as material. They also want to know what we're looking at next. Companies are better at communicating with MSCI, we have seen an increase of almost three times the number of company inquiries over a period of almost four years to 30 November 2017.

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***Listed@ASX:* Who's driving the ESG discussion from within listed companies?**

Michael Chandler: Investor relations is struggling now because of the multitude of ESG surveys. Domestic and international stakeholders are bombarding them. They are really struggling to manage that environment at the moment. Directors understand their reputation is on the line, so they are driving it, too. We are seeing higher no votes on director election resolutions as a result of a lack of focus on ESG. That's new.

Jana: Often, a number of non-executive directors are passionate about these issues and the impetus comes from them.

***Listed@ASX:* What's the best way to engage with activists?**

Michael Salvatico: Activists are smarter now and they're empowered by social media.

Michael Chandler: They play an important role in driving the discussion and the agenda. What's going to increase is the size of the investors who are behind them. Right now, they are quite small. But I expect that is going to grow over time.

Susheela: Non-government organisation (NGO) activists are becoming more sophisticated and coordinated, and the proposals they are putting forward are increasingly investment-grade.

Ian: There used to be a view resolutions put up by an NGO should be voted down. But increasingly, these resolutions must be dealt with on their own merit. If an NGO's resolution has merit, as an investor and shareholder, we'll vote it on its merits.

Jana: But NGO activity in Australia is still very low compared to the rest of the world. In the US you have companies that have 15 shareholder proposals on a ballot. In Australia there were just 11 across the market in 2017, two of which were withdrawn at the last minute.

Ian: I think that's a credit to Australian companies. As a generalisation, in the US they have a very hands-off approach. They don't want to talk to investors or activists. Whereas, Australian companies are prepared to talk to investors such as ourselves, and others and NGOs. Putting up a resolution at the AGM should be a last

resort. Doing this, you're really using a sledgehammer to push an issue. There is a lot of other discussion, which may or may not be successful, but you can and should have it, before you get to that point.

Jana: Many more proposed resolutions were avoided in 2017 thanks to engagement between companies and activist investors. There may have been many more if that sort of engagement wasn't happening.

***Listed@ASX:* Which is the most critical ESG issue for listed businesses?**

Michael Salvatico: The UN's Sustainable Development Goals should be on companies' radars. We've talked a lot today about risks that companies face and engagement on risks. An opportunity is for companies to communicate to stakeholders about how their products and services are providing positive benefits to communities. An ideal way to do that, a way that is being quickly adopted, is to take the UN's Sustainable Development Goals and identify how your company's behaviour aligns with those goals.

Jana: Based on the type of shareholder resolutions we saw last year, it's all about climate change. But it's very much a case-by-case situation for each company. Identifying and responding to material risks is up to the company. That is what issuers should be exploring.

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Susheela: It depends on the company's own business model, risks and opportunities.

Ian: Climate change is going to be important given the structural changes required in the Australian and global economies. There are lots of other issues and for some businesses climate change isn't a material risk. But for the market as a whole, climate change is number one.

> "The UN's Sustainable Development Goals should be on companies' radars."

Michael Chandler: "We're going to see traditional activists that seek control of companies at the board level also begin to exploit an absence of oversight and governance deficiencies to strengthen the argument for change and to convert those who control the votes to their view. This is something we are going to see more frequently.

Jana: Also human rights, modern slavery and the supply chain are the other important topics. That is driven bythe nature and the type of investors in the Australian market; many industry super funds are close to these issues.

***Listed@ASX:* Is this when it comes to sourcing products overseas or paying contractors appropriately?**

Jana: Both, as well as entrapment of employees.

Michael Salvatico: Companies generally have global supply chains. Often, if a business sources supplies from Asia there will be a link to slavery or child labour. Analysis on the MSCI ACWI index showed 62.4 per cent of companies are or will be subject to a slavery act, and 53 per cent of controversies for companies in this index had a link to forced labour through supply chains in south east Asia.

Ian: This issue has crystallised with the proposed *Modern Slavery Act*, encouraging companies to consider their disclosures about this. Businesses need to do due diligence on their supply chain to feel comfortable they can make trustworthy disclosures about the reliance on slavery in their business.

Susheela: Any instance where a company can be viewed as having outsourced responsibilities is increasingly under scrutiny. Franchising, joint ventures and contract workforces are in focus and companies should be prepared.