Ausbil – ESG Engagement Report 2017

Ausbil Investment
Management Limited
ABN 26 076 316 473
ACN 076 316 473
AFSL 229722

Annual Report

January 2018

Celebrating 20 YEARS

Contents

Executive Summary

1.0 Executive Summary

This paper provides a summary of Ausbil's ESG engagement activities during 2017. This includes main engagement themes; objectives, activities and outcomes; as well as topics for engagement in 2018.

Ausbil has a dedicated team of ESG specialists within its investment team, working closely with stock analysts. Ausbil produces proprietary ESG research in-house as we believe this is the optimal solution to derive unique insight. To Ausbil, ESG integration ultimately means two things:
1. More informed investment decisions, which can lead to better investment outcomes; and
2. Active ownership and engagements on ESG issues.

At Ausbil, we believe share prices are driven by earnings and earnings revisions and we prefer to invest in companies with assessable and sustainable earnings, as well as companies with quality management. As a result, ESG integration can add significant value:

- First, in regards to earnings revisions, ESG analysis can identify earnings' risks proactively and it can assist when forming a view on earnings versus consensus forecasts.
- Second, ESG analysis covers a wide range of factors and whilst not all of those will have a direct impact on earnings, we believe that collectively the way a company deals with its ESG risks can tell you something about management quality.
- Third, ESG analysis can help us to assess earnings sustainability; if a company's business model relies on under-priced labour, misinformed customers, weak regulation, etc. perhaps current earnings levels are not sustainable.

1.1 The role of ESG integration and engagement on ESG issues

Engagements on ESG issues contribute to better informed investment decisions, preserve invested capital and expand the investible universe. Ausbil has an extensive company visitation program and regularly engages with companies on ESG issues, either with executive management, the Board or other company representatives. In addition, Ausbil occasionally participates in collaborative engagements with other investors and engages with policy makers.

For more information on how Ausbil integrates ESG, please visit our website and search 'ESG integration at Ausbil: why, how and what are the benefits'.

1.2 Engagement themes in 2017

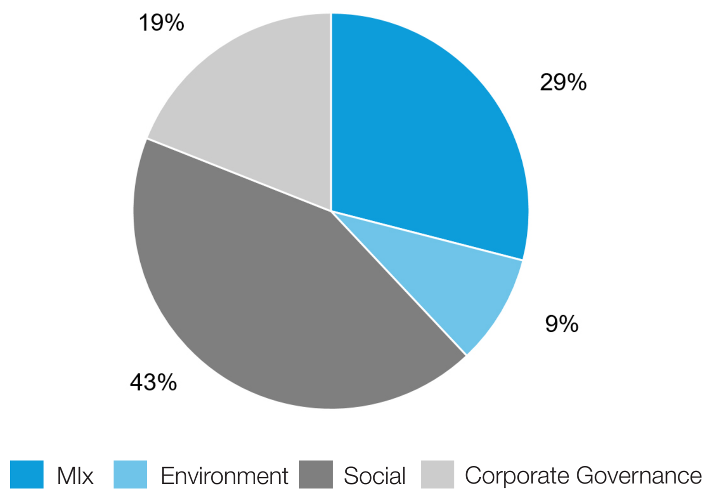
In 2017, Ausbil engaged with ESG issues on approximately 140 occasions with approximately 65 companies. Many of these engagements touched on a number of common themes. The key themes in 2017 were:
- Human rights in supply chains
- Climate change
- Improved ESG disclosure
- Corporate governance

Other major topics for 2017 included the use of credit cards for online gambling (engagements with banks), culture and cultural transformation (major topic for banks and a number of other industries), occupational health and safety as well as customer safety, underpayment of workers, whistle-blower protection and ethical sourcing.

Executive Summary

While engagements typically deal with a number of overlapping areas, the chart below shows a rudimentary break-down of the main ESG categories (Corporate Governance, Environment, Social or a mix of these) discussed during the engagements. A noticeable shift from 2016 was the increased engagement on 'social' topics.

2017 Ausbil ESG Engagements



Pleasingly, in terms of outcomes, we have seen major Australian businesses improving their supply chain risk management after adoption of key recommendations made in the past. We are also encouraged by the developments to establish a Modern Slavery Act in Australia. Further, the Bangladesh Accord on Fire and Building Safety has been extended until 2021. Consequently we believe the investor community at large has become increasingly sophisticated in its engagement with companies on human rights issues.

We have also seen varied commitments on climate change disclosure by relevant companies, although these engagements will continue in 2018. We have also seen a range of improvements in terms of general ESG disclosure among ASX200 companies as well as some positive changes to remuneration structures.

Detailed summaries of these engagements, including rationale, objectives, strategy and outcomes are provided in this report.

Human rights in supply chains

2.0 Human rights in supply chains

2.1 Rationale

Ausbil's investment philosophy (based on earnings revisions, earnings sustainability and quality of management), makes engagement on human rights in supply chains a very natural process. Brands are key assets, particularly for consumer-facing businesses, and brand damage from adverse human rights findings can lead to e.g. loss of sales, difficulty in winning new business and distraction for management. Also, a business model or margins that rely on e.g. underpaid workers or a supply chain that does not fully cover its true environmental and / or social costs, will not be sustainable in the long term. The way a company deals with its suppliers and labour rights in the supply chain can also be a good proxy for management quality.

2.2 Objective and strategy

The prime objective with this engagement theme is to encourage industry best practice in order to improve the quality of companies in our investible universe, as well as reducing the risk of capital destruction. Pursuit of these engagements can lead to positive social and economic benefits.

Ausbil has a long history of engagement on human rights issues in supply chains. Over the years, Ausbil has built up extensive experience on human rights issues and hands-on industry best practice. Ausbil's strategy is to capitalise on this knowledge by actively encouraging industry best practice on a pragmatic basis, continue to educate other investors and participate in collaborative engagements. All of these factors can potentially influence regulatory behaviours.

The latter points are significant given the systemic nature of many of the human rights issues in many industries. We believe these issues are best solved by a collaborative effort and through multi-stakeholder action.

Chinese garment factory in Guangzhou (photo: Ausbil)

Human rights in supply chains

2.3 Activities and outcomes

In 2016, Ausbil went on an ESG field trip to China, including a factory visit and meetings with a number of non-governmental organisations (NGOs). These meetings provided Ausbil with better understanding of the interaction between social and environmental issues in the supply chain, identified a number of risks and added to Ausbil's existing knowledge on the topic. In particular, as highlighted in our research paper 'Is the fast fashion industry at an inflection point', China is at very high water risk and many industries compete for the scarce resource, including energy, food production and garments. The garment sector, which is both a highly water intensive industry and a major polluter, is facing tougher rules and higher costs. The higher costs, will impact international retailers buying from China and will need to be passed on to consumers. Over time, Ausbil believes this could force the textile manufacturing industry out of China. The problem, however, is that no other country has the capacity to replicate China's garment sector. China is a major supplier of input material, such as textiles, to other garment producing countries. As a result, the new legislation could have a significant impact on the entire global fast fashion industry. This risk might be particularly high for smaller and highly transactional players. We have discussed these findings with a number of retailers and highlighted the need for companies to close the loop on water efficiency. We have also consulted with a specialist on sustainable fashion and introduced the specialist to one of the portfolio companies to explore opportunities.

The discussions on sustainable fashion added to existing, ongoing engagements on labour rights issues. While China has come a long way in eradicating some of the worst types of labour rights issues, certain labour rights problems may be on the rise again in China due to a migration of factories towards inland China, fierce competition with other countries, increased pressure from buyers and a general shift in the power balance between employers and employees.

Ausbil has had ongoing and productive engagements with some of the larger retailers on labour rights for some time. In addition, Ausbil has actively participated in industry events. For example in prior years, Ausbil has presented at a Living Wage Forum to a retail audience and also at UN Global Compact. In 2017, Ausbil presented to mainly a corporate audience at UN Global Compact and a major KPMG / SEDEX[i] conference. As a result, Ausbil's messages have reached out to a large number of companies. These messages are built on key initiatives which we believe companies need to implement in order to reduce the risk of human rights issues in the supply chain, such as the following, somewhat overlapping areas:

- Map out and as much as possible understand the full supply chain. Importantly, this needs to go beyond the first tier supplier. Thereafter, identify high-risk areas and Know Your Supplier (KYS);
- Enhance the ability to influence by consolidating the supply chain (for example, sourcing more from fewer suppliers, which creates leverage that can result in both positive economic and social benefits). While it is positive that companies are increasingly adopting supplier codes of conduct, companies need to be in a position to influence in order for these to be effective;
- Actively collaborate with peers and participate in multi-stakeholder initiatives to address systemic issues. While many Australian companies are small, increased collaboration can lead to positive outcomes;
- Cultivate long-term relationships with suppliers and reward suppliers that improve with more business. The shift away from an overly transactional relationship can incentivise suppliers to help monitor and enforce a company's supplier code of conduct further down the supply chain;
- Combine and align ethical sourcing and procurement objectives and avoid conflicting demands on suppliers. Too much price pressure and playing out suppliers against each other on price can easily backfire and lead to subcontracting and suppliers taking short cuts on labour rights issues;
- Increase presence 'on the ground'. Leaders on ethical sourcing are moving away from only relying on annual audits to more frequent and regular supplier visits. All of Ausbil's factory visits have been pre-announced, which gives factories time to prepare, while regular visits make it harder to hide issues. Also, while audits might identify some of the issues, they don't necessarily guarantee any improvements;

i The world's largest collaborative platform for sharing responsible sourcing data on supply chains, used by more than 43,000 members in over 150 countries.

Human rights in supply chains

- Actively encourage and work towards solutions on the two key underlying labour rights issues (common issues in a number of industries), namely the lack of freedom of association (right to unionise) and living wages (i.e. a wage that covers basic costs of living – as opposed to just legal minimum wage, which is often completely insufficient); and
- Increased transparency. A number of companies have, partly due to investor engagement, published factory lists, including factory names and location. As a result, NGOs can monitor and identify risk and alert companies before issues blow up.

In these engagements, Ausbil has maintained a very practical focus and avoided simple rhetoric. Pleasingly, we are seeing a number of improvements and adoption of our key recommendations by some of the larger retailers in Australia. These relate to e.g. consolidation of the supply chain, more people on the ground, more focus on establishing long-term relationships with suppliers, initiatives to address the living wage issue and increased collaboration and transparency.

Ausbil is looking forward to continuing these ongoing dialogues going forward. While progress may seem slow at an industry level, the labour rights issues in supply chains can be very complex and even companies with the best intentions are not immune to risk. We believe by engaging with the large retailers with the greatest resources, they will set the benchmark for smaller retailers to follow.

Ausbil is also the investor voice on the Advisory Committee of the Australian Business Pledge against Forced Labour. This initiative is a retailer-driven initiative to eliminate forced labour in supply chains, founded by a small group of Australian retailers (Goodman Fielder, Wesfarmers group companies and Woolworths). Progress was made in 2017 and the initiative will issue a report on best practice in 2018.

2.3.1 Collaborative engagement

In the wake of the Rana Plaza tragedy in Dhaka, Bangladesh, in April 2013, a new multi-stakeholder initiative called the Bangladesh Accord on Fire and Building Safety (the Accord) was enacted. This is a 5-year legally binding initiative involving retailers, NGOs and unions, aiming to eliminate the risk of further factory disasters in Bangladesh.

In parallel to this, ICCR (the Interfaith Center for Corporate Responsibility in New York) issued an Investor Statement on Bangladesh, of which Ausbil is an active signatory. Initially, this initiative was primarily focused on encouraging companies to sign the Accord. This outcome has been fairly successful with 12 Australian signatories and 200 brand companies globally.

The Accord has not been the panacea that many had hoped for due to a number of practical complexities in Bangladesh; as well as protracted negotiations for funding of factory remediation. However, the Accord has made significant progress on factory inspections, corrective action plans and some enforcement of the latter. As a result, the risk of further factory disasters has reduced.

The Accord was due to expire in 2018, but due to calls for extension of it, in June this year, companies and unions have agreed to extend the Accord for a second term, until 31 May 2021. The ICCR Investor Statement and Ausbil have been very supportive of that. After that, it is expected that a national regulatory body will take over the role of the Accord. Ausbil will continue to participate in the ICCR Investor Statement on Bangladesh and provide feedback on how we would like the Accord to develop. Also, pleasingly, the next phase of the Accord wants to tackle the right for workers to unionise and also safety training will be extended to all factories. We believe this is vital as freedom of association is one of the two key underlying issues we see in Bangladesh. As an illustration, a common denominator for the factory disasters to date in Bangladesh is that none of the factories had any union representation.

2.3.2 Investor education

Ausbil has also continued its strategy of investor education. In prior years, Ausbil has, for instance, presented on the topic and moderated in panels at the RIAA (Responsible Investment Association Australasia) Conference, a PRI event in Australia and host a labour rights forum with investors and NGOs. In 2017, Ausbil participated in an EY / Australian Human Rights Commission study on human rights and fiduciary duty for investors called 'Human rights in investments'. Ausbil has also provided input to a major PRI (Principles for Responsible Investment) paper called 'Moving the needle on responsible labour practices', which gives investors enhanced tools for engagement. We believe this is a good outcome and that these reports will positively contribute to more sophisticated engagements by the local and global investor community.

2.3.3 Engagement with regulators

In 2015, the UK implemented a Modern Slavery Act, which encourages companies above a certain threshold to report on what they do to minimise the risk of modern slavery in their supply chains. Ausbil believes this is a good initiative and in 2016, Ausbil issued its own investor statement on slavery. In 2017, the Australian Federal Government announced that it would potentially introduce a Modern Slavery Act.

Ausbil has been very vocal in its support of such an Act. Ausbil made two submissions to the Federal Government in 2017, one on a stand-alone basis and one through a collaborative engagement through the PRI. Ausbil also co-drafted and signed a response to the Federal Government's initial report together with a number of civil society groups and the Australian Human Rights Commission ('Coalition of organisations support Modern Slavery legislation'). Prior to that, Ausbil also participated, as the only investor representative, in a workshop on a Chatham House rules basis with large Australian businesses and the Shadow Minister for Justice. Ausbil also had a dedicated meeting on the Modern Slavery Act with the Attorney General's Department in Canberra.

During these engagements, Ausbil has put forward the investor rationale for the support of a Modern Day Slavery Act in Australia and also provided feedback on what we believe such an Act should cover. From our perspective, we support a requirement for large companies to investigate and report on modern slavery in their operations and supply chain. We believe clear guidance and support should be provided for organisations that identify slavery and access to appropriate remedies and that there should be transparency on modern slavery statements. We also believe a Modern Slavery Act and guidance should be aligned with and reinforce the UN Guiding Principles on Business and Human Rights. While we would like to see robust legislation that has teeth, we are also cognisant of the fact that there will be a steep learning curve for some companies that previously have done little analysis to identify slavery risks in their supply chains. Also, we are encouraged by the support from the business community and want to avoid a situation where businesses perceive proposed legislation as being 'anti-business' or 'red tape'.

At the time of writing, we are awaiting a new report by the Federal Government to respond to the extensive consultation (expected in the first half of 2018) and therefore it is too early to say what will happen. However, we are encouraged by the fact that to date, the Federal Government and the Opposition, investors, civil society and large businesses are generally supportive. As a result, we believe there will be further progress on a Modern Slavery Act in 2018.

Climate change

3.0 Climate change

3.1 Rationale

Failure of climate-change mitigation and adaptation has been highlighted as the number one risk in the World Economic Forum's top ten risks in terms of impact and the number three risk in terms of likelihood. The risk is associated with, for instance, extreme weather events, biodiversity loss, the collapse of ecosystems, natural catastrophes, food crises and water crises. In other words, Ausbil believes climate change poses a major risk to economic growth. As a result, Ausbil supports the Paris Agreement framework from 2015.

Ausbil believes climate change is presenting a number of investment risks and opportunities, which can broadly be divided into physical climate change risk and economic transition to a low carbon economy:

- Impact on investments from physical climate change, such as extreme weather events and changes to weather patterns, may include direct and indirect impact on company valuations and earnings volatility, for instance from production disruption.
- Impacts on investments from a transition to a low carbon economy may include regulatory changes, such as policies to reduce greenhouse gas emissions, which may impact the valuation of companies and their value chains. These may also be impacted by technological change.

3.2 Objective and strategy

The prime objective is to improve resilience of companies and seek improved climate-related disclosure to help investors to identify risks and opportunities in relation to climate change.
Ausbil's strategy for engagement is to encourage companies to seek energy efficiency opportunities where relevant and seek greater disclosure on climate change risks and opportunities. In 2016, Ausbil became an investor signatory to the CDP (formerly known as the Carbon Disclosure Project) calling for greater company disclosure on carbon emissions and reporting on climate change risk. In 2017, Ausbil also issued a climate change statement where Ausbil recognised climate change as a major global issue and that the majority of scientific opinion support the view that climate change is caused by increased levels of greenhouse gases, which are a result of human activity. Ausbil also joined the Climate Action 100+ and in January 2018, Ausbil became a member of the Investor Group on Climate Change.

3.3 Activities and outcomes

In late 2016, the Task Force on Climate-related Financial Disclosures (TCFD) issued its interim report and in mid-2017, the final report was issued. The TCFD highlights that climate change is a risk to financial systems and investors need better disclosure. The TCFD provided recommendations around four key areas: governance, strategy, risk management as well as metrics and targets.

From our perspective, we welcome the shift of focus from purely on CO2 emissions (which can be relevant e.g. in the event of a price on carbon) to greater focus on the actual risks and opportunities. We are particularly supportive of companies issuing scenario analyses, including a 2 degree global warming scenario. As a result, we believe the TCFD framework provides greater clarity on investment risks and opportunities, which will enable investors to engage more effectively with companies and therefore make better informed investment decisions.

The TCFD also provided investors, such as Ausbil, with a tangible engagement objective. During 2017, we had engagements with two major energy companies where we actively encouraged adoption of the TCFD guidelines. In one case, a company made a commitment to review the TCFD guidelines and in another case, the company in question was hesitant to commit in 2017 but we believe it is likely that the company will commit in 2018.

Ausbil will continue the engagements with these companies in 2018. We also believe that membership in IGCC and Climate Action 100+ will facilitate these engagements. Climate Action+ is a 5-year initiative led by investors to engage with large greenhouse gas emitters to improve governance on climate change, curb emissions and strengthen climate-related disclosure. To date, 225 investors with more than USD $26.3 trillion in assets under management[ii] have signed on to the initiative. The initiative was designed to implement the investor commitment first set out in the Global Investor Statement on Climate Change in the months leading up to the adoption of the historic Paris Agreement in 2015.

ii http://www.climateaction100.org/

Improved ESG disclosure

4.0 Improved ESG disclosure

4.1 Rationale

Ausbil's proprietary ESG research uses a wide range of information and corporate disclosure is one of them (along with e.g. independent staff reviews, other stakeholders, field trips and more). As a result, we believe better ESG disclosures by companies enable investors to make better informed investment decisions. We also believe strong external reporting requires strong internal ESG reporting processes and, therefore, better ESG risk management.

Ausbil has a long history of providing stakeholder input and participating in materiality reviews as well as providing constructive feedback on sustainability reports. This is done on an ad-hoc or ongoing basis. In addition, Ausbil also seeks improved increased disclosure on particular key topics, e.g. climate change and labour rights risk management, as outlined above, or other areas.

4.2 Activities and outcomes

In 2017, Ausbil participated in five sustainability briefings and roundtable discussions and participated in six ESG surveys with listed companies from various industries. In some cases these were facilitated directly by the companies and in some cases through external third parties. Pleasingly, we saw improvements in some of the areas where we have engaged with companies in prior years. However, on the whole, we believe ESG disclosure in general can improve significantly in corporate Australia, e.g. in the areas of cyber security, whistle-blower protection, staff engagement and culture as well as succession planning. Ausbil also encouraged increased disclosure in specific areas for some companies, such as increased disclosure on rehabilitation provisions from AGL Energy, which subsequently provided more detailed information in conjunction with its FY17 results. Examples of companies Ausbil engaged with on improved ESG disclosure include:

- Oil Search
- Santos
- Origin Energy
- South 32
- Metals X
- Westgold Resources

Corporate governance

5.0 Corporate governance

5.1 Rationale

Management quality is a key feature of Ausbil's investment philosophy and as such we prefer investments in companies who demonstrate good corporate governance. In particular, we pay attention to board independence, separation between chairman and CEO, strong alignment between executive remuneration and shareholders' best interest and board quality. Our proprietary ESG research also scrutinises potential conflicts of interest, value-destructive related party transactions, accounting risk and general risk management governance.

5.2 Objective and strategy

Ausbil's proprietary ESG research scores companies on corporate governance and also provides a qualitative assessment, which may identify corporate governance concerns to engage with companies on. Each year, Ausbil regularly engages with boards of investee companies ahead of the AGM, which is also an opportune time to discuss other ESG issues. While Ausbil's preference is to engage with companies, when we are not satisfied with the results of an engagement Ausbil may vote against a resolution at the AGM. Ausbil subscribes to the proxy voting advice but decides how to vote independently.

5.3 Activities and outcomes

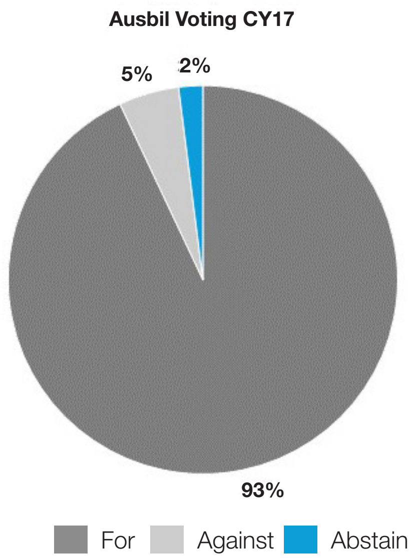
In 2017, Ausbil had 23 meetings primarily focused on corporate governance, with the chair person and / or other members of the board. Key topics discussed or provided feedback on in these meetings were:

- Remuneration: quantum, appropriateness of hurdles, alignment with strategy, transparency and reporting, executive retention and turnover, links between ESG performance outcomes (e.g. occupational health and safety) and remuneration outcomes and more.
- Board composition: succession planning, board skills and experience (e.g. in terms of technology, industry-relevant experience, board and organisational diversity (including gender diversity) and board accountability and more.
- Other governance-related issues: related party transactions, minimum shareholding requirements, shareholder activism, whistle-blower procedures and more.

During the year we saw some positive changes to remuneration structures in companies we have engaged with previously, such as introduction of performance hurdles (previously absent) and removal of retention-style incentives (e.g. performance rights vesting on no other hurdles than continued service) as well as change from fair value to face value for the purpose of long-term incentive awards. Another company decided not to make retrospective FX changes to its long-term incentive based on feedback from us and other investors. We also saw a female director appointed to the board in a company that previously had no female directors, which we had engaged with the company about.

In terms of voting, Ausbil voted on 702 resolutions related to 133 companies across the Australian equity portfolios. Of those, 93% were cast in favour, 5% against and 2% remuneration reports where we believe bonus outcomes the financial performance during FY17 and director re- there is an issue of board accountability for the company's against a number of shareholder resolutions, such as activist seats as well as some shareholder resolutions seeking ESG-related resolutions following extensive engagements. resolutions were poorly worded or unjustified.

Vote	Resolutions	% of total
For	702	93%
Against	38	5%
Abstain	14	2%



Other key ESG engagements in 2017

6.0 Other key ESG engagements in 2017

In addition to the themes discussed above, Ausbil also engaged with companies on a number of company-specific or particular topics in 2017. Below is a summary of some of these topics.

6.1 Banks

Citibank in the US has blocked use of its credit cards for internet gambling transactions after regulators from NY State told Citibank that it could face criminal prosecution for aiding in the promotion of online gambling. We believe Australian banks could be subject to various credit and fraud risks in relation to credit cards for online gambling purposes. We engaged with the major banks to follow Citibank or limit card spend on online gambling to debit cards. The responses by the banks was mixed but at least one bank seemed positive about the idea.

In 2016, we published a research report called 'Conduct risk – assessing intangible and cultural risks in the financial sector' where we highlighted the link between corporate culture and compliance / conduct risk. We have also been concerned about banks' importance of maintaining the social license to operate and a potential Royal Commission into banks. In 2017, we engaged with the banks on culture, staff engagement, diversity and other workplace drivers to create a better understanding of the risks in the banking sector. This contributed to a change in our portfolio positioning. We also engaged with CBA on the AUSTRAC issues, particularly around implications for executive remuneration outcomes in 2017, as well as those culture and continuous disclosure.

6.2 Culture

Corporate culture is one of the most intangible drivers in ESG analysis but identification of cultural momentum or cultural issues can have significant impacts on investments. Ausbil closely tracks culture and staff engagements for Australian companies and frequently engages on the topic too. In particular, we have paid attention to cultural factors in relation to M&A and post-merger integration. In one case we identified major cultural transformation in a company that previously used to be a laggard on ESG. That insight reinforced our positive view on the company's turnaround. In another case, we were very disappointed in the cultural aspects of a company, which contributed to our decision to divest from that company. Culture remains a cornerstone of our ESG analysis and our view on momentum in cultural factors, positive or negative, have contributed to a number of portfolio decisions in 2017.

6.3 Underpayment of workers

In early 2016, we identified a number of anecdotes of underpaid workers in Australian franchise businesses that we capitalised on from a portfolio management perspective, e.g. Ausbil's long-short fund has had short positions in some of those stocks. On average, approximately 50% of the short positions in the fund have had a major link to ESG research. The issues of underpaid workers came to a head in 2017 following major investigations by Fairfax media. In 2017, we engaged with one of the companies involved and suggested changes to avoid similar issues in the future.

6.4 Whistle-blower procedures

As many examples have shown, corporate Australia has had an issue with protection of whistle-blowers. We have engaged with several companies about their whistle-blower procedures and in one case where a whistle-blower has allegedly been dismissed we were encouraged about improvements, such as a third-party operated whistle-blower channel.

6.5 Occupational health and safety

While most companies have made significant in-roads on safety risk management, a number of companies experienced workplace fatalities in 2017. We engaged with management about these incidents, e.g. the nature of the fatalities, lessons and learnings from the incidents as well as cultural aspects and actions taken to mitigate the risk going forward. As noted above, we were also enquiring about the links between safety outcomes and executive remuneration outcomes. We also engaged with companies about the role of automation in terms of reducing workplace injuries.

Other key ESG engagements in 2017

6.6 Exposure to high-risk geographies

Country risk is an integral part of Ausbil's ESG research, particularly in regards to countries with high corruption and bribery risk and where local laws on environmental as well as labour rights or the enforcement of such laws is weak. In 2017, Ausbil engaged with a number of companies operating in or sourcing from high-risk countries in order to better understand how these risks are managed and / or outlining what we would like the company to do to manage these risks.

6.7 Environmental compliance

Ausbil engaged with companies about their environmental performance, particularly where there had been environmental non-compliance incidents, such as EPA (Environmental Protection Agency) notifications. Ausbil also extensively engaged with a listed waste disposal company prior and post allegations broadcast by the ABC's Four Corners show.

Looking ahead

7.0 Looking ahead – what are the ESG engagement topics in 2018?

Heading into the 2018 calendar year, Ausbil perceives a number of key ESG themes.

7.1 Continued clean-up of the environment in China

One of the key messages from our ESG field trip in China in 2016 was the increased environmental regulation / increased enforcement of environmental regulation in China, such as Water 10, Air 10 and other regulation. We have already seen this theme play out in 2017, for instance through curtailment of heavily polluting factories, which has had an impact on the supply / demand balance in some commodities. We have also seen increased commitments for electrical vehicles, which has buoyed lithium miners. We believe China's environmental clean-up will continue in 2018, which means both risks and opportunities for Australian companies. On the risk side, Australian companies that have hitherto mainly focused on labour rights in their supplier audits will also need to increase their focus on environmental supply chain issues to avoid supply chain disruption.

7.2 Wage inflation and underpayment of workers

Unemployment is low and wages in some industries have not moved much in recent years. As a result, we expect strong union activity in 2018 around upcoming enterprise agreement renegotiations. This could particularly become an issue in some of the service sectors where staff costs represent over 60-70% of total costs and where revenue is highly regulated. Such sectors could be subject to margin compression. Already, we have identified anecdotes of under staffing, which could potentially also lead to deterioration of the quality of service, and in turn, compliance breaches and other ESG issues.

Following a number of wage scandals for franchise companies, in supply chains and in other business operations, we believe the Fair Work Ombudsman will continue to be busy in 2018. We will pay particular attention to sectors where input costs are going up while prices are going down, which can be a red flag for companies taking short cuts on wages. We will continue to engage with companies on the importance of having 3rd party-operated whistle-blower channels and to systematically monitor the risk of underpaid workers.

7.3 Royal Commission into banks – and other areas ripe for increased regulation

In late November, the Australian Federal Government announced its decision to call a royal commission into the banking sector. This came on the back of various well-publicised ESG issues in Australian banks. However, the commission will likely be broader than just the big four banks. In his announcement, Prime Minister Malcolm Turnbull said it would cover banks, wealth managers, superannuation providers and insurance companies. At the time of writing, the commission will have 12 months to complete its enquiries with a final report expected to be delivered by February 2019. The commission means it be vital for investors to understand and engage with financial companies about culture. We also believe ASIC will be more active. In November 2017, it started to probe buy-now-pay-later schemes. We have also identified another area of financial services that is currently highly self-regulated but where there is significant anecdotes about rogue practices, which we believe eventually will need to be investigated.

7.4 Cyber security

In 2017, the Australian government introduced new legislation to strengthen the protection of privacy and personal information and to improve organisational transparency in regards to data breaches. This will come into effect in February 2018. We have already seen various examples of costly data breaches overseas. In the US, it has been reported that the average cyber attack for enterprises was US$1.3m in 2017[iii]. We believe it will be increasingly important for investors to engage with and understand how Australian companies are managing the cyber security risk, particularly for consumer-facing businesses that are increasingly adopting an omni-channel approach.

iii https://www.csoonline.com/article/3227065/security/cyber-attacks-cost-us-enterprises-13-million-on-average-in-2017.html

Looking ahead

7.5 Continued engagements on the main ESG engagement themes

In addition to the these themes, Ausbil sees continued engagement opportunities under the main engagement themes discussed above.

- Ausbil aims to continue a constructive dialogue with companies about human rights and labour rights in supply chains. As before, Ausbil will maintain a consultative approach with focus on practical solutions on key issues as well as further investor education. Ausbil also aims to continue its support and engagement with policy makers and businesses in regards to a Modern Slavery Act in Australia.
- In regards to climate change, Ausbil forecasts additional shareholder resolutions in 2018 and will continue to encourage companies to be proactive on climate-change related disclosure and analysis. Ausbil is joining IGCC, which will facilitate collaborative engagement on climate change with companies and policy makers. Ausbil continues to believe the current regulation on climate change is insufficient for Australia to meet its Paris Agreement commitments. The same applies for our involvement in Climate Action 100+. We see the TCFD framework as a productive way to engage with companies and to provide investors with better information for investment decisions.
- Ausbil will also continue to engage with companies about improved ESG disclosure through company-specific meetings as well as provision of stakeholder input and provision of feedback on companies' sustainability reports. In particular, we will encourage companies to disclose more on so-called social factors. As we have seen in 2017, social factors can have significant impacts on share prices but assessing culture can be a difficult task when disclosure on key metrics is poor.
- When it comes to corporate governance, Ausbil has an ongoing discussion with companies on executive remuneration and there will be a number of follow-ups from 2017 in regards to changes to remuneration structures. Also, Ausbil will continue to have a dialogue with companies on board composition, including board diversity and board skills.

In short, we expect 2018 will be another year of significant ESG engagements.

Contact details

Måns Carlsson-Sweeny
Head of ESG Research
Phone 61 2 9259 0262
Email mans carlsson-sweeny@ausbil.com.au

Nicholas Varcoe
ESG Analyst
Phone 61 2 9259 0276
Email nicholas.varcoe@ausbil.com.au

Mark Knight
Head of Distribution
Phone 61 2 9259 0226
Email mark.knight@ausbil.com.au

Notes

Ausbil Investment
Management Limited
Level 27
225 George Street
Sydney NSW 2000
Australia
Toll Free 1800 287 245

Contactus@
ausbil.com.au

ausbil