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ausbil Celebrating 20 YEARS

ESG insights from the FY17 reporting season

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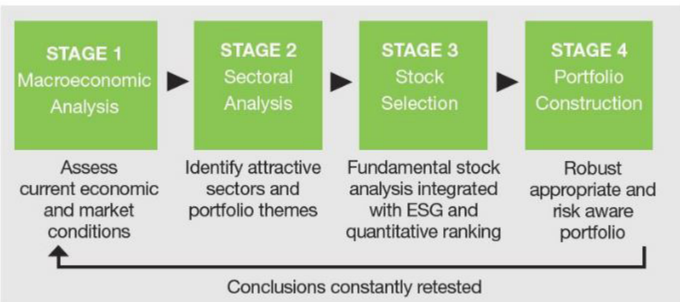
ESG integration at Ausbil

Ausbil integrates environmental, social and governance (ESG) factors in order to make better informed investment decisions. ESG issues can be time-consuming to research and can have complex implications on investments, which is why Ausbil has a dedicated ESG research team within its investment team. The proprietary ESG research produced by the team can feed into all four stages of Ausbil's investment process: macroeconomic analysis, sectoral analysis, stock selection and portfolio construction. However, it is important to point out that ESG integration in an investment process does not necessarily equate to investing in companies with the very best ESG profiles, particularly in the Australian market, which offers a limited investible universe and therefore difficulty in pursuing a best-in-class approach on ESG. Rather, we believe there are alpha opportunities in companies with positive *momentum* on ESG drivers, particularly cultural factors.

In our experience, major cultural transformations can be particularly good at unlocking value. As an example, the Coles (Wesfarmers) turnaround in the last decade was significantly driven by cultural factors. As a result, it is important for investors to identify early signs of cultural transformation, both positive and negative.

The impact from ESG insights on individual stocks varies, but ultimately it is tied to Ausbil's investment philosophy that earnings drive share prices and also that we have a preference to invest in companies with sustainable earnings and quality management. Sometimes ESG insights can result in adjustment to earnings forecasts and at other times it can impact our conviction about a company's management or strategy. Ausbil believes ESG factors, particularly changes in momentum in ESG performance, can serve as good lead indicators of earnings sustainability as well as be a proxy for management quality.



Ausbil's investment process consists of four stages, each of which can have an ESG input.

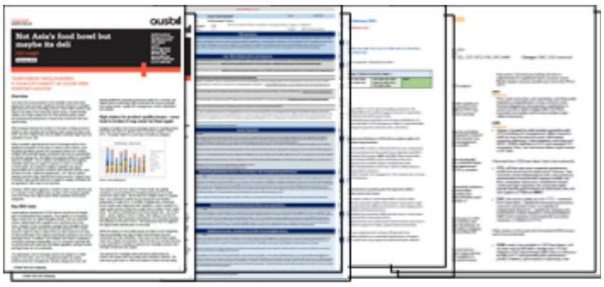
Key insights from the FY17 reporting season

On a high level, there were a number of discernible general trends in the FY17 reporting season:

- Firstly, it is increasingly evident that China is becoming serious about fixing its environmental challenges. The increased environmental focus in China will result in both risks and opportunities for Australian companies, e.g., in the materials sector, while it's also likely to lead to cost inflation in supply chains, reinforcing the main conclusions from our ESG field trip to China in 2016 and the paper *'Is the fast fashion industry at an inflection point?'*
- Secondly, many companies across industries are scaling up their automation efforts - for instance, in the extractive industries, where this can lead to productivity benefits, but also significant safety performance improvements. Other sectors where there is increased focus on automation include agriculture / food production and consumer services.
- Thirdly, many companies recorded overall safety performance improvements, at least of their own staff and on the measures published, such as lost time injury frequency rates or total recordable injury frequency rates. A large number of ASX-listed companies now have occupational health and safety (OH&S) measures as part of their short term incentive structures and the reductions in injury rates (lag indicators) follow efforts to change safety culture and behavioural changes in recent years. However, investors need to look beyond what companies report to understand a company's OH&S risk management. Some companies have restated safety statistics over time, suggesting there could be some data quality issues, while a number of companies that reported fatalities in FY17 also (perplexingly) recorded improved performance on headline safety statistics.
- Fourthly, companies are increasingly talking about 'culture' and staff engagement, which we regard as positive given that many corporate scandals and failures in the past have partly been related to questionable culture. In addition, culture can be a key positive value driver and is often an integral part of profitability improvements.
- Fifthly, rising energy costs are eating into profit margins, which highlights the importance of focusing on energy efficiency e.g., in manufacturing and construction materials. Many companies are also increasingly scaling up their own energy production, including renewable energy.

Ausbil's ESG research team analyses a large number of companies during the reporting season. That analysis covers a wide range of factors, such as trends in corporate governance, environmental performance, OH&S or process safety performance, conduct risk and much more. In particular, Ausbil's ESG research team focuses on momentum and directional changes.

In the FY17 reporting season, we believe 44% of the companies analysed have net overall positive momentum on ESG factors, while 33% were neutral and 24% negative. This is in line with what we would expect, whereby the majority of companies should be improving.



Thematic research | *Company ESG summaries* | *Weekly ESG newsletters* | *Monthly ESG best ideas*

Ausbil's proprietary ESG research includes thematic research, company ESG summaries, weekly ESG newsletters and monthly ESG updates for stock selection meetings.

Woolworths was among the positive movers. Its cultural transformation is becoming increasingly evident and resulting in improved staff engagement and customer satisfaction, which are important elements in an industry subject to increased competition. Other examples of ongoing cultural transformation include Sims Metal Management and QUBE Logistics, which also appointed its first female director to the board.

The new management team of G8 Education is also implementing changes that could drive improved staff engagement, which in turn could drive better customer retention rates - a key business driver. JB Hi-Fi's integration of The Good Guys appears to be tracking well and the company is experiencing positive momentum in staff engagement. We have previously seen correlation between staff engagement and customer satisfaction among companies such as Super Retail Group. A review of ombudsman statistics and customer satisfaction data also shows that Medibank Private is currently experiencing positive momentum.

Some companies reported significant improvement in safety performance, such as Fortescue Metals, Boral, Bega Cheese and Bingo Industries.

The negative movers generally referred to companies with fatalities, including a company that had previously been fatality-free for many years. There were also cases of deteriorating injury rates, deteriorating staff engagement and deteriorating CEO approval rates, which could be seen as leading indicators of cultural deterioration.
There were also cases of excessive executive remuneration outcomes and companies that continue to be subject to significant structural challenges, including sustainability issues, such as obesity. The reporting season also highlighted the high ESG risk facing Australian companies operating in, or entering, developing countries, particularly in Africa.

Engagements and follow ups from the previous reporting season

As a fund manager that integrates ESG, Ausbil puts significant emphasis on active ownership or engagement on ESG issues. In addition to proxy voting, Ausbil also frequently engages with companies on ESG issues as part of the reporting season. Typically, when Ausbil meets with a company, Ausbil is represented by a portfolio manager, a stock analyst and an ESG analyst. In the reporting season, Ausbil discussed a wide range of ESG issues, such as succession planning, changes to executive remuneration structures, OH&S risk management, cultural change, staff engagement, geopolitical risk and much more with these companies.

In some cases, Ausbil also actively encouraged companies to adopt industry-best practice and other measures to reduce downside risk, such as better disclosure on climate change (including scenario analysis), adoption of more effective whistleblower channels and whistleblower protection and more.

Engagements can sometimes be long journeys, but on a positive note, in the FY17 reporting season, Ausbil saw good development in some areas where we have previously engaged, such as improvement in supply chain risk management. For example we witnessed consolidation of supply chains, which means a greater opportunity to influence suppliers on labour and environmental standards, as well as improved disclosure on rehabilitation provisions and some adjustments to executive remuneration.

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