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ESG Reporting Season Wrap

ESG Insights

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In our opinion, the way companies manage human rights risk in their supply chains can be a good proxy for management quality. Moreover, business models that rely on underpaid workers or slavery will inevitably be subject to earnings sustainability risk.

Consideration of environmental, social and governance (ESG) factors is integral to the Ausbil investment management process.

The August corporate profit reporting season provides a timely opportunity to evaluate the state of play with regard to ESG issues and to comment on how selected companies are performing in this area.

Ausbil made several changes to ESG scores on individual companies and also upgraded and downgraded a large number of companies when it comes to ESG direction, which is our measure of which direction a company's ESG profile is developing. The latter can be a lead indicator for operational performance.

At an overall level, the reporting season was characterised by several notable themes:

Staff engagement

Staff engagement is an important consideration for company evaluation. Research shows that the majority of a company's value is increasingly sourced from intangible factors, of which culture naturally forms a big part. Staff engagement is also closely linked with productivity and staff turnover.

Crown Resorts was among the notable improvers in the area of staff engagement, reflecting an increased level of commitment from staff and a greater approval rating of the CEO. Staff engagement similarly improved at **Medibank Private**, and importantly the previously elevated turnover rate among senior and executive staff has stabilised.

In contrast, staff engagement at various companies in the financial sector continues to lag amid negative publicity emanating from the ongoing Royal Commission, which has taken its toll on staff engagement, notably at **Commonwealth Bank**. This was confirmed by this year's internal staff engagement survey, which showed a marked decline in 'pride in the organisation'. However, this was not the only company subject to deteriorating staff engagement.

Key recent initiatives - Business Simplification and Cost Reduction

Over the course of the reporting season, a variety of companies have indicated that upward wage inflation is driving costs higher. Wage pressure is particularly evident in the costs associated with fly-in-fly-out mining operations, equally impacting major miners such as **Rio Tinto** and **BHP Billiton** and smaller players such as **Western Areas**. However, some of the more specialised miners, such as **Northern Star**, are partly insulated from this impact by the specialised nature of their workforce and innovative remuneration structures. It is also interesting to note that companies such as **Emeco Holdings** are responding to tight labour market conditions by leveraging their status as employers of choice by focusing on training, with a view to optimising labour efficiency.

Occupational health and safety

There has been a continued improvement in occupational health and safety (OH&S) standards and an accompanying increase in the disclosure of OH&S statistics.

Bega Cheese has been among the notable improvers in this area, reporting a 36% reduction in Total Recordable Injury Frequency Rate (TRIFR) and an increased investment in people and sites. The company has also reduced its emissions from operations by way of investment and ongoing community involvement through the NSW South East Local Land Services agency. In contrast, **Lendlease Group** reported two fatalities in the 2018 financial year. The company has announced its intention to undertake a review of how it approaches and manages occupational health and safety.

Climate change

Several companies have improved their disclosure in this area, partly due to continued investor engagement, particularly in relation to the Task Force on Climate-related Financial Disclosures (TCFD) guidelines. **WorleyParsons, Beach Energy** and **Transurban Group** are among those companies that are strengthening their TCFD reporting and climate change strategies.

Interestingly, with the continued divestment of thermal coal exposure by listed companies, these assets are increasingly falling into the hands of unlisted companies, resulting in them moving out of scope for sustainability oriented investors who wish to engage in this area.

Modern Slavery Bill

The Bill has passed the House of Representatives and will now proceed to the Senate. Some companies, for instance **Transurban**, have indicated that they are currently preparing for its implementation. We recently engaged with **Bluescope Steel** to discuss their updated supply chain standards, which are adopting a risk-prioritised approach to assess and engage with suppliers. The company has also published a statement on human rights and responsible sourcing standards and has completed an ESG risk assessment and analysis of its supply chain management processes.

In our opinion, the way companies manage human rights risk in their supply chains can be a good proxy for management quality. Moreover, business models that rely on underpaid workers or slavery will inevitably be subject to earnings sustainability risk.

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