



ENVIRONMENTAL, SOCIAL AND GOVERNANCE

SEPTEMBER 2018 FOR PROFESSIONAL CLIENTS ONLY



2 | ACCESSING THE TRUE VALUE OF ESG

Businesses that prudently manage environmental, social and governance (ESG) factors are more likely to generate sustainable returns over the long term (see our paper *The Value of ESG*). In the second part of our series, we set out how fully embedding ESG analysis into the investment process is the best way for investment managers to identify risks, opportunities and, therefore, the companies best positioned to succeed.

WHAT WE AIM TO UNDERSTAND – GOVERNANCE IS THE KEY

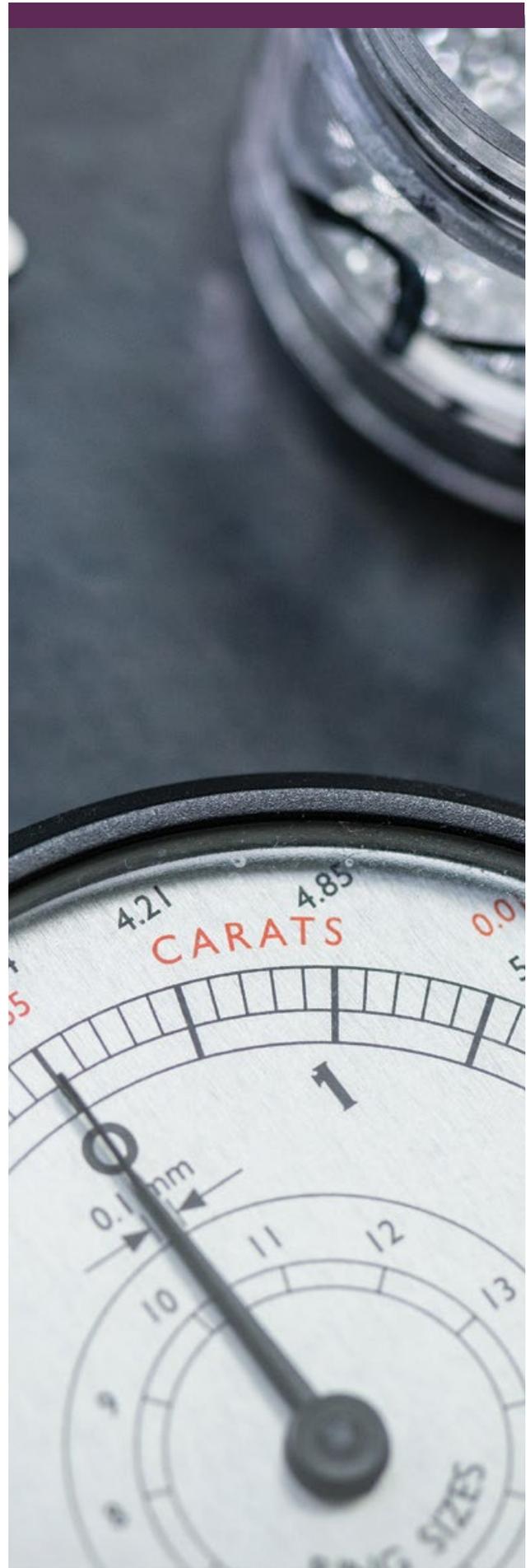
We consider the integration of ESG analysis into our investment process as a fundamental part of our fiduciary duty – protecting and advancing the economic interests of our clients. Understanding the governance of the companies we invest in is the starting point for this analysis. It provides us with the context for how a company creates value and helps us identify the ‘non-financial’, or more accurately, the ‘not-yet-financial’ factors that could impact its ability to generate long-term sustainable returns. This focus on governance finds validation in the International Corporate Governance Network’s statement on how corporate sustainability is best achieved:

‘Sustainability implies that the company must manage effectively the governance, social and environmental aspects of its activities as well as its financial operations. In doing so, companies should aspire to meet the cost of capital invested and generate a return over and above such capital. This is achievable sustainably only if the focus on economic returns and strategic planning includes the effective management of company relationships with stakeholders such as employees, suppliers, customers, local communities and the environment as a whole.’

Our particular emphasis on governance therefore stems from the belief that it is a fundamental determinant of long-term performance. Problems here are more often than not reflected in a company’s environmental and social track record, making it a reliable proxy for wider sustainability. As such, governance provides us with both an overview and a framework for integrating ESG analysis into our investment process.



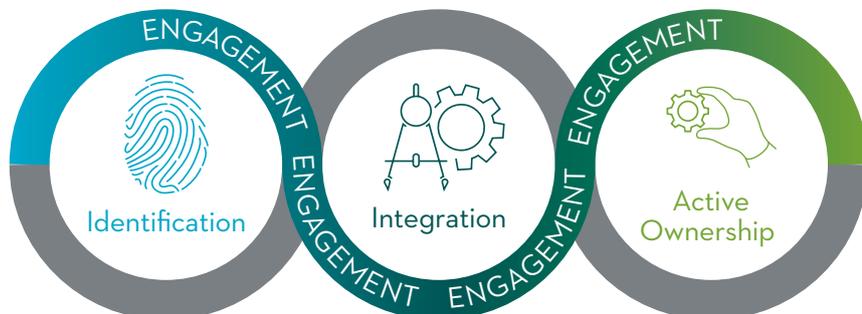
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PUTTING THEORY INTO PRACTICE

Analysis of ESG cannot be done by half measures. To gain a full understanding of how sustainability factors can impact a company's future returns, they must be embedded throughout the entire investment process - from idea generation and stock research, to financial modelling and portfolio construction.

In our view, there are three core strands:



- 1. Identification** - recognising the ESG factors most material to a company's business model.
- 2. Integration** - incorporating these factors into financial modelling, for a more complete image of the business' stability.
- 3. Active Ownership** - developing strong relationships with companies to gain greater insight, and build conviction in the sustainability of their business models, as well as engaging to improve ESG practices.

At the heart of each stage is **Engagement**. Led by our portfolio managers and analysts with day-to-day responsibility for investment decisions, we engage through a range of interactions: one-to-one with individual firms; in collaboration with other investors (through initiatives such as those run by the Principles for Responsible Investment [PRI]); with outside bodies, including government departments or non-governmental organisations (NGOs); and with other relevant stakeholders.

Engagement underpins our approach to ESG analysis and allows us to turn the theory (discussed in our first paper) into practice. Throughout this document, we refer to three companies which are prime examples of how active engagement has helped us better understand whether performance is sustainable in the long term.



Croda - A UK-based specialty chemicals company, where sustainability and ESG are central to its business model.



AGL - A leading Australian energy company, which generates electricity from both coal and renewable sources.



Credicorp - A Peruvian financial services company, with a long history of sustainable growth, which has addressed many ESG factors traditionally associated with emerging markets.

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1. IDENTIFICATION: TARGETING WHAT MATTERS MOST

The materiality of ESG factors is essential in our analysis. As we established in our first paper, research has shown companies focusing on ESG factors most material to their business models tend to fare better than those adopting a less targeted approach. A Harvard Business School research paper discovered that, over a 10-year period, investments involving 'high performance' on material factors and 'low performance' on immaterial, produced greater alpha than all other investments, including those scoring highly on both material and immaterial issues.¹

When analysing materiality through the governance lens, we look to understand the mechanisms in place, how a company allocates capital and creates value, and get a sense of the culture of the organisation. We want to gauge the extent to which the board/management understands the potential material risks and opportunities presented by ESG factors to a company's ability to generate long-term sustainable returns.

We recognise, however, that these ESG factors vary greatly by industry. As such, we have created bespoke research frameworks, which help shape our conversations with company management and allow us to understand how they are dealing with the environmental and social issues most material to their business. For each individual firm assessed, we build into our research template the potential impact of material ESG risks and opportunities, assess how the company is managing these, and identify areas for future engagement. This work is then added to by wider external research. In the following case studies, we highlight how we have identified material ESG factors: **Exhibits 1 and 2** demonstrate the importance of balancing the risks and opportunities, while in **Exhibit 3**, we show how materiality is rarely static and evolves over time.

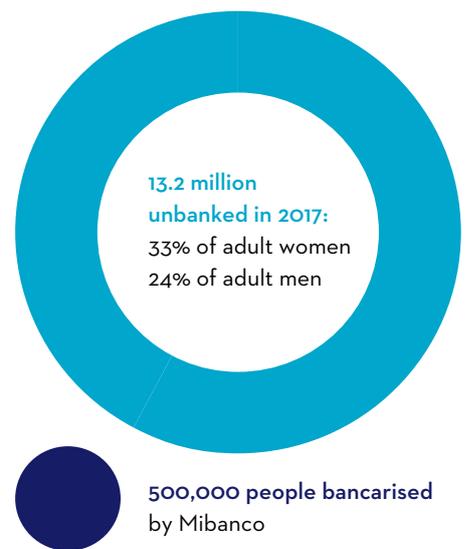
EXHIBIT 1. CREDICORP - BANKS AND THE 'SOCIAL LICENSE TO OPERATE'

A small percentage of Peru's population controls much of the wealth, while a large proportion are under-served (or non-served), in terms of banking penetration. This presents an opportunity for Credicorp to grow its customer base (over the last five years, more than 500,000 people have been bancarised by the company, receiving their first ever loan through its subsidiary Mibanco.²)

There is an accompanying risk, in countries like Peru, of poorly educated portions of the population being exploited by mis-selling and inappropriate lending. As can be seen in the UK's scandal over mis-sold payment protection insurance, society is no longer as likely to tolerate unscrupulous behaviour from banks. Institutions need to ensure they can retain their social license to operate - as well as avoid regulatory sanctions.

This has been a particular area of engagement for us with Credicorp. It has a programme to increase financial literacy among younger people as they come into the formal workforce, as well as a talent programme to train and develop the next wave of its banking staff and leadership. The firm's social agenda is not based purely on altruistic intentions, but on the belief that it will enable sustainable and profitable growth, creating more value for shareholders.

Number of unbanked in Peru



Source: World Bank Global Findex; Credicorp Annual Report 2017.



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¹Khan, Mozaffar N., George Serafeim, and Aaron Yoon. 'Corporate Sustainability: First Evidence on Materiality.' Harvard Business School Working Paper, No. 15-073, March 2015.

²Credicorp annual report 2017.



EXHIBIT 2. CRODA - IDENTIFYING THE OPPORTUNITIES (NOT JUST THE RISKS)

The UK-based company's products often form critical components to brands where sustainability is the key selling point. For instance, companies including sustainability 'superstars' Unilever and L'Oreal (both A rated by CDP³) rely on Croda's know-how to make their end-product a success.

In our engagement, it has been evident that customers' desire for sustainable produce is driving innovation. The most recent example of this in the commissioning of Atlas Point, a US\$170 million bio-ethanol plant in the US. Its output will allow Croda's customers to stamp their products as 'USDA Certified Bio-based'. This clears an important obstacle to calling their products 100% renewable, enabling them to achieve the so-called 'green premium', justifying higher prices for eco-friendly products.

In addition, a significant issue for many personal-care companies (about one-third of Croda's business) is palm oil, because of the environmental and social impacts it has on the ecosystems of the countries where it is produced, such as Indonesia. Croda uses very little palm oil, but is a significant buyer of palm-oil derivatives, such as fatty acids and glycerine. The company is aware of its responsibilities in this area - 12 of its 13 manufacturing sites already have certification from the Roundtable on Sustainable Palm Oil (RSPO), and while it has not yet achieved 100% RSPO accreditation, it says addressing the issue is a priority.



EXHIBIT 3. AGL - ESG FACTORS AREN'T STATIC

This integrated power generator with exposure to coal, gas and renewables has been held in some of our Australian investment strategies for several years and its quality rating has remained fairly constant. However, there has been considerable fluctuation over that time in the relevance and materiality of various ESG factors.

There are clear environmental risks to consider, resulting from the company's coal exposure. In Australia (and globally), there has been a shift in demand towards power production that is less harmful to the environment. Around 70% of AGL's portfolio is currently coal generated, which includes two New South Wales Government coal power stations, Bayswater and Liddell, acquired in 2014.

However, around 20% of AGL's portfolio is from renewable sources and the company has also announced its intention to move away from coal - with a long-term plan to shut its coal-fired power stations (in 2022, 2030 and 2048).

What has been clear in our engagement though is that, while the facts over climate change have not changed, its materiality to AGL's business case has shifted in recent years. Dramatic rises in energy prices (such as the sharp rise in the cost of electricity - see chart) have led to public opinion veering away from greener energy in favour of cutting the costs of powering people's homes. Moreover, a change of government has led to an increased threat of regulation to keep prices low.

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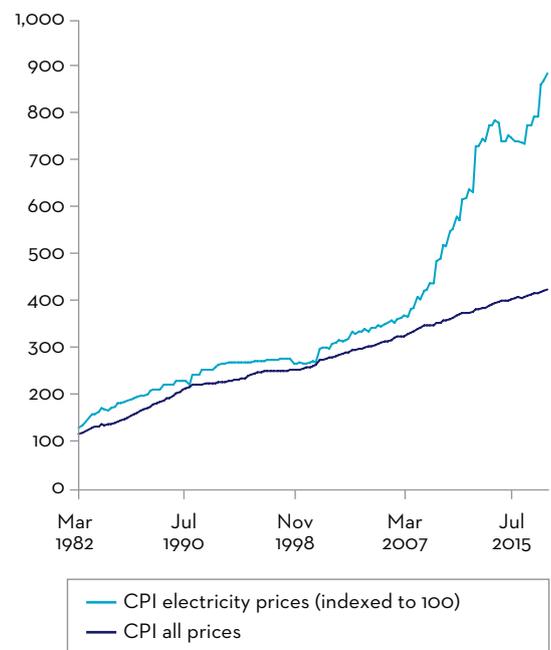
³Formerly the Carbon Disclosure Project.



[Atlas Point's] output will allow Croda's customers to stamp their products as 'USDA Certified Bio-based'. This clears an important obstacle to calling their products 100% renewable.



Australian electricity prices are on the rise



Source: Australia Bureau of Statistics.



2. INTEGRATION – ASSESSING THE IMPACT OF ESG

With the material ESG factors identified, these are then integrated into fundamental stock analysis and the decision-making process. The relevant factors are incorporated into extensive financial modelling, as we assess a range of probable impacts on variables – such as the cost of capital, cash flow, revenue projections and capital expenditure.

Assessing the risks and opportunities from ESG factors helps us build a fuller picture of the company and how we expect it to perform in the future. **Exhibit 4**, for example, shows how, given the likelihood of large rises in the carbon price in the future, Croda’s commitment to sustainability could see a tangible benefit, while **Exhibit 5** demonstrates the less-obvious impacts of AGL’s policy to pull out of coal power. Ultimately, we are looking for signs a firm can continue on a path of sustainable growth and that its business model is not at risk from exogenous shocks arising from governance structures or mismanagement of stakeholder risks. **Exhibit 6** shows some of the evidence we seek from companies, to show they are taking ESG factors into account.



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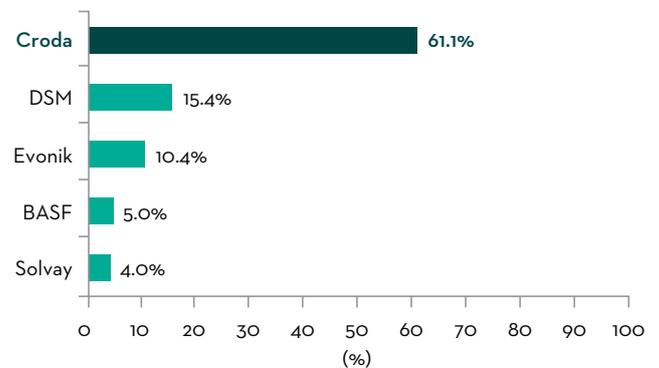
EXHIBIT 4. CRODA – CALCULATING THE ESG PREMIUM

Croda views its sustainability programmes as helping customers manage their risk in terms of achieving their own sustainability objectives – an insurance policy with a hard-to-quantify premium.

That said, although classed as a specialty chemicals firm, its predominant use of lanolin (wool grease), rather than ‘cracking’ hydrocarbons, in manufacturing, gives it an advantage over other businesses in the same sector. A greater proportion of Croda’s raw materials come from renewable sources – around 60%, compared with less than 16% among its main competitors, which have their roots in the carbon economy of the 19th and 20th centuries.

This renewables mix will be a major source of differentiation for the company, especially with the carbon price predicted to rise swiftly in the future. Indeed, the EU carbon price has risen to more than four times that amount – from a very low €4.39 (around US\$5) per tonne – between May 2017 and August 2018⁴. Looking ahead, the High-Level Commission on Carbon Prices has said the explicit global price level needs to be at least US\$40–80 per tonne by 2020, and US\$50–100 per tonne by 2030, in order to achieve current decarbonisation targets⁵.

Croda’s Favourable Renewables Mix



Croda’s percentage of renewable raw materials, compared with selected competitors. Source: Company sustainability reports 2017.

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⁴Source: EU Allowance carbon price. Sandbag Climate Campaign CIC, under a Creative Commons Attribution Licence (CC BY 2.0 UK).

⁵Source: Carbon Pricing Leadership Coalition, May 2017.



EXHIBIT 5. AGL - ACCOUNTING FOR UNINTENDED CONSEQUENCES

AGL flagging its intentions to exit coal by 2050 is beneficial to the environment, but could have other knock-on effects for the company. Announcing the closure of its coal assets so far in advance has allowed competitors to speculatively build renewable energy capacity and solar plants, raising the question of whether AGL has yielded some competitive advantage to its peers by encouraging others to build renewable energy. We have engaged with the company's management on this area, who recognise that, in hindsight, this strategic shift could have been managed differently.

As the market moves towards more renewable energy we have also adjusted how we model the future, as an overbuild of renewable energy plants would see marginal power prices fall to zero if there is an over-supply of power. In addition, the risk to reliability of supply (for example from periods of low wind speeds) is encouraging investment in batteries or gas as a backup. These are areas of future engagement.

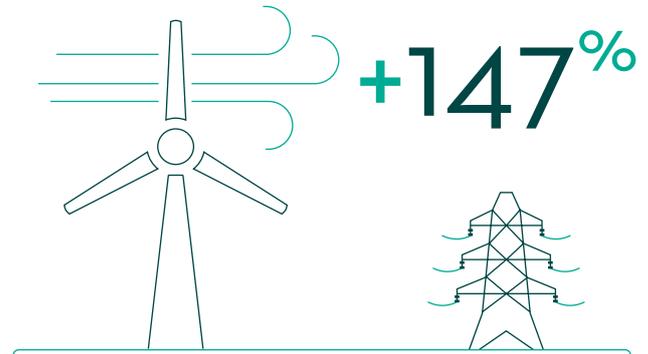


EXHIBIT 6. CREDICORP - KEEPING A CLOSE EYE ON LENDING DECISIONS

Around 55-60% of Credicorp's balance sheet still comes from corporate lending. Peru's resource-intensive economy is dominated by minerals and mining and, in such an environment, there is a great deal of scrutiny on banks' corporate lending decisions. Financial institutions globally are increasingly being held to a greater level of responsibility for these decisions. As a result, we expect to see evidence that banks are cognisant of the implicit and explicit risks associated with their roles in financing large projects or direct capital investment in businesses which impact local communities and the environment. These include the effects of mining operations on water resources, a project's impact on the local habitat and biodiversity, or the social consequences of health & safety considerations for employees.

As a result of our engagement over the years, we have seen increased disclosure in these areas, and evidence that the company is not just aware of these issues, but making some headway in addressing them. Measures include: reporting annually on greenhouse-gas emissions, designing and implementing systems to monitor direct & indirect environmental risks generated by its operations, and measuring its carbon footprint through independent consultants.

Australian investment growth in clean energy in 2017



Source: Statista UNEP; FS-UNEP Collaborating Centre; Bloomberg New Energy Finance



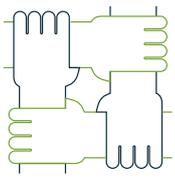
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3. ACTIVE OWNERSHIP – SEEING THE BIGGER PICTURE



(I) DEVELOPING STRONG RELATIONSHIPS

As we referenced earlier, a fundamental tenet of unlocking the value of ESG analysis is that it must be embedded into the day-to-day work of the people who actually make the investment decisions, rather than delegated to a separate team, one step removed from the process. Our analysts incorporate ESG factors into their research & scrutiny of companies to delve deeper and build conviction in each investment case.

Active ownership is vital to this process. By developing strong relationships with companies, we are able to encourage greater transparency, ask more insightful questions and ultimately, gain greater insight into the company's governance – and by extension the sustainability of the business model. Credicorp is a good example here. A lengthy holding period in our Emerging Markets strategy has enabled a consistency of dialogue and allowed us to work with officials who have graduated to more senior positions in the group (for example, the former Head of Retail, who is now the Deputy Chief Executive). As a result, we can be confident that, while ours will not be the sole voice on engagement issues, it will be among those which resonates most.

Crucially, active ownership allows us to be more forward-looking and make qualitative assessments of vital governance factors – such as culture or quality of management. Our conviction will also be significantly influenced by non-quantifiable issues – for example, our impression of the people at the helm, whether we feel they exhibit integrity, transparency, and a genuine understanding of many factors that will determine the sustainability of their business.

By contrast, a purely quantitative approach, relying too heavily on ESG metrics and disclosures, is inherently backward looking. Strategies that do this may be unable to take into account ESG risks which take time to rise to the surface. We believe active ownership is vital for highlighting potential problems (and opportunities) at a much earlier stage.



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(II) GETTING IT RIGHT – NOT JUST 'RIGHT NOW'

We recognise there is no 'perfect company'. From an investment perspective, the pace of positive change is often more important than a company's precise starting point. As discussed in our previous paper, there is an academic grounding for this, as higher rates of improvement in ESG characteristics ('momentum') have been found to be an important indicator of improved financial performance – leading to increasing valuations.⁶ Management teams that are committed to improvement, transparent about where ESG issues fit into a broad vision and demonstrate a move towards best practice, typically indicate a sound long-term investment.

Context matters, and this means being sensitive to local regulations and levels of corporate maturity when gauging a company's relative performance on ESG metrics. Our framework for corporate governance reflects this, looking at broad-based principles, rather than a single set of global standards. An overly rigid approach might well result in avoiding companies which are actually the best governed among regional peers. By contrast, as we demonstrate in **Exhibit 7**, engagement allows us to take a more nuanced view.

Proxy voting is a core element of our approach to active ownership. Our analysis and engagement informs how we vote, but our focus is always on our clients' best interests, and promoting the long-term sustainability of the business concerned. This requires integrity and objectivity, at times differing from the consensus view, going against management (and indeed supporting them) if we believe this is needed to ensure future sustainable growth of a company. Proxy voting is a powerful tool for active investors, as is demonstrated by the action taken regarding AGL in **Exhibit 8**. By steering companies in the right direction, we aim to ultimately improve corporate practice.

EXHIBIT 7. CREDICORP – EVERY CASE IS UNIQUE

The Romero family has been involved with the bank for a century and still has a significant stake, with members of the family having served in various management roles. Until recently Dionisio Romero, was joint chairman and chief executive, which would generally be considered a corporate governance flag. On the face of it, governance arrangements such as these, which are not optimal, might not pass an ESG screen. However, our focus has been on whether the structure has resulted in any inappropriate behaviour, or whether there are any obvious family conflicts of interest which could pose a risk to minority shareholders. With Credicorp, on investigation we found no indication of activity historically where minority investors were being exploited, or our clients' interests misrepresented by the firm's governance structure.

In fact, the roles have now been separated, with Walter Bayly (formerly Chief Executive of a Credicorp subsidiary) the new chief executive, while Romero remains as chairman. This highlights both a maturing approach to governance and sustainability, and the benefit to us as investors of allowing things to evolve.

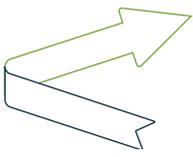
EXHIBIT 8. AGL – MAKING OUR VOICE HEARD

The 'two-strikes' law on remuneration in Australia is designed to hold directors accountable for executive salaries and bonuses. It means an entire company board can face re-election if shareholders disagree over how much executives are to be paid.

AGL was hit by its first 'strike' at its AGM in 2016, over the chief executive Andy Veysey's A\$6.9 million salary. We were among the shareholders who voted against the company's remuneration report as we were unhappy with both the level and some of the underlying metrics it was based on. What has been significant for us is how the company has approached the issue in our engagement since then. Management has made it clear it is conscious of the issue and that remuneration of any new chief executive is likely to be less.

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⁶"Can ESG Add Alpha? An Analysis of ESG Tilt and Momentum Strategies", Zoltan Nagy, Altaf Kassam and Linda-Eling Lee, Journal of Investing, Vol. 25, No. 2, Copyright © Institutional Investor Journals.



(III) EFFECTING POSITIVE CHANGE

Finally, active ownership is also a key means of influencing positive change. Through engagement and voting we can work to improve governance behaviours among investee companies, enhance disclosure on how firms are approaching material ESG issues, and share best practice we see at other companies. We engage with companies on a regular basis, and look to understand how the business is evolving, how it is impacted by changes in the external environment and, where we identify potential shortcomings, try to nudge them in the right direction.

This is only possible because ESG analysis is embedded fully in the lifecycle of the investment case. Importantly, we are, in many cases, able to take on the role of 'trusted advisor', rather than simply a shareholder, offering ESG-related guidance. Increasingly we are noticing this is not a one-way street; given our strong interest and experience in this area, and we are often approached by the companies who we engage with. Most recently, our engagement with Credicorp has benefited from our wider collaborative engagement, as part of a PRI initiative on cybersecurity. The wider engagement has helped in two ways: in terms of us assessing the financial institution's cybersecurity measures (an issue of increasing importance in modern society); and in helping the business improve its disclosure on the subject and develop a greater understanding of investors expectations.

CONCLUSION

There is growing evidence that companies taking material sustainability factors seriously, perform better than those that don't. However, taking a best-in-class approach is not necessarily the wisest path for investors. We place the emphasis on positive ESG change, and believe that active ownership is a key tool with which we can help drive this. Critically, we believe ownership of the ESG analysis and engagement should sit with the analysts and portfolio managers themselves, rather than being managed by a separate team. This ensures that material sustainability factors are integral parts of the conviction-building process and inform our engagement, both before and after a decision to invest has been made. When we talk about full integration, this is what we mean.



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