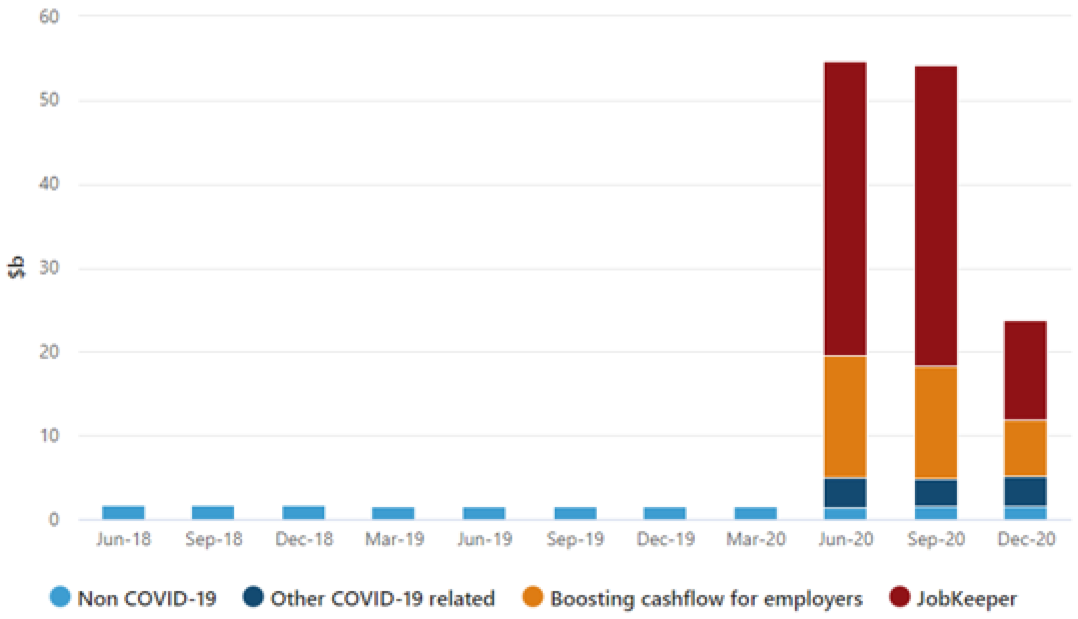
Wavestone ESG Activity Report - 2021

ESG activity – March quarter 2021

A key recurring theme during the February 2021 reporting season was how Australian listed companies handled JobKeeper payments received from the Australian Federal Government. Given our approach to corporate governance and social factors, we have scrutinised the behaviour of our investee companies, as well as the broader universe.

The JobKeeper initiative has fulfilled its intended economic purpose in response to COVID-19. The scheme has resulted in most Australians keeping their jobs and improved business confidence and working capital for corporates. According to the ABS, ~$83bn of JobKeeper payments were paid in the 9 months to 31 December 2020, with industries such as Arts & Recreation services and Accommodation & Food services receiving higher JobKeeper payments relative to compensation of employees. This is not surprising given these industries have been hit hardest by the pandemic.

Government support for business in response to COVID-19



Source: ABS

We applaud the corporates that chose to hand back the JobKeeper payments to the Australian government – some of which come to mind includes **DMP**, **SUL, JBH, COH, QUB** and **CKF**. The latter three companies are held within the Funds. Nick Scali (**NCK**) initially intended to keep the JobKeeper payments despite delivering 100% underlying net profit growth, until intense media scrutiny saw the company change their stance and $3.6m of wage subsidies were paid back to the Federal Government.

Some companies were not as forthcoming as those listed above, choosing to keep the payments despite posting record levels of profits; this includes some names such as **APE, HVN** and **PMV**. None of these companies are held in the Funds. On top of this, record levels of dividends were paid out to shareholders in some cases.

In terms of our holdings, **LOV**, **IEL** and **SYD** received JobKeeper payments that were not returned to the Federal Government. We discussed this with each respective management team during their results roadshow and came to the conclusion that unlike the companies mentioned above, these companies relied on JobKeeper to keep their staff employed and were arguably the intended recipients of the wage subsidy given their profitability fell sharply during the period.

In **LOV's** case, parts of their retail store network were closed throughout the year as lockdowns impacted their ability to trade and the business did not have a substantial online business to offset the large fall in sales. **IEL** only received ~$5.8m in government wage subsidies representing less than 8% of their total labour costs during the period, mainly due to the fact that **IEL** is a global business and has staff in multiple jurisdictions.

We believe that the scrutiny applied on the treatment of the JobKeeper payments gave us further insight into the corporate DNA of our investee companies.

ESG activity – June quarter 2021

As part of our research work, we focused this quarter on the impact of climate change on the utility space. The sector has been caught in the crosshairs of a rapidly changing outlook, a function of shifting government requirements and changing consumer preferences on carbon on the face of falling demand and technological change. Industry participants, including the listed players, have struggled to cope, resulting in significant destruction of shareholder value.

It is our belief that as generation becomes less centralised, the role of the energy utilities will be more one of coordination. The future of energy retail is likely to be behind the meter, controlling and coordinating demand with increasingly disaggregated storage and generation. The move is lowering the barriers to entry implying lower prospective returns.

Carbon emitters are seeing higher costs of financing and insurance as the pool of investors available for these projects shrinks and/or seeks higher compensation for assuming climate risk. The Renewables 2021 Global Status Report highlights that public sentiment is rapidly turning against fossil fuels with Public and Private institutional investors worth nearly US$15 Trillion committed to divestment in early 2021. Access to insurance is also becoming more difficult, with many of the large insurance companies in Australia committed to not investing in nor insuring any new thermal coal. This higher cost of capital effectively performs the role of a carbon tax, increasing the relative cost of carbon intensive generation versus the renewable alternatives. Our main question for management teams and boards in the sector is, have they done enough to engender trust with their consumers such that they have the social licence to succeed in a renewables world?

ESG activity – September quarter 2021

As part of WaveStone's ESG research, we focused this quarter on the aviation industry, as it has accounted for ~2.5% of global carbon dioxide for the past 30 years. While aircraft have become more fuel efficient in recent years, the growth in passenger volumes has more than offset these efficiency gains. Pre-COVID, passenger growth was ~6% per year while fuel efficiency gains were ~1% per year. As developing economies mature and GDP per capita increases, global passenger growth will likely accelerate.

Insights into companies with a high proportion of 'knowledge workers', who typically maintain a low carbon footprint, reveal that business travel is often their largest source of emissions. For example, PWC estimated that business travel contributed to 90% of the company's emissions in 2019. With the use of Zoom and other video conferencing platforms, substitution of traditional in-person meetings may now be a thing of the past, for example Microsoft eliminating nearly 5,0000 metric tonnes of emissions by hosting their MVP Global Summit in March 2020, virtually.

It is difficult to predict what will happen to business travel volumes as the world re-opens. However, we take the view that a post-covid world will integrate both traditional and virtual forms of communications, where we have positioned some of the portfolio to take advantage of a rebound in travel post-COVID. Favouring companies with strong brands in industries with tangible evidence of improving competitive dynamics such as Qantas Airways (QAN) is a key holding for WaveStone, yet approaching with caution by avoiding travel agents such as Flight Centre (FLT) due to the uncertainty of the medium-term outlook are factors we have considered. We are unlikely to have an idea about post-COVID travel patterns until the removal of most, or all, restrictions, which may take some time. More companies taking active steps to address the carbon footprint of an expanding knowledge worker base could further complicate the recovery.

ESG activity – December quarter 2021

Major Banks are supporting Australia's energy transition to a low carbon economy

We've just been through the AGM reporting season for three of the major banks and we've met with the Chairs of the banks and reviewed:

1. The fossil fuel exposures of the major banks
2. Current climate change policies and the differences between the bank's lending policies and the current Regulatory Oversight

3. How the banks are supporting Australia's transition to net zero by 2050
4. Hunter coal region and Port of Newcastle - an example of a region being supported by the banks as it transitions from dependence on fossil fuel exports to new industries

The Fossil Fuel exposure for the major banks are as follows:

	ANZ			CBA			NAB			WBC		
A$bn	**2019**	**2020**	**2021**	**2019**	**2020**	**2021**	**2019**	**2020**	**2021**	**2019**	**2020**	**2021**
Metallurgical Coal	0.7	0.8	0.6	0.1	0.1	0.0	0.8	0.6	0.4		0.2	0.3
Thermal Coal	0.8	0.5	0.5	1.5	1.4	0.9	0.9	0.8	0.6	1.2	1.3	1.1
Total Coal	**1.5**	**1.3**	**1.1**	**1.6**	**1.5**	**1.0**	**1.6**	**1.4**	**1.0**	**1.2**	**1.6**	**1.4**
Oil & Gas Direct	9.8	9.3	7.3	6.3	5.7	4.7	4.7	3.7	3.7	4.1	5.5	3.3
Oil & Gas Indirect	10.1	8.3	8.3	1.6	1.7	1.4	1.2	1.0	1.2		1.9	2.6
Total Fossil Fuel Exposure	**21.4**	**18.9**	**16.7**	**9.5**	**8.9**	**7.1**	**7.5**	**6.1**	**5.8**	**5.3**	**8.9**	**7.3**
% of Total Committed Exposures			**2.50%**			**0.86%**			**0.93%**			**1.85%**

Source: Annual reports, Climate reports on various bank websites.

Current fossil fuel lending policies

ANZ is Australia's largest institutional bank so it is not surprising that it has the largest absolute exposure to fossil fuels, which it has reduced by 22% over three years. The disclosure across the major banks is not unanimous and only includes the direct or balance sheet exposure to fossil fuel sectors. It may not include financing activities around arranging or underwriting capital market transactions such as bonds or derivatives which is an important component of institutional banking revenues as large corporates prefer to access cheaper debt or lengthier tenure from offshore markets that the Australian banks facilitate.

The banks have announced the following on fossil fuel lending policies:

i. Thermal Coal - all four major banks have announced commitments to exit by 2030.
ii. Metallurgical Coal - whilst 3 of the 4 majors excluding ANZ have announced increased due diligence and WBC and CBA have both announced the projects must be Paris aligned, none are planning to reduce exposure citing the importance to steel production.
iii. Oil and Gas - only NAB has set an exposure limit of US$2.4bn and it will reduce this from 2026. The other 3 majors have committed to projects being Paris aligned but no plan to reduce sector exposure.

Regulatory Oversight

In November 2021 APRA released its final prudential practice guide on climate change financial risks or CP229. As per APRA's release "*The guide imposes no new regulatory requirements or obligations but will instead assist APRA-regulated entities to manage climate-related risks and opportunities within their existing risk management and governance practices*".

In 2022, APRA intends to undertake a survey to help gauge the alignment between institution's management of climate change financial risks, the guidance set out in CPG 229, and the Financial Stability Board’s Taskforce for Climate-related Financial Disclosures. In addition, APRA continues to advance its climate-related program of activities, including the Climate Vulnerability Assessment (CVA) that is underway with Australia’s five largest banks. This has been delayed due to lack of granular data but is expected some time in 2022.

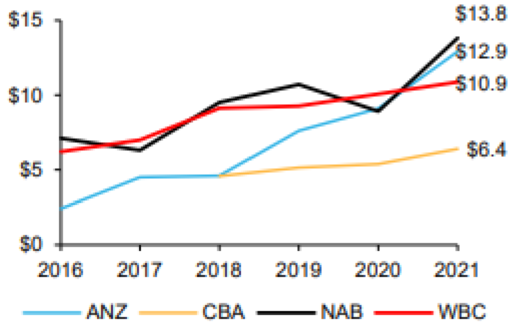
The major banks have joined over a dozen climate related bodies both here and globally and all report progress in line with frameworks and standards:

WBC	Taskforce on Climate related Financial Disclosures (TCFD); Climate Measurement Initiative
NAB	Member UN Environment Programme Finance Initiative (UNEP FI); TCFD
CBA	Global Reporting Initiative (GRI), TCFD
ANZ	UNEP FI; TCFD

Sustainability Finance

While analysis remains opaque, the cost to decarbonise Australia is estimated to be between $35bn-$80bn to 2030 and $130bn-$165bn by 2050*. The four major banks have announced sustainable finance targets totalling ~A$215bn committed by 2030. Since 2015, a total of $86bn has been deployed across sustainable projects, including renewable energy, low-carbon transport and green buildings.

Australian Major Banks Sustainable finance (A$bn)



Note: ANZ & NAB disclose financing deployed per year while CBA and WBC disclose balances.
Source: Company data, Macquarie Research, November 2021

The commitments by the major banks are as follows:

- ANZ: $50bn sustainable financing - includes low carbon projects as well as affordable housing.
- CBA: $70bn sustainable financing - includes low carbon funding of $15bn as well as funding for broader social issues such as affordable housing.
- NAB: $70bn environmental financing target. NAB also has a $2bn affordable housing target.
- WBC: $25bn climate change solutions fund.

In the past decade due to the large number of finance companies looking to support renewable energy projects, the banks have seen a flood of capital coming into the sector which has meant the risk return trade off (ROE<WACC) has not been as attractive. However, the returns are better now and the banks are looking to both use their balance sheets and act as arrangers to provide debt to new sustainable projects. In FY21 ANZ took part in >$100m of sustainable finance, up 75% yoy, and CEO Shane Elliott believes this loan book could put on an additional $500-$700m growth over 5 years.

Supporting the transition to Net Zero

The Chair of NAB, Phil Chronican said "to get to net zero, every business in every industry will have to evolve and every household will need to make changes". He cautioned that even if Australia was to source 100% of its power from renewables that that will only address a third of our carbon emissions. Citing Deloitte analysis that electrifying Australia's transport, heating and cooling systems could reduce our emissions by 80% by 2050 once electricity reaches 100% renewable supported by battery storage.

NAB has taken reported data from its corporate customers and made sector estimates for three sectors below for the attributable financed emissions of 8 key sectors within its lending portfolio and it is intending to disclose how they will align lending to its 1.5 degree Paris commitment in 2022:

SECTOR	% OF SECTOR EAD COVERED	ABSOLUTE EMISSIONS (TCO2-E)	EMISSIONS INTENSITY (TCO2-E/AU$M EAD)
Power generation	22%	2,036,484	1,018
Heavy manufacturing	69%	185,727	267
Resources	22%	536,921	261
Transport	9%	101,347	135
Agriculture	100%	3,929,316	115
SMEs	100%	990,005	24
Residential mortgages	100%	3,072,195	8
Commercial real estate (office and retail)	19%	33,844	6

Port of Newcastle - a long term commitment to energy transition
Port of Newcastle (PON) is co-owned 50% by The Infrastructure Fund (Macquarie Asset Management) and 50% by CMPort. The port handles approximately 4,400 ship movements, and 164 million tonnes of cargo annually handling a diversity of international trade, including coal, wheat and other grains, fertiliser, steel, cement, bulk liquids, containers, machinery and alumina. However, the bulk of the trade is thermal coal for export which will naturally reduce by 2050. As a result in November 2021, the PON with the backing of the NSW and Federal Governments announced a diversification of the port in two areas - a feasibility study into the PON Green Hydrogen hub and a release of tenders to expand the port's container berths and to take bulk liquids. In 2021 NAB arranged for PON a $515m sustainability linked loan which aligns with the International Capital Market Association climate transition handbook and incentivises PON to keep greenhouse gas emissions below agreed levels and various social targets in return for a lower cost of funding. Transitioning the 9000 direct jobs and the up to 200,000 coal direct and indirect employment in the Hunter Valley region requires a long-term commitment by all parties to diversify this region's emission intensive economy.

Conclusion

Whilst the exposure of the Australian major banks is low in context of the loan books to fossil fuels and the commitment to zero lending to thermal coal by 2030 by all banks allows an orderly transition. The question remains 'Are the major banks doing enough to support the transition of the economy and is 2050 too far away?" The oil & gas exposure is the most problematic as gas is acknowledged to be a transition fuel but the emissions remain large. We can't help but think this needs to happen a lot sooner.

Carbon Emission and Intensity Tracker:

WaveStone Australian Share Fund (WASF)	Carbon Emissions Scope (tonnes CO2e)		
	Scope 1	**Scope 2**	**Total**
Portfolio – WASF	25,649	5,429	31,077
Benchmark - S&P ASX 300 Accumulation Index	36,603	11,182	47,784
Difference	-30%	-51%	-35%

Source: MSCI ESG (as at 31/12/2021)

WaveStone Australian Share Fund (WASF)	Carbon Intensity Scope (tonnes CO2e/sales)		
	Scope 1	**Scope 2**	**Total**
Portfolio – WASF	96.0	34.0	130.0
Benchmark - S&P ASX 300 Accumulation Index	98.3	54.5	152.7
Difference	-2%	-38%	-15%

Source: MSCI ESG (as at 31/12/2021)

Selection of ESG Insights from the Quarter

Endeavour Group (EDV)

Following our discussion with the Endeavour Group (EDV) Board in October on ESG related issues, we met with Endeavour's head of sustainability and general counsel (IR was there too) in December. Given the news related to 60 minutes, it was an interesting meeting. The core business for Endeavour is Alcohol retailing and through the hotels business (ALH), gambling and serving alcohol. Following the demerger from Woolworths there is a concerted effort on the part of Board and management to present their ESG credentials.

The main thrust of the conversation was that they have put sustainability at the heart of doing business. EDV as the largest operator in each of their segments is leading the way, with a commitment to be above the regulatory requirements in the areas they operate. Responsible service of alcohol and gambling is core to how they think. The key will be whether this has been made integral to their business operations.

We touched upon the Dan Murphy in Darwin (well publicised case) as well as the issues related to money laundering in pubs around the country (60 minutes). The General Counsel couldn't confirm that they didn't have any venues involved – the regulator couldn't confirm – but they were quietly confident that they wouldn't have an adverse outcome given their own systems and processes.

The first line of defence for EDV is ensuring that the staff are properly trained to meet the risk compliance standards at the coal face. Suspicious activity is reported back through to head office. EDV has one AML structure and if an individual is perceived to be doing illegal activity, it will be spotted across the network. The AML regulations apply to pubs with more than 15 gaming machines but given the expenses involved, their view was that it was very unlikely that the whole industry is regulated. Similarly, no likelihood of face recognition is expected to be widely implemented even though there are trials in NSW happening now. At this stage, our conclusion is that not much will come from the recent 60 minutes story given we are heading into an election and there will be little appetite from politicians on this front. EDV is also trialling algorithms that will highlight problem gamblers as well as potentially risky behaviour. On average pre-Covid, EDV were sending in 4-6 SMRs to Austrack. EDV haven't heard from Austrack since 2014. Also given that most of their competitors have agricultural systems at best, more than likely EDV will be less of a target for money laundering.

EDV use the Responsible Gaming Council of Canada to run audits which is considered best practice.

On ecommerce alcohol and the recent press on Jimmy Brings selling alcohol to someone who was already intoxicated, EDV have instituted their own standards around training, making sure that drivers – their own as well as partners – are all trained to do the right thing. Given that in ecommerce, EDV has a lot more information about the purchaser, they can use technology to find people who are dealing with a drinking problem. So the bar is higher. The Jimmy Brings incident happened 5 months after EDV acquired them in 2018. The learnings have been taken into consideration while framing their current approach.

Organisational design has changed – the entire business operates on a functional basis. The rules that apply to Dans and BWS also apply to the Hotels division. This has worked for them in that they are able to attract and hire people from outside the hospitality industry.

Oil Search (OSH) and Santos (STO)

Through the quarter we continued to engage with Santos and Oil Search extensively in the lead up to the merger vote of both companies which took place in December 2021. Corporate governance has been disappointing at Oil Search for some time and we believe that this poor performance has manifested in dilution of the value of the company's PNG LNG project through poor staff hires, capital allocation decisions and balance sheet management. It was disappointing that our extensive engagement with Oil Search prior to Santos merger proposal did not deliver any real change to our concerns, which is one of the reasons that we were supportive of the merger between Santos and Oil Search that in our view would provide enhanced stewardship over the Oil Search business and benefit unitholders.

In our discussions with Santos, we understood how the company would look to integrate the Oil Search assets into the portfolio and the governance around the business. Santos CFO, Anthony Nielson, would transition to Chief Commercial Officer, effectively run the existing Oil Search business and be responsible for integration, while Santos would promote Anthea Mckinnell from deputy CFO to group CFO. At a high level, portfolio optimisation would be approached by reducing equity exposure to PNG LNG and progressing a divesture of the proposed Alaskan development in some form. In our view these transactions would reduce group gearing and also lower the cost of capital of the firm given the lack of investor appetite for oil developments in Alaska. In turn our discussions with new CEO at Oil Search, Peter Fredricson, were honest and refreshing and felt that he protected the interests of Oil Search Shareholders for the period of time that he was at the company.

Also, while engaging with Santos, we were keen to discuss the feedback of the company's involvement at COP26. CEO, Kevin Gallagher, was part of the Australian delegation at the event. We were pleased to understand that natural gas and LNG was increasingly being seen as an acceptable transitory fuel source by governments (noting that the European Union has subsequently included gas in its Taxonomy plan). In addition, we also got the sense of the growing acceptance of Carbon Capture and Storage as a means to reduce/offset emissions. In our view Santos, as one of the first movers in this space, will likely accelerate its strategy of CCUS in the coming years.

Qube Holdings (QUB)

Over the quarter we met with QUB management and board. One of the topics we discussed was gender balance within the organization and management / board diversity. We highlighted our commitment to the Vision 40:40 initiative and encouraged them to sign up.

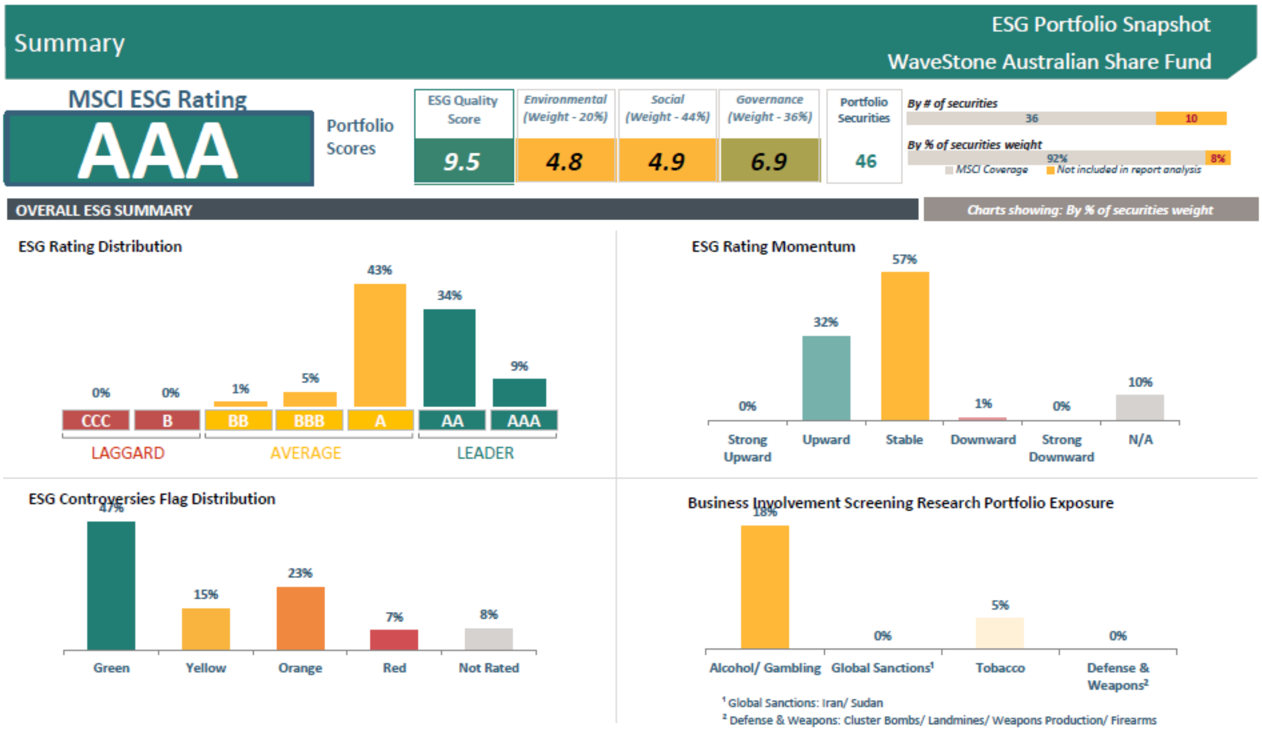
While QUB is committed to improving its diversity metrics it still falls well short of the 40:40 Vision aim. Recent board appointments in Nicole Hollows and Jackie McArthur form part of a process of realignment at that level and they will try and take that further with future appointments. Within the operating business, QUB have been trialling new initiatives to improve the gender mix with a view to this creating a pipeline of promotable talent in time. One of the initiatives they have had success with is recruiting and inducting pools of entirely female talent in WA which they train separately before sending them into the broader workforce. Giving female inductees a relatable cohort has delivered a significant enough uptick in retention of those female staff that they now plan to roll the program more broadly through the organisation. QUB recognizes their industry has a significant gender imbalance but the new CEO is committed to drive change. WaveStone will continue to engage with QUB on this issue.

Lifestyle Communities (LIC)

Lifestyle Communities (LIC) board expanded on their ESG framework in more detail at the AGM in November. We believe LIC is an ESG positive company, given it provides affordable housing to the elderly in Victoria, while also making sure that all new villages it develops use 100% renewable energy. LIC's houses emit 3.3 tonnes of carbon per annum vs. 8.5 tonnes for a typical 2-person house in the suburbs.

In late 2021, LIC commenced construction on a village in Clyde North, Victoria that will be run by its own solar-powered micro grid. The grid will be powered by rooftop solar installed on the individual houses. It also committed to a plan for net-zero emissions by 2035, at the latest. Having now defined its carbon footprint, LIC is working to embed energy efficient features in new developments, in additional to generating electricity on site. LIC has also committed to a workforce that is 50% female, at company and executive levels. LIC's board is 50% female already, while its entire workforce is 2/3 female.

MSCI ESG Ratings



LARGEST 5 HOLDINGS IN THE PORTFOLIO

ISSUER	PORTFOLIO WEIGHT	SECTOR	DOMICILE COUNTRY	ESG RATING	CONTROVERSIES OVERALL FLAG	BISR ACTIVITIES
CSL LIMITED	7.93%	Health Care	Australia	A		*Animal Welfare*
BHP GROUP LIMITED	7.10%	Materials	Australia	A		*Nuclear Power*
COMMONWEALTH BANK OF AUSTRALIA	5.74%	Financials	Australia	AA		*No involvement*
AUSTRALIA AND NEW ZEALAND BANKING GROUP LIMITED	5.59%	Financials	Australia	AA		*No involvement*
NATIONAL AUSTRALIA BANK LIMITED	5.53%	Financials	Australia	A		*No involvement*

Memberships and initiatives

- Principles of Responsible Investment (PRI)
- Climate Action 100+
- 40:40 Vision