regnan

Annual Report 2017/2018

Regnan's engagement and advocacy activity

↑18% increase in total number of companies engaged above five year historical averages	85% of active engagements have demonstrated progress	We released testing of **conduct culture** scores, supporting ongoing advocacy and engagement on this theme
29% of companies engaged multiple times during the year to secure change	Strong media presence on **carbon lobbying** supporting awareness raising of this longstanding concern	24 companies engaged had not been engaged in the 2 years prior, increasing the breadth of Regnan influence
Regnan released a paper highlighting the need for enhanced **strategic human capital** disclosures	29 engagements discussed **TCFD** climate risk disclosure in detail	52% index coverage

OUR ENGAGEMENT PROCESS

Regnan conducts engagement and advocacy on behalf of clients to drive improved ESG performance in S&P/ASX200 listed companies. This also aims to amplify good practice more broadly across corporate Australia. Regnan meets with directors and senior company leaders, in a constructive manner, to influence change on issues with the potential to impact value over the long term.

Engagement is a means for clients to demonstrate their commitment to active ownership. By ensuring that engagement is done in an effective and targeted manner, positive outcomes can be achieved, both at the stock and portfolio level.

Regnan engagement enables the protection and enhancement of portfolio value through:

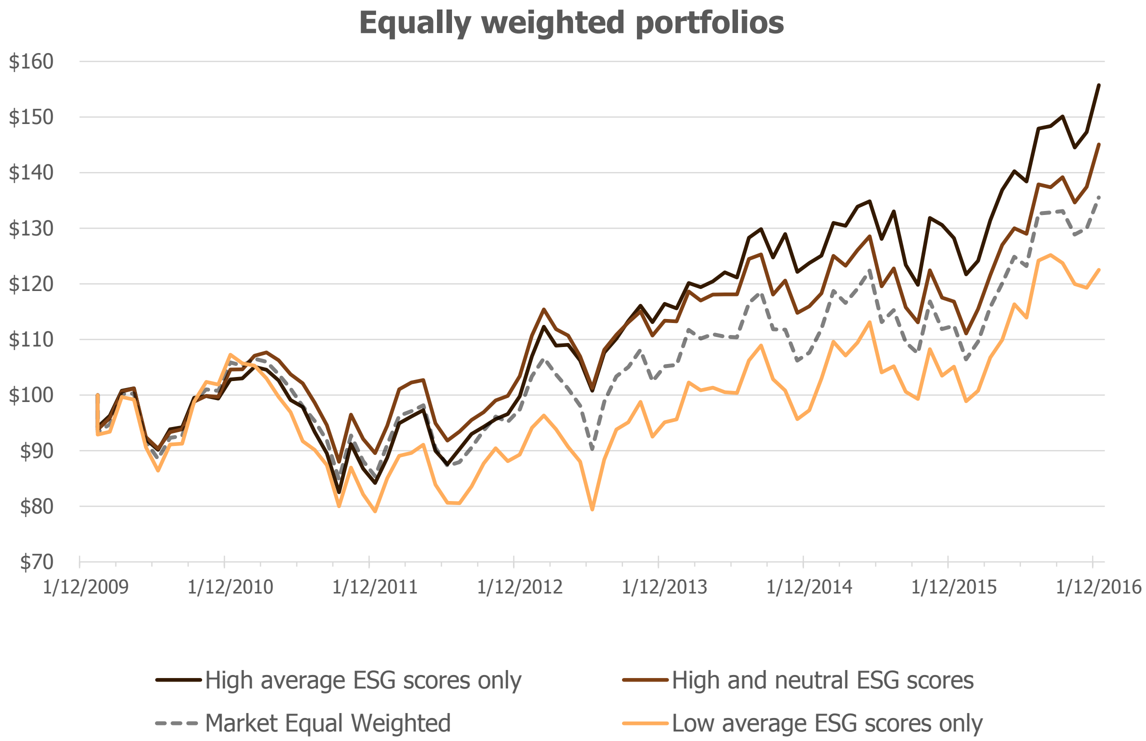
- **Clear objectives.** Careful targeting of engagement objectives to outcomes that add value, such as improved governance, risk management, or assurances for shareholders that material ESG matters are well managed.
- **Collaboration**. We regularly provide input to help shape the enabling environment (e.g. ASX guidelines, global disclosure frameworks and industry standards).
- **An outcomes focus**. While we measure and report on engagement activity, our focus is assessing impact, defined as the extent to which underlying ESG concerns have been addressed – risks mitigated, opportunities realised.

We require robust evidence of change (such as public reporting) and sufficiently detailed confirmation at company board and/or management level before our change objectives are considered achieved.

Research-led

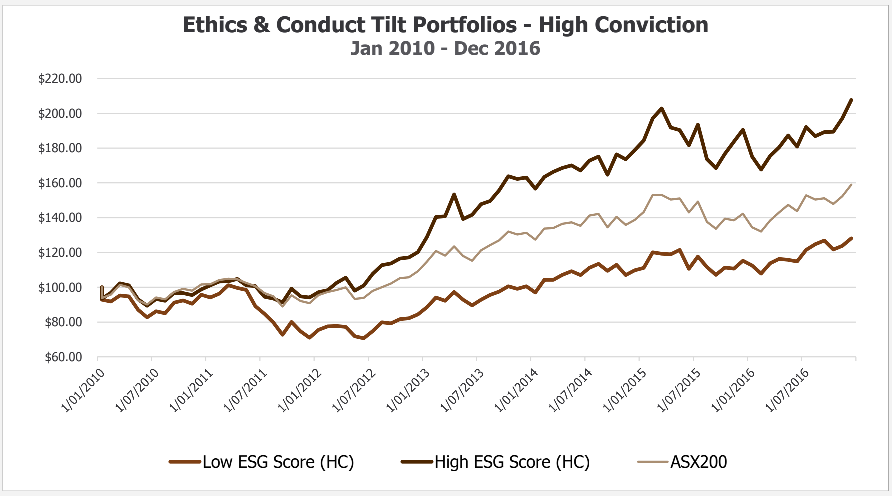
Our engagement program benefits from our role as an ESG researcher. The issues we raise with companies are identified using our own research into the most material ESG issues on a stock by stock basis. Recent analysis of our research, which includes scores that reflect exposures to and management of various ESG risks, has highlighted the potential for the scores to be used to seek alpha. The modelling of a test portfolio composed exclusively of firms with high average scores was found to outperform the market, while a portfolio comprised of low average scores underperformed (see figure 1). With such research informing our engagement activity, clients can have confidence that efforts are prioritised towards issues and companies which will have the most impact.

Figure 1 | Equally weighted high conviction portfolios.



CASE STUDY: Spotlight on culture

We began a structured engagement stream on conduct culture in 2015 specifically focused on those companies with business models that heighten the risk of misalignment between strategy, remuneration, culture and risk management. For instance, vertically integrated business models where the potential for cross-selling may result in a misalignment with customer outcomes.



Our focus on conduct culture is supported by our internal research. This demonstrates that companies deemed to have managed conduct culture well significantly outperform those companies considered to manage it poorly. Typically these top performers:

- Recognise the potential impact of ethical risks.
- Have in place codes of conduct that address all key areas of risk, often providing guidance or scenarios to clarify expectations.
- Have in place whistleblowing systems that are in many cases accessible to a wide range of stakeholders and provide options for concerns to be raised anonymously.
- Are able to provide evidence of the efficacy of these systems.
- Have board and senior executive oversight of ethical conduct, including dedicated committees.
- Demonstrate attentiveness to the potential misalignment of strategy, risk and remuneration.

In all, we have engaged with 20 ASX200 companies since 2015, with more than two-thirds of these engagements occurring with the directors of these companies. More than 55 meetings have been held with banks, insurers, diversified finance companies, healthcare providers and gaming companies.

Over the last three years we have seen a distinct shift towards a much greater acceptance of the role of the board in overseeing conduct culture. From a role simply appointing a CEO that will set the right tone, to a more explicit role in actively identifying potential areas that may give rise to conduct issues and monitoring performance. These activities have been further buoyed by increased interest from regulators and more recently by the Prudential Inquiry into the Commonwealth Bank of Australia.

However, many directors have demonstrated a lack of familiarity with the subject, and are still grappling with how this stewardship might best be exercised. We have focused on communicating: the potential of human capital data and predictive techniques to identify possible areas of concern; the need to proactively establish the board's conduct risk appetite; and the need to test the alignment of organisational settings (such as remuneration arrangements) with that appetite.

Specific examples of changes observed in the companies with whom we have engaged include:

- The revision of board charters to specifically call out the board's responsibility for organisational culture, and of conduct culture specifically.
- A shift from a compliance to a cultural framing when considering conduct issues.
- Public disclosure of codes of conduct and whistleblowing policies.
- The inclusion of metrics on breaches of the code of conduct and the types of issues raised via whistleblowing channels in annual and sustainability reports.
- Increased evidence of regular monitoring of key conduct metrics by the board, including some evidence of the triangulation of these metrics to more thoroughly investigate and identify potential areas of concern.

With heightened interest in issues of ethics and conduct, and based on our analysis of the early proceedings of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, we will continue our engagement efforts with an enhanced scrutiny of:

- The governance of third party relationships as well as the role of subsidiary boards.
- Implications for the consideration of risk appetite.
- How businesses are managing the challenges of increased public interest in conduct on strategic execution, given the potential impacts on aspects including employee morale.

REGNAN'S YEAR IN REVIEW

This year has seen ESG issues hit the front page like never before. The finalisation of the TCFD's guidelines for the disclosure of climate-related risks and the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services has seen heightened attention surrounding longstanding engagement themes of climate risk and conduct culture. Momentum has continued on the UN Guiding Principles for Business and Human Rights and the Sustainable Development Goals.

These initiatives have all raised questions regarding the role and expectations of investors. And as we complete our tenth year of operation, it is a question we continue to ask ourselves as we continue to explore ways to better measure the impact of our work, and how we can better design stewardship activities to help clients protect and enhance long term value.

We are firmly of the view that if all of the goodwill and investment in ESG infrastructure is to fulfil its promise, it needs to be channelled to outcomes. We have again in this report included measures of the proportion of our engagements demonstrating progress (85%) but additionally we have provided case studies on engagement and advocacy activity. These provide better insight not only into our perspective, but also into outcomes and actions on areas we have identified as financially material for beneficiaries and the community – who in aggregate, on average, are the same people.

86	55	29%	52%	76%	76%
engagements	stocks	companies engaged multiple times	index cover	engagement via meetings	planned

> "In any business, you are faced with ethical dilemmas every day. If you don't bring ethics into a decision-making process you will destroy value. The Corporations Act is all about what you must do legally but today it is all about the fact you have an obligation not just to your shareholders but to your community."

– Pauline Vamos, Regnan CEO
Australian Financial Review, 24 April 2018

CASE STUDY: Continued vigilance on externally managed structures

A major infrastructure company made substantial improvements to its governance structures, internalising management and adopting good practice standards. Our engagement over an 18 month period laid seeds for change ahead of widespread criticism being directed to the external management structure when high fees eventuated, consistent with our risk identification.

Externally managed structures have been a strong focus of our engagement when such structures were common in the index. Although such structures have declined in use, we have remained attentive to the risks inherent in such structures where they continue, and vigilant against re-emergence of widespread use.

See also our position paper on externally managed structures at: https://www.regnan.com/corporate-governance-in-externally-managed-trusts

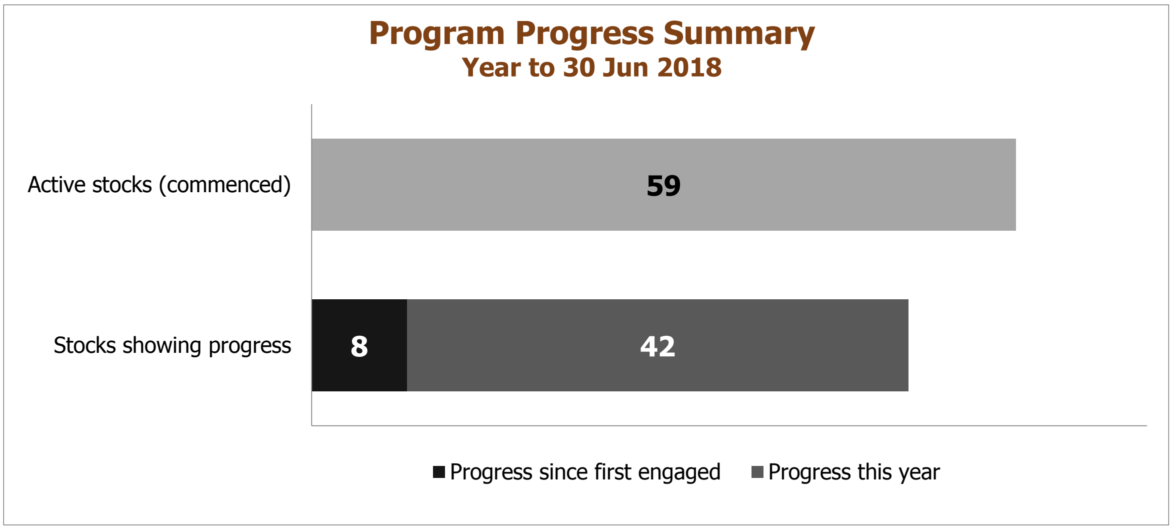
85% OF STOCKS DEMONSTRATING PROGRESS

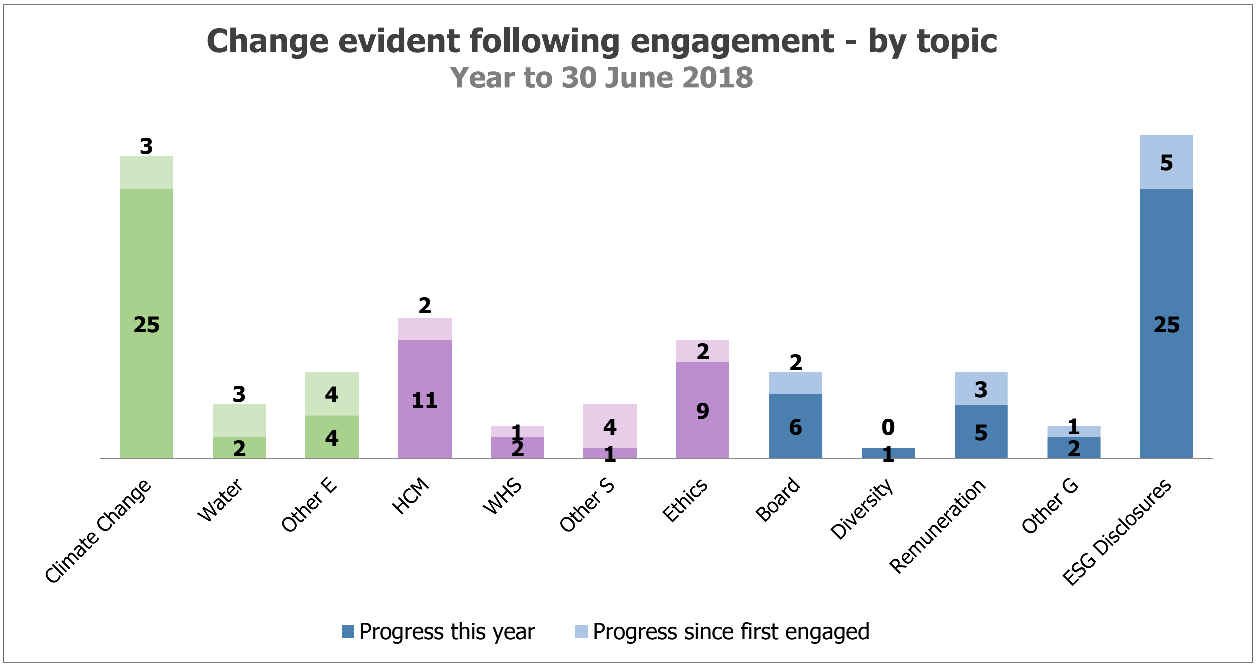
In addition to reporting the total number of our active engagements showing progress this year, we have also reported a more detailed breakdown of the nature of this progress. The results reflect the success of our priority thematics on climate change (tailored to the nature of the key risks to individual companies) as well as strategic human capital and ethical conduct.

Disclosure remains a core underpinning of our engagement, as informed markets best serve the interests of investors. It is therefore not surprising that enhancements to disclosures also feature prominently.

> "The key to getting the right outcomes is through proactive and outcomes-based company-investor engagement meetings. We need to move our focus from emissions intensity to transition and pay more attention to action taken to adapt. As disclosure improves, so too will quality and impact of engagement."

– Pauline Vamos, Regnan CEO
Super Funds Magazine, April 2018





CASE STUDY: Building recognition for strategic human capital management

We sought assurances from the board of a health company that it was remaining vigilant to the risk that its strong culture may become diluted as it expands its operations, including through a number of acquisitions. We sought assurances that this important organisational asset was being safeguarded in light of these changed operating conditions.

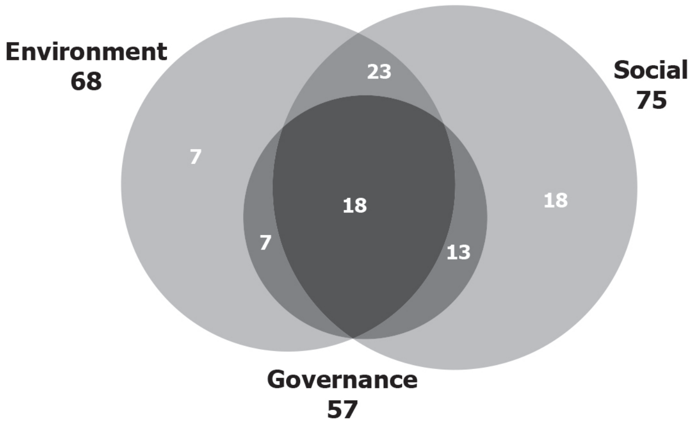
We met with the company five times over a three year period. Initially our concerns were dismissed as the board was confident that the culture was strong. More detailed discussions with management identified opportunities to take a more strategic approach across geographies and business divisions. Subsequent meetings with the board enabled us to further build the case for oversight and test progress, reinforcing that our concern was not with the current culture, but rather in ensuring that this strategic asset is being maintained in order to protect long term value.

Our later meetings with the company demonstrated an acceptance of the need to more formally protect the company's cultural assets. Since commencing our engagement, the company has appointed a global head of HR, indicating an acknowledgement of the need to more formally manage human capital across its growing international operations. Further, the role of the board in overseeing culture has been formalised within its committee charters. The board skills matrix has been revised to explicitly call out people and culture as a competency and recent appointments add greater depth on this skill.

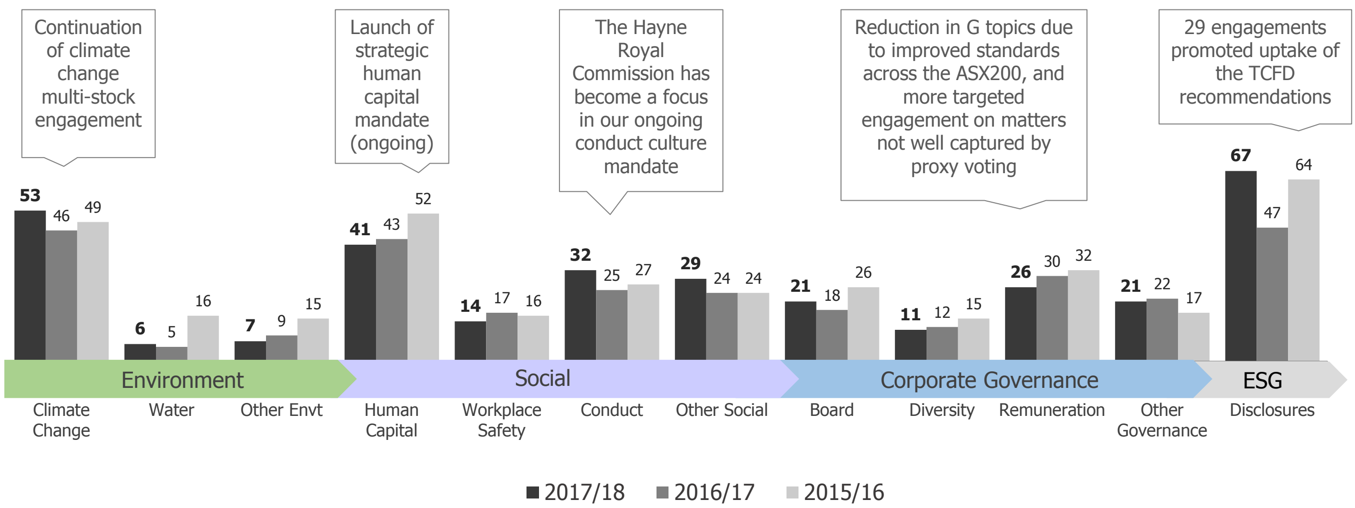
STRONG COVERAGE ACROSS A RANGE OF ISSUES

Whilst we take a targeted approach to our engagement led by bottom up research to focus our efforts, the complex and often interrelated nature of modern challenges sees engagement quite often cut across environmental, social and governance topics. For instance, ensuring that a company has in place the right culture and skillsets, including amongst the board and senior leaders, to tackle issues of disruption – whether they be from technology, regulation, decarbonisation or other means – highlights the interrelated nature of environment, social and governance issues.

Engagements overlap on E, S and G



Engagement by topic



CASE STUDY: Sustained activity on climate risks

We have continued climate change engagement and advocacy over the last 12 months, including seeking corporate reporting in line with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) finalised in June 2017 and on management of energy transition risks.

Heightened focus on climate and energy has been evident throughout the year. This has been spurred by comments by regulators APRA and ASIC and a rapid acceleration in shareholder activism, with 7 stocks receiving climate change-related resolutions for their annual general meeting in 2017/18 (up from 2 the prior year). For each of these resolutions, we provided clients with in depth perspectives, drawing on our understanding, built up over many years, of the stock's risk profile and management approach.

Regarding the TCFD, we encouraged adoption of the reporting recommendations in 29 engagements with 22 companies, while ongoing concern for the management of energy transition risks saw us hold 9 engagements with 4 energy and utilities stocks – two sectors significantly exposed to the risks stemming from the transition to a low carbon economy.

Outside of the formal engagement program, our expert insight was sought out by listed companies due to the specificity to which we can speak on the issues for their company, as well as our broad view across market trends. This resulted in Regnan:

- Presenting to the employees of an ASX20 company on understanding and responding to climate risk.
- Providing input into the development of a financial services company's climate change position statement.
- Meeting with the management working group of an ASX100 company to offer detailed early input to planned reporting in line with the TCFD recommendations.

Regnan was also invited to address the Australian Council of Financial Regulators regarding current climate risks and responses within the ASX200 and the Australian investment community. In addition to providing Regnan's view on the current state of play, Regnan encouraged the regulators to support enhanced climate disclosures, especially in light of Federal Government confirmation that there are no legislative barriers to the full adoption of the TCFD recommendations.

Related: Advocacy on shareholder resolutions

Well-targeted shareholder resolutions provide a concrete, unambiguous and transparent message to companies about investor expectations. These characteristics are increasingly important complements to engagement, given increases in the volume and diversity of ESG related engagement activity in the market.

Regnan voiced support for certain shareholder resolutions put to the Australian market in FY18, many of which related to climate change, which we saw as well-targeted and aligned to long term investor interests. We received international attention for our stance and were pleased to note that most companies treated resolutions in a principled manner (for instance voluntarily disclosing results) in line with the position we put to them.

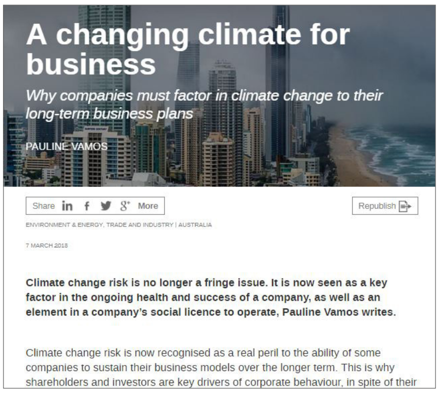
Regnan also advocated in trade press that investors should modify relevant stewardship policies to better accommodate support for shareholder resolutions going forward, and note early evidence of this. This includes thorough consideration of the substance of the issues raised by these resolutions, not just their form.

ADVOCACY HIGHLIGHTS

Climate change

In addition to advocating for enhanced management of climate-related risks directly with companies and across the financial system via participation in industry initiatives, Regnan has been active in the wider public sphere. (See also case study page 7)

We have contributed to media debate on the need for investors and companies alike to manage such risks in mainstream and industry publications. We have also contributed our expertise on this area to conferences including a keynote speech at the inaugural ANU Climate Summit and the Australasian Emissions Reduction Summit.



Integrated reporting

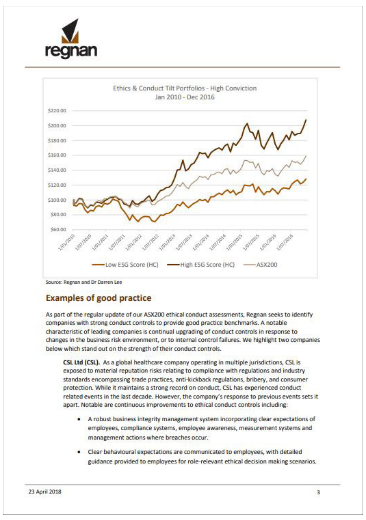
In line with engagement priorities for improving disclosures of material ESG issues, Regnan has continued to endorse integrated reporting <IR> as a means for corporates to satisfy the information needs of long term investors.

Advocacy has included participation in presentations run by the International Integrated Reporting Council as well as providing commentary on <IR> tailored to company directors and accounting professionals including in Company Director Magazine and Acuity Magazine.

Strategic human capital management

Regnan considers the ways in which knowledge, skills and abilities are organised to achieve corporate objectives – or, strategic human capital management – to be an increasing determinant of share value. However, there is a gap in the information provided to investors on an issue with implications for strategic execution.

To support engagement and advocacy objectives, during the year Regnan published a paper on this subject, which included guidance for corporates to enhance their disclosures. The paper's launch attracted media attention, with pieces appearing in the Constant Investor and Top1000Funds among other publications. The paper has subsequently been used in support of our ongoing company engagement on this topic.



Conduct culture

With increased public scrutiny of the conduct of Australian companies, as well as a growing discourse around social licence to operate, resulting from the Royal Commission and other high profile ethical failings, Regnan was well placed to contribute to the wider debate. Ethical conduct in listed companies has been a focus area for engagement since our inception.

The publication of years of testing of Regnan's proprietary ethical conduct scores demonstrated a link between conduct and share price performance, providing evidence that instilling a corporate culture in which staff behave in line with community expectations has financial benefits for companies. The testing provided opportunity for Regnan to comment publicly on revelations stemming from the Royal Commission and regulatory activity in this area, in the interest of driving improved conduct throughout corporate Australia. (See also case study page 3)

CELEBRATING 10 YEARS AS REGNAN

In November 2017, we celebrated 10 years operating as Regnan. It was a chance to reflect on how far responsible investment has come in Australia over the decade, yet how much more needs to be done. Highlights of the evening included the keynote address from our head of advisory Susheela Peres da Costa on going the 'last mile' in stewardship, the themes of which were the discussion points of another highlight – a guest panel session comprised of company directors Sam Mostyn and Holly Kramer, CSC CEO Peter Carrigy-Ryan and former ASX general counsel Amanda Harkness.

NED Sam Mostyn at our 10 year event

> "To travel that last mile we have to move the conversation on. Beyond just corporate governance, or glancing mention of E&S. We need to fast-forward to the crux of the issues, and speak honestly about them. Seize opportunities to ask what needs to be asked, and say what needs to be said. Because it is only by sustaining our commitment through the last, most challenging mile that we will end up where we set out to go."

– Susheela Peres da Costa
Head of Advisory, Regnan

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Regnan was established to investigate and address environmental, social and corporate governance (ESG) related sources of risk and value for long term shareholders in Australian companies.

Its research is used by institutional investors making investment decisions, and also used in directing the company engagement and advocacy it undertakes on behalf of long term investors invested in S&P/ASX200 companies.

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