2019

Engagement Impact Report FY2019

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Content

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. As at 30 June 2019, these were Advance Asset Management, Catholic Super, HESTA, L1 Capital, Pendal Group, and Victorian Funds Management Corporation.

Regnan became wholly owned by Pendal Group in 2019. Further details of the systems in place to maintain its independence are available on the Regnan website.

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How do we best focus on impact?

The role and value of engagement is increasingly questioned as stakeholder scrutiny of investors increases.

Critics express concerns that it is overly – even unnecessarily – opaque. There are questions of measurement (how do you know if you have been successful?); of attribution (what was your role relative to the role of others?); and transparency (what really happens behind closed doors?).

These are questions Regnan has grappled with for almost two decades.

So in this report we want to shed more light on our response to these challenges. Not only to be more transparent and hold ourselves to account, but also to contribute our experiences to other organisations thinking about becoming more active stewards themselves.

The onus is on investors to ensure their stewardship activities are consequential.

This year we have, for the first time, included a full list of the companies with which we engaged during the year. We have continued to introduce new measures of the impact of our engagement. In addition to the case studies we have provided in previous years, we have included a more detailed breakdown of progress achieved, by topic and by type, and why this important. This is a work in progress and we welcome feedback on our approach.

Stakeholders are right to question whether investors (and their representatives such as Regnan) are simply going through the motions in their engagement, or using it to avoid making more difficult decisions. The onus is on investors to ensure their stewardship activities are consequential. To truly be active, stewards must do their homework to understand the issues, and continually monitor progress (or in some cases a deterioration) in performance and to consider alternatives when the need rises.

As investors, we do well when the companies in which we invest do well. It is in our interest to engage in a way that focuses on achieving changes that benefit both parties.

We engage to hold companies to account for protecting long term value. We do this to contribute to a secure future. And we know that we too need to be held to account on this.

2019 Highlights

+14% increase in total number of **companies engaged** above five year historical averages

54 companies engaged

16 companies engaged in FY19 had not been engaged in the 2 years prior, increasing the breadth of Regnan influence

41% of companies engaged multiple times during the year to secure change

Provided feedback to the consultation on the 4th edition ASX Corporate Governance Council's Principles and Recommendations

88% of active engagements have demonstrated progress

47 engagements discussed **TCFD** climate risk disclosure

60% S&P/ASX200 coverage

Commenced formal engagement on **Modern Slavery** supporting compliance with the new Modern Slavery Act

Drawing on almost two decades of experience

We engage and advocate with S&P/ASX200 listed companies on behalf of our clients on a range of issues, most typically categorised as environmental, social and governance or ESG. Although we tend to think of them more as 'unattended risks' – that is, issues that have the potential to materially impact the performance of specific investee companies over the long term and which may not be sufficiently managed.

This means that, although we may discuss similar issues with a range of companies, the nature of discussions with each is likely to be quite different. Our approach is guided by the specific nature of the risks to the company's business model, the amount of progress already demonstrated, and an assessment of what a suitable response might look like – recognising that this may vary between companies, even between those within the same sector.

Ultimately we want the companies in which our clients invest to do well.

We primarily raise these issues in meetings with directors and senior company leaders in order to build the case for change. Our approach is focused on doing this in a constructive manner. Ultimately we want the companies in which our clients invest to do well. It is therefore not in our interest to make unnecessary demands or denounce them publicly.

While we might offer examples of leading practices or cite relevant case study examples, we do not typically prescribe how a company should go about addressing a specific issue. We believe that the organisation should design a response that bests suit its operating context. It would be presumptuous for us to assume greater expertise in the business than its own management by prescribing how this is done. Our primary concern is that the underlying risk is managed.

We engage, seeking 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).

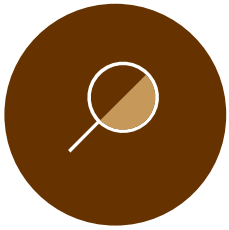
An outcomes focus

While we measure and report on engagement activity, our focus is on 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 specific confirmation at company board and/or management level before our change objectives are considered achieved. More detail on how we approach this on page 11.

Our engagement process:

Identify target companies



Research-based assessment of value at risk

Consideration given to propensity for change, whether the issue is being addressed by others

Set change objectives

Objectives set at thematic and stock level

Informed by deep knowledge of the company and ESG issues

Objectives address value at risk

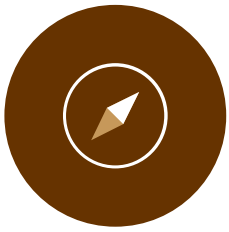
Constructive engagement

Two-way dialogue at board and/or senior management level

Not a 'chat' – targeted and outcomes-focused

Recognition of unique value drivers for that business supports constructive engagement

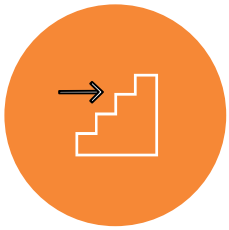
Track progress



Monitor for evidence of change

Focus on public evidence such as corporate disclosures

Impact achieved



Risks mitigated

Opportunities realised

Ongoing monitoring that change is sustained

Year in review

89 engagements

54 stocks

41% companies engaged multiple times

60% index cover

85% engagement via meetings

47% board level

During the year we undertook 89 engagements with 54 companies – 14% higher than our five year historical average. Of these, 17% were engaged three or more times in order to secure the change objectives sought.

Our primary method of engagement continued to be via meetings, representing 85% of all our engagements.

The proportion of engagements occurring at board level remained consistent with previous years, whilst the number of planned engagements, that is those sought on client mandated objectives, fell to 67% (down from 76% the prior year). This is in part cyclical – we are in the process of reviewing our engagement plan and have been testing new themes likely to be included in the next revision of the program. In addition, there were a number of follow up meetings with companies seeking input on issues such executive pay arrangements or broader disclosure trends.

We continue to increase our engagement on climate change year on year, supported by the advancement of global commitments and reporting frameworks, most notably the Task Force on Climate-related Financial Disclosures (TCFD). In addition, there has been increased evidence of the impact of climate events on financial performance. See also our case study on page 17.

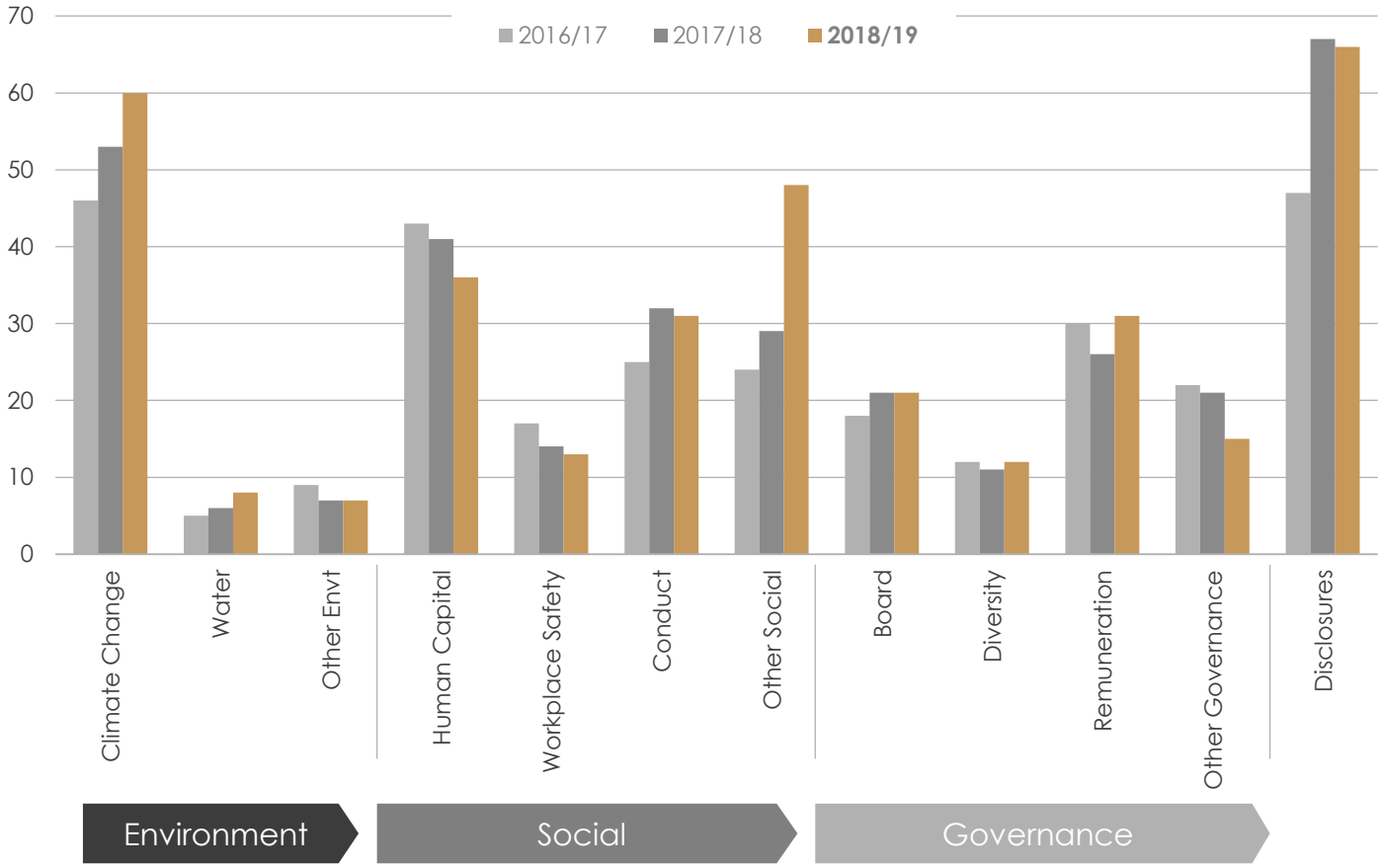
Engagement on human capital management and ethical conduct remained high, consistent with our thematic work in these areas. We undertook increased levels of engagement on a range of social issues, including stakeholder management, human rights (including modern slavery) and supplier relations. We commenced tracking of engagement in support of the Sustainable Development Goals (SDGs) and the introduction of the Modern Slavery Act in Australia.

Engagement by topic

Steady growth in climate related disclosures in line with shortening horizons of climate risks

Engagement on modern slavery and stakeholder management has driven an increase in 'other social' engagements

Higher number of engagements on disclosures reflects increased regulatory and voluntary frameworks



Sustainable Development Goals (SDGs)

We have engaged on the SDGs framework, encouraging companies to consider not only the areas where business activities align positively with the goals, but to also consider where the key activities of the business may negatively impact the goals, providing another lens through which to view risk.

In addition, we are increasingly looking at how our existing engagement program aligns with the SDGs and where it can make a meaningful addition to the goals. This will become more evident as we review our plans in the coming year.

Promoting preparation for Modern Slavery legislation

The introduction of the Modern Slavery Act in Australia, which came into effect on 1 January 2019, means all entities based or operating in Australia with an annual revenue of more than $100 million, will be required to prepare an annual Modern Slavery Statement. The Statements should cover the risks of modern slavery in the entity's operations and supply chains, and the actions to address those risks.

...we know this needs to be more than a disclosure exercise

However, we know this needs to be much more than a disclosure exercise if we are to make meaningful headway for the estimated 40 million people globally who are working under conditions of modern slavery[1].

Therefore our engagement to date on modern slavery has sought to encourage:

- The consideration of risks to the company, as well as to rights holders, including where these might lie beyond the control of the company, for instance via joint venture relationships or beyond the first tier of their supply chain.
- The opportunity to consider broader risks and opportunities given that, for a number of companies, this may be the first time they have mapped these business relationships.
- A robust approach to due diligence, acknowledging that enhanced processes are more likely to identify leading indicators or instances of modern slavery. Detection should be considered progress – provided that it is acted upon.
- Consideration of the options for soft influence, including in collaboration with others.
- Effective feedback and grievance approaches, including alternative methods, understanding that those most vulnerable to modern slavery will also be the least likely to use formal mechanisms.
- Investor-useful disclosure.

We have also encouraged companies to think about what they would do should instances of modern slavery be identified. There can be times when efforts to remedy the situation, with the best intentions, may result in potentially dangerous outcomes. Therefore additional sensitivity and care is required in handling these often complex situations. Companies who have considered an approach ahead of such discoveries will be better placed to manage them in a way that protects both the interests of the impacted individuals and against potential brand damage.

Whilst this is a new initiative, we have already engaged with 12 companies with a view to encouraging early good practice examples and establishing a benchmark for leading practice.

[1] Anti-Slavery - https://www.antislavery.org/slavery-today/modern-slavery/

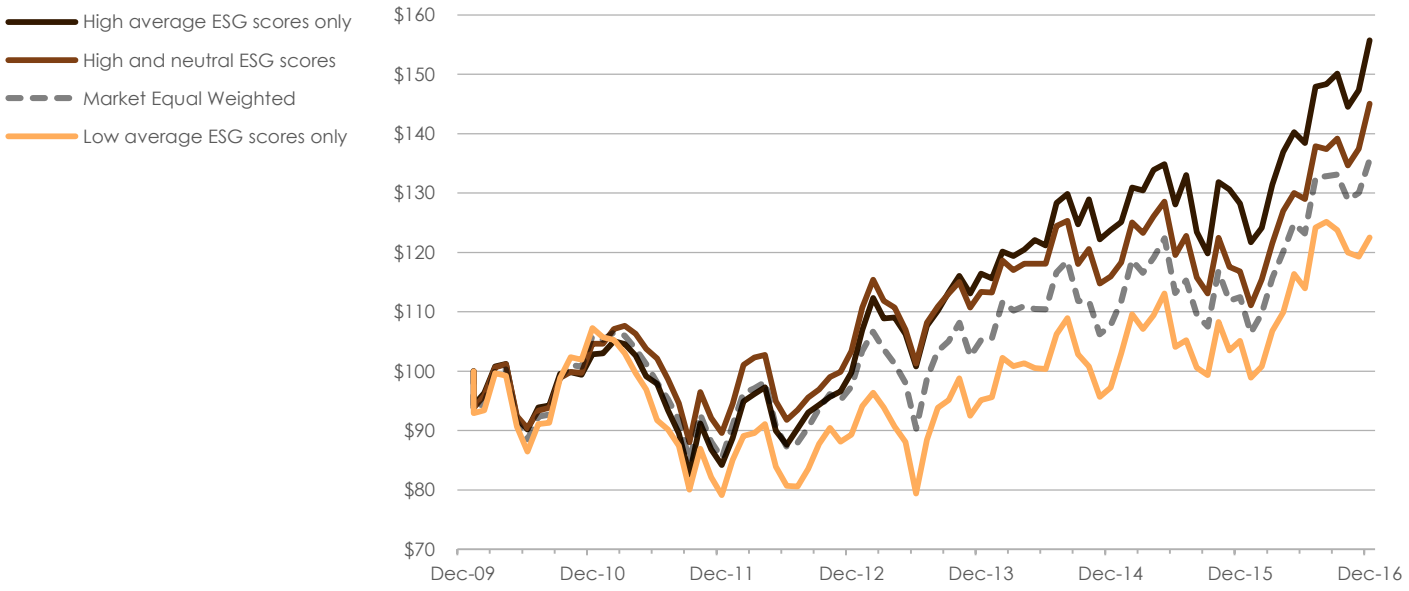
Does our engagement really make a difference?

This is a question for which the answers are imperfect – we can't measure what would have happened if we had not engaged. However, our in-house research has enabled us to track whether we are focused on the right things.

Analysis of this data gives us confidence that our efforts are prioritised towards issues and companies that will have the most impact.

Expert, external modelling of a test portfolio composed exclusively of firms with high average Regnan ESG scores was found to outperform the market, while a portfolio comprised of low average scores underperformed. Based on our exposure and controls model, we are able to prioritise engagement where our research indicates it will make the most difference.

Equally weighted portfolios



For individual companies, we track the impact of our engagement to test whether it leads to change in corporate practice – including in the management of risk and the realisation of opportunity.

We know that this is not the same question as to whether more systemic and structural impediments are being addressed. It is in these areas that we focus our advocacy efforts, the role and impact of which is also discussed in this report.

How do we know if we are successful?

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

Measurement of engagement progress is a critical part of the process

Therefore, measurement of engagement progress is a critical part of the process. The measurement of engagement impact is by no means a perfect science, but by acknowledging the challenges we can begin to consider how to best address them.

Our focus in assessing engagement progress (success) is the extent to which the underlying concerns have been addressed – that is, risks mitigated and opportunities pursued. This is consistent with our collaborative approach to engagement and a focus on achieving acceptance of and action on our concerns, rather than prescribing the way in which this occurs or presupposing the solution that should be implemented.

The attribution problem. How do we know if our engagement contributed to change?

In cases where an issue is more evolved or generally recognised by the market, numerous stakeholders may be approaching a company. Whilst our approach seeks to identify issues early, meaning that we are often amongst the first to raise an issue, others may also be engaging before change is evident.

First, we need to establish that progress has been made. We look at whether it is something the company claims privately or it has been disclosed more publicly. How formal is that claim? For instance, is it in a publicly available policy or a formal statement to the market that has been supported by internal approval processes or external verification?

Only then do we consider our influence…

Consideration 1

When assessing progress, our first question is one for ourselves. We look at how substantively we have discussed an issue with the company and consider whether the engagement was significant enough to have had influence. Although referencing an issue may have had added weight to the work of others, this is not typically enough for us to consider ourselves as a meaningful contributor to the change.

Consideration 2

We consider the company's response to our engagement. Was it apparent that it was aware of the issue and was work already underway? If so, we consider whether our encouragement influenced the disclosure of these actions. For instance, this has been the case in some of our strategic human capital engagements that identified activities were being taken, however the company had not considered these would be of interest to the market.

Consideration 3

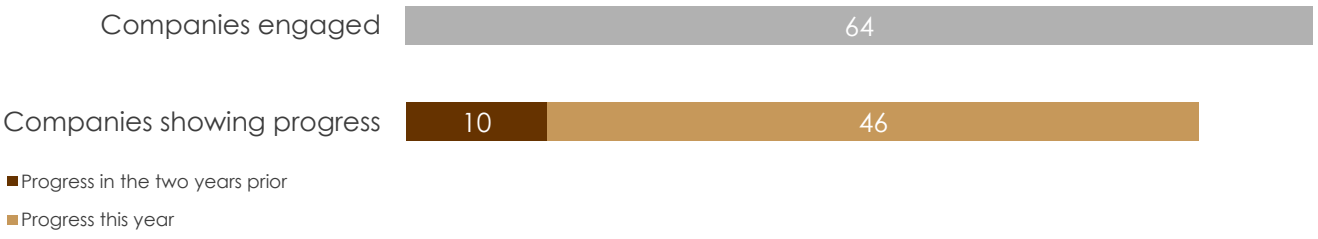
We consider how aligned the company's response is to our engagement. Are the details reflective of our concerns/discussion? For example, whilst a company may have advanced its response to climate change, we assess whether it was in the areas that we raised as material. Where there were activities already underway, have there been changes to its approach consistent with our discussion? For instance, to the type of indicators used or changes within the supporting governance frameworks.

Sometimes the company engaged will itself come back to us to provide an update on what it has done based on its discussion with us (and others), in which case the task is easier. In other cases, we need to monitor closely for evidence of change when judging the impact of our efforts.

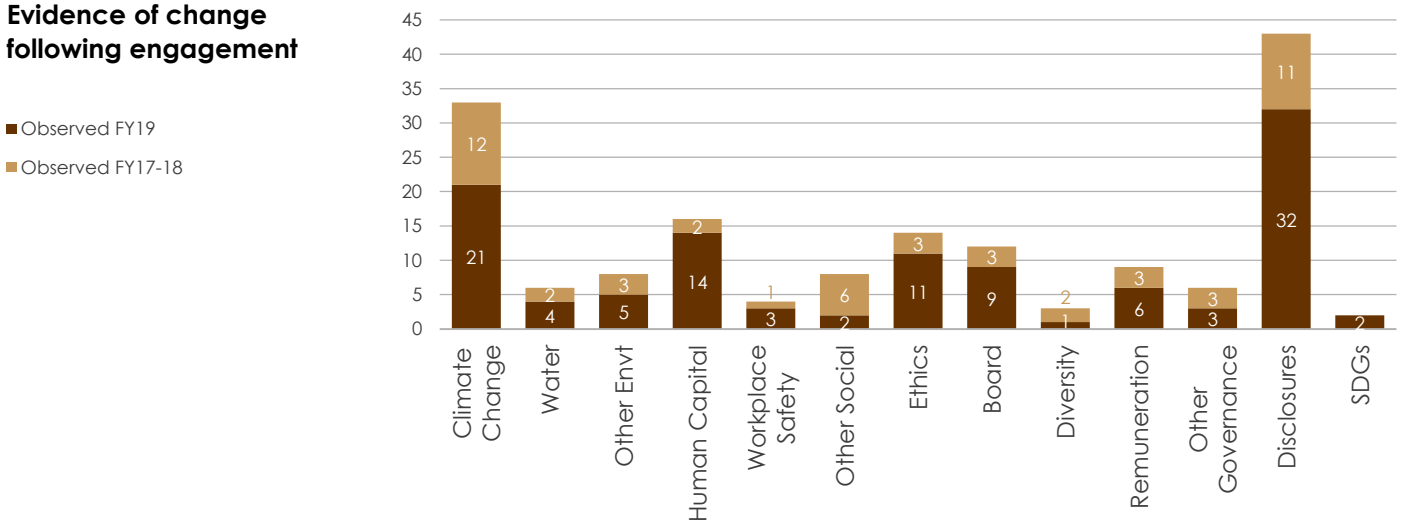
Even when change has been secured, continued vigilance is required – a change in management, strategic priority or resourcing may see concerns resurface.

Summary of Regnan engagement impact 2019

Program Progress Summary | Year to 30 Jun 2019



Evidence of change following engagement



Case study: site remediation

The remediation or rehabilitation of industrial sites after they have come to the end of their life has been a focus of our research and engagement for some time. Companies involved in extractive activities or other heavy industries are obliged to plan for remediation of sites and set aside appropriate funds for the anticipated costs, which can be substantial.

Expectations of both regulators and communities are escalating, as are remediation costs (especially hazardous waste disposal). It is important for companies to adequately provision against remediation liabilities, but it is challenging to know the timing and extent of costs, and there have been instances of poor practice on these responsibilities.

This year we saw positive progress at an ASX-listed company after multi-year engagement between 2013 and 2018. Engagement commenced in anticipation of the closure of one of its Australian sites and continued throughout the subsequent multi-year decommissioning process. In all, we held 5 engagements on the issue of remediation with the company. We expressed concerns that the company had not transparently disclosed to the market the inherent uncertainties in estimating these liabilities and the likelihood of extra costs being recognised if regulator and community expectations were to be met. We urged the company to provide investors with more detail on the provisions, highlighting that additional provisioning would be prudent to allow for cost blow outs.

The company's most recent corporate disclosures begin to address these priorities, including the explicit acknowledgement of site remediation as a risk subject to accounting judgement.

The type of progress matters

In 2016 we began reporting the proportion of engagement showing progress, applying the considerations already described. Last year we followed this up with a breakdown of progress by topic to provide a better indication of **where** this progress is being made. Further, this year we have also reported more detail on **what** this progress was and **why** this matters.

We have categorised the types of progress we have identified over the year – as disclosure, policy, procedural, oversight and strategic progress (see box below) – and report against each on page 15. Given this bottom up approach, we anticipate that the categories will evolve over time.

As we work with these measures more, we will also seek to explore how we might best convey the significance of the progress achieved, considering such things as how difficult the change was to secure and how material it is to value creation over the long term.

Strategic progress as the name suggests, includes changes in strategic direction and/or business model in order to better manage exposure to ESG risks or improve its ability to realise ESG opportunities. Examples include decarbonisation, a fundamental change in a company's approach to stakeholder engagement, or a move away from joint venture structures owing to governance concerns.

Oversight progress includes the creation of new (or an expansion of the charter of existing) committees or forums to provide enhanced oversight of issues of concern. It also includes capacity building to enable more effective oversight – for instance, substantive training or the addition of new skills or advisory committees to the board.

Policy progress can refer to the development of new or the enhancement of existing policies, or increased evidence of the measurement of these policies and/or improvements in these measures. We know that even the best written policies are not effective if they are not 'live' within the organisation. In addition to seeking that the company has policies in place to address material issues for the business, our engagement often seeks to test the effectiveness of policies.

Procedural progress covers such things as new systems, training programs or approaches to address material ESG concerns. These procedural improvements can contribute to an effective policy response and the overall governance of the organisation. Progress supports the overall risk management of these issues.

Disclosure progress refers to instances where engagement has led to an increase in information available to the market. It is an important input to the improved integration of ESG issues into investment decision making. Proportionally it is typically the largest area of progress as it often accompanies other forms – for example, policies and procedures need to be in place before they can be disclosed.

Summary of Regnan engagement impact 2019 (cont.)

Examples of change evidenced by companies following engagement

Strategic progress
4%

- Announced a change in operating model to reduce ESG risk exposure
- Strong evidence of a more strategic focus on human capital, key to strategic execution

Oversight progress
12%

- The introduction of new committees for oversight of ethics and customer care
- Evidence of formal oversight of human capital matters as evidenced by changes to board committee charters

Policy progress
8%

- Development of a formal policy for climate change
- Development of a formal bribery and corruption policy
- Enhancements to whistleblower policy

Procedural progress
26%

- The inclusion of a climate event in portfolio stress testing
- Alignment of executive remuneration to business strategy via the inclusion of more targeted financial metrics
- Clear timeline for climate analysis developed (and communicated)
- Climate analysis expanded to include physical risks

Disclosure progress
50%

- Detailed disclosure of the underlying drivers of employee engagement
- Human capital approach clearly articulated within the annual report
- Inaugural sustainability report covered all material issues raised with the company
- More detailed remuneration disclosures now enable investors to more effectively assess the appropriateness of the quantum paid

What about when engagement fails or progress is too slow?

Where we think engagement priorities would be better advanced via other means, we alert clients to our concerns. Typically clients have in place escalation processes within their own stewardship frameworks. Our role may be to provide information to support clients' deliberations on voting and whether or not to continue to hold a stock.

In addition to these activities, we may also discuss our concerns with non-client investors, peers or other relevant stakeholders.

Do you receive information not available to the rest of the market?

As a governance house, we are committed to upholding continuous disclosure obligations and have processes in place to ensure they are upheld. Ultimately companies are responsible for ensuring they adhere to these obligations and in our experience they are very attentive to this. There may be detail that we seek that is not currently disclosed elsewhere and, where we think this would be of general interest, we encourage the company to disclose.

While we seek confirmation that issues are being well managed, our methodology actively discounts private assurances.

Looking ahead: evolving to support clients' active stewardship goals

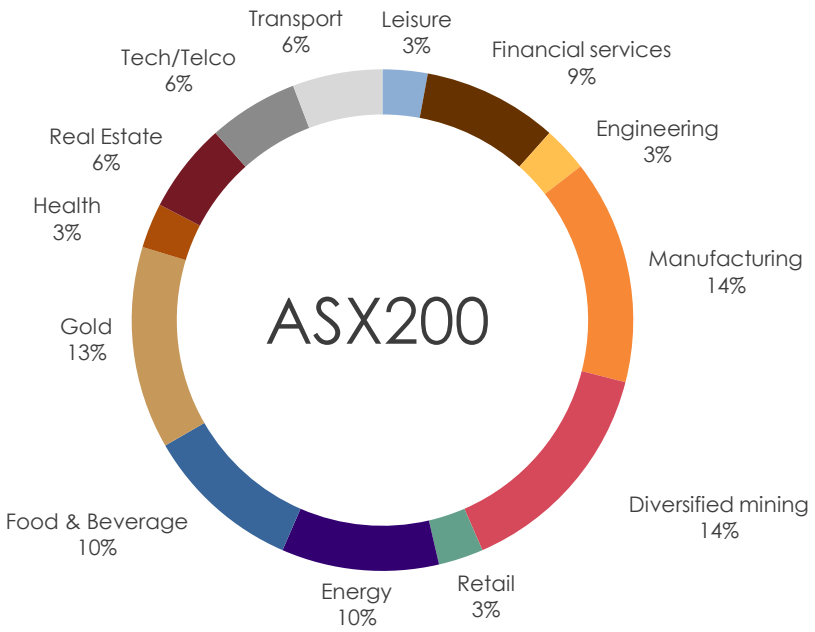
Our engagement offering is responsive to clients' evolving needs.

As investors become interested in taking a more active role in engagement, and promoting the same to their investment managers, we have been increasingly working with clients in diverse ways, tailored to their needs. This ranges from support for single meetings, including the preparation of briefing materials and coaching, through to the co-creation of entire programs and providing information they can use in conversations with their managers.

Case study: Engagement on physical risks since 2013

Rapid emissions reduction is required to avoid the worst impacts of climate change and associated systemic risks. For many companies, adaptation to these impacts can no longer be left as an issue for future consideration. We have identified more than a third of the ASX200 (69 companies) as having elevated exposure to the physical risks of climate change, with the potential to impact financial performance over the short to medium term. As can be seen below, the impacts are across a range of sectors. These are not limited to the headline-grabbing extreme events; physical risks also manifest in prolonged droughts lowering the supply of agricultural products and changing growing regions, increased rainfall patterns reducing visitors to outdoor-related businesses, or shortened winter seasons challenging inventory management.

Physical risks within the ASX200 by sector



Globally, the recommendations by the Task Force on Climate-related Financial Disclosures (TCFD) have urged greater attention to physical risks from climate change as well as transition risks. Locally, ASIC has also noted a concerning lack of listed company disclosures on such risks which, for many, are likely to be material over the long term.

Pre-empting this high-level recognition, we commenced a dedicated physical resilience engagement thematic in 2013, focusing on companies our research revealed to be more exposed from sectors such as agriculture, mining, finance and infrastructure. While quality, investor-useful disclosures are looked-for as a minimum, engagement has sought:

- to test company understanding of the difference between weather risk and climate risk,
- evidence of processes in place to identify and assess risks and controls in place to mitigate and adapt to risks, and
- attention to scientific and data developments.

Case study: Engagement on physical risks since 2013 (cont.)

Stocks evidencing change by topic*

27 companies engaged

9 commencing physical risk analysis

6 publicly committing to undertaking analysis

9 making procedural changes and/or increasing resourcing

13 publicly acknowledging the risk

19 releasing enhanced disclosures

6 Evidence of and/enhanced governance structures

*Note these numbers indicate changes attributable to Regnan engagement. It does not include instances where a company had already undertaken the activity.

Specific examples of publicly-evidenced progress include companies:

- Undertaking physical risk analysis and disclosing results in main filings in a manner consistent with the TCFD recommendations;
- Appointing a dedicated role with the responsibility of ESG analysis, including climate risk assessments;
- Developing their first climate change policy;
- Shortening timelines for the publication of TCFD reporting;
- Changing contracting arrangements to transfer risks from climate events; and
- Investment in more resilient infrastructure.

Companies engaged:

AGL Energy
ANZ Banking Group
Aurizon Holdings
Australian Agricultural Company
Bank of Queensland
Bega Cheese
Bellamy's Australia
Bendigo and Adelaide Bank
BHP Group
Challenger Ltd
Commonwealth Bank
Costa Group
Fortescue Metals Group
Graincorp
Incitec Pivot
Macquarie Group
National Australia Bank
Newcrest Mining
NextDC
Nufarm
QBE Insurance Group
Rio Tinto
South32
Suncorp
Tassal Group
The a2 Milk Company
Treasury Wine Estates
Westpac Banking Corporation

The role of advocacy

Where there are structural issues impeding a company or sector's ability to address ESG risks, we may also undertake broader advocacy work. This may include discussions with regulators, participation in government and other submissions, bespoke research and other forms of public commentary, including in the media.

Where there are structural issues impeding a company or sector's ability to address ESG risks, we may also undertake broader advocacy work.

We do this to raise awareness of the potentially material nature of an issue amongst a wider audience, to challenge prevailing norms and to draw attention to market failures.

Our advocacy program is designed to support the achievement of engagement objectives.

2019 advocacy highlights

Climate change

We sought opportunities to raise awareness of climate-related risk within the finance sector more broadly, i.e. outside of ESG audiences. This included a number of speaking engagements and media articles in industry publications.

We facilitated an interactive masterclass for Investor Group on Climate Change (IGCC) members supporting their own TCFD adoption and disclosure efforts.

Corporate governance

We provided a submission to the public consultation on the draft of the 4th edition of the ASX Corporate Governance Council's Principles and Recommendations, arguing for a clear, principles-based approach. With many stakeholders, including investors, encouraging companies to produce a variety of information, our submission noted that it is important for the Council to achieve cut-through via precision in the expectations being communicated, and robust rationales for the priority they are accorded.

During the year, we continued to encourage investors to focus on the substance of AGM resolutions on ESG matters in their voting decisions. Where there is strong alignment with private engagement, we consider such public engagement to provide clear and unambiguous confirmation of investor priorities.

Support for a Sustainable Finance Roadmap

Our banking sector analyst participated in a panel at the initial UN conference exploring a sustainable finance roadmap for Australia from which the Australian Sustainable Finance Initiative (ASFI) was announced. A Regnan team member has been appointed to an ASFI technical working group and another appointed to serve as a special advisor to the initiative's Co-Chair.

Companies engaged during FY19

We met with 42 companies during the year

AGL Energy Ltd
Alumina Ltd
AMP Ltd
Australia & New Zealand Banking Group Ltd
Bank of Queensland Ltd
Bendigo and Adelaide Bank Ltd
BHP Group Ltd
BlueScope Steel Ltd
Challenger Ltd
Coca-Cola Amatil Ltd
Coles Group Ltd
Commonwealth Bank of Australia
Fortescue Metals Group Ltd
GPT Group
Healthscope Ltd
Insurance Australia Group Ltd
Investa Office Fund
IOOF Holdings Ltd
Lendlease Group
Macquarie Group Ltd
Medibank Private Ltd
Monadelphous Group Ltd
National Australia Bank Ltd
Newcrest Mining Ltd
Oil Search Ltd
Origin Energy Ltd
Qantas Airways Ltd
QBE Insurance Group Ltd
Ramsay Health Care Ltd
Rio Tinto Ltd
Sonic Healthcare Ltd
South32 Ltd
Suncorp Group Ltd
Sydney Airport Holdings Pty Ltd
Tassal Group Ltd
The a2 Milk Company Ltd
Vocus Group Ltd
Wesfarmers Ltd
Westpac Banking Corporation
Whitehaven Coal Ltd
Woodside Petroleum Ltd
Xero Ltd

We wrote to 13 companies during the year

Alumina Ltd
Beach Energy Ltd
BWP Trust
Caltex Australia Ltd
CIMIC Group Ltd
Crown Resorts Ltd
Fisher & Paykel Healthcare Corporation Ltd
Incitec Pivot Ltd
JB Hi-Fi Ltd
Metcash Ltd
Super Retail Group Ltd
Tabcorp Holdings Ltd
Woolworths Ltd

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ABN 93 125 320 041 AFSL 316351

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