ESG and Sustainability Quarterly Report – June 2022

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In this edition of our ESG and Sustainability quarterly, we look at how inflationary pressures may test corporate commitment to social and environmental initiatives and discuss our approach to sustainability in this environment. We have also updated our report format to better highlight our team's activity this quarter. We welcome and encourage your feedback.

June 2022 Quarter ESG & Sustainability Activity Snapshot

56

ESG specific research initiatives carried out by the team across numerous topics through engaging with companies and domain experts

30

Environmental

- Sustainable Aviation Fuels
- Water management
- Waste & packaging
- Emissions
- Decarbonisation
- Energy efficiency
- Biodiversity
- Sustainable farming

19

Social

- Cybersecurity
- War
- Diversity
- Safety
- Human Capital
- Culture
- Responsible gaming
- License to operate

7

Governance

- Board
- Remuneration
- Incentives
- Accountability
- Governance of non-operated JVs

3 key strategic engagements

1. Presented recommendations on transparency and disclosure (including ESG credentials) to small cap company.
2. Engaged with Board of biotech on improvements to remuneration and disclosure to drive better accountability.
3. Engaged with CEO of resources company on the complexity of remuneration and retention post fatalities.

2 portfolio decisions across the funds influenced by ESG insights

- Added Worley (lift in transition capex)
- Added Aurizon (ESG discount unwind)

Voted on

91 resolutions, at 6 meetings

78 were voted "for",
12 were voted "against".
We abstained from 1 resolution.

Feature article: Inflationary pressures to test corporate commitment to ESG

In this note, we look back to look forward – diving into the rise of corporate responsibility as it pertains to ESG and sustainability. We suggest that the current inflationary environment will challenge the trend of corporates adopting ESG initiatives we have seen in recent years and discuss our approach to sustainability in this context.

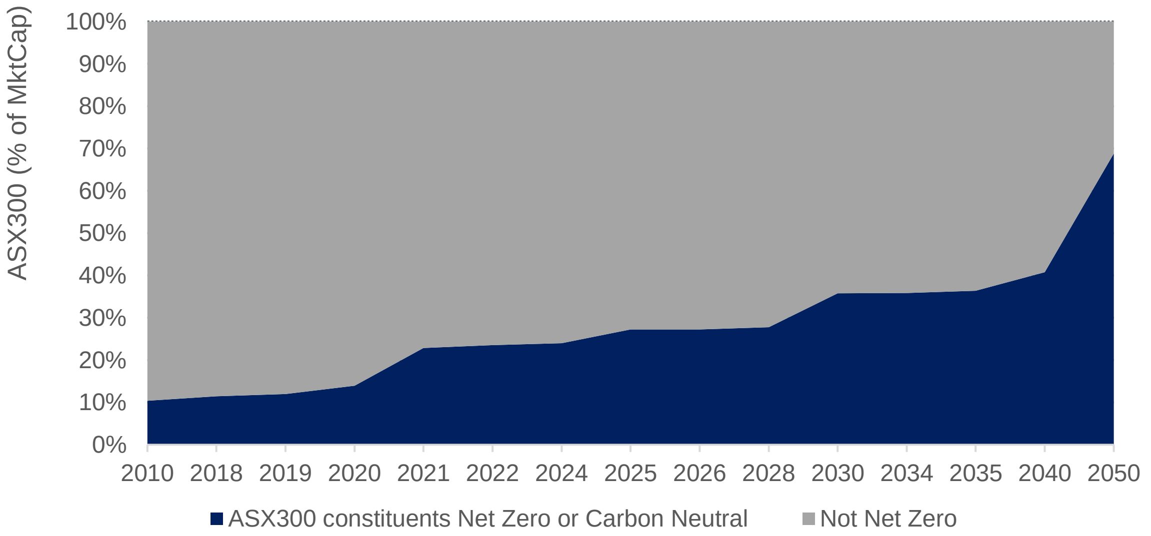
The "mainstreaming" of ESG

There has been growing momentum behind corporate led ESG and sustainability initiatives in Australia in recent years. A short time ago, ESG and sustainability sat in the domain of the corporate social responsibility department of most companies and was often simply an afterthought for most management teams. However, market observers will agree that it is common today for companies to talk purpose and values as core to their strategy, and for ESG and sustainability initiatives to be front and centre of the C-suite domain. ESG has been "mainstreamed".

Structural or cyclical?

Our observations and research suggest there have been a number of driving forces behind this change. Some of these reasons include a need for corporates to regain legitimacy following institutional failures, societal and generational shifts in values, changes to executive education, re-regulation and the influence of investors calling for greater action on ESG (although there is a chicken and egg argument to be made here) amongst others. It could be argued that many of these forces have existed for a long time – however the key change observed in recent years is that *corporates* have decided to act on ESG and sustainability. A look into the growing number of sustainability reports and net zero commitments by ASX listed companies is evidence of this.

Figure 1: Net zero commitments by ASX 300 listed companies by market cap



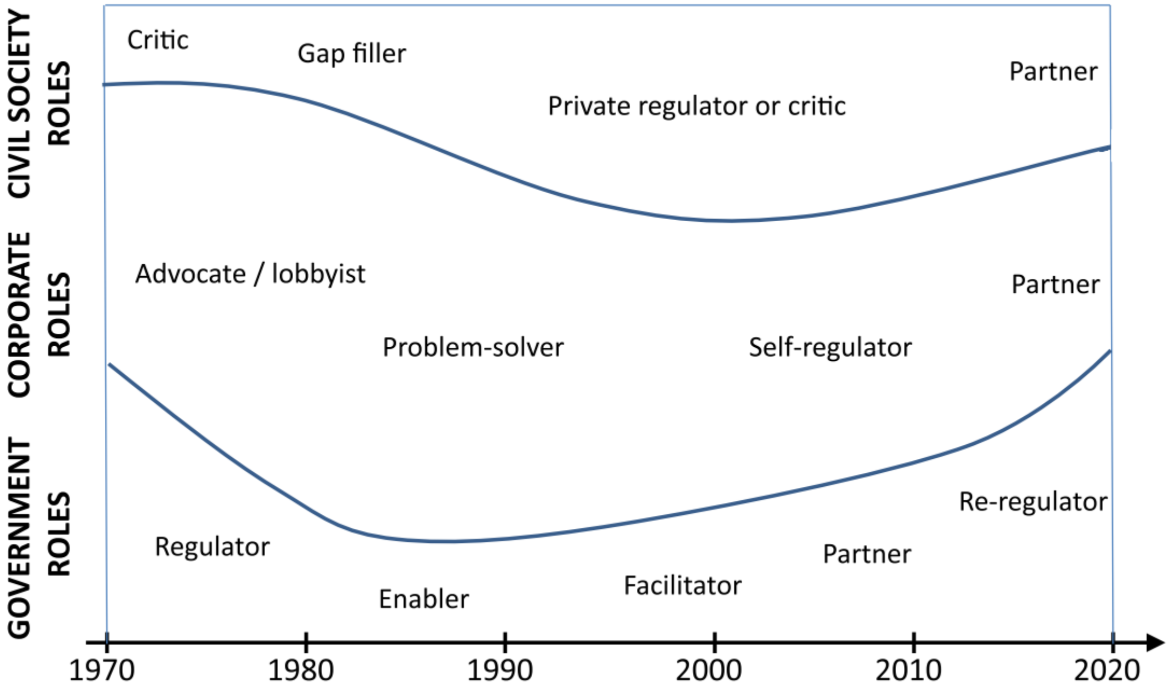
Source: Jefferies, June 2022

The question for investors with any observed trend is: **is this structural or cyclical?** The same can be asked of the rise of ESG and sustainability in corporate dialogue. Is this heightened focus on ESG & sustainability here to stay, or is it a "fad"? Many of the factors we pointed to in the prior paragraph suggest there are some powerful secular forces behind the current trend. However, there is also an argument to be made that structural trends are simply longer cycles.

The balance between government, corporates and civil society

We also observe that more generally markets (and human behaviour) are cyclical in nature, and history repeats itself or at the very least, in the words of Mark Twain, it rhymes. The figure below is a stylised interpretation of dominant discourses about primary roles of the three societal sectors (government, corporates and civil society) over time by Kourula et al (2019).

Figure 2: The changing dominance of government, corporates and civil society



Source: Kourula et al (2019)

The depiction above suggests that the post war era saw a significant period of deregulation where corporates and markets were leant on as agents of modernisation and economic prosperity (corporates were seen as "problem solvers" and governments "enablers").

Coupled with the advent of globalisation, this arguably led corporates to gain the dominant role in society with a decreasing emphasis on government responsibility, and society more broadly left to fill the gaps. As the role of the corporate became larger and larger, the 1990s and 2000's have seen an increase in the role of civil society as a "private regulator" of business in response to corporate failures, and corporates responding through self-regulation.

The current era can be interpreted as one of "partnership" where we are increasingly seeing all sectors work together to address challenges (of a social and environmental nature) on both a local and global scale. In business circles terms like "stakeholder capitalism" or "shared value" have come to the fore, and have driven much of the ESG and sustainability activity we have seen corporates undertake.

Stakeholder capitalism is a concept put forward by economist Joseph Stiglitz and adopted by the Business Roundtable in 2019 suggesting that companies share a fundamental commitment to all their stakeholders (and not just shareholders). It seeks to replace the principle of **shareholder primacy**, an idea put forward by Nobel Prize winner Milton Friedman that "*the only social responsibility of a business is to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.*"

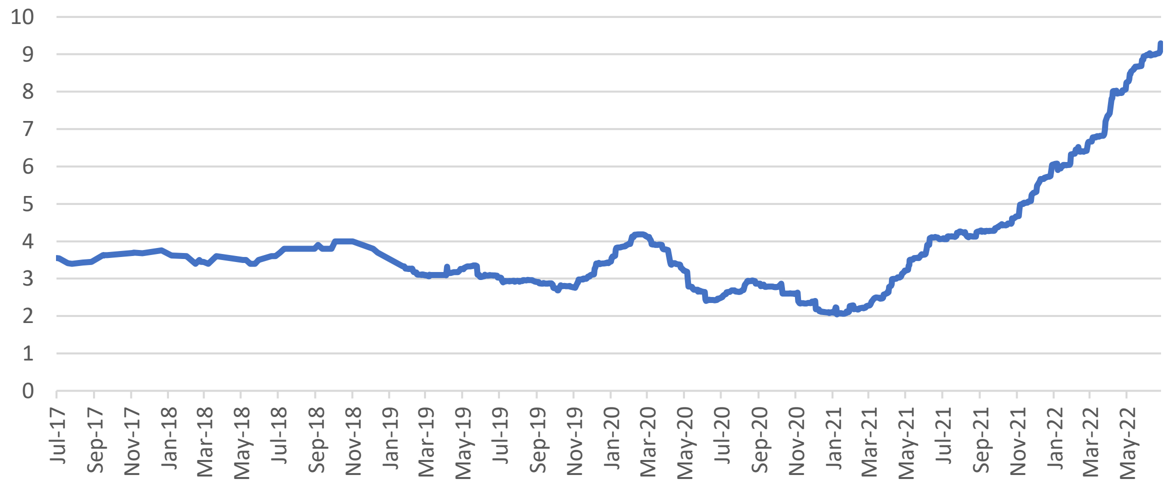
Of course, the above discussion is just one interpretation of the past and current state, and naturally entertains a number of generalisations and assumptions. However, it does present a question as to where we are at now and what the future holds. What is interesting is that this heightened era of corporate responsibility is not new. Research on businesses in the 1950's era suggests that managers (particularly small businesses) were often viewed as "public trustees" and "social stewards" (Frederick, 2008), because of the employment, housing and prosperity and help they brought to their communities.

Hence, the question is, 70 years later are we at the same point? Will society and governments cede their roles and lean on business in a tougher economic environment? Or will we see a continued rise on the pressure for business to partner to address societal and environmental challenges? Moreover, will corporates themselves still have the resolve to do so? We explain how Antares plans to approach this last question in the rest of this note.

Inflationary environment is a critical test point for ESG and sustainability

At present, the topic du jour in markets is the inflationary pressures we are seeing and whether tightening financial conditions will lead to a recession.

Figure 3: World Economy Weighted Inflation Index (%yoy)



Source: Bloomberg, June 2022

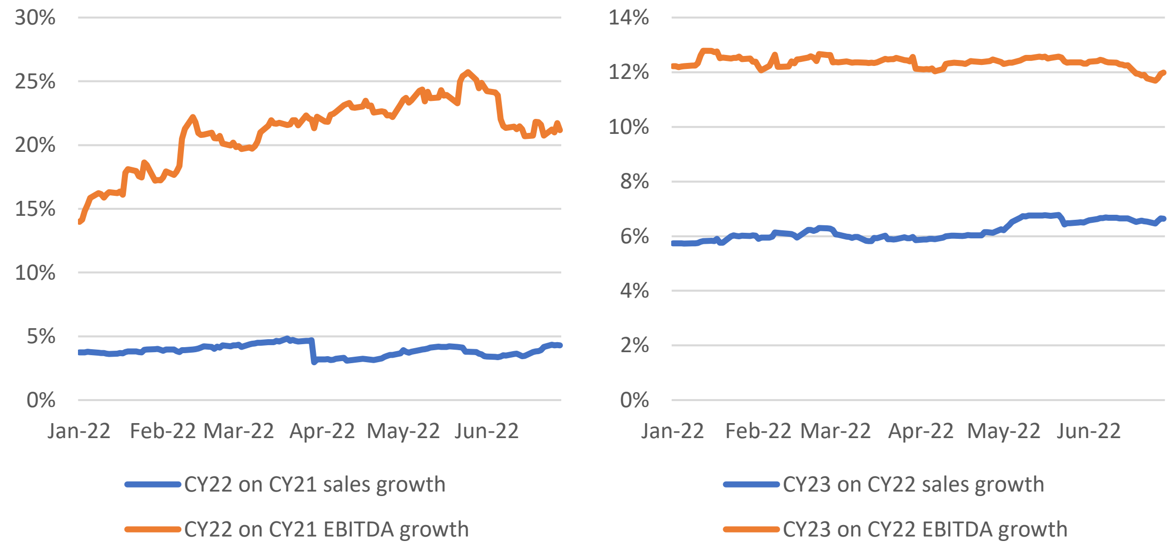
It is worth considering how inflation might impact corporate social and environmental initiatives. In this "partnership era", corporates are being asked to play their role in solving social and environmental problems that are systemic in nature. In an economic sense, governments and society have been putting pressure on companies to internalise what economists call "externalities". Put simply, companies are now paying (or sharing) costs that society, the environment or the government were previously bearing.

An **externality** is a cost or benefit of an economic activity experience by an unrelated third party. The external cost or benefit is not reflected in the final cost or benefit of a good or service.

One example of an externality are the emissions a manufacturer may emit in their process in absence of a carbon price. Introducing a carbon price would result in this externality being priced and hence reflected in the goods manufactured. Whilst Australia does not have a carbon price, the broad commitments made by Australian companies to reduce emissions has a similar effect.

In the last six months, many of the companies we have met with have assumed they will be able to deal with inflationary cost pressures by passing them on through to end customers and thereby protect their margins. The reality is that very few companies have this kind of pricing power. As the following charts highlight, since the start of this year, the market's expectations for revenue growth have increased on the back of inflation, however EBITDA growth is still well ahead of revenue growth which assumes companies are able to increase their margins (i.e. pass on costs) in this inflationary environment.

Figure 4: ASX200 Industrials sales and EBITDA growth for CY22 and CY23

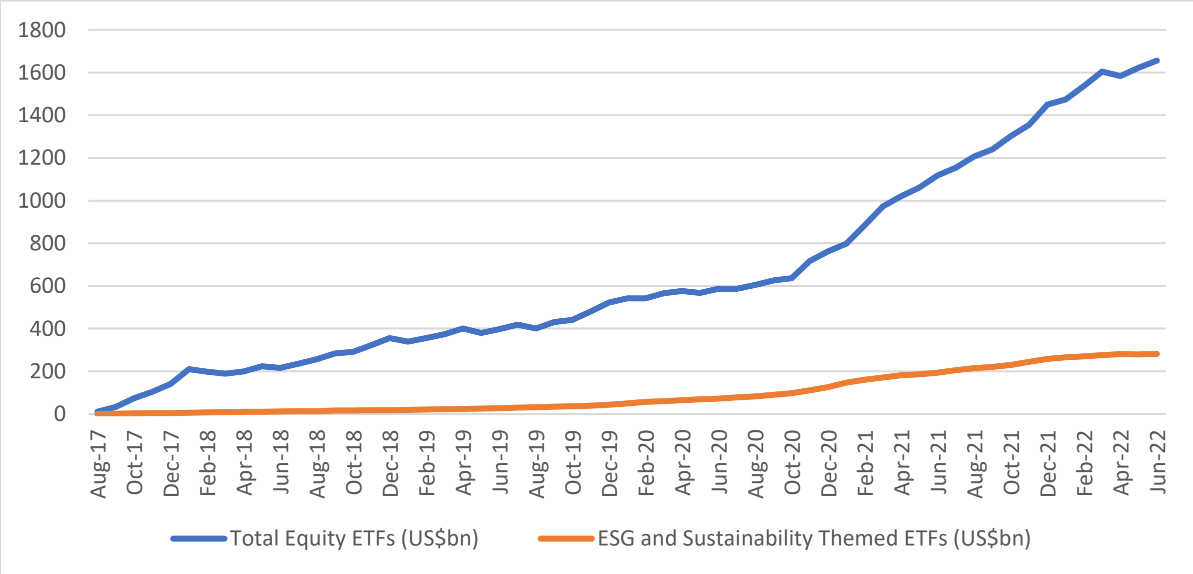


Source: Bloomberg, June 2022

Whilst companies may be able to pass on some initial cost inflation, the higher prices rise, the more likely we are to see demand destruction and margin degradation due to the negative fixed cost leverage that exists in most businesses. At this point we believe this will result in an increased focus on cost reduction by management. Likely in these considerations will be an assessment of discretionary spending on environmental and social initiatives and whether they can be postponed. These decisions will need to be weighed up against the return such investments provide (both quantum and timing), and will test how committed companies are to their planned ESG initiatives.

At a macro level, we are already seeing some evidence of this wavering. The war between Russia and Ukraine has seen renewed investment in traditional hydrocarbons following several years of underinvestment. On the investment side, fund flows into ESG themed ETFs have been slowing since the start of the year, recording their first month of net outflow in five years in April.

Figure 5: 5 yr cumulative net flows into global ETFs – US$bn



Source: Bloomberg, June 2022

Pulling this together, we believe that whilst the long term structural trends behind the mainstreaming of ESG are likely to persist, the current period is likely to see a consolidation and reassessment amongst both corporates and investors.

The Antares approach to sustainability is unchanged

When capital is cheap and economic growth is strong, it is easier for companies to be benevolent and think longer term. However, as discussed, in the event that we see tougher economic conditions, management teams are likely to face some hard choices around cost reduction and deciding which investments are discretionary.

To be clear, we are not saying that abandoning environmental and social initiatives is the right thing to do in this environment. Many companies need to decarbonise to ensure their long-term viability, whilst human capital-intensive businesses must ensure they are retaining and remunerating properly to ensure their futures. As such, in the event of a recession which the market is increasingly pricing in, we are focussed on whether management teams are able to balance current pressures with the long-term, or conversely whether they are making short term decisions at the expense of the long term.

Antares views sustainability in a holistic sense, employing a framework where we score companies on their stewardship of various forms of financial and non-financial capital available to them within their industries. We believe companies need to be sustainable across all forms of capital on which they draw to create value.

Figure 6: Antares Sustainability Framework

Where	Industry					
What	Vision and Strategy					
With	Financial Capital	Manufactured Capital	Environmental Capital	Social & Relationship Capital	Human Capital	Intellectual Capital
How	Business Model & Governance					

Source: Antares Equities

We approach sustainability in our investment process by scoring our entire coverage universe from 1 (poor) to 5 (good) across 4 key categories and 16 subcategories as highlighted in Figure 7. Our coverage is then quintiled based on these scores, such that we have a view on the long-term sustainability each company's ability to create value over the long term. This is particularly important from a valuation perspective given >60% of our DCF valuations are derived from terminal year assumptions.

Figure 7: Antares Sustainability Scoring Criteria

Management	Industry	Financial	Non Financial
Alignment & Remuneration	Industry structure	Return on Equity	Relationship management
Capability	Opportunity size	Predictability	License to operate
Strategy	Capital flows	Leverage	Human capital & culture
Integrity/Disclosure	Disruption & innovation	Financial sustainability	Other non-financial capital (e.g. intellectual, environmental)

Source: Antares Equities

With markets selling off, there will be opportunities to buy companies who manage their capital well at attractive valuations. We will be looking at all forms of capital and management decisions around how they are managed to create long term value for shareholders in the context of industry conditions – whether it be financial, physical, human, social, intellectual, relationship or environmental. In this sense, our approach is much broader, and more holistic and integrated than traditional ESG analysis - but we believe it is well suited to analyse the choices management teams will be making in balancing short and long term priorities in the current environment.

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