ESG and Sustainability Quarterly Report – March 2022

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In this edition of our ESG and Sustainability quarterly, we look at why biodiversity matters for investors but has been largely ignored until now. We also explore some of the risks and opportunities tight labour markets are creating for companies and provide an example of how we think about Board diversity and how it influences our voting. As always, your feedback is welcomed and encouraged.

Environmental: Biodiversity – the other side of the net zero coin

Most readers will be aware of the significant groundswell of activity that has occurred in recent years to combat climate change through emissions reductions. As of March 2022, 60% of ASX100 companies have now committed to net zero, compared to 1% five years ago.

The basic premise behind emissions reductions is that by producing less carbon, the global community may be able to slow global warming and its associated widespread effects. The other side to this equation however, is the role the environment, or natural capital can play in providing a buffer against climate change and its impacts. This is where biodiversity comes in. Whilst there is much that can be written on this topic, we provide an overview on the issue in the following pages.

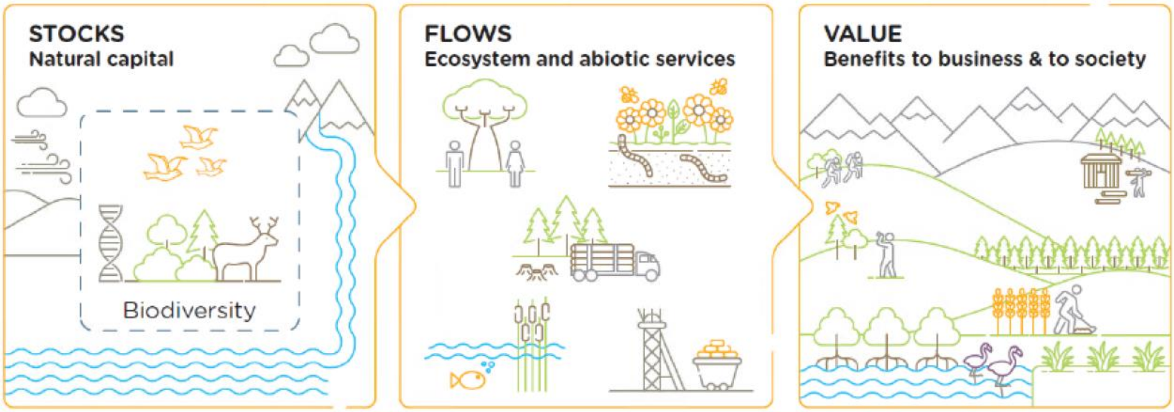
Why does biodiversity matter?

Biodiversity refers to the biological diversity of the all life forms on earth. This variety can refer to the level of genetic variation, the variety of species present, or the variety of groups of species or ecosystems.

At the heart of much of economic activity lies a reliance on natural capital. The World Economic Forum estimates that nearly half of global GDP (US$44 trillion) is moderately or highly dependent on nature and its services. Biodiversity speaks to the resilience of the earth's natural capital stock. In the same way portfolio theory suggests that diversification in an investment portfolio reduces systemic risks and improves its ability to weather shocks, biodiversity also provides resilience to the world's natural capital and therefore the services and value we derive from it.

Natural capital is the stock of renewable and non-renewable natural resources (e.g. plants, animals, air, water soils, minerals) that combine to yield a flow of benefits to people. The flow of these benefits is often referred to as **ecosystem (living) and abiotic (non-living) services.**

Figure 1: Relationship between natural capital, biodiversity and ecosystem services



Source: Capitals Coalition, March 2020

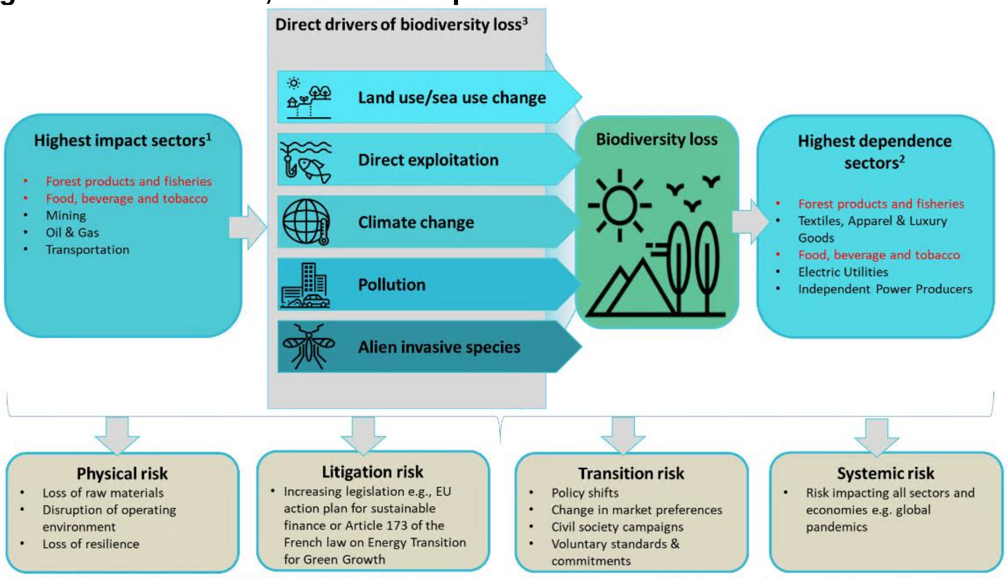
Loss of biodiversity presents significant risks

Companies, and society more broadly draw from natural capital and ecosystem services for a wide range of things essential to daily life – think food, medicines, materials for shelter, the various uses for land and so on. At the same time our activities also create direct and indirect impacts on nature. This two-way relationship between business and the environment is a concept known in ESG reporting as “double materiality”.

Double materiality is a concept that was introduced by the European Commission in 2019 that suggests companies should report about how sustainability issues affect their own businesses as well as the impact businesses themselves had on people and the environment.

Studies show that there has been a significant acceleration in species extinction rates and overall loss of biodiversity in the last century. This loss of biodiversity has wide ranging impacts and increases a number of risks across key sectors vital to economies because of the vulnerabilities they create to natural capital stock and the ecosystem services that flow from them.

Figure 2: Nature loss, risks and implications for investment



Sources: 1 Calculated using IUCN Red List threat data as detailed in Maxwell et al (2016) and UN Environment Programme, UNEP Finance Initiative and Global Canopy (2020): sectors translated to GICS 2) from WEF (2020) and UN Environment Programme, UNEP Finance Initiative and Global Canopy (2020): sectors translated to GICS , 3) IPBES (2019) and 4) PWC and WWF (2020).

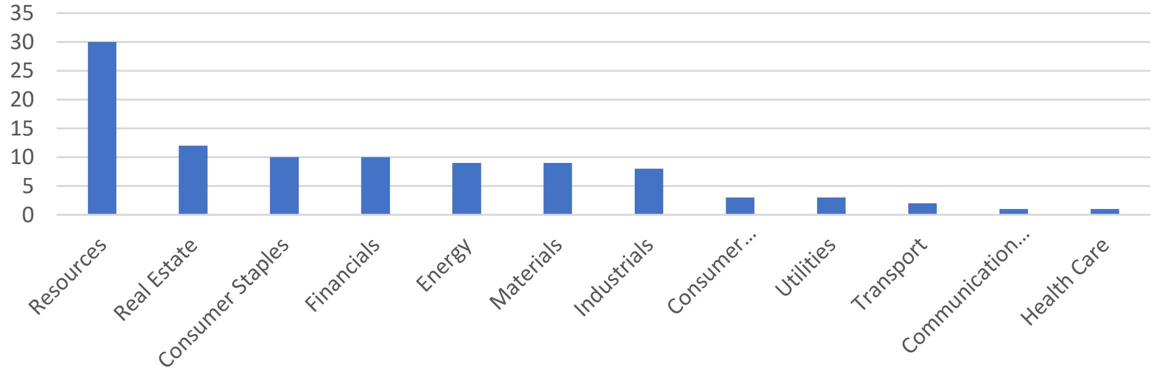
Source: Investor Action on Biodiversity Discussion Paper (PRI); 2020

In addition to the general resilience biodiversity provides to natural capital stocks, it also plays a specific role in combatting climate change. For example, the structures of mangroves and coral reefs provide natural protection for coastlines. Similarly, it is widely known that trees and soils play a critical role in capturing and storing carbon for hundreds of years with some research even suggesting that full restoration of the world's rainforests and soil plains would be sufficient to fully offset the additional 300 gigatons of carbon that has been added to the atmosphere since the start of the industrial revolution (Bastin et al., 2019, Van Den Hoogen et al, 2019). While such statistics are highly dependent on assumptions, they do highlight the potential importance of biodiversity acting as a defense against emissions and unsustainable depletion of natural capital.

Closer to home than we think
The last few years have reminded us all about how long and globalised supply chains are – for example, the current conflict in Ukraine and resulting sanctions on Russian products have highlighted the world's dependence on that region for critical products like timber and oil. This also highlights another key issue with biodiversity – it is time and place specific and is not fungible (i.e. increasing biodiversity in one place does not offset loss of biodiversity elsewhere the same way carbon credits might). This means that a loss of biodiversity in a South American rainforest can have impacts on the supply of certain medicines elsewhere in the world, yet the pharmaceutical company may have little control over the management of this natural capital asset. In this regard, Australia is a critical contributor to the world's biodiversity - the remoteness of our continent means that we have biodiversity that is both rich and unique - accounting for between 7-10% of all species on earth. Our biodiversity is critical to providing global resilience to the world's natural capital stock.

A problem being largely ignored, but perhaps not for much longer
Despite being such a significant and system wide issue, Antares' observation is that biodiversity risks are not being adequately discussed by Australian corporates. A review of 2021 company disclosures finds that less than a third of ASX300 companies even mention biodiversity. In instances where we have queried such risks with management teams it has been revealed that in most cases these issues are not being talked about at a Board level, and companies are unsure of what they should be disclosing with regard to biodiversity.

Figure 3: Number of ASX 300 companies that mentioned biodiversity in 2021 disclosures



Source: Macquarie Research January 2022.

Biodiversity is also not front of mind for most investors. A 2020 report by ShareAction found that none of the 75 world's largest asset managers had published a dedicated policy on specific biodiversity risks and impacts, and only 11% referenced a need to mitigate negative impacts on the natural environment.

As such, it appears that this risk has been largely ignored. We might hypothesise that this is because of all the focus on climate and other social issues, but at its core, biodiversity is arguably a bigger risk than climate given it serves to protect all natural capital.

However, we expect biodiversity to become an increasing focus as policy makers globally begin to address what positive action can be taken to improve the resilience of natural capital to combat climate change in addition to the work already undertaken in reducing carbon emissions.

As we highlighted in December, a key feature of COP26 was an increased focus on loss and destruction of land and forests. Later this year COP15 will be held in Kunming, China and will feature a discussion of new targets for biodiversity. For investors, the first beta version of the Taskforce on Nature-related Financial Disclosures was launched in March 2022, with a 2023 deadline set for the introduction of a new reporting framework. We expect this to receive similar widespread adoption as the sister TCFD framework that is now widely being used by corporates.

Nature related reporting will have some key differences and necessarily be more complex than climate related reporting, stemming from the need for data and analysis on not just activities, but locations too. However, we believe that this will enable greater interrogation of both the risks and opportunities arising from analysis of natural capital and biodiversity.

An example of biodiversity impacts on an ASX listed company

Covalent Lithium (a 50:50 JV between Wesfarmers and SQM) is developing the Mt Holland Lithium Project. The project is located on the Earl Grey hard-rock lithium deposit, approximately 500 km east of Perth. This area intersects with the habitat of two conservation significant fauna species, the Malleefowl (Leipoa ocellata) and the Chuditch, also known as the western quoll (Dasyurus geoffroii). Both species are listed as vulnerable under various state and federal environmental protection acts and also considered Matters of National Environmental Significance. The area is also home to rare flora species that require protection. The Malleefowl is the only living representative of the genus Leipoa and can now only be found in three locations in Australia. Similarly, the Chuditch which could once be found across 70% of Australia is now only present in this pocket of Western Australia. As such they are globally significant contributors to biodiversity. The Mount Holland mine site is located on a brownfield area that was previously used for gold operations but was mostly left unrehabilitated which we suspect has contributed to the decline in these species.

Our due diligence has found that Covalent has been required to purchase four times the disrupted area (i.e. over 1500 hectares) in farm land to convert to national parks for the relocation of these endangered species. Aside from the material cost associated with the responsibility to protect against biodiversity risk, we believe this example also serves to highlight the integrated nature of ESG analysis – in that a lithium project which will be an enabler of the energy transition also poses risks to biodiversity which need to be managed.

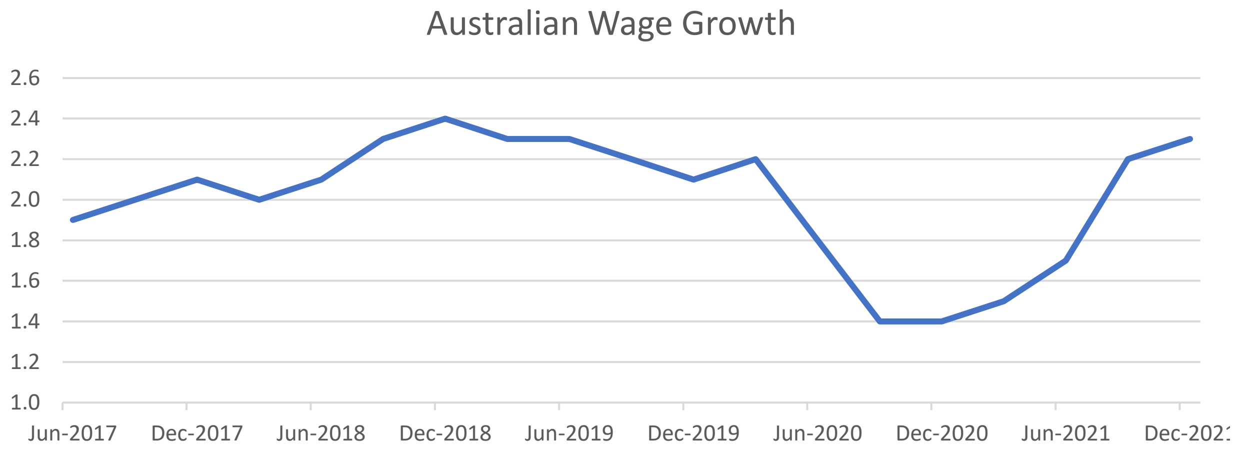

Source: Department of Agriculture, Water and Environment

Social: Risks and opportunities in a tight labour market

Inflationary risks exacerbated by current events have been a hot topic in markets. While the official data is yet to show a meaningful lift above trend, a key theme through reporting season has been a notable rise in competition for labour with demand exceeding supply in some pockets of the economy due to a lack of mobility and skills shortages.

The pressures appear to be the greatest across software, mining and construction industries where vacancy rates have been trending higher.

Figure 4: Australian Wage Growth (%)



Source: Bloomberg, ABS; 2022

Beyond paying higher wages for staff however, we have also observed companies that are employing a number of creative strategies to attract and retain staff in such a tight market. We provide some of the more interesting examples in the highlighted panel.

Iress (IRE) noted that despite hot competition for software developers it had seen minimal turnover due to generous leave allowance implemented in recent years that afforded significant flexibility and trust to employees. In addition to generous parental and other leave policies, Iress also has introduced “the Long Weekend” which enables employees to take up to six Mondays or Fridays off per calendar year; and up to 8.5 days additional leave for parents whose children are starting school.

Ventia (VNT) indicated that it had not seen an increased level of turnover, but was not seeing the same level of applications for new roles as before. In response the company has been looking at their opportunity to increase their work force diversity. This has included partnering with an indigenous services companies to place more employees (noting that VNT already has a 400 strong indigenous workforce). The company has also been hiring a greater number of people with disabilities for certain roles where there is a skills match.

Medibank (MPL) spoke about the importance of its purpose and values and their importance to talent attraction and retention given the roles they play in intrinsic motivation leading to innovation and discretionary effort.

On the flip side, we have also found some instances of questionable hiring practices to fill gaps in a tight market such as lowering criteria and taking on less experienced employees for specialised roles. This is a key concern for us, particularly in the mining sector which may have negative consequences for safety and project delivery. Other companies who are not managing these pressures are seeing increased turnover and are suffering significant labour inflation as a result. Our March quarter fund reports detail some of the portfolio activity we have undertaken to insure ourselves against such risks where we don't believe they can be managed adequately.

Governance: A spotlight on board diversity

Antares Equities - voting activity during the March 2022 Quarter

4	meetings where voting rights were exercised.
36	resolutions voted on. Of these, 33 resolutions were voted "for", 3 were voted "against". Our against votes predominately related to votes on remuneration and governance.

It has been a quiet period for voting post the November AGM season last year. Below we provide a case study on a recent decision we made to vote against the election of a director.

Case study: Cross sectional diversity in the property sector
During the quarter, one of our recommendations has been to vote against the election of a proposed director for a property company. Our proxy adviser had advised doing so because of a past tenure the Board member had on a financial services company during a time where the Board had overseen significant value destruction for that business.

Whilst Antares decided to vote against the election of the Director, our reasons for doing so were different to that of our proxy advisor; namely that we believed the addition of the proposed director did not contribute adequately to board diversity. The company in question already had two other Board members who were on the same financial services company board in question during the same period, which would mean a third of the Board were ex directors of that company. Moreover, the proposed director and another existing director also previously sat on the same board of another company. As such, we were very wary that the appointment of this proposed director could result in groupthink or create a "club culture".

In addition, when we looked at the skills matrix of the board, the proposed director did not fill any skills gaps and in fact their skills had complete overlap with several other Board members.

Figure 5: Board Skills Matrix

	M&A / Capital markets	Audit / Corporate Finance	Real Estate	Funds Management	Public Policy / Legal	Technology / IT	Disruption/ Innovation	Marketing	Social / Environment
Director 1		x		x	x			x	
Director 2		x		x	x				
Director 3	x						x		
Director 4		x						x	
Director 5	x	x							x
Director 6				x	x			x	x
Director 7	x	x			x				
Director 8				x		x	x	x	x
Director 9	x	x			x				x

Source: Glass Lewis; 2022

At Antares, diversity of thought is a characteristic we like to see on Boards. Different skills, experience, ages, genders, backgrounds and perspectives bring more robust discussion to the table when it comes to decision making.

Rather than narrow down diversity to one aspect we prefer to look at cross sectional diversity – the rich array of background, perspective, experience and other factors that contribute to better decision making at a board level. We believe this to be good governance and in the best interests of shareholders. Ultimately, we contributed to an 18% against vote on the resolution, which we hope will be food for thought for future appointments.

Thank you for your interest in our ESG and Sustainability quarterly report. We trust it has provided some insight into our recent activity in the space. As always, your feedback is encouraged and welcomed.

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