ESG investment

In partnership with NAB

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Low-carbon goals drive the economy

Long-term results

Christopher Niesche

For fund manager Chris Newton, pursuing environmental, social and governance outcomes is more about producing long-term returns than it is about improving the planet.

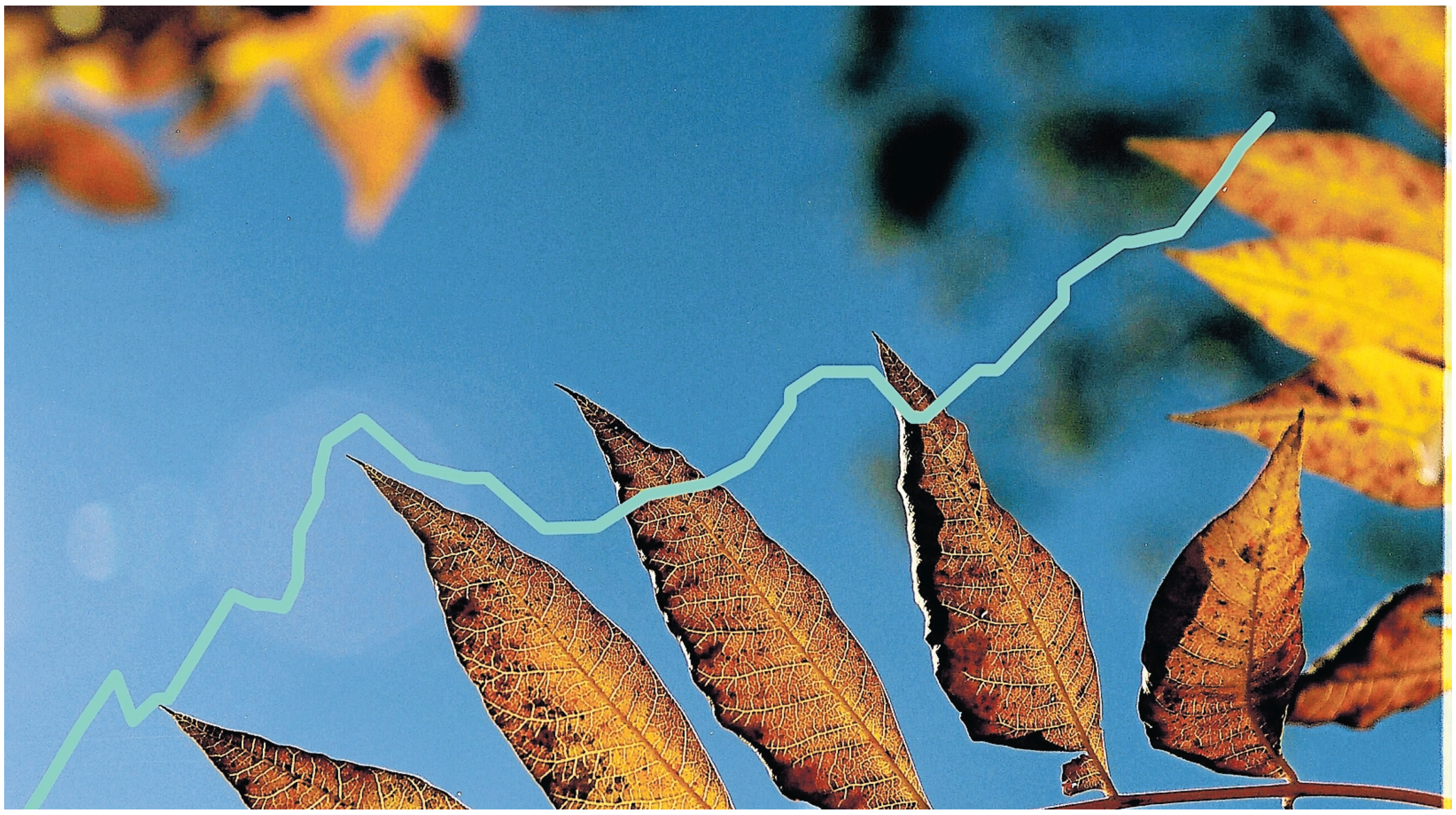
The executive director, responsible investment at IFM Investors, says an ESG investing approach has been embedded in the fund manager's purpose since it was created in 2004.

"We're here to provide net returns for our investors and our shareholders and, ultimately, the beneficiaries and the members," Newton says.

"We fundamentally believe that ESG, if you integrate it, understand it and act upon it, will deliver the long-run results that we're striving for. So it's definitely not an ideological bent at all."

IFM is seeking a reduced impact on climate and more transparency about reporting its carbon footprint and risks. "We do believe the economy is heading into the lower carbon future and so we want businesses and investments that are well-positioned to survive and thrive in that future and so on," he says.

The approach is growing in popularity. The *Responsible Investment Benchmark Report 2019 Australia* reveals that the responsible investment market continues to grow locally, with assets under management up 13 per cent over the course of 2018 to $980 billion.



The responsible investment market is growing, with assets under management at $980 billion, or 44 per cent of total professionally managed assets, now at $2.24 trillion.

The dominant responsible investment strategy is ESG integration, which represents 44 per cent of assets under management, according to the report produced by the Responsible Investment Association Australasia. ESG integration involves considering the earnings and valuation impact of ESG factors when making investment decisions. Positive screening, sustainability-themed investing and impact and community investing strategies make up a small but growing proportion of responsible investing strategies, the report finds.

While IFM primarily pursues an ESG strategy, it does also have bespoke funds for clients which are tilted towards sustainability, such as a low carbon fund.

"That is really responding to some of our investors' perspectives that low carbon, in this example, is really where the global economy is heading and that therefore those companies will outperform the market," says Newton.

IFM is also working with its investments and infrastructure assets to set emission reduction targets.

Another systemic risk identified by IFM – and one which forms part of the "social" metric of ESG – is around labour rights and protecting workers.

It is working with Coles and Woolworths around improving the labour rights in their supply chains, because that is an investment risk, in particular the fruit pickers and packers who aren't directly employed by the supermarkets because they can be at risk from underpayment or harassment.

"If you're at risk from that and a regulatory change happens or the workers are unavailable, then ultimately you and I can't buy our strawberries and therefore that will actually impact Woolworths' and Coles' revenue line," Newton says.

The third part of responsible investing is governance, which can often be overlooked by retail investors, but is no less important, says Tim Conly, head of responsible investment research at investment consultant JANA.

"It's ensuring companies are well run, which in turn then drives better E and S outcomes as well," he says.

For instance, a mining company will by the nature of its core activities have environmental and social risks to contend with, but if it is well governed, it will be better placed to manage and mitigate the risks associated with the activities.

Beyond ESG, more funds are striving for impact investments, Conly says. "There's more of a focus on understanding how the traditional portfolios can be tilted towards basically sectors or products or companies that are doing good in the community relative to those that aren't."

These investments include renewable energy and the healthcare and community services sectors.

"The evolution is the industry has gone from getting rid of the bad to now understanding that there's a demand to do good as well.

"So it's not just good enough to say, we don't invest in tobacco. There's an expectation now saying look we don't invest in tobacco but we also tilt towards these positive things," Conly says. Funds are trying to mitigate investment risk and deliver positive investment returns, and it can be a challenge finding impact investments that stack up. "Just because it's going to have a positive impact on society or the environment doesn't mean it's necessarily going to give you a positive investment return," he says.

Even so, he sees the potential for investing for good to make a positive change. "Money does talk. So if you get this huge flow of capital towards things that can be sustainable and can positively influence society, it sends a really strong signal; it does create these industries or fund these industries that we do need at the end of the day to positively address climate change and those type of things." AFR

Hydrogen has a key role to play

Decarbonisation

Christopher Niesche

The decarbonisation of Australia's economy is a massive and costly task.

It is also a major investment thematic and a once-in-a-lifetime investment opportunity, says Andrew Smith, global head of energy at NAB.

Decarbonisation in Australia – replacing fossil fuel power sources with low or zero carbon sources – began with the electricity sector, where wind and solar farms are coming onto the grid and replacing carbon-intensive generation.

The next step will be to start decarbonising other sectors, such as residential heating and transport.

One option is electrification of these sectors and the other is replacing the fossil fuels they use with hydrogen, which requires electricity to split water into its two component parts.

"All roads lead back to wind farms and solar parks as we continue to decarbonise not just the electricity grid, but the hard to decarbonise sectors," Smith says.

As long as hydrogen is produced from renewable electricity, then it is a zero emissions fuel, whose only by-product is water.

Daniel Roberts, the leader of the Hydrogen Energy Systems Future Science Platform at the CSIRO, says hydrogen has become a more viable renewable energy source because the cost of the technology to produce hydrogen from renewable energy and of renewable electricity itself have all come down. Additionally, technologies for storing and distributing hydrogen have become a lot more deployable.

Hydrogen can be used for industrial processes and transport, and there are already hydrogen-powered cars on the streets of California and Tokyo.

Under Australia's National Hydrogen Strategy, the COAG energy council aims for Australia to be one of the top three exporters of hydrogen to Asian markets and for the nation to be a destination of choice for international investors in hydrogen.

"Australia has significant competitive advantages for developing a substantial hydrogen export industry. It has all the natural resources needed to make clean hydrogen. It has a track record in building large-scale energy industries. It has an established reputation as a trusted energy supplier to Asia. It can compete with any other nation," the report states.

The CSIRO's National Hydrogen Roadmap from 2018 says demand for imported hydrogen in China, Japan, South Korea and Singapore could reach 3.8 million tonnes in 2030, at a value of about $9.5 billion with Australia well positioned to play a key role in the export market. Australia needs to develop a domestic market for hydrogen in order support a viable export market, says Roberts.

The government's Australian Renewable Energy Agency is spending tens of millions of dollars building large-scale electrolysers, but this still leaves the question of where domestic demand will come from.

"There's no point in having lots of hydrogen if you've got nothing to do with it. And it's a classic chicken and egg problem," Roberts says. "No one is going to buy a hydrogen car because you can't go anywhere and fill it up. And no one is building the refuelling stations because no one has got any cars to fill up."

NAB's Smith says despite the falling price of hydrogen, it is still more expensive than other fuels, but he says the cost gap has narrowed.

"It is most likely that hydrogen will out-compete fossil fuels for transport first and in particular long-haul transport, and the studies that are out there seem to suggest that will happen in the next five to 10 years."

More broadly, banks have a central role to play in decarbonisation and have "significant appetite" to finance renewables.

Hydrogen is a zero emissions fuel (above). (Left) NAB's Andrew Smith.

"A mature, deep, well-functioning finance market is crucial as this lowers the cost of capital.

"Given about 70 per cent of the project lifetime cashflows are allocated to servicing capital, lower-cost capital equals lower-cost electricity," Smith says.

"The opportunity is not simply in lending, but repackaging the loans/assets and creating investment products that provide financial and social returns."

Banks are also working to decarbonise their lending portfolios in line with public commitments they have made.

Accelerating investment in renewables will not only help address climate change, it will also help stimulate with the economic recovery in the wake of the COVID-19 pandemic.

"There's no doubt large-scale construction projects will be a key tool used to get Australians back to work – and the renewable energy industry should be an important part," Smith says.

Additionally, renewable energy has the potential to reduce energy costs as it is the lowest-cost new entrant into the energy market, and so could help lay the foundation for competitive energy-intensive energy in Australia.

Looking at what is required to manage the transition to balance decarbonisation, affordability and reliability, Smith says bipartisan support for long-term energy policy and decarbonisation is needed along with investment in modernising the electricity grid. Investors need market-wide frameworks to reduce costs. AFR

Banks help businesses reach social objectives

Finance for sustainability

Alexandra Cain

With investors increasingly directing capital towards clean, green assets, the banking sector is playing an important role helping organisations meet critical international initiatives such as the UN's Sustainable Development Goals (SDG) and the Paris Agreement on climate change.

These international objectives are directing vital work by organisations and the financial sector around the world to address climate change and support a more sustainable way of life.

Connie Sokaris, NAB's executive general manager, corporate, says banks are central in businesses' efforts to make their operations more sustainable. "We have the ability to influence decision makers, as well as provide capital to support sustainability goals," she says.

NAB plays a leadership role in this dynamic. The bank is investing $2 billion in affordable housing.

Additionally, since 2003 it has supported more than 130 domestic and global transactions involving wind farms and solar energy. It has also committed to deploying $70 billion to environmental finance by 2025, with $17 billion already invested to support green infrastructure, finance, capital markets and asset financing.

"The volume of capital we have to address pressing social and environmental challenges keeps growing," Sokaris says. "How we and other financial institutions deploy funds is helping to create the type of society we want to live in."

For instance, increasingly, investors are assisting companies to explore the potential for green bonds to support their sustainability initiatives.

"These instruments are key to funding social and green assets. They also give investors an opportunity to see first hand how companies are improving their approach to sustainability over time," says Sokaris.

Aside from helping them to achieve their social contracts, this in turn offers real financial benefits to companies. Some organisations are now able to access funding at lower interest rates if they consistently achieve the sustainability goals tied to the assets funded by these bonds.

The Australian Sustainable Financial Initiative, of which Sokaris is a director, is helping to coalesce organisations' work in this area.

"Many broader sustainability challenges can't be solved by a single institution. So ASFI brings together 90 organisations across the banking, superannuation and insurance sectors to help shape the environmental initiatives companies are undertaking and to help them meet international objectives such as the UN's SDGs," she says.

NAB has supported wind farms and solar energy projects. (Left) Connie Sokaris of NAB.

ASFI is finalising a road map comprising six core principles to help guide businesses and the investment sector towards a more sustainable future. It explores concepts such as leadership, community expectations, establishing frameworks, decision making, applying capital and oversight and policy setting.

"Given the challenges we're facing through COVID, it's never been more important to put sustainability front and centre," says Sokaris. "This is not just about climate change. It also involves healthcare, housing and unemployment. The road map will help guide this."

ASFI's road map can help during the post-COVID economic recovery, by prioritising sustainability while governments invest in infrastructure, and accelerate efforts to achieve targets set out in the UN's SDGs and the Paris Agreement on climate change.

The road map, which was modelled on similar programs in the UK and Europe, also adds to the work being undertaken around the world on international efforts including the UN Environmental Program and its related Finance Initiative. "NAB has been a member of the UNEP FI since 2002. We believe it's key to developing a sustainable global finance sector."

Sokaris stresses industry leaders such as NAB must help facilitate and model the required cultural change to embed a focus on sustainability across the community. AFR

Big end of town gets assertive

Institutional investors

Mark Eggleton

Australian private equity players are increasingly taking a more active role in the environmental, social and governance space.

They're beginning to demand portfolio companies operate in the best interests of their entire stakeholder community.

Private equity's ESG focus a decade ago was probably considered a "nice to have but not necessary" whereas today there is a more forceful discussion going on, says Australian Investment Council's chief executive Yasser El-Ansary.

"We're at a point where there's more banging on tables going on and institutional investors are demanding things happen, but we're not quite yet at the point where we're seeing those investors completely walk away from the table if the fund managers don't deliver on ESG expectations, but I think we're on that journey now," El-Ansary says.

At present, discussions around ESG are built into the due diligence process and for El-Ansary we're probably around five to 10 years away from investors voting with their feet.

He's happy to see institutional investors play a more assertive role because it will lead to change because those who need capital will be forced to evolve and adapt their practices to fall into line or their businesses will be left behind.

> **The collective call for change is growing louder.**
> Sue Thompson, State Street Global Advisors

"And in an industry like private capital investment, being left behind effectively means you perish and die," El-Ansary says.

Importantly, ESG is not a flavour of the month trend for private equity, which generally invests for the mid to long-term. Investors looking further over the horizon need to look beyond just the commercial returns profile of a particular investment opportunity to how the underlying investment goes about generating returns.

It's a point recently made by Sue Thompson, who heads up SPDR Americas Distribution at State Street Global Advisors (SSGA). Speaking at the launch of SSGA's S&P 500 ESG Exchange Traded Fund last month, Thompson said, "ESG investing is approaching a critical inflection point".

"The collective call for change is growing louder and investors are increasingly taking a stand through their investment choices," Thompson said.

Managing director of Impact Investing at Artesian, Vicky Lay, says not investing into fossil fuels or extractive industries for example goes beyond climate change.

"Who are the greatest climate casualties? Women and children are the most affected.

"Or the reason we don't invest into tobacco is, because the industry, vastly unregulated in the developing world, has received backlash from women's rights groups for its predatory marketing practices preying on the insecurities of economically vulnerable women," Lay says.

More pertinently for investors, "by integrating a strong ESG overlay into our investment policy, the strong evidence is we will increase returns for investors," Lay says. AFR

Adversity brings social purpose to the forefront

Sustainable future

Mark Eggleton

Many Australian investors looking at a nation battered by a long drought followed by catastrophic bushfires and now the ongoing COVID-19 pandemic are recalibrating their portfolios to focus more on funds and firms with strong environmental, social and governance principles.

They're not alone, as ESG-focused funds and sustainable companies globally have tended to attract more capital in recent months.

The pandemic seems to have focused people's minds on the enormous social risks associated with a global pandemic and the importance of ensuring we pivot to a more equitable and sustainable future.

In Europe for example, the EU's coronavirus relief package and its Green Deal are skewed heavily towards a sustainable future with over $2 trillion earmarked for sustainable investments.

Across the Atlantic in the United States – despite the current administration's sometimes open hostility to ESG issues – there's been a huge surge in ESG investing and some of it in the energy space is being led by the tech leviathans such as Facebook, Apple, Amazon, Microsoft, Netflix and Google.

In fact, Apple and Google currently get all of their energy from renewables and the others are following fast.

According to Goldman Sachs these big players, which already have an outsized presence on Wall Street, have the potential to have a larger influence on the future of renewable energy than the US government.

Closer to home, NAB's global head of sustainable finance, David Jenkins, recently told the *The Australian Financial Review* that NAB's customers on the investor and the issuer side are extremely motivated to invest in sustainable opportunities and also to deploy more capital towards making their business models more sustainable, more long-term.

In the energy space, NAB is joined by all of the major banks in committing to transition away from fossil fuel financing and "we're all actively doing so, and supporting our customers through that transition to alternative forms of energy generation," Jenkins says.

Sydney Airport last year refinanced $1.4 billion of debt facilities. (Left) David Jenkins of NAB. PHOTO: GETTY

"Each of us has committed to being 100 per cent renewable energy powered within a certain timeframe and we're all actively managing our balance sheets to tilt towards more green or sustainable lending."

Put bluntly, Jenkins says "we're certainly not doing new fossil fuel financing". Jenkins admits this is a double-edged sword because the bank cannot just "turn the tap-off" on existing energy customers, so they continue to support existing customers while they transition to sustainable futures.

ESG-focused funds and sustainable companies globally have tended to attract more capital.

And while Australia was perceived as being a little slow out of the blocks on the ESG front, Jenkins says we've come a long way since NAB released its first green bond back in 2014.

"We were very cautious and nervous (back in 2014) whether there would be sufficient demand but we launched it at $150 million and we then printed a $300 million deal. Since then, every deal we've done has been well oversubscribed for both NAB and other issuers."

He says for such a small market, Australia is actually quite progressive and "in my experience, having met with investors in Asia, the US and Europe, Australia is probably second only to Europe and the UK in the ESG investment space". Yet in Europe, the EU has taken a really proactive approach in the space while here, we don't have any strong policy drivers from government to incentivise corporates to act.

Despite this lack of policy certainty from government, we're doing quite well and it's purely investor and issuer-led.

A case in point is Sydney Airport, which last year successfully refinanced $1.4 billion of bank debt facilities by way of a multi-tranche 3-, 4- and 5-year tenor syndicated sustainability linked loan (SLL).

Under the loan, margins decrease or increase depending on Sydney Airport's sustainability performance over time, as assessed by an independent third-party Sustainalytics – a specialised investment research and ratings provider dedicated to ESG.

Following the success of the SLL, the airport success issued a $600 million multi-tranche 15-, 20- and 30-year tenor US private placement bond.

The SLB (sustainability-linked bond) included a $100-million 20-year sustainability-linked tranche. Under the bond, the sustainability-linked tranche coupon decreases or increases depending on Sydney Airport's sustainability performance over time as assessed by Sustainalytics.

According to Sydney Airport group treasurer Michael Momdjian, the airport was the first to report on sustainability over five years ago.

The airport's SLL represented the first syndicated SLL in Australia and the largest across the Asia Pacific, while the SLB represented the first SLB issued in the US private placement bond market and first SLB with two-way pricing issued across all bond markets globally.

For Sydney Airport, the SLLs and SLBs provide funding certainty and incentivise improvements in sustainability across all operations because they ascribe financial value to sustainability performance.

Momdjian says there is scope to grow sustainability-linked issuance here in Australia as both have been very well received. "Even universities and their students wanted to understand more," he says. AFR

Industry insight

Comment by
David Gall
Group executive, corporate and institutional banking, NAB

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Over recent months, we've all observed the resilience and adaptability of Australians to changing circumstances.

Many business owners have experienced an immediate shock to their economic outlook and more face ongoing uncertainty as the pandemic continues.

Through this hit to confidence, the financial services sector adapted quickly to support Australians over this period.

At the same time, our customers are leading the way in how they are supporting their own employees, with an enduring focus on care and empathy.

We are also seeing a surge in innovation – often out of necessity – as existing business models pivot to new product lines and ways of working.

We will never get a better test of resilience than what we are all collectively facing this year.

And through this, some big questions: where are the further opportunities for innovation? And what do we want Australia to look like when we get to the other side?

Throughout the world, we are witnessing government spending at unprecedented pace. This is for multiple reasons: to shore up confidence, to keep businesses afloat and to mitigate the loss of livelihoods caused by shutdowns.

For businesses and institutions in strong economic positions at the beginning of the crisis, the opportunity will come again where they can invest and grow.

Public and private sectors will each play an important role in investing into our economy to drive recovery, to create new jobs and to supercharge innovation.

The allocation and flow of capital to enable this is critically important.

There are plenty of opportunities for Australia to allocate capital in areas where we have a natural competitive advantage.

For example, we benefit from some of the best wind and solar resources in the world.

We have a proven ability to deliver large infrastructure.

We're a nation of resilient small business entrepreneurs.

And we're also very adaptable. This crisis has proved that.

How we choose to build on these strengths to create sustainable and innovative future opportunities is ahead of us.

It's about making decisions for the long term to future-proof business models, but also to serve customers well and to help communities prosper.

The allocation of today's capital towards sustainable projects is a long-term view.

It is one that benefits generations of Australians for years to come.

There is an important role for NAB here. It begins with our own credentials.

It includes an accelerated $70 billion commitment to environmental finance by 2025, where over $17 billion has already been arranged to support green infrastructure finance, capital markets and asset finance. A further $16 billion is supporting mortgage lending for energy efficient residential housing.

The role deepens when we consider the position we play as capital connectors.

We maintain a strong balance sheet to foster business investment, to improve productivity and enable innovation.

This enables us to be the leading arranger of climate finance in Australia, with over $10 billion to finance renewable power from wind, solar parks and hydro since 2003.

It also means we are uniquely placed to connect ESG focused clients with the right investors who can accelerate their goals.

Clients such as QIC Shopping Centre Fund (QSCF), one of the largest shopping centre landlords in Australia, which issued a $300 million climate bond-certified green bond – the first to be issued by a retail property landlord.

This green bond was well received by investors across Asia and Australia, attracting investors with green and ESG investment mandates who were new to QSCF.

Backing sustainable initiatives with the right capital now will build a more resilient Australia when we get to the other side.

This is just one example; there are many others.

Backing sustainable initiatives with the right capital now will build a more resilient Australia when we get to the other side.

We have all the ingredients to fast-track work in this space.

Looking ahead, the role of banks in using capital for sustainability-driven financial innovation is exciting.

For instance, sustainability-linked loans (SLLs) offer fresh opportunities to innovate.

They are behaviour-based debt and incentivise better environmental and social performance outcomes within the arrangement.

We've already worked with AGL, Sydney Airport and other clients to achieve these outcomes.

Enabling longer-term growth and innovation when we get to the other side of this crisis is a function of thinking sustainably and using capital in a better way.

It is through capital – and great ideas – that will help Australia reach its full potential.

Ultimately, it will also make us less sensitive to shocks.

As a bank, we're committed to doing our part here.

We urge all Australian business owners – from the corner shop to the large institutions – to keep thinking bigger and to keep innovating. AFR

Values matter for the wealthy

Impact investment

Christopher Niesche

Australia's wealthiest families are turning to their legacy and starting to direct some of their holdings' funds to impact investments as a new generation takes over the family office.

Gillian Gordon, head of alternative investments at JB Were, says wealthy families are still primarily focused on performance but also on purpose.

"It links to their requirement for a legacy, to build intergenerational wealth that stands for something and that really aligns to that," Gordon says.

Australia has more than 3000 ultra high net worth individuals with wealth of $45 million or more and this is forecast to grow by 20 per cent over the next five years, according to the *Wealth Report 2019* by Knight Frank.

In the past much of the wealth came from property and operating businesses, and now the ranks of the wealthy also include families with tech businesses and high net worth families who have migrated to Australia.

Many family offices – the wealth management arm of the ultra rich families – spilt their money into two. One part goes to the main family office and another part is put into trust or charitable foundation, which then invests for impact, says Gordon.

However, she adds that even the main family office investments can adopt responsible or ethical investing as well.

Many have already adopted exclusionary or negative screening investment strategies, where they might choose not to invest in fossil fuel producers or gambling assets and some are pushing into social change and impact investing, although Gordon describes this trend as nascent.

In this regard, they have an advantage over large public investment funds, which can often struggle to find social impact investments of sufficient size and scale. Family offices' smaller investment size and comparative nimbleness means they can take advantage of other opportunities denied larger investors.

They can, for instance, put funds into small plays such as renewable energy plays and individual solar farms.

Family offices are also being targeted by niche impact funds, which are too small for institutional investors, but suit the smaller parcel sizes of family investors.

Typically, family offices allocate about one-third of their assets to alternative assets, including infrastructure, venture capital, private equity and private debt. Part of the reason for that is that families are weighting less of their portfolios to lower yield bonds and equities in the current low interest rate environment and seeking better returns from alternative, Gordon says.

Renewable energy sources (top) play a strong role in impact investing. Gillian Gordon and Tim Gardiner.

A consequence of that is that alternative assets lend themselves far more to responsible investing than assets such as fixed income or equities, says Gordon. "One area that I see family offices playing in quite a big way is around disability or affordable housing in Australia," she says.

"It attracts the families because it's of sufficient size and scale but it's also having a real impact in their own backyard."

Social impact bonds, where capital is at risk and more akin to an equity linked investment with returns linked to outcomes, are also proving popular, says Tim Gardiner, a director at NAB Corporate.

In the past, few HNW investors have been willing to put capital into these, but many are willing to go further up the risk curve as more traditional assets aren't providing the sorts of returns they did in the past.

"Social bonds do generate returns and investors need to understand their true impact and how returns are measured," Gardiner says.

"Unlike philanthropy, impact investing also aims to generate a future financial return, to be recouped by the investor, or ploughed back into other worthwhile projects or entities."

Gardiner says impact investing in Australia has increased fourfold in the past three years and is estimated to hit $32 billion by 2022.

Even so, it remains a little-known concept in Australia.

"It's partly about awareness, partly about education, and partly about creating the opportunities in the first place," he says. "Whether it's plastics in the ocean, renewable energy, homelessness, there's always a worthwhile cause out there.

"It's simply a matter of finding investors to help support them while also ensuring people are teamed up with a business, social enterprise or managed impact investment fund that meets their family's objectives."

These approaches are becoming more popular as Generation X and Millennials start to take over family offices.

Where institutional investors often have set parameters, family offices can be more nimble in their investment choices. "Families, patriarchs and matriarchs might be a little bit more flexible in their appetite in terms of scale of an ESG investment and breadth of a variety of ESG investments," he says.

JB Were's Gordon says the next challenge for family offices is to roll out impact investing in a more scalable way.

"Building a framework and the ability to apply it across a family office is actually quite a lot of work," she says. "To access scale and size within responsible investing or even in alternatives, which is usually the asset class of responsible investing, you really do need size and scale." AFR