FLINDERS
Investment Partners

Our Guiding Principles and Approach to ESG

At Flinders, we consider Environmental, Social and Governance (ESG) factors to be at the core of evaluating risk when investing in listed small (ex-top 100) companies, "small caps". The assessment of ESG factors has always been an important part of the Flinders investment process and plays a critical role in stock selection and portfolio construction.

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ESG factors are dynamic and evolving, requiring ongoing assessment. We assess a company's ESG credentials through regular company engagement and research into how a company is dealing with ESG-related risks that are important to minority shareholders and ultimately, our investors. ESG assessment is particularly important in addressing long-term and systemic risks within a company. Understanding these risks is a vital tool in generating long-term returns for our investors.

Our Guiding ESG Principles:

1) **ESG assessment is a vital tool in understanding and addressing long-term corporate risk.**
2) **ESG analysis must be incorporated in the investment process on an ongoing basis.**
3) **Understanding and addressing ESG issues must involve direct company engagement.**
4) **The importance of voting on proposals put forward by a company's board.**
5) **The approach to ESG assessment must be consistent and recorded.**

Our Unique Approach to ESG

In our view, ESG analysis in the small-cap equity market is the evaluation of long-term risk factors that could impact the performance of a company. A corporate that addresses these factors consistently well is likely to have a lower risk profile than one that does not. Assessing that risk will impact how we value a company's equity, and consequently if it is suitable for inclusion in our portfolio.

Analysing and understanding ESG factors in small caps is very different to top-100 companies. For a start, there is less public information available and fewer groups doing external research.

Smaller companies often don't have the resources to produce a glossy annual sustainability report or have proxy advisors examining board structures and remuneration reports. Broker analysis of ESG issues largely relate to larger companies and mid-tier brokers tend to avoid the issues altogether.

In short – in smalls caps the manager must do the research themselves.

The added complexity is that smaller companies are inherently higher risk than large. Which is why understanding ESG issues is fundamentally more important. Smaller events can cause larger problems. Understanding ESG issues must be a core part of any risk assessment of a company. Just as understanding a company's management of costs, margins, marketing, debt and working capital are all vital to their short-term prospects and risk profile, understanding a company's environmental impact, people and culture, industry regulation, board composition and competency are all related to longer term risk and need constant assessment.

How We Assess ESG

The following overview explains how we think about each of the Environmental, Social and Governance factors, their relative importance, and examples of why it is a necessary part of our research process.

1) Environmental

Contrary to common expectations, in our view environmental impact is the least important ESG investment criteria when investing in small caps. Unlike the top 100 companies, there are few primary manufacturing, chemical or operating mining companies (no shortage of explorers) amongst small caps.

The majority of this part of the market are service companies ranging from retail, financial services, technology, health, property and tourism. That is to say, low environmental impact sectors of the economy.

However, there are companies that do require close assessment - resource companies in production in particular. Issues such as waste product disposal, ground contamination and mine rehabilitation are all significant, and compliance on a consistent basis is a minimum. Areas of risk need to be understood and the best way to do that is through discussions with management, site visits and knowing the history and record of a company's compliance. Again, it's not something covered adequately in a sustainability report (most small companies don't have them). It has to be through engagement and background research.

Also in this category comes the issue of carbon emissions and abatement. Ultimately, we seek to understand a company's carbon intensity, the strategy and protocols they have for reduction and the risks to future earnings (if any) from addressing or not addressing their emissions footprint.

The de-carbonisation of economies over the next decades also provides significant opportunity for many companies. Understanding investment opportunities that stem from de-carbonising economies will be just as important as understanding the risks.

The key areas of Flinders' environmental risk assessment are as follows:

- **Environmental regulatory compliance and approach to industry regulations**
- **Communication and transparency on environmental matters**
- **Environmental track record**
- **Carbon emission intensity and relevance**
- **Potential investment opportunities in environmental change**

Environmental issues make up **20%** of our total ESG Assessment Score.

2) Social

The social aspect of ESG can get confusing but need not be. The way we look at 'social' is the behaviour, and the impact of that behaviour, of a company on its broader operating environment. By that we mean everything from its customers, suppliers, employees, contractors, landlords, tenants plus many others; but most importantly with the regulatory landscape in which a company operates.

Ultimately, regulators exist to provide an operating environment in which businesses have to adhere to a set of rules that protect stakeholders (those that may be impacted by a company) from poor corporate behaviour. Well known bodies such as the ACCC, ASIC, APRA, various Ombudsman and any number of Government departments provide a regulatory framework for companies to operate within. Step out of line and there are usually consequences and consequences with a regulator equals risk.

A good example is the large number of smaller listed companies that rely on Government (Federal, State or Local) for a significant proportion of their revenue. They may be involved in healthcare, education or aged care - all socially (and politically) sensitive sectors. We've seen poor behaviour in all of the above at various times and it has led to stricter regulation, licences being pulled, and even Royal Commissions. This can even impact companies complying with regulation. So, understanding those industries, spotting unsustainable profitability or companies working against (rather than with) the spirit of the regulation are reasons for concern – and engagement with management, competitors and industry bodies helps evaluate those risks.

Corporate governance overlaps with social. A well-run company that provides a good professional work environment is likely to have more consistent regulatory compliance. When staff are well trained and incentivised, they will be more responsive to how they deal with customers, peers and others they deal with. These are often the hardest aspects to evaluate by an investor but it's often easier to get an insight with a small company than a top 100 company with public relations and investor relations departments controlling information to shareholders.

We also don't underestimate the potential negative impact of social media on a company if there is poor corporate behaviour (no matter how serious). Deterioration of a corporate image can have a rapid and significant impact on any company, but it is amplified in smaller ones. Another reason companies must address the potential risks associated with its social responsibilities.

The emphasis is again on assessing things that could go wrong. Social considerations are about a company's interaction with its human surroundings and most of us have worked for companies that do it well and ones that don't.

The key areas of Flinders' social risk assessment are as follows:

- **Regulatory compliance history**
- **Safety record**
- **Staff engagement surveys, staff turnover and customer net promoter scores (NPS)**
- **Product sourcing transparency (addressing modern slavery and human rights issues)**
- **Community involvement**

Evaluating the social aspects of a company makes up **30%** of our ESG scoring.

3) Governance

At Flinders, our highest ESG weighting when we assess companies is governance. That's because in our experience, poor governance poses the highest risk to longer term performance of small companies. A company's governance also has clear implications for environmental and social issues. When we assess a company on an ESG basis, governance has a 50% weight.

The term governance covers a broad field. Simplistically, it refers to the board of directors and how they govern the strategy and management of a company on behalf of its shareholders. However in reality it involves much more. Assembling the right management team, compliance, legal, audit, culture, systems, strategy, human resources and use of shareholder funds are just some of the important aspects of governance.

Small companies must be looked at differently (and more closely) in this regard. Sadly, there is no simple or consistent way of assessing smaller companies like there can be for large ones. The key reason is the evolution of a company from when it is first listed and then how (and if) it grows and matures as a listed company.

When companies first list, it is either to access growth capital or to provide a sales mechanism for existing shareholders to divest some or part of their holding – or a combination of both. Consequently, it is not unusual to have board and management with significant or controlling holdings in smaller companies (and occasionally in large ones).

From one angle, that looks like alignment of interest with minority shareholders. From another angle, risk that minorities get a nasty surprise from an event not in their interest. That's where an assessment of the board and their relationship with the management team is vital.

Independent directors that are truly independent are essential for the protection of all shareholders. In fact, it is a legal requirement. Sadly, not always properly adhered to. Independence is one thing, but non-executive directors (NEDs) also need to bring skills that will help the company develop and carry out its strategy and importantly, make sure that their management team adhere to the strategy to the best of their ability.

As a fund manager, it is our job to assess if those skills exist, if the NEDs have the voice to be independent when needed and to understand what is expected of both board and management by shareholders.

We look for companies that communicate their strategy and have consistency in adhering to it. If there are changes (and there naturally are), why and what are the expected outcomes. We respect companies that can also articulate and put in honest context bad news. Consistent, transparent and clear financial accounts are very important, as is a company's history of capital management – especially their use of working capital, which is ultimately the shareholder funds we are looking for a return on.

We watch senior staff turnover closely as well as CEO and board tenure. Succession planning at both board and management level is also important. And then for smaller companies, their corporate evolution as they grow. How they deal with their capital structure, increased stakeholders, the greater demands and responsibilities of both management and board have to be monitored because when things go wrong in small companies, they tend to go seriously wrong.

There is no simple approach, it's about engaging with the companies, understanding their history, and keeping close to the way they currently go about their business. Governance is largely a subjective assessment, one that will always be based on risk.

The key areas of Flinders' Governance assessment are as follows:

- **Board composition – mix of skills and experience**
- **Board composition – executive and non-executive**
- **Consistency of strategy and management execution of that strategy**
- **Alignment of board, management and shareholders**
- **Remuneration and incentive structure of management**
- **Communication with shareholders**

Evaluating the governance aspects of a company makes up **50%** of our ESG Assessment Score.

Our ESG Scoring Framework

Our ESG analysis is integrated in our company valuation process and portfolio construction. Each of the ESG factors are scored out of 5 and weighted according to the importance level of the factor (E = 20%, S = 30% and G = 50%).

Higher scores reflect a company with lower long-term non-financial risk and conversely a low score reflects higher risk.

This score is integrated in a company's valuation – either through a target earnings multiple, discount rate or growth potential. By impacting the valuation, the process is dynamic and will lead to higher aggregate weightings for companies that score well on their ESG assessment.

No company can be added to the portfolio with any factor score below 2.5 or a total weighted score of less than 3. If a company in the portfolio has its ESG assessment score lowered to those thresholds it will be sold. There would be active engagement with a company during this process.

Risk mitigation is a core discipline when investing in a volatile asset class such as small companies. Having an ESG evaluation framework to assess long-term risk is a vital part of our investment approach.

Conclusion

ESG assessment is a key part of the Flinders investment process and always has been. It is about assessing long-term risks and opportunities and the better we can understand the risk or opportunity, the better result we can achieve for our investors.