ESG

Navigating Sustainability on the Investment Landscape

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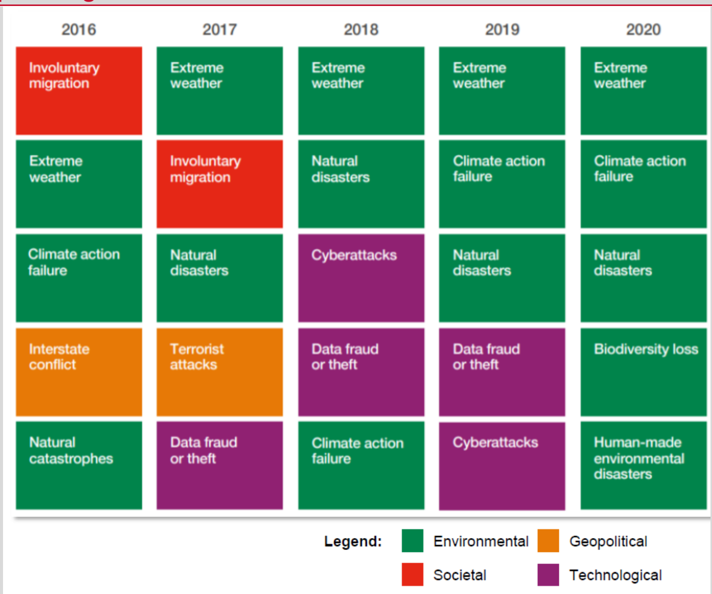
Last week, we organised a half-day ESG webinar led by PWC's Sustainability Team to better understand the impact and value of sustainability in the investment landscape. Projections data up till 2050 suggest the risk of flooding in coastal areas which could be harmful to a multitude of industries (utilities, ports, industrial facilities, housing and development projects located by the coast) as well as plantation companies, with rising temperatures brought about by climate change if no action is taken immediately. As such, we advocate government-business collaborations to avert these risks for national well-being. We also favour companies that are making efforts to incorporate Integrated Reporting (IR) which provides a deeper understanding of business processes and is crucial in determining the value of sustainable initiatives. Advanced IR would include the triple bottom line methodology which measures net profits to include the impact on people, profit and planet, thus giving ESG a dollar value today. All in, we favour companies that are making strides in IR for now, and look forward to a sustainably focussed Budget 2021 next month as indicated by our Prime Minister. Our Preferred Picks are DIGI, SIMEPROP, DIALOG, ASTRO, TM, RHBBANK, AMBANK, MISC, KLCC given their efforts in IR and commitment to long term sustainability, while fundamentals warrant an OUTPERFORM call at current levels.

"Yes, the planet got destroyed. But for a beautiful moment in time we created a lot of value for shareholders."

Last week, we organised a half-day ESG webinar led by PWC's Sustainability Team; Andrew WK Chan (Sustainability & Climate Change Leader, South East Asia), Redha Shukor (Operations and Sustainability Leader, Malaysia) and Xing Juen Goh (Sustainability and Strategy, South East Asia). *The webinar provided attendees with a thorough understanding of ESG or sustainable investing and its motivations, its impact on businesses, local and global responses taken, the value of ESG to a business, and sustainability data and disclosures. We have highlighted some of these points in our previous ESG report (dated 24th December 2019 "A Growing Tide of Responsible Investors"), but salient topics that piqued our interest were, the potential impact of climate change on Malaysian industries, and how sustainability impacts value in a business. Below are our key highlights.*

World Economic Forum - Top 5 Long Term Risks in terms of Likelihood

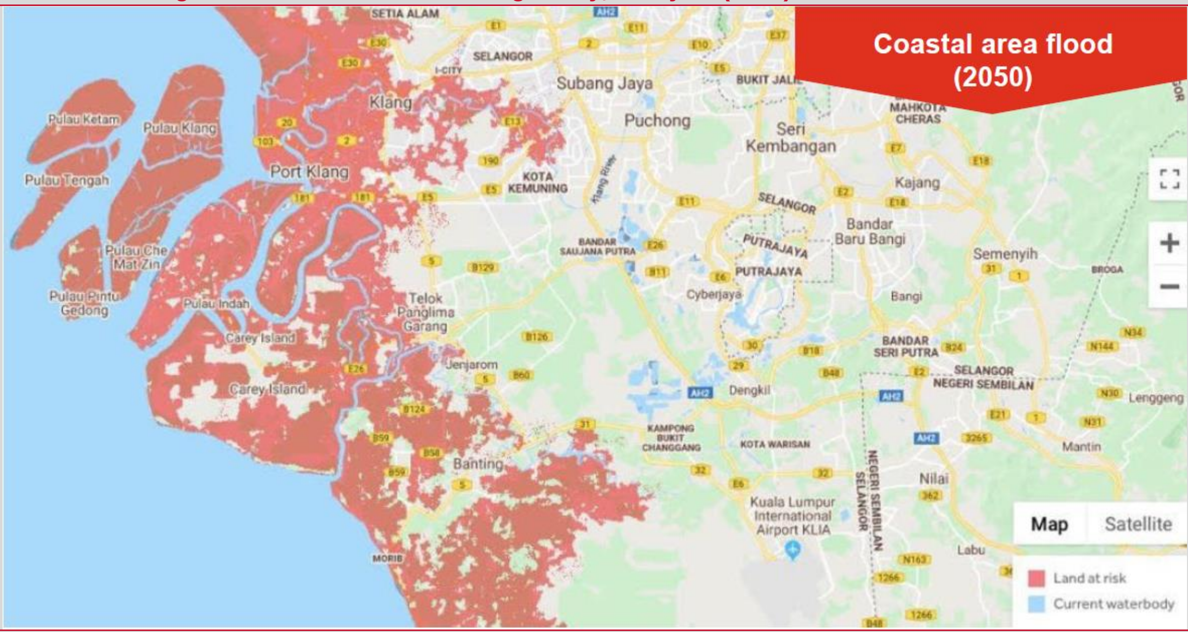


Source: World Economic Forum 2007-2020, Global Risks Reports, PWC

Environmental risk a dominant cause for concern. Over the past five years, the World Economic Forum's members have highlighted increasing environmental risk as their main concern. In 2020, it appears that environmental concerns dominate the top five risks which include: (i) extreme weather, (ii) climate action failure, (iii) natural disasters, (iv) biodiversity loss, and (v) human-made environmental disasters, which can all be linked to climate change. A projection by Climate Change (*an independent organization of scientists and journalists researching and reporting the facts about changing climate and its impact on the public*) below shows the areas prone to flooding in Peninsular Malaysia by 2050. This intensifies the concern for action to mitigate the impact of climate change which apart from displacing communities and cities would also result in stranded assets and depreciating values.

** Areas lower than the selected water level and with an unobstructed path to the ocean are shaded red.*

Effects of climate change on the environment – Klang Valley, Malaysia (2050)



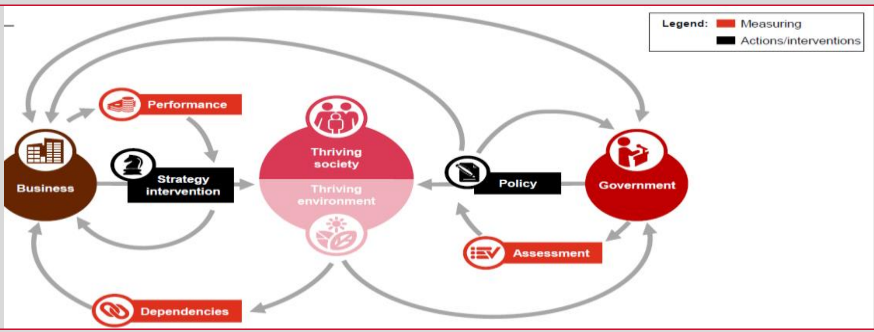
Source: Climate Central, Impact Assessment Studies & Regional Climate Change Scenarios Data Requirements in Malaysia, PWC

Climate change expected to affect a multitude of sectors in the Malaysian economy which may include the utility sector, ports, industrial factories and housing and development projects located by the coast, as well as plantation companies. Utility companies that have assets located in coastal areas could have to contend with stranded assets as water levels rise. This may result in the useful life of such assets decreasing significantly and affect their ROI and entity valuations going forward. Plantation companies are also at the mercy of mother nature due to rising temperatures or changes in rainfall patterns. Should temperature increase by two degree Celsius above optimum levels, and rainfall decrease by 10%, oil palm yield could decrease by approximately 30%. Additionally, rising temperatures also affect society with the projected increase of 1.5 degree Celsius in ambient temperature potentially increasing malaria cases by 15%.

Strong government-business collaboration required to fix the impact of climate change. Long-term solutions are required the reverse the detrimental impact of climate change to the Malaysian economy as no single company/business can take up this monstrous task. When it comes to fixing the problem, we advocate engagement between companies and policy makers to make any meaningful sustainability efforts.

Additionally, not all companies are on a level playing field due to their size and reach. As such, sound government policy is required to help smaller companies as they may not be able to meet sustainability standards. For instance, for a plantation company, resources required to be RSPO certified are too cost prohibitive relative to sales value, and as such smaller companies selling to Asia cannot expand into Europe easily and may indulge in practices that are detrimental to society and the environment in order to save cost.

The "Interconnected Business in Context" Model



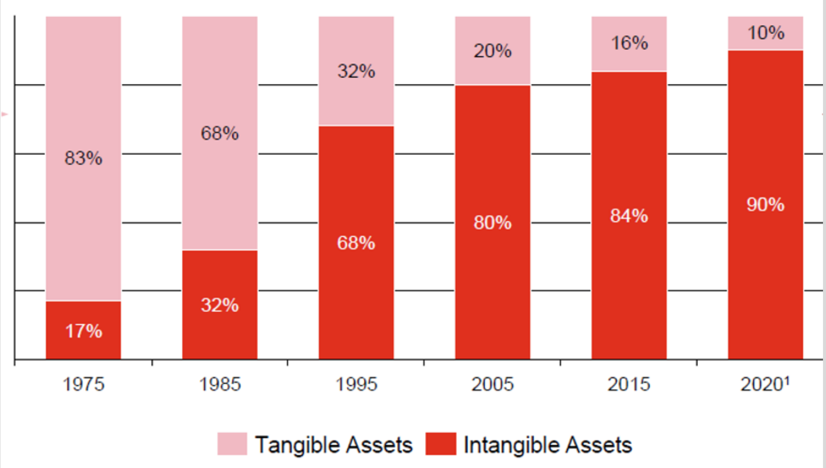
Source: PwC —"Business Through a New, PWC

THE VALUE OF SUSTAINABILITY

Market value relies heavily on intangible assets, which is mostly affected by sustainability driven agendas... Research by Ocean Tomo LLC on S&P 500 companies over the years showed a staggering shift in the market value of a company which was predominantly driven by tangible assets in 1975 (83%) vs. 2020 whereby **intangible assets currently make up 90% of a company's market value**. Most of the intangible value apart from Brand Value, resides in ESG component metrics such as; (i) reputation, (ii) R&D pipelines, (iii) customer satisfaction, (iv) health & safety, (v) environmental performance, (vi) social license to operate, (vii) governance, and (viii) employee engagement.

…but capturing intangible value may be cumbersome with the overwhelming number of inputs, and underwhelming standardisation in reporting metrics within and across sectors to make meaningful comparisons. As a result**, analysts and investors still struggle to value a company fairly or systematically based on the qualitative or intangible nature of ESG component metrics.** Even though most of market value is made up of intangibles (c.90%), annual reports contain disproportionately more financial data than non-financial data. It is advisable for investors to scrutinise sustainability statements, and get management to provide key data that might be missing.

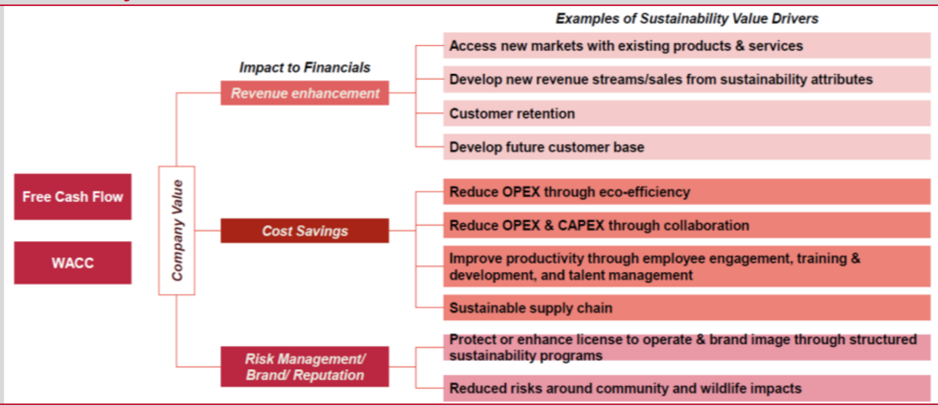
Components of S&P 500 Market Value



Source: Ocean Tomo , LLC Intangible Asset Market Value Study, 2020
Note: 1) Interim study update as of 7/1/2020

The impact of sustainability initiatives on company value can be summarised in 3 phases; ***(i) risk aversion, (ii) cost savings, and (iii) revenue enhancement***. Risk aversion would be Phase 1 and most companies would have risk management teams to mitigate foreseeable issues. For example, the failure of proper risk management was in the case of BP with the Deepwater Horizon oil spill where the company spilt an estimated 4.9mn barrels of oil, lost 51% of market value in 40 days, and had to pay fines of c.USD19b and clean-up costs of c.USD65b. Phase 2 is the cost saving method and most Malaysian companies tend to focus on this currently. This includes retrofitting of chiller systems in buildings and plants to reduce the cost of energy consumption. Phase 3 would be enhancing revenue streams by providing new sustainable products or services, for example, building sustainable eco-friendly buildings, or selling renewable energy to customers.

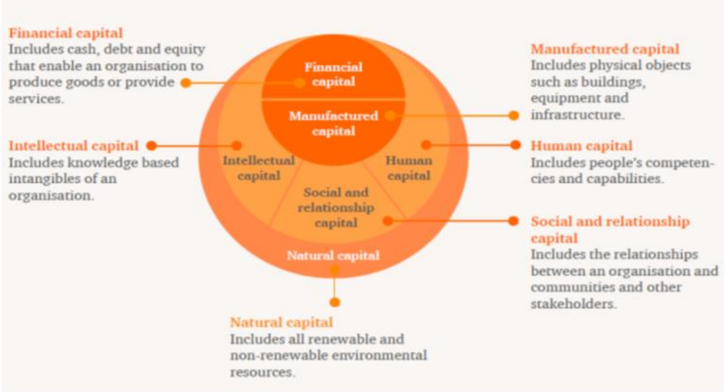
Value Impact of Sustainability Initiatives



Source: PWC Analysis

Integrated reporting (IR) provides a proper understanding of business processes and is crucial in determining the value of sustainable initiatives. IR is best suited for finance providers, highlighting efforts related to a company's business model that generate value that goes beyond just tangible assets. IR looks at value add through the lens of 6 capitals (as labelled in the Table below, *6 Capitals of Integrated Reporting).* IR provides investors with a deeper understanding of the cause and effect of sustainability initiatives, but it is also paramount that investors know what data to ask for to understand what creates or diminishes value for a company. We believe that it is important for a company to explicitly highlight and document its sustainability/ESG strides to avoid its intangible value from going unnoticed.

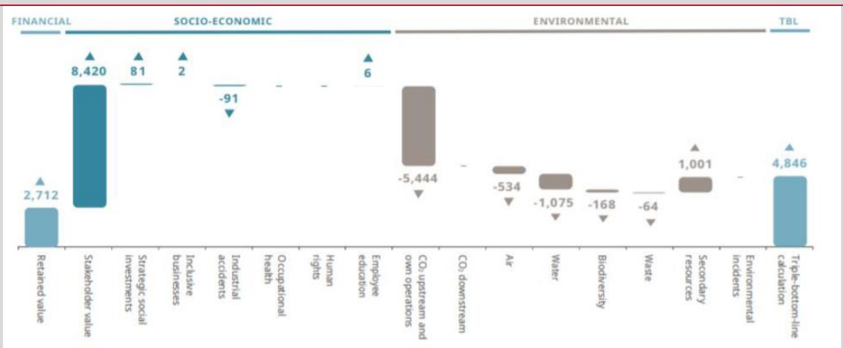
6 Capitals of Integrated Reporting <IR>



Source: Integrated Reporting – 6 Capitals, PWC

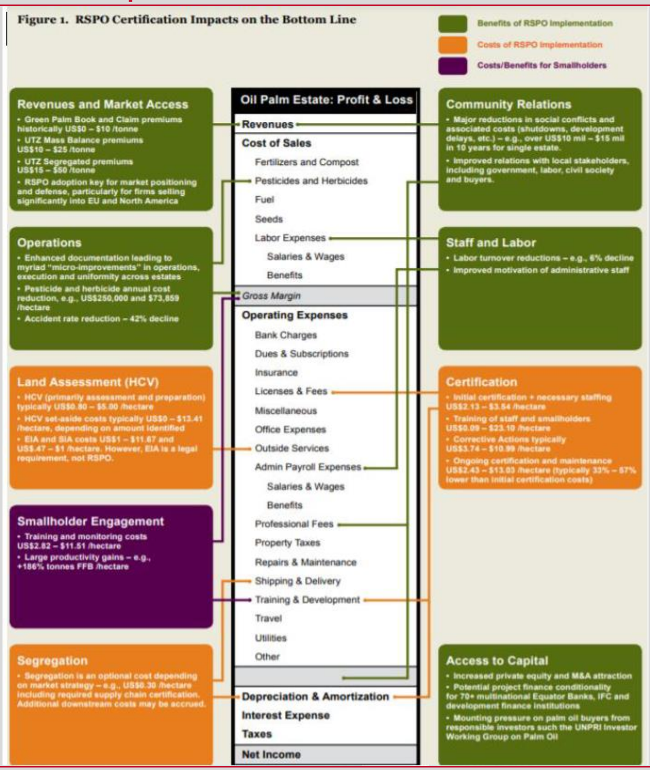
Quantifying the true value of sustainability. The triple bottom line is an alternative measure of net profit that includes the impact on people, profit and planet to the standard net profit calculation (refer to Table below *Triple Bottom Line*). An alternative would be quantifying the sum value of ESG efforts to derive an adjusted shareholder value (refer to the example below *Example: Adjustment to shareholder value*), but this is reliant on advanced Integrated Reporting (IR). We note that complex analysis uses dollar quantification methods but this option is not widely available yet.

Triple Bottom Line



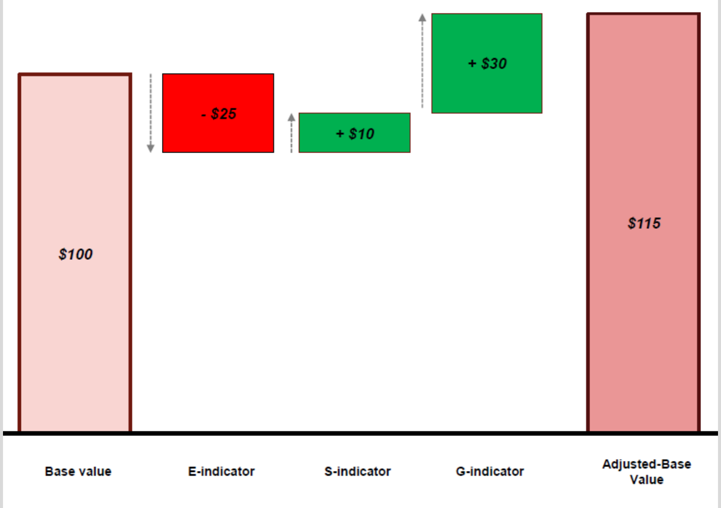
Source: LafargeHolcim Sustainability Report 2019

Triple Bottom Line - RSPO Certification Impacts on the Bottom Line



Source: RSPO

Example: Adjustment to shareholder value



Source: PWC Analysis

Alternatively, **investors and analyst can utilise sustainability indices and ratings to determine ESG contributions.** However, when it comes to assigning an ESG score for company, data gaps include; (i) lack of transparency on how data used, (ii) each provider has a different ESG rating len, and (iii) lack of coverage on Asia Pacific and SEA companies.

What do you do when you don't have the data? Without explicit company guidance of the dollar value of its ESG efforts, most investors and analysts are left to their own subjectivity which is not favorable when valuing a company as this could cause huge discrepancies in valuations depending on their ESG lens. However, as a short-term stop gap solution, there are some non-exhaustive ways to embed sustainability initiatives in financial valuations, provided some guidance is obtained from management.

Embedding sustainability initiatives in financial valuations

Financial Forecasting	• Future cash flows: Sales to reflect ESG opportunities or risks • Operating margins: Affected by ESG risks
Valuations	• Terminal value: Reflect long-term business continuity and potential business opportunities • Beta and discount rates: Run peer analysis of companies using ESG factors • Scenario Analysis: ESG-integrated valuation vs baseline valuation
Equity risk	• Profitability and dividend growth: Competitive advantages driven by sustainability factors[1] • Potential downsides and tail risk: Company's risk control, compliance standards and governance

Sources: CFA, Harvard Business Review, ValueScope , UNPRI, PWC

All in, **high quality ESG data is essential to accurately measure and track ESG performance**. The first step is to: (i) generate industry specific insights which can only be done if the analyst/investor knows the business operations thoroughly, (ii) enable effective investment analysis, and (iii) allow linkage between financial results and ESG performance. That is why the investors' role is crucial as investors have the ability to influence management goals, direction and performance seeing how companies rely heavily on stakeholder concerns regarding material matters. With **investors, financial institutions and asset managers becoming more sustainability aware, they will need to raise the right questions and concerns to management to be addressed in sustainability reporting.** The main goal when it comes to obtaining high quality ESG/sustainability data is that it would have to be: (i) accurate, (ii) comparable and consistent across the sector, and (iii) externally assured.

CONCLUSION

Companies should look beyond pure financials, and focus more on outcome-based goals which require long-term foresight. When companies are only focussed on pure financials (i.e. net profit, balance sheet and cash flow), they may fail to see the long-term benefits of sustainable initiatives. The drawback to sustainable initiatives today is the additional cost incurred (ex: R&D, transition cost, employment of new capital and expertise). Even though these efforts may avert risk, provide economies of scale or generate new revenue streams in the future, the crux of the matter is that **most companies are short-term driven while sustainability/ESG goals require more long-term foresight**. That is why we believe triple bottom line calculations may be extremely beneficial in rewarding ESG efforts today. The triple bottom line methodology speaks the same finance language as the investment community and puts the dollar and cents value in clear context.

Integrated reporting is the first step. The integrated report is a preliminary report for all stakeholders to better understand a company's view on its value creation story**.** As such, we believe the adoption of integrated reporting is crucial in determining value from sustainability efforts or the lack of. For now, we understand that IR reporting is at its early years with IIRC reporting only 28 Malaysian companies having used IR thus far, while expectations of calculations of triple bottom line of a business is still premature. In conclusion, for now, we would favour companies that are gearing towards IR in the near term as it is a testament to their commitment towards embedding sustainability into organisational goals.

Our Preferred Picks are DIGI (OP; TP:RM4.25), **SIMEPROP** (OP; TP:RM0.700), **DIALOG** (OP; TP:RM3.80), **ASTRO** (OP; TP; RM0.830), **TM** (OP; TP:RM4.95), **RHBBANK** (OP; TP:RM5.75), **AMBANK** (OP; TP:RM3.60), **MISC** (OP; TP: RM8.90), and **KLCC** (OP; TP: RM8.55) given their efforts in Integrated Reporting (IR) and commitment to long term sustainability, while fundamentals warrant an OUTPERFORM call at current levels.

Lastly, since we advocate strong government and business collaboration to fix longer term ESG issues, we are **looking forward to a sustainability focussed Budget 2021 to be heard** in Parliament on 6th November 2020. In light of the Covid-19 pandemic and increased concerns of climate change, the Prime Minister recently announced that the green recovery approach is meant to drive the nation towards a low carbon and climate resilience pathway whilst spurring the economy and social wellbeing.

We also take comfort in the fact that regulators are also serious on climate change with BNM, SC and Bursa Malaysia having expressed Task Force on Climate Related Financial Disclosures (TCFD) TCFD commitments while both the SC and BNM have already formed the Joint Committee on Climate Change (JC3) in September 2019 to push for climate resilience within the Malaysian financial sector to help it transition towards a low-carbon economy.

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Stock Ratings are defined as follows:

Stock Recommendations

OUTPERFORM	: A particular stock's Expected Total Return is MORE than 10%
MARKET PERFORM	: A particular stock's Expected Total Return is WITHIN the range of -5% to 10%
UNDERPERFORM	: A particular stock's Expected Total Return is LESS than -5%

Sector Recommendations***

OVERWEIGHT	: A particular sector's Expected Total Return is MORE than 10%
NEUTRAL	: A particular sector's Expected Total Return is WITHIN the range of -5% to 10%
UNDERWEIGHT	: A particular sector's Expected Total Return is LESS than -5%

******Sector recommendations are defined based on market capitalisation weighted average expected total return for stocks under our coverage.***

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