WaveStone CAPITAL

# WaveStone ESG Report
# Quarter ending June 2024

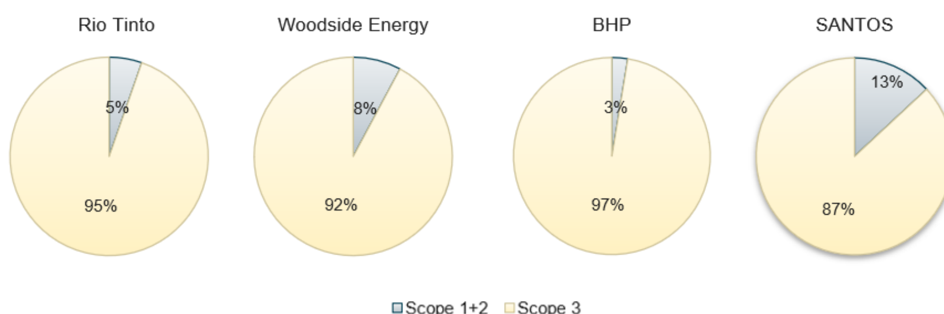
## ESG Quarterly: Scope 3 – The Elephant in Our Portfolios

WaveStone's investment process attempts to identify companies that have a Sustainable Competitive Advantage (SCA). A company that has a high SCA score, we believe, will deliver better long term returns for investors. At the core, we believe that sustainable business practices are a key determinant of long-term profitability. Companies that are able to understand and actively manage sustainability considerations are likely to create a competitive advantage.[1] This guiding philosophy and investment process underpins our scope 3 research and engagement, and in our view is critical to meaningful progress towards a net zero economy.

**Importance of scope 3**

Despite being indirect, scope 3[2] emissions often constitute the largest portion of a company's total carbon footprint. Carbon Disclosure Project (CDP) estimates that scope 3 emissions account for an average of three-quarters of a company's total emissions. Climateworks 2022 net zero momentum tracker report stated that *"Based on company reporting, scope 3 emissions represent 60% of the total ASX200 reported scope 1, 2 and 3 emissions.[3]"*

For some of the largest ASX emitters, scope 3 is over 80% of their total emissions.




Source: Company reports

With most of our asset owner clients committed to net zero, the intent of real economy decarbonisation & the principle of universal ownership calls for a close consideration of scope 3 emissions. Studies show that addressing the entire carbon footprint of a company's value chain is essential to achieving concrete progress towards real economy decarbonisation, and yet this is not a widespread practice. Scope 3 has been described as the most relevant and least measured category[4].

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[1] WaveStone ESG Policy; https://www.wavestonecapital.com.au/wp-content/uploads/2023/06/WaveStone-ESG-Policy.pdf

[2] Scope 3 emissions are the result of activities from assets not owned or controlled by the reporting organisation, but that the organisation indirectly affects in its value chain.

[3] The total ASX200 reported scope 1, 2 and 3 emissions is a simple sum of their reported emissions. CWC_NZMT_How-does-the-ASX-stack-up_December-2022.pdf (climateworkscentre.org)

[4] Economist Impact, "No business decarbonisation without supply-chain buy-in"; No business decarbonisation without supply-chain buy-in (economist.com)

**Scope 3 requirements across key climate reporting standards**

More and more regulators, investors, consumers are seeking information about companies' scope 3 emissions. The data is key to understanding how resilient are companies' supply chains to climate related risks.

Disclosure by ASX companies on scope 3 has increased in recent years with several companies also setting scope 3 reduction targets[5]. Whilst this is positive, we believe that the complexity of resolving the scope 3 challenge would deservedly be aided by impending clarity on scope 3 disclosure within mandatory climate disclosure obligations across key jurisdictions.

Below are some key standards and policies that lend (or in time would lend) to the scope 3 reporting landscape:

### Australian draft mandatory climate related financial disclosures

Australia released draft legislation earlier this year which would introduce climate-related reporting requirements for large and medium sized companies, including disclosures on climate-related risks and opportunities, and on greenhouse gas emissions across the value chain. Australian climate reporting regime draft proposes reporting entities to report on scope 3 emissions from their second year of reporting.

### EU CSRD

Europe has enacted the Corporate Sustainability Reporting Directive (CSRD) that phases in scope 3 disclosures over the coming years for companies that meet certain criteria.

### GHG Protocol

In our view, the GHG Protocol Corporate Value Chain (scope 3) Standard[6] serves as the current best practice for scope 3 disclosure for companies.

It defines 15 categories of scope 3 emissions across upstream and downstream activities as below:

| **Upstream scope 3:** indirect GHG emissions related to purchased or acquired goods and services | **Downstream scope 3**: indirect GHG emissions related to sold goods and services. |
|---|---|
| Category 1: Purchased goods and service | Category 9: Downstream transport and distribution |
| Category 2: Capital goods | Category 10: Processing of sold product |
| Category 3: Fuel- and energy-related activities (not included in scope 1 or scope 2) | Category 11: Use of sold product |
| Category 4: Upstream transportation and distribution | Category 12: End-of-life treatment of sold products |
| Category 5: Waste generated in operations | Category 13: Downstream leased assets |
| Category 6: Business travel | Category 14: Franchises |
| Category 7: Employee commuting | Category 15: Investments |
| Category 8: Upstream leased asset | |

### Carbon Disclosure Project (CDP)

CDP strongly encourages companies to disclose their supply chain emissions, and provides guidance on scope 3 relevance per sector.

[5] ACSI, Promises-Pathways-Performance-Climate-reporting-in-the-ASX200-August-2023.pdf (acsi.org.au)
[6] Corporate Value Chain (Scope 3) Standard | GHG Protocol

### Task Force on Climate Related Financial Disclosures (TCFD)

The Task Force strongly encourages[7] all organizations to disclose scope 3 GHG emissions. While the Task Force recognizes the data and methodological challenges associated with calculating scope 3 GHG emissions, it believes such emissions are an important metric reflecting an organization's exposure to climate-related risks and opportunities.

### Science Based Targets Initiative (SBTi)[8]

SBTi's three key requirements in regards scope 3 are as follows:

- If a company's relevant scope 3 emissions are 40% or more of total scope 1, 2, and 3 emissions, they must be included in near-term science-based targets.
- All companies involved in the sale or distribution of natural gas and/or other fossil fuels must set separate scope 3 targets for the use of sold products, irrespective of the share of these emissions compared to total scope 1, 2, and 3 emissions of the company.
- All companies must include emissions from all relevant scope 3 categories in long-term science-based targets.

## WaveStone Scope 3 Assessment Framework

In line with WaveStone's investment process, ESG considerations such as scope 3 form part of the fundamental research process. We acknowledge that sustainable business practices will be a key determinant of long-term profitability, with companies that are able to understand and actively manage sustainability considerations likely to achieve a competitive advantage. We see environmental issues as not only a potential investment constraint but also an opportunity, with many companies set to benefit from the push towards decarbonisation.

As investors it is imperative, we take stock of our portfolio scope 3 footprint and engage with companies as key to our fiduciary role to protect and grow capital.

By initiating our research & engagement on scope 3 emissions, we aim to:

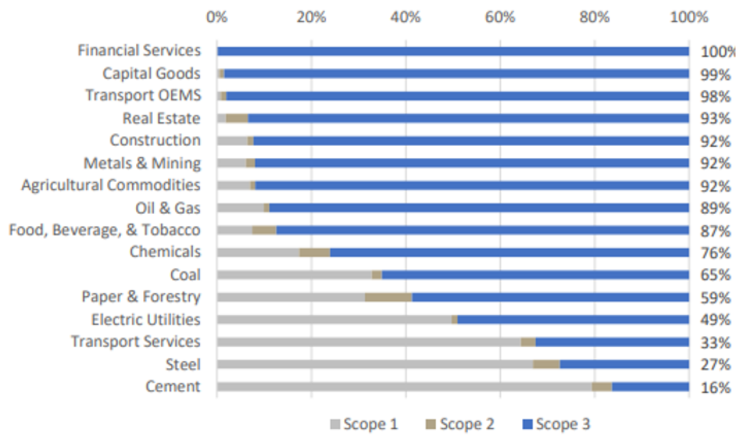
- Understand the complete emissions profile of an investee company
- Clearly identify the emissions hotspots that may be financially material within our portfolio companies' supply chains
- Engage with companies' regarding their supply chain resiliency
- Is the company applying an internal carbon price in its decision making to reduce its scope 3?
- Support companies seeking investor feedback on climate disclosure reporting, climate related metrics within executive remuneration etc. along their journey
- Where needed, set expectations for companies to manage & mitigate material risks from their scope 3 using relevant business levers. Example could be (i) collaborate or switch with suppliers for low-emission alternatives; (ii) modify design of products so that they are more energy efficient; (iii) diversify away from fossil fuel revenue reliance.

Much of scope 3 consideration in our view is company specific and blends within our fundamental investment research, as every company's supply chain from upstream sourcing to downstream customers would look different.

Further, even if we were to notice the output variations of scope 3 vs scope 1&2 at a sector level, there are interesting takeaways for investors aiming real economy decarbonisation. For example, Financials may be classified as low-carbon when looking at scope 1&2 emissions only, but with scope 3 inclusions, their carbon footprint becomes more exposed. Likewise, for the Oil & Gas Sector the high scope 1&2 emissions are further compounded by adding scope 3 emissions which are more than 80% of the sector's total GHG emissions for most companies.

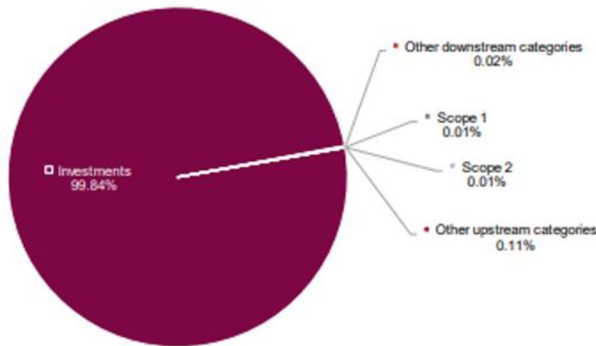
[7] 2021-TCFD-Implementing_Guidance.pdf (bbhub.io)
[8] https://sciencebasedtargets.org/resources/files/Net-Zero-Standard.pdf

**Chart 1: Contribution of Scope 3 Emissions to Total GHG Emissions by Sector**



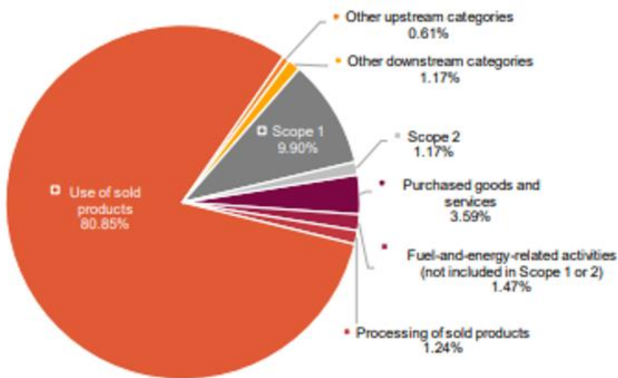

Source: CDP

**Chart 2: Scope 3 Categories as % Total Scope 1+2+3 Emissions – Financial Services Sector**




Source: CDP

**Chart 3: Scope 3 Categories as % Total Scope 1+2+3 Emissions – Oil & Gas Sector**




Source: CDP

**Materiality of scope 3 to expected risk/return profile**

Scope 3 emissions can pose both risks and opportunities to a company's business model. How this translates to financial materiality is varied across each business.

For instance, companies with large downstream emissions footprints – future emissions that are generated when customers use the companies' products, such as an aircraft manufacturer or a fossil fuel producer – may come under pressure from regulators or face obsolescence risk from the introduction of low carbon alternatives.

Where companies rely on carbon-intensive inputs, such as consumer electronics or food and beverage they may face significant future cost inflation or pressure from customers to decarbonise their supply chains.

The below table highlights well the types of risks and opportunities relating to a company's scope 3 emissions:

| SCOPE 3 EMISSIONS | |
|---|---|
| **Types of Risk** | **Types of Opportunity** |
| **Regulatory:** emissions reduction laws or regulation introduced where the company, its suppliers, or its customers operate | **Efficiency and cost saving:** efforts to reduce scope 3 emissions can correspond to decreased costs and increase in companies' operational efficiency |
| **Supply chain costs and reliability:** suppliers passing higher energy or emission related costs to customers; supply chain business interruption risk | **Drive innovation:** a comprehensive approach to lowering value chain emissions can provide new incentives for innovation in supply chain management and product design |
| **Product and technology:** decreased demand for products with relatively high GHG emissions; increased demand for competitors' products with lower emissions | **Increase sales and customer loyalty:** low emissions goods and services are increasingly more valuable to consumers, and demand will continue to grow for new products that demonstrably reduce emissions throughout the value chain |
| **Litigation:** GHG related lawsuits directed at the company or an entity in the value chain | **Improve stakeholder relations:** improve stakeholder relationships through proactive disclosure and demonstration of environmental stewardship. |
| **Reputation:** Consumer backlash, stakeholder backlash, or negative media coverage about a company, its activities, or entities in the value chain based on GHG management practices, emissions in the value chain etc. | **Company differentiation:** external parties are increasingly interested in documented emissions reductions. A scope 3 inventory is a best practice that can differentiate companies in an increasingly environmentally conscious marketplace. |

**Scope 3 risks and opportunity case example: Wesfarmers (ASX: WES)**
Scope 3 related business risks and opportunities can be gleaned from the following WES disclosure:

| RISKS | MITIGATION & OPPORTUNITIES |
|---|---|
| "For the Kmart Group, synthetic fabrics and chemicals used to produce certain textiles for clothing and accessories may become more expensive as the cost of polymers and other inputs, including energy increased." | "Actively investigate circular economy inputs and greener choices. As the cost of one input increases, other options will become viable." |
| "For Bunnings and Officeworks, timber and pulp shortages may occur because supply decreases as plantations are used to instead generate carbon offsets or logging is reduced to slow land degradation." | "Continue to assess tree species that require less water and are more resilient to extreme heat. Support the transition to more circular products." |
| "For WesCEF, demand for natural gas may fall as consumers favour renewables and hydrogen." | "In the shorter term, the use of natural gas as a transition fuel is an opportunity. In the longer term, investing in R&D for alternate energy sources and technologies, including green ammonia, is a priority to capitalise on expanding markets as they develop." |

Source: WES Sustainability Report

WES Scope 3 summary

WES scope 3 emissions are approximately 97% of their total reported GHG emissions (scope 1+2+3). Bunnings and Kmart Group are the largest contributors accounting for 65.2% of WES Group's scope 3 emissions. Purchased goods and services (category 1) & Use of sold products (category 11) make up more than 80% of their scope 3 emissions.

**Scope 3 challenge and decarbonisation business levers**
In this section, we shed light on scope 3 challenge for companies as well as case examples on decarbonisation levers that companies are using as part of their scope 3 reduction targets.

Scope 3 measurement and reporting can be challenging, due to the difficulties involved in accounting for supply chain emissions. Relying on suppliers reporting their emissions data is a common barrier, and many companies lack visibility into their upstream and downstream supply chain and the provenance of goods.

**Scope 3 re-baselined (as actual replaces estimated data) case example: Treasury Wine Estates (ASX: TWE)**
A significant portion of TWE's reported scope 3 relies on assumptions and estimates. As the company undertook steps to improve the accuracy of their data, by using actual logistics data replacing the extrapolation method used earlier, it resulted in a *"63% decrease in our emissions profile for the upstream transportation and distribution (category 4)"*

Further TWE notes that *"Our supplier engagement was expanded this year to cover our top 100 suppliers globally based on spend. However, only 17 suppliers were able to participate in the survey. This is because many of our suppliers are in the early stages of emissions data collection or have not fully accounted for their scope 1 and 2 emission footprints. These methodological refinements and re-baselining have resulted in a 21% adjustment in the size of our overall scope 3 emission baseline (F21), from 812,541 tonnes CO2e to 644,631 tonnes CO2e…"*

TWE Scope 3 summary

TWE scope 3 emissions are approximately 93% of their total reported GHG emissions (scope 1+2+3). Purchased goods and services (category 1) and upstream transportation and distribution (category 4) account for the bulk of its scope 3, at 71% and 18% respectively.

## Scope 3 decarbonisation levers

**Low carbon procurement and product design case example: Transurban Limited (ASX: TCL)**
The production of many road construction materials (including concrete, steel and asphalt) relies heavily on fossil fuels. For instance, the production of cement – an ingredient used in concrete – accounts for about 7% of all global GHG emissions.

TCL's scope 3 reduction efforts have included:

- Setting mandatory sustainability ratings[9] for their major projects, both in Australia and North America.
- Working with delivery partners to source low-carbon materials such as those with high recycled content like crushed glass, cement replacement and warm mix asphalt.
- Where possible, reduce the use of carbon intensive materials such as steel.
- Making design changes in the construction phase that lead to a reduction in embodied emissions in materials used.
- Working with their contractors to transition to electric vehicles (EVs) in replacing combustion engine vehicles.
- Where relevant partnering with government on the design of its development activities. To that end where government favours lower carbon construction methods/materials, any increase in construction cost would presumably be compensated in a higher toll allowance on the project. From an investor perspective, there are mitigants in the business to decarbonising the construction supply chain whilst also delivering sustainable returns.

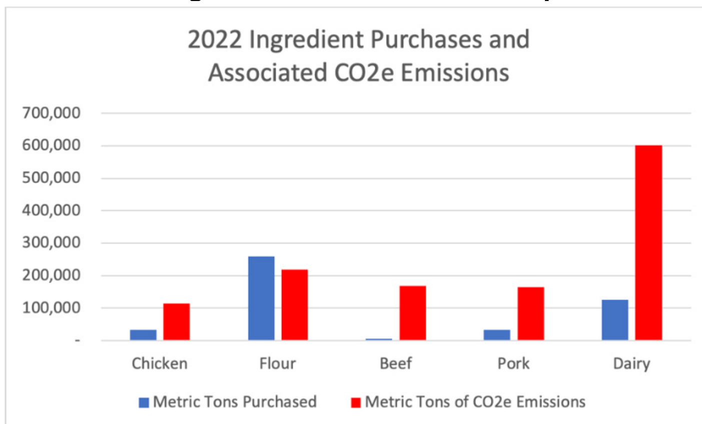
TCL Scope 3 summary

TCL scope 3 emissions are approximately 90% of their total reported GHG emissions (scope 1+2+3). Purchased goods and services (category 1) and capital goods (major projects[10]) (category 2) account for the bulk of its scope 3, at 43% and 46% respectively. TCL targets a 55% reduction in scope 3 intensity for their major projects by 2030 and a 22% reduction in scope 3 intensity for purchased goods and services by 2030.

**Upstream Supplier Collaboration case example: Domino's Limited (ASX:DMP)**
Supplier collaboration can be an effective strategy to lower emissions associated with upstream purchased goods and services. For instance, dairy and animal-based proteins account for approximately 36% of DMP's total GHG emissions in FY23.

Similarly, Domino's Pizza Incorporated (DPZ) disclose that purchased goods represent a significant, although complex, opportunity to reduce their overall carbon footprint. The top 5 ingredients comprise over 30% of overall carbon footprint with four of them being animal-based products (cheese, chicken, pork and beef) and one grain based (flour). While beef, pork and chicken represent a smaller percentage of purchased goods than other products, they represent a higher portion of the overall carbon footprint.

**Chart 4: DPZ Ingredients and Emissions Exposures**




Source: DPZ sustainability disclosure

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[9] Infrastructure Sustainability Council IS Rating
[10] Major development project construction, including embodied emissions of materials

To combat this Domino's launched a Dairy Initiative to drive ethical and sustainable dairy supply chain. DMP notes that *"[t]he farmers and business partners who grow, produce and deliver our products to us are vital to our success, and it is imperative that our business partners and their upstream supply chains are aligned with and committed to our responsible sourcing policy."*

### DMP Scope 3 summary

DMP scope 3 emissions are approximately 96% of their total reported GHG emissions (scope 1+2+3). Procurement accounts for 51% of the emissions. DMP have targets in place to reduce scope 3 as follows:

- Reduce scope 3 GHG emissions by 55% per pizza sold by FY31 from FY21 baseline.
- Reduce absolute Scope 3 FLAG GHG emissions 33.3% by FY31 from FY21 baseline.
- Reduce absolute scopes 1, 2, and 3 GHG emissions by 90% by FY50 from FY21 baseline

**Adapt product, partner with customers on low emissions technologies case example: BHP Limited (ASX: BHP)**

Staying ahead of customers' decarbonisation journeys and partnering with them, can be an effective strategy for companies facing demand disruption risks in their downstream supply chain.

GHG emissions from the processing of BHP's iron ore and metallurgical coal for steelmaking account for more than 80% of the company's overall reported GHG emissions (scope 1+2+3).

BHP's scope 3 reduction efforts have included:

- Working with steel manufacturers to research how iron ore can be optimally processed for use in direct-reduced-iron (DRI), which can be used as an input into an electric arc furnace (EAF) or electric smelting furnace (ESF) and help lower overall emissions relative to the traditional blast furnace method.
- Committing US$114 million in steelmaking partnerships and ventures to date.
- Building collaborative partnerships with ArcelorMittal, China Baowu, JFE Steel, HBIS Group, POSCO, Tata Steel and Zenith Steel who collectively represent approximately 19% of reported global steel production (World Steel in Figures 2023, World Steel Association). These partners account for direct sales in FY2023 of approximately 33% of BHP's iron ore and metallurgical coal.

### BHP Scope 3 summary

BHP scope 3 emissions are approximately 97% of their total reported GHG emissions (scope 1+2+3). Processing of sold products (category 10) and use of sold products (Category 11) account for bulk of their scope 3, at approximately 84% and 10% respectively. 99% of their category 10 is GHG emissions from steelmaking. BHP have *goals* in place to reduce scope 3 as follows:

- CY2030 Steelmaking: Support industry to develop technologies and pathways capable of 30% emissions intensity reduction in integrated steelmaking.
- CY2030 shipping: Support 40% emissions intensity reduction of BHP chartered shipping of BHP products.
- CY2050. Pursue the goal of net zero scope 3 GHG emissions.

**Conclusion**

Overall, scope 3 emissions are rightly a key focus area for industry participants tracking progress on real economy decarbonisation. In our view, effective scope 3 company engagements stem from foundational understanding of a company's business model, their upstream and downstream supply chains and where ability to influence lies.

We acknowledge that currently there is significant variability in company disclosures and appetite to set scope 3 reduction targets. Likewise, scope 3 disclosure guidance and requirements are still evolving. Even for the most ambitious companies adopting scope 3 reduction targets, being able to map accurately actual value chain emissions data including their suppliers remains a low proportion.

We encourage companies to view scope 3 reduction through the lens of value creation, closely tied to their business objective of having resilient supply chains. Our scope 3 analysis and ongoing research will feature in our constructive dialogue with companies this upcoming reporting season with the aim to improve industry practice and scope 3 disclosure.

# Carbon Emission and Intensity Tracker:

| WaveStone – Australian Share Fund (WASF) | Carbon Emissions | | |
|---|---|---|---|
| | **Portfolio** | **Benchmark** | **Difference** |
| Carbon Emissions Scope 1+2 (tonnes CO2e/USD M invested) | 72.7 | 113.8 | -36.1% |
| Carbon Intensity Scope 1+2 (tonnes CO2e/USD sales) | 97.6 | 171.3 | -43.0% |

Source: MSCI ESG (as at 30/06/2024)
Benchmark is the S&P ASX 300 Accumulation Index

# Engagement

### ESG-related Engagements during the Quarter

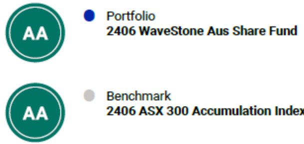
| Company | ESG Category | Topics |
|---|---|---|
| CSL | Governance | Leadership team and culture; Board expertise and tenor of members; capital allocation, stakeholder expectations; REM |
| IFT | Governance | Governance; External management and shareholder alignment; Asset valuations and fees |
| TCL | Social<br>Governance | Management team and BOD composition; REM; Tolling Reform; Cyber risk; Cost containment |
| NAB | Environment | NAB supplementary climate disclosure |
| CBA | Social<br>Governance | Credit exclusion |
| GMG | Environment<br>Social<br>Governance | Sustainability disclosure; Embodied carbon measurement, targets, use of offsets; Energy and water for DCs in pipeline; New EU supply chain directive; Senior exec gender diversity |
| CHC | Environment | Scope ½ targets progress to 2025, setting Scope 3 target for 2030 |
| SQ2 | Governance | Cash App and AfterPay regulatory investigation; Relationship with regulators and compliance team efforts |
| FPH | Social | Airvo 2 recall – timing and engagement with regulators; Management and BOD changes; Cyber risks; Safety data NZ and Mexico; EBAs |
| NAB | Social<br>Governance | Credit exclusion and work with Good Sheppard; H1 Result; New CEO |
| ANZ | Social<br>Governance | H1 Result; Suncorp acquisition; Credit exclusion and responsible lending. |
| IGO | Governance | Changes to executive REM; Carbon targets/metrics consideration in STI/LTIs |
| LIC | Governance | Equity raising; management succession |
| CWY | Environment<br>Social<br>Governance | HR initiatives to improve retention. Progress on safety. Landfill remediation and gas capture; Portfolio synergies on decommissioning opportunities in Oil and Gas; Soft plastics opportunities; FOGO; Management succession |
| MQG | Governance | FY24 result and FY25 outlook; Management changes |
| PXA | Governance | UK performance management |

Source: WaveStone

# MSCI ESG Ratings*

Portfolio : 2406 WaveStone Aus Share Fund Currency : USD
Benchmark : 2406 ASX 300 Accumulation Index

### MSCI ESG Ratings




Portfolio
**2406 WaveStone Aus Share Fund**

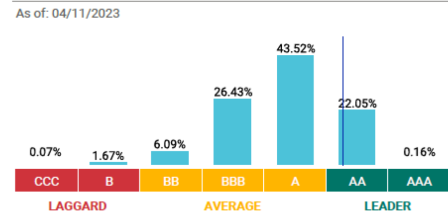
Benchmark
**2406 ASX 300 Accumulation Index**

### How the MSCI ESG Rating is calculated

| | Portfolio | Benchmark |
|---|---|---|
| **Weighted Avg ESG Score** | 7.56 | 7.56 |
| **ESG Quality Score** | 7.56 | 7.56 |
| ESG Rating | AA | AA |

### Distribution of MSCI ESG Fund Ratings Universe

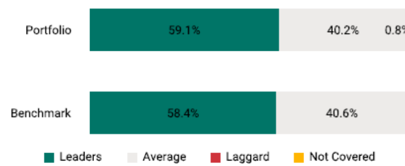
As of: 04/11/2023



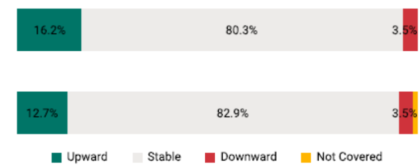

### Portfolio ESG Rating Summary

| | |
|---|---|
| ESG Quality | Leaders<br>0.02% below benchmark |
| ESG Ratings Distribution | Leaders 0.66% over benchmark<br>Laggards 0.20% over benchmark |
| ESG Ratings Momentum | Upward momentum 3.57% over benchmark<br>Downward momentum 0.07% under benchmark |

### ESG Ratings Distribution



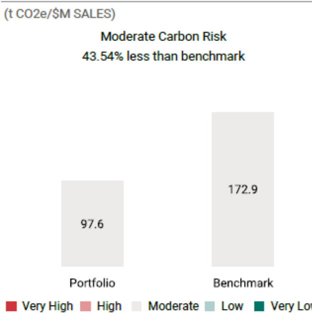

### ESG Ratings Momentum




### Carbon Risk

(t CO2e/$M SALES)

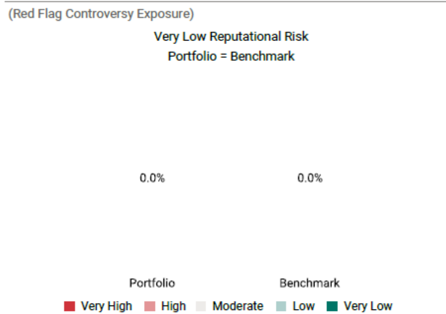
Moderate Carbon Risk
43.54% less than benchmark




### Reputational Risk

(Red Flag Controversy Exposure)

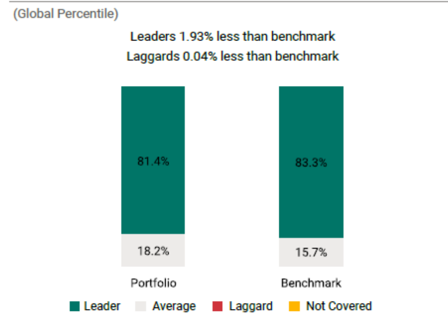
Very Low Reputational Risk
Portfolio = Benchmark




### Governance Risk

(Global Percentile)

Leaders 1.93% less than benchmark
Laggards 0.04% less than benchmark

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## Memberships and initiatives

- Principles of Responsible Investment (PRI)
- Climate Action 100+
- 40:40 Vision

## Links to WaveStone Policies

- ESG Policy: **WaveStone ESG Policy**
- ESG Activity Report: **WaveStone ESG Activity Reports**
- Proxy Voting Policy: **WaveStone Proxy Voting Policy**
- Proxy Voting Records: **WaveStone Proxy Voting Records**
- Engagement Policy: **WaveStone Engagement Policy**
- **WaveStone PRI Transparency Report 2023**
- **WaveStone PRI Summary Scorecard 2023**

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