

## Good Governance: key to growth and value

If companies are to deliver sustainable outcomes for their shareholders, then they will need to have sound governance processes and high quality people populating management and boards.



**Don Argus,**  
Chairman,  
BHP Billiton Limited

I believe we are going through a unique period in Australia's business history.

While some of the problems we have seen in corporate Australia have been caused by issues to do with corporate governance, the reality is, all of us are facing a period of unprecedented change.

Globalisation, consolidation, extraordinary competition, downward pressure on prices, technology and competition for capital are impacting on companies of all sizes in Australia.

### GOING GLOBAL

Most large and many medium-sized Australian corporates eventually realise they have no choice but to move outside Australia if they want to continue to grow and in fact to survive.

Unfortunately, it's easy to name the ones that have been seen to fail. As a result, a fiction has become fact. The fiction is that Australian managers can't manage outside Australia and every Australian business that looks to put its head up outside the Pacific or Indian Ocean coastline, will have it chopped off.

In fact, Australians head or play leading roles in some of the world's most successful multinationals and companies ranging in size from News Corporation to Cochlear have managed the transition from domestic to multinational pretty well.

However, the change from domestic to global and the increase in size, complexity and reach that entails, is not simply an arithmetic progression but an exponential one.

That is why it is critical to have sound governance processes and high quality people populating management ranks and boards.

*If they are not in place, then sooner or later, that exponential change in size, complexity and reach will cause them to fail ... as we have seen former American and European blue chip multinationals fail.*

One of the responses to the need to expand globally has been the use of new structures such as dual listings.

These new structures have inevitably produced greater volatility and brought together groups of people in

**“Australians head or play leading roles in some of the world's most successful multinationals”**

management and boards that have not previously worked together.

Again, this has emphasised the need for strong corporate governance including the depth of talent on boards and in management.

#### CYCLES OF THE PAST

I suggest we can learn a lot about what might happen in the future by looking at the cycles of the past.

The one sure thing you learn as you get older is that history has a terrible habit of repeating itself.

Are the 1990s a one off period in financial markets history?

The answer is easy.

Remember the savings and loan scandals of the 1980s? Michael Milken and junk bonds? Christopher Skase and the appropriately named Mirage Resorts? The Bond Corporation? Or the Teapot Dome in the 1920s? Tulip mania? The South Seas bubble?

The difference between then and now as one observer said recently is what happens on Wall Street also hits Main Street. A majority of Australians and Americans are now invested in the stock market.

These highly publicised events have

undermined investor confidence in business, in systems of governance, have contributed to falls in stock markets and have dashed savings and retirement plans of many Australians.

Losses in the U.S. stock market alone equalled nearly a year of national economic output.

#### CREATING ORGANISATION VALUE

So what creates value? I suggest there are five factors.

The first is return on capital.

The second is margin expansion.

The third is focussing on, and reducing, costs.

The fourth is strong and consistent cash flow.

And the fifth is growth in Earnings Per Share.

If a company delivers on these fundamentals, then it will make most investors screens.

On the issue of value being created by mergers, and in particular Dual Listed Companies, I am disappointed that some commentators pursue an argument that is based on the totally spurious premise that subsequent changes in the share price are entirely related to merger decisions. They run a line that mergers are not working and infer that value is not created.

In fact, if I charted the share price movement for many leading Australian companies based on some commentary I have seen, you could well come to the conclusion that many of these would in fact have been better off seeking to merge.

I will use the BHP Billiton DLC as a case in point. We announced the merger intentions on the 19th of March 2001. Since that date, the ASX index has declined by 10.7% while the BHP Billiton Limited share price has declined by 2.3%.

BHP Billiton has therefore outperformed the ASX 200 since the merger was announced.

In addition, BHP Billiton shareholders have benefited from the spin-outs of BHP Steel and OneSteel and, if you had invested \$1,000 in November 1998, it would be now worth \$1,981.

In my experience, if a stock is to sell

at a premium to the market, the scale of the premium is generally mirrored to improvements in the business fundamentals suggesting that investors usually reward companies with a track record of success.

That, of course, includes an organic growth strategy augmented with an event driven strategy which should reflect in the five factors I mentioned earlier.

#### GOOD GOVERNANCE

Given this brief overview of the investment climate, what is the key to value and growth? My proposition is that good governance is a key.

So, when looking at a company, what specific qualities should fund managers look for in terms of corporate governance?

I suggest that governance is really about managing risk. The key areas are -

- operational and financial risk,
- environmental and social risk,
- legal compliance and country risk.

I'll touch on some key governance issues that are increasingly in the spotlight these days and are particularly relevant to my role as Chairman of BHP Billiton.

As I indicated earlier, the issue of corporate governance has attracted the business world's full attention following a spate of scandals and failures that have undermined investor confidence in systems of governance and contributed to falls in stock markets.

As with all complex problems there is a demand for a simple answer ... and as you know there are simple answers to complex problems; and they are usually wrong.

#### COMPANIES GOOD AND BAD

We have had a tidal wave of rules, regulations and laws. There is no shortage of remedies for failures of governance.

Most of these remedies are, however, structured. They are concerned with rules, procedures, composition of committees and the like, and together they are supposed to produce vigilant involved boards.

I read some research recently which concluded that good and bad public

## CHIEF EXECUTIVE OPINION

companies have followed most of the accepted standards for board operations.

Against this background, it is somewhat surprising that the Corporate Governance debate has focussed on a very limited number of themes:

- Board organisation
- Shareholder rights and voting on resolutions
- Independence of auditors
- Role and independence of NEDs
- Transparency and accuracy of financial statements.

### WHAT SHOULD GOVERNANCE ACHIEVE?

In focussing on the details and procedures of governance, the market has, in my view, failed to debate what I believe to be the central question: "What do we want good corporate governance to achieve?"

In my view, corporate governance is there to ensure that the Board of Directors develops, implements and explains policies that -

- increase shareholder value
- lower the cost of capital
- reduce financial, business and operational risk

- ensure there is a real depth of management talent

- address reasonable shareholder concerns.

This is, of course, a much broader definition of corporate governance than usual and positions it in the heart of business operations. In essence, governance is there to ensure that companies control and report on material business risk.

In other words, a great audit committee won't make a company great, but a great company will have a strong audit committee.

### BUILDING A TEAM

Jeffrey Sommerfield, who has been studying board effectiveness now for over 25 years, believes that it is not about rules and regulations, it is the way people on boards work together.

I find myself persuaded by his thesis. It is difficult to highlight the factors that make one group of people an effective team and another equally

talented group a dysfunctional team.

In other words, it's hard to build a great team, but it's harder to get them to play together.

Winning teams usually have a chemistry that can be difficult to quantify, but members seem to develop mutual respect. Because of this respect they develop trust in one another, they are able to deal with complexity, they share and understand difficult information, and they challenge one another's conclusions.

More than ever, directors need to be able to argue, to challenge and to work hard to find the reality on what is really going on in a business.



*“More than ever, directors need to be able to argue, to challenge and to work hard to find the reality on what is really going on in a business”*

*Often this means not accepting on face value what is being presented at board meetings, of forming teams of directors to really delve into operating areas of concern.*

This is not the traditional view of boards.

It also takes directors with courage and it often means taking the heat as a result.

But it does set the lead for the kind of a culture any successful company needs.

Culture is the most important element in any business. As former IBM chief executive Lou Gerstner said recently: "The levers you have to pull are cultural, not directional. It's how people think, what they value, what they do."

### AN EFFECTIVE BOARD

In my view, I think there is a general consensus that an effective board has the following characteristics:

- Does this board have the right blend of skills and experience to take the company forward? Do board members have sufficient time to discharge their responsibilities conscientiously? Is the board's committee structure appropriate?
- Are more clear objectives a viable

strategy to achieve them and a sound approach to risk management that reflects those objectives?

- Is the board paying enough attention to human resource issues and to communications with external stakeholders?

- Does the board receive and discuss financial and other key performance measures on a timely and regular basis?

- Does the board provide a challenging yet supportive environment for the executive team, with full discussion of major issues before decisions are taken? Does the board assess its own performance on a

regular basis?

- Is sufficient emphasis given to providing relevant training for board members?

Any framework for Corporate Governance must nurture a perspective that looks beyond quick fixes, to the permanent need for the private sector to deliver continuing prosperity in a responsible manner.

### RISK FACTORS

Now having said that, it is impossible to earn profits without an element of risk, particularly when doing something new.

There is no such thing as risk-free investment.

Risk management will always involve judgment, balancing risk and reward. In the go-go eighties, the financial services industry ran headlong for the reward side. Nowadays, caution is more the watchword. But not everyone is listening.

We should not be afraid of entrepreneurship if a business is to hold its own in the highly competitive world markets, because essentially it is companies that compete in this globalised environment, rather than countries.

## CHIEF EXECUTIVE OPINION

If the research undertaken by McKinsey Global Institute proves to be correct, over the next five years, technology will halve transaction costs that on average currently account for 30-40% of business operating costs.

Companies therefore face some very interesting strategic choices.

Managing that complexity will test the effectiveness of boards, because if you don't have a performance driven board which is prepared to analyse, challenge and debate in a climate of trust and respect, then I am afraid the value proposition that we all seek will not be delivered.

### SOCIAL RESPONSIBILITY

The other issue which is internal to good corporate governance is Corporate Social Responsibility.

Good corporate governance must include effective management of a company's environmental and social impacts.

Apart from the moral imperative

### Total Shareholder Return

AS\$1,000 invested in BHP on 30 November 1998 equals AS\$1,981 today.

Total Shareholder Return of 93%/

Includes: - Dividends re-invested  
- OneSteel de-merger  
- BHP Steel de-merger.

failure to do so limits organisational autonomy.

The bottom line impacts include:

- increased costs;
- unfavourable effects on the company's reputation; (OK Tedi)
- constraints on opportunities;
- action by shareholders and professional litigators; and
- regulators.

all of which can threaten the long-term sustainability of the enterprise.

Conversely, managing these aspects well can bring significant competitive advantage, particularly in the resources sector.

Some of the benefits can include:

- a reduction in potential liabilities;
- enhanced access to land and new



The BHP Billiton Charter is a common discussion point among all employees.

projects - and if you're working in developing countries, it can also help in forming alliances with good partners;

- improved employee morale;
- strong recruiting - you can be seen as the employer of first choice; and
- the potential for restrictive regulations can be reduced.

BHP Billiton for example has a clearly defined and articulated approach to the management of social and environmental issues, and that lays the groundwork for a high standard of performance.

### NEW VALUES

The BHP Billiton Charter includes 'an overriding commitment to safety, to environmental responsibility and to sustainable development'. Copies of the Charter are distributed to every employee and provide the context and framework for all of our policies.

Health, Safety, Environment and Community issues are all dealt with under one integrated Policy (HSEC).

But it is no good having strong social and environmental policies if they're not put into practice.

At BHP Billiton, ultimate day-to-day responsibility for HSEC matters rests with our general and senior management, but the role of line managers and functional personnel is absolutely vital to the successful implementation of the HSEC Management Standards.

The new regulatory regimes are

putting CSR risks at the centre of the debate (Corporate Social Responsibility).

If CSR risks are likely to have a material impact on investment values, then they must be managed properly and reported on to investors.

The recent emergence of the Socially Responsible Investment sector reflects the increasing awareness and importance the investment community is placing on these issues. BHP Billiton are pleased to have been included in the Dow Jones Sustainability Indexes and the FTSE4Good, and late last year we held our first briefing for analysts specifically dealing with our HSEC systems and performance.

I want to stress that environmental, social and CSR issues are a top priority at BHP Billiton, particularly as these issues can be mapped against a handful of investment value levers that indicate the potential of the particular issue to have a material impact on investment values.

### FINALLY

Restoring integrity to the Corporate Governance system will ultimately occur one step, one director, one audit committee, one board and one organisation at a time.

It will require men and women of courage and conviction on boards and in management teams. They must put actions behind their words to preserve their reputations and fulfil their duty to "the preservation and creation of value in the organisations they serve". ■