

“The Effect of Private Equity Takeovers on Corporate Social Responsibility”

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Good evening ladies and gentlemen and thank you Leeora for your kind introduction.

I am delighted to have the opportunity to share some thoughts on this emerging issue in the Australian capital markets – the private equity buyout of large publicly owned companies and its effect on corporate social responsibility.

I agree with David Tonuri in his presentation – that the providers of finance to private equity fund managers have a major opportunity to improve private equity investment’s contribution to long term value through enhancing economic, social and environmental outcomes.

I will consider the issue of private equity takeovers from the perspective of one of the major providers of finance – the superannuation or pension fund industry.

I have taken the liberty in my presentation to use the term corporate sustainability to have the same meaning as corporate social responsibility (CSR).

When I refer to corporate sustainability I mean the wide range of economic, social and environmental challenges and developments that will impact a company’s long run competitive position in its business sector and therefore its long run financial performance and shareholder value depending on how the company manages the risks and invests in the opportunities.

Corporate sustainability is clearly a business issue.

For example if your business is primarily a food retailer such as Coles which is currently the subject of private equity interest, there are many economic, social and environmental trends that will either present risks to the business and which need to be managed or alternatively will present opportunities that can be pursued to expand the company’s revenues.

Emerging economic, social and environmental challenges for a food retailer will include issues such as transparency on food product sourcing and along the supply chain, efficiency of transport systems and associated management of carbon emissions, staff turnover and development, brand management and good

customer relationship management, use and disposal of packaging and many others which will impact long term profitability.

Carbon emissions alone represent a considerable challenge. I suspect a company like Coles would incur most of its emissions indirectly through its supply chain but would also incur direct emissions. I would guesstimate that its environmental emissions currently externalized if costed and internalized might be in the order of \$1 billion pa. This would overwhelm current profits in the absence of management action.

Many of these issues will also be of interest to environmental groups, the union movement, the community and governments.

While these stakeholders are important and have legitimate interests it is the company and its owners (which maybe a private equity firm, institutional investors or individuals) who, if they have an interest in long term growth and profitability, should be most concerned with corporate sustainability.

I have structured my presentation around three questions which you may wish to debate in question and answer time later.

The first question concerns whether the ownership of a company – private or public changes the corporate sustainability value proposition? This is a threshold question.

The second question looks at an Australian company Qantas which as you know has been in the news lately as the subject of a purchase offer from a public equity consortium.

Some questions were and are being raised about the implications of this bid for Qantas on corporate social responsibility.

The question I ask is whether Qantas is already an icon of sustainability – are the current owners of Qantas, in the main institutional investors feeling comfortable about Qantas' approach to the sustainability challenges facing the aviation industry? Were these risks factored into the share price by investors prior to the bid taking place?

Were the growth opportunities for Qantas factored into the share price prior to the bid and has the current Qantas management to date shown public leadership on the many sustainability challenges facing the aviation industry – such as jet fuel carbon emissions?

The third and final question I ask this evening concerns super funds. Are super funds who are now major owners of Australian public companies and increasingly owners of private companies through investment in private equity firms doing enough to understand the impact of corporate sustainability on long term

shareholder value regardless of whether the capital structure of that ownership is public or private.

Are super funds stepping up to the plate on sustainability, engaging with companies and the fund managers who invest on their behalf? Can super funds and other institutional investors collaborate and influence corporate sustainability outcomes in private equity takeovers of public companies?

Turning now to the first question. Does ownership of a company – private or public change the corporate sustainability value proposition?

In a word no.

Sustainability challenges and developments impact all industry sectors and the companies that operate in them – there are risks and there are opportunities.

SAM Sustainable Asset Management a Swiss based fund manager defines sustainable companies as companies that adopt an approach to business which:

- (a) recognizes that sustainability developments alter the forces of competition on an industry and therefore companies within it, and
- (b) if a business tackles the risks head-on and manages them and seeks to invest in the opportunities thereby improving sustainability performance this will flow onto financial performance and ultimately improved shareholder value

The fact that a company is publicly owned or privately owned doesn't change this value proposition.

What may be different and may change when a private equity firm takes over a publicly listed company will be management's focus.

As David said earlier we have all read the case histories. Private equity firms load up with debt, purchase an underperforming public company, take out a lot of the costs, maybe trim staff, outsource non core activities, generate cash from asset sales and pay large dividends to the new owners who then on-sell the company as a trade sale or public float.

If a private equity firm does this and then soon after refloats the company it will probably perform poorly in the stock market.

On the other hand there is research from the USA which found that the shares of companies taken private and then refloated some years down the track outperformed initial public offerings that were not backed by private equity.

One of the reasons for this is that public companies that are purchased by private equity firms and managed with the long term in mind, free from the listed markets' focus on the next quarter's earnings, can capture the benefits of a sustainability focused business approach.

So what have we got.

The best private equity firms will provide a strong yield to their investors – generally super or pension funds. They won't be able to do this by destroying the company because to gain a good price with a refloat they need a company that can maximize long term value.

The best way to do this is to understand the long term sustainability drivers of value across the economic, environmental and social dimensions.

They have got a real opportunity to do this – as they are not subject to the short term demands of the public markets.

The risk though is that they will not engage with stakeholders and not disclose.

We are all concerned about corporate sustainability when a private equity firm takes over a public company. That is, we are concerned that a sustainability business approach will not be adopted and a short term focus will prevail.

This of course assumes that the public company has a sustainability business approach in the first place.

Let's look at a public company that is the target of a private equity takeover and that is in the news at the moment – Qantas. The question that we need to ask: is Qantas already an icon of corporate sustainability?

Let's pick a couple of broad indicators to see whether we could classify Qantas as an icon of corporate sustainability.

Do they take a public leadership position on social and environmental issues impacting the aviation industry. For example do they have a public policy on climate change? No.

Do they take a leadership position on carbon trading as one of a number of policy responses to carbon abatement. No.

Did they respond last year to the inaugural Carbon Disclosure Project Australia and New Zealand? No.

Do they have a publicly disclosed target for reducing emissions, carbon and others. No.

Are they a sustainability leader in the airline sector? For example are they recognized as such in leadership indicators such as the DJSI. No.

Do they produce a corporate sustainability report. No.

Qantas is in the transport industry. They are involved in the business of mobility – for people for work and leisure and for commercial for high value goods such as equipment, food, flowers and documents.

Demand for mobility is increasing, the airline sector is in expansion mode and it is dependent upon jet fuel.

While Co2 emissions of the industry are only 3% of the world's total the impact of those emissions at high altitude is not totally understood. Nearly 80% of a commercial jet's carbon emissions are released when cruising at high altitude.

To reduce emissions requires a reduction in total fuel use. This is not easy.

If you were preparing a sustainability road map for the airline industry it would include:

- human capital development
- climate policy
- emissions reduction including air quality around airports
- noise management
- airline route distribution management
- brand and reputation management
- fleet age and maintenance
- supply chain standards
- fuel cost, efficiency, reliability and so on

Have a look at the Air France-KLM website on corporate social responsibility, climate policy, emissions management and leadership in the industry.

Also see Virgin Atlantic and contrast these sites with Qantas.

My final question this evening is:

Will super funds step up to the plate on sustainability? Can super funds and other institutional investors influence corporate sustainability outcomes in a private equity takeover. And if so how should they do this?

I suggest the following may help. Super funds and other institutional investors can:

- Establish and publish a governance policy for investee companies. Then monitor implementation of the policy.
- Establish and publish an engagement policy for investments in companies covering environmental, social and governance issues, encouraging companies to unlock the financial performance opportunities by adopting sustainability business strategies. Then engage with companies.
- Establish and publish a sustainability policy.
- Integrate environmental, social and governance issues into fund manager mandates. Then engage with fund managers.
- Establish and publish a climate policy.
- Produce a sustainability report.
- Disclose emissions of the investment portfolio.

Conclusion

The time has come for action on corporate sustainability. The world is facing its greatest challenge of all – the threat and disruption of rapid climate change. It is more than an environmental issue it is an economic issue, it is a business issue.

Its time to stand up and be accountable.

Superannuation funds and other institutional investors as owners can influence corporate sustainability regardless of ownership structure. But first they have to recognise that they have a responsibility to do so not because it might be the right thing to do but because it helps to build long term shareholder value.

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