Corporate Governance 2012 mid year report

JULY 2012

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Why investors should care about ESG

The sustainability of company business models and profit growth can be affected by a wide range of environmental, social and governance issues (ESG). For precisely this reason AMP Capital searches for ESG insights and seeks to incorporate them into investment decision making – whether these relate to oil spills, poor human rights records, questionable remuneration structures, or anything in between.

Milton Friedman, the eminent economist from the last century, spoke only one language. His was the language of making profits. To quote Friedman himself, "The business of business is business". No mention here of governance and environmental management affecting efficiencies and profits. Likewise some investors might not care about environmental, social and governance issues, as long as they are able to make a good return on their investment. After all, not all companies will have a giant oil spill in the Mexican Gulf, so why speak in a language that extends beyond profits?

These hard nosed views of the world are old views. They suggest there is little room for thinking about or acting on broader ESG issues as a company, let alone an investor. However, these days smart investors are brushing up on languages other than 'profit-ese'. Investors now hear a wider spectrum of messages on a company's performance than just 'EBITDA and P&L', and they realise that ESG issues can be material to investment performance. Understanding how companies are managing these issues provides additional insight with which to make better investment decisions.

So what is the difference between ESG investment analysis, and traditional analysis? While many investors are well versed in traditional financial analysis, ESG issues require a different perspective and skillset, and as such these issues are sometimes difficult to appreciate. Often, investors may recognise the importance of the issue when it is too late – when the share price has already reacted to a particular ESG issue. There are no quick fixes for looking at ESG issues and for many investors it is all too hard and often much easier to simply dismiss.

To really see the issues, and the impact these issues can have on a company's financial performance, investors should ideally marry a strong understanding of ESG issues with an equally strong investment background. Being bilingual, as we put it, is the key to answering the 'so what?' question many investors ask when confronted by ESG issues.

Case study: Coal-seam methane – environmental and community issues front and centre

Australia has seen a surge in interest in coal-seam gas (CSG) projects. Coal-seam methane extraction is an intensive industrial process, generally imposing a larger environmental footprint than conventional gas development and agricultural processes. Often many wells are needed and the scale of development can have major implications for local communities, land use and water resources. As such, this is a classic example of both environmental and community issues combining to shape this emerging industry.

AMP Capital's analysis indicates that environmental issues such as the risk of reduced water supply and reduced water quality might have been overstated. While residual risks remain, companies that proactively address the concerns should be able to meet regulatory and community expectations. In contrast, companies that are less organised may struggle with these same issues, taking up valuable management time and costs as they face continued scrutiny from regulators and the community. The ability of companies to adapt will certainly impact their ability to deliver on stated objectives.

Understanding the more technical environmental issues related to a CSG project is important in measuring the investment risks associated with potential capital expenditure. Technical environmental issues, such as those related to groundwater and surface water, are challenging and may result in significant residual liability. The management of these issues typically relies on long-term forecasting to predict impacts in 10 to 50 years' time. Investors focusing on near-term financials rather than the technical and environmental issues, may miss the impact of long-term liabilities.

How a company addresses community concerns and community consultation will often have immediate investment implications via the constraints placed on exploration and timing of approval and development of CSG projects. Over the longer term, effectively addressing community issues such as concerns around compensation, visual amenity and the impact on the social and economic character of local communities are very important.

While on an industry level the issues may be similar, how individual companies are exposed depends not only on their location and stage of development, but also the way each company is equipped to manage specific risks and stakeholder concerns.

Ethical issues aside – poor risk/reward ratio for labour exploitation in the supply chain

Why should investors care about human rights abuses in Asian factories, sweatshops, child labour, etc? Surely the cheaper prices generated by Asian sweatshops more than offsets any damage to reputation or brand? AMP Capital's proprietary research shows that chasing costs in Asia can have a very poor risk/reward ratio – even when you disregard the ethical aspects.

Fashion companies have been scouring the Asian continent in search of a good deal in producing their fashionable designs, especially when, as last year, companies were also impacted by weakening consumer markets and rising cotton prices. In this tough environment many companies started to steer away from old pastures in south-eastern China (e.g. Guangdong) to areas with even lower unit labour costs. This process was accelerated by higher costs of living and China's five-year plan to reduce the economic gap between eastern and inland China. Outside of China, the labour unit cost is often even lower. Countries such as Bangladesh offer very cheap labour costs and poorly regulated labour conditions. However, the unit labour cost does not tell the full story.

In reality, the labour cost in the garment industry is only a small proportion of the total cost of goods sold. Once differences in productivity and fixed costs have been considered, the elusive savings might be even smaller or gone altogether. By moving production to remote areas, companies are actually taking a gamble on poor infrastructure and potentially longer lead times which can be painful when you rely on fast-moving fashion trends. Workers' conditions are often poorer which can lead to lower productivity and further production disruptions.

Therefore, a company's relocation to poorly regulated and remote areas for cheap labour may not be as profitable as it seems. After considering the real fixed costs and infrastructure needs, the change in sourcing strategy may actually leave investors' profits at risk.

Governance – a warning light of a crash ahead

A company with good leadership at the helm, where transparent accountable behaviour is consistently demonstrated, will generally not get the news coverage it deserves. While good news is not news, bad governance consistently grabs the headlines.

When the reckless behaviour of conflicted boards and management destroys shareholder value, shareholders and the general public sit up and take interest. Corporate collapses have shown there is no point investing in the companies that make great products if none of the rewards flow through to the shareholders. So how can shareholders make sure their companies are governed properly, and that they see the corresponding value in their shareholdings?

After two decades of analysing corporate governance, we have learned how to spot the warning signs. In particular a company's public disclosure, board and pay structure can tell us a lot about the character and intentions of the leadership of the company. For instance, flashing lights appear when companies lack transparency, when boards are not representative of their public shareholders, or when pay structures reward management for risk taking and achievements contrary to shareholders' interests.

Good transparency and disclosure gives comfort to shareholders as it says a lot about the culture of accountability within a company. Clear disclosure of various material aspects of the business and its governance also helps shareholders make an informed judgment on the risks and rewards of their investment.

Similarly, shareholders take comfort in board structures where directors are not only well-qualified for their role, but are also majority independent (i.e. they have no interest in the direction of the company, other than to provide value for the shareholders) and hence more likely to be free from potential conflicts of interest.

Finally, thorough analysis of executive remuneration over many years has taught us that poorly structured pay can be costly to shareholders and in the worst cases can encourage value-destroying behaviours. The right balance of base pay and short-term and long-term incentives needs to be found to attract, retain and motivate management to perform for the long-term benefit of shareholders.

Diligent analysis of these governance aspects can help identify which companies to invest in and which to avoid. Although companies that are poorly governed may perform well, most investors prefer to invest in a company where they are confident funds will be used wisely.

ESG analysis can give original insight to equity investments before it is too late

As outlined above, ESG integration is a process of identifying a company's hidden earnings risks through detailed analysis. By making a holistic assessment of how a company manages their ESG related risks, and by considering these risks when forming a final investment decision, AMP Capital gains a clearer picture of the companies we are investing in on behalf of our clients.

Key to that process is to understand that the majority of a company's value mostly relates to non-financial drivers. Whether it is technical environmental management details, or insights into the background of a company's board of directors, ESG issues can be industry or even company specific. ESG integration into investment decisions is more than just 'ethics' and carbon emissions – it is about assessing and unlocking a company's hidden value-drivers and risks.

It is not always what you see, but what you cannot see that drives a company's earnings and share price. By analysing these drivers to equity investments, AMP Capital obtains original insight, which can be the difference between a good and a bad investment.

Two-strike rule: will boards be spilled?

In the February 2012 edition of our Corporate Governance Report, AMP Capital detailed its views on preferred remuneration structures and the workings of the two-strike rule.

We admitted initially to being a reluctant supporter of the two-strike rule due to the potential to create unnecessary distraction and unintended consequences. We had felt the 25 per cent threshold may have been set too low. However we have been voting against poorly structured remuneration for many years and often the concerns raised have fallen on deaf ears.

With the two-strike rule providing shareholders with the opportunity to spill the entire board of a company (once it has received two-strikes), it is not surprising directors are now more inclined to listen and respond to the views expressed by shareholders on remuneration issues.

Increased engagement on remuneration issues

Since seeing 21 large Australian companies record a first-strike in the recent proxy seasons, we have continued to see more and more companies engage with their large shareholders in a quest to better understand their specific concerns. AMP Capital has been pleased to see companies engaging with shareholders in a timely manner, well in advance of the time-pressured Annual General Meeting (AGM) seasons.

Most companies AMP Capital has engaged with have either committed to improve their remuneration structures or have committed to provide much clearer disclosure to ensure shareholders can better understand the rationale for the remuneration structures they have put in place.

On the back of these improvements, AMP Capital expects few of these companies will receive the second-strike which would trigger a board-spill resolution being put to shareholders. A combination of improved remuneration and the fact that a board-spill resolution requires 50 per cent of votes to be cast for the spill means it is unlikely many boards will be spilled over shareholders' remuneration concerns.

Australian shareholders are unlikely to vote out directors who are generally considered to be doing a good job. Boards of companies who have taken the time to engage with shareholders and have resolved to, either improve remuneration structures and/or improve disclosure, should have little reason to fear a board spill – assuming of course, that the positive discussions on remuneration, do in fact translate into action.

Low voter turnout

Interestingly, the total number of votes recently cast on the adoption of remuneration reports was down on previous years. This reduction in voter turnout could have been because of two main factors; firstly, a reluctance of some investors to cast a vote now that the stakes had risen and secondly, the fact that associated parties, such as directors who are significant shareholders, were excluded from voting*.

AMP Capital's voting intentions

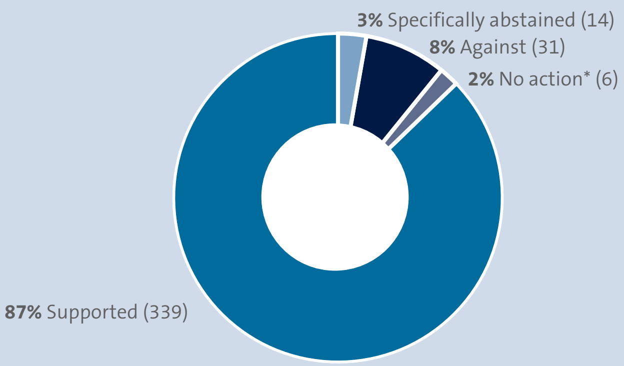
AMP Capital expects the manner in which we cast votes on remuneration reports will not differ from previous years. We will continue to either vote against, or specifically abstain from voting, on remuneration reports we consider to be unfair or poorly aligned with shareholder interests. Our vote on any board-spill motions will not focus purely on remuneration issues but will take into consideration our views on the effectiveness of the board of directors, and their ability to act in the interests of shareholders.

*Note: At coming AGMs Chairmen will be able to vote undirected proxies on remuneration reports (see page 6 of this report.)

AMP Capital proxy voting statistics:

1 January to 30 June 2012

Voting: January - June 2012



Voting: January - June 2012
AMP Capital voted on 390 resolutions
at 86 company meetings.

* includes resolutions on which AMP Capital was excluded from voting eg participated in share issues.

AMP Capital's shareholder activism

AMP Capital continues to be actively committed to encouraging good corporate governance at the companies in which portfolios we manage have invested.

While our lodgment of proxy votes has an impact on governance we believe communication, either via letters or our meetings with company directors, to be a more constructive and effective form of shareholder activism.

Each year many governance-related letters are written to company chairmen. We continue to be pleased with the companies' positive response to these letters – with many companies addressing our specific concerns and improving governance practices in subsequent years. In addition, many company chairmen have accepted our invitation to discuss governance matters further, meeting with us personally to discuss issues of concern. This influence has been constructive, with some visible improvements including greater disclosure and transparency, the appointment of independent directors, improved terms for incentive plans and the abolition of termination benefits for non-executive directors.

Since the introduction of the two-strike rule, there has been a significant increase in the number of companies seeking to engage with shareholders, particularly with regard to remuneration issues.

Non-executive director remuneration

Over the six month period, seven companies in portfolios managed by AMP Capital sought approval for an increase in the maximum aggregate level of fees that could be paid to the company's non-executive directors (NEDs).

Most increases sought were considered reasonable after taking into account various factors including the size of the company, the company's complexity, performance, board composition (including the number of directors and the balance of independent directors), whether options or retirement benefits are paid to directors and the factors put forward by the company to explain the need for the increase being sought.

In line with generally accepted principles of good governance, AMP Capital is not in favour of option grants being made to non-executive directors. It is preferred that non-executive directors' interests be aligned with the shareholders they represent rather than potentially being influenced by incentive structures that may not reflect the experience of the shareholders who hold listed securities. Preferably, non-executive directors should be encouraged to invest their own capital in the company or to acquire shares from the allocation of a portion of their fees.

AMP Capital proxy voting statistics (2006 to 2012)

	2012 First half (6 months)	2011 First half (6 months)	2010 First half (6 months)	2009 First half (6 months)	2008 First half (6 months)	2007 First half (6 months)	2006 First half (6 months)
Number of company meetings where votes were submitted	86	96	83	97	109	122	94
Number of resolutions voted on	390	473	365	473	561	556	449
% of meetings where all resolutions were supported by AMP Capital*	68%	67%	71%	62%	71%	59%	63%
% of meetings where incentive issues were considered	57% (49)	56% (52)	63% (54)	60% (58)	66% (72)	54% (66)	71% (67)
% of meetings where incentive issues were not supported by AMP Capital	33% (16)	40% (21)	25% (13)	34% (20)	35% (25)	34% (23)	42% (28)

* Includes meetings where AMP Capital was excluded from voting due to conflicts of interest eg. participation in share issues.

Share and option incentive plans

In the first half of 2012 AMP Capital submitted votes on 54 incentive-related resolutions (not including votes on NED fees and remuneration reports).

Over the period, AMP Capital voted against at least one incentive-related resolution at the following companies:

Aurora Oil & Gas Ltd	Endeavour Mining Ltd
Ausenco Ltd	Ivanhoe Australia Ltd
Beadell Resources Ltd	Oceanagold Corp
Coalspur Mines Ltd	

AMP Capital also specifically abstained from voting on incentive schemes in several other companies.

We will specifically abstain from voting where schemes contain minor 'flaws', or where it may be the first time we have raised the concern with the company. We find this 'abstention and communication' mechanism more constructive than simply voting 'for' a 'slightly flawed' resolution as it allows us to send clear signals to companies, which can often lead to useful dialogue.

In almost all cases we endeavoured to make contact with the company (usually via a letter to the chairman) to provide reasons for our position.

As investors, we seek to invest in companies that will provide the best relative share market performance over the long-term and as such we prefer a significant portion of the CEO's remuneration is aligned with that goal. The underlying reasons for not supporting long-term incentive related resolutions include:

> Poor disclosure of the terms of the incentive plans

> Plans are shorter than the desired three-year minimum

> Plans had no performance hurdles or hurdles that lacked sufficient alignment with the interests of shareholders

> Proposed plan amendments would increase the value to employees, without any corresponding benefit to shareholders

> Participation of NEDs in executive schemes, and

> Plans showed no improvement, despite the company having received comments/input and the matter being not supported previously

AMP Capital continues to consider how incentive grants should respond upon a change of control at the company. We became interested in this feature several years ago after seeing instances where company executives and directors engaged in behaviour that could potentially destroy shareholder value while themselves reaping significant personal gains.

Remuneration reports

Since the introduction of the non-binding votes on remuneration reports in 2005, Australian investors now have a mechanism by which to review and comment on the approach to remuneration used by the companies in which they invest. The impact of a shareholder's 'against' vote on remuneration is now greater since the introduction of the two-strike rule.

When reviewing the appropriateness of remuneration reports, AMP Capital generally considers a wide range of factors.

Remuneration reports should be concise and facilitate a clear understanding of the company's remuneration policy, providing evidence that the policy is both fair and reasonable and is aligned with shareholder interests.

We particularly look for criteria such as the clarity of disclosure, satisfactory short and long-term incentive and termination arrangements and also appropriate non-executive director remuneration.

Over the period AMP Capital submitted votes on 42 remuneration reports, supporting 31(74%) of them. The remuneration reports AMP Capital voted against (as opposed to either 'supporting' or 'abstaining') over this period include:

Aurora Oil and Gas Ltd	Beadell Resources Ltd
Ivanhoe Australia Ltd	

AMP Capital voted against remuneration reports which exhibited one or more of the following criteria; poor disclosure, poor alignment with shareholder interests, inclusion of non-executive directors in executive incentive plans, excessive quantum and poorly structured performance hurdles (eg. absolute rather than relative, not sufficiently challenging, too short-term, purely accounting-based, allowing too many opportunities for re-testing etc).

Another feature of concern has been the excessive termination payments (both actual and potential) that were made to some departing senior executives – particularly as actual payments often bore little resemblance to previously agreed limits.

AMP Capital also specifically abstained from voting on other remuneration reports, adopting the 'abstention and communication' mechanism mentioned earlier.

Board composition

Board composition continues to be one of the most important corporate governance issues for shareholders. Despite its significance, we acknowledge it is often difficult for shareholders to determine whether they have the right boards governing their companies. The short biographies available in annual reports provide little detail and without being present in the boardroom, shareholders cannot observe the dynamics of the board, nor its overall effectiveness.

In any proxy season, most company meetings are Annual General Meetings which require shareholders to vote on the election or re-election of directors. Votes against directors would generally reflect concerns including poor board attendance, an insufficient number of independent directors to represent public shareholders and issues related to poor governance.

In the first half of 2012, AMP Capital supported the majority of directors seeking re-election; those not supported were predominantly self-nominated, non board-endorsed candidates who we considered not to be ideal candidates.

Termination Payments

In 2009 amendments to the Corporations Act 2001 (Cth) tightened restrictions on the termination payments that can be made to executives without shareholder approval.

As a result of these amendments any employment contracts entered into (or varied) on or after 24 November 2009 require shareholder approval for termination benefits (paid to directors or certain executives) in excess of one year's base salary. Previously, termination benefits could reach up to seven times a recipient's total annual remuneration before shareholder approval was required.

These changes were first announced in March 2009 as part of the Federal Government's focus on excessive retirement payments following significant negative media surrounding this issue.

It has been interesting observing how different companies have responded to these amendments. Initially some companies viewed an increase in base pay as an 'amendment to their employment contract' and therefore chose voluntarily to seek shareholder approval for the termination payments, while it appeared others were more opportunistic – locking in generous and long-term termination arrangements by issuing new employment contracts just prior to the 24 November 2010 deadline.

AMP Capital continues to monitor these developments with interest.

Governance in brief

AGM chairmen now able to vote undirected proxies on remuneration report resolutions

While AMP Capital directs proxies as to how shares under our control should be voted (for, against, abstain), we note the government has recently passed amendments to the Corporations Act which clarify that the chair of an AGM will be able to exercise undirected proxies when voting on the adoption of remuneration reports.

Up until now it has been unclear as to whether shareholders could authorise the chairmen of company meetings to exercise their undirected votes on the adoption of the remuneration report and the board-spill resolution.

To permit the chair to vote, the proxy form must give express authority to the chair 'even if the resolution is connected directly or indirectly with remuneration of a member of the key management personnel ...'.

This amendment will be welcomed by companies, particularly those that received a 'first-strike' on their remuneration reports in the last AGM season. However, organisations such as the Australian Shareholders' Association have claimed this weakens the two-strike rule as chairmen are conflicted.

Note: Votes can still not be cast on behalf of a member of the key management personnel or a closely related party of such a member.

UK ups the ante on shareholder power

Increased combativeness by UK shareholders has led to the recent AGM season being dubbed the 'Shareholder Spring'. More and more companies have received large votes against their high executive pay packages as the alignment between pay and performance appears to drift even further apart. The backlash started against banks who paid out a large proportion of their profits in salaries and bonuses, and now more investors are voting against overly generous pay structures at a broader range of companies.

Interestingly, there is coincidentally a move to bring in binding votes on future executive remuneration policy, including salaries, incentives and termination pay. It is hoped the binding vote will address failures in corporate governance by giving shareholders more clout and therefore the ability to engage more effectively on remuneration.

British Business Secretary Vince Cable said[1]:

> "Over the last decade directors' pay has quadrupled with no clear link to company performance. At the same time company reports have become increasingly complex without giving shareholders the information they need.
>
> "These regulations will significantly improve reporting. For the first time companies will be required to set out every element of pay that a director could be entitled to and how it supports long-term company strategy and performance. If the policy isn't specific enough, shareholders will have a legally binding vote they can use to reject it.
>
> "Companies will also have to clearly disclose directors' pay in a single figure. This means that it will no longer be possible to mask what they are actually earning.
>
> "I expect shareholders to use this new framework to maintain recent activism and challenge companies to inject greater pay discipline and prevent rewards for failure."

It is expected the government will introduce the reforms through amendments to the Enterprise and Regulatory Reform Bill, which is currently before Parliament and the reforms will be enacted by October 2013.

US Research: Cost of combined CEO/Chairman

GMI Ratings, an independent corporate governance research and rating agency recently published research on the cost of companies combining the role of CEO and Chairman[2]. The following is an excerpt:

> The two most authoritative positions in a boardroom are the CEO and the chairman. However, when these roles are combined, all the authority is vested in one individual; there are no checks and balances, and no balance of power. The CEO is charged with monitoring him or herself, presenting an obvious conflict of interest. Indeed, if the CEO is responsible for running the company, and the board is tasked with overseeing the CEO's decisions in the interests of shareholders, how can the board properly monitor the CEO's conduct if he or she is also serving as board chair?
>
> While the theory behind separating the two roles has been the subject of much shareholder and governance activist protest and commentary, an analysis of GMI Ratings' data suggests that other, more practical considerations would support the separation of the two roles. In addition to the inherent conflict of interest already discussed, CEOs who also command the title of chairman are more expensive than their counterparts serving solely as CEO. In fact, executives with a joint role of chairman and CEO are paid more than even the combined cost of a CEO and a separate chairman.
>
> Also, companies with a combined CEO and chairman appear to present a greater risk of ESG (environmental, social and governance) and accounting risk than companies that separate the roles. Furthermore, companies with combined CEOs and chairmen also appear to present a greater risk for investors and provide lower stock returns over the longer term than companies that have separated the roles. Thus having a separate chairman and CEO costs less, is less risky and is a better investment. The GMI Ratings report focuses on 180 North American mega-caps, those with a market capitalization of $20 billion or more. This group was chosen because, given the relative complexity of running the companies, it might be expected that the resulting differentials between leadership structures in cost structure, performance and risk exposure would be more marked. Here are some of the main findings of the report:
>
> - Executives with a combined CEO and chair role earn a median of just over US$16 million.
> - CEOs who do not serve as chair earn US$9.8 million in total summary compensation at the median.
> - Chairman only (all chairmen) earn median total summary compensation of US$492,259.
> - CEO plus a separate chairman earn a combined US$11 million.
> - CEO plus a separate, independent chairman earn a combined US$9.3 million.
> - Less than one percent of companies with a combined chair and CEO and a market cap in excess of US$20 billion score an ESG rating of above average compared to almost 20 percent of companies with separate roles.
> - 31.74 percent of companies with a combined chairman and CEO score an ESG rating of "F" compared to 15.87 percent of companies with a separate CEO and chair.
> - Companies with a combined CEO and chair and an ESG rating of "F" include Goldman Sachs Group, Inc., News Corporation, Bank of New York Mellon Corporation, Wells Fargo & Company, Coca-Cola Company and AT&T Inc.
> - Corporations with combined CEO and chair roles are 86 percent more likely to register as "Aggressive" in our Accounting and Governance Risk (AGR®) model.
> - Five-year shareholders returns are nearly 28 percent higher at companies with a separate CEO and chair.

NOTE: In Australia it is rare for companies to have executive chairmen. Companies that currently combine the roles include: Aurora Oil and Gas, Aquila Resources, Cabcharge, Cudeco, Karoon Gas, Mineral Resources, News Corportation and TPG Telecom.

1. **Department for Business Innovation and Skills:** *Government strengthens reporting framework for directors' pay (27 June, 2012)*

2. **Hodgson, P. and Ruel, G. July 2012.** *The Costs of a Combined Chair/CEO*. **GMI Ratings (July 2012)**

Contact us

If you would like to know more about how AMP Capital can help you, please visit ampcapital.com.au, or contact one of the following:

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