

Corporate Governance

Resources versus the rest

By John Robertson

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There is more evidence that Australia's resources companies have a poor governance track record with the potential to harm investor returns.

Corporate governance has loomed large in recent years as a topic among policymakers and academics worldwide. There is widespread agreement that governance standards are an important risk mitigation tool which assists in safeguarding the interests of shareholders.

If appropriate corporate governance structures reduce risks for shareholders, investors should pay more for companies with high governance standards than for companies that fail to apply high standards, for comparable streams of dividends or profits.

Analytically, therefore, companies that have below average or inadequate governance standards should experience lower share prices than would otherwise be the case. Their shareholders would be worse off as a result and would continue to suffer excess dilution as further capital raisings occur at lower than necessary share prices.

The purpose of this article is to:

- ▼ describe some recent data about corporate governance standards among Australia's listed companies;
- ▼ highlight the disparity between the standards generally accepted by Australian companies and those adopted by Australia's resources companies; and
- ▼ outline some of the investment implications for the resources sector of its weaker adherence to generally accepted governance principles.

University Studies

In each of the past seven years, academics from the Faculty of Business and Law at the University of Newcastle have surveyed Australia's listed companies to measure adherence to corporate governance structures.

Their series of published studies, sponsored by accounting firms BDO Kendalls and WHK Horwath, allows us to track changes in the commitment of companies to governance best practice.

The corporate governance assessment model used in the research is based upon a combination of factors identified in national and international best practice guidelines and research studies. These include the *USA Blue Ribbon Committee Report* (1999), the *UK Hampel Report* (1999), the *OECD Report* (2004), the *UK Higgs Report* (2003), the *Australian Ramsay Report* (2001), the *Investment and Financial Services Association of Australia Corporate Governance Guide* (2003), the *ASX Corporate Governance Council Principles and Recommendations* (2007) and *CLERP 9*.

I do not intend to canvass the arguments in favour of these standards being applied. There is evidence of more successful companies having more rigorous standards in place. However, there is also some conjecture as to whether success follows from the application of high standards or whether historical success subsequently permits more resources to be deployed in establishing relatively sophisticated and complex governance regimes.

There is also academic debate about the magnitude of the benefits that flow from governance reform and whether the additional costs make the effort worthwhile.

Whatever the benefits and costs, policy makers worldwide have reacted to a spate of corporate failures and executive misdeeds by prescribing more rigorous standards for their corporate citizens. In Australia, these are voluntary insofar as departures from the ASX Corporate Governance Council Principles and Recommendations are permitted provided companies justify their alternative approaches to their shareholders.

In undertaking their review of governance structures, the University of Newcastle researchers differentiate between the 250 largest companies listed on the ASX and the next 150 so-called 'mid-cap' companies. This distinction is valuable as it allows comparisons among similarly sized companies.

Directors at smaller companies often complain that their governance practices are compared unfairly with the standards adopted by better resourced larger companies. The Newcastle study can help us avoid this legitimate criticism by comparing the governance practices of similarly sized companies. The study is also helpful in highlighting disparities in governance standards among different industry segments.

The studies use publicly disclosed information to measure:

- ▼ board independence;
- ▼ the extent to which companies maintain their independence from external auditors; and
- ▼ the extent to which companies have adopted codes of conduct relating to risk management and share trading policy.

The researchers derive a governance score for each company on a scale of 1-5. A score of 5 implies that the company has met best practice standards. A score of 1, on the other hand, means corporate governance structures were lacking in most of the key identified areas.

Results

Released in July 2009, the study is based on information reported by companies in their 2008 annual reports and public disclosures and shows an overall deterioration in corporate governance standards.

Among the largest 250 companies, 39 received the highest rating. This was similar to the outcome in 2008 (40), but slightly better than in 2007 (35).



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At the same time, there was an increase in the number of companies with significant deficiencies in corporate governance. The lowest rating possible was received by 14 companies in 2009, compared with ten in 2008 and six in 2007.

The overall mean rating dropped from 3.66 in 2008 to 3.49 in 2009.

Given the prominence of this subject within the business community and among policymakers and public commentators, the backward drift in the governance scores is somewhat surprising. However, compositional effects have played a role.

Among both large-cap and mid-cap companies, the proportion of mining companies grew as their share prices benefited from cyclically strong market conditions. These favourable conditions continued until the middle of 2008, well after the share prices of companies in other market segments had begun to decline, pushing the better performing resources companies into the upper levels of the market capitalisation rankings.

Resources sector ranking

Despite the greater number of resources companies, none were ranked among the top 20 for the quality of their corporate governance. BHP Billiton and Santos were the only resources companies from amongst Australia's largest 250 companies to have governance scores high enough to place them among the 30 top ranked companies.

In contrast, half of the 14 companies with the lowest governance ranking came from the metals and mining sector of the market.

Sixty-five percent of resources companies fell into the two lowest performance categories. In contrast, only 16.9% of all companies fell into these two categories.

In some ways, reviewing resources companies in the context of large cap stocks is unfair. Strong cyclical conditions lifted the market capitalisation of many resources companies so quickly that they would have had insufficient time to bring their governance structures into line with those of larger companies even if they had a mind to do so.

Consequently, despite their higher market values, they retained many of the characteristics of early stage development companies.

Thus copper explorer Cudeco, for example, whose market capitalisation more than doubled over the two years to the end of 2008 through the issue of new shares, snuck into the top 250. However, it was always likely to appear unfavourably when compared with David Jones or Brambles, which have long been major corporations operating in relatively stable business environments.

While they can be cut some slack when looked at in the context of larger industrial, resources company standards do not look any better when compared with similarly sized companies over several years.

In the 2007 University of Newcastle study based on company filings for the year ended June 2006, there were 32 resources companies reviewed among the 150 companies that constituted the mid-cap sector of the market. Of these, 21 or (66%) had Newcastle governance scores of 2.0 or lower. In other words, corporate governance structures were lacking in some or most key areas.

In the following year, 19 of 31 resources companies (61%) had similar scores. In the 2009 study, the number of companies had grown to 48 but 35 (73%) had scores at the bottom end of the scale.

Help or hindrance?

At face value, Australia's resources companies have an unjustifiably appalling governance record. The interpretation of the data most favourable to the industry is that the resources sector is made up of action oriented individuals bent on getting the job done.

Defenders of the apparently lower governance scores will argue that the world has become too preoccupied with overly prescriptive standards that distract executives unduly from their primary development activities. On this view, the resources sector is focused on development and growth and not on unnecessary corporate trappings.

The other interpretation of the Newcastle findings is that resources sector executives are arrogantly thumbing their noses at demands from the investment community and corporate regulators. As long as they can escape meaningful penalties, they will remain obdurately opposed to compromising a culture of independence exemplified by the prominent roles played in the industry by some larger than life personalities.

At what cost?

Colourful industry characters might sometimes facilitate development outcomes, but there are some potential costs in allowing such a critical sector to opt out of mainstream governance practices.

Resources company executives are responsible for a disproportionate part of Australia's wealth generating capacity. Their roles entail important strategic decisions. The speed of mine development, the terms on which product is sold and the prices at which assets are sold to foreign interests are largely in the hands of private sector executives.

While the Australian and state governments can influence some of these decisions, this happens only at the margin. By and large, Australia's resource endowment has been privatised, leaving the returns available to the broader community to depend very much on the skill and integrity of its individual custodians.

The Australian community relies on the application of sound corporate governance principles as its safeguard to ensure that it gets as good a deal as possible for its resource endowment.

To the extent this safeguard is lacking, the community is at risk of getting a sub-standard return from its resource endowment.

Investment risk

Intuitively, investors understand that the resources sector has a peculiar risk profile. Risks relating to geological, metallurgical and environmental conditions, for example, are often the causes of businesses failing to meet their potential. Some of these risks are unavoidable.



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However, realisation of some risks reflects executive judgments rather than naturally occurring conditions. Mistimed hedging policies, mines falling below design capacity, poorly implemented marketing strategies and infrastructure delays are examples.

Australian resources companies have a history of being run by executives with little or no experience in managing public companies, dealing in the capital markets and assembling the necessary management skills for commercial success. However outstanding they might have been in their original technical disciplines, many flounder badly when confronted with this broader range of demands.

High quality independent directors are likely to be most valuable under these circumstances. However, the mining industry is especially prone to blurring the distinction between executives and non-executive directors.

Boards of mining companies frequently contain large shareholders who have had a hand in founding the business and who retain influential positions as a result of their historical involvement.

There are many examples of companies with an executive chairman, who derives that role from being a founding shareholder, as well as a managing director, who has been recruited to realise the company's development potential, but who must jostle for executive authority with the chairman.

Directors are often recruited because of their direct and continuing involvement in the industry. Their special skills in mine development, metallurgical processing techniques, negotiating with Chinese customers, or capital raising, are commonly called on in the normal course of business. It is understood that they will fill quasi-executive roles.

There are frequent examples of mergers and acquisitions effected or attempted between companies with common directors who actively promote the transactions.

One recent example illustrating the blurred division of responsibility came from junior miner Terramin Australia.

Terramin was already failing an important governance test by having an executive chairman who was a founding shareholder and who remains one of the largest shareholders in the company with an 8% holding.

Terramin appointed a new director whose 40 year background as a mining engineer included lengthy stints at large public companies. At face value, this seemed a good fit for a company about to begin a major mining development in Algeria. Indeed, Terramin must have thought so because, according to its announcement to the ASX, it appointed him to "oversee the Tala Hamza development".

Again, there was nothing necessarily wrong with this. What was startling, however, was to see this director described as "independent and non-executive". Just as surprising was the description of the company's former chief operating officer, appointed to the board in June, as "independent".

One of the roles of directors is to question corporate actions initiated by executives without being compromised by having had a personal involvement in their execution. As directors become more immersed in their executive roles, they lose this capacity. More importantly, shareholders are correspondingly deprived of having someone in this role to protect their interests when the need arises.

The ASX allows for some companies to exempt themselves from its governance guidelines. While individual resources companies are legitimately availing themselves of this allowance, investors must come to terms with the idea that so widespread are the exceptions that the guidelines are only observed fully by the occasional and exceptional company in the sector.

The industry's widespread and consistent determination to skirt around generally accepted governance practices helps to validate perceptions among investors that resources investments are more risky than they need to be and, for any given level of returns, more risky than other parts of the market.

A solution

One way for investors to deal with this relatively lax policing of the governance standards in the sector is to explicitly adopt correspondingly higher discount rates or rate of return targets, depending on the standards of individual companies, when valuing potential investments.

An analyst valuing a company that fails to apply best practice standards should apply an additional risk premium to the discount rate used in any valuation, effectively reducing the maximum price at which he would buy the stock or recommend its purchase to an investor.

This, together with appropriate diversification strategies, is the course taken by specialist resources sector investment group E.I.M. Capital Managers in assessing stocks for inclusion in its *Emerging Resources Company Share Fund*.

The Fund is able to invest in companies of any size. However, its portfolio is weighted toward mid-sized companies because of its focus on growth-oriented companies developing new projects. Inevitably, the manager must deal with the sector's governance shortcomings every day and, one way or another, incorporate the additional risks into its valuation analysis.

Professional investors might be able to do this in a variety of ways, but it is not a straightforward task for individual investors attempting to manage their own portfolios.

For these individuals, the message is clear. If, as a private investor, one wishes to take a direct stake in companies with even average (let alone above average) corporate governance standards, stay clear of Australian miners.

John Robertson is proprietor of thebigpicture Economics and a director of equity fund manager, E.I.M. Capital Managers. Contact John at john.robertson@thebigpicture.com.au