

The Grill – February 2011

Welcome back. Use these links to sample as much or as little as you'd like from this month's Grill, or just graze:

- [Land, Water, Food, Energy \(aka Climate Change\)](#): sugar industry, carbon price, more change
- [Sustainable Investment \(ESG\)](#): MIT-BCG Study, US and Aust funds rise, private equity cases, Caisse de Depot valuations, cost of credit
- [People](#): China supply chain, Australian computers, African health
- [Innovation](#): Biomimicry, Pricing, The Empire State
- [Brand](#): Post, Real estate, Adidas research

See past Grills and additional blogs at www.dowse-csp.com.au.

Land, Water, Food, Energy

- **Sugar: blow hard and jump 60 years ... or not.** The Yasi destruction of Queensland's sugarcane fields has rightfully drawn much concern. Drawing fewer headlines but greater industry alarm is what's happened to the sugar *mills*. These were relics of postwar expansion, held together by wire, Aussie ingenuity and hope, and they didn't get through the cyclone well. The youngest of 30-odd was built in 1953. They were dotted through Queensland according to the economic rationale of the first half of last century. Now, with mills blown apart, spare parts unavailable and a blank sheet for reinvestment, what will the industry do? If every other industry is a guide, there will be fewer and larger mills, placed to take advantage of new logistics networks. The Babinda mill south of Cairns has been the first to [shut](#), prompting Bob Katter to enlist the AWU to save the industry. If Babinda was hard hit, hundreds of kilometres from the storm's eye, what about the others? The industry will be saved, but local communities literally won't know themselves. It's all a reminder that when you're looking at your environmental risks, it's well beyond a compliance issue. And, for better or worse, opportunities in climate change adaptation will continue to arise. [Top](#)
- **A price on carbon?** With sixteen journalists apiece lodged in Canberra with nothing to do at night, the mainstream press covers this better than I can. Previous *Grills* have expressed my view that an initial, clear fixed price signal is theoretically weaker though practically and politically stronger than an ETS. As the proposals stand, it seems that there will be a price, but consumers and a handful of major emitters won't be paying it, as their hold over Canberra is vice-like in tender places. Which leaves most businesses in Australia bearing the responsibility for investing in Australia's future. Niceties like industry policy, public policy, public benefit, environmental outcomes, macro-economics and micro-economics are becalmed in laggards' lane while our climate change policies race to most-cost least-benefit glories. It's still not too late to trace through the price effects and market dynamics for your business, while the window to do something about them creaks shut. There'll be positives and negatives. If your industry association hasn't outgunned the BCA, and it seems few have, there may be more negatives than there needs to be. [Top](#)
- **Ice island calving and other unrelated events.** While snowstorms, cyclones and bushfires are understandably well reported, other events sometimes pass by unnoticed. Like an ice

island four times the size of Manhattan breaking off Greenland's Petermann Glacier last August, the biggest such event in the Arctic in nearly 50 years. Nicely [pictured](#) by NASA, the ice island was 100 square miles in area, and half the height of the Empire State Building thick. Andreas Muenchow, professor of ocean science and engineering at the University of Delaware suggests: "Nobody can claim this was caused by global warming. On the other hand nobody can claim that it wasn't." As you would have heard, NASA announced that 2010 tied with 2005 as the hottest year on record, though it also said that 1998, 2002, 2003, 2006, 2007 were all so close we shouldn't split hairs. The evidence keeps [accumulating](#), and with it the need for adaptation plans. [Top](#)

Sustainable investment

- **MIT-BCG confirm value of sustainability.** The [second annual global sustainability study](#) from the MIT Sloan Management Review and The Boston Consulting Group have narrowed the full spectrum of company interest in sustainability to two main groups: those that see sustainability as risk management and efficiency, and those "embracers" that take a longer view, seeing sustainability as a core strategy that fosters growth and creates a range of intangible advantages. [Sound familiar?]

About 60% of surveyed companies revealed that their sustainability investments grew in 2010, despite the recession. And, two-thirds of the "embracers" believe those investments are boosting their profits. The report's co-author Michael Hopkins says "What's fascinating is ... a business landscape ... that's tilting hard toward where the embracers already are. Their insights and behaviours suggest a blueprint for how management practice and competitive strategy will evolve."

The embracers share some common traits: they balance broader perspectives against short-term results; sustainability has traction both at the top and from the bottom; it is integrated across the company; and there is measurement, transparency and authenticity.

"They are setting realistic goals expectations for the return on [their] investments. And yet by heading down one path they are finding unexpected benefits. Employees are more engaged... Brand value is enhanced, often in unexpected ways." [Top](#)

- **ESG funds on the rise.** Data has recently been published in both the US and Australia to indicate that there is an increasing share of the pie being invested in companies with a better environmental, social and governance record.

In the US, the [data](#) to the end of 2010 suggests that from 2005 to 2010 inclusive, "socially responsible investment" (SRI) assets have increased more than 34%, while total professionally managed assets increased 3%. Those SRI assets constitute 12.2% percent of the \$25.2 trillion in total FUM tracked by Thomson Reuters Nelson. Professionally managed funds tracked as incorporating ESG criteria rose 90% between 2007 and 2010 – from 260 to 493 – with their assets increasing 182% from \$202 billion to \$569 billion.

In [Australia](#), Corporate Monitor and Morningstar report a 10% rise in responsible investment (RI) portfolios in the year to 30 June 2010, with total funds rising 13% to \$18.19billion. The claim is a strong one: that RI funds have outperformed the average mainstream fund over 1, 3, 5 and 7 year periods (see over page). There is something very disturbing about these results, but I wouldn't be the one to suggest it. [Top](#)

	1yr	3yr	5yr	7yr
Average Australian equity fund	11.56	-8.05	3.70	8.75
Average RI Aust equity fund	15.09	-7.50	5.14	9.95
S&P/ASX 300 Accumulation index	13.05	-8.05	4.49	9.70

- More private equity cases.** The UN PRI's second selection of case studies has 13 examples of investors gaining benefits from enlightened self-interest. The cases mostly reiterate the returns available from a closer watch on eco-efficiency, but there is an additional and less acknowledged common thread. By concentrating on ESG-related issues, companies build ideas and relationships that offer other advantages. For example:
 - Doughty Hanson's Avanza transport group quickly saved over €1million in annual energy costs, a performance that "helped the group win the competitive tender for the Zaragoza Tramway concession in June 2009".
 - Cordiant invested heavily in the social infrastructure of its Banro goldmine in the DRC and found that the community engagement kept business disruption to a minimum.
 - KKR's agreement with the Environmental Defence Fund on its TXU purchase has led to an analytic, operational and communication partnership delivering cost-savings across 16 companies in KKR's portfolio.
 - Blackstone studied the high cost of health care in the US, and saw the opportunity to launch its own fund, making it available across its portfolio (saving over \$200m in 3 years) and to that of other private equity firms. [Top](#)
- Valuing risk at Caisse de Depot.** Stephen Kibsey, VP-Risk Management for Caisse de Depot's CAD\$131bill Equity Market portfolio, has revealed online a little more of how they value ESG risk in that portfolio. Risk is analysed across the management, board, competitive environment of the company, encompassing competitive position, value creation, and financial position, with ESG elements affecting most of these. Risks are then integrated into the weighted average cost of capital (WACC) of the company used to discount its cash flow. Say a company has a qualitative risk rating that translates to a net equity risk premium of 4.9%, which is added to an assumed risk-free rate of 4.50%, for a total weighted average cost of capital (WACC) of 9.4%. Due diligence on the company's sustainability program may result in the risk rating being revised upwards, flowing through to a revised WACC of 10.5%. When applied to discount the company's cash flows, it may be that the company is worth less than first thought. The better a company's sustainability program, the better their qualitative risk score, the lower the WACC and the higher the intrinsic value. [Top](#)
- Reduce your cost of credit.** As our and global banks openly compete on their sustainability credentials, push them to reward yours. One of the earliest academic research pieces on the value of environmental management found that banks gave firms with an objectively stronger environmental performance – an average 50bp discount on their loans. It's good to see this connection has been maintained. Rob Bauer (former head of research at Dutch pension fund ABP) and PhD student Daniel Hann have [found](#) that companies with stronger environmental performance consistently pay lower costs for debt. Those with weaker records have higher costs and, unsurprisingly, poorer credit ratings. Bauer and Hann studied 582 US firms between 1995 and 2006, and also found that the correlation was growing stronger year by year. [Top](#)

People

- **China supply-chain: More transparent than you'd think.** Sunlight is proving the best disinfectant in China. Despite reluctance in other fields, the government publishes detail on environmental performance all the time, and will take highly visible action to make an example of a hapless factory owner prone to using the local stream as an arsenic outfall. But to make sense of all the data takes a bit of work. The very small and privately run Institute of Public and Environmental Affairs (not to be confused with our own IPA, though it would be hilarious if they were) publishes the official data in a way NGOs and others can use it. It just makes it easier to track supply chain breaches. "Every month [Walmart] are comparing their list of thousands of suppliers with our list of violators and when they identify polluters ... they will call them, they will push them to take corrective actions, and eventually make a public disclosure about what went wrong and how they tried to fix their problem", [says](#) IPEA chief and my nominee for "Bravest publisher since Danish comics poked fun at Allah" award, Ma Jun. [Top](#)
- **Human rights are OK in OZ, right?** Human rights are all about Filipino sweatshops and factory mice in Guangzhou, right? Yet it can be a little closer to home. Imagine working in Sydney, building laptops for HP, and getting an SMS every night to see if you'll be working in the morning. That's the way Foxteq has been doing it in Rydalmere. Another spotfire that HP has had to spend time on putting out – time with the media, time with its suppliers, time with unions, time with regulators. Might even face prosecution for breaching the award. Wonder what they saved? And how many layers of responsibility do they have – contract out the assembly to Foxteq, who contracts out its labour needs to Weststaff, who texts someone daily with the good or the bad news. The [Herald](#) describes it as the return of the 'Hungry Mile', the 1930s line up at Sydney's Barangaroo wharves in search of a day's pay. Labour history swings back and forth. (Workers who experienced the Hungry Mile didn't need to be persuaded of the need for a union, and built up their defences so strongly it needed Patricks and the government to tear them down decades later.) This news ends up not just in Sydney's Teaset Tittilator, but gets picked up in global reports, such as [here](#). The Nuremburg defence is of course used – the market demands computers. Do we really need a laptop to be \$300, delivered yesterday in whatever colour we want? Or is it that HP has pushed responsibility for its inventory so far back up the chain that everybody holds the costs but HP. I'm sure any government purchaser would be impressed by that record – and let's face it, who else is buying HP laptops? [Top](#)
- **HIV and the benefits of health.** Anglo-American knows ESG issues in Africa better than most – notably HIV. Of their 71,000 employees, 12,000 are HIVpositive. Ten years ago, Anglo would employ and train two people for every position, in case one of them died. The immediate financial cost of HIV remains 3.4% of payroll. But Anglo now invests heavily in antiretroviral treatments (ARTs). It costs \$126 (£80) per HIV+ employee per month, but then those people are able to work. Absenteeism declines 1.9 days per employee per month. The use of healthcare services also declines. Staff turnover and benefits payments are reduced. All up, the savings are \$219 per patient per month, far more than the cost of treatment. Giving out ART [free of charge](#) makes total economic sense. Anglo's next problem is an extremely drug resistant strain of TB called XDR. Worker health can be readily affordable (as in this case), or as mindblowingly expensive as in the US. [Top](#)

Innovation

- **More biomimicry.** One of the earlier books worth reading on sustainability was Amory Lovins et al's *Natural Capitalism* 1997. One of its themes was the power of biomimicry: replicating the unique properties that species have developed to cope with their environment. A classic example is reproducing the water-repellent qualities of the lotus flower in marine paints to reduce drag by 25%. This week we're turning waste to product again. Chemicals company Genomatica has [partnered](#) with Waste Management to turn gas from trash into chemicals with the help of organisms. Genomatica would use the syngas from the anaerobic digestion of waste or from landfill gas into more of its bio-based version of the common chemical 1,4-butanediol (BDO). The market for BDO is about \$3 billion a year, and the chemical is used to make spandex, automotive engineering plastics, and other materials. Genomatica makes BDO out of sugars and genetically-modified E. coli more cheaply than from traditional petroleum and natural gas sources. [Top](#)
- **Marketing – you name the price.** One day, an entire *Grill* will be devoted to the logic of allowing mobile billboards on the back of trucks or motorbikes, whichever is the noisier. I'm told that's called marketing whizzbang innovation and is what makes our economy strong. It's another good use for piano wire if you ask me. Sustainability thinking would suggest that those who benefit from less offensive outdoor advertising may mention to governments the noise, emissions, visual pollution and congestion. Universal support for new regulations is rare. Call me if you want me to lead the charge

But I digress. There seems more interesting ways to prod our soft hearts for good cash. Leif Nelson from the credible Haas School of Business at UC Berkeley [found out](#) that letting people pay what they want for a product, with the promise that 50% will go to charity, may produce a higher profit than selling the product at a fixed market price. Nelson ran a test with 28,224 people at an amusement park. As they got off the rollercoaster and started looking for the 3yo they tethered to the giant mouse an hour before, they were offered a happy snap of their terror down the vertical drop. Only 0.5% of funseekers bought the \$12.95 photo, generating 6 cents of profit per visitor. But when riders could choose their price, half going to charity, things moved. Volume increased nine-fold, at \$5.33 per photo, delivering 20 cents profit per visitor, and four times more for the charity.

Maybe this is worth a go, following existing pay-what-you-want models (One World Everybody Eats, Panera Bread or SAME or Radiohead's "In Rainbows" album or Mixergy's subscription option). In any model a few tweaks may be needed to get it right, but who knows! [Top](#)

- **The Empire strikes back.** Building retrofits are getting pretty ho-hum. But when they do it to the [Empire State Building](#), surely they can do it to anything. Spending \$13.2m to retrofit for energy efficiency seems a lot. But returning \$4.4m a year means a very nice IRR of 31% over ten years. [Top](#)

Brand

- **Post flops.** Last time I had a [look](#) at Australia Post, we taxpayers had lost \$6.7 billion in brand value due to its determined efforts to discredit itself. Since then Post has been in the news for two things: its potential re-launch as a bank, and its delivery of “adult-only” direct mail spruiking the discredited nose-blower. (When this pearler hit my letterbox, my first thought was “and the rest is directed at my kids?”) Any social radar would question the practice. Any business radar would question the wisdom of new clients that are in voluntary administration and under investigation by the ACCC. I’m really beginning to doubt if Post will last In financial services, 80% or more of market value represents the intangibles of brand, people, innovation capacity and networks. Post’s physical networks might be in strong shape, but its treatment of intangibles suggests it’s not going to fly as a bank. And when it fails at that? Why do I care? Because no-one else seems to, and I part own the thing. [Top](#)
- **Real estate.** Financial models are well in place to help property owners know whether to push for 4 or 5 or 6 star developments. But how would a tenant evaluate that choice? In the US, as in Australia, more companies than ever before say they’re willing to pay more for green office space, according to Jones Lang LaSalle’s fourth annual [Sustainability Survey](#), released this month. Almost all (92%) say green credentials are considered, and 64% say it’s critical: ie all else being equal, a green building will get the tenant. Just on half say they’d pay more, up from 37% in 2009. How much more? About 10%. Energy is important, but not as much as you’d think: 32% put it as the top sustainability metric, down from 37% last time. Employee health and productivity is tops for 31%, with a further 11% saying employee satisfaction. (May be some overlap there!) What then is guiding that choice? Consider a [valuation analysis](#) to identify just how much this may be worth to your business. [Top](#)

Networks

- **ADIDAS goes for triple bottom line performance.** In a nice piece of news, Adidas has [partnered](#) with the Royal Melbourne Institute of Technology (RMIT) to take a close look at its supply chain in SE Asia, and develop projects to improve it. RMIT’s team is led by Professor Aleksandar Subic, head of its School of Aerospace, Mechanical and Manufacturing Engineering, and will include researchers from sports technology, manufacturing, sustainable development, sustainable energy, supply chain management and textiles. “RMIT secured this assignment based on their strengths in engineering, depth of understanding of sustainable manufacturing processes and their ongoing commitment to education in the region, which is exemplified by their Vietnam campuses,” said Adidas. Engagement in one aspect leads to rewards in others. [Top](#)

The Dowse Grill is information and opinion from Dowse CSP, advisers on corporate sustainability, responsible investment and related actions. For all enquiries contact thegrill@dowse-csp.com.au, or call Josh Dowse on 02 8922 9617