AFR Leadership Forum

Presentation by Mr Don Argus

Thursday 25 July 2002

CORPORATE CHALLENGES IN A GLOBALISED WORLD

In preparing for today's presentation I asked Glenn Burge whether there were any particular themes he wanted me to cover, given that my address is for 25 minutes.

His suggested topics would keep us here all afternoon, so I will see if I can précis my remarks, and see if we can stimulate some discussion.

For a decade now a number of people in Australia, including myself, have been endeavouring to stimulate debate on how we would handle the impact of globalisation on this country.

Just so that we are all speaking from the same term sheet, globalisation is a phenomenon whose economic dimensions involve increases in flows of trade, capital, and information as well as mobility of individuals across borders.

Even though it has received much attention, it of course is by no means new!

It has been argued that globalisation has proceeded throughout the course of recorded history though not in a steady or linear fashion.

It has been driven in many cases by significant technology advances, and has, as such, been associated with the vast improvements in prosperity that the world has experienced in recent times.

While increased international trade and capital flows associated with globalisation, have been the source of an unprecedented rise in living standards around the world, neither the process of globalisation nor the gains are guaranteed or automatic.

On the contrary, there are examples from the 20th century of countries limiting their exposure to foreign trade and capital.

However, attempts to restrict the advance of globalisation hamper individual countries' abilities to share in the gains, and can have disastrous consequences when imposed on a global scale.

Despite the general trend to increasing globalisation in the post 1950 period, not all countries have benefited, nor have all citizens of a given globalising country prospered.

Those countries that have seen the greatest increases in per capita income, have pursued outward oriented policies, and put in place structural reforms to develop institutions for good governance and economic growth, and to increase their economies' flexibility.

History also shows that strong economic growth gives governments the resources to improve the prospects of the less well off.

Since globalisation, like technology change, produces both winners and losers within each country, it is important to put in place safety nets to cushion the losers from the worst effects and more generally to put in place policies that equalise opportunities. Under that heading you put public education, health and security.

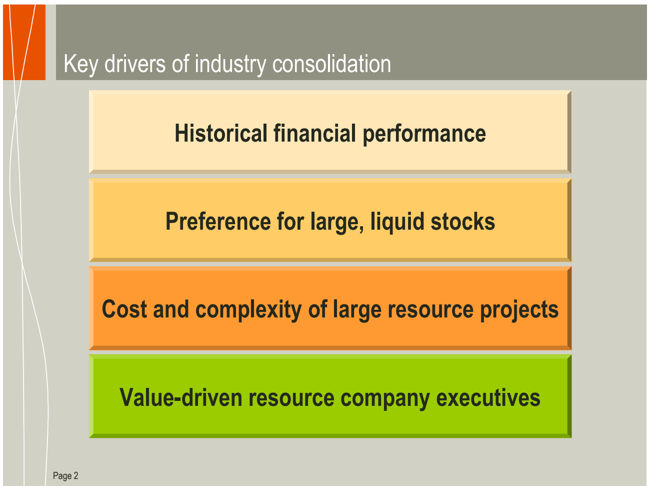
Those subjects are all issues of their own and encourage plenty of debate, but the point I want to make, it is no longer a matter of how we face the impact of globalisation and its consequences, but when!!

The market economy in my view has established its primacy, and businesses in particular are redefining the traditional role of the industries in which they operate, as well as redefining the traditional roles of the businesses themselves.

What then does this mean for companies like BHP Billiton?

We were all aware of the fundamental shift in the dynamics of the resources sector, and the announcement of the merger 12 months ago was in many respects the culmination of a process of consolidation that had been underway in the resources sector for a decade.

There are many drivers of industry consolidation, but important among these were:



(SLIDE 1 – Key drivers of industry consolidation)

1. **The generally poor financial performance of some resource companies in the past.**

These companies, typically with only one major commodity exposure, generally tended to over-expand when the relevant commodity price was high and then face cash shortfall when prices declined. This pattern led to an industry that, on average, failed to cover its cost of capital.

2. **The desire of portfolio managers for large, liquid stocks.**

Fund Managers have a preference for stocks which allow changes to portfolio composition without significantly affecting the share price. I have had it said to me on a number of occasions that companies below US$10 billion just don't make it on the radar screens of many institutional investors.

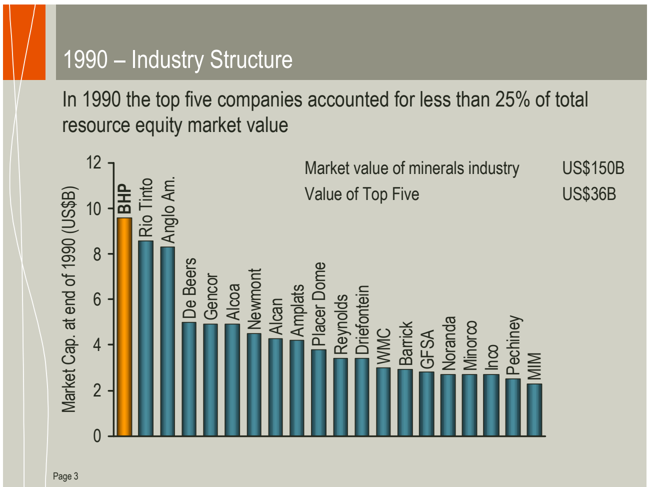
3. **The escalating cost and complexity of large resource projects.**

The resource industry is one of long lead-times and often massive capital expenditure. There is also often the need to manage some combination of both geological and country risk.

Two of the projects most recently approved by BHP Billiton have been a US$450 million expansion of the Hillside aluminium smelter in South Africa and the US$335m development of the Mad Dog oil & gas field in the deep water U.S. Gulf of Mexico – one reflecting the need to manage country risk and the other significant technical and environmental challenges.

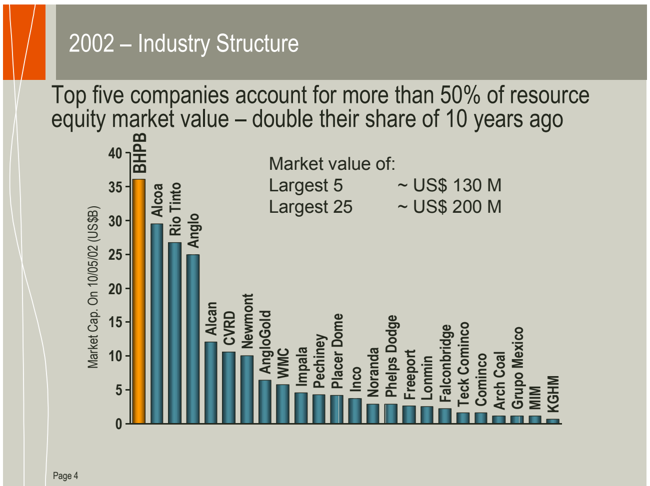
Small to mid size companies do not have the ability to take on these exposures without significantly risking their overall portfolio.

SLIDE 2



In 1990, the top 5 metals and mining companies accounted for less than 25% of the total equity value of the US$150 billion metals and mining industry. The then-largest company, BHP, had a market capitalisation of around US$9 billion. (SLIDE 2)

SLIDE 3



Today, the top 5 companies account for almost 50% of the resource equity value of $US250 billion, effectively a doubling for the top 5 over the decade (SLIDE 3). BHP Billiton is still the largest company, 4 times bigger than in 1990, and as large as the top five aggregated in that earlier year.

Such a fundamental shift has changed the face of both the industry and its players. This slide illustrates the emergence of the current market leaders, and the large gap that is forming between them and the rest.

The industry now comprises a small number of large, more disciplined companies, focused on maximising value. These companies are now in a better position to achieve this value due to a number of factors.

The resulting positive impact of these changes on the bottom line provides the basis for some resource companies to be highly attractive investment choices for fund managers.

What then have we learnt from Dual Listed transactions?

As you will already have gathered, we think we have created something special with this merger.

In the BHP Billiton case we have been able to participate in the industry consolidation and influence the change when probably both BHP and Billiton would themselves have been prizes, in the consolidation process.

Obviously execution risk is always a factor in any merger or acquisition, and if a deal has been misconceived no degree of brilliant post merger integration will clean up the mess.

In the two transactions that I was involved with in 2001, ie, BHP Billiton and the Brambles transaction, the strategic imperative just made so much sense!

Don't let me mislead you, in any merger or acquisition you will always find entrenched corporate cultures, parochial outlooks, fear of change, and well meaning investment bankers with agendas that may not necessarily align to delivering long term shareholder value, not to mention lots of "armchair" critics.

You can even get caught up with the excitement and demands of consummating the deal.

Much is made of cost reduction, increased purchasing power and perhaps even a lower cost of capital but few notice the potential to realign your business model which offers opportunities to optimise enhanced income from your product offering.

In BHP Billiton's case you have the creation of the Customer Sector Groups which adds extra value to the old "dig and deliver" mentality which pervades the mining industry.

In Brambles' case, the new operating model that CK Chow and his team have introduced has really exposed the value drivers along the total service chain for Chep in particular. This has enabled better pricing decisions to be undertaken for all functions within that chain. It has also enabled the Company to better negotiate contracts with its customer base. Brambles have been able to entice non-participating distributors back into the network and the pallet recovery programme is now far more vigorous.

Both companies have a rigorous capital allocation process and a strong commitment to Shareholder Value Creation which makes decisions on the management of the respective Asset portfolios very focussed.

But of course the obvious comment you will make; this all sounds fine but where has value been created.

In my view, there are two ways to create value in a business. The first is the external factor. Why does a company's share price rise or fall over a given period?

TSR, or Total Shareholder Return, which is the rise of a company's share price plus dividends over a period of time, is a popular measure of how a company performs against other stocks.

Market corrections can significantly reduce rises in TSR and there are many investor strategies that can influence the value proposition.

For instance, it is very difficult for Management or a Board to take a view on what value will be created when some investors endeavour to take advantage of relative pricing discrepancies between equities, debt, options, and futures. These investors use mathematical, or technical analysis to determine what they perceive to be misevaluations in all instruments used in balance sheet structures.

Hedge Funds are now very much a factor and very professional as they seek arbitrage opportunities in global markets. These can range from exploiting pricing inefficiencies between markets, you may find them short selling securities because of a particular corporate, political, or economic event or you may see Index arbitrage initiatives.

There is a very interesting paper produced by JB Were on Global Asset Allocation. In that paper there are a number of observations made, but the point that attracted me was:

- There is a consensus emerging that the trend towards increased economic integration is undermining the traditional diversification benefits from investing across countries and promoting the importance of sectoral diversification in global portfolio strategies.

They go on to conclude that in terms of asset allocation, countries still matter. Trade and capital integration partly explains the convergence across the G7 markets from the mid 1990's. But this trend has been exacerbated by the unusual coincidence of two global shocks, the demise of the new economy bubble, and the rise in real crude oil prices. Further significant dispersion in country betas persist, largely reflecting differences in industrial structures, and we should not forget this, as we endeavour to put our footprint onto the world stage.

With so many factors likely to increase volatility and influence value, a major challenge is to endeavour to reposition the stock outside of the traditional sector rating.

Markets in my experience, adopt a cautious approach to new initiatives which may provide a premium to the traditional sector rating – we have taken the first step in BHP Billiton by overtaking the sector leader. The next step is to prove to the market that the new model does in fact provide additional value.

Delivery of the traditional economic tests will always ensure that you are at least with the leaders should the market re-rate the particular sector in which you operate.

If an entity produces

- Consistent EPS growth
- Consistent R.O.I.C. in excess of the W.A.C.C.
- EBIT margin maintained and improved
- Good cost control and efficient use of assets
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then you are on the radar screen of most investors.

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

At the end of the end of the day, performance will dictate what value is created.

The second way to create value is to recognise the importance of one's Human Resources and Customer base.

There is no doubt in my mind that if you are to be a long term "market darling" then the retention and development of your people is fundamental to top performers.

With the growing popularity of equity related remuneration packages, it is important for companies to achieve sustained improvements in their value if they are to attract and keep the best staff. Success in this area also enhances job security and loyalty.

As I indicated earlier, I think BHP Billiton and Brambles have executed the merger transformation extremely well and it is a credit to the respective management teams for their focus.

The real challenge now of course is proving to the market that we can consistently deliver on our value proposition.

What then are some of the issues that we may confront going forward?

I am sure that there are some fertile minds in the Investment Banking community who spend time thinking about structures which could take BHP Billiton and Brambles out of Australia without consideration for the reasons FIRB approved the transactions in the first instance or for that matter not compensating shareholders adequately for the unique Asset Base, or intellectual capital contribution inherent in these businesses.

That is a situation for all countries and companies if your currency is under valued to one of the major currencies. The challenge for Management and Boards is to ensure that these companies perform to their optimum level and that Australia continues to provide an attractive place to do business.

I have no doubt about the future performance of the respective companies otherwise the transactions would not have been completed.

That then brings me to the challenges that I see for Corporate Australia, and in particular BHP Billiton and Brambles in this country? I believe it goes to the very heart of the debate that has been undertaken for fifteen years, that I can remember. How do you attract International companies, and headquarters, into Australia and how do you foster international growth of Australian based companies.

Australia has an economy that has performed extremely well for the last decade; we have a stock market that outperforms the Dow, FTSE and MSCI indices; we have growing prosperity in our community; we have a health and education system that, relatively speaking, is effective; and we are now seeing projected unemployment levels that have not been part of our landscape of 20 years.

A combination of low inflation, strong productivity growth and a competitive dollar has provided a stable and positive environment for investment, a safe haven if you will, at this point in time.

I do not have an answer as to why International Companies do not locate here in Australia. One argument is that we are too distant from where the bulk of International Trade is conducted. I have read the arguments that our economic integration should be aligned with the developing nations in the Asia Region, and whilst I have some sympathy with that thesis, I am not convinced that is the answer either.

There is also the argument that we are constrained by population size. Even if you double our population that is not going to give us the market size of the US or Europe. Perhaps our strategy should be to understand the levers to international competition akin to Singapore. Whichever course we take one issue is very clear, we do need to grow our population to ameliorate issues associated with an ageing population.

If you accept my argument that the market economy is the primary thrust for developing nations such as ours, then companies must be able to compete. Business has the choice in this globalised world of becoming part of the convergence process or becoming a highly focussed player.

If business is going to compete, then Government too must understand that they also are competing, particularly in terms of investment and to achieve preferred country status. We must have a competitive environment to complement the stability that we have in terms of low risk for Law and Order and political extremism.

That said, I was particularly taken by the section on risk in the BCA's submission to the Dawson Review of the Trade Practices Act.

Whilst there are many good arguments proposed in the document, for me the following captured what I believe to be one of the inhibitors to the certainty and consistency that investors are looking for.

" *The process of competition is becoming increasingly dynamic. Globalisation, liberalisation and technology advances mean that the sources of competition geographically and over time are changing quickly*. "

This, to my mind, increases the difficulty of defining markets, particularly in a regional sense as distinct from a National or Global perspective, and it makes it extremely difficult to determine market power.

I also totally agree with that section of the BCA submission which canvasses a view that whenever uncertainty appears in markets, there is a propensity to regulate, ie, to err on the side of intervening, particularly when the cost of doing so – often opportunity costs – can be difficult to quantify.

Against such a backdrop of uncertainty, to endeavour to prescribe for eventualities in a volatile environment is not sensible and could artificially constrain competitive initiatives.

With regard to the Taxation issues associated with the DLCs, dealings with the Australian and UK Tax authorities has been very professional and their cooperation in dealing with complex matters and the subsequent issue of tax rulings, has certainly been appreciated.

Ongoing discussions with the Tax authorities continue to achieve practical outcomes on administrative matters.

That said, Australia still has not shed the reputation of having complex and open-ended anti avoidance tax rules which I would observe has the potential to turn away opportunities to participate in the global market.

To give you an example, certain finance transactions are possible in places like the UK and the US, but are sometimes frowned upon here.

In April this year the UK introduced exemptions from UK CG Tax and certain foreign assets to encourage the UK to be adopted as an investment base. This is similar to the Netherlands. On the other hand the UK did not endear itself to the Oil and Gas industry when it applied, in the last Budget, an additional 10% levy to the North Sea Oil & Gas Producers (notwithstanding CAPEX write-offs were also increased to 100%) – overall an unattractive measure to a mature business region. The UK Offshore Operators Association has acknowledged this will adversely impact employment and future investment in the region.

It is comforting that our Government is committed to further tax reform, but we need a bipartisan approach to further tax reform if Australia is to attract international business and for that matter hold its current business base.

The reform equally applies to cutting the top marginal rate of income tax.

Comparative statistics on marginal corporate and personal tax rates still put us towards the higher end of the developed world, though this is improving. It is interesting to study Ireland's development where it has a corporate rate of 10% with a high marginal personal rate (31.5% median personal rate and a GST of 21%).

I don't like oversimplifying solutions but for the sake of this delivery today a preferred location for headquarters of a multi-national company is therefore a country which has:

- a good tax treaty network
- minimal set-up and running costs;
- a low income tax burden (as well as reasonable certainty of that result under the relevant taxation laws); and
- negligible, if any, withholding taxes on dividends, interest, royalty and other payments paid by the company.

I know there will be the dismissive arguments that such reform and tax cuts has the potential to drive the budget into deficit – If Australia and the companies domiciled here are to be a competitive force into the future, and here I am talking mobile capital and skilled labour, then we must not lose our nerve, and must continue to build on some of the good initiatives already undertaken.

No presentation at a forum such as this would be complete without some comment on the role of Boards, particularly in the light of recent events offshore and in Australia.

I have read the commentary that some of the influences of change experienced in world markets are not penetrating Corporate Board Rooms.

Boards are perceived to be self-perpetuating clubs that perform a passive review function for the executive, rather than providing a guiding role for the organisation.

It is now argued in some jurisdictions that it is not enough to have non executive directors, they need to be independent and they must have accountability.

There is also a real concern about the extent to which auditors are selling other services to their audit clients and that this can stop them from being tough when toughness is needed.

Another theme being promoted is that Corporate wellbeing, embraces institutional shareholders and analysts as well as auditors and Boards – I fully support that thrust because together this group can set much of the framework in which Boards and Auditors operate.

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.

Now, having said that, it is impossible to earn profits without an element of risk, particularly when doing something new. One should not be afraid of entrepreneurship if a business is to hold its own in highly competitive global markets. Businesses need proper risk management not red tape.

It is also reassuring to see a move in overseas jurisdictions to require Boards to review their own performance on a regular basis. I have found that a strong group of independent directors assisted by an outside facilitator help make this a rigorous process. I really do not see how Directors can offer themselves for re-election unless there is some form of critical performance assessment.

I could spend hours on this corporate governance subject because when I look at Corporate failures, invariably there is a common theme. Directors do not understand the strategy which is being pursued or the risks inherent in that strategy.

The Dual Listed Company structure has allowed the Boards of both BHP Billiton and Brambles the opportunity to study the corporate governance practices where we are listed and implement a "highest common denominator" approach to corporate governance.

You will be interested in some of the differences between the UK and Australian Corporate Governance Regimes.

- Financial statements are put to a shareholder vote in the UK under the UK Combined Code on Corporate Governance (which is not a mandatory code under law but with which all listed companies are expected to comply in practice). There is no requirement or practice in Australia for financial statements to be approved by shareholders – they are just laid before the AGM.
  (<u>BHP Billiton position</u>: *financial statements will be put to shareholder vote for both companies this year*.)

- It is traditional practice, but not law, in the UK for companies to put their final dividends to shareholders for approval. In fact, many companies avoid this by declaring interim dividends only. There is no requirement for shareholder approval of dividends in Australia and no practice of obtaining it.
  (<u>BHP Billiton position</u>: *Plc Articles have been amended to comply with Australian practice – no shareholder approval of dividends necessary*.)

- UK law requires the Annual Report to include a remuneration report containing extensive disclosure on directors' remuneration. Australian disclosure requirements are not as extensive on directors' remuneration but require disclosure of emoluments of the top five executives which is not required in the UK.
  (<u>BHP Billiton position</u>: *Annual Reports of Plc and Limited this year will include a remuneration report complying with UK practice and including the top five information. There are proposed changes to UK law that will require the Remuneration Reports to be considered by shareholders at the AGM. BHP Billiton's approach this year will be to seek approval of remuneration policy*.)

- UK law requires auditors to be re-appointed by shareholders every year. Australian law requires auditors to be approved by shareholders only when the directors have appointed new auditors during the year or there is a vacancy.
  (<u>BHP Billiton position</u>: *Both Plc and Limited will put auditors to shareholders for approval every year*.)

- Adoption of an employee/executive share plan requires shareholder approval under the UK Listing Rules but there is no such requirement in Australia (the ASX Listing Rules used to contain the same requirement but it was dropped a few years ago). However, in Australia, executive director participation in an employee share plan requires specific prior shareholder approval for each director and this requirement does not exist in the UK).
  (<u>BHP Billiton position</u>: *Both Limited and Plc will request shareholder approval for adoption of new employee plans and also for executive director participation. This will be included in the Remuneration Policy.*)

It is interesting to read the NYSE Stock Exchange Corporate Accountability and Listing Standards now being introduced, and the review of the Code of Practice being undertaken in the United Kingdom.

I found myself reflecting on the corporate failures of the 1980s in this country and what standards were introduced to prevent similar problems re-occurring. These standards enshrined in Law, and listing rules, in my view moved Australian Boards away from the conformance based model to one of analysis, challenge and critique, all with a constructive end – shareholder value.

There will always be the exception of course but I find the new consciousness of the Corporate World in the United States quite intriguing and whilst the UK have stiffened their Corporate Governance Standards over the last ten years, they too have been shaken by the events in the US and are moving to another review of their Companies Act and Combined Code with much more emphasis on the independence of Non Executive Directors.

Restrictions on Auditors providing certain services to audit clients, Performance Review of boards, roles of Board sub-committees and more disclosure on the Corporate Strategy, Key Drivers of Performance, future prospects, major risks and environmental and social performance are all items which are now under the microscope for review. These issues of course should be under constant scrutiny if Boards are to be really effective.

Almost everyone's economic wellbeing is now linked closely to the way companies are run, particularly if they are listed on a Stock Exchange. Share values support a large proportion of superannuation and pension funds and if companies fail employees and suppliers jobs are at stake.

Well run companies are absolutely crucial to our prosperity and if a major company should collapse amidst suspicion of wrong doing or dereliction of duty, it strikes a serious blow to public trust in the system as a whole.

That is why I make a somewhat bold statement that whilst auditors have a vital role to play in good governance, as have other market practitioners, the responsibility for effective stewardship of a company rests squarely with the Board of Directors.

Whilst there is no doubt that we are entering an era where the application of Corporate Governance standards will have a bearing on the value of a company.

That however will not be sufficient unless we get harmonisation of Accounting Standards around the world.

We currently have a nonsensical situation with the DLCs where BHP Billiton for instance reported seven different results to shareholders for the period ending 31 December last.

Under the DLC structure the Group has primary listings in both Australia and the UK and the laws of each jurisdiction require us to report under their accounting standards respectively. Under UK accounting standards, the BHP Billiton DLC arrangement is considered to be a merger and we report a single set of results for the merged Group. UK accounting standards permit us to report the results solely in US dollars, the dominant currency in which the Group operates.

However, Australian accounting standards do not deal with DLCs per se.

We are required under the Corporations Act to report the standalone results of the ASX listed entity, BHP Billiton Limited; ASIC requires us, quite rightly, to report the results of the combined BHP Billiton Group. On a voluntary basis and under relief granted by ASIC, we report the combined Group results in US dollars given this is the basis under which the Group is managed and provides the best measure of performance.

I can see many eyes are already spinning. However, I have been remiss in not discussing our reporting outcomes in the United States. Under US accounting standards the former BHP is deemed to have acquired the former Billiton and, accordingly, we are required to adopt acquisition accounting, rather than merger accounting. The acquisition accounting basis requires the former Billiton assets to be accounted for at fair value, rather than book value. This gives rise to significantly different financial results to those reported under Australian and UK accounting standards. The US financial results are reported in both US dollars and Australian dollars.

What are the issues with reporting multiple financial results?

Firstly, reporting multiple results for the combined Group is confusing and shareholders are entitled to ask "Which result is right?" As I mentioned earlier, the business is managed on a single basis and surely shareholders are entitled to a single version of "the truth".

Secondly, reporting results of the standalone BHP Billiton Limited Group is not only confusing it is potentially misleading. For example, Limited shareholders could think the Limited Group represents their interest in the combined BHP Billiton Group, which is not the case. Limited shareholders have a common interest in all assets of the BHP Billiton Group, as do Plc shareholders. We are not aware of any potential users of the standalone Limited Group accounts.

Thirdly, the Group bears the costs associated with preparing multiple sets of accounts, which are not insignificant for a business of our size. Whilst this may be positive for accountants, auditors, printers etc, it is negative for shareholder value. You may be interested to know that when we tried to send all of this information to shareholders last year we were advised by Australia Post that the volume would have exceeded their weight allowance for delivery to letterboxes.

I should say that I am confident that ASIC recognise these issues and have been responsive to our applications for relief to assist in making the position clearer for all.

ASIC, I know, share my view that the medium term solution will be the adoption by Australia and the UK of International Accounting Standards. Reporting under International Accounting Standards would allow the Group to present a single set of clear and unambiguous financial information to all stakeholders globally. We are strongly supportive of initiatives in this direction. I note the Financial Reporting Council's recent press release of July 3rd nominated an objective of this occurring from 2005, in line with a decision taken by the European Union. Ultimately, of course, we hope the US will also adopt International Accounting Standards.

Let me then conclude with a few overarching comments.

Essentially it is companies that compete in this globalised environment, rather than countries. In the current business environment, to become more competitive companies must widen their capabilities in activities such as marketing, logistics and services.

If the research undertaken by the 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 the strategic choice of getting much bigger, or being highly focussed niche players.

I have a view that a company's ability to successfully deliver on their strategic intent, is inextricably linked with the quality of the national business environment where they choose to operate.

More sophisticated strategies require more highly skilled people, better information, improved infrastructure, more advanced institutions and stronger competitive pressure.

With that background, are the DLCs working? – the answer is yes. Have they delivered value, the answer is yes in the BHP Billiton case; in the Brambles case it is a matter of watch this space. As I indicated earlier, there are many external market influences effecting share prices at the moment and if we can achieve

- Consistent EPS growth
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- EBIT margin maintained and improved
- Good cost control and efficient use of assets
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Then I would expect both stocks to outperform the markets where they are listed.

Finally, I have read many opinions about Australia becoming a Branch Office economy. That does not necessarily need to be the case. I agree with John Schubert's comments in that "*it is very important that we get our system of regulation right* ".

We have been talking about attracting Global Companies to our shores since 1983 when the currency was floated.

The latest World Competitiveness Report places Australia tenth in terms of the overall competitiveness of the business environment.

This improvement reflects increased attention to the flexibility of our labour market and other micro-economic reforms and improved macro-economic management.

If we can produce a National Business Environment where we can be unequivocal on providing

1. Quality/availability of factor inputs
   (people, money, physical infrastructure and law & order)

2. Competitive conditions where we understand the dynamics of a changing world

3. Quality of demand conditions (ie, macro-economic stability)

4. Presence of efficient related/supporting industries and infrastructure.

then this will be a highly attractive place to invest and do business.

Thank you