

Commercial services sector – struggling with new dynamics

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Insights



In this Insights paper, Dr Ian Woods, the Head of ESG Research at AMP Capital, compares the findings of the 2012 Environmental, Social and Governance (ESG) review of the commercial services sector with analysis of the sector from 2006. The comparison has resulted in some interesting insights into how ESG analysis can assist in portfolio investment. While much has changed in the sector, the ESG drivers identified in 2006 have remained valid.

ESG insights for investment

The AMP Capital ESG research team regularly undertakes major reviews of Australian Securities Exchange (ASX) sectors from an ESG perspective. In this paper, we look to see if the sustainability drivers (i.e. the external ESG factors that shape the market in which companies within a sector operate) and the intangible assets (i.e. the internal ESG factors that are needed to protect and grow company value) are still valid¹.

By reviewing past sector reviews and subsequent investment returns, we can also assess how much insight ESG analysis contributes to the future performance of companies within a sector.

ESG analysis helps identify success of companies

The AMP Capital ESG research team undertook its first major ESG review of the commercial services sector in mid 2006, reviewing 25 companies. The commercial services sector is a diverse sector, covering a range of different industries or sub-sectors, from human resource consultants, labour hire companies, commercial service contractors to debt collection and equipment hire/supply contractors. The 2006 review identified the least preferred and more preferred companies in each sub-sector of the commercial services sector from an ESG perspective. It also created two portfolios of equally weighted stocks of least preferred and more preferred stocks.

In 2012, the ESG research team revisited the sector and identified companies that were no longer listed and those that had joined the sector. The 2012 review, which considered 20 stocks, found that significant change had occurred in the sector, with ten of the initial 25 companies

no longer listed and some such as Brambles and Salmat, which had changed their businesses significantly.

Interestingly, seven of the ten companies that were no longer listed were companies that were considered least preferred from an ESG perspective in 2006. Likewise, eight out of the ten companies no longer listed were ranked the poorest in governance in 2006. In addition, the portfolio of more preferred companies outperformed the least preferred by over 10% over this six year period².

Despite the diversity within the sector, the changes within the sector and the disruption of the global financial crisis (GFC), the 2012 review confirmed that the ESG factors identified in the 2006 review had continued to play a role in those companies.

A sector struggling to manage key issues

Many companies in the sector have struggled over the last few years. While the sustainability drivers of more flexible working conditions/employment and outsourcing have provided a tailwind for the sector, many companies have struggled to manage key issues.

High staff turnover

Employee costs are typically 30 to 70% of total operating costs for companies in the commercial services sector. It is the skill, capability and motivation of their employees including senior management, which is critical in protecting and growing company value.

Yet many companies in the sector are characterised by high employee turnover, high CEO and senior management turnovers and inadequate human resource management systems, e.g. legacy IT systems that need or needed upgrading.

Employee turnover is a lag indicator with respect to the management of this key asset. Proactive measures for demonstrating effective management of employees include training, assessment of employee engagement and a focus on diversity. Yet only a few companies have demonstrated this commitment.

Interestingly, engaging employees have been one of the key focuses of new management bought in to turn some of the companies around in the sector.

¹ Companies are continually monitored from an ESG perspective to identify any material changes that may have occurred outside these major sector reviews.

² Overall, both portfolios provided negative returns, consistent with the general trend of the ASX over the same period.

For some in the sector, managing employee growth has been and continues to be a key challenge, whether the growth has come from organic growth or by acquisition. Growth by acquisition, especially overseas companies, has posed problems for some who are thriving in the sector. Working with different national cultures and alignment of company cultures and human resources systems have been problematic for some.

No clear customer value proposition

Many companies in the commercial services sector have struggled to articulate a clear customer value proposition and demonstrate proactive measurement of customer satisfaction.

Many in the sector have been certified to quality management standard ISO9001 but surprisingly six have not been certified and only two appear to have clearly focused on customer performance metrics that drive the actions within the company to improve customer satisfaction.

Environmental and safety issues

For many in the sector, especially those in the equipment hire/supply, labour hire and services contractors sub-sectors, their environmental and safety performance is important not only to their own and client operations and financial performance but also in the selection process of customers in the first place.

Pleasingly, the focus on safety in the sector seems to have increased since the last sector review. For example, the number of companies with certified safety management systems has increased. Similarly, some have been able to demonstrate significant improvement in safety performance, as measured by Loss Time Injury Frequency rates (LTIFR) and improvements in injury management.

Unfortunately, a number of companies where safety is a key issue have continued to not disclose safety performance.

A number of companies have been impacted by the recently introduced price on carbon, either as a liable party or have been impacted by changes to the diesel fuel rebate schemes. Disclosure of carbon emissions or how the scheme will impact these companies has been mixed, though it would appear that the net financial impact is not material as the costs is relatively small, have been partly ameliorated by energy efficiency initiatives, or can be passed through to customers.

Governance and remuneration practices are mixed

Corporate governance and remuneration practices have been mixed across the sector. As highlighted in our biannual Corporate Governance reports, we have concerns

about the governance and remuneration at Cabcharge. We continue to have concerns over the transparency and poorly structured remuneration practices for some in the sector.

Other governance issues that have raised concerns for some companies in the sector include Board structural issues, such as a lack of independence of the Board and in Board sub-committees, a lack of appropriate industry experience on the Board and significant related-party transactions between Board members and the company.

We also have concerns over some of the companies' relationships with their auditors. In some cases, non-audit fees have been significant, at greater than 10% of the total auditor fees for a number of years. This and long audit tenure have raised concerns about the independence of the auditors, even though most companies have a policy of auditor rotation.

The Future

The sector will continue to be shaped by some key sustainability drivers such as the need for a more skilled workforce expecting more flexible working conditions, greater assurance of the safety, environmental and social impact of the products and services and an increase in new ways of doing business driven by technology and internationalisation.

Some companies are better positioned than others to benefit from these drivers and as we have witnessed over the last seven years, those that haven't managed the key intangible assets within their companies will not survive.

From an investor's perspective, understanding these complex sustainability and ESG dynamics will continue, as it has done over the last seven years, to provide additional investment insight.

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