

Transport and ESG – watch out for bumps along the road

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Insights

In this Insights paper, Måns Carlsson-Sweeny, Senior ESG research analyst at AMP Capital, looks at how Environmental, Social, Corporate Governance (ESG) research can be used to identify mispriced stocks. Måns also looks beyond past researches' focus on the "Environmental" in ESG and discusses some of the key "Social" and "Governance" risks in the transport sector.

Using ESG to find mispriced stocks

The transport sector is cyclical by nature and historically earnings have generally correlated with the overall economy. However, the industry's road to recovery is subject to a number of structural changes and sustainability trends. While some of these are long-term in nature, others can have a material short-term impact on earnings. As a result, the financial performance by individual companies will depend on how well they manage these risks and opportunities in the external environment. By incorporating ESG analysis with financial analysis, investors can find mispriced securities.

The way a company manages its ESG risks can act as a good proxy for overall management quality. However, in the transport sector, which has relatively high environmental and workplace risk, ESG performance is more than a proxy for management quality; poor risk management can lead to significant direct or indirect costs.

Costs of poor occupational health and safety are rising

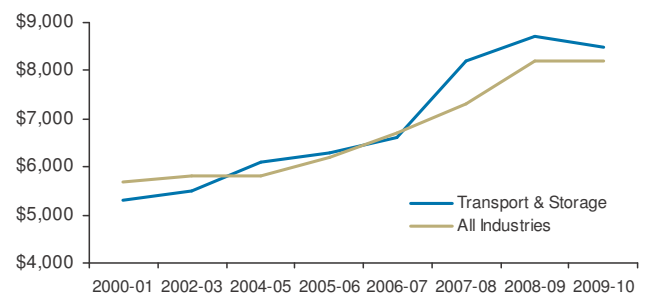
While statistics have indicated that safety on a national level has improved over the last decade, Australia still has a high workplace fatality rate compared to many other developed countries. Also, though the numbers of incident and frequency rates are going down, the cost of safety incidents is rising.

Direct cost – workers' compensation claims

The main direct cost is workers' compensation. A paper by Safe Work Australia¹ in March 2013, covering data to 2009-10 shows that the transport & storage industry had the highest incidence rate of all industries, almost twice the national rate. Also, statistics show that almost a third of compensated fatalities in Australia were due to a vehicle accident and the average payment for serious claims has

increased significantly². Across all industries, the median payment for serious claims rose by 44% between FY01 to FY09 but in the transport & storage industry, it rose by 64%. In FY10, the median for the transport & storage industry was \$8,500 (up 60% since 2000-01). These payment statistics only refer to accepted workers' compensation claims which mean self-employed workers (which are frequent in roads transport) are largely excluded.

Serious claims: median payments by industry division 2000-01 to 2009-10



The latest statistics available show that the transport & storage industry has one of the highest fatality rate of all industries, almost four times the national average. Road freight transport topped the list, mainly due to vehicle accidents: between FY04 and FY10, there were 1,297 compensated injury fatalities in Australia, of which 61% were caused by vehicle accidents. Transport & storage recorded the highest number of fatalities in most years.

Indirect cost – the intangible impact

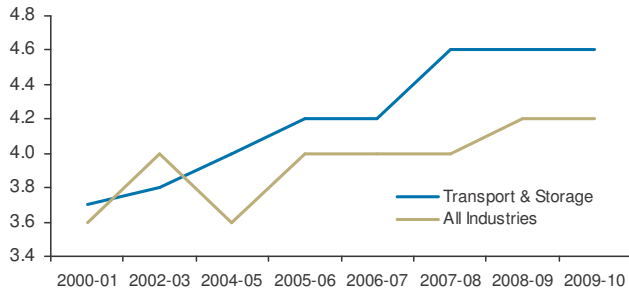
As well as the direct costs, investors need to be aware of the indirect costs associated with OH&S.

While incidence rates have fallen across all sectors, the median time lost from work has increased from 3.6 working weeks to 4.2 between FY01 and FY10. In the transport & storage sector, the median time lost has risen from 3.7 to 4.6 working weeks.

¹ Compendium of Workers Compensation Statistics, Australia 2010-11 (SafeWorkAustralia.gov.au)

² Compendium of Workers' Compensation Statistics, Australia 2010-11 (SafeWorkAustralia.gov.au)

Serious claims: median time lost 2000-01 to 2009-10



Poor safety performance can have a number of other indirect cost impacts, including:

- > Production disruptions: temporary shutdowns and lower productivity;
- > Brand damage: potential loss of customers, poor community and union relations and difficulty to attract and retain new staff. This is a particular problem for the roads transport sector, which has an ageing workforce;
- > Negative impact on staff engagement: lower morale and productivity among staff, higher absenteeism, staff turnover and more time spent/ higher costs from recruitment and training;
- > Corrective costs and damage to physical assets: repairs or replacement of damaged or obsolete equipment and property as well as costs/ capital expenditure to improve obsolete equipment to a higher safety standard.

Some of the impacts are highly inter-related. For instance, poor safety performance can both be a result of, and lead to, high staff turnover.

Many of the impacts can be difficult to quantify due to their intangible nature but there have been attempts. The American Society of Safety Engineers estimate that the ratio of indirect costs of workplace injuries versus direct costs can vary between 1:1 and 20:1. As a rule of thumb, the lower the indirect cost of an accident, the higher the ratio of indirect to direct costs. In Australia, an Industry Commission study in 1995 found that only 25% of the total cost of work-related injury and disease was due to the direct costs of work-related incidents.

What does this mean to investors?

Poor workplace risk management can lead to higher workers' compensation costs, loss of productivity and business disruptions or even industrial action. To estimate the potential earnings impact and whether it has been priced in by the market, investors need to have a comprehensive view of a company's safety risk management profile.

To begin with, investors need to understand the systems and processes in place to manage workplace risk. Many companies appear to have sound OH&S risk management procedures and policies in place and many companies have outlined safety targets as well as long-term visions of zero injuries. However, our analysis only identified a few listed transport companies (only Asciano, Qantas, Transurban and Toll Holdings) that have certified OH&S management systems that cover a significant part of their operations.

Investors also need to understand the links between OH&S performance and executive remuneration, including what it

could mean to actual reporting of incidents. The key question is whether having specific targets fosters under reporting.

Many transport companies have gradually improved their disclosure on OH&S performance although significant gaps remain. Almost all companies researched (for instance, Asciano, Aurizon, Qube Logistics, Toll Holdings and Virgin Australia) have recorded significant improvements in terms of lost time injury frequency rates (LTIFR) although, in some cases, the rates are still higher than the industry averages. However, investors need to look beyond the high-level LTIFR they are presented with. For instance, few companies include contractors in the high level safety statistics and there is anecdotal evidence that safety performance is worse among contractors. AMP Capital's analysis shows that there is room for improvement on how workplace data is captured.

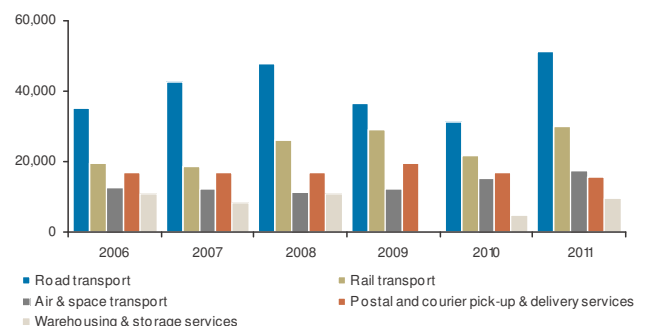
Finally, the LTIFR trends can also mask the severity of injuries or the trend in fatalities. Our analysis shows that some companies, whose LTIFR have fallen sharply in recent years and compare favourably to industry average (e.g. Toll Holdings) still have a high number of work-related fatalities.

However, a detailed analysis needs to go beyond just OH&S. It also needs to include an assessment of more intangible features, such as staff culture and staff engagement. This is where the biggest gap in the industry is, in terms of meaningful disclosure. Our analysis has relied on conversations with management, industry contacts, unions and anecdotal evidence.

Risk of industrial action and the changing nature of the workforce

If Australia's workforce has become increasingly de-unionised, the transport sector has bucked the trend: between 2006 and 2011 both the numbers of members as well as membership rates have increased for many unions in the transport sector³ :

Union membership in the transport sector



A large number of Enterprise Bargaining Agreements (EBAs) are expiring for listed transport companies between now and the Federal election in September and there have already been several disputes.

Australia's workforce is also becoming increasingly casualised and anecdotally, safety performance is worse among contractors. The road freight industry is highly competitive with low barriers to entry and margins are often thin. The key cost is labour and the unions are blaming poor

³ ABS, August 2011 – 6310.0 – Employee Earnings, Benefits and Trade Union Membership Australia

road safety on the pressure from large customers to reduce prices. The Road Safety Remuneration Act 2012 seeks to address the link between remuneration and safety and the Road Safety Remuneration Tribunal is empowered to inquire and determine minimum rates of pay for employed and self-employed drivers.

What does this mean to investors?

Recent industrial disputes in the transport sector have been costly affairs. For instance, Asciano's dispute with Patrick port workers in 2012 cost approximately \$15 million and Qantas' dispute in 2011 cost the company almost \$200 million. The resulting brand damage and other consequences can be more difficult to assess. Qantas' grounding of the fleet in 2011 led to loss of customers to Virgin Australia and it likely soured industrial relations even further. According to an independent brand assessment by brandirectory.com, Qantas' brand has dropped from \$1,851 million in 2009 to \$1,083 million in 2011 and \$1,026 million in 2012. According to the same assessment, the brand of major listed airlines in the world is equivalent to approximately 28% of market capitalisation.

Some companies with major upcoming EBAs in 2013 are Toll Holdings (the Transport Workers Union), Aurizon (all EBAs expiring at the end of the year), Asciano (ongoing dispute at Pacific National Coal), Mermaid Marine (major EBA with the Maritime Union) and Qantas (a large number of EBAs are expiring throughout the year).

Overall, the Road Safety Remuneration Act 2012 is expected to increase costs although the impact on larger players will be relatively small compared to the impact on smaller trucking companies.

The ageing of the workforce in the roads transport sector might lead to further cost pressure, particularly for line haulers. The industry is expected to see a major shortfall in truck drivers within 10-20 years and the industry has some major obstacles in replacing drivers due to the high safety risk and competition from the resources sector. As a result, investors need to understand companies' strategies for attraction, development and retention of employees. Companies without risk mitigation strategies might incur higher costs.

Corporate governance risk in the transport sector is high

The sector has a number of structural corporate governance issues, which pose risks for minority shareholders. For instance, 21% of the companies researched have a non-independent chairperson and only 62% of the companies have boards where the majority of the directors are truly independent. In some cases the directors have held their positions for over 15 years. Furthermore 28% of the

companies do not have a majority independent audit committee. This is a concern for investors as the role of the audit committee is oversight of financial reporting, risk management, control systems and internal/external control function.

We also note that many companies have large boards, where a number of directors have significant external commitments, such as directorship of other listed companies, or have small or no shareholding. Also, in some cases, company directors hold external executive positions. This questions their engagement and effectiveness as directors.

Our research also identified a number of accounting and remuneration related governance risks in the sector. For example, there are companies that have used the same auditor for over 15 years and in several cases the non-audit fees represent a significant part of the total fees paid to the auditor, which indicates a risk of poor independence.

We have noted a positive change in terms of increased engagement with shareholders on remuneration. However, several issues remain and we continue to engage with companies through our proxy voting and dialogue with listed transport companies.

Some of the key concerns are poor disclosure on short-term incentive hurdles and seemingly discretionary bonus structures. Also, in some cases we are concerned about certain accounting changes, which appear to have been made to ensure that management meet their short-term incentive hurdles. The use of 'normalised' earnings as a base for incentives calculations also rises concerns.

The links between environmental issues and governance

Looking ahead, we believe climate change will pose some interesting challenges to 'normalised' earnings and executive remuneration. The transport sector is subject to significant physical climate change risk, which can lead to direct impacts such as damage to assets, business disruptions, higher insurance costs, higher workers' compensation costs and more. However, physical climate change through increased frequency of extreme weather events can also have an indirect impact on transport companies' customers, such as coal miners and agricultural companies. The question is whether 'normalised' earnings should be adjusted for direct or indirect impacts from extreme weather events in the future if these events are in fact part of a new trend?

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