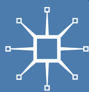

Strategic Leadership for Business Value Creation

Principles and Case Studies

Don Argus · Danny Samson

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ISBN 978-981-15-9429-8 ISBN 978-981-15-9430-4 (eBook)
https://doi.org/10.1007/978-981-15-9430-4

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The registered company address is: 152 Beach Road, #21-01/04 Gateway East, Singapore 189721, Singapore

Preface

It is not all that common for a business executive to co-author a book with a university professor. Our objective as a CEO/Chairman and professional business practitioner, and university professor/researcher/lecturer and consultant, is to provide insights for business leaders of the present and future, based on observations and lessons of the past, together with concepts and frameworks that have proven useful, even in turbulent times. We hope that the next generation of potential business leaders, in Australia and beyond, will be able to learn from the real examples described in this book, some of which were examples of excellent strategies, sound leadership, good decision-making, and hence value-creating outcomes, and some of which were not.

As co-authors we have worked together extensively since 1988. Don joined the National Australia Bank (NAB) in Queensland and spent most of four decades going from teller to 'head teller' there. Just after Don completed the Harvard Advanced Management Program in 1988 he was appointed to succeed Nobby Clark as Group CEO of NAB, and engaged Danny Samson to design a business strategy process which led to a decade of strategic discussions that grew into strategy debates, where the future direction of the NAB was robustly debated and wherein quality outcome thinking was demonstrated. The process, in short, involved the NAB executive leadership team engaging with the various business units within the group to disseminate and agree each Business Unit 'piece' of that action and design implementation programmes. Their contribution to the group effort and outcomes had to be carefully

defined, clarified and communicated in local dialect. These regional strategy meetings were also often frank and fearless discussions with Key Performance Indicators (KPIs) developed and stretch targets debated. Upon retirement from that banking career in 1999, Don went on to accept directorships at BHP, Brambles, Southcorp and Australian Foundation Investment Company (AFIC), and subsequently became Chairman of BHP and Brambles. Both BHP and Brambles had global operating footprints and both companies created Dual Listed Company structures (DLCs) to further develop their international footprint to not only expand their growth opportunities, but such structures enabled the boards and management of those companies to overcome significant corporate and strategic challenges, uniting disparate operations under a single common economic and governance structure which would not otherwise have been achievable. In doing so both organisations created global powerhouses in their respective fields.

Danny discontinued his association with NAB following Don's retirement from NAB in 1999 but continued on into the next decade to pursue research and executive teaching interests, consulting with various businesses, and served as director of the Transport Accident Commission for nine years. His subsequent experience with a number of great organisations confirmed that high-performance organisations achieve their objectives by recognising that people are the intellectual assets and strategy implementers that make things happen; the cost of mismanaging them can be disastrous. Equally, achieving financial success is always a necessary condition that provides the freedom to achieve great things.

We believe this to be a truth in all organisations in all sectors, in that it is always about mobilising people and unleashing their competence, creativity and commitment. It is also about value creation and competitive strategy and it really gets down to how we invest a dollar today to ensure that it's worth more a year from now. Therein lies the key to increasing value where an institution earns a rate of return on new investments that exceeds its cost of capital. The strategies are of course to be implemented in the organisation's operations and innovations.

We have called this book *Strategic Leadership for Business Value Creation: Principles and Case Studies* because literally there are no textbooks or models which enable or sustain organisational success in a world marked by breathtaking technological advances, cultural and political shifts, international competition and economic uncertainty. Strategies and

leadership of organisations must be ever dynamic as conditions change: and they always do, seemingly at an accelerating pace. As executives progress in our careers, the key matters that we must focus on increasingly become about two main things: strategy and leadership, both individually and together.

As we write this book our workforce grows more diverse every day, and our attitudes about work are constantly changing. At the same time customers are demanding intensive service and near-perfect quality. Everything has to be better, cheaper, faster.

Continuous innovation and improvement cannot come from technology alone, which can become obsolete very quickly. It comes from a sound strategy and it comes from human creativity and commitment, from employees giving their best at all levels of the organisation. In short, success depends on people and in order to achieve success people depend on good leaders and their strategies.

The ultimate challenge of any leadership group is to create a world-class organisation, one that is both highly productive, and able to withstand competitive assault.

To make that happen, the leadership group must unify the organisation into one holistic, integrated business. Their approach to leading must be embraced throughout the organisation. All policies, systems, and rewards must support the vision and goals. And the climate must inspire people to achieve extraordinary results.

In this kind of environment, the leadership group must manage by facts, not gut feel. Clear, quantifiable goals are indicators of success. In high-performance organisations, measurement is a way of life. And the leaders must link those measurements to high-performance outcomes. It is not enough to measure things; you must measure the right things.

If this was easy, we would have high levels of morale in most of our organisations and communities, with people uniformly discharging 'discretionary work effort' to their customers and employing organisations and community generally. Most acquisitions would succeed in creating net value, CEO transitions would always be smooth and effective, and business-government relations would be clear and effective for all stakeholders. Technology projects would always work and deliver net benefits, and new products would all be successful. We would see good governance and sound, universally ethical decision making, with a good balance between short- and long-term objectives, delivering financial,

environmental and social outcomes. If all these ideals were occurring broadly at an organisational level, economies would be growing smoothly, providing not just full employment, but would be comprised of enterprises providing job enrichment and satisfaction to staff, great value to customers, and a solid, consistent stream of value to shareholders. We are not there yet, but some organisations are much closer than others.

Facing reality, the ideal outcomes described in this preface are clearly not the norm, at least not on this planet. In actuality, we see some great businesses: the very best of which can sustain some decades of success as evidenced by the movement in the ASX Top 10 companies by market capitalisation as at 30 June from 1970 through to 2012 and beyond:

By early 2020 the top ten Australian businesses by market capitalisation included the four major banks and Macquarie, CSL, Woolworths, Wesfarmers, and resource business BHP and Rio Tinto, showing a quite stable list of our largest organisations across time. Yet their returns on shareholder funds have not always been anything near world class. Further, despite their impressive stability and endurance, some companies in the table above have been found in recent years to have been part of money-laundering networks, underpaying their staff, environmental disasters, and treating their customers badly. We say this just to be explicit about how much upside potential there is that can come from better strategic leadership, governance and management.

Unfortunately, we also see unethical behaviour in business, professions and the bureaucracy, politically expedient decisions that lead to poorly allocated resources, poorly thought-through strategies and policies, and poor project implementation. Such circumstances lead to de-motivated staff in many organisations, which inevitably lead to suboptimal outcomes for all stakeholders and a cynical constituency which hinders sustainable growth in world economies.

Rank	1970	1980	1990	2000	2010	2012
1	BHP	BHP	BHP	Telstra	BHP Billiton	BHP Billiton
2	Rio Tinto	Rio Tinto	Rio Tinto	News Corp	CBA	CBA
3	M.I.M. Holdings	CSR	BTR Nylex	National Australia Bank	Westpac	Westpac
4	WMC Resources	M.I.M. Holdings	National Australia Bank	BHP Billiton	ANZ	ANZ
5	CSR	Woodside Petroleum	Westpac	CBA	National Australia Bank	National Australia Bank
6	Westpac	WMC Resources	ANZ	Westpac	Telstra	Telstra
7	Normandy Mining	Bougainville Copper	Coles Group	ANZ	Woolworths	Woolworths
8	Orica	Comalco	WMC Resources	Cable & Wireless Optus	Woodside Petroleum	Wesfarmers
9	North Limited	Santos	CSR	AMP	Rio Tinto	Woodside Petroleum
10	Amcor	Westpac	Fosters Group Ltd Shs	Brambles Ltd.	Wesfarmers	Rio Tinto

Fig. 1 ASX Top 10 Companies

This book is structured into a number of parts. We provide focussed chapters and detailed case studies. That is because we think we have something useful to say about major areas relating to organisations and their value-creation processes. **We begin with Chap. 1 on leadership itself**: because leadership is at the heart of organisations. Leadership is the glue that holds everything else together: staff, capital, profits generated, products and services, technologies of products and processes, decisions and strategies, indeed everything. When we refer to leadership we do not only mean the chief executive or even his/her top team, but a much deeper group in the organisation, certainly through to middle managers, supervisors and team leaders, and in the very best of organisations, every staff member and contractor, who is 'self-leading', meaning acting with high levels of energy, accountability and responsibility in fulfilling their tasks and achieving their goals. If an organisation has poor leadership, then with very few exceptions, suboptimal outcomes will prevail! This is especially going to be the case in competitive markets, and with the advance of globalisation, there are relatively few corners of the world where one can get away with poor leadership and the inefficiency it brings, and still be productive over time. The reason as to why leadership needs to be sound and strong, but also be so deep down throughout the organisation, is because the CEO of all but the smallest organisation cannot implement strategy personally! He/she must be able to delegate, and be able to engage trustworthy people, giving those middle-level leaders scope to independently act on, while closely monitoring, supporting and coordinating activities.

Ultimately a competent leader will watch closely and keep control over activities and outcomes. In other words, leaders must walk the line between trust and delegation, but at the same time be continually keeping the finger on the daily pulse, forever watching the lead indicators of the business or activity. We will articulate our views about how leadership consists of certain characteristics, which we call leadership principles, and we will propose that these can be significantly developed and professionally practised.

Chapter 2 of this book is concerned with strategy. Businesses, large and small, need to set correct directions, focus on core capabilities, and implement with vigour, while carefully managing risk and return, which is always at the heart of strategic decisions such as acquisitions, product developments, outsourcing strategies and all other aspects of corporate business strategy. There is no single formula, as every strategic opportunity is different to every other, and some are a once-in-a-lifetime opportunity. We will use as examples, the National Australia Bank (NAB)

acquisitions of banks and institutions in UK/Ireland/New Zealand/USA, the BHP strategies of divesting steel assets, acquisitions of Magma, Billiton plc and Western Mining Ltd. and failing to achieve a merger with Rio Tinto, whilst still becoming the largest and most profitable company in Australia, and one of the most successful in the world. We also discuss the refocussing of Brambles' business strategies, and reflect on the now-defunct Southcorp Ltd. No discussion on strategy would be complete without highlighting the success of the Australian Foundation Investment Company, which has a remarkable record of outperforming the ASX index over many years.

We will argue for 'enterprise value' as a basis for goal setting and incentive creation. We will also argue that this can be devolved down to business unit managers, using examples from organisations where this has worked to great effect. This can also work in back office and support operations, whether it is a bank or a shared service centre of a mining house. We propose that whatever has been the achievements of the past for an organisation, implemented strategies or those in process are essentially built into its existing trajectory and its share price valuation, and that therefore strategic leadership should be significantly focussed on developing and implementing a stream of strategic initiatives, focussed on further value creation. Related to this, a precursor is that of operational excellence in the organisation's mainstream, no matter what industry it is in, as we discuss in the Appendix to Chap. 2.

Chapter 3 of this book is about organisational governance. We refer here partly to minimum standards and 'rules of the game', but also to the role of boards, corporations' law and the issues of compliance versus performance-enhancing governance processes. From the banking sector we draw on examples of governance problems, and of instances where sound governance has led to sound outcomes. Succession planning, and the related topic of incentives for executives and directors, is also one that has baffled many a board and commentator, not to mention politicians who seem to always be prepared to make populist comments when in need of improvements in their own polls. How do our organisations best manage what is often called the agency problem, in ensuring the best possible alignment between outcomes for board and executives, and all the other stakeholders who have a claim on the organisation?

Chapter 4 is concerned with ethics and social responsibility. Just what should be a company's contract with society, from which it draws its labour force, sells its products to, raise capital from, and hence make its

living? How far should corporate social responsibility go? Why are banks less community oriented now than they traditionally were, when they played a key role in communities? Why and how much should mining companies put back into communities in the vicinity of its operations? Why should executives never stray from the absolute high road of personal integrity? What has constituted 'best practices' in recent times in corporate social responsibility, and what generalisable lessons can be learned from those instances?

In Chap. 5 we look forward to how many of the issues covered in previous sections of the book are likely to play out in the future.

Business leaders of the future will need to deal with vastly different contextual factors, such as more instability, further advanced globalisation, ever more new technology, demographics that change fast, the China phenomenon, and climate change to name but a few big issues! Steering a steady course and crafting a stable set of value-creating outcomes through people in organisations will require outstanding leadership indeed!

We hope the reader can see that we have quite a lot of raw material to draw on in our discussions that follow in this book, of leadership, strategy, governance, business-government relations, ethics, and many related topics within these areas. We hope you find this book as satisfying to read as it was for us to create and write.

Following the major topics covered in the five chapters, we present case studies, of NAB, BHP and Brambles, to illustrate real challenges, best practice where it was achieved, and lessons learned from what didn't go so well also. All is presented in the spirit of insights that can be generated to accelerate the learning and capability of our next generations of strategic leaders.

Melbourne, VIC, Australia

Don Argus
Danny Samson

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PART I

Key Elements of Strategic Leadership

In this first part of the book, we provide five chapters, that are key elements of 'strategic leadership, being leadership itself, strategy, governance, corporate social responsibility (CSR)', and 'leaders of the future'. In all of these, we have combined rich frameworks based on a combination of our own experience, with both direct and indirect knowledge of 'what works', and why, in these key areas.

In these chapters, we often refer to BHP and NAB in particular, from which much of our direct experience comes, and we also draw on lessons we have learned from numerous other organisations that we have worked with such as Toyota and Brambles.

No organisation is perfect, or even close, although some are clearly further along in their maturity and effectiveness of strategic leadership than others. There is much to be learned from both success and failure, and all the organisations referred to above and herein have experienced highs and lows, that are all grist for the mill of learning and improvement.

In Part 1 of the book we have tried to shine a light through the specific lenses of leadership, strategy, governance and CSR, on organisations, particularly BHP and NAB. Chapter 5 then integrates these specific themes into development points for the maturing executive/leader.

In Part 2 of this book, we focus specifically on companies, NAB, BHP and Brambles, and refer back to the Part 1 chapter contents of leadership, strategy, governance and CSR.

CHAPTER 1

Leadership

Introduction

This chapter provides an overview of the impact of leadership on organisations and their performance outcomes, illustrated starkly with data from National Australia Bank (NAB) where we worked, and other organisations. We then derive from our experience and from more general knowledge and examples, a set of specific characteristics, often referred to as leadership traits elsewhere, that are the key components of effective leadership. We acknowledge that such traits need to be adjusted for the contingencies of different situations yet argue that sound leadership has these basic characteristics in common, albeit customised. These characteristics can be developed, and for developmental guidance we state a set of 'leadership axioms' that have sound conceptual foundation, and practical value in helping developing leaders to clearly envisage and put in to practice an answer to the key question about leadership: 'What works?' In this part of the book, we outline and give examples of some key aspects of leadership, attempting to provide useful insights on the following questions:

1. What level of importance does leadership play in organisations?
2. Can you reinvent yourself and develop the leader within you (in other words are leaders born or made)?
3. What are the general qualities of effective leaders?

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D. Argus, D. Samson, *Strategic Leadership for Business Value Creation*,
https://doi.org/10.1007/978-981-15-9430-4_1

4. For organisations, what constitutes best practices in terms of leadership development and succession planning, and talent development?
5. For senior executives, especially CEOs, what guidelines make sense for remuneration structures?
6. What practices do effective leaders undertake to maintain control and to motivate staff?

We argue that these points above are all critically important questions for every executive and Board to have a sound grasp of, and a plan of action for, implementing. For individuals who want to maximise their contribution to their organisation's outcomes and effectiveness, there is a personal development plan that comes directly from the ideas in this chapter, especially in respect of questions 3 and 6 above. For Boards, not many things in their sphere of influence could be more important than having sound plans in place for dealing with the matters in questions 4 and 5 above. For investors, given the importance of leadership that we will discuss, it is very useful if they can also access information to guide them in respect of the quality of leaders in organisations and the impact of those leaders on the future prospects, strategic initiatives and hence value of firms.

In stable business environments, the questions above are challenging enough to take on and form and deploy excellent responses to. In the current era of extreme turbulence and unpredictable events, from climate change, bushfires and floods, unprecedented virus events and recessions, these leadership challenges and capability requirements become even more important for all stakeholders in every organisation, from nation states, to large businesses, to micro organisations.

Leadership and Its Impact

It is well documented and accepted by most working people that the quality of leadership in organisational settings has a significant impact on performance and outcomes. Rigorous research in many studies backs this up. Case studies abound of how great leaders have made a large positive difference to their firm's outcomes, and also how poor leadership can destroy value, sometimes all too easily and quickly. Leaders have powerful influence, directly and through others, on their organisations. Some examples of how people take their lead from more senior members of their organisation are:

- In political parties, where policies are set substantially by party leaders, and articulated so that less senior members can follow these, and pursue their implementation in government departments

- In large business organisations, where boards and senior executives set strategies in place for achieving competitiveness and profitability, followed by implementation led by middle managers and teams on the shop floor
- In smaller and family businesses, where leaders, often owners, make decisions for staff to implement
- In sporting organisations where coaches and captains, and leadership teams set tactics for team members to pursue
- In schools and universities, where the principal, teacher or lecturer/ professor sets the standards for the learning processes
- In specific aspects of work such as in ethical standards, where the policies and actions of senior leaders are watched by staff who deduce what is, and what is not, acceptable
- In work teams at all levels of organisations, in every sector, where the team leader, junior or middle manager, explains to operating staff the work requirements, plans and goals in order to get the job done

A fascinating question is that with this pure logic set out in the dot point examples above, and with the commonly understood influence that leaders have on their subordinates, how and why there is so much poor leadership apparent in organisations, and so much resulting dysfunction and underperformance. Obviously, outstanding leadership is not so easy to achieve as to describe. When leadership is deficient, staff morale and then effort diminishes: many studies have shown that on average, morale and trust of employees in their leaders is low in most organisations, and when it gets to the point of Royal Commissions such as the recent investigation into Banking and Financial Services, it is almost frightening to consider what bank staff must think of their bank leaders. For example, it seems only reasonable that stakeholders including staff, customers, shareholders and the broader community are astonished to find out that Westpac allegedly facilitated some 23 million transactions that breached anti-money laundering and counter-terrorism financing laws. As a result, the CEO and some board members have resigned. The recent fall from grace of our major banks and a number of other financial institutions has been quite spectacular, from being considered pillars of society for many decades, to being seen by many as untrustworthy and interested only in 'fleecing' customers. Some would say that their leadership has become 'broken', and clearly this is a relatively twenty-first century phenomenon, both in Australia and many other countries.

Everybody, in all workplaces, looks to their boss for standard setting, for direction setting and for recognition of achievements. Expert leaders know how powerful these factors are on workforces. Looking back from the leader role to the subordinates, a sound working definition of leadership is the directing and influencing of people to act in the organisation's interest, through conducting production and other support activities in pursuit of goals. We must remember that we are all human and unique, with individually different personalities, such as our natural differences in the so called 'big five' personality traits of openness, conscientiousness, extraversion, agreeableness, and neuroticism, and these do indeed relate to how we lead, which is part of how we behave.

Leadership Axioms: What Works?

From our (Don's and Danny's) combined 100 years of work experience and leadership in many domains, where we have seen and worked with many successful leaders and some failures, we propose some important axioms relating to leadership behaviours, which apply to whatever natural personality and capability that one begins with.

First, while some personality traits and predisposition associated with those are brought by people to their leadership roles, it clearly is possible to substantially reinvent oneself and develop a mature set of leadership capabilities during life. A well-known recent example of a much-admired leader is the late Steven Jobs who built then rebuilt Apple into the world's most valuable company, with a series of industry leading products and services, and a resultant return on shareholders' funds that was the envy of many. According to biographers and many who knew him, Steve Jobs was not always the great pillar of a leader that he became later in his life. He developed great leadership skills during his time of founding and building Apple in the 1980s, honed his skills when he left Apple to undertake other significant business developments, and then reapplied them with great vigour and success when he returned to lead the company that he co-founded. His early life did not consist of being a great leader of people, such as at school and university, in academic, sporting or community pursuits. He dropped out of university and was reported as partaking in the drug scene of the day. Without question, he became an inspirational leader, with great vision, drive and determination, and resulting accomplishment.

Just as Steve jobs reinvented himself from difficult early years to be one of the world's most admired business leaders, so did we both go through reinvention. Don changed from bank leader to mining company and

resources industry leader, a significant reinvention and change, as these industries are about as different as any pair that one could name. Danny reinvented himself from a technologically oriented career as a chemical engineer working in chemical plants, to become professor of management: once again not an incremental change, but a reinvention.

Hence Leadership Axiom 1 is that leadership capability can largely be developed by those who aspire to lead well. Learning to lead starts with getting to know yourself. The most successful leaders that we have encountered have a profound understanding of themselves, of the motivations of people around them and of the external challenges which their enterprise or institution faces. Leadership can be developed, and people can and do reinvent themselves and their activities.

Leadership Characteristics

We set out in this section the set of principles, and the guided behaviours that effective leaders have found successful. There are many theories relating to leadership, which readers will have likely heard of, such as charismatic leadership, transformational leadership, and many others, to which we generally do not wholly subscribe. If anything, we will adhere to a concept of leadership traits, and although none of the leadership theories we have studied are very powerful, there are some guiding principles, traits if you prefer, that guide behaviours in most effective leadership situations. We also accept the concept, not really a theory, of ‘situational leadership’ which we interpret as the intelligent choice of leadership style and behaviour to suit the particular situation, challenge or decision being faced. In summary, our view is that most so-called leadership theories are quite weak and vague, that practice leads theory by a long way, and that there are some general principles common to successful leaders that can be deduced as mostly working well, albeit that they need to be adapted to fit situations. These are set out below, along with a diagnostic set of questions that follows.

Leadership Characteristic: Vision and Strategy

Effective leaders can ‘paint a picture’ for the whole of the organisation that they are responsible for. This might be a whole country, bank, government or government department, or not-for-profit organisation, or a

sub-unit of one of these. If one is a nation's Prime Minister, or a CEO, functional head within an organisation or a team leader of say five people in a factory or shop, vision and strategy needs to be set in every context, authorised for implementation, and communicated to all stakeholders in a manner that will motivate them. Once again we refer to Steve Jobs as an example of a well-regarded visionary and inspirational leader, just as were Nelson Mandela and Winston Churchill of their nations. Similarly, every day, in local teams within organisations all over the world, team leaders set vision for their team members, and ask them to sign on to the implementation strategy that hangs from that vision.

Implied in these statements above is the concept that leadership can and must be a set of behaviours that is present and exhibited at all levels of organisations. However, it is also true that the more senior the manager or executive, the bigger is the impact of their leadership actions, of course being over a larger domain.

In other words, the direction of overall 'movement', competitive positioning, values that are applied in its dealings with stakeholders, and fit of its capabilities and the general external environment, are ultimately the responsibility of the most senior people in the organisation. Senior executives can indeed consult widely with staff and other stakeholders, hire consultants and pay large sums to them for strategy ideas, workshop the proposed strategy as much as they want, but the 'buck stops' at the top. Leadership is about setting direction and also following through on it!

Leaders need to create a common purpose for all employees. The idea is to get them to 'sign on' to this purpose, ideally of course through viewing it as in their personal interest. Paul Keating, a former Prime Minister of Australia and a successful change agent, correctly pointed out the power of aligning with self-interest. A key skill for leaders is finding this intersection of personal interest for all employees with that of other stakeholders such as customers and shareholders. This alignment of interests is best done around strategies that will create real enterprise value and drive the organisation to win. Exactly as in sporting endeavours, everyone gets joy and wants to be associated with a winning team, so the crafting of strategies that lead to winning outcomes, 'selling' of these strategies to stakeholders, and then leading their implementation, are keys to effective leadership. The art and act of winning can build on itself, leading to increases in morale and motivation, higher levels of support from all stakeholders, and the leader gets to 'conduct the orchestra' of a virtuous cycle of higher performance levels, which can last for quite a long time, but seemingly not forever in corporate or sporting life. For example, Toyota, Volkswagen and

GM all produce of the order of 10 million vehicles each year. Yet at the time of writing, Toyota's market capitalisation exceeds that of the other two put together, indeed by more than the market capitalisation of Ford! There are many aspects that explain why this is so, including the Volkswagen emission scandal, GM's and Fords quality problems and labour cost issues, and a host of other details, but given that these businesses are all competing globally to design, make and sell essentially the same thing going into the same mass markets, why is there such a big difference? It's quality and consistency of leadership! Toyota has for decades developed and deployed leaders from within, who without exception strive to consistently implement its two core values, of Respect for People and of Continuous Improvement, which are led from the President and consistently applied globally. Danny has had the opportunity to work with Toyota from the inside and was most impressed with the strength and consistency of the culture and values. Even in challenging times, when Toyota for its first time ever closed a significant manufacturing plant, it was determined to do so in what its global President said was to be 'the most respectful way', hence the treatment of employees who were to be made redundant was nothing short of exceptionally good. These 2800 employees were offered astonishing amounts of retraining and education, preparation of many types for their life 'after Toyota'. When Danny questioned executives about the return on the big investments that the company was making in these 'leavers' over a multi-year period leading up to the October 2017 closure, he was firmly told that return on investment is the wrong question: it was done as a matter of core company values, namely Respect for People. Inspired leadership indeed, following a vision. We return to this example in a later chapter, to provide more detail of how it was implemented.

Interestingly, even the very best of organisations generally seem fallible to changes of circumstances, such as under-management related to new technologies (e.g., Kodak), key people leaving (e.g., National Australia Bank, NAB, in 2001) followed by poor succession planning which delivered leaders bereft of required risk skills, which saw the UK Division engage in a flawed strategy of risky asset growth followed by an investment in the CDOs (collateralised debt obligations) which seriously damaged NAB's Balance Sheet for many years.

Hubris is an insidious corporate and political disease within winners (e.g., BHP in the 90s). Sporting teams and clubs often lose their winning culture through hubris; they then cannot deal with rapid changes in economic circumstances that have not been planned. The current malaise in the European Union is a great case study of self-interest versus

self-awareness. Similar can be said of the captain and some members of the Australian cricket team in 2018 who were involved in a cheating scandal.

To implement vision and its strategies, leaders must effectively guide and drive change. Wise leaders will determine a proposed strategy and direction for change, allow time for debate about consequences and risk, then declare that the time for debate is over and expect solid support for implementing the change process.

Should leaders tolerate dissent about the changes? We would expect questions and challenges about proposed changes and try to provide significant time for such debates where possible, while pointing out that it is important for stakeholders to take a fair and balanced position of their self-interest with that of others who have a claim on the organisation. The banking industry found it difficult to accept the changes which evolved from the Campbell Committee in the 1980s, but the tensions which emerged between the older employees and the new age banker were quickly dismissed with a new mantra of shareholder value; and performance became the norm! What is not reasonable or acceptable is the executive or manager who resists change and fights turf wars purely out of self-interest or protecting one's own patch, while holding back the organisation's progress and goal achievement. Such people usually need firm counselling about the balance that is required and reasonable, and ultimately leaders must sometimes do the hardest thing in their job description, namely separate such people from the organisation if their position on matters is intractable. Effective leaders rarely need to wield these official powers, keeping them in reserve, but getting them out when necessary and being decisive with them is occasionally required. This illustrates the concept of situational leadership, interpreted as leaders being consultative much of the time, yet able to be directive and decisive when circumstances require it.

During the decade that Don was CEO of NAB, when Danny facilitated all the global and many of the regional and national strategy conferences and debates, we took a collaborative approach and were rarely directive when up to 50 of NAB's most senior executives debated strategies, yet at times when decisive direction was needed as to how a strategy would be implemented and within what time frames, there was little compromise. It was a very successful decade in NAB's history, as will be evidenced later in this book.

In our experience, most of leadership's role in managing change involves influencing, convincing, decision-making, then announcing

changes and overseeing their effective implementation through disciplined project management. Our experience with effective navigation of changes is not very different from the well-known Kotter approach, beginning with creating a sense of 'why', namely motivating the change process, sometimes known as the sense of urgency or burning platform. Depending on circumstances, the critical mass of support is a sense of 'must achieve' and this is a leadership task. A path to the end game must be articulated as well as the vision of how things will be better when 'we' get there. Again, this clearly is a leadership task. The steps in the implementation process should preferably involve picking the 'low hanging fruit' first, to achieve quick wins, convince the sceptics and provide a quick return on effort and capital. Following that, the change needs to be bedded down and spread, until it becomes the new standard operating procedure. The leader's task in change management includes communicating the new strategy and its net benefits. It must be convincing, planned and resourced appropriately and a monitoring system introduced. One needs to be flexible with the rollout of change and alert to any missteps in implementation and resistance.

In excellent companies such as Toyota, renowned for getting changes implemented effectively, meticulous planning is balanced with correct delegation. Similarly, in BHP under Paul Anderson, an idea might start as Paul's idea, then it was debated until it becomes a BHP idea, in which case it was institutionalised, and only then was it considered ready for implementation. Toyota and BHP spent much time gathering support for change in this way, which pays dividends later when the going gets tough on the challenges that often occur in major change or technology implementation processes.

Paul Anderson was recruited to BHP in November 1998 from the US based energy company Duke Energy Corporation. He had been instrumental in creating Duke Energy through the merger of Duke Power Company and Pan Energy Corporation, and quite apart from his expertise in recovery and development of companies in the USA, he had an enviable record in dealing with the human side of change programmes. He realised quickly that given the instability and uncertainty which existed at BHP through the 1990s, that he had to build trust in a workforce which was multicultural and prove to his people that he was authentic.

He quickly articulated a vision of what he saw as challenges for the stakeholders of BHP and actually invited input from his workforce and

external stakeholders as to how he might address the challenges which he had clearly articulated.

Paul had a clear understanding that suppliers, customers, employees and shareholders all knew what was required to return BHP to the 'winners circle' and he demonstrated that he had deep listening skills which enabled him to engage in constructive conversations for learning and possibilities. He had clearly mastered the skills of understanding, clarifying perspectives, and finding new ways of solving problems. In hindsight, Paul understood the link between deep listening, dialogue and achieving highly productive growth, and that is reflected in the capital market charts elsewhere in this book.

In contrast to other leaders whom we have observed, status was not symbolic to Paul. He was not influenced by planes, helicopters, limousines, flats in major cities, yachts in the Mediterranean, fast cars, art or personal wealth creating activities. Just as clothes do not make a man, trappings do not make a leader: they just stroke someone's vanity.

Such trappings also intimidate people, which is good if you want to be a dictator or run a personality-based cult, but bad if you want to create an open, vibrant, high performing team. Leaders inspire rather than intimidate, motivate rather than monitor, mobilise rather than manage.

The investment banking industry spawned such selfish behaviour at the beginning of the twenty-first century, BHP Billiton flirted with such behaviour for a short time. Southcorp under Keith Lambert (Bob Oatley's son-in-law at the time of the Rosemount acquisition by Southcorp) also became confused with such trappings.

Rather than status, leadership is an activity. To emphasise this, we prefer to use leading instead of leadership, a verb instead of a noun, a process rather than a position. Leading is like marketing or manufacturing or accounting—it does something. What it does is enable a group of people to pursue a shared vision and create extraordinary outcomes.

It is interesting to reflect on the banking industry in Australia post the Campbell Report and how people rotated into leadership roles. Prior to Campbell, the industry was heavily regulated and the concept of a high-performance organisation where people perform to the best of their abilities and get excited about the opportunity to measure the results of their work was an anathema.

Nobby Clark, Don's predecessor as CEO at NAB, led the industry revolution and did a marvellous job, which without doubt set up the platform for future generations. Not everyone was comfortable with the new

Most of the leadership models existing in the industry were hierarchical where one reached positions on merit most of the time, but unfortunately we had more than our share of leaders who hoarded control, knew how to manipulate the politics of the enterprise, issue edicts under the banner of policy, and that culture of leadership became difficult to change following deregulation of the industry. The old glue of formal boundaries, rules, hierarchy, walls, policies and authority which held the banking organisations together, were about to be replaced with a new glue of shared values, common purpose, clear responsibilities and accountability.

environment: he was very tolerant with dissenters, but we had the strategy right, we understood the consequences of the changed environment and we understood the risks better than our competitors.

Nobby left NAB a fine platform to work from and we would like to think that during Don's nine years as CEO of NAB, when Danny facilitated our global and regional strategy meetings, we did get a collaborative approach to setting strategy; execution, timeframes and budget formulation were always robustly debated affairs, and with not much compromise, but the results spoke for themselves and we did transform the Bank into a high performance organisation which resulted in the NAB becoming the No. 1 Corporation by market capitalisation on the Australian Stock Exchange (ASX) in 1997.

How did we achieve this? Quite apart from executing the strategy effectively, we realised that our people were our most valuable asset, we gave them the option to participate in a high-performance organisation where people felt good about themselves, or they could seek opportunities elsewhere. We lost some very capable people who were unable to make the transition from the old regulated environment of command and control to the new way where we had three simple objectives: satisfy customers, commit to developing a mature and motivated workforce, and a commitment to earning excellent returns for shareholders.

In recent times, CLSA produced a performance chart which characterises the financial success of NAB under respective CEOs over the last 27 years (see Fig. 1.1).

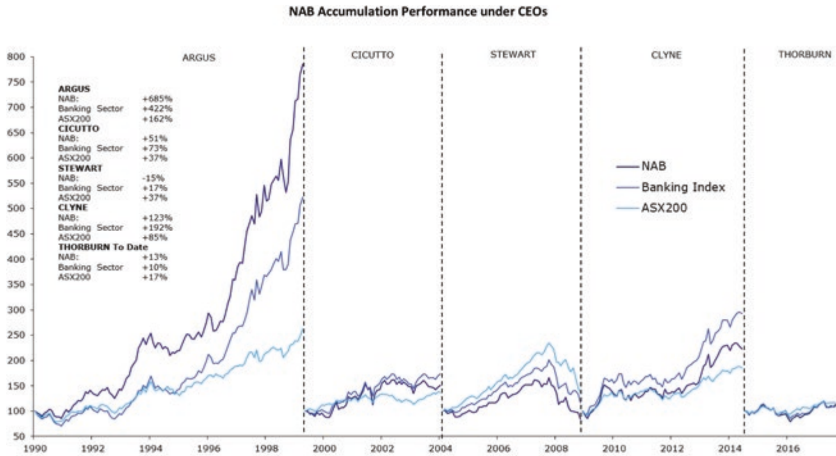

Fig. 1.1 NAB accumulation performance under CEOs

The data in Fig. 1.1 speak for themselves, but they also open up the question of why NAB appears to have lost its way in terms of creating superior levels of shareholder value over the last 20 years. The answer of course lies with succession planning which is covered elsewhere in this book. It is clear with hindsight that succession planning was not effective post 1999. A succession of four CEOs over the most recent two decades have failed to outperform the industry index or market, following a period of clear and substantial outperformance. The strategies of those CEOs essentially didn't work. They tried a great deal of strategic initiatives, many of which are referred to later in this book: most were unsuccessful. When we compare Fig. 1.1 with Toyota's continued and consistent outperformance of its industry, we find the key difference to be a leadership factor, where Toyota does everything that NAB did in its decade of success up to 1999, namely consistent leadership and disciplined strategy execution, but it also has the maturity to be developing generations of leaders that will assure continuance of values and strategies long beyond the tenure of any single leader or leadership team.

Leaders must also build a high-performance culture. We define this high-performance culture as one where people at all levels of the organisation will be largely self-motivated to 'be the best they can be' and 'do the best they can do', with the test of this being a case of what they do when

the boss is not watching or monitoring. A fine goal is to achieve a culture of high 'discretionary work effort', a term meaning the conscious and purposeful work effort above and beyond a reasonable and acceptable minimum standard. Leaders tap into and find ways to deliver job satisfaction to all staff, so that they can all take that sense of accomplishment home with them. Effective leaders set up work structures and task structures so that people are well informed about what is required, balanced with their ability to use skills and be creative. Leaders then provide feedback and recognition of effort and achievement. Rewards follow achievements. This combination of measures can lift efforts and performance levels by large amounts.

At NAB, scandals, lack of control of rogue operators within the organisation and dysfunctional work processes, that were highlighted during the recent Royal Commission crept in quickly when the top executive team members departed after 2000. The leadership style changed over the next decades, and even after the Royal Commission report, new dysfunction has surfaced, for example in mid-December 2019, some 12,000 instances of charging customers fees for 'no service' have been alleged and ASIC has pursued NAB over alleged matters of unconscionable conduct and false representations. Some of these have been admitted by NAB executives and others are in processes of legal and other investigations. It is cold comfort for employees, customers and shareholders to see that other banks and companies also have ethical and legal problems and breaches that they are dealing with. We have seen that when a culture of 'rigorous debate leading to thoughtful consensus' and agreed strategies is replaced by a combination of command and control styles and personal power seeking by senior executives, that the confusion that arises can lead to these types of dysfunction and Fig. 1.1 tells the ultimate story.

When executive leaders take their eye off the ball of what is best for the organisation and become too self-serving as against providing selfless service and stewardship, then the details will not be effectively managed, and control of operations is lost. In banking perhaps more than other industries, getting the details right on credit risk management is key, and requires disciplined process. Up until 2000, the ethos of the NAB leadership team was that the enterprise was always prioritised and indeed put first, and it was implicitly recognised of course that people who contributed effectively to the success of the organisation would ultimately benefit personally, such as through bonuses and promotions. Prior to 2000, there were relatively few internal power struggles, and the focus was on mutual

value creation for customers and shareholders, with success for those shareholders also providing opportunities for employees at all levels. This positive dynamic clearly became broken in subsequent years and decades, and referring to the saying ‘The fish rots from the head down’, we can all see the 2019/2020 media headlines that no employee, customer or shareholder wants to see of alleged and admitted breaches and fines, and CEO and board chairs resigning across the banking industry. The positive dynamic and growth mindset that was built can be quickly replaced when the fish starts to rot, by a lack of trust, relationship breakdowns, and that is where the ‘enterprise first’ priority can go out the window. After having CEOs who stayed a decade prior to 2000, there have since been five in 20 years, and shareholder dissatisfaction and anger is explicit and palpable at Annual General Meetings.

Leadership Axiom 2 is that leaders set direction and follow through to ensure that the outcomes are achieved, and the benefits are won, for all stakeholders. Understanding the link between deep listening, dialogue and higher productivity is essential; and being solid and predictable makes it safe for people to work together, to take risks and deliver quality outcomes. Both Paul Anderson and Nobby Clark were fine examples of good leadership in action and they achieved quality outcomes.

Leadership Characteristic: Trust

Trust means a two-way relationship when people, leaders and subordinates, will do what is reasonably expected of each other without ‘micromanagement’ or too much scrutiny by any party of the other. When high levels of trust are in place, people ‘do the right thing’ in the workplace, delivering on their commitments reliably.

Since it is impossible and certainly not good managerial practice to watch over every move made by employees, trust is a necessary ingredient of a high-performance workplace. With trust, it is a mutual thing! Effective leaders trust their staff, and effective staff trust their leaders.

We note that these characteristics of sound leadership are not independent of each other: quite the contrary. The trust comes better and stronger when there is an agreed and well communicated vision and strategy that people are all signed up to! Conversely, when trust and strong

relationships are in place in all directions, then people are more likely to sign up for the proposed vision and strategy.

Some key aspects of trust include the sharing of the leader's 'self' and the strategies and numbers in the business with employees. In Danny's long past experience in the chemical company ICI (renamed Orica) in the 1970s, his general manager kept the numbers to himself, managing information on a 'needs to know' basis only, and letting people know that information is power and that he had information that his staff did not have. Danny experienced exactly this leadership style even more recently in his employing university, where some managers displayed no sharing of information beyond what is necessary as a minimum, leading to low trust levels, and low levels of commitment and alignment. Others were quite the opposite. In the worst of cases, managers micro-manage their employees, signalling low trust of their staff to have information and do the job competently, which lowers morale and commitment, and can even become a self-fulfilling prophecy of low effort levels. Such managers are poor leaders.

Effective leaders give something of themselves to the relationships with their staff. They show their humanity. This is sensibly balanced without becoming overly familiar. They realise that their staff, just like themselves have put a significant investment of their human capital into the organisation, and they recognise that through sharing information. When this is done, motivation and participation increase. Leaders can make the workplace comfortably 'human', as against 'in-human'. Some extreme workplaces have been described as 'toxic' by staff, and this can surely only come about through the behaviours of ineffective leaders and can only be fixed by effective leadership.

Key to achieving trust is the practice of 'deep listening'. This means thoroughly listening to the concerns of employees and stakeholders, and also listening to employees deep down into the organisation. Deeply listening means not just a superficial effort, but really taking in the concerns and ideas of employees, and customers, shareholders, suppliers, and the community. Even more, effective leaders verify then act on the most important of these concerns (e.g., Paul Anderson at BHP).

Should a leader listen only to his/her direct reports? We would strongly advocate NO on this question, for two good reasons. First it is important for leaders to directly get word from people at all levels in the organisation, and importantly, this includes people at the organisation's front line of service or shop floor, where the actual work gets done. Leaders can be

effective in catalysing improvement and change when they are IN TOUCH with the real issues of the shop floor. Second, staff get a motivating 'lift' when leaders show themselves to be interested and approachable. The practice of 'Management by Walking Around' (MBWA) generally works, when the walking around leads to contact, trust and relationship building, listening and then problem solving. Don practised this walk-around widely in the NAB, as a way of keeping in touch, and helping to resolve problems. It helped him to be a more informed, connected and effective CEO, and it helped staff understand and commit to the strategy. There was not a business unit in that large Bank that did not have open dialogue with their CEO, during that decade of success. All Toyota's leaders practise MBWA, usually every day, as part of their leadership makeup. It is deeply embedded as part of Toyota's 'Respect for People' based culture.

Another important aspect of trust is that leaders must be predictable and consistent. The organisation and its staff, whether it is the whole of a large bank, or a team of ten within a business need to be assured of a 'steady hand on the tiller'. People need their employing organisation, embodied by its leader and his/her attitudes and behaviours to be stable. No one likes or has confidence in a capricious boss, who doesn't pursue a stable vision or strategies. Danny once had a boss who was highly influenced in his mood and strategy by his last phone call and was unpredictable in his actions and stance on issues and strategies. Whether it was deliberate or just a matter of incompetence, his inconsistency destabilised staff and the organisation: good people left, and the organisation suffered. On the other hand, and much more positively, a leader who consistently articulates and shows enthusiasm, passion and confidence in a strategic direction that is viable will attract followers and colleagues who want to bring their passion too and apply it. Quality guru Dr W. Edwards Deming stated this idea concisely and well with his term 'Pursue constancy of purpose'.

The revered CEO of the Hong Kong and Shanghai Bank, Willie Purves, was a renowned communicator. Willie was a pragmatic Scot and one of the best bankers of his time, and he didn't waste words. He had eighteen success imperatives:

Vision—Vision is the ability to imagine what's beyond the horizon and make it real.

Leadership—Leaders are identified not by title, but by what happens to people, events, and actions around them.

Organisation—Our organisation is what we make it. It is flexible, and constantly evolving.
Diversity—Diversity is about the opportunity to learn from the broad mix of skills, knowledge, experience, backgrounds and lifestyles.
Teams—Teams are the most powerful tool we have for creating change.
Quality—Quality is defined by our customers who tell us what it is, how to improve it, and whether we've delivered it.
Involvement—Involvement means being more than a spectator. It takes a willingness to be on the field—playing hard.
Initiative—Initiative is a 'just do it' approach to getting the job done.
People Development—In today's rapidly changing business environment, our strongest competitive advantage is our people.
Education and Training—Our world is in constant motion, ever changing with greater velocity. The only way to master change is to be constantly learning.
Opinion Surveys—The opinion survey enables us to assess where we are, so we can make midpoint corrections on our journey toward world class.
Communications—Communication is the exchange of ideas and information in support of a goal.
Recognition—Recognition is the regular celebration of accomplishment.
Coaching—Good coaches help us explore our capacity to grow.
Technology—Technology is the capacity to access and utilise information or knowledge.
Innovation—Innovation, an element of continuous improvement, encourages experimentation and risk taking.
Creativity—If you have asked yourself, 'What can I do today to make this company and job better?' and then experience the energy and excitement of chiselling your ideas into something new and original, you have entered the world of creativity.
Trust—Trust is the glue that holds the other seventeen imperatives together. It is the sum of respect, openness, integrity, performance, and communications, and must flow in all directions.

Another interesting style under the Trust principle, is that of Marius Kloppers, the CEO of BHP Billiton from 2007 to 2013, in which time the combined market capitalisation of the company grew strongly, as detailed later in this book. Marius inherited the CEO's role at BHP Billiton from Chip Goodyear, at the age of 44. BHP Billiton had emerged as a high-performance organisation by 2007 and it would be fair to say that the

Board had some concerns about his ability to lead the employees to the next horizon. His six years as CEO of BHP Billiton was quite a roller coaster. The business was growing fast organically with demand from China for mineral resources placing much pressure on the operations, and Marius had M&A aspirations. He had good intellect, he had much energy and he had few peers in the resource sector. He gave trust to those who he considered would follow him and deliver on an agreed plan, but his leadership style contrasted with that of predecessors Paul Anderson and Chip Goodyear. Marius did not follow the convention of sharing himself with the business. He devolved authority and expected business leaders to deliver high performance outcomes. This unfortunately created a gulf between him and some employees and a gulf with some in the investment community, with the inevitable cynicism leaking into the public domain. Sublimely but powerfully, some of his critics interpreted his actions as being 'better than themselves'. Whilst some of his employees may not have engaged, history will treat his leadership with respect, because he did take BHP Billiton to a new horizon and he single-handedly led the resource industry in Australia to become price makers not price takers in iron ore in particular, and other commodities. Generations to come will benefit from the disciplines and operational processes which he introduced. This will become evident elsewhere in this book. We note here that every leader is indeed human with an individual personality, and we must therefore accept that we will all bring different styles to leadership roles, with some individual strengths and weaknesses, within the framework of general axioms specified herein. Hence when we are assessing people in existing leader positions or in prospect for such roles, we must provide reasonable 'wiggle room' for individuality. Another fitting example is the late Steve Jobs, who many people report was difficult to deal with in his leadership role, whilst being unquestionably successful for Apple and its stakeholders in his leadership effectiveness.

In contrast to Marius Kloppers at BHP, Chip Goodyear assumed the role of CEO of BHP Billiton in unsettling circumstances when Brian Gilbertson resigned after irreconcilable differences surfaced between himself and the Board. Chip quickly articulated his vision, he quickly provided a feeling of security for all employees, and he was seen as predictable which enabled people to feel safe, to take sensible risks, and give their discretionary effort in an environment where there was still uncertainty following a merger with Billiton plc, and an unplanned CEO transition. Chip was a good communicator and people became comfortable with his beliefs and

behaviours to create a sense of trust and commitment that laid the foundation for building an open culture during his tenure.

Another contrast of leadership style from which we can all learn was Southcorp Ltd. Bob Oatley and his family used their 19.7% shareholder interest to convince a majority of the Southcorp Board in 2000 to replace Tom Park who was elevated to CEO when Graham Kraehe resigned. Keith Lambert who was the son-in-law of Bob Oatley at that time was quite a respected executive with Fosters Ltd which was focussed on marketing beer. Keith, who became CEO of Southcorp in mid-2001 and resigned in 2003, introduced many different marketing concepts, but failed to take the established wine executives and wine makers with him. Not only was Southcorp endeavouring to integrate Rosemount employees into the Company after the acquisition, many questioned the Corporate Governance issues associated with Keith Lambert's elevation to CEO, and in particular the independence of the two Oatley Board representatives. The whole corporation became dysfunctional, with competence, creativity and commitment lost in the workforce. Keith Lambert resigned from Southcorp on 3 February 2003, and the Oatley Family sold 18.8% of their shareholding to Fosters in January 2005, 2 years after the takeover of Rosemount. Fosters eventually acquired Southcorp in June 2005.

Great leaders are approachable! For all employees in particular, but also for suppliers, customers and others, the 'door is open'. Mars Corporation practised an extreme form of open-door policy: it is folklore that they had no doors at all! Their regional head office in Wodonga, just adjacent to one of their pet food plants, has a completely open plan office, as do all their major offices, where senior executives sit in the same very large room as less senior employees. Leaders in that environment cannot help but be in touch, be approachable and be part of the action of the workplace. It's mentally very healthy for all concerned. There are a few meeting rooms with doors and walls to be used when conversations need to be private, but the standard operating procedure and hence the business's culture is 'open' with all staff, especially compared to many others where the executives sit in large closed offices and the culture is that staff would not recognise their senior executive at all, because those executives consciously keep themselves remote and do not practise management by walking around.

Navigating leadership styles is a very subjective issue for all stakeholders, as expressed in these examples from our experience:

(a) A CEO who visited the business units regularly, communicated constantly with his/her employees and enquired about the well-being of the organisation from an employee perspective is a preferred style. In the process he/she is able to assess the emotional climate of the organisation and deal with momentum change.
(b) A CEO who installed a special key system in the exclusive basement car park, which only he/she could control so the lift did not stop at ground level on its way to his top floor office, such as to allow him/her to avoid any contact with the external world is hardly a foundation to build a company's common purpose, and yet it happens.
(c) A leader who commutes to work by helicopter and engages in private commuting across borders without communicating with the people who make things happen is hardly a recipe for sustainable success. Again, if leaders hold themselves too far apart from the people they lead, they will not achieve that discretionary effort so essential in achieving successful outcomes.

Leadership Axiom 3 is that leaders must create a culture of trust, providing an open forum for fully truthful communications up and down and provide a work environment where people feel safe to work together, to take risks, and to expose themselves, even when their lives may be filled with complexity and uncertainty. Being honest is the first step toward building trust in the workplace. Sharing yourself tells people you are authentic, and they are more than just a number. If people have a good relationship with their leaders, and share numbers about the business, they contribute more to productivity, the essential ingredient to competitive advantage.

Leadership Characteristic: Participation

When it comes to relationships in the workplace, these need to be adult to adult relationships in order to stimulate high levels of effort. No staff member enjoys or responds positively to being 'spoken down to', and although a strictly command and control approach to leadership may well achieve short term compliance, it also builds resentment. It can be used occasionally of course, especially when there is just no time for

consultation and discussion, such as in a crisis. However even in a crisis, people in the workplace are adults and great leaders know how to treat them as such.

A case study in the 1992 Harvard Business Review, highlighted professor Paul Adler's (1993) review of the remarkable revitalisation of the automotive assembly plant in Fremont, California, once it was taken over by Toyota, which came in as partner to GM and ran the Toyota philosophy at that site. Toyota broke the vicious cycle which had prevailed, characterised by Adler as 'Manager Coercion and Worker Recalcitrance'. Before too long, with a new leadership approach ('Respect for People'), the very same workers were effectively driving much higher productivity levels, improved quality, and they participated actively in solving problems and driving improvement, unheard of in the bad old days under GM leadership. Unfortunately, the rest of GM seemed to learn and apply little from Fremont to the rest of its organisation, contributing in part to its severe problems, loss of market share and lack of profitability over succeeding decades, until it was brought to its knees in 2008 during the Global Financial Crisis.

Why is participation so important today? Primarily because the competitive environment most organisations find themselves in now require them to do more work, in less time, with fewer resources. Participative styles are core to motivation. If they succeed, they will gain a competitive edge.

To achieve that edge means expanding the capacity and increasing the commitment of each and every person in the organisation. People must work faster, smarter and more effectively. They must produce higher quality and better service, and do it with a greater sense of urgency than ever before. Customers are now more demanding, and only people closest to the work can give them what they want within required timeframes.

These individuals must want to achieve. Organisations need people who will take initiative, be accountable for results and support the organisation's goals. There is of course something beyond mere economies driving this; employees want a voice, to have some control over their work and to feel they have a sense of ownership in the organisation.

This does not mean that leaders simply hand over the reins and should delegate almost everything to their staff. Paul Anderson, Chip Goodyear and Marius Kloppers at BHP all understood such dynamics; and Don thought he had a good understanding of how success depended on unleashing the power dormant inside of NAB in the halcyon days of the

'90s. Don was known in NAB as having a close finger on the pulse of many detailed items of work. Similarly, members of the executive committee of NAB during the period 1988 to 1999, in which NAB significantly outperformed the industry, led with passion, knowledge and participation. There was a solid mix of delegation and trust with control and verification. NAB was one of few banks in Australia that introduced strong risk management practices following the deregulation of the banking system in 1983. When most other banks got into severe trouble through impaired lending books and weakened balance sheets, NAB was much less directly troubled. This did not happen because senior executives simply handed over and delegated such decisions and policies to less experienced and inadequately trained staff: quite the opposite! Trust was built, respect was given when earned, and this was balanced with verification. Delegation was not overdone at NAB, in the ways that got various State banks and other major banks into severe trouble in that era. If any reader of this book is not of the view that these matters are important, please reconsider, in the light of the evidence that many of Australia's State banks became insolvent as a result of getting risk management wrong, and other major banks became severely impaired for the same reason. Indeed resulting from these events, the relative strength of NAB versus two of the other major banks was such that only the Prime Minister's intervention and other regulatory authorities and rules stopped NAB on more than one occasion from accomplishing what market forces made possible and viable, namely takeovers by NAB of either of those lowly valued assets/banks at that time. Thanks to its competitiveness, risk management and related capabilities, NAB was fully able and ready to convert the 'big four' into the 'big three' in more than one instance, but was stopped by national policy. Perhaps the history of Australia's banking sector would now be very different if market forces had been allowed to act.

There is a case for handing over control to staff and delegating, and showing trust in staff, but there is also a case for balancing this trust with verifying the process and outcomes! The key is in being able to judge how much and what to delegate, and what not to delegate, and to whom, and then keeping an eye on lead indicators of outcomes, while remembering that preventing problems is better than trying to cope with later disasters when they are under-managed and 'blow up'. The aim is for all decisions to be made at the right level by the people who know best which way to go.

After 1999, when Don retired from NAB, there was, with the wisdom of hindsight, one leadership task which was not fully mature, namely

succession planning and implementation of an orderly leadership transition at CEO level. During the period immediately following that CEO succession, when almost all of the previous executive committee and many other talented senior people left NAB, it spiralled out of control and fell from grace, resulting in an essential halving of its earned value and 20 subsequent years of under-performance. Such can be the impact of a small proportion of senior leaders changing, and the subsequent changes in the leadership matters being raised in this chapter, and their dramatic impact.

Leadership Axiom 4 is that effective leaders carefully delegate on the right matters and to the right extent, to the right people, and set up a culture where this trust is sensibly reciprocated. If vision provides the direction, and trust creates the safe foundation, then participation is the fuel that drives the organisation forward. The leader's challenge is to unleash that power and focus it on achieving the organisation's goals.

Bruce Teele, the legendary Chairman of AFIC, is one of the most innovative leaders of our era in the Australian business environment. He has a marvellous record of leading people who make a difference and he is a classic case study of a leader who has intellect, skill and performance over many years. Bruce joined JBWere & Son in February 1959 and joined the Partnership of JBWere & Son in October 1967 as the seventh Senior Partner in the firm's history. He inherited a culture in the firm stretching right back to its formation in which the first priority was to look after client interests and to conduct business with the utmost integrity and based on Christian principles. This dedication to serve clients meant that their interests came first, the interests of the firm were secondary and personal interest followed after that. Bruce maintained the culture he inherited and reinforced it as Senior Partner.

JBWere was involved in the creation of Australian Foundation Investment Company in 1928 as an investment vehicle for its clients to obtain a diversified exposure to a range of Australian enterprises listed on the ASX. JBWere sponsored a number of other investment and underwriting companies alongside Australian Foundation Investment Company. However, in the mid-seventies a number of these were merged in Australian Foundation Investment Company to increase its size and efficiency. This was in response to attempts to takeover some of them by outside parties.

Bruce joined the Board of Australian Foundation Investment Company in 1966 and became Chairman in 1984. In 1989 he initiated the establishment of another investment company, Djerriwarrh Investments Limited, which had a portfolio of larger listed companies on the Australian Stock Exchange and which also sold call options over a significant part of the portfolio to create additional income. Once its track record was established it was also promoted to clients of the firm as a diversified portfolio of Australian listed companies but with a higher income and lower capital gain profile but with similar total returns.

In 1996 a further investment company called AMCIL Limited was established to invest primarily in media and telecommunications and related internet and technology companies. In 2003 this Company was recapitalised, and its mandate broadened beyond the original two industry groups.

Following on the firm's culture these investment companies were established and run in the interests of their shareholders not for the purpose of creating a funds management business for the firm or personal interest. These investment companies now have wide support in the investment community.

When Bruce retired Australian Foundation Investment Company had over 100,000 shareholders, up from 8600 when he became Chairman in 1984. As a public person and private citizen, he knew what was important in life and acted by deep-seated principles.

Every wise leader has a moral compass and a sense of right and wrong. Don Sundquist of Wal-Mart summed this up in a speech to Harvard AMP participants in 1988:

> *I have come to believe that wisdom is not understanding the complexities of the universe. Wisdom is understanding the simple things, the interpersonal relationship things and practising them—not just reading them, not just agreeing with them but practising them.*

This sums up Bruce Teele's contribution to the Australian business landscape.

Great leaders build great teams, which outperform the competition. In many circumstances a team, meaning a collection of people with shared goals and ways of achieving them, beats a loose collection or group of people, or a set of separate individuals.

The Australian Cricket Team of 2013–2014 is a classic example of a team which, having been dealt a serious thrashing by India, in India, and subsequent Series loss to England in the UK were able to re-gather their winning culture and respect by changing their Coach and Selection Panel. The new leaders then tapped into the collective wisdom of a dysfunctional team of skilful players who had lost their confidence and momentum. In that environment the leaders of Cricket Australia started by inspiring the playing group with a meaningful mission and clear plan with objectives. Those with accountability for the playing group's performance then set out to share power, trust the competence and judgement of the playing group and we began to witness the development of further leaders with the group. It is now history, but that previously maligned group of players abandoned the old baggage of dominance, control and self-centredness and re-created a winning environment that built individuals' confidence one day at a time. That skill to make it happen grows out of a deep understanding of peoples' needs and aspirations. Yet effective leadership is more complicated than just doing one thing well. When leadership integrity was severely compromised in 2018, performance failings followed for example losing a Test series in Australia to India for the first time ever.

Similarly, with people in business, whether it is a branch of a bank, miners doing shift work on a remote site, or an executive team, the role of the effective leader is to foster cohesiveness and alignment of members, so that their efforts complement and coordinate each other's. Nurturing a positive team environment means articulating a vision and explaining why alignment to that vision will lead to success. This explanation, followed by confirmation that people are 'on board', may need to be done many times. Once the team is formed as such, people's energy will be unleashed, because of the powerful psychology of motivating 'belongingness' (from Maslow's hierarchy of personal needs), and the creation of both individual and collective belief in that vision.

NAB moved to a new level of team based behaviour in the 1990s when the group formalised its vision and mission statements, accompanied by statements of objectives which were rolled out throughout the organisation. At the best of times, it felt like one large team! People generally knew how their job and work activities contributed, albeit in a small way, to the overall group mission and vision. Although many were sceptical at first, which was a healthy challenge, once the debates were held, the implied values in the statements of vision/mission and objectives were seen as positive and the 'sign on' became strong enough to foster effective

teamwork. There were always 'nay-sayers', some of whom were in senior roles, however there was an eventual critical mass which overcame most of that resistance and led to positive work outcomes. The strong sense of teamwork helps in both the large and the small context when new players are brought into the workplace. When a high-function team is in place, whether it is a local team on a shop floor, or a senior executive team, new recruits or team members can quickly and effectively see what the team is aligned to and can know how to 'sign on'. Strong teams perpetuate their alignment.

This sense of team even applies at the macro level to whole organisations such as during acquisitions. The early NAB acquisitions of banks in UK/Ireland were not followed by fast and effective integration into the NAB group's activities, coincident with the lack of organisational maturity then, early and mid-1980s, of the sense of NAB as an integrated whole and team. By the time the Bank of New Zealand (BNZ) was acquired in the 1990s, the NAB group executive was well formed, the group was maturing its newly articulated group vision, mission and objectives, and much work was done to more effectively transition BNZ into the overall team: this applied at the executive and personal level, and hence at the organisational level. Teams can be very powerful as motivators, alignment vehicles and organising mechanisms! Leaders can facilitate team formation and cohesive team behaviours.

Once people feel part of a team, or in some other way feel strongly connected in their personal job and work context to the overall goals and accomplishments of the organisation, their behaviour can be seen as 'owner-like'. How does an organisation achieve this state of 'engagement' and stewardship in its employees? The answer is only that it is instilled by leaders, who demonstrate it through role model behaviours, and then encourage and expect others to do similar. Leaders can push responsibility down the line, such as delegating profit responsibility down to mine managers and their teams at BHP Billiton. This was very effective. When rewards are also linked to the controllable parts of that profit outcome, a measure of earned value, or the drivers of those profit outcomes, such as productivity, wastage rates etc, then ownership like behaviour is linked even more tightly to people's variable outcomes.

There is both a psychological and a rewards side to supporting people to feel and behave like owners. Engaging staffs' hearts and minds can be very powerful, regardless of the rewards structure. Danny once had a direct boss who made it clear to all staff, including senior people, that the

organisation's ownership, from a psychological perspective, was his alone and that essentially everyone else was a hired hand. This was poor leadership, leading to low levels of engagement and motivation. High levels of variable rewards paid in that organisation led to compliance and 'chasing' of those rewards, until it suited people to do otherwise, when the lack of goodwill and psychological connection cut in, to create significant dysfunction. On the other hand, at BHP Billiton, Paul Anderson, Chip Goodyear and Marius Kloppers all knew that they could not look to past practices as a guide to the future, because they were now dealing with an industry heavily influenced by demand from China and other Asian economies where the marginal steel producer was influencing the price of iron ore which saw the spot price of the commodity over-inflated during their stewardship. The increases which we saw, and the growing volatility of raw material prices meant that the conversation with customers quickly turned to efficiency and productivity.

Nothing succeeds like success! People generally like to be associated with a winning team. For those who follow a sporting team such as a football team, or the Australian cricket team, it is uncanny that there is so much more support and attendance when the team we support is winning as against losing. Similar applies in the workplace. When an organisation is 'kicking goals' or getting lots of 'runs on the board', then enthusiasm goes up and people want to contribute, whereas when an organisation is sliding downhill, people who are employable elsewhere will tend to leave. The Leaders' job clearly includes imparting a sense of mission and strategy, and this needs to also include a sense of success and achievement. It was relatively easy at NAB in the 1990s to recruit and keep talented people and create powerful teams of senior and middle level executives: people wanted to join a team that was performing well and had momentum. The business was growing, profits and share price were rising well, and it was a clearly industry leading organisation. Once it fell from grace, NAB lost many of the talented executives, and others of the same calibre would not have been easy to attract. Similar applies at BHP Billiton, which was seen as a clear industry leader, and which was able to attract talented people at all levels as a result of its success. Similar is true in most other walks of life. When Danny was Head of the Department of Management at the University of Melbourne, recruiting academic staff of high calibre was not hard because of the winning reputation of the institution. It was not unusual to attract fields of over 50 people composed of many strong applicants from many other universities, from Australia and elsewhere. When

asked why they applied, the universal comment was, and still is, the reputation effect of being part of a top level university. The same is true for sporting teams, when prospective players in say AFL drafts generally much prefer to get recruited and join winning teams than bottom teams. It's human nature.

So, what are the implications for leaders? Provide a winning culture, use the language of positive accomplishment, and paint a picture of what success does and will look like. Of course, it is important to be realistic, however we would advocate a general 'glass half full' approach of optimism in interpreting even adverse events. Optimism can be catchy when it is role modelled, without overdoing it. It can become a self-fulfilling prophecy up to a point. A winning attitude can cause people to lift their heads and efforts. Importantly, leaders must never lose their sense of perspective and realism. Hubris is the enemy of sustained success. Arrogance breeds contempt, de-motivation and eventually a fall from grace, lowering performance. Pessimism rarely helps, as it tends to lead people to lower their heads and effort levels. The modern terms that have been carefully researched over the past decade that we call on are 'positive psychology' and 'growth mindset', that we assert can be powerful as both an individual and a team phenomenon.

Leadership Axiom 5 is that effective leaders build teams that they can trust and set them up to succeed. Successful leaders also know to nurture a winning environment by creating a winning attitude that builds peoples' confidence one day at a time. These leaders teach each other how to win, how to lose and how to play by the rules. This ability and the skill to make it happen grows out of a deep understanding of peoples' needs and aspirations.

Leadership Characteristic: Learning

Organisations, markets, regulatory regimes, clients/customers, staff and each of us personally as humans are complex entities. None of us will ever know everything about how we work or behave. When we group ourselves together and interact to create organisational outcomes, compete in markets, organise suppliers, innovate and produce, there is always more complexity than we can fully understand in our world of work. We may often grasp main effects but don't get to optimise on the details.

This complexity in the business environment in which we lead and work begs the question about the learning curve in each of us. Are we developing as leaders? Are we learning, and what is the slope of our learning and development curve? What are the tangible actions each of us are taking to ensure we will be a better leader 12 months from now? Which of the characteristics discussed in this chapter constitute our personal strengths and weaknesses and what is the formal plan for learning new skills and implementing these as new leadership capabilities?

In order to formulate and implement such a leadership development plan, we need to know our strengths and weaknesses to begin with. After reading this part of this book, a second read can be effective in asking and focussing on how 'I' stack up on the many characteristics and sub-points made. Do you implement all the axioms that we state, consistently and effectively? From a realistic analysis of 'my' present position, a plan for improvement can be crafted.

One effective way for leaders to drive their development is to engage in mentoring. Don and Danny have learned a lot from both mentoring and being mentored by others during their careers. Each and every discussion, when mentoring or being mentored, is an opportunity to mature as a leader. When mentoring, we are supposed to be imparting advice, perhaps even wisdom, yet the mature leader learns as much as the person being mentored. We learn from the reactions of our mentoring partner to our statements, from observing another point of view, and if there is a difference in age or generation, then we can learn a great deal about how such people think and apply their values and ambitions.

To be useful, mentoring does not need to be formally organised as such, nor does it need to be within your place of primary employment. Independent networks exist and provide opportunities for one-to-one mentoring or group-based networking. Business or industry associations, such as Rotary and many other private and public settings offer opportunities for people to frankly exchange views and to give and receive advice in a non-threatening environment. These can stimulate our development as leaders, whatever our level of seniority or responsibility in our organisation.

The Australian Institute of Company Directors (AICD) developed a Chairmen's Mentoring Programme to assist emerging female company directors. It was seen as a development tool providing opportunities to extend professional director networks, improve governance knowledge and gain unique Boardroom insights. The programme was designed to

introduce highly experienced and qualified female Directors (mentees) to Chairmen and experienced Directors (mentors) with the aim of assisting mentees:

- develop connections with influential business leaders;
- gain knowledge and skills that will assist them with director appointments as well as development careers generally;
- increase their understanding of governance issues in listed companies and how listed company Boards work in practice;
- gain insights, advice and guidance on the process of selecting and appointing new directors.

The framework developed has application across all walks of life because of our diverse backgrounds. All of us are inspired by different kinds of people at different points in our lives. Whatever the case, we have found the mentoring experience integral to our development and have learned lessons from both positive and negative people.

Leadership Axiom 6 is that effective leaders always learn and develop from every experience and opportunity. Whatever the case, we each use the mentoring experience as part of our own leadership development. As most successful leaders have realised, there are lessons from positive and negative people.

Leadership Characteristic: Creating a Winning Attitude

'The only constant is change.' Leaders have been saying this as long as there have been leaders. The changes are coming much faster now. Whilst economic changes are hard enough, they are just the beginning. It seems that technology changes occur daily. So does the nature of the workforce and society. Given that, leaders need the ability to adapt and constantly renew themselves. They need the ability to bounce back from crisis. They need to learn and grow on the job and they must understand that their real power is outside themselves. It rests with the people for whom they are responsible.

As leaders a key part of everyone's learning and developing in the workplace is to encourage people to give as much discretionary work effort as

they wish to. Most organisations and job descriptions have minimum standards and levels of accomplishment. These minima are usually quite low. They are irrelevant to what sound leaders achieve, and where they take their staff and teams, where these high-performance organisations accomplish much more than any specified minimum! The passion and enthusiasm for the organisation and the accomplishments, which we referred to earlier in this chapter, usually lead to high levels of 'discretionary work effort'. This 'extra effort' often leads to winning in the mind and in the market. Once again, consider the metaphor of the sporting team. It is clear that discretionary work effort, on and off the field of endeavour, can make the key difference between winning and losing. Consider whichever sport you are most interested in and how winners just will themselves to be that bit more effective such as to make a difference. For Don, it is the Australian Hockey and Australian Cricket Teams. For Danny it is the Geelong Cats and the Liverpool FC soccer team. We would argue that, in sport and in business, talent counts for a lot, but it is far from everything, and we have all seen talented individuals and teams, in sport and business, lose to those with perhaps less talent who simply competed harder and more efficiently!

The strong desire to achieve and win, with the accompanying strong sense of satisfaction is desired by almost all humans, and if dormant in some of us, it can be lit or relit by great leaders! This discretionary work effort can be related to everyone in the workplace being on a learning curve. The leader is not just responsible for their own personal development as such but should take a lead in stimulating and sharing responsibility for all team members in his/her sphere of influence.

Leadership Axiom 7 is that successful leaders create successful people who know how to win. They do that by caring deeply about their people. They recognise that the people who work for them want to feel good about themselves. The NAB of the 90's, BHP of the late 90's and 2000, and AFIC are classic examples of winning combinations. Paul Anderson, Bruce Teele and Terry Campbell were all exceptional at building a workforce of people who acted as if they owned and created a winning institution.

Leadership Characteristic: Making the most of Diversity

Diversity means differences. If one accepts that people are the intellectual assets that make things happen then it is important to get the best people into jobs they are suited to and can excel in. This is necessary regardless of any individual's personal characteristics. Factors such as race, religion, disabilities, gender, sexual preference, age and other personal aspects, should not enter into the appointment, promotion or treatment of people. The key question is who is most capable, meaning most suited to doing the job really well, regardless of their personal background!

On this issue as with most other leadership aspects, leadership, meaning influencing of others, starts with each of us, so it's good to begin with deeply examining 'ME'. For each of us, what biases and prejudices do we have? How can we overcome them? Whether we inherited them from our parents, or developed them ourselves, or saw them modelled in the media, acknowledging them is a fine starting point, then 'deleting' them can hopefully be consciously affected, often by stamping out the ignorance that usually underpins them. For Danny, an example was the attitude he had seen to Muslim people based on the post 9/11 rhetoric. After 50 trips to Malaysia, a primarily Muslim country, over 12 years to conduct management development programmes inside PETRONAS, Danny came to fully realise that these folks had at least as strong a sense of family as the average Australian, a strong sense of ethics and generally a very similar sense of right and wrong. Danny learned that stereotypes can be dangerous, and fortunately, through understanding, knowledge and choice, can be dispelled and demystified.

Once a leader realises that 'people are people' regardless of personal characteristics, we can get on with leading and promoting the best people in our organisations. We can invest in making our workplace diversity friendly and lead others to adopt a prejudice free approach, then move the organisation to fully embrace diversity. While some other leaders and organisations have not yet achieved this enlightened approach, there is competitive advantage to be gained in the workplace, through being able to attract the best employees from across the whole population. People from minority groups often show deep appreciation to employers who give them a 'fair go' and very often become high performing employees, displaying strong levels of discretionary work effort!

People can be different at home, personally be different at work, yet be solidly welded into effective work-teams, displaying high levels of

discretionary work efforts, in pursuing common team goals. People can all, and indeed must all show fully professional levels of respect for all stakeholders in the work environment. These values of respect for all colleagues come from the example set by leaders at all levels of organisations. In Banks, the behaviour and attitudes of the Business Unit Head will manifest in how the staff behave with respect to each other and to customers. The manager will take his/her lead from the leaders up the line, such as regional or state managers. Ultimately the CEO is the 'keeper' and 'setter' of standards of behaviour across broader culture.

BHP Billiton's footprint was a classic challenge of diversified management. The Ekati Diamond Mine was located in the Arctic Circle and staffed with Aboriginal peoples. The workforce was a mixed gender group and the diamonds were extracted from the ice-covered ore body with the production undertaken by mining under a high canopy, 24 hours a day. The working conditions were extremely challenging and tested the resilience of the workforce. The workforce was housed in comfortable accommodation with shifts of 14 days on and 14 days off. Allowing this workforce to retain their ethnic and cultural heritage was a high priority and Paul Anderson's appreciation of this diversified ethnic group's differences was evident. Different people require different kinds of leadership. Tailoring one's style to their diversity is a prerequisite for success in today's world. There are no losers once this set of values are maturely in place, as employees, customers, shareholders, and even the organisation's leaders at all levels gain.

Leadership Axiom 8 is that a culture of respect helps a leader understand his/her organisation at a deeper level and assists in gathering a better understanding of motivations of others. The NAB in the late 1980's and early 1990's became leaders in how to manage a global footprint and diversified workforce after a somewhat immature approach following the acquisitions in the UK, Ireland and New Zealand banking organisations.

Leadership Characteristic: Creativity

Great leaders do more than demonstrate their commitment to hard work efforts and serving customers efficiently and effectively, but they also

unleash the creativity in their workforce, which otherwise might lay dormant. Everyone in every workforce has a brain, albeit some are further trained and developed in areas such as problem solving, and the unleashing of creative ideas from the whole workforce is a wonderful ideal for leaders at all levels to have, and act on. Much research has shown that highly innovative organisations get many of their best ideas from their workforce!

A critical challenge that we urge all leaders to consider is that no-one knows better what the problems, and therefore the opportunities are related to their local work processes, than to the employee who is right on the spot. Of course, these employees need to be trained and skilled on how to identify problems and opportunities, and processes need to be in place to support the problem solving and improvement processes. This resourcing activity, and even the training and up-skilling itself perhaps, is the leaders' job! This is exactly what Paul Adler (referred to earlier) found that Toyota team leaders were doing with American workers at the Fremont, California (previously GM) plant, when Toyota took over managing that facility, known as NUMMI. The workforce involvement in on-the-ground problem solving, improving outcomes for customers, product and service quality, workplace safety and productivity and other aspects of improvement of work can be driven by staff members who need only the mindset of improvement and the associated skills. Toyota does this 'Continuous Improvement' very effectively on a worldwide basis. Leaders' role is to train, support and resource the solutions, and then measure and expect improvement efforts and outcomes.

Leaders' personal creativity can be unleashed to set an example and role model the problem-solving behaviours. We should all take note of our personal strengths and weaknesses as problem solvers and process improvers. Some of us are good at recognising opportunities, some at analysing and diagnosing, and some excel at implementing solutions and changes. This is where carefully formed teams comprising members with complementary skills can outperform individuals!

Some people are more naturally creative than others, always thinking outside the square and searching laterally for improvements in their world. Leaders can identify these naturally gifted and motivated people, add training and capabilities of structured problem solving, harness these people's talents into roles where they can maximise their contribution, and try to spread the culture and behaviour of continuous improvement.

Leaders can also set expectations about trying new things and accepting some risk of failure. ABB has a fine corporate approach to risk tolerance, asking its staff to make (not avoid) decisions and take sensible risks in solving problems, being tolerant of occasional mistakes (as long as a person's 'batting average' is high). This created a sense of dynamism in this company. It drove improvement.

This leads to a consideration of how creativity in a workforce can be harnessed by leaders to stimulate systematic innovation in the organisation. It is a fact that people, of all types and in all skill groups, are capable of having good ideas. We all have ideas and can be trained to tell the difference between valuable ideas and those that should not be taken further. Some people have stronger levels of predisposition to solve problems, whether they are technical problems or customer's problems. Leaders can recognise these skills and dispositions, enhance and encourage them, and match people to roles in order to give them the opportunity to apply these skills for the benefit of all concerned.

For many of the opportunities that people can recognise and seize, technology or equipment, software or hardware can play a role. Leaders can judge the right level of technical tools to apply in the workplace, attempting to find the right mix of brainpower and technology to apply to work processes and their improvement. In order to know how to do this effectively, leaders cannot be technically illiterate when it comes to their products/services and processes. They need to know enough to ask the right questions of technical people and know how to take technical advice and participate in decisions about technology. Perhaps most importantly they need to be able to ensure that technological systems are people-centric, and not expect things to be the other way around. Leading firms design technical systems around the needs of staff and customers. The guidance for this powerful idea comes from senior executives, who build this understanding into their firms' technical functions.

Successful leaders of their organisation's creativity ensure that measures and rewards of creative behaviours are in place. These measures and rewards stimulate creativity and its conversion into innovation. For leaders who are more senior than team leaders, such as senior executives, it is also a case of recognising good people managers, and supporting them in particular, since they are the treasured managers who can bring out the best in large numbers of staff.

The NAB in the 1990's actually put an obligation on all its employees to work to their full potential. It was a response to the deregulation of the

Financial Services Industry in the early 1980's, and it helped build an environment that unearthed much creativity. People like the late Cliff Breeze, Glenn Barnes, Mike Soden, Tricia Cross all fostered innovation within their Business Units and were supported by a Human Resource Manager, Gordon Wheaton, a former Army officer who introduced a concept which during the appointment process determined whether a potential recruit, or aspirant for a higher classified position in the organisation, had the necessary skills and intelligence to perform a particular function. Prior to the new assessment process the organisation was spending a huge amount of time resolving problems caused by employees who did not have a grasp of the necessary competencies to complete tasks for which they were responsible.

The assessment of self-awareness was not intended to just eliminate problems. Each employee was expected to choose a range of activities in which he/she could contribute best to the organisation. It was quite amazing how pockets of creativity were unearthed throughout the organisation.

In the course of building off that work what we did learn was:

- Smart people learn from their own mistakes. Wise people, from the mistakes of others.
- Reality does not necessarily count. Perceptions do.
- If anybody really thinks deeply about things, it is easier to be intellectually humble.
- When asking people for business advice, the strongest opinions generally come from individuals with little direct experience—and they are usually wrong.
- Articulate people rise in power and assume control. Knowledgeable people, if not also articulate, become discouraged and either leave the organisation or settle into middle management positions or become passive obstructionists. The process takes about 18 months.

When NAB decided to intellectually cleanse the organisation of the 'Articulate Leaders' in the period from 2000 to 2003, it was a market view that NAB was run by a '3rd Eleven' group, some of whom had become passive obstructionists and lacked the required skills. Enterprise value creation matched this perception.

Further learning was:

- If you want to get out of a hole, first start digging—Many companies prefer to hire PR firms to spin their way out of difficulties, and as NAB discovered in 2002, this did not resolve anything, in fact it began a long period of sub-optimal performance.
- In times of rapid change, experience can be your worst enemy if employees do not feel involved.
- If people are too serious, they probably won't take risks.
- Getting there isn't half the fun, it is all the fun; we discovered this at NAB from the 1980's through to 2000 and BHP Billiton from 1999 through to 2010.

Leadership Axiom 9 is to build a creative organisation, where the leader must believe there is a rich pool of talent hidden inside the organisation. Nobby Clark and Bill Hodgson recognised this in the 80's and those of us fortunate to lead NAB during the 90's were able to bring this talent to light. We did this by establishing an environment that allowed people to make full use of their creative gifts to leverage those intellectual assets: we encouraged spontaneity and independent thinking. We examined the work culture, its systems, the way people were promoted and the overall bureaucracy to ensure the company continued to nurture creative processes and not negate them. AFIC was very effective in this area but BHP had to rebuild its workforce and its culture, and it was not until the end of Chip Goodyear's reign and the beginning of Marius Kloppers stewardship that we began to get traction in this space. Ultimately a leader never manages creativity. Rather he/she learns to uncover it, unleash it, and channel it in the best direction for the enterprise.

Leadership Characteristic: Integrity

Wherever in the world one is leading and managing, the ethical standards in the workplace and the sense of fairness, or doing the right thing by all stakeholders, must be a pillar of effective leadership behaviours. We argue here for institutional fairness, being the reasonable and 'equal opportunity treatment' of all staff. We argue for a fair and balanced and certainly ethical treatment of customers, suppliers and regulators, indeed all stakeholders. Few things de-motivate staff more than senior people in leadership roles

who 'play favourites' or have an in-group and an out-group in the workplace.

Senior leaders need to have their ears up to detect and correct such behaviours, never play favourites themselves, rewarding and promoting primarily on performance and capability. We have seen massively dysfunctional outcomes and lowered morale in a family business in which family friends were promoted and rewarded ahead of more capable people, and in a university where a senior executive established a small group of 'yes-people' and excluded most others from opportunities and discretionary resources.

On the other hand, when an open and fair process was implemented regarding promotions in NAB, based on capability and judgements about future performance, it was accepted by most staff, even if some of them disagreed with some of the actual judgements of senior leaders.

Standards of integrity for the whole organisation are set by leaders. Dealings with a variety of stakeholders offer opportunities to take short-cuts, cut corners and take chips off the 'high road of integrity'. Great leaders play hard, but do not behave unethically, ever. They never trade off on their ethical standards. This is a high ideal to live up to, and it sets the tone for the whole organisation.

The character of the organisation is established by the character of the people who work there. That character is determined by the integrity of the leader. Textbooks contend that integrity is a timeless virtue that is central to living a healthy, ethical life. Ethics may twist and turn, be subjected to economics, law, psychology and management whims. Ethics means different things to different people as they debate what is right and what is wrong. The concept of integrity however never changes.

Most people want to following leaders who are driven by fundamental, undeniable principles. These principles are deeply ingrained in the leader's make-up, shaped over a life-time of development and introspection. They serve as the moral compass, an internal guidance. Bruce Teele of AFIC, Paul Anderson, Chip Goodyear, Marius Kloppers, Nobby Clark and Jack Booth were all business leaders who displayed these qualities.

Leadership Characteristic: Community—Caring Beyond Yourself

Great leaders work to create a sense of community both in and beyond the workplace. Within the workplace, we have already expounded on this as a sense of team and teamwork, and beyond the immediate workplace,

Leadership Axiom 10 is that effective leaders never compromise on their high standard of integrity, and they articulate that standard and expect all stakeholders to behave to that standard.

To show respect and set a level of integrity and respect, leaders should 'have the courage of their convictions'. For a leader to achieve influence and for people to want to sign on and join / follow, a leader must have self-respect, and follow through on their beliefs and initiatives. Leaders must not only be true to themselves, but also ask and expect others to be courageous. When a leader develops a strategy or wants to implement an initiative, and has influenced others to sign on, then what does a great leader do when the going gets tough? They do not go to water, but they persist, because if it is worth doing, then it is probably worth overcoming points of resistance. If leaders in an organisation were to quit on their initiatives when things got tough, then those organisations would never get any bold initiatives such as radical innovations, culture changes, and acquisitions etc, accomplished.

Courage goes hand in hand with an entrepreneurial spirit, of breaking through barriers that others will not attempt. Yet sensibly, effective leaders do know when to finally quit on initiatives that are just not going to work out. BHP Billiton's withdrawal from its attempted acquisition of Rio Tinto plc when the commodity markets collapsed is a classic example of courage in action. Being too stubborn to change when it is needed, perhaps because of too much personal pride, is not being courageous; it is just being too stubborn. If a leader's strategy is clearly not working, a stubborn leader will hang on to it for too long, and a courageous leader will bring realism to bear and admit fault, then make the change.

Putting integrity into action means taking decisions and not compromising on ethical standards, for example in chasing profits. All leaders will face a variety of ethical dilemmas in their career, and those who really have a strong sense of integrity stay the course, in the knowledge that leadership work is a marathon-like career, not a sprint.

NAB's decision to overlay a strong risk management culture within the organisation during the 1980's and 1990's when the 'entrepreneurs' were pressing high risk demands on the financial sector took courage and in some instances loss of potential business.

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BHP Billiton's decision to exit Steel Manufacturing in 2001 was one of the defining strategic decisions a business makes. It had all the political and environmental and business risk that one could define, the ultimate decision to exit the sector took 12 months to plan and resolve. The decision involved conflicts and compromise but at the end of the day both Management and the Board believed that the course of action taken was doing the right thing for all stakeholders.

The best leaders, like Paul Anderson, Chip Goodyear, Marius Kloppers, Bruce Teele, Jack Booth, and Nobby Clark all walk the talk. There is a common connection between their values and business behaviours. History will reveal that all confronted tough decisions during their tenures at their various organisations but none of them waivered on ethical behaviour. No one person possesses pristine ethics that have never been challenged and in some cases relaxed, but, when it comes to integrity there is only one road, the high road.

leaders exhibit corporate social responsibility to influence the external environment to be better than it otherwise would be. Organisational leaders contribute to the social health of the extended community, and they do this for good business reasons. They draw their workforce from the community and for that matter their customers, and there is often a set of efficiency, reputational and stakeholder support benefits from giving to the community. It's win-win.

Organisational leaders in this increasingly crowded world need to be mindful of their organisation's environmental impact. They are the stewards of their organisation and its outcomes, including on the environment at large. Here we mean both the business environment and the 'green' environment!

Fortunately, most industry standards have moved a long way forward from the bad old days of just a couple of decades ago when great advantage was taken by some companies of the planet's resources, and essentially vandal like behaviour was seemingly acceptable. Newer 'high integrity' approaches are now clearly much more effective and are being demanded by more and more by stakeholders.

Successful leaders that we have known or studied have a longer and broader perspective on business and life. They measure their success not just in terms of how much money they have but also their contribution to society. That sense of social responsibility isn't imposed upon a corporation. It starts inside those leaders who are generous people, who are concerned about others and the circumstances that surround them.

At BHP Billiton for example, as the world's largest diversified natural resource company, its operations touched many areas of the globe and they recognised and embraced their responsibility to consider and respond to the needs of many different stakeholders. Their Charter set out their values, in particular, their commitment to ensuring the safety of their people, their respect for the environment and the communities where they operated.

In addition to the wider Group corporate governance processes, they have systems in place to implement their policy commitment to sustainable development. The Sustainability Committee of the Board oversees the sustainability strategy, policy, initiatives and activities. Management obviously holds primary responsibility for the Health, Safety, Environment and Community (HSEC) processes and performance.

Their Code of Business Conduct applies to every member of their workforce and provides a framework for decision making. It is based on the values articulated in the Charter and highlights that the Board and Management care as much about how results are obtained as they do about delivering good results.

The HSEC standards were part of a wider suite of Group Level Documents. They provide mandatory performance requirements and performance controls which are the basis for developing and applying management systems at all sites operated by the Company.

The documents highlight the four key components of sustainable development:

HEALTH: focussing on the elimination of risks through the control of potential workplace exposures to noise and substance abuse which could result in long term harm

SAFETY: providing a workplace where people can work without being injured.

ENVIRONMENT: delivering efficient resource use, reducing and preventing pollution and enhancing biodiversity production.

COMMUNITY: engaging with those affected by the operations including employees, contractors and communities, and respecting and upholding fundamental human rights.

There are many rich examples of positive outcomes from such a focus and it is quite clear as to the Company's commitment when one examines the operations in terms of diversity and scale, and the nature of the social impact which can vary significantly. Obviously there is a clear goal to minimise negative social impacts, whilst maximising the opportunities and benefits which the Group's presence brings. A clear example evident at BHP Billiton was when one overlays the stated aim to continue to invest one per cent of the pre-tax profits (based on the average of the previous three years pre-tax profits publicly reported) in community programmes.

> *Leadership Axiom 11 is that effective leaders drive change, not for its own sake, but to sustain their organisation's performance. As a result, they see a broad role for business within society. They know companies cannot be islands of self-interest. As partners in the community, business must share their talents and resources to help serve public needs, work on social issues and help build healthier communities. It is not only the right thing to do: it is good business.*

Conclusion: Postscript on Leadership

From the axioms and ideas above, and the examples of how and why it works well and sometimes does not, readers can see that effective leadership can be a complex and demanding activity and role.

If it were easy to be a great leader, we would see many more, and much less in the way of organisational dysfunction. Many companies that got into serious trouble need not have, if their leadership had been better. Our views on the elements of effective leadership, applicable at all levels of organisations, are stated and illustrated above. Now we address the costs and benefits of undertaking leadership roles. First the costs: leadership

roles can be very demanding, on a person's time and energy, and the challenges of leadership mean that it is hard to leave your work at the office, as can be done with some other job types. Leadership roles can be almost consuming of the person: just look at the before and after photos of some US presidents to see how such a job can 'age' them. Great leaders can however reduce this personal burden by building and sustaining a great leadership team, and by trusting and delegating (but verifying!) tasks and decisions as appropriate, as discussed above. Nevertheless, a senior leadership role is a tough job, demanding and tiring. Responsibilities weigh on leaders' shoulders. Dedication is necessary, perhaps meaning that to some extent, personal sacrifices are necessary. For example, we have both spent very many nights and days, sometimes multiple weeks, away from our families.

Now to the benefits: why would anyone in their right mind want to take on all this responsibility, given the costs we refer to above? The answer is easy and known to all those who have held significant leadership roles. First is the tremendous sense of accomplishment that comes from having influenced and contributed to value creation in organisations, community and society. Leaders benefit from satisfying their 'need for achievement'. Second, since a part of a leadership role is to mentor and develop great people around you, comes the joy and satisfaction of doing just that, of working and mixing with people of great capability. Third comes the satisfaction from contributing to solving problems and improving the outcomes for all stakeholders of an organisation. Finally, yes, for successful leaders there are, as there should be, tangible personal benefits, for there is a good reason as to why the labour market for effective senior leaders clears at higher 'prices' (meaning salary packages) than for most other roles.

Leadership of organisations is not for everybody. Leadership requires much courage, patience, intelligence, emotional energy, and many other virtues. It can be immensely frustrating when people disappoint you in their lack of delivery or commitment. Yet in the end, the achievement of winning and overcoming challenges, developing others around you, then leaving a successful legacy for others to further build on and pursue, makes it a very worthwhile activity for those that are attracted to it! What could be more satisfying than serving a range of others with better outcomes, though effective leadership?

We hope that after reading this chapter, you will know whether and to what extent you are predisposed to take on a leadership role, and you will feel informed, and either attracted to such work or not. The world of

organisations is short of great leaders, many more are always needed, but our experience is that if people are not capable or not desirous of the responsibilities, then such appointments usually end in grief. On the other hand, for those who have read this chapter and feel attracted to leadership work and responsibilities, the good news is that you can significantly and perpetually develop your abilities to contribute, so please consider putting in the 'hard yards and years' of learning the principles and the intricacies, develop your capabilities, and ultimately, go for it!

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CHAPTER 2

Organisational (Business) Strategy

Introduction

In this chapter we outline the essence and necessity of having and living a sound organisational strategy. Every successful organisation has at its foundation a sound and sensible strategy. Strategy defines purpose, goals and the means for achieving these. It exists in large organisations at a number of levels, from whole of organisation level to business unit and department, ultimately linked to team and individual goals and plans if it is to be fully mature and effective. Strategy is discussed in terms of its capability to guide decisions, from a strategy formulation perspective, using BHP and NAB as examples of large business, that variously were successful strategically, but not always so. Competitive strategy and ways of effectively implementing strategy are discussed. In the appendix to this chapter, we examine operational effectiveness, as it relates to implementation of strategic direction and strategic initiatives.

In Chap. 1 we have set out the importance of strong and sound leadership, necessary to motivate and align all stakeholders, especially employees. That sound leadership is a necessary but not sufficient condition of business and organisational success, which also requires the 'tangibles' side of the business to be right, namely the purpose, direction, asset base, offerings to the market, values, mission, capabilities that must be fitted to the external environment and opportunity set, and positioning in markets, all of which can be aggregated and summarised in the term 'strategy'. Strategy is a combination of what the firm does, how it does it, and even

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D. Argus, D. Samson, *Strategic Leadership for Business Value Creation*,
https://doi.org/10.1007/978-981-15-9430-4_2

the logic behind why it does it. Underpinning strategy are the implementation tactics of course, of when and where it does it too.

These matters of organisational strategy have never been more important than today, and with increasing complexity in the world of business, economics and society's requirements going forward, it should be expected to continue to become more important. We describe the essence of strategy, the need for it as the integrative and guiding purpose-making vehicle of the organisation, the need to fit the forward strategy to the organisation's capability and external environment, and finally, but not least, the need to have a strategy that will provide competitive advantage and value for stakeholders, especially customers, employees and of course business owners. Finally, we discuss the key elements of enacting strategy via a set of strategic initiatives that should be considered as a portfolio, and that must ultimately result in delivery of the goods and services of the organisation in an operationally efficient and effective manner. In an Appendix to this chapter we discuss the imperative of operational effectiveness and project management disciplines that must underpin strategic execution of Business As Usual (BAU) and continuous improvement and change management.

The Ever-Changing World in Which We Must Create Value

Few would dispute that the current era of economic circumstances, geopolitics, technological change, sustainability challenges and human needs mean that the volatility in most markets is higher than ever before. The world in which businesses operate is more complex, more interconnected, faster paced and riskier than in previous decades, and it would seemingly not be about to go back to a stable equilibrium. Thirty years ago, it was reasonable to assume a high degree of stability in regions or markets. Turbulence and shocks now abound in technology and the way market forces act. The 2008–2010 Global Financial Crisis was a fine example of this on a grand scale, and on a lesser scale at a corporate level, consider Morgan Stanley and its 2012 fall from grace. In 2013, Apple, the most highly valued company in the world for a while, exceeding even the value of Exxon Mobil, lost some of its market shine and was quickly devalued by stock-market investors by over 40% in January 2013. Apple then bounced back. The future is increasingly difficult to forecast, for both those who lead businesses and those who invest in them.

Yet where there is risk there is always opportunity for astute business leaders to carefully assess and cleverly take some risk and manage their portfolio of investments such as to generate the cash flow stream that will be attractive to investors.

Intellectual capital has increasingly become the key to success. The era when structural capital was almost enough to assure a successful competitive position is essentially over. Having deep corporate pockets still helps, but only if those assets are used to great effect, otherwise markets quickly mark down the executives and strategies (or lack thereof) which can be seen to have 'lazy assets' in their firm.

Consider for example the declining share price of a significant gold mining and refining company, which has been adding substantially to its upstream gold reserves at a time when the price of gold has never been higher. The missing value creator that has caused the market to mark this company's value down is the ability to convert resources under the ground into cash, in the next few years, and indeed, increasing the reserve base from 15 years to 30 years volume of deposits only serves to dilute the market's valuation of its overall asset base, because of the cash flow timing issue that is created. Perhaps more than ever, a consideration that must pervade strategy formulation, is that while long term competitive advantage is a 'nice to have' capability to invest in, that the old adage was never more true or powerful: 'Cash (flow) is king!'. The increasing volatility in all aspects of business environments leads to heavier discounts of potential future cash flow streams in how investors think and choose, relative to that cashflow stream of the 'bird in the hand'. As an example, when Newcrest Mining increased its underground reserves but had significant problems in its extraction and operations during the period 2011 to 2014, its share price was marked down from a peak over $42 to a trough of below $8, which was a spectacular fall. The company had lots of gold assets; indeed, they were increased, but they were deep underground and not in the bank, and at that time they had not created the matching capability to convert gold ore assets into cash. Post 2014, improved operational capabilities led to cash flow upgrades, and this was reflected in a tripling of the share price from its bottom point.

In contrast, consider the intellectual capital and promise of the 'new economy' and the promise of profitable business activity in that realm. An early example was Amazon, which did not make a profit for quite a few of its early years, yet astute investors could see the position it was creating, ultimately completely transforming an industry (book retailing/distribution), and continuing to further develop and create a platform for online

sales well beyond books, and indeed, well beyond retailing and distribution. In the markets of consumer electronics and internet related services, the entrenched and successful players such as Sony and Hewlett Packard have seen new and innovative companies, often started from scratch by fresh graduates, overtake their positions and market power. In cases such as Google and Facebook, and in the hardware end of computing, Cisco and Dell, we have seen innovative new business models and strategies leave the entrenched and previously dominant players behind at a speed that has been unprecedented. Market forces are fast-acting, chasing cash-generating potential and are unforgiving of laggards or lazy assets like never before.

The Centrality of Business Strategy

A great deal has been written about business strategy, by professors such as Harvard's Michael Porter in his famous books, and many others. We contend that the ultimate purpose of a businesses' strategy statement is to guide decisions, attract and give confidence to a range of stakeholders, so that the business can succeed and be competitive in a number of competitive markets, which are related:

1. The offerings to the market must be competitive, whether they be shiploads of iron ore from BHP Billiton or retail bank services from the NAB, customers must be able to see and access the value proposition in these offerings, otherwise there is no demand side and no revenue stream and its 'game over'. There is a great deal of detail involved in getting these service features and product designs right, and implemented competitively, and there are paths to success and many paths to failure, which we will outline in this chapter, and in the detailed case examples of NAB and BHP in this volume. When NAB had the most efficient bank in its industry in Australia, as measured by its industry leading Cost/Income ratio, it was given the opportunity to competitively outbid its rivals in financing deals, and it also made sense for it, and not its competitors to nearly the same degree, to generate enough free cash flow in order to take its competitive edge to other jurisdictions, such as the UK, USA and New Zealand. Similarly for BHP, in industries that could hardly be more different from banking, steelmaking in Australia did not have a low-cost and long-term strategic position in global terms, but iron ore and other mineral resource positions did, hence the business case and motivation for the major conversion of that asset set.

2. Leaders must be able to win in the labour market, to attract talented people, which some have called the 'war for talent'. They must be able to attract great people and energise them to be the best they can be in pursuing the formulation and implementation of the strategies, that embody the supply of those goods and services referred to above. A fine example of this is the NAB, which during the period of approximately 1985 through 1999 was able to attract an extremely talented set of senior group executives, who led that organisation to over a decade of market leadership, in every sense, and profit outperformance. The industry leadership of some 15 years, of growing market share, innovation, cost leadership, careful geographical diversification and growth, was however quickly undone, in about a year, when success in the war for talent rapidly became failure and the talented top team evaporated very quickly once the tide turned. We admit openly that the bank's strategy and performance at that time, strongest in the industry by a long way, had one 'fatal flaw' in it, which was the lack of a solidly implemented succession plan, hence the failure at the top end of the executive labour market. The cascading series of failures which were catalysed by this labour market failure are now history but provide a strong lesson on this element of this compulsory ingredient of success: ignore the talent factor at your peril! We contend that this is not at all just a top management factor, but that it ricochets right around the organisation. While the NAB was at the top of the industry, it was relatively easy to attract the best middle managers and the brightest graduates, since everyone wants to be part of a winning, growing team. However, the salutary lesson is that the snowball effect, which was so positive for 15 years, was even sharper and faster on the downward spiral. Shareholders witnessed a profit boom during the period of 1988 to 1999 (see Fig. 1.1 in Chap. 1), with share price and dividends rising well beyond industry norms and market expectations, and the NAB being clearly the industry leader in every way, including return on shareholder funds. Yet the bank quickly fell from grace, from number one in Australian banking to the back of the pack, and this was and still is reflected directly in the share price too. The war for talent was won by NAB until 1999, then it became just another large player in a pack. As shown by the Royal Commission that reported in 2019, NAB suffered similar problems as the other banks, leading to an unprecedented 'falling on their swords' of both Chairman and CEO in February 2019. With the wrong leadership approach, and with

unsuccessful strategies, poor strategic decisions and lack of process and risk control, this illustrates just how far an organisation can fall, from share market darling to such lows in almost all its outcomes.

3. The competition to attract invested funds must be won. The NAB example above and the Apple example demonstrate how quickly investor sentiment can turn. It also serves to demonstrate the strong interconnectedness between these various markets that we must succeed in: the war for executive talent was quite suddenly lost at NAB, and the share price and industry position quickly tumbled. It is too early to firmly conclude the future of Apple, but hard to not wonder whether the death of its charismatic leader, Steven Jobs, who was so hands-on and personally involved in guiding all elements of strategy, will be associated with a decline in its ability to continue to win the 'war for talent' and achieve an ongoing market leadership position in the long run, even though it is 'so far so good' up to 2020. Will Apple continue for another decade or two to attract the best designers and executives as over the past decade, leading to having the most attractive market offerings, and therefore being a share market darling? Or will its competitors, such as Samsung, who are themselves well-resourced and through large innovation investments fiercely trying to shoot past Apple, achieve exactly that? It would appear that Apple's owners, who have witnessed a share price that went from US$4 to over US$180, essentially during Steven Jobs tenure as leader, are asking some tough questions about the sustainability of that performance level and of the strategies that underpin it. Is the long trajectory built on Jobs' iPhone and iPad almost fully mature? At time of writing, Apple has experienced a resurgence in its fortunes (share price US$275), but its traditional competitors and newer businesses such as Huawei, Oppo and Xiaomi are increasing smartphone sales, such that Apple volumes, still an impressive 35 million units in 2019, are now fourth highest in the world.

The 'Grand Plan' and Its Execution

Strategy is often discussed in terms of its formulation first, then its implementation. Of course, the feasibility of implementation is critical and must be taken carefully into account during the strategy formulation process. This is unarguably a sensible way to consider strategy, yet we propose a deeper frame from which to approach strategy. We propose that there are

five deep questions that every business must answer in order to achieve any form of lasting success, and in this section we outline and illustrate those:

1. Purpose: where are we going and why?
2. Plan: how will we get there?
3. Networks: how do we work together?
4. Tools: what resources do we need?
5. Results: how do we measure success?

We now take each of these in turn for further detailed explanation and examples. These can be used as a practical yet powerful way of building an organisation's strategic framework.

1. Sense of Purpose Needs to Be Strong, Compelling and Supported

The vision and/or mission statement and sense of purpose that it provides needs to give clear direction and guidance for those who make decisions throughout the organisation. The statement(s) of purpose also provide clear messages for a range of external stakeholders. In the early 1990s, NAB did not have an explicit central vision and mission statement, so we formulated these, along with a set of overall objectives, and rolled them out through a group wide communication programme, and displayed these statements in many places, such as within bank branches. These statements served to tell stakeholders, especially staff and customers, how we wanted to distinguish ourselves from our competitors. In formulating these statements of purpose, which we called by their traditional names as Vision, Mission and Objectives, there were a series of debates amongst our executives all over the NAB world, about why we were doing this and how these activities would add value, as against being just a lot of hot air and a waste of time. We debated the content and the processes. Some executives said we didn't need them at all. The sceptics were soon won over when they saw application of the mission and the statements of objectives, which were really also inclusive of a value system that we specified. An example is where other banks left rural customers stranded with foreign currency loans that had turned against them when the A$ rapidly fell: we referred to our objectives and responsibilities as stated in our published standards and interpreted from these the ethical stance that we required, as guided by those published documents of explicit Objectives, and we stood by our rural customers at that time,

when others did not. There was a short-term cash cost, that came with a long term reputational and market benefit.

It was important that the NAB mission and vision along with the accompanying objectives be seen as a group corporate level standard, and for example even though the Bank of New Zealand leadership team argued that they needed their own separate and distinct statements of purpose, when we took BNZ over, we didn't allow for such exceptions. The reason was that we were forming a single entity and wanted to move towards a globalised company (the journey toward globalisation was never finished because of major problems post 2000). The move towards group-wide standards was to have common technology, common product platforms, common culture and values, and the starting point had to be the high-level group Mission, Vision and Objectives. They were the pillars of our success at that time. They served the NAB well. They helped to distinguish us from the rest of the pack. They communicated these elements of our aspiration to customers, and we had many instances, large and small where customers reminded us of our high standards and told us that we needed to 'step up' to them, when our service was occasionally light on. They provided what Dr. Deming called 'constancy of purpose', explicit stability and consistency.

At BHP Billiton, a statement of purpose was created to consolidate some elements of what had been described as mission, vision, objectives and values into a Charter statement, shown below (from February 2013):

BHPB: Our Charter

The BHP Billiton Charter describes our purpose and values and how we measure our success. Our Charter is the single most important means by which we communicate who we are, what we do, and what we stand for as an organisation, and is the basis for our decision-making.

We are BHP Billiton, a leading global resources company.

Our purpose is to create long-term shareholder value through the discovery, acquisition, development and marketing of natural resources.

Our strategy is to own and operate large, long-life, low-cost, expandable, upstream assets diversified by commodity, geography and market.

Our Values

- *Sustainability*
  Putting health and safety first, being environmentally responsible and supporting our communities.
- *Integrity*
  Doing what is right and doing what we say we will do.
- *Respect*
  Embracing openness, trust, teamwork, diversity and relationships that are mutually beneficial.
- *Performance*
  Achieving superior business results by stretching our capabilities.
- *Simplicity*
  Focusing our efforts on the things that matter most.
- *Accountability*
  Defining and accepting responsibility and delivering on our commitments.
- *We are successful when:*
- *Our people start each day with a sense of purpose and end the day with a sense of accomplishment.*
- *Our communities, customers and suppliers value their relationships with us.*
- *Our asset portfolio is world-class and sustainably developed.*
- *Our operational discipline and financial strength enable our future growth.*
- *Our shareholders receive a superior return on their investment.*

This charter is most useful in a large and geographically diversified business. It not only describes the intent and the forward strategic intent, but it also sets out values, expected behaviours and performance expectations, and a set of success factors by which the company measures itself. It is specific enough to define scope and let all stakeholders know what they are a part of, and it can be made meaningful to all those stakeholders. BHP Billiton regularly measures and accounts for a published statement on the success measures in that Charter. Hence the sense of purpose that this charter espouses is the central unifying edifice, and the call to action, that aligns and guides resource allocation and other decisions, from the board, right through to operating staff.

While no charter will ever be fully unambiguous and even close to perfect, this example is quite clear, sets out a common direction, and yet

allows business unit leaders to tailor it to their specific purpose, in terms of how they will align to it in detail. Ultimately its aim is to provide both alignment and meaning to peoples' work, leading to measurable value creation.

2. Having a Strategic Plan: how will we get there?

It is indeed a truism that 'Prior planning prevents poor performance', and while there are no guarantees in life or business, especially given the global volatility we referred to earlier, there is no question that planning helps with the guiding of resources application and decisions.

Perhaps it is also true that larger and more complex organisations have a greater need for planning, and the coordination that follows it, but we would argue that even for a small business, that: 'Failing to plan is planning to fail!'

The plan needs to be in place to create a road map into the future. Its content must be the clear explanation of strategies and priorities. There are almost never enough resources to do all the things that people want to do in an organisation, so the plan guides action, through stating what the intended strategy and action set is, and at least by implication, what is outside the scope of planned actions.

As Henry Mintzberg pointed out, plans must be flexible, and allow for adaptation in real time realisation of them. This is because the world is changing fast, so plans and the executives responsible for their implementation need to be able to flex with those changes. Consider how much prices have changed, on commodity items such as oil, iron ore, and indeed currencies themselves, and how these are essentially unpredictable and certainly uncontrollable for most of us. Laws and taxes change, consumer sentiment can change, and technology certainly does change too. This is why it is useful to at least consider contingency planning, as part of future planning, and sometimes to do some scenario planning around our strategies.

To implement the strategic plan, the organisation must consider and align the elements of structure, processes and people. Structure needs to fit the strategy, so that the relationships, power and authority, and in particular the decisions will be made by the right individuals and teams and for the right reasons, namely to accomplish the strategic goals. When there is a 'disconnect' between the strategy and the organisational structure, then even with excellent leadership, implementation will always be like trying to push water up a slope with a sieve: it becomes overly hard work

and there will always be lots of leakage! If the organisation is trying to accomplish a series of projects, then perhaps a matrix structure should be considered, and if it is trying to globalise from having been a federation of separate country brands (as it was at NAB in 1998), then a move from nation-based divisions to global or regional business unit structures is likely to be warranted. Global teams should be formed in that situation, to achieve standardisation and global spreading of best practices.

As to the design of processes, the choices of various process types configures the organisation's production system to deliver particular profiles of characteristics, such as lowest possible cost, versus flexibility, or service excellence and quality, or innovation. For example, if a 'flow shop' is used to process credit card applications, or a conveyor belt is used to move minerals, then efficiency should hopefully result, but flexibility is low. So, if the strategy is to achieve low cost in a fairly stable environment, then such processes and technologies might well be the right things to commit to, but if flexibility is required, then will a conveyor belt do as well as a fleet of large trucks? Similarly, a line-flow process in a manufacturing setting will not be reconfigured as easily and cheaply as a set of cellular teams. Choice of process should be governed by the overall answer to the big competitiveness question: 'How do you compete in your market segments and why do people buy your services?' This question needs to be answered in very specific terms: such that 'We aim to be the best!' is not an acceptable answer, but the specific value proposition should articulate just how the firm will be the best, for example on dimensions of low cost, superior service or quality, flexibility and tailoring, innovation, delivery reliability, etc.

Employees require quite a lot of communication, which must be consistent in delivering the messages about the plan and its priorities required to deliver the strategy. In every corner of the organisation, staff make decisions, large stakes decisions and small, and the more they can be informed and motivated to drive towards the specific goals and desired outcomes of the organisation as a whole, the better. Further, the staff, the processes that they work in and the organisational structure need to be singly congruent with the strategy, and also work together to synergistically fit each other and the competitive strategy well. If the competitive strategy is, for example, 'Tailoring Banking to your needs' as it once was at NAB retail operations, then people with a service and flexibility mind set need to be recruited and trained to do exactly that, and work processes and even product designs need to be tuned to that market position and value proposition. Structures and delegation levels need to be set so that frontline

staff can indeed apply the right amount of flexibility in their dealings with customers. Further, the achievement of that 'tailoring' should have been a key measure and KPI.

In a large organisation, plans should be able to get the best of both the economies of scale that are available, and the closeness to the customer in each market that wins their hearts and loyalties. This has been summarised by many into the phrase: 'Think global and act local.' The global company ABB does this effectively, with a structure that has independent business units all over the world, and teams that spread best practices and corporate knowledge and capability globally, yet with local managers who know the local market conditions and have in-country networks and closeness to the customer running every local business unit. Although it is different in every industry, depending on the nature of the economics, cost functions and product/services being offered, the core ABB approach is quite universal, namely finding the optimal point where standardisation brings economy of scale, needing to be combined and balanced with the particular response required by differences in regions/countries/market segments. In retail banking, it can be argued that a basic mortgage or credit card is just exactly that, no matter which country one is in, and similar with some mining processes and the equipment needed. Therefore, common technology, procurement efficiency, and standardisation are attractive to reduce costs. Yet every market has different legal and other jurisdictional requirements, and every mine might have different logistics profiles to at least some extent. The strategy and market positioning should lead to the balance and choices of process, technology and skills to match these types of requirements, and deliver the outcomes. This should be considered and accomplished while ensuring that the business is on the efficient frontier that balances cost efficiency with quality and flexibility.

3. Networks: how do we work and succeed together?

Companies and their executives need to build networks both inside and outside the organisation. These networks are of people-to-people relationships, based on trust and teamwork. It is unrealistic to assume that everything can be written down and fully specified in contracts, whether these are employment contracts or service supply contracts, and very often, important things can only get done because of the store of goodwill that has been invested in between colleagues in and around the organisation. It is only human to build these relationships, especially professional

relationships, into a network of people who are aligned in their values and goals. The brilliant individual who is a 'loner', no matter how brilliant and hardworking, will always be limited in his/her contribution and accomplishments, relative to the seasoned network builder, who can effectively connect and cooperate with a range of people across and outside the firm.

Business is so competitive and complex enough these days that no organisation, just like no human being can succeed as an 'island'. None of us, either individually or as a firm, can excel at all activities and functions, and the good news is that we don't have to, but we do have to be good at networking, and increasingly so. This networking point is one that could be classified as much under the heading of leadership as of strategy and is indeed a core of the notion of 'strategic leadership' itself that integrates these very important matters.

Inside the organisation, no matter what shape and size it is, cooperative relationships are key to implementing strategies and initiatives. In large and geographically spread companies, these networks are often built across countries and cultures, and therefore require a highly 'worldly' approach for employees at all levels to be able to effectively build relationships and communicate using technologies and when travelling internationally. NAB and BHP built virtual global teams for a variety of purposes.

These networks and relationships are a matter of personal and organisational investment. Individuals invest in getting to know their colleagues, which will create reserves of goodwill that will come in handy at a future date, and also just because we are human! This can and does occur very much within an organisation, and also with clients and suppliers too, up to an extent, as long as it never leads to unethical behaviours, such as breaching confidentiality or probity standards.

Such network building is also in the organisation's and shareholders' direct interests as it leads to more effective strategy implementation. A good example is the investment and management of knowledge and intellectual property. Firms such as ABB, PwC and BCG, and a host of others have invested in two major types of knowledge management: both computerised knowledge management and human, people-to-people knowledge exchange can be very powerful when done well. One of the great benefits from having a focussed company and consistent strategy operating in multiple locations is precisely that lessons learned and knowledge gained through strategy implementation in one place or business unit, can be used to effect and effectiveness in other business units. Part of this can be done through the use of intranet-based knowledge capture, and

sharing, but it also requires the right culture, and much can also be accomplished by just putting people together in the same room or via telecommunications systems such as video links. This is where and how 'structured networking' creates significant value: we observe that many large organisations are not yet mature in their ability to leverage intellectual property and knowledge in a mature manner. Ruthven Institute has estimated that the percentage of share price that comprises intangible assets (mostly intellectual property) has risen from 17% to 88% since 1975, which is a remarkable change in what is valued by investors and what drives profitability (https://ruthven.institute/products/latest-insights/).

Consider the need to build cooperative networks and knowledge sharing mechanisms across the functions of almost any organisation. For example, the marketing and sales divisions and function managers need to know well and trust the supply chain managers, the financial managers and the human resource managers, and many others. It certainly helps a lot if this coordination is born of mutual respect and shared key performance indicators, such that a high level of cooperative behaviour is naturally in everyone's interest in the group. And it also is most useful if this mutual respect, networking and cooperation to achieve high performance starts with the most senior executives across the top of the organisation, as role models, which can then lead to cascading of the team/network approach and the KPIs throughout the business.

A good example of this network and cooperative behaviour was the top team known as the group executive committee at NAB during the 1990s. These executives were all excellent and highly talented individuals but were much more than that. They worked intimately together to solve problems and lead the increasingly complex and growing organisation to achieve great things, year after year of record profits for an Australian company, and clear industry leadership. This spirit of cooperation and comradeship was indeed role modelled at the top and took root throughout the organisation. Importantly this is not to say that those executives did not have robust, and when necessary even quite fierce debates about strategy, yet the vision was shared and debates were usually for all the right reasons, about the best way to achieve that vision, through formulating and implementing great strategies.

Once the successful NAB top team of the 1990s had gone elsewhere, which happened rapidly as of 2000, the networking and respect evaporated quickly too, and also, sadly cascaded down the business, with quite disastrous results.

As was the case with NAB, the external networking and respect, and the flow of business in the market is a spill over from the state of these factors inside the company. While the top team and the bulk of the staff were working so well together in the 1990s, similar was happening in markets, from the commercial bank and treasury operations where billion dollar and multimillion-dollar customers worked with us, to the retail markets where the amounts of money being transacted were much smaller. In the retail bank, just like in treasury operations, NAB was sharing best practices throughout the branch network, and we were spreading best practices around the NAB banking world. This all depended on establishment and leadership of trust, respect, shared vision and values, and a joint will to win and deliver the overall strategy.

4. Tools: what resources do we need?

To effectively implement strategy, the right resources are needed, from the most important resource, namely great people, to equipment and facilities. People at all levels need challenging jobs, where they can strive to succeed and get both job satisfaction and other forms of both psychological and material rewards. This is central to the nature of how economies work, including the internal economy of an organisation, where people give their time and effort (human capital) voluntarily in exchange for that mix of rewards that they take from their employment relationship. Executives who are in control of designing work processes need to consider making jobs into challenging and achievable, rewarding experiences. This is obviously easier to say than to do, given how many people in the workforce express their frustration and sometimes downright unhappiness with their jobs. We have found that a human touch, which can be embodied easily by doing some 'managing by walking around' can work wonders as a managerial behaviour, when we as managers are sincere in trying to improve work processes and job design. Indeed, people generally are quite resilient when things are not going as well as they might, but there are limits to this, and our experience is that if managers try to take advantage of this element of human nature, it will likely blow up in their faces.

We would argue for an approach to tools and resources which is to put those tools in the hands of people that they need so that they can succeed and 'be the best they can be'. Setting people up to succeed almost never backfires: rather people will almost always step up to high levels of effort and performance outcomes when the conditions are conducive. This

element of 'discretionary work effort', which we wrote about in the leadership chapter of this book, comes from trust, sincerity, but also requires jobs and workflows to be well designed so that people can achieve. We remind readers that not only must people be set up to succeed, but they need feedback as a part of this, so that they can explicitly know of their contribution. The benefit to cost ratio of providing lots of feedback to people at all levels in the organisation is high: nearly all of us in the business community should try to find time to do more than we currently get to do on a regular basis. These ideas give guidance as to the workplace tools required to make strategies work well.

We also strongly believe that people should be 'invested in', meaning investments in learning and skills upgrades. There is ample evidence that this is one of the hallmarks of successful organisations, where people are seen as worthy of investment in learning, and as a result, voluntarily create a culture of providing a return to the organisation on that investment. In all but the smallest of businesses, part of this learning is to teach people about doing business cross culturally, and this is even so within Australia, with our multicultural workforce and customer base. Toyota effectively provides its whole workforce with extensive tools and resources, including standard approaches to working in cross cultural teams, problem solving, communication skills, process management and data analysis skills and a host of others.

Connected to the leadership ideas elsewhere in this book, is perhaps the ultimate benefit from taking the approach we advocate about investing in people: they will assume responsibility, behave like owners (caring as if resources they are working with are owned by them personally), and develop into future business leaders. This was achieved in the NAB where for over a decade, while some leaders were indeed brought in deliberately for some key roles from outside the bank and indeed the industry, very many of the leaders were developed within the bank. This internal development is indeed Toyota's approach and leads ultimately to much of its comparative advantage.

In terms of material rewards, as we commented in the leadership section of this book, we have seen that when a large number of people obtain benefits from their discretionary work efforts, that are non-trivial, that they can give high levels of energy beyond that which otherwise would likely occur. This is definitely not to say that a high level of monetary rewards can in anyway substitute for or replace trust and sincerity, for it cannot. However, if the goal is to create above industry average returns on

shareholder investments, then the more that staff measures and rewards can be connected to specific and controllable measures of value creation, the better. Then they can behave like owners, because their human capital is directly aligned in its interests to the monetary return on capital outcomes. Once again we acknowledge that this idea is easier to articulate than to implement, however it clearly can be done to great effect, albeit never perfectly.

So in summary, great executives do spend time and effort getting the settings right on job design, reward systems and alignment of these with organisational goals, and also through 'managing by walking around', they both keep their finger on the pulse of the workplace, and they provide the tools, resources and psychological rewards and feedback that their staff need. Executives who think that getting the tangibles of strategy right, the structural variables only, is all that matters, will find that even beautifully conceived strategies will fail in implementation if the tools are not well led and managed, because these tools and resources, principally human effort, are critical to strategy implementation!

5. Results: how do we measure success?

Formulating and creating a desire to strongly achieve stretching goals is a critical part of the culture and behaviour of sound executives and the organisations that they lead. These performance results can be considered as the 'other side of the same coin' from the strategies: in that they are the focus and objective of those strategies in the first place. Great executives and great strategies are strongly results oriented: results provide and indeed are the ultimate raison d'etre of the organisation.

Shareholders want results: that's why they provided their capital in the first place to those executives. They want to see a return on that capital of course. And they want a superior return, to whatever is a reasonable benchmark. They want the return to outperform the industry average and compensate them for putting their capital at some risk.

Employees want results: they want the sense of contributing to a high-performance organisation, and being part of a winning team/organisation, because of the joy of that (the psychological reward), and because of the link between organisational success and personal prospects that occurs.

Customers want results: whether it's those who choose a certain hotel, restaurant or bank expecting good service, or those who want on time

delivery of their shiploads of minerals, or those who buy consumer electronics expecting reliable and user-friendly product performance.

Suppliers want results too: they want to know that they will have continuity of demand, and in a reciprocal manner, executives want their suppliers to provide efficient and reliable supply, and they measure suppliers against those expectations.

Indeed, all organisations are fundamentally goal directed and hence strive for measured results. They want to achieve their strategic ambitions and they also want to achieve their regular operational outcomes regularly.

The goals that senior executives set provide the context for being results oriented, and having a 'bias for action', in pursuit of those goals. Having clear and well communicated goals can be highly motivating for employees at all levels and can also provide clarity for other stakeholders too.

We see and have set an infrastructure of cascaded goals in organisations. At NAB once the highest level of aggregate results was set for the NAB group, then each division was given its piece to achieve. This was in terms of divisions such as retail, commercial etc., and each brand and country operation. In turn these were cascaded down to regional managers, and in the retail bank, ultimately to branch managers who then provided a set of objectives to their line operating staff. The results orientation and the alignment that comes from those results can be empowering and motivating, when they are linked to the strategies and resources that are deployed. In addition, managers in leading companies are given high levels of responsibility and accountability for delivering those results. In BHP Billiton, divisional responsibility for profit achievement has been delegated to divisional and operating managers, down to quite a low level from those at board and C-suite level who are responsible to shareholders for the aggregate result. This 'results orientation' flows through the organisation: it pervades thinking, decision making, and it creates the action orientation that is so desirable as a part of overall success.

Focus Versus Diversification

A key strategic decision for organisational leaders in everything from the largest to the smallest organisation is how narrow versus broad their scope of products and services should be. We have all heard the famous phrase: 'Stick to your knitting', and it is indeed very sensible. We have seen many Australian and other organisations who have come to grief by venturing outside their area of expertise, either by investing in products or going

into industries that are new to them or going into countries or cultures that are different to their home market. The first thing to acknowledge is that once any change is made to the home market success strategy, of course the riskiness goes up. Further, the more the changes, in number and in nature, the more and faster the risk goes up. Yet this is not a reason to never take a risk at all! Risk and reward often go together, and it is usually those who can recognise opportunity and effectively take and manage reasonable risk who can achieve superior returns. Let us consider some examples from Australian corporate history of recent decades. Coles and Myer merged in the 1980s and struggled for well over 20 years to achieve economies of scale or improvements associated with being our biggest retailer, without success, until the group was demerged. Most divisions of Coles Myer underperformed, despite many changes of leadership, restructures and attempts at almost every business improvement initiative known to humankind. When Coles was taken into a highly diversified company, Wesfarmers, it was initially revitalised, and results improved significantly. Yet after some painful years, the Coles business was then sold off/ demerged from Wesfarmers, in an attempt to narrow scope and achieve singular focus. With the wisdom of hindsight, it would seem that the Coles Myer merger was not successful because the scope was broad in nature and merging operations was just not sensible, when for example, high end services such as Myer were joined to discount stores such as Kmart and a large Coles grocery chain. These brands and their operations have very different price points, service levels and in short, customer value propositions, so why would merging them ever be thought to have a chance of working? Within Wesfarmers, such an attempt to achieve economies of scale which founders on the rocks of 'diseconomies of scope complexity' has not been attempted. Wesfarmers value proposition for the Coles acquisition was that it brought discipline, results orientation, strong governance, sound leadership, capital management and investment disciplines, and people orientation to a business such as Coles, and clearly can lift its game, which many would say was from a level of previous 'underperformance'. Yet it brought diversification, which means a scope that can dilute any effort at concentrating efforts, which was ultimately undone. Coles was sold off ('demerged') by the Wesfarmers group in November 2018 and is an independent and finally a focussed, business, which it hasn't been for a long time.

From this we recognise the strategic importance of managing 'strategic scope', meaning the breadth of business operations that are brought together.

Pacific Dunlop, which was once a large manufacturing conglomerate in Australia, in some nine different industries also proved that size alone does not bring success. The company produced goods as variant as food, condoms, tyres, cables and clothing, as well as high technology products like pacemakers and innovatively designed car batteries. They tried many different approaches during the 1970's through to 2006 when the group was broken up and sold off, and nothing seemed to work. They tried closing local factories and moving them to China in pursuit of low costs. They had leading brands and market dominance in many of their product ranges. They restructured many times. They changed leaders. Nothing worked to save that company or its shareholder wealth from sinking. It was broken up and sold off to those who could formulate and implement *focussed* business strategies more successfully. For a conglomerate like that to succeed, surely there is a need to have a consistent strategy, which relates to fit between business capabilities and the external business environment and market, and this begs the question of how that can possibly be accomplished in so many different industries and markets?

For Pacific Dunlop, with the wisdom of hindsight, a theme associated with a dominant approach to value creation was needed but was not in place. General Electric, GE, on the other hand did have such a consistent approach to value creation, which has seen it able to create significant amounts of shareholder wealth, over many decades, across a range of industries. From jet engines to GE Capital/Money in financial services, GE was creating value for shareholders due to its ability to create competitive goods and services for customers. GE had done this through excellence in process discipline, it's now famous and long-standing commitment to developing leaders and high performing people in general, and its use of approaches such as Six Sigma (quality and process improvement methods), in a long-term process of driving improvement. Yet in recent years as market forces sharpened even further, GE has narrowed its scope, selling off a number of business units. Where excellence in leadership was achieved as it was in GE, then the cost of being diluted in strategy through diversification can be perhaps carried for a while, yet in Coles Myer, and certainly Pacific Dunlop, such leadership capabilities were not in place or able to overcome the burden of complexity that those executives created. GE has suffered significantly in more recent years, which is perhaps a leadership

case study more than one of strategic focus. The lesson from GE's ups and downs is perhaps that businesses must get a good few things right, definitely including the many aspects that we have grouped as firstly leadership, then secondly strategy, and in an integrated sense, strategic leadership. Since the decade of success under CEO Jack Welch, GE is at the end of 2019 a mere shadow of its former self. Once again there has been a change of leadership at GE and a promise to trim the company, with sales of businesses and massive job losses, but will these really count as value creating strategic initiatives that will create lasting competitive advantage?

In contrast, consider CSL and Microsoft, which have been superior value creators for decades. They each have a fiercely concentrated focus. CSL sticks closely to its knitting, investing in all forms of innovation across its supply chain. Ditto for Microsoft: it is focussed on its core capabilities. The same could be said for Shell, Unilever, Toyota, IKEA and other long successful large organisations. These businesses stay the course of their strategic intent, invest in having competitive products and processes, and do not stray far at all from their mainstream areas of capability.

Generic Strategies for Business Competitiveness and Capabilities

Michael Porter from Harvard Business School suggested generic strategies of cost leadership and differentiation, and also of being a 'niche'/specialist. Many others have provided different terms or recut some of the variables associated with competitive advantage. Treacy and Wiersma (1993, 1997) suggested the alternate generic strategies of operational excellence, product leadership and customer intimacy (basically meaning superior service). There are many others. From that school of thought of generic strategies, comes the powerful idea that businesses should not try to be all things to all people, but since markets are structured into different market segments, companies should position their operations and assets to compete specifically in a limited set of those segments. The argument is that capabilities should be focussed on one major aspect of competitiveness, such as low cost, or differentiation, through for example superior quality, innovativeness, delivery performance, or service.

As the intensity of business competitiveness has ramped up in recent decades, we argue that it just isn't enough to only try to excel at one dimension of competition, but that a 'full court press' is required to be

successful in most industries. Yes, there are trade-offs, in the sense that if the aim is to achieve superior competitiveness, then it is hard to have the most innovative products and the industry's lowest cost structure. Simply put, innovation requires investment, hence cost, relative to a no frills, purely low-cost approach. Similarly, if the aim is to have superior service in a hospitality industry, then more staff and significantly more training of those staff is likely to be necessary, which means incurring more cost. However, while these trade-offs imply that many firms must adopt hybrid strategies, in pursuing the full court press, there are also significant synergies, especially around the operational excellence capability.

There are synergies between operational excellence and low-cost achievements on one hand, and quality management on the other. In all organisations, we have learned that the principle of 'getting things right the first time' and eliminating errors at the source, has an overall effect of reducing total cost (through reducing errors and rework), while usually improving customers service and outcomes. Similarly, when an organisation achieves consistent process control and stability in its operational platforms, which can be regarded as operational excellence (consistently meeting customer requirements), then that stable capability can become a very useful platform for introducing innovations in an orderly manner. Conversely, the organisation that has poor process control, and which has operations that are chaotic, will be unlikely to be able to be systematically innovative, because its managers and staff spend most of their time 'putting out fires'.

This combination of trade-offs and synergies must be traversed by all organisations as part of their competitive positioning. What combination of cost, service, innovation, quality, delivery, flexibility, makes sense for your business units in terms of offering to the market, and how can that best be achieved and fitted to the existing internal capabilities available or those able to be effectively developed? In the NAB in the mid-1980s, the dominant dimension of competitive advantage was having, and using to market-place advantage, the lowest cost structure in the industry. This low-cost structure was pursued with vigour, and its achievement led to a good deal of very profitable growth. Attempts were then made to build additional capabilities including superior service and flexibility ('Tailoring banking to your needs'). These attempts at significant differentiation were successful in part, with a key lesson being that a long-term strategy and investment is needed to build such deep capabilities, not just short-term initiatives. In the past 15 or so years NAB has fallen from grace in terms of

customer and investor related reputation because of strategic mis-steps, lack of process control, and financial losses that resulted. While the Commonwealth Bank (CBA) and others have improved their services, technology strategies and their cost competitiveness, and hence their profitability and share price, NAB has recently achieved relatively little progress in this regard. Elsewhere in this text we point out that leadership capability is a key indicator of such strategic outcomes.

In BHP Billiton, where the product is more commodity like that in most industries, cost competitiveness is critical to value creation. The strategy leaves BHP quite exposed to market forces as its products are mostly commodities, yet it has effectively exerted pressure back against those market forces in order to not just be fully commoditised as such, to generally sound effect. BHP has become at least partly a price maker rather than just a commoditised price taker. As we describe in the case studies in this book, this was accomplished by effective strategic leadership during the 2000's decade, and should not be taken for granted, as it was a deliberate purposeful strategy, that with different leaders, would not have happened.

In many other companies and industries, other than in mining and in basic financial products, operational excellence is still a valuable platform but is not the dominant success factor. At luxury hotels, or in sectors where significant differentiation of product or service and brand are possible, operational excellence is clearly not the only game in town, even though it can be a great support for differentiation-based companies like Apple, Samsung, Gucci and 3M in their pursuit of innovation-based superiority.

Strategy Implementation

When it comes to that part of strategy which is the 'doing' of it, hard won experience teaches us that nothing beats or substitutes for commitment, accountability and discipline. At NAB, we quickly moved from agreeing on strategic courses of action, to checking that there was broad agreement and commitment on those strategies, into disciplined implementation mindset and mode. The aim is to be as good at implementing strategy as at formulating those strategies. This is easier said than done. We propose that well organised implementation of strategy can best be done using the wonderful philosophy and tools of project management, as briefly set out in this chapter's appendix.

Commitment to the Strategy

Commitment to the strategy opens the question of 'Who' needs to be committed. The answer is everybody in the organisation, and even beyond. However, commitment starts with top management, and if there is insufficient commitment at senior management levels, then it will not take hold elsewhere. At NAB, for 15 years or so from the mid-1980s, we created a high performance, unified top team. They had shared goals, and strong commitment to those goals, so that when they went about leading their various divisions and teams throughout the group, there was a cascading of alignment to the strategies and goals. NAB was far from perfect in this or any other regard, but the results indicated that it was certainly a relatively successful strategy implementer during that period. To form a sound and committed team, rather than have a somewhat loosely connected group, we advocate having the opportunity to have robust and honest debate about what the best strategy actually is, until the strategy becomes collectively owned as 'the' organisational strategy. Toyota has this culture as a matter of its core strategic system, and while less pervasive, so did NAB when it was performing strongly (see Fig. 1.1). This takes some time and effort, but once the collective commitment is in place, then implementation is likely to go much faster, and better! As can be seen from Fig. 1.1, when the top team left in 1999–2001, and leadership cohesion became fragmented, conflicts increasingly led to dysfunction, and the fall from grace is history.

Strategy Implementation as Change Management

We remind readers again of the famous Kotter 8 step change management process (Kotter 2012), which clearly includes the notion, of 'form a guiding coalition' for good reason. Without this commitment from influential people in organisation, it is likely that during implementation, when the going gets tough, people will get a little weak on staying the course, unless there is a reserve of commitment and team-based goodwill to call on. A core part of our strategic process at NAB was an ongoing debate of strategies, in the Executive Committee team, which comprised the top ten executives in the group. We then had the top fifty or so executives engaged in regular strategy debates, and then this process was cascaded down to the various divisions and 'franchises' in the hierarchy. In each country in which we operated, group NAB strategy was disseminated and interpreted so

that each local executive team could formulate their 'piece' of contribution to the strategy achievement and associated business goals. Local executives were then tasked with the detailed implementation.

Implementation Requires Alignment and Forcefulness: But there Are no Guarantees

When strategies are formulated, solid implementation makes basically all the difference as to whether the impact will be achieved. Attention to some key factors will help but never can absolutely guarantee success. The reason is that even if we have all our 'ducks lined up' we cannot control all factors. The 2020 pandemic is a fine example of an uncontrollable factor, that has derailed some strategies of organisations and industries from smallest to largest. Small cafés and major airlines and hotel chains were severely disrupted.

First, we propose that **alignment** of key people in the organisation and as necessary some key external stakeholders is the first key to implementation success. Solid consultation and debates are a good way to professionally 'argue' one's way to collective alignment. During NAB's successful decade (see Fig. 1.1), regular small group and large group (50 senior people) debates were held, whereby anyone, including naysayers, were free to put their views. Yet once a strategy was thoroughly debated, is agreed and the group converges towards a solution or agreed path forward, even those who were against it during the debate can and should be expected to be aligned with the group decision. When alignment is absent, undermining will occur, and implementation will be tough going indeed. We would argue that the strategy is not fully formulated, until and unless agreement and alignment to proceed is strongly in place. While there is never a perfect strategy, minor flaws or imperfections come with the territory, and it is important to communicate the primary net benefits of a strategy, placing secondary drawbacks into perspective.

Once alignment is strongly in place, disciplined and forceful implementation can proceed. By forceful, we mean 'high energy', and by disciplined, we mean well-structured, planned and orderly. This approach was key to the successful acquisition of Bank of New Zealand into the NAB Group under Don's leadership, in which a comprehensive plan was created then implemented. A more complex transaction of the merger/acquisition of BHP and Billiton certainly required 'high energy' and discipline, to overcome many significant and challenging issues.

Even when these properties of discipline and good organisation are in place, we note that there is never a guarantee of success. The clear reason is that one can never control all relevant factors, such as currency, commodity prices, actions of competitors, political and macro-economic forces being amongst them. For example, despite the clear and compelling strategic logic for NAB acquiring ANZ bank in the 1990s, it did not occur because it was politically unacceptable from an Australian Government perspective. Somewhat similarly, although restraining forces in this instance were international, BHP was prevented from executing its acquisition and merging of assets with Rio Tinto, even though it was compelling for all stakeholders from a value creation perspective (see the BHP Case studies in this book for details).

Accountability for Outcomes

At BHP Billiton, this notion of commitment was taken even further, so that each business unit leader was not only committed to the group strategy and its overall outcomes, but was clearly and fully accountable for profit/loss of that division, such that the group result and group decisions and investments became maturely linked to those divisional accountabilities for delivering performance outcomes. Divisional executives bear full accountability for their outcomes. Commitment without accountability is not enough. There must be consequences for outcomes, whether they deliver on the goals or fall short. The BHP Billiton model for this had the properties of clarity and transparency, so that all players could know without doubt who had achieved which outcomes. By cascading accountability, commitment was wrapped up in the actions and outcomes that we sometimes fell short of at NAB.

AT NAB we had strong commitment, and strong clarity and alignment of purpose, which held us in good stead relative to the competitors in the 1990s, but accountability wasn't always as strong as we would ideally want, with the wisdom of hindsight, and it later fell away. At BHP Billiton, the added accountability reinforces the commitment and closes the loop on executive efforts to lead and drive for superior performance.

At the TAC when Danny was a member of the board, efforts to improve client satisfaction seemed to have plateaued, at a solid but certainly not spectacular level. We knew that key to delivering our strategy was to achieve a measurable increase in the measured client satisfaction levels, and it didn't occur until we declared that executive bonuses wouldn't be paid

until an ambitious, yet previously elusive level of client satisfaction was achieved. Almost like magic, what was previously unachievable, was achieved in the next half year! We had commitment, accountability, measures and now we had alignment of personal rewards for influential leaders, all aligned and powered up.

Strategy Making in the New Global Context: 2020–2030

It is almost an understatement to say that we live in uncertain times. Many factors such as ballooning debt were already and increasingly challenging the stability of many economies and societies in 2018–2019, and as of 2020 the Covid19 pandemic has put a thick layer of icing on this cake.

As the world confronts the pandemic, the context is that the rapidly increasing global debt levels are not sustainable, and its citizens are fearful of the unknown as scientists search for a vaccine which will enable our economies to function productively again. Our Central Banks are struggling with how to muddle through an environment where job opportunities are diminishing and jobless numbers are putting stress on economies. The confluence of circumstances, being the pandemic and its impacts on consumer confidence, reducing GDP and productivity, plus debt, unemployment, investor activism, and new technologies means that there will be major winners and losers going forward, as governments change policies and markets are reshaped. What does all this mean for 'go forward' corporate strategies?

Even before this pandemic, the world was on a debt binge, and there was the beginning of asset bubbles in many developed economies. We had climate activists predicting an Armageddon; the technology disrupters were gathering momentum with 3 billion people predicted to soon be connected online and global data and knowledge expanding exponentially. New forms of war are predicted to be cyber-war and cyber terrorism is already a reality. The world was facing a deflationary profile of debt which is being incurred in the form of benefits, interest and discretionary spending that are simply not sustainable in a rapidly ageing population, with millions of people facing the threat of redundancy through job automation.

There are many other inflection points but some themes to think about in terms of how we can frame strategy this next decade are:

- **Peak Globalisation:** The end of unrestricted free movement of labour, goods and capital around the world—these are no longer guaranteed. Where is this headed as countries and companies undertake 'reshoring' and seek to build up their national independence from critical global supply chains?
- **Peak Inequality:** We now have advocates that profit maximisation is no longer the sole objective for Wall Street and shareholders, with the rise of 'moral capitalism', and the wider move by larger shareholders who endeavour to influence strategy. The debate on corporate social responsibility continues, and forces are at play, with no definitive answers available on where, when, how and how much CSR is strategically sensible for any organisation (see our later chapter on this subject). Examples of stakeholders working to influence boards and CEOs are Elliott Management and BHP in recent years, and BlackRock's new approach to investment decision-making.
- **Peak Youth:** There are now more seniors than children in the global population—what are the consequences? The world's third largest economy, Japan, is leading this trend with its population forecast to decrease significantly over this and subsequent decades, while the age profile also does not help productivity and GDP. While other OECD countries are also near to zero population growth, some developing countries with low GDP per capita are still growing fast, fuelling another level of global variance and inequality. Meanwhile, inequality of asset concentration intensifies in most economies as measured by the GINI coefficient. While very many people have indeed been lifted out of poverty in some developing countries, wealth and control of assets are still being increasingly concentrated.
- **Peak Oil:** This is the first time that global oil demand has plateaued as we transition away from fossil fuels toward renewable energy and electric vehicles: what are the economic consequences of this that pertain to businesses' strategies? Australia's chief scientist suggest moving to an 'electric planet' but signals a need for two to three decades of gas use in the global economy during such a transition.

On top of the pre-existent challenges, the loss of jobs and the GDP recession that has hit the world thanks to Covid19 represents a big hit to productivity, in other words the cake is shrinking and may do so for a few years in some countries and markets, which means there is less to go around. With additional debt throughout economies, many youthful

consumers experiencing their first recession will be forced to adjust their consumption habits, and perhaps all stakeholders will need to get used to a few tough years until perhaps 2024/5. This is likely to include shareholder returns, whereby both risk and return in the next five years are likely to be more challenging than in the past five years.

These constraints are not just from the debt burden, but from the time needed to restore consumer confidence, the politics surrounding nationalism and globalisation forces, and the technological developments requiring new skills and making some jobs redundant. In Australia, where businesses have always been able to bring people from overseas to fill skill gaps and do needed work tasks, borders closed in early 2020. Other countries are making it more difficult to access their markets, such as China's 80% tariff on Australian barley as of May 2020, and reductions in access to coal, beef and other markets being mooted. Delicate political-economic balances are being traversed.

Every CEO and board will need to reformulate their business strategies with new considerations of the world at large, that is changing in essentially unique ways. The following guidelines can be a starting point:

1. It is impossible to avoid risk, and going forward there is indeed much uncertainty in markets, politics and technologies that cannot be avoided. We must build risk taking approaches into our strategy formulations. Useful techniques such as decision tree and risk analysis have long been used in some industries by astute boards and executives, to give the clearest picture possible that integrates risk and return.
2. One way to deal with risks is to establish strategies that are sound from a long-term perspective, even though there will be significant bumps along the way, that stakeholders will have to come to expect. BHP took essentially this approach as of 2000 when it established a strategy paradigm of focussing on long term, high quality, efficient (low cost) assets, even though it was clearly exposed to the 'zig-zags' of commodity prices. NAB established a sustainable low-cost position in its industry, along with effective risk management in the 1980s that underpinned its growth and success right through to 2000, after which strategic missteps and governance problems set in. These two examples are detailed in this book's case studies.
3. Embrace the opportunities afforded by new technologies, by normally not being on the bleeding edge (too risky for most), but being

not too far behind the leading edge, or perhaps a 'fast follower' when evaluated from a risk/return perspective.

4. Prepare strategies and our organisations better for the next shock, whether it be a future pandemic or something else. Strategies can be tested using Scenario Planning exercises, and cultures and employees' mindsets can be conditioned so as to be more comfortable in the next few years of high volatility. The relatively new term of corporate resilience is pertinent here. Can our organisations get better at both planning for new 'shocks', then rapidly deploying an agile response to those? Such planning can also help to overcome any sense of complacency that can become an insidious part of a culture.
5. Balance operational effectiveness with innovative capabilities. Cash flow is a necessity, coming from today's business operations and markets, and a key element of ongoing strategies is the new business development stream, whether it is new services/products, new ore deposits, new efficient process technologies, or new business models. We note that US stock market index valuations are now led and dominated by those who have innovated, particularly Facebook, Apple, Alphabet/Google, Amazon and this group's 'elder statesman', Microsoft. Companies such as GM, GE, Exxon Mobil and other traditional businesses lost their innovation edge and their lustre and attractiveness for investors naturally went with it.

As an example, GE's stock price has dropped 80% in the past three years, and it has market capitalisation of around 5% of that of either Apple or Microsoft, who have successfully innovated. Amazon's innovative business model has seen it shoot past retailing giant Walmart in terms of valuations, in a classic case of the innovator disrupting the traditional industry, at scale.

6. Adjust the asset and business mix in a decisive manner. In its heyday, GE was prepared to take hard decisions to either effectively raise the performance of business units to industry leading standards, or sell off those businesses as 'underperformers' that diluted its overall performance. This was a fine example of a disciplined approach to strategy that is a hallmark of successful organisations. Along with disposal of assets that no longer fit the new strategy or underperform, comes the opportunity to scan the business environment and seize upon asset acquisition opportunities where value can be created. Both

BHP and NAB were proactive in this regard during their multi-decade periods of industry outperformance.

A key element of sound strategy making is to consciously and explicitly create surplus from its operating units to fuel further strategic investments. It boils down to allocating some element of its cash flow generated from today's businesses to the businesses of tomorrow and future years. Amazon, Apple, Google, and Microsoft are all making major reinvestments in long term innovativeness capabilities that are paying dividends, and Australia's banks have recently been criticised for almost the opposite, of paying high dividends out to shareholders and underinvesting in the next generation of services, while newer Fintechs are doing the innovative exploration. These are matters of 'strategic judgement' that should be backed with the best data and models available, and indeed a keen sense of judgement is required to get the strategic path right on innovation investments. Perhaps the best large company at this element of strategy in Australia is CSL, and its spectacular market capitalisation growth over two decades reflects this.

2020–2025 as an Opportunity to Review and Renew

The changed economic and social conditions that make this decade different from those in the past provide both the motivation and the need to review and renew strategies. It is an opportunity. The corollary is of course that those who assume that old strategies will work in new 'post-pandemic' conditions will come under pressure of being out of date and out of kilter with stakeholders: that is a threat.

In a strategic review, an initial step would be to clearly examine what the new world context is likely to look like for 'us', given our current asset base, industry set and market position. Next comes the generation of some options where we can make decisions to change our existing trajectory. What are the cost/benefit and risk factors of product/services choices, such as new offerings, rationalising offerings, or redesigning existing offerings? What do the new digitalisation technologies present us with: including blockchain, big data, artificial intelligence, other forms of automation?

What markets and market segments should we enter, expand in, and exit? Markets include not just market as place these days, but also market space, meaning online in the fast-growing virtual world.

Although banking has been an industry in place for hundreds of years, finance innovations such as wrap accounts, reverse mortgages, mobile banking and a host of others such as open APIs (application program interfaces) and including all things digital such as 'robo advisors' came from new strategies set by existing players and some Fintechs. Universities are moving into online teaching faster than ever would have been considered prior to the pandemic. Retail is also moving its business models towards online services. Very many businesses have realised that they don't need to have their employees keep office hours, or indeed keep offices at all. Can this be a source of cost reduction?

Strategic reviews should explicitly consider risk levels and attitudes to taking risk. Risk sources are changing. If our business is lagging in its digitalisation capability, is there a risk we will be run over by a new player, with a digital approach and a lower cost structure? Or can a competitor's digital capability allow them to customise services for consumers and 'out-service' us?

On the productivity front, can we reduce our organisational waste, eliminate overhead costs, and reorganise our operations to improve operating performance? Both NAB and ANZ banks are strenuously attempting to update and upgrade their technology platforms this decade so they can cost effectively serve customers with the new products required, at speed.

How bold should a strategy be? It is likely that the more the strategy involves either new markets, new products or new industries, the higher is the riskiness inherent in it. The core reason is to do with capabilities, whereby many a good company based in Australia have got into trouble when they went overseas (e.g. Fosters, Country Road), because what worked in their domestic market did not translate, or at least, they failed to sufficiently adapt. Similar risks arise when a new industry or market sector is entered.

As we have already noted, Coles Myer was a retailing conglomerate disaster, because its knowledge in a market sector did not translate into other parts of retailing and complexity killed it. However there can be exceptions. Perhaps Samsung is one of those, as it operates globally in most countries and many industries. Being known for its consumer electronics, construction, household appliances, financial services and other products, what would we have forecast when it announced in 2010 that biotechnology was going to be a big part of its group's future. Samsung conducted a strategic search and sector analysis, and determined that biotech as a sector was going to surge for some decades, so it plunged billions

of dollars into essentially a start-up. Whereas capability theory might forecast a dismal outcome, Samsung Biologics, some 75% owned and controlled within the Samsung group, has become the world's largest contract pharma producer. Although not without its scandals, this company has grown within a decade to be a large and successful manufacturer. One could argue that this was, for Samsung much more of a stretch than when NAB acquired banks in the US, UK and NZ, where banking capability could be leveraged into reasonably similar markets, yet Samsung must have judged that the return of the biotech opportunity justified the riskiness, and this seems to have been a correct judgement, a decade later. Samsung can be seen to have taken a sensible portfolio approach, incrementally innovating its mobile phone and other products, mixed with a higher risk/higher return biotech investment.

Having determined that some strategies are high risk and return, while others are more incremental, lower in both risk and return, the company leadership team can then screen out strategies that are not on the risk-return efficient frontier, and assemble such a portfolio: what is the best set of strategies as investments in aggregate? CSL takes this portfolio approach.

Summary Comments on Strategic Futures: 2020–2030

We are assuming here that the world's monetary system will remain intact and generally stable this decade. This presumes that spiralling debt and recession will not significantly destabilise the foundations of global financial institutions enough to lead to another 'Bretton Woods' moment whereby essentially all global economic arrangements would need to be redesigned. While many country's economies will clearly sag heavily under the burden of debt currently created and exacerbated, and political developments such as Brexit and China's expansionist approach, for example to South China Sea territories, cause waves to wash across the global system, the Covid19 pandemic is seen by most commentators to be a shock of large but recoverable impact. It may take many years to achieve that recovery, yet the forces that would require a wholesale rewriting of how the global economy works seem to not be in play, yet. However, severe storm clouds are on the horizon. The Economist Intelligence Unit estimated in 2020 that many African and a number of South American countries have acquired large amounts of debt with China as the main or only major creditor, often linked to large projects as assets in those countries. Quite a few of those countries have such debt above 10% of their GDP, and in

some countries, it is above 25%. The Economist report of May 2020, dramatically entitled 'Sovereign Debt Crises are Coming', suggests that 'If debt is not restructured or repaid, however, China might look to seize some assets from its creditors, as it did with a port in Sri Lanka in 2018. In the medium term, this will only increase the dependency of poorer countries on China.' Companies with international operations or markets served should be cognisant that these factors will not disappear of their own accord and may contribute to further global instability.

In forming corporate and business unit strategies, while very many contextual parameters are changing fast and hard, perhaps the cornerstones of business competitiveness, value creation and capital efficiency can be assumed to remain intact, even if a Bretton Woods II or structural readjustment of global institutions and trade rules does occur. However, the international 'rules' of trade are evolving, and hence international investments and markets needs to be regularly reconsidered, as do potential acquisitions, and the location of facilities, be they factories, mines, call centres or other service and business operations.

Concluding Remarks on Strategy

Don't be a rudderless ship: focussed direction setting and priorities tell all stakeholders what our strategic intent is. We must have a robust and sustainable answer to the question 'How do we compete?', then apply the tools and other necessary resources to achieve it. We must consider risk and return in our strategic outlook, and be focussed in our approach, as against trying to be all things to all people.

Strategy implementation needs a network of committed stakeholders, especially executives and their staff, and a disciplined approach to introducing change. When an organisation is mobilised to deliver a focussed strategy, great things can happen (Fig. 1.1), but when implementation fails and strategic intent flounders, then so do outcomes (once again, Fig. 1.1). The rise of businesses such as Dell, Lego, IKEA, PETRONAS, Google, and others, and the continued success of Shell, Unilever, Toyota, Microsoft and Apple are based primarily on excellence in strategic leadership, being comprised of stable focussed strategies and committed leaders who drive them forward.

Appendix: Operational Efficiency and 'Excellence': Production and Change Management

In this appendix we provide two distinct yet connected sets of ideas. First is the notion of pursuing operational effectiveness in the daily operations of the organisation, and second is the effective use of project management in effecting strategic change. Both of these are foundational building blocks of any organisation that wishes to be strategically effective and to perform successfully.

It is one thing to formulate effective strategies, and it is another to implement them effectively and to have effective operations in your organisation. These require the two elements of major importance to every organisation: first the operational management challenges and opportunities that every organisation must succeed at, and second the opportunity to excel at implementing change, including introducing new strategies, that are always about implementing change, by definition. These two elements of operations management and change management are related because strategic change usually means changing mainly the state of the organisation's operations, amongst other things.

It's only a slight oversimplification to separate our world of organisations into the two aspects of 'business as usual' (BAU) running of the daily operations, and second, of implementing new strategies, innovations and improvement initiatives. This is indeed a useful frame for leaders and managers because BAU is all about stability, of systems processes, products and services, and running them in a smooth and consistent way, while continuously engaging in problem solving and incrementally improving operations. Toyota uses the term 'abnormalities' which are identified, problem-solved, then fool-proofed in process terms so that we never again experience the same abnormality again in our mainstream processes. The aim is of course to be able to run our operations in a Lean manner, achieving as close as we can to 'Swift and Even Flow' of services provision, customers and resources use, with minimal waste.

In contrast, new initiatives, new strategies and innovations, are about significantly changing the BAU from one state to another. They can be disruptive to BAU. Yet we must be good at both mainstream BAU work, and simultaneously, change implementation, which we also call 'new-stream' work. Having clarity around these different types of work, their challenges and goals is very helpful to all employees. Both types of work are important to organisations. If we are not effective at change

implementation, then BAU processes that are competitive today will soon be off the efficient frontier.

Operational Effectiveness and Value Creation

In any and every organisation its operations function is best defined as that part of the organisation where it produces the goods or services that it supplies to its consumers. We define operations management as the systems design, conduct of, and continuous improvement of the organisations productive and supply processes. We emphasise that in most organisations, the operations function is of central importance because that is where the bulk of the workforce are deployed, often around 80%, and similar with the assets, including the physical and financial assets. Whether the operations are effectively designed, conducted and improved over time will impact on the key outcomes of cost, quality/service, and delivery performance and timeliness. These are fundamental to how competitive and effective the whole organisation will be, in its market.

In almost every conceivable market, consumers choose and buy on their perception of value, and even though value means very different things in different market segments, there are almost always competitors in every different market segment trying to outdo each other on the value of their competitive offerings. What has this got to do with the internally facing function of operations management? Everything! Value offered to customers is a function of benefits and prices, with customers wanting higher levels of benefits and lower prices, whatever the market segment. Customers in the five-star hotel luxury segment want value, but it means specifically different things to their segment than in the two-star hotel segment of course, yet it is still always about value.

Benefits are principally about quality, service, features, customisation perhaps, innovations that come with the service and some other factors. These benefits are produced on a daily basis within the operations function! If it is effectively designed, conducted and improved over time, then superior benefits can arise: just ask Toyota, Dell, Walmart, Amazon, South West Airlines, Google and McDonald's about their operational effectiveness parameters. As to the price element of the 'value equation', we immediately acknowledge that price equals costs plus a margin, so if an organisation can have an effective cost structure, then it can have a competitive price and still achieve a sound margin. Once again, because most of the employed people and most of the physical and financial assets are within the operations function, then that is primarily where the cost is determined!

The value equation can be represented as:
VALUE = BENEFITS/PRICE

Designing for Operations Effectiveness
Leading organisations set up their competitive business strategies in order to ensure a good fit between the organisation's capabilities and the market requirement that it wishes to respond to. Before we describe these design parameters, we want to acknowledge the importance of primarily being focussed on the specific market requirement, and of therefore being customer/client centric in framing the operational design. At The NAB, even from the 1980's we labelled this the 'Outside-In 'approach. Given that essentially all markets exist in market segments and the consumers' buying criteria are different across those segments, then clear understanding should be in place about those specific criteria, so that the operation can be set up to maximise competitive effectiveness in a 'rifle-shot' focussed manner. This is to ask and answer the question about just how the value equation is positioned in different market segments. Consider the differences between two-star and five-star hotels (e.g. Ibis and Intercontinental), inexpensive watches and luxury watches (Casio and Rolex), similar with vehicles (Hyundai and Mercedes) and a host of other goods and services markets. The market clears in the inexpensive and in the expensive market segments, but on very different answers to the same value equation.

Is the organisation trying to compete in the low price/no frills market segment (Ibis hotels, Casio watches, Hyundai vehicles), or in the luxury segment, or somewhere in between, or perhaps in a specialty niche segment, such as underwater watches, hotels that accept pets or fully electric vehicles? The operations system parameters can then be designed in order to fit the answer to the market requirement, specifically. The core argument here is again one of focus, as it is not yet possible to create a hotel that simultaneously houses inexpensive rooms and facilities at a low cost and price, with five-star luxury. Attempting to be all things to all people across market positioning segments is a recipe for confusion and strategic dilution, opposite to strategic focus.

Generic Strategies and Operations Implications
Whether it is low cost, superior service and quality, flexibility and customisation, or differentiation through innovation, the 'production system' will differ to suit these different market segments. Cost in never unimportant, yet it might be the single most important element in a market segment, such as in the no frills segment of the airlines market, or relatively less

important in segments such as that of luxury watches or hotels. Cost will be carefully managed even in high cost/high margin/low volume segments (such as Rolls-Royce), but in such high-end markets, cost competitiveness is not key to the 'order winner' in the market, so cost is managed for good, solid, profit margin reasons.

When NAB was in its business-dominating period of the 1990s, cost competitiveness was a key to both business competitiveness and profit margins. Having the lowest operating cost in the market (as measured by the cost/income ratio) provided a significant advantage of being able to shave prices below that of competitors while still achieving a solid gross margin, at a point where competitors would be hurting significantly in their margins and return on equity.

Similarly, with BHP, the goal is always to achieve low cost sources of resources, because when commodity prices get challengingly low, it is always much more problematic for the higher cost operations, first.

There are very few exceptions to this argument for cost competitiveness, whether it is big business or small local organisations. Consider the competitiveness of local realtors, competing for the business of home sellers: they compete by offering selling services that are hard to differentiate, so they also compete on the price they charge, either as a fixed price or a commission percentage of the selling price. If one agency can establish a cost advantage, they can of course offer a lower price at a higher profit margin than their competitors.

Specific Design Decisions of the Operation

The positioning of the business in its market and segments can guide the operations system configuration, particularly the facility location, capacity provided, technology and automation choices, supply chain partner choices, human skills levels, insourcing/outsourcing choices, and other elements. If low cost and no frills is the chosen position and market segment, then perhaps a call centre should be located overseas in a low-cost country, but if high service is the dominant positioning differentiator of a business, then a local call centre that costs more is likely to work best.

Quality and Cost: Untangling Their Complex Relationship

Some 50 years ago, conventional business wisdom was that quality always costs more. That was when quality was interpreted as meaning a 'higher' level of specification, such as a five-star hotel instead of two star, in which case it is often true that higher levels of luxury and service do indeed cost

more to produce. However, to consider that quality primarily means luxury is a notion that was dispelled in the 1970s and beyond, and indeed, we now recognise that 'quality' means meeting the customer requirement, precisely, in whichever segment of the market that we choose to compete into. This implies that in the no frills segment of the market, whether it is wrist watches, hotels or airlines, or anything else, the supplier that efficiently and fully meets that client requirement is a quality supplier. From an operations management perspective, doing so efficiently means 'getting it right the first time', with low levels of 'waste', which implies low levels of rework, over-production, and defectives.

Our comprehensive research has demonstrated that wastefulness in operations accounts for fully one third of people's time and organisations' costs! This is not 'quality' work processes. To become a quality organisation, including quality processes, these wastes need to be reduced, and once they are, then of course costs can reduce. So, when quality is interpreted not as luxury, but as getting it right for the customer at whatever the goods/services specification is, then we can see that the firms with the best quality, are exactly those with the best cost structures and simultaneously the most satisfied customers. Lexus, Porsche and Toyota, in very different market segments, are fine examples of such.

From an operations management perspective, one can usually measure an aggregate metric known by its acronym as 'DIFOTIS' or similar, which refers to 'Delivery, In Full, On Time, In Spec.', as a percentage of total customer orders, and we should expect that an operationally effective organisation would have this ratio as high. McDonald's has a high DIFOTIS, especially over the counter (less so in drive through), and it is also very cost efficient. When Danny did some work inside McDonald's a decade ago, he was very impressed with the high degree of operational discipline incorporated into the error-proofing of operating procedures there, as well as the standardisation and impressive details of measurement, that resulted in high levels of DIFOTIS. Toyota is equally excellent in its operations at least, making much more complex products than hamburgers. Australia's banks, insurance companies, law firms, and universities have not yet achieved such operational maturity. As described elsewhere in this book, Bank of America has moved significantly up the operational excellence curve in the past decade. Operational excellence is a means to the end of providing customers with what they want, right first time, efficiently.

Discipline of Implementation Actions: Project Management

As well as attempting to have an efficient and waste free set of BAU operations, we must all be able to implement new strategic initiatives effectively. This means managing change, while still reliably producing goods and services every day! This is quite a challenge, whether it is a mining company introducing new processing technology, a manufacturer introducing and offering new products, or a bank that is growing internationally through acquisitions.

Commitment and accountability, along with aligned measures and rewards are great properties of strategic implementation processes, but they are not everything. They drive to motivation. A high level of motivation is a wonderful thing: who can argue against enthusiasm! But it is not enough: the added necessary ingredient is the capability of great organisational skill, needed to coordinate the implementation. This coordinating capability might not be so important if organisations were simple in their structure, and perhaps smaller, but large, complex and geographically diversified organisations must have their strategy implementations carefully orchestrated, because without a detailed script, best called a project plan, and the discipline to follow the plan, progress will always descend into chaos. So, this line of argument begs an important question: how can we best achieve a high state of orderliness and discipline of strategy implementation? The aim is simple and compelling, to efficiently and effectively get the changes in place, and win the desired results.

To achieve this, we invoked at NAB and at BHP Billiton, the most powerful method known to us all: systematic project management. Many of the world's best organisations, large and small, use project management as the core approach to introducing strategic initiatives. Project management brings planning, reporting, orderliness, budgets, resources, timing control, alignment with BAU, and discipline. The alternative is to basically make it up as we go along, which is wasteful and chaotic.

Once a strategy is agreed, and commitment and accountabilities are established, then it is time to move into organisation and action mode. A good and memorable phrase which must be carefully answered, that we often used in our implementation considerations, is 'Who does What by When?' That is precisely what the project plan organises and accomplishes. Every significant strategy that an organisation designs and wishes to go forward with is complex to some extent, because they can involve:

1. Multiple People
2. many organisational roles, and divisions
3. multiple processes
4. many locations
5. new or different use of technology
6. cutting across peoples' day jobs and urgent BAU responsibilities
7. short term costs in the pursuit of long-term gains

There are more aspects to complexity, but those main elements above are enough to give a sense of the organisational mountains that we need to climb in implementing strategic change. The only systematic way to overcome these natural challenges is to be wonderfully and forcefully well organised, and although we will always fall short of getting it precisely right, the use of project management approaches is the best way to approach this sense of effectiveness and win the 'war against chaos'. Strategic leadership at its finest ensures that there is disciplined progress to a plan.

We assume that most readers will have a strong sense of what comprises project management, so now give only a brief summary of its essential ingredients and benefits:

1. Project management provides a time-based script of the actions which ARE the implementation path of the strategy.
2. Tools and systems set out the milestones along the way, so that the implementation can be managed in real time, relative to plans and expectations, then managers can take corrective actions based on knowing which aspects of the implementation are on track, and which are not.
3. Budgets can be formulated, cash flow planned, and costs and progress tracked against budget.
4. Resources can be scheduled and allocated, including human resources and equipment.
5. Trade-offs in project design can be explicitly considered, such as between project cost, time to implement and outcome specification, then these priorities can be built into the action plan.
6. Connection between the project plan and team, and the mainstream business units can be affected through progress reports, which are an integral part of project management.
7. Progress can be measured and reported to general managers in the mainstream business, relative to the agreed plan

In summary, project management can become an effective organising mechanism for strategy implementation, which makes the difference in terms of how much discipline can be brought to bear on the implementation, to complement the commitment and accountability. All three, commitment, accountability and discipline, are necessary.

In broader summary, this Appendix serves to provide an overview of the need to be effective as an organisation in both the BAU of operational effectiveness, which can be thought of as daily operations plus incremental improvement and small improvement initiatives, over which we must be able to 'superimpose' strategic initiatives, whatever these are chosen to be. We emphasise that focus and discipline are key to both types of work, of operations process management and strategic project management, although their goals, styles and ethos are quite different. Strategic competitiveness demands effectiveness of leadership of both these domains of work.

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CHAPTER 3

Organisational Governance

Introduction: Effective Corporate Governance

Over the past 20 years the concept of corporate governance has unquestionably climbed the corporate agenda. Across the globe we have witnessed a proliferation of codes, recommendations, principles and resolutions on the subject, stemming from governments, shareholder groups, international bodies and indeed individual corporations. In this chapter we point out that effectiveness in corporate governance can contribute to an organisation and its outcomes from top to bottom and end to end, being a widely applicable set of sound business practices that go well beyond a compliance approach. Like many other aspects of what makes for a great organisation, effective corporate governance starts at the top, meaning the board and its directors. We outline the capabilities and characteristics of an effective board and director, and some general principles for boards and directors to consider and use as guidance, in their actions and contributions in activities ranging from CEO selection to board and organisational performance management.

As the debate has developed, so has the range of issues falling under 'corporate governance' increased. In the developed world, what began as a measure to counteract concerns at the perceived low level of confidence both in financial reporting and in the ability of auditors to provide the safeguards which the users of company reports sought and expected, has now developed into a series of debates regarding issues as diverse as

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D. Argus, D. Samson, *Strategic Leadership for Business Value Creation*,
https://doi.org/10.1007/978-981-15-9430-4_3

executive remuneration, remuneration of directors, internal control procedures, sustainability reports, environmental issues, the role of institutional investors, corporate social responsibility and gender diversification.

Barely a single aspect of the modern corporation has been left untouched. This in itself is no bad thing. It is both healthy and desirable for every organisation and institution to take stock of what progress has been made and what it hopes to achieve in the future, adjusting itself according to the demands and challenges it will face.

It is a tired but true cliché that no institution ever thrived whilst standing still. There is a danger however when this process becomes an end in itself. If corporate governance simply becomes synonymous with a system of codes, regulations and structures, neither corporations nor society as a whole will be any better for it.

Regulation for instance can, if taken too far, stifle the innovation of enterprise which is the true-life blood of a successful business. Indeed, blind faith in a 'tick a box' system of corporate governance can cause shareholders, creditors and other corporate stakeholders to lower their guard, to their own detriment and that of society at large. Elsewhere in this book, we examine the extraordinary outcomes of the Royal Commission that determined that despite all the corporate governance advances in the past two decades, and the regulation, 'watchdogs', media scrutiny and customer awareness, that widespread ethical breaches were systemic in some financial service organisations, and that laws were regularly broken! What does this say about the effectiveness of corporate governance measures?

If in contrast we allow a definition of 'good corporate governance' to step beyond a mere description of whether a company complies with every recommendation in the plethora of published codes, and become the positive application of sound business practice to every aspect of corporate life overall, we will see its true value, for corporate governance properly describes the manner in which a company directs and controls itself. It can be a driver of performance, not just a driver of conformance!

Indeed, if we apply this description, the debate regarding whether good corporate governance codes are futile or effective becomes insubstantial. After all, a corporation with the right directors, fulfilling the correct roles, with sound strategic management and planning, reacting and adapting to each new problem and challenge, will be worthy of the respect of the community as a whole. It would do this whilst also having strong, honest and transparent relationships with investors, employees, customers and suppliers. It would also have to use its own resources, including intellectual

capital to their full effect. It should then be unlikely and exceptionally unlucky to fail.

Why then did the world financial system nearly collapse in 2008, why are we still experiencing the aftershocks of that fall-out, and why did the assertion from the United States 'too big to fail' not prevent this destruction of wealth?

Compliance with specific rules of corporate governance form only part of a complex management skill set that must be deployed in order to make any business succeed. No code, principles and resolutions on the subject can address the fact that a fully compliant but dysfunctional board can create as much disaster as one that does not comply at all.

The Enron Case Study is a classic example of a fully compliant board, but one questions whether the board had the right skill sets to 'smell the smoke' of the disaster that occurred.

Effective Governance Starts with Boardroom standards and Activities

It would be unreasonable to expect governance to be effective in an organisation if it is not at a high standard in the boardroom. Standards are set in a 'tone at the top' sense and can then be cascaded. In this section we outline an approach to effective boardroom governance.

The banking system in the UK and Europe plus some banks in the US brings into question some of the basic ingredients of effective boardroom operations, such as the basis of timely provision of information, regular board meetings with full attendance and the appropriate understanding of the risk profile of those financial institutions, plus the toxic environment in which those financial institutions operated during the Global Financial Crisis of 2008 and subsequent depressed economic conditions thereafter.

Other basic ingredients of an effective boardroom are ensuring being able to deal with expectations of certain stakeholder groups (such as reporting requirements to shareholders): these are usefully codified and published to create conformity in the marketplace. However, neither category deals with the most difficult ingredient of all, namely the relationships between directors and how they function as a group, which is integral to the creation of an effective team at board level.

In order for any board to operate effectively it is imperative that they understand that they set the tone of the organisation and the following must exist:

- *a climate of trust*—every member of the board should not only be provided with timely information but should be encouraged to have regular contact with and an ability to question each other as well as operational management;
- *a willingness to challenge*—it is a prerequisite that directors should be free to contribute dissenting views and to challenge accepted wisdom and strategy; this should never lead to retribution or recriminations and, in contrast, should be fostered as one important step towards formulating the right corporate decision;
- *individual evaluation and development plans* are an important ingredient for all board members and these evaluations and development plans should be undertaken by professionals in this field to enable the Chairman of the board to have a meaningful performance discussion with each individual.

These properties are foundational to effective board operation and governance. On a board that Danny has served on, the high trust environment that existed was compromised by some unfortunate events and changes to key roles of key people, and trust was compromised, such that governance effectiveness was significantly diminished as a result. Then the 'willingness to challenge' was very much reduced, once independent directors realised that not all members of the board were on the same page and board member alignment, previously very strong, diminished. Such things cannot be hidden from senior and middle managers in the organisation, and widespread impacts ranging from what gets debated and how, decision-making and even organisational morale are negatively impacted.

Accompanying the ongoing and ever louder contributions to the corporate governance debate are two common, but fundamental misconceptions. The first is that directors owe their primary duty to shareholders. The second is that non-executive directors are a class of director that sits apart from the executive team and has separately identifiable responsibilities imposed by law or statute.

It is a common error to see commentators describing corporate governance responsibilities in terms of the duties owed to shareholders. Although the interests of shareholders need to be taken into account, there is no requirement to treat this particular stakeholder group as having precedence over any other group.

This group of course are important, being the primary source of capital with which to build a company's business, but by their very nature in a free market economy, they are not required to have any long-term vision

or commitment to the company itself. Shareholders, if allowed to hold sway over strategy and operational implementation, could force management to drastically change the fortunes of a particular company by voting at an AGM, but then be gone in the blink of an eye by selling their shares the very next day. The imbalanced approach of 'shareholder's primacy' and the overwhelming desire by boards and executives to create ever increasing returns to shareholders is seen as contributing to the ills that were 'outed' by the Financial Services Royal Commission in 2019.

Power without responsibility and commitment to the long term is another recipe for disaster.

Accordingly, all competing stakeholder interests need to be factored into the complex equation facing leaders when formulating a corporate governance strategy for the benefit of the company.

So, given the above and to ensure focus is maintained on the right governance principle, the following guidance is provided:

1. Every board of directors owes its primary duty to the company itself. No stakeholder (shareholder, employee, customer or any other) is entitled to preferential treatment. The only exception is when a company is insolvent, at which point directors must regard creditors' interests over other groups.
2. Directors must look to the company's short, medium and long-term interests. Short-termism (such as focusing solely on this year's shareholder returns) leads to poor corporate governance and damages a company's long-term health.
3. Directors must strike a complex balance between many competing interest groups (stakeholders) that play a role in the daily life of the company's business and are impacted by its actions.
4. In discharging their fiduciary duty, directors should disregard their own interests. Their purpose is to safeguard the company's inheritance, as the framework for the future well-being of its business and then drive that business forward within the law and best practice.
5. The real key to effective corporate governance is a properly functioning board where mutual trust and respect lead to open, informed and timely debate on any and every aspect of a company's affairs. This point aligns strongly with our views in Chap. 1 concerning sound leadership.
6. There is no distinction in the eyes of the law between executive and non-executive directors. Directors need to understand that they are collectively (not just individually) charged to look after the company's best interests.

7. Every board must be collectively satisfied that each director's skills are appropriate for the industry and the company.
8. Directors should, of course, ensure compliance with relevant regulations and codes. However, they have a much broader responsibility to develop a long-term corporate governance strategy that addresses the interests of all stakeholders and is aligned to the ongoing role that their company is to play in society.
9. In developing this strategy, directors should make themselves aware of the wide range of issues that need to be addressed, in addition to financial transparency, from the perspectives of both legal compliance and the company's long-term interests. An example is responsibility for the safety-in-use of their products and services.

Whilst many questions continue to be raised about the role and performance of non-executive directors, the risks and responsibilities for non-executive directors have gone up, the time commitment has gone up and the pay has finally started to reflect these changes.

Vital questions will continue to be asked. For instance, what do those who sit across the boardroom table actually think and expect of their non-executive director colleagues? What do they believe makes for the best non-executive directors distinguishing them from the average, and what makes a truly exceptional non-executive director?

In our experience there is no perfect fit for all situations, there is no size-fits-all and each board must be a skill-based composition and be the right mix to suit a particular profile and situation.

The 'old boys network' that prevailed prior to the turn of the century no longer prevails, and the X-factors that we allude to comprise the following.

What Is an Exceptional Director | 10 'X-Factors'?

What makes for an excellent Board director:

(1) To bring a breadth of experience

Outstanding directors do not have to be expert in the company or sector but do need a breadth of experience to be able to assess and comment on a full range of commercial and governance issues. They must be financially smart with a strong understanding of business processes and models and have a proven track in an area of business expertise.

(2) Team players who leave their ego at the door

The best non-executive directors know how to stand back and not usurp the CEO or other executives. They let the executive team get on with their work, keeping them on their toes and taking a different view if necessary, acting as a 'check and balance' but not attempting to micro-manage. They don't feel they need to win every argument or be the top dog.

(3) They are independent advisers, able to challenge as well as support

Non-executive directors have the capacity to ask difficult questions to probe, to penetrate and be persistent to test and stimulate change. They can act as a catalyst, facilitator or mentor earning respect by providing guidance. They are detached and objective and act decisively and energetically if problems occur.

(4) They are committed and prepared

Non-executive directors must be committed to spend time understanding and getting to know the business. They also need to be well prepared for meetings not just reading papers but asking questions in advance of meetings. They need to be available to the executive team at the end of the phone and participate fully. There is no room for passengers.

(5) They are articulate communicators and good listeners

Non-executive directors need strong communication skills to be independent advisors but still be able to influence board decisions. The best non-executive directors do more listening than talking, they watch non-verbal communication, they are articulate and command respect when they are speaking. They can deliver a message in a constructive and concise way.

(6) They have sharp minds and good judgement

Being effective means having a sharp mind which can get under the skin of issues, grasp concepts and distil information quickly. Exceptional non-executive directors can analyse the essence of what is going on without getting lost in minutiae. They are intellectually flexible, able to judge people and business issues and take a balanced approach to decisions.

(7) They are visionary, creative and passionate about business

The best non-executive directors help the board to stay focussed on strategic issues, challenging and inspiring the board to take a leap forward. They are enthusiastic and passionately interested in the company and its business. They invest energy in the company's success and their enthusiasm fuels their learning and understanding of the business and its stakeholders.

(8) They have strong relationships and act as ambassadors

Outstanding non-executive directors are widely respected with a wide network of contacts and they continue to build strong relationships both within and outside the boardroom. They get to know the executive team, senior management and shareholders. They help to open doors for the company, persisting and protecting the company in the outside world.

(9) They are self-confident without being dogmatic

High self-confidence enables the best non-executive directors to hold and express strong opinions but at the same time to admit when they don't know something. They feel secure in their own track record of success to act as an advisor and to work towards getting the best results for the business without needing to insist that their view is always correct.

(10) They want to enhance their contribution through feedback

The performance of the board is vital, and non-executive directors contribute to collective decisions to define and deliver the business strategy. To help improve their fulfilment of the role the best non-executive directors welcome ongoing feedback and coaching and are ready to have their personal performance evaluated as part of enhancing the total strength of the team.

Now with those X-factors it is not surprising that many non-executive directors are evidencing increasing discomfort at being singled out for blame when there has been a corporate disaster (where were the non-executive directors? is a question often asked by the shareholders) and for being seen by some as a panacea of future governance salvation. The truth is that non-executive directors are not a separate class of directors in the

eyes of the law. They are jointly and severally liable for the conduct of the company, they are certainly not the representative mouth-piece for institutional investors or the guardians of the public good. They should act with the rest of the board to ensure that effective corporate governance is delivered.

Directors and Board Performance

Every board needs to be satisfied that with the available resources of all directors it has optimised the board's collective performance (if the answer is 'no' then re-assigning responsibilities or bringing another director on board may be the answer) and each non-executive director should know the answer to the questions: why am I here and do I have enough time available to properly discharge my responsibilities? (If the answers are not immediately apparent more work needs to be done as soon as possible by both the director and the board).

Having established an effective and functional team at board level the next greatest challenge is a proper evaluation of what risks currently affect and will in the future affect the company's business. Formulating strategy can include dealing with them and then actively managing these risks in practice. These risks are multiple and varied but include market risks such as product obsolescence and competitor action, together with operational issues such as weak systems in internal control to which considerable tension is addressed in recent corporate governance discussions. In addition, risk evaluation should include an analysis of a company's exposure to intangible dangers, for example, a dynamic, enthusiastic and even dogmatic CEO may enhance performance in the short term but they may have an ultimately negative effect in the long term by stifling the positive contribution from other executives and then inhibiting any debate on issues relating to board succession.

An effective board needs to evaluate and understand these risks, be prepared to debate them openly and ensure that they are dealt with promptly and adequately. In addition, it should be appreciated that the company is a perpetual entity. In analysing risk, the board should have regard to short-, medium- and long-term risk sources and issues. Building a risk management strategy around only short-term issues such as shareholder returns in the year to come will inevitably lead to important long-term problems being overlooked or ignored.

But what if the board does not perform? Today more than ever, having a high-performing board is a crucial success factor for company leadership and performance as we have outlined. Continued economic and regulatory pressures have raised the stakes for boards, requiring chairmen, directors, and CEOs to perform effectively as a group to make critical decisions and formulate strategy. But companies still struggle with functional operations in the boardroom. Even those boards that have been held up as 'high-performing'—such as that of HSBC—look very average when they have a very visible misstep in a critical area like succession planning. There is really no room for error as the level of scrutiny from shareholders, media, and the government hits new highs. Chairman/Lead Directors must ensure that they truly have the best group of non-executive directors around the table to help navigate the murky waters. No longer is it acceptable for one or more members of the board to be 'along for the ride'—companies and shareholders simply cannot afford it.

Even more damaging are directors who are disruptive to the board process. A board's culture is a very delicate thing and an important component to its functionality. It can easily be disrupted by someone who does not 'fit', quickly changing the dynamics around the table. For example, a board member may engage in bilateral conversations with other members of the board outside of the boardroom, trying to pre-align on topics before they reach the full board or trying to run separate personal agendas through management. This behaviour can erode trust or begin to form a 'board within the board', which can be devastating to the board's effectiveness and performance.

A director may also leak sensitive information to the media, which damages the safe environment within the boardroom and potentially causes management to avoid bringing pertinent issues to the board at an early stage. Or a director can simply stay beyond his or her ability to meaningfully contribute. This person might have been brought on for specific expertise, and, over time, this expertise might have become less relevant, reducing their ability to contribute in a meaningful way. Another way directors fail to contribute is by not preparing or paying attention; some even fall asleep in board meetings, which is both distracting and disrespectful.

So, what is a Chairman/Lead Director to do? Having a high-performance board all starts with director recruitment: selecting the best people in terms of experience and expertise, combined with the right cultural 'fit'. But the process doesn't end there: periodic performance

evaluations and reviews of all board members are an important part of keeping directors fully engaged—and fully aware of the expectations placed upon them. And, finally, boards cannot be afraid to 'refresh' where needed: all too often board members have looked the other way when a fellow director underperforms—even when the rest of the board feels the same way!

Creating a high-performance board is a time-consuming challenge and a world-class director recruitment, assessment, and on-boarding effort is required. It is critical that the board adopt a strong process on the front end to ensure the best people are joining the board from a competency and fit perspective in the first place. It may seem difficult to derail a candidacy that enjoys a lot of directors' support, but it is much more difficult to remove a director once they have already joined.

Regardless of how well known a potential recruit is to other directors, it is critical that he or she still go through a proper screening process. Board members should take this process very seriously by having thorough meetings and interviews with candidates in both formal and informal settings. Similar to the process of recruiting executives, it is best to give people conducting the interviews specific and discrete tasks; otherwise, you risk ending up doing the same interview multiple times. For example, one director might do the 'deep dive' interview into the prospect's experience and expertise, while another member may explore his or her potential 'fit.' Additionally, doing a 'tandem' interview can be very powerful, as it provides a report-out from each dimension covered, allowing for a fuller and more robust discussion around how the candidate appeared to more than one director at the same sitting.

Director recruiting should not be a secret process by a hidden committee that lacks transparency to the full board. It needs to be as open a process as possible by getting the full views out on the table. Letting concerns go unsaid will inevitably cause problems to arise later once the candidate joins the board—and where the options to deal with it are far fewer and more complicated.

Boards typically demand high performance from their CEO and the management team, setting clear expectations around their performance. When expectations are not met, this is often dealt with through the removal of the CEO; one only has to review the statistics of CEO 'life span' to know that this is happening. But the same boards often turn a blind eye to underperforming directors, allowing one or two to be 'along for the ride' and only addressing an issue when it becomes truly

dysfunctional. There are some who believe that being a director is akin to tenured professorship, and this attitude is not good for any stakeholders.

When a director begins to fail to perform, it is critical that the Chairman (or Lead Director) not let this fester and go into 'diagnostic' mode right away. The circumstances could vary dramatically: it could be that the director is overcommitted in other areas or has a health or family issue. The director may have exhausted his technical expertise or may not be a cultural fit with his fellow members. Or he may be highly political, undermining the rest of the board and its functioning by running separate agendas through management and then denying it. Whatever the reason is, entering into a diagnostic mode when you suspect there is a problem can allow you to examine a broader range of options rather than simply letting it get worse. An underperforming director can lead to a much larger dysfunction. This not only can significantly damage board performance, but also can leak over to management performance if trust is lost or the CEO is spending a lot of time trying to fix the issue instead of focusing on their number one job, which is to run the company.

The very best boards are opening themselves up to rigorous performance evaluations led by external advisers, just as they expect the management team to undergo. What is changing today is the evolution beyond 'compliance-based' board evaluations, where everyone fills in a questionnaire that is mostly around governance requirements, to a real assessment of performance—with consequences. High-performing boards today are tackling the common attitude of 'directorship as a tenured professorship' by adopting measures that are very similar in approach and methodology to the assessments being done at the CEO and upper management levels. This includes everything from 360-degree feedback from their boardroom colleagues and upper management to an examination of how each director is performing as a chair, lead director, or committee chair, as well as at the individual level in the full board environment. Typically conducted annually with check-ins throughout the year, these evaluations are used to form a set of recommendations to the overall board as well as personalised development plans for each director that are delivered through an in-person feedback session.

In the United States, evaluations are typically done through an external adviser on a confidential basis with each director. We are also seeing a move to include the Chairman in this process in other countries such as Australia and the United Kingdom. In these countries, the external adviser does the initial coaching session and then there are follow on sessions with

the Chairman, using the development plan as a vehicle to engage in conversation around effectiveness and performance. While this more rigorous process might seem daunting at first, it is something that should be considered depending on the maturity of your existing board performance review processes. An evolutionary approach in these situations tends to work best, versus completely changing the process all at once.

BHP Billiton and Brambles were leaders in this performance evaluation model. 'Refreshing' the board involves both removing those directors who are not delivering as well as bringing on new directors to meet the immediate and future needs of the company. Boards have a combination of tools and processes at their disposal for effecting these changes and building the board team they are looking for. Handling a low-performing director requires using tools such as age and term limits—vehicles that boards have adopted to be used in transitioning directors off the board. Without these tools, the board must undertake the more complex task of entering into a 'performance discussion'. Current practice varies in countries around the world, but what is common is that despite various recommendations and guidelines, it is ultimately up to the corporation's bylaws to determine the mechanisms by which to evaluate and/or remove a director.

In the United States, the National Association of Corporate Directors (NACD) has been the first to suggest a term limit for board members (after a time of 10 to 15 years of service); however, term limits seem to be the least popular method of keeping board membership 'fresh'. Although age limits are more common, boards in the U.S. overall seem to favour the evaluation process as the method for removing directors and managing performance. However, so far, most boards in the U.S. have not implemented this evaluative process in a truly robust manner, instead focusing on a more 'check the box,' compliance-based approach to board evaluation. By contrast, the Australian Securities Exchange Listing Rules require that a non-executive director seek re-election by shareholders every three years, and many Australian-based organisations take this one step further by then limiting the tenure of directors to three terms (with certain exceptions applying). Likewise, the UK Corporate Governance Code also recommends that any term beyond six years be subject to a rigorous review, taking into account the need for progressive refreshing of the board.

Best practice is a combination of using rigorous annual performance reviews combined with the development of a board skills-and-experience matrix that inventories the current capabilities across expertise,

experience, geography, and diversity. To further inform the recruiting process, the matrix should also look out into the future against the needs of the company and the CEO and identify where the gaps are. Maybe the company is moving into a new region (e.g., entering the Chinese market), or requires a specific expertise (e.g., finance or manufacturing) or experience (e.g. former or current CEO or succession planning expertise). Additionally, an often-neglected constituency is the CEO. For example, if there has been a recent succession event and you have a new CEO, they can often benefit tremendously from having recently retired or sitting CEO on their board that can provide them with wisdom and guidance and be a sounding board on key issues. It is important to take into account the needs of your CEO as you build your matrix.

In drawing attention to the gaps in skills and experience the board needs now, the matrix can also reveal when a director has exhausted his or her useful contribution, ultimately allowing for another way to enter into the performance discussion. This provides the Chairman/Lead Director with an alternate avenue for effectively transitioning a long-serving director off the board. The person heading the process can point to the positive contributions of the director over time (and celebrate them!) and then lead into a fact-based discussion of why these contributions are no longer necessary as the company is moving in a different direction.

The combination of age and term limits with rigorous performance evaluations and a forward-looking skills-and-experience matrix gives the Chairman/Lead Director the ability to begin to have more meaningful discussions around performance and the needs of the company and CEO. All of this said, these are not easy tasks and can be highly charged and emotive issues. Therefore, it is critical that the Chairman/Lead Director get alignment around the board's future needs to deal with an underperforming director as objectively as possible. It will take conviction, and often stamina, to lead this process from end to end.

The Role of the Company Secretary

The Institute of Company Directors observed some time ago that the importance of the Company Secretary's role had increased over the years. No longer the person who merely keeps the minutes of the Board and handles Board correspondence, the Company Secretary role had become more about administering the affairs of the Company and managing / supporting the business of the Board.

Depending on the size of a company, the Company Secretary can be considered the chief governance specialist within an organisation, and it is a role which is increasingly relied upon by the Board to provide advice and implement good governance practices.

Companies with which Don was involved with—NAB, BHP Billiton, Brambles, AFIC, Southcorp- all recognised the changing role and value of the Company Secretary and were fortunate to have self-motivated, committed people engaged in the development of those companies.

Each incumbent had a distinguishing style. Garry Nolan at NAB ushered the NAB Board through the deregulated era of the 1980's, 1990's and 2000's. He was challenged with the creation of a Company global footprint, and the various interpretations of jurisdictional corporate law as well as the sensitive role of the Central Bankers who could prove parochial when confronted with foreign operators. It was interesting observing his own development in a geopolitical sense as well as educating those around him, of the legal and commercial risks of an organisation which required increased diligence with governance risks and multiple jurisdictions.

Doug Corben of Brambles was more of a gatekeeper style Company Secretary until that Company experienced six different Chairmen in as many years. In those circumstances his legal obligations were challenged by an International Management Team who had numerous reporting lines, two principal shareholders in GKN and Brambles and generous delegated authorities which evolved to ensure the Company retained its momentum. A very difficult situation to maintain the integrity of sound governance practices.

The emergence of the Dual Listed Company structures at Brambles and BHP Billiton in 2001 really brought into play the role of Company Secretary in terms of compliance and performance. Both Craig van der Laan who succeeded Doug Corben at Brambles and Karen Wood, who joined BHP in 2001, were lawyers and their professional disciplines of law and commercial knowledge were surely tested.

Both Companies set up Governance Structures which were universally recognised as best practice and through their respective discretionary efforts and diligence, both Companies executed and implemented the complex terms and conditions of the respective DLC.

Craig went on to lead the unification of the Brambles DLC in 2007, he discharged a Business Unit Head's role at Brambles for a short term and then became CEO of the Barangaroo development, a challenging

position, in Sydney. Upon completion of that project he entered the Consulting world.

Karen progressed her career at BHP Billiton to become a member of the Group Executive Committee, she undertook a couple of outside Board assignments including the MCC Board before becoming Chairman of South 32 Ltd., succeeding the inaugural Chairman, David Crawford.

Karen was succeeded by Jane McAloon as Company Secretary of BHP Billiton and was confronted with the complexities and challenges of Chairman succession from Don Argus to Jac Nasser, and CEO transition when Andrew Mackenzie succeeded Marius Kloppers. This new environment saw Board changes and quality executives like Alberto Calderon moving on to become a successful CEO of Orica Ltd. Jane moved down the non-executive director route following her completion of office at BHP.

A US investor, Elliott and Associates, entered the share register and highlighted a chronic under-performance of BHP Billiton from 2010 to 2017. Their analysis raised questions of why the standards and principles set following the merger of BHP and Billiton, in particular judgment, seemed to have gotten lost in the maze of events reported in the media.

All Company Secretaries mentioned had good judgment, but when an external analyst calls a Company out for losing value and cites the causes below, one has to ask the question: what can we learn from this activity and what should a company secretary react to in such circumstances?

- Outlaying US$10 billion to complete a buyback of shares at peak cycle prices.
- Endeavours to takeover Potash Corporation of Saskatchewan Inc. to accelerate BHP Billiton's entry into the fertilizer industry ended in an embarrassing withdrawal of the offer which was generous at a 32% premium to Potash Corporation's share price on the NYSE. A leading Banker in the USA was prompted to observe that the bid, whilst compelling, completely misread the political influence of a patriot Canadian CEO named William Doyle.
- There was the US$30 billion loss on the ill-timed US Shale acquisitions which proved too costly to acquire and further capital wasted by trying to grow with excessive haste. Andrew Mackenzie conceded on this shale failure at a Miners meeting in Barcelona in 2017.
- The South32 Ltd. spin out was undertaken without addressing the DLC unification structure, on the basis of costs which again were challenged.

- The Samarco Dam disaster in 2015 would have taken much time and diligence with the operating company in Brazil and one of the joint venture partners, BHP Billiton, exposed to protracted law suits.

People who have discharged the duties of Company Secretary under Don's Chairmanship, all attest to his mantra of encouraging incumbents to shed routine thinking and challenge convention. From his experience he believed that some individuals are born with an ability to listen, be self-aware and understand and digest other people's qualities that make good judgment easier.

Bad judgments occur because people unconsciously filter information they receive or are not sufficiently critical of what they hear and read. There is also the possibility that people ignore insights which they do not wish to hear; a tendency that one could observe where there is familiarity of process, over-optimism, and/or personal emotion.

A sad era in BHP's history and a challenging time to be a Company Secretary. That said, *a Company Secretary has many tasks, much of it around legal compliance and legislation within the jurisdiction where the entity that engages them operate. Because they filter all issues presented to a Board, an individual with sound commercial judgement is an advantage as organisations do undertake generational change, and human nature being what it is, individuals can find it difficult to shed prejudices and biases from past experience and a Company Secretary with intellect, skill and sound business judgement can neutralise individuals seeking to influence decisions based on flawed analysis and / or questionable advice.*

We came from the school where the Company Secretary's role is one of the more important development roles in any organisation and alumni through those positions should qualify for future leadership consideration in any organisation. The individuals mentioned above have all gone on to develop their careers and achieve leadership roles in other organisations.

Concluding Remarks

Corporate governance has come a long way since the term was first used, evolving for all the right reasons from a compliance-oriented box-ticking exercise to a set of processes where directors and executives can manage risk and performance in addition to ensuring compliance.

Boards have a vital role to play, and directors' selection, behaviour and activities are critical to the livelihood of organisations. The tone at the top,

of both non-executive directors and executives, will likely be either the limiting factor on the organisation if it functions badly, or a positive driver if it functions well. Either way, the organisation's trajectory is guided, including being raised and limited by these factors.

The board, as a team of Directors, should comprise high calibre individuals, with enthusiasm and a collective set of skills that will give the right guidance and leadership, which implies that individual directors need wisdom and maturity, integrity and other qualities as set out above.

Director selection, performance management and work should be a performance oriented and measured processes just like any other in a high-performing organisation. In the complex business world of regulations and stakeholder demands, boards must manage much more than compliance in their governance work, but also risk, that can come from anywhere within or outside the organisation. With primary allegiance and duties aligned to the organisation itself, a balanced view of all stakeholder demands can then be pursued. Finally, Directors have the challenge of judging and where required challenging the CEO and executive team, and ensuring the strategies being implemented have a balance across time horizons, from short to long, in ensuring that capability and outcomes develop beyond the initial annual cycle.

CHAPTER 4

Corporate Social Responsibility

Introduction: Important Things Well Beyond This Year's Profits

Corporate social responsibility (CSR) has long been debated amongst business leaders, politicians, and even philosophers. Many business leaders are using the term 'sustainable development', or just 'sustainability' to refer to similar ideas, and we choose to not differentiate between them here, but simply to refer to the other oft used term of 'people, planet and profits' (Triple P), which gets quickly to the heart of the matter. Let's examine these concepts and consider what constitutes best practice in leadership and strategic practice within modern organisations in this domain. In this chapter we outline and review the modern approach to corporate social responsibility and compare it to the classical approach, using many examples from around the globe to acknowledge the progress being made by businesses and governments, while still acknowledging that this element of strategic leadership is not fully mature in most organisations. Stakeholders are increasingly turning their attention to non-financial organisational outcomes, which for leaders mean that they must face into the challenges of tradeoffs in satisfying those stakeholders, while seeking to formulate strategies that are win-win, across dimensions of 'People-Planet-Profit', that will see their organisations well positioned in the medium and longer terms. We cite many corporate examples of how CSR work and activities are rapidly becoming mainstream and indeed core to organisations' work, including resource

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D. Argus, D. Samson, *Strategic Leadership for Business Value Creation*,
https://doi.org/10.1007/978-981-15-9430-4_4

allocation and other strategic decisions. Noting the prevalence of published corporate CSR and sustainability reports, it is noted that a broader stakeholder approach and longer-term sustainable development initiatives are providing advantage to many organisations in attracting talented employees, customers and investors, more than ever before.

The 'Old School' Sceptical View

We deliberately begin with the use of a somewhat 'straw man' argument, briefly as a base from which to take the argument forward. We cite the famous University of Chicago economist, the late Professor Milton Friedman, who won a Nobel Prize in Economic Sciences (but not for his views on CSR). His views on CSR are of interest to base newer versions of what is possible as a comparison. Friedman wrote an article based on earlier books, published in *The New York Times Magazine* (September 13, 1970), in which the article title summarised his views accurately:

> *The Social Responsibility of Business is to Increase its Profits.*

We would argue that he wasn't completely wrong on this, but that he was not completely right in his views, because he went on to state in the article that:

> …. in my book *Capitalism and Freedom, I have called it* (Social Responsibility) *a "fundamentally subversive doctrine" in a free society, and have said that in such a society, "there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.*" Whilst mostly denouncing social responsibility on behalf of businesses, Friedman made assertions such as: "*This is the basic reason why the doctrine of "social responsibility" involves the acceptance of the socialist view that political mechanisms, not market mechanisms, are the appropriate way to determine the allocation of scarce resources to alternative uses.*

Friedman did acknowledge that:

> *…it may well be in the long-run interest of a corporation that is a major employer in a small community to devote resources to providing amenities to that community or to improving its government. That may make it easier to attract desirable employees, it may reduce the wage bill or lessen losses from pilferage and sabotage or have other worthwhile effects. Or it may be that, given*

the laws about the deductibility of corporate charitable contributions, the stockholders can contribute more to charities they favor by having the corporation make the gift than by doing it themselves, since they can in that way contribute an amount that would otherwise have been paid as corporate taxes.

This rather weak acknowledgement shows the limitations of his argument in his paying essentially lip service to the possibility of taking more than a short term and minimalist view to activities that are legitimate for businesses to undertake in advancing the stakeholder outcomes for going forward on People and Planet, whilst always maximising Profit outcomes. We contend that when practices are cleverly and carefully chosen and well implemented, that there is no necessity of a conflict between People and Planet on one hand and Profit on the other. There is now ample evidence of such synergies, all over the corporate world.

The Modern Approach

Friedman's view from some 50 years ago has been proven in practice to be an at best an incomplete description of the truth of what is possible and sensible, and of the potential in the modern way that markets and businesses can work. At worst, Friedman's view can be seen as a short term only prescription, and is simply, flawed. We now see companies of all sizes engaging and allocating resources, often significant in terms of budget and effort, to activities that do not directly create profits. And this is where Friedman didn't adequately express what is possible. The longer term and more indirect benefits from such actions are themselves finding a 'market', meaning they (CSR and sustainable development initiatives) are now being valued and conducted by companies that are indeed very focused on profits and maximising shareholder value creation. Indeed, the new reality is that companies have found ways to increase the effectiveness of their strategies, and the profits that ensue, through the less direct benefits that come from doing good things to various stakeholder groups of people and to the planet, above and beyond legal and ethically expected minima. They are doing this while they increase their corporate value, through improving profit potential.

In early 2020, Microsoft announced that it would not just go carbon neutral, but also achieve a state of being carbon negative by 2030, and further that it would remove from the environment all carbon it has emitted since it was founded in 1975. The world's largest asset manager, BlackRock, with some A$10 trillion under investment, has announced new policies whereby climate change would be a strong focus of its

investment policies and decisions. In his 2020 letter to investors, BlackRock Chairman and CEO Larry Fink pointed to the importance of climate risk, headlining a 'fundamental reshaping of finance'.

Motivation for CSR / Sustainability Initiatives

This (motivation) goes to the heart of the matter that underpins CSR activities, undertaken by business owners or their managers (as agents of the owners). Why should we do CSR? The answer is not one of philanthropy, or charity or of being a do-gooder for its own sake, but because it's good for the short- and longer-term prospects of the business, meaning, once again, it creates business value, and benefits a range of stakeholders. One can invoke the summary phrase of 'Doing well by doing good' here, where doing well is indeed exactly as Professor Friedman would have approved of, doing well is primarily for shareholders, and the mechanism that he didn't fully embrace was of strategies and actions that do good for a range of stakeholders, with a profit payback that is expected to be significant. In other words, some CSR actions and activities should be considered just like any other activities in business life, as investments, aimed at achieving a positive return for the organisation. However, we have seen that some such activities go beyond even seeking a return on investment and are conducted as a matter of corporate values (such as Toyota's 'Respect for People' core value). So, the correct question when considering CSR activities is to evaluate the full costs and benefits from an NPV (Net Present Value) perspective, and also its congruence with the organisation's values. Generic examples are:

1. Benefitting the 'planet' through doing an energy use audit and reducing energy consumption, hence producing less greenhouse gases, leads to a reduced energy bill and is a profit driver.
2. Providing a corporate gym, or other health promoting services for staff leads to strong employee loyalty, and a healthier, fitter workforce, leading to increased productivity and motivation, and hence, ultimately, profits.
3. Using environmentally less damaging materials of construction in products is increasingly being appreciated by customers and driving consumer choices, leading to marketplace advantages, and hence profits.

Google has been at the cutting edge of doing significantly more than minimally required with its staff: much more. Why does Google provide free unlimited food to its staff, of very high quality in restaurants at its workplace, subsidised eco-friendly cars, free medical services, and a host of other employee benefits? These benefits for staff are clearly way beyond any notion of what is in an enterprise agreement or award! Google has won numerous awards for being 'Best Company To Work For' in numerous countries. The reason we cite for such expenditures is not charity, but good business, namely that it strengthens employer-employee bonds, and hence loyalty, motivation, productivity, discretionary work effort and staff retention factors, and arguably perhaps, staff creativity. At the time of our writing this, Google's share price has reached an all-time high of US$1820, indicating that the investment market believes it is getting quite a few things right.

So, the first motivation and rationale for acting positively on CSR is that by sensibly choosing CSR-related strategic initiatives that will lead to 'doing well by doing good', then win-win outcomes can be achieved across the triple bottom lines. A further motivation discussed later in this chapter is that it can be driven by core values of the enterprise.

The Core of CSR

The core questions of CSR, or as some prefer, Sustainable Development (SD), are which strategies and practices to choose, how much should be invested and how should they be implemented. In this regard, we can consider what some organisations have been doing in recent years, many of which have gone well beyond any minimal legal or even moral or ethical requirement. In presenting this summary of examples, we remind readers of the 'scorched earth' approach of doing nothing more than the minimum requirement, against which these initiatives described below can be considered. One way to clarify thinking about such actions is to ask: 'What would (the late) Professor Friedman have said about these actions and initiatives?' How are they congruent or incongruent with his view as summarised in the article titled '*The Social Responsibility of Business is to Increase its Profits*'? We would like to think that Friedman would not turn over in his grave, not even a little bit, but rather be enlightened at the modern approach to increasingly create new forms of profit/shareholder value through CSR activities that provide efficiencies and cost reduction,

stakeholder engagement, and an edge in the market place (Goldsmith and Samson 2006). Some interesting examples are of:

1. Wal-Mart, not always considered in the past as a good corporate citizen, has engaged in efforts to reduce greenhouse gas emissions in its own operations and to influence its supply chain partners to do similar. Wal-Mart has even begun to explain and publish for its customers some information about the eco-friendliness of the products it sells them. This allows customers to better take such considerations into effect in their buying choices. Wal-Mart has come a long way (from a low initial base) in this regard. Wal-Mart has created numerous 'sustainability value networks', whose aim is to find ways to gain bottom line advantage for Wal-Mart, while simultaneously providing benefits for other stakeholders such as staff, customers and the environment. Many successful initiatives have come from these efforts and Wal-Mart's profile and approach is much changed from that of a decade ago, when its relationships with employees and communities were more often adversarial than cooperative. An example of Wal-Mart's work was to increase its logistics efficiency, which led to 38% efficiency gain, saving some $200 m per year in costs and simultaneously cutting greenhouse gas emissions by 200,000 tons per year. Both the Planet and Wal-Mart's profits went nicely forward. From its initial low base, Wal-Mart has openly published environmental, social, governance (ESG) metrics and initiatives, including for example significantly increased pay rates, hiring over 200,000 veterans, and influencing its large supplier base to follow an advanced ESG path. See https://corporate.walmart.com/esgreport/data
2. IKEA has been actively trying to find ways of making progress in all three bottom lines (environment, community, profit) simultaneously for a long time. It has made much progress in mainstreaming CSR/SD. These have been not only to reduce the energy use and other polluting aspects of its processes and its supply mechanisms, as well as insisting that even in emerging economies where it sources many of its goods, that sound labour practices are in place, but the designs and materials used in its products are themselves specified with a strong influence of eco-friendliness. This is aimed at reducing its environmental footprint, reducing its costs of production and transport, and giving it a market edge. In other words, the aim is to

work for win-win, or even win-win-win outcomes on the people-plant-profit outcome dimensions. IKEA searches for opportunities to achieve this and implemented the best of them. IKEA began these initiatives, as do most, in a modest fashion, and incrementally moved forward with deeper and bolder strategies and practices, to the point where these opportunities are now fully mainstreamed, and IKEA is mature in its value system and decision criteria. IKEA has recently focused on advanced practices in energy efficiency, waste reduction and sustainable sourcing, for example of timber. IKEA is highly transparent in reporting its progress on these matters. This is in a company that has a long and strong tradition of 'leanness' and low cost, but has had the strategic 'nouse' to move forward with CSR rather than stick to a minimalist position.

3. When one thinks of Dow Chemicals, and its 100+ years of history, it is true that up until 20 years ago, it was not always a great corporate citizen. Products and their safety, pollution and efficient energy use were not always strong points in this businesses' long history, and its reputation was previously poor, until it realised and actioned a modern approach, of wanting to 'Do well by doing good'. Similarly, Danny well remembers from his first 'career' as a chemical engineer working for ICI Australia (later Orica) that the standards of safety and environment were not high, to say the least, in this whole industry, some 30+ years ago. Dow has been accused of and made to clean up a series of 'messes' it was responsible for, ranging from dioxin in rivers to various other types of chemical related problems. Dow's acquired subsidiary Union Carbide, still has significant liabilities from its Bhopal, India disaster, some 20 years later. The interesting and impressive thing about Dow is that it has reacted to changing societal and governmental requirements by going much further than a minimalist compliance-based approach. It has proactively chosen to implement CSR related strategic initiatives much further ahead of those required by legislators, and this is done to serve to its long-term business advantage. It also serves its employees well, and its communities, and of course its corporate value rises, through both risk reduction and value creation directly (energy use reduction) and indirectly (customer and stakeholder engagement, risk reduction, safety improvement and reputation enhancement). To implement this, Dow is an example now of a proactive company, much transformed from its traditional self, involved in a plethora of

CSR/SD initiatives, all aimed at 'doing well by doing good'. Dow has done this since 1995, and has published long term sustainability goals, against which it is rigorously measured, such as significantly reducing energy intensity. It has been awarded a prestigious A+ rating, through its progress, against the GRI (Global Reporting Initiative) criteria, which shows just how far it has come from the industry's 'bad old days'. We want to acknowledge the obvious which was that the behaviour of Dow, ICI/Orica, and many others of some 25 years ago was not 'sustainable' and that companies like Dow have moved forward in order to improve their risk and return profile, and not necessarily from some motivation of being 'nice'. The best of these companies has done these things very well, and as a result have done well financially from their SD initiatives. Dow's recent framework of CSR is summarised around the pillars of 'Valuing Nature, Advancing a Circular Economy, World-Leading Operations Performance, and Engaging for Impact: Communities, Employees, Customers', and it has implemented a series of strategic initiatives in each of these areas.

4. Hewlett Packard (HP) has been a deeply principled company ever since it began with the legendary values instilled by its founders, often referred to fondly as 'Bill and Dave'. It has carefully gone through evolutions of CSR development and maturity, from pollution reduction some 30 years ago, to 'product stewardship' recently, and now an even more proactive approach to improving its environmental and social footprint, through searching for ways to do business with net positive outcomes to People and Planet, as well as, of course, Profit. HP surveyed its major customers and found that the business case for sustainability actions was strong, with key factors (Preston 2001) being customer and market expectations, market access, cost savings, market opportunities, brand image and ultimately competitive advantage and shareholder value.

HP has communicated and published its achievements in order to ensure its stakeholders know of its efforts and has engaged in transformational work of everything from its supply chain designs, product and packaging, to its business models, moving from selling to leasing out its products in some sectors. Once again, we see HP as driving to position itself to be itself sustainable by getting ahead of the curve, or at least not behind, on the stakeholders' changing requirements.

HP reports: 'Over a five-year period, HP reduced energy consumption of our product portfolio by 50% on average'. (http://www8.hp.com/us/en/hp-information/environment/sustainability.html).

In its 2012 Global Citizenship Report, HP provides 146 pages of openly published descriptions of its CSR activities and their outcomes, which are extensive and global in their reach. The budget for these activities is clearly large, and HP does these things fully expecting and achieving a financially sustainable return. More recently, President and CEO Dion Weisler has stated in their 2017 Sustainable Impact Report that 'At HP, we are on a journey to keep reinventing everything we do. Our aim is to make life better for everyone, everywhere. At the heart of our reinvention is the need to create a business that can have a lasting sustainable impact on the world. This is not just the right thing to do, it fuels our innovation, our growth, and creates a stronger and healthier company for the long term.' We note that this HP approach connects precisely to our comments in Chaps. 2 and 3 of the intents of strategy and sound corporate governance being of achieving the enterprise's goals first, through interacting positively with a range of stakeholders. When connected to the core ideas of strategic leadership elements of business strategy and good governance, CSR clearly opens a domain of opportunity to go significantly further forward than taking a Friedman-like approach, no more and no less.

CSR Concepts

Sustainability is often thought of in terms of the 1987 Brundtland Commission definition 'Developments that meet the need of the present without compromising the ability of future generations to meet their own needs'. Many surveys have determined that the majority of Western business leaders state that their objectives are to move forward on the broad triple bottom line objectives of People-Planet-Profit, with the gold standard being the criteria measured by the aforementioned GRI.

Lubin and Esty (2010) claim that sustainability is a 'megatrend' as were the advent of internet and quality management, in their scale, impact and promise to the business sector. These are presented as big, permanent, pervasive changes. These researchers point to elements of such transformations as leadership, systematic opportunity analysis, strategising and creation of operational plans and practices, shared accountability for sustainability/ CSR outcomes, and systematic reporting of progress. They sensibly suggest stages of progress of first doing existing things in new

ways, then doing new things in new ways, transforming businesses and creating new business models. This fundamental shift in how 'business does business' should not be underestimated in importance, according to Lubin and Esty, who point to previous errors of not moving fast enough by GM in terms of the quality movement, and Kodak who suffered greatly through being slow to digitise their products when the world changed. Even worse, we would point to James Hardie in Australia, who denied their full responsibility and liability related to asbestos exposure and suffered greatly as a result in reputation terms.

A survey of executives published in Sloan management Review (Kiron et al. 2012) found that the interest in actioning sustainability agendas has risen fast, with sustainability leaders harvesting solid business benefits. That study, of over 200 companies, found, not surprisingly, that CEO support and leadership were key ingredients of success, that external collaborations were increasingly being used to find CSR opportunities, and that most leading firms used 'business case' rationale as a way to drive their agendas forward.

Just as leading companies report the success factors of executive leadership, business case development as supporting the belief system, and then execution of CSR strategies as being integrated with mainstream business strategies, so the converse is reported as being almost a mirror image of these factors in businesses that lag in making CSR progress. Berns et al. (2009) in the Sloan Management Review point to CSR challenges of management lacking in understanding of CSR, problems with business case establishment, and then even when those factors are overcome, poor implementation of the sustainability actions/initiatives. These lagging positions are costly to profits and capability and can threaten even basic viability of a business.

Researcher Michael Hopkins (Sloan Management Review) pointed to some powerful forces and factors that will or have commanded urgent executive attention and action, particularly that there is no escaping the trends and forces, when companies fall short of stakeholder expectations on matters of Planet or People. He cites Nike, Rio Tinto, Boral, Unilever and Chevron, and we would add BP, James Hardie and AMP as companies that were forcibly brought into the world of CSR by powerful external forces. He points out that efficient and user-friendly buildings clearly save energy (hence money) but more than that, reports 16% improved labour productivity from healthy and comfortable buildings. Hopkins also adds

the notions of partnering/collaborating that is fostered by and contributes to the opportunity set of sustainability.

Goleman and Lueneburger (2010) gave a succinct description of the stages of maturity of CSR approaches, moving first from the traditional beginning state of being 'unconsciously reactive' to a state of knowing, called 'consciously reactive'. This means moving from being essentially unaware of the issues and opportunities to a state of knowledge of what is possible and the why of CSR. Through formulating and moving forward with initiatives, the third state of being 'consciously proactive' can be achieved. They cite the journey of Owens Corning, moving from 'nowhere' on these matters to maturity, and being a stronger and higher valued company as a result. Finally, when the initiatives become mainstreamed in the business, the maturity can be described as 'unconscious pro-activity'. Few firms were at this level in 2010, but those at the leading edge in their industry are on their way, and those first movers will gain long term advantages.

In 2011, a large survey (Haanaes et al. 2011) demonstrated that sustainability 'embracers' demonstrated three characteristics, being the existence of a business case for it, the agreement that it is necessary for being competitive, and its permanence on the management agenda. The survey shows how fast the CSR-leading companies are moving and what they are doing, as:

- Moving forward, even on incomplete information, especially doing the 'low hanging fruit' work, such as waste and energy reduction
- Taking the quick wins while developing the longer-term vision and initiatives
- Driving it throughout the organisation (top-down and bottom up)
- Integration of initiatives into mainstream activities, not separating it out
- Measure and report achievements
- Value the intangibles and the risk reduction
- Pursue sincerity in the belief of the strategies and benefits

Interestingly, these dot points above are reasonably generic statements about good management and particularly good change management methodology, and could have been applied to say quality management, innovation strategies, technology and internet adoptions etc. They are validated as applying to sustainability initiatives and culture.

Kruschwitz and Velken (2011) reported on a survey of 4700 managers and their responses, with overwhelming findings of increasing attention and work being applied to CSR/sustainability agendas, being everything from cost reducing initiatives to innovation drivers. For those of us who are keen to see organisations move forward on triple bottom line outcomes, this is good news, of widespread attention and adoption coming into play. While the typical studies and cases cited herein are often of Western and first world practices surveys and case histories, it is also gratifying to know that a strong push is occurring in many less-developed economies. In those economies, the challenges are in some ways greater, because it cannot reasonably be assumed that proprietors there can or will afford the luxury of pollution control equipment, however the influence of advanced multinationals, supply chain procurement practices thereof, and business leaders in those economies are moving the agenda along.

Global Considerations

The corporate CSR journey, in global terms, is only beginning. While some companies in first world countries have moved forward, it is from a base of high pollution and historical disconnection of corporate existence from communities, that good things are now happening that capture win-win-win opportunities on the triple bottom line. Australian executives should be looking to use their influence amongst supply chain partners to extend these practices into our international supply networks. This is, in a word, hard. Consider a first world wholesaling firm, with whom Danny worked for a decade, advising its suppliers in Bangladesh to install an (expensive) water purification system in its factories, so that employees can drink water that is acceptable by Australian standards. This company's owners simply refused to install the water purification system. Similar applies to safety systems, labour standards, and environmental pollution standards, and we should remember that it has not been very long in our corporate history since we engaged in practices that are not acceptable, and certainly not best practice today.

Consider how far and fast the mining industry has come, since the days, less than two decades ago, of Ok Tedi and Bougainville, and more recently, Samarco. Our research has shown just how far our mining and energy/resources industry has come, admittedly from a previously quite low base, when it comes to the past twenty years of environmental performance and local (often indigenous) community engagement. Much progress has

been made. Returning to the global consideration, there is much to learn and adapt from the past twenty years in the first world to drive forward in emerging economies, and we should take on the responsibility to not only continue the journey in our own firms, but to inform and influence on a global basis. The BHP case studies later in this book refer to such progress, but we immediately acknowledge that there is a long way to go, particularly in developing nations, and that developed nation company policies have much to contribute.

While the primary driver of development in China and India is of economic development, a key question is how those countries and others in similar developmental states, such as Indonesia, can integrate CSR better and faster than Western organisations and societies have done. Our industrial revolution was 200+ years ago, and with the remarkable growth through industrialisation and mass production in the past 100 years, we in the West often turned a blind eye to Planet and People in the large part until only very recently. Heaven help us if the current large population countries of China, India, Indonesia, Brazil and others are as slow as we were to drive forward on CSR! There just isn't time. Good news from these countries, particularly China is that the government can mandate change much more forcefully that in democracies, where market forces have moved quite slowly. National strategies of sustainable development in China are moving from policy development stage into full blown implementation. Anyone who has looked for a blue sky in Chinese cities will be gratified to know that action agendas are being implemented, but it is a likely fact of life that things will likely get a fair bit worse before they get better in some developing countries.

How About Government?

We have addressed how companies have determined that there is strong direct and indirect connection, between 'doing good and doing well' for companies. Some of this argument is time based, in that there is a lag between investments and action initiatives, and longer-term reputation benefits, with some spheres of influence acting faster, such as energy efficiency. However, markets are acting, in that reputation management and consumer and employee expectations are driving change. Consumers want to buy from 'good' companies, and not from 'bad'. Talented value-oriented professional and other staff want to work for 'good' companies and not 'bad'. And increasingly because of the impacts on risk and return,

investors and their asset managers such as BlackRock look to invest in 'good' companies and not 'bad'.

What about government? Government does not and has not got the same marketplace imperative, often having the luxury of a monopoly, or at least a local monopoly, whether it is local, state or national level government. Government's accountability in political terms only comes to the fore sharply every three or four years in elections. While governments do not generally pursue competitive advantage in local markets in the way businesses do, they are in the business of pursuing effectiveness, and are hopefully trying hard to do more with less, so they are keen to achieve cost reduction, stakeholder satisfaction and also reputation enhancement. They are differently accountable to their stakeholders but are nevertheless accountable. There are a similar set of opportunities available, in terms of energy and utilities, water, green buildings, waste reduction, transport efficiency and sustainability etc in the public to the private sector. Further, government sets policy and regulation and can catalyse leading edge practice in community and even corporate behaviour, especially when the market (such as for best practices in CSR) is not efficient or is slow moving. Whereas most of our examples above are for large and well-known companies, who are big enough to plan and resource their own CSR initiatives and strategies, government can support, educate and catalyse action for Small and Medium Enterprises (SMEs) to move faster than would otherwise be the case, through setting policy, providing incentives, and leading from the front with their own actions. Government's role is important. This is especially the case with how government can advise, encourage and incentivise small and medium sized businesses as well as lead through their own actions.

Taking CSR / Sustainability Forward

Concern with CSR and sustainability is here to stay. In a survey of 47,000 consumers, they were found to have identified 60% with the company and its reputation and only 40% with the product (Reputation Institute 2012) in making purchase decisions. Top companies were cited as Microsoft, Google, BMW, Disney, Mercedes, Daimler, Colgate Palmolive, Sony, VW and Lego. Perusal of their corporate websites immediately shows how pervasively they have adopted strategies and practices of CSR into their mainstream business processes, and the dividend that has been reaped. Research

has also shown that many consumers, roughly half of the total, are sceptical of businesses who report sustainability progress, so evidence-based actions and positive reporting are a must. Those who attempt to 'greenwash' their customers are likely to see this backfire, such as when McDonald's changed its logo in Europe to incorporate a green element, ahead of its CSR implementation. Similarly, VW took a big step backwards in their deliberate cheating scandal of recent years.

We reiterate that CSR has moved to be a part of doing business well. It makes firms sustainable, reduces their riskiness, and hence should, once deeply understood, have made Professor Friedman happy. Like anything it is possible to over-invest, or to implement ineffectively of course, however when the right practices are chosen, and executed well, then it is clearly possible to make sound progress simultaneously on People, Planet and Profits.

Many businesses, large and small have decided to allocate resources to CSR activities. Apart from those described above, most large organisations are active in this sphere, although activities are different in nature and extent in each case. Some further examples are (sourced from https://digitalmarketinginstitute.com/blog/corporate-16-brands-doing-corporate-social-responsibility-successfully)

- Johnson and Johnson, aiming to achieve 35% renewable energy sourcing, including buying an energy supplier as part of this. Yet no organisation is perfect, and this company has been alleged to have been deliberately a part of creating the recent opioid crisis in the USA.
- Google's data centres are designed and operated so as to use 50% less energy that others
- Wal-Mart and Coca Cola have focused on their logistics and truck delivery fleets, improving their carbon efficiency by between 20% and 40%
- Toyota, Ford, BMW and GM are all redesigning their vehicles and propulsion systems in order to reduce environmental impacts, by double digit amounts.
- Netflix offers 52 weeks of paid parental leave to employees
- Wells Fargo gives 1.5% of revenue to charity
- Bosch and GE have focused on making their products and indeed devising new products that will benefit both them and the environment

- Starbucks is hiring thousands of veterans, aiming for 25,000 by 2025. Wal-Mart is doing similar, attempting to hire an order of magnitude more veterans than this.
- Disney and Lego are making major commitments to energy use reduction, waste reduction and eco-efficiency.

These companies are doing these programmes and initiatives not because of regulations, but in a generally proactive manner, aimed at finding ways to 'win' (meaning achieve) on more than one of the so-called bottom lines.

Miners such as BHP are generally attempting to improve their 'sustainability'. BHP's 2019 sustainability report boasts of a 1% reduction in freshwater use from 2017, and a 3% reduction in greenhouse gas emission. BHP invested $93.5 million in its host communities that year, and even more in its climate investment programme, $400 million. There are no hard and fast rules as to whether this is sufficient, or 'enough' in such a business with some $60 billion in revenue, substantial that it is. BHP has suffered great losses from its most recent tailings dam disaster (operated by major partner Vale), and one can only consider that larger and more effective investments in ESG (environmental, societal, governance), would result in fewer such disasters. Would stronger focus and considerations of ESG at the Vale-BHP owned Samarco have prevented the 2015 disaster? This question is clearly only a hypothetical, yet if BHP was stronger in its insistence of bringing its corporate operating and safety standards to Samarco, could a different outcome have been achieved?

CSR: Win-win, an Illusion or Inherent in Business Values?

One useful way to consider CSR and its different dimensions is as in 'Carroll's pyramid'. The pyramid's foundation level is economic responsibility (Carroll 2016), without which the organisation does not have the resources to do other types of things and is not sustainable, in every sense of the word. Then comes the level of legal responsibility, meaning operate lawfully. The third level, built on economic and legal responsibility foundations, is of ethical responsibility, usually interpreted as operating in a fair and just manner, and doing what is judged by society as 'right'. The highest level of the pyramid is of philanthropic responsibility, of contributing

to community through being a good corporate citizen. It is too fine a point as to whether these can be thought of as strictly sequential or structured always and only in this way, as there are grey areas between them in practice, but it is a quite useful way to consider CSR. For those who argue against economic success being at the base and core of the pyramid, we must remember that without sustainable prosperity, organisations simply won't be there to do 'higher level' activities such as philanthropy.

Much of the argument about corporate social responsibility such as the pyramid described above is sensible and compelling, and it is equally interesting and useful to consider where our world of organisations is placed in this context. The brutal truth is that while many executives and their decisions are made to 'do no harm' and play by the rules/laws that apply, many exceptions occur, including in high profile strongly branded companies. Enron was a big one. Bernie Madoff was sentenced to 150 years jail for his US$60 billion Ponzi scheme activities. Alan Bond and Christopher Skase (and many others of lower profile) were indeed not always acting according to the laws of the land when they built their 'entrepreneurial' empires. More recently, Ferguson (2019) has pointed to the breadth and depth of unethical and illegal behaviour in our four large banks, and the Royal Commission into financial services found that problems, unethical actions and illegalities went well beyond the ANZ, CBA, NAB and Westpac. Ferguson's observation that the findings of this Royal Commission were shocking was literally true in that most members of society would never have imagined, and certainly not expected what is described in her book in chapters sub-titled as NAB's dirty secrets, CBA in damage control, Unmasking CBA's rogue planners, Money laundering with CBA, misleading advice, deception and revisiting the regulators. One could be forgiven, when reconciling the evidence of where the banking and financial services sector got to with concepts of Corporate Social Responsibility, from scratching one's head, almost in disbelief that this has occurred in this day and age. Interestingly, what happened in Australia's financial sector is not as extreme in its 'lack of CSR' as the events in the northern hemisphere that led to the 2008–2009 global financial crisis. However even since the 2019 Royal Commission report, and with much higher levels of regulatory compliance in action, even more unethical and illegal behaviour has surfaced in some of Australia's major banks, and fines approaching $1 billion are anticipated as we write. Even more salutary is the fact that we live and work in one of the least corrupt government and

business cultures in the world,[1] with the standards of legality and ethics that we wish to step up to not even under consideration in business cultures where corruption and corporate theft are endemic, systematic and accepted. And even in the role model countries that exhibit least corruption levels, no one is even close to perfect, as illustrated by recent scandals in Swiss and Danish banks, and in generally respected companies such as Apple, evidence and accusations of tax evasion, hidden offshore investments, and turning a blind eye to 'sweat-shop' and unsafe conditions in offshore suppliers have been alleged.

Most businesses have not yet achieved full maturity in measuring their social and environmental bottom lines, relative to how much effort goes into measuring their financials. This is understandable, given that CSR is a relatively new activity for companies, whereas profits have been sought by investors for hundreds and indeed thousands of years. Standard measures and metrics with benchmarks are being developed. Governments and standards associations have a role to play. Indeed, governments should be leading the charge and be most advanced and influencing the private sector, and they have not stepped up nearly as much as could be hoped. In Australia, with total government spending being over 35% of GDP, there is large scope for further public sector leadership, for example through advanced procurement practices and other policies.

From the instances described above of less than desirable behaviour, we acknowledge that no-one is consistently perfect, and we move forward to consider how progress can and has been made in a leading example: Toyota. Danny has had recent experience through close contact within Toyota in Australia that gave cause to re-examine the potential motivation for CSR activities, as follows. By way of background, Toyota is often admired for its innovation and leadership in greenhouse gas reductions, for example in its industry leading development of the hybrid synergy drive that began in the Prius and was then migrated throughout the Toyota products and its Lexus range. This was done well ahead of GM and Ford, who took business decisions 20 years ago to not develop such technologies, whereas Toyota was driven by a long-term vision.

More recently, Toyota was ready and able to persist with manufacturing Camry vehicles in Australia, and indeed had invested in new technology and equipment here for its advanced hybrid Camry, but when GM and

[1] Transparency International ranked Australia as 13th (least corrupt) out of 180 countries in 2018.

Ford announced local manufacturing shutdowns, then their local supply base would clearly not have the volume to remain viable, and Toyota announced its local manufacturing closure in February 2014, slated for late 2017. Toyota's global president who came to Australia to make this difficult announcement, a global first major closure for Toyota, told local executives that following the Toyota Way philosophy, this process in which 2800 people would lose their jobs, would be conducted in a 'most respectful way'. Toyota's primary explicit 'value' is 'Respect for People'.

In its 3½ years of preparing for the plant closure, Toyota created two very large initiatives for its employees who were to leave, and other initiatives for supporting suppliers. The employee initiatives were known as upskilling and reskilling. Upskilling was the training/development of employees who would be leaving at a higher level of skills than their current job level required. So, a team member who was an assembly line worker was encouraged to get skills in team supervision and leadership. These activities involved Toyota partnering with a local TAFE college and developing curriculum consistent with Toyota's 'lean' approach (which is world leading), with employees gaining formal certification of their qualification. Toyota paid costs. In addition, career counselling services were provided, with composing cv's, job search skills and many other activities offered to help with post-Toyota careers.

Just like the generous redundancies that were paid, and the monetary help given to some suppliers, these activities were well beyond what most other employers do, and well above what would be considered a reasonable industry standard approach.

The reskilling initiative was even further enlightened at Toyota: first, industries were identified that had good employment growth prospects, and this information was disseminated to the workforce. Then each employee was invited to express their preferences for their future. Growing industries included health care, age care, construction and logistics. Employees nominated their preferred future direction and a training/education path and career path was designed and implemented. One example was that over twenty Toyota manufacturing people nominated their preferred future in nursing. Toyota set up these as a distinct cohort into a formal nursing qualification. Over the 3 years, Toyota paid all fees. Further, in Danny's extensive interviews with 160 managers and shop floor employees, one engineer expressed a desire to undertake a specific Master's degree at University of Melbourne, which was coincidentally designed and run by Danny. Toyota paid the approximately $50,000 in fees and also sponsored

this person to do another smaller full-fee qualification. The reskilling support was offered to all 2800 ‘leavers’ of the company.

Impressive as such CSR activities are, the motivation was as surprising and impressive to independent outside observers as was the magnitude of the efforts involved in these initiatives. Danny asked many executives of the company what the justification for the large budget was, asking about what the return on investment of such funds would be, which was clearly a large invested amount. What did the ‘business case’ look like? Was it done in a desire for gaining a halo like reputation in the market, thus being seen as a ‘good’ company, leading to positive reputational impact and ultimately more vehicle sales? The answer was a strong and sincere ‘No’. It was done as a matter of the company’s values: ‘Respect for People’. The question about how Toyota would get a return on such investment was said by some to be the wrong question. A return on investment was not expected. This advanced approach seems to take CSR to another new level. What Professor Friedman would have said about this some 50 years ago, signifies how far some advanced companies such as Toyota have come.

Ultimately it is worth examining whether this enlightened approach to ‘respect for people’ does indeed have a net cost to shareholders. Does Toyota get discretionary work effort back from taking this high-respect approach? It appears that the answer, in terms of productivity and profitability, as measured by bottom line and share price, is a resounding yes! Toyota’s profit per vehicle, overall profit, market share growth, market capitalisation and productivity that underlies the financials, show superiority to all its rivals. Having begun making vehicles quite a few decades after GM and Ford, Toyota’s market capitalisation at time of writing is well over twice that of GM’s and Ford’s put together. Toyota’s vehicle quality, reliability, and durability are at or near the top of consumer and reviewer evaluations. Toyota is far from perfect in its performance, having had product recalls and other issues, but it does do CSR activities such as described above, well beyond industry standards, because of its core value system. And it pays.

Conclusion

In our fast-changing world of hyper-competition, leaders and managers are trying to satisfy a range of stakeholders, who can have competing priorities and are becoming more demanding. Many companies have done great things in the domain of CSR. It is generally advancing. When it

comes to integrity, that underpins executives' stance on their standard of ethics, our collective record is highly mixed. In our own economy in Australia, we have seen examples of the high road, such as in how Toyota closed its Melbourne plant, to the low road as exposed by the financial services royal commission. This material should be evidence for all business owners and managers to consider what will be your position when you either own or operate on behalf of others, assets, products, and when we employ people to create and sell products, and service our clients.

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CHAPTER 5

Leaders of the Future

Introduction: A Leadership Journey

In this chapter we note that leadership can be a daunting and challenging role and set of tasks, demanding a lot of individuals, but that it can also be very satisfying, when conducted well, because of the outcomes that it drives for individuals and organisations. While leadership roles are demanding on us, it is a natural progression for many to move towards and into partial or full leadership roles, and just like anything else, such work can be done to a great or to a lesser effect. To that end and purpose, we provide a total of twenty-one distinct advisory guidance elements for developing leaders to consider as elements of their journey and capability set. These range from analytic and technology oriented, to behavioural and people-oriented elements, all of which are necessary for a well-rounded leader to be able to affect. Herein we want to outline some high-level points of guidance for up-and-coming leaders of the future, based on our two life-times of learning about how to create value through effectiveness in organisational life. This chapter will cover and expand on some of the previous sections of this book, especially the leadership and strategy chapters, but also others. Our core question here is:

> *What skills, practices and attributes can a rising manager focus on in order to advance their own career, as part of creating value in their organisation?*

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D. Argus, D. Samson, *Strategic Leadership for Business Value Creation*,
https://doi.org/10.1007/978-981-15-9430-4_5

We provide our answer to this question for those rising up and building organisations, whether you are an owner or an employed executive. In both cases, the overall aim is to create value for the organisation and to maximally drive it forward in order to help it reach its goals to the highest level possible, whilst also progressing and growing yourself as a leader. This means organisational profitability but also can mean other goals depending on the context (see our earlier chapter on CSR). In the public sector it may mean advancing the public interest. It might also mean advancing the environmental and/or community outcomes of the organisation's actions.

This list and the descriptions below are not meant to be definitive, nor do we specify it as a 'must do' for future business leaders, but we offer it as guidance and food for thought, based on our combined experience.

Mentor and Be Mentored

No one ever knows everything, and so in keeping with our theme of pursuing continuous professional development and learning, we should always be looking to build a network of people from whom we can learn (a whole of life concept and journey), and mutually, seek out those who can benefit from our knowledge and experience. Mentoring can be beneficial and indeed mutual, and even for those of us who act as formal or informal mentors, we learn plenty from our mentees. Mentoring a more junior person can be a highly satisfying experience as we see them benefitting from our experience and it is a satisfying way of 'putting something back' into the system. Being mentored can be a really effective way to gain from others' wisdom, especially if the relationship can be one of trust and open conversations, about how to deal with the many complex nuances of organisational life, from politics to leadership tactics to business strategy.

The only cost of establishing a mentoring relationship is some time, and we find that the return on that time invested is usually very high. Just the act and experience of have a 'confidant' who is a safe person to speak about issues with, which are difficult to bring up with other colleagues, can be a part of how executives can become more mature. The direct and indirect learning is a bonus.

Develop the Leader Within You

In our earlier chapter on leadership, we described characteristics and axioms that are quite general, and being so, should be expected to generally work to advantage in getting the job done. However, leadership is an art,

and as so is never able to be perfected, but is to be applied differently as every leadership challenge is indeed unique from every previously experienced situation. Hence we can assert that the job of developing the leader within you is never finished. Indeed, even the most accomplished of leaders can be considered a fairly rough diamond, with some strengths and some areas that could and should be shored up further. If we self-assess against the characteristic axioms, we can clearly see that even the best—the most successful—leaders, have flaws in various of their aspects of leadership, or at least times where with the benefit of hindsight and experience, they would now have done it differently, meaning better. So, given that none of us is perfect as a leader, nor even close, continual development in the art of leadership is clearly part of what we all should be striving to do.

While we have done our best in the earlier leadership chapter to set out some clear leadership axioms, it is clear that much of what great leaders are and do cannot be formally codified and summarised, and this development of tacit leadership knowledge and capability is a lifelong journey.

Learn How to See Both the Big Picture and the Details

It is not good enough for leaders to be only able to stand back, or stand tall and manage the strategic—or big picture—issues, while ignoring the details. The details do not take care of themselves, and indeed, the saying that 'the devil is in the detail' often turns out to be true. Successful executives need to be across both the big picture—of course—and also the detail. For example, one small error of omission or fact that is wrong in a due diligence project can turn a value creating acquisition proposition, into a value loser. One missed or ineffectively conducted phone call to a key referee can make the difference between hiring the right person and making a big mistake. One error in a spreadsheet, that goes undetected until too late, as happened at a critical time in the NAB HomeSide business, can lead to large losses. Many thousands of details in the form of facts, figures, indeed considerations of all kinds, must be kept in perspective and in mind by general managers, who can make decisions and guide initiatives effectively using that knowledge.

Balance is required. It is also important to not get too bogged down in details such as to ignore the big strategic picture, of course. Setting vision and formulating effective strategies in pursuit of that vision is paramount. We have written quite extensively about strategy making in a previous chapter.

So, to summarise, there are two elements to doing executive leadership well in this regard, and we ignore either at our peril. First is strategically

'doing the right things' meaning choosing the right strategies and directions for asset allocation and focused business competitiveness. The alternative is unthinkable to an intelligent executive, meaning either setting ineffective direction or just bobbing along on the tide, without focus at all. Second of course is doing the things that are chosen as the focus for activity and progress, really well. That's where the implementation detail comes in. These statements are sometimes expressed succinctly as:

1. Do the right things
2. Do them well

These points connect to our comments in this book about project management effectiveness: choose the right project-based initiatives and implement them in a highly organised manner. For the moment, the key point is that executives cannot just focus on the big picture and expect the details to take care of themselves, nor can they avoid managing strategy and go back to their comfort zone of functional details. An example from Danny's consulting experiences was of a senior general management team in a major plastics and packaging business in which the relatively newly appointed senior team were not managing the big picture fully. They had all been promoted from functional roles into general manager roles and found it most comfortable to focus on their core area of expertise, namely their functional areas, which were finance, marketing or operations. As a result, there was 'under-management' across the top of the significant challenges that they were supposed to tackle.

Conversely, at NAB during the long period up to Don's departure, a leadership team was assembled that very strongly and fully managed strategic matters, which was a decade long strategic capability build that Danny assisted with and supported, and which disintegrated within a short time after the well documented departure of that senior leadership team, leading to significant shareholder value destruction. Control over many of the thousands of details (deals, transactions, loans etc) that goes on every day in a bank was essentially lost, capability was no longer applied in a consistent and disciplined manner, and a few major transactions went out of control. Although some blame was assigned in the media to poor strategy, such as acquisitions, the truth is that loss of control of the details of operational matters accounts for much of the losses that followed a period (1985–1998) of massive shareholder value creation, which rapidly turned into a period of significant shareholder losses (as documented earlier in

this book, Fig. 1.1). When control was diminished, the devil (that is always in the detail) came out to play. Powerful and painful lessons come from this particular piece of hindsight, and long-time NAB shareholders are still paying the price of the disasters of that making.

Never Stop Learning

Both Danny and Don have tried to keep gaining knowledge over their whole careers, and lives really, as part of life's journey and also to become more effective as professionals in the workplace. Categorising learning as coming from both formal sources, such as university degrees and programmes, and from the 'school of hard knocks' or experience: we would argue that both are important. There is some fundamental knowledge that the effective executive just must have such as in economics (micro- and macro-), financial statement analysis, marketing acumen, operational management matters, and perhaps above all else, effective human relations, leadership and strategic thinking ability. While this is certainly not an exhaustive list, it gives a sense of the core fields of knowledge required. This knowledge can be picked up informally of course, however it can be effectively and efficiently gained through education programmes. Don participated in the Harvard Advanced Management Program prior to becoming Group CEO at NAB, and there and then realised the importance of having mature strategic management processes and commenced work with Danny soon after. Danny studied both engineering and business management extensively at University. The core knowledge of these fields has proven invaluable to both of us, but there is always much more to know, and indeed in every field, knowledge is itself expanding fast, so just keeping up is a significant challenge, much less getting ahead in some measure.

Apart from some formal learning, for which it is never too late, there is the conversion of experience from work and life into knowledge, capability and hopefully wisdom that can be adapted and reapplied over the course of one's life. This involves reflecting on events, both successes and failures, and seeing all of these as learning opportunities. This type of learning can differentiate the executive who makes it a long way forward and up in their career, and those who may well have a couple of university degrees, such as a science or business degree and an MBA, who never make it far past middle management. We would argue that in the case of entrepreneurs and start-ups, similar is the case, in that the truly successful

entrepreneurs achieve much of their success based on their 'street smarts' as well as their core knowledge, while the unsuccessful folks rely more on 'book-knowledge basics'.

Become Globally Oriented

For those wanting to make their mark in or build large organisations, or even fairly large organisations, Australia and its markets can quickly become a quite small and limiting place. Such is the case for marketing and sales, with Australia having only about 0.3% of the world's population. Similarly, for capital raising, we have limitations in Australia, and it is also the case in terms of labour markets. However, just as labour markets are quickly globalising, in that many companies search internationally for the best people to fill executive and professional roles, so do many individuals as their careers develop, need to and want to work internationally.

For goods and services being marketed, since trade has become so relatively easy these days, with low costs of transport through containerisation, easy global communications (thanks to the internet), and funds flow, it is now a case of benchmarking your goods and services against the best in the world, not just locally.

Even for small companies, and especially for niche companies—meaning those whose services or products are specialised to small and narrow markets—the world can be your oyster if you have the knowledge and courage to go forward.

Australian businesses and our executives have made a lot of progress in this regard in the past 20 years. When Danny was a member of the Karpin/federal government task force into leadership and management in the mid-1990s, one key finding was our lack of global orientation and business acumen associated with working globally. Of course, there were exceptions, such as NAB successfully operating banks it had acquired in England, Scotland, Ireland, USA and New Zealand. For each of those who did try and succeed, there were many more who tried and failed, or who shrank back and stayed home.

By 2020, a new generation of Australian managers and executives have extensively travelled on business or holidays, understand cultural and business protocol differences, and many of our industries and supply chains have certainly internationalised. We are both exporting and importing a significant part of our GDP, from minerals and agricultural products mostly going out, to elaborately transformed manufactured goods mostly coming in. Trade in services has grown fast too, including education. In

all these directions and trade relationships, and with all the 'offshoring' going on, we are becoming more globally oriented, and it is a must for business and its executives today.

Even for small businesses, offshoring of some of its inputs must be considered today. And for most of these, why limit your consideration of market opportunities to Australia? If it is an information or professional service, then it can be moved around the world at low cost on the internet, and in all cases, we must remember that Australia's market is some 25 million people out of some 7 billion globally. We are poised to become nicely positioned as 'the' first world, English speaking country in the same time zone as the world's fastest growing region (Asia) too, for those who want to use such advantages. Australia's education sector is a leading example of a successful mover in this regard, with both schools and universities effectively having expanded their foreign income from students from the Asian region.

Never Compromise Your Integrity

This item of integrity was outlined in some detail in our leadership chapter, so here we just reiterate its importance. We emphasise the word 'never' in the heading above. Don remembers having to oust a very senior executive of long- standing and high regard and contribution from NAB because he did the wrong thing just once. Danny recalls having to work to remove an academic who similarly, after a decade of sound service, compromised on accepted standards of behaviour.

By being true to oneself first, then it is possible to be true to the high standards of integrity that we want to set for others.

These standards are not always easy to live up to, which is presumably why a significant number of managers do not always achieve them. Examples abound of illegal and unethical behaviour in the world of corporations and of corruption in governments too.

As an organisational leader, it is worth remembering just how closely staff watch for signals and symbols from senior people, whom they then role model. Integrity is so important because it provides a foundation for being able to strategically influence and contribute, and conversely becomes a severe limiter of that ability when integrity is compromised.

Build a Network for the Long Term

A lot of know-how is in 'who' you know as much as what you know. Building a network of people that you can call on to ask for advice, to ask

for introductions to others, to ask for a host of things which are many and various, and who you should expect to call on you for similar things, is a key part of modern executive life. Many people get important information through their network, as much or more than through more official market signals.

By knowing the opinion leaders in your industry and beyond, you can extend your sphere of influence beyond what it would otherwise be.

The aim of building a network as a natural part of what we humans do is to participate in all respects, meaning to give as much as to take information from it.

The network can provide support, and sometimes even your next job opportunity can start because of who you know as much as what you can do.

It can and will lead to friendships if you want it to, and certainly to valuable professional relationships.

Know Your Customers, Competitors and Marketplace

No matter how senior an executive is, keeping a finger on marketplace trends is critically important. This means knowing what customers value and want and also what they do not want. It means knowing what the leading edge of marketplace offerings are moving towards. It means knowing what your competitors are up to, in terms of their strategies, their attempts to create competitive advantage, their strengths and weaknesses, and even what their customers think and say about them, as well as about your business and products/services.

There are many pertinent questions we must be able to answer, including:

- *What will be the driving trends in the marketplace in 3 months, 12 months and 5 years?*
- *Who is competing on innovation in your markets?*
- *What are the new technologies impacting on our industry?*
- *What are the key market segments in your marketplace and industry?*
- *What are the key drivers in the markets overseas that impact my industry?*
- *What do my existing customers say about our services, strengths and weaknesses?*
- *What do our competitors say about us?*
- *What do the customers of our competitors say about their services, and ours?*

- *What would it take to get some customers to switch to us?*
- *Is our next generation of products/services going to be competitive with those of our competitors?*
- *How do our price points compare with our competitor's and is there room for profitable adjustments?*
- *How do our costs compare with competitors and how can we improve?*
- *How does our customer satisfaction level compare with the industry and our market segment average?*
- *What driving risk factors are coming to light in our industry?*

This detailed knowledge of the industry, market and consumer choice dynamics is a key part of how effective executives can make better decisions and get their firms and themselves ahead.

Danny and Don have seen that successful executives in industries as diverse as mining, insurance, telecommunications, building and construction, banking and manufacturing of cars, tires, logistics, oil and gas, and many more, make it their business to know a great deal about competitors, and customers. This 'finger on the pulse' of all the elements that determine competitive advantage is a must.

Develop a High-accountability Organisation

One of the core elements of any organisation's achievements and success is that people at all levels are taking on a high personal level of accountability for their actions. For executives who are running strategic business units, this means having profit/loss measures and accountability for meeting stretch targets, being directly sheeted home to them. Right down to the shop floor, it means every employee having a set of objectives that they work to and strive to achieve. This ideally applies to all three bottom lines as outlined in our CSR chapter above.

This is clearly a 'must have' for success born of high performing people throughout the organisation. The opposite is unthinkable and of course unacceptable, namely people in an organisation being able to get away with poor performance, not being held accountable for their actions and outcomes.

This begs the question of course, how is the high-accountability organisation achieved as such? The answer is like so many things, that the standard must be set at the top of the organisation. Effective executives lead from the front on this, role-modelling such behaviours and publishing

their performance reports. This measurement, accountability and transparency can be catchy as a part of a strong performance-oriented culture and it can then be expected to take hold throughout the organisation. The BHP board holds the CEO accountable, and he in turn holds the business segment leaders accountable, who hold the business unit leaders accountable, and down the line it cascades! Importantly this applies to those managing operating businesses and also just as much to project leaders and line managers. The cascading accountability is a core element of success at BHP, and when it is at its best, it cascades right throughout the business, with no exception.

Always Apply the Common-Sense Test

Despite the best analytical power that money can buy, sound executive leadership involves subjecting all deals, whether they be major banking arrangements, new mining initiatives, acquisitions or other strategic moves, to the common-sense test. Yes, the numbers do indeed tell the story, and we much like the use of a variety of analytical procedures, ranging from Du Pont charts to risk analysis via sophisticated simulations, for the insights they provide, but common sense should always prevail and be applied over and above these models.

Inexperienced executives and sharp young analysts can do sophisticated analysis, and these should be considered as an important input to a decision process, but not the whole decision process. The reason is that all modelling processes, even on the most carefully done and detailed spreadsheets or risk analyses, make a number of assumptions, and one needs to stand back from the analysis and look holistically at the decision and the opportunity using common sense, including the analysis and its 'recommendations' in that light.

A second reason is that research has shown that spreadsheets and other models contain errors, more often that most of us would suppose. The problems at HomeSide in the early 2000s were substantially due to a spread-sheeting error that was not checked nor subjected to the common-sense test, which led to catastrophic decisions. So in summary, mature leaders apply the common-sense test, question the assumptions going into models, and do not fall prey to the illusion of assuming false precision of answers coming from such models. We should all remember that when it comes to models, 'Garbage in, garbage out' still applies, and so does 'Good stuff in, good stuff out', so we should guide such modelling

processes carefully, and not blindly accept their answers. A good example is calculating firm valuations when examining potential acquisitions. Many assumptions about both revenue streams and costs must be made and sensitivity analysis at least, or perhaps comprehensive risk analysis approaches are called for, just to underpin the common sense that we should all sharpen up and apply. The analysis should only ever support the common sense, and never replace it.

Know Social Media and Technology

Recent developments have brought people closer together than ever on a global basis through wonderful new technologies and their capabilities. Whole industries that have existed for many decades with relatively little change, have recently dramatically changed. These fast evolutions and in some cases revolutions are not over, but are continuing apace. Keeping in touch with customers, advertising, and indeed knowing what community values and requirements are has been moved from old media such as print newspapers and TV to online and social media channels and streaming. Services such as stockbroking, travel arranging, distribution of news, music, indeed entertainment of all kinds, retail banking, education, product retailing and many others are undergoing massive changes. Improvements in information technology have led to large changes in the speed at which business proceeds and in transparency of procurement and supply. Customers have been informed and empowered like never before. Some wise advice we have been given and applied is to not be defensive about the old methods and channels to the customer that worked traditionally but rather to try and get out in front of the new curve. Mobile phone banking is an example where one just must not get left behind, and indeed there are major advantages to achieving a first mover position, if the service design is right.

A pertinent question for general managers is whether they can responsibly leave these matters to lower level marketing and distribution or product managers, or be at least somewhat hands on in formulating their strategies for development and use of new technologies and social media. We assert that these are matters of strategy, and as such must be taken in the broader context of the business unit's overall direction, mission, etc., hence must be part of what senior leaders consider in designing the big picture going forward. The corollary is that senior executives cannot be ignorant of these trends and the massive changes we are seeing in

consumer markets, as to how people want their products and services designed and delivered. In business-to-business relationships as well, new technologies are having pervasive effects on service levels, productivity and choices of supplier partners. Astute executives have captured major new opportunities for cost reduction too.

Be a Team Player

A 'team' differs from a mere 'group' of people, principally because a team of people has shared goals. So being a team player means driving the alignment of colleagues around you so as to achieve those shared goals. This requires some quite sophisticated skills, of negotiation and influencing others, and perhaps compromising on your own natural instincts and behaviours to 'just do it' in order to achieve team spirit, cohesiveness and effective actions. When a group of people, in this instance business executives, behaves as a fully cohesive team, then a great deal of power and achievement can occur, for all the right reasons in taking the organisation forward. Contributing to or facilitating, or leading and creating such a team, in order to achieve those outcomes, is a core success factor for executives.

The power of a fully aligned team can be illustrated through comparison with the dysfunctionality that occurs when a group of executives does not share goals. When a group of executives are pursuing poorly aligned goals, they will tend to pull the organisation apart. Consider a group of executives running a business unit who have functional leadership roles, such as marketing, operations, IT, finance, sales, risk management, HR, and other functions such as product development. If they each try to maximise the outcomes and achievements of their individual functions, there will likely be lots of value left on the table and lots of problems, relative to a coordinated team approach, in the pursuit of a united overall purpose and shared strategic goals. A classic example is where marketing and salespeople chase and accept orders, which are difficult and expensive for operations to fill, which happens all too commonly in organisations of all sizes and shapes. This is not good teamwork! It is sub-optimisation, separately working between functions, and will certainly not lead to optimal profit outcomes.

To produce a team of executives or managers, working effectively together, leaders make sure that it is in people's interests to do so, through aligning the structure of their goals, lifting their goals at least partly to be

high level shared goals, and fostering real teamwork and cooperation. Just as in team sports, teams of executives usually outperform people who are individually high performers, acting separately.

These ideas, basically about the power of teams, applies all the way from the most senior executives to the shop floor. At NAB the senior group executive team often had disagreements, but debated and argued these differences until they were resolved, then implemented as a team! At Toyota, ideas do not move into implementation mode while they are considered as having come from or belong to a single person, and they go around and around until consensus is achieved and they become 'Toyota ideas', approved for implementation by the nominated project team. We will comment on project teams further in the next section, but for now we simply point to the power of teams in general, and therefore to the importance for future leaders to be team players and not individualists. Unless the individualist is a particularly brilliant person, such as Einstein was, then the benefits from team behaviours will very likely be productive for all concerned.

Lead Both Processes and Projects

Processes (see the discussion in Chap. 3, Appendix) involve turning inputs into outputs, and we usually aim to establish standard operating procedures in order to keep process standards under control and the outputs consistent and predictable. The idea is to achieve stability, which is the cornerstone of the famous Toyota production system. This stability can be harnessed and then adjusted in a controlled manner (often called continuous process improvement, or 'Kaizen') to continue to drive improvements in efficiency and service levels. Approaches such as quality circles can harness problem solving techniques and staff knowledge to drive for improvement of stable processes, and ensure they are able to consistently drive to capably satisfy customer requirements. Processes are generally ongoing, and managers strive to keep things steady in these 'Business As Usual' parts of the organisation.

Projects are fundamentally different to ongoing work processes, in that they are specific, and aim to do the opposite to the steadiness of ongoing processes, which is to accomplish changes to some aspect the state of the organisation. Consider IT projects whether large or small, that all businesses do: the aim is that after the project, the IT systems will be advanced from the state they were in before. The same applies to product

development projects, reorganisation projects, acquisition projects, building development projects, capital expenditure projects, and indeed, all projects. Projects have aims stated as outcomes, cost budgets and timelines for completion. They aim to change the state of the organisation, then finish as projects, leaving an improved footprint behind them. Whereas processes aim for stability, projects are all about changing something.

We suggest that to be a successful executive, understanding and capability is required to clearly differentiate between the pursuit of process efficiency and service levels and the improvement of these, and project work. The two types of work require different skills and different leadership styles. An example of a mature leader who clearly saw these differences was Steven Jobs of Apple: in the 1980s he recognised that his core skill was in leading product development teams and projects, which was and is different to running organisational production, and sales processes, so he brought in to the company a seasoned executive who had been a leader at a mature company, Pepsi Cola, essentially to run Apple's processes, while he, Jobs, remained in a project leading role.

We argue that a well-rounded executive should be capable of running both processes within organisations, often known as line management, and also should be capable at project management. The organisation must be able to do both well, so leaders should be experienced and capable of both.

Always Keep Your Feet on the Ground: Remain Humble

Even if one is primarily responsible for some admirable achievements, it is always more effective to remain humble and never 'big-note' oneself, than to take a lot of credit for an organisation's achievements. Very few people are attracted towards and want to follow self-important leaders or work with arrogant managers. It takes little effort, and perhaps just a little emotional maturity to make sure that credit is shared amongst a whole group of people working in an organisation. And it pays back handsomely in the motivation that results. It is also usually just a matter of truth that behind every successful leader, there actually is a fine team of staff, so recognising and crediting those staff is just being human. We have observed that when even a hint of arrogance sets in to leaders/managers, soon after there is an aloofness and a loss of connectedness with those rank and file staff who do the work! Then shortly after that it is 'game over' in terms of

organisational effectiveness. Humility is an endearing quality as long as it is sincere and not overdone, and arrogance is usually seen by most staff as 'ugly', and hence demotivating.

Be Sincere: Tell the Truth

When the facts of a situation are pleasant, 'rosy' and things are going well, then it is easy to have honest conversations in an organisation, about the positive outcomes and even the improvement opportunities. Good leaders are differentiated from the rest of the pack by what they do in times of difficulty or underperformance. Let us consider what actions constitute best practice when either individuals or part of an organisation is underperforming: it is very clear that effective managers/leaders do not undermanage their underperforming staff or business units. They fully manage them, by firstly putting the facts—the evidence—on the table and frankly discussing how problems can be solved, efforts raised and skills developed, and performance lifted. It can be surprising at first to see that not only will most people respond positively to such a performance management framework, but also that higher performing staff will appreciate that underperformers are not able to continue as such. The rising tide usually lifts all boats in this regard. To undermanage underperformance reflects badly on all those who are putting in a high level of discretionary work effort, and is, at least indirectly, disrespectful of them. This ideal of fully managing performance and telling the whole truth applies from the top floor to the shop floor in great organisations.

The 'tell the whole truth' principle, even though it is sometimes easier to not do so in the short term, also applies to shareholders, customers and indeed, all stakeholders. If a delivery or service is going to be late to a customer, it is not good leadership to ignore it, then cheat or lie about why it happened, or hope the problem will go away. Best practice involves being open with those customers, and accepting responsibility, then moving forward with integrity intact, even if there were some costs and some 'bruising' occurred as a result of those delivery or service problems.

Know the Numbers: and the 'Competitive Advantage' That Drives Them

By 'the numbers' we mean the performance metrics. This means everything from the highest level of strategic performance measures, such as

return on assets and on investment, revenue, profitability, and also the operating metrics such as service levels, delivery performance, and client satisfaction, community engagement and environmental performance. It also includes important internal metrics such as employee satisfaction, quality levels and costs. There is a lot of information in all this: it is not just the measures, but it is the trends (which measures are improving/deteriorating over time?) and comparison benchmarks with and beyond industry norms (how are we doing relative to competitors and best practices?). The management theorists and gurus such as Drucker and Deming were undoubtedly right when they stressed the notion of management by fact, more recently re-expressed and extended as 'evidence based' management and decision making. Facts are powerful. It is also very good practice to measure, take action or set strategies then re-measure and reflect on what worked, what didn't work, and why. All this requires managers to know the numbers.

However, it is not enough to just know the numbers: sound leadership includes having a detailed understanding of the drivers of those performance metrics, both the operating and business metrics. What actions drive profitability, and how does this play out in both the short and long term? Which client types are profitable, and which are unprofitable? Which products and services are profitable and which are unprofitable? Which divisions have high and which have low employee engagement, why is it so and what should be done about it? These are but a few examples of questions that astute executives work at, developing answers and implementing improvements on. At its core, knowing the metrics and their drivers reflects the ability to do cause and effect' analysis, which is a form of organisational intelligence that is a key ingredient of leadership effectiveness.

It has been popular in recent years for executives to set up 'performance dashboards' comprising key metrics, and beyond that to attempt to derive and validate those cause and effect relationships.

Help Others to Succeed

The very best way for any leader to succeed as defined by the performance of their organisation, is to work to make their staff successful. This also applies to people at higher levels of authority than each of us too, and our peers. A critical task, which we have stated elsewhere in this book, is to

lead people such as to 'provide them with the circumstances and resources that will allow them to excel!'

Which of the following would be a better use of an executive's time: working hard for 10 hours to create more personal output of say 20% for the week, or allocating those ten hours to fix problems for say 100 staff and increase their effective productivity by 5% each? This is an arguable proposition, and we must all find a balance between doing and leading, but there is no doubt that helping others to succeed is one of the key contributions of effective executives. This means realising and acting on the idea that it is not only all about 'me' and my productivity directly, but more about my ability to influence 'us', that is critical.

Deliver!

Leading 'from the front' is critical. People watch their bosses carefully, so the standards and attitudes set by executives will be modelled throughout the organisation. Therefore, if we want our staff to deliver their products and services with good levels of timeliness, service, quality and efficiency, we must lead and conduct our tasks in exactly that manner. Indeed, looking at it the other way, only when we deliver with high levels of effectiveness on our commitments, can we reasonably and sincerely ask staff to do so. To do otherwise would be hypocritical and will not be sustainable in high performing organisations.

So, if it is decided at a meeting that various people will conduct certain actions afterwards, great leaders only accept those tasks that they can and will deliver on, and the culture can and should be that everyone understands that a commitment to act is 'real' and not loose or illusory.

Deeply Understand Both Risk and Return

With all strategies, there is the promise of success and of returns on investment, or effectiveness outcomes, however it is also the case that in most circumstances, higher levels of return come with higher levels of risk. It is only rarely the case that if something looks 'too good to be true', that there is not a significant riskiness about the 'good' outcome. In even reasonably efficient markets, returns come with risk in approximate proportion to each other. So, the astute executive knows about risk, can almost 'smell it' intuitively, and where the investment or initiative being considered is significant will conduct a quite formal risk assessment exercise to

ensure that it is well understood and recognised. Even in the 1980s, National Australia Bank was running all significant transactions through its credit bureau, where riskiness was explicitly assessed, which helped it to not fall prey to the disasters that befell most of the other large and small Australian based banks. Acquisition targets were valued through a sophisticated risk analysis framework. Risk analysis was conducted on the group balance sheet. Elsewhere in this book we address how and why some of these practices and the group's risk management itself fell over after 2000. This point about risk management is easy to underplay: there is more uncertainty to contend with in our world of work than perhaps ever before. For those who went into the Christmas 2019 break with a 2020 business plan and strategy mapped out in detail, how many anticipated the cataclysm that has occurred in the early months of 2020? Such 'un-knowables' call for solid contingency planning and flexibility of analysis and strategy.

So, in summary, executives need to have their intuitive 'risk tentacles' always up and active, and be able to back that intuition with sound analytical thinking.

Strive to Achieve Work-Life Balance

For many of us, the demands upon us and hours required to do our jobs well seems to be increasing and not the other way around, despite all the gadgets, app's and productivity tools we can acquire. In respect of work life balance, we reflect on the many decades of long hours we have collectively put in and would say that without a family and home context in our lives, the work achievements would be very much less meaningful and satisfying. There are some sacrifices that come with demanding professional roles. We have both been travelling for work hence away from home and missed being present for children's birthdays for example. Having noted those personal and family sacrifices, we wouldn't do it any differently with the wisdom of hindsight, because there are many ways to flexibly make up for such things. Perhaps most important is to act, no matter how important the work issue or even crisis, so that 'you' are in control of the workload, and not the other way around. Occasionally the workload will seem like an infinite mountain, but this must not become a permanent or even too frequent an occurrence. So how can a big responsible job be conducted effectively and successfully with a fulfilled family and personal life? We can only give from our experience, which is to never waste time, indeed plan and manage it well, become good at delegating and 'don't sweat the small stuff'.

We have met many successful people who measure that success in only professional or work accomplishment terms, and we often meet such professional successes whose personal life is unsuccessful, meaning unfulfilled at best, or disastrous at worst. Perhaps they got things out of balance just a little too much. We summarise with two points that many readers might have heard before, but they are clearly pertinent: first, nobody on their deathbed said 'I wish I had spent more time at the office!' Second, we ask the rhetorical question, of: 'What is the point of getting ahead at work if it entails leaving your family and friends behind?'

Never Forget the Shareholder

When making decisions, allocating resources, serving customers, recruiting staff, and everything else, we should never get disconnected with the idea of creating outcomes, as expressed in our corporate goals statements, and perhaps the mission and vision statements, about providing a return to those who invested, set up the organisation, and sustain it: the shareholder. While there are many stakeholders who have a claim on the organisation and its outcomes, the shareholder is often not there every day, and we ought as managers and executives to work to remember whose money we are allocating, and whose risk and return our decisions will impact upon. For those in listed companies, there is also a case in point that the company is of course a legal entity in itself, and shareholders can come and go through simply buying and selling shares, but even so, the point about who ultimately bears the risk and return remains.

In the case of small and particularly family or closely held businesses, where the managers and executives, and the owners are often the very same people, we see little disconnect between ownership and decision outcomes. In larger corporations, we have mechanisms such as AGMs (Annual General Meetings) as touch points between boards and owners, but that leaves a lot of room for middle and senior managers to wriggle and lose alignment with shareholder preferences, of course. Best practice in this regard means not losing touch with those preferences, even when the shareholder is not represented directly in the room!

In Conclusion: Consider the Costs and Benefits

When one considers the quite long list of elements above that we propose to be important ingredients to developing executives, it is useful to consider the benefits and costs of 'stepping up' to these characteristics and

trying to live them at high levels. First we point to the costs: they are indeed not trivial. There is much weight on the shoulder of leaders in both corporate or public life, whether it be large or small businesses. The fate of many people rests on the success or failure of leaders' strategies and tactics. When leaders fail and their organisations decline, many people lose their jobs, and suppliers might lose their key customers (hence shedding more jobs). Notable examples are Pacific Dunlop and HIH in Australia, and Enron in the USA followed by a series of major corporate collapses during the 2009–11 financial crisis.

The ideals listed in this chapter can be individually demanding and also require some delicate balances in aggregate, plus a good deal of selfless effort. Senior executives must make themselves transparently open to scrutiny of their efforts and achievements, and they will have critics, no matter how well they and their organisations perform. The late Steven Jobs, who created tremendous amounts of shareholder value and led his organisation to produce services and products that the world admires and most customers strongly like, has been criticised for being too hands on and tough in his uncompromising style, and a poor delegator. In our view his tremendous ability to keep personal tabs on product development details and to coordinate those details was a key strength, and we speculate that if he had not had his hands so firmly on the wheel, the products, corporate and retail strategies might not have been so successful. In both the sustained periods in Apple's history when he was at the helm the company thrived, and in the intervening period when he was not, the company faltered.

In summary, the costs of becoming a senior executive leader in an organisation are that one must dedicate a great deal of one's effort and life to that role. From public life, we cite the oft shown before and after pictures of US presidents, who seem to age considerably from that very demanding job. To a lesser extent, because the scope and scale is of course much lower, consider the responsibility of a CEO in a medium sized family company: the same demands are generally in place, although at a lesser level and with less public scrutiny. We assert that the points made above in this chapter can be adapted and generally applied at any of these levels of leadership in terms of the requirements, success factors and demands on executives.

So, then what of the benefits? Given that many people aspire to increasingly senior roles, which do indeed involve more and broader responsibilities, what benefits and returns on effort can be expected? The obvious

return is in remuneration, and labour markets, just like all markets exist in segments such that supply and demand for senior executives meet at higher levels of pay and benefits than at lower levels. Senior executives have bigger, more demanding roles than middle managers or shop floor staff, and they get paid to reflect that and their performance. We have dealt with that issue earlier in this book.

However, there is much more on the rewards side to effectively leading an organisation or part of it than the remuneration. The psychological rewards can be tremendous. The joy of winning can be substantial, whether it is from business growth, or seeing and helping people inside one's organisation develop and themselves become successful or seeing one's leading or innovative products and services provide value to customers or other stakeholders.

The emotional satisfaction of contributing to the development and success of a modern organisation also can be exhilarating in its own right. The modern organisation, especially companies, are not a natural phenomenon, but exist as an artefact in capital markets, requiring simultaneous success in those capital markets, as well as in labour markets, and in the chosen markets for goods and services. Success requires a state of organisation in which the natural forces of entropy, which lead to 'disorderliness', can be consistently overcome, by process disciplines, policies and strategies, which many people have to stick at. Just 200 years ago which is a small part of human history, large organisations were not possible except in governments and the military, because markets were immature and fragmented, and mechanisms and processes for disciplines and orderliness did not exist. We can now build large business organisations, as well as those in other sectors, which sustainably implement policies, values, culture, and alignment to these: and in the best of such cases, businesses such as Toyota and BHP can make them succeed over many decades.

The sense of achievement and joy of such 'institution building' can be very satisfying, and for many of us, more than compensates for the costs and efforts.

Now we would like to raise the bar and assert that the really excellent executive can not only relate to what is said above on a personal level, but can importantly spread these costs and benefits to sustainably give the organisation a life beyond the talents of a single executive, leader or even executive team. This means folding a number of people into the organisation's vision and developing them to fully participate in the benefits, costs, and indeed the qualities described above in this chapter. Toyota has

seemingly achieved solid maturity in this regard but NAB faltered seriously when the leadership team left in 1999–2000, and proved to not be sustainable as a market and shareholder value creation leader. During NAB's 15+ years at the top of the game, deep people development occurred, strong alignment to values, culture and strategies was achieved, but it turned out to be fragile enough to be reversible 'under new management'. This is not to underplay the terrific achievements of the 15+ years of market success. Many of the people who were developed into fine managers and executives during that period have gone on to do fine things since, but they did it elsewhere, once the NAB fell into disarray. Ultimately they lost the fight of control and were overcome by entropy (disorderliness). Had a more mature organisation been built at this level (requiring a stronger and more cohesive board and better succession planning), the executive team would not have dissolved and success could have been sustained.

In those organisations that do achieve this higher level of 'quality' such as Toyota, then the characteristics described in this chapter apply not just to senior managers, but are taken on in an adapted form by people throughout the organisation. Toyota staff who assemble vehicles, design, market and sell, administer, procure, train—indeed all their staff across the world—are given the opportunity and strong encouragements to develop and apply strong Toyota values and culture, process disciplines in particular, all of which are encompassed in 'The Toyota Way' of working. Leadership transitions in Toyota are generally quite smooth, and although there is of course politics inside that organisation, it is not so disruptive so as to cause the dysfunction that other organisations experience.

In summary, the work of the developing executive is first and foremost to learn and exhibit the characteristics listed and described in this book, in order to create value and 'institution build', but importantly beyond that to create a team of like-minded people who will collectively do similar, such as was achieved at NAB during 1985–1999. This participation can go deep into the organisation, with staff at all levels taking them on in adapted from, appropriate to their work context. And ultimately, it can become so deeply entrenched, whether it is a large corporation or a family company, that it becomes inter-generational. Such longevity is something to aspire to!

PART II

Introduction to the Case Studies

Virtually all leaders believe that to stay competitive, their enterprises must learn and improve every day. Even companies revered for their dedication to continuous learning find it difficult to deliver on this objective.

Most textbooks on leadership concentrate on individuals and yet organisations can lose momentum because individual leaders impose their own will and biases on an organisation.

Leaders across the organisations that are covered in these case studies would all acknowledge that some of their learning comes from failure, but their actions had all the characteristics of a preoccupation with success. This focus is not surprising, but if excessive it can impede learning as we witness in some of the cases outlined.

In developing the case studies, we dealt with massive changes in economics, bureaucracies, industries, finance and social expectations.

The 'better, cheaper, faster' world in which we now live, has delivered companies and institutions that are strong, lean and efficient. Yet under the surface of short-term profits, companies have become more emotionally volatile and vulnerable; mistrust and cynicism are at an all-time high as tensions simmer between leaders and followers.

In today's knowledge economy people are the 'intellectual assets' that make things happen; the cost of mismanaging them can be a disaster.

Our case studies have revealed a company like NAB who for a time suffered an attribution bias. It is common for leaders of people to ascribe their success to hard work, brilliance and skill rather than luck. The attribution bias research highlighted that unless people recognise that

failure resulted from their own actions they do not learn from their mistakes.

The HomeSide purchase undertaken in 1998 and subsequent legacy attribution, without fully detailing the nature of the circumstances leading to the loss of value, is a classic example. The economics behind some of the M&A activity which did not deliver the required return on the investment made, the disastrous attempt to take over AMP, the foreign exchange losses and the toxic atmosphere reported in the Trading Room activities (similar to the circumstance reported by the ANZ as we prepared this manuscript), the investment in CDOs (collateral debt obligations) and the venture into the property market in SE England are just a few examples of where in each circumstance there was an alternative solution, but few people were able to identify the correct solution to create value, and sustain a high performance organisation.

To add to this misery the NAB lost a generation of skills through forced retirements. During the 1980 and 1990s NAB employees were encouraged to develop a growth mindset, which provided opportunities for self-improvement and a willingness to embrace challenges and confront obstacles. We were all encouraged to be part of a high-performance organisation.

The organisation was values-based and vision-driven internally. The people were the leading indicators of success. How they were led, and the environment created, was seen to be the determination of business success in the long term. Our goals were quite clear in that we strengthened the organisation's capability, increased the competence, commitment and creativity of the people. It required a top down, bottom up strategy. It required managing costs and developing assets at the same time. There was also a strong focus in developing our principles which were reflected and reinforced in the policies, practices and systems of the organisation.

Alas these simple objectives which had been the cornerstone of success for two decades were lost as was the momentum of a once great organisation.

Leading people is hard work. It is full of tensions and trade-offs, celebrations and disappointments. There are some rich stories and interesting analyses reported in the cases presented.

Readers will have noted about Toyota, where 'continuous improvement' was one of the pillars of its famed business philosophy. Toyota's other pillar is 'respect for people'. After serious problems in late 2009 which led Toyota to recall more than nine million vehicles worldwide, its

leaders confessed that their quest to become the world's largest automobile producer had compromised their devotion to learning.

Some research out in the USA suggests that biases cause people to focus too much on success, take actions too quickly, try too hard to fit in, and depend too much on so-called experts.

These biases can manifest themselves to conditions that impede learning. These include fear of failure, insufficient reflection, believing that one needs to confirm and inadequate frontline involvement which leads to lack of transparency.

BHP experienced these conditions in the mid-1990s where a pre-occupation with success and this once great company deteriorated to a stage where it should have been taken over in 1997 and continued to stumble from one debilitating decision to another until installation of a new CEO and Chairman of the Board was completed. Paul Anderson who figures prominently as a standout CEO in this book, transformed the company from the inside out. He re-asserted a set of values and beliefs for the organisation. His operating style was all about building relationships with others that reflected the values. His philosophy of creating a work environment of strategies, systems and practices that grow naturally with transparency, gave the people who he led a sense of ownership in their work, a broader understanding of the business objectives. The company was again developing a growth mindset.

> The creation of BHP Billiton and departure of Paul Anderson brought complexity associated with the DLC and an external analysis that the Company was developing a mindset that departed from the stated strategy. It was observed that the leadership team seemed confused about the objectives.

By contrast the employees who have a growth mindset seek challenges and learning opportunities. They had a belief that no matter how good they were, they could always get better through effort and practise.

> Fortunately BHP did not endure the confused messages for too long and reverted back to a growth mindset under Chip Goodyear who introduced the risk management model. Marius Kloppers later succeeded Chip and preserved the transparency which had been introduced by Chip, with extraordinary outcomes produced through the cycle.

CHAPTER 6

NAB (A): Banking and Financial Services, 1960–2020

Banking Deregulation

The changes in strategy, leadership approach, governance, services, technologies and almost every other aspect of business life make the banking/financial services industry a most interesting one to examine with the wisdom of hindsight. Lessons can be effectively learned in all these realms from past successes and mistakes in this sector. The recent Royal Commission and scandals such as the alleged 23 million breaches at Westpac reported in late 2019 make leadership, governance and strategy in the financial sector a very much live issue, with very many challenges to overcome. Whilst the 1960s may seem a remote starting point to begin the story of a lifetime of learning, the period provides a good model of what was a stable, regulated and controlled industry, that is very different today. 1960s and 1970s was the era of what was called the traditional financial system. The system distinguished the financial intermediation sector, comprising those institutions whose core functions involved borrowing and lending, and the managed fund sector, comprising mainly life insurance and superannuation type funds along with investment vehicles like unit trusts. One could conclude at the time that this was a natural distinction and that competition within each of the two sectors was generally more important than competition across sectors. The banking sector accounted for around 85% of the total assets, pastoral financiers had about 4% of the assets and the balance was made up from building societies and finance companies.

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D. Argus, D. Samson, *Strategic Leadership for Business Value Creation*,
https://doi.org/10.1007/978-981-15-9430-4_6

Deposits were raised mainly from low cost sources with non-interest-bearing cheque accounts and low interest savings bank deposits together funding around 85% of a bank balance sheet. Fixed interest deposits and equity funds represented most of the remainder. On the asset side of the bank balance sheet almost half was invested in government securities or held in Statutory Reserve Deposits (SRDs) and about 40% accounted for by loans. Interest rate controls were in place, bank loans were rationed and available only to the most credit worthy borrowers. Banks faced little competitive pressure from other institutions, which had not begun their rapid development and the Australian system was not open to foreign bank entry or to offshore transactions. Banking business was essentially a low risk proposition conducted at regulated prices.

The other main part of the system was the managed fund sector which in terms of assets was around one-third the size of the banks. This comprised principally life offices and superannuation funds which offered very different services from banks in the form of long term, high tax favoured savings plans. Some life offices helped satisfy the demand for mortgages not covered by banks (Fig. 6.1).

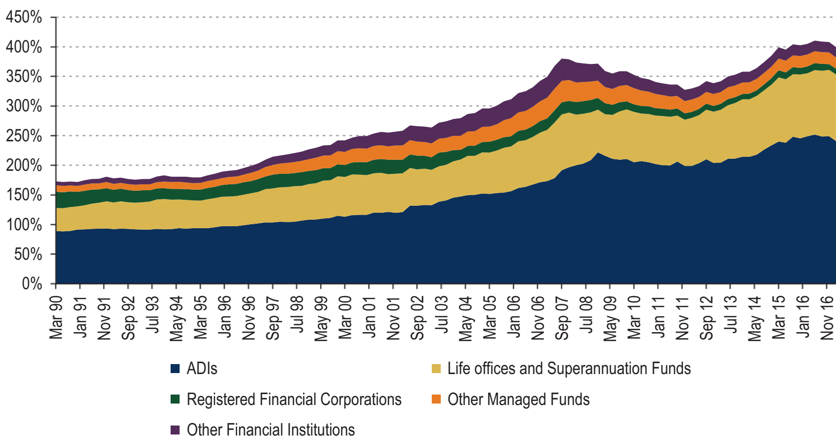

Fig. 6.1 Assets of financial institutions (Per cent of GDP)

Change Was in the Air: Non-banks and Superannuation

Banks went through an extended period of declining market share during the 1960s and 1970s, when corresponding gains were made by non-bank financial intermediaries, particularly building societies, finance companies, merchant banks and, later, unit trusts (trends that will be elaborated further on). This trend reflected the competitive disadvantage that financial regulations placed on banks. In particular, interest rate controls tended to keep the entire structure of bank rates below market-clearing levels, with a consequent rationing of bank funds and the emergence of a ready market for funding at higher rates. To some extent, the banks became involved in this market by creating new non-bank subsidiaries to conduct this business 'outside' the bank itself and, therefore, outside regulatory constraints. But there was also a substantial growth of non-bank financial institutions (NBFIs) not affiliated to the domestic banking sector. In a number of cases, these institutions were owned by foreign banks that sought a financial presence in Australia but were precluded from establishing a formal banking operation by the effective moratorium on new foreign banking authorities before 1985. In other cases, non-bank institutions were joint ventures between domestic and foreign banks.

Subsequently, the impact of compulsory superannuation on the national savings regime, introduced in 1988, has been having quite an influence on the wealth accumulation of Australian taxpayers.

Australians entrust almost $1.5 trillion pa of their retirement savings to the superannuation industry. It is critical that their hard-earned money is properly invested and protected to give them the secure retirement they expect. Prudent management of superannuation funds is now central to the thinking of every taxpayer since the cost of any shortfall is paid from the public purse through the aged pension.

In July 2017, the Government announced legislation to improve the governance of superannuation funds by giving fund members greater transparency into the way their savings are managed. Under the legislation, funds would be obliged to disclose when assets are transferred to third parties, and explain the benefit—or lack thereof—of the transaction to members. They would also be required to hold Annual General Meetings for members.

Yet increased transparency, welcome as it is, is not enough to ensure the security of Australia's retirement savings. Governance standards must be

improved through the introduction of independent directors. There is a strong case to mandate a majority of independent directors on the board of superannuation funds with an independent chair. However, the transition to this greater independence must also be a smooth one. It must not become an excuse for increasing the size of boards, many of which are already considerably larger than those in other sectors.

There is a body of opinion that Australia's superannuation system is riddled with potentially conflicting parties each looking to benefit their own interests at the expense of members and their retirement savings. They include asset consultants, investment managers hired by super funds, managers of superannuation funds, unions, employer groups, political parties and directors on superannuation fund boards.

In economics text books, the 'principal-agent relationship' theory encapsulates the risks to individual investors when their interests are at odds with those of the people managing their investment. The separation of ownership and control can introduce conflicts between the outsiders (the owners) and insiders (those in control). These agency conflicts are accentuated by an imbalance in knowledge between insiders and outsiders. For the superannuation industry, this imbalance favours superannuation fund insiders and their service providers. Without effective governance and transparency, superannuation fund boards will continue to amplify the risks to members' money.

Conflicts may result in insufficient attention to their members' objectives, such as the failure to appropriately monitor staff. They might result in extravagant investments in pet projects through unnecessary advertising campaigns, or investments in non-core business. There is an increased likelihood of entrenchment strategies, such as, investing in underperforming or old systems that only they can run. They may include self-dealing, such as the sponsorship of corporate boxes at sports stadiums, the financing of political parties or contracts written with friends or associates on non-commercial terms. The risk of conflicts of interest should be mitigated by the fund's board of directors which have statutory and fiduciary duties to act in the members' best interests. It is hard, however, to see how this governance mechanism can operate effectively when only 6.9 per cent of superannuation fund directors are independent. This compares to the United States, the largest funds management centre in the world, where independent directors make up three-quarters of boards in 83 percent of fund complexes.

Those who favour the status quo frequently claim that their funds consistently produce 'superior' returns that will be jeopardised by changes to governance rules. They offer no empirical evidence to support the

relationship between better governance and poorer returns. Indeed, common sense suggests that the presence of professional independent directors with expertise in financial services will mean that greater, and not less, attention is given to the interests of members.

The claim that industry funds outperform others is misleading at best. The Australian Prudential Regulation Authority (APRA) has consistently noted that these whole-of-fund performance claims misrepresent the underlying performance once differences in age cohorts and underlying investment objectives are considered. For example, a fund in which most members are under 40 will adopt a very different investment strategy than a fund in which most members are over 65. The claimed differences in overall performance may merely reflect the difference in returns between the adoption of an aggressive growth strategy and a cautious capital preservation approach.

There is no attempt, either, to account for the staggering market advantages enjoyed by funds backed by the union movement. The inclusion of default funds in industrial relations awards and enterprise agreements has a coercive effect that gives industry funds a free kick. A consistent inflow allows them to invest in assets with longer investment horizons and to capture the liquidity premium. Since this advantage is not provided to all members of superannuation funds in Australia, it begs the question: why should industry superannuation funds be granted favours that distort the market to the disadvantage of members of other funds?

It is sometimes claimed that the presence of an employee representative on the board safeguards the interests of members. Such reasoning is naive at best, particularly because since many of the funds in question are now open offer funds delinking them from a particular workforce.

Further, with an ageing population, the superannuation system has yet to mature. Without independent directors on superannuation fund boards, it is hard to see who will represent the interest of members in retirement. The primary concern of both union leaders and employee representatives is the active workforce. Independent directors, on the other hand, have no such vested interest.

The large banks in Australia are all disposing of their more risk inherent products such as General and Life Insurance and the Union Superannuation Funds are agitating against the banking sector becoming more involved in the superannuation fund management industry. One suspects the Government Regulators will eventually determine the most prudent application of how this thriving industry will be administered and best governed.

Financial Services and the 1979–81 Campbell Committee Report

The pre-Campbell world was one in which monetary policy was synonymous with direct controls on bank lending and interest rates. It was a period in which there was little faith in the ability of interest rates to act as regulators. The monetary authorities from time to time expressed concern about the resultant deterioration in the relative position of the formal banks vis-à-vis the rapidly expanding non-bank sector, and professed a desire to achieve a wider focus for policy through more reliance on the processes of the market. However, they were impeded by the inadequacies of the government securities market, particularly the new issues market, and political constraints preventing yields rising to market clearing levels.

In effect the regulatory regime was becoming increasingly inappropriate for a financial system growing in sophistication, flexibility and international exposure. Within the banks themselves there was increasing questioning as to whether there were not more efficient ways of achieving the monetary policy objectives.

This questioning culminated in the Australian Bankers' Association at the end of 1978 presenting a 'statement of position' paper to the monetary authorities entitled 'Banking Industry Developments since 1960—Banks' Declining Share of Total Financial Assets'. The basic philosophy behind the paper, which was to serve as a basis for future discussions with the authorities, was the need for more recognition of the primary role of free market mechanisms in shaping an efficient capital market in Australia.

No discussions eventuated as the Commonwealth Treasurer in January 1979, John Howard (Federal Treasurer 1977–83), announced the establishment of a committee to enquire into the Australian financial system, subsequently referred to as the Campbell Committee after the Chairman, Sir Keith Campbell. The committee provided the banks with a forum to further develop and publicly put their views.

Banks and the Campbell Committee

In their prime submission to the Campbell Committee, the Australian Bankers' Association argued for fundamental rather than piecemeal reform of the Australian financial system. It put forward a package of recommendations which it believed would result in the community being better served by a more competitive financial system in which:

- Individual institutions were free to compete on an equitable basis;
- the macro-economic policy mix was equitably distributed between fiscal, monetary and exchange rate policy; and
- financial regulation was essentially market-oriented rather than a system of direct and discriminatory controls on particular institutions.

In an environment characterised by the growing interdependence of financial markets, the Association believed that such a policy approach, if superimposed on a market-determined interest and exchange rate structure, would ensure that official influence was exerted on the supply, demand and cost of finance across the entire capital market.

The alternative to the above approach was to move in the opposite direction, i.e., extend direct controls to non-bank financial institutions. Indeed, there was some initial dissention between banks on this question but the majority perceived the alternative approach to be very much a 'second best' solution. In the final analysis, all banks supported the philosophy behind the Association's submission as the desired long-term objective.

Process of Deregulation

It is now history that the Campbell Committee in its report released in November 1981, came down strongly in favour of a shift in emphasis of public policy away from direct intervention towards greater reliance on the discipline and processes of competitive markets. It emphasised freedom of entry, competitive neutrality, interest and exchange rate flexibility and diversity of choice, with freedom of entry a primary weapon to ensure fully competitive markets.

The committee acknowledged that government intervention in the financial system could be justified to ensure free, fair and competitive markets and to maintain the underlying stability of the system. However, it rejected forms of government intervention for social or redistribution purposes in favour of more direct assistance delivered through the Budget.

The progress of deregulation in Australian financial markets was seen to be quite dramatic despite the change of government in 1983. The process started even before the Campbell Report was released, no doubt in part a reflection of the questioning of past practices which the committee brought to the surface. The initial reaction of the Labor Party to the report was that it would not support the implementation of the major recommendations. However soon after coming to government in March 1983, it commissioned a review group (the Martin Group) to report on possible changes

in the framework of official regulation and control having regard to the Campbell Committee's recommendations and taking account of the new government's economic and social objectives. The Martin Group attempted to take a more pragmatic approach to its task than the Campbell Committee but in the final analysis its report, released in December 1983, had the effect of confirming the broad direction of change advocated by Campbell and pursued by the previous Liberal Government.

The crucial step in the deregulatory process was the development of the Treasury Note and Commonwealth Bond tender systems (originally introduced in 1979 and 1982 respectively). These allowed the market determination of interest rates. The subsequent floating of the dollar in December 1983 was a further crucial step—combined with the tender systems, it allowed the market determination of both interest and exchange rates. The virtual removal of all exchange controls at the time the dollar was floated, combined with the communications revolution, led to greater internationalisation of the Australian financial system.

The changes also facilitated the Reserve Bank's ability to rely on market operations to achieve its monetary policy aims and thus removed the need for direct controls on banks.

Most of the controls were removed with the noticeable exemption of an interest rate ceiling on housing loans under $100,000 and a penalty interest rate. Statutory Reserve Deposits (Trading Banks) were required to lodge an amount equivalent to 7% of their Australian deposits in a Statutory Reserve Deposit Account at the Reserve Bank bearing an interest rate of 5% per annum.

The banks of course argued against these remaining imposts. Suffice to say these imposts created price distortions in an otherwise liberated financial market. One lesson from experiences of deregulation is that once a set of controls are removed, pressure is generated on those remaining and inevitably they go.

The Entry of Foreign Banks

The Campbell Committee believed that while freeing the domestic banks would increase competition, more would be achieved if there were a greater breadth and depth to the market and a larger banking population. Foreign banks were perceived as having the most immediate potential to improve competition—hence the issue of 16 new banking licences to banks domiciled overseas to establish fully capitalised subsidiaries in

Australia. In addition, there was a reinstatement of the Bank of China's earlier licence and the recent establishment of two new domestic banks—Macquarie Bank (formerly Hill Samuel) and Advance Bank (formerly NSW Building Society).

In inviting applications for banking licences in September 1984, the government indicated that it would adopt a flexible approach to Australian equity requirements. As it turned out, of the 16 foreign banks invited to apply for a licence, eight proposed 100 per cent foreign ownership, three proposed 50 per cent joint ventures with Australian partners while the remainder proposed various levels of foreign equity above 50 per cent. Of the 16, six came from the Asia-Pacific region, six from North America and four from Europe.

The entry of so many new banks certainly changed the structure of the whole banking system. Australia's bankers were naturally expecting some new players but 16 was quite a number for such a small market and sat at odds with the Campbell Committee's recommendations that the rate of entry of foreign banks be carefully managed to minimise transitional problems, including adverse effects on the cost structure of the banking industry. It also sat at odds with the process of continual consolidation and rationalisation which had characterised the Australian banking scene over history.

This led to a very overcrowded market and it became difficult for all the new players to achieve an adequate return on the Capital invested.

Competition had already been invigorated as the existing banks lifted their game to meet the new challenge and consolidate their positions in the market. The 1981 mergers—between the Bank of New South Wales and the Commercial Bank of Australia Limited to form Westpac Banking Corporation and between the National Australia Bank of Australasia Ltd and the Commercial Banking Company of Sydney Ltd to form National Australia Bank Ltd—could be perceived as the banks positioning themselves to achieve the necessary size, strength and efficiency, including a more geographically balanced network of branches, to meet the new competition.

The existing banks had also been rapidly expanding their involvement in electronic banking and taking advantage of their increasing ability to access international financial markets due to the removal of exchange controls and the reciprocity arrangements flowing from the new bank entry (e.g., all the major trading banks had moved to establish branch operations in Tokyo).

Australian banks had, of course, long established international operations, mainly related to trade links, but it would be fair to say that offshore expansion had undergone a major resurgence at that time. Some of the major banks felt that to expand beyond the limitations imposed by the absolute size of the Australian market, they must become significant players in the increasingly integrated world money and capital markets. The Australian and New Zealand Bank's purchase of Grindlay's world-wide operations epitomised the broader international outlook at the time.

The rapid expansion of Australian banks into international capital markets had allowed them to adopt a more global approach in funding their own balance sheets and providing competitively priced funds for their corporate clients. The banks had become active issuers in the Euro-note and US Commercial Paper markets. At the longer end, they had been frequent issuers of fixed term debt in various Eurobond sectors—Sterling, Swiss franc, Deutschemark, Yen and US dollars. By way of currency and interest swaps, those raisings had been moulded to suit the needs of both the banks and their clients.

The Euro-Australian bond market had been a major growth sector in those times but a two-tiered market had developed because Australian withholding tax problems put Australian issuers at a cost disadvantage. This matter had been raised with the relevant Australian authorities.

Withholding tax problems were also amongst the factors precluding the development of an offshore currency market from Australia. A prerequisite for such a market was a tax jurisdiction which treats interest income derived from offshore lending very favourably. The State governments of both New South Wales and Victoria commissioned reports on the subject and as a result, were anxious to see such a market established. A special committee of Commonwealth and State government officials had also been examining the subject.

Australia had certain locational/time advantages over other centres in the Asia/Pacific region. If favourable company and withholding tax arrangements could have been introduced, on a par with those available in centres such as Singapore, an offshore currency market could quickly have developed from Australia and tended to supplant some existing centres.

The Government established the Australian Financial Forum in September 2008 as part of a commitment to position Australia as a leading financial service centre. The Forum report was released on 15 January 2010 and there were 19 well considered Recommendations. It would be timely to revisit those recommendations given the volatile state of the World Financial markets to ensure Australia does remain competitive and at some point have a robust debate about tax reform and our competitive position in the Asian markets.
Our primary industry, mining and healthcare capabilities are examples of other industries that could provide a source of tax revenue if we get this right.
Politicians and some bureaucrats still grapple with an understanding of the competitiveness of Australia in the Asian region and one could conclude that this ignorance still prevails.

Effects of Deregulation on the Domestic Financial Scene

The domestic financial scene encompassed a virtual plethora of institutions—trading banks, savings banks, finance companies, merchant banks, building societies, credit unions, life insurance offices etc. Prior to deregulation, many of those institutions were advantaged by direct controls on banks (e.g., the prohibition on trading banks paying interest on deposits of less than 30 days opened a window for the merchant banks).

At that early transitional stage, however, it was difficult to be very specific about the effects of deregulation on individual or groups of financial institutions. There was a lot of jockeying for positions in the market. Building societies and credit unions, for example, were opening up their ATM networks and, in some cases, even their branches to the new banks.

A research report by the Reserve Bank on inter-sector lending to the private sector suggested that over 1984/85, there was a substantial increase in the share of intermediation vis-à-vis direct financing and within intermediation, lending by banks grew a lot more strongly than lending by non-bank financial institutions.

Deregulation, combined with the entry of such a large number of new banks, certainly led to pressure on margins. Indeed, the lowering of

operating margins and thus increasing operational efficiency was a major justification for deregulation.

By international standards, Australian banks were generally perceived to be operating on rather fat margins. For example, the 1985 OECD release 'Costs and Margins in Banking' covering the period 1978/82 suggested that in the large bank classification, Australia's major trading banks had the highest ratio of profit before tax to average total assets in each of the five years and, over most of the period, by far the highest profit before tax to capital and reserves. On the other side of the coin, they also had the highest ratio of total operating costs to total assets.

There were well known objections to putting too much reliance on inter-country comparisons (e.g., differing split between retail, wholesale and offshore business, different accounting conventions). Nevertheless, the comparison did suggest that the major trading banks as a group were very profitable indeed despite their high operating costs, that is they had wide operating margins. It would be fair to say, however, that the high operating costs reflected the large branch networks, widely dispersed geographically, but serving a relatively small population.

Australian bank profits had continued to rise strongly as they gained the benefits from deregulation, including in some areas the natural slowness in unwinding some of the administered margins from the days of direct controls.

Australian banks were forced to gradually unwind the system of cross subsidisation of services. Cross subsidisation had continued to exist because of the similar type and scope of operations undertaken by the major domestic banks—to the extent that it remained, it presented opportunities for the new entrants to target the most profitable segments of business.

For their part, the existing banks did find it difficult to unbundle their pricing of services because of all the problems that arose in relation to average and marginal costs and the pricing of joint products. They found it difficult to close branches on a large scale as they saw themselves, and were seen by the public, as having an important role in servicing the many small communities across Australia.

There were also changes in the risk characteristics of the banking system. Traditionally, no price tiering as between banks had existed in Australian financial markets. All licensed banks were perceived to have similar risk characteristics—they were diversified both regionally and industrially and had a strong base of relatively stable retail deposits. They

also came within the ambit of the depositor protection provisions of the Banking Act.

Many of the newer banks, however, did not, initially at least, have such a wide dispersion of business and could rely more heavily on non-deposit liabilities which did not fall within the ambit of the depositor protection provisions. The market had come to acknowledge that all banks were not similar, price tiering had developed in short term paper markets with the four major trading banks providing the benchmark.

As noted in other parts of the world, there had also been a gradual blurring of the previously clear distinction between banks and other financial institutions—not only between the institutions themselves but between the types of products they offered.

Banks had historically been perceived as a distinct class of institution with certain safety characteristics and having a particular role in relation to the domestic and international payments systems. Legally this distinction was being maintained but at the operational level, it was gradually being broken down.

Building societies and credit unions, for example, had negotiated through banks, agency access to the cheque payments system and had thus acquired some elements of the public safety perception historically associated with banks. They also offered card access to both ATM and EFTPOS systems. A large number of non-banks had also been given licences to deal in foreign exchange, previously a monopoly of the banks.

With deregulation of deposit interest rates and maturities, banks and non-banks were offering new types of deposit facilities which were virtually indistinguishable. Two of the new foreign banks had major Australian life insurance companies as 50 per cent partners. That movement of life offices into banking had a counterpart in that some banks were selling, or moving towards selling, life insurance through their branch networks as part of their desire to become full service centres. Some insurance companies were also offering facilities which were very similar to bank deposits. Those developments obviously tended to blur the previously clear delineation between banking and insurance.

In the capital markets area, the major private banks had taken the opportunity given by the decision to admit corporate members to the stock exchanges to buy equity interests in stockbroking firms in order to acquire market related skills and offer share-broking services through their branch networks.

In summary, significant deregulation and some diversification had led to the industry profile being very different in 1985 from 1965, and even 1975.

Leadership and Management of Banks

Some chief executives of individual banks were naturally facing problems in managing rapid change. In previous periods, banking was restricted to a comparatively limited number of activities that could be carefully and prudently managed. With deregulation, there had been a rapid development of new instruments and entry into new financial markets where risks and exposures—on or off balance sheet—were very difficult to assess, e.g., trading in financial futures and options, the provision of long-term interest rate and currency swaps and participation in note issue and resolving underwriting facilities.

Entry into many of those markets had of course been in response to the need to reduce risk in the face of greater volatility in interest and exchange rates but it gave rise to other challenges in addition to those associated with entering unfamiliar waters. For example, while arranging swaps reduced banks' exposure to interest and exchange rate risk, it increased credit risk because of the possibility of counterparty default. Similarly, while the spread of floating rate loan facilities reduced banks' exposure to interest rate risk, it seriously increased long term credit risk as subsequent rises in interest rates reduced the ability of borrowers to service their debt obligations.

With those developments, the banks became acutely aware of the need for a continuing review and strengthening of management reporting systems. Effective balance sheet management moved away from sole reliance on liability management to encompass management of asset structures in relation to pricing, determining cash flow profiles and more rigorous risk assessment.

Banks also found an increasing need to employ specialists in various fields with all the problems that arise in relation to compensation and risk as such specialists were more mobile than the traditional generalist bank employees. This was a factor that banks found difficult when considering how far they wanted to go down the investment banking trail. In addition, technology was changing, and major investments were needed in new capabilities and systems for every financial services institution.

National Australia Bank

So what happened to the Bank that became an industry leader, became No. 1 by market capitalisation in 1997 and then to quote from the Company Directors Magazine 'fall apart like a house of straw and sticks once the wind started blowing'. See Fig. 1.1 in Chap. 1 to examine the share price accumulation history of NAB and the industry and economy.

What were the leadership (Chap. 1), strategic (Chap. 2) and governance (Chap. 3) factors that led to the NAB upheavals and fall from its market leadership position?

It all comes down to TRUST. Trust binds people together, creating a strong, resilient organisation. To build trust, leaders must be predictable and they must share information and power.

Post 2000 NAB lost a generation of leaders who were trusted by the workforce because they gave trust to people within the organisation to make things happen.

The 'wise and the worldly' who have occupied the highest echelons of the NAB since 2000 were expected to keep the Human Resource focus going by unleashing the competencies, creativity and commitment of the existing workforce. Alas, with the reported advent of short-term profit imperatives, we have seen this once great institution succumb to become an emotionally volatile and vulnerable institution where mistrust and cynicism reached all-time highs in some business units and where tension simmered between leaders and followers. It fell from absolute industry and sector outperformance to a low point where the Chairman and CEO resigned simultaneously in early February, 2019, immediately following damning findings of the Royal Commission.

The institution of the 80's and 90's was built around a strategy of creating a world class organisation that was highly productive and able to withstand competitive assault. Governance was strong (see Chap. 3).

To make that happen, the leadership post Campbell operated under a mantra that leaders must unify the organisation into one holistic integrated business, but at the same time respect the individual characteristics of local environments. The approach was that all policies, systems and rewards must support the vision and the goals. The climate created inspired people to achieve extraordinary results. Evidence of this strategy working is reflected in Fig. 6.2.

Market Value of an institution is the clearest and most reliable signal about sustainability of a company's performance, although never perfect.

Fig. 6.2 NAB price

The market price however is only the beginning and investors make their judgements about the competency and the quality of the stewards of their money, the future of the industry in which they are investing and the successful investors spend much time analysing the consensus forecasts of the enterprise and the ability of that enterprise to generate a flow of cash from corporate assets. Assets producing cash flows will ultimately return the owners investment without depending on the whims of other providers of capital. Even if the cash flows are some distance in the future, their prospects endow them with a present value.

The post 2000 environment in NAB prompted a long-term Analyst to comment that there seemed to be an overconcentration on strong short term returns on equity at the expense of its disciplined compliance culture.

Obviously when missteps occur there is much commentary around the reasons for loss of momentum, some adverse comment can be justified and validated but be that as it may, we examine below the Market Performance of the Group plus some numerical data which covers the

Table 6.1 NAB's numerical data

Share price	NAB	Bank Index	All Ords Index
31/8/90	649¢ (XR)	2075.4	1553.8
30/6/99	2500¢	6503.7	2886.1
Change	**+285%**	**+213%**	**+86%**
Maximum price: $30.14 on 22/4/99			
NAB Market Capitalisation		31/8/90	$6,350m
		30/6/99	$36,773m
			+479%
NAB EPS Growth		YE 9/90	79.7¢ (XE)
		YE 9/99	181.6¢
			+128%
NAB DPS		YE 9/90	54.2¢ (XR)
		YE 9/99	112¢
			+106%
NAB ROE		YE 9/90	12.7%
		YE 9/99	17.3%
			+36%
NAB Cash ROE		YE 9/90	13.3%
		YE 9/99	22.8%
			+71%

Source: JB Were

period from 31 August 1990 to 30 June 1999 and the subsequent years (Table 6.1).

In the pre-2000 environment NAB was managed by facts, not gut-feel. NAB leaders had clear, quantifiable goals, and these were presented as indicators of success. Measurement was a way of life and all NAB leaders knew that we needed to link those measurements to high performance outcomes. It was not enough to measure things; it was a case of continually measuring the right things, and only then could leaders be assured that vision was becoming a reality.

Some of the many issues that challenged the management of the day and resulted in judgements by the market practitioners and customers must be considered. It is a truth universally acknowledged, and more publicised in recent times, that we live in a post-truth age. Some commentary can be attributed to analysts and various other commentators about NAB's offshore growth strategy, HomeSide, technology innovation, and other myths, but for this case study to be beneficial, one has to recognise all commentary and claims, whose only relationship to validated data, is that

some contradict reality. Sound leadership means basing decisions and analysis on fact.

National Australia Bank Limited (the 'Bank'), together with its subsidiaries (collectively, the 'Group'), was one of the four major Australian commercial banks ('trading banks' in Australian terminology) which together accounted for approximately 72% of commercial banking assets in Australia as of September 1990, according to the Commonwealth of Australia Gazette, an official publication of the Australian Government. National Australia Bank Group undertook a range of banking, financial and related activities in Australia and elsewhere in the world, including commercial banking, savings banking, finance and life insurance, and investment banking. As of 30 September 1990, the Group's assets totalled A$94.6 billion, of which approximately 58.0% was domiciled in Australia, and Group deposits totalled A$60.3 billion of which approximately 56.1% was domiciled in Australia.

The Bank was established as 'The National Bank of Australasia' in 1858 in Victoria, Australia. Through internal expansion and the acquisition of other banks, the Bank developed into a national commercial bank. In September 1990, the Bank was the product of the merger in 1981 of The National Bank of Australasia Limited and The Commercial Banking Company of Sydney Limited, the latter Bank being established in 1834 in New South Wales, Australia.

At 30 September 1990, the Group had 45,471 full-time and part-time employees worldwide.

Banking, the Group's principal business activity, was conducted in Australia by the Bank and internationally by the Bank and certain subsidiaries. As at 30 September 1990, the Bank was the third largest commercial bank in Australia based on domestic assets of A$54.4 billion (according to the Commonwealth of Australia Gazette). The Group was the third largest Australian banking group based on its global assets of $94.6 billion.

At 30 September 1990, the Group had no rescheduling country debt following a controlled programme of disposal during 1988 (many banks around the world suffered as a result of the South American economic collapse in that era.) From 1983 onwards the banking and financial services sector in Australia had been substantially deregulated (as detailed earlier in this case study and in the Appendix). This deregulation exposed the Group to increased competition in its traditional commercial banking activities but permitted it to offer an increased range of financial services and pursue new opportunities for growth. Since 1987 the Group had

consolidated its Australian banking operations and expanded its offshore banking business base with a series of acquisitions in the United Kingdom, Ireland, New Zealand and the United States. In Australia the Group had taken advantage of the deregulated environment to introduce certain non-banking financial services, notably life insurance and funds management activities and disposed of activities not considered strategic for the future.

The Figures and data above provide some indication of NAB being the high performing and preferred organisation for a time which saw it reach No.1 in market capitalisation in Australia in 1997.

NAB Vision and Strategy

The Bank was focused on building a leading international financial services group. With the evolution of a global business model, the vision was being pursued through a strategy of controlled growth and careful diversification of income streams. The Group's growth strategy was being achieved through a mixture of organic expansion and acquisition within its core markets of Australia, New Zealand, the United Kingdom, Ireland, the United States and Asia. Organic growth had been achieved through the Bank's Business, Personal and Wholesale financial service franchises supported by a strong customer orientation and brand position. This growth had been further supported by the development the Bank's financial services activities, including insurance products, funds management, custodian and trustee operations.

Underpinning the Vision and Strategy in a changing operating environment and regulatory system, was the relentless pursuit to transform operating systems to reduce complexity and support business growth. The emergence of the internet increased demands to deliver banking services over new distribution channels and offered competitive advantages to those institutions who were able to adjust strategy and structure in a cost-effective manner. NAB proved to be an early leader in the transformation processes but there are mixed messages about how they have been more recently handling the digital revolution.

Internationalisation of Australian Banking

From the outset, Australian banks took advantage of opportunities to generate revenue by financing trade. From the early days of European settlement to the 1950s, Australian banks maintained few international offices

outside London, reflecting the strong trade ties between the two countries. A small number of branches had been established in New Zealand by 1864 and later in the islands of Papua New Guinea and Fiji, mainly reflecting close geographical and political ties with those countries. The volume of transactions conducted with countries outside Britain was relatively small and the establishment of an extensive network of correspondent relationships, in lieu of offshore branches, sufficed.

It was common for senior managers of Australian banks to call on their correspondents periodically in the hope of gaining referrals of companies trading with Australia or of winning the correspondent's VOSTRO account in $A. VOSTRO accounts generally held good credit balances due to the high cost of re-converting $A into the foreign bank's domestic currency on a regular basis. They were especially lucrative in the high interest rate period following the mid-1970s, as VOSTRO accounts typically did not bear interest.

A nostro account is usually in foreign currency (it is a record of funds held by a bank in another country) i.e., a bank in Country A keeping a record of money held by a bank in Country B, in the currency of Country B. A vostro account is the local currency of the Bank where the money is being held, i.e. it is the Bank where in Country B's record of the money kept by the Bank from Country A. For these accounts, the domestic bank is acting like a custodian or managing the accounts for a foreign counterpart. These accounts are utilised for facilitating the settlements of Forex and foreign trades.

Owing to their large number, geographical spread and the great distances involved, monitoring the creditworthiness of such agents proved difficult. London was the major banking centre and functioned as an effective listening post. Australian banks with strong relationships in London were able to share information concerning creditworthiness of correspondents, as well as catch up on what was happening in the rest of the world.

From the late 1960s, Japan and some of its Asian neighbours were beginning to replace Britain as Australia's major trading partners. As the volume of trade with these countries increased, the banks established and staffed their own offices in host countries. These 'representative offices' generally housed one or more international bankers, eliminating the need for Australian personnel to commute constantly between countries. Their function was to work closely with correspondent banks to develop

relationships with customers who were trading with Australia or wishing to do so, ironing out problems on the spot.

As correspondent business grew, it eventually became worthwhile for a bank to establish a full branch in the foreign location so as to service its clients directly and capture the entire foreign transaction. To augment foreign branch earnings, a bank would lend or borrow respective foreign surplus or deficit funds at the best rates. They would also trade in their local money markets, borrowing money from large companies or other banks at low interest rates and lending to different institutions at higher rates, generating a small interest rate 'spread'. This practice began to emerge in the 1960s, signalling the beginning of the wholesale or inter-bank market.

The ability of Australian banks to increase the size of their offshore presence and internationalise was significantly impaired by the imposition of regulations by both the Australian government and many host nations, particularly in the post-war period. The Australian government, through control of foreign exchange, did not allow Australian banks or companies to move significant volumes of funds offshore to develop or acquire large foreign operations. Supervision by the Commonwealth Bank and later the Reserve Bank of Australia was an additional roadblock preventing banks from developing an offshore presence. In some instances (especially some of the Asian countries), restrictions were imposed by foreign governments in retaliation for their banks being unable to enter Australia.

While foreign banks were precluded by regulation from obtaining banking licences in Australia, they sought alternative means of participating in the Australian market, attracted by its potential for growth, political stability and legal transparency. From the 1960s onwards, North American, Japanese, European and other Asian banks operated as merchant banks, finance companies or even as representative offices, and booked deals offshore. They were thus able to turn a disadvantage (their inability to hold a full banking licence) into an advantage by avoiding the regulatory shackles imposed on domestic banks.

NBA's operating performance improved markedly following a restructure recommended by McKinsey and Company towards the end of the 1960s. By the end of the 1970s, however, NBA was still outperformed by other banks. This prompted the new Managing Director, Jack Booth, to request a second review by McKinsey in 1979.

John (Jack) Denisse Booth: Born in Texas, Queensland, joined the Bank (then National Bank of Australasia) in 1939, at the age of 16. He held

several positions in Queensland before being posted to the position of manager at Dandenong, Victoria, in 1966. By 1974, Booth had progressed to State Manager of the Bank in his home state, Queensland. He became Managing Director and CEO of the Bank in 1981, and held that position until 1985, when he was succeeded by Nobby Clark.

After 46 years of service, including four and a half as CEO, Jack Booth retired from the Bank and the Board on July 5, 1985. During his career, he had always maintained a low profile, and is often remembered as shy and reserved. He valued his privacy and was not a captive of the media. Even in his retirement, he led a secluded life in an inner eastern suburb of Melbourne but he is remembered for his strong values and leadership in the Bank.

The focus of the McKinsey recommendations, presented in 1981, was to improve the Bank's flexibility in dealing with a rapidly changing environment. That review shifted much authority to the business units and with a bottom up strategy, provided the framework for the momentum over the next 20 years. Prior to the second McKinsey review, the Bank had already recognised the need to sharpen customer focus in an environment of heightened competition. To facilitate such a re-orientation, senior executives believed it would be necessary to spin off retail, corporate and international banking into separate business units. The concept of strategic business units (SBUs) was popular at the time. Proponents of this thinking included Nobby Clark, Bill Hodgson, John Marshall, Jim Ambridge, Marshall Browne, Ian Grover, Barry Hedron, John Edwards, Ray Forrest and many other reformists within the NBA organisation.

Whilst Jack Booth supported the approach, there were internal vested interests opposing the forces for change. Personnel Department, for instance, was perceived by some to have considerable power through the role it played in staff movements, promotions and remuneration levels. There was an associated perception that the General Manager—Personnel had virtually unrestricted access to the office of the Managing Director. Divisionalisation of the Bank into customer-focused SBUs threatened to eclipse Personnel Department's power and influence. The changes nevertheless were executed and driven hard by Jack Booth's successor, Nobby Clark.

Not only did the McKinsey study encourage and support these developments, it went further in recommending considerable delegation of authority to branch level, a development which had become feasible given the considerable advance of the technology which at the time proved to be

a competitive advantage. At the same time, with deregulation, non-banking activities such as finance and insurance products could now be added to the traditional range of banking services.

The delegation of authority was important as, in Nobby Clark's view, 'it gave the Bank an idea of what it was good at … and highlighted people who not only had intelligence, but judgement was a key characteristic'.

From NBA to NAB: The CBC/NBA Merger

During the 1950s and 1960s, NBA had made a concerted effort to strengthen its comparatively weak position in NSW through a series of branch openings and considerable investment in that State. Despite this commitment, only marginal increases in market share were realised, with NBA's share of the largest market for deposit and lending opportunities in Australia languishing. Aspirations for organic growth were not being met. Now, in the 1970s, with the added threat of foreign competition, NBA lacked critical mass in NSW.

At the same time, management was mindful of the rising cost of technology and there was concern that NBA would not be able to afford the leading-edge technology needed to secure market leadership. Jack Booth and his management team believed that acquisition of, or merger with, another Australian bank, such as the Commercial Banking Company of Sydney (CBC) and/or the Commercial Bank of Australia (CBA), would give NBA the necessary scale to exploit new technology efficiently.

To prepare the Bank for possible merger, a committee was formed comprising a number of senior executives including John Marshall, David Bruce and Bob Prowse. The committee produced a report that came to be known as 'the red book'. The initial merger plans outlined in the red book envisaged the marriage of the NBA, CBC and CBA. The major objective of the strategy, '…was to out-flank the Wales with a three-way merger…', according to the Bank's chief strategist. The Bank of New South Wales had always been the dominant private bank in Australia and therefore the one to overtake.

Following a flurry of activity and considerable jockeying amongst various suitors, permission was granted by the Commonwealth Treasurer in June 1981 for the Wales to merge with the CBA, and NBA to merge with the CBC.

The integration of the CBC and NBA was largely complete within 12 months of the merger. A significant jump in market share was realised, a feat

especially noteworthy in light of the decline in market share of the enlarged Westpac Banking Corporation. The merged bank was renamed the National Australia Bank (NAB). Reflecting on the merger, there were many in the senior executive ranks who doubted that the CBC merger would have occurred without the strength and leadership of Jack Booth.

Nobby Clark, who had been appointed General Manager—Retail Banking, attributed the success of the integration process to excellent project management. NBA adopted a project team approach, establishing over 200 integration teams comprising NAB and CBC staff. Each team was given a task and objectives, which included the preparation of a plan of approach, timelines, budgets and deliverables. These were presented to a project committee for vetting and approval, following which the teams completed the implementation.

The CBC merger proved seminal, in that it was the first step towards competency in effecting successful mergers. The merger illustrated the need for flexibility in IT systems and formed the genesis of the Bank's strong IT capability with Jack Booth opting for systems emphasising robustness, efficiency and effectiveness. The experience further highlighted the importance of involving the target company in the merger process, especially identifying which staff and assets would be retained in the merged entity. Integration initially proved to be a challenge but this was quickly overcome.

Jack Booth stressed the need to retain focus on running the existing business throughout the merger process, ensuring that management was not preoccupied with integration speculation which comes with uncertainty following a merger. He insisted on continuous and effective communication with staff and customers. The emphasis on involving people extended to management ranks. Jack Booth was credited as the first CEO to take a team approach to managing the Bank, departing from the more traditional 'command and control'.

It is useful to ask the question of how the Australian financial system differed from overseas. While all financial systems are different and have idiosyncratic features, at an aggregate level the structure and scale of the Australian financial system was not markedly different from other high-income countries. The banking sector plays the key role in financial intermediation, and the stock market is well developed, while bond markets play a lesser role in financing.

In Australia, trading banks have similar functions to commercial banks in the United States, conducting both retail and wholesale banking

business and some have differentiated themselves from wealth management better than others.

The major part of the NAB Group's business was commercial banking conducted through the Bank. These operations included the provision of deposit and checking accounts for individuals' and corporations' payments facilities, and the provision of finance in the form of loans, advances, bill facilities and leasing. Consumer credit was provided by way of personal loans and credit cards. Specialised customer needs were met through such facilities as development loans for farmers and resource companies, and leveraged leasing for capital projects. Long-term mortgage finance was provided for housing purchases. Other facilities offered by the Bank include nominee, safe-keeping and custodian services.

The Bank had direct access to the Australian payments system, allowing it to clear cheques and other instruments for its customers and as an agent for other licensed banks and non-bank financial institutions. The Bank also provided payments services through an expanding network of automatic teller machines and electronic funds transfer at point of sale (EFTPOS) terminals. Similar payments services were provided by the Group's subsidiaries in the United Kingdom, Ireland and New Zealand.

Along with the other major Australian banks, the Bank issued Bankcard, Australia's major domestic credit card at that time. It also issued both MasterCard and Visa cards for domestic and international use. In addition to their normal credit card function, these cards could be used to access the Bank's electronic banking network.

Banking operations in Australia were conducted through a network of more than 1500 branches and other business outlets.

The Brand positioning initiative was a strategy developed by Glenn Barnes, a former employee of the Mars Corporation. Glenn was one of a number of external professionals recruited who made a difference to the way traditional Bankers thought about engagement with the customer base of the Group. Acceptance of these external recruits was difficult for some traditionalists but they assimilated well and a number of these recruits progressed to senior positions. Glenn Barnes for instance was a serious contender to succeed Don Argus.

International banking business was generated by the Bank's Australian offices and branches, by its offshore commercial banking subsidiaries in the United Kingdom, Ireland, New Zealand and Papua New Guinea, through overseas branches in Hong Kong, Singapore, Tokyo, Seoul, Taipei, London, New York and Chicago, and representative offices in

Atlanta, Dallas, Houston, Frankfurt, Bangkok, Beijing, Shanghai, Jakarta, Kuala Lumpur, New Delhi and an agency in Los Angeles. The Bank also maintained correspondent banking relationships with 2,353 banks. International operations included international lending through the Bank's foreign branches, international trade finance and development, foreign exchange dealing, the provision of credit and liquidity enhancement facilities to bond issuers and other third-party borrowers, acceptance of foreign currency deposits, and guarantee and documentary credit business.

Domestic and international money market and foreign exchange operations were conducted through the Bank's Treasury Division, which also managed the Bank's day to day funding. A global, 24 hour a day dealing capability was maintained through dealing centres in Melbourne, Sydney, Auckland, Tokyo, Hong Kong, Singapore, London, New York and Los Angeles. The Bank dealt in all major currencies and was an important market maker in the Australia dollar. The Bank traded Eurocurrency securities, underwrote and arranged facilities for major corporate clients, and engaged in interest rate and cross currency swap transactions. In the Australian money market the Bank was a major trader of commercial bills. The Bank also operated in the financial futures market as a principal and trader.

Total assets of the Bank amounted to A$56.3 billion at 30 September 1990.

The Internal Analyses

In the early 1980s, the strategy group carried out internal analyses of the Bank's activities, focusing on the performance of the various business units. Business units were benchmarked against one another as well as other domestic and international banks. Internal strategic capabilities were developed.

The underlying philosophy, in marked contrast to that prevailing in other domestic banks, was that profitable growth, rather than the size of the loan book, was to be the prime driver of investment decisions. The implication for the future direction of the Bank was clear: further expansion of the Bank would be driven by an adequate return on investment. (This is aligned with strategy concepts expressed generally in Chap. 2*)*

This discipline imposed by driving for return on investment enabled the Bank to build a capability for analysing risk and margins by product and later also by customer, a perspective which would become embedded in its IT systems and corporate culture. This occurred long before the Bank's competitors and proved to be a source of competitive advantage, particularly during the cyclical downturns in the economy. The Bank was growing relatively quickly and additional capital could only be raised cost effectively at higher levels of profitability. At that time, the Bank's share price was trading below net tangible assets. Any capital raising would probably dilute the Bank's shareholder value, given that new shares would have to be issued at a further discount to market price.

An integrated strategy of capital management was developed to boost earnings and the share price. This incorporated the conservation of capital, tightening up returns from operations and off-loading low yielding assets. As part of this process, the strategy group identified areas that were using capital but were not meeting the hurdle rate of return.

Formation of the Credit Bureau

With the advent of deregulation of the financial services industry, the changing environment with the foreign bank expansion and the fast-paced development of new products and technologies, the extent and type of delegated authorities proposed began to be more closely scrutinised from a risk perspective. The initial review of credit risk was commissioned by Nobby Clark and undertaken by Don Argus.

Don Argus' mandate defined credit risk as the risk of loss arising from the inability or failure of a borrower or counterparty to meet its obligations. The delegated authorities in this area defined the credit exposure to a borrower or counterparty as the loss potential arising from product classifications, including loans and leases, the evolving derivative market and other extensions of credit.

Argus argued at the time that the McKinsey review a few years earlier had wrongly assumed that the people to whom the authorities had been delegated had the knowledge and/or skills to manage risk, without formal training or proven processes and overview of decisions made. The review paper proposed the establishment of a comprehensive credit risk strategy and the development of processes and education to provide for the efficient execution of the credit risk strategy.

The credit risk strategy and the processes enabled the Credit Bureau to determine the appropriate level of credit risk exposures which was based on short-term and long-term considerations.

Short-Term: The composition of the current credit risk portfolio was established to take into account risk appetite, any pockets of concentration (e.g., sector, product or geography) and an analysis in relation to expectations of future performance.

Long-Term: Consistency of the strategy with established credit risk limits and standards set by specific product profiles.

This strategy enabled the Bank to set and enforce different limits by business, segment, country or risk type at origination so that the Bank maintained actual risk exposures within approved risk tolerances (e.g., annual targets for net losses and non-performing loans) and still maintain appropriate diversification across business activities. It was about being proactive on risk.

The *Credit Processes* were designed to execute the credit strategy (e.g., product specific underwriting and customer selection criteria based on the integrity of that customer and capacity to repay a loan) and of course adhere to the agreed credit policies, while remaining compliant with laws and regulations.

Effective credit risk management, which became a core competency in the 1980's and 90's, required coordinated reporting and review of credit risk exposures and discussion of the quality of the Bank's portfolio and emerging credit risk trends. To achieve this, the Credit Bureau established a credit risk governance structure that provided oversight from the Board to the Business Units and onto those who were delegated individual credit limits. The structure kept oversight flowing down while vital credit risk insights flowed upwards.

Formation of the Credit Bureau was contrary to the strategy of devolution adopted by the McKinsey review, but the decision to adopt the Argus recommendations proved critical in allowing NAB to tighten its credit risk position and it is now folklore how NAB weathered the numerous downturns through the 80s and 90s, whilst competitors lost capital, with ANZ and Westpac fortunate to survive in the late 80s/90 economic downturn. Credit risk management became a key differentiator.

With the assistance of Ken Coutts who was the People Development Leader of the time, the Credit Bureau was populated with the 'best and

brightest' individuals, and their remit was to establish a risk framework throughout the Group. A strong risk management culture was seen as critical to the future success of NAB. Apart from the development of a strong risk culture, the risk appetite and philosophy began to be communicated through the Group, risk governance and augmentation began to be defined and governance structures were introduced that established and pursued the Bank's objectives whilst monitoring performance.

There was a committed focus to building on the required capabilities and processes to ensure that employees could clearly determine and understand the broad risk parameters that should be considered when designing a business strategy.

The risk framework set the foundation to the development of the strategic risk standards plus the credit risk, market risk, liquidity risk, operational risk, compliance risk and reputational risk standards which became the hallmark standards for the industry for 15 years. This discipline, unfortunately, was lost to history as the Bank entered the new millennium. So were the advantages that it delivered.

NAB also entered the era of credit-risk models which saw it graduate from 'value-at-risk' models, which were developed to estimate how much of a bank's trading portfolio—foreign exchange, cash, securities and derivatives—it could lose in a single day because of adverse movements in financial prices. These models were criticised for assuming that past correlations in the prices of different assets would hold in future and for making simplistic assumptions about the range of possible price changes. They also failed when prices for the underlying assets become available—when a stock market suspends trading, for example. Those criticisms applied just as well to credit-risk models.

Value-at-risk models had one big advantage over credit-risk models, however. They generally dealt with assets that were publicly traded, so there was a vast amount of data for the models to crunch. It was far harder to come up with data on the market value of bad loans which banks eventually recover. That left it uncertain whether the results cranked out by credit-risk models were statistically valid. The models were clever, but how much relation they bore to reality was not clear at the time and evolution was slow.

It is interesting to reflect on those buccaneer years and fast forward to 2017 where we now view risk through the prism of Bank of America experience who many will recall have written off US$74bn since 2008.

Banks' credit-risk models can become complex. But the question they try to answer is actually quite simple: how much of a bank's lending might plausibly turn bad? Armed with the answer, banks can set aside enough capital to make sure they stay solvent should the worst happen.

No model, of course, can take account of every possibility. Credit-risk models have tried to put a value on how much a bank should realistically expect to lose in the 99.9% or so of the time that passes for normality. This requires estimating three different things: the likelihood that any given borrower will default; the amount that might be recoverable if that happened; and the likelihood that the borrower will default at the same time others are doing so.

This last factor is crucial. In effect, it will decide whether some unforeseen event is likely to wreck the bank. Broadly speaking, the less likely it is that many loans will go bad at the same time—that is, the lower the correlation of the individual risks—the lower the risk will be of a big loss from bad loans.

None of this is easy to do. Many of the banking industry's brightest have been given over to the task. Credit Suisse Financial Products launched 'CreditRisk+', which attempted to provide an actuarial model of the likelihood that a loan will turn bad, much as an insurance firm would produce a forecast of likely claims. McKinsey has a model that links default probabilities to macroeconomic variables, such as interest rates and growth in GDP. JP Morgan's 'Credit-Metrics' applies a theoretical model of when borrowers default, using credit ratings for bonds and drawing on another model developed by KMV, a Californian firm, which calculates the risk that a firm will endure.

The Real Risk in Banking

As of 2020, the world is awash with debt and with many countries, including Australia, indulging in a debt binge which sees Government, Corporate and Household gross debt now exceeding 250% of GDP, any credit contraction which will involve debt repayment or default will exert deflationary influence on the global economy, as well as pressure on traditional Bank Balance Sheets. When one included stories about rogue traders losing fortunes in the securities market it causes one to pause and reflect on where we are heading. Whilst we experienced the emotional aspects of the Royal Commission, in Australia we have a spectacle of Moral Hazard besetting the banking industry in particular, where reputational risk may affect competition. Some of the case studies being published are

frightening and involve serious breaches of ethical behaviour and obligations when dealing with a customer base. We are yet to fully see what develops in terms of penalties, potential personal charges and regulations which evolve from the Royal Commission, and without detracting from the serious breaches of Trust revealed, the biggest risk facing Commercial Banks is still the oldest risk of all …. not that of guessing badly the price of some security, but that of lending to somebody who is unable to service and/or repay the debt provided.

When one compares these, the Royal Commission findings with the high profile trading losses as recorded in the excellent publication '*Great Financial Disasters of our time*[1]' with the damage caused by reckless lending at Crédit Lyonnais in the 1980s (more than $20 billion) or by Japan's and East Asia's banks (hundreds of $billions); forget the whizz-bang technology of modern financial markets: the various financial crises confirms that it is still loans, not trades, that pose the greatest threat to the solvency of the Bank.

The question is how this threat should be managed. Nobody denies the importance of requiring banks to hold capital as a protection against losses. What is harder to say is how much. Global rules were established in 1988, when the Basle Accord called for banks to retain capital equal to 8% or more of their 'risk-weighted' assets (i.e., loans). The accord obliged many countries to strengthen regulation and to close their weakest banks. Partly because of that, most big banks are much better capitalised today than they were in 1988.

The Basle regime was an improvement on what went before—but it is far from perfect. The risk-weightings that the rules attach to different loans are crude. Currently, a bank must hold the same capital against a loan to General Electric as against a loan to a personal borrower, even though the first is far safer. The rules deem GE riskier than the governments of, say, Indonesia or Russia. So, some banks are forced to hold more capital than they need, and some encouraged to hold less.

A Model Solution

Most regulators agree that change is needed. What form should it take? A good alternative is coming from banks themselves. Many already measure risk using their own formulae, far more refined than the Basle rules. Banks

[1] 2011, by A Peachey, Intersentia Uitgevers N V; Revised edition.

such as JP Morgan and Credit Suisse have built and published sophisticated computer models which show the maximum likely loss on portfolios of many different loans, thus allowing the need for capital to be judged more precisely.

Regulators have accepted the use of such models in managing the risk of trading securities and derivatives. However, they worry that 'credit risk' is harder to model than 'market risk'—and so it is. One reason is lack of information: banks guard their data on past loans, whereas the prices of securities are public. But this and other obstacles are not inseparable. The biggest banks already have adequate data and are learning how to plug the remaining gaps (by studying borrowers' equity prices, for instance).

Allowing every bank to use its own formula straight away would be rash. But regulators could move cautiously in this direction by accepting, to begin with, the best models. That would encourage other banks to improve their own procedures, and in due course propose them to regulators. For lending in emerging markets, where the information required by this approach is sparse and of poor quality, regulators could still encourage the use of models, while recognising the extra risk by adding a thick margin to the capital they deem necessary to cover accidents. With that in mind, it seems to us that our first priority is to ensure that our banking system retains the confidence of the public at large.

Our Financial Service Providers will need to clearly articulate how they will operate in the disruptive technology space and policy makers will need to re-educate themselves very quickly to clearly articulate what they wish to achieve in terms of another review of the industry, when one considers we have completed an excellent study under David Murray in Australia.

There are messages coming out of the recent Economic Forum in Davos which suggests that new technology has the ability to replace human operators in the finance sector as well as other sectors, much the same as robots have taken the place of factory workers for decades. Bankers at the leading edge of this technological transformation believe that the distinction between finance and technology will become less and less clear presenting established financial institutions with formidable new competitors at a time when they are already under pressure.

This of course will be a bonanza for consulting firms who are already producing papers on the subject. One piece of the jigsaw reveals that those on the fringes of banking are moving cautiously as they don't wish to be caught up in some of the draconian regulations which pervade the industry.

Banking in Europe for instance is expected to be transformed by new EU regulations that will force banks to provide third parties with access to data

of customers who authorise such action. It will be interesting to observe the competition that will be unleashed for banks from Fintech start-ups and other Silicon Valley enterprises plus Chinese technology groups.

As we become focussed on these changes we should not forget that if an enterprise provides money it is not only equity. Banks for instance get it by taking deposits and issue bonds in local and offshore markets. The reality is if any lending enterprise cannot collect loans booked on its balance sheet, it cannot repay the money it has borrowed, and the whole edifice collapses. A bank collapse can be ugly and minimising that ugliness is one reason we have Bank Regulators.

Our major banks in Australia provide 140% of the lending to the real economy. Total loans outstanding are $2.4 trillion. There are some important lessons to learn from the malaise in Europe at the moment; when the European banks falter so do the various economic zones comprising the European economy.

When broken banks stop lending, companies get starved of loans and job creation wanes, pushing out any recovery to who knows when. In a world awash with debt, that would not be a comfortable environment.

If Deutsche Bank, Germany's biggest lender and reported to have one of the largest derivative exposures in the world of finance, and Monte del Paschi di Siena, the world's oldest bank and Italy's third largest, are weakened to the point that the mandated regulatory capital cushion vanishes and bail out is required—they are too big to mimic a Lehmann Brothers style collapse; the financial and the economic repercussions could be gruesome.

We read that Italy's banks are holding something like Euro 350–400 billion in non-performing loans depending on whose numbers you believe. The vast majority of that is not just temporarily non-performing—it is dead money and not recoverable. There is a suggestion that the Banks are in denial and the European Central Bankers are struggling with a solution to avoid the gruesome experience mentioned earlier.

If there is anything that the 2008 crisis taught us it is that big banks, including our own Australian banks, are all interconnected. Shocks are delivered through the global financial system instantaneously.

Since the 2008 financial crisis and the passage of the Dodd-Frank legislation in the USA two years later, global financial regulators have been pushing a deliberate agenda to increase the capitalisation of large banks. The objective of this increase in capital, we are told, is to make public rescues of the largest banks less likely and to change their corporate behaviour. Despite the fact that the 2008 financial crisis was not caused by a lack of capital inside major financial institutions, raising capital levels has become the primary policy response among many of the G-20 nations and the prudential regulators who oversee global banks.

Part of the problem with using capital as a broad prescription for avoiding rescues for large financial institutions, a.k.a. 'too big to fail', is that this approach explicitly avoids addressing the actual cause of the problem, namely errors and omissions by the officers and directors of major banks that undermined investor confidence. A combination of poor loan underwriting, excess risk taking in the trading and investment portfolios, deliberate acts of deceit, a systemic failure to disclose the true extent of bank liabilities, and/or acts of securities fraud actually caused the failure of or need to rescue a number of institutions in the USA. These rescues or events of default were driven by a sharp decline in liquidity available to these obligors and led to the wider financial crisis in 2008 and beyond.

Thus when regulators and policy makers sign on to the idea of higher capital levels as a solution (for T.B.T.F.), it seems are we all effectively burying our collective heads in the sand? In mid-2008, when a bank in the USA was receiving inquiries from bond investors about early redemption of long-term debt, the bank's stated level of balance sheet capital was not at issue. Instead, investors, counterparties, and corporate/institutional depositors were concerned that they no longer understood or trusted the bank's asset quality and financial statements, and therefore backed away from any risk exposures with that bank.

There are two basic reasons why the current fixation with higher capital levels should be a cause for concern among policy makers. First, there is no evidence that higher levels of capital would have prevented the 'run on liquidity' which caused a number of large depositories and non-banks to fail starting in 2007. Reckless and questionable financial decisions characterised, for example, by a failure to properly evaluate the creditworthiness of borrowers were the proximate causes of an erosion in investor confidence which ultimately caused these firms to collapse.

Second, significantly higher capital levels and other regulatory constraints reduce the profitability of banks and limit credit expansion. The

fact that the U.S. banking industry was able to fund the post-crisis clean-up internally by diverting income is a remarkable achievement, yet the response from policy makers has been to take deliberate action that make banks less profitable and less able to fund future losses.

Moreover, higher capital levels have negative effects on capital formation and credit creation that may work against the broader goals of financial stability and economic growth. Witness the declining bank lending volumes in the US residential mortgage market. Banks which cannot achieve sufficient equity returns to retain investors will, over time, either shrink or discontinue businesses altogether in order to survive. Under the current regulatory regime, banks in the G-20 nations are effectively being turned into utilities which take little or no credit risk and thus do not support economic activity.

Not only do higher capital levels and other forms of punitive regulation reduce the availability of credit from depositories, but these strictures will tend to force consumers and businesses to seek out credit from unconventional sources that may actually increase total systemic risk to the financial system. The proliferation of various types of non-bank lenders purporting to offer 'new' business models are a familiar response to increased regulation and tougher prudential standards. Many of these models have originate-to-sell business models similar to that used in originating sub-prime mortgages in the 2000s. For example, JPMorgan Chase & Co. Chief Executive Officer Jamie Dimon says marketplace lenders might find that sources of funding evaporate during a downturn.

One of the key fallacies embraced by some bank regulators is the notion that higher capital levels will help (TBTF) banks avoid failure and, even in the event, the failure of a large bank will not require public support. First and foremost, banks fail not because they run out of capital, but because a lack of confidence results in a diminution of liquidity available to the enterprise.

Ultimately, market liquidity is a function of investor confidence, and not capital. Cash flowed into the largest banks in the weeks after the failure of Lehman Brothers because the banks were big and investors believed these banks would receive government support. Liquidity is the key determinant of whether a bank or nonbank fails. Indeed, for many credit professionals, credit spreads and ratings, and other dynamic market indicators, are far more important measures of particular counterparty risk than static, backward-looking measures of balance sheet capital.

Managing the liquidity of a bank or non-bank involves not just cash and collateral, but also reputation and transparency. Measuring the static level of capital on a bank's balance sheet may provide some comfort as to enhanced financial stability. Managing liquidity, however, is a dynamic task that defies easy quantification but is, at day's end, crucial to maintaining financial and economic strength. By focusing much of the attention of regulators and policy makers on the static issue of capital, many practitioners in the USA believe they are not addressing the true qualitative, behavioural issues that undermined investor confidence in all types of financial institutions and led to the 2008 financial crisis.

Financial Industry Changing Plus a Royal Commission

We have been reading about the future of the established Financial Institutions in the digital world, which has become a consistent theme as analysts assess the condition of northern hemisphere banks post their half yearly results.

Many have warned of a massive move to online account management (especially mobile), which would shift assets away from legacy banks and brokers to lower-cost managers. Fidelity are reported to have recently launched some index funds with 0% management fee. They will make money in other ways, but it has captured the competitors' attention in the USA.

Those expressing the most concern were from the big banks and institutions whose dominion is threatened. They are competing on price, and prices are going down. Yes, younger customers are shifting away from some traditional institutions. But for now, at least, those are also smaller accounts that cost more to maintain and service.

However, a very well-known asset manager argued that the simple fact is that people are not going to manage a $500,000 or $1 million account or more from their phone. Most are still going to use a financial advisor/ broker (or Bank), even if some competitors take a sharper pencil to the fees for service provided.

Fees are going to fall across the board in the industry. Those who have been selling high-fee services and products are going to see less demand and clients are becoming more sophisticated. This is projected to be true after the next bear market when for the third time in 20 years, traditional

portfolio managers will have once again charged high fees for very low returns. Traditional bank balance sheet structures will also come under pressure as funding becomes more expensive with a higher interest rate environment. Some analysts are also beginning to express concern about the massive growing global debt that will make the next recovery even slower until that debt gets 'rationalised' in some way.

Given that background, one cannot help but be intrigued and disappointed at what has been reported from the Royal Commission into misconduct into the Banking, Superannuation and Financial Services industry here in Australia. The findings reveal that Banks' Financial Planning divisions conducted aggressive sales driven cultures with a sales volume and 'profit at all costs' attitude, leading to scandal after scandal, and there now appears to be a flawed compliance structure in some institutions.

We have seen cases reported on lending practices within the Banks and we are now reading about the hardships of the rural sector which is probably one of the toughest industries to lend to because of the variability of the markets and the climate, and where attempts have been made over the years, by Governments, to assist industry difficulties and shortcomings.

The Commission reported broad and deep malpractice across the sector. It pointed to greed and short-termism, poor regulator behaviour and unacceptable leadership and governance standards (see Chaps. 1 and 3).

The Commission concentrated on aggrieved customers and quite a number of people are now beginning to question how these misdemeanours have occurred and what should be done to prevent further occurrences, given the digital revolution now reported to be challenging the existence of a commercial bank model. One has to wonder what happened to the Internal Audit process, the external audit obligations, the Ombudsman role in such misdemeanours, APRA's overview process and ASIC's review process.

Former Federal Treasurer, Peter Costello, is reported to have spoken '*of how the financial crisis made bankers feel like infallible geniuses. It was this belief that led them to lose their way and venture into peripheral profit making areas outside of banking's core business*'.

Perhaps there is merit in his observations, but all the institutions appearing before the Commission would have direct and indirect subsidiaries with operations organised for specific purposes, and all of these business activities would have inherent risks. One would expect that they all have stated core values, Code of Ethics, and operating principles.

Two of those basic principles should be to 'manage risk well' and 'good ethics' should be seen as good business.

From what we have read, one could conclude that there was a breakdown in Risk Disciplines and in some instances questions raised as to whether a risk framework actually exists. The risk frameworks that we have studied comprises: Risk Culture, Risk Appetite and philosophy, Risk Governance within the organisation, Risk Transparency and reporting, Risk Management processes. Obviously each Business Unit would have approved supporting documentation, e.g., policies, procedures, standard operating requirements, guidelines, playbooks, etc.

There has been some concentration on a new credit reporting regime, but credit risk is one element of a risk framework and whilst repayment history is important when considering loan applications, integrity of the customer and his/her capacity to repay a loan will always be paramount.

One of the other issues emerging from the Royal Commission's work, has been the question of capabilities of employees who deal with customers. One of the features which emerged in the USA following the GFC was that some financial institutions had untrained employees selling products about which they had little knowledge, and risk ignorance certainly prevailed. It is not an unreasonable expectation for customers to be dealing with employees who have the appropriate accreditation to help customers achieve their goals, and we would argue that further light will be shining on the adequacy or otherwise of employee development programmes as the Commission's recommendations are implemented.

It is also interesting to observe the Australian Government proposals to ramp up the powers of ASIC (Australian Securities and Investment Commission); this is reported as the most concerted effort in more than a decade to deal with financial sector misconduct. Stronger penalties will make our political classes feel as if they are in control, and a clear message to the financial sector that compliance failures are not victimless crimes.

There is no acknowledgement yet that over the last 10 years technology advancement has revolutionised the business of banking. Mobile and online banking has allowed traditional financial institutions to cut down on paper costs and branches, and now we see the industry being disrupted further by a new range of technologies where consumers are demanding instant and convenient banking and payment services. New technology firms have begun providing banking services, and private companies have begun issuing digital currencies based on new crypto-technology. We even have the Reserve Bank of New Zealand asking whether it makes sense for a Central Bank to issue either cryptocurrency or a more conventional

digital currency.—Whether they end up doing so or not, it is notable that a major central bank is considering the idea openly.

Key Points which gathered from their research include:

- Central-bank issued currencies are already largely digital, but exist on paper as well. Issuing a currency only digitally would be a major change, with both advantages and disadvantages. A digital currency circulating alongside physical cash is a more likely first step.
- Digital currency is likely safer and easier to distribute than cash and, as legal tender, would be less risky than the electronic tokens issued by commercial banks and other non-Bank operators.
- On the downside, digital currency would depend on technology that is itself imperfect and subject to either hacking or technical flaws.
- A central bank could conceivably issue a cryptocurrency, based on a blockchain-like distributed ledger, that would be more secure but also make monetary policy more difficult to implement.

The Bank of England who had also been researching the crypto-technology since 2015, dropped the idea in 2017 because it wanted to promote 'traditional banks'.

Clearly, the world of Central Bankers is grappling with these challenges, but it is good that the Central Banks are prepared to share their thinking on these complex issues.

In search for remedies to the misconduct reported in the Royal commission's processes, issuing more regulation when we still have to absorb a very comprehensive report into the Financial System conducted by David Murray, released in December 2014 and accepted by the Government in October 2015, seems to be superfluous. The Murray Report should be compulsory reading for all commentators and politicians. It had 44 Recommendations and had 5 specific themes:

- Strengthen the economy by making the financial system more resilient;
- Lift the value of the superannuation system and retirement incomes;
- Drive economic growth and productivity through settings and promote innovation;
- Enhance confidence and trust by creating an environment in which financial firms treat customers fairly;
- Enhance regulator independence and accountability and minimise the need for future regulation.

Given some of the non-Royal Commission commentary, one could conclude that there is a lack of understanding of the value chain between product/service provider and the customer, plus of course the risks inherent in those processes. Let's hope one of the Institutions engages in this education process sooner rather than later.

Given the specific themes outlined in the Royal Commission and the seriousness of the findings, what is required is the need to get back to basic levels of trust where an advisor is truly independent and not just a fee churner. There is need for basic tenets of honesty, integrity and accountability. Regulations without a spirit of morality do not work. This returns us to the centrality of the need for a high quality of leadership of banks (see Chap. 1) !

There must also be clear disclosures provided to consumers. Having a dense legalised disclosure statement for consumers to read so organisations can protect themselves is not the answer. Customers need to receive advice from accredited/competent employees; fair fees and proper disclosure must be accepted standards. To assist with a transition to the digital era of Banking, appropriate risk frameworks for all products and operations, understood and approved by Boards, and acceptable to APRA, should begin now.

Customer facing employees must be accredited and standards introduced to ensure customers' demands are fulfilled within a reasonable period of time.

The collapsing of Bancassurance models in Australia is gathering pace, but the call to eliminate a vertical integrated model when the intermediation process is beginning to change, needs careful thought and study of what has been achieved in other developed economies, and what trends are occurring.

Whilst the traditional Bank still enjoys trust of their depositors, they also have long term cross cycle credit data and can provide more differentiated financial services, albeit given one could question the quality of relevant product risk profiles. There is a looming risk that the younger generation of potential customers, who grow up using payment/Fintech APPs on smart phones before they open Bank accounts, will not have the use of banking services. No doubt most industry practitioners are aware of new competitors offering comprehensive financial services, from payment, wealth management, financing, insurance and credit scoring. Each of these five business pillars are proving popular with Fintech firms and some consumers. It is instructive to read the US analysts' reports on the major

Banks in the US, some of whom are handling the disruptive technology challenge very competitively.

A Legitimate question is whether the users get used to these new offerings and suppliers and give up banking services over time? Or will they only use banks for storage of funds, while the key transactions, thus the relationships and understanding of the customers, reside with the Fintech Firms?

It is interesting to observe the efforts of the Banks around the world to launch their mobile banking APPs. There are reports that most banking APPs lack differentiation, anchoring products or function to attract customer loyalty and traffic. Most mobile banking APPs are used several times a month whilst Fintech APPs, especially with social media function, are used multiple times a day. Thus it seems at this stage Fintech APPs are generally much better positioned to provide effective payment services. Will mobile banking APPs become obsolete due to the low frequency of usage? How should Banks proactively engage customers in the digital era?

Ten years ago we started to see migration of customer referrals to sales agents and/or telephones. The Banks around the world have massive data banks but have struggled to use that data to gain 'share of wallet' and have invested heavily without competitive advantage.

The CBA in Australia were the first serious player into the wealth management game through the purchase of CML in the mid 90's but integration into the Bank appeared slow. Other Australian Banks followed suit with NAB purchasing MLC in 2001, Westpac and ANZ purchased Funds under Management but it seemed that they were not interested in manufacturing insurance type products.

The Royal Commission has quite rightly raised questions about the knowledge of Boards of Australian Banks and whether they understood the risks associated with products being sold by people who it appears had little knowledge of the product being sold, not to mention the technology support and how that integrated with the traditional Bank systems (see our Chap. 3 on governance and boards).

Legacy technology systems are a real challenge for financial institutions who transform from old platforms to new digitised technology. They can be a massive burden on those who are trying to move with the times and market forces, combatting the Fintechs. As in the USA, Australia has begun to see solid growth of digital handsets for banking, less reliance on cash transaction and more sales people with questionable understanding of the products and inherent risks.

On a comparative basis, the US customer seems more attuned to investment type products than Australia at this point in time, and thus we are seeing the traditional Bank Branch being converted into a Financial Centre populated with people with specific training now dealing with the customer base. Some banks in USA have commoditised their consumer lending activities with most loans taken off Balance Sheet through securitisation. They are advancing very quickly in enriching their database to enable a customer to control their own data and use artificial intelligence to build their own requirements for loans and investment transactions. The successful institutions not only educate their staff to deal with this new era but they also have an 'Apple-type' configuration in physical outlets to enable their customers to 'touch and play' with the new platform devices.

Following the GFC, when US Banks wrote off billions of dollars in fines and bad debts, the larger US institutions realised that their processes had become complex and that their people, their most important asset, were inadequately trained to handle the demands of their customer base in a world of constant change.

There is an example outlined in one of the analyst's reports where staff submitted 1600 new ideas to simplify the business and recreate operational efficiencies with particular emphasis on client care. Their high-tech, high-touch enhancement was proving a competitive advantage for a Brand which had been damaged. Their old Branch/Telephone Centres have been reconfigured; they opened 500 new Financial Centres, re-designed 1500 Branches into Financial Centres, and they have concentrated on the competencies of customer facing employees by adding 5400 certified professionals and reconfigured those irritating telephone centres into centres of resolution to which their customer base has responded positively. The particular Bank spent $10 billion on technology and $3 billion on new initiatives and that included cyber/information security. They have an expense target and automation/artificial intelligence is a significant driver in reaching that target.

Summary and Forward Projections

Whilst many banks around the world, including Banks in Australia, have been adjusting their old banking model, there is hardly a day passes where there isn't new commentary which highlights the sea-change disrupting the banking industry and with that comes the challenge of increased risk.

Tech firms focus on the customer experience, innovation and volume growth, whereas the Banks prioritise safety of data/funding, risk control and profitability.

We are now entering the brave new world of Open Banking, driven by a combination of competitive pressure and regulatory actions such as the revised Payment Services in Europe and the Open Banking initiative in the UK. Banks are being forced to open up and operate in a world where the value chain is becoming more fragmented and the competitive environment more intense.

In this new world, bank customers will be able to share access to their financial data with non-bank third parties through Application Programming Interfaces (APIs). Third parties will be able to integrate their services with those of a Bank to create a better consumer experience. Privacy and Cyber security will likely be a real challenge in this environment.

The disaggregation of the banking value chain including proliferation of partnership interfaces is still in its early days. As it develops, and it certainly will, there will undoubtedly be winners and losers among incumbent Banks.

The Banks who understand their value chain and have sound knowledge of their Risk will avoid the creative destruction of their business—those banks that focus simply on harvesting their current business franchise should expect rapidly increasing erosion of their business. The ability of national regulators to draft meaningful legislation will require a collaboration between banking practitioners, bureaucrats, academia, consumers and politicians with financial literacy; otherwise implementation will become untenable.

Wayne Byers, Chairman of the Australian Business Economists, gave a presentation recently where he outlined some observations where he sees the community wanting their financial institutions to be safe and secure, and they certainly seek ethical behaviour. He did point out that the business of finance is one of risk taking so building resilience against those risks was fundamental to preserving ongoing trust and confidence in the financial sector.

Given the above, perhaps this new financial environment requires a different regulatory approach. The boundaries between different financial institutions and products are eroding; the successful institutions understand their product value chains so one could argue that it is time to focus on products rather than just institutions. Distinguishing between high risk, lightly regulated products and low risk prudentially assured products

will ensure sufficient competition within each product market, distribute the burden of cross-subsidies across the system and ensure simplicity and coherence in regulatory structures.

We have been fortunate to witness the re-emergence of the Bank of America, after a near death experience following the GFC. They do segment their customer base, they have very disciplined risk protocols, they price for risk, their investment in technology and new initiatives has positioned them well to compete with the so-called disrupters, and they concentrated on customer expectations by providing appropriate accredited people to assist achieve the goals of that increasing customer base.

As observed earlier, the world is awash with debt and with many countries, including Australia, indulging in a debt binge which sees Government, Corporate and Household debt now exceeding 250% of GDP, any credit contraction which involves repayment of principal debt or default will exert deflationary influence on the global economy as well as pressure on traditional Bank Balance Sheets.

When one hears stories of rogue traders losing fortunes in the securities and financial markets, trade debates, currency wars and then closer to home, the issues surfaced from the Royal Commission, we have a spectacle of Moral Hazard besetting the Financial Services Industry where reputational risk will affect competition and potentially restrict Institutions confronting the disruptive technology world.

We should all learn from the Greek experience plus other potential default problems in Europe. When banks falter so do countries as the contagion effect can escalate quickly.

When banks stop lending for any reason, companies get starved of capital, job creation wanes, economic growth stalls, and recovery becomes a distant projection.

The banks who understand product value chains, have a strong risk framework, and engage their accredited workforce in outcome thinking will thrive in the new world of Digital Technology and Artificial Intelligence.

No history of counterparty risk in Australia would be complete without reference to the chronological list of events which occurred in Australia between 1980 and 1996 as outlined in Trevor Sykes book *The Bold Riders*.[2] There was a funding requirement for each event outlined and the quality of the risk assessment processes of the providers of debt was surely tested.

[2] Trevor Sykes, The Bold riders, Allen & Unwin; First Edition, February 1, 1995, Sydney.

NAB's credit risk policy was developed around the concept of cash flow coverage ratios where the basic components of the ratio were Capital Debt Repayment capacity and Annual Debt Service Requirements. This applied to all counterparty risk assessment no matter which industry was being assessed or challenged, with one exception, Rothwells, where we committed funding against a WA Government Guarantee: we incurred minimum losses after acrimonious discussions with Treasury Officials in WA. The 'Paper Castles' which developed around the many entrepreneurs in Australia at that time, who had discovered the meaning of Leveraged Balance Sheets and Intercompany Loans within questionable financial structures tested our resolve to bypass business which did not align with our policies.

The Bold Riders has a very interesting section on the Bond Corporation and his many dealings. The 1989 Bond Corporation Annual Report is worth reading because not only has it one of the longest audit qualifications seen at the time, but it also highlighted the strength of the basic covenants which NAB's legal team included in a loan agreement that allowed us to issue default notices if the Bond corporation did not comply with covenants protecting our senior debt position should cash be transferred out of Bond Brewing.

There are many stories to be told about individuals in the Corporations listed in the chronological list of events mentioned, and Rupert Murdoch, Frank Lowy, John Elliott and Kerry Packer would lead any list of Australian business people who have introduced Australia into the real world of capital markets with a great deal of success. However, the 'Doyen of the Deal' Michael Robert Holmes à Court was the individual who made the front pages of the world business press with his audacious takeover bid for control of BHP through Wigmore, a company controlled by Holmes à Court, capitalised at $39 million, when BHP had a market capitalisation of $3.7 billion. Holmes à Court offered 2 Wigmore shares for 1 BHP share. The initial offer failed but Wigmore held $10 million BHP shares and increased its own market value by $25 million. This was a classic Holmes à Court play, within the National Companies and Securities Commission rules at that time.

One commentator noted that BHP shareholders who accepted the Wigmore offer did not receive any dividend on their new shares as they had forfeited that dividend as pointed out in their Part A offer. Whilst not having much bearing when assessing the concept of the bid it also reflected

the cult following developed by Holmes à Court. These were cosmetic setbacks to what was referred to as a cosmetic offer.

Holmes à Court had only just begun: he reconstructed his business activities into Bell Resources who eventually accumulated 29.93% of the BHP registrar and he was offered a seat on the BHP Board. After the stock market crash of 1987, he sold his interest for $2.3 billion, withdrawing from the world of listed companies. In less than 3 months he disposed of $5 billion in assets. The price of Bell Group's shares at that point collapsed from $10 to $1.30. Holmes à Court is reported to have received twice the latter amount when the control of his Group passed to that mercurial West Australian businessman, Alan Bond.

Holmes à Court had a gift for seeing an opportunity and developed a legendary reputation for his daring company raids. He perfected option trading in the Australian market to assist with his acquisition strategy and divided the financial institutions of Melbourne and Sydney as to how his initiatives would be structured and financed. Holmes à Court laughed at suggestions that he was a swash buckling corporate pirate plunging impulsively into deals worth hundreds of millions of dollars. His main hobby was breeding thoroughbred horses—in 1984 his horse *Black Knight* won the Melbourne Cup. He collected vintage cars and European and Australian art.

He died in September 1990 reportedly intestate, an incredible individual, the likes of whom we have not seen since in our market place. Respect or disrespect him, he did push the envelope of risk management to the limit and contributed to various reviews of the Corporations Act.

There are many who masquerade as understanding the risk profile of a Bank, and models are certainly useful but they are a guide only and are no substitute for understanding the economic levers influencing the quality of assets being written or the cost of funding a balance sheet. Previous generations were all taught these basic elements of risk and NAB in particular were fortunate to have concentrated development of these characteristics. When one views the Banking System in hindsight, we are thankful that NAB had people of the calibre of Allan Diplock, Bob Miller, Les Ryan and Paul May who all perpetuated the Credit Bureau model in the 80's and 90's; alas, none of the original talented teams continued employment with NAB; their skills were recognised and deployed elsewhere. This is a shameful waste of developed talent when one considers the many disasters and strategic missteps suffered by the NAB post 2000 (see Fig. 1.1, Chap. 1).

Appendix

Upheaval and Uncertainty in the Financial Services Sector

Whilst the Australian banking sector had experienced radical changes and occasional turmoil throughout its development, the decades from the late 1950s onwards would be notable for the diverse nature of and numerous forces for change. A technological revolution, shifting trade patterns and a growing spirit of internationalisation would all be influential in sculpting the Australian industry. The regulatory climate would be transformed not once, but several times—partially in response to the other forces for change—and the local competitive environment would also present new challenges.

Technological change swept through the financial services sector in the latter half of the twentieth century. In the 1950s, mechanical ledger and adding machines were introduced into Australian banks. Electronic data processing arrived in the late 1960s and automated previously manual activities. Subsequent and continued improvements in telecommunications, computing hardware and software improved the industry's efficiency and enabled the creation of innovative financial products. In 1977, the ATM (automatic teller machine) was adopted in Australia and this was followed in 1984 by EFTPOS (electronic funds transfer at point of sale).

At the same time, another force for change was building. Until the 1960s, with the minor exceptions of a few branches in New Zealand and various countries in the South Pacific, the only offshore branches maintained by Australian banks were those in London, since the bulk of Australia's trade had been with Britain. To finance trade with and service their clients' needs in other nations, Australian banks had relied on a network of correspondent relationships with foreign banks, who acted on behalf of the clients of Australian banks.

However, from the late 1960s onwards, bilateral trade patterns between Britain and Australian began to change. As the former looked increasingly to the European Common Market, so the latter was compelled to look north to the Pacific Rim, particularly to Japan. Australian companies broadened their horizons and the banks began to establish representative offices, and latter branches, to service their customers' operations overseas. This spirit of internationalisation was not confined to Australian businesses and banks, however, with North American, Japanese, European and other banks seeking a reciprocal presence in Australia. Prohibited

from operating as licensed banks in Australia at the time, foreign banks established merchant bank subsidiaries, finance companies and representative offices.

On 14 January 1960, after sustained pressure from the private banks, the government transferred the regulatory functions of the CBA to the newly constituted Reserve Bank of Australia. The new central bank's charter, under the *Reserve Bank Act 1959* was and is to 'contribute to (a) the stability of the currency of Australia; (b) the maintenance of full employment in Australia; and (c) the economic prosperity and welfare of the people of Australia'. In practice, its responsibilities comprise:

- prudential supervision of the banks and financial system;
- the conduct of monetary policy (to achieve price stability and full employment); and
- other monetary management duties, including acting as custodian for Australia's foreign reserves and as banker to the government and banks as well as note printing.

Several years earlier, again after much agitation, the private banks had been granted permission to open their own savings bank subsidiaries, and to operate both trading and savings banks, as the CBA had done with great success since its inception.

However, the emergence of non-bank financial institutions (NBFI) in significant numbers proved a more significant stimulus than the incorporation of savings bank subsidiaries. Building societies and credit unions, typically established as cooperatives and regulated by state legislation, commanded an increasing share of the housing finance market. They also became attractive repositories for short-term deposits because unlike the banks, they were not subject to the restrictions on paying interest on such deposits. The inflation of the 1970s increased the demand for interest-bearing short-term deposits even further. The growth of the NBFI was not merely a function of new entrants but also the result of diversification by the incumbent private trading banks.

This diversification represented an evasive reaction by the trading banks to the onerous regulations binding their operations and restricting them from providing new services and from entering growth markets. For example, by the late 1950s, all the major banks held equity stakes in the blossoming finance companies that were supplying consumer credit for the post-war surge in demand for consumer goods. The Bank of NSW and the National

Bank of Australasia purchased a significant minority interest in AGC (Australian Guarantee Corporation) and Custom Credit, respectively. Many of the banks also took minority positions in the foreign-dominated merchant banks, which conducted official short-term money market operations. The Australian banks also branched out into the provision of travel and insurance services and, in the mid-1970s, into credit cards.

As the importance of NBFIs in private borrowing and lending increased and the dominance of commercial banks correspondingly decreased, the ability of the monetary authorities—which regulated banks, but not NBFIs—to control the aggregate volume of borrowing and lending in the economy diminished. In such an environment, government policies for macroeconomic stabilisation were being jeopardised, or at least diluted. At this point, the government and monetary authorities faced two alternatives. First, they could have extended the web of regulation to cover NBFIs. While the banks had lost ground increasingly to non-banks, both forms of intermediated finance experienced increasing competition from mechanisms of direct (i.e. non-intermediated) finance. This was facilitated by the development of securitisation and the increasing tendency of large corporate to access financial markets directly through their own treasury divisions. To extend the regulatory net beyond the banks to incorporate non-banks would simply have exacerbated the trend towards non-intermediated finance and moved financial activity beyond the reach of the monetary authorities altogether—at least so long as they relied on direct controls.

The second alternative was to rely on indirect controls such as interest rates and exchange rates. This required liberalisation (deregulation and re-regulation) of the financial system, which would 'ensure that the influence of the monetary authorities was felt throughout the financial system, whether borrowing or lending was direct or via an intermediary.'

The Australian Financial System Inquiry 1981 (Campbell Committee) and the subsequent Review Group on the Australian Financial System (Martin Review Group) recommended the latter course of action and a policy of financial liberalisation was adopted by the incoming Labor government following its election in 1983.

The Australian dollar was floated and exchange controls were removed in December 1983, and 16 new Australian banking licences were granted to foreign concerns in February 1985 and controls over interest rates were largely abandoned in April 1985.

The recommendations of the Campbell Committee, particularly the removal of barriers to foreign bank entry, had been widely anticipated. The period leading up to and the period immediately subsequent to the release of the Committee's Final Report saw a flurry of merger activity which left four main players in the Australian banking industry. The ANZ (Australia and New Zealand) Bank, headquartered in London until 1976, had been the result of a merger in 1951 of the Union Bank of Australia and the Bank of Australasia and takeovers in the 1970s of the ES & A (English, Scottish & Australia) Bank and the troubled Bank of Adelaide. However, in the early 1980s, it was unsuccessful in both its bids for the Commercial Bank of Australia and the Commercial Banking Company of Sydney. The latter was acquired by the Melbourne-based National Bank of Australasia, the merged corporation becoming the National Australia Bank in 1981. A year later, the ANZ Bank's other takeover target, the Commercial Bank of Australia, was acquired by the much larger Bank of New South Wales to form the Westpac Banking Corporation. In 1983, however, the ANZ Bank purchased Grindlays Bank, with its extensive Asian (especially Indian) branch network, from Citibank and Lloyds Bank. The CBA formed the fourth 'pillar' of the Australian banking sector, with the remaining state banks also figuring reasonably prominently in their respective states.

By the mid-1980s, the Australian banking industry faced an uncertain future. Although profits and market shares remained high, so too did costs and branch numbers. The banks also faced growing non-bank and foreign bank competition, the challenges of technological change and the uncertainties of internationalisation. The days of rum were gone, but perhaps the days of pioneering had returned.

Regulation 2016/2017

Fast forward, to the extensive and detailed regulation of Australia's banking system split mainly between the Australian Prudential Regulation Authority (APRA) and Australian Securities and Investments Commission (ASIC). The Reserve Bank or (Central Bank as it is known in Europe) also has an important involvement. However, in practice banks in Australia are self-regulated through External Dispute Resolution (EDR) schemes the most prominent of which is the Financial Ombudsman Service (Australia).

APRA is responsible for the licensing and prudential supervision of Authorised Deposit taking Institutions (ADIS) banks, building societies,

credit unions, friendly societies and participants in certain credit card schemes and certain payment facilities, life and general insurance companies and superannuation funds. APRA issues capital adequacy guidelines for banks which are consistent with BASEL IV guidelines. All financial institutions regulated by APRA are required to report on a periodic basis to APRA. Certain financial intermediaries such as Investment Banks (which do not otherwise operate as ADIs) are neither licenced nor regulated under the Banking Act and not subject to the prudential provision of APRA.

ASIC has responsibility for market integrity, consumer integrity and consumer protection and the regulation of certain financial institutions (including Investment Banks and finance companies). However, ASIC does not actually investigate any issues or proposed any regulation that concern consumer protection; thus authority is delegated to the External Dispute Resolution schemes and the Australian Competition and Consumer Commission (ACCC).

Banks are subject to obligations under the Anti-Money Laundering and Counter Terrorism Financing Act as reporting entities.

There were in fact 17 different Enquiries together with a Royal Commission being undertaken. These Enquiries are probably justified with self-inflicted events stimulating emotion within the political classes and some sections of the public. It begs the question as to the effectiveness of our regulators who are universally recognised as highly professional and efficient, but it also highlights how ignorant some commentary is as we examine the emerging disruptive technology that has the potential to transform life, business and the global economy. Changes like the impact of the semi-conductor microchip, the internet or steam power in the industrial revolution transform the way we live and work, enabled new business models and provide an opening for new players to upset the established order.

Banking as we know it is not immune from these disruptive technologies.

One would have thought that our business leaders and policy makers would be endeavouring to identify the disruptive technologies and carefully consider their potential before these technologies begin to exert their disruptive powers in the economy and society.

Political opportunism in Australia seems to be inhibiting the innovation beginning to emerge in other countries.

For instance, Don was in India recently and like many people, had a preconceived perception about the Indian economy—scrappy infrastructure, corruption, bureaucracy and antiquated institutions but with a massively growing middle class. Well, that is the narrative and has been for the last 20 years.

But that phase now seems to be over and no one noticed. So few people in the investment community or even Silicon Valley are even vaguely aware of what has happened in India.

It seems that the future for India is massive technological advancement, a higher trend rate of GDP and more tax revenues. Tax revenues will fund infrastructure—ports, roads, rail and healthcare. Technology will increase agricultural productivity, online services and manufacturing productivity.

Telecom, banking, insurance and online retailing will be the beneficiaries, as will the tech sector.

Nothing in India will be the same and it seems to be in a growth phase.

Foreign Direct Investment (FDI) is already exploding and will rise massively in the years ahead as technology giants and others pour into India to take advantage of the opportunities now presenting themselves.

In 2016, India introduced another innovation called India Stack. This is a series of secured and connected systems that allows people to store and share personal data such as addresses, bank statements, medical records, employment records and tax filings and it enables the digital signing of documents. This is all accessed, and can be shared, via Aadhaar biometric authentication.

Essentially, it is a secure Dropbox for your entire official life and creates what is known as eKYC: Electronic Know Your Customer.

Using India Stack APIs, all that is required is a fingerprint or retina scan to open a bank account, mobile phone account, brokerage account, buy a mutual fund or share medical records at any hospital or clinic in India. It also creates the opportunity or instant loans and brings insurance to the masses, particularly life insurance. All of this data can also in turn be stored on India Stack to give, for example, proof of utility bill payment or life insurance coverage.

India Stack is the framework that will make the new digital economy work seamlessly.

It's a set of APIs that allows governments, businesses, start-ups and developers to utilise a unique digital infrastructure to solve India's hard problems towards presence-less, paperless and cashless service delivery.

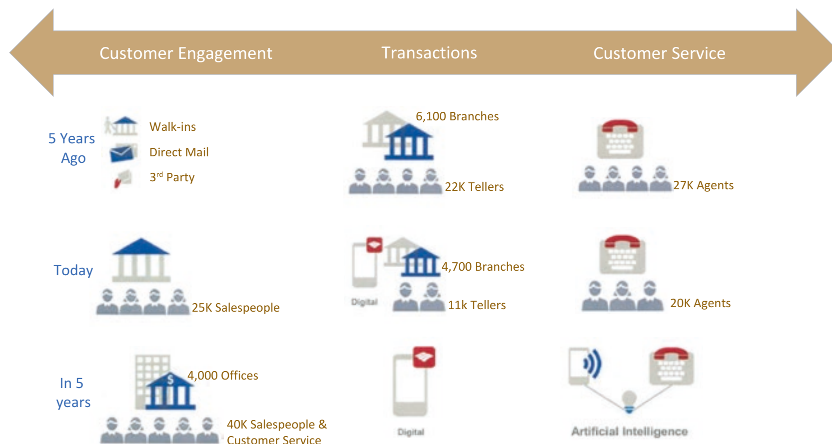

Fig. 6.3 A model of modern consumer banking

- Presence-less: Retina scan and finger prints will be used to participate in any service from anywhere in the country.
- Cashless: A single interface to all the country's bank accounts and wallets.
- Paperless: Digital records are available in the cloud, eliminating the need for massive amount of paper collection and storage.
- Consent layer: Give secured access on demand to documents.

India Stack provides the ability to operate in real time, transactions such as lending, bank or mobile account opening that usually can take few days to complete are now instant.

This revolutionary digital infrastructure will soon be able to process billions more transactions than bitcoin ever has. It may well be a bitcoin killer or at best provide the framework for how block chain technology could be applied in the real world. Bank of America is now trialling this Technology in its Financial Services Centres throughout the USA, and whilst it is early days, outcomes look very positive. An over-simplified version of what is happening in Consumer Banking is depicted in Fig. 6.3.

CHAPTER 7

NAB (B): NAB's Acquisition Strategy

The Context of NAB's International Activities

NAB's acquisition strategy had generally been aimed at enhancing the Group's position within its chosen markets through the purchase of retail banks with strong retail customer franchises. It had also focused on building key capabilities and developing critical mass in selected financial services activities through acquisitions and internal growth. NAB's ability to participate in further rationalisation of the banking industry in Australia had been constrained by the prohibition of the merger of major banks in Australia by the Commonwealth Government. So it looked elsewhere. An international network was built by the end of last century, and plans to go and grow further were in progress. In 1990 the government in Australia announced that it would reject any mergers between the four major Banks: ANZ, Commonwealth Bank (CBA), NAB and Westpac plus AMP and National Mutual (NML). This was a long-standing policy rather than formal regulation, but it reflected the broad political unpopularity of further bank mergers and NAB argued at the time that the 'Six Pillars Policy' was built upon economic fallacies and actually worked against Australia's interest.

The Six Pillars Policy became the Four Pillars Policy but did not prevent the four major banks from acquiring smaller competitors. In 2000, CBA acquired the Colonial Group which had emerged as a major Bank/Insurance combine, after the Colonial Mutual Insurance Group had taken

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D. Argus, D. Samson, *Strategic Leadership for Business Value Creation*,
https://doi.org/10.1007/978-981-15-9430-4_7

over the State Bank of NSW in 1994. The CBA also acquired State Bank of Victoria in 1990. Westpac acquired Challenge Bank in 1995, CBA acquired Bank West in 2008, Westpac acquired Bank of Melbourne in 1997 and St George's Bank in 2008.

The Australian Government direct ownership of banks ceased with the full privatisation of the Commonwealth Bank between 1991 and 1996. There was also increased competition from non-bank lenders, such as providers of securitised home loans. A category of authorised deposit taking institutions was created for a corporation which was authorised under the Banking Act 1959 to take deposits from customers. The change formalised the right of non-bank financial institutions, such as Building Societies and Credit Unions, to accept deposits.

Following the Wallis Committee Report in 1998 (Wallis Report), the oversight of banks was transferred from the Reserve Bank of Australia (RBA) to the Australian Prudential Regulation Authority (APRA) and Payments Systems Board (PSB) was created which would attempt to maintain the safety of the payments system.

The Wallis Report recommended that the Four Pillars Policy model be dismantled, to leave the banks subject to the same merger competition tests as other businesses. The response; the Coalition Treasurer, Peter Costello, removed the 'Pillar' status of the two large insurers (National Mutual had by that time already been acquired by France's AXA) but the ban on mergers of the remaining four banks was retained, with the rider that none of them were considered immune from foreign takeover.

When NAB approached the then Treasurer of the Federal Labor Government to merge NAB and the then distressed ANZ Bank in 1991, NAB was reminded that the Six Pillars Policy was introduced in 1990 to prevent a proposed merger between ANZ and National Mutual, and that intervention had saved the Nation from a potential financial crisis. NAB attempted to have the so-called policy reviewed on two other occasions with proposals to merge with ANZ. A proposed merger with Westpac was thwarted with disagreement on social issues, (it was suspected it has more to do with the disposition of the Chairman at that time), plus little political interest shown by the then Federal Treasurer, John Kerin. The respective business cases were compelling but politically non-deliverable. It is understood that NAB and ANZ attempted to merge in 2008 but again the Federal Treasurer of the day, Wayne Swan, is reported to have supported the existing policy—*'The government considers that Australia is best served*

by a stable banking system that can continue to draw on the strength of and risk management skills of four major banks rather than a lesser number.'

NAB had been successful in Australia both in relative and absolute terms (See Fig. 1.1, Chap. 1), and had a natural appetite to take its capabilities and strategies to achieve and apply these at larger scale. Hence given the conservative approach in its domestic market, this appetite was applied to other jurisdictions.

Going Offshore

Deregulation of the Australian financial system gathered pace during the early 1980s, culminating in the admission of 16 foreign and three new domestic banks in 1985. As a major player, NAB's ability to achieve significant growth within its domestic market was limited. Two of its main rivals, ANZ and Westpac, had internationalised by 1984, ANZ acquiring Grindlays Bank and Westpac embarking on an aggressive, almost frenetic, expansion into the wholesale markets of Europe, USA and Asia.

Despite being the last of the major private Australian banks to move into the international arena, NAB was determined not to play 'follow the leader'. The Bank deliberated at length both about the countries in which overseas expansion might be viable and the form it should take.

There was general agreement that an initial foray overseas should be confined to countries whose language, laws, culture and ethics were compatible with Australia's. As to the form of offshore expansion, two aspects of its experience within Australia pre-disposed the Bank to acquisition rather than organic growth. The Bank's initial move into New South Wales from Victoria in the 1970s had demonstrated how ineffectual a policy of organic growth could be in a crowded market. One of the chief factors behind the decision to acquire CBC in 1981 was frustration at the failure of seven years of organic growth to produce any discernible increase in market share in NSW.

Furthermore, the success of the CBC merger, including the integration of activities, people and systems, boosted NAB's confidence that it could manage the integration of a foreign bank, given sufficient compatibility between the banking systems of two countries. The NAB was convinced from the outset that simply following its clients overseas in the 1980s was no more likely to succeed than following those same clients into NSW in the 1970s.

International Division (ID) in its various forms had been the flag carrier for the Bank in foreign parts for almost a century. It had initiated foreign activities of one sort or another as far back as the gold rushes of the 1850s. In later years, ID had forged correspondent relationships with foreign banks and opened branches of the Bank overseas. Jim Ambridge and Ian Grover were advocates of this strategy. Despite this history, ID was not seen as the logical vehicle for offshore expansion once a strategic commitment to a major foreign direct investment had been formulated by senior management and approved by the Board. This decision did cause some dissention between those who preferred the old regulated environment to the more deregulated form of financial services.

Following the merger with CBC, the Strategic Planning Group, led by John Marshall and Bob Prowse, continued a series of studies of the financial services marketplace, NAB's relative position within that marketplace and the bank's internal performance. At the 1984 Strategic conference held in Frankston, Victoria, Bob Prowse and his team consolidated their analysis and recommendations. This seminal presentation focused on the need for an international strategy. It dealt with the NAB group then and ten years out, profit trends, capital base requirements, funding needs and required management capabilities. The paper detailed the limited potential for growth in Australia, the turbulent economy and inflationary trends. It identified the need to avoid the 'vortex' of bad lending as banks struggled to expand market share; the dangers of competing in marginal markets were emphasised. The paper further recognised the strong retail competencies of NAB, flows of surplus capital were anticipated and the conclusion was argued that NAB had to develop an integrated international strategy.

Prowse and Roland Matrenza presented a subsequent paper to the NAB Board in 1985, whose conclusions directly contradicted those of management consultants, McKinsey and Company, delivered independently to the Board. McKinsey was strongly of the view that offshore expansion would consume large amounts of scarce resources and jeopardise NAB's return on capital. They felt that NAB should become a regional or niche player. However, this view was strongly opposed by the Senior Management Group at the time, who believed that such a strategy would lock the Bank into too narrow a market segment.

Preparing to Go Offshore: Financial Structuring and Choice of Target

Preparations to go offshore involved two related but distinct phases: financial structuring and target identification. With respect to financial structuring, management devoted its attention to:

- conserving capital so as to fund an acquisition;
- off-loading low-yielding assets so as to boost the earnings rate;
- changing the emphasis of existing international business to include more fee-based services;
- becoming more efficient and profitable, enabling NAB to raise capital more cost effectively; and
- listing on the New York and Tokyo stock exchanges so as to tap capital markets outside Australia.

Preparing for an overseas acquisition focused the Bank on its internal vulnerabilities, some of which were highlighted through the rigorous process of listing on the NYSE in 1987. Without doubt, this was one of the game changing processes undertaken, which set a sound platform for data integrity going forward.

With regard to the choice of target, the criteria were highly specific and designed to complement the perceived strengths and weaknesses of the Bank's culture and strategic direction.

The criteria for a potential target was as follows:

- the target had to be either a retail bank (identified by the Strategic Planning Group as the most profitable market segment) or a fee-generating merchant bank, specialising in capital markets;
- it should be under-performing but not 'broken';
- it should have a sound management team in place;
- it should have been profitable over the preceding 5 years and meet a hurdle rate of 15 per cent return on shareholders' funds and 0.7 per cent return on assets;
- it should not exceed one third of NAB's size and have assets of at least A$2 billion;
- it should have a reputable brand/customer franchise;

- it should have adequate loan/loss provisions, with limited credit exposure to debt-rescheduled countries (i.e., South and Central America);
- it should have an adequate computer/MIS platform in place;
- it should be located in a country with similar or at least compatible language, laws, culture and ethics to those in Australia; and
- it should preferably be available for 100 per cent ownership.

Banks with heavy corporate exposure were excluded from consideration on account of their perceived lack of profitability and higher risk and vulnerable to cyclical change in a number of industries. Senior management believed that NAB's balance sheet was not sufficiently robust to sustain a series of large bad debts which could, and did, occur with a more liberal approach to Balance Sheet leverage. This also steered NAB away from banks with substantial exposure to third-world loans. ANZ had been saddled with third-world debt through its purchase of Grindlays Bank, and the market had become wary of such exposures.

The target could be under-performing but not 'broken'. NAB had only a limited supply of high-quality people who could be sent offshore without affecting domestic operations adversely. The target therefore needed to have a sound management team in place.

In the USA, price multiples were high, at up to twice net tangible assets (NTA), while at the same time NAB's share price was trading at or below NTA. Combined with a weak USD:AUD exchange rate, this made an acquisition in the USA expensive. There were also legal barriers to establishing branches across state borders in the USA, a factor likely to constrain expansion within that country.

By a process of elimination, the United Kingdom (UK) became the market of choice. NAB thought it understood the UK market, it believed the Bank's presence might even be welcome and there were good prospects for making further inroads over time.

The reasons for passing over Asia in favour of the mature markets of the UK and USA went beyond the concern over culture, although this was a significant issue. The Senior Management Team of the day had a view that no institution in Asia fitted the Bank's criteria for an acquisition. Many financial institutions were large family concerns and lacked the depth of professional management required by NAB. Furthermore, the Team felt that NAB's lack of familiarity with the region mandated entry with a local partner, and there was scepticism with such arrangements having been

disappointed on previous occasions. Finally, NAB management could not see in the short/medium term how or where to add value in this region.

A task force was formed to make the necessary preparations and draw up a list of potential targets. This group would eventually evolve into the Acquisitions Unit. By the close of 1985, some 200 banks were under surveillance in the UK and the USA.

Earlier Attempts to Move Offshore

While the Bank had defined its formal strategy for internationalisation by 1985, this was not the first time it had contemplated a foreign acquisition.

Rainier Bank

In the early 1980s, a proposal to acquire Rainier Bank, headquartered in the State of Washington, USA was considered. Rainier Bank was well run, with a good franchise in the USA and an extensive network of branches across Asia.

According to senior executives, the deal failed for a variety of reasons. Rainier wanted NAB to take a small shareholding initially and then to work with them to see how the relationship developed. NAB preferred outright ownership but an aggressive takeover would have been resisted by Rainier, potentially destroying value for NAB. Another, and critical, objection was that the deal was too big, Rainier's total asset base of US$7.1 billion exceeding NAB's by one third. Westpac also considered Rainier in 1984 but rejected it. Finally, the view within NAB was it had neither the resources nor the capability to analyse let alone effect such a purchase.

Royal Bank of Scotland (RBS)

The General Manager of the Strategic Planning Group in the late 70's, early 80's, John Marshall, made regular trips to Europe, paying courtesy calls on NAB's correspondent banks and gathering information on what was happening in the major financial centres, in particular, London. In 1983, in the course of one of these visits to the UK, discussions turned to the possibility of acquiring the Royal Bank of Scotland (RBS), one of a number of banks being promoted for sale in the London market.

The General Manager returned to Australia and undertook a preliminary analysis, which indicated that RBS would make a good strategic fit for

the Bank. Board approval was obtained for a 'dawn raid' and permission was then sought from the Reserve Bank of Australia (RBA). The RBA declined to give its blessing to the proposal, indicating that it was too soon after the recent merger with CBC and that, in the central bank's view; NAB had enough on its plate already.

In anticipation of offshore expansion, and with the UK in mind as a possible primary destination, NAB had quietly built its network of contacts in London. One of the longest-standing relationships, initiated in the nineteenth century, was with Cameron Markby, a London based legal practice. Through this contact, the Bank was introduced to the London firm of merchant and investment bankers, Lazard Bros & Co, who then assumed responsibility for the relationship with NAB.

In 1986, executives from Lazard Bros & Co were invited to NAB's headquarters in Melbourne and the UK based Midland Bank was discussed as a potential acquisition. Midland was at that time struggling with defaulting third-world loans and was in desperate need of cash. It was recognised that Midland was probably too big to swallow whole but some of its subsidiaries, for example, Clydesdale Bank in Scotland, might be available.

Accordingly, Midland was approached by Lazard but was rebuffed in short order. The proposal received a similarly frosty reception at the Bank of England, whom Lazard were obliged to keep abreast of the matter. At the time, it was suspected that Standard Chartered Bank was also interested in Midland and that, as a UK bank, it would have been the preferred suitor. Midland eventually offered to sell the Northern Bank but the NAB Board rejected this on account of its comparatively small size and its desire to stay with a mainland UK presence.

Later in 1985, NAB learned that the Yorkshire Bank, owned jointly by four major UK clearing banks, was for sale. NAB, as an anonymous buyer, approached the clearers through the Merchant Bank but they refused to proceed until they knew the name of the interested party. NAB reluctantly agreed to be identified, whereupon the clearers responded that they would put the Yorkshire up for tender—which they eventually did, some four years later. The reluctance of the clearing banks to entertain an offer from NAB has been variously ascribed to traditional British resistance to overtures from 'colonials' and to the perception of swash-buckling behaviour on the part of some Australian entrepreneurs in London at the time. Our so-called 'entrepreneurs' did not help the business reputation of Australia in foreign markets at that time.

Despite these setbacks the Senior Management Team were confident that persistence and the gradual building of relationships would ultimately pay off. This view was confirmed when Midland approached NAB to form a strategic alliance under with the two banks would establish joint operations and divide responsibility for their management between the Northern and Southern hemispheres, respectively. The alliance was to be consummated through a cross shareholding. Once again, however, the Bank of England blocked the move.

The Strategic Journey Continued

Meanwhile NAB had continued to position itself to take advantage of any opportunity that might unexpectedly arise. By mid-1987, the Bank had listed and raised capital on the New York and Tokyo Stock Exchanges, as well as having raised additional capital in Australia. The Australian economy was booming; each week brought news of record profits by Australia's largest companies, driving the Australian stock market to new highs. Eyeing NAB's 'fat' balance sheet, the acquisitive Adelaide Steamship Company, led by John Spalvins, accumulated a 14 per cent holding in NAB and sought Board representation. He had built up a shareholding stake in NAB to 9.8% of the shareholding through David Jones Ltd, a subsidiary of Adelaide Steamship Company, and indicated that he wished to grow that stake to 15% as well as requesting two seats on the Board.

The Bank's Board rejected his repeated attempts to gain Board representation with his painful 'two and a half share' ploy coming to an end in July 1990. The futility of that exercise would only be known to those close to the Adelaide Steamship Company which eventually went into liquidation in 1991.

In mid-1987, the Bank's newly appointed chairman, Sir Rupert Clarke, joined Nobby Clark on yet another of his familiarisation and relationship building visits to the UK. Included in their schedule was the usual courtesy visit to the Bank of England (BoE). During their discussions, Nobby Clark again indicated NAB's interest in purchasing a UK bank. Surprisingly, on this occasion, the BoE suggested they speak to Midland Bank.

Within 48 hours of meeting with the chairman of Midland Bank, Sir Kit McMahon, Nobby Clark received an invitation for a further meeting. To his astonishment, he was asked if NAB would be interested in buying

certain assets. It transpired that a cash-strapped Midland Bank had been negotiating to sell three of its provincial banks—Clydesdale Bank plc of Scotland, Northern Bank Ltd of Northern Ireland and the Northern Bank (Ireland) Limited of the Republic of Ireland; to Standard Chartered Bank. However, two of Standard Chartered Bank's largest shareholders, one being the Australian, Robert Holmes-á-Court, objected to the deal, believing that Standard Chartered Bank was in no position to take on these acquisitions. As a consequence, the deal fell through.

The opportunity to purchase the banks was then given to NAB. The potential acquisitions met the criteria (see above) that NAB had previously set for offshore targets, including especially the compatibility of the banks' retail networks with that of NAB. The purchase was settled in July 1987. Being in the right place at the right time had finally paid off and the consideration for the purchase of those assets was A$1 billion.

Due Diligence

The terms of the deal allowed NAB three months in which to conduct a due diligence investigation and put problem loans back to the vendor. Don Argus, then head of the Bank's Credit Bureau, was appointed to lead the due diligence team. The Bank's insistence on a long due diligence period stemmed directly from its bad experience with Broadbank in New Zealand.

The team worked from a vacated warehouse in an open-plan environment with little evidence of hierarchy. During the due diligence process, a database programme for recording and analysing loans was developed. This was to prove especially valuable during the extensive negotiations with lawyers over precisely which loans could be put back to Midland. A modified version of the programme was also used in subsequent due diligence exercises, enabling the Bank to become increasingly proficient at the task.

Attention to detail and the determination not to be caught with bad or doubtful loans paid off. Loans worth more than £50 million were put back to Midland.

Again, there has been much 'post-truth' commentary about the Bank's venture into the United Kingdom and Ireland. Public records reveal just how important the diversified revenue stream was to the Group given the uncertain economic conditions which prevailed in Australia in the early 1990's. During the period of 1994 to 2000, NAB's revenue from Australia moved from 56% to 51%, meaning that NAB had got to the point where essentially half of its revenue was from international sources. At that time,

this was not seen as any type of end point in strategic terms, but a point on a path to even more ambitious global goals. NAB's capabilities, such as its credit assessment capability and relative efficiency, could be further leveraged in other jurisdictions.

Yet when focus was diminished and leadership changed, the reverse occurred. The subjective judgments made without disciplined analysis of the factual performance has been disappointing, but one can understand the decision made to sell these Banks given the reported lack of commitment to grow these institutions. Figure 7.1 demonstrates revenue and profit outcomes.

As these transactions were completed with cash there was a risk of a 'Colonial Bank' raising the requisite pounds sterling at that time to complete the settlement given some of the infamous entrepreneurs of the 80's had damaged Australia's reputation as a stable economy with questionable Corporate Governance standards. The Bank of England were particularly interested in NAB's corporate integrity.

Synergistic gains were minimal until technology integration had been completed and that was going to take time given the assurance NAB provided about autonomy. There was a large upside in the cost base of the Banks, the economic areas of influence were beginning to show signs of growth, and like most service type companies, economies of scale arose when NAB was able to perform key banking activities at a lower unit cost as volumes rose and the counter party risks were tightly managed.

The Assets and Liabilities of the Balance Sheet received much greater attention with improvement in margins evident.

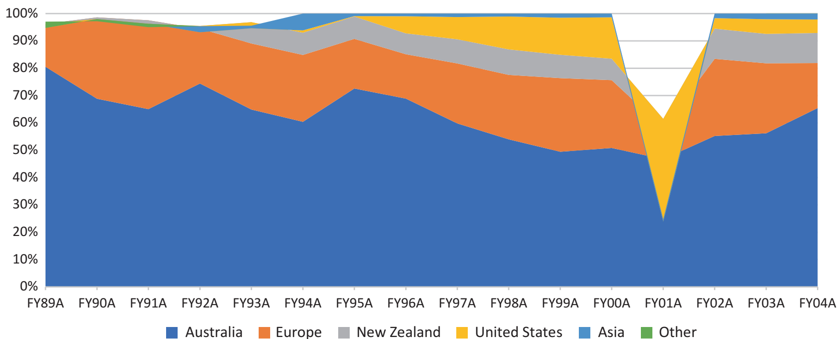

Fig. 7.1 NAB overseas revenue and profit by geography

It is also worth recounting the purchase consideration for the United Kingdom and Irish banks.

30 October 1987–	Clydesdale Bank, Northern Bank Ireland and National Irish Bank were purchased for GBP£427 million (A$1.049 billion) ® Clydesdale Bank had total assets of A$9 billion ® Northern Bank had total assets of A$3 billion ® National Irish Bank had total assets of A$1.2 billion
18 January 1990–	Yorkshire Bank was purchased for GBP£1003.3 million (A$2.197 billion) ® total assets were A$852 million

Clydesdale Bank, Northern Bank Ireland and Yorkshire Bank all had strong regional franchises with sound market shares for personal and small/commercial business market shares for their respective regions and had strong individual brands.

The Group's retailing operations in the United Kingdom and Republic of Ireland primarily consisted of four regional banks and a life insurance company. These investments made NAB the largest foreign owned banking and financial services group in the United Kingdom and Ireland in terms of assets, with more than four million customers.

Clydesdale Bank was the third largest bank in Scotland in terms of assets, with total assets of US$19.2 billion at 30 September 1999. Clydesdale had a well-balanced business and personal portfolio, achieving particular success in the custom and packaged business segments. It had 307 outlets and a staff of 4013 (or 3640 full time equivalent positions) at 30 September 1999.

Yorkshire Bank operated through 313 outlets in the north of England and the Midlands and at 30 September 1999 had an asset base of US$14.4 billion. Yorkshire had traditionally focused on the personal lending market although it had been actively expanding its presence in personal segments, though the provision of mortgages, and in the business segments by applying NAB's business banking template. At 30 September 1999, it had a staff of 5330 (or 4685 full time equivalent positions).

Northern Bank was the largest bank in Northern Ireland with total assets of US$9.2 billion at 30 September 1999. Northern had a strong

business banking presence and over the years had expanded its profile in the personal segments utilising NAB's tailored home loan product. It had 109 outlets and a staff of 2167 (or 1933 full time equivalent positions) at 30 September 1999.

National Irish Bank had total assets of US$3.7 billion at 30 September 1999 and operated through the Republic of Ireland. It had 68 outlets and a staff of 758 (or 730 full time equivalent positions) at 30 September 1999.

In 1995, the Bank established National Australia Life Limited in the UK to provide a selected range of life insurance and investment products. These were marketed through the UK Banks as an integrated part of each bank's product and service range.

The Bank's European banking subsidiaries also operated a number of finance and leasing businesses to support their operations across the region.

As NAB progressed with the integration of the Banks into the group, the world was undergoing massive change; reengineering, retooling and restructuring were the 'buzz words' of the time. NAB was entering a period of better cheaper, faster. Many businesses were becoming more lean and efficient organisations, financial institutions were beginning to grow again after a period of sustained and restrictive regulation.

Companies in the UK and Ireland as well as Australia and USA were confronted with emotionally volatile and vulnerable workforces who were clearly becoming uneasy with the push for short term profits. Mistrust and cynicism were growing and there were clearly tensions between leaders and followers in Clydesdale and Yorkshire Banks.

In an effort to get traction with the integration process, Don Argus developed a mantra about employees being the 'intellectual assets that make things happen'. He urged everyone to challenge their leaders to provide opportunities to mobilise the people and unleash their competencies, creativity and commitment.

As the UK institutions began to see their contribution to the NAB Group become meaningful, there were many who demanded change and there was progress in undoing structures and systems that hither to had snuffed out initiative.

Much of that achievement was attributed to the efforts of senior people relocated to the UK and Ireland to assist existing local management with the integration and unleash the resource pool that had been painfully underutilised. People like Barry Hefron, Frank Davis, David Deeble, Allan

Diplock, John Dawson, Glenn Barnes and Stuart Grimshaw all developed with their new accountabilities and provided the 'glue' to assist integrate the institutions into the NAB family. The spreading of 'best practices' was occurring.

UK/Irish Bank Boards/People/and the Quest for High Performance

As a statutory requirement, regulators in the UK and Ireland required that local boards be established for each bank. There was residual resentment of the acquisitions amongst various members of these boards and, consequently, considerable resistance to NAB-initiated change.

The NAB Group Chairman of that time, Bill Irvine, did a marvellous job in pacifying recalcitrant subsidiary Bank Directors and actually convinced many of the virtues of pursuing NAB's strategies. John Wright, the CEO of Northern Bank Ireland, was a strong advocate for the NAB's strategies but at the same time ensuring his bank's consistent performance was recognised. Over time, however, membership of the boards changed, in particular through replacement of local dignitaries with more commercially-oriented people supportive of NAB initiatives.

The early resistance of the UK boards was mirrored by local management. The four UK banks showed little interest in convergence to derive synergies, denouncing such pressure as shareholder interference. According to Don Argus, this made it difficult to reduce costs in the UK for a time and it was not until 1994 that significant progress was made not only on the back-office efficiencies but also at the customer facing activities.

People such as Sir Desmond Lorrimer, Russell Sanderson and Hugh Sykes all realised the value of building partnerships with their parent and their support for CEOs like John Wright, of Northern Bank and then subsequently Fred Goodwin of Clydesdale Bank for a short period of time prior to his defection to the Royal Bank of Scotland.

Secondees to NAB's Holding Company in the UK to whom these Banks reported all did a great job of building partnerships with the diverse cultures of the respective subsidiary organisations. Their efforts in breaking down and abandoning old baggage of dominance and control assisted in building a confident group of people who were able to see that their efforts were making a difference as reflect in the performance charts.

Up until 2000 the UK and Irish Banks had contributed handsomely to the NAB Groups performance. They had also transformed from organisations that were:

Backward Looking	to	Future Oriented
Paternalistic	to	Professional
Company Focused	to	Customer Focused
Hierarchical	to	Empowered Associates
Authoritative Leaders	to	Culture of Learning

Some of the significant events from which the NAB group developed a better understanding of local challenges were:

- Sir David Nixon a Chairman of Clydesdale Bank and Principal Director of NAB resigned from both Boards when John Elliott made his unwelcome bid for Scottish and Newcastle Breweries. Nixon believed that he had a conflict of interest and was intent to give John Elliott a lesson in how not to get growth through a hostile acquisition.
- 1993 Jim Lacey CEO of National Irish Bank, his wife Joan, children and baby sitter, were kidnapped outside of their home in Dublin with the robbers demanding IR £10 million in cash. IR £243 k was withdrawn from an ATM at a NIB Branch as ransom for their release from false imprisonment. Mrs Lacey and her children were released and the perpetrator of the crime apprehended, thankfully without physical harm to the detainees.

This action was a test of the Groups Crisis protocols, and whilst there was some unrest as to the payment of a ransom, the Garda (Police) provided sound advice, with the family being safely released and the kidnapper/robber arrested the next day.

In January 1998, RTE the Irish National and TV Broadcaster published allegations of NIB promoting a product known as CMI which was adjudged to have the characteristics of evading taxation and overcharging customers. It was alleged that NIB used bogus non-resident accounts and opened accounts in fictitious names to facilitate tax evasion. A six-year investigation by two inspectors of the Irish regulatory authority appointed by the High Court (400-page report) noted the report to be deeply disturbing in revealing the extent to which illegality and bad practices were

tolerated. The report noted that the creation of non-resident accounts for tax evasion was an industry wide phenomenon at the time. NIBs initial response to the RTE news reports was to deny the stories, concentrate on protecting customers' confidentiality and dispute the validity of the RTE report. The Groups Crisis Committee became involved once the severity of the claims became apparent, and a more accommodating approach to investigations introduced.

Given the reputational damage and cost to NIB with resultant disqualification of a number of Senior Managers, and the subsequent revelation that Tax minimisation products were embedded in the Irish financial system, one could conclude in hindsight that accepting inclusion of the NIB Banking franchise as a condition of closure of the original deal to purchase Northern Bank Ireland and Clydesdale Bank from Midland Bank was an error of judgment. The purchase would not have been completed without inclusion of NIB.

Whilst the events above did lead to the suboptimal performance of NIB, it did not affect the stellar performance of Clydesdale, Northern Bank Ireland or Yorkshire Bank from 1988 through to 2000.

Northern Bank Ireland which dominated the Northern Ireland Banking market was a model Commercial Banking franchise generating consistent returns on the equity invested and on the Assets which it accumulated. It was prudently managed, with a strong risk management culture, and handled the technology transition and data assimilation better than its peers. Its Management and Board were no doubt the catalyst for their consistent performance.

In December 2004, NAB announced the sale of National Irish Bank, headquarter in Dublin and Northern Bank Ireland, headquartered in Belfast for A$2.5 million, to Danske Bank Group of Denmark. In February 2005, NAB settled for the sale of its two Irish Banks for $2.5 billion netting a handsome profit of $1.1 billion.

One could again conclude that in the wake of the NIB problems and damaging foreign currency trading scandals in the Australian operation in 2004 the parent CEO and Board of the time made a decision to exit the overseas investments. We would argue that it is always easier to sell Assets than buy and build a franchise. The earlier strategic plans to build a global banking group headquartered in Australia, proceeding strongly until 2000, were now moving in reverse. Problems in NAB Australia and overseas banks were significantly accumulating by 2004.

Purchase of Yorkshire Bank—1990

In late 1989, NAB invested heavily in IT and support services in the UK. The purchase of Yorkshire was seen as a way of spreading the costs of this investment while at the same time growing the Bank's UK presence.

Following their earlier refusal to sell, Yorkshire's clearing bank owners faced credit problems brought on by a deteriorating British economy. NAB had retained an interest in Yorkshire Bank and in 1988 had encouraged Lazard to review the possibility of Yorkshire Bank as a target. In the event, four years after the initial approach from NAB, Yorkshire Bank came onto the market for sale by tender.

The 1990 sale took the form of a US-style competitive tender, a very different process from that of NAB's previous acquisitions. Six other banks and consortia submitted bids, including Australia's Westpac Banking Corporation. The UK clearers had previously opposed a direct sale to 'a colonial bank' and now appeared even more resistant to NAB's overtures in light of the recent UK and Irish acquisitions. Considerable gaming surrounded the bidding process, with NAB giving an indicative offer in the first round, followed by an aggressive bid in the second. NAB had decided that, at the right price, Yorkshire Bank would be a valuable addition to its growing portfolio and longer-term strategic ambitions. The bid was successful at £986 million (A$2.1 billion).

Owing to the competitive nature of the tender process and the short time leading up to the deal, pressure was put on NAB to bypass the due diligence process. Nevertheless, the Bank proceeded with it and completed a truncated due diligence within ten days, a far cry from the three months allocated for the initial UK purchases.

Yorkshire Bank—Post Acquisition

Yorkshire Bank joined the NAB Group in January 1990, bringing with it a strong regional franchise and a loyal customer base. Yorkshire Bank's main strength lay in its cost control systems—its cost/income ratios were amongst the lowest in Europe, and were well below those of NAB, mainly because of the attractive margins prevailing in their consumer book. Yorkshire Bank also had a strong brand name in its area of operations and comparatively few bad debts.

These positives were offset, however, by a mixture of Human Resources, Information Technology and credit-related problems. Prior to acquisition

by NAB, board membership had been weighted in favour of retired executives from each of the clearing bank shareholders. These members typically served on the board for short periods of time following their retirement. The resultant lack of continuity allowed the incumbent CEO a high degree of personal autonomy. This posed some problems for NAB when it came to wresting control of the bank from a CEO who had run Yorkshire Bank successfully for 20 years and had come to invest much of his pride and identity in the institution.

Yorkshire Bank started out as a 'penny bank', run by locals to help the poor save for their funerals. It was later taken over by the clearing banks and did not become an aggressive leader until the mid-to-late 1980s, by which time it had failed to develop a well-established credit culture. Following the acquisition, it soon became apparent that corporate banking had assumed unacceptable levels of risk. Once NAB had assumed control, large write-offs of corporate credits ensued.

Matters were compounded when NAB attempted to reposition Yorkshire Bank to focus on business banking. A commercial banking operation was established but failed to achieve to its plan because of deficiencies in lending skills. Yorkshire Bank's competitive advantage appeared to lie in consumer banking, which continued to generate healthy margins.

Structural and management reforms were clearly necessary. However, NAB's attempts to step in and effect synergies and cost savings along the lines taken with Clydesdale were strongly resisted. Yorkshire Bank management took NAB at its word when it assured them of their independence. The 'Yorkshiremen' did not yield easily, and board meetings often degenerated into recriminations about shareholder interference. The mood of resistance filtered down to management who consequently showed little commitment to NAB, its processes or its ambitions.

There followed a slow process of painstaking change, during which NAB progressively replaced the old board with directors more attuned to the parent company's expectations and a more efficient governance process. The general conclusion of those involved was that the Scottish and Irish subsidiaries were more amenable to changes introduced by NAB as the new parent.

The parent Company moved quickly to improve credit assessment procedures and risk protocols for the UK and Irish banks and introduced formal Key Performance Indicators (KPIs) around capital management, targeted market programmes and IT integration. A cultural change programme was also introduced around people development. Don Argus,

who succeeded Nobby Clark and who had developed and managed NAB's first credit bureau in Australia back in 1985, was keen to expand NAB's best practices throughout the whole Group. A UK credit bureau was established within the holding company, National Australia Group (UK) Limited. Furthermore, in response to a doubling of bad and doubtful debts in the previous year, an internal credit bureau was installed within Yorkshire Bank in 1992. Robust KPIs were introduced to coordinate planning processes and integration within the Group was accelerated.

NAB seconded Australians into lower level positions within Yorkshire Bank, supported by a senior executive in London. There were suggestions that an Australian CEO should be appointed but these were withheld to preserve the good will of early assurances to preserve independence, despite the ongoing recalcitrance of Yorkshire Bank management. NAB was still confident that the Bank had acquired a regional franchise with a loyal and parochial customer base. Had NAB installed an Australian CEO at this early stage, loss of good customers would also have ensued quite apart from the adverse publicity for a foreign owner. Yorkshire Bank grew its deposit base by 8 per cent and increased its new accounts by 10 per cent within a year of the acquisition—and this despite the onset of recession in Britain. The structure of the Yorkshire Bank Balance Sheet changed dramatically to reflect the Asset/Liability management model develop to preserve the revenue base of a Bank heavily reliant on consumer banking activities.

Withdrawal 'Back to Australia'

The ambition of the late 1990s towards a global model presupposed effective leadership (see Chap. 1) of the NAB group and its brands and banks, solid and consistent strategic decision making (see Chap. 2), asset allocation and governance (see Chap. 3). The international investments brought foreign banks into the group that had significant potential, and this was being effectively developed and harvested in their first decade as part of NAB. After 15 years of mismanagement of the Clydesdale and Yorkshire Banks and substantial write offs when these franchises become embroiled in an industry wide revelation involving mis-selling product scandals such as payment protection and interest rate swap mis-selling where a provision of £420 million was required for payment protection products and £250 million for interest rate swaps, the Management and the Board of the Parent Company announced their intentions to exit the UK.

It should not be overlooked that Clydesdale Bank had been hit by a downgrade of its credit rating in 2012 after a further deterioration in the Asset quality of a key part of its lending business.

The downgrade prompted a number of commentators to reflect on the Stewart stewardship which saw NAB absorbing Clydesdale's £6 billion (A$10.4 billion) commercial property lending folly and lead to a change in strategy which saw notification of intent to sell the UK operations.

In May 2005, under the leadership of John Stewart, the Bank undertook many sweeping reforms including the merger of Clydesdale Bank and Yorkshire Bank under one operating licence in which the former would be a trading name of the latter. Both operated under separate identities although the Clydesdale Brand was used in the strategy of expanding into the South of England, an initiative which appears to have severely damaged the franchise.

In 2015 the then CEO, Andrew Thorburn, issued the following statement.

> The courts approval today is the final significant step in the separation of NAB and CYBG into two independent corporate groups. The demerger allows each business to focus on improving performance in their home markets and on business priorities that will maximise value of their respective shareholders. Both companies can now look ahead to the future.

The demerger approved between NAB and Clydesdale and Yorkshire Bank involved selling 75% of CYBG to NAB shareholders and 25% to institutional investors via an IPO.

While Clydesdale and Yorkshire Bank may have been a drag on NAB from 2005, it is revealing to see the current stock price of the IPO trading at around $5.20 which is significantly higher than its float price of $3.92.

This is a classic case study of how generational change of Management ignored the history of the UK acquisitions and chose the expedient sale process rather than endeavour to resurrect the potentially great value in these profitable franchises.

Bank of New Zealand

As with the Bank's purchases in the UK and Ireland, the acquisition of Bank of New Zealand (BNZ) was transacted several years after the initial approach was made. In 1988 the Bank entered into serious discussions

with the New Zealand Government, hoping to acquire BNZ. A due diligence team, including members of Argus' UK team, went to NZ. The bid failed at the eleventh hour, however, when rejected by a NZ Cabinet overly distracted by an impending general election.

Although the acquisition did not proceed at that time, the due diligence team used the opportunity to develop a procedural document that would form the blueprint for future due diligence processes. This document was the Bank's first attempt to articulate its due diligence experiences acquired in New Zealand and the United Kingdom. This became a valuable capability in itself, that would potentially pay dividends as the bank moved increasingly towards a global model.

The document contained specifications for:

- statistical sampling procedures and techniques for identifying high-risk loans in target organisations;
- procedures for monitoring delinquent debts;
- procedures for valuing properties and identifying and appointing consultants;
- procedures for testing client databases to determine industry exposure and risk profiles; as well as
- general audit procedures.

In addition, social activities were suggested, aimed at boosting the morale of teams working under tight deadlines and in stressful circumstances. The aim was to define the resources needed and the procedures to be adopted from day one of the due diligence process. The document proved especially valuable when time was limited, as was true for subsequent purchases of Yorkshire Bank, Michigan National Corporation and HomeSide.

NAB's interest in New Zealand had increased on account of sweeping economic reforms introduced in that country in the 1980s. NAB executives were confident that the NZ economy would respond positively to these changes, much as the UK economy had done in the wake of the Thatcher reforms.

In management's view, BNZ differed from the Bank's earlier NZ purchases in that it was a quality institution employing some of the best banking staff in NZ who had been employed with a mission to restore value in the Government owned Bank. It had developed problems with some poor lending to the property market in Australia which was symptomatic with

the experiences of some Australian Banks. It had national representation with 288 branches, a domestic market share of approximately 21 per cent and derived 40 per cent of its income from exceptionally well managed treasury activities. NAB had looked long and hard at the New Zealand market. It was one of the three countries identified as being relevant to the international aspirations which had crystallised at the 1984 Frankston conference. Relatively small incursions had been made with variable success. A view had formed that BNZ really constituted two banks; a 'good' bank and a 'bad' bank. NAB wanted the good bank—the one without the questionable loan portfolio. The deal which eventuated was based around NAB's evaluation of the total enterprise, factoring in provisions of non-recoverable loans up to a certain level beyond which they would be shared equally by the NAB and the vendor (the New Zealand government).

The risks associated with the purchase were carefully defined within the context of the NAB's strategic aspirations. The BNZ was perceived to have excellent management, a great franchise in the market-place, proximity to the Australian market and a political and economic system consistent with that of Australia. To these attractions could be added the familiarity derived from some years of involvement in New Zealand, albeit at a lesser level.

NAB made an offer for all of the issued ordinary and preference shares in BNZ in July 1992. The total offer valued BNZ at NZ$1.48 billion (approximately 1.9 times BNZ's published net tangible assets at March 1992). The offer was accepted and BNZ joined the Group in November 1992.

Bob Prowse was promoted from head of the Strategic Planning Group to Managing Director of the New Zealand operation. An immediate review of the Bank's market positioning was undertaken and a new range of products introduced. In particular, tailored products for home loans, personal loans and personal investment funds were introduced at the personal banking level, while a range of products with proven performance in the Australian market were aimed at the business clientele. Products were also introduced for the bank's rural customers.

In addition to a broader product range, NAB brought professional banking skills to BNZ as well as a market focus not then evident in the NZ banking industry. NAB's efforts were aided by the removal of impediments which BNZ's former public ownership had placed on management. In particular, it was no longer unacceptable to pursue normal capital management targets and KPIs consistent with Bank returns around the Group.

Whilst the BNZ acquisition proved to be successful by any measure it is revealing to understand the background work undertaken.

In the early 1980s, NAB was the only major private Australian bank without a presence in New Zealand (NZ). By contrast, its chief rivals, ANZ and Westpac, had operated in NZ since the early nineteenth century. The impetus to move was given by the signing of the Closer Economic Relations Treaty, which promised to ease trade restrictions between Australia and New Zealand. The prospect of stronger economic ties between the two countries made an acquisition in NZ look sensible. Perhaps some of NAB's clients with interests in NZ might be coaxed away by one of the other majors as their NZ businesses expanded. NAB management also thought NZ could be managed relatively easily from Australia.

There were, however, two factors militating against a NZ acquisition: NAB's earlier unsuccessful attempts to purchase the National Bank of New Zealand from Lloyds Bank and its failure to secure a NZ banking license in its own right. Nevertheless, Management was especially keen to see expansion into New Zealand. In 1985, NAB formed a subsidiary operation, National Australia Finance Ltd (NZ). The new entity was to be the primary vehicle for the Bank's expanded presence in NZ. During that year, the opportunity arose to purchase Beneficial Finance, a well-run second mortgage operation in NZ. The acquisition took place in late 1985 and, while small, was seen as providing the Bank with a toe-hold in the NZ market.

Broadbank

In that same year, NAB was approached by Fletcher Challenge (a NZ conglomerate) seeking to sell Broadbank (a NZ finance house) and Marac (a finance company). Broadbank had developed the reputation as a 'lender of last resort' in NZ. Preliminary due diligence highlighted its poor asset quality and NAB turned the deal down, considering it more prudent to stick with Beneficial.

Broadbank was eventually sold to the NZ Government Life Insurance Corporation, which split the bank into corporate and retail operations. Within a year, the new owners were in trouble and approached NAB proposing the formation of a joint venture that would bring NAB expertise to bear on Broadbank's problems. NAB declined at first but the vendor lowered the price to make the deal more attractive. The Bank had been

making slow progress in NZ with Beneficial and still had not secured a formal banking license. Broadbank, with its 30 branches across NZ, was now seen as a way of increasing market share quickly and, more importantly, of securing the elusive NZ banking license.

In December 1986, NAB purchased a controlling stake in Broadbank, leaving Government Life as the minority shareholder. Broadbank subsequently acquired NAB's existing subsidiaries in NZ. In July 1987, Broadbank was granted a full banking license and was re-named National Australia Bank (NZ) Limited.

Opportunities for increasing penetration of the New Zealand market continued into 1988 when the chance to buy the Auckland Savings Bank arose. Around the same time, the Bank of New Zealand also come into play and the Strategy Group presented a paper to the Board recommending this option. This opportunity did in fact materialise but NAB was initially deterred by the prospect of acquiring bad debts of $1 to 1.5 billion. The acquisition was eventually completed in 1992.

Steady and solid increases in Net Operating Profits during the decade from 1993, were the result of both sound strategic decision making and leadership within BNZ and part of NAB, and of the value add achieved from BNZ becoming a part of NAB.

Entering the US: Michigan National

By 1990, potential bank acquisitions in the UK were extremely limited in number, leaving only building societies as targets. These were not attractive, as impending deregulation would very likely erode their protected positions. Ten years on, the growth and acquisition criteria laid down in 1985 were still considered relevant to NAB's international aspirations. Given the strong presence in NZ through BNZ, USA was identified as the most promising remaining region of opportunity. The Acquisitions Unit had monitored the US market since 1985, both to remain abreast of emerging opportunities and to keep a careful watch on competitor activity.

A watching brief had been maintained over a period of years following the Frankston conference and discussions had been held with some US banks in the mid-1980s. The BNZ acquisition had interrupted these conversations.

In 1991, Argus and Prowse visited six regional banks in USA to assess the quality of those institutions and to determine their receptiveness

to acquisition. The banks visited were United Jersey Bank Financial Corporation (UJB), Meridian Bankcorp, Old Kent Financial Corporation, Michigan National Corporation, Marshall & Ilisley Corporation (M&I) and First Interstate Bankcorp.

The gathering pace of consolidation in the US heightened the need to move sooner rather than later. Failure to gain a foothold would lock NAB out of the market for the foreseeable future. Notwithstanding the narrowing margins inherent in a consolidating market, Argus believed there was much to be gained from the experience in the world's most sophisticated financial services market, knowing that the regional banks had progressed rapidly with technology and product development; the smaller mid-tier banks represented a low risk option to enter the retail/small business bank market in USA.

NAB acquired Michigan National Corporation in 1995. With 196 branches, it was the fifth largest bank in Michigan and a good fit for NAB. Unlike Yorkshire, Michigan's loan book complemented NAB's and provided the necessary critical mass for a beachhead in the USA market. Its geographic spread fitted the specific regions within USA that NAB had identified as profitable on the basis of ten years' research into the US banking industry.

When NAB acquired Michigan, it secured a regional banking franchise. The north-eastern region of USA was doing well economically, and NAB believed the USA economy in general was at the bottom of the business cycle. The State of Michigan was one of the largest exporting states in USA with its massive automotive industry.

Following the Michigan acquisition, a new CEO, Doug Ebert, was appointed. He had been recruited as COO of Michigan in December 1993. Prior to that, he had spent 22 years with Manufacturers Hanover during which time he saw something of the challenges of managing an international bank.

The new CEO quickly recognised the benefits that NAB ownership brought to Michigan National. These included greater discipline in business management, marketing, planning and financial management. He also appreciated the fact that NAB did not arrive with a cost-cutting mentality, recognising that much had been achieved on this front prior to the acquisition. He was nevertheless surprised at the degree of centralisation that NAB sought to effect, including the detailed 'micro-management' of some functions like strategic planning.

Conversely, Argus acknowledged benefits to the Australian operations of the Group. These included, in addition to return on assets and return on funds invested, the less tangible R&D benefits deriving from an active presence in a more technologically advanced market.

'Michigan,' he observed, 'is like having a laboratory for new products'. There were a number of specific areas in which NAB could expect to adapt USA developments to other geographic areas of its operations. These ranged across developments in electronic payments systems, telephone call centres and financial services products such as mutual funds.

A number of executives from the NAB Group moved to Michigan. At the same time, a number of Michigan National Corporation executives transferred to head office in Melbourne, highlighting the two-way transfer of knowledge and expertise within the Group.

The purchase of Michigan National Corporation marked a shift in NAB's internationalisation paradigm. Up to this point, a key driver for offshore expansion had been selection of localities and targets that would be compatible with NAB's values, culture and core competencies. The move into Michigan was to be the first step in re-balancing the strategy towards acquisition of capabilities.

MNB had a strong presence in both business and personal segments. Commercial business represented approximately 76% of MNB's loan portfolio as at 30 September 1999, with the balance in consumer business.

At 30 September 1999, MNB operated through 188 financial service centres (including 33 supermarket financial services centres) and 3212 ATMs across the State of Michigan. MNB also provided a sophisticated telephone and web banking service enabling customers to open accounts, apply for loans and conduct transactions over the phone. At 30 September 1999, it had staff of 3833 (or 3397 full time equivalent positions).

During the year to 30 September 1999, MNB established a joint venture with Rock Financial, a leading provider of retail mortgages that offered a full range of residential mortgage products to Michigan National's customer base. This initiative provided benefits for both partners, improving the penetration of MNB's customer base while providing additional scale to Rock Financial.

Michigan National Corporation was purchased on 2 November 1995 for A$2.1 billion and sold in April 2001 for US$2750 million (A$5314 million).

Great Western Bank

In November 2007 NAB announced the purchase of Great Western Bank, a regional bank in South Dakota for US$798m (A$898.5m). Great Western was owed by the Hamann family. It was reported by John Stewart to have growth opportunities for agriculture in the USA. It had 100 Branches and Assets of US$3.4bn.

NAB reported in July 2015 that it had completed divestment of Great Western Bank and would book a A$67m loss on the sale.

HomeSide Purchase

There has been much written about HomeSide Inc which was purchased in 1998 for US$1.2 billion (A$2.3 billion).

Leading commentator Robert Gottliebsen listed the HomeSide episode as one of the 10 worst decisions made between 1992 and 2001.

At the time of its acquisition by NAB, HomeSide was the fourth largest originator and seventh largest servicer of mortgages in USA with approximately US$97 billion of loans in its servicing portfolio. By the summer of 2001 HomeSide was the sixth largest mortgage servicer in the USA servicing over US$187 billion of outstanding mortgage principal balances. It obtained mortgage servicing rights (MSRs) either by buying those rights in bulk, or by selling mortgages that it produced and then retaining the servicing rights to those mortgages. HomeSide was one of the most efficient mortgage services in the USA. HomeSide derived its revenues predominantly from servicing US residential mortgages.

The idiosyncratic structure of US Mortgage finance was creating another set of specific issues for regulators and fund managers. The declines in long term interest rates allowed home owners to refinance their mortgages (at low transaction costs).

The right for home owning Americans to refinance their mortgages at a time of their choice was almost as universally accepted as the First Amendment protecting free speech or the Second Amendment protecting gun ownership. Over the years 'mortgage servicing rights', i.e., the contracts to do all the paperwork and payment directing for mortgages had become a multi hundred billion asset class that was in turn scrutinised and hedged with derivate trades. The MSRs terminate when the mortgages are refinances or mature. If that occurred within 5 years the mortgage servicing

rights holders could plan the possibility. If it happened in two years or less the booked equity value of those rights became very difficult to hedge. From time-to-time, particularly when interest rates are falling, the non-Bank Mortgage lenders become very active and capture profitable up front 'origination fees'. Share prices in the independent mortgage banking sector, which were generating most home loans were marked to sell.

Valuing MSRs

MSRs were difficult assets to hold because of their unpredictable value. An MSR (mortgage servicing rights) was not a tangible asset but rather an accruing interest component of a loan. The value of the asset to the holder was its expected future cash flows, net of servicing expenses. Most of the elements that go into determining the value of servicing rights were not known with certainty. While the servicing right for each loan, or pool of loans, carried contractual income, the period over which that income was earned was not known because US mortgagors usually had the right to prepay their loans at will, and without penalties. If interest rates fell, mortgagors were incentivised to refinance their homes by paying off their higher rate mortgage and replacing it with a lower rate mortgage. This was the single biggest risk in an MSR portfolio rendering it highly sensitive to interest rate changes that were extremely difficult to predict at any time.

Other risks, other than changes in interest rates, as well as an extended period of historically low interest rates were:

- the sharp rise and fall in house prices, and the corresponding changes in mortgage debt and surge in non-performing loans;
- changes in a firm's interest in serving as aggregators by purchasing the servicing rights and originations of other firms (mainly banks);
- shift in the incentives to securitise mortgages versus holding them in a portfolio on a Balance Sheet;

It is important to understand that in the USA, consumer loans in the form of mortgages and auto loans as in Australia comprise principal and interest and each monthly payment includes a principal and interest component. A loan originator in the US decides whether to book the principal outstanding on its balance sheet or bundle those loans and securitise them where market practitioners buy the securities instrument. A CDO (collateralised debt obligation) is an example.

The accruing interest component or Mortgage Servicing Right (MSR) is then sold to institutions like HomeSide and other banks. The history of such activity began in 1996 which was the first full year in which GAAP permitted the recognition of an MSR associated with loans a bank originated and sold, but for which it retained the servicing rights. Some analysts in the USA at the time believed such an accounting development may have given banks the incentive to conduct a business which added value to their loan origination activities.

Housing prices rose sharply from 1998 to 2006 in the USA, then contracted substantially through 2011. During the build-up in housing prices to 2006, mortgage debt rose in part because borrowers needed larger loans in order to purchase more expensive houses and also in part because borrowers extracted equity from their home in order to finance other activities.

MSRs increased from US$20 billion in 1998 to US$78 billion in 2008 as a result of increased loan growth and this measure included only MSR holdings of banks and did not include loans originated by Savings Association or other non-bank originators who indulged in securitisation of housing loans.

Under GAAP, MSR's could be booked as an asset. GAAP required that they be carried at the lower of cost or market. If market falls below cost or book value, the asset must be written down. However, MSR 'market values' were by their nature imprecise and difficult to ascertain. There was no daily or even weekly market price—nor could there be. Bulk sales could be used as benchmarks of value, but even these involved unique sets of loans, and even at its best there would be only a few of these traded each month.

In the few years leading up to 2001, the industry had come to rely primarily on computer models to estimate MSR values. All the models used discounted cash flow methodologies to provide an aggregate net present value of an MSR portfolio, reflecting the fact that MSRs were just streams of future income.

The most critical aspect of MSR valuation models was the estimation of future prepayments. Falling interest rate environments encouraged home owners to prepay their mortgages by refinancing with cheaper mortgages. This drove up prepayments. Predicting consumer behaviour was not precise and they did not always behave as, or when, expected.

Managing Risk at HomeSide

These uncertainties underscore the critical importance of understanding and managing the risk of the MSR portfolio. The risk management of the organisation needs to match the risk in the portfolio. The Board and senior management at HomeSide needed to be on top of this every day, very similar to a trading book in currency or interest rate hedging. The process must at a minimum provide for measurement of the asset's value, and its sensitivity to interest rate changes; a thorough understanding by decision-makers of the assumptions going into the measurement; scenarios of possible alternative outcomes and an understanding of their likelihood; and actions to mitigate the volatility of the asset (primarily hedging with interest rate sensitive financial instruments).

Where models are used, there was testing and validation of inputs, model calculations and outputs. Staff involved should have sufficient judgment, training and experience to perform their jobs. Certain duties should have been performed independently of others, and senior management should have received clear, regular and meaningful information.

With appropriate risk management, MSR servicing was for many years, a viable and profitable business. It grew to be a major part of the US mortgage industry, leading the world in low cost and efficient servicing of mortgages and helping to lower borrowing costs for homeowners.

Hedging MSRs

Hedging MSRs was challenging because hedging decisions were based on an asset profile subject to a high degree of uncertainty. Hedging moreover, was further complicated by a rule added to US GAAP called FAS 133 requiring that any hedge that does not pass a strict correlation test must be marked to market, potentially subjecting the portfolio to losses. It was reported that this became effective for HomeSide in October 2000.

This would have become quite complex for HomeSide because in the few years preceding the introduction of FAS 133, the growth of its servicing business had outstripped its mortgage origination business. It could be argued that it increased HomeSide risk profile as mortgage origination can sometimes act as a natural hedge for MSR assets. Whereas MSR assets tend to decline as interest rates fall (because borrowers are more likely to refinance), mortgage originations tend to increase (because of the

increased refinancing). HomeSide was more exposed to a falling interest rate environment as it did not have as much mortgage origination business as its competitors. It was therefore more reliant on hedging through financial instruments and faced greater risk of impairment under US GAAP.

US Interest Rate Environment

The unusual interest rate environment in the US in 2001 also needed to be appreciated. One can only speculate that this further served to increase the uncertainty and volatility of MSR valuations.

In 2001 the Federal Reserve Board of the US lowered its benchmark rates seven times by a total of 300 basis points during the first eight months of the year, and in the next three months announced three more rate cuts totalling another 150 basis points.

2001 also saw a collapse in the market for bulk MSR purchases, caused in large part by the changing interest rate environment. Another factor was FAS 133 which made it more difficult for mortgage servicers to use hedge instruments to limit the income-statement impact of fluctuations in MSR valuations. One could conclude that no-one wanted the increased volatility by buying bulk portfolios. Finally, the number of market participants decreased as a result of concentration in the industry. The top ten mortgage servicers then controlled over 50% of the market compared with 25% share in 1995. These large servicers also competed in the same market for hedging instruments which further increased the challenge of obtaining cost-effective hedging.

In 2001 other servicers also experienced difficulties with MSR valuations. Washington Mutual announced US$554 million impairment to its MSR portfolio for the third quarter of 2001. GMAC Mortgage took a US$161.2 million impairment charge during the first nine months of the year and warned of more to come. FleetBoston announced a US$225 million loss from the sale of Fleet Mortgage to Washington Mutual in March 2001. Chase Manhattan Mortgage also took losses.

These losses were the result of a combination of factors: deteriorating market conditions, overly optimistic past valuations, and imperfect hedging of FAS 133 correlations.

At the time of the acquisition, notwithstanding the financial analysis, NAB's preliminary investigations revealed that there was a highly qualified senior management team in place at HomeSide whose competency was unquestioned. The HomeSide management team was highly regarded in

the industry and experienced. They had an average of 20 years' experience in mortgage banking and experience in integrating sixteen mortgage company acquisitions over the prior eight years. HomeSide's President and CEO had served as President of the Mortgage Bankers Association of America. NAB relied on this management team to export HomeSide's experience to Australia and possibly elsewhere, and achieve cost savings of up to 30% in production and 45% in servicing.

Extensive Due Diligence was Performed on HomeSide

Post write-off it was reported that independent investigations of the due diligence process found no deficiencies in its thoroughness. In addition to an experienced internal team at NAB, external experts were engaged including Cohane Rafferty Securities Inc. (mortgage banking and MSR valuation experts), KPMG and Sullivan & Cromwell.

The due diligence focused on, and documented, all key aspects of the business and potential risk areas. These included MSR valuation, hedging, middle-office, and risk management.

An independent review of the due diligence process concluded that the Group's pre-acquisition due diligence investigation, as well as its post-acquisition mechanisms of oversight, were extensive and thorough. A view was expressed that it may have been wiser to have placed a full-time Group executive at HomeSide in the executive suite, such as a senior risk manager. HomeSide, not being a deposit-taking bank, and lacking oversight by a prudential banking regulator, never developed the same attention to risk management as was prevalent in the NAB culture. It is, of course, pure speculation as to what impact this would have had in reality and whether any of the outcomes would have been different. NAB's subsequent experience with rogue foreign exchange traders within one of its core businesses and physically located in its headquarters building under the direct oversight of its risk management and audit departments, is a case in point.

It should be noted that the APRA Tripartite Report in August 2001, immediately in the wake of the hedging losses, said that *'the control frameworks and processes in place'* at the Group *'provided a sound basis for controlling subsidiaries'*. It identified some weakness but said none *'cause(s) us to conclude that control of subsidiaries by the Group is inadequate'* and emphasised that as to each of the weaknesses, *'management is aware of the issue and is in the process of taking corrective action'*.

The review's discussion of the Group's control over HomeSide noted that the US$450 million MSR hedge loss write-down resulted from *'extreme volatility in the US interest rate markets'* and that the *'historically successful risk management strategy for hedging the MSR was not fully effective in the current interest rate environment'*. And it was observed that *'(t)his is currently being addressed by HomeSide and the Group senior management reviewing the hedging, or risk management strategy and environment in consultation with industry expertise'*. And that *'(t)he control and reporting structure is in the process of being strengthened together with improvements in the timeliness of interest rate risk position and metrics reporting through HomeSide and the Group'*. The review went on to say that *'(t)here has been a lack of routine oversight by the Group in terms of the key business risks generated by HomeSide'*, and that *'there was no routine involvement of any corporate function in terms of reporting or reviewing these positions'*.

It was reported that the independent investigation ordered by NAB disagreed with the last conclusion of APRA and said *'we would not agree with these last conclusions. There* **was** *routine involvement of numerous corporate functions in terms of reporting and reviewing HomeSide's risk management. In reality, the Group ALCO process, together with the internal audit reviews and other integration steps taken, did constitute a reasonable level of regular and sustained oversight of HomeSide by the Group'*.

As to NAB oversight of HomeSide post-closing: independent investigation after the write-downs concluded that there were a number of reporting channels, formal and informal, and that overall the level of NAB oversight and flow of information achieved were reasonable and appropriate from the time of acquisition to the date of the report.

It should be noted that the level of oversight by NAB increased over time and by 1999–2000 was regarded as of a high standard. It is also noteworthy that in July 1999 the HomeSide International Board was advised by the Federal Reserve Board of the US after its examination of HomeSide that it had concluded that it had appropriate risk management in place relative to the corporation's risk profile, and that its Year 2000 preparedness was appropriate.

HomeSide Summary

HomeSide took a write-down in 2001 because the internal valuation of its MSR was too high. The overvaluation of the MSR asset led HomeSide to incorrectly hedge interest rate risk of its MSR portfolio.

NAB announced a write-down of US$450 million on 5 July 2001. On 3 September 2001 it announced a further US$1.75 billion write-down.

Of the total US$2.2 billion write-down at HomeSide in 2001, there was a view that approximately US$1.35 billion reflected the Group's strategic decision to sell the business and thus adopt a near term sale valuation instead of a going concern valuation.

Failure to Detect Modelling Error

It was reported that failure to detect a computer modelling error was one of the three principal causes to this malaise:

- A failure to understand how new valuation software introduced in February or March 2000 differed from software in use prior to that time.
- Weakness in staffing at HomeSide risk management department and the virtual absence at HomeSide of a supervisory, or middle-office, level of review of the MSR valuation process.
- By its nature the input error was difficult for parties outside HomeSide to detect (e.g., auditors or Group personnel). The Group's external auditors conducted a special review of the MSR valuation process in August 2000 yet did not discover the error. Nor did the third-party valuation by an industry specialist valuation firm.

It was reported that there was no evidence found of this problem being the result of any fraudulent activity. There was a disgruntled former HomeSide employee who made allegations of irregularities. The external auditors in Florida are reported to have been engaged to investigate the allegations and concluded there was no valid basis for the concerns.

Modelling uncertainties were inherent in MSR valuations, and indeed in any model-driven valuation, but were exacerbated here by the fact that by mid-2000 and throughout 2001, there were few, if any, open market bulk sales of MSR assets whose prices could be compared to HomeSide's internal valuations. As a result, the discretionary assumptions used in the valuation model could no longer be tested in a meaningful way against true market prices.

When it was decided to sell the business, accounting rules then required a valuation shift from going-concern to near-term sale valuation. This occurred during a major downturn in the MSR market in 2001 and

resulted in a much larger write-down for NAB than might otherwise have been the case. A number of mortgage servicing companies in the US also wrote down their MSR assets by large amounts in 2001.

HomeSide Lessons in Leadership and Strategy

So why did HomeSide become such a problem which saw the write-off of A$3.6 billion in NAB's balance sheet?

In the absence of transparency on several investigations undertaken to establish the reasons for the write-offs associated with HomeSide, extensive research has been undertaken in an endeavour to 'clear the air' on this historic matter. A succession of missteps from 2000 to 2014 has seen NAB inherit the label of the 'bank who buries its mistakes in legacy issues' so the readers of this case study will understand the sensitivity this matter has with former executives who drove the Bank professionally to be such a successful organisation during the 1980s and 90s.

One could conclude that HomeSide made a mistake in how it used computer models to manage market risk. There were also reports at the time that HomeSide changed its risk model technique resulting in input errors. One would have thought that an audit trail would have highlighted any risks associated with transitions of software packages but this was not clear in the limited public statements made about the issues.

There have been so many internal and external reviews of this asset one would have thought a public disclosure of the cause of the write-off of US$450 million on 5 July 2001 and a further US$1.75 billion write-off on 3 September 2001 would have assisted clear the market uncertainty which prevailed at the time. There was an external view that US$1.35 billion reflected the Group's strategic decision to sell the business and thus adopt a near term sale valuation instead of a going concern valuation.

It was disappointing that the Board and Management of the Bank at the time allowed the perception of a poor strategic decision to purchase HomeSide in 1998 to prevail when in fact some would opine that if the Assets had been managed prudently like any other asset on a Bank balance sheet, then much of the adverse commentary could have been avoided notwithstanding the loss incurred.

The reality was, the first HomeSide write down was $450m and resulted from a failure of the hedge designed to protect the MSR asset value, the further provision of $1.16m was taken when an error was discovered in HomeSide's valuation model following the introduction of new technology.

Concluding Comments on Overseas Expansion and Acquisition

During the period up until late 1999, when the NAB group was so profitable and significantly outperforming the other major banks in Australia, investors wanted to provide it with additional capital so it could further expand, given the returns that were being created. The momentum created through acquisitions and their integration into a value-adding assets group led to a plan to further expand and indeed move towards a global platform and organisation with further acquisitions planned over time.

Because the acquisitions were in other markets than Australia, it was difficult to justify the purchase with synergistic benefits. NAB's value add was the ability to transition/integrate the acquired Commercial Bank quickly into a NAB business model. The emphasis was on Commercial Banks that had experienced a 'Bad Debt' moment and/or a franchise where margins could be sustained. In most cases NAB paid a premium but the business case included provisions to recover any goodwill component in the purchase price over a three-year term. There were options to grow the Insurance Company franchises but they were declined preferring the Commercial Bank route which at the time provided enhanced ROI opportunities.

The Bank had achieved strong organic growth in its various jurisdictions with a segmented marketing approach to its customer base, plus targeted industry sectors. They were well advanced with their data management through a Current Account Management system that was eventually replaced in 2009 with reportedly much disruption.

The unified leadership team which was in place was highly skilled and focused and once that leadership team that was in place from before 1990 until 1999 turned over, that trajectory quickly diminished and plans to further grow were clearly shelved. While the organisation experienced many years of 'damage control' and losses, the withdrawal from US and UK markets coincided with the dramatic return of NAB from a position of clearly outperforming its industry, to the middle of the pack in Australian banking, and below. Moreover, the multibillion-dollar losses to shareholders were significant enough, yet might well be much less than the opportunity cost of profits foregone, had the growth strategies at the time (1998–99) been implemented. It is a matter of speculation to consider 'what might have been', if not for the leadership issues, strategic mis-steps, short-termism and scandals that arose from control problems, and the reputation loss that followed. Might NAB have been able to fulfil its strategic

global ambitions, continued to add quality bank assets to its international portfolio and group, spread best practices even further and more effectively, whilst maintaining operational control? It would have left the other Australian-based banks even further in its wake.

The Bank of America model that Don Argus became part of, is a classic case study of a Bank which suffered heavy losses following the GFC but recovered to be a pre-eminent Banking Institution by making bold decisions about its technology and data management. It has a customer centric strategy which covers its Commercial Bank, Consumer Bank, Investment Bank with zero Risk Management Standards and a wealth management system which complements its Banking Activities. They have a concentration on people development and actually outlay funds to educate their customers and customer facing staff as to risk/benefits of their product range.

What could have been at NAB?

CHAPTER 8

NAB (C): Banking in Australia, NAB's Track Record and Trajectory

Descriptive Introduction of NAB's Australian Operations

In Australia, NAB's retailing activities were principally conducted through its Australian Financial Services business unit, which provided a full range of financial services to over three million customers across all segments. It was in its Australian business that NAB established a strong credit risk management discipline that distinguished it in the industry. During the period up to 2000, its performance reflected that differentiation. Within the personal segments, NAB was one of the largest providers of credit and deposit facilities in Australia. Other financial services were also provided to those segments through the Company's wholly owned subsidiary National Australia Financial Management limited. Services included personal financial planning, life and disability insurance, superannuation and a range of managed investment funds. In addition, personal trustee services, including wills, power of attorney, and personal asset care and management services were provided through NAB's subsidiary, National Australia Trustees Limited. Importantly the sale and distribution of all financial services was integrated with NAB's distribution network with customers managed on the basis of segments rather than products.

NAB was also a substantial provider of business and rural financial service in Australia. NAB's strong position in business markets was the result of carefully targeted initiatives over a number of years. These had included

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D. Argus, D. Samson, *Strategic Leadership for Business Value Creation*,
https://doi.org/10.1007/978-981-15-9430-4_8

the development of specialist business and rural banking teams with expert business knowledge and a sound understanding of how to tailor financial solutions to the needs of customers.

NAB's Business Model had its foundation in the Rural Finance Unit who had perfected a customer interface with its strong technology programmes promoted by specially trained operatives. Chris Shearer who was an agronomist by training but who also assisted in the family business of agricultural production was the prime instigator of the rural programme. It took some time and effort to transform this model to the traditional business bank, but once that breakthrough occurred the NAB had a distinct competitive advantage compared to other service providers.

Services were provided through a network of traditional branches and electronic distribution channels. Financial service centres and financial service suites were the primary sales outlets for the personal segments while transactions were conducted through over 1100 outlets, 1000 Automatic Teller Machines (ATMs) and 67,000 point of sale terminals. Customers were also able to conduct a range of transactions and other information services over the telephone or via the Internet. As at 30 September 1999, Australia Financial Services had staff of 24,213 (or 21,210 full time equivalent positions).

NAB's Approach to Lending and Credit Management in Australia

Having worked through a number of droughts with a large agricultural exposure where farm incomes became very tight, it taught those developing risk policies to understand the concept of Cash Flow coverage ratios, where the basic components of the ratio were Capital Debt Repayment Capacity and the Annual Debt Service requirements. This applied to all risk assessment no matter which industry was being developed or examined, and partly answers the question of how NAB performed so well during the 80's and 90's and avoided many of the write offs experienced with other institutions during that time. It contributed significantly to NAB's industry leadership position (see Fig. 1.1, Chap. 1).

Some observers of the major banks' and State banks' lending behaviours and credit assessment policies in the 1980's and 1990's found it incredulous that their lending standards were so poor in discipline, assessment procedures and standards. Danny observed at the time that it should surely be a central and essential capability of any and every bank to be able to use evidence, data and judgement based on experience and validated models, to be

able to tell a prospective 'good' loan from a 'bad' loan and get it right much of the time. In truth, the capability that existed at NAB must not have been maturely in place in other major banks and State banks at that time. If it was, would they have made the loans, individually and in syndicates, to those 'entrepreneurs' and others who were not credit worthy? NAB always believed that Bad Lending was a much bigger risk than market turbulence. The Basel Rules that were introduced in 1988 called for all Banks to retain capital equal to 8% or more of risk weighted assets [loans]. The Basel regime was an improvement but came too late in Australia as the so-called entrepreneurs had already convinced some Banks and other Institutions to weaken traditional lending standards. NAB believed in the first principle, that was ingrained in the Credit Culture, that was to understand the riskiness of an individual's or business' cash flow. Static measures of near-term performance did not capture future performance upon which NAB would be relying to have any commitment serviced. Globalisation was beginning to take hold, spirited competition and disruptive technologies were beginning to effect markets and many businesses began to focus on short term measures to satisfy equity markets rather than long term cash flows.

In other banks, and some NBFIs, the result of poor credit checking, analysis and a lack of 'credit culture' was of much lending to those who were clearly not credit-worthy, write-offs and impaired balance sheets, and in some State banks, the ultimate price was paid. NAB insisted, without exception, on independently evaluating business plans and credit worthiness (or lack thereof) was firmly established, judged and checked in detail before loans were approved. Danny's broader question at the time was about what exactly the other Australian banks' core capabilities were: it wasn't marketing and customer service, it wasn't 'lean' and waste free operations, and it clearly wasn't credit management. Was it government relations and lobbying, to preserve their protected positions, so they could not be acquired by more competitive organisations? Danny likened a bank that was unable to effectively assess credit worthiness to an automotive assembler that couldn't weld or paint cars: it's their core.

Some analysts in the 80's and 90's shared Mr Spalvins[1]' view that NAB had a 'fat and lazy Balance Sheet' and that NAB's conservative stance with some of the entrepreneurs of the 80's was ultra conservative. Yet it saw NAB remain strong when essentially all other banks in Australia got into trouble.

[1] John Spalvins built conglomerate Adelaide Steamship, into a large organisation until its collapse in 1991

For bank executives that era, it is easy to remember Tuesday 20 October 1987 when the ASX plunged 27.2 per cent after the NYSE fell 22.6 per cent the previous day.

Australia's takeover titans headed by the likes of Alan Bond and Christopher Skase used overt exhibitions of wealth as a marketing tool to purport success. They pressured some in the Banking Industry to raise capital and many books have been written about their exploits.

Many of their corporate targets were long term customers of the Australian Banks, they operated under trust deeds which determined their financial behaviour, but all this changed with worthless letters of comfort, loose loan agreements, and financial structures designed to move capital around without recognition of prudent corporate governance, and little recognition of debt payback capability.

Acquisition and rationalisation were the boardroom war cries of these so-called entrepreneurs. Who could forget Australia's richest people lists, published in the now defunct Business Review Weekly magazine. Our so-called entrepreneurs of the 80's found their way into the Euro market and damaged Australia's reputation as a safe nation in which to invest, once the string of company collapses began to unfold costing the Banking Industry an estimated A$28 billion at that time.

The volatile boom bust cycle, a string of company collapses, a falling A$ against all currencies, crunched commodity prices and rising interest rates which saw the overnight rate exceed 20% pa, led the then Treasurer, Paul Keating, to issue his memorable missive that the meltdown was the recession that 'Australia had to have'.

There was a great deal of risk in the market during that period: many Victorians will remember the Pyramid Building Society collapse with reported debts of $2 billion: a salutary lesson for those contemplating long-term growth in the Fintech revolution. A youthful Warwick Fairfax inherited control of John Fairfax Ltd but by 1990 with a highly leveraged balance sheet, an ill-fated attempt to re-privatise the public company threatened its destruction.

Everyone in the financial sector has an Alan Bond story. NAB inherited his demands when he acquired Castlemaine, Tooheys and Emu Breweries; NAB's shareholders would be grateful to the diligence of our legal department at the time, in particular a young lawyer named Rob Allendale, who assisted in crafting a loan agreement which prevented any diversion of cash generated by the breweries outside of an agreed financial structure.

Bond's debt funded purchase of the St. Moritz Hotel in New York and his interests in coal and copper made headlines but a Royal Commission in 1990 uncovered the depths of 'WA Inc' which revealed the former state government, engaged in dealings with several prominent businessmen—including Mr Bond which resulted in a loss of public money. With the collapse of Bond Corporation, and his 1992 bankruptcy with reported debts of $1.8 billion, creditors were later awarded $12 million representing a little over half a cent in the dollar invested. Rothwell's, a former men's clothing store in Brisbane, converted into an Investment Bank by Laurie Connell became part of the WA Inc Royal Commission and was provided with a finance facility by NAB against a WA Government Guarantee. That loan was cleared in full. Mr Connell was charged with fraud and died awaiting trial.

The Corporate 'watch dog' ASIC instigated charges in the 1990's resulting in some 142 business people being jailed.

Robert Holmes à Court's tilt at BHP and John Elliott's white knight's involvement is well documented. These two business people actually were genuine corporate raiders and whilst the 1987 stock market crash affected the outcome of the raid on BHP, both parties had fall back finance positions to absorb losses which eventuated. The position taken by the Banking sector has received little public scrutiny. Westpac backed Holmes à Court and NAB and ANZ assisted with the defence finance strategy of BHP. It was interesting to observe the deep feelings between the Melbourne/Sydney finance institutions with this transition and we have no doubt some of the living practitioners in this transaction still have strong feelings about the behaviours of some of the professionals involved.

No comment about the 80's and 90's would be complete without mention of Christopher Skase and his Qintex Group. They splurged other people's money in many ventures such as an unsuccessful takeover bid for MGM Studios. He and Alan Bond were awarded the status of poster boys for indulgence and deception and I am sure would have created many hours of frustration for auditors of their public disclosures.

From a NAB perspective examination of public documents will disclose how effective our concept of Cash Flow coverage ratios had protected the Balance Sheet of the NAB Group and positioned the Bank to take advantage to acquire quality businesses available at that time. NAB experienced minimal loss to the entrepreneurs of the 80's and 90's. its approach to Risk Management differentiated it from the rest of the industry.

John Spalvins

The entrepreneurs of the 1980s exploited the word leverage to the fullest. They used limited amounts of equity as a base and built empires based on mountains of debt. Following the approval of the Campbell Report in 1981 and a follow-up with the Martin Report in 1983, competition between Banks began to mushroom, corporate balance sheets were being leveraged, Corporate Treasurers (CFOs) learned to take advantage of the opportunities available after floating of the Australian currency and we began to witness a new breed of Merchant Bankers ‘shopping deals’ to the entrepreneurs in the local as well as offshore financial markets. These merchant bankers began to divide the traditional commercial Banks; we saw the proliferation of Standy lines of credit for a fee, a breakdown of the traditional trust deed which specified the ratio of asset to liabilities and replaced by so-called negative pledges which in short prevented any lender securing assets and a pledge that no other lender would rank ahead of other defined lenders in the event of a liquidation. We also saw the increased usage of the overnight liquidity market to assist fund the activities of some entrepreneurs whose lines of credit were fully drawn.

John Spalvins was one of the smarter entrepreneurs and in 1985 he had accumulated 101 million shares in BHP, 70 million of which had been optioned to Robert Holmes á Court for a substantial profit reported to be in excess of $100 million.

Spalvins and Holmes á Court engaged in a legal wrangle through to 1987 over the non-delivery of shares in the original option play, but in the meantime both continued to buy BHP shares with a view to launching a takeover bid for the Big Australian. Both Spalvins and Holmes á Court suffered severely through their respective investment vehicles on ‘Black Tuesday’, 20 October 1987. This did not deter Spalvins who also had been accumulating NAB stock and other investments. He was also a large borrower from NAB and with a 14.8% shareholding in the Bank demanded two seats on the Board which was rejected.

Continued accumulation of BHP shares was not his best investment as Adsteam acquired the stock without an apparent exit strategy. Adsteam was constrained as the source of funding was becoming difficult to obtain. Adsteam had done well from a profit point of view with its first sale to Holmes á Court but thereafter there appeared to be misjudgements as to just how far Holmes á Court was prepared to take his play for control of BHP. Spalvins took a huge risk in shorting the BHP stock price which

ended with Spalvins barely breaking even with the deal. In the meantime the Australian market was becoming restless with the operational aspects of the Spalvins controlled Companies, not least of all was his Club of Bankers. The Banks began demanding asset sales to which he conceded some ground, but Australia had entered one of its worst recessions in 60 years. By the time the Adsteam group released its Annual Report in November 1990 Adsteam shares had 'tanked', the Bankers sought a Receivership and began trying to get agreement on a restructuring plan. Trevor Sykes in his excellent history of Australian entrepreneurs titled '*Bold Rider*' opined that '*the men who ran Adsteam seem to have fallen into their own trap. None were more brilliant users of financial techniques, but they began to confuse the numbers which they were producing with reality.*'

Liquidation of Adelaide Steamship Company was completed on 30 April 1997.

Technology

Investing in retail consumer and Investment Banking platforms became a real challenge for the core of banking, in which digital systems underpin nearly every major banking process. They have progressed from hand posted ledgers to automatic ledger machines to cheque/deposit processing technology to information technology that runs a bank's central nervous system—the Banks are now dealing with software and infrastructure that links services to business units, customers and back office function. The systems not only drive the banks' day to day operations but also serve as the core IT platform for new capabilities and growth.

The new millennium saw many banks saddled with underperforming systems and outdated architectures that barely supported key processes at a time when institutions were facing renewed pressure to cut costs and adjust to volatile conditions in a turbulent financial system. There have been many attempts to improve the performance of these aging systems, and the magnitude of those initiatives translated into high costs and high risks.

The Australian operations of NAB relied on a Current Account Management System which was developed back in the late 1970's and kept for a long time, with necessary updates. This technology gave NAB a competitive advantage for three decades and the early adoption of a general ledger system by Graham Upton and a team of young professionals

also gave management confidence in the integrity of the financial data produced.

Core Banking refers to a bank's basic functions such as gathering deposits, making loans, and managing the cash float which emerges from corporations and small businesses. This saw the emergence of large capital outlays with the introduction of mainframes–based transaction processing which allowed banks to coordinate their operations centrally.

With the exception of National Irish Bank, Clydesdale and Yorkshire Banks, the inherited systems created a dependable platform to handle large volumes of transactions efficiently with minimal disruption for a time. Clydesdale, Yorkshire and NIB struggled to reduce complexity in underperforming systems and outdated architectures, and this was a challenge from the beginning of the relationship.

The IT environment in the early 2000's changed markedly, and web communications with network computing emerged as building blocks of high-performance IT platforms.

Transitioning a bank from old inflexible technology stems with a narrow set of functions, was not only time consuming but costly and one had to be careful not to get seduced by one's financial performance to ensure that standards, applications and packages would endure long enough to pay off the investment. Getting engagement between IT professionals and business practitioners was essential to minimise risk in any technology change and NAB achieved this with success during the 80's and 90's through having dedicated people in place who not only knew what they were doing but who also gave much discretionary time.

There is current speculation that new Digital Technologies will disrupt the traditional Banking models. The collection of data and advanced analysis of that data has changed the way customers are viewed and the introduction of mobile devices has altered the way consumers in particular access their bank. Artificial intelligence and Big Data with sophisticated analytics are impacting on productivity and decision quality, including very much in financial services operations. At a time when most organisations are still playing catch up, this new wave of digital technology is upending workflow and processes in the financial services industry generally.

Tasks once handled with paper money, bulky computers and human interaction are now being completed entirely by digital interfaces. Add cyber security to the list of challenges; the cost/benefit will need to have rigor and be transparent if the bank in particular are to avoid obsolescence

in the future. Bank of America is now accelerating technology development in its Global Banking and Market Business having made significant strides in its consumer facing businesses. A JP Morgan report highlighted that Bank of America spend US$10 billion on technology, US$7 billion on maintenance and US$3 billion on new initiatives: this US$3 billion development is all done by inhouse staff.

It is interesting to observe that infrastructure maintenance has been reduced significantly due to reduction in data centres and servers, reducing duplication of data storage and networks.

They cite Automation and Artificial Intelligence as significant drivers of achieving their overall expense target. In an interview with the Wall Street Journal in October 2017 Cathy Bessant, the Chief Operations and Technology Officer at Bank of America Corp, observed the following:

> *The skill sets of the future are creative, problem solving skill sets. They are not the old progress through the finance organisation and knowhow to spread a financial statement. I used to do that with a No. 2 pencil. That's how I started in corporate banking. That is not the skill set anymore. The skill set is all about creative problem solving.*

She was also asked to comment on what the next revolution was, given the ATM and mobile banking has revolutionised the consumer side of the banking business.

She highlighted voice recognition, which enabled people to access information and manage their banking through voice recognition. With the exception of coin and currency she was of the view that voice recognition had the potential of putting a branch, financial advisor or corporate banker into the home office.

She observed that voice recognition was more of a reporting, data retrieval process and less of an analytical process. She saw biometrics and digital identity as the next wave with four factor authentication being the objective.

For NAB and other financial service players in Australia, technology is a key area for capability, competitiveness and performance. With legacy systems deeply rooted within traditional organisations, new players from small Fintechs to Apple, Facebook, AfterPay and others are working diligently to capture increasing 'share of wallet', and these threats are very real and ongoing.

Finance and Life Insurance Subsidiaries

Custom Credit Holdings Limited and its subsidiaries ('Custom Credit') was formerly one of Australia's largest general finance companies. In response to major bad debt problems, particularly in the commercial property sector, and an unfavourable outlook for a number of Custom Credit's traditional business activities, during 1991 the Group downsized and restructured Custom Credit. On 28 February 1991 a $60 million subordinated loan was made to Custom Credit by the Company. On 1 April 1991 Custom Credit transferred to the company property loans of $756 million at their net book value, while as a consequence of a strategic review it was decided the Custom Credit should no longer be a broadly-based financier. Custom Credit was subsequently re-organised into a vehicle leasing and fleet services division and a specialised trade finance house, Carrington Confirmers Pty Ltd, which was acquired by Custom Credit during 1991 for its net asset value of $13 million. Carrington was combined with Custom Credit's former factoring and working capital financing operations.

Custom Credit's funding was principally derived from the issue in Australia of debenture stock (secured debt securities) with maturities from 6 to 24 months. In April 1992, Custom Credit withdrew from new public debenture borrowings. From November 1992, new business in the areas of general leasing and motor vehicle leasing and management were henceforth written on NAB's balance sheet, or in special purpose subsidiaries directly funded by the Company.

On 1 February 1994 Custom Credit was placed into member's voluntary liquidation. The ongoing operations were transferred to the Australian Bank as part of its final winding up process.

The Group's United Kingdom banking subsidiaries operated a number of finance entity and leasing businesses, including Clyde General Finance Limited (Clydesdale Bank); Northern Bank Factors Limited and Northern Bank Leasing Limited (Northern Bank); and Yorkshire Bank Finance Limited and a number of leasing entities (Yorkshire Bank).

Life Insurance and Investment Products

Consistent with its philosophy of providing customers with a comprehensive range of financial products and services, in 1985 the Group established a life insurance and funds management entity, National Australia

Financial Management Limited. This entity and its subsidiaries provide the Australian market with a range of personal financial planning services, personal life and disability insurance, personal superannuation and managed investments, corporate superannuation, group life insurance and various investment management services.

Two of the Group's banking subsidiaries in the United Kingdom, Yorkshire Bank and Northern Bank, offered certain insurance and investment products through subsidiaries, mainly in the areas of funds management and other investment related products. BNZ offered certain finance and life assurance products through subsidiaries.

Acquisition of MLC

On 30 June 2000 the National's subsidiary, National Australia Financial Management Limited (NAFM) acquired the financial services businesses of Lend Lease Corporation, known as MLC group (MLC), for approximately $4.6 billion.

The National established a service infrastructure group, National Wealth Management Services, comprising service entities previously owned by NAFM and MLC. The service infrastructure group provided employees, information technology and related services to the wealth management operations.

The benefit of the structure was the grouping of the National's major insurance and investment operations separately from its other financial services businesses, as required by the Australian Prudential Regulatory Authority (APRA).

In 2003, NAB surprised the market with a 'dawn raid' on the AMP share register to attempt to acquire more than 10% of the target company. AMP shares soared to $6.28 but the market closed with NAB holding 5.4% of the market. Many market practitioners were quick to point out the difference between the $6.00 offering in 2003 to the failed offering of $21.00 per share in late 2003.

In 2009, NAB announced the purchase of Aviva Australia's holding of their Life Insurance business to become the Country's biggest life insurer and investment platform provider.

In April 2010, it was reported that NAB made a bid for AXA Asia Pacific Holdings only to find that the ACCC found that a merger between NAB and AXA Pacific would result in a substantial lessening of competition in the market for retail investment platforms for investors with

complex investment needs. The reported merger price was A$14 billion. At the time ACCC Chairman, Graeme Samuel, is reported to have said the decision to knock back NAB's bid was based on the Bank's involvement within retail funds platforms through its ownership of MLC, Aviva and the JB Were business.

In 2016, NAB announced the completion of the sale of 80% of its life insurance business to Nippon Life Insurance Company for $2.4 billion. NAB retained ownership of 20% of the new Life Insurance Business and refocused on its existing investment businesses which included Superannuation platforms, advice and asset management. Part of the sale included a distribution agreement to provide life insurance products through NAB‘s distribution networks. At time of writing a statement has been made that NAB has committed an additional investment of $300 million at least over 4 years in their superannuation platform advice and asset management business plus:

- a transaction loss of approximately $1.2 billion–$1.3 billion;
- goodwill for the Wealth Business was expected to reduce by approximately $1.6 billion–$1.7 billion; and
- upon completion of the transaction NAB CET 1 Ration was expected to increase by 50 basis points.

The Royal Commission into misconduct into Banking, Superannuation and Financial Services Industry has seen calls for more regulation and a collapse of the Bancassurance model. The calls to eliminate a vertically integrated model seem to be ignoring the challenges ahead in terms of disruptive technology and needs careful thought and study of what has been achieved in other developed economies, before regulating change which merely transfers the risks to some other balance sheet.

Merchant and Investment Banking

In 1988, the Group restructured and consolidated its corporate advisory and capital markets activities through an investment bank, National Australia Limited and subsidiary companies. As a result of changing market conditions, in 1990 it was decided to incorporate most of these activities into the Bank. At 30 September 1990, National Australia Limited had total term commitments of A$1.1 billion. The Group also operated merchant banking subsidiaries in Hong Kong, Singapore and New Zealand.

At 30 September 1990, the combined assets of these subsidiaries amounted to A$446 million. A stockbroking subsidiary, AC Goode & Co Limited, was closed in 1990.

Specialised Subsidiaries

The Group undertook a number of specialised business activities through other subsidiary companies, principally in Australia. These included a property company (NBA Properties Limited) mainly involved in managing the Group's own properties; a customs, freight forwarding and trade advisory group (International Trade Management Pty Ltd); a trade finance and confirming house (Carrington Confirmers Limited); travel sales and holiday packaging (National Australia Travel Limited and Prima Holidays Limited); and trustee services (National Australia Trustees Limited and Northern Bank Executor and Trustee Company Limited).

Savings Bank

For many years the Group had operated a savings bank subsidiary in Australia, National Australia Savings Bank Limited (the 'Savings Bank'), which raised retail deposits and primarily provided variable-rate, long-term mortgage finance for owner-occupied housing. As a result of regulatory changes introduced by the Reserve Bank of Australia, the traditional distinction between trading and savings banks has been effectively eliminated, thus removing the rationale for a separate savings bank with the Group. In 1990 the Group ceased writing new housing loans through the Savings Bank. However, at 30 September 1990 the Savings Bank's assets amounted to A$9.4 billion, or 10.0% of Group assets, and its deposits totalled A$7.6 billion. At that date housing loans accounted for 55.9% of the Savings Bank's assets. For the year ended 30 September 1990, the Savings Bank contributed 6.5% of the Group's operating profit after tax.

Until April 1986 the maximum interest rate Australian savings banks could charge on housing mortgage loans under A$100,000 was 13.5% pa. Due to the increase during 1986 in the average interest rate paid on deposits by Australian financial institutions, the Savings Bank was forced to reduce its housing loan approvals because its cost of funds caused such loans to yield unsatisfactory or negative returns. The 13.5% interest rate ceiling was removed in April 1986 in respect of loans made after that time, but retained for existing loans. With respect to existing loans the Australian

Government provided the interest rate subsidy to major savings banks for a 12-month period ending on 31 March 1987. The subsidy was the equivalent of approximately two thirds of 1.0% of balances held in investment and statement savings accounts as reported to the Reserve Bank of Australia in last Wednesday of February 1986. Of the total subsidy received by the Savings Bank of A$21.7 million, A$14.1 million was attributable to 1986 and A$7.6 million to 1987. In return for receiving these subsidies, the savings banks undertook to increase lending for housing at a level consistent with total Australian savings bank lending of A$6 billion in 1987.

Although new lending was not subject to any interest rate ceiling, 22% of the Savings Bank's housing loans, at 30 September 1990, (A$1353 million) were still subject to the previous maximum rate of 13.5%. On 20 November 1990 the Savings Bank's minimum interest rate for new owner-occupied housing loans was 15.5%.

It is important to remember that in the early 1990's, Australia went into a recession whose origins were a matter of political dispute and whose legacy should not be forgotten. At the end of the 80's deregulation and expansion of the Australian Economy was overstretched and there began an international recession. Paul Keating who was the Treasurer of Australia made the comment that 'It was the recession we had to have'. His comment was seen by some as stupid and there was much finger pointing when the overnight interest rates exceeded 18%.

Of the 18 Countries of OPEC of reasonable size, 17 experienced a recession in the 1990's—a similar situation to the mid 1970's and 1980 global recessions. One of the reasons promoted for the recession at the time was the relentless pressure of high interest rates on business which in many cases were geared up to the hilt. The combination of high interest rates and high debt constrained cash flows as well as limiting a firm's ability to undertake investment and increase employment. At the same time households were affected by the rise in mortgage interest rates which reduced their disposable income available for consumption.

Looking back from today, where overnight cash rates are down to or below 3% (hitting 1.5% in 2019 and reducing further towards 2020 and remaining low during the Covid19 pandemic period) and comparing that with the 18% in 1989, one finds it difficult today to appreciate how different things were in the high inflation period particularly when it was combined with a competitive banking system eager to lend. It is interesting to

reflect that whilst we all lamented high interest rates, the rates exceeded 18% in December 1985 and even higher in April 1992.

One difference was that in 1989 mortgage rates had been deregulated and so for the first time, some of the tightness of monetary policy flowed through to the household sector. The reason only some flowed through was that all mortgages written before 1986 were grandfathered at 13%.

The emphasis on interest rates at least reminds us that what we were dealing with was essentially a financial event. Just as the expansion of the 1980's was dominated by rapid growth in credit and asset prices, the recession of 1990–1991 was dominated by financial failure. In most cases it was the fall of the asset prices which meant that loans could not be repaid, thus transferring the stress to financial institutions.

Fast forward to 2018 and today, and we are now dealing with a real elephant in the room. Australia's household debt to income level has reached a new milestone of 200%, total household debt has reached a record $2.47 trillion.

In household debt, Australians owe $1.4 trillion on their homes and if house prices fall mortgagors will owe more than their homes are worth and that will lead to more default and bankruptcies. When that occurs the lending standards of our financial institutions will again come under the spotlight and our record of quarters of growth will become a memory with that recessionary word will again returning to the nation's narrative.

Having lived through the tough economic circumstances of the 70's, 80's and 90's with ballooning debt, high house prices, high interest rates and Central Bankers of the world struggling to keep the Economic Circus running, it is a matter of hope that those who wish to play political football with our banks really understand the consequences of an overregulated financial system.

NAB Post 2000: Leadership, Governance and Strategy

NAB became No. 1 on the ASX in 1997 and its performance on the stock market up to 2000 was exceptional (see Fig. 1.1, Chap. 1). How did such a fine institution lose its momentum and fail to convince the market that it has a sustainable growth story going forward?

Commentators will make their own judgements about decisions taken that destroyed value. Those events are described generally in the Case

Study descriptions in this book. This was clearly a point of inflection in NAB's history in 1999/2000, involving leadership, succession of leadership, and then strategies and governance.

The one characteristic that is constant in all organisations is change. Leading people is about leading change and that becomes even more important when a Chairman of a Board, a CEO, or a Divisional Head exits the organisation. In NAB's case the CEO succession in 1999 was the subject of Board discussion for three years prior to Don Argus's departure and the profiles of four internal candidates were constantly tested against external talent to ensure the CEO succession process had not lost rigour or integrity.

When the Board's preferred candidate, Fred Goodwin, elected to take up an employment offer with the Royal Bank of Scotland in 1999, instead of delaying the process to more rigorously assess the options available including the external market, the Board proceeded with the appointment of their next preferred candidate, Frank Cicutto, who was a career banker and well known to the Board.

The logic of that decision was understandable whilst the incumbent Chairman, Mark Rayner, presided over the Board. However, Mark Rayner resigned from the Board in August 2001 as a result of difficulties experienced by another company of which he was Chairman, Pasminco. Mark was a man of high integrity and he chose to relinquish his NAB role to concentrate on Pasminco who had credit lines with NAB.

Charles Allen was appointed to replace him as Chairman of NAB which surprised many in the market. Graham Kraehe was the favourite Board member to replace Mark Rayner should he retire or resign. This preferment was not formalised from which one could conclude that the Board succession process had not been perfected at the time of Mark's resignation.

Charles Allen was a thoughtful Board member having joined the NAB Board in 1992. He could be a contrarian at times, but management respected his constructive input. He was a former Managing Director of Woodside and had other board appointments, but was not seen as a potential Chairman of the NAB Board.

It was interesting to note that Cathy Walter was appointed Chair of the Audit Committee in 2000 with Charles Allen and Mark Rayner, and Chris Lewis of KPMG the Audit Partner who carried out a due diligence on the HomeSide acquisition and who became General Manager Group Risk Manager at NAB.

The period from 2000 on became quite volatile for NAB; there were reports of a failed acquisition attempt in the UK, they acquired MLC for $4.6 billion from Lend Lease in June 2001.

One might conclude that the handling of the HomeSide write-off was ineffective with the company appearing to pursue a public relations strategy which positioned the missteps as a legacy issue evolving from the HomeSide purchase, rather than reporting the facts of poor execution of a technology project at HomeSide which are reported elsewhere and reported more broadly as an 'interest rate calculation bungle'. Clearly it is possible to make a sound strategic acquisition, then bungle its technology strategy, operational effectiveness or leadership down the track.

The market quite rightly was frustrated with differing market intelligence and when considered with the botched AMP bid, a reported failure of an M&A transaction in the UK; the investment in St George Bank reported as a core asset, and then unwound shortly after acquisition, and rumours of forex traders operating outside risk management guidelines beginning to emerge, market confidence in the Chairman and CEO began to wane.

Charles Allen resigned as Chairman of NAB in February 2004, two weeks after Frank Cicutto's resignation as CEO of NAB. Both were victims of the currency trading scandal reported earlier in this book.

It was announced that John Stewart, a former Building Society Manager from the UK with some banking experience at Barclays Ltd, would become CEO, and Graham Kraehe would become the new Chairman. The Bank, quite apart from experiencing a departure of some very experienced and talented individuals in 2000 and 2001, was now confronted with the loss of its CEO and Chairman plus four traders. The Company had three chairmen in four years, only surpassed by Brambles with six chairmen in seven years during the 90's.

It was reported that the NAB departures were the result of a PwC report which concluded that there was inadequate management supervision, significant gaps in back-office monitoring, weaknesses in controls, a failure of risk management systems and an absence of financial controls. This is an obverse set of descriptors to what was reported and in place during the period 1985–2000. For example, as described above, risk management was a key differentiator, pre-2000, that explains a significant part of NAB's outperformance of the banking index.

In the 80's and 90's, the disciplines of risk management and controls generally were 'a way of life' with delegated authorities devolved to those

who earned the right to control the destiny of the Bank and their own careers.

Unfortunately the turmoil did not end there: the Australian Institute of Company Directors published an article in its June 2004 edition magazine including:

> *What started as the actions of rogue forex traders operating outside risk management guidelines escalated into one of Australia's nastiest public boardroom brawls, between Graham Kraehe and Cathy Walter. With the boardroom divided, institutional shareholders demanded an end to the ego driven dispute that tarnished the Brand of the NAB.*

It is history but the well-publicised boardroom difficulties finished with experienced directors leaving the board, and the NAB institution struggling again to regain its winning formula.

John Stewart was appointed CEO of NAB following Frank Cicutto's resignation and his reign will be remembered by his global cost cutting programme, outsourced back-office positions offshore, sale of the Northern Bank and National Irish Bank. He delisted from the New York, London and Tokyo Stock Exchanges and announced a A$830 million provision for the investment into Collateralised Debt Obligation (CDOs) which were closely related to the US real estate markets meltdown. He is attributed with investing in these financial instruments by relying on an External Rating Agency assessment of Risk.[2] It is unclear what the quantum of value the Bank had in CDOs, given the Specialised Group Asset area recorded $15 billion of exposures including high yield debt—The aim was for an orderly write-down of these assets over time.

So given the HomeSide example of risk management and using the examples outlined in Alan Peachey's book '*Great Financial Disasters of our Time*' plus NAB's own experiences with rogue traders, why do we see a fine institutions like NAB encounter the risk difficulties recorded from 2000 to 2010.

First are the subjective lessons. NAB went from an organisation which was a leader in credit and operational risk to one out of control. There was a loss of talented executives over a short period of time who could not be replaced, and the institution lost momentum—the ability to learn from its

[2] Danny observed that risk management seemed to have gone from being a core capability, delivering major competitive advantage, to an outsourced activity.

rich history and forgetting, indeed ignoring things one already knew. Motivation clearly deteriorated with the upheaval at Board level, the winning culture which took years to develop was lost and trust and teamwork disappeared. These things cascade and reverberate both within and external to organisations.

'*There are none so blind as those who did not wish to see*' is a comment which emerged during this era and the Market became very critical of succession planning which some observed as more ad hoc, rather than a well-planned process.

The Financial Services industry generally has not been without its missteps and NAB is no exception. Banking is a high-risk business; one can endeavour to mitigate those risks by securing commitments with enforceable legal documents but as a messenger in the economy it has to deal with economic cycles, so the integrity of a borrower can test the Bank/customer relationship when corrections in economic settings can adversely affect the viability of that relationship resulting in Court Actions and other extended litigation.

Pertaining to the period up to June 1999, Don Argus and his leadership team was proud of the wider team of professionals who ushered NAB through the disruptions of deregulation, the economic downturns which saw interest rates increase to an overnight cash rate of 20%, the floating of the Australian dollar, the introductions of 16 new banking licences, to name a few events which had an enormous effect on the strategic direction of the NAB and other financial institutions in Australia.

The process of overseas expansions and the shareholder benefits derived were fully in place by 2000, as was the onward trajectory. It was a mission driven longer term strategic direction, of highly focussed growth, acquisition, value adding to acquired assets, and economies of scale and scope. This includes HomeSide which has been incorrectly described in some poorly informed third-party post-mortems as an error in strategic acquisition, rather than part of the risk control fallibility that set in post 2000.

The post 2000 environment in NAB prompted a long-term Analyst to comment that there seemed to be an over-concentration on strong short term returns on equity at the expense of its disciplined compliance culture. Be that as it may, for good order let's look at the market performance of the Group plus some numerical data which covers the period from 31 August 1990 to 30 June 1999.

CHAPTER 9

BHP (A): 'The Big Australian' Overview and Strategic Roots

Introduction and Background Context

The Broken Hill Proprietary Company Limited (BHP) is one of the leading businesses in Australia. It was the fifth biggest company after World War 2 (WW2) when the Bank of New South Wales was the biggest. It grew to become the largest in later years. At the time of writing, it is still the backbone of Australian industrial development. It is a very successful and resilient company; and is now the largest mining company in the world. Insight into its values, strategy and structure, the strategic issues it has faced, and its strategic decisions are instructive and worthy of understanding, thinking about and remembering by students of business. BHP was formed and listed as a mining company in Melbourne, Victoria on 13th August 1885 by some friends who discovered the first silver/lead/zinc deposit at Broken Hill in the western part of the State of New South Wales. It was a major high-grade deposit. BHP invented a new float separation process for silver/lead/zinc that was highly productive and the deposit was mined for many years until it was exhausted.

Mining to Steel

The established major mining company decided to diversify and seek other business endeavours. It chose manufacturing in the form of steel making based on an iron ore deposit at Iron Knob near Whyalla that was owned

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D. Argus, D. Samson, *Strategic Leadership for Business Value Creation*,
https://doi.org/10.1007/978-981-15-9430-4_9

and used for a flux in its silver/lead smelter at Port Pirie nearby. It established a steelworks at Newcastle on a coking coal field and a port, which opened in 1915. It became one of two early Australian steelmakers. It was very efficient, but struggled during the Great Depression in the 1930s. BHP and its competitor, Australian Iron and Steel at Port Kembla, agreed on a friendly merger in 1935.

After WW2, BHP expanded and modernised its steel making. It kept steel price increases in the 1960s–1980s below the increase in the CPI. This encouraged steel use, which increased demand. The steelworks were expanded further, which made them more efficient. BHP grew in a virtuous circle.

By 1969 the company had begun large-scale minerals exporting. During the 1970s it joined with Shell Australia Ltd to develop the North West Shelf gas fields off WA with several other partners. It also began mining for coal in central Queensland and acquired John Lysaght (Australia), a coated steel products manufacturer, part of BHP Steel. Restructuring in 1987 led to the company's major business being conducted through three globally-integrated business groups: BHP Steel, BHP Petroleum and BHP Minerals.

A five-year modernisation of the company's steel making operations was completed in 1989 for $1.9 billion. The company's policy of disposal of non-strategic assets continued throughout the 1980s, with the sale of Blue Circle Southern Cement in 1987, Rheem Australia Ltd in 1988, Brownbuilt Ltd in 1989, Woodside Petroleum in 1989 and BHP Gold Mines Ltd in 1991.

In 1990/91 BHP Minerals entered into an agreement with Delta Gold NL to evaluate Zimbabwe's Hartley platinum deposit. Subsidiaries, BHP Aerospace and Electronics Pty Ltd and BHP Information Technology Ltd, were merged in 1991. In 1992 the BHP Steel group was reorganised, with its downstream activities emphasised through a new building and industrial products division, and its international focus highlighted by a new international business division. Also, BHP and CRA Ltd formed a joint venture, Australian Associated Technologies Pty Ltd, to invest in technology-based projects considered to have potential relevance to BHP and CRA core businesses.

In 1993 BHP acquired a 36.6% interest in Foster's Brewing Group Ltd for $1.6 billion. It also decided not to pursue a number of non-core business activities, including the wastewater and waste treatment sectors. As a result, Environmental Studies International Limited (ESI) negotiated to acquire BHP's minority interest in the ESI subsidiary, ESA Technologies

Pty Limited. During that period, BHP steel was producing sound results. The Company diversified by entering the new businesses of iron ore mining at Mount Newman, and oil and gas production in Bass Strait.

BHP Steel remained strong when the traditional and world steel industry declined in the 1970's. In 1984, it acquired Utah Mining from General Electric in America, which had changed its strategy and exited mining. It provided first class open-cut coal mines in Queensland and a major copper mine in Chile. It also bought into Woodside Petroleum, which had large gas deposits on the Northwest Shelf of Australia. Each of these were friendly deals.

Challenging Years

In the late 1980s, BHP suffered its first and only take-over raid from Robert Holmes á Court who many believe to be Australia's first billionaire. Holmes á Court came to prominence in the 80s and burnished his reputation as a turnaround specialist/corporate raider who introduced green-mailing (e.g., where a company is put in play on the stock market to raise the price and the 'green-mailer' then sells his/her interest at a profit) with stunning affect.

In 1983 in what was dubbed as a mouse molesting an elephant, Holmes á Court made an initial offer for BHP that netted him 2% of BHP's issued capital. Three subsequent offers saw his stake rise to 29.9%, along with a Board seat in May 1986. Holmes á Court's strategy was to break up BHP, sell off the manufacturing business and focus on mining. In the governance history of BHP and subsequently BHP Billiton, much public attention in Australia was directed to the long takeover battle for BHP led by Holmes á Court. Some background to this saga is useful. In 1988, Beswick was established by BHP as a takeover defence, after Holmes á Court's initial attack on the Company.

BHP became a takeover target in the 1980s because its share price and dividend policy was suboptimal and what might be expected after a review of its net tangible assets. The Beswick deal was structured in such a way that BHP held about 50% of the ordinary shares of Beswick, Elders IXL (then Fosters Brewing) held 49.999% and ANZ Executors & Agency held 0.001%. BHP's effective ownership of Beswick increased to 97.3% after taking into account the preference shares that it held. In return, Beswick owned about 18% of BHP, which effectively 'created a structure (to enable BHP) to own a significant slice of itself'. This type of arrangement in the eyes of some analysts at the time 'not only [served] as a formidable

takeover defence, but also [acted] as a powerful means of entrenching the board and management'. The 18% voting shares held by Beswick effectively meant that BHP could vote for itself. In 1994, a request made by the Australian Shareholders Association (ASA) for BHP to cancel the 18% voting rights in BHP held by Beswick was unsuccessful. In the same year, BHP was able to avoid the Beswick deal being categorised (by the Australian Securities Commission [ASC]) as an 'unacceptable self-acquisition'.

The heavy losses suffered by BHP in 1997 and 1998 led some shareholders to argue that the shares held by Beswick made the board less accountable than they otherwise may have been for the performance of BHP. This criticism probably contributed to the ending of the controversial Beswick deal in 1999. During March 1999, BHP entered into an agreement to buy back shares held by Beswick in four separate tranches. With the buyback of Beswick's shares in 1999, BHP started to adopt a more transparent share structure. In hindsight, one could argue that the construction of the Beswick deal as a takeover defence by seeking to exploit voting rights was a flawed corporate governance practice, as it challenged the transparency of these practices. Collapsing the Beswick structure was one of the first initiatives undertaken by CEO Paul Anderson to ensure transparency prevailed during his tenure.

It is instructive to understand the detail of the Beswick structure. At May 31, 1996, BHP held 50% of the ordinary share capital of Beswick Pty Ltd (Beswick). Beswick and its 100% owned subsidiary, Panary Pty Lt (Panary), in turn, held approximately 338.1 million ordinary shares in BHP. The shares owned by Beswick and Panary represented approximately 17.22% of BHP's ordinary share capital as at May 31, 1996. They retained normal dividend and voting rights, but special arrangements concerning the exercise of the voting rights existed.

The other ordinary shareholders of Beswick were a subsidiary of Foster's Brewing Group Ltd (FBG), which owned 49.999% of the ordinary share capital and ANZ Executors & Trustee Company Limited (ANZ) which owned the remaining 0.001%. BHP held a call option over the share (including convertible redeemable preference shares referred to below) held by FBG and FBG had agreed not to dispose of them before 2010.

BHP had a power of veto at Board level, with the exception of the appointment of directors to Beswick. Beswick had also issued several classes of preference shares, as follows:

'A' Redeemable preference shares: 990,000 shares of 10 cents each, issued at a premium of $999.90, fully paid; rebateable, cumulative, dividend of 11% per annum; non-participating. BHP held options to purchase those shares at any time. The holders had agreed not to exercise their right of redemption prior to October 1, 1996, (in relation to 700,000 shares) and December 31, 1996, (in relation to 290,000 shares).

'B' Redeemable preference shares: 500,000 shares of 10 cents each, issued at a premium of $999.90, fully paid, rebateable, cumulative, dividend of 8% per annum; non-participating. Redeemable at the option of the issuer at any time, at a premium of $999.90. BHP held options to purchase those shares at any time. The holders had the right to put the shares to BHP Finance Ltd after October 1, 1996.

Convertible preference shares: 500 million shares of $1 each, held by BHP. The shares carried the right to receive dividends (subject to certain limits) pari passu with ordinary shares. Those shares could be converted to 'C' ordinary shares at any time at BHP's option, except that BHP was not entitled to convert the shares if to do so would cause Beswick to become a subsidiary.

Convertible redeemable preference shares: 58,886,816 shares of $1 each, fully paid, no fixed dividends. Redeemable at the option of the issuer at any time, or at the option of the holder only if the fully diluted underlying value of the holder's shares would not fall below its 1988 investment in Beswick and five years after any previous redemption by that holder, for a premium to be agreed or determined by value in a notional winding up. They were (subject to certain limits) entitled to 1,500 times the rights of the existing ordinary shares for the purposes of dividends and distributions on winding up. The shares could be converted into voting shares with the consent of the Board unless doing so would cause Beswick to become a subsidiary of BHP, FBG or ANZ or their related corporations.

Notwithstanding that Beswick was not a subsidiary of BHP as defined by the Australian Corporations Law, Beswick and Panary were included in the BHP consolidated accounts by virtue of their being classified as controlled entities pursuant to Australian Accounting Standard AASB 1025: Consolidated Accounts because of an agreement that, in substance, gave the BHP Group the capacity to enjoy the majority of the benefits and to be exposed to the majority of the risks of Beswick and Panary. This

accounting treatment was consistent with that required by US Generally Accepted Accounting Principles.

Foster's Brewing Group Ltd

Foster's Brewing Group Limited (FBG) had significant brewing interests in Australia, North America and Asia. The United Kingdom brewing interests were sold in the year ended May 1995.

Effective November 13, 1995, FBG implemented a capital reconstruction, issuing three new shares for every existing five shares held. As a consequence, BHP held 716,583,725 shares in FBG representing 36.5% of the paid-up capital. The carrying value of the investment at May 31, 1996, was $1,672 million (approximately $2.33 per share). In the period to May 31, 1996, FBG shares traded on the Australian Stock Exchange in the range of $1.93 to $2.38 per share. The market value of BHP's shareholding at May 31, 1996, was $1,672 million.

BHP was contributing to the governance of its investment through its Board representation. It considered there was long term value in the investment and that the current carrying value would be recovered.

'Black Monday' on 1 October 1987 put an end to Holmes á Court's ambitious takeover when Merrill Lynch decided to withdraw its A$1 billion Bond facility. Post the stock market crash, Holmes á Court sold his interest for A$2.3 billion.

This is a case study in its own right. Not many market practitioners are around these days to opine on what his original intentions were. One topic you will encounter, is the availability of credit lines which Holmes á Court was able to secure to mount such a raid, given the small market cap size of his bid vehicle. The transaction did divide the Bankers, Brokers, Legal and Accounting professions, and on reflection, it probably said something about the success or otherwise about the risk structures of those financial institutions when they became challenged with the economic recession of the early 90s and heavy commitments to some corporate entities.

Governance

Corporate governance practices in BHP Billiton have changed dramatically since the controversies raised by the Beswick deal. According to one report, the corporate governance structure of BHP Billiton subsequently

was seen as outstanding, at least in terms of *director independence*, *structure of board committees* and *audit independence*; this conclusion was based on the information disclosed in its 2002 Annual Report. In 2004, BHP Billiton also won the Corporate Governance Reporting Award and the Occupational Health and Safety Reporting Award, administered by the Australasian Reporting Awards. In 2007, BHP Billiton was again the Gold Award Winner of the Australasian Reporting Awards, which were originally established in 1951 and sought to improve reporting to stakeholders.

The DLC status of BHP Billiton, established in 2001, may have helped to improve the corporate governance practices of the group, as DLCs needed to comply with the higher governance test in the two different jurisdictions. In BHP Billiton's case, the company issued two Annual Reports each year to comply with the different disclosure requirements of Australia and the UK. Since the two Annual Reports were effectively reporting on the same group, the two reports would be evaluated together to help to draw a more comprehensive picture of corporate governance practices in BHP Billiton. Because BHP Billiton's shares were traded in the US as American Depository Receipts (ADRs), the company also needed to comply with corporate governance requirements in the US. Overall, the company needed to comply with the following listing rules and requirements:

1. The Listing Rules of the UK Listing Authority required reporting on the extent to which a listed company had complied with its Principles and Good Governance and Code of Best Practice, which were contained in Section 1 of the Combined Code of Corporate Governance.
2. The Listing Rules of the ASX required reporting on the extent that the company had met the Principles of Good Corporate Governance issued by the Australian Corporate Governance Council.
3. The Sarbanes-Oxley Act (US) and regulations made by the Securities and Exchange Commission.

The degree of compliance by BHP Billiton with these regulations and corporate governance codes was set out in the company's 2007 Annual Report. An overview of the corporate governance structure in BHP Billiton is illustrated in Fig. 9.1.

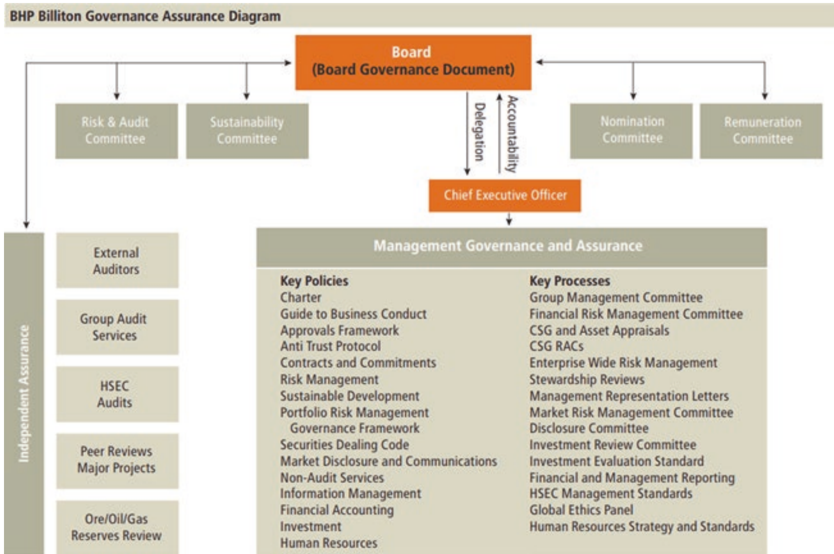

Fig. 9.1 BHP governance structure

The corporate governance model shown above illustrates that BHP Billiton's board of directors appoints and monitors the CEO and that the CEO is accountable to the board for the overall management and operations of the company. Also, the board had established various sub-committees, such as a risk and audit committee, a sustainability committee, a nomination committee and a remuneration committee to assist it; the board also provided oversight of external auditors; group audit services; health, safety, environment and community (HSEC) audits; peer review of major projects; and an ore, oil and gas review. On the other hand, the CEO was responsible for establishing proper policies and maintaining the functions of management committees as illustrated. In summary, the corporate governance structure in BHP Billiton was fairly typical of the so-called Anglo-American model of governance.

In 1998, 60% of BHP's 285,000 individual shareholders were categorised as small shareholders and the shares that they held accounted for less than 4% of the company's total share value. After the merger of BHP and Billiton, the characteristics of a DLC were also relevant in evaluating BHP Billiton's ownership structure. The top 20 shareholders (as listed on the

register of shareholders) of BHP Billiton Ltd and BHP Billiton plc were disclosed in BHP Billiton Ltd's annual reports. According to BHP Billiton's 2007 Annual Report (as with BHP Billiton Ltd), the company's top four shareholders held 45.13% of shares registered under their names. However, because these top four shareholders were all nominee companies, this did not convey much information about the underlying ownership of those shares. Nominee or custodian companies usually do not have voting rights in aggregation of the shares registered under their names—they simply follow the instructions of the real owners of the shares held by them in terms of executing the 'property rights' associated with the corresponding share. Under the Australian Corporations Act 2001, a 'substantial shareholder' is one who is 'entitled' to not less than 5% of any class of a company's voting shares.

In BHP Billiton Ltd's case, the company had also disclosed that no person beneficially owned more than 5% of BHP Billiton Ltd's voting securities. This information indicated that there were no substantial shareholders entitled to more than 5% of the voting shares in BHP Billiton Ltd, which indicated that share ownership in BHP Billiton Ltd was relatively widely dispersed.

In BHP Billiton plc's case, the majority of its top 20 shareholders were also nominee companies. In the UK, different shareholders are represented by the same nominee company but by using a different in-house nominee company for custodial purposes. According to BHP Billiton's 2007 Annual Report, as in BHP Billiton plc's case, Chase Nominees Limited appeared three times in the company's top 20 registered shareholder list, with different account codes to represent different ownership interests. Despite the top two registered shareholders having 23.66% and 4.57% of shares, respectively, under their names, the disclosure of substantial shareholders indicated a different picture. According to the UK's listing requirements, a shareholder who owns 3% or more of a company is characterised as a substantial shareholder. In the case of BHP Billiton plc, there were two substantial shareholders, holding 4.82% and 3.53%. The DLC structure is covered more specifically further in this manuscript.

BHP's values were and still are the soul of a business and are led by the CEO and the leadership team. They influenced what the company would or would not do: what it stands for. The values of BHP were initially centred on integrity in business, hard work, efficiency, technological development, good engineering, financial stability and prudence, performance

improvement, first class leadership, efficient and effective Board and governance, strength without monopoly behaviours, and a desire to serve Australia. There was a strong focus on the Tier 1 Assets, an awareness of its role of business leadership in Australia, employment of good people and fair reward, staff development, straight forward negotiation with unions, and good relations with government, but eschews politics.

BHP still has a strong commitment to social responsibility. As one of Australia's biggest companies, it tends to be the 'Aunt Sally' for activists and special interest groups but still has a high regard for the environment, sustainable growth and people and this is now defined in a very comprehensive report titled *Sustainability Report*.

Essington Lewis

No short history of BHP would be complete without mention of the shadow of Essington Lewis when he was part of the BHP DNA, and mature aged executives were still able to recount his legacy. Mr Essington Lewis, as he was respectfully addressed, became the CEO of BHP in February 1921 and a Company Director in 1926. He was described as a brilliant man. He made BHP into a leading world steelmaker, though small by international standards. He demanded efficiency. He travelled every year to steelmakers overseas. He was well known and respected in political and business circles, because BHP was a domestic steelmaker that exported very little and so did not compete directly. He sought out new technology and ways to improve efficiency to apply back home. BHP steelworks were among the most efficient in the world. Essington Lewis sought to compare BHP costs with leading steelmakers overseas and found that BHP was often lowest producer. He visited BHP steelworks frequently and brought new ideas for improving efficiency. He knew the managers and many workers on the shop floor by name. Essington Lewis developed a brilliant, enduring strategy for BHP, the steel company.

In the mid-1930s, Essington Lewis is reported to have had a premonition that there would be war in Japan. He prepared BHP and the Government for it. He established Commonwealth Steel Corporation to make special steels for manufacturing, machinery and stainless steel. He

set up Commonwealth Aircraft Corporation, which built war planes in the 1940s. During the war, he became the Minister for Munitions. Essington Lewis was the honoured head of BHP until he retired from the company as Chairman in 1952.

BHP commenced steel making activities in Australia in 1915. It was the sole integrated producer in Australia of basic iron, raw steel and related steel products, supplying approximately 68% of Australia's steel requirements. BHP was NZ's only fully integrated flat products steelmaker and supplied a large proportion of its domestic demand. BHP had downstream operations in Asia, North America and the Pacific region. BHP also manufactured sheet steel, pipe and tube and wire products. It was largely self-sufficient in the raw materials necessary for steel making. With combined production of 8.9 mt of raw steel in 1998 (excluding the Ohio compact steel mill in the US), BHP was one of the top 20 steel producing companies in the world (as measured by raw steel production).

In June 1989, JB Were completed a special report on the BHP Group. It provided readers an insight into the operations of BHP Ltd at that time and is worthwhile reading to provide context as to the inheritance and challenges which future management and the board would encounter. To provide readers of this manuscript some idea of the complexity of the BHP business it is also worthwhile studying the structure of the organisation as at June 1989 and some financial data on base case earnings an outlook from 1987 to 1995. It is insightful to provide at this point a graphical history of the share market performance to provide some context around how this great company restructured itself and achieved extraordinary growth. Figures 9.2 and 9.3 show the share price history and earlier structure of the company.

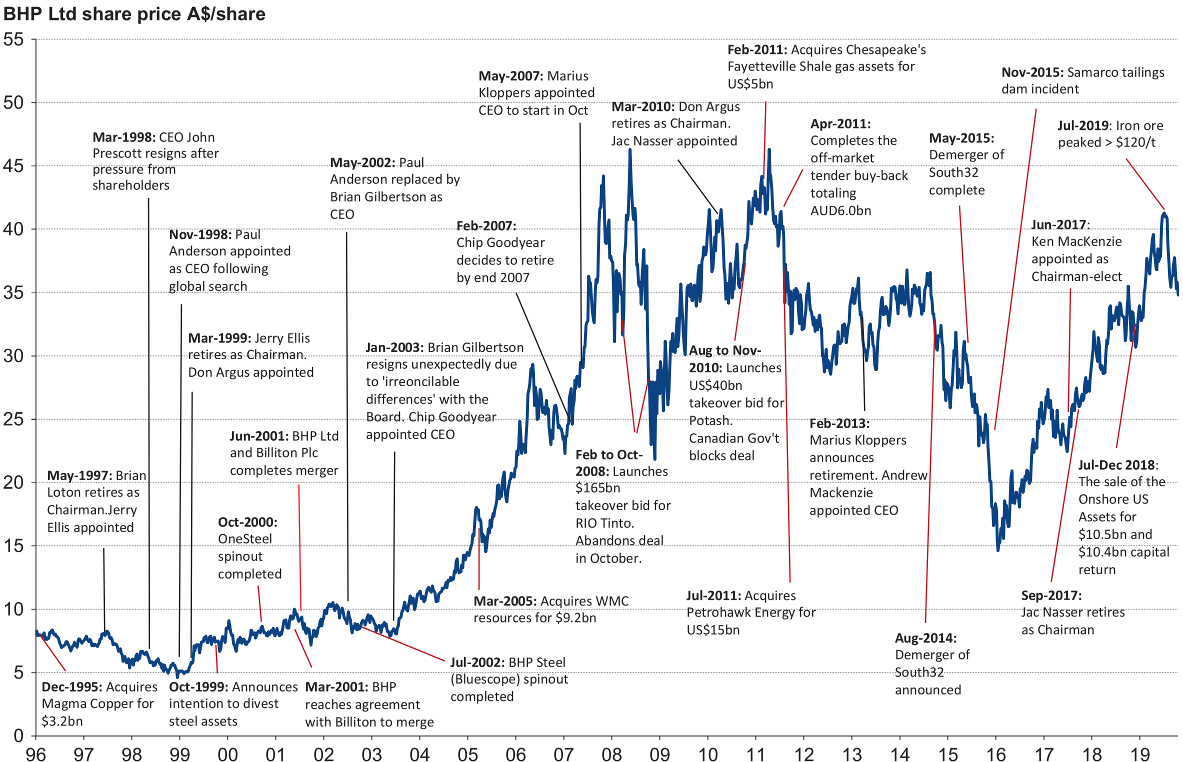

Fig. 9.2 BHP share price history

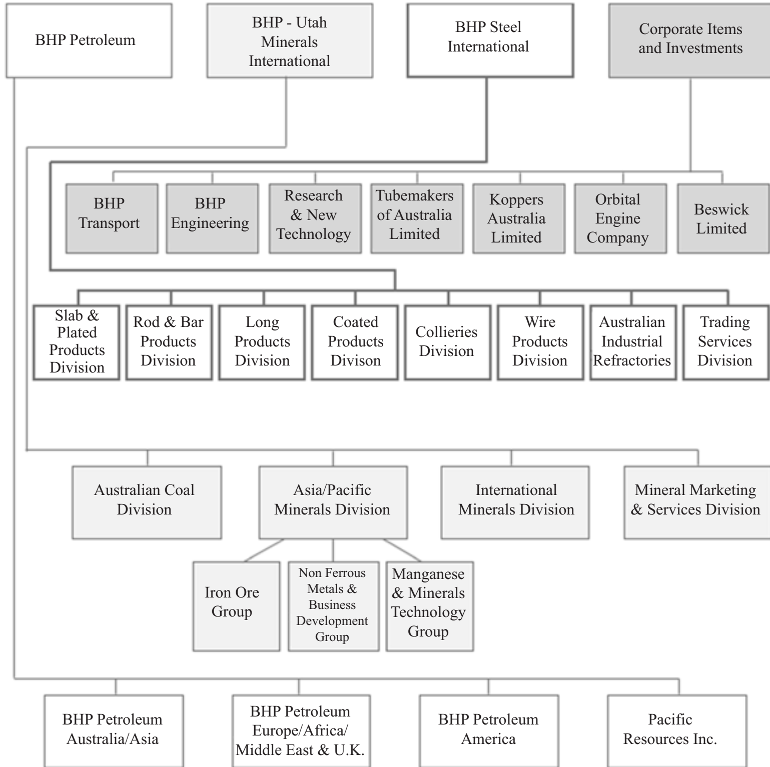

Fig. 9.3 BHP structure as of 1989. (Source: JB Were Research Report, June 1989)

CHAPTER 10

BHP (B): Steel

Introduction: A History of Vertical Integration

Whilst the original strategy may have been mining, much capital was directed to steel making. The BHP steel strategy was based on the fact that the Australian market was just large enough for one steelmaker at optimum economic scale of operation. If two steelmakers became established in Australia, one would not survive. BHP became one of the most integrated of the integrated steelmakers in the world. This business was successful for decades, yet the time came for a decision to demerge the steel business and exit that industry. BHP owned quality iron ore mines at Koolan Island and Cockatoo Island off the northwest coast and iron ore near Whyalla in South Australia. It had its own coal mines, and limestone shipped from South Australia. It had its own supply of zircon refractory bricks for its furnaces. It owned its own shipping line of ore carriers to prevent being cut off from ore sources. It built its own ships at the shipyard in Whyalla. Its steelworks at Newcastle, Port Kembla, Whyalla and its blast furnace at Kwinana were all at sea ports. Newcastle and Port Kembla were on coalfields with wholly owned coal mines. (Traditional steelworks in Europe and America were located on coal fields because it took 1.5 tonnes of coal to every tonne of ore to make iron in a blast furnace. Most coal deposits were well inland away from cheap imports.)

The BHP steelworks were fully integrated which meant, like steelmakers overseas, they had their own ore stockpiles, blast furnaces, coke ovens,

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D. Argus, D. Samson, *Strategic Leadership for Business Value Creation*,
https://doi.org/10.1007/978-981-15-9430-4_10

open hearth steel furnaces, rolling mills, finishing mills, flat product mills and tin mills for cans together on the site. BHP integrated further than foreign steel companies. It went up stream by owning its own ore, coal and limestone (the flux for blast furnaces) mines and shipping. BHP integrated further than others into downstream steel users, such as wholly owned wire mills for fencing, ball mills for ore grinding balls for mining companies, and special steels for quality manufacturing. It owned 30% of the only producer of rebar for construction. It owned 50% of the coated steelmaker, John Lysaght Australia (JLA). Later it bought 100% of JLA. The purpose of these additional interests was to prevent a foreign steel company buying them to gain a foothold in the Australian market on which to base a second steelworks.

The company was in the vanguard of adopting new technology for blast furnaces, steel furnaces and continuous casting, where hot liquid steel was poured into the top of a curved casting machine and came out as a red hot solid for rolling into final product. All these improved productivity, kept costs down and protected profits, while under continuous pressure from unions that increased wages and conditions. BHP was also an early adopter of artificial intelligence in the 1970s. It was applied to blast furnaces, which could be temperamental. Senior staff and workers got to know and operate them successfully. Artificial intelligence was developed to capture this knowledge before people retired and two research centres which focused on productivity improvement contributed to the continuous improvement focus. BHP Steel tested iron ore blends from Mt Newman in its blast furnaces and shared these experiences with Japanese steel company customers.

BHP made a full range of steel products for the Australian market which gave it a monopoly position in the Australian market. That said, BHP priced steel not at FOR (free on rail), which would have meant customers pay insurance and freight, but on CIF (cost, insurance and freight), so that the price of a steel product was the same to a customer anywhere in Australia. This avoided foreign steel companies using distance as a shield to start another steelworks in Australia.

BHP installed steelmaking capacity to meet above average demand, but not peak business cycle demand. Small amounts of steel were sometimes exported. In the occasional boom, it could not supply all customers. It had to ration some products. Customers would complain and double their order to get the amount they wanted, or arrange imports at higher prices which took longer to be landed. Confusion would arise for a time. BHP would be accused of being a monopolist then, but it did not raise prices

above the CPI. It saved installing idle surplus capacity for a lot of the time. It fully supplied most of the cycle, and it did not price gouge when it could have done.

The BHP virtuous circle continued and led to its expansion and that of steel users based on low prices. Australia experienced the most industrialisation in its history. There was little doubt in the mind of some commentators that BHP's strategy underwrote Australia's industrial development at that time.

The company was a leader in environmental initiatives and was proud of its transparency associated with difficulties outlined in this manuscript. This environmental concentration was the forerunner to this being the centre piece of future expansion.

In the late 1980s and 1990s, inflation was also troublingly high. For a seriously capital intense company like BHP, it meant that a piece of equipment bought for, say, $100 would cost $200 to replace in 10 years' time. BHP retained only enough depreciation for $100. There was some market criticism when profit was distributed to shareholders at that time that should have been retained to finance replacement of fixed assets, not growth. BHP introduced an accounting policy called FAVA (fixed asset value adjustment), the annual retention of extra depreciation for inflation in that year charged against profit, and FAU (fixed asset utilisation), the accumulated capitalised retained earning attributed to inflation. BHP was not only very profitable, it had a large cash flow from the additional retained earnings. It had a large treasury function and was courted by many merchant banks, as they described themselves at that time. BHP invested its finances in renewal and many new enterprises.

When Don Argus joined the Board of BHP in 1996 he encountered a company that had survived and stabilised to a large extent after the Holmes á Court take-over ructions of the late 1980s. The Company was expanding carefully in both steel, minerals and oil and gas resources. BHP had acquired Magma Copper Company, Tubemakers of Australia Limited, and invested in a new blast furnace in Port Kembla as well as expanding its oil exploration and production in the North West Shelf of Australia. The Company's stated vision at that time was: 'BHP seeks to be the world's best resource company'. The company was investing in the USA and across Asia, as well as in Australia. Total revenue was $19.8 billion, operating profit after tax was $1.29 billion and capital expenditure, acquisitions and investments, research and exploration were a notable $7.59 billion. The Magma acquisition made BHP the world's biggest non-government

copper producer. 1996 was the fifth consecutive year of BHP providing a return on equity in the range 10% to 15%. The company reported its strong commitment and activities in the areas of safety, environment and community. As Australia's largest public company by market capitalisation, BHP accounted for 1.3% of Australian GDP and 7.7% of Australian merchandise exports.

In the early 1990s, BHP experienced a capital management dilemma. Its Steel mills were capital hungry, the Oil & Gas division became frustrated, because the Steel Division's demand for capital was seen by some to be limiting the growth options available in Oil & Gas, the Minerals division convinced the Board in 1995 to purchase the copper asset called Magma Copper, which from the outset underperformed expectations and led to extraordinary write-offs. This purchase plus the sharp deterioration of commodity prices, intense global competition, industry over-capacity and cash flow margin problems, led to the appointment of a new CEO in 1998 and a new Chairman in 1999. It is important to understand the transition of BHP from a challenging operating environment with the appointment of Paul Anderson, a USA businessman, as CEO in 1998. In addition to the Magma losses, the company was experiencing losses and write-offs associated with the HBI Plant in West Australia, and the Zimbabwe platinum plant, it had cash flow issues and real questions about the maintenance of a dividend. There were also financial challenges with a relatively highly geared balance sheet, a relative under-investment in the pipeline of growth projects 1996–2000 which clearly had implications for the slope of any recovery, and resulted in the 1999 Annual Report effectively summarised on the cover as 'Under Pressure'.

Significant changes were in the wind; in 1998, BHP reported operating profits, but large abnormal losses. Asset write-downs, lower prices on copper and oil and the Asian financial turmoil significantly impacted on overall performance. $3billion of assets were sold, and just under $5billion was invested, with a ROE of 11.2% before abnormal items and -12.7% including abnormals. CEO John Prescott resigned, after 40 years in the company. The Company was also experiencing change in 1997 with the retirement of its Chairman, Brian Loton, to be replaced by Jerry Ellis. This difficult time for BHP led to increased focus on cost reduction and risk management. The steel business was being reshaped, including announcement of the closure of Newcastle works scheduled for 1999, and moved investments downstream in the value chain. BHP also announced to the market that it recognised a need to change fast and significantly,

with the CEO stating, '*We have introduced stringent systems to manage the capital proposal process, project management and risk assessment.*' The market was beginning to highlight that BHP was not achieving its weighted average cost of capital and free cash flow was diminishing.

Breaking the Frame

To achieve change in this environment, as an external CEO appointee, Paul Anderson had to break the frame which had defined BHP over many decades. He had to challenge the fundamental aspects of the Company's business model and/or challenge the underlying operating assumptions of the various business units.

Breaking the frame required strategic insight and a sound understanding of what the market would bear. He had a good understanding of where world markets were heading and challenge a company which some market practitioners opined had become stuck in routines that had become obsolete.

Paul, as described elsewhere in this manuscript, was a good listener and a good strategic thinker and was able to build advocacy for his 'new day' and get resources moving in the right direction. He used both informal and formal aspects of the various business units to build the advocacy required.

Paul and Don were at one in thinking of culture as synonymous with values. It was more useful to think of it as information, influence and insights that flow among peers and Don included the Board in that category. Whether you have a strong or weak culture often depends on the strength and calibre of these peer connections.

Before moving to the 'Game Changers' introduced by Paul Anderson and his team, it is important to understand the company and the cultural environment prevailing in BHP. As one would expect, BHP was a proud company with a strong insider Leadership Team, but where information did not move freely, and influence and insights seemed more isolated rather than sharing freely amongst peers.

For the students of Management Theory, one could pose a legitimate question: 'how does an external CEO appointee of the calibre of Paul Anderson achieve success in a company so steeped in history?'

That said, BHP had a consistent record of success with its strong focus on steel making activities and which was still the principal Australian steelmaker.

BHP's three principal areas of business were minerals exploration and production (principally coal, iron ore, copper concentrate and metal and manganese ore), hydrocarbon exploration, production and refining and steel production.

Steel Operations

Much has been written about steel making and its development, and Professor Geoffrey Blainey has an excellent video produced by BHP on the early history of steel making in Australia and should be compulsory viewing by students of industrial history. For the purposes of this case study however we will concentrate on the exit of BHP from steel making.

In 1997 following a strategic review of all business activities, BHP's CEO of BHP Steel, Ron McNeilly, confirmed that the world steel industry would continue to be characterised by intense competition, falling prices, increasingly demanding customer needs, the emergence of new low capital-intensive technology and the need for a relentless focus on cost reduction.

The following specific decisions were to be implemented:

- The strategic review confirmed and endorsed the Steel Group's multi domestic growth strategy, which focused on servicing the building and construction markets in the Pacific Rim. This strategy would continue to be pursued and would involve the further establishment of high added value coated products facilities together with further downstream processing and merchandising facilities;
- Involvement in relevant downstream businesses of a significant scale would continue. Further opportunities for growth in the Pacific Rim would be pursued in line with the multi domestic strategy;
- By the end of 1999 export business from Australasian plants would focus on added value flat products;
- Port Kembla Steelworks would continue its development as a flat products integrated steelwork. Further development of those facilities would be aimed at achieving world scale in each of its main activities;

The combined integrated steel business would deliver the benefits of scale and specialisation in supplying feed to support the downstream businesses.

In Whyalla, whilst the steel making facilities were sub-scale, they had the unique advantage of being close to high quality iron ore reserves.

Notwithstanding this, the Whyalla facilities would remain under intense competitive pressure and the replacement of the existing facilities at the end of their useful working life could not be automatically assumed.

BHP Steel saw its greatest opportunities for world competitiveness and growth in the flat products segment of the steel industry. It saw its major integrated steel making and hot strip rolling activities in Australasia being increasingly cantered at Port Kembla.

Speculation about the closure of the iconic Newcastle Steel Mill increased and in 1999 the Steel Mill closed on September 30th.

The transition of Steelworks employees who, in many cases were part of multigenerational families who had worked there, had begun. Given this impact on the employees, contractors and a community, the objective was to provide a structured and effective way of facilitating transition to new careers or pursuits. There was in place a very wide ranging programme that allowed former workers to retrain into skills and careers of their choice. Easy to plan, very difficult to execute in an emotional time.

The closure of the Steelworks was part of a broader rationalisation of the long products side to the then BHP Steel business. Globally, technology had moved on from the scale and cost of major integrated Steelworks providing those kind of products. BHP reacted to this technology shift by building a billet mill in Whyalla Steelworks, upgrade the Sydney steel mill, and bring together the downstream parts of the long products business. Many of these latter facilities were located in Newcastle which therefore remained an important part of the reconfigured business. The combined business was to become part of the OneSteel spin-off which will be articulated shortly.

Looking back on the closure process; the management team under Paul Anderson set some fundamental principles which as a management group they held themselves accountable. Safety of course was a key, but beyond that it was about doing everything they could to help look after the employees and contractors, their families and the proud Newcastle people to make the transition effective. While there will always be things that could have been done better, University of Newcastle chancellor Paul Jeans, a fourth-generation Novocastrian who ran both the Newcastle and Port Kembla steelworks during a stellar management career with BHP, told a gathering at the 20th Anniversary of the steelworks closure that by the time he came to manage the plant in the early 1990s, it was

increasingly difficult to keep pace with the international market, especially in Asia, where steel plants ten times the size of Newcastle had been built.

Unfortunately, its limited size meant that despite 'good costs, quality products and a great workforce' the company 'couldn't make it viable'.

Mr Jeans said that while the steelworks closure seemed like a 'tragedy' at the time, it had 'released' Newcastle to find a new way forward.

The rolling mill side of the business continued to operate after the closure along with a number of steel processors, such as Tubemakers that had been set up beside the old steelworks. The mill received their feedstock from Whyalla steelworks and an electric arc furnace steelmaking mill in Sydney's Rooty Hill.

On 25 February 2000, Broken Hill Limited (BHP) announced its intention to divest (Spin-out) certain steel businesses into a new company called OneSteel Limited (OneSteel). After the relevant approvals had been obtained it was intended that OneSteel would become a separately listed public company on the Australia Stock Exchange (ASX).

The Spin-out would be affected by a capital reduction and pro rata transfer of OneSteel shares to holders of fully paid BHP shares as at 27 October 2000. Under the terms of the Spin-out, holders of fully paid Ordinary BHP shares would receive one fully paid Ordinary OneSteel share for every four fully paid Ordinary BHP shares held.

The Spin-out was subject to shareholder approval at the company's AGM on 17 October 2000 and Court approval on 18 October 2000. Subject to approval of the capital reduction by BHP shareholders and the Court, BHP shares would begin trading ex-entitlement on Monday 23 October 2000.

OneSteel continued to focus as a steel manufacturer and distributor with its principal operations at Whyalla supported by the iron ore mining operations at Middleback Range.

In 2007 it merged with Smorgon Steel after lengthy ACCC deliberations. It changed its name to Arrium Limited in 2012.

It made acquisitions in Chile and Canada and sold its sheet and coil processing plus its distribution businesses to BlueScope Steel in 2013.

In 2016 the Directors placed the company into voluntary liquidation and in 2017 British owned GFG Alliance acquired Arrium mining; Arrium Steel business. Arrium Mining was renamed SIMEC Mining and the OneSteel brand was changed to Liberty Steel. The acquisition also included some of the old brands—Australian Reinforcing Company,

Austube Mills and Emrails together with Waratah and Cyclone. A touch of nostalgia for all the steelmakers of Australia.

Further rationalisation occurred with BlueScope Steel being demerged from BHP Steel and renamed BlueScope in November 2003. Kirby Adams, an up and coming recruit at BHP, became the CEO of BlueScope and Graham Kraehe became Chairman of the Board with Ron McNeilly, who had performed admirably as caretaker of BHP when John Prescott retired from the Company in 1998, becoming Deputy Chairman.

Merger / DLC

At the time of the announcement of the DLC between BHP Ltd and Billiton Plc, BHP disclosed its intention to demerge and separately list it on the ASX. The business had a strong market presence manufacturing and distributing a wide range of flat and coated steel products. The BHP Board and management had been deliberating on the advantages, disadvantages and the risks associated with a demerger of BHP Steel for a number of years but finally found the will and the courage to separate the Steel activities from its minerals and petroleum businesses. As BHP had been experiencing difficulty making its weighted average cost of capital as an industrial conglomerate, growing BHP Steel as an independent company and pursue its own business strategy without having to compete with other businesses in the new BHP Billiton portfolio became a compelling case study.

The demerger was implemented by way of a capital reduction and distribution of BHP Steel shares to eligible BHP Billiton shareholders. BHP Billiton would hold 6% of the total BHP Steel shares which it offered for sale under a sale facility established in connection with the demerger process. The demerger of BHP Steel Limited and its subsidiaries involved a return of capital of $0.69 per share in BHP Billiton Ltd. This amount was compulsorily applied as consideration for the acquisition of shares in BHP Steel Ltd. BHP Billiton Ltd shareholders were entitled to one share in BHP Steel Ltd for every five of their BHP Billiton Ltd shares. The BHP Billiton shareholders who did not want to keep their BHP Steel Ltd shares were offered a sale through a sale facility for $2.80 per share. Alternatively, shareholders wishing to acquire more BHP Steel Ltd shares could buy them through the facility for $2.00.

BHP Billiton Plc shareholders would not receive BHP Steel shares. Instead, to ensure equality of treatment under the DLC agreement, they

received a bonus share of BHP Billiton Plc to reflect the value of the BHP Steel shares being distributed to BHP Billiton Plc shareholders.

When Don mentioned courage in arriving at the decision to demerge BHP Steel Ltd; it was undertaken against a backdrop of the worst price environment for its main products in 15 years. The US Government decision to impose a 30 percent ban on steel imports was not helpful. There was however a view at the time that the steel cycle was about to turn up.

The shareholders of BHP Billiton accepted the transaction as a positive as it effectively was giving the business to Ltd shareholders and passing an equivalent benefit to former Billiton shareholders. BHP Steel Limited changed its name to BlueScope Steel Ltd on 17 November 2003. BHP today has a market capitalisation of A$106 billion and is ranked third biggest on the ASX.

CHAPTER 11

BHP (C): Minerals

BHP Minerals Strategy

BHP commenced operations in 1885 as a miner of silver, lead and zinc, and later expanded its principal mineral interests in order to satisfy the majority of the raw material requirements of its steel operations. Those mineral interests have since been further developed, and the Company managed large mining operations, including joint ventures in a number of foreign jurisdictions. BHP Minerals produced iron ore, coking coal and manganese ore in Australia, copper concentrate and gold in Chile, Papua New Guinea and Peru, copper metals in the United States and energy coal in the United States and Australia. BHP also had a 49% interest in an iron ore project in Brazil. It became a major global player in this sector, with strategic leadership being critical to its outcomes. The Minerals strategy recognised that the mining industry had many deposits of different minerals, each with its own characteristics from which to select. The common factor was that deposits could be classified into first, second and third class (called 'tiers' these days). For the purpose of this case study, a Tier 1 deposit was amongst the largest and highest grade of the mineral known by world standards. It must be the most economical to process and best located for most economic transport to market. A Tier 1 deposit would make a profit in a boom, in average times and in a recession. It is the prime target for exploration though rarely found. It is a prime world resource and a valuable investment. A second-class deposit will make a profit in a

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D. Argus, D. Samson, *Strategic Leadership for Business Value Creation*,
https://doi.org/10.1007/978-981-15-9430-4_11

boom and in average conditions, but not in a recession. A third-class deposit will only make a profit in a boom. It is generally shut down at other times to wait for better conditions.

As BHP Minerals became a priority in BHP, this focus was more important because minerals were in the highest upstream of the supply chain of consumer products. During the business cycle, minerals prices vary much more than consumer products, as higher and lower demands for production and for inventory pass up and down each stage of the supply chain. Minerals are like the tip of a whip that travels further than the handle over a cycle. Tier 1 deposits of major minerals in a diverse portfolio are crucial to BHP's stability and long-term resilience.

Each mineral has a different size of Tier 1 deposit, like gold and iron ore. Large scale deposits require a big investment to bring them to market. They tend to be operated by large, well-financed companies. Iron ore and bauxite are good examples. They are the most abundant minerals and the biggest mined in the world. Tier 1 deposits of these minerals are scarce, highly desirable and very valuable.

Prices of minerals tends to reflect their rarity, gold being the most valuable per tonne and the most difficult to find on any scale.

The proposed BHP minerals strategy was to focus only on Tier 1 deposits of large-scale production minerals and to develop its portfolio anywhere in the world. Second- and third-class mines were to be divested.

BHP Minerals Portfolio

In this section we describe some of BHP's most significant minerals operations, and later we provide a table showing many of the others, in what was developed as a global and diversified minerals portfolio.

BHP had Tier 1 deposits of iron ore, open-cut coking coal and thermal coal, and a manganese deposit at Groote Eylandt in the Gulf of Carpentaria. The Escondida copper mine in Chile, acquired with the Utah acquisition, was first class. BHP had acquired Ok Tedi gold/copper mine after Kennecott was unable to develop it. It was in a mountainous 400-inch rainfall area and was difficult to access. The tailings dam built at a high cost, then, of $100 million, slid down the mountain and was never replaced. This became a real environmental challenge and is covered elsewhere in this manuscript. BHP had some small nickel deposits in Western Australia. The company developed a diamond mine in the Arctic Circle. It was high value, but high cost extraction. It was sold.

Minerals had a highly skilled Exploration division and a large budget. It sought Tier 1 deposits and was the centre for many small explorers who

brought their good discoveries to BHP for development. It justified exploration, though it was recognised that first class discoveries were rare.

BHP explored around Cape York for bauxite but was not successful. It developed the Worsley mine on a bauxite deposit in southwest Western Australia with Reynolds Aluminium and Shell. Worsley was the fifth largest bauxite mine in the world. Later BHP entered alumina refining when it acquired Billiton Plc and Western Mining Corporation (WMC). BHP was reluctant to enter the aluminium smelting business, as it was already in a depressed world industry, and given its exposure to steel, BHP did not wish to be exposed to both steel and aluminium. A large silver/lead/zinc deposit in Queensland was analysed, but processing and separation were found to be complex and uneconomic. BHP bought a large share of Woodside Petroleum for its gas fields on the Northwest Shelf.

In earlier years, BHP had a gold dredge. It was small and a distraction to senior management. It was divested. BHP had a small tungsten mine on King Island in Bass Strait as an additive to steel for very hard tool steels during the war. It was later uneconomic and closed. BHP Minerals also owned Temco, a high electricity intense, ferro-alloys manufacturer in Tasmania. It refined BHP manganese into ferro-manganese and produced free-silicon for use in its steel making.

As it was the biggest company, BHP's underground mines were subject to union pressure to keep up to the very highest standards of the law on safety, which it did at considerable cost and competitive disadvantage, since other companies' mines were not held to the same standards. BHP has always been a highly safety conscious company throughout its history.

In the 1980s, BHP Minerals formed a gold business. It bought up second- and third-class gold mines and amalgamated them under one management. It missed the major Telfer gold deposit in Western Australia. BHP Gold became a senior management distraction. BHP Gold was floated off to shareholders. It was recognised in the 1990s that, of the divisions, Minerals needed to increase its scale and that of the company, but some would argue it was starved of capital and had to play catch-up as demand from China began to increase.

Minerals Division was much the same weight as the other divisions of BHP at that time. It became clear that the main source of growth for the company in future was Minerals because the steel industry became depressed, and oil and gas was difficult to expand. It had to explore for oil and gas fields successfully or acquire interests in other producers at great expense. The BHP Board was against hostile take-overs and small new businesses that would distract senior management. There were few options. All the known Tier 1 deposits of minerals in BHP's portfolio,

iron ore copper, coal and manganese, were closely held by public companies. This led to consideration of other minerals.

In scanning for opportunities, one company became of interest to senior management. It was Magma Copper in the US. Magma was a large private company with copper holdings in mining and refining. BHP management entered negotiations to buy the company. Magma's profit and ROI were suboptimal and original discussions were not fruitful. There were two problems. Magma did not really have any Tier 1 deposits. The copper price rose markedly over the 2–3 years of negotiations, so the price that BHP had to pay escalated.

The purchase seemed attractive to the Board at the time as it was a friendly acquisition, it added to BHP's copper business, it offered refining and smelting as a new strategic arm, and it was an entry into America for Minerals. It was planned to increase the scale of Minerals Division and the company as desired. It grew BHP in an area in which it already had expertise and hopefully offered further growth. BHP bought Magma for $4.5 billion in 1995.

When BHP management finally took over, it was clear that the limited due diligence had not been effective, as its deposits were depleted, its equipment was run down and smelters too far to transport concentrate economically, and it had no Tier 1 deposits. BHP management at the time tried to turn Magma around, but without success. Worse was to come. The world copper price had been rising for several years beyond the general price levels of other minerals with which the copper price was normally associated. It turned out that an international copper executive of the Japanese company, Sumitomo, had been fraudulently boosting the copper price at great expense to Sumitomo. The copper price collapsed.

BHP divested Magma and lost $2–3 billion. Some commentators suggested it was a consequence of a Board that had never made a hostile bid and avoided putting an acquisition to the stock market for evaluation in a hostile bid. Only market practitioners of the time could confirm or deny that observation.

BHP subsequently developed its iron ore and copper businesses organically. It acquired Billiton plc, Western Mining Corporation Ltd and made an unsuccessful bid to acquire Rio Tinto Ltd. More about those initiatives are elsewhere in this manuscript.

Mt Newman

One of BHP's diversified investments was in the Mt Newman iron ore mine in the Pilbara in north western West Australia. Enormous deposits of

high-grade iron ore had just been discovered in the 1960s. BHP analysed the mine project and found it had no NPV (net present value). The Managing Director at that time, Ian McLellan, made a strategic decision. BHP began mining in 1968 with AMAX, who it bought in 1986. Mt Newman mine became a jewel in BHP's portfolio. In fact, it is now one of the greatest iron ore mines in the world's biggest miner.

The untold background to Mr Newman is the development of the Japanese steel industry with the help of Australian miners. After the war in the 1950s, Japan produced about 5 million tonnes of steel per annum. By the 1980s, it was making 120 million tonnes of steel a year. Japanese blast furnaces at the time made 900 tonnes of hot metal a day. Blast furnaces were improved gradually over the years to make 4500 tonnes a day. Coking coal usage was cut from 1.5 tonnes per tonne of ore to 0.45 tonnes. Japanese steelmakers transferred steel making from open-hearth furnaces to BOS furnaces, cutting production time from 12 hours to 1 hour. Steelworkers cut the time of roll change for one product to another on a rolling mill from 8 hours to 1 hour. Japanese steelworks were all located at a port. They imported most of their high-quality iron ore from the Pilbara and coking coal from Queensland. The iron ore deposits in the Pilbara were 200–300 km inland, so world leading heavy railways were built to transport ore to ports, which grew bigger for the many ships. Originally, the ore carrier ships were 20,000 tonnes. Gradually, carriers built in Japanese shipyards increase in size to 250,000 tonnes. During this time, BHP's and others iron ore mines expanded enormously in size. Coking coal was produced in a growing number of larger open-cut mines, carried in larger coal ships.

This huge increase in productivity in steel making led to more Japanese exports of steel and steel containing products such as ships, cars and domestic appliances. It transformed the Japanese economy. Competition from Japan contributed to the pressure on integrated steel making in the US and Europe. Highly productive local mini-mills were introduced in their markets. Very high wages and conditions that were gained by unions in previous times of high profits of steel companies now cut deeply into profitability. Many of these steel companies struggled to survive from the down-turn in 1968. Most declined substantially.

The Mt Newman project, was a joint venture in which BHP held an 85% interest; they also managed the Mt Newman project. Other participants and their interests in this venture were Mitsui—Itochu Iron Pty Ltd (10%) and CI Minerals Australia Pty Ltd (5%). Production commenced in 1968 and annual mine capacity was 28 million metric tons of iron ore from

one major orebody, Mt Whaleback and one minor orebody, Orebody 29. It was planned for OB29 to be temporarily closed from September 1996 to match altered market mix requirements. Additional short-term satellite orebodies were brought on stream in 1988–89. The annual capacity from these satellite orebodies was approximately 9.4 million metric tons. The Mt Whaleback mine was one of the world's largest open-pit ore mines. Facilities at the mine included primary and secondary crushing plants, a heavy media beneficiation plant and a train-loading facility.

All production was transported for shipment 426 kilometres to Port Hedland on a railway owned by the joint venturers. Facilities at the port included crushing and screening plants, stockpile reclaimers and ship-loading equipment. Vessels of 250,000 deadweight metric tons could be loaded in the sheltered harbour. With the completion during 1993–94 of a major development at Port Hedland, the railway and port capacity was approximately 52 million metric tons of product per annum.

In May 1996 BHP announced a $375 million project to increase its rail and port capacity to match future iron ore and hot briquetted iron sales growth. The capacity expansion project would include a third car dumper, upgrades to crushing and screening plant, new conveyors and other infrastructure. Capacity of the Nelson Point Port would be increased to approximately 64 million metric tons per annum. The coincident purchase of new locomotives and ore cars would allow for the additional tonnages to be railed from the Newman and expanded Yandi mines. Construction would start in September 1996 and would take approximately 20 months.

Mt Newman Agreement

The Mt Newman mines operated under a lease granted in 1967, which was renewable every 21 years and was renewed in 1988. Under the terms of the Iron Ore (Mt Newman) Agreement, BHP and its co-venturers were obliged to undertake a feasibility study for the construction in Western Australia of an integrated iron and steel plant with an ultimate production capacity of approximately one million metric tons of steel per annum and, in order to retain the lease, could be required to build and operate such a plant.

In lieu of the abovementioned feasibility study requirement, the Western Australian State Government agreed to cancel the obligations to conduct the study and construct an iron and steel plant if BHP completed the construction of:

a) a gas fired power station of at least 100 megawatts at Port Hedland;

b) a gas fired power station of at least 70 megawatts at Newman and a connecting gas pipeline from an off-take point of the proposed Goldfields Gas Transmission pipeline in the vicinity of Newman; and
c) a gas pipeline from an offtake point near Karratha to the Port Hedland Power Station together with a connecting gas pipeline (Burrup pipeline) from the Karratha offtake to the Northwest Shelf Gas Joint Venture Plant on the Burrup Peninsula.

This alteration in requirements was pursuant to a ratified variation agreement with the Western Australian State Government to the Iron Ore (Mt Newman) Agreement.

The Port Hedland Power Station was commissioned in May 1995 and supplied power to the BHP port operations at Nelson Point and Finucane Island and the mining operations at Nimingarra and Yarrie. Construction of the gas fired power station at Newman, with an installed capacity of 105 megawatts, was completed in March 1996. Commercial generation of power commenced in June 1996 after a minor delay in the completion of the Goldfields Gas Transmission pipeline to Newman stage. The power station would provide power for the Mt Whaleback operations and Newman township. Application had been made to the WA State Government to acknowledge that the two power stations and the associated infrastructure as outlined above had been completed, and that accordingly the obligation in respect of the iron and steel plant, under the Iron Ore (Mt Newman) Agreement would cease. During 1995–96 Mt Newman shipments to Japan represented 41% of total despatches. Sales were also made to South Korea, Taiwan, Europe and China. Approximately 6% of shipments were to BHP Steel during 1995–96. Estimated recoverable proved ore reserves totalled about 568 million metric tons at May 31, 1996, of which BHP's 85% share was 483 million metric tons. The iron ore was of high grade with an average iron content of 63.5%

Mt Goldsworthy Mines

In March 1990 BHP bought the 70% interest in the Mt Goldsworthy Mining Associates Joint Venture in Western Australia which it did not already own. On October 1, 1990, BHP reduced its interest in that joint venture so that its ownership was uniform with its ownership of the Mt Newman Joint Venture (85%). The other joint venture participants are CI Minerals Australia Pty Ltd (8%) and Mitsui Iron Ore Corporation Pty Ltd

(7%). During the year mining was carried out at Nimingarra and Yarrie mine sites in the Pilbara region of Western Australia. BHP's share of production in 1995–96 was 6.4 million metric tons. Shipments to Japan in 1995–96 totalled 40% of Mt Goldsworthy's sales for that year. The estimated recoverable proved ore reserves at May 31, 1996, were 4 million metric tons (BHP share: 3 million metric tons) from the Nimingarra area and 35 million metric tons (BHP share: 30 million metric tons) from the Yarrie area. Mining at the Mt Goldsworthy leases were carried out by an independent mining contractor on behalf of BHP.

Yandi Mine

The Yandi orebody is located 92 kilometres north of Newman in Western Australia. Development of the orebody commenced in 1991 and included construction of a rail spur to the existing Newman/Hedland rail line, mine load-out tunnel and on-site administration infrastructure as well as the contract mining of the orebody. The first shipment of iron ore was despatched in March 1992. The infrastructure was now in place that would allow the existing Yandi mine to produce 15 million metric tons per annum, allowed in terms of the Iron Ore (Marillana Creek) Agreement. At May 31, 1996, total estimated recoverable proved ore reserves were 72 million metric tons (BHP share: 61 million metric tons) of assigned reserves for the existing Yandi mine (then known as Yandi I; see below). BHP's share of production in 1995–96 was 11 million metric tons.

The Yandi mine was granted a mining lease in September 1991 under the Iron Ore (Marillana Creek) Agreement Act 1991. This lease expired in 2012 with the right to extend for a further 42 years if required.

Development of the orebody began in 1991. This included construction of a rail spur to the existing Newman/Hedland rail line, crushing and screening facilities with a capacity of 10 million tons per annum, ore stacker, mine load-out tunnel, and on-site administration infrastructure. The project's first shipment of iron was in March 1992. With minor modifications undertaken in 1994, the capacity of the plant was expanded to 15 million tons per annum.

In October 1995, the joint venture expanded the capacity of the Yandi mine by 10 million tons per annum to 25 million tons per annum. The expansion involved the construction of a new mine at Central Mesa 1, processing plant, train loading facilities and an additional 10-kilometre railway spur. The joint venture began railing of the first ore from the new

mine in September 1996. The joint venture completed pre-stripping activities at another mine called Central Mesa 5 during 2000–2001 with ore from this deposit now being handled through an existing processing plant and train loading facilities. Again with minor modifications, the total capacity at Yandi was increased to approximately 30 million tons per annum. At price assumptions at that time, blend grades and production rates, it was expected that production from the Yandi mine would continue for at least 20 years.

On March 3, 2004, BHP announced that it would deliver up to 4 million tons per annum of a new lump product which would command a premium price over the existing fines. Additional infrastructure was added to the existing Ore Handling Plant 2 to support the on-site production of fine and lump ores, without affecting the quality of the two distinct products. Commissioning took place in June 2002 and increased overall capacity from 30 million tons per annum to approximately 40 million tons per annum, in accordance with the terms of the Iron Ore (Marillana Creek) Agreement Act 1991.

The Yandi mine had produced lump on a trial basis since 1999, already shipping more than 2 million tons to customers. These trials indicated that Yandi lump performance was suitable for the iron-making process and provided strong support for its permanent addition to the product range. The Company was undertaking feasibility studies on a further expansion of the Yandi mine capacity. During 2001–2002, 40% of the venture's shipments by volume went to Japan and 26% went to Korea. The Yandi deposits were mined by an independent contract mining company on behalf of the joint venture.

Port Hedland Hot Briquetted Iron (HBI) Plant

BHP announced in February 1999 that it would close its Beenup mine in Western Australia. Following a feasibility study into the construction of an HBI plant near Port Hedland, the Board of BHP gave its approval to proceed with this project on June 30, 1995. The HBI Plant in the Pilbara was conceived in mid-1994 in response to pressure from the West Australian Government to add value to the State's raw iron ore exports to the growing Asian economies.

A site, eight kilometres south of Finucane Island, one of two port facilities operated by BHP Iron Ore at Port Hedland, was selected and initial site preparation and earthworks was commenced. Full production from

the plant was expected in mid-1998, when it would have a capacity of 2 to 2.5 million metric tons of hot briquetted iron per annum. The plant itself would require an investment of $900 million whilst associated infrastructure, including tunnel under Port Hedland harbour, would add a further $585 million.

This along with safety issues was the beginning of consideration being given to how real value would be released from the BHI project. This project was the result of commitment to the Western Australian Government to foster downstream industry in WA. Hot briquetted iron was a concentrated iron product used as feedstock in electric ore steel making. BHP's plan was to produce iron feedstock directly from iron ore fines. Hot briquetted iron would consume millions of tonnes of low value fines through conversion into high iron content briquettes destined for use in the popular electric arc furnaces being built in Asia and at the same time satisfy its commitment to upgrade iron ore in Western Australia. The technology was already developed in operations in Venezuela in a joint venture with Sirensa, a Government controlled institution.

Construction of an HBI plant at Port Hedland was completed during the second half of 1999. Following a review of project scope in August 1997, revised cost estimates and completion dates were developed. Project costs were estimated to be in the range of $2.17b to $2.45b. The plant included associated infrastructure and an iron ore beneficiation plant, an overland conveyor from Finucane Island to take ore eight kilometres to the HBI plant and return the HBI to the port, beneficiation residue storage, iron ore stockpiles and service structures. First HBI was obtained from the research and development train in February 1999. The first shipment of HBI was despatched to Korea in May 1999, following the commissioning of the first production train in April 1999. The HBI plant had an ultimate capacity of two to 2.5 million tonnes per annum of HBI.

Original budget costs were A$1.5 billion, it was delivered for A$2.5 billion after a series of planning and construction missteps. In November 2004 it was announced that the plant would be placed on 'care and maintenance' and in November 2005 it was announced that the HBI Plant would be closed after writing off A$2.6 billion.

BHP's Performance

1999 was obviously a watershed year for BHP. Its annual report, titled 'UNDER PRESSURE', acknowledged the challenges of restoring confidence in BHP's management, steep commodity price declines, intense global competition, industry overcapacity, cash flow and margin problems, and the need to reshape the business portfolio, culture and achieve growth. Table 11.1 shows BHP's revenue and profit over time, by industry and region.

Strategies for meeting these challenges included lowering of costs, eliminating non-core and underperforming assets, pursuing innovation, instilling rigorous approval processes for capital allocation, simplifying the structure and linking employee rewards to shareholder results, and attracting outside talent, in order to broaden the management base. BHP's 1999 profit had dipped to $365 million before abnormals, a reduction of 72% from the previous year's profit of $1302 million. After abnormals the profit number was -2.3 billion, and shareholder equity was down in the year from a starting position of $12.4 billion, to a year's end $9.4 billion. The dividend of 51c per share was retained. Total shareholder return was not as bad as 1998, yet was still -9.6% (1998 was -14.9%).

BHP owned and operated a substantial portfolio of minerals operations. Key to their success as an Australian owned operation were a set of factors as follows:

1. Not all mining ventures are successful. Risks are high and they take many forms.
2. The process of discovery and developing any mineral deposit involves many people with different skills and expenditure of billions of dollars. The question to ask when evaluation a deposit is always the same. Does it contain enough recoverable and marketable metal or gems dug out of the ground, transported to market and sold at a profit. Obviously there are risks involved in each of the steps and one wrong calculation can be disastrous.
3. The most serious risks in any mining project are those associated with geology (the actual size and grade of the mineable portion of the orebody) metallurgy (how much metal can be recovered) and economies (metal markets, interest rates, transport costs). There are many other risks such as unforeseen political developments, new restrictive regulations, or the availability of labour to name a few.

Table 11.1 BHP revenue and profit

US$m	*1996*	*2000*	*2005*	*2005*	*2010*	*2015*	*2019*
Operating revenue by geographic market			%				
Australia	5418	4295	10%	3111	4515	2205	2568
North America	2791	3119	7%	2177	5547	7990	2442
Japan	2319	2246	12%	3733	5336	4863	4193
China	0	0	12%	3733	13,236	16,337	24,274
South Korea	0	1003	0%	0	0	2688	2550
India	0	0	0%	0	0	1680	2479
Europe	0	3738	33%	10,265	9843	0	0
Rest of world	5284	4001	26%	8088	14,321	8873	5782
Total	15,812	18,402	100%	31,107	52,798	44,636	44,288
Operating revenue by industry							
Minerals	**5738**	**4731**		**10,698**	**18,184**	**11,453**	**10,838**
Copper	[a]1	[a]1		[a]1	[a]1	11,453	10,838
Aluminium	[a]1	2357		5324	4353	*sold	*sold
Other minerals	[a]1	2374		5374	13,831	*na	*na
Iron ore	[b]2	[a]1		[a]1	11,139	14,753	17,255
Coal	[b]2	1597		3054	10,324	5885	9121
Steel	6110	8684		10,042	3617	*sold	*sold
Petroleum	3419	2963		6175	8782	11,447	5930
Other—Group and unallocated items/eliminations	545	427		1138	752	1098	1144
Total	15,812	18,402		31,107	52,798	44,636	44,288
Operating profit by industry							
Minerals	**860**	**916**		**3051**	**6235**	**3353**	**2587**
Copper	[a]1	[a]1		[a]1	[a]1	3353	2587
Aluminium	[a]1	438		939	406	*sold	*sold
Other minerals	[a]1	478		2112	5829	*na	*na
Iron ore	[b]2	[b]2		[b]2	6001	6932	8426
Coal	[b]2	137		310	2783	348	3400
Steel	122	297		3160	668	*sold	*sold
Petroleum	263	1142		2014	4573	1802	2220
Other—Group and unallocated items/eliminations	-239	-714		-54	-541	-569	-520
Total	1006	1641		8171	19,719	11,866	16,113

[a]Reported under Mineral segment
[b]Reported under Steel segment

*Note: Other minerals for 2005/2010 include base minerals such as copper, silver, zinc, lead, uranium
*Note: Iron ore and coking coal for years before 2010 are included in Steel—Carbon steel materials
*Note: Revenue split by geographic market for 2005 is calculated and based on percentages given by company report
*Potash included in Other—Group and unallocated items/eliminations

4. One of the features that distinguishes a mining enterprise from any other business is that during production the company's assets (the ore) is progressively consumed. The assets will be exhausted at some point in time, hence, a mine may be referred to as a 'wasting asset'.

This of course has implications for the justification of allocating capital to any new mining project. The time value of money plays an important role here. Simply put, the annual profits generated by a mine must be sufficient to pay back (within a reasonable time) the money invested in the mine. It is a discipline with mining engineers to estimate the payback period. One of the essential elements in any feasibility study is to estimate a mine's operating costs. Labour, electricity, power, transport, shipping costs are all factors that influence the capital cost of a mining project.

Low cost producers have a competitive edge when negotiating supply contracts and as each country has its cost related advantages and disadvantages, it is important to consider the overall political stability of a country before allocating capital to a mining project.

Another interesting feature in the natural resource industry is the preparation of compliance programs and controls. Because transactional and development projects involving natural resource entities can present significant risks under anti-bribery, anti-corruption and trade sanction laws particularly if one operates in markets where there may be a lack of infrastructure and controls.

With State ownership of resources and permitting, plus other development conditions requiring a high degree of interaction with government officials, high visibility of compliance risks are essential as the consequences from an international reputation point of view can be disastrous.

The seasoned mining engineer will also confirm that economics of scale operate well in the mining industry; a large mine will produce significantly more output per unit of output than will a small mine, but not all orebodies can support a large mine. Table 11.2 describes BHP's minerals assets and operations.

There is a case study behind the development of each of the mineral operations mentioned and it is not proposed to deal with each business. There are however some interesting issues to consider from which historians and students may develop their thoughts; the proposition proposed by some analysts that BHP and subsequently BHP Billiton had become too large to manage is a worthy debate.

Table 11.2 BHP owned/operated minerals

Name of BHP minerals operation	*Description*
Jimblebar Mine	Near Newman in WA, it was 100% owned by BHP, with reserves of 31 million tonnes
Port Hedland Hot Briquetted Iron (HBI) Plant	In 1995, nearly $1bilion was invested into this plant near Port Hedland, along with a tunnel ($585 million). Significant other infrastructure was required.
Goldfields Gas Transmission Pipeline	BHP had 11% interest in this pipeline
Pilbara Energy	BHP owned two gas fired power stations at and near Pt Hedland, for supplying power to its and other operations
Whyalla Mines	Iron ore was supplied from two BHP mines in SA to local steelworks
Waikato North Head Mine	Proven reserves of 18.3 million tonnes of iron sand is used to supply BHP NZ's steel operation
Taharoa Mine	BHP Steel has a lease on iron sand, exporting 1.1 million tonnes per year.
Samarco	BHP owns 49% of Samarco in Brazil, with an open pit iron ore mine, concentrator, pellet plant and port. 11–12 million tonnes per year are exported.
Groote Eylandt Mine	This manganese mine in the Gulf of Carpentaria ships to both BHP operations and exports.
BHP Copper; Escondida	Escondida is a major copper operation in Chile, owned $57.5 by BHP, with product being sold in japan, Germany, Finland and Chile. Expansion to over 0.5 million tonnes per year also facilitated sales into other global markets.
Magma Copper	Fully owned mines in the USA including Arizona and Nevada were acquired and operated from 1996
Ok Tedi	BHP held majority shares in PNG operations producing copper and gold. After years of successful operations, tailings dam discharges caused legal and other significant problems.
Tintaya, Peru	Gold and copper production was achieved since 1985
Smelting , refining in Arizona and Rod mill	3600 tonnes per day were processed
Gold: Syama mine	This mine in Mali was 65% BHP owned, at 4 grams gold per tonne of ore
BHP Titanium Minerals Pty Ltd	This operation in NSW, Australia produced producing rutile, zircon, ilmenite and monazite, with proven reserves of 612 million tonnes
Coal: Central Queensland Coal Associates (CQCA) and Gregory Joint Venture	BHP owned the majority of CQCA, operating five open pit mines, with coking coal transported to ports and exported, of 30 million tonnes per year.

(*continued*)

Table 11.2 (continued)

Name of BHP minerals operation	*Description*
BHP Mitsui Coal	BHP owned 80% of these Queensland operations that produced both coking and energy coal, exporting over 8 million tonnes per year.
Illawarra Collieries	Four underground coal mines in NSW produced mainly coking coal, 7 million tonnes per year, for local consumption and export.
Energy coal	BHP fully owned three mines in New Mexico, and a majority ownership in Indonesian mines as well as mines in Australia
Diamonds: Ekati, Canada	BHP mined and self-marketed diamonds from its Canadian operations

Goldfields Transmission Pipeline

BHP had an 11.843% interest in the Goldfields Gas Transmission joint venture. The other joint venture participants were Westminco Oil Pty Ltd (62.664%) and Normandy Pipelines Pty Ltd (25.493% and their interests).

This project was being undertaken to construct and operate a natural gas pipeline to transport gas approximately 1400 kilometres from Karratha on the northwest coast of Western Australia to Kalgoorlie via Newman and Leinster. The project was due to deliver full flow gas to Kalgoorlie by September 30, 1996. The pipeline was commissioned to Newman where it was providing gas to the 100% BHP owned 105-megawatt power station. This pipeline was one of the new transmission pipelines introduced around Australia which has trebled in length since 1990. Further large investments have been undertaken which has introduced security of supply and large economic benefits. Quite a competitive advantage.

Whyalla Mines

BHP Steel's Whyalla steelworks had been supplied with iron ore from 100% BHP owned mines in South Australia; two large open-pit mines and two smaller satellite deposits. Those operations produced a total of 2.9 million metric tons of iron ore during 1995–96. The 226 relevant mining leases granted under various indenture agreements with the South Australian Government had generally been granted for initial periods of

50 years and were renewable for periods of 21 years with expiry dates ranging from 2008 to 2050. A further 139 leases (mineral, extractive mineral leases and miscellaneous purpose licences) were held with the South Australian Government for various terms in support of associated mining activities. Estimated recoverable proved ore reserves at May 31, 1996, were 25 million metric tons, with an iron content averaging 63.1%.

There is a rich history here and is covered in a number of publications about Whyalla's integrated Steelworks. The quarrying of iron from Iron Knob and Iron Monarch provided high quality feedstock to Newcastle and Port Kembla Steelworks and later the Whyalla Steelworks and shipyards. These businesses specialised in rail tracks and Australian Navy vessels plus commercial vessels. Some of its Industrial Relations history is instructive, leading to strikes and arrests for supplying ore to Japanese Steel Mills prior to World War 2.

In February 2000, BHP announced its intention to divest of certain steel mills into a new company called OneSteel Ltd. The Assets consisted of domestic steel manufacturing and distribution, the Whyalla Steelworks, harbour facilities and associated iron ore mining operations along the Middleback Range in South Australia.

In 2007, OneSteel commenced iron ore export from the port of Whyalla via transhipment. In October 2012, a new dual gauge railway balloon loop was commissioned at Whyalla with the purpose of increasing Arrium's iron ore export capacity to 12 million tonnes per annum. Arrium's iron ore export volumes from Whyalla peaked at 12.5 million tonnes per annum in 2013–14 and 2014–15. In March 2015, Arrium's Southern Iron project, which included the Iron Knob mine, was 'mothballed'. Export volumes were expected to drop to between 9 and 10 million tonnes in 2015–16 and again to between 6 and 8 million tonnes from 2017. In October 2015, the company announced that it was working with the South Australian government to facilitate third party use of the Whyalla harbour to make use of its excess capacity.

In July 2012, OneSteel was renamed Arrium Ltd and in 2017 it was acquired by Liberty House Group, a British controlled company.

Samarco

Samarco is co-owned by BHP and Vale and operated as a Brazilian joint venture entity. Samarco operated an open-pit iron ore mine (Alegria), a concentrator, a pellet plant and a port in Brazil pursuant to long-term

mining concessions from the Brazilian Government. Iron concentrates were transported to the port by a 396-kilometre slurry pipeline. Production commenced in 1977 from the Germano mine. The capacity of the operation was approximately 9.6 million metric tons of pellets and pellet feed per year. Except for minor trial cargo sales all sales were under multi-year contracts. The Alegria mine commenced production in 1992 and replaced the almost depleted Germano mine. Total proved reserves of the Germano, Alegria and Alegria Sul mining areas are 341 million metric tons grading 48% Fe. BHP estimated that the combined reserves would yield 176 million metric tons of product.

On 5 November the Fundão tailings dam at the Germano Iron Mine of the Samarco Mining Complex near Mariana, Minas Gerais, Brazil suffered a catastrophic failure resulting in flooding that devastated the downstream villages killing 19 people and devastated the Doce River Valley. It was described as the worst environmental disaster in Brazil's history and has marked by dogged ongoing legal disputes. As we write, there seems to be a long road to redemption, with litigation pending, compensation packages still being negotiated and a plan on the table to eventually resume operations at the Germano mine.

Ok Tedi Mine

The history of Ok Tedi Mine dates back to 1963 when copper mineralisation was first identified by a Government patrol made contact with the Min people of Star Mountain in the Western Province of Papua New Guinea.

In 1968 the Fubilan Copper Gold was discovered and the Kennecott Copper Corporation commenced commercial drilling. After the withdrawal of Kennecott in 1975, BHP secured a mining lease and commenced a feasibility study, culminating in a report to the PNG Government in 1979.

Ok Tedi Mining Limited (OTML) was incorporated as an entity in 1981 with BHP a major shareholder with the PNG Government, Amoco Corporation, and Inmet Mining Corporation. The copper/gold mine was opened in 1982 but during development Ok Tedi tailings dam failed with waste flowing into creeks that ran into the Ok Tedi and Fly rivers.

In 1994 four writs were issued in the Supreme Court of Victoria on behalf of certain persons resident in Papua New Guinea seeking unspecified damages and other relief in respect of loss and damage allegedly caused by the discharge of tailings and other releases from the Ok Tedi mine into the Ok Tedi (river). These writs were all discontinued on 11 June 1996, in

accordance with the Terms of Settlement agreed to between BHP, OTML, others, Messrs Slater & Gordon and other plaintiffs. Settlement was for the sum of $7.6 million.

After Paul Anderson joined BHP in 1998 he felt that the environmental issues associated with Ok Tedi, which BHP operated, meant the mine should be closed. However, the PNG Government would not agree to closure because of the significant contribution the revenue generated by the mine made to PNG's GDP and export earnings, and to the welfare of the Western Province.

Negotiations were entered into with the PNG Government and Inmet with the legal agreement in 2002 being that BHP would take no future benefit from its equity but rather that the earnings from its equity would flow to PNG, especially the Western Province; that BHP would have no ongoing liabilities for future environmental damage not being a beneficiary; and that ongoing compensation arrangements and environmental provisions for eventual mine closure would be funded. The agreement was approved by the PNG Parliament.

The vehicle agreed and established to give effect to the funds transfer was the PNG Sustainable Development Program Company, which was set up as an independent entity with its own Articles of Association soon after the agreement. After the PNG Government moved to assume control of Ok Tedi in 2013, the Sustainable Program Company had to cease working on programs, though about $US 1.4 billion remains reportedly held in abeyance in Singapore. The mine has been closed since 2015, and there have been a number of unsuccessful court challenges by the PNG Government to gain access to the assets of the Sustainable Development Program Company.

The ownership of Ok Tedi has been the subject of legal dispute since the PNG Government moved to nationalise the mine in 2013. There have been a number of attempts to gain access to the reported $1.4 billion accumulated by PNG Sustainable Development Program Limited.

No-one has denied the gravity of environmental damage to the rivers in the Western Province of Papua New Guinea. The private investors in the Ok Tedi Mine contributed to the agreed restoration plans and set aside funds for the development of the people in the damaged area. Political instability in resource rich countries can deprive citizens of satisfactory returns from their rich endowments and unfortunately with the mine now fully closed it is difficult to see when the Ok Tedi Mine will again be a substantial contributor to the growth of PNG.

Somewhat perversely, the existence of any combination of negative factors leads to less exploration in a region which in turn can increase one's chances of discovering an economic orebody. In mineral exploration something is always better than nothing.

Escondida Copper Mine

The Escondida Copper Mine operates 3200 meters above sea level and is an example of a large-scale mining project in a remote part of the world which delivers enormous economic benefits to Chile. Its ownership is BHP 57.5%, Rio Tinto 30%, Jeco Corporation 10% and Jeco 2 Ltd 2.5%. The mine is operated by BHP. The project in the Andes Mountain range commenced development with a copper concentrator, crushing and conveyancing system, a camp, and a 200 km power transmission line. A 167 km copper concentrate pipeline, filtering and port load out in Coloso near Antofagasta.

As part of the Sulphide Leach process, Escondida pioneered the use of desalination for processing in this arid region of Chile. Water supply originates from the 500 litre per second desalination plant through a 24-inch, 167 km pipeline on route from sea level at the port to 3200 meters at the mine site. An extraordinary engineering feat.

Escondida is the world's largest copper mine with the owners investing in increased production with Escondida Norde, a sulphide leach project designed to produce copper cathodes which would use bacterially assisted leaching on low grade run of mine ore from both Escondida and Escondida Norde.

The Escondida orebody had recoverable proved ore estimated at 1676 million metric tons of ore at an average grade of 1.36% copper. The recoverable contained copper was estimated to be 44.6 billion pounds (BHP share—25.6 billion pounds). About 50% of the installed production capacity to the year 2002 had been committed under long term contracts of 10 years duration to smelter companies in Japan, Germany, Finland and Chile. Contracts of shorter duration—from two to six years—had been concluded with smelters in Spain, South Korea, Canada, China, Japan, Brazil, Philippines, Chile and Sweden, with merchants accounting for the remaining yearly output.

Mine equipment and mill facilities were expanded in two construction phases. The expansion projects increased nominal annual capacity from 480,000 metric tons to 800,000 metric tons of contained copper. The

filter plant had a nominal annual capacity of 720,000 metric tons of copper contained in concentrate and the leach plant had a capacity of 80,000 metric tons of copper contained in cathode. As ore grades declined and without further production expansions, annual copper production would decrease after 2003 to approximately 550,000 metric tons. A feasibility study was being carried out to evaluate the construction of an oxide leach plant with an annual capacity of 125,000 metric tons of copper cathode. The cost was estimated to be around US$436 million.

In 2017 output from the Chilean Copper mines included 975,893 tonnes of copper in concentrates and 266,794 tonnes in copper cathodes. Obviously the Escondida operations are a large contributor to the Chilean economy which was one of the advanced thinkers on how to derive benefit from their natural resources. Given the world growth and the flow on effect to nations with rich resource endowments, many mineral exporting countries search for ways to increase the contribution of mining to GDP growth.

Over the last three decades some tax regimes and policies have encouraged private investors to develop many new mines in Chile and other countries. The growth of China has seen an increase in demand for all base metals and those countries have attracted the lion's share of the global investor in this sector. Success, or perhaps because of it, is seeing the emergence of populist politics, with advocates pushing for change in policies, and in particular Industrial Relations and Taxation, in some of the resource rich countries.

Higher tax rates shift tax revenues over time, from the more distant future to the present and near future. This means that a tax increase is easier to justify if the interests of society are largely focused on the present generation and in particular its welfare over the next several years. In this case tax revenues in the more distant future are more heavily discounted. However, if the welfare of the current generation, beyond the next few years and the welfare of future generations are of concern as well, then the longer run negative effects of an increase in tax rate arising from the reduction in exploration and new mine development become important. In this case, the short run gains in tax revenues are less likely to offset the longer run losses sufficiently to enhance the welfare of society. A similar argument could be developed around Industrial Relations.

It will be interesting to observe how Chilean citizens handle the apparent restlessness, because a mining country that relies on private firms to find and exploit its mineral resources must compete with other countries

for investment. Its investment climate which reflects how attractive the country is to domestic and foreign investors depends ultimately on two considerations. First, the expected rate of return which the country offers investors on their investment in domestic projects; and second, the level of risk associated with those projects. These two critical determinants in turn vary with a host of factors including the country's geological potential, political stability and in particular industrial laws, level of corruption, tax regimes and government relations.

As mentioned earlier, political instability in resource rich nations can deprive citizens of satisfactory returns from their rich endowment. Chile has been a leader in this area. Let's hope the adult administrators can continue with the success achieved to date.

San Manuel Mining Operations

The San Manuel Mining operations were acquired in January 1996 as part of the acquisition of Magma Copper Company. The San Manuel Mining operation, near San Manuel, Arizona, was 28 kilometres north-east of Tucson, Arizona. Sulphide ore was mined from the San Manuel and Kalamazoo orebodies through underground block caving, while oxide ore was leached through heap leaching and in situ leaching processes. Cathode copper is produced from leach solutions using the solvent extraction-electrowinning (SX-EW) process. Sulphide ore was processed at the concentrator into copper concentrate which was further processed into cathode copper at the smelting and refining complex.

Ore reserves in the San Manuel orebody consisted of both copper sulphide and oxide ore with oxide ore confined to the upper regions of the orebody. Production of sulphide ore from the San Manuel underground mine commenced in 1956. The filter plant had a nominal annual capacity of 150,000 metric tons of copper contained in concentrate and the leach/SX-EW plant had an annual capacity of 88,000 metric tons of copper contained in cathode. The Lower Kalamazoo orebody was under development with production scheduled to begin in early 1997. The open-pit extraction of oxide ore began in 1985, and concluded in January, 1995. The conclusion of the open-pit operations resulted in no additional oxide ore being placed into the heap leaching process, although, a substantial expansion of in situ leaching within the open-pit had been implemented,.

Estimated recoverable proved ore reserves at May 31, 1996, were 220 million metric tons of sulphide ore at an average grade of 0.62% copper and 191 million metric tons of oxide ore at an average grade of 0.43% acid-soluble copper. The contained product was estimated to be 2687 million pounds of copper in concentrate and 397 million pounds of copper cathode.

San Manuel Mine was the largest underground copper mine in the world in terms of production capacity size of the orebody and infrastructure. Open pit mining and a heap leach facility were initiated in 1985 to extract and process 93 tonnes of oxide over a 10-year period.

Mining operations ended in 1999 due to a decline in mineable reserves along with sinking copper prices from a high of $1.95 per pound in 1995 to 65 cents in 1999. The mine closed in 2003 and held the distinction of being the largest open pit reclamation project undertaken in Arizona's history and was completed in 2006.

Pinto Valley Mining Operations

The Pinto Valley Mining operations was another asset acquired in January 1996 as part of the acquisition of Magma Copper Company. Pinto Valley Mining Operations, located in the State of Arizona, conducted its mining activities through two units: the Pinto Valley Unit and the Miami Unit. The Pinto Valley Unit mined copper sulphide ore from its open-pit mine for both concentrating/ smelting/refining and leaching/SX-EW production methods, while the Miami Unit conducted in situ leaching of the area of rubble above a closed underground mine and hydraulic mining/leaching of concentrator tailings.

The Pinto Valley Mine was located in the Globe-Miami district in Arizona, one of the oldest and largest copper districts in the USA and among the world's most favourable mining jurisdictions with respect to tax, regulation and labour. BHP Billiton is reported to have invested US$194 million in 2012/13 to upgrade and recommission the operation which was successfully restarted in 2012. Capstone Mining Corp purchased the mine in 2013 for a reported US$650 million.

Miami Unit

The Miami Unit is immediately north of the town of Miami, Arizona. All operations took place on BHP owned land. The Miami Unit's underground

mine ceased operation in 1959 upon the depletion of all the copper ore that could be economically mined using block caving methods. However, the area of rubble created by the block caving had been used for in situ leaching of mixed oxide/sulphide ore since 1941. The geographic area of the leaching operations was expanded in 1986 and the sulphuric acid content of the leach solution as increased. The copper bearing leach solution was processed in the SX-EW plant near the underground mine. The plant had the capacity to produce 28 million pounds of copper cathode per year.

Mill tailings associated with the old Miami underground mine were reclaimed using hydraulic mining methods to produce a slurry of tailings and water. Sulphuric acid was added to the slurry to dissolve the copper contained therein and the resulting pregnant leach solution was processed through the Miami Unit's SX-EW plant. The remaining tailings were transported for disposal through an overland pipeline to an abandoned pit.

Robinson Mining Limited Partnership

The Robinson Mining District consisted of 12,500 acres and was located 11 kilometres west of Ely, Nevada. The patented mining claims and other real property comprising this project were owned by the Robinson Mining Limited Partnership which Magma Copper purchased in 1991 and which formed part of the Magma Copper Company sale to BHP in 1996. The assets were purchased by Quadra mining in 2004 who in turn were acquired by a large Polish copper producer KGHM Miedź SA in 2017.

In June 1993, the Bureau of Land Management required the preparation of an Environmental Impact Statement (EIS) as a precursor to the final permitting of the Robinson Project. The EIS was completed in September 1994 and final approval was received on October 11, 1994. Copper production commenced in February 1996.

The property was expected to produce an average of 274,000 metric tons of concentrate per year, containing 146 million pounds of copper, 101,000 ounces of gold and 363,000 ounces of silver from sulphide copper ore over a 15-year mine life. In addition to the copper sulphide operations, it was projected that an average of 16,000 ounces of gold would be produced annually over the life of mine.

Estimated recoverable proved ore reserves at May 31, 1996, were 361 million metric tons of sulphide ore at an average grade of 0.55%

copper and 0.316 grams per metric ton gold. The contained product was estimated to be 3547 million pounds of copper in concentrate and 2.41 million ounces of gold.

BHP Tintaya SA

BHP Copper Inc held 25.15% of the ordinary shares of BHP Tintaya SA and Global BHP Copper Ltd held another 73.87% of the shares, giving BHP a total ownership of 99.02%. Tintaya was established to produce copper concentrates through the development and exploitation of ore deposits located in the province of Espinar, Cuzco, in Peru. Tintaya began its mining activity of April 1, 1985. Production was initiated after an open-pit and concentrator were developed on the site in early 1980s with the assistance of Canadian expertise, technology and equipment.

The Tintaya concession (the Concession), granted by the Republic of Peru, is 16 kilometre from the town of Yauri. The Concession was within the 'Tintaya Bamba Copper Belt' of south-eastern Peru which contains a variety of non-ferrous metals including copper, lead, zinc, gold and silver. The Concession was linked by the national road network to Cuzco (26 km) and to the port of Matarani through Arequipa (370 km). Concentrate was transported by road to either the Southern Peru Copper Corporation Smelter at ILO (595 km) or to the port of Matarani. From Matarani, the concentrates were shipped to overseas destinations.

This mine was also part of the Magma stable of assets. It did not have the scale to qualify as a Tier 1 asset in the post Billiton merger in 2001; copper prices remained volatile, and the asset was sold to Xstrata in 2006 for a consideration of US$750 million.

Analysts at the time speculated that the price seemed much higher than most thought possible and probably ameliorated some of the criticism directed at the Board and Senior Management at the time of the Magma purchase.

Apart from not fitting BHP plans for world class size or potential of assets, and with smelting assets and other mines long gone, it was seen as an opportunity for BHP Billiton to concentrate on its acquired WMC resource assets. It should not be overlooked that Tintaya was somewhat of a lightning rod for protest from local communities wanting a larger share of mine royalties as well as general criticism from Non-Government Organisations (NGOs).

BHP Smelting and Refining

Smelting

BHP Minerals operated one of the largest and most modern copper smelting and refining complexes in the United States, located in San Manuel, Arizona. In addition to smelting and refining copper concentrate from its own mining operations, BHP Minerals smelted and refined a substantial amount of copper concentrate on a toll or purchase basis. Copper concentrate was processed through the smelter and cast into copper anodes. Sulphur dioxide off gases collected from the smelter and converters was processed into sulphuric acid and was either used in the Company's leaching operations or sold to third parties. The major smelter components included: (1) an oxygen-enriched flash furnace, (2) an oxygen plant, and (3) acid plants. The smelter had the capacity to process 3600 metric tons per day of new sulphide copper concentrate.

Refining

The refinery electrolytically refined the copper anode produced in the smelter into copper cathode with a minimum 99.95% pure copper content. The refinery had an annual production capacity of approximately 330,000 metric tons of copper cathode.

Other Minerals

BHP Titanium Minerals Pty Ltd

BHP Titanium Minerals Pty Ltd (BHPTM) (formerly Mineral Deposits Proprietary Limited) was a wholly owned BHP subsidiary which had three titanium minerals mining operations in New South Wales, producing rutile, zircon, ilmenite and monazite. Production recommenced at the Stockden deposit on August 1, 1995.

BHPTM held mining leases over a large resource of titanium minerals (predominantly ilmenite) in the south-west of Western Australia at Beenup. The Beenup mine was operated pursuant to a number of mining leases granted by the Department of Minerals & Energy (WA) in 1990 and 1993. The term of each of these mining leases was for an initial period of 21 years. During the currency of the Minerals Sands (Beenup)

Agreement Act 1995 BHP Titanium Minerals Pty Ltd was entitled to take two successive renewals of the mining leases, each for a further period of 21 years, upon the same terms and conditions as the initial grant.

BHP Board approval for the development of this resource was given in November 1994 and construction was well under way with commissioning of the plant scheduled for late calendar 1996. The design capacity of the plant was 600,000 tons of ilmenite and 20,000 tons of zircon per annum. BHP had entered into a joint venture arrangement with an ilmenite processor in Tyssedal, Norway, whereby BHP would acquire an interest of up to 49% in the processing plant. In addition, BHP had entered into a long-term contract to supply ilmenite to the plant.

The Beenup mineral sands mine was opened in 1997 with an expected mine life of 20 years. It was closed after only two years in April 1999. The closure was cited as technical issues related to insufficient consolidation of clay tailings.

Rehabilitation of the site was completed in 2018 and part of that rehabilitation included a wetlands project established in collaboration with the Western Australian Botanic Gardens and Wildlife.

Hartley Platinum

Pursuant to a Joint Venture Agreement with Delta Gold NL, BHP completed a feasibility study for the Harley platinum mine in Zimbabwe in August 1993. On August 24, 1994, after the issuance of a Special Mining Lease from the Government of Zimbabwe, the joint venture signed a Mining Agreement with the Government and gave its approval to develop the project. This development decision provided BHP with a 67% interest in the project through a wholly-owned subsidiary, BHP Minerals Zimbabwe Pty Ltd.

BHP's share of estimated recoverable proved ore reserves of the Hartley Platinum Mine were 29.7 million metric tons of ore grading 2.20 grams per metric ton platinum, 1.63 grams per metric ton palladium, 0.17 grams per metric ton rhodium, 0.35 grams per metric ton gold, 0.15% nickel and 0.11% copper. At full production, 2.16 million metric tons of ore per year would be mined and processed. The mine was expected to reach full production in calendar 1997.

In October 1998, Delta separated its gold and platinum assets through a demerger. As a consequence of this Zimbabwe Mines Limited (Zimplats), via Hartley Management Company (PVT) Limited, became the 33%

participant in the Hartley Platinum project. With the commencement of underground mining production in 1995, delays in the production build-up to full capacity was experienced. This had been primarily as a result of unstable ground conditions in the mine causing safety problems, loss of reserves and unacceptable dilution of the ore compared to the original feasibility study. The requirement for additional hanging wall support in such conditions resulted in poor labour productivity. Trial mining of open cast oxide ore was conducted but found to be uneconomic due to poor metallurgical recoveries from the oxide ore. Early in calendar 1999, a complete project review was undertaken by independent mining experts. The experts concluded that although the BHP mineral resource estimate was valid, an ore reserve did not exist due to the existing uneconomic operation of the mine. After an unsuccessful international search for a potential purchaser of the operation, BHP entered into a sale agreement dated May 1999 with Zimplats for the conditional sale of BHP's share in the Hartley Platinum project for nominal consideration. As part of the conditions of sale, the Hartley operation was suspended and plant and equipment placed on care and maintenance by BHP. Most of the existing workforce was retrenched. The completion of sale was conditional upon the release of BHP from various legal obligations.

BHP wrote-off A$310 million and sold its interests to Zimplats Holding Ltd.

Cannington

A feasibility study into the development of the Cannington silver-lead-zinc deposit in north-west Queensland located 200 kilometres south-west of Mount Isa, was completed in December 1994. The mineral resource at Cannington was estimated to contain 47.3 million metric tons, grading 10.9% lead, 4.3% zinc and 493 grams per metric ton of silver. It had previously been announced that the MIM Holdings Limited Group was negotiating with BHP for the acquisition of a one-third interest in the Cannington project. On April 19, 1995, MIM Holdings Limited gave notice that it no longer intended to proceed to acquire this interest.

Following the withdrawal of MIM Holdings Limited from the project, an extensive re-evaluation of the project was completed. Major changes to the planned mine infrastructure were made with the decision to build a ship loading facility for the export of lead and zinc concentrates at Townsville. Extensive marketing efforts took place throughout 1995–96

to place the full production tonnage of lead concentrate previously destined for the Mount Isa smelter owned by MIM. The project was approved on February 1, 1996, and construction of the surface facilities had commenced. Mine exploration development continued throughout the year with the decline face of 430 metres below surface by May 31, 1996. Silver-lead-zine ore was exposed on a number of levels. Underground stopping would start in May 1997. Surface construction had started with the Trepell airstrip completed and initial siteworks underway. Construction of the process plant was scheduled to start in October 1996 with completion in August 1997. First ore was scheduled to be processed by September 1997 with first concentrate expected to be shipped through the port by the end of January 1998. The mine achieved its full capacity of 1.5 million tons in 1999. The assets were transferred to South32 in 2014. The mine was the supplier of silver for the Sydney and Beijing Olympic Games.

Diamonds

BHP had a 51% interest in the Ekati diamonds project in the Northwest Territories in Canada through its wholly owned subsidiary, BHP Diamonds Inc. The other participants in the core zone joint venture were Dia Met Minerals Limited (29%), Charles E. Fipke (10%) and Stewart L. Blusson (10%). The other participants in the buffer zone joint venture were Archon Minerals Limited (31.2%), Charles E. Fipke (10%) and Dia Met Minerals Limited (7.8%j. The mine development was approved by the BHP board in September 1996. A feasibility study was prepared and released to the participants in February 1997. The study covered a production plan spanning 17 years for the development of five kimberlite pipes, all of which were within the core zone joint venture. Feasibility studies were conducted on two additional pipes that were bulk sampled in 1998. Additionally, four pipes were bulk sampled in early calendar 1999.

Mining rates for each pipe were determined by ore grade, diamond quality and specific ore processing characteristics. A total of 64 million tonnes (100% terms) had been identified as proved or probable ore reserves as at 31 May 1999 with an average of 1.09 carats per tonne. The participants held title to the project area via a combination of claims and leases. BHP was converting claims to leases as and when required. Fifty-nine claims totalling 141,000 acres had been converted to leases and an additional 65 claims totalling 165,280 acres were expected to be converted

in calendar 1999. In October 1998 the mine was officially opened. Production reached nameplate capacity of three million tonnes per annum in May 1999. In November 1997 BHP Diamonds Inc. opened a marketing and sales office in Antwerp, Belgium. Also in November 1997 BHP Diamonds, signed a marketing consulting agreement with I.D.H. Diamonds NV of Antwerp, a prominent diamond dealer, to help establish the Antwerp office and facilitate the sale of diamonds. In May 1998 the participants agreed that BHP would act as sales representative for the project for five years from 1 November 1997. In July 1999 BHP Diamonds., for itself and the other participants, signed an agreement with De Beers Centenary for the sale of 35% of the run-of-mine production from the Ekati diamond mine over a three-year time period. Regular sales to De Beers began in September 1999. in May 1998, an understanding was reached with the government of the Northwest Territories whereby BHP Diamonds agreed to establish a diamond valuation facility in the community of Yellowknife, which was to be used for training, basic sorting and government valuation. The construction of this facility was completed in February 1999. BHP Billiton announced the sale of its interests in Ekati in 2011 which was consistent with their focus on large, long life, low cost, expandable upstream assets.

Market Conditions

Comparing market conditions of the 1990s and early 2000 with current activities is like comparing chalk and cheese. Approximately 41% of BHP Minerals' revenue was generated by sales of metallurgical coal, iron ore and manganese ore to the world steel industry. Copper represents 36% of sales, and steam coal 14%. Revenue by market area was approximately as follows: Japan 31%, other Asian nations 21%, North and South America 20%, Europe 15%, Australia and New Zealand 3% and other nations 10%.

During calendar year 1995, the world steel industry produced approximately 3% more product than in 1994. Increases were spread relatively equally across the major producing regions of Asia, North America and Western Europe. In the five months to May 1996, steel output was down by 2.7% compared to the similar 1995 period, with Western Europe experiencing the largest declines. BHP's sales volumes of iron ore and metallurgical coal established new records during 1995–96. Hard coking coal prices, in US$ terms, were higher during 1995–96 than in the previous period and increased again by about 5% for the contract year beginning

April 1. Iron ore prices increased by 6% for fines and 5% for lump for the Japanese contract year beginning April 1, 1996. For the previous contract year, prices increased 7.9% for lump and 5.8% for fines. Manganese prices increased by over 7% for the new contract year.

Copper was the most important commodity in terms of profit during 1995–96, and the Escondida mine in Chile experienced record shipments. Copper prices during the period averaged US$1.27 versus US$1.23 in the year-earlier period. The London Metal Exchange copper spot price at May 31, 1996, was US$1.15 per pound and at August 23, 1996, US$0.89 per pound. Although demand was holding up well, the market was anticipating surpluses developing due to increased production. Fast forward to 2010 and a read of the Increased Demand from China and what impact it had on supply gives a perspective which no-one could have envisaged in the 1990s era.

Export Controls

During 1991–92 there were significant changes in Australia Federal Government regulation of mineral exports. As a consequence, of the mineral products exported from Australia by BHP Minerals, only mineral sands and coal were still subject to export controls.

In the case of mineral sands, an exporter could seek a 'total volume approval' in respect of a project and upon grant of that approval, was at liberty to conduct negotiations with buyers in accordance with its own commercial judgement and sell product up to the approved tonnage limit.

In the case of coal, exporters were free to conduct negotiations with buyers in accordance with their own commercial judgement. However, exporters were required to obtain Australian Federal Government approval before exporting coal.

Commodity Hedging

BHP Minerals hedged gold and copper sales. Copper hedging was accomplished by the use of put options which provided a minimum guaranteed price and allowed the Company to benefit from higher prices should they occur, or forward contracts which provide a contractual selling price. Forward contracts were used to hedge gold sales.

BHP Minerals' hedging programme had the following features:

- Hedges cover only specific commercial transactions. There was no futures or speculative trading.
- Transactions did not exceed 36 months.
- Forward gold sales were generally limited to a long term 50% maximum of sales. This maximum could be raised for short term periods. There was no percentage limitation on the use of put options. No forward sales exceeded two years.
- Credit limits were set and reviewed for each counterparty.
- Control procedures separated policy, implementation and accounting. The results of hedging activities were reported monthly, and were subject to internal and external audit.
- The hedging policy was established by senior BHP Minerals management and was reviewed periodically in recognition of market circumstances.

Coal

Coal is a critical building block for development, an important energy source for electricity generation and essential in the production of steel and cement and other energy intensive products vital for modern life. Energy is essential to nearly everything we do—for jobs, security, food production and modern infrastructure, access to energy for all is vital. This huge demand for energy can only be met with a diversified energy mix, which includes coal.

Beyond electricity, coal helps build modern cities and economies. 85% of the world's cement is made by using coal, and 75% of steel produced today uses coal. Coal-fuelled power currently provides 37% of global electricity. As nations develop, they seek secure, reliable and affordable sources of energy to strengthen and build their economies. Coal is a logical choice in many of these countries because it is widely available, safe, reliable and relatively affordable.

Around the world many communities benefit from coal mining—jobs, royalties, infrastructure and other improvements that mining brings. One in five people do not have access to electricity, and 2.5 billion people rely on the traditional use of biomass for cooking. Coal has lifted more than 600 million people in China out of poverty over the past 30 years.

Each nation will choose an energy mix that best meets its needs, and for most countries, coal is readily available and has been identified as a growing fuel source which is integral to their economic growth. Coal became one of BHP's Tier 1 Assets in 1984 when it acquired the US mining and construction company Utah Mines Ltd from General Electric for US$2.4 billion. The move extended BHP's interest abroad into the USA, Canada and South America and enlarged its interests in iron ore, copper and coal.

Queensland Coal comprises the BHP Mitsubishi Alliance (**BMA**) and BHP Mitsui Coal (**BMC**). Queensland Coal has access to key infrastructure in the Bowen Basin, including a modern, multi-user rail network and its own coal-loading terminal at Hay Point, located near the city of Mackay. **BMA** is Australia's largest coal producer and supplier of seaborne metallurgical coal. It is owned 50:50 by BHP and Mitsubishi Development. BMA operates seven Bowen Basin mines (Goonyella Riverside, Broadmeadow, Daunia, Peak Downs, Saraji, Blackwater and Caval Ridge) and owns and operates the Hay Point Coal Terminal near Mackay. With the exception of the Broadmeadow underground longwall operation, BMA's mines are open-cut, using draglines and truck and shovel fleets for overburden removal.

BMC owns and operates two open-cut metallurgical coal mines in the Bowen Basin—South Walker Creek mine and Poitrel Mine. BMC is owned by BHP (80 per cent) and Mitsui and Co (20 per cent). South Walker Creek Mine is located on the eastern flank of the Bowen Basin, 35 kilometres west of the town of Nebo and 132 kilometres west of the Hay point port facilities. Poitrel Mine is situated southeast of the town of Moranbah and began open-cut operations in October 2006.

BHP's new chief executive Mike Henry has signalled the mining giant could exit thermal coal and boost exposure to minerals used in green technologies as it looks to reposition itself for a lower-carbon world. Thermal coal is regarded as one of the heaviest-polluting fuels and the focus of rising investor pressure in response to concerns surrounding its contribution to global warming. It is interesting to observe that New York-based global money manager BlackRock, one of BHP's biggest shareholders, announced a partial retreat from its thermal coal investments, as part of what it described as a climate-driven 'reshaping of finance'.

Mr Henry has indicated that thermal coal was a 'small part of the portfolio', owning one mine at Mt Arthur in New South Wales and part-owning another, the Cerrejon project in Colombia, which together

account for about 3 per cent of revenue. He would not comment when asked if BHP was already in talks with prospective buyers. A leading analyst has commented that Mr Henry's remarks were reflective of a trend of businesses—even resources companies—recognising and responding to the power of the decarbonisation push globally.

Finding a buyer of BHP's thermal coal mines, however, could prove challenging owing to the coal prices variability and a lack of interest in picking up emissions-intensive assets in a market under pressure although many developing countries are still attracted to new coal fired power station development on economic factors.

Potash

In August 2010, BHP Billiton launched a US$40 billion bid for Canadian Potash firm Potash Corporation having had an initial offer rejected.

The UN Foods and Agriculture Organisation (FAO) had projected that annual meat production in the developed world would expand from 228 million tonnes in 2009 to 463 million tonnes by 2050 with cattle population estimated to grow from 1.5 billion head to 2.6 billion head. BHP Billiton stated at the time that the proposed acquisition would accelerate their entry into the fertiliser industry and was consistent with the company's strategy of becoming a leading miner of potash.

The deal was promoted as a step in a diversified strategy to lessen the reliance on resources with high exposure to carbon price risk.

The bid was rejected as undervalued, and the Government of Saskatchewan opposed a foreign interloper. The Canadian Industry Minister referred the matter under the under the Investment Canada Act and gave BHP Billiton 30 days to refine its deal. The bid was withdrawn on 14 November 2010.

BHP Billiton had already purchased a Potash deposit in January 2010 for US$320 million reportedly planning to invest sufficient funds to be a large supplier to world demand for fertiliser.

The future of Potash will be a challenge for management teams as Russia and Canada seem to be price makers for this commodity with barriers to entry high for any new investor.

CHAPTER 12

BHP (D): Petroleum

Introduction and Context

BHP has owned oil and gas assets since the 1960s. They have high margin conventional assets located in the US Gulf of Mexico, Australia, Trinidad and Tobago, and Algeria as well as appraisal and exploration options in Mexico, Deepwater Trinidad and Tobago, Western Gulf of Mexico, Eastern Canada and Barbados. BHP has continued to invest in these operations as part of its strategy and portfolio. In 1964, BHP entered a 50:50 partnership with Esso Standard, the Australian subsidiary of Standard Oil Company of New Jersey (later, Exxon and ExxonMobil). The partnership discovered major oil and gas fields in the Bass Strait of Australia and that partnership has continued to recent times with BHP announcing a potential sale of assets in Bass Strait following a reported decline in oil and gas production.

Six months on ExxonMobil announced that it was planning to enter into negotiations with prospective buyers for the sale of its stake in the Bass Strait oil and gas operations jointly owned with BHP. At the same time Exxon also announced that it was forging ahead with multibillion-dollar investments in potential new discoveries in the largest remaining undeveloped gas field known as West Barracouta near the existing permits operated by Exxon and BHP.

The apparent gas supply from offshore wells and the hunt for more reservoirs has become the subject of heightened attention as authorities warn of an impending supply shortage unless more supply is brought to

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D. Argus, D. Samson, *Strategic Leadership for Business Value Creation*, https://doi.org/10.1007/978-981-15-9430-4_12

market. From 1986–1988 BHP Petroleum division acquired Monsanto Oil, Hamilton Oil and Gulf Energy Development which also gave it a position in the North Sea. It continued its drive to expand by purchasing Atlantis, based in the Gulf of Mexico.

Northwest Shelf

Substantial reserves of gas and condensate were discovered in the North Rankin and Goodwyn fields off the northwest cost of Western Australia in the early 1970s. These fields met the contract requirements of the Domestic Gas Phase and the LNG Export Phase. The North Rankin A platform was developed as the project's first producing field in 1984. Production from Goodwyn 'A', the project's second offshore gas and condensate platform, commenced in February 1995.

Prior to June 1990, BHP had a direct and indirect shareholding of approximately 40% in Woodside Petroleum Ltd, giving it a total direct and indirect interest of approximately 28% in the Domestic Gas Phase and 23% in the LNG Export Phase. The shareholding in Woodside was reduced in June 1990 to 10%, and in October 1994 that remaining shareholding was sold. BHP's direct interests were 8.33% in the Domestic Gas Phase and 16.67% in the LNG Export Phase, as detailed below, and there were no remaining indirect interests.

Construction of the Domestic Gas Phase was completed in August 1984 at a total cost of approximately $2.2 billion. This phase of the North West Shelf Project had the capacity for uninterruptable supply of 800 MMcf of gas per day following capital expenditure to debottleneck the facilities. Total production net of royalties, during the 1995–1996 year was 320 MMcf of gas per day (BHP share 27 MMcf per day).

Participants in the Domestic Gas Phase were BHP (8.33%), Shell Development (Australia) Proprietary Limited (8.33%), Chevron Asiatic Limited (16.67%, BP Developments Australia Ltd (16.67%) and Woodside Petroleum Ltd group (50%).

The LNG Export Phase came on-stream in July 1989 and the first cargo was delivered to Japan in the following month. The LNG system capacity was operating at its plateau. Total LNG production into tanks, net of royalties, for 1995–1996 was 7.140 million metric tons (BHP share 1.190 million metric tons).

Participants in the LNG Export Phase were the same as for the Domestic Gas Phase, with the addition of a Japanese consortium of Mitsubishi

Corporation and Mitsui and Co Ltd. Each of the six participants held an equal (one sixth) share of the phase.

Total condensate production net of royalties during the 1995–1996 year was 26.8 million barrels (BHP share 4.0 million barrels).

In October 1993, the North West shelf participants, each having a one-sixth share in the Cossack oil fields and associated liquefied petroleum gas (LPG) extraction facilities. These facilities were completed in 1995 at a cost in excess of $1 billion (BHP share $170 million).

Production from the Wanaea and Cossack fields was via a floating production, storage and offloading facility with a planned peak production of 115,000 barrels per day. The facilities were commissioned in November 1995 and cumulative production net of royalties for the year was 8.9 million barrels (BHP share 1.5 million barrels).

Lambert 2 well in the Lambert field was drilled in early calendar 1996 resulting in the discovery of a separate oil accumulation. Development options were considered.

The LPG extraction facilities include storage tanks and a loading jetty, and had a production capacity of 800,000 metric tons of LPG per annum. Production began in November 1995 and cumulative production net of royalties for the year was 173.6 thousand metric tons (BHP share 28.9 thousand metric tons)

BHP's estimated net proved reserves in the North West shelf at May 31, 1996, were:

Crude oil, condensate and LPG	85.87	million barrels
Dry gas	1015.1	billion standard cubic feet

Reserves increased significantly with the discovery and subsequent appraisal drilling of the Perseus field.

All of this activity in Petroleum and other assets in the pursuit of broadening BHP's global reach and diversifying its asset base was against a background of weakening earnings. Copper prices had fallen, crude oil prices had fallen to US$15 per barrel, a sharp fall in the steel prices for product exported into Asia; there was speculation around write-downs in Hartley platinum mine in Zimbabwe, Beenup mineral sands, Magma Copper, Ok Tedi; Newcastle Steel Mill closure. This was not an exclusive list, but it did lead to the market becoming uneasy with asset valuations culminating with an article in *The Economist* suggesting the Head of Petroleum had favoured spinning off Petroleum which at the time was the Group's most

profitable business. This only added to commentators' observations that BHP's parts were worth more than the whole.

Mr O'Connor, Head of the Petroleum Division, resigned soon after as did a number of other senior executives. Mr Prescott resigned on 4 March 1998 with Ron McNeilly acting as CEO until a recruitment process for a replacement CEO had been completed.

As we write this case study there is speculation that demand for Liquefied Gas could double by 2035 as LNG becomes increasingly used as a transitional fuel in any shift from coal fired power generation.

The problem seems to be two vexed issues confronting business generally, an in particular the call to develop a manufacturing industry so we can be self-supporting. One is energy. We have gone from an OECD nation which had very cheap energy costs 10 years ago to one of the dearest in the OECD, and that impacts our competitiveness. We have a ridiculous situation where offshore competitors use Australian gas shipped 6000 kilometres away to out-compete local manufacturers only a few kilometres away from a gas pipeline. Prices for gas have fallen but they are ridiculously high in Australia and one could suggest we are dreaming if we think we can be self-sufficient if our energy costs are so high.

The only way to subdue the environmentalists, OECD, 'peak oilers' energy security hawks, cleaner coal, nuclear and renewable advocates is to provide them with a dose of reality financial maths. The production of our own clean and affordable gas will provide the controlled capital adaption climate to foster new competitive manufacturing businesses.

The other issue is the flexibility of our workforce and its laws; this is covered elsewhere in this book's case studies.

Some commentators over the years have criticised BHP's investments in oil and gas. Northern Hemisphere investors have consistently recommended sale of the business. Oil and gas are essentially other minerals. They require much the same decision-making dimensions as mining. BHP had experienced great benefit from its diverse business portfolio. When one leg is below par, another is better and adds to the stability of the company and dividends. BHP was regarded by investors as a strong company with growing dividends. If Oil and Gas were sold, BHP would be less resilient, dividends would decline, and the stock market could potentially rerate the share prices downwards. For these reasons, there was no incentive for BHP to exit the profitable oil and gas business. Sale would risk a great company becoming a mid-range entity.

It is reassuring to read that the new CEO, Mike Henry, is committed to his Oil and Gas Strategy. The recent disagreement between Saudi Arabia and Russia on pricing, followed by the COVID-19 virus and resultant debt incurred in saving economies from severe pain, will see a huge disruption to economic settings and radically change some of the ideological thinking in the cost of energy space; one can only hope!!

In February 2011 BHP Billiton announced that it had paid US$4.75 billion in cash to Chesapeake Energy for its Fayetteville shale gas assets including approximately 487,000 acres of prospective shale gas.

By June 2011 it had upped its bet significantly with a US$19 billion takeover of Petrohawk and its one million acres of reported prime Permian Basin shale oil real estate stretching from Louisiana to Texas. At the time, the oil price had risen from GFC lows of US$40 per barrel to be around US$120 a barrel.

The accelerating oil price stimulated more production. Technological advances in the controversial field of hydraulic fracturing, or fracking as it is commonly known, saw production costs tumble. Marginal acreages were reported to be brought into production, drilling rigs were installed as soon as they could be acquired and production soared to an over-supply position.

By 2014, the oil price had dropped 75% from the heady days of 2011/2012, BHP sold some of its holdings in the Texan Permian Basin for a reported US$75 million and as hedge fund Elliott Management pointed out in its scathing critique of BHP Billiton, the purchasers of the holdings mentioned above sold the same reserves for US$855 million.

BHP delivered a US$23 billion profit in 2011, the biggest in Australia's corporate history and a loss of US$6 billion in 2016. The 2010–2016 era did not deliver the value investors had expected.

CHAPTER 13

BHP(E): Rejuvenation and Renovation Towards a New Century

Introduction: The Context of Strategic Change

Jerry Ellis retired as Chairman and Don Argus took over this role. As recorded earlier, Paul Anderson was appointed as CEO and Managing Director in 1998. The chairman's report at the AGM reported a period of renovation and rejuvenation of the company the magnitude of which is highlighted by an understanding of the complexities in the diversified asset base recorded earlier, rebuilding management, and a number of changes to the board membership. Paul Anderson reported embarking on 'an unprecedented change program.... a very difficult year' (BHP Annual Report, 1999). In the late 1990's, challenges abounded at BHP. Magma Copper had been written back to zero, the HBI plant was plagued with construction stoppages which saw cost blowouts, and more pressure was looming over the troubled Beenup mineral sands play and the Hartley platinum mine in Zimbabwe. Steel prices had also plummeted, iron ore prices were slashed in negotiations with world steelmakers and serious questions were being asked about BHP's return on its weighted average cost of its capital. Significant restructuring and simplification were implemented, including reduction from eight business units into Minerals, Steel and Petroleum, and the Services support group. Coordination, improved accountability and faster decision making was delivered through a single Management Committee, corporate culture 'began to change radically', including reducing hierarchy- and performance-based remuneration

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D. Argus, D. Samson, *Strategic Leadership for Business Value Creation*,
https://doi.org/10.1007/978-981-15-9430-4_13

packages, aligning executive outcomes with shareholders'. In his first annual report to shareholders, Paul Anderson also reported strong cost reduction measures, and increased focus on safety and environment, with the previous standard being less than acceptable.

Clearly signalling a 'new future trajectory' under a new Chairman and CEO, with many other new senior executive and board appointments, 1999 was not only an extremely tough year for all stakeholders, but was a year of setting up the company, despite the stringent conditions, through 'cleaning the closet' by eliminating old culture and ways, unwinding the Beswick capital structure, selling off old and underperforming business assets and renewing BHPs commitment to all its stakeholders. Paul Anderson reported that 7 people died while working for BHP in 1999 and that 610 people were injured severely enough to take at least one day off work. Altogether an 'annus horribilis', yet 1999 became a turning point for renewal. Newcastle steelworks and North American copper operations were closed and prices for most BHP products were low.

Paul Anderson reported acceleration of the cultural change from 'scale, growth and a preference for owning and operating assets, to one where the central focus was shareholder value'. The CEO confidently forecast significant future improvements in considering the BHP outlook as of 1999.

The BHP Annual Report in 2000, titled 'Coming Out of a Tight Corner' reported a major turnaround, indeed 'our best year ever'. An international search led to replacement of retiring directors with three experienced external directors, particularly in international oil, gas and minerals businesses. A BHP Board Charter was implemented. Paul Anderson reflected the ongoing nature of BHP business activities as 'We see BHP as a global natural resources company with a regional steel business.' The company reported a dramatic turnaround from 1999, with profit uplift of 457%, at $2032 million. Return on capital was 12%, debt was reduced, with gearing dropping from 54% to 43%, and a cost reduction of $330 million was achieved, on top of the previous year's cost reduction of $360 million.

Paul Anderson, reported on the ongoing challenges of HBI (hot briquetted iron), and Ok Tedi, low commodity process, and in that year, we had five people died while working for BHP.

The **BHP Charter**, as of 2000, was headlined: We are BHP, an Australian based global company, founded in 1885, which is undergoing fundamental change as we adjust to a highly competitive global business environment. Our purpose is to create shareholder value through the discovery, development and conversion of natural resources. This charter then set out the details of BHP values, stakeholder commitments and

success factors, in a succinct manner. These were fine sentiments indeed, yet the proof was to be in the execution and behaviours over the next few years, indeed the next decade and beyond. Many companies had set out such fine intentions, and failed to deliver on them. Change is hard, even when times are tough. BHP had set up a 'corporate governance' process, which had become a popular yet often misunderstood term at that time, which for BHP meant solid driving connection between its high-level charter, its strategies that cascaded into its business streams, its people strategy and its remuneration strategy.

2001 was a year of transformation for BHP, indeed BHP no longer was such as an entity, but was involved in a large Dual Listed Companies (DLC) merger with Billiton Plc, signalling within the resources and particularly the mining sector a move to a new scale of balance sheet size and strength. BHP Billiton Group had, in 2001, a market capitalisation of US$31 billion and annual turnover of US$19 billion. The group became one of the world's largest players in coal, iron ore, copper, aluminium, manganese, chrome, and ferroalloys, and significant positions in oil, gas, steel, nickel, silver and diamonds. BHP Billiton became a member of the FTSE 100 in London, and one of the ASX largest entities. The DLC merger, diversified operations, and created competitive cost structures that contributed to improved risk profiles, which when combined with improving returns, raised the trajectory of BHP Billiton shareholders significantly from just a few years prior, when it had many intimidating challenges. Investment was increased and considered on a global basis, such as the Phase II aluminium smelter in Mozal, Mozambique, and the Australian coal project in Mount Arthur. The group's financial position had moved in 3 years from precarious to strong.

The merger and related DLC listing improved the potential for access to capital, risk and return profile, management capability set, and geographical spread of asset/ access/coverage.

Executive Remuneration and Its Governance

The executive remuneration system was further developed and reported to shareholders, including fixed base rate at the 50th percentile of market rate, with additional short-term incentives based on degree of achievement of financial strategic and operational objectives. This formed the total of cash component, and was supplemented by shares or options based on relative TSR (total shareholder return) against global peer group and ASX 100 outcomes. BHP Billiton group reported record profits in 2001 of $2007 million after tax. ROE was over 18% that year. Mr. Argus reported as chairman

that traded metal prices had fallen sharply. Copper prices were still very low, oil was US$26 per barrel, while coal and iron ore prices were solid.

The merger and DLC caused complexity (dual reporting entities), and a board of 17 Directors, with significant change to many people's roles, including senior management. The transaction was not simple, as it was across jurisdictions, and such mergers often do not yield shareholder value, even when it is evident in prospect. Implementation required discipline, diligence and when required strong leadership in pursuit of the benefits and in accordance with the Charter. CEO Paul Anderson wrote in the annual report of the 'Transformation' and opportunity to become 'the pre-eminent company in the global resources industry', an ambitious trajectory indeed. He reflected on the journey, of just two years of transition from 'a troubled company in search of a strategy' to 'premier natural resources company in the 21st century'.

The groups gearing was reduced again to 38.3%, down from previous year's 42.7%, and with total debt better than halved in absolute terms, since 1998 when it was $15 billion, to 2001 levels of $7.2 billion. The merger and DLC provided a platform for significant further growth and the pursuit of industry leadership, as expressed by Paul Anderson of not necessarily or just being the biggest but being and performing as 'the best' in the sector. The growth of customers such as in China had begun to ramp up, and the group was well positioned to grow and perform based on that outlook.

In 2001, Paul Anderson set stakeholder expectations at high levels indeed with his statements that once the merger arrangements were sorted out, 'no-one will be able to catch us'.

The merger of BHP and Billiton was a transformational transaction not only for both companies but also for the mining industry. At that time, the natural resources industry was relatively fragmented and characterised by low to moderate demand growth and prices declining in real terms. In the past four years, BHP Billiton had been successful in integrating the two organisations, generating outstanding returns to shareholders and further enhancing its reputation as one of the leading natural resources companies in the world.

BHP Billiton faced a new environment, dominated by a step-change increase in demand from China, that resulted in the prices then for most commodities being significantly above long-term averages. This new environment presented BHP Billiton with a range of opportunities and challenges quite different from those faced in 2001. In late 2004, the

decision was made to revisit the current strategy taking into account both the new environment and BHP Billiton's current competitive position. The initial hypothesis was that the revised strategy would be an evolution of the current strategy and not a major shift in direction. This hypothesis has borne out to be true and implemented by a relatively new CEO, Chip Goodyear.

Strategy and Markets

The existing strategy was being revised to leverage BHP Billiton's core skills and capabilities, take into account their current competitive position and address the opportunities and challenges of the new environment in order to maximise value for shareholders. Importantly, the revised strategy should be consistent with all aspects of the Charter and the Fundamental choices of how and where BHP Billiton choose to compete.

Management's first indication of the emergence of China's demand for natural resources was not through economic analysis, but a surge by Chinese steel mills to book seaborne capacity for transportation of iron ore and metallurgical coal. Our Shipping Division alerted us at the time and led to a strategy revisit and the emergence of the Charter:

> To create long term value through the discovery (capture) development and conversion of natural resources and the provision natural resources and the provision of innovative customer and market focussed solutions.

Given the historical concentration on steel making, a strategy revision to ensure BHP had the financial capacity to maintain consistency of purpose in funding any business plan, was completed. This saw BHP spin off its revered Steel Division and purchase a South African mining organisation called Billiton Plc. Quite a dramatic change of direction.

China's demand for natural resources saw a secular shift in the natural resources industry. A sustained (12 year) period of strong demand was projected in 2000 and whilst we have seen some slowing in that demand in recent times, the original period of demand has been followed by increased demand from India, Japan and other developing countries.

Growth in the Resource Sector had been directly correlated with the socio-economic development of emerging economies, both in demand for products and competitiveness for global custom—for access to mineral resources, capital, human resources and access to markets.

In 1950, the leading mining companies were almost by definition largely focussed on the then existing resource basins. These leading companies, with some exceptions, had not been successful at securing major resources in these new countries and have thereby allowed a new generation of mining companies to prosper, including both BHP and Billiton. In addition, the operations in new geographies were typically large scale and low-cost and their ore reduced the competitiveness and profitability of the previous industry leaders. Table 13.1 lists the largest 20 mining companies based on market capitalisation in 1950, 1970, 1990 and 2004 and 2019.

Only 7 of the largest mining companies today were in the top 20 in 1950. Most importantly, the companies that were successful in securing and developing resources in the new geographies emerged as the current industry leaders and generated an annual total return to shareholders on average 6 percentage points greater than the industry leaders of the previous generation. Specifically, Anglo American, BHP Billiton and CVRD (Vale) were all effectively 'national champions' of the new geographies while Rio Tinto was somewhat unique in successfully securing resources in Australia where it had limited prior presence.

The following provides a summary of the increased demand, the opportunities and challenges of the new environment and the difficulties in securing resources in new geographies.

Increased Demand from China and Impact on Supply

China's economic growth in 2010 had averaged over 9% per year over the last 15 years and was expected to continue but not at the same rate of growth. China's economic growth had also been highly resource intensive due to strong industrial production, continued urbanisation and increasing penetration of consumer durables. In 2004, China accounted for over 30% of the world's seaborne iron ore consumption and between 10% and 20% of the world's consumption of primary aluminium, refined copper and refined nickel.

Historically, as the GDP per capita of a country increases above approximately $1000 per capita, the country begins to more rapidly industrialise and urbanise and therefore had increased demand per capita for natural resources. China's per capita demand, for natural resources was following a similar path—albeit even more resource intensive—than that taken by

Table 13.1 Largest mining companies by market capitalisation

Market capitalisation ($ billions)

1950			*1970*			*1990*			*2004*			*2019*		
1	Inco	4.0	1	Inco	15.0	1	BHP	13.0	1	BHP Billiton	64.0	1	BHP	92.11
2	Alcan	3.5	2	Alcoa	11.0	2	Anglo American Corp	13.0	2	Rio Tinto	45.8	2	Rio Tinto	75.37
3	Alcoa	3.5	3	Alcan	7.5	3	Rio Tinto	12.5	3	Anglo American	44.4	3	Newmont Mining	50.11
4	Consolidated Mining	2.5	4	MIM	6.0	4	Alcoa	7.5	4	Alcoa	33.8	4	Barrick Gold	47.22
5	Anaconda	2.0	5	Phelps Dodge	5.5	5	Alcan	7.0	5	Alcan	23.7	5	China Shenhua	42.55
6	Phelps Dodge	2.0	6	WMC	5.5	6	Newmont	7.0	6	CVRD	23.0	6	Vale	41.11
7	Newmont	1.0	7	American Metal	5.5	7	Placer Dome	5.5	7	Newmont	19.0	7	Franco-Nevada	26.98
8	St Joseph Lead	1.0	8	Rio Tinto	4.0	8	WMC	5.5	8	Xstrata	11.4	8	Glencore	23.86
9	Homestake	<1.0	9	Anaconda	4.0	9	Gold Fields	5.0	9	Norilsk	11.3	9	Fortescue	22.29
10	American Metal		10	Newmont	3.0	10	Anglo Am Platinum	5.0	10	Anglo Gold	10.2	10	Anglo American	21.20
11	US Smelting		11	De Beers	2.5	11	Reynolds Metals	4.5	11	Barrick Gold	10.0	11	Wheaton Precious Me	18.84
12	Steep Rock Iron		12	Anglo American Corp	2.5	12	Noranda	4.0	12	Amplats	9.0	12	Agnico Eagle	15.25
13	Hollinger		13	BHP	2.0	13	Union Miniere	4.0	13	Phelps Dodge	8.4	13	Newcrest	14.89

(*continued*)

Table 13.1 (continued)

Market capitalisation ($ billions)

1950		*1970*			*1990*			*2004*			*2019*		
14	Calumet and Hecla	14	St Joseph Lead	1.8	14	Inco	3.5	14	Inco	7.6	14	Freeport	12.47
15	BHP	15	Gold Fields	1.0	15	Pechiney	3.5	15	Freeport	7.5	15	Kinross Gold	8.51
16	Anglo American Corp	16	US Smelting		16	Minorco	3.3	16	Placer Dome	7.2	16	Norilsk	8.30
17	De Beers	17	Patino	1.0	17	Barrick Gold	3.0	17	Chalco	6.0	17	Northern Star	6.14
18	Patino	18	Hollinger		18	Anglo Gold	3.0	18	Gold Fields	5.0	18	Chalco	6.08
19	Eagle-Picher	19	Homestake	<1.0	19	MIM	3.0	19	Impala	4.6	19	China Coal	6.01
20	JCI	20	Eagle-Picher		20	Phelps Dodge	3.0	20	Alumina	4.5	20	South32	5.80

Source: CRU, Computerstat, Datastream, BofA

economies that have industrialised in the last 50 years including Japan, South Korea, Taiwan and Germany.

Based on a population of 1.3 billion people and an intensity of use expected to follow a path similar to that of other countries that had industrialised, China had caused a secular shift in the demand for natural resources for a multi-decade period. Although this secular shift was upward, the path was not expected to be a straight line and multi-year periods of reduced demand, and therefore prices, were expected.

In addition to China, India's income per capita was beginning to reach threshold levels that may lead to a material increase in demand for natural resources. The probable scenario was for China to have a multidecade period of high demand for natural resources, with India's demand lagging China's by one to two decades. It was further possible that other economies, including Brazil and Russia, would continue to develop and augment this growth in demand. In any scenario, demand, and therefore prices, would almost certainly be more volatile than that experienced in the past and BHP Billiton's strategy has been robust with respect to such volatility.

BHPs Uniqueness

What differentiated the BHP business model from competitors and how did the Company adjust to guarantee supply of product?

To answer those questions, one was to understand the relative capital strike which prevailed during the 1990s that left the Mineral Resources industry with capacity constraints to supply growth which was the key determinant of competitiveness as the industry struggled to gear supply to meet the emerging demands of China and other developing nations. BHP had quality resources but they had not been mined and as mentioned earlier the Company had to play catch up given its concentration on steel manufacture and oil & gas.

There were some basic beliefs that when considered would give competitive advantage on how to restructure the Balance Sheet, how best to compete and create shareholder value. Some of those beliefs consisted of:

- Determining which products would be relevant to the strategic objectives (Tier 1) Assets rather than an assortment of minerals which could not achieve scale in a relatively short period of time.

- The products were commodities with whatever quality differentials typically being efficiently 'priced' by the market.
- Over the long-term, the majority of the 'rent' was captured by the resource owner and not downstream. BHP was not committed to marketing refined products.
- Because natural resources generally had high value relative to transportation costs, the industry was global with prices set based on global supply and demand and transportation cost differentials. That was not always the case.
- Prices for natural resources on average displayed relatively high short-term volatility, multi-year cycles and long-term secular shifts.
- Real prices had generally declined over long periods of time as technology improvements had reduced operating and capital costs. Production costs had been and continued to be an important consideration for long-term industry participants.
- Commodities that were exported via seaborne transportation had multiple markets and therefore had more stable and hence attractive fundamentals than those that were only sold to the local or domestic market. The attractive fundamentals of a global market were to some extent offset by the greater number of competitors relative to domestic products.
- Historically, commodities in which the top producers had a higher share of total production had generated better returns than commodities in which the top producers had a lower share of total production. A range of factors contribute to determining the concentration of an industry including the benefits of scale, the scarcity of the resource, the degree of capital intensity, access to critical technologies and other barriers to entry.
- Periods of high prices also generate higher returns which in turn induce new supply. New entrants capture a share of this new supply which reduces the concentration of the industry and has historically led to an over-supplied market and resultant lower prices.
- The natural resources industry had extremely long product cycles and payback periods due to high capital costs, the long time required for development of a world class resource and the relatively low rate of product or technological obsolescence.
- Scale had become increasingly important due to the global nature of supply and demand, the magnitude of the capital commitments and the volatility of prices.

- The potential next generation of world class resources was likely to come from countries which were less developed and had lower standards of living. In addition, national, regional and local governments were likely to demand a greater involvement because natural resources were increasingly seen as 'belonging to the people'.

What Influences the Demand for Product?

The resource industry in Australia had difficulty believing the remarkable minerals demand projections of analysts following China's accession to the World Trade Organisation in 2000.

The last multi-decade period of high growth in the demand for natural resources was the post-war industrialisation of Japan and the reconstruction of Europe. From the late 1940s to the early 1970s, high demand growth resulted in a period of increasing, albeit volatile, real prices for many commodities thereby interrupting the long-term trend of real prices declining through time. In some cases, real prices declined during this period due to significant technological advances (e.g., aluminium) that materially reduced capital and operating costs. Nevertheless, real margins increased during this period.

Major Producing Countries

The period of increased demand required additional resources to be developed. These additional resources were generally located in countries that were not already major producers but were developed due to a range of factors including resource quality, access, political stability and technology. Figure 13.1 displays the top 4 producing countries in 1950, 1985 and 2004 of bauxite, nickel, iron ore and copper.

For bauxite and iron ore, not one of the 4 major producing countries in 1950 was still a top 4 producer in 2004. For in nickel and copper, 2 of the 4 major producing countries in 1950 remained major producing countries in 2004.

The major oil and natural gas producing regions had also changed over the past decades. The oil markets had been characterised by the decline in the role of OPEC, the rise in production from deepwater (primarily the US Gulf of Mexico and Nigeria) and Russia and increased involvement of national oil companies. With respect to natural gas, LNG had become a major supply source and has created linkages among the major markets

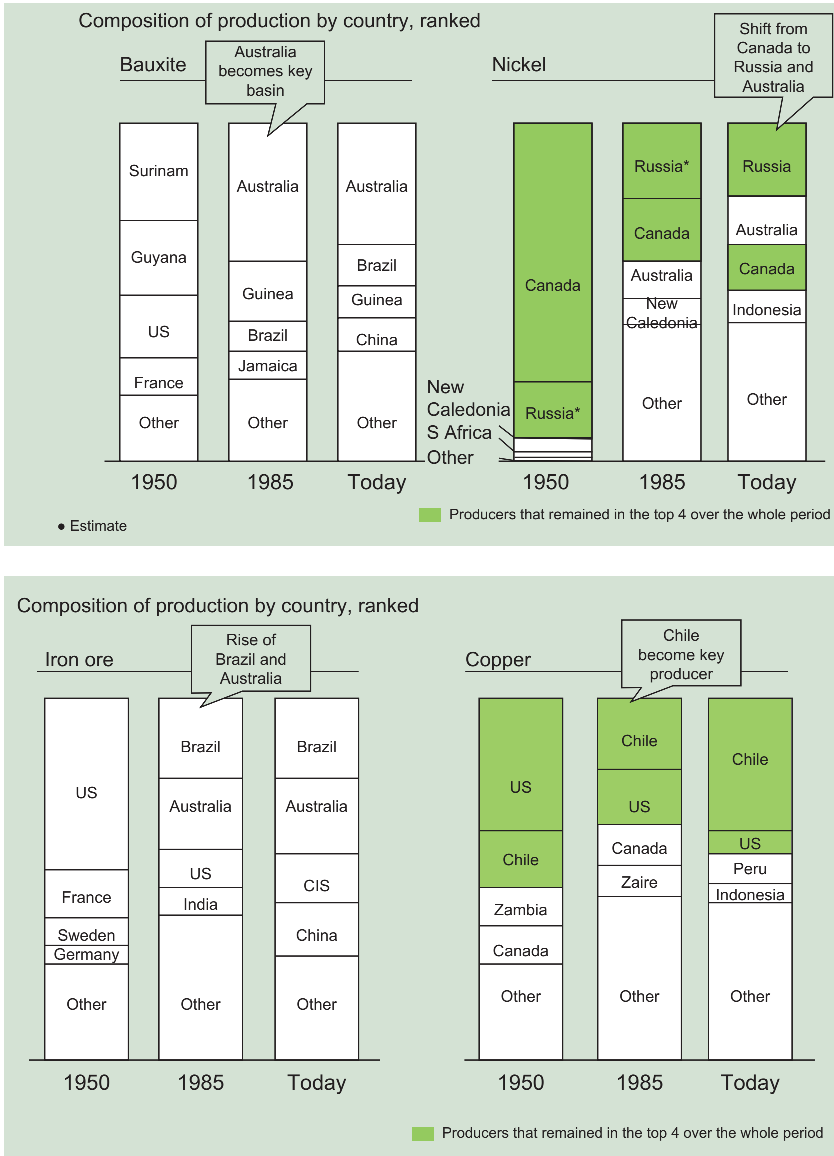

Fig. 13.1 Bauxite, nickel, iron ore and copper production by country

while natural gas production from the continental US and North Sea had continued to decline.

Table 13.2 contrasts the opportunities and challenges of the new environment with the environment in 2001 when the previous strategy was developed.

A key uncertainty around the 2006 scenario was the supply response and potential implications of commodity prices remaining significantly above historical averages for a number of years. The potential implications included increased substitution, potential nationalisation and increasing tensions between the world's major consuming countries. In addition, based on the boom in mining equity valuations of the late 1960's through to the early 1970's, valuations of resources companies could have the potential to further increase relative to historical valuation benchmarks.

A critical challenge facing BHP Billiton was finding, capturing and developing future world class resources that were largely located in countries in which BHP Billiton did not have significant current operations. Figure 13.2 shows the locations by commodity (excluding oil and natural gas) of the top 137 prospects—the majority of which were located in counties where BHP Billiton did not have a strong presence and had been assessed as representing high entry risk.

With respect to petroleum, increases in oil production were expected largely from the Middle East, Russia, Venezuela and West Africa, with increases in natural gas production expected from the same areas and North Africa and Canada.

BHP Billiton was competing not only with other international natural resources companies but emerging national champions and China as it continued to secure resources in order to supply its future demands. These new geographies frequently presented additional challenges including less developed judicial institutions and natural resources legislation. In order to be successful, BHP Billiton needed a more diverse employee base with more regional capability including the knowledge and relationships to assess opportunities and manage risks. In addition, the current business model of generally out-right control of operation would change a s BHP Billiton would have to participate in unique partnership structures with state-owned enterprises, national champions and major customers.

Because BHP Billiton had basically achieved the goals as set at the time of the BHP/Billiton merger including generating outstanding returns to shareholders, BHP Billiton was in a position to 'raise the bar' by resetting its aspirations at a higher level. The new aspirations would take into

Table 13.2 BHP business conditions over time

	2001	*2006*	*2010*	*2018*
Demand	• Historical demand growth of 2% of so—slightly less than GDP growth	• Demand growth of +3% largely driven by China—with India to follow • 'Hiccups' are certain	• Stimulus-driven demand recovery following the 2008 financial crisis	• \China growth moderating • Rise of environmental concerns driving structural industry changes • China steel demand peaking • Emergence of electric vehicles
Supply	• Generally adequate reserve lives • Periodic brownfield expansions sufficient to meet demand growth	• Substantially shortened reserve lives • Brownfield expansions are likely to be insufficient to meet demand • Development of new resources—typically in new geographies • Increased exploration and technology spending • Uncertain supply response	• Higher prices incentivising new project approvals and a step change in capital expenditure • Record production in petroleum and iron ore • A return to growth	• Imposition of a more rigorous capital allocation framework and 'value over volume' • No new world class discoveries • Focus on growth in copper supply • Exploration and capital spending picking back up off lows • Resource nationalism trend continuing
Prices	• Continuing to decline in real prices by 1% per year or so Price cyclical	• Prices remain above long-term mean for next 5 years—although current pricing level will not continue indefinitely • Increased volatility in demand and prices is expected	• Rapid price increases following the 2008 financial crisis • Pricing approaching a cyclical peak, well above LT norms • Move to market pricing in key bulk commodities	• Trade wars driving volatility • Supply interruptions triggering short-term price spikes • Overall pricing still expected to trend to long-term norms

	2001	*2006*	*2010*	*2018*
Costs	• Cost squeeze due to real price declines • Continuous performance improvements necessary	• Significant increase in input cost pressures • No longer the imperative to reduce costs to stay in business although still critical to maximising returns	• The start of sustained cost inflation (with costs continuing to rise rapidly until c.2013) • Cost control takes a backseat as price gains and growth outlook take centre stage	• Automation and technology gains have driven costs lower • Cost out programmes largely over • Inflation muted although oil price volatility persists
Competitors	• Status quo	• National champions from new geographies • China, as the major customer, will continue to secure resources outside of China • China will also induce the development of increased supply	• Attempted direct entry into the potash market in unsuccessful acquisition of Potash Corp • Approaching entry into US shale • New public competitor in Glencore which IPOs in 2011	• No material change across the majors since the 2015 spin-out of South32 • China-led resource acquisitions shifted to One Belt, One Road investments
Competitive position	• Moderately diversified portfolio for BHP and Billiton • Single countries dominate respective production	• Leading TSR for past 5 years • One of the world's leading resource companies • Increased diversity of commodities and geographies • Greater financial strength with reduced cash flow volatility • Good growth pipeline through to at least 2020 in place	• Much approved net gearing levels • Baseline strategy unchanged • Uniquely diversified portfolio of assets, prior to the focus on its four key pillars (with potash a potential fifth pillar)	• BHP remains one of the world's leading resource companies with a significant market share in iron ore, metallurgical coal and copper • Divestment of assets has been seen across the majors with an emphasis on achieving an improved ESG position

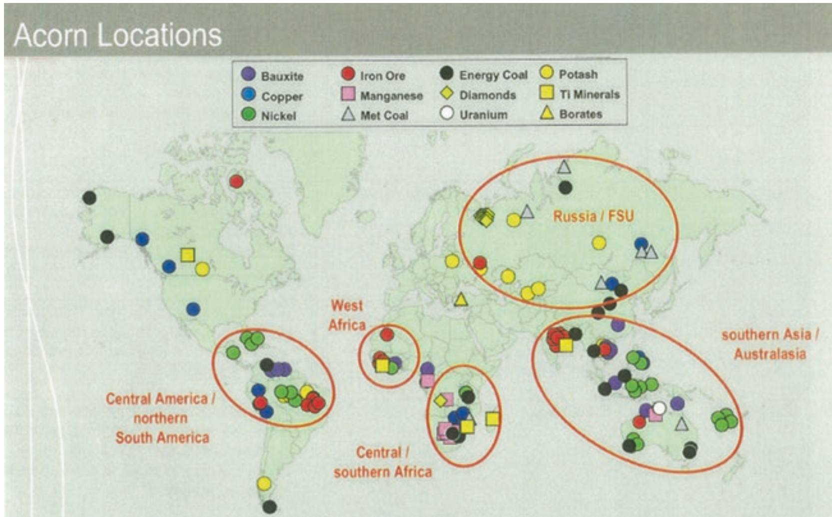

Fig. 13.2 Prospective resource locations: a world view

account not only BHP Billiton's competitive position but also the unique opportunities and challenges of the new industry environment, most importantly, the potential for a multi-decade period of high demand growth driven by China.

While the ultimate purpose of BHP Billiton was to maximise total return to shareholders over a 5+ year timeframe, the aspiration should address and resonate with each of the principal stakeholder groups: shareholders; customers; resource owners, communities and governments; partners and suppliers; and employees.

- *Shareholders*—Be a secure long-term investment generating leading returns within not just the natural resources peer group but the world's leading companies.
- *Customers*—Provide outstanding value and service by working with customers to ensure a cost-competitive and reliable supply that meet their needs. Minimising supply chain costs was an important aspect of providing a cost-competitive supply
- *Resource owners, communities and governments*—Be the 'partner of choice' to operate assets and develop new ones by structuring 'win-

win' transactions that supported the communities in which the company operated and setting the standard for sustainability of operations which included the environment, and involvement of communities.
- *Partners and Suppliers*—Be the partner and customer of choice by maintaining integrity and delivering on what was promised.
- *Employees*—Provide outstanding global careers for a talented and diverse workforce by fostering a high-performance culture that sets the standard for safety, ethics, integrity and skills.

The above stakeholder aspiration can be combined to the single aspiration of being 'one of the world's most admired companies'.

There were two important and material differences between the above set of aspirations and the post-merger aspirations: the aspiration addressed all the key stakeholders but was still fully consistent with the corporate objective of creating value for shareholders; and the benchmark was no longer the natural resources industry but the leading companies in all industries.

Where to Compete

In conjunction with the Charter, BHP Billiton had made some fundamental choices with respect to both where to compete and how to compete. Each of the choices was consistent with and reinforced one another and were generally expected to remain unchanged for an extended period of time.

Based on BHP Billiton's skills and capabilities and assessment of the attractiveness of segments within the natural resources industry and adjacent industries. Those choices largely formed BHP Billiton's competitive boundaries and consisted of the following:

- The extraction of natural resources to supply the world's growing demand was and remained the core business. BHP Billiton's focus was to be up to the point of beneficiation when the product is commercially saleable into a liquid market.
- Ownership of high-quality, large and low-cost assets which are consistently profitable throughout all phases of the cycle.
- A diversified portfolio of commodities and assets that reduced the volatility of cash flows and provided a broad set of growth options that could be exercised when determined appropriate.

- Commodities for which the price was set based on global fundamentals rather than local market fundamentals. One exception was a domestic business which could provide attractive returns and be a building block in developing a global portfolio (e.g., natural gas).
- An increasingly global portfolio of employees, assets and customers including a presence in all major markets and most if not all key producing areas.

Foremost, the choice of how to compete flowed from the Charter and similarly would not change through time.

- BHP Billiton exemplified the highest standards of ethics, safety, community and environment thereby being the preferred employer and partner by countries and customers. Maintaining that reputation and integrity of BHP Billiton was paramount.
- BHP Billiton maintained financial strength and discipline in all areas including a strong credit rating, rigorous investment evaluation procedures and processes, active management of the portfolio and risk management practices to enable a 'constancy of purpose' through downturns.

'Not for BHP Billiton': A Key Element of Strategy

As importantly, the choices delineated where BHP Billiton chose not to compete. Specifically, BHP Billiton would NOT:

- Enter businesses unrelated to the extraction of natural resource for which its core capabilities were not material drivers of performance. Nevertheless, BHP Billiton would continue to evaluate opportunities that leveraged its core capabilities in businesses related to, or adjacent with, the competitive boundaries.
- Acquire high-cost assets that would not be profitable in a downturn or with the intention of not holding the asset for the long-term.
- Allow a single commodity or country exposure to dominate the portfolio for an extended period.
- Enter businesses for which the production was sold only to the local market at prices set by the local supply-demand balance (except for building blocks in developing new businesses).

- Incur significantly greater leverage and thereby, increasing the risk profile to the shareholders.
- Operate businesses for which the aspiration of zero harm and adherence to BHP Billiton's HSEC standards was not possible.

What Were the Government's Regulations?

This question is probably best answered under Public Policy.

The last time we had a commodities boom in the 1970s, the Australian economy had all the hallmarks of the European Union today.

Australia was an inflexible, rigid economy, mired in regulatory control, enterprise stifled by bureaucracy, state owned enterprises, a culture of state dependency and entitlement, and antipathy towards business and economic development.

The 1970s mining boom ended in tears for Australia—double digit inflation, interest rates and unemployment.

In the intervening period, as indicated at the outset, the global socio-economic orientation shifted profoundly to open markets and to individual enterprise and initiative, both in culture and structure.

In Australia, just as in other reforming economies, the whole point of the Hawke-Howard reform era in Australian economic policy was to improve the economy's flexibility, supply side capacity and adaptability, where labour and capital move to where they are used most productively in those industries that we do best.

And yet through the course of successive Labor Governments from 2007, during a period of minerals resources led strongest terms of trade in 150 years and vastly improved national prosperity and living standards, there was.

- an unashamedly regressive shift in economic policy towards the redistributive than the productive side of the economy,
- an emerging protectionist sentiment notably in workplace arrangements, excessive and soft regulation, new taxes without tangible dividend, industries assistance, and an antipathy towards foreign investment, foreign skills and foreign enterprise.
- and as we all know only too well, governments went after a greater cut either through increased royalties which added significantly to project costs, or as rent taxes which prospectively destroys project value, and certainly eroded investor confidence.

In effectively denying the virtues of the preceding decades of open market reforms, the Australian economy moved to structural deficit in just about every key economic indicator.

Add to this scenario, the product of a national complacency and economic reform inertia, even backsliding, born of a false sense of security aided and abetted by the politics of envy and class warfare.

To its great credit the minerals industry, in the main, stayed the course of market oriented economic reforms, arguing for more not less.

Rather than being distracted by claims about two-speed economy or that the so called 'boom' is more a threat than an opportunity for Australia coming at the expense of other parts of the economy, the Minerals Council of Australia stressed.

- that the Australian economy's structural tensions created by the rapid expansion of high productive mining could be eased by policies designed to lift the speed limits at which Australia's economy can grow—open market access to foreign capital, to skilled workers and to material inputs principal among them.
- that Australia simply could not afford to wait for the traditional spur of economic crisis to provide the impulse for further economic reforms—even though one might reasonably conclude that we were already in that space.
- that we must dispense with the politics of envy in favour of a platform of mutual respect and mutual dependency. There could be no greater 'beacon on the hill' than the remarkable transformation in the mining industry's relationship with Indigenous Australians, and
- critically, that the reform imperative was transitional and incremental, not revolutionary, if it was to be sustainable.

But there are always exceptions—some more prospectively damaging than others—a few come to mind where the principle of not allowing public policy to become a key point of competitive differentiation in the internal market, stood to be compromised for narrow commercial benefit.

Parts of the industry's initial approach to climate change management policy was classically defensive—to the point where it was head in the sand stuff and there was a view we lost opportunities to better shape the policy response.

The Howard led Ralph reforms of business taxation proposal to trade depreciation tax preferences for a reduction in company tax rates became

mired in a tug of war between company's variations on capital intensity rather than key principles of tax reform.

The debate over Part IIIA access to the Pilbara railways was another classic where those with prospective commercial gain became proponents of third-party access to another company's infrastructure that was never a privatised state-owned entity, nor access is absolutely essential to competition as subsequent developments bear testament.

The super profits tax debate nearly went even further into the realms of the ridiculous with industry breakaway proposals that starting base asset valuations be double the written down book value as a means of redressing the inequities of retrospectivity where those with longer term assets would be disadvantaged compared to later entrants.

Added to which it was proposed that the point of ore valuation not be Run of Mine pad, but rather further downstream—now that would have really compromised the design objectives of a resource rent tax, and widened the commodity coverage significantly giving those who derive value add from downstream processing a real difficult time.

We also witnessed the self-proclaimed experts' commentary of those who were barely bystanders to the mining tax policy machinations declaring that the industry was poorly served by the negotiated outcome.

CHAPTER 14

BHP(F): Mergers and Acquisitions

Introduction: Merger Processes

One of the biggest days in the 130-year history of BHP was 29 June 2001, when the merger was formalised with Billiton Plc. The DLC structure meant that the combined entity was to be operated, even though it involved distinct organisations, to create the best overall outcomes for the aggregate of those entities, which would share the returns, through equal dividends. Although not formally a single entity, the business of the two entities were to be operated as if they were one. The group restructured assets from both previously separate businesses into seven business units called Customer Sector Groups, each with clear financial and operating goals and responsibilities. The group's global footprint had expanded and diversified, including to Pakistan, Gulf of Mexico, South Africa, Chile and many other regions. When companies merge, the good news gets all the attention; greater efficiency and effectiveness, growth potential, increases in profitability. These great expectations become self-fulfilling prophecies, as stock market analysts jump on the bandwagon. The BHP Billiton merger was no exception and the stock market graph below is a clear signal of the combined entities delivering on what was promised but unfortunately there were some suboptimal judgments made after 2010 which saw the Company underperform for a period. See Fig. 14.1.

Successful companies that transact mergers focus on size, scale and ultimately sustainable growth. BHP got the strategy development right, the

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D. Argus, D. Samson, *Strategic Leadership for Business Value Creation*,
https://doi.org/10.1007/978-981-15-9430-4_14

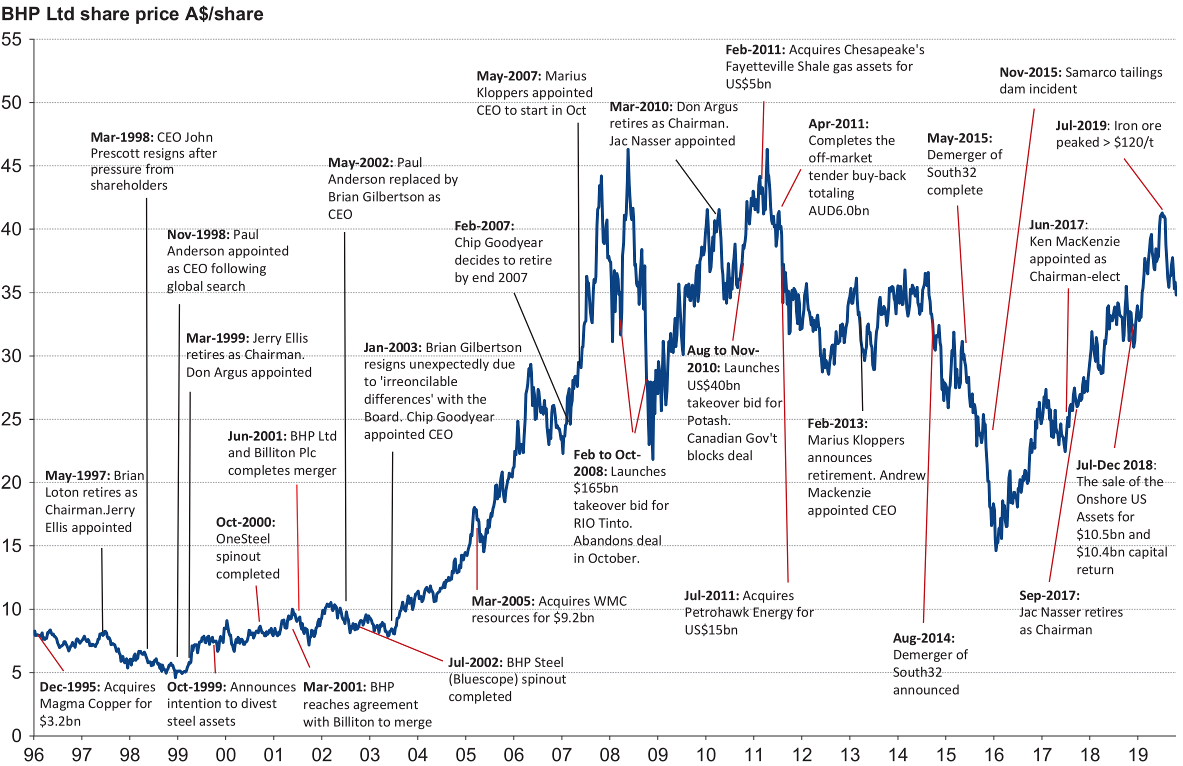


Fig. 14.1 BHP share price history

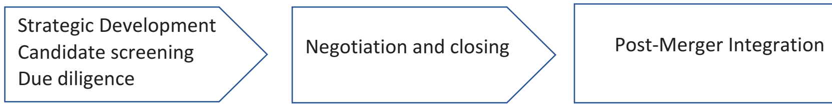


Fig. 14.2 Merger process overview

candidate screen right (other than CEO succession) and the due diligence right, but the unknown was how effective the post-merger integration would be as in Fig. 14.2:

Those of us who were seasoned practitioners had real concern for the post-merger integration, particularly as we were dealing with a combined business footprint spanning 34 countries.

The financial due diligence had to be more future orientated, and we needed a clear understanding of how we integrated the various business issues, such as customers, competitors, costs and sustainability of cash being generated from natural resource reserves and there were safety and environmental issues prevalent in both companies.

A first glance, post-merger integration presented a seemingly insurmountable task to accomplish. The partners needed to learn about each other and learn to live with each other. There was a host of business due diligence issues to be examined, none more pressing than to deal with an anonymous fax sent to the Chairman of the Board about specific allegations regarding fraud and suspected malfeasance.

None of the allegations could be substantiated but for a short period of time harmonisation of the Group presented a challenge because the loss of trust and respect endangered the momentum in the post-merger integration.

The efforts of Mike Salamon, John Fast, Chip Goodyear, Chris Lynch, Brad Mills and Karen Wood were fundamental to achieving a successful post-merger integration because they recognised the three action areas so crucial during the post-merger integration process. Mike Salamon who was an Executive Director of BHP Billiton gave a rare interview on the integration process: '*We actually did it ourselves. We had our vision, we knew what we wanted to achieve, we used our own team to deliver it, so people very early on bought into what we were doing.*'

The keys to success of the merger was ignoring the textbooks and not hiring consultants.

- **Buy-in**—They achieved buy-in from all levels of management and employees. They achieved this early and quickly.

- **Orientation**—The people asset had to be well informed and oriented in order to support the vision and merger rationale articulated by Paul Anderson and Brian Gilbertson. The company needed to be seen as having a clear compass—an overall direction from day one onwards. There were some pockets of resistance and scepticism but overall this orientation was achieved very quickly.
- **Expectations**—All expectations—inside and outside the merged entities—were managed around the international assets.

So, what could go wrong and what did we learn?

Vision

Merger partners at times lack a clear idea of what the merger is about. Don did not believe that was the case in the BHP Billiton transaction. There was more emphasis on growth opportunities rather than cutting costs and realising synergies. The strategy was clearly articulated although we did have to deal with a diversion that the transaction was a reverse take-over by Billiton acquiring BHP. There was also public discussion about the premium paid to complete the transaction and some analysts concentrated on cutting costs in the short term rather than the strategic rationale for the merger.

Leadership

Companies can be slow in assigning leadership. Some tend to tolerate leadership chaos that eventually denigrates into the survival of the fittest. This wastes precious time and resources, whilst also causing uncertainty and demotivation among the workforce. The leadership appointments for the new enterprise was completed quickly. Some leaders associated with the individual entities decided to seek employment elsewhere, some accepted appointments within the new structure but resolved to move to other competitors early in the developing process. The merger agreement also provided for Brian Gilbertson to succeed Paul Anderson within a short period of time after closure of the transaction. Whilst this may have seemed admirable to some as an expediency, Don would not encourage trading a CEO's position in any merger as it deprives the Board the opportunity to test the outside market to recruit the best candidate to take a new company forward without the prejudice of the past.

Growth

An essential outcome in any merger and certainly an objective from BHP's management's perspective was the growth strategy designed around organic growth and targeted mergers/acquisitions. It became clear that a majority of Billiton's executives who became part of the new BHP Billiton accepted the growth objective. There were however consistent rumours from the investment banking community that some assets were identified as being surplus to the needs going forward and would be sold. This was contrary to the message given to the market at the time of the merger. The merged entity quickly returned to its strategic objectives under a new but untested CEO, Chip Goodyear, and he achieved much success as reflected in the market performance.

Early Wins

Companies often lose contact with reality by believing that employees will buy into any merger as soon as it is announced. Buy-in can never be assumed. It must be earned. If early wins, quick, positive, tangible results can be created and communicated appropriately, people will begin to acknowledge that there is indeed a brighter future for them and their new entity. Paul Anderson, Mike Salamon and Chip Goodyear did a fabulous job with this communication.

Culture

Much has been written about culture. Companies all too often decline to acknowledge that cultural barriers exist and they cannot be removed quickly. They neglect the fact that change must happen and must therefore be addressed in a professional way. Some leaders think of culture as synonymous with values. We think it more useful to think of it as information, influence and insights that flow among peers whether you have a strong or weak culture often depends on the strength and calibre of these peer connections. For example, when peers spend time telling one another why specific change won't work, it creates negative momentum that can derail even detailed performance initiatives. In strong cultures, peers reinforce an innovative and positive response to change and much credit must be given to Chip Goodyear's efforts in setting the framework for a strong culture within the merged BHP and Billiton.

Risk Management

The traditional rule on risk management says that a company that has just merged should be prepared for unforeseen setbacks, unexpected development and unforeseen problems as outlined earlier. Nothing will go to plan so be prepared to react, according to conventional wisdom.

In today's world, the circumstances are different. The very nature of competition in global markets is being changed beyond recognition by unforeseen setbacks, development and unforeseen problems, and the impact of China's development is challenging the World Trade Organisation and Donald Trump's tariffs has the world in a quandary as to 'What's next?'.

Australian companies such as BHP Billiton have had a phenomenal run in trading with China but with Trade Wars developing and world awash with debt we are entering a period where traditional economic theories are being challenged. A merger risk impact assessment matrix was necessary to ensure potential integration issues are covered.

In response to criticism of the transaction between BHP and Billiton, Don Argus recalls a world shaping up to nationalisation and parochialism but was beginning to acknowledge an increase in Chinese commodity market demand, but little understanding of geopolitics and a rapid underestimation of the quantum of the demand rise and its consequences.

It really required judgments of that era to take off the spectacles of that day and assume those of 2001, with the knowledge, aspirations and concerns that were alive then. There are many source documents which help in this respect, but one of the best is a report prepared by Merrill Lynch in October 1999 titled '*The Big Four Miners: Games without Frontiers*'. This research quite effectively captured and reflected the thinking of some of the more influential players at the time. Its relevance today in examining the thinking of yesterday is also enhanced when one considers that BHP and Billiton first considered a potential combination in 1998 and then again in 1999. Talks became serious in late 2000 and early 2001 and the rapidity of reaching an announcement on 19 March 2001 reflected how much work had been done in prior evaluations.

BHP's Context in the New Century

It is also important in the broader context of considerations to remember how different a company BHP was in 1998 and 1999. Paul Anderson was leading the company out of a tough period and his legacy still casts a huge

footprint from which successive management teams can understand and hopefully learn.

By 2000 Paul Anderson had progressed much of the restructuring and his mind was clearly turning to what next. This can be seen in a number of the speeches and presentations made where he reflected on what would be the key features of the new super-majors including the need to have international equity capital market access. The beginnings of 'large, expandable, low-cost and upstream' can also be seen. At the same time, increasing project size and cost, and the benefits of geographic and commodity diversity were aired as reasons why capital scale was necessary and the likely rise of super-majors was flagged.

In a presentation to the financial community at the time of the announcement of the DLC, Paul Anderson displayed a bar chart of the enterprise value of the world's largest resources groups. Figure 14.3 makes several points clearly and is in large part a component of the background to the payment of a premium to Billiton shareholders:

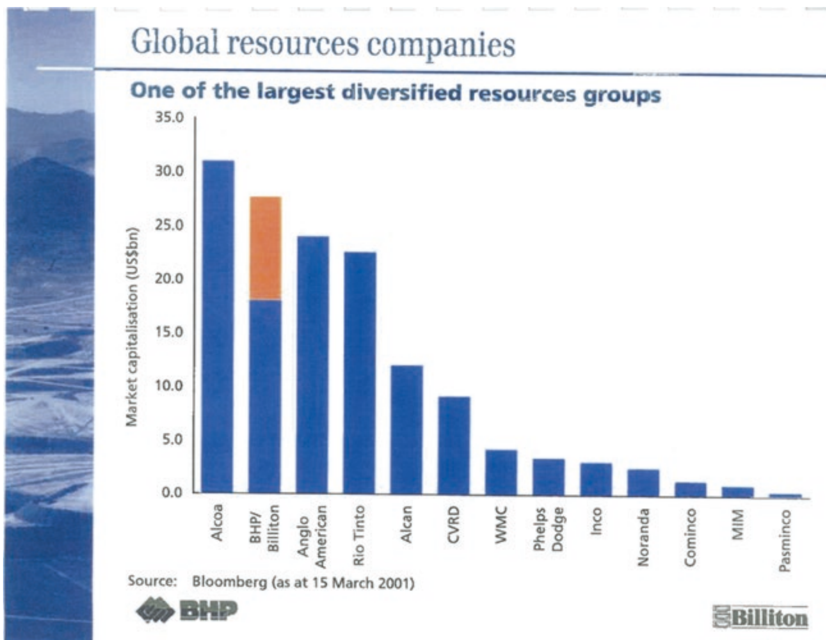


Fig. 14.3 BHP and Billiton scale of market capitalisation in the industry

- BHP was ranked 4th of the then Big 4 with Alcoa, Anglo and Rio Tinto ahead of it. Alcan ranked 5th; Billiton 6th; CVRD 7th; Phelps Dodge 8th and WMC 9th.
- BHP and Billiton together ranked 2nd.

In casting around for growth, internationalisation, access to global capital markets, management talent and fresh blood in senior ranks, sectoral and commodity diversity, a merger with Billiton clearly fitted the bill the best. A combination with a party larger than BHP would have seen BHP dealing its future from a position of weakness; Alcan was largely downstream and very focussed although they eventually succumbed to Rio Tinto overtures when BHP were sizing up Rio Tinto for take-over; a merger with Vale was not available as a result of Brazilian nationalistic issues and, potentially, competition concerns; Phelps Dodge and WMC were respectively too small to make a difference and did not meet many of the other criteria.

Whilst this analysis was happening within BHP four particularly important developments were also occurring in 1999 and 2000:

- In 1999, following discussions, BHP concluded that a joint venture with Rio in the Pilbara was not a viable option at that time. (In hindsight one could argue that this did not represent the critical thinking required to create an institution which would have delivered untold wealth to a nation for many decades.);
- In 2000 Rio Tinto made a lunge for growth, spending $14 billion on three acquisitions—buying North, Ashton and taking out the minorities in Comalco. When combined with Rio Tinto's settled DLC structure, access to two capital markets, superior asset performance and relatively few stumbles, this put Rio in a superior position to BHP in terms of near- and mid-term likely profit growth and trajectory;
- Anglo's acquisition of a 7% stake in Billiton in late 2000;
- Billiton's assessment of a range of merger partners.

Combined, these elements made for a particularly unstable atmosphere and led to the realisation that Billiton and its future alignment could well be highly determinative of the patter of consolidation, the formation of super-majors and future industry pecking order and opportunities.

An acquisition by Anglo (who had been outbid for North by Rio Tinto) or Rio Tinto or Billiton would have fundamentally changed the set of opportunities available to BHP and would have put clear air between the resulting Top 3 and BHP.

- BHP had to be able to sell a premium to its shareholders in which it was helped by the fact that the head office was demonstrably staying in Australia;
- BHP had to pay a sufficient premium to secure a strong board recommendation; not to put Billiton in play and bring about an auction which BHP could not win and where a loss would have adverse consequences;
- Billiton had to show a premium given it was the smaller partner, had lost the head office location issue and avoid ending up being acquired by Anglo (not a favoured outcome by Billiton which, among other things, wanted to diversity its shareholders further from South African assets rather than increase their relative exposure.)

This dynamic tension resulted in a negotiated premium of 9% (calculated on an average market capitalisation for the five-week period prior to announcement; the spot premium was 13%). As noted, this premium was calculated by reference to the respective average market capitalisations—which was not unusual. If one accepts that the market valued each stock fairly, notwithstanding that some argued that the Billiton share price already included a premium when Anglo entered its registrar then the quantum for the debate as to whether the premium was fair or too much is defined to a maximum of 9%. This must follow if it is considered that there was no capacity at all for BHP (particularly in the circumstances outlined) to secure a board recommendation and vote from Billiton shareholders at a 'discount' to the market.

Accordingly, the argument as to the premium BHP should have paid set boundaries—0% and 9%. This reality limited the scope of the argument for those who claimed that BHP paid too much bearing in mind the considerations at the time. One could argue that the real range for argument was possibly between 6% and 9%, i.e., precious little to have a large argument about. Why? A premium had to be paid—Billiton shareholders demanded it; the respective sizes and effective migration of control demanded it; the Anglo shareholder demanded it by the premium setting a barrier for a counter-bid; BHP required it for, once having started the

transaction and advocated its relevance and importance to the BHP shareholders, it needed to complete the deal to avoid damage and having crystallised the subsequent migration of Billiton to another stable.

Whether 6% would have done it, one can only speculate, other than to comment that we doubt it would have secured a board recommendation. We are pretty sure that 5% or less would not have done it or would have been extremely risky to attempt. Accordingly, it was believed that to complete this transaction the premium paid was right and necessary.

History has shown, firstly, quite how catalytic that deal has been to the recovery of BHP and unleashing of its potential and, secondly, how pivotal it has been to the reshaping of the industry in BHP's favour.

The Genesis of the DLC (Dual Listed Company)

To provide a better understanding of how the structure of the DLC, how it is defined and how the objectives are to be delivered, it is useful to understand the implementation procedure.

On March 19, 2001, BHP Limited and Billiton Plc announced that they had agreed to form a Dual Listed Companies structure, to establish a diversified global resource group, to be called BHP Billiton. The implementation of the DLC structure was completed on June 29, 2001. BHP Limited changed its name to BHP Billiton Limited and Billiton Plc changed its name to BHP Billiton Plc and more recently BHP without collapsing the structural aspects of the DLC.

A unified Board and management team ran the BHP Billiton Limited Group and the BHP Billiton Plc Group, with headquarters in Melbourne, Australia, and with a corporate management centre in London. The existing primary listings on the Australian and London stock exchanges continue to be maintained, as are the secondary listings of BHP Billiton Plc on the Johannesburg and Paris stock exchanges and an American Depositary Receipt listing of BHP Billiton Limited on the New York Stock Exchange.

The shareholders of BHP Billiton Limited and BHP Billiton Plc make key decisions on matters affecting the combined group through a procedure in which the shareholders of both companies have equal voting rights per share. Accordingly, shareholders of BHP Billiton Limited and BHP Billiton Plc effectively have an interest in a single group combining all of the assets of both companies with a unified Board of Directors and management. Should any future corporate action benefit shareholders in only

one of the two companies, an appropriate action will be taken to ensure parity between BHP Billiton Limited and BHP Billiton Plc shares.

The purpose of implementing the DLC structure was to allow BHP Billiton Limited and BHP Billiton Plc to function as a combined economic entity which benefits from shared assets and growth prospects, combines a number of large, low cost and long life mining, metals and energy assets with global scale and, through diversification, is more resilient and better placed to manage exposure to commodity price cycle risk inherent to the resources industry while maintaining their status as separate legal entities with separate primary listings in major economic centres.

Under the DLC structure (Fig. 14.4), BHP Billiton Limited continues to have a primary listing on the Australian Stock Exchange and BHP Billiton Plc continues to have a primary listing on the London Stock Exchange. These dual listings provides each company with broader access

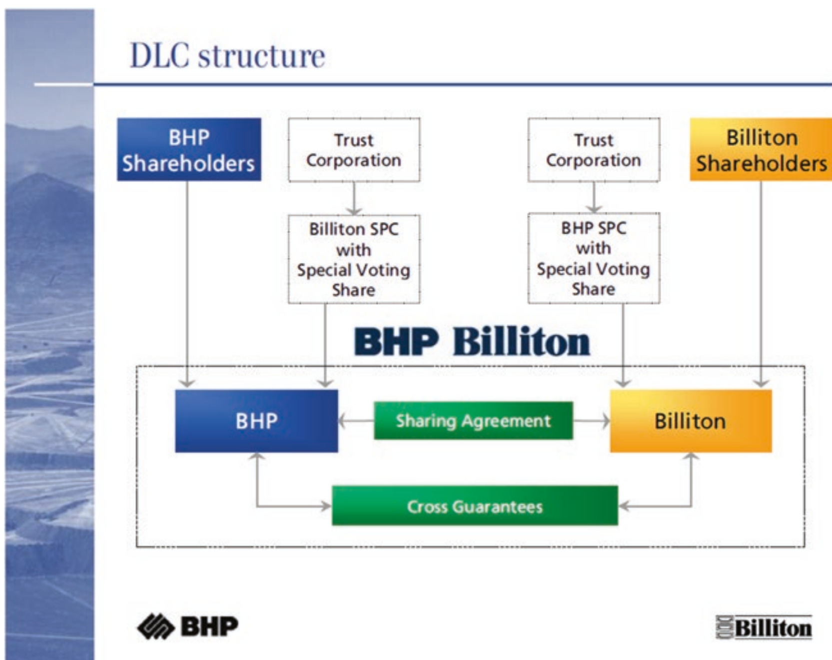


Fig. 14.4 BHP Billiton DLC structure. (Source: BHP corporate presentation March 2001)

to global investors and facilitates their access to capital markets. This structure also preserved favourable tax treatment for the dividend payments of BHP Billiton Limited.

The DLC structure did not require any BHP Billiton Limited shareholder or BHP Billiton Plc shareholder to exchange or tender their shares for shares in the other company, which helped to avoid the selling pressure on each company's shares in connection with implementation of the DLC, which often accompanies business combination transactions when one constituent's equity is used as the consideration for the transaction.

More details regarding the rights and responsibilities are included in the Chap. 18.

A dual listed company was a way for two companies to conduct a cross-border merger while keeping all of the assets in the original legal entities which continue to trade on their respective stock exchanges.

There had been a precedent transaction of RTZ and CRA which merged to form Rio Tinto in a dual listed company structure in 1996. At the time of the BHP and Billiton merger, the companies listed the following key points as to why a DLC made sense;

- A cross-border merger without flow back—the concern would be if BHP had acquired Billiton outright, the Billiton shareholders may not want, or be able to, hold BHP shares and would have been sellers.
- Trading liquidity across three major share markets (Australia, UK and South Africa).
- Enhanced access to international capital markets—tapping access to capital in both the UK and Australia.
- No change in ownership of assets (pre-emptions)—this would also potentially have had capital gains tax benefits.
- Shareholders continue to receive dividends from the local company.

Following the 2015 demerger of South32 only four substantive assets remain in Plc—Antamina, Spence, Cerrejón and Mt Arthur, which together generated only approximately 9% of BHP 2017 operating profit, but Plc shareholders still account for approximately 40% of BHP's shareholder base.

As we write this Case Study a number of shareholders and activist group Elliott Advisors Ltd are asking the question: 'Has the BHP dual listed structure reached its use-by date?'

The question of whether BHP should unify its dual-listed company structure (DLC) creates much discussion among analysts, journalists and, most importantly, BHP's shareholders. The current interest has been triggered by a report released by Elliott Management suggesting that unification could unlock significant shareholder value. The simple fact, however, is that the unification of BHP has been an important issue for much longer than the current debate and a full and transparent consideration of the merits of unification is both long overdue and clearly in the interests of BHP's shareholders. To be fair to succeeding regimes, statements have been made regarding a continuing review of the effectiveness and efficiency of the DLC structure.

As Chairman of BHP at the time when its DLC was formed, and a shareholder, it has become increasingly intriguing to observe an apparent lack of understanding of why the DLC was created, why it was left in place at a time when other DLCs were being unified, and why it has remained beyond its useful life. Given the importance of the continuing Balance Sheet structure and importance of the Franking Credits to Limited shareholders, it is worthwhile to record some of the thinking at the time of the merger.

At the outset, Don noted the case of Brambles of which he was also Chairman and which formed a DLC in 2001, identical to BHP's in almost every respect. Brambles decided to unify its DLC four years after it was created. The rationale for that decision is directly relevant to the decision BHP faces today because it was underpinned by a single-minded focus on shareholder value and a recognition that the DLC's purpose had been served.

Nothing is Forever?

DLCs are complicated and difficult structures. From a Chairman's perspective, they are certainly not for the faint hearted, and there were many times during his tenure as Chairman at BHP and Brambles when Don found himself questioning the utility of the structure. The reality however is that a DLC is the only way in which some complex, multi-jurisdictional mergers can be achieved to create real shareholder value. This was the case at both BHP and Brambles, where transformational mergers were only possible with the establishment of a DLC.

The fact is, however, that the key benefit of a DLC- making possible a merger which is otherwise not possible—is realised at the moment the

DLC is formed. Thereafter, the DLC creates organisational and structural complexity and, as history has demonstrated, share-price disparity between the two listed stocks. This disparity alone creates significant issues for directors as they seek to discharge their duties to shareholders, reducing flexibility in capital management and making share-based acquisitions almost impossible. In the case of BHP however even more significant shareholder value issues have emerged from the DLC over time, namely the wastage of shareholders' valuable franking credits, exacerbated by the demerger of assets by the Plc entity. We comment further on this critical issue later in this commentary.

It is important to realise that DLCs should not be regarded as permanent structures—rather, they are a means to an end. Of the 15 companies to have adopted DLCs, more than half have since unified, and for good reason—shareholder value. Against this backdrop, we are struck by the level of confusion in the market about the value that can be released through a unification of the DLC and find that many commentators either overlook or misunderstand the practical implications of unification for investors.

Take Brambles, where unification allowed the company to focus on its key growth businesses, concentrate capital in one market, eliminate the price differential between shares, reduce costs and complexity and add strategic flexibility. By eliminating the DLC, Brambles became a simpler, more efficient and more valuable company. Management and the Board of Brambles made the decision to seek to unify their DLC with an explicit focus on shareholder value. Mindful of the challenges of any corporate reorganisation, the unification process was also designed to include strategies to ensure all shareholders would realise the immediate and lasting benefits of an Australian-unified company.

In the end, Brambles' Plc and Ltd shareholders supported the unification effort with near unanimity: more than 99% of shareholders approved the unification vote. And for both groups of shareholders, the benefits were immediate -the Plc and the Ltd share prices independently outperformed the market from the announcement to the close of unification.

While in the case of BHP it made sense for some time to keep the DLC to facilitate a potential merger between BHP and Rio Tinto once under consideration, that has long since ceased to be relevant, while both the potential benefits of unification and the costs of inaction have significantly increased.

First and foremost among these is the issue of franking credits. Absent unification, BHP will have limited prospects of monetising a large and growing portion of its valuable franking credit balance that is currently stranded by virtue of the DLC, forgoing a valuable opportunity to boost the yield upon which so many investors rely.

Of even greater concern, however, is the issue of the shareholder and asset imbalance between the two DLC entities, exacerbated by the demerger of most of the legacy Billiton assets in 2015. BHP now finds itself in a situation in which dividends to Plc investors are questionable in terms of support by the remaining Billiton assets in which event must be funded by profits from the Australian Ltd entity. This transfer of value would lead to the unavoidable destruction of shareholders' franking credits if perpetuated.

As a shareholder, Don is surprised at the approach that has been taken to the destruction of value associated with franking credits within the BHP and Rio Tinto structures. The potential opportunity through unification of the DLC to mitigate this value destruction demands a complete and transparent review, without any pre-conceived views about corporate structure, and with a maximum focus on generating value for shareholders.

By contrast, a primary ASX listing for a unified, Australian-incorporated BHP would likely increase the proportion of BHP shares owned by Australian taxpayers—as occurred with Brambles -thus increasing the distribution of franking credits and the realisation of shareholder value, enhancing BHP's position as a leading company on the ASX. Don noted with interest comments that this could be achieved while maintaining BHP's premium international listings, particularly in the UK.

Finally, another important opportunity relates to the strategic value of having a single, unified stock to use as currency for acquisitions. Acquisitions using stock are a critical means through which any company can achieve a fair sharing of transaction risk with the shareholders of a target company. Paying only in cash for acquisitions, as BHP has done under the DLC structure, leaves BHP shareholders shouldering all of the risk and has led to some unfortunate outcomes.

Like many, we have followed Elliott's work on unification with great interest; the opportunities for value creation reported by them and others appear to be very significant. There are of course complex calculations to be done but, given the shareholder value suggested, and the list of key benefits of unification published we are surprised that knowledgeable shareholders have not taken action to ensure these benefits are realised.

Some of the Key Benefits of Unification are worthy of consideration and articulated more fully by the Elliott Group:

Operational Focus and Efficiency

Unification creates a single transparent Australian incorporated, Australian headquartered and Australian tax resident New BHP which would continue to be managed from Australia. New BHP could have a primary listing on the ASX and a premium listing on the LSE, with a single shareholder base. Permanent annual cost savings will accrue from a simplified structure that can operate without the restrictions of the DLC agreements.

Strategic Flexibility

New BHP could more readily make appropriate strategic acquisitions at opportune moments in the cycle using its own newly-issued shares, rather than having to utilise cash which instead could be deployed (1) to generate optimised returns for shareholders via buybacks; and (2) for cash-based expansion at cyclical low points. Since the inception of the DLC structure, it seems that BHP has never closed an acquisition using its own shares as consideration -that is quite amazing for a company of this size, considering the counter-cyclical opportunities in the mining sector.

Optimised Release and Monetisation of Franking Credits

As an Australian tax resident company, New BHP would be able to attach franking credits to (a) any dividend it makes; or (b) any income component of a share buyback which it undertakes, in each case on all of its shares, thereby unlocking the intrinsic value of BHP's huge A$12.8bn (US$9.7bn) franking credit balance.

The Dividend Share Mechanism would no longer be required and would be removed, ensuring that BHP does not needlessly waste valuable franking credits through Limited having to issue dividends on the Ltd DLC Share to ensure that PLC has sufficient distributable reserves to provide its shareholders with the necessary equivalent economic returns on their shares.

According to the annual report, in FY2016 c. A$1.1bn (US$853m) of franking credits were wasted due to the A$2.6bn (US$1990m) dividend that was paid by Limited to PLC using the Dividend Share Mechanism -so

that equates to about A$550m (US$426m) in terms of BHP equity market value which has been irretrievably lost, based on the typical way in which the market values franking credits.

New BHP will be able to monetise franking credits for its shareholders more quickly and more efficiently via 14% discounted off-market share buybacks. Analysis indicates that following unification much more of the A$12.8bn (US$9.7bn) franking credit balance can be released directly into the hands of shareholders via off-market share buybacks, generating a significant equity value uplift for shareholders.

This would be a highly value-accretive way of management deploying a large amount of capital without any additional operational risk -effectively buying BHP's own first-class core assets at a meaningful discount to their market price and unlocking BHP's substantial franking credit balance for the benefit of all shareholders. All shareholders could benefit from the incremental accretion and share demand resulting from more franking credits being released. With the post-unification full fungibility of BHP's shares and the opportunity for the much more efficient use of franking credits, BHP's investor base could migrate towards those Australian tax resident investors who can take full advantage of the unlocked franking credits.

The returns from discounted off-market share buybacks would set a high shareholder returns threshold, which will provide much improved capital allocation discipline -resulting in less write-downs on investments like the A$17.2bn (US$13.1bn) written off by BHP on its US shale investments over four years.

Generating an Enhanced Yield for Australian Shareholders

Post-unification discounted off-market share buybacks will facilitate much greater franking credit usage and therefore shareholder value. Assuming they are undertaken at sensible long-term valuations and tailored to ensure stable, long-term gearing ratios, such discounted off-market buybacks would be highly value-accretive without incurring additional strategic or operational risk.

Enhanced Market Value

BHP's market value could increase as a result of the share price of New BHP being in line with or better than Limited's share price, consistent

with precedent unifications such as the 2006 Brambles reorganisation. The drivers for this increase in market value include the increased weighting that New BHP would achieve in the relevant indices, the market recognising the value of stockpiled and future-generated franking credits once they can be used effectively because of unification, which is supported by academic studies, and removal of the PLC Discount due to the full fungibility and frankability of all of the shares in New BHP.

The economic asymmetry evidenced by the PLC Discount undermines the fundamental principles and objectives of the DLC structure, which require the two companies to be operated as a single unified economic entity and to ensure that both PLC shareholders and Limited shareholders receive equivalent economic returns. The PLC Discount represents an inequality of market valuation that needs to be addressed and can only be addressed through unification.

Maximising Index Inclusion

On unification BHP's weighting in the S&P/ASX 200 could significantly increase -making it the second largest company by market capitalisation. This would mean that a number of funds, including those with index focussed strategies, which can take full advantage of the unlocked franking credits, will need to increase their BHP holdings to account for this increased weighting.

Also, assuming full FTSE inclusion, BHP's weighting in the FTSE 100 could increase from c.1.4% to c.3.9% (7th largest in FTSE 100). New BHP would meet all the requirements for obtaining a premium listing on the LSE (including all corporate governance criteria), as well as the free float, price/size and liquidity requirements for FTSE UK Index Series inclusion. New BHP can be expected to continue to see strong liquidity in trading on the LSE.

Although new BHP would be an Australian-incorporated company, clear precedent exists for it to be included in the FTSE UK. Groups such as International Consolidated Airlines (the merger of Iberia and British Airways in 2011) and TUI (the merger of German TUI AG and British TUI Travel) show FTSE's willingness to consider important existing listed groups for continued inclusion after a corporate reorganisation that results in a company being incorporated and listed outside the UK, but with a premium listing on the LSE. Given the size of BHP and the perceived Anglo-Australian nature of the group, there is a strong rationale for

retaining BHP on the FTSE—particularly given the LSE's drive to attract and retain listings of international groups.

An analyst from Jeffries Hong Kong endeavoured to answer the question above.

The main costs to collapsing the DLC are reported to be tax related. In 2017, BHP estimated the cost of US$1.3–3.0 billion, although the tax advantage of the Singapore trading hub would be removed in 2019 and the cost today is estimated to be below US$500 million.

The key advantage to collapsing the DLC was to be the simplification of BHP's corporate structure. There is a view, BHP has sometimes made sub-optimal portfolio decisions based on maintaining cash flow in the Plc side of the DLC.

Since the BHP Billiton merger, the Australian listing of BHP Ltd has traded at an average premium of 20% to the UK listed BHP Billiton plc. The key advantage of the DLC structure was that it is an efficient way to streaming franking credits to investors who can utilise them.

In April 2017, Elliott Advisors released a three-point plan to unlock ~50% upside value in BHP. Their plan called for BHP to;

(a) Collapse the BHP dual listed company structure,
(b) Spin out the US petroleum (onshore and Gulf of Mexico) business, and
(c) Lock in a set balance sheet structure and use excess cash flow for buy-backs to unlock franking credits.

BHP's response to the plan was dismissive. It argued that the costs of collapsing the DLC far outweighed the benefits, the US petroleum business was a core asset, and that a structured balance sheet was inappropriate for a cyclical business.

Since then, BHP has changed its mind on US shale (but not the Deepwater Gulf of Mexico), and although BHP deny it, it is likely that the catalyst for the decision was the pressure from Elliott and other shareholders.

Was this the right decision given the recently announced take-over of Anadarko by Chevron US$50 billion and subsequent US$55 billion counter bid by Occidental Petroleum (Commentary on the merits/demerits of Shale Sale in Appendix). History will be the judge of that decision.

In response to the Elliott proposal, BHP released further information on how much it would cost to collapse the DLC. BHP estimated the cost at US$1.3–3.0 billion and although it did not break the cost down,

analysts suggested that the two largest components were the tax advantage of the Singapore marketing hub, and the utilisation of tax losses at Hunter Valley coal.

Again, Analysts reported the following.

BHP operates a commodities marketing business in Singapore called BHP Billiton Marketing AG, which is owned 58% of BHP Ltd, and 42% by BHP plc. This marketing business has two different, but related, positive tax implications for the DLC structure;

- BHP's operating divisions sell commodities to the marketing hub, which then on-sells those commodities to end-users at a mark-up. BHP has historically generated a profit in Singapore of about US$500 million from this activity.
- The profit from the commodity trading is then taxed in three different jurisdictions—Australia, UK and Singapore—which depends on the tax treaties between the different countries. The profits from the UK 42% of the business are taxed at the low Singapore rate of tax, whereas the profits from the Australian 58% share are taxed at a higher Australian rate of tax.

The second of these two factors effectively operated as a tax shield for BHP which is directly attributable to the DLC structure. If the US$500 million Singapore profit number is correct, then the DLC is effectively reducing BHP's tax bill by about US$65mpa. On an NPV basis, this is worth about US$650 million.

BHP and the Australian Tax Office have been in disagreement about both aspects of the tax treatment of the Singapore hub. The ATO believes that BHP is claiming too much mark-up from the value-adding activities of the marketing team, and also believes that all of the profits from the Australian commodities should be taxed in Australia rather than split 58%/42% across Australia and the UK (Singapore).

In 2018, BHP and ATO reached an agreement in which BHP agreed to pay additional back taxes on a no-admission of fault basis, and importantly, agreed to change the ownership of the Singapore marketing hub to 100% Australian owned. The second aspect of the settlement was effective from July 2019 and means there will no longer be any tax benefit from the DLC structure.

The second major tax implication of the DLC is the utilisation of tax losses which sit within the corporate entity which operates the Mount

Arthur thermal coal mine in the Hunter Valley. If the DLC is collapsed, BHP believes the tax losses will be lost.

One can only speculate how large the tax losses are, but since the end of FY16, the asset has generated a cumulative EBIT of around US$1236 million so it is not unreasonable to expect that some tax losses would be used. The Australian Financial Review summed up the Singapore Marketing Hub activities recently with an article which highlighted some history. Since July 2006, BHP had accumulated up to $US8.6 billion in profit on its marketing hub, none of which has been taxable in Singapore. The profit is created because since 2006 BHP Singapore had bought iron ore and other minerals from BHP companies in Australia, for a total of $US316 billion. It had paid marketing and freight expenses from Singapore, then sold the same ore (which actually never goes to Singapore) to China and Japan for $US354 billion.

About 58 per cent of this profit was ultimately attributable to BHP in Australia, so it was taxed here, but the other 42 per cent ($US3.3 billion since 2006) went to the UK-listed arm, BHP Plc, which remained tax-free. Reputational damage was one of the factors BHP's chief financial officer, Peter Beaven, cited in November 2018 when announcing a $529 million settlement deal with the ATO to cover claims dating back to 2006.

The Australian Financial Review observed that BHP reported $US517 million profit in Singapore for the June 2019 year, which triggered Australian tax of about $US90 million under the old arrangements. A similar profit for 2020, under the new arrangement, would lift Australian tax to around $US155 million. Except that BHP's tax-free status in Singapore expires in the near term. Without a new deal, Singapore will charge BHP for 11 per cent tax—and the Australia-Singapore tax treaty means that these payments will be credited against tax payable here.

Using the example quoted above, Australia's share of the tax-take would rise from $US90 million under the old system, to just $US98 million. There was speculation that BHP would be paying more tax … just not here. It's almost like BHP is sending a message to Tax Commissioner Chris Jordan.

The Australian Financial Review also observed that Rio Tinto meanwhile was still robustly denying similar ATO claims on its marketing hub. It pays 5 per cent tax in Singapore though even less than BHP overall for its UK-owned marketing operation. So what happens to the spread between share prices of the Australian and London listings? The spread

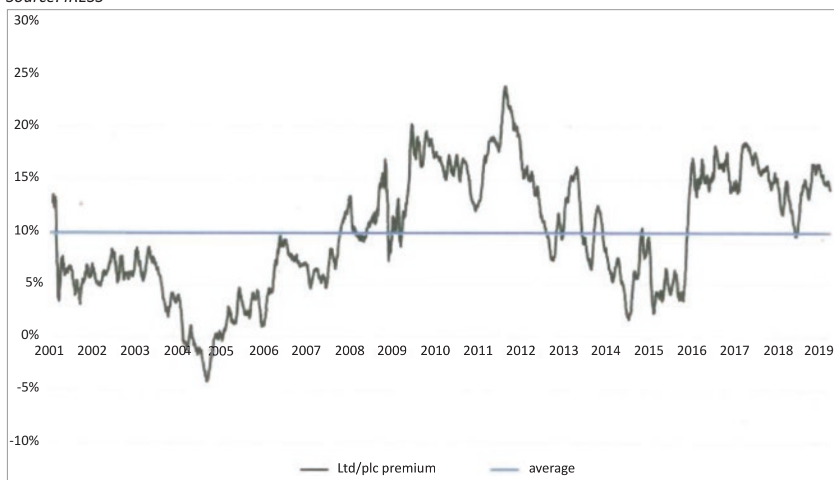
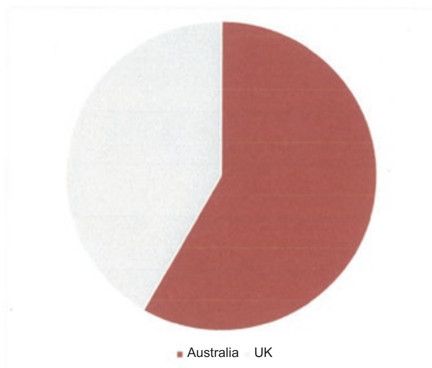


Fig. 14.5 BHP spread—premium for BHP Ltd vs BHP plc

between BHP Ltd and BHP plc has averaged 10% since the BHP Billiton merger in 2001. The spread reversed briefly in 2004, and reached a peak of 24% in late 2011 when iron ore reached US$180/t. The premium in Australia at the time of writing is sitting at around 14%, above the long-term average, which some argue is related to the current strength in iron ore (higher Australian earnings, tax payments and therefore franking credits). See Fig. 14.5.

There have been a number of possible reasons for the Australian premium postulated over the years including;

- Taxation: dividends are worth more in Australia than in the UK.
- Index exposure: BHP has a different weighting in each market and trading will be influenced by the index trackers.
- Geographical risk: there is a timing difference between the two markets. Whereas London tends to follow closely any markets movements in New York, trading in Australia is open at different times and can follow Asian markets.
- Regional analyst expectations: Australian analyst' earnings expectations for the stock may differ from analysts based in London.
- Currency: movements in the AUD GBP exchange rate can influence the relative values.



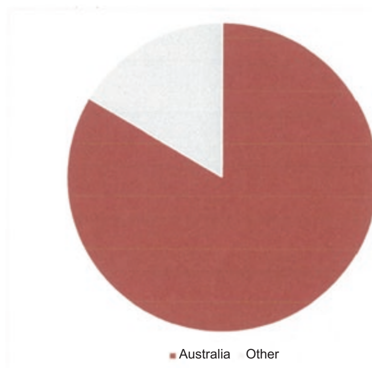


Fig. 14.6 Imbalance of share split and EBIT

Analysts believe that it is franking credits that explain the bulk of the premium, with the other factors only causing temporary diversion from the average premium.

The different share prices of the UK and Australian listing arise because of the large imbalance in the DLC in terms of where shareholders are located, and where earnings are generated (see Fig. 14.6). BHP's share split is 58% Australia and 42% UK, whereas 84% of BHP's FY19 EBIT will be generated from Australian assets and only 16% from elsewhere (mainly from petroleum in the US Gulf of Mexico and Escondida in Chile).

Franking credits were introduced in Australia to eliminate double taxation of corporate earnings. When an Australian corporate pays tax it generates a tax credit that can be attached to a dividend and distributed to shareholders.

A DLC is actually an efficient way to streaming franking credits to only those shareholders that can value them. When BHP pays out dividends, the dividends to UK shareholders are paid from earnings in the Billiton side of the DLC without franking, and the Australia shareholders receive a franked dividend.

The advantage was somewhat diluted post the South32 demerger when a number of the Billiton assets were divested. This meant that BHP needed to introduce a dividend share mechanism to pay dividends from BHP Ltd to BHP plc to make up a shortfall. This does result in franking credits being lost. It is worth noting that this is a bigger problem for Rio Tinto

(RIO) with its 80/20 Australia/UK share split, and RIO has had a dividend share mechanism in place since the start of the DLC in 1996.

- BHP's DLC structure has served its purpose and is now actively harming shareholder value -by destroying valuable franking credits, preventing the market from ascribing a proper value to the group's franking credits (both the existing stockpiled and future credits) and acting as a strategic constraint on M&A, capital returns and other matters.
- South32 was probably a missed opportunity to deal with the DLC millstone -but unification is very achievable on a standalone basis or in combination with another value-enhancing strategic transaction (e.g. a spin-off or a joint venture arrangement in WA for the Pilbara assets).
- The costs of unification are reasonable, particularly in light of the expected value benefits and the further value destruction avoided based upon a reasonable assessment of tax and other costs, unification could cost as little as A$248m (US$188m) (of stamp duties) to A$458m (US$348m) (including net loss of NPV benefits of Singapore structure).
- Key approvals for unification look readily achievable.
- Brambles is a directly analogous, almost identical precedent case study for the BHP unification, which demonstrated the strong shareholder support for achieving better long-term shareholder value through unification (with more than 99.9% of the votes in favour).
- Achieving unification and successfully distributing BHP's existing stockpile of stranded franking credits could have the effect of boosting effective yields from 4.9% to 9.7% and from 5.7% to 12.3% for superfunds with a 15% and 0% tax rate respectively.
- The benefits of unification at BHP are obvious: operational efficiency and cost savings, strategic flexibility in terms of M&A and otherwise, and a significantly enhanced market value for the group through the release and proper valuation of franking credits.

We have no doubt that the BHP Board have all the nuances of the DLC under review. We just hope someone takes the time to reflect on the dividend history of BHP, because there was a time when the company struggled to pay a fully franked dividend and heaven forbid should such event reoccur, there will certainly be some disenchanted shareholders who have

experienced the fruits of the Paul Anderson's, Chip Goodyear's and Marius Kloppers legacy only to see those benefits disappear when the cyclical nature of the resource industry or some catastrophic event appears and dividends become a premium once more.

Notwithstanding the DLC history, by 2002, the group had substantially settled down to making the most of its new structure and assets, and its position and power in its markets. The 2002 form 20-F/A reported comprehensively on the first full year of the merged entity under the DLC arrangements. While many operations were continued successfully, one unfortunate chapter in BHP's history was closed as it withdrew from the Ok Tedi mine in which significantly negative environmental and local community outcomes had occurred. BHP Billiton paid down significant amounts of money over the preceding years and had reserved further draw down of funds provisions for three further years as part of its official withdrawal arrangements. This saga is covered separately. During this period of consolidation, six Directors of the entities retired with the Board reducing from 17 to 11.

By 2003, EBITDA was US$4.9 billion, and dividends were increased by 11.5%, over the previous year. US$4.6 billion of projects were reported as within the investment pipeline and many projects had been brought in ahead of budget and timeline. Market cap was US$ 42 billion up from US$28 billion at the time of the merger. Charles 'Chip' Goodyear was appointed as CEO during this year and in his first annual report to shareholders he was able to assert that the merger process had been able to accomplish all its objectives. Mr Goodyear emphasised strategies going forward of HSEC, operational excellence, growth and portfolio management, financial strength, innovation, and capabilities through people. This period also saw the company take a historical and significant step away from its roots, through its float and sale of its steel assets reported elsewhere in this manuscript.

By 2004, Chairman, Don Argus, reported to shareholders that performance was 'Stellar'. EBITDA was US$6.7 billion, and the fruits of the value drivers, from cost efficiency through to organic growth were joined that year with some rising commodity prices, such that market cap. Rose from US$35 billion to US$58 billion during 2004. BHP Billiton outperformed the ASX 200, S&P 500, FTSE 100 by over 85%. Return on capital was 19.7%. Not all was rosy: despite aiming for zero harm and allocating significant amounts towards safety, community and other aspects of Corporate Social Responsibility (CSR), 2004 had 17 employees or

contractors die at work in the group. The growth of Chinese customers looked very positive for the future. BHP Billiton's 35,000 employees generated record sales of US$22.9 billion in 2004.

Board Visit to China—June 2005

Given the developments in China and the build-up in demand for commodities generally, we began planning a Board visit to China in 2004. We were particularly interested in a number of themes, all case studies in their own right:

- Future growth in the economy
- Strong move to self sufficiency
- RMB revaluation
- Steel and Iron Ore pricing
- Oil, energy coal and chemicals
- Banks NPLs not an issue for now
- Little respect for intellectual property
- Corporate environment very competitive
- Chinese equity market under-performing
- Property market—urbanisation or speculation
- China risks.

Long term nature of BHP Billiton's relationships in China became a priority, but we did have issues with the terms of supply contracts, price of commodities and the freight differential which favoured South American producers. In fact, BHP Billiton was seeking an increase of 71.5% in the iron ore price at the time.

BHP Billiton was also making major decisions to expand production capacity to help meet the Chinese requirements and ease the supply/demand imbalance. At the time of visiting China we regarded China's steel industry as one of the most market driver steel industries in the world. Product prices were determined by the market and investment decisions were made on the basis of returns. The industry was largely unprotected by tariffs or quotas, unlike steel industries in many other countries.

We saw the industry continuing to develop along economically rational lines and we expected smaller sub scale participants to gradually drop out and the ultimate shape of the industry to be characterised by 10–15 larger integrated producers and a slightly larger number of smaller regional

producers (versus the 250-plus industry participants who were making steel in China at the time.)

Because China's economy was booming, the pressure to rationalise was reduced and we did expect as supply expanded to meet demand, natural pricing pressures would cause margin squeeze allowing industry rationalisation to take place. Alas, this rationalisation was slower than expected as the spot price for iron ore accelerated to US$170 per tonne, and, as explained elsewhere in this manuscript, BHP Billiton shouldered the burden of price and contract negotiations without other industry players.

As we complete this case study the world is confronted with a contest between USA and China for global supremacy. There is conflict over Trade, technology, strategic intent and values with some commentators suggesting that these issues are precipitating another cold war.

The western developed world is awash with debt and about to incur further debt to save their economies as a result of the COVID-19 pandemic shutting down much economic activity and Central Bankers engaging in monetary stimulus to avoid a depression. There is no growth in these economies.

China has also announced that there will be no growth in gross domestic target this year (2020) and that they plan to lift infrastructure investment.

There has also been an indignant response from China for calls for an independent investigation to be undertaken to establish the source and circumstances of this pandemic which is threatening the health and welfare of the world's 7.7 billion citizens. Australia has been singled out for leading the call for an independent enquiry and we now have diplomats from China threatening trade retaliation with countries who pursue such activity including Australia.

When Don reflected on these activities he was reminded of a BHP Billiton's Board preparation to visit China in 2005 when it was diplomatically suggested that we visit China to get a better understanding of how to do business in that country.

Demand from China was to exceed supply in iron ore, coking coal, and manganese and we were locked into antiquated long-term contracts and a benchmark price regime. Obviously we were confronted with potential large-scale capital spending to open up our resources and whilst the demand for seaborne transport was increasing exponentially the decision to visit China as a Board was taken after extensive consultation with the Australian Government Agencies, the Department of Foreign Affairs and our people on the ground in Beijing.

The customer/supplier relationship was strong on the ground but we were under no illusion that the Chinese Communist Party was principal in the ultimate dealings, and it was imperative we all understood the risks in dealing with a Communist regime who had a blemished record in human rights and were developing expertise in cyber spying on an industrial scale.

Don vividly recalls hosting a dinner in Melbourne for the Ambassador of China, Madam Fu Ying, in 2004 before visiting Beijing in 2005. She unceremoniously launched into a lecture to the Board and Senior Management of BHP Billiton about persisting with our thrust on how BHP dealt with pricing of commodity exports to China and reminding us of the consequences if we persisted. After delivering her lecture she promptly left the meeting before finishing her dinner. Not quite the behaviour of an experienced diplomat.

Don was also mindful of the warning that Willie Purves, CEO of the Hong Kong and Shanghai Bank, had given, that he should never overlook that whilst the Chinese Communist Party will always engage in economic threats and punishment, every uttering is about politics. Even beneficial trade and investments is considered Chinese largesse which can be used to demand allegiance, obedience and silence.

2005 was once again a year of growth and reaching new performance heights. On a revenue increase of 32.3%, PBIT rose 84.8% and market cap reached $US95 billion, with the share price surging ahead of share market indexes. EBITDA was US$11 billion and the dividend was increased to 28c per share. High energy and commodity prices combined with the group's operational effectiveness in producing increasing volumes with sound efficiency, to drive outstanding financial outcomes. WMC Resources was acquired, again an expansion into related assets, with significant further development upside. New projects in copper, iron ore and petroleum were initiated. The company was riding on the crest of a wave of operational success, with most of its 100 operating assets across 25 countries running hard to meet growing demand. It had worked hard on CSR, winning prestigious international awards, which is quite an achievement for a resources company, which by its nature dealt with difficult matters in the environment and in safety terms. Significantly, the company took an innovative approach to corporate governance, being well beyond the compliance approach that characterised the risk aversion stance taken by regulators and other companies to corporate governance. Corporate governance for BHP Billiton was set up to deliver the highest levels possible of reaching corporate objectives, meaning that it was about integrity, and beyond

compliance, it was about providing the right platform for achieving effectiveness and high levels of performance.

Western Mining Resources (WMC) Acquisition

When Chip Goodyear assumed the role of CEO, there was very little concentration on his attributes as there was more interest in the former CEO's compensation payout. That news story passed with one UK analyst describing Chip as an 'impeccably groomed American former Investment banker who works out at the gym and prefers Hildon mineral water to Fosters Lager'.

Chip's legacy at BHP will be remembered for overseeing the integration of BHP and Billiton without further drama, he had been working on a China strategy well before his appointment as CEO of the Group. The world economy was volatile, the share price had dropped, but by the time he had finished his term in office the share price had tripled, dividends were strong and he had differentiated the company by educating the market on the quality of the asset base and what and when revenue would be derived from the assets held.

As described elsewhere in this manuscript, he led his people because he gave respect and his people reciprocated. Mergers and acquisitions did not over excite him but Western Mining Corporation which had been on BHP's radar for many years did get his attention, when the Anglo-Swiss Xtrata Group made a bold bid to acquire the Company. Western Mining had a rich history in nickel mining and processing, it had copper and uranium deposits at Olympic Dam in South Australia and it had a fertiliser production business in Queensland which was subsequently sold following the eventual acquisition by BHP Billiton in June 2005.

Its uranium deposits were reported to contain 33% of the world's known reserves.

Xtrata's CEO was Mick Davis, former CFO of Billiton Plc, who elected to pursue his career through Xstrata rather than become involved with the future of BHP Billiton. He was a highly respected operator and announced a takeover bid for WMC in December 2004. This initial offer of $6.35 per share was rejected by the WMC Board. The government of the day did not object to the takeover through the Foreign Investment Review Board (FIRB), however concerns were expressed due to the economic importance of the Olympic Dam Reserves.

The target's shares jumped $1.84 from $5.13 to $6.97 after the widely telegraphed $6.35 bid was swiftly rejected by the WMC Board as insufficient.

Certainly there were potential buyers out there. According to one analyst, BHP Billiton had moved three times to build up positions in WMC of just less than 5 per cent, but pulled back from the brink of the mandatorily reportable number of shares held for various reasons. After earning $4.7 billion in the last financial year it certainly had the means to launch a counter-bid.

Rio Tinto, a second oft-mentioned bidder, had no nickel mines, which would make WMC especially attractive.

WMC was the world's third-biggest nickel producer; it owned the world's biggest deposit of uranium and it was one of the world's biggest copper miners.

Anglo-American, the third of the world's global mining giants, had also been mooted as a possible bidder and it would not have been surprising to see Canadian nickel producer Inco joining the fray either.

But how high might these rivals go?

Most of the Sydney mining analysts had a target price for WMC of $4.50. So there was already a yawning chasm between those targets and WMC's trading price.

The good news was that even at those elevated levels there was unlikely to be much downside to owning WMC.

Everyone thought that there would be a change of control at WMC as a result of the bid. WMC finally put years of under-production at the company's Olympic Dam site behind it (in 2004), when the company turned in $515 million in earnings—10 times the prior year—on the back of record metal prices.

Worst case, if no counter-bidders emerged, Xstrata's $6.35 bid could have conceivably triumphed. But at the time it was difficult to see that happening.

Aside from the long list of rivals for WMC, Xstrata had already won one highly prized Australian mining asset for what many saw as a knock-down price. After the spectacularly successful acquisition of MIM (in 2003), the Swiss raider seemed unlikely to get so lucky a second time.

In February 2005, Xstrata increased its offer to A$7.20 per share with the offer remaining open until 28 February 2005.

A political circus surrounding the Government's green light for Xstrata's A$8.5 billion bid for WMC developed with the WA Government

lobbying to block the bid. Much of the lobbying centred around the argument that it was against the national interest for control of WMC's Olympic Dam copper-uranium mine to fall into foreign hands.

On 8 March 2005 BHP Billiton announced that it had appointed Deutsche Bank to assess the feasibility of acquiring a stake in WMC Resources Ltd. It also advised the market that it held an economic exposure to 50.6 million shares (4.3%) of WMC and that it would seek discussions with the Board of WMC regarding the possibility of making a cash offer for the entire issued share capital of WMC Resources.

On Friday 17 June 2005 BHP announced that it had a relevant interest in 90.95% of WMC Resources issued shares which enabled it to compulsorily acquire all of the outstanding shares in WMC under the Corporations Act.

There had been speculation about the sale of WMC for at least two years before the announcement and prior to the above announcement WMC share registry had got to a point where Hedge Funds held 45% of the capital, domestic institutions accounted for 20%, foreign institutions held 18% and retail investors 17%.

Xstrata had made a bid in October 2004 but pulled out when BHP Billiton made a counter cash bid of $7.85 per share.

After some complex share trading gymnastics, the bid was declared unconditional with target holders paid within five days of acceptance.

Did BHP Billiton lose its capital management discipline? No: from a financial point of view BHP Billiton's market rating was unaffected, the Company retained its strong liquidity position, strong free cash flows and acquired an outstanding suite of assets, which included nickel, and the Olympic Dam resource base which had the fourth largest copper mine in the world, one of the largest gold producers, and the largest uranium producer.

Fast forward 15 years; one analyst has observed that the WMC acquisition is somewhat of a mixed bag.

The prize in the acquisition was meant to be Olympic Dam, but despite the boom in copper prices through the super cycle, the assets have not only generated the returns originally expected over a 10-year period. With the large pit option apparently scrapped due to prohibitive cost and permitting challenges, the likely expansion option for Olympic Dam now seems more modest with the potential to improve over the next decade.

Progress was made in 2007 in implementing remuneration approaches for senior managers, including key principles of;

1. Provide competitive rewards
2. Apply demanding key performance indicators
3. Link a large component of pay to performance
4. Ensure equitable remuneration and limit severance payments to contractual obligations

Fixed remuneration including base salary and retirement and other benefits was to be 34% of total package, with the rest, 66% being at risk, dependent on performance and structured from short- and long-term incentives. A clear and standardised system was implemented based on KPIs and involving vested shares, options, and long-term Performance Shares.

Detailed disclosure of executive performance and remuneration was published in form F-20. Total TSR for 2007 was 23% and 26% for the (dual listed entities) group, reflecting five years of well above market performance.

2008 saw record profits once again of $15.4 billion, being the seventh consecutive year of such growth. Over that seven years, TSR had increased by 863%. With slowing economies in USA and Europe on the horizon, focus was renewed on BRIC markets.

Despite best efforts, the CEO reported numerous safety and health issues, including 11 deaths in 2007, and a renewed effort in this regard going forward.

Production and profits continued to soar. Some large new resources projects were in prospect, including Olympic Dam, Escondida, Resolution copper, EKATI Diamonds (Canada), and Titanium (Africa). Potash (fertiliser) was also identified as a potentially significant new business. Large expansions were implemented in Western Australia (iron ore), manganese, and other existing businesses.

Rio Tinto

In June 2007 BHP Billiton began preparations to launch a bid for Rio Tinto. If one uses a simple metric of dividing the market capitalisation of Rio Tinto (Rio) by BHP Billiton's (BHPB) market cap, the average of that month indicated that Rio was valued at 61% of the market cap of BHPB.

In July of 2007 Rio also acquired Alcan for US$44 billion (EV). The market's reaction was swift, quickly understanding that they had greatly overpaid for that company. It was clear to many that the acquisition was done for the wrong reasons, with some commentators observing that the initiative was to make an acquisition by BHP Billiton very difficult. The consequences of the Alcan acquisition were very quickly evident. By late July of 2007 the market cap ratio had fallen to 54.6% and by August it had fallen to 52%. This ratio, six years after the 2007 acquisition, was basically unchanged, it moved around to 53%. One could conclude that the main source of differentiation in the relative performance of the two companies during that six-year period was the misguided acquisition that Rio did in overpaying for Alcan to get away from BHPB. Nevertheless, BHPB still continued with its efforts to acquire Rio. The enormous generation of value for all shareholders became more and more evident every day.

On 1 November 2007 the Chairman of BHP Billiton (Don Argus) sent a letter to the Chairman of Rio Tinto (Paul Skinner) outlining the proposal to acquire Rio, Share ratio, equivalent to a premium of 30% based on the previous month's average market capitalisation. The letter showed preliminary estimates of synergies of US$3.7 billion per annum (later the synergies were revised upwards to US$4.4 billion). It also indicated that the anti-trust issues which would arise would be manageable and should not impact in a meaningful way either the future prospects of the combined group or the amount or achievability of synergies.

On November 5th a letter from Paul Skinner was received indicating that BHPB's proposal 'significantly undervalues Rio and its prospects', and after consideration Rio's Boards (Ltd and plc) have unanimously rejected the proposal as not in the best interests of their shareholders.

With the exception of a few fund managers in the UK, the proposal by BHPB had been received well by the market and with total credibility, indicated by the fact that the share exchange ratio overshot the 3 ratio that was initially offered.

BHP Billiton's intentions were always to complete an agreed transaction on a friendly basis. During the following months BHPB made endless attempts to meet with their counterparts on a friendly basis. In what was considered by all of BHPB's advisors as an extreme position. Paul Skinner, Leigh Clifford, Tom Albanese had met with Don Argus and Chip Goodyear in Melbourne in August 2007 for a meal and general industry discussion but thereafter Paul Skinner never agreed to meet with the Chairman or Executives of BHP Billiton. What became evident was his

opposition to the deal on what some concluded were on nationalistic grounds, Rio would remain a proud UK company. The shareholder base in the UK was substantial, but 50% of Rio's assets by value were located in Australia with a larger proportion of their profit also derived from Australia. This was not uncommon when dealing with some UK Fund Management managers; one could opine that value creation was the last consideration and local expectations a secondary issue.

On December [22nd] [dated 21st in London] BHPB was given, by the UK Takeover Panel, until the 6th of February to 'put up or shut up'. On February 6th BHPB made an offer of 3.4 BHPB Shares per Rio Share. The Offer contained a minimum acceptance condition requiring acceptances relating to more than 50 per cent of the publicly-held shares in each of Rio Tinto Limited and Rio Tinto plc. BHP Billiton also proposed a buy-back of up to US$30 billion within one year of completing the acquisition if its 3.4 for one offer was successful. What was also made evident to the market was that BHPB had a line of credit up to US$55 billion that would allow it to substitute all of Rio's debt obligations and subsequently have the cash to fulfil the announced US$30 billion buyback. A real test for the banking systems to commit to such a facility.

Regarding competition/anti-trust Regulators, BHPB began discussions in February 2008. It was always clear that the key gating approval would be iron ore and that the EU would be the lead regulator. The main argument BHPB had, which was supported by the evidence, was that the combined company would be the lowest cost producer in the world, whose main incentive would be to produce more tons, faster than anyone else.

During 2008 BHPB received antitrust clearance without remedies from the US Department of Justice and the Australian Competition and Consumer Commission (1 October 2008). BHPB had several meetings with the EU regarding remedies, and BHPB believed it could reach agreement with the EU during the last week of November 2008, concerning BHPB's offer of remedies of divesting selected assets, had it been in the interests of the company to offer those remedies.

By 2008, BHP Billiton was the world's largest resources company, with 41,000 employees and 61, 000 contractors working in over 100 operations in 25 countries. While these operations continued on a strongly governed and fully performance-oriented manner during 2008, the big initiative for that year was the ambitious offers made for Rio Tinto Shares, made on February 6, 2008. The initial offer was 3.4 BHPB shares for each of Rio Tinto.

By August 2008 it was clear that the hearts and minds of the combined shareholders had been won over. The aggressive but unsubstantiated defence that Rio had put forward had lost credibility. In fact, when one reflects on some of the statements made at the time one has to question the effectiveness and objectivity of the UK Takeover Panel. After BHPB obtained all regulatory clearances, the compelling case to acquire Rio at the prevailing offered share exchange ratio was strong. On August 29th Rio reported its financial results. The media summary summarised the day's news: 'While the consensus was that the company's underlying interim profit was solid, it was viewed as not enough to change the dynamics of the bid. BHP Billiton's response, attributed to Alberto Calderon, was effective in framing the result in the context of the transaction, leading the majority of journalists to highlight that the result represented only 37 per cent of the earnings of a combined BHP / Rio.' Indeed, The Australian's Bryan Frith probably put it best with his observation, 'Moreover, if the results of Rio and BHP were combined for the past four reporting periods, BHP would average 63.9 per cent and Rio 36.1 per cent. That doesn't support a claim that Rio has the greater momentum.' And Malcolm Maiden correctly added: 'Alcan is the weak spot in Rio Tinto's profit result, and a problem for the group as it defends against BHP Billiton's takeover offer'.

That said, the world financial crisis was destroying the world's financial system and also the commodity market. The price of copper, that averaged 8000 $/t in July 2008, had more than halved, to 3500, by November 2008; similarly for oil, that dropped from 120 to 55 $/b, and iron ore, that collapsed from 180 $/t to 65 $/t during the same period. BHP Billiton lost during that period, on an annualised basis, more than $ 40 billion of revenue. To complicate things further, the banks that had committed the $55 billion debt facility were in dire straits. It wasn't clear that they could fulfil their commitments, and even if they could, the covenants implied that BHP Billiton would have to go to the bond capital markets six months after closing the transaction. This in a period where all the capital markets were closed, where there seemed no end to the financial crisis and where one week brought worse news than the previous one.

A simple financial exercise done during the third week of November summed up the situation. If one assumed that the 'correct' ratio of Economic Value (market cap plus debt) between Rio and BHPB was the one prevailing one month before the initial offer was launched, and if one applied this ratio in November 2008, one could find the 'true',

undisturbed EV of Rio Tinto in that month. This would allow one to estimate the undisturbed true market cap of Rio. This financial calculation showed that if BHPB withdrew its offer, the share exchange ratio between the two companies would fall to 1.7 (the prevailing offer was for 3.4). The collapse in the EV of all the top world companies, combined with the fixed and very high level of debt of Rio, implied that Rio's 'real' share price would collapse if BHPB withdrew their offer.

On 25 November 2008 the Board and Management decided that it was no longer in the best interest of BHP Billiton's shareholders to complete the acquisition offer. 'We have said that we would only do this transaction if it made sense for BHP Billiton's shareholders. Recent events in the world economies have caused us real concern about the risk to our otherwise strong balance sheet that would arise from combining our company with Rio Tinto. For example, Rio Tinto has significant debt and its market capitalisation has now fallen to almost the same level as that debt.' Minutes after BHPB had withdrawn its offer, the share price of Rio collapsed, the share exchange ratio dropped even below where BHPB had anticipated, to 1.5. One of our advisors wondered if that withdrawal decision was the most price sensitive information ever in terms of aggregate $ value impact on the combined Rio and BHPB market capitalisation.

The aftermath was difficult for all, but especially for Rio, who some would opine had disregarded its obligations to look after the creation of value for its shareholders. One analyst summarised the position as follows; 'It takes many years to build a reputation as a value adding company but only months to destroy it.' For Rio the writing was on the wall with its strategic failures in iron ore marketing, the acquisition of Alcan (following an earlier discussion with BHPB), paying cash for the acquisition and failing to grasp the lifeline it was offered.

BHPB made the correct decisions for its shareholders, but there will always be a misgiving that sensible commercial practitioners were unable to reach agreement on the value such a transaction would have created, which after all is what we as servants of the company offer as non-executive directors.

There was of course much other activity occurring for both sets of shareholders not to mention the benefits that could have flowed from all transactions whilst BHPB was endeavouring to close the original offer. These are all case studies in themselves.

On 1 February 2008 Aluminium Corporation of China Ltd (Chinalco) announced the acquisition of approximately 12% of Rio Tinto plc. On 12 February 2009, the Rio Tinto board announced it would recommend to

shareholders a ‘strategic partnership’ with Chinalco. This transaction was supported by a 600+ page document, where the understanding of risk and consequences seemed to have been seriously miscalculated, given the adverse commentary in the market at the time.

There was a further attempt to consolidate the Pilbara operations and on this occasion the new Chairman of Rio Tinto, Jan du Plessis, displayed a far greater understanding of the value that could be released if all other issues could be agreed. Unfortunately this transaction did not proceed (see Fig. 14.7).

The centrepiece of the original bid and subsequent discussions was synergies which could be released with the combination of the two iron ore operations. The main assumption then, that was validated months later when BHPB signed a Heads of Agreement (HoA) to create a Joint Venture, was that Rio was long on infrastructure and BHPB was long on resources. This meant that the combination of the two operations would allow the two companies to produce more tons, and in a faster way, to sell them into the market.

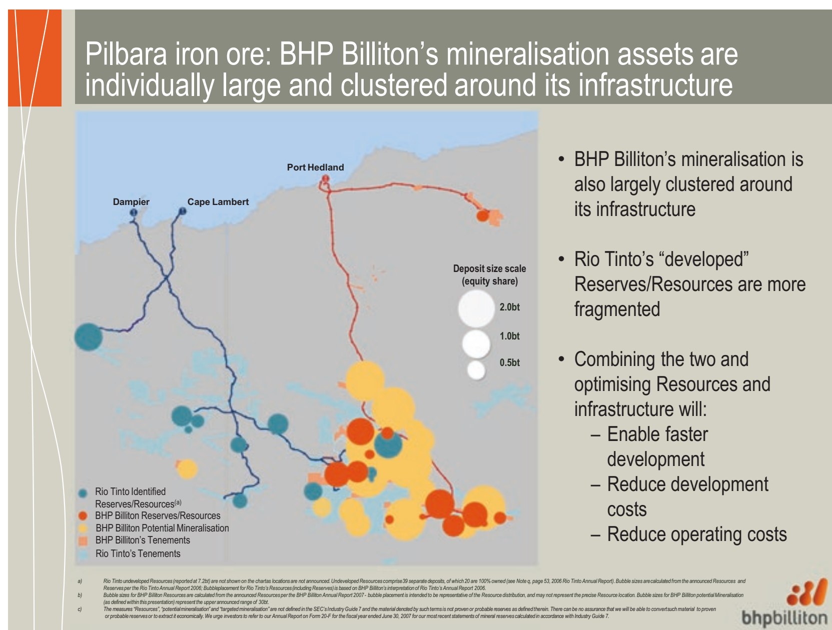


Fig. 14.7 Pilbara diagram

The HoA was signed on 5 June 2009. The Anglo-Australian miner would have gained the most initial benefit from the decision of highly indebted rival Rio to scrap its $19.5 billion fundraising pact with the Chinese. Instead of chasing a deal which threatened to leave BHPB on the sidelines, Rio was now opting for one that gave BHPB much of what it wanted. Rio, which needed the money to repay $19 billion of debt, might have preferred to go it alone but the equity markets were only judged strong enough to support a $15 billion rights issue. So it turned to BHPB to get the remaining needed cash, plus a little. BHPB would pay $5.8 billion to even out a 50–50 joint venture of the two miners' West Australian iron ore assets. The joint venture would have been good for both sides. Synergies from combining the adjacent operations were valued at $10 billion. And both Rio and BHPB were emphasising that management as well as ownership of the new company would be split evenly between the two parents. But BHPB has three reasons for extra satisfaction. First, it no longer had to compete against a rival producer that might be favoured by the largest customer. If anything, China was now likely to be less keen to buy iron ore from Rio, which jilted it on the way to the altar. Second, BHPB would achieve one of the principal gains of the merger it proposed with Rio in 2007: maximal efficiency in iron ore production. Finally, it seemed that BHPB's 50% share of the joint venture was worth a bit more than Rio's. BHPB appoints the chief executive for the first four years. Also, a crude calculation of the price per ton produced suggested BHPB was paying a little less than Chinalco offered. How did BHPB seem to be achieving a more beneficial share? Luck, in the form of an unexpected recovery in commodity and share prices, played a major role. Shareholder discontent with the Chinalco deal also helped. But the Company's main advantage was its massively under-leveraged balance sheet with just 9% gearing. Ready money would have helped BHPB achieve its goal.

Given that BHPB were able to jointly work on the synergies, the revised estimated operating cost and capital synergies from the combination was estimated to be well in excess of US$10 billion. The reasons were obvious, as can be seen from the map below: The last true 'gigantic' synergies in the mining world. As will be observed, the opposition 'at any cost' lead by the Chairman of Rio Tinto, and the poison pills that they left behind with regulators, killed not only the possibility of creating enormous value for all shareholders by BHPB acquiring Rio, but also implicitly led to the inability to get regulatory approval when we tried to get the iron ore joint venture approved in 2009.

M&A Lessons Learned

So, what does one learn from such exercises? Here we turn to the lessons articulated by a leading US merger and acquisitions expert with a proven track record and educator.

Clearly he states the obvious, that mergers are an integral part of market capitalisation, but he also says that mergers are an element of the Schumpeterian theory of creation and destruction of companies that characterises market capitalisation. (Schumpeterian theory is an economic theory named after an Austrian economist, Joseph Schumpeter. Unlike traditional economic theories his approach explains growth by innovation and entrepreneurial spirit.)

His second observation about mergers is the autogenous factors or self-produced factors. These include:

1. Increasing revenue and profitability by product or geographic expansion, acquisition of talent and intellectual property or by increasing market power.
   In some of the early financial analyses it was obvious that Rio had the infrastructure and BHP had the long-term reserves. When Marius Kloppers negotiated a change to the old benchmark pricing models in 2004, BHPB ceased being a price taker and moved more to price making which added to the compelling business case of merging these two entities. Rio did not seem to be as committed in this area as BHPB initially, and perhaps did not fully understand the effect this had on profitability.
2. Reducing costs by eliminating excess capacity and/or labour.
   There is always some market scepticism about eliminating costs and capacity in any M&A transactions. The one thing Don can confirm here is that the quality of individuals around the BHPB table was such that they fully understood and were sharply focused on the impact on each company's shareholder base if the synergy expectations embedded in the premium failed to materialise. One thing you learn very quickly when dealing with resource entities, scale is a material factor in any initiative.
3. Confidence of the management team and the Board of Directors of the acquitting company that it can effectively integrate the acquired business.
   The BHP Billiton Board was confident that BHPB and Rio had the combined management skills to integrate the entities without too much disruption. Both companies were leaders in the hard rock mining area.

4. Ego and the desire for size and diversity without regard to profitability.
   Size was never a consideration in the BHPB mindset, it was all about value. BHPB had a compelling argument as was presented to the market. It seemed from the outside that BHPB's overtures were thwarted by one man's view of the world. Others will have a view about egos and no-one is a Saint in this area. As a leader it is always wise to get all egos attached to the goals of the organisation. You have to get ego out of the individual and into the organisation as much as possible in order to maximise creativity. As an example, in large organisations it is usual to have two or more people involved in projects. A second and/or third or fourth person helps refine the original author's idea. The sooner authorship gets diluted and becomes invisible the better outcome one can achieve, and egos eliminated and prejudices resolved. BHPB had no idea who controlled the decision making on M&A activities in Rio Tinto, but the more options a Board has to consider the better the outcome.
   As a shareholder of Rio Tinto, Don still asks the question who was accountable for rejecting creation of value in a combined entity as outlined in the original offer. As recorded earlier, value was at a standstill for a number of years and only in recent times (circa 2019) has there been a marked improvement.
5. A desire to remain an independent company and sense of responsibility to all stakeholders, i.e., employees, customers, suppliers, creditors, and communities, as well as shareholders.
   Boards of any company are the stewards of someone else's money and as such it is an investor's expectation that the funds provided will be worth more a year from the original investment. Whilst we do not have an argument with Marty Lipton's thesis;

   - *Directors must strike a complex balance between competing interest groups (stakeholders) that play a role in the daily life of the Company's business and are affected by its actions.*
   - *In discharging their fiduciary duty, directors should disregard their own interests. Their purpose is to safeguard the Company's inheritance, set the framework for the future well-being of its business and then drive forward within the law and best practice.*
   - *Directors must look to the Company's short-term and long-term interests. Short-termism leads to poor corporate governance and damages a company's long-term health.*

- *Every board owes its primary duty of care to the company itself. No stakeholder (shareholder, employee, customer or activist) is entitled preferential treatment. The only exception is when a company is insolvent, at which point directors must prioritise creditors' interests over other groups.*

Marty also lists a number of exogenous factors (these are external factors) all have stories in themselves, and are too extensive to relate in this exercise:

- Availability of accounting conventions (principally those relating to depreciation and amortisation) that enhance, or at least do not detract from, profitability.
- Pressure from activist hedge funds and lack of support from institutional investors to remain an independent public company seeking long term creation of value.
- Government antitrust and competition policies.
- Availability of arbitrage to facilitate liquidity for securities that result from mergers.
- Foreign exchange fluctuations that make one currency 'cheap' and the other more favourable as merger consideration.
- Regulation and deregulation and privatisation and nationalisation by governments.
- National policies to encourage 'global champions' or to discourage foreign investment.
- The availability of experts in merger technology and in the creation of special merger currencies, such as contingent value rights and pay-in-kind debentures.
- Recognition of legitimacy of hostile takeover bids and proxy fights and the availability of experts in the waging of hostile efforts to achieve a merger.
- Labour unions, government labour policies and the political and popular power of labour generally.
- The existence of private equity funds and the amount of funds that they have available for acquisitions.
- The state of the equity and debt markets and the receptivity of the markets and banks to merger activity.
- Litigation, shareholder and class actions designed to enjoin mergers or increase the cost.

- Taxes, tax policies and potential changes therein.
- Demographic changes.
- General business and political conditions.
- Technological developments, especially breakthroughs.
- Military research, military procurement and military policies with respect to suppliers and contracting.
- Trade treaties and the creation of trade and currency blocs of nations.

The potential merger of BHP Billiton and Rio Tinto in 2007 was very persuasive. BHPB's case was based on release of enormous value for shareholders but as the rejection letter, dated November 5th 2007, indicated it was alleged that the proposal significantly undervalued Rio and its prospects. History has of course proven that assertion to be a miscalculation and we shareholders can only fantasise about what could have been.

As for the UK Fund Managers who rejected the offer initially, one could conclude that some were unable to think critically about complex market transactions.

A brief history of the attempt by BHP Billiton to acquire Rio Tinto for $**150** billion (D**e Bello)**

A chronological sequence of events	
June 2007	BHP Billiton prepared to launch a bid for Rio Tinto (Alberto Calderon decamps to London with a team exclusively to run the acquisition)
July 2007	Rio Tinto acquire Alcan for US$44 billion
August 2007	Don Argus and Chip Goodyear meet with Rio Tinto Chairman Paul Skinner, Leigh Clifford and Tom Albanese for general industry discussions.
1st November 2007	Don Argus sends letter to Chairman of Rio Tinto outlining proposal to acquire Rio Tinto shares.
5th November 2007	Letter received from Paul Skinner indicating that BHP Billiton's proposal 'significantly undervalues Rio Tinto and its prospects'.
21st December 2007	UK Takeover Panel gives BHP Billiton until 8 February 2008 to 'put up or shut up'.
6th February 2008	BHP Billiton made an offer of 3.4 BHP Billiton shares for one Rio Tinto share.
25th November 2008	BHP Billiton Board and Management decided to withdraw its offer.
5th September 2009	Heads of Agreement to discuss combining Iron Ore operations in the Pilbara.

During 2008 and 2009, the Rio Tinto proposed acquisition was the single largest strategic initiative of the group. However in 2009, the extraordinary events of the Global Financial Crisis provided external forces on the company that sorely tested every aspect of its risk management and governance frameworks. Every company in the world was impacted by the contraction, and the drop-in commodity prices impacted BHPB substantially. During this year Chairman Don Argus announced his retirement from the board, to be replaced by Jac Nasser. The decade had been one of extraordinary growth, and indeed, a reshaping of the company from being poorly performing in 1999, to be an outstanding diversified resources group in 2009.

The sharp corrections brought on as part of the GFC led to refocussing of strategy, with recognition by the CEO Marius Kloppers, successor to Chip Goodyear, that record global growth of the previous decade would not continue. China represented 20% of the group's revenue, and its renewed investments in infrastructure and building of cities fed BHPB's forecasts quite positively, going forward, even though growth rates were somewhat uncertain at that time. 2009 market cap (June 30) was US$144 billion, and net profit was US$5.9 billion on revenue of US$50 billion (down from US$59 billion the year before).

BHPB had come through the GFC with lower production rates that during the pre-GFC boom period, and with lowered revenue and profits during this period, but with its long-term strategy and assets still in place and secure, and its 'uniquely diversified and high-margin portfolio' (CEO report, 2009 annual report) providing an excellent return to investors. Marius Kloppers commented that BHPB does not need Rio Tinto within its portfolio in order to have a great future, but that the complementarity of the two firm's assets led to a value creation opportunity that was being pursued. From the market cap of June 30, 2007, of US$165 billion, BHP had suffered along with all businesses due to the GFC, but was in a financially and physically healthy position going forward to the inevitable economic recovery that would follow.

In 2010 growth and profits continued as BHPB was still the world's largest diversified natural resources company. As is often the case during downturns, a focus on productivity and cost had been implemented, and most importantly the strategy from 2001 of long term large, long life, high quality, upstream assets had continued, along with both geographic and product diversification. By 2010 dividends were up to 87c per share, and operating profit was $19.7 billion on US$52.8 billion of revenue. The completed acquisition of the Saskatchewan potash business fitted the strategy, and further diversified the revenue stream.

2011 was once again a fine year of high and growing performance. With the GFC left behind and some restoration of demand in place, in and beyond China, the Group's strategy continued unabated. Yet further growth occurred into a new class of resources, namely shale (oil) assets.

When Marius Kloppers succeeded Chip Goodyear on 1 October 2007, from the outset it was obvious that he would maintain the relentless focus on the Company's core strategy.

BHP Billiton's core strategy to invest in large, long-life, low cost, upstream and expandable assets, while remaining a simple and scalable organisation, set up originally by Paul Anderson and Chip Goodyear, remained clear and consistent during Marius' tenure. The Company had repeatedly proven that it was committed to this approach through the strategic decisions it had taken. The analyst community had commended the Company for committing and executing on this strategy over the years.

> 'The group has developed an expansive portfolio of top tier assets through a strategy of investing only in high-quality, long-life assets rather than only pursuing assets on the basis of valuation.'—Jefferies, July 2012

> 'All mining companies are looking for large, long-life, low-cost assets. Therefore, there are no easily accessible, cheap resources of this nature left. Luckily, BHP has been pursuing this strategy for some time and has a large inventory of such projects it can choose from.'—Morgan Stanley, July 2012

Focused Diversification

BHP Billiton had a more balanced portfolio with diverse commodity exposure compared to its peers. It had continued to invest to diversify its portfolio and politically stable geography through the cycle. The investment community had applauded its efforts to diversify its commodity exposure through organic growth and mergers and acquisitions which had ultimately put the Company in a position to better weather commodity and macro-economic cycles.

The common theme with Paul Anderson, Chip Goodyear and Marius Kloppers was that they all involved the Board in strategic development. Given the pressure and accountability being placed on Boards; Board members needed to take part in the strategic conversation as it developed; otherwise they may overly focus on risk mitigation, a hallmark of inexperienced or uninformed boards. With Board members like John Ralph, David Crawford, Michael Chaney, David Brink, David Jenkins, John Schubert, Jac Nasser, Robin Renwick, John Buchanan and Don Argus

worked to seek out in both informal and formal aspects of various business units' initiatives to build advocacy for initiatives was encouraged to get resources directed in the right direction.

The leadership executive teams were encouraged to attend and participate all Board meetings depending on their availability.

They shaped the Company's definition of success and all had their own way of rallying their people around a coherent course of action, which benefited the stakeholders.

In a similar way to BHP Billiton's view of the growing demand for iron ore and many other of the company's products, BHP Billiton's focus on potash also reflected a long-term view that urbanisation and increasing world population would drive growth in demand for food. Millions of people with rising incomes want to feed their families better diets with high-quality fruits and vegetables and protein from meat. With pressure on global crop supplies mounting, the need to sustainably increase production was clear. Fertiliser would play a key role in achieving this, and that the agronomic and economic opportunities which existed—and were expected in the years ahead—would encourage farmers to apply more fertiliser, especially potash. BHP Billiton invested US$2 billion in Saskatchewan giving a land holding in the world's premier potash basin. The Jansen project in Saskatchewan was designed to produce approximately 8 million tonnes per annum of agricultural grad potash, and presented BHP Billiton's first production of potash, despite unsuccessful attempts to enter through the M&A market in Russia and Canada in 2005.

Despite these growth and development objectives, BHP Billiton had also made strong progress on its commitment to simplify the portfolio including: selling its 35% interest in Richards Bay Minerals for US$1.9 billion; the sale of the Yeelirrie uranium deposit for US$430 million; the sale of the EKATI diamonds business for US$500 million; the sale of its 8.33% interest in the East Browse Joint Venture and 20% interest in the West Browse Joint Venture for US$1.63 billion. These divestments represented US$4.3 billion in completed or announced transactions in 2012.

Brownfield Growth

The commitment to continued investment in brownfield projects and capacity expansion through the cycle was one of the key element of BHP Billiton's broader strategy that set it apart from its peers. BHP Billiton had a total of 19 predominantly brownfield projects that were on-budget and

on-schedule, with the majority delivering first production before the end of the 2015 financial year. With that extensive pipeline of projects in execution, and capital and exploration expenditure of US$22 billion for the company in the 2013 financial year, they were fully committed and no major project approvals were anticipated in the near future. The completion of projects and the release of latent capacity in Escondida, Queensland Coal and the Gulf of Mexico as they recovered from temporary production issues, would underpin a compound annual volume growth rate of around 10%.

Expansions included: over US$2 billion in Iron Ore in 2010, US$5 billion in 2008; Mt Arthur coal in 2009 and 2012; Caval Ridge Mine project and expansion of the Peak Downs Mine in the northern Bowen Basin in Central Queensland, Australia; in 2008, nearly US$1 billion in the North West Shelf, US$437 million in the Cerrejon Coal mine in La Guajira, Colombia, US$320 million at Escondida and another US$2 billion in 2012; in 2012, US$845 million in Illawarra Coal.

Centralising Marketing—By centralising the marketing function and so sharing information across the businesses, BHP Billiton created important advantages:

- Greater alignment between the businesses in the Company helped de-risk the business by providing real-time insight into customer's credit and other behaviours
- Generated greater insight into the market by being able to correlate what was happening in countries, industries and regions within countries
- Made for better investment decisions by having a more informed view on both long term economic and commodity trends.

Tax—BHP Billiton led the Resources Industry's campaign with the Minerals Council of Australia against the Australian Government's planned Resources Super Profit Tax (RSPT). Following the campaign, the resources industry successfully negotiated a large restructuring of the RSPT, leading to the introduction of the Mineral Resource Rent Tax (MRRT).

The financial disciplines that had successfully guided the Company through very difficult conditions—condition that had negatively impacted many of BHP Billiton's peers and many other companies around the world, resulted in outstanding performance. That, of course, does not happen by accident.

The Company had one of the highest Return of Capital Employed (ROCE) versus its peers at 24% during Marius' tenure. This demonstrated that it had a record of both investing strategically in higher return business opportunities, and investing throughout the cycle. As an example, the Company chose to invest US$4.8 billion in its iron ore business at the depth of the global financial crisis in 2008 and the benefits of that decision became very clear. Iron ore production was expected to increase by 5% in the near term with port capacity increasing from the December 2012 quarter run-rate of 188 million tonnes per annum to 220 million tonnes per annum. Moreover, since 2007 the Company had set production records at 10 or more of its operations every year.

Bank of America noted that given BHP Billiton's hither quality asset base, the Company was one of the lowest spenders on sustaining capital relative to its peers over a period of time. With that said, BHP Billiton had been one of the highest spenders on M&A.

The superior performance of the business had also enabled BHP Billiton to create more value for its shareholders. BHP Billiton delivered strong total shareholder returns of more than 600% over the decade through to the end of the 2012 financial year. This approximately doubled that of its core peer group. Over Marius Kloppers' tenure and in the face of the global financial crisis, BHP Billiton's total shareholder return was 49.2%. Total shareholder return shown in Table 14.1 in aggregate is from the end of full year 2007 to January 31, 2013.

Table 14.1 Shareholder returns

Company	*Compounded total shareholder returns January 2008 through January 2013*[a]
BHP Billiton	49.2%
Rio Tinto	3.9%
Vale S.A	17.3%
Anglo American	-47.1%
S&P/TSX Global Mining Index	-13.4%
FTSE 100	-2.8%
ASX 200	3.3%

Source: Company Report, Capital IQ

[a]All returns stated in USD

Table 14.2 Resource company metrics

Valuation Metrics	*AAL*	*AAL*	*AAL*	*AAL*
Price/Sales (x)	2.7	2.0	3.0	1.8
Enterprise Value/Sales (x)	2.9	2.2	3.5	2.3
Dividend Payout Ratio (%)	33.5	17.3	31.8	13.6

Source: Company Report, FactSet

In regard to several valuation metrics, BHP Billiton outperformed Rio Tinto and Anglo American in price/sales and enterprise value/sales on average over a five-year period. Its dividend payout ratio was higher than Anglo American's, Rio Tinto's and Vale's over the same timeframe, see Table 14.2.

BHP Operating Model

BHP Billiton's unique operating model and global 1SAP system contributed to overall productivity and performance. This model was predicated on clear accountabilities for all its people and standard operating procedures across its global businesses. The BHP Billiton operating model delivered a simple and scalable organisation, providing a competitive advantage through defining how people work, how the company was organised and how it measured performance. By having a common set of organisation design principles, systems and processes, and a defined set of performance requirements, BHP Billiton could achieve its objective of creating long-term shareholder value through the discovery, acquisition, development and marketing of natural resources while providing a planned, controlled and safe work environment for its people and making a positive contribution to the lives of the communities in and near where the company operated and to society more generally.

BHP Billiton developed and implemented a global SAP system which managed more than 70% of the company's total external spend. The system collated and analysed BHP Billiton's expenditure across more than 20 divisions of BHP Billiton globally, making strategic sourcing activities more efficient. The spend analysis system was also used to benchmark suppliers and individual purchasing operations in different locations. For example, the volume of spend covered by contracts could be examined to determine whether better conditions or pricing might be possible. 1SAP had improved efficiency and significantly reduced overall costs.

By 2007 Marius Kloppers had been on the company management team for a decade. This allowed him to have some empirical observations about both the industry and BHP Billiton. These observations led him to the conclusion that given the size and complexity of BHP Billiton, the company was not configured for long-term sustainability without serious dis-synergies of scope and scale. 'We had built a big company without the systems and processes necessary to run a company of that size without incident and without surplus costs incurred to overcome the absence of synergies of scale and scope.'

The CEO's observations about the industry were:

- That there were (in mining) no generally accepted industry standards on how to organise and systematise a company. This was in contrast to, for example, the oil and gas multinationals, where consolidation had taken place much earlier and these standards had evolved over the decades.
- That the industry performed some basic actions (for example, fixed and mobile plant and equipment maintenance) remarkably poorly when compared to process industries and that this lack of performance was associated with generally poor planning and adherence to plan discipline.
- That there was no apparent benchmark companies in the industry that had any capability towards endogenous improvement. The general response to lack of performance was firefighting the particular issue at hand, followed by the inevitable loss of focus on the particular issue when the 'fire' had been extinguished. This cycle tended to repeat, with net progress.

In addition, observations on BHP Billiton included:

- That transparency of performance (but also accounting and other) data was very limited, given the lack of integrated systems that captured and presented data on uniform global definitions. Data went through multiple collation, adjustment and rebasing steps as it flowed upwards through the organisation. As a result, benchmarking was impossible.
- That functional people in general, but particularly in the head office, had no clear understanding of their accountabilities and how they interfaced with the businesses. This led to a generation of activity

that had not been planned and the consequent proliferation of employees without clear mandates and operating directions.
- The rate of personnel turnover meant that net accumulation of organisational knowledge was near impossible. The rate of decay outstripped even the most concerted effort at knowledge accumulation.
- That corporate policies and standards were arbitrarily set by low level personnel in the head office and allowed to grow without reference to any codified mandate or controls. There was no constraint on the generation of policy and the impact (financial and other) was rarely assessed in terms of their operational impact. The results was tens of thousands of pages of policy, unimplemented and routinely flouted by the businesses.

In order to build an organisation that could overcome these deficiencies, a multi-pronged approach was initiated. It was collectively called the operating model and it aimed to build a company that could operate and grow its businesses more sustainably. This required demonstrating that the company could, at a reasonable cost, exist without major incident and with a capability for endogenous improvement.

These initiatives were embarked on with the understanding up front that the journey was multi-year or even multi-decade. The core parts of it were:

- Clarifying responsibilities by requiring the centralised functions to articulate their mandates and seek approval for those mandates. Mandates were formulated against the core design principle that the closer a decision was made, or an action taken, to the business, the better that decision or action was likely to be. By default all decision making would rest at the business level. Exceptions were approved and work permitted through centralised functions only where it was necessary for governance or effectiveness purposes. The notion of 'effectiveness' was distinguished from 'efficiency' on the basis that cost savings, while desirable as an outcome, should only be sought through the safe delivery of more product to customers at the lowest possible cost.
- The mandates for each of the 16 designated functions allowed for the preparation and publication of a limited set of group level documents. These documents set out the minimum mandatory perfor-

mance requirements for each business and are owned by the Group Functions. The documents converted around 40,000 pages of policy into approximately 1000 performance standards all contained within approximately 1000 pages.

- Codifying single version core procedures for company, embedding them in a global 1SAP system and emphasising adherence to standard functionality and no deviations from the adopted standard. Important to this implementation were developing centralised single point accountability and control procedures and master data in order to prevent drift. The core deliverables of this system were (a) increasing the decay time of implemented procedures by rigorous change control policy, and absolute adherence to one set of procedures, as well as (b) creating transparency of performance by 'data entry at source, one version of the truth' as base framework for system design.
- Designing a base organisation for the operating businesses, codified by job type and job description to complement the standardisation of procedures, and also contributing to adoption of best practice and increasing decay time of knowledge.

The implementation had achieved critical mass with the accountabilities largely unchanged over a short period of time, costed core policies and standards in place through three annual cycles of review, and the baseline systems implementation complete in October of 2013 with the fourth phase of systems roll-out.

The benefits from the overall model were already evident, data transparency was improving, and endogenous improvement through benchmarking opportunities were being realised. Lack of performance on core processes (for example, work management) was transparent and the baseline had been laid for improvement.

Despite the programme being more successful than was envisaged at its inception, return on invested capital and effort was not complete, and turning the operational model into a core differentiator would take concerted effort over the ensuing years.

The ultimate objective of any leader is to create a world class organisation, one that is both highly productive and able to withstand competitive assault.

To make that happen leaders must unify the organisation into one holistic integrated business. A leader's approach must be embraced throughout the organisation. All policies, systems and rewards should

support the vision and goals. BHP Billiton was extremely fortunate to have been served by quality CEOs like Paul Anderson, Chip Goodyear and Marius Kloppers. At the time of writing the legacy of Andrew MacKenzie, who succeeded Marius Kloppers in 2013, is still to be resolved.

Further M&A Activities

The M&A activity during Andrew's tenure with Chairman Jac Nasser saw the investment of US$20 billion plus further development costs of US$17 billion, an impairment charge of US$13 billion and a further write-down following sale of the assets to BP for a reported US$10.8 billion. One analyst described this acquisition as an unmitigated disaster. Shale was seen as having a fast payback with internal rates of return high suggesting aggressive investment. The economics of shale were challenging not only because of capital intensity, but also because of the nature of shale oil and gas resources.

The Permian basin was much sort after because it had the most productive acreage with a higher number of 'sweet spots' or shale containing good volumes of liquids. The downside was the wells had short life and therefore, because production tapered off quickly; companies have to drill ever increasing numbers of wells to maintain production. Some commentators point out that BHP may have halved the time and the cost of drilling its wells while more than doubling the production from its acquired acreage. The rate of increased productivity across the sector has however been slowing after an initial burst due to new techniques developed in the still youthful industry.

Whilst it was disappointing that shareholders of BHP Billiton lost considerable capital in the venture, it is interesting to observe the actions of Chevron and Occidental Petroleum. They look at the US onshore oil and gas sector much more positively with their US$50 billion acquisition of shale oil and gas from Anadarko Corp. Chevron and Occidental already have the biggest portfolios of acreage in the Permian and the Anadarko holdings are contiguous with their own holding. Their investment is on scale and projects the 'highest return on investment dollar that they spend'.

Perhaps the real story here will be told in the future.

The other apparent misstep in the M&A space was the foiled attempt to acquire Potash Corp for US$40 billion in 2010. It was a complete misread of the political climate in Canada at the time. The market capitalisation of Potash Corp had been trending between US$13 billion and US$16 billion since that foray.

Notwithstanding the apparent missteps and disappointment with M&A activities, leading journalist Matt Stevens captured the most significant market pricing activity change in any industry when he wrote about the retirement of Arnoud Balhuizen, the Chief Commercial Officer of BHP. Marius Kloppers was actually the architect of a change that has generated billions of US dollars in revenue and profits for BHP and every other contributor to the seaborne trade in bulk minerals and coal plus a wealth of royalty payments to the States and income tax payment to the national exchequer.

He observed that the index-based mechanics forced on the market by BHP freed the bulk commodities world of the distraction of annual price negotiations and released the potential of scarcity pricing by making the landed price in China the benchmark for Australia's two richest commodity exports.

The switch to shorter, market-clearing pricing arrived with one other important benefit to Australian exporters.

The new marketing structures expressed and then released the value of the regional freight cost advantage that Australia enjoys over its biggest competitor in iron ore, Brazil.

It generally costs about half as much to send ore from the Pilbara to China as it does to freight it from Brazil. By standardising a landed Chinese price, BHP's marketing initiative meant the Australian miners got to bank that freight differential.

Given all that, the shift to transparent, short-term price discovery in the iron ore market was always a natural, right as was expected.

The strategy was hatched by former chief executive Marius Kloppers during his time as BHP chief commercial officer following the entry into the Indian spot iron ore market by Chinese traders seeking to fill supply gaps at home.

Those trades opened a window on the state of shortage in Chinese supply and just how much the emerging giant was prepared to pay to meet its demands by securing spot tonnes. They also opened the window on market reform that would end the 40-year-old marketing system that saw the price of iron ore, coal and a host of bulk minerals set once a year.

But the push for market reform was resisted by customers and competitors alike and, at points along the way, it was even resisted within BHP, both because it was causing too much anxiety and because many just could not quite get their heads around the need for change.

Rio Tinto, which traditionally had taken the lead in contract negotiations, had no time for the thesis and neither did the other elephant in the supply-side room, Vale of Brazil, which by that time was the single biggest producer.

The supply-short Chinese steel mills had no time for the idea either, not least because it would mean that iron ore was suddenly going to be priced on its domestic cost cure rather than on the rather more comfy supply-demand fundamentals of the existing price-setter, the Japanese steel mills.

To be clear, not only was the iron ore price set annually but the major customer represented its interests through a cartel. Understandably, Japan were not in favour of the move away from annual pricing of contracted tonnages.

The problem for Japan was that its demand was not growing and China's arrival in the seaborne markets meant an inevitable power shift.

In the end, early in 2010 China and Brazil came on board, with Baosteel and Vale joining BHP in the embrace of shorter-term pricing models in supply contract. BHP promptly warned that it would sign no new supply contracts and existing contracts would not be rolled over on anything but shorter term, index-based pricing.

That was game over for the contract huggers in Japan and at Rio Tinto. And it was game on for the iron ore industry as, to the subsequent disappointment of a world of short-sighted funds managers, the new-found wealth was poured back into expansion of the Pilbara's iron ore capacity.

We don't hear so much about over-supply and over-investment in the Pilbara these days. As we have always insisted, iron ore's post-boom bear market was as necessary as it was going to be short-lived, and the capacity installed in Western Australia's northwest would prove a multi-generational boon for our nation.

The incentive offered by Chinese-derived pricing also opened the door for other miners to create massive shareholder value and increase Australia's share of the seaborne iron ore trade.

In today's world we take all these issues for granted but the efforts of Marius Kloppers, Arnoud Balhuizen, Alberto Calderon and others should be etched in the history of Australia's economic and industrial growth.

The period from 2013 to 2016 when BHP posted its largest loss in history was a rough ride for Andrew Mackenzie his senior management team, and Jac Nasser and his Board.

Market Value of an Institution is the clearest and most reliable signal about sustainability of a company's performance although never perfect. The market price however is only the beginning and investors make their judgements about the competency and the quality of the stewards of their money, the future of the industry in which they are investing and the successful investors spend much time analysing the consensus forecasts of the enterprise and the ability of that enterprise to generate a flow of cash from corporate assets. Assets producing cash flows will ultimately return the

owners investment without depending on the whims of other providers of capital. Even if the cash flows are some distance in the future, their prospects endow them with a present value.

Figure 14.1 is indicative of how the market saw the Company and its stewards with one of the large shareholders pointing out in 2017 that South32, the company with the so-called sub scale assets, spun out from BHP's balance sheet in 2015, outperformed its larger sibling which saw its share price rise 28% compared to a 21% drop of its larger sibling, BHP, in 2017.

South32 has gone on to prove its spin-off sceptics wrong and their current CEO, Graham Kerr, and Chairperson, Karen Wood, are quick to point out that South32 still retains its value around the original float value and that has been achieved with much the same suite of assets with which it started. It is instructive to read the CEO comments that he is now replacing some of the more mature assets with assets that have strong growth with a bias to base metals.

One of the missing features in any analysis of the South32 balance sheet is the low level of debt which it carries. This should be a lesson for any student of M&A activity. The amount of debt which any balance sheet should carry is always debatable but it is particularly relevant in this case as it has been reported this was a topic of much debate of how much of BHP's US$24 billion of debt would be transferred to South 32 at the time of the float. Thanks to Chairman David Crawford's financial discipline and Graham Kerr's knowledge of commodity price curves and the mining industry generally, only US$674 million was transferred.

South32 has retained its capital discipline, it has weathered an early correction in commodity prices, it has acquired assets to complement its current portfolio, it has completed a share buyback and has accumulated sufficient cash to grow and weather any market corrections.

BHP on the other hand has been able to deliver on Andrew Mackenzie's strategy of slimming the company down, reduce its cost base and get its own debt level back under control after the setbacks outlined earlier.

Jac Nasser retired from the BHP Board in September 2017 and was replaced by Ken MacKenzie.

Andrew Mackenzie retired as CEO of BHP on 31 March 2020 and was succeeded by in-house candidate Mike Henry.

The Company moved to a new brand, BHP, in May 2018 dropping its stylised 'blobs' introduced in 2000 and shareholders approved dropping the Billiton name at the respective AGMs in October 2018. The dual listed company structure remains in place, a mystery to most shareholders who follow the stock closely.

CHAPTER 15

BHP(G): Global Strategy and the Foreign Investment Review Board (FIRB)

Introduction: A Challenging Context Post 2020

It is worthwhile examining an important area of investment growth for a small economy like Australia, and that is the Foreign Investment Review Board (FIRB) particularly in the light of recent changes introduced by the Federal Treasurer, Josh Frydenberg. The Australian Foreign Investment Review Board (FIRB) examines proposals by foreign persons to invest in Australia and makes recommendations to the Federal Treasurer on those subject to the Foreign Acquisitions and Takeovers Act 1975 and Foreign Investment Policy. It is a non-statutory body established in 1976 to advise the Treasurer and Government on Australia's Foreign Investment Policy. The Governments of the day have generally encouraged foreign investment consistent with community interests. In recognition of the contribution that foreign investment has made, and continues to make to the development of Australia, the general stance of the policy has been to welcome foreign investment. The benefits of this policy have been outlined in the Annual Reports over the years. As we complete this case study we are being challenged daily in the news about the Health and Economic risks associated with a COVID-19 virus: it is a global phenomenon and there are now projections of a world-wide recession. Whilst this pandemic is different, it is not the first pandemic or global war or global recession that humanity has seen. The one certainty after each such episode, the world is not the same as it was. There is always a new normal, and we suspect this time will be no different.

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D. Argus, D. Samson, *Strategic Leadership for Business Value Creation*,
https://doi.org/10.1007/978-981-15-9430-4_15

Many companies now have employees working from home and many will continue doing so after the virus is in check. Some will no longer want as much office space. We are clearly going to see supply chains change and the value of manufacturing closer to home is being urgently assessed. We are not convinced globalisation will end but it will change and the age of transformation will continue just as it has since the Industrial Revolution. Hopefully this correction will see the critical thinkers, whose judgments are founded on validated facts rather than modelled fantasies, emerge and all bureaucrats will be challenged by their elected politicians to review policy settings for a reset of the economic environment.

Our economy is currently facing some serious challenges as a consequence of the COVID-19 virus and the resultant stimulus packages introduced to assist the economy over a period of stress. There is genuine concern about foreign investment opportunistically targeting Australian assets as values fall. FIRB will most likely find itself under scrutiny as to whether the national interest test should be strengthened at this period of our economic uncertainty.

That said, FIRB has been criticised from time-to-time, as some of their decisions seemed to have lacked consistency of application and 'the selling of the farm' has always been an emotional sensitivity.

It is however instructive to understand a little history of Foreign Investment Policy in Australia and some of its cases. In 1978 John Howard announced the terms of arrangements for the naturalisation of foreign owned companies. At that time the Government did not believe that it would be realistic to impose a strict timetable by which companies would be required to introduce majority Australian equity.

Participating companies were not expected to commit themselves to a firm timetable for the introduction of majority Australian equity. There was a requirement that companies affected would have to advise the Government through FIRB, of practical arrangements for achieving majority Australian ownership and on progress made to that end.

In 1979 for example, CRA Limited was granted naturalising status in terms of the Government's foreign investment policy, following arrangements reached between the Government, CRA Limited and its parent company, Rio Tinto Zinc Corporation Ltd (RTZ) a UK listed entity. CRA and RTZ had committed to achieving the appropriate level of Australian ownership within a reasonable time period and were required to hold regular discussions with FIRB to report on progress being made towards naturalisation status. In 1979 Australian equity had increased from 27.4% to 38.9%.

Fast forward to *21 December 1995*: Rio Tinto plc (then RTZ Corporation Plc (RTZ)) owned 49% of Rio Tinto Limited (then CRA Limited (CRA)) at the time the Rio Tinto DLC was established.

FIRB Conditions

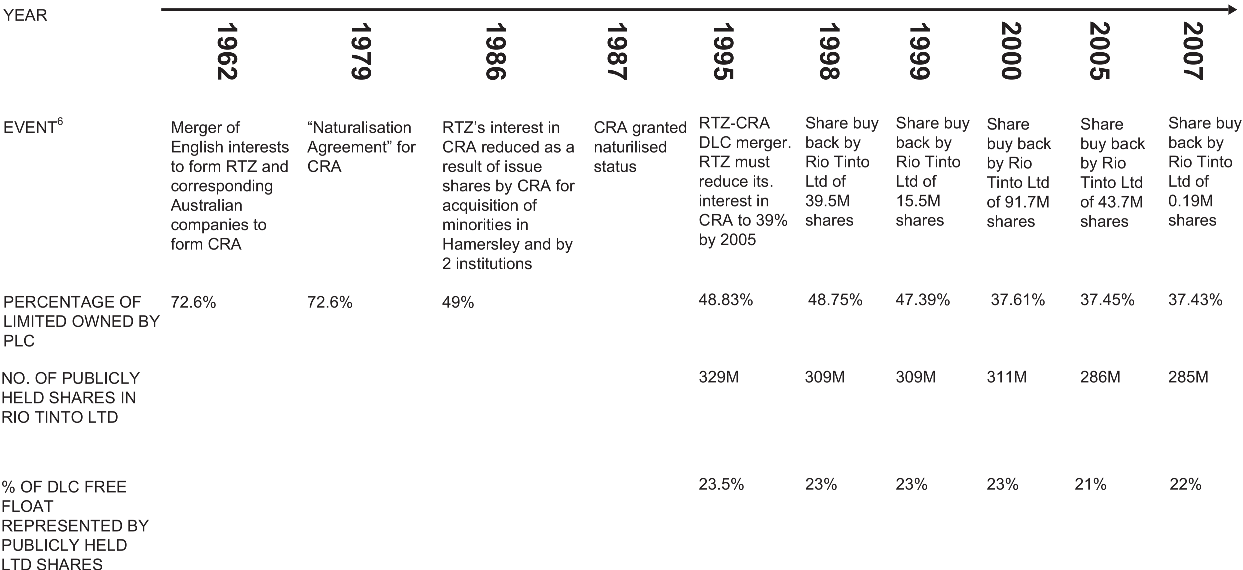
(a) RTZ's interest in CRA reduced from 49% to at most 39% by the end of 2005. No further purchases of CRA shares by RTZ.
(b) Appropriately located projects managed in Australia. Australian employees provided expertise for diamond, coal and iron ore developments overseas. Australian representation at senior levels of management of exploration group.
(c) Nominations to the Board made having regard to public shareholding in CRA.

The Headquarters location and residency of the CEO and CFO were contentious issues in the BHP Billiton merger but there was no restriction on location of headquarters, residence of CEO or CFO or procedures to be followed by Rio Tinto if it wishes to act differently to the FIRB conditions imposed on the Rio Tinto DLC merger.

Rio Tinto had conducted various buy-backs of Rio Tinto Limited shares and Rio Tinto plc shares between 1998 and 2007 (a timeline showing Australian equity vs foreign ownership in Rio Tinto is provided in Fig. 15.1). These buy-backs (in conjunction with various share issues) had resulted in the Rio Tinto DLC equity ratio (Rio Tinto Limited vs Rio Tinto plc) shifting from **37:63** to **31:69** and the ratio of publicly-held shares moving from **24:76** to **22:78**, i.e., the Australian publicly held percentage ownership of the Rio Tinto DLC had declined. (A comparison of the equity base of Rio Tinto Ltd vs Rio Tinto plc and the publicly-held shares in Rio Tinto Limited vs Rio Tinto plc is provided in Figs. 15.2 and 15.3.) One could conclude that Rio Tinto had therefore honoured its commitment not to buy further shares in CRA, however, this commitment had effectively been eroded as a result of share buy-backs.

Rio Tinto had stated that when seeking shareholder approval for buy-backs of Rio Tinto shares it would seek approval from FIRB.[1]

[1] See for example, explanatory notes to 2006, 2007 and 2008 Notice of Meeting for Rio Tinto Limited's AGM.

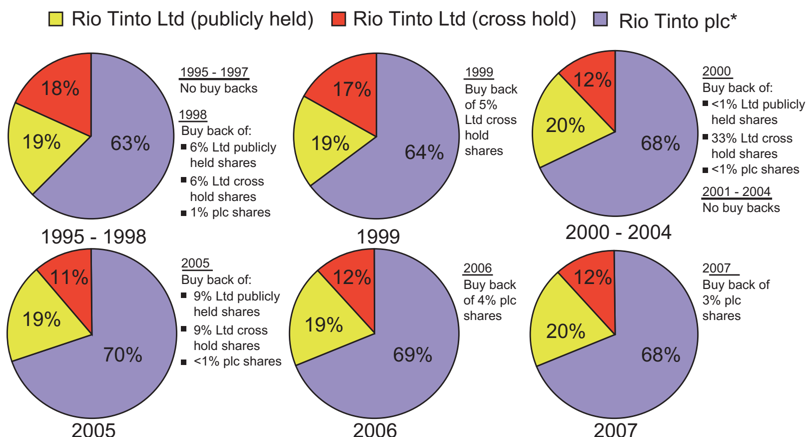


YEAR	1962	1979	1986	1987	1995	1998	1999	2000	2005	2007
EVENT[6]	Merger of English interests to form RTZ and corresponding Australian companies to form CRA	"Naturalisation Agreement" for CRA	RTZ's interest in CRA reduced as a result of issue shares by CRA for acquisition of minorities in Hamersley and by 2 institutions	CRA granted naturilised status	RTZ-CRA DLC merger. RTZ must reduce its. interest in CRA to 39% by 2005	Share buy back by Rio Tinto Ltd of 39.5M shares	Share buy back by Rio Tinto Ltd of 15.5M shares	Share buy back by Rio Tinto Ltd of 91.7M shares	Share buy back by Rio Tinto Ltd of 43.7M shares	Share buy back by Rio Tinto Ltd of 0.19M shares
PERCENTAGE OF LIMITED OWNED BY PLC	72.6%	72.6%	49%		48.83%	48.75%	47.39%	37.61%	37.45%	37.43%
NO. OF PUBLICLY HELD SHARES IN RIO TINTO LTD					329M	309M	309M	311M	286M	285M
% OF DLC FREE FLOAT REPRESENTED BY PUBLICLY HELD LTD SHARES					23.5%	23%	23%	23%	21%	22%

6 Buy backs include any buy backs of Rio Tinto pic's aharaholding in Rio Tinto Ltd.
7 This increase reflects the issue by Rio Tinto Ltd of approximately 2.5 million Rio Tinto Ltd shares in connection with the acquisition of Comaicos minorities and the acquisition of Ashion Mining.
8 This number increased as a result of Rio Tinto plc buying back approximately 59 million Rio Tinto plc shares during 2006/07.

Fig. 15.1 Rio Tinto: Australian Equity vs Foreign Ownership—Timeline

Comparison of equity base of Rio Tinto Ltd vs Rio Tinto plc

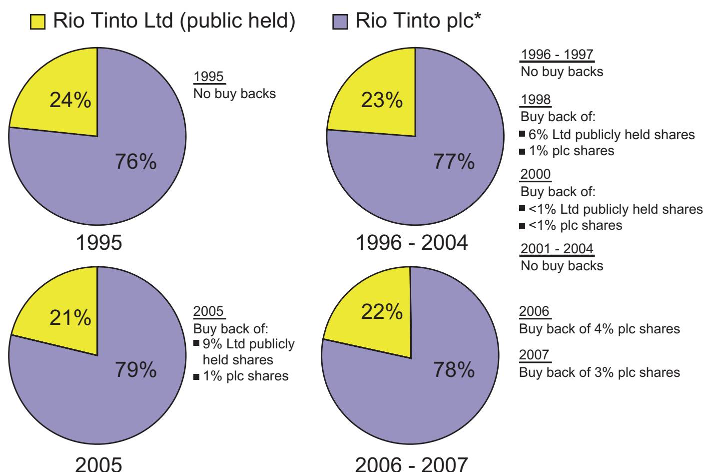


Issue of Ltd shares: For each of 1999 - 2005 and 2007, the number of shares issued comprised <1% of Ltd's total share capital
Issue of plc shares: For each of 1995 - 2007 , the number of shares issued comprised <1% of plc's total share capital

All numbers are rounded to the nearest 1% - this explains any apparent arithmetical inconsistencies.
Excludes treasury shares.

Fig. 15.2 Comparison of equity base of Rio Tinto Ltd. vs Rio Tinto plc

Comparison of publicly held shares in Rio Tinto Ltd vs Rio Tinto plc



Issue of Ltd shares: For each of 1999 - 2005 and 2007, the number of shares issued comprised <1% of Ltd's total share capital
Issue of plc shares: For each of 1995 - 2007 , the number of shares issued comprised <1% of plc's total share capital
All numbers are rounded to the nearest 1% - this explains any apparent arithmetical inconsistencies.
Excludes treasury shares.

Fig. 15.3 Comparison of publicly held shares in of Rio Tinto Ltd. vs Rio Tinto plc

Board Composition as at 2007

Rio Tinto's Board consisted of 15 Directors, 11 of whom were Non-executive Directors), two of whom were Australian. The ratio of Australian directors to the total number of directors was approximately 1:7 and of Australian directors to the total number of non-executive directors was approximately 1:6. However, the ratio of Rio Tinto Limited shares to the total number of shares of Rio Tinto Limited shares and Rio Tinto plc shares (on a publicly-held basis) was approximately 1:4, and therefore the ratio of directors to the publicly-held shares was no longer aligned.

In February 2008, the Treasurer released a set of six principles to be applied when considering applications to invest in Australia by foreign governments and their agencies. These were in addition to the considerations the Treasurer would normally consider in determining whether an investment by a foreign person in an Australian business or asset was consistent with Australia's national interest.

The factors that the Treasurer would have regard to when examining proposed investments by foreign entities were:

(a) The independence of the prospective investor's operations from the relevant foreign government (i.e. operates at arm's length). (NB: The Government was concerned whether that investor's governance arrangements could facilitate actual or potential control by a foreign government.)
(b) That the investor was subject to adequate and transparent regulation and supervision. The Government would examine the investor's governance practices, including its investment policy and how it proposes to exercise voting power.
(c) The extent to which an investment will hinder competition or lead to undue concentration or control in the industry or sectors concerned. (NB: Cross-over with the ACCC's examination of the investment.)
(d) The expected impact on Australian Government revenue.
(e) Whether the investment will impact on Australia's national security.
(f) The impact on Australian business, the economy and the broader community (including, impacts on imports, exports, local processing of materials, research and development, employment and industrial relations and the extent of Australian participation in

ownership, control and management of the enterprise after the foreign investment).

FIRB would also consider whether the foreign investor intended to seek representation on the target's board of directors. While passive investors or investors seeking the appointment of nominee directors (not resulting in a majority of the target's board being nominees of the foreign investor) were less likely to give rise to objections by FIRB in comparison to where the foreign investor seeks to control the target's board, in their opinion the nominee director could still be significantly influenced by the foreign investor.

Background: The Rio Tinto Arrangements

In 2007 when BHP Billiton was considering a merger with Rio Tinto and following some value destroying acquisitions by Rio Tinto, Chinalco, the Chinese owned State-Owned Enterprise, approached BHP Billiton to acquire a stake in the business. They would require two Board seats and their MOU would include preemptive rights to selected assets, secondment of personnel appointments in operations.

Conflict of interest test was unclear, commodity pricing sensitivity and protection of intellectual property, strategic intent and conflict resolution issues all unclear, and given the FIRB conditions applied to the BHP Billiton DLC, they elected not to proceed with their plan but instead they redirected their interest to the Rio Tinto business.

On 1 February 2008, through Shining Prospect Pte. Ltd, Chinalco acquired a 12% stake in Rio Tinto plc (equivalent to ~9% of the Rio Tinto DLC on a publicly-held shares basis). At the time of the acquisition Chinalco considered it did not need FIRB approval for the acquisition because it did not acquire any shares in the Australian arm of the DLC. For those who had been involved in the creation of two DLCs and integration of another, this was just arrogant and naïve.

In August 2008, the Treasurer, Wayne Swan, approved Chinalco acquiring up to 14.99% of the shares in Rio Tinto plc (which equated to around 11.7% of the Rio Tinto DLC (on a publicly-held shares basis).

Undertakings by Chinalco

Chinalco was required to make two undertakings:

(a) Chinalco would not raise its shareholding above 14.99% of Rio Tinto plc without notifying and receiving fresh approval from the Treasurer; and
(b) Chinalco would not seek to appoint a director to Rio Tinto plc or Rio Tinto Limited for as long as it holds a shareholding of below 15%.

Any Future Proposals

The Treasurer stated that any future proposal to increase Chinalco's level of ownership above 14.99% would require re-assessment at the relevant time against Australia's national interest under the *Foreign Acquisitions and Takeovers Act 1975* (Cth).

Given BHP Billiton's experience with Chinalco, the approach raised questions to the following key points.

Is the National Interest test satisfied?

- *Where* the interest in 100% owned unique asset are being sold to a sovereign government (who is also a competitor and customer, and who has a much lower cost of capital than other shareholders) and at the bottom of the market.
- *Where* the proposal results in a sovereign government (who is also a competitor and customer), being interwoven into the fabric of the organisation through a significant involvement in a myriad of structures. Chinalco would be integrated into the decision-making processes and information flows from the operations.
- *Where* the conflicts of interest will be numerous and resolution procedures not clear.
- *Where* one would question whether the Chinalco involvement would result in a 'straight jacket' being placed on Rio Tinto.
- *Where* shareholders had lost control of their right to determine all the Directors on the Board.
- *Where* Chinalco could act in their own interests

  – at the Strategic Alliance level, Chinalco again pursuing to have the right to act in their own commercial interests—this has the potential to conflict against the interests of Rio Tinto shareholders; and
  – at the Sales Company level, Chinalco could take into account their own interests to the exclusion of all other interests and the Directors could be required to disclose sensitive information to Chinalco.

- *Where* Rio Tinto Limited shareholders being given an opportunity to vote independently.
- *Where* Rio Tinto plc's interest combined with Chinalco's bond interest could take plc's interest in Limited from 37.5% to 44%.
- *Where* Chinalco had the right to assign their interests to any approved SOE of which there are many.
- *Where* Chinalco would have significant involvement in the iron ore group including involvement in the sales of product, access to budgets, involvement in capital decisions, ability to second personnel into the operations, review the performance of management (some of whom would be involved with sales to China);
- *Where* one could argue that product pricing tension could have been lost.
- *Where* conflict of interest procedures are unclear.
- *Where* it was not clear how you agree on new customers, production levels, and prioritisation of projects with an existing customer/ competitor?
- *Where* if Rio Tinto takes on debt from the Chinese, would this create further influence on the company.
- *Where* it was not clear how the board would assure itself that they were not losing control or leaking revenue.
- *Where* one had to ask the questions as to whether the board was across every detail and consequence of the transaction on a longer-term basis.

At the end of the day, the board was accountable for ensuring the transaction was in the company's best interests. One will never know the answers to these questions because they will only emerge over time and they are not exclusive.

The former Treasurer of Australia published an article in The Sydney Morning Herald newspaper on 18 February 2009, '*To get a view of the future it pays to look at the past*'.

In that article he responded to some criticism of why he had rejected Shell's application for oil and gas producer Woodside. He also articulated some views on the RIO/CRA transaction, BHP Billiton transaction and Chinalco's interest in Rio Tinto. The article still has relevance today. In that article, Mr Costello wrote that the key element of foreign ownership of Australian assets were conditions that can be policed, not assurances (that can be changed). He emphasised the importance of having 'flag

carrier' companies in our economy, rather than be a country of branch offices, and he explained how BHP had 'scrupulously complied' with the conditions he set in approving their DLC, implying that assurances, rather than conditions, have not and may not be effective in the case of Rio.

But Who is Chinalco?

Research at that time revealed that Chinalco was a 100% Chinese state-owned entity. It was understood that China's State Council, the highest executive body of the Chinese Government, had ownership rights over China's state-owned entities, and that the State-owned Assets Supervision and Administration Commission (SASAC) had been delegated responsibility for managing those entities, including in respect of Chinalco.[2] SASAC reports directly to the State Council.

SASAC's main functions and responsibilities included:

1. performing the responsibility as the investor, guiding and pushing forward the reform and restructuring of state-owned enterprises; supervising the preservation and increment the value of state-owned assets for enterprises under its supervision, and enhancing the management of state-owned assets; advancing the establishment of modern enterprise systems in state-owned enterprises, perfecting corporate governance; and propelling the strategic adjustment of the structure and layout of the state economy;
2. dispatching supervisory panels to some large enterprises on behalf of the state; taking charge of the daily management of supervisory panels;
3. appointing and removing top executives of enterprises, as well as evaluating their performance;
4. supervising and administering the preservation and increment of [*sic*] the value of state-owned assets;
5. drafting laws and regulations relating to the management of state-owned assets; and
6. carrying out other tasks assigned by the State Council.[3]

[2] http://www.chinalco.com.
[3] http://www.sasac.gov.cn/n2963340/n2963393/2965120.html.

The Supervisory Committee also made recommendations on appointments, dismissals, remuneration and other incentives.

The President and other members of the Executive Committee, as well as the Supervisory Committee were appointed by various bodies, including the State Council, SASAC and Chinalco employees.[4] The Executive Committee consisted of the President and seven senior managers. In an article in the Australian (February 2009), it was reported that five of the Executive Committee members of Chinalco held at one time senior party positions.[5] It was also reported that Xiao Yaqing would be promoted to deputy secretary-general of the State Council, having stepped down as Chinalco's president.[6]

According to Chinalco's website, Chinese law provides for the separation of the ownership of Chinalco and its assets from the management of its commercial operations.

The key point to note here, however, is that Chinalco is subject to the control of a Chinese state body which has responsibility for supervising and administering the preservation and increment of the value of state-owned assets generally. Whether or not Chinese law currently provides for the separation of the ownership of Chinalco and its assets from the management of its commercial operations, there is a lack of transparency in decision-making and information flows as between Chinalco, SASAC, the State Council and other Chinese Government bodies and other Chinese state-owned entities. Consequently, there is potential for:

- Chinalco to become a mere cipher for SASAC and the Chinese Government; and/or
- coordinated action by Chinese state-owned entities and the Chinese Government to further the interests of China at the expense of Rio Tinto and Australia; and/or
- SASAC (through the various state-owned enterprises that own other mining assets) to become in effect a Chinese state-owned global mining house.

[4] http://www.chinalco.com/chinalco/media/factbook/factbookfeb09/factbook-feb09.pdf.

[5] Callick, R., 'Chinalco's luxurious bet for Rio Tinto pays off', *The Australian* 14 February 2009.

[6] Mining Weekly, 'Chinalco names new head, no change to Rio deal', 19 February 2009 (www.miningweekly.com).

One could observe that the risk of coordinated action, particularly when one aggregates the proposed acquisitions by Chinalco with existing Chinese investments in Australian iron ore companies and/or assets as real. Research at the time indicated existing Chinese investments in Australian assets had become large in number.

The Rio Tinto/Chinalco Transaction

- Rio Tinto is a Dual Listed Company (DLC)
  - Rio Tinto DLC balance was 78% plc and 22% Limited (on a free float) with over 50% of the assets owned by Limited.
  - There is an existing FIRB approval specifying a maximum holding by Chinalco in Rio Tinto plc of 15%.
  - It was reported that the Rio Tinto/Chinalco transaction involved a $19.5 billion cash deal with multiple investments in key assets (iron ore, alumina) through synthetic type JV investments and a proposal to increase equity at the parent level from 15% of Rio Tinto plc to 18% of the DLC made up of 19% plc and 14.9% Limited (free float).
- There is still speculation as to why Chinalco chose to increase equity in plc. It is presumed to be because they did not consider that the Australian Government did not have jurisdiction to regulate plc. In addition, in relation to any shareholder vote that Chinalco was entitled to undertake would almost ensure that a vote in plc would determine the outcome for the DLC.
- A potential consequence was that the collapse of the DLC back into plc would be easier to achieve—in other words, a takeover of an iconic Australian company with valuable legacy assets at no premium for control.

Fast forward to current times; leading commentator and journalist, Matthew Stevens, raised the issue of the consequence of Chinalco's agreement with the Australian Government that it would not own more than 15% of the business.

The announcement by Rio Tinto to pay a $4 billion special dividend in 2019 highlighted the fact that the Company could not do a further buy-back because over time Chinalco's initial buy-in of 12% had appreciated

into 14%. That increase reflected the impact of past buy-backs because Chinalco did not sell into them.

The reason this mattered was because Chinalco had the agreement mentioned; the special dividend rather than buy-backs appears to restrict future buy-backs unless Chinalco can strike a new deal with the Australian Government of the day and that would be after referral back to FIRB, one would imagine. The diplomatic climate at the time would doubtless create a number of challenges.

It is also revealing to read an article in the UK Financial Times which raised the question as to why Rio Tinto's biggest shareholder had flexed its muscles by voting against a resolution to repurchase shares at the miner's AGM in London in April 2019.

They speculated that a buy-back of shares could result in a breach of the 15% threshold ownership ceiling imposed by the Australian Government when Chinalco first made its investment in 2008. The article further speculated that '*Chinalco's share purchase was designed to scupper the deal*'; referring to a takeover approach from BHP Billiton at that time.

The same article also speculated that Chinalco's decision to rebel against AGM Resolution 19, which needed 75% of votes cast at the AGM to pass, came amid heightened tensions between Beijing and Canberra over a decision to ban Chinese telecoms company Huawei from operating 5G networks.

This tension will doubtless escalate as the puzzle of who knew what about the outbreak of COVID-19 virus begins to unravel, and questions are answered about the integrity of data presented by all countries as to the severity of local epidemics.

Notwithstanding the above, there was also much comment when in 2005 the Federal Government gave a green light for Xstrata, the Swiss-based associate of Glencore, to takeover WMC Resources for $8.5 billion without similar conditions imposed on the BHP Billiton acquisition which were specific in terms of location of headquarters, residency of the Chief Executive Officer and the Chief Financial Officer.

The WMC bid had also become a political issue in West Australia as a result of the Swiss-based group closing down the Windimurra Vanadium mine in WA which upset the WA Government who had contributed $30 million in infrastructure support.

It was reported that the WA Government lobbied with others to block the bid, their main argument that the proposed transaction was not in the

national interest. The Treasurer of the day, Peter Costello, did not block the bid, but let the market determine the outcome.

The process did however receive worldwide press coverage with the UK Financial Times calling for a full review of FIRB with a view to scrapping the process. Doubtless Shell's $10 billion bid for outright control of Woodside in 2001 had some Investment Bankers irritated when that deal was blocked as were the terms and conditions imposed on the BHP Billiton transaction, which shocked those who peddled the concept of a reverse takeover by Billiton for BHP.

An interesting meeting of the BHP Billiton Board as guests of the Federal Government Cabinet in Canberra also revealed some residual unrest amongst some former Billiton directors who expressed concerns about the terms and conditions of the FIRB approval. The Federal Treasurer at the time, Peter Costello, explained very clearly to the gathering, the critical thinking path which was followed to achieve the decision made. An instructive exercise revealing personalities with prejudices which would prove unhelpful for a short period of time after the closure of the transaction.

We have no doubt that there are many other anecdotes which emerge from FIRB decisions. Australia does need foreign investment to keep the economy moving but we also need a robust national interest test to ensure the citizens of Australia benefit from our endowment assets. Perhaps we should consider a probationary period imposed before majority control is achieved for our iconic businesses, a vacancy tax for properties not inhabited, and a withholding tax on any asset which passes into foreign ownership and which has the capacity to contribute to GDP.

A review of the transaction to lease parts of the Port of Darwin and the Andrew's Government in Victoria deal with China under the Belt and Road Initiative may help us all to understand the FIRB policy in this sensitive and complex area.

CHAPTER 16

BHP(H): Industrial Relations

Industrial Progress?

During Don Argus' tenure as Chairman of BHP Billiton (1999–2010), he witnessed the most profound changes in our industrial relations (IR) system and our industrial relationships that BHP had ever experienced. For the first time, we were able to engage directly with our employees and to work with them to make our workplaces as productive and rewarding as they could be. We were able to communicate with our employees directly, rather than through their representatives or unions or industrial tribunals. For their part, employees were able to gain a sense of alignment with the company's direction and to share in the company's successes. Management were able to make significant gains in productivity, primarily through the removal of artificial barriers to efficiency. Management had the freedom to manage the operations as flexibly and responsively as possible, without being met with union rights of veto over their decision-making.

Whilst our labour costs increased during that period—as our employees enjoyed increased in real wages and generous working conditions, mainly through individual agreements—the efficiency gains that were achieved offset the increased costs.

At the time of retiring from the Company, Don did have significant concerns about the direction in which the new IR system was heading. Don outlined some of the signs that were likely to spook both global

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D. Argus, D. Samson, *Strategic Leadership for Business Value Creation*,
https://doi.org/10.1007/978-981-15-9430-4_16

investors in our economy and our key global customers, for whom a stable and reliable IR system is fundamentally critical.

- The quantum of emerging wage demands was of grave concern. Whilst the global financial crisis clearly had a moderating influence on the size of the wage claims that unions pursued in agreements in the past year, there were already signs that this was changing; a situation which could only be exacerbated by the future re-emergence of critical skill shortages, for example:

  - The MUA's industrial campaign against Total Marine Services to achieve a 30% wage increase over 3 years plus an allowance to bring seafarers on construction projects into line with non-marine riggers, was simply gobsmacking. Don was even more alarmed that the parties acknowledged that there were no productivity offsets to justify the increase. In other words, the employer was bludgeoned into capitulation by the force of industrial action—as the Australian Shipowners Association said, Total Marine could only 'resist repeated strike action for so long'.
  - Whilst the Government berates company Boards for giving CEOs increases tied directly to their Companies' performances, the MUA's claim was not condemned as being excessive. Indeed, the Deputy Prime Minister's spokesperson congratulated the parties on finally reaching an agreement themselves, without any external intervention: a farcical response, if you really think about it.
  - If this level of increase was to be used to establish the new 'going rate' in strongly performing industries, such as the oil and gas or resources industries, then Australia's competitive position is under genuine threat. Increases of this level, without corresponding productivity offsets, are a recipe for economic havoc. Surely the policy makers can still remember the dire consequences that industries experienced when we last saw a major wages breakout: indeed, many of those industries no longer exist on our shores (e.g., clothing and textiles, motor industry).
  - An IR system that is designed to allow employers, who have no capacity to ensure continuity of supply to their customers, to be held to ransom by industrial action to extract increases which are not economically sustainable is, in our view, fundamentally flawed.
  - Not only was the MUA's campaign directed against TMS, it was also affecting another two vessel operators (Farstad and Go

Offshore). Here again, the legislation was defective. Whilst the MUA was clearly pursuing an industry settlement and had engaged in industry negotiations, the union was still at large to take protected industrial action against an enterprise, as this tactic was not deemed to be 'pattern bargaining'.

- The unprotected action on Woodside's Pluto LNG construction project (over trite accommodation changes) can only damage Australia's international reputation with our customers. Any suggestion that BHP was no longer a reliable supplier was reputational damage that simply could not be sustained in the twenty-first century, in an industry so key to the Australian economy. Again, the legislation appears to have proved totally ineffectual in avoiding and then bringing to a stop this unlawful action. The unions and the employees displayed total disregard to Fair Work Australia's orders. If we experience a return to the bad old days when unions and their members flouted the law and held Australian industry and the community to ransom, then as a nation, we would deeply regret allowing that to happen, as the consequences in a globally exposed economy will be far more dramatic now than they were before. Yet, where was the Minister at the time—simply bemoaning that such unprotected action should not be occurring.
- The nature of the claims that we were witnessing in other industries, such as manufacturing, are also a concern as they would seriously erode the flexibilities that businesses have been able to achieve since Paul Keating first freed up the IR system, e.g.:

  - Need for union agreement for any operational changes to improve efficiencies, where there is no detriment to the employees
  - Minimum manning levels on equipment, plant, etc
  - Limitation on usage of contractors and other flexible employment types (casuals, fixed terms, etc.)
  - Frustration of the Government's intent around individual flexibility arrangements—the unions' limitation on the areas of employment that can be covered by such arrangements (i.e., meal breaks and banking of RDOs only) render them of virtually no value to employers at all
  - The incorporation of the much-heralded Modern Awards into the terms of new agreements was totally opposed by the unions, who were trying to lock employers into the old awards as they stood back in 2006.

- The Government's desire to abolish the Australian Building and Construction Commissioner and replace it with a toothless tiger, so embalmed in bureaucratic red tape, that it will be impossible to succeed in the role of 'tough cop on the block', as the Minister likes to say. This was seen as a recipe for a return to the dark ages of a 'culture of lawlessness' where industrial standover tactics and intimidation prevail on all our major building sites, significantly adding to the costs of construction in this country.

At the time of preparing these thoughts, the Fair Work Act had not had any dramatic impacts on our businesses. This was chiefly because—by and large—we had not engaged in collective bargaining, given that 99% of our agreements were still in term.

The one collective agreement that we had been negotiating was still not voted up after 10 months of protracted bargaining, even though the Company did not have a robust agenda, given that this was one of our best agreements. The fact was that long after the agreement was initially drafted and agreed with the employees, the union produced its Bargaining Manual and BHP was forced to revisit issues already settled.

Upon reflection, it was apparent that there were emerging developments that truly disturbed Don, as BHP Chairman. For instance:

- On the ground, we were witnessing the unions trying to meddle in operational decision-making (*e.g., they demand to have a say in who we appoint to jobs, through controlling the recruitment process and therefore ensuing that union supporters are employed*) and thwart key drives for increased efficiency (*e.g., frustrating our ability gain agreement for changes to start and finish times*)
- Any decision that the unions or their delegates do not like were being 'put in dispute' so that management was drowning in the onerous process soft ring to manage non-genuine disputes, rather than running their mines as efficiently as possible.
- Such unwarranted interference by the unions in denying management the capacity to manage—where it involves no detriment to their members but is simply driven by power and ego—is the very feature which caused management, more than a decade ago, to elect to bypass such nonsense and engage directly with our employees. This engagement was permitted by the legislative framework then in place.

- Nothing will do this country's competitive position more damage than an IR system that requires management to spend a substantial percentage of their time dealing with union attempts to make a business less flexible or to try to address non-value-adding 'industrial noise' through meaningless disputes, rather than focussing on making our businesses as agile, productive and responsive as possible.
- Adverse action—the legislation's new concept which allows unions to seek injunctions to stop an employer from making a decision which it is alleged could affect an employee's workplace rights—is being abused to frustrate management from being able to take disciplinary action against employees. Previously, management was permitted to manage and make decisions and, if a union were aggrieved by outcome, they could challenge it in the tribunal or pursue a breach through the Courts. However, now adverse action is being used to deny management the ability to make operational decisions and manage their employees.
- The unions were already boasting that—at the next round of collective bargaining they will win back restrictions on the use of contractors and will again dictate their rates of pay, etc. This was purely a 'big union' agenda and had little relevance or interest to our employees, when they know their job security is not at risk. Such a development would significantly damage the operational flexibility and harm our cost base to no benefit of our employees whatsoever. The unions' ability to make such claims arises from the Government's ill-advised decision to allow the unions to make demand on employers in relation to any matter (i.e., through the abolition of 'prohibited content' which protected the business from such inappropriate claims).
- As the unions firmly see themselves in the ascendancy and believe the industrial pendulum has swung back in their favour through the introduction of the Government's Fair Work legislation, they are keen to exploit the new environment to recapture the union privileges that they lost during the Workchoices era. Such privileges neither benefit their members nor our business.

Perhaps this sounds a little like 'the boy and the wolf', since employers have traditionally complained about poor work practices and the impact of excessive union behaviour on their operations. However, this time we believe it is tangibly different. We now know what productive and flexible workplaces really look like and that Australia is capable of achieving best

practice productivity and world class competitiveness. Hence, to watch as this outcome is threatened, and indeed starts to unravel, is much more painful than it ever was.

Like troglodytes, we emerged from our industrial Neolithic state into the sunshine of flexibility and rewarding employment. We all enjoyed better business outcomes and better jobs. Hence, it is not surprising that we want to vigorously resist the attempts to return us to the darkness of the prehistoric industrial cave!

BHP Progression: A Journey from Difficulty to Success

The 'mining boom' and the BHP restructuring and reallocation of assets brought it from a very difficult position in 1999–2000 to a very health footing in 2006. During these prosperous times, BHP employees had also benefitted significantly from the improved prosperity of the company.

By 2006, revenue for the BHP group had climbed to over $32 billion, with sound margins leading to profits of over $10 billion. Dividends were increased from the previous year's 28c/share to 36c. Most financial measures of growth, such as equity, revenue and profit indicated approximately 12% growth of the group. Sound acknowledgement of the business' risks included factors such as commodity prices, currency exchange, failure to discover new reserves or enhance existing reserves, lower oil and gas reserves than anticipated, HSE exposures, land tenure disputes, actions by governments, emerging markets/countries risks (such as political instability, terrorism), unsuccessful integration of acquisitions, low return on exploration investments, non-controlled assets not complying with group standards, slowdown in the Chinese market which was a major marketplace, inflation and skilled labour shortages. The group was diversified by 2006, into seven customer sector groups (CSGs), being (largest to smallest);

- Carbon steel materials
- Petroleum
- Aluminium
- Base metals
- Stainless steel
- Energy coal
- Diamonds and specialty materials
- Other (technology, freight, logistics)

Geographic diversification was also significant, with the following regions being the main revenue sources (largest to smallest):

- Europe
- China
- Japan
- Australia
- Rest of Asia
- South Africa
- South America
- Rest of world

This diversification provided investors, staff, customers and indeed all stakeholders, with a maturing profile of what was clearly an increasingly attractive set of businesses, where risk was being prudently managed (e.g. through diversification), and growth-related products and markets were being effectively pursued and captured. Further, from board level to middle management and beyond, high level principles of accountability and performance were being driven towards achieving business excellence, with initiatives such as operational excellence being inculcated through the businesses. Governance was also strengthened during this period, with much effort going in to ensuring high standards of measurement, reporting, and the achievement of high standards of integrity throughout the businesses.

The strong growth continued in 2007, with revenue at $38 billion, profit of $13.4 billion and a dividend increase to 38.5c per share. The company further highlighted that its success needed to be tempered by continuing risk watchfulness, going forward, acknowledging publicly its additional risk categories of natural catastrophes, climate change and greenhouse effects on operations, cost pressures and shortages of key resources, breaches in IT security, or in governance. These risks were not only identified, but in every category, were measured and had plans in place and implemented in order to minimise their possible negative impact. For example the group implemented a Guide to Business conduct and Anti-trust Protocols as part of its proactive governance approaches. A governance assurance framework, involving board and its committees (risk and audit, sustainability, nomination, remuneration), CEO, various audit processes was implemented. A specific Board Governance Document was published and implemented.

As Australia and the world move forward and deal with the pandemic and highly challenging economic outcomes that governments actions have necessarily occurred recently, a major question arises about which direction employee relations should best go towards over the next decade, hopefully of economic recovery.

CHAPTER 17

BHP(I): Environment

Environmental Challenges and Some History

The challenge for mining companies is to find, extract and process mineral resources with the least possible disruption to the environment. Meeting this challenge requires the adoption of a broad range of protective measures, including: sensitive treatment of land during exploration; environmental and aesthetic management of land under development; environmentally sustainable production procedures during the mining and metallurgical processes and of course decommissioning and reclamation practices aimed at restoring the land. Environmental performance and accountability are important issues for mining companies, their shareholders and the public. Most companies now include a discussion of environmental issues in their annual reports so as to keep shareholders and public informed about the steps they are taking to protect land, water and air quality at their operations. BHP produce annually an excellent document called the Sustainability Report, which covers all assets under their control.

Sustainability is one of the core values set out in its Charter which was originally set up in the Paul Anderson era, but modified to cover any new risks. Sustainability of BHP means putting health and safety first, being environmentally responsible and supporting communities generally. The wellbeing of its people, the community and the environment is considered in any endeavour undertaken.

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D. Argus, D. Samson, *Strategic Leadership for Business Value Creation*,
https://doi.org/10.1007/978-981-15-9430-4_17

Whilst the sustainability approach is admirable and has Industry leadership, BHP has not escaped accidents and missteps in the sustainability space and all of these incidents can be investigated in Annual Reports.

What has not been reported widely was BHPB's involvement in the Socio Economic Project at the Mozal Aluminium Smelter Project in Mozambique—a good news story and a humane project outcome from which is a credit to the resource industry. Along with environmental considerations, came a focus on the local social and community outcomes.

Mozal Project Profile

The Mozal aluminium smelter project is located in the Maputo province in southern Mozambique. The feasibility study for the project commenced in November 1995. Designed as an advanced, cost-efficient plant, phase 1 of the project officially started in July 1998. At a budgeted cost of US$1.18 billion, it was to be the first major development in Mozambique for 30 years and the country's largest private investment ever.

Phase 1 was successfully completed six months ahead of schedule and more than US$120 million under budget. The first aluminium was cast in June 2000, and the first ingots were exported in August that year.

In June 2001, phase 2 of the project was given the go-ahead, with a construction budget of US$860 million. The planned expansion of the smelter would double its capacity. It was completed in August 2003, seven months ahead of schedule and US$195 million under budget.

During the two construction phases, the project contributed more than US$160 million to the local economy, principally through the employment of Mozambican labour and the use of local contractors and suppliers. Since operations began, expenditure in the local economy has grown to over US$140 million per annum.

Mozal is one of the largest smelters of its kind in the western world, producing more than 500,000 tonnes of aluminium per year. The operation at that time employed more than 1100 people.

The Challenges

From its earliest days, the project presented a number of significant challenges for the Company and the Company's venture partners, Mitsubishi Corporation of Japan and the Industrial Development Corporation (IDC) of South Africa:

- Mozambique was one of the world's poorest countries, emerging from 17 years of civil war and making the difficult transition to a market-oriented economy.
- The country was hampered by fragile legal, financial and HSEC institutional structures and capacity.
- There were limited numbers of people with the training and skills required for the construction and operational phase.
- Malaria was widespread and debilitating to the local communities from which Mozal would draw most of its workforce and a threat to attracting expatriate managers and skilled workers.
- HIV/AIDS was prevalent, with infection rates exacerbated by the influx of construction workers from neighbouring South Africa.
- Public services were bureaucratic, poorly equipped and with limited capacity. Functions such as customs, immigration, public works, public health, port operations and police would be challenged to cope with the magnitude of the project.
- Infrastructure such as roads, water supply, sewerage and waste disposal was poorly developed and poorly maintained. There was limited access to appropriate, affordable housing.
- All suitable development sites were occupied by concentrations of medium to large communities that were informal in structure.
- Local commerce and industry were characterised by high prices and poor quality and service. There was limited capacity to satisfy the needs of a major, world-class project.

Acknowledging that all stakeholders had a role to play in achieving a successful and sustainable project, BHPB adopted 'Together we make a difference' as the Mozal slogan.

Mitigating Financial Risk

An initial step in the development of the project was to involve the International Finance Corporation (IFC) as a partner in phase 1. The IFC provided US$120 million, its largest single investment in the non-financial sector. This not only helped to mitigate financial risk but also facilitated loan syndication and promoted the project internationally.

The IFC has robust environmental and social policies, procedures and guidelines drawn from the World Bank Group. Requirements for strict compliance gave assurances to other lenders and the host country that

minimum standards relating to all social and environmental impacts would be achieved.

The following sections outline some of the health, safety, environment, community and socio-economic initiatives that Mozal has put in place as part of its contribution to sustainable development. Initiatives which developed and implemented by the operation and also, since 2000, through the Mozal Community Development Trust (MCDT).

Health and Safety Initiatives

While caring for the health and wellbeing of all employees, the Company also recognised the opportunity to work with host communities in setting up programmes focused on significant community health matters.

Malaria Prevention Programmes

A baseline malaria survey conducted in southern Mozambique in December 1999 showed infection rates in the area surrounding the Beluluane Industrial Park, in which Mozal is located, exceeded 85 per cent.

The MCDT conducted a spraying programme within a ten-kilometre radius of the smelter and has contributed funds to the Lubombo Special Development Initiative, a joint venture between the governments of South Africa, Mozambique and Swaziland aimed at eradicating malaria in the region.

After three years of intensive effort, the infection rate in the Beluluane area had been reduced from 85 per cent to 18.6 per cent. With a peak of more than 9000 employees during phase 1, the project introduced health measures to provide medical treatment for all workers and established a malaria diagnosis and treatment facility.

The large number of expatriate workers with no natural immunity to malaria posed a major challenge. Many thousands of cases were diagnosed and treated during phase 1. Based on these early learnings, the malaria management strategy focused on awareness, early diagnosis and prevention, resulting in malaria incidence being significantly reduced during phase 2.

HIV/AIDS Programmes

From 2001 to 2003, the MCDT sponsored the Total Control of Epidemic programme, through which approximately 200 000 people in the local

communities of Boane, Matola and Maputo were educated by a group of 100 field officers about the dangers of HIV/AIDS and how to prevent it.

Pivotal to the prevention of the disease are knowledge of status and the management of behaviour and health. Since 2001, Mozal has provided assistance for a Voluntary Counselling and Testing Centre (VCT) in Boane, managed on behalf of the Ministry of Health by a Danish NGO, Ajuda De Povos Para Povos (ADPP). Eleven satellite units of the VCT have been opened in Boane and Matola. Community leaders have been trained to manage the facilities and provide counselling services.

The control of sexually transmitted diseases and opportunistic infections is an important strategy in the fight against HIV/AIDS. With the approval of provincial authorities, Mozal has supplemented the stock levels of appropriate drugs at local clinics.

The Beluluane Public Health and Maternity Clinic

The local public health clinic, operated by the District/Provincial Health Directorate of the Mozambican Ministry of Health, serves a community of about 18 000 people within a ten-kilometre radius of the smelter. The MCDT provided the clinic with doctors' facilities, a laboratory and three residences for staff, and constructed a maternity centre within the facility. More than 300 babies have been born there since January 2003, with no fatalities.

Enfa Margarida, the maternity clinic matron, has said, 'Mozal's assistance in upgrading the Beluluane health clinic and building the maternity block has brought a lot of relief to local mothers who previously had to walk long distances for births'.

Initiatives further afield have included the provision of a mother and child health care facility within the Matola health clinic, which serves more than 300 000 people in the Matola municipality.

Community Initiatives

In the BHP Company Charter, an indicator of success is that our host communities value our presence. From the outset, community needs were identified and support programmes put in place to achieve sustainable outcomes for the community.

The Minister of Women and Social Welfare, Virgilia Matabele, has stated, 'We are pleased to note that Mozal, apart from its core business, has also been supporting the surrounding communities within the scope of its social corporate responsibilities. This is something that Mozal has

been doing long before the government formally launched the Corporate Social Responsibility initiative. With Mozal's support, many Mozambican families have seen improvement in their lives'.

Relocation of Communities

The original site proposed for the smelter was densely populated and would have required the relocation of approximately 7500 people. The social impact assessment led to an alternative site being selected, requiring the resettlement of 80 families and the provision of agricultural land for 910 farmers. The land, allocated to Mozal by the Government of Mozambique, forms part of the Beluluane Industrial Park development.

A Resettlement Action Plan was drawn up in September 1998 by ACER Africa, a specialist resettlement consultant appointed by Mozal. The government, with support and financing from Mozal, managed the relocation process in accordance with the World Bank Operational Directive on Involuntary Resettlement. Formal monitoring of the programme has indicated that the quality of life of all the affected people has improved.

The Mozal Community Development Trust

The MCDT was created by the Mozal Board in August 2000 with the specific mission of facilitating projects and programmes to improve the quality of life of the communities surrounding the Beluluane Industrial Park. Development initiatives began in January 2001 with an initial annual budget of US$2 million, which has been increasing since.

To achieve its mission, the MCDT defined four key policies.

- align development initiatives with those of national, provincial and local governments
- act as a catalyst and facilitator in establishing pilot projects that can be replicated (e.g. the IFC is funding the local replication of some projects)
- form partnerships with stakeholders to achieve sustainable results
- involve relevant stakeholders from all levels of government, non-government organisations (NGOs), communities and the private sector, as well as Mozal employees.

Approximately 200 projects and programmes have been initiated by the MCDT, with expenditure exceeding US$10 million.

Educational Projects

To overcome the lack of secondary education facilities in the region, the Nelson Mandela Secondary School was built, the first in the vicinity of Mozal. The project was a joint initiative, with Mozal providing the funding, the local communities providing ten-hectares of land and the government managing the school's construction and operation.

The school is in its second year of operation and accommodates 1800 students, with plans to expand the capacity to 2400 students. The total investment by Mozal will be around US$1 million. The MCDT has donated 41 computers to the school.

The primary school closest to Mozal was operating in an abandoned house with no roof. A new school, constructed in two phases, includes seven new classrooms, an administration unit, three staff houses and sports facilities. Twelve other primary schools in the region have been significantly upgraded with improvements that include new classrooms, sports grounds and water and electricity reticulation.

To build teaching capacity in the region, each year the MCDT supports the training of 40 teachers in new teaching methodologies and national curricula.

Community Theatre

Health and safety messages presented to Mozal's employees have also been delivered to their families through the medium of industrial theatre in residential areas.

Emphasis is placed on health and safety at work and the support needed at home to help ensure employees are fit for work. More than 100 performances have been attended by over 30,000 people.

Public Safety

A new police station has been built to improve the policing presence in the region. Four police vehicles have been supplied to improve mobility and response times. Mozal provides fuel and maintains the vehicles.

To mitigate risks associated with the increase in traffic since the project commenced, a road safety awareness campaign was initiated in conjunction with traffic police and local community leaders.

Sports

The MCDT works with the Ministry of Education and Culture, the Ministry of Youth and Sport and school directorates in promoting student

participation in sports. Support includes the funding of sports federations to provide skills development specialists and the sponsorship of annual tournaments in all the major sports.

Culture
The maintenance and development of local culture is supported by the MCDT through sponsorships of youth activities in sculpture, painting and clay handicrafts and the promotion of traditional dance and music. Funding is also provided to theatre groups, particularly those reaching outlying communities with messages related to HIV/AIDS, malaria and other social issues.

Ongoing Community Interaction
Interaction with the community is undertaken through numerous channels, among which the six-monthly Interested and Affected Parties meetings remain a cornerstone. These meetings have contributed to the building of positive relationships based on transparency and mutual trust.

Socio-Economic Initiatives
A stable, healthy and supportive society facilitates the effective operation of the business. By contributing to the social and economic fabric of the host communities, BHPB created an environment in which the business could grow and in turn support sustainable development of the region.

Workforce Training and Development
To help ensure that Mozambican workers had the skills to execute their duties in a safe and productive manner, Mozal provided funding to establish local facilities for the training of mechanical and electrical maintenance and construction workers. Training at these centres, located in Maputo and Machava, has been conducted in conjunction with the Mozambique Department of Labour training section (INEPF).

The two facilities have been able to operate autonomously since 2004. The Maputo centre conducts courses in electrical and mechanical disciplines and the Machava centre provides training in bricklaying, plumbing, carpentry, painting and welding. Several Mozambican industries are recruiting graduate trainees from the courses and sending technical staff to the centres for training.

During the two establishment phases of the project, a total of 9846 Mozambicans received training in various construction disciplines, which

resulted in over 70 per cent of the Mozal construction workforce being local.

Other initiatives by Mozal to enhance employee competency and promote career opportunities include an Operators Development Program, Supervisory Capacity Building Program, ‘MY’ Development Program (self-driven competency-based training), Assisted Education Program (degree and post-graduate education), and a Graduate Development Program (GDP).

Presently, 93 per cent of the 1105 permanent staff at Mozal are Mozambican, and efforts are continuing to maximise the number of nationals in senior management positions and to employ more women. Eighty-five women are presently employed, of which 79 are Mozambican.

Housing Project

Developing a residential area within the vicinity of the smelter was identified as being of great importance, as many employees were having difficulty buying homes, which was affecting the stability and motivation of the workforce. Under the Beluluane Land Use Management Plan established by Mozal, a site was selected and 96 houses constructed. In the second stage, now in progress, another 96 houses are being built. Mozal manages the construction process, the procurement of materials and the training of local enterprises to provide services.

Eliseu Canuma, a Superintendent of Industrial Relations at Mozal, says, ‘Entering the housing market in Mozambique for the first time is very difficult because there is no consistent housing policy in the country. The quality of the lives of the residents and that of the surrounding communities has visibly improved. Mozal is making a difference’.

Public Infrastructure

Through the Mozal project, the region has been provided with significant public infrastructure, including roads and bridges, potable water supplies, electricity supplies, telephone services, sewage treatment works, housing units and general amenities buildings.

Mozal has also funded the construction of a smelter import/export quay and infrastructure at the Matola port and a modern landfill facility to handle all hazardous waste from industries in the region.

Mozal—Focusing on Sustainability, for the Business and the Community

Careful planning of the construction and operational phases of Mozal took into account all of the challenges posed when investing in Mozambique. Since commencement, the project has complied with the environmental and social requirements of the IFC.

Following phase 1, any gaps related to the values embodied in the BHP Billiton Charter and Zero Harm philosophy were addressed in phase 2.

Commitment from the joint venturers, the contractor and subcontractors and the Mozal operations teams across project implementation, operational functions and sustainability initiatives has delivered significant achievements:

- Both project implementation phases were completed well under budget and ahead of schedule.
- Following good HSEC performance during phase 1, considerably better performance was recorded during phase 2 and the organisation of operations.
- Harmonious industrial relations are exemplified by the phase 2 construction period, totalling 16 million work hours, when no days were lost due to industrial action.
- Operational performance has exceeded design and is running at benchmark levels.
- The region and the country have benefited from needs-based infrastructure, social and community upliftment projects.
- Ongoing projects and programmes delivered by Mozal and the MCDT reinforce the principles of sustainable project implementation.

The IFC, in their publication 'The Environmental and Social Challenges of Private Sector Projects', stated that 'Mozal has set a precedent for future projects in Mozambique. It illustrates the clear advantages of incorporating environmental and social issues early in a project, and reflects the approach and procedures IFC has been refining and putting in place to deal with environmental and social issues'.

The Mozal experience demonstrates that, when establishing a major resource project, it makes good business sense to invest not only in the venture but also in the host community. Primary business objectives do not have to be sacrificed in the process. Risks can be mitigated through the

collective efforts of the business, community, governments and their instrumentalities—for 'together they make a difference'.

As indicated in the preamble to this segment, the sustainability value which forms part of the BHP Charter is the core to the strategic direction of this great Company.

Annual Reports through BHP's rich history reveals a number of accidents, misadventures and miscalculations, culminating in unintended consequences, which resulted in fines, external investigation, remediation initiatives and in some cases legal action.

There has never been any doubt about the organisations commitment to high standards of governance and transparency and the identification of risks across the many business activities, functions and processes, so necessary to delivering the strategy, long term value and maintaining the social license to operate.

CHAPTER 18

Attachment 1: BHP DLC

Transaction Information

On June 29, 2001, BHP Limited and Billiton Plc completed the formation of a Dual Listed Companies structure, or DLC. To affect the DLC, BHP Limited and Billiton Plc entered into certain contractual arrangements which were designed to place the shareholders of both companies in a position where they effectively had an interest in a single group that combined the assets and was subject to all the liabilities of both companies. BHP Billiton Limited and BHP Billiton Plc had each retained their separate corporate identities and maintained their separate stock exchange listings. BHP Billiton Limited had a primary listing on the ASX and secondary listings in London, Frankfurt, Wellington, Zurich and, in the form of ADSs, on the New York Stock Exchange. BHP Billiton Plc has a primary listing in London and secondary listings in Johannesburg and Paris. The contractual agreements that BHP Billiton Limited and BHP Billiton Plc entered into to effect the DLC consist of the:

- Implementation Agreement;
- Sharing Agreement;
- Special Voting Shares Deed;
- BHP Deed Poll Guarantee; and
- Billiton Deed Poll Guarantee.

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D. Argus, D. Samson, *Strategic Leadership for Business Value Creation*,
https://doi.org/10.1007/978-981-15-9430-4_18

In addition, BHP Billiton Limited adopted a new corporate constitution, and BHP Billiton Plc adopted a new memorandum and articles of association.

The principles embodied in the Sharing Agreement are that:

- the two companies are to operate as if they were a single unified economic entity, through Boards of Directors which comprise the same individuals and a unified senior executive management;
- the Directors of the two companies will, in addition to their duties to the company concerned, have regard to the interests of holders of shares in BHP Billiton Limited and holders of shares in BHP Billiton Plc as if the two companies were a single unified economic entity and for that purpose the Directors of each company shall take into account in the exercise of their powers the interests of the shareholders of the other; and
- the DLC equalisation principles (discussed below) must be observed.

Australian Foreign Investment Review Board (FIRB) Conditions

The Treasurer of Australia approved the dual listed merger of BHP Limited and Billiton Plc subject to the following conditions:

- BHP Limited remains an Australian resident company, incorporated under the Corporations Law, that is listed on the Australian Stock Exchange under the name 'BHP Limited' and trades under that name;
- BHP Limited remains the ultimate holding company of, and continues to ultimately manage and control the companies conducting the businesses which are presently conducted by the subsidiaries of BHP Limited, including: the Minerals, Petroleum, Steel and Services businesses for so long as those businesses form part of the combined BHP Billiton Group (the Group);
- the headquarters of BHP Limited and the global headquarters of the Group are to be in Australia;
- the headquarters of BHP Limited and the global headquarters of the Group is publicly acknowledged as being in Australia in significant public announcements and in all public documents (as that term is defined in section 88A(1)(a) of the Corporations Law);

- that both the Chief Executive Officer of the Group and Chief Financial Officer of BHP Limited have their principal place of residence in Australia;
- the majority of all regularly scheduled Board meetings and Executive Committee meetings of BHP Limited in any calendar year occurs in Australia;
- the Board of directors of BHP Limited is elected in accordance with the procedures notified in the proposal or in accordance with procedures approved by the Treasurer (for further information refer 'Directors, Senior Management and Employees—Directors and Senior Management—Directors and Officers of BHP Billiton Group'); and
- that if BHP Limited wishes to act differently to these conditions, it seeks and obtains the prior approval of the Treasurer.

For the purposes of these conditions a reference to:

1. 'BHP Limited' means BHP Limited, ACN 004028077, and includes 'BHP Billiton Limited' or other name adopted by that corporation;
2. Corporations Law (or a provision of that law) includes any re-enactment or substitution of that law (or provision);
3. 'global headquarters' includes the requirement that both the Chief Executive Officer and the Chief Financial Officer of the dual listed entities, namely BHP Limited and Billiton Plc, will be based in Australia and have their principal offices and key supporting functions in Australia. In addition, the centre of administrative and practice management of BHP Limited shall be in Australia and BHP Limited's corporate head office activities, of the kind presently carried on in Australia, will continue to be carried on in Australia.

The conditions will have effect indefinitely subject to amendment of the Act or any revocation or amendment by the Treasurer.

Pursuant to section 25(1A) of the Foreign Acquisitions and Takeovers Act 1975 (Commonwealth), the Government considers that compliance with these conditions is necessary to avoid the proposal being in conflict with the national interest. Failure to comply attracts substantial penalties under Section 25(1C) of the Act.

Management

Each of BHP Billiton Limited and BHP Billiton Plc has a Board of Directors, but each Board is comprised of the same individuals. The Boards of Directors are responsible for the overall direction of the businesses of both companies, including major policy and strategic decisions of both companies. For example, the Boards will be responsible for:

- corporate acquisitions, expenditures and divestments;
- equity and debt capital raising;
- approval of annual budgets;
- dividend policy and authorising the payment of dividends;
- appointments to the Executive Committee;
- removals from the Executive Committee;
- appointments and remuneration of key senior executives; and
- succession planning.

It is currently intended that each Board of Directors will hold seven regularly scheduled meetings each year.

A strategic management committee, called the Executive Committee, has been established. The Executive Committee has been formed under a separate corporate entity that is jointly owned by BHP Billiton Limited and BHP Billiton Plc. The Executive Committee's two main functions are:

- to consider proposals requiring the approval of both Boards of Directors and then make recommendations to the Boards in respect of the proposals, such as proposals regarding new projects or ventures, strategic and business plans, dividend policies and borrowing, treasury and risk management functions, and
- to enter into contracts with other companies in the combined group for the provision of support services.

Equalisation of Economic and Voting Rights

BHP Billiton Limited shareholders and BHP Billiton Plc shareholders have economic and voting interests in the combined group. The economic and voting interests represented by a share in one company relative to the economic and voting interests of a share in the other company is determined by reference to a ratio known as the 'Equalisation Ratio'. Initially,

the economic and voting interests attached to each BHP Billiton Limited share and each BHP Billiton Plc share will be the same, which is based on an Equalisation Ratio of 1:1.

This equalisation principle ensures that there is equitable treatment as regards the holder of one BHP Billiton Limited ordinary share and the holder of one BHP Billiton Plc ordinary share. However, the principle does not of itself establish a legal right in favour of a shareholder of one company over the assets of the other company. The principle provides that the Equalisation Ratio shall govern the economic rights of one BHP Billiton Limited ordinary share relative to one BHP Billiton Plc ordinary share (and vice versa). Where the Equalisation Ratio is 1:1, a holder of one BHP Billiton Limited ordinary share and a holder of one BHP Billiton Plc ordinary share shall, so far as practicable, receive equivalent economic returns and enjoy equivalent rights as to voting in relation to matters affecting the shareholders in similar ways.

Where an action by BHP Billiton Limited or BHP Billiton Plc is proposed such that the action would result in the ratio of the economic returns on, or voting rights of, a BHP Billiton Limited ordinary share to a BHP Billiton Plc ordinary share not being the same as the then prevailing Equalisation Ratio, or which would benefit the holders of ordinary shares in one company relative to the holders of ordinary shares in the other company, then:

- unless the Board of Directors determines that it is not practicable, a matching action, as described below under '–Matching Action' will be undertaken; or
- if no matching action is to be undertaken, an appropriate adjustment to the Equalisation Ratio shall be made,

in order to ensure that there is equitable treatment, having regard to the then prevailing Equalisation Ratio, as between the holder of one BHP Billiton Limited ordinary share and the holder of one BHP Billiton Plc ordinary share. Where the Board of Director determines that an adjustment to the Equalisation Ratio would not be appropriate or practicable in relation to an action, then the action may be undertaken provided that the action has been approved by the shareholders who are not receiving the benefit.

Rights to Assets on Insolvency

Under the terms of the Sharing Agreement, if one of the companies that is a company to the DLC is or is likely to become insolvent, it must immediately give notice to the other company. The solvent company must take steps to ensure that as soon as practicable, economic equivalence is restored as between the shareholders of the solvent company relative to the insolvent company, having regard to the Equalisation Ratio.

If the solvent company has not acted within 12 months of receipt of the notice as set out above, the solvent company must pay in full all creditors of the insolvent company and pay to the insolvent company an amount equal to that proportion of the solvent company's total market capitalisation on the date that creditors of the insolvent company were paid, such that the amount paid and the balance remaining ensure that economic equivalence is achieved. These payments would only be made to the extent that the amount paid and the balance remaining ensure that economic equivalence is achieved and to the extent that the solvent party would retain sufficient assets to pay all amounts due in respect of statutory entitlements ranking ahead of shareholders on a liquidation and to return capital to holders of shares that rank in priority to the ordinary shares.

If both companies are insolvent and, after payment of the creditors of both companies, there is a surplus in one or both of the companies, the residual surplus is shared by shareholders of both companies so as to ensure that the return on one ordinary share in each company is in proportion to the Equalisation Ratio.

Dividends

The amount of any cash dividend paid by BHP Billiton Limited in respect of each BHP Billiton Limited share will normally be matched by an equivalent cash dividend by BHP Billiton Plc in respect of each BHP Billiton Plc share, and vice versa. If one company has insufficient profits or is otherwise unable to pay the agreed dividend, the other company will, as far as practicable, enter into such transactions as are necessary so as to enable both companies to pay the equivalent quantum of dividends. The matching dividend will be calculated before deduction of any withholding taxes or tax payable by or on behalf of, or any tax benefit arising to, a shareholder.

BHP Billiton Limited's constitution allows for the issue of an equalisation share to a member of the BHP Billiton Plc Group and BHP Billiton

Plc's Articles of Association allows for the issue of an equalisation share to a member of the BHP Billiton Limited Group. If issued, distributions may be made on the equalisation shares. The amount of any such distribution would be such as the relevant board determines to be necessary, for example, to assist or enable the other company to pay matching dividends on its shares. Whether or not equalisation shares are issued, the Boards of Directors retain the flexibility to decide from case to case whether to make contractual payments from one company to the other, or to take any other action considered appropriate by the Boards to ensure the DLC equalisation principals are observed. The shareholders of both companies will not have any interest in any equalisation shares issued and the equalisation shares will carry no voting rights.

BHP Billiton Limited will declare its dividends and other distributions in US dollars but will continue to pay its dividends in Australian dollars or other currencies as its shareholders may elect in cases determined by the BHP Billiton Limited Board. BHP Billiton Plc will continue to declare its dividends and other distributions in US dollars and make payments in pounds sterling to its shareholders registered in the United Kingdom and South African rand to its shareholders registered in South Africa.

Voting

Under the terms of the DLC Agreements, the BHP Billiton Limited Constitution and the BHP Billiton Plc Articles of Association, special voting arrangements have been implemented so that the shareholders of both companies vote together as a single decision-making body on matters affecting the shareholders of each company in similar ways. Matters to be decided by the shareholders of both companies on a combined basis are referred to as 'Joint Electorate Actions'. For so long as the Equalisation Ratio remains 1:1, each BHP Billiton Limited share will effectively have the same voting rights as each BHP Billiton Plc share on Joint Electorate Actions.

The voting arrangements are secured through the constituent documents of the two companies, the Sharing Agreement, the Special Voting Shares Deed and rights attaching to a specially created Special Voting Share issued by each company and held in each case by a Special Voting Company. The shares in the Special Voting Companies are held legally and beneficially by Law Debenture Trust Corporation Plc.

In the case of certain actions in relation to which the two bodies of shareholders may have divergent interests, which are referred to as 'Class Rights Actions', the company wishing to carry out the Class Rights Action would require the prior approval of the shareholders in the other company voting separately and, where appropriate, the approval of its own shareholders voting separately.

There are four categories of matters or actions requiring shareholder decisions consisting of:

- Joint Electorate Actions;
- Class Rights Actions;
- Any action which is neither a Class Rights Action nor a Joint Electorate Action but which, under applicable law or regulation, or under the BHP Billiton Limited Constitution or the BHP Billiton Plc Articles of Association, requires shareholder approval. Such matters require only the approval of holders of shares of the company proposing to take the relevant action, unless the Board of Directors decide that such action should be treated as a Joint Electorate Action or a Class Rights Action; and
- Procedural resolutions, when considered at a shareholders' meeting at which the holder of a Special Voting Share is entitled to vote, may be voted on by the relevant Special Voting Company either in person or by proxy given to the chairman of the meeting, as it (or the chairman) thinks fit.

Matters which will require approval as a Joint Electorate Action are as follows:

- the appointment, removal or re-election of any Director of BHP Billiton Limited or BHP Billiton Plc;
- the receipt or adoption of the annual accounts of each company and any accounts prepared on a combined basis;
- a change of name by BHP Billiton Limited or BHP Billiton Plc;
- the appointment or removal of the auditors of each company;
- any proposed acquisition, disposal or other transaction of the kinds referred to in Chapters 10 and 11 of the ASX Listing Rules or Chapters 10 and 11 of the UK Listing Rules which, in any case, is required under applicable laws and regulations to be authorised by shareholders any proposed acceptance of a third-party takeover offer

by a member of the BHP Billiton Plc group in respect of any BHP Billiton Limited's shares held by that member;
- any proposed acceptance of a third-party takeover offer by a member of BHP Billiton Limited in respect of any BHP Billiton Plc shares held by that member;
- any matter considered at an annual or extraordinary general meeting of either company; and
- any other matter which the Boards of Directors decide should be approved as a Joint Electorate Action.

Joint Electorate Actions must be submitted to both companies for approval by shareholders voting at separate meetings but acting as a joint electorate. Parallel shareholders' meetings will be held on the same date or as close together in time as possible. A Joint Electorate Action will be taken to have been approved if it is approved by ordinary or special resolution of the holders of shares of one company and the holder of the Special Voting Share, voting as a single class.

At the BHP Billiton Limited shareholders meeting, voting in respect of Joint Electorate Actions will be on a poll which will, as regards the Special Voting Share, remain open for sufficient time to allow the parallel BHP Billiton Plc shareholders meeting to be held and for the votes attaching to the Special Voting Share to be ascertained and cast on the poll. On the poll, each fully paid share will have one vote, each partly paid share will have a fraction of a vote which is equivalent to the proportion which the amounts bears to the issue price of the share, and provided that the Equalisation Ratio is 1:1, the BHP Billiton Limited Special Voting Company will have the same number of votes as were validly cast for and against on the equivalent resolution at the parallel BHP Billiton Plc shareholders meeting. Through this mechanism, the votes of the shareholders at the BHP Billiton Plc meeting will be reflected at the BHP Billiton Limited meeting by the Special Voting Company casting the votes on the Special Voting Share precisely to reflect voting at the parallel BHP Billiton Plc shareholders meeting. Voting at the BHP Billiton Plc shareholders meeting with respect to Joint Electorate Actions will be conducted in the same manner as voting at the BHP Billiton Limited shareholders meeting is conducted with respect to Joint Electorate Actions.

Class Rights Actions are normally those matters on which shareholders of each company may have divergent interests and which require the approval of the holders of shares of the company not proposing to take the

action and, in some cases, the approval of the holders of shares of the company proposing to take the action. Matters which require approval as a Class Rights Action include:

- the voluntary liquidation of either company;
- certain amendments to the terms of, or termination of, the Sharing Agreement, the Special Voting Shares Deed, either of the Deed Poll Guarantees;
- amendment, removal or alteration of the effect of (including the ratification of any breach of) any existing provision in the BHP Billiton Limited Constitution or the BHP Billiton Plc Articles of Association;
- any action by one company in respect of which a matching action is not taken by the other, and in respect of which the Boards of Directors agree that an adjustment to the Equalisation Ratio would not provide an adequate or appropriate adjustment;
- a change of the corporate status of BHP Billiton Limited from a public company limited by shares registered under the Corporations Act with its primary listing on the ASX or of BHP Billiton Plc from a public listed company incorporated in England and Wales with its primary listing on the LSE; and
- any actions or matters which the Boards of Directors agree should be treated as a Class Rights Action.

If a particular matter falls both within the list of matters which constitute Joint Electorate Actions and the list of matters which constitute Class Rights Actions, such matter will be treated as a Class Rights Action.

Where a Class Rights Action that benefits the shareholders of one company is proposed, and such company is not, under applicable law and regulations or under its corporate constitution or memorandum and articles of association, required to seek approval of its shareholders, it need not convene a meeting of its shareholders, but can only undertake the action if the holder of the Special Voting Share in the company gives its written consent to the proposed action. The holder of the Special Voting Share will only give its written consent if the shareholders of the other company have passed a resolution by the requisite majority approving the action. Otherwise, the holder of the Special Voting Share must refuse to provide its consent.

At a BHP Billiton Limited shareholders' meeting, voting in respect of Class Rights Actions will be on a poll with each fully paid share having one

vote and each partly paid share having a fraction of a vote which is equivalent to the proportion which the amounts bears to the issue price of the share. BHP Billiton Limited Special Voting Company will not vote unless the proposed action to which the resolution relates is required to be approved by an equivalent resolution at a BHP Billiton Plc shareholders meeting and the proposed action has not been approved at the parallel BHP Billiton Plc shareholders meeting. In any such case, the Special Voting Company will vote to defeat the resolution at the BHP Billiton Limited shareholders meeting and the Special Voting Share will carry sufficient votes to effect such defeat. Voting at the BHP Billiton Plc shareholders meeting with respect to Class Rights Actions will be conducted in the same manner as voting at the BHP Billiton Limited shareholders meeting is conducted with respect to Class Rights Actions.

Matching Actions

In the case where an action by either BHP Billiton Limited or BHP Billiton Plc is proposed such that the ratio of the economic returns or voting rights in relation to Joint Electorate Actions of a BHP Billiton Limited share relative to a BHP Billiton Plc share would no longer be in proportion to the then existing Equalisation Ratio or which would benefit the holders of shares in one company relative to the holders of shares in the other company, then either a matching action shall be undertaken by such other company unless the Boards of Directors determine that it is not appropriate or practicable or if no matching action is to be undertaken, an appropriate adjustment to the Equalisation Ratio shall be made, in order to ensure that there is equitable treatment as regards the holder of one BHP Billiton Limited share and the holder of one BHP Billiton Plc share. However, if the Boards of Directors determine that it is not appropriate or practicable to undertake either a matching action or adjust the Equalisation Ratio in relation to an action, then the action may be undertaken after it has been approved as a Class Rights Action. In any event, no matching action is required for:

- any action which would not result in the ratio of the economic returns on, or the voting rights in relation to Joint Electorate Actions of, a holder of shares in one company to a holder of shares in the other company not being the same as the then prevailing Equalisation

Ratio, or which would not benefit the holders of shares in one company relative to the holders of shares in the other company;
- the issue of securities or the granting of rights over securities by either company pursuant to an employee share scheme;
- an issue of any securities in either company other than an offer by way of rights; or
- a buy-back, repurchase or redemption of any shares, including a share cancellation in connection with a reduction of capital, on market in compliance with the rules of the relevant stock exchange and listing rules, at or below market value or pursuant to a general offer to shareholders in both companies which, applying the Equalisation Ratio, is made on equivalent terms.

In addition, there is no requirement for a matching action, an adjustment to the Equalisation Ratio or approval as a Class Rights Action where an action is taken in circumstances where the Boards of Directors consider that the effect of such action upon the holder of a share in one company relative to its effect on the holder of a share in the other company is not material. For this purpose, an effect is taken to be 'not material' if:

- the costs to the companies of taking a matching action or seeking approval as a Class Rights Action would be, in the opinion of the Boards of Directors, disproportionate to the effect of such action upon the holders of shares in the company for whose benefit a matching action would otherwise, in the absence of an adjustment to the Equalisation Ratio or approval as a Class Rights Action, be required; and
- the adjustment that would be required to be made to the Equalisation Ratio would result in an adjustment to the relevant element of the Equalisation Ratio of less than 0.1%.

However, in considering the application of the DLC equalisation principles to any subsequent actions, the Boards of Directors will take into account the effect of all prior unadjusted actions in deciding whether a matching action, an adjustment to the Equalisation Ratio or approval as a Class Rights Action is appropriate.

In relation to any action, when calculating any economic return to the holders of shares in either company, any tax payable by or on behalf of or tax benefit arising to, such holders will be disregarded. The Boards of

Directors are not required to take into account fluctuations in exchange rates or in the market value of any securities or any other changes in circumstances arising after the date on which they make a determination as to the form and value of any matching action or the calculation of any adjustment to the Equalisation Ratio.

Cross Guarantees

Each of BHP Billiton Limited and BHP Billiton Plc has executed a Deed Poll Guarantee, pursuant to which creditors entitled to the benefit of the Deed Poll Guarantees will, to the extent possible, be placed in the same position as if the relevant debts were owed by both BHP Billiton Limited and BHP Billiton Plc combined. Each of BHP Billiton Limited and BHP Billiton Plc will in respect of obligations subject to its Deed Poll Guarantee, unconditionally and irrevocably guarantee those obligations to creditors of the other company, subject to certain exceptions, and will undertake to each of them that, if for any reason the obligation is not met on its due date, such company will pay the amount due and unpaid to the creditor upon written demand by the creditor. A demand may not be made under the guarantee without a demand first having been made on the other company or the relevant principal debtor and/or, if such recourse is required under the terms of the relevant obligation, to any other person. BHP Billiton Limited and BHP Billiton Plc may at any time agree to exclude obligations of a particular type or a particular obligation or obligations, incurred after a future time from the scope of a Deed Poll Guarantee. The Deed Poll Guarantees may be terminated at any time after the Sharing Agreement is terminated or by agreement of the parties.

Takeover Provisions

Amendments have been made to the BHP Billiton Limited Constitution and the BHP Billiton Plc Articles of Association to ensure that a person cannot gain control of one company without having made an equivalent offer to the shareholders of both companies on equivalent terms. Sanctions for breach of these provisions would include withholding of dividends, voting restrictions and the compulsory divestment of shares to the extent a shareholder and its associates exceed the relevant threshold.

BHP Billiton Limited and BHP Billiton Plc, as separate listed companies, will remain subject to the takeover laws and rules in Australia and the

United Kingdom respectively, subject to modifications to those laws in Australia and provisions in the two companies' corporate constitutions, which are intended to have the effect of:

- recognising the substantive effect of the DLC, that the two companies should be regarded as a single combined group;
- allowing the two regulatory systems to work together harmoniously and sensibly;
- respecting the acquisition limits of 20% and 30% under Australian takeovers law and the United Kingdom takeovers rules respectively; and
- avoiding any unintended impediment to any takeover of the combined group.

It is expected that under Australian takeovers law, as modified, and under the BHP Billiton Limited Constitution there will be a limit which prevents a person and its associates from exceeding a voting power threshold of 20% in relation to BHP Billiton Limited on a 'stand-alone' basis as if there were no Special Voting Share and only counting BHP Billiton Limited's ordinary shares and there will be a separate limit which prevents a person and its associates from exceeding a voting power threshold of 20% in relation to BHP Billiton Plc, calculated having regard to all the voting power on a joint electorate basis.

Under the BHP Billiton Plc Articles of Association there is a limit that prevents a person and its concert parties from exceeding a voting power threshold of 30% in relation to BHP Billiton Plc on a 'stand-alone' basis as if there were no Special Voting Share and only counting BHP Billiton Plc's ordinary shares. There will also be a separate limit which prevents a person and its associates from exceeding a voting power threshold of 20% in relation to BHP Billiton Plc, calculated having regard to all the voting power on a joint electorate basis. Under the United Kingdom City Code a compulsory offer will be required where a person and persons acting in concert with it acquires 30% of the voting rights of a company will apply to the voting rights of BHP Billiton Plc on the joint electorate basis.

The principal requirement for exceeding a limit is for all shareholders in both companies to be treated in an equivalent manner and sanctions may be imposed for breaches of these provisions. The BHP Billiton Limited Constitution has been amended to provide in effect that a person may only exceed any of these limits if an equivalent opportunity is provided to

both BHP Billiton Limited shareholders and BHP Billiton Plc shareholders. In summary, this would require:

- an equivalent procedure for the shares of both companies, such as an off market takeover offer;
- that each procedure comply with the takeover laws and rules in Australia as regards the offer for the BHP Billiton Limited shares and in the United Kingdom as regards the offer for the BHP Billiton Plc shares; and
- equivalent consideration, terms, information and time to consider being offered to the two groups of shareholders, both in relation to an initial offer and any increases or extensions.

With equivalent treatment in terms of the opportunities afforded to each group of shareholders, each group of shareholders will make its own decision as to whether the relevant offer is to be accepted. It is possible that one offer will become unconditional because the minimum acceptance condition is satisfied but that the other offer does not become unconditional because the equivalent minimum acceptance condition is not satisfied. Under the BHP Billiton Limited Constitution and the BHP Billiton Plc Articles of Association, if a person breaches a shareholding limit without providing equivalent opportunities to both groups of shareholders, then each company has the power to deny voting and dividend rights in respect of that number of shares which results in the threshold being exceeded, and powers to dispose of that same number of shares. The powers only extend to that number of shares which exceed the threshold.

Bonus Issue

Under the terms of the DLC Implementation Agreement one existing BHP Billiton Plc share had an economic interest equivalent to 0.4842 existing BHP Billiton Limited shares. In order to ensure that the economic and voting interest of each BHP Billiton Limited and BHP Billiton Plc share was equivalent following implementation of the DLC, there was a bonus issue to BHP Billiton Limited shareholders at a ratio of 1.0651 additional BHP Billiton Limited shares for each existing share held. The bonus share issue was effective July 5, 2001.

CHAPTER 19

Brambles: Dual Listed Company Structures

Introduction

Business leaders have over the years been presented with every imaginable idea—many of them short term and loaded with risk; some hare-brained and down-right dangerous. But occasionally ideas came along that were truly well designed and thought through—ideas that solved intractable corporate problems and helped create long term sustainable value or avoid its destruction. Oddly enough, the good ideas were often also old ideas—refreshed for current issues and times but with enough history to ensure they were not just the latest corporate 'fad'. The investment banking, legal and accounting fraternities spend an extraordinary amount of time and effort developing ideas to pitch to clients—ideas for mergers, corporate reconstructions and financial products: they pitch these with enough detail to make them sound interesting, but also with enough complexity to ensure the client can't work it out alone. They hope of course to earn tidy fees if the client decides to press ahead. In reality, the client often ends up doing a lot of the leg work if they do proceed—the devil is usually in the detail—but the fact remains that few companies are set up or adequately resourced to develop sophisticated structural ideas or financial solutions on their own, nor in our view should they be. This is where the banking and professional firms shine, and can add significant value.

One such idea with which Don became deeply involved from early 2000 onwards was the use of a 'dual listed companies structure' or 'DLC'

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D. Argus, D. Samson, *Strategic Leadership for Business Value Creation*,
https://doi.org/10.1007/978-981-15-9430-4_19

to implement mergers which were otherwise impossible to achieve: specifically, the mergers in 2001 of the Australian company, Broken Hill Proprietary Company Limited (BHP) with the Anglo-Dutch company Billiton plc to create the dual listed BHP-Billiton Group; and of the Australian company Brambles Industries Limited (BIL) with the support services activities of the UK based GKN plc, creating the dual listed Brambles Group.

The structures we used to implement the BHP-Billiton and Brambles DLCs were virtually identical and resulted in the creation of Australia-United Kingdom dual listed groups. The particular reasons for doing so were of course different in each case but, fundamentally, we did so to overcome significant corporate and strategic challenges, uniting disparate operations under a single, common economic and governance structure which would not otherwise have been achievable. And in doing so, we reinvigorated both organisations, creating global powerhouses in their respective fields.

We also avoided potentially damaging alternative outcomes—alternatives which could ultimately have seen the loss of corporate icons from their respective markets. Moreover, in moving to a DLC structure, we chose to adopt a common, highest global standard for corporate governance across both Groups. It is our belief that, in doing so, we did our bit to raise the bar for corporate governance.

The creation of a DLC delivered some very interesting investment challenges for Australian shareholders who at the time of writing this case study benefit from dividend imputation which is a corporate tax system in which some or all of the tax paid by a company may be attributed by way of a tax credit to reduce the income tax payable on distribution. In comparison to the classical system, it reduces or eliminates the tax disadvantages of distributing dividends to shareholders by only requiring them to pay the difference between the corporate rate and their marginal rate.

The Australian tax system allows companies to attach franking credits to dividends paid. A franking credit is a nominal unit of tax paid by companies using dividend imputation. Franking credits are passed onto shareholders along with dividends. Shareholders then include in their assessable income not the dividends received, but the grossed-up amount back calculated from that dividend and the current tax rate, then have their income tax payable calculated thereupon, then using franking credits to offset tax payable at the rate of a dollar per credit in Australia and New Zealand. The end result is the elimination of double taxation upon company profits.

Brambles: A Growth Future Divided

When Don joined the Board of Brambles Industries Limited as a non-executive director in March 1999, the then 125-year-old Australian company was coming off a long growth phase. One of the few Australian corporate icons, Brambles had interests in a broad portfolio of disparate businesses around the world. The company had followed the difficult path of an industrial conglomerate and, for a long time, that strategy had been seen as successful. But like so many other conglomerates, performance was as varied as the markets served: while Brambles had many successes, there were also performance issues and, as the group grew in scale and complexity, effective oversight became progressively more challenging. It was clear that the group needed to be rationalised but, with no single business forming a dominant part of the portfolio, even in a simplified form, Brambles as a group would continue to involve a portfolio of business interests.

The situation was further compounded by the fact that two of Brambles' key businesses were not wholly owned in certain key markets. Rather, they held non-controlling investments in those operations through a joint venture with the British company, GKN plc. The businesses covered by the joint venture were the UK and US operations of CHEP—the world's largest pallet and container management business; and the UK and European operations of Cleanaway—a major player in the waste management business.

Having begun in 1974, these joint venture arrangements with GKN had been designed to de-risk Brambles' early expansion into new overseas markets. No doubt they served that purpose well, but they also created a great deal of complexity for the Board and senior management of Brambles (and, we believe, also for GKN). The deadlocked nature of the joint venture prevented either Brambles or GKN from exercising full control of operations in these markets. Solutions were sought to improve control, such as Brambles and GKN rotating the chairmanship of the joint venture businesses, but these were largely ineffective. And as the scale of CHEP's operations expanded in the USA and the UK and pushed into broader and more remote European markets, management at the joint venture level became progressively more independent and underlying performance less immediately transparent to its shareholders. At the same time, the potential impact of those operations on Brambles and GKN as the joint venture partners greatly increased—both in a positive and negative sense.

This was unsustainable. It was clear that CHEP and Cleanaway needed to be united under a single ownership, governance and management structure if they were to realise their full potential. Having worried for years about the potential capital drain and risks, both Brambles and GKN now saw a bright future for the joint venture businesses (and for CHEP in particular). This led to increasing friction between Brambles and GKN as our interests diverged in the knowledge that the existing arrangements could not continue. And this in turn made it even more difficult for the joint venture partners to play an effective role in the oversight and control of the joint ventures.

There were however two major difficulties in pursuing the 'normal' solutions to this conundrum in order to bring together both halves of the joint venture.

First, neither Brambles nor GKN was prepared to sell its interest in the joint venture to the other. CHEP had attractive growth and market penetration opportunities and Cleanaway was generating good cash returns.

Secondly, a takeover or merger between Brambles and GKN would have been impossible. Each company had interests in businesses to which the other didn't want exposure: GKN, for example, manufactured helicopters, which was of no interest to Brambles' shareholders. A takeover of either by the other would also have been strongly resisted by shareholders: Brambles would have struggled to gain acceptance in the UK if it made a bid for GKN (an icon of British industry) and a takeover of Brambles by GKN would have seen management of the combined group being run from London.

By maintaining its global headquarters in Sydney, Brambles was helping to demonstrate the fallacy of a long-held view in some circles that global corporations cannot be managed from Australia. Doing so also helped develop the global management skills of the executives who served the company. A takeover of Brambles by GKN, or anything similar in effect, would therefore have been a sad day for corporate Australia. The point was however never considered, and was academic in any event: the Australian federal government would have resisted a takeover of Brambles which saw its senior management and headquarters moved overseas.

A solution therefore had to be found—one which brought the separate interests of Brambles and GKN in CHEP and Cleanaway into a single economic entity, with a common governance and management structure, which did not involve a takeover or usual merger approach, did not trigger unintended commercial or tax consequences, and allowed the proud

history of both companies to continue. In short, exactly the sort of complex challenge which the investment bankers enjoy.

An Old Idea Made New

As it turned out, the solution identified was an old one—a DLC was proposed. Dual listed company structures had of course been around for many years. Royal Dutch Shell for example was formed as a DLC in 1903, and there were other cases in which such structures had been used since then. Only a few years earlier in 1995, for example, a DLC structure had been used to form Rio Tinto, the first Anglo-Australian DLC, although in that case the result was more a takeover than a merger of equals. This, as we will further discuss, created difficulties for Brambles and BHP in forming their DLCs, particularly in relation to the requirement for approval of the transaction from the Australian Federal Treasurer.

In simple terms (if they can ever be described that way), the DLC involved GKN transferring its joint venture interests in CHEP and Cleanaway into a new company in the UK, which was renamed Brambles Industries plc. The shares in this new company were then given (or 'distributed') to all of GKN's shareholders via a demerger. The new entity (which we came to call BIP) was then listed on the London Stock Exchange and entered into a series of agreements with Brambles in Australia, locking the two companies together via a complex 'pre-nuptial' agreement, which created the DLC.

The DLC agreements embodied certain other fundamental principles. Although the two companies continued to exist as separate legal entities, they would be run in effect as a single economic enterprise with two heads—one listed in Australia and one listed in London (the UK body of shareholders having come from the GKN side and the Australian shareholders from the BIL side). Although each entity would have its own boards of directors, the membership of those boards would also be identical, and there would be a single common senior management team across both companies.

The Devil in the Detail

On the face of it, the solution was elegant. The investment bankers, lawyers and accountants were heavily involved on both sides. On the investment banking side, Macquarie acted for Brambles while the Australian

legal firm of Allen Allen & Hemsley, and in particular its late partner Peter Cameron, helped guide management and the Board through the maze of legal and tax complexities, shareholder concerns and the simple practicalities of making it all happen. These issues all needed to be carefully thought through and resolved—and they were, through the efforts and dedication of a very hard-working team of internal management and external advisers.

As the process of pulling together the DLC proposal unfolded, it emerged that GKN would need to contribute more to the DLC than just its interests in CHEP and Cleanaway. The DLC would otherwise have been 'lop-sided', since the Australian entity in the DLC contained all of Brambles' other operations and investments, including the Recall document management business, the Brambles Industrial Services business as well as those parts of the CHEP and Cleanaway business that were not in the joint venture with GKN. Most of the value would in fact sit on the Australian side of the proposed DLC. If this were not addressed and carefully balanced, there was a risk that forming the DLC would be seen as a takeover of the GKN businesses by Brambles, rather than a merger. As a result, the DLC assets in their final form therefore included GKN's stakes in two other US businesses: Meineke—a muffler and brake repair business, and Interlake—a warehouse racking manufacturer.

There was little logic or rationale for these businesses being included in the DLC, although Interlake at least manufactured racking on which CHEP's pallets might someday sit. Ultimately, however, their inclusion was necessary if we were to form the DLC, which was demonstrably in shareholders' interests, and they were small by comparison to the other assets. Ultimately, both these businesses were divested by the DLC shortly after it was formed.

A more significant issue we needed to resolve was the composition of the Board of the DLC. Both entities in the DLC needed their own Boards, but the composition of those Boards needed to be identical. It would have been impractical for all the Brambles and GKN directors to go onto the DLC Boards and so we agreed that each of Brambles and GKN would nominate some of their existing directors to the new Boards. For the existing members of the Brambles Board in Australia, this meant that some would have to leave the Board when the DLC was formed. Regrettably, this meant that Brambles lost Neelie Kroes and John Cloney as directors, although neither of them looked back. John was already Chairman of QBE (a major insurance company of which he had been CEO), a role which he continued to hold until July 2010, while Neelie was a former

Minister for Transport and Public Works in the Netherlands government, and went on to hold powerful roles in Europe in the oversight of competition law: Neelie became a Member of the European Commission responsible for the European Digital Agenda.

The most significant issue we faced in forming the DLC was however the choice of the senior management team to run the combined operations. At the time, Brambles' Chief Executive Officer was John Fletcher, while GKN's was Sir C K Chow. As for Chief Financial Officers, GKN had David Turner and Brambles was operating without a permanent CFO (Michael Brown having departed Brambles as CFO in [late] 2000). Overlaying this issue was the need for the CEO and CFO of the DLC to be resident in Australia, and for the Group's headquarters to be based in Australia, in order to obtain approval from the Australian Federal Treasurer.

This led to some very challenging discussions between the Brambles and GKN Boards. Ultimately, the deal was struck on the basis that the combined entity would be managed with Sir C K Chow as CEO and David Turner as CFO, both of whom would leave their roles at GKN and move to Australia. It is a strong indication of the strong future presented by the DLC that both the CEO and CFO of GKN wished to be part of that future. The decisions on their appointments were among the last issues we had to resolve before the button could be pressed and shareholder approval sought to form the DLC, but once agreed things moved swiftly, and at the shareholder meetings in July 2001, the formation of the DLC was approved with very significant majorities. As a result, the Brambles DLC commenced operation in September 2001.

Looking back, this was a major turning point for Brambles. Overnight, Brambles went from being a well-respected icon in the Australian market—but one with a predominantly Australian operating portfolio, some large but non-controlled international joint venture interests and a somewhat parochial attitude—to becoming a truly global group with a portfolio of extraordinary businesses, a bright future and a reinvigorated strategy.

A Bumpy Ride, and the Story that Got Away from us

The road ahead was however not to be smooth. While Brambles' wholly-owned businesses before the DLC had a strong culture of compliance and transparency—there was even an internally published 'Doctrine of No Surprises'—the GKN-Brambles joint venture assets had not been under the control of either GKN or Brambles: they ran their own race to a very

large extent and, as already mentioned, addressing this was one of the key reasons for forming the DLC. It was therefore probably inevitable that, once the DLC was formed, historical issues began to emerge.

Front of mind are those issues which led to the now legendary 'lost pallets' story, the origin of which lay in the historical pursuit by CHEP in Europe and the USA of 'growth for growth's sake'—an approach which, as can be said with some pride, we were able to identify and overcome as a direct consequence of forming the DLC and taking control of the joint venture businesses. This requires some explanation.

CHEP's business fundamentally involves customers using CHEP's pallets and containers in return for the payment of fees. Before the formation of the DLC, CHEP in Europe and the USA had been allowed to grow rapidly into new markets and service lines, and the capital to purchase new pallets and containers to support that growth was being provided by GKN and Brambles. Strong growth of itself was much to be desired, as long as three things were satisfied: first, CHEP needed to know how many pallets were being lost or destroyed through their use by customers; secondly, customers needed to take responsibility for their destruction of CHEP's assets; and thirdly, the overall financial modelling and the fees paid by clients needed to take all this into account. Unfortunately, after formation of the DLC it became apparent that there were significant deficiencies in these basic areas in CHEP's European and USA operations. In order to expand rapidly, controls had been relaxed, with customers having little responsibility for the loss of or damage to CHEP's pallets. The implementation of tighter and appropriate controls led to the calculation—on a theoretical basis—that a significant number of pallets were likely to have been lost or destroyed over the years, and not written off in the company's books. We took the decision to rebalance the number of pallets on our books, and implement a bold restructuring and additional controls and audit processes to ensure the issue was solved for the future.

It was frustrating at the time to see the media frenzy which followed these events. It seemed somehow surprising to many outside the company that CHEP did not know at any particular point in time where its pallets and containers were but the logic for this is simple. In order for CHEP to make money, its pallets and containers needed to be in the hands of customers, flowing through the supply chain loaded with customers' products. It was simply impossible to know at a point in time the location of all those millions of pallets throughout the world's supply chains.

As a consequence, CHEP generally knew at any time only how many pallets it had bought in the past, how many of them it had written off over the years, how many it now had in its own hands, and how many were on the accounts of each of its customers. Reconciling these numbers involved extensive audit processes and complicated theoretical calculations about 'pool growth efficiency' and probability assessments.

It was based on such extensive audits and theoretical calculations in 2002 that Brambles determined the number of pallets in productive economic use in the UK and European supply chain—that is which it could be proved were being used by customers and attributable to their accounts—was around 15 million less than the number on the company's books. This did not necessarily mean that those pallets had been destroyed. No doubt many were still part of the overall pallet pool, and would find their way in due course back to CHEP's service centres for repairs. But CHEP was unable to reconcile and allocate those 'lost' pallets to customers' accounts. The prudent decision was therefore taken to write off those pallets: should they re-emerge as customers returned them, they would then be written back.

We have no doubt with the benefit of hindsight that the media got away from us on this issue: we managed the messaging badly. But in our defence, there was an incredible reluctance on the part of the media and some commentators to take the time to understand this complicated issue. CHEP wrote off significant numbers of pallets every year, and the costs of doing so was part of the business model. The difference here was the fact that we boldly and transparently addressed a potential issue, rather than trying to muddle our way through it over an extended period. Cheap and amusing headlines were unfortunately far more interesting than sound decisions and good governance addressing difficult issues.

Realising and addressing these issues was a painful but important process. Don feel very strongly that, without forming the DLC, Brambles and GKN would not have identified the problems until it was far too late. The consequences would have been dire, and could have threatened both companies. As it was, we were able to identify them swiftly, deal with them in an open and transparent manner, and re-position the operations for the future. That alone was proof of the value of the DLC.

A Complex Beast, but Not Without Some Lighter Moments

The complexities of a DLC lie not only in its formation, but also in its day to day operation. For example, the UK entity was required to comply with the corporate law and listing rules applicable in the UK, while the Australian entity needed to comply with those applicable in Australia. The differences were sometimes significant and sometimes subtle, but the rules were rarely the same. A decision was therefore made early on that both entities would observe a common standard, which was the highest standard in both markets. While this was for practical reasons, in that it allowed us to ensure that we met the requirements wherever we operated, it had another consequence: we set and observed a higher standard in practice than many of our peers were required to observe. In Don's view, we raised the overall bar in both markets. Working our way through the morass of competing requirements also kept the management team on their toes—something which kept them at the cutting edge.

There were some complexities however which led to some lighter moments. Take for example the question of how a DLC carries out its annual general meetings of shareholders. Both entities in the DLC were required to hold their own annual general meetings but, on most resolutions, the votes of both bodies of shareholders were aggregated to determine the outcome. In an attempt to give the notion of a common body of shareholders its fullest meaning, Don experimented in 2003 with holding the Annual General Meetings simultaneously in Sydney and London, linked by video conference. Shareholders were able to see shareholders in the other location, to hear the questions they asked, and the Board's responses. Unfortunately, the opportunity to see themselves on the big screen, knowing they were being broadcast around the world, proved an irresistible attraction for some of the more colourful shareholder activists and we were treated to an endless line-up of repeat questions. It didn't help of course that the meeting was held shortly after Sir C K Chow decided to resign to take up a new position in Hong Kong. We gave our shareholders plenty to talk about. But with the benefit of hindsight, the sideshow of being part of a global broadcast probably only made matters worse. It was nevertheless amusing to read the press in the UK and Australia afterwards, commenting on the performances of shareholders in the other location. There were certainly concerns in some quarters that we had risked exporting to the UK our particularly aggressive Australian brand of shareholder democracy. The Australians, on the other hand, were

bemused by the striking resemblance of one shareholder to John Cleese—from where Don stood at times things certainly did resemble a Monty Python sketch.

A Means to an End

As the years rolled on, the initial rationale for forming the DLC became more of a memory. The joint ventures were now a thing of the past and the group was operating as a single economic entity. Brambles had ready access to capital through the Australian markets and had no need to access new equity on the London exchange.

The UK shares also traded at a persistent discount to their Australian equivalent. The simple reason was that, on the Australian market, Brambles was a Top 20 stock, whereas in the UK, we floated in and out of the FTSE100 list. As a result, in Australia we were a compulsory stock for index funds to hold, while in the UK we were not. Simple supply and demand placed upward pressure on the Australian price, and downward pressure on the UK stock. Unfortunately, none of the brightest minds around the world could find a way to close the gap via arbitrage mechanisms—and many tried.

This led to increasing calls from some quarters to collapse the DLC. Ultimately, however, the trigger to unify the DLC came with a review of the Group's strategy in mid-2005, and the recognition that the group's future growth prospects lay in CHEP and the Recall document management business. Comparing the future growth prospects, and the strong market conditions for divestments at that time, it was clear that Brambles should concentrate on CHEP and Recall and divest Cleanaway and Brambles Industrial Services. The resulting reduction in the size and complexity of the group suggested that the DLC structure should also be unified at that time.

On 1 December 2005, we made an announcement to that effect. The divestments were implemented with extraordinary success over the following 12 months and, on 13 September 2006, the Board released an Information Memorandum calling for the unification of the DLC under a single Australian holding company—Brambles Limited—with a primary listing on the Australian Stock Exchange and a secondary listing on the London Stock Exchange.

Meetings of the group's shareholders were held on 1 November and 9 November 2006 at which the unification proposal was overwhelmingly

approved. Unification—the collapse of the DLC—became finally effective on 4 December 2006.

No doubt there are many who would argue—without knowing the history—that the DLC was a failure. Nothing could be further from reality. There is not the slightest doubt that the DLC was a major success for Brambles. It achieved the key objectives of unifying the CHEP and Cleanaway joint ventures with minimal disruption. It allowed the Board to identify and address operational and governance issues to which the companies were exposed, but previously had no means to address. It allowed the combined group to forge ahead and realise their potential. And it allowed our people to grow and develop in ways previously unimaginable. In the end, the DLC was a means to an end, not an end in its own right, at Brambles, that served a fine purpose.

Every DLC has a different context, and different strategic goals and circumstances. The Brambles DLC served its purpose, but as the late SEK Hulme, one of Australia's leading QC's pointed out in his advice to the Australian Council of Superannuation Investors, there were commercial assumptions used with which he did not agree particularly in relation to the BHP Ltd. and Billiton plc structure.

In recent times the Elliott Group, large investors from overseas, has challenged BHP Billiton as to the future of that DLC given that the South 32 spinout, completed in 2015, involved most of the assets incorporated in BHP Billiton's plc and quite a material change to the original attributed economic value.

BHPB have defended any push to collapse that DLC and we will make further comment on that issue in the BHP case study in this book, but it is worthwhile to highlight the challenges which confronted Brambles when that DLC was unified. What is worth considering is that the formation of a DLC or similar major structural change will likely not be the best structure 'forever', as was the case for Brambles, and will likely be the case for others, because as market forces and strategies change- so must sometimes the structure.

Brambles Unification

The unification of the Brambles Group in 2006 represented a directly analogous precedent for any proposed BHP unification. The Brambles DLC and the BHP DLC were formed at the same time, using the same advisors and almost identical transaction documents.

Background

As recorded elsewhere the Brambles Group was governed under a dual-listed company structure from 2001, comprising Brambles Industries plc (BIP), and English company listed on the LSE, and Brambles Industries Limited (BIL), an Australian company listed on the ASX.

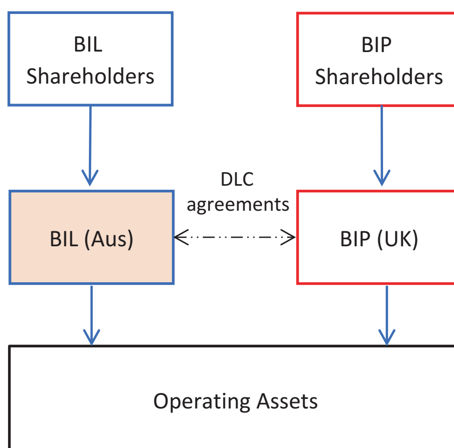
BIL and BIP were separate legal entities that were parties to a dual-listed company structure agreement pursuant to which BIL and BIP would operate as if they were a single economic entity (Fig. 19.1). Like BHP, for example, the two Brambles entities shared the same board, as well as profits and expenses. BIP held approximately 41% of the economic interest in the Brambles group and BIL held approximately 59%.

The Brambles unification was announced in November 2005, pursuant to which a newly-incorporated Australian entity, Brambles Limited, would be incorporated and become the sole parent company of both BIL and BIP and would be the sole listed entity of the Brambles group. The unification was announced alongside several other restructuring elements.

The published rationale for the unification was as follows:

- Allow greater focus on its key businesses, CHEP and Recall—by eliminating the complexity of the DLC structure
- Concentrate Brambles' capital in a single market, the ASX, which should result in an increase in index weighting
- Eliminate the differential in share prices between the BIL shares on the ASX and he BIP shares on the LSE

Fig. 19.1 Brambles structure



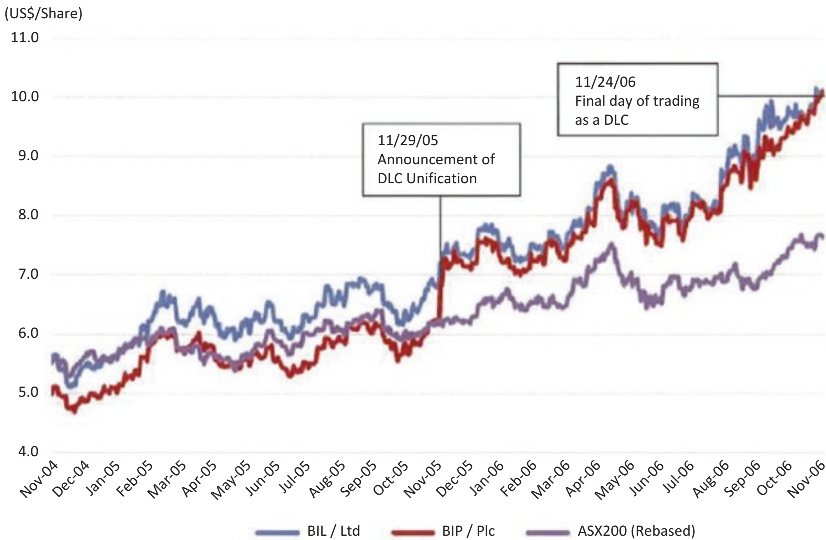


Fig. 19.2 Brambles share price and ASX 200

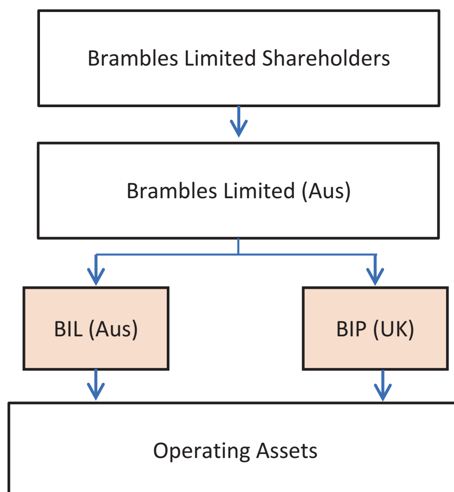
Both during and immediately after the unification process the BIL shares outperformed the ASX200—with which it had been highly correlated prior to unification (see Fig. 19.2). On unification Brambles' weighting in the ASX200 increased by approximately 60%. It is likely that Brambles benefited from a market value uplift by virtue of unlocking the value of its franking credits, even though its ability to generate franking credits was constrained by its non-Australian income level.

In contrast, the base majority of income at new BHP would be purely Australian-originated and so could all generate a stream of valuable franking credits which would significantly boost returns for shareholders and BHP's equity market value.

Unification Terms and Details

In line with any proposed BHP unification, the Brambles unification was to occur by way of schemes of arrangement of both BIL (in Australia) and BIP (in the UK). Shareholders in BIP were also offered a 'cash alternative' under which shareholders could receive cash by way of a buy-back of their shares instead of receiving shares in Brambles Limited (Fig. 19.3).

Fig. 19.3 Brambles structured unification



The required approvals were similar to those that would be required for BHP. Unification was subject to BIL and BIP shareholder approval, as well as court approval for the scheme component.

Both schemes required approval by a majority in number of the company's shareholders who were present and voting at the meeting and by 75% or more of the votes cast on the resolution. Both schemes also required the approval by a special resolution of the shareholders of the other company by virtue of the DLC agreements and respective constitutions.

The Brambles unification was approved by 99.9% of the votes cast by BIL shareholders and BIP shareholders being in favour of unification.

The Brambles unification was also conditional of obtaining FIRB approval (including approval of the termination of BIL's 2001 undertaking to FIRB in respect of establishing the DLC Agreement), ASX approving Brambles Limited for admission to the official list (and granting the requisite listing rules waivers) and the UKLA admitting Brambles Limited to the LSE.

Cost of Brambles Unification

UK stamp duty was 0.5% of the value of the BIP shares transferred to Brambles Limited under the BIP Scheme—but not those bought back and

cancelled under the cash alternative—disclosed as US$28.8 m in the 2007 Brambles annual report.

The total after-tax cost of restructuring and unification across FY2006 and FY2007 was disclosed as US$144.4 m.

Further details of the DLC approach and the relevant criticisms that were prevalent at the time are documented in the letter from Don to P Spathis, in terms of investor interests in particular, as reproduced below, but with the same relevance to Brambles.

Chairman's Office (DLC Letter)

15 October 2003

Mr Phillip Spathis
Executive Officer
Australian Council of Super Investors Inc.
Level 29
2 Lonsdale Street
Melbourne VIC 3000

Dear Mr. Spathis

ACSI Study into Dual Listed Company Structures

Thank you for sending me a copy of the paper prepared by SEK Hulme on Dual Listed Company Structures (DLC's).

Let me say at the outset that I heartily support your work in providing advice to your member funds on the corporate governance practices of companies in which they invest. One of the (regrettably few) comments from the paper that I endorse is the proposition that '*defective governance has a close association with commercial failure*'.[1] In my view corporate governance is now receiving the attention it deserves in the investment debate in Australia. In this climate, it becomes critically important that the information that is disseminated on matters of governance is accurate. While a study on the nature of the DLC as a corporate structure is welcome, I am deeply troubled by the conclusions that the author reaches. Two matters are notable in this regard. First, the analysis is conducted on the basis of the former Constitution of BHP Billiton Limited; given that a new Constitution was adopted at the AGM of the Company held on 18 May 2001 (and would have been known to the author at the time he wrote his paper), it is puzzling why he apparently elected to ignore this fact and to

[1] Implications of Dual-Listed Companies for their Shareholders. Page 6.

proceed with the paper, basing much of it on an earlier and discontinued Constitution. Secondly, the author was invited to meet with me to discuss his previously expressed views on DLC's, which he elected not to do. Had he availed himself of this opportunity, some of the more glaring errors in the logic of his paper may have been avoided altogether.

I have attached a summary of the key conclusions in the paper, to which we have added our comments and ask that you consider the material in this letter and the annexure when you are briefing your member funds.

The issues are, as the author points out, complex. There are, however, some fundamental misconceptions of the DLC structure that underpin the analysis and, as a consequence, have led to erroneous conclusions. The key feature of the DLC, and one that is largely ignored is that a single economic entity was created. That entity operates as though the merger had been effected by way of an exchange of scrip.

The threshold issue—that has received no attention in the paper—is why the Boards of BHP Limited and Billiton Plc (in the BHP Billiton case, though the issue is largely the same in the case of Brambles and GKN) elected to merge using a DLC structure instead of, for example, an exchange of scrip.

The reasons why the Board recommended the DLC structure to shareholders (that they overwhelmingly approved) are important, and worthy of attention.

First, shareholders in both entities can continue to receive dividends from the company in which they hold the shares. This is very important in BHP Billiton Limited's case because it means that shareholders can continue to receive franked dividends.

Second, the retention of companies listed on the separate Stock Exchanges entitles both BHP Billiton Limited and BHP Billiton Plc to qualify as local companies, thereby gaining and maintaining index inclusion. The retention of a separate listing of each company is an important factor in avoiding what is known as 'flowback'. That is, the propensity of target shareholders to relinquish what might be regarded as 'foreign' scrip following a merger, which removes the company from the target's main stock market index.

Third, the DLC structure provides enhanced access to international capital markets and, finally, the structure does not give rise to any change in ownership issues, triggering possible rights of pre-emption and the need, in some instances, to seek and obtain third party and regulatory consents.

Having made the decision that a merger by way of a dual listing met the economic imperatives, the Board of BHP Limited part of the merger duo

(which I chaired through this process and on whose behalf I can speak), turned its mind to whether the structure could be designed in a way that met our governance imperatives. The Board and, ultimately, the shareholders agreed that this could be achieved.

In summary, my response to the key issues raised in the paper is as follows:

1. The commercial reality of the DLC is that shareholders are, and clearly understand that they are, investing in the whole of a single economic entity. The structure itself is designed to operate as a single economic entity and the technical amendments that were made to the relevant laws and company constitutions were designed to enable the entity to operate in practice as one, despite comprising separate legal entities. To conduct the analysis on the basis of separate legal entities ignores totally the reality of the outcome and the commercial basis, underpinned and supported by the legal modifications effected to the Group.
2. The equalisation ratio that forms part of the structure merely ensures that each share carries appropriate economic and voting interests in the merged Group. This is no different than the outcome in traditional scrip mergers where the ratio that determines the relative interests of the members of each merger party is set through negotiation by reference to the relative valuations of each company.
3. The voting procedures that form part of the DLC are predicated on the creation of the single economic entity and the rules simply ensure that voting is on a 'look through' basis as if it were a single company.

   To look, post-merger, at the interests of one group of shareholders versus the other ignores the fact that shareholders participate in one consolidated entity. The logical extension of the writer's analysis would be to treat the assets of one entity as the assets of the shareholders of that one entity alone. In BHP Billiton's case, for example, it would mean that the aluminium assets in Mozambique would be treated as the assets of the Plc since that is the entity (through its subsidiary companies) that owns the interest. Such an outcome is clearly absurd and perverse. It is not the outcome that shareholders in BHP Limited or in Billiton Plc voted to accept—in fact, quite the contrary.
4. It is difficult to conclude that the DLC arrangements undermine the intentions of the rules that relate to 'ordinary' companies. The intention behind the current law giving shareholders a right to con-

vene a meeting must be interpreted as allowing shareholders who own a meaningful stake (i.e. 5%) an ability to call a meeting. Under the DLC arrangements shareholders with the requisite number of shares in the combined entity can call meetings. This intention is thereby preserved. If, as the paper suggests, the rules were that shareholders with just 5% of one-half of the DLC could call an EGM, only 2.5% of the whole entity could call an EGM. To further illustrate the weakness in the writer's argument, if one was to assume for the purpose of the discussion that the merger of BHP Limited and Billiton Plc had occurred through a scrip offer resulting in all of the former Billiton Plc shareholders becoming shareholders in BHP Limited, then the same number of shares as would represent 5% of the enlarged BHP Limited shareholder base would be required to call a meeting, as is the case under the current DLC structure.

5. It is undeniable that spreading a shareholder base across the geographies in which BHP Billiton operates adds some cost and complexity. However, BHP Billiton is a large multinational group with operations in 30 countries and shareholders spread throughout the world. Once an entity (and there are many listed in the ASX 100) has a significant shareholding base outside its country of residency, cost and complexity follow. It is difficult to see that this could seriously be advanced as a reason for remaining 'local'.
6. The paper suggests that shareholders may have been disadvantaged by the matching action that was used in the Steel de-merger because the valuation of the Steel assets should have been assessed at the time of the formation of the DLC, rather than the time of the de-merger. This conclusion is contrary to advice of independent experts and what shareholders considered appropriate and approved in the separate extraordinary general meetings of both Limited and Plc.

   Just as with any collection of assets, the market value of the components of each half of the DLC fluctuate over time, pinning the value of any one set of assets to a point in time deprives the shareholders in the Group of the realities of investing in the equities market. Compensating shareholders via a matching action, while complex, is not flawed because it takes into account valuation at the time rather than some historical value.
7. The DLC structure does provide some additional complexity in relation to takeovers and schemes of arrangement. However, it is wrong to say that these complexities would not have existed had BHP and Billiton merged by way of a traditional scrip merger. A takeover of any large multi-national group with shareholders in a number of jurisdic-

tions would need to be conducted in accordance with the laws in the relevant jurisdictions. These laws often extend to matters such as foreign ownership, tax, exchange controls and specific requirements relating to equity structures. They are relevant with or without the existence of DLC structures. It is not true to imply that compliance with regulation beyond our shores is a consequence of the DLC structure. For example, BHP Billiton's requirement to comply with extensive sections of the Sarbanes-Oxley Act in the US is evidence that compliance does not stop at the shores of the home country.

8. On the issue of regulatory control in the event of takeovers I cannot speak for the legislature, but it is clear to the most casual observer that the provisions of the Corporations Act are constantly under review to accommodate changes in legal and commercial practice. The UK Takeovers Panel has, for example, assumed responsibility for DLC's and, no doubt, if the issue arose in Australia, the relevant bodies would examine the merits of a similar revision to the law.
9. Far from being a negative, compliance with the governance requirements in more than one jurisdiction has given the shareholders of BHP Billiton much greater insight into the operation and performance of the Group. Any review of BHP Billiton's Annual Report would conclude the high standard of transparency that has been adopted in reporting on all facets of the Group, as well as the clear recognition of shareholder rights and levels of participation—something that has been recognised on several occasions by a number of independent bodies and commentators.
10. The requirement for a DLC to operate in a governance framework that spans more than one jurisdiction exposes the Group and its directors and senior management to a broader regulatory and shareholder base, which can only lead to greater accountability and scrutiny. This must ultimately translate to an ongoing improvement in the quality of the Board and of the senior management.

I thank you again for sending the paper to me. Once you and your colleagues have had an opportunity to review this material I would welcome the opportunity to discuss the various issues with you. I intend to copy this letter to Corporate Governance International who is mentioned in the paper and to whom I assume a copy of the paper has been sent.

Yours sincerely
D R Argus
Chairman

Commentary on Summary and Overview Paper

Issues	*Commentary*
I. Introduction	
There has been little public discussion of the DLC development.	Royal Dutch and Shell formed the oldest DLC structure (a dual holding company structure) in 1907. Unilever is the second oldest DLC structure (a dual-listed company structure) formed in 1938. The DLC structure is not new and has been subject to much discussion.
II. The DLC structure principles	
The provisions of the DLC structure are extremely intricate, make unfamiliar assumptions, and are cast in unhelpful terminology.	The Explanatory Memorandum prepared for the DLC merger was sent to shareholders in April 2001. Since that time, BHP Billiton has prepared annual reports and notices of meeting, including the scheme booklet for the demerger of BHP Steel Limited. The voting arrangements, equalisation principles, and other matters specific to the DLC have been explained and disclosed now for over 2 years to shareholders.
The DLC arrangement assumes that it is possible for the board of a company to function whilst accounting for 2 separate bodies of members. However, the interests of the 2 bodies of members can diverge.	The DLC structure acknowledges that there are matters on which shareholders of each entity may have divergent interests. The class rights actions voting procedure ensures that the approval of each group of shareholders occurs separately on matters where interests diverge. In addition, the matching action principle ensures that both groups of shareholders are as far as possible treated equally.
There are no specific legislative rules and the DLC documents give no guidance on the board function with respect to the DLC structure. The matter is simply left to the Board.	Directors are subject to their duties as a director of each entity. In addition, directors must have regard to the interests of the holders of the shares in each entity as if the 2 were a single unified economic entity and must take into account in the exercise of their powers the interests of the shareholders of the other. This clear statement of principle, in addition to the DLC equalisation principles, provides clear guidance to the Boards in operating the DLC.

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Issues	*Commentary*
The Board has power to decide that a resolution which would otherwise be a class rights action shall be treated as a joint electorate action. The Board has power to decide that a resolution which would otherwise be a joint electorate action shall be treated as a class rights action.	The description of the discretions is not correct. Resolutions shall be subject to the joint electorate or class rights procedure (as decided by the Boards) if they relate to any other matter which the Board determines should be approved under the joint electorate or class rights procedure respectively. These are catch all provisions and must be read subject to the more specific provisions which specify the voting procedure to be followed.
Equalisation principles	
When the equalisation ratio is not 1:1, the shareholders will not receive equivalent economic returns. This is the opposite of the intention.	Shareholders have economic and voting interests in the combined group. The economic and voting interests represented by a share in one entity relative to the economic and voting interests of a share in the other is determined by reference to the ratio known as the 'equalisation ratio'. The DLC merger was formed on the basis that the equalisation ratio was set at 1:1. The ratio can change to ensure that there is equitable treatment as between the holder of a share in one entity and the holder of a share in the other entity. The reason for the equalisation ratio changing would be because of an action occurring which results in the ratio of economic returns or voting rights not being the same and the Boards' determining to adjust the equalisation ratio rather than undertake a matching action or seek shareholder approval as a class rights action. The implication drawn in the Paper that shareholders will not receive equal economic returns when the ratio is not 1:1 is not a correct interpretation of the provisions—The obverse applies i.e., the equalisation ratio will be altered from 1:1 to ensure shareholders receive equivalent economic returns.
The Sharing Agreement does not describe the basis of calculation of the initial equalisation ratio.	The Sharing Agreement was entered into on completion of the DLC merger and regulates the ongoing relationship. The initial equalisation ratio was determined as part of the DLC merger and is disclosed in the Explanatory Memorandum.

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Issues	*Commentary*
The Board has wide powers in relation to matching actions and equalisation ratio adjustments.	The DLC equalisation principles govern the process that the Board must follow in determining matching actions and any appropriate adjustments. The power to make determinations within this regime is no different to the powers granted to directors of any other company to govern.
III. The DLC voting structure	
The DLC voting structure is complex.	The DLC voting arrangements were explained in the Explanatory Memorandum. Since that time, BHP Billiton has prepared annual reports and notices of meeting, including the scheme booklet for the demerger of BHP Steel Limited. The voting arrangements are also described on the BHP Billiton website. Complexity does not of itself compromise corporate governance and the complexity that does exist ensures good corporate governance and shareholder democracy within the DLC structure.
IV. A. Statutory qualifications by reference to votes	
The DLC structure alters the effect of provisions of the Corporations Act which give particular rights to shareholders by reference to votes which can be cast at a general meeting. The DLC structure results in a doubling of the thresholds—e.g. if holders of 5% of the shares in BHPB Limited wish to requisition a general meeting and holders of 5% of the shares in BHPB plc likewise wish to do so, the threshold becomes 10% of the shares in both companies.	This is not correct. Directors of AusCo are required to convene a meeting of AusCo if the 5% threshold in section 249D is met. If the business to be considered at that meeting involves a class rights action or a joint electorate action, AusCo must notify the UKCo and UKCo must convene a parallel general meeting for considering the joint electorate action or class rights action. If the business of the meeting does not involve a joint electorate action or class rights action, no parallel general meeting will be required. The special voting share only confers rights to vote on a procedural resolution, a class rights action and a joint electorate action. The special voting share is not taken into account in determining participation thresholds under the Corporations Act. In any event, if the merger had been implemented as a scrip takeover the percentage of shareholders in 1 jurisdiction with power to convene a meeting would have been significantly higher than 5%.
IV. B. Some difficulties of distance and cost	

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Issues	*Commentary*
Where the subject matter of a joint electorate action is disputed by members in one company, they will be at a very significant disadvantage compared with members involved in a similar dispute in a company wholly within Australia as the dispute would cost 5 times what a similar challenge would cost if fought wholly within Australia and there would be practical difficulties in connection with the financial press.	By definition, a joint electorate action requires the same resolution to be put to both AusCo and UKCo. On general law principles, the reasons for the relevant resolution would be contained in the notice of meeting. If members who proposed the resolution have provided a statement of reasons, that would also be included in the notice of meeting for the sister company. There would be no cost associated with contacting the press in the country of the sister company. Where parallel general meetings are conducted they are often conducted by video linkup which enables shareholders in both companies to participate. The basic premise of a DLC is that the shareholders in both companies have common interests. If the shareholders of one company propose a resolution which is a joint electorate action and therefore notified to all shareholders in both companies of the DLC and as a result of the voting, the shareholders in the other company cause that resolution to be voted down, this is no more than a shareholder democracy at work within the DLC structure. The comment in the report that 'it would be surprising if a 2 country campaign involving an Australia–England DLC did not cost something like 5 times the cost of an Australian campaign' is not proof of the allegation.
IV. C. Valuation, the equalisation ratio and BHP Steel	
Shareholders have never been told what the method of calculation of the reduction in economic investment per BHPB Limited share was as a result of the spin-off of BHP Steel. The figure taken as the reduction of economic investment per share was calculated from the stock exchange price of shares in BHP Steel after spin-off. On no view was that the method used to put a value on the BHP Steel assets on their way into the DLC structure.	The value of the assets contributed to the BHP DLC structure was calculated at the time that that structure was set up. The value did not remain static between the time of the establishment of the DLC until the time of the BHP Steel spin-off. A scheme booklet was produced at the time of the BHP Steel spin-off which booklet contains an independent expert's report. Plc shareholders received a bonus share issue as a matching action and the independent expert concluded that the method used to calculate the number of bonus shares issued was an objective measure of value and represented a balanced attempt to determine the market value of BHP Steel shares.
V. Election of directors in a DLC	

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Issues	*Commentary*
Difficulty would arise in an election if a person were proposed as a director of one of the companies but not the other as the initiating members in AusCo would not, in that capacity, have power to put on the agenda of UKCo a proposal for the election of that person as a director of AusCo, and still less a proposal of the election of the person as a director of UKCo.	This is not correct. The appointment of a director is a joint electorate action and therefore the relevant resolution is put to both the AusCo and the UKCo shareholders. This is clearly set out in the constitutions of DLC companies.
VI. The removal of directors of DLC companies	
If a director were removed from the board of AusCo, the 2 boards would be differently composed until the director were removed from the board of UKCo. That would require a quite separate resolution.	This is not correct. The removal of a director is a joint electorate action and therefore the relevant resolution would be put to both companies. In addition, if a director ceases to be a director of one company, he also ceases to be a director of the other company. These matters are clearly set out in the constitutions of the DLC companies.
VII. The DLC and schemes of arrangement	
It is improbable that any scheme will be brought forward in one company unless it is practicable for a matching scheme or at any rate some matching action to be brought forward in the other. In these circumstances, it is surprising that the DLC structure documents say nothing in relation to schemes.	The BHP Steel demerger involved a scheme of arrangement. Under the constitution of the DLC companies, where a company proposes to enter into any transaction which is required to be authorised by shareholders under relevant laws, this constitutes a joint electorate action. In addition, the Sharing Agreement provides that the parties must ensure that transactions affecting share capital ensure that there is equitable treatment. Where a matching action is not available, the equalisation ratio is adjusted unless the boards consider that this would not provide an appropriate or practicable adjustment, in which case the relevant issue or transaction requires approval as a class rights action. Shareholders in the company which does not propose the transaction would therefore have the right to reject that transaction.
VIII. The DLC and takeovers	

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(continued)

Issues	*Commentary*
The elaborate takeover provisions act as poison pill since the takeover bid must involve both companies. In addition, the board has the power to allow any takeover offer to proceed if it thinks fit, notwithstanding that it does not comply with the rules set out in the constitution.	The takeover rules are designed to ensure that both companies in the DLC structure receive the benefit of a takeover offer. This is consistent with the basic premise of the DLC structure, that shareholders have a common interest. The DLC structure is also a merged entity. If the interests of shareholders in each company diverge, the shareholders can act to demerge the DLC. While their common interest subsists, it is appropriate that shareholders in both companies receive the benefit of takeover offers. It is not correct that the board can allow a takeover offer to proceed if it does not comply with the constitution. The constitutions state that a 'permitted acquisition' is one consented to by the board where it is satisfied that the acquisition complies with all relevant laws and the provisions of the constitutions of both companies. Recent takeover bids in which the bidder has had to comply with the regulatory regime in more than 1 jurisdiction include the US Filter bid for Memtec and the bids for Normandy.
IX. The DLC and winding up	

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(continued)

Issues	*Commentary*
The passing of any resolution for winding up will be influenced by the wishes of the members of UKCo, under the joint electorate procedure of the class rights actions procedure. The decision whether AusCo is to enter into voluntary winding up will be made not by the members of Ausco, but by the members of UKCo, under the class rights actions procedure. The class rights action procedures do not include a resolution of members under section 461 of the Corporations Act, that the company be wound up by the court. The voting procedure for this is not set out in the constitution with the result that the voting procedure will be the one elected by the board.	Joint electorate actions and class right actions are 2 different types of resolution. To the extent that a class rights action is voted down by one company in the DLC, the resolution is deemed to also have been voted down in the other company. Voluntary winding up is a class rights action and therefore, if proposed by AusCo, can be defeated if the shareholders of UKCo do not wish AusCo to be wound up. This right is fundamental to the DLC structure. Class rights actions are specified as such as they go to the very existence of the DLC entity and the rights of shareholders of each company vis a vis each other. Under section 461, the court may order the winding up of a company if the company has by special resolution resolved that it be wound up by the court. This is not included as a class rights action since if it was, this would give the other company the right to veto that special resolution and therefore override the order of the court. There is no need to select a voting procedure—AusCo would merely be required to pass a special resolution in accordance with section 461. The winding up provisions in the constitutions are designed to ensure that shareholders are treated equitably in the event of insolvency having regard to the equalisation ratio.
X. The DLC and entrenching the powers of directors	
1. Power to amend the objects of the company, via power to amend the DLC agreements.	Amendment of the Sharing Agreement and Voting Agreement are class rights actions and therefore require shareholder approval.
2. The leeway in protection given by the fact that nothing the directors do in good faith in giving effect the DLC principles or in amending the DLC agreements shall constitute a breach of fiduciary duty to the company.	Amendments to the DLC agreements require shareholder approval. The qualification regarding fiduciary duty is to ensure that directors are entitled to have regard to the interest of combined shareholders as if the two companies were a single economic entity. Nothing in that concept overrides the general fiduciary duties of the directors to the company.

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(continued)

Issues	*Commentary*
3. Power to determine, with no criteria enunciated for making a determination, whether any issue is to be decided as a joint electorate action or as a class rights action.	This discretion is to the advantage of all shareholders since without such classification, a resolution will be voted on only by one company in the DLC. The constitutions set out which issues are to be treated as joint electorate actions and which as class right actions. The discretion arises outside of these specific issues.
4. Power to decide what is to be done when the 2 groups of members have competing interests, and to do so without any criteria.	The directors are required under the Sharing Agreement to enhance the rewards and returns to both groups of shareholders and to ensure that the DLC operates as a single unified economic entity. This restricts the ability of the directors to favour the interests of one set of shareholders over the other and as a practical matter, the DLC principles in the Sharing Agreement act as a mandate to directors, where the groups have competing interests, to endeavour to align those interests.
5. Power under the Shareholder Agreement and the related documents to determine whether to have a matching action in the other company, or to make some equalisation ratio adjustment in the other company, and power to determine the values at which that is to be done.	This is advantageous to all shareholders as the purpose of these provisions is to ensure that shareholders in both companies are treated equally. There is no power for the directors to ignore the interests of one group of shareholders in favour of the other.
6. Power to determine whether the effect of an action is immaterial and not to be counterbalanced by a matching action or adjustment.	If the action is immaterial, no matching action will be required. If the action is material, the directors are required to either propose a matching action or adjust the equalisation ratio, and where that is not possible, whatever is proposed is treated as a class rights action, thereby allowing shareholders to participate in the outcome.
7. The fact that the DLC structure raises the hurdle dissentient shareholder groups must surmount to attract the assistance of the Corporations Act, thereby making challenge more difficult.	This is addressed above under the heading **Statutory Qualifications By Reference to Votes**.

(*continued*)

(continued)

Issues	*Commentary*
8. The practical difficulties in addressing one half, if the two companies are of equal shareholder size, of the persons who control the votes to be cast within AusCo, again inhibits challenge.	This is addressed above under the heading **Some difficulties of distance and cost**.
9. Power to decide what assistance if any to give or not to give to dissentient shareholder groups forced by the DLC structure to address persons not members of their own company.	This is addressed above under the heading **Some difficulties of distance and cost**.
10. Power to decide whether or not to allow the making of a takeover offer not falling within the normal rules of the permitted acquisition.	This is addressed above under the heading **The DLC and takeovers**.
11. Power to determine whether the members of AusCo and the members of the UKCo together, or the UK alone, are to have the final say on whether AusCo shall apply to the court for an order that AusCo be wound up.	This is addressed above under the heading **The DLC and winding up**.
XI. A glance at the future	
The issues of a triple or quadruple listed company structure are considered.	No such structures currently exist and even if they did, the basic DLC principles, we assume, would equally apply i.e. those entities would be merged entities operated on the basis that they are a single economic unit with shareholders having a common interest, with that interest protected by the structures put in place. It is not correct to say that a DLC structure results in shareholders not having control over their board or its composition.
XII. An adventure in finding the law	

(*continued*)

Issues	*Commentary*
The complexity of the provisions of the Corporations Act is criticised, as are difficulties encountered in ascertaining what orders ASIC has made. ASIC has made 12 orders, 48 sub-orders, affecting 160 provisions.	These are issues outside the power of the companies comprising DLC structures. The Paper states that these are the orders made in respect of the DLC, excluding orders related to the Steel spin-off. This does not seem correct on our review of ASIC's online records. Firstly, many of the instruments referred to in the Paper on this issue have been repealed by subsequent orders, and all of these in any event relate to the spin-off. The 4 orders made in respect of the DLC were those in June 2001 relating to the t/over provisions.

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