



Business Acting in Service of Society

Transparency Task Force

A BASOS Perspective on Finance Sector Reform

10 November 2020

Topic for Today

How can we reform the finance sector in Australia?

- Denis Kilroy and Marvin Schneider have been working for more than a decade to bring BASOS to the global business and investment communities
- BASOS is an acronym that stands for Business Acting in Service of Society
- Today, we will address the topic of finance sector reform from a BASOS vantage point

Putting BASOS Into Context

The global business and investment communities are undergoing a significant paradigm shift



Shareholder Primacy

Description

A corporation exists to *serve its shareholders* and to maximise shareholder return **for current shareholders**

Key attributes

- An obsession with managing by the numbers, with budgets often dominating strategy development and implementation
- A focus on buybacks and financial engineering, to benefit current shareholders, often at the expense of the company
- A strong focus on EPS growth, and on growth through EPS accretive acquisitions
- Cost reduction as an end in its own right, often involving outsourcing that would not otherwise be justified
- Remuneration systems highly leveraged to financial 'performance' during tenure



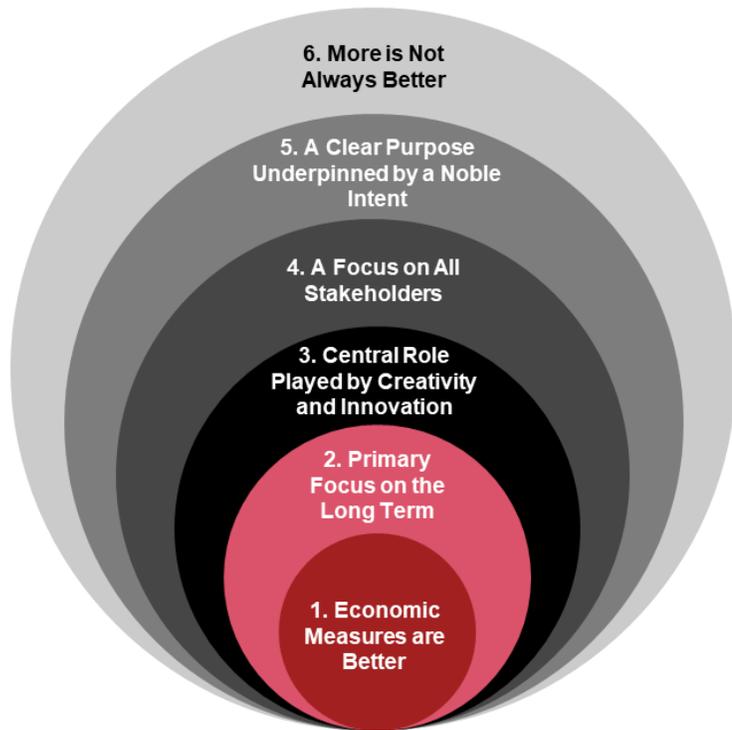
Purpose-centric business paradigm delivered (BASOS)

Enduring institutions create wealth on an **ongoing basis** through the successful pursuit of a **clear purpose, underpinned by a noble intent, to be of service to society and all stakeholders** - customers, employees, suppliers, communities, and shareholders

- Focus on innovation, and organic growth through innovation
- Understanding that there is a sustainable level of ongoing wealth creation the company should seek to achieve
- Understand impact on individuals, community and environment
- Board focused primarily on governance of corporate purpose, and on creating conditions for long-term success
- Use economic performance measures: ROE-Ke and TSR-Ke
- Remuneration that encourages long-term wealth creation

The BASOS Vantage Point

BASOS key question: “How can we create wealth on an ongoing basis while enhancing the wellbeing of the individual, the wider community and the environment?”



| Principle | Description |
|--|--|
| 1 Economic measures are better | With economic measures , we can observe how the financial performance produced by management, translates into capital market outcomes experienced by shareholders – and see how wealth is really created in listed companies. |
| 2 Primary focus on the long term | Top-performing companies tend not to focus on beating short-term financial performance expectations, but instead, on actions and decisions that increase economic profit expectations to be delivered over the long term |
| 3 Central role played by creativity and innovation | In top-performing organisations, revenue growth through creativity and innovation focused mainly on enhancing the value or benefit provided to customers , plays a central role. It is not possible to enhance economic profit expectations year after year, through cost reduction and capital efficiency gains |
| 4 A focus on all stakeholders | Maintaining a positive economic profit stream for the long term is only possible if non-shareholder stakeholders also benefit appropriately , and are seen as allies in creating wealth over the longer term |
| 5 A clear purpose underpinned by a noble intent | An organisation’s purpose is an outgrowth of its conscious intent. A noble intent that can apply to many companies is to build an enduring institution that creates wealth on an ongoing basis, by doing something to benefit society, and in ways that enhance the wellbeing of all stakeholders |
| 6 More is not always better | Over the longer term, there is an optimal sustainable level of economic profitability (ROE-Ke) achievable in the market for a company’s products and services, and an optimum sustainable level of wealth creation (TSR-Ke) achievable in the capital market. Seeking to exceed either is generally not in the interest of shareholders or other stakeholders. |

The BASOS Vantage Point

That question, and the understanding that comes with it, is as relevant to the investment community as it is the business community

Ongoing wealth creation while enhancing societal wellbeing



Business Community Response to BASOS

Many companies face major strategic challenges, which make navigating the strategic landscape complex and convoluted

AGL Energy

- Poor capital market performance. Share price suggests market not clear on a path forward for AGL
- Path to achieving decarbonisation of electricity generation still fluid; government policy appears mercurial
- Trend towards decentralised generation and storage, but new solutions are not yet fully mature
- Significant pace of innovation in renewables and energy storage solutions
- Low barriers to entry into simple energy retailing
- Decline in NEM electricity demand precipitating fall in wholesale pricing

Business Community Response to BASOS

Many years of experience suggest three important things are required in the face of seismic shifts in markets

- Don't fight fire with fire and engage in a slug fest to compete over market share and lowest unit price. Need to adopt exponential thinking and change the game, not compete harder in the existing game. This often means shifting from 'flogging' products, to providing value added and appropriately priced solutions
- Need a structured approach to harness innovation and draw on intuition. Our solution is the four ribbons and the role of hybrid thinking, using analysis as a proving mechanism
- When changing the game to this extent, it is often important to build an ecosystem around value-creating networks. It is often necessary to shift consumer attitudes about the value of the product, as well as public policy on issues of national interest

The Business Community Response to BASOS

When we shift the intention to creating wealth on an ongoing basis... it's better to 'change the game' than to 'slug it out'

How do we create wealth on an ongoing basis in ways that enhance the wellbeing of the individual, the wider community and the environment?

Slug it out in the existing game

- Defend or gain market share
- Compete on price
- Success relies on cost reduction
- Declining industry economics
- Tends to lead to commoditisation
- Constrains capital for ongoing reinvestment
- Limits investment in innovation

A race to the bottom

Change the game

- Solution rather than products
- Value adding not commodity
- Price on value not cost
- Often requires partners
- Primary focus on innovation not cost
- Focus on making the offer more worthy, not 'beating' the competition

A new lease on life

The Business Community Response to BASOS

A structured approach is essential to establish and embed capabilities

1. Culture & Organisation Capability

Evolve and energise org and culture towards a 'BASOS' purpose enabled through a coherent operating model to accelerate value creation



2. Value Measurement Capability



Understand EP required to preserve wealth, plus which parts are value creating, and which are value destroying and why, under the strategy being pursued

3. Value Creation Capability



Develop alternative strategies mainly at a segment level that create customer value and build shareholder wealth in ways that enhance stakeholder and societal wellbeing

4. Value Realisation & Management Capability

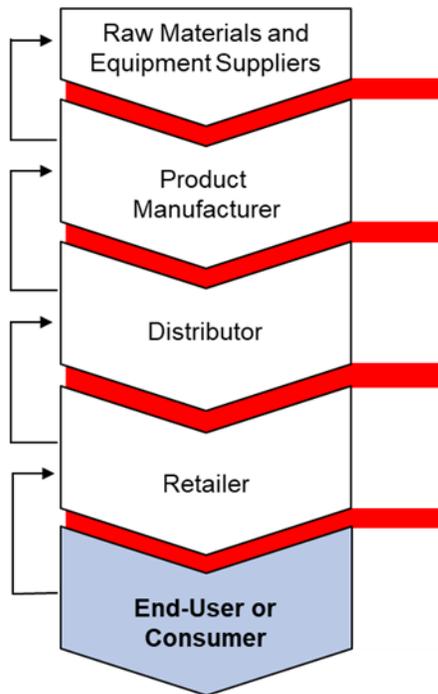


Put in place processes and systems that encourage the pursuit and successful implementation of strategies that enhance value for all stakeholders including the wider community, and deliver a sustainable level of ongoing wealth creation for shareholders

The Business Community Response to BASOS

It is often necessary to form an ecosystem of companies operating as a value-creating network

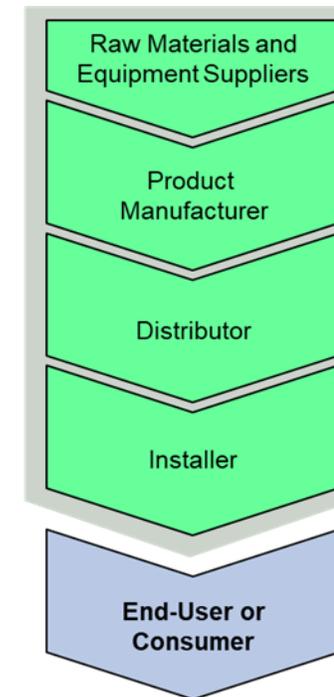
The typical supply chain establishes intermediate markets that ensure each participant gets the lowest possible price from the businesses competing one step up in the chain ...



... This encourages regressive competition at each point of interface within the supply chain resulting in:

- Specialisation in small elements of the supply chain
- Participants being disconnected from the real needs of end-users
- Reduced value being delivered to end-users
- Commoditisation as price rather than customer value delivered becomes the primary basis of competition

Members of the Value-Creating Network co-operate with each other to co-create value for end-users in a way that creates wealth for all network participants



The network delivers a value proposition in the form of a deliberate combination of end-user benefits and price

Unlike the typical supply chain it is not just about ensuring each player gets the lowest possible price from those competing one step up in the chain ...

Progressive competition is focused at the interface with the end-user and is centred on which is the best end-user value proposition

Prices are set mainly on the basis of end-user benefits delivered

The Investment Community Response to BASOS

Our focus in the finance sector is on institutional investors

Observations

- High proportion of passive investing
- High proportion of investment outsourced to external fund managers
- Excessive focus on 'relative fund performance ranking' driving FUM flow and remuneration
- High proportion of new money into the superannuation system invested in the secondary markets

- Highly volatile share prices – winners and losers, focus on timing the market to generate 'alpha'
- Emergence of equity price bubbles
- Pressure on boards to engage in short-termism

Opportunities for Reform

- Get educated in the BASOS principles, understandings and techniques
- Insource a higher proportion of investment decision making and active
- Actively engage with investee companies on significant strategic issues using the BASOS framework to frame the engagement process
- Adopt an active investment approach by investing in companies that are committed to undergoing BASOS transformation – “better investments in better companies”
- Move away from relative TSR to rank and measure fund performance, and adopt wealth creation performance metrics (TSR-Ke approx. 1-2%)
- Be prepared to invest a reasonable proportion of the fund's capital in the primary capital market to fund innovation and growth, and reduce the emergence of inflated asset prices in the secondary markets
- Be prepared to go long cash during periods of inflated asset prices

Business Acting in Service of Society

