

TBLI CONFERENCE™ ASIA 2008

29 May 2008

Workshop: Corporate Governance

Topic: *As the countdown to the catastrophic consequences of industrialized and industrializing countries' abuse of natural resources accelerates, the urgency to widen the circle of engagement exponentially intensifies.¹*

by

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Good Afternoon, It's a pleasure to be here, thank you Robert for inviting me.

Ancient Asian wisdom says that there are never any accidents. That having been said, I can't help but note the irony in my making this presentation under the governance category. I look forward to hearing your thoughts after you have heard this presentation.

In this talk, I will provide a brief summary of my view on the current State of SRI and CSR in terms of its impact on the wider corporate environment and explore reframing the current perspective. I'll propose some thoughts on ways to expand the community of engagement and explore the concept of rating the sustainability of corporate profitability.

As most attendees of this Triple Bottom Line Investment conference know, today the equivalent of almost three trillion US Dollars invested around the world use one or more of three core Socially Responsible Investment (SRI) strategies. In 2001, SRI funds' investment represented 3 % of all invested funds, as of December 2007 the Social Investment Forum indicated that this segment represented 10.43% of all funds invested. Progress there is BUT as the countdown to the catastrophic consequences of industrialized and industrializing countries' abuse of natural resources accelerates, the urgency to widen the circle of engagement exponentially intensifies.

To say that the Corporate Social Responsibility (CSR) movement has played a seminal role in driving awareness among Multi National Corporations (MNC) as well as the public in the industrialized world would be an understatement. While the CSR movement has brought us to where we are today, at the same time sophistication with which corporate CSR officers walk the walk and speak the speak has grown into the presentation of brilliantly positioned and worded CSR reports. We know that most companies have not made as significant changes to their business models as they have to their sustainability reporting. At the same time, many/most business leaders continue to view sustainability as a corporate social responsibility issue. There is a clear need to deepen the understanding of the business opportunity in this strategic area for business to capitalize on the unprecedented value migration underwayⁱⁱ at this stage in time. To do this sustainability must move out of the charitable side of the balance sheet and onto the profit and loss side, where it rightly belongs. I propose that if we are going to meet the challenge of sustainability in front of us that this is absolutely critical.

While many Sustainability/CSR leadersⁱⁱⁱ have taken actions, many executives -not directly connected to the initiatives- in those companies don't even know what those initiatives are. Many of these initiatives have not been driven down through the value chain, across the various channels of the business or introduced into internal processes. Despite the fact that many of these initiatives deliver bottom line advantages, they are framed in CSR terms, which inadvertently obscure the financial benefits conveyed.

We are all familiar with Einstein's statement; quote "You can't solve the problem from the consciousness that created it." There is a shift of consciousness required for the issue of sustainability to move into the main stream of business and to thus obtain the attention necessary from business and its leaders. The question is how? I propose that that shift of perspective is encapsulated in the term "Sustainable Profitability".

Indeed it is this shift of perspective (consciousness) that must be imbedded into wide spread understanding and inculcated in the everyday thoughts of business. The more this consciousness is adopted, the more solutions and innovations, with their abiding

economic advantages, will emerge.

Corporate strategies will need to be aligned with innovative business models in order to discover the unrecognized business opportunities on this new frontier of profit in sustainability.^{iv} It is this paradigm shift that is required to enable a wider understanding of the requirements for sustainable economic value creation and capture^v. There is a nexus at which some aspects of sustainability directly impact the ability to sustain profitability. This is the point of focus. This may also serve to move investors' fixation on the quarterly return to a longer term view.

Can shifting the emphasis to Sustainable Profitability present an entry point through which a wider community may be attracted to deepen their understanding of the new business model and opportunity?

I propose that it can. Why? Because there is a current mental model in the market promoted by vested interests that there is a Chinese wall between certain aspects of sustainability such as climate change and business performance. For instance, violent and unpredictable weather patterns can and do result in increased costs and lost revenue.

At the 2007 presentation of Price Waterhouse Coopers' (PWC) Annual CEO Survey, in Singapore, PWC's regional CEO reported, based on the survey, that the biggest concerns of CEOs were non business risks, such as climate change. I asked PWC's CEO what the basis was on which they proposed that climate change's impending disruptions to logistics, were non business risk. He acknowledged with what appeared to be an uncomfortable laugh that it was indeed a business risk. PWC's Global Chief Executive Officer is the chairman of the executive committee of the World Business Council for Sustainable Development and yet that they published the survey referring to such concerns as non-business risk. There appear to be some serious disconnections here. By the way, PWC has taken on the logo/ slogan "connected thinking"! Most people are just in 'knee jerk' denial about the dire consequences that are unfolding; this shuts down natural progressions in systemic thinking. And then, calling it 'as it is' can be quite inconvenient around those that don't want to be reminded. It's one of those situations that go hand in hand with "don't confuse me with the facts". We need a realignment of conventional thinking with the facts.

This Chinese wall historic separation between that which has been traditionally considered non business risk because the costs were quietly externalized^{vi} and silently absorbed by the whole system is a case in point. There needs to be a shift of awareness among business people (and the public), who still hold that engrained mental model. To do so awareness needs to be driven on issues that are obvious and via a message that is "sticky". For those not familiar with this term, it refers to one of three elements required to 'tip' an epidemic. According to Malcolm Gladwell, author of "The Tipping Point", epidemics are a function of the people who transmit infectious agents and the environment in which they are transmitted. When the epidemic tips, its status quo equilibrium is disrupted by one or more of three agents: law of the few, stickiness and the power of context. I am proposing that in this case stickiness and the power of context could bring us to that "magic moment when an idea trend or social behavior crosses the threshold, tips, and spreads like wildfire."^{vii}

If any business person is called to think about the specific issue of logistics disruptions, it is very obvious that it is a business issue. Nevertheless we live in a society that is predominately moved to do only that which makes money, that which is advertised, trendy, coveted, and or fashionable. Thus Sustainable Profitability needs to be framed and promoted as such, if it is to succeed. Since it does present a revenue producing proposition for many, it is note worthy that it is framed as not doing so.

This type of reframing will drive innovation and entrepreneurial undertakings, which can engender corporate 'take-up' as observers note the revenues derived by Leading and Pioneering corporations and entrepreneurs. A case in point, where early signs can be seen, is that rising car manufacturers in China, Chery Automobile and Geely^{viii}, in particular have picked up on the opportunity in hybrid electric and other alternative-energy vehicles, and are accelerating development and production. They are focused on the opportunity to follow their successes in mobile phones and digital technology, not a concern about climate change or sustainability. We will be seeing more of these and would have already seen more but for the power of vested interests and weight of old mental models.

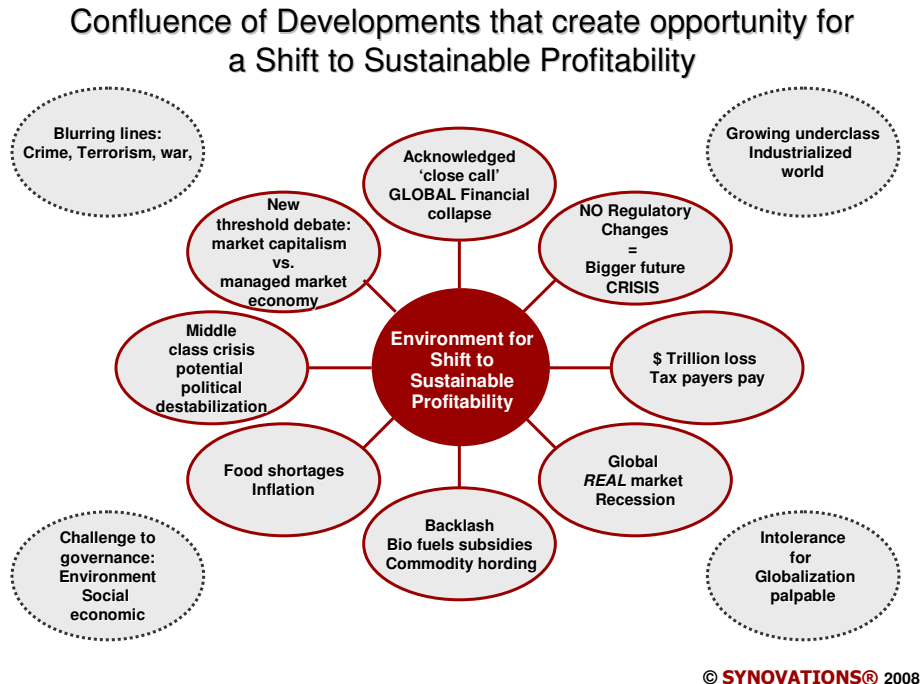
This type of reframing represents business opportunities for those corporations who take it up ahead of the regulations that will ultimately force the recognition of costs that have long been externalized. A perfect analogy is that of cigarettes to the health care costs of the individual American states. When a counterparty 'figures out' that the externalized costs have been dumped on them and they have the means to take action about it, they are likely to do so provided it is in their interest. Cigarette cases of the future can be spotted in a multitude of health care sectors, the costs of which are externalized on to governments. Watch this space.

This type of reframing attracts business leaders. After all CEO's must dedicate their prime time to profitability and the revenue generators on the balance sheet; to date CSR is an expense. Thereby sustainability can not receive the needed attention, as long as it remains in that column.

Most corporations are not interested in the 'raison d'etre' of CSR, despite that which they profess. We know that they adjust only from pressure. Look at the length of time it has taken us to get where we are. However, they are concerned about the sustainability of their profits and there have been now a confluence of events that provide an opportunity to shift the consciousness to that which the traditional business model cares only. It flips the whole dialogue on sustainability over and strikes at that which is at the heart of the matter and most dear to the corporations. The sustainability of profit is indeed at stake in the face of some of the unprecedented changes that climate and related issues present.

The reality is that there are profits to be made from addressing the company and society's environmental and other challenges.^{ix} Indeed there is low hanging fruit to be had in sustaining profitability. This can act as an attraction for the attention of those who may otherwise have deaf ears. The sustainability of company profitability must be every company's solution.^x From whichever perspective one looks at it, MNC sponsoring of *compensatory* "Corporate Social Responsibility" initiatives, not directly tied to strategic intent and profitability are no longer enough.^{xi}

There has been a Confluence of developments at this time that creates an opportunity for a shift in perspective to sustainable profitability.



Let's move clock wise around this slide.

- On 20 April 2008, Paul H O'Neil, former secretary of the US Treasury, stated on Bloomberg that it appeared that "the actions of the Federal Reserve had avoided the bullet of a global financial collapse as of that point in time."
- A financial crisis of this magnitude (the most recent in an obvious series) is unprecedented; the IMF proposes it could be a Trillion US Dollars. This financial crisis is different from other financial crises in that it is domiciled in money centered banks and about trade-able credit instruments.^{xii} Results from abuse of leverage and compensation, 'sleeping' regulators, and clearly a complete vacuum of social and ethical conscience. Indeed, the largest fraud perpetrated by the heretofore purportedly most trusted counter party in the world. There is acknowledgement that if nothing is done on the regulatory front, an even greater crisis will likely emerge within the not too distant future^{xiii}.
- Financial Investors are enduring unprecedented losses, As of 16 April 2008, UBS shareholders had watched their shares fall 60 per cent highs of the year before^{xiv} Tax payers will 'ultimately hold the bag' for the losses .As of 24 April BBC reported that 32% of UBS market capitalization was lost
- Underlying real market recession still unfolding.

- A serious backlash has emerged against industrialized nations from their distorting subsidies of bio fuels. This putting in motion an exceptional race for and hoarding of commodities that are generating cessations of exports by major grain growing countries. In March of 2008, The EU became the first governing body to admit its error and wrong doing and to announce that it would remove the subsidies. This however has not been executed as of this writing.

As an aside its interesting to note here that due to the commodities crisis, countries opposed to GMO food are de facto, being forced to accept it. For instance the FT reported on the 16 of April that Nihon Shokuhin Kako, a Japanese food company, indicated that high corn prices had forced it to buy cheaper genetically modified corn for the first time, breaking a social, though not legal, taboo. Stay tuned for a backlash here.

- The crisis hits the middle class, with the potential to cause political destabilization.^{xv}
- a new threshold has been reached in the debate between free market capitalism and managed market economy;^{xvi}

While looming in the background are

- A growing underclass in industrialized countries.
- Greater, palpable intolerance among industrialized and unindustrialized nations for globalization.
- Broad based challenge to governance: environment , social and economic
- Increasingly blurry lines between crime, terrorism and war

I herald the Hart- Milstein Sustainable Value Framework and Portfolio^{xvii}, and propose that focusing on Sustainable Profitability could provide a 'segue' for those who are currently 'closed' to these business models to potentially 'open-up' to understanding them, an initial 'shift'.

Can a rating system that rates the sustainability of profits be developed and utilized to accelerate the process of understanding and engagement?

Although my preference is to answer a resounding yes, I have not yet drawn my final conclusion but would rather put it forward for exploration and dialogue with you.

Indeed from the fall of 2007 up to today, my initial reaction to this question has been that with the well founded lack of credibility in the credit rating agencies, absolutely not!

However, "this too shall pass", so I 'tried on' a different perspective. Consider a rating company, after regaining enough creditability, under a set of voluntary or forced regulations, utilizing its traditional credit rating models with some adjustments and offering this rating on an unsolicited basis.

Perhaps this is achievable with a fine tuned focus on issues that are at the nexus of sustainability and profitability, framed in the economics of the traditional rating models and widened to include categories not yet included such as 'non-business risks' which

are clearly business risks. Later on, economic value will need to be attributed to heretofore unvalued externalities including loss of biodiversity, but not initially; the low hanging fruit would best be addressed first.

Of course, the sustainability of the profitability would need to be quantified in various specified time frames.

It would appear best to first address some of the more apparent possibilities in the sectors of transportation, logistics and natural resources; those clearly impacted by the relatively early stages of weather pattern changes already resulting from climate change. It's easy to recall newsworthy items earlier this year such as the Danish ship in the Atlantic Ocean in particularly turbulent seas that lost all its containers off the top deck^{xviii}. I also recall the freighter in the Mediterranean, which had to seek shelter closer to shore due to the same, when it anchored it cut off all the fiber optic cables to the Middle East.

Of course the leading companies already undertake extensive scenario planning on safety and crisis issues, leading companies engage specialists singularly focused on the effects of global warming. Clearly they recognize internally the risk to their profitability. This appears to me to be the easiest point of entry as the frequency of dramatically disruptive weather increases.

Would any of the fund managers in the room find this Sustainable Profitability rating useful?

I recognize that on 15 April 2008 the Financial Times Asian edition online, front page headline read, "China's economy expanded 10.6 per cent in the first quarter of the year, only a bit slower than the final three months of 2007, despite widespread disruption from ice storms and power cuts". However I am highly skeptical given the limitations of press reporting in China. Remember the millions trying to go home for Lunar New Year? At the same time, this did shave a couple of percentage points off of China's gross domestic product for the quarter.

The impact of the cost of oil is already considered in credit rating models. Would not a sustainable profitability rating that addresses the impact of climate change be a natural follow on?

There is an asymmetrical analogy here to the way in which one-off financial events are taken into account. If the one off nature of a gain is noted, it appears to me that the probability of one off or multiple climate change disruptions are statistically likely enough that they should also be taken into account?

Let's look at how a Sustainable Profitability rating may have worked in the current financial crisis. Bearing in mind this is an unsolicited rating, it may have been an early warning. Yes, I recognize ninety-nine percent of the inebriated did not want to listen. Nevertheless let's proceed here for exploration sake.

In an FT interview with Dr. Henry Kaufman, (The Wall Street legend, at Solomon Brothers during 1970 & 80s), he quite squarely held the regulators and the rating agencies at the top of a cascading list of those responsible. He commented on the observable nature of the tell tale signs of the looming crisis, which were ignored, as

follows:

- Great availability of credit and debt,
- interest rates at narrow differentials despite differences in risk (risk not priced into the interest rates);
- high volumes of financings of low quality;
- Every financial institution in US and Europe with aggressive expansion plans.

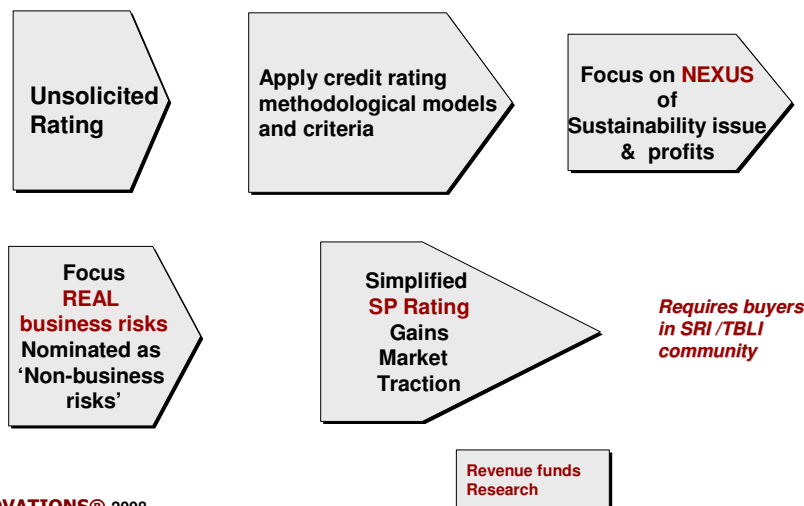
These quantifiable criteria could have been and might be incorporated into one aspect of a sustainable profitability rating, which on an unsolicited basis may have been worth considering.

I propose that the potential for a Sustainable Profitability rating is there. While I recognize the fact that the most egregious companies violating the planet with highly talented green-washing capability and propaganda machines, will try to turn it into an opportunity to manipulate it for their gain. Nevertheless, there are corporations who will likely take up this concern to the degree the market does and this rating could prove useful to fund managers and other investors.

Of course, all the accompanying research must be completed. While I recognize that the results must be known and that those results may uncover new issues, the goal is to drive the shift in perception to

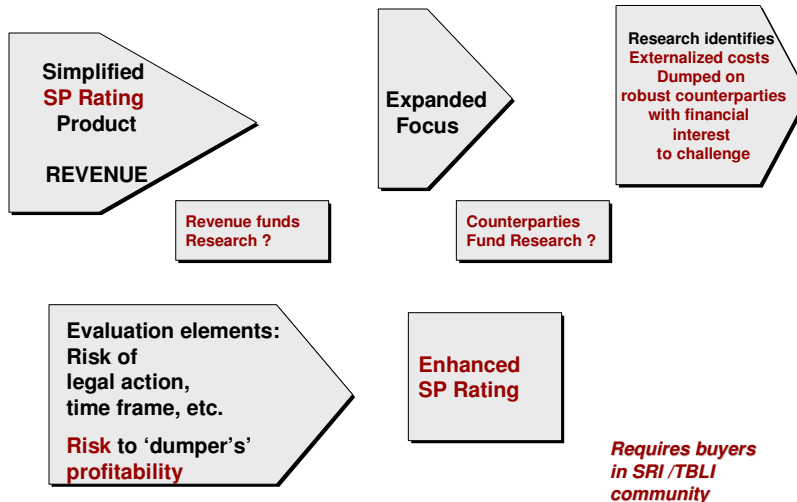
- a focus on financial opportunity from the perspective of sustainability of profits,
- a focus longer than one quarter
- to use this as an opening wedge to place economic evaluations on externalities heretofore not accounted and
- to see the aforementioned actually priced into the value of the shares.

Rating Sustainable Profitability



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Rating Sustainable Profitability



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In conclusion, a Sustainable Profitability rating would be structured on an unsolicited basis, a credit rating methodological model and criteria. In the initial phases, focused exclusively on the nexus where specific sustainability issues directly impact profitability. Begin with the obvious business risks that are commonly categorized as non business risks. As this simplified rating product gains market traction, the revenue funds research for further development. Buy in from SRI and TBLI community would be essential.

As revenues are generated the focus can be expanded to include research that identifies counterparties on which externalities are dumped and which are robust enough to take action. For example this research would identify situations that are similar to that which existed between the cigarette companies and the US States that were funding the illnesses that the cigarettes caused. Clearly this phase would need to be undertaken in the USA because of the supportive legal framework. Further funding for research could be solicited from these robust “dump-e’ counterparties. Research studies could evaluate the risk of legal action, time frame variations and risk to ‘dumper’s’ profitability. Subsequently this enhanced sustainable profitability rating would be introduced. The enhanced model would need to be constructed organically and one step at a time.

I welcome your thoughts and open this for dialogue. Thank you for your kind attention.

ⁱ Tara Kimbrell Cole, *Sustainable Profitability*, to be released in 2009.

(SG ISBN: 978-981-08-088-4). Excerpted and adapted from the chapter: “Rating Sustainable Profitability”

ⁱⁱ Tara Kimbrell Cole and Roger Moore, *Confidential strategic dialogues on Climate change and Sustainable Profitability*, 2007-9

ⁱⁱⁱ Refers to best in class of an industry, companies that maximize market value through sustainability / csr strategies. Examples are Henkel, Johnson & Johnson. *Who’s Who in CSR Rating?* Bertlesman Foundation and University of Stuttgart. 2006.

iv Ibid

v Ibid

^{vi} Externalization costs are the real costs of making distributing and disposing of products and services that are not captured in the price. These costs are paid for by indigenous communities who lose their agrarian life support systems, increasing asthma and cancer rates among the general public, and children in developing countries who work at slave wages in one form or other on retrieving the resources to be used are manufacturing the product.

^{vii} Malcolm Gladwell, *The Tipping Point*, (Back Bay Books, Little Brown and company, USA) 2000

^{viii} London Financial Times article, 21 April 08

ix Ibid

x Ibid, 3 April 2008

xi Ibid

^{xii} Dr. Henry Kaufman, interview Financial Times of London April 08

^{xiii} Ibid

^{xiv} Financial Times 16 April 2008

^{xv} Ibid

^{xvi} Stuart Hart, *Capitalism at the Crossroads*, (Wharton School Publishing) 2005

^{xvii} Ibid

^{xviii} BBC March 2008