

Sustainability the Indian way

Written by Amanda McCluskey, Head of Responsible Investment

August 2011

What surprised me the most during my first trip to India was how much companies genuinely want to grow their business in a way that addresses the wealth gap. *Inclusive Growth* is a common mantra. Either through philanthropy or growing 'responsibly', the approach was more genuine than you typically see in other global companies.

The common question I tried to ask all the people I met was: *What are the biggest sustainable development challenges for your company and for India?* I was really struck by how much the good company leaders had thought about the issues. Some argued that people in India waste too much and others argued inequality was the big challenge. Having more than 50% of people without access to basic financial services creates major sustainable development challenges¹. As one business leader eloquently put it, *"Poverty is the biggest polluter."*

The challenges at the company level were obviously broad and varied. Some of particular note and frequently mentioned include:

- bringing people along the sustainability journey and convincing them it's good business (sounds familiar?)
- education and making people understand they have an impact
- lack of regulatory certainty, and
- human capital and finding skilled labour.

Some of the more concerning things were no surprise. Obvious pollution challenges. Poverty like nowhere else I have seen. Corruption. Corporate governance; how many Boards is too many? All these issues create massive challenges for companies and barriers to achieving sustainable development. More specifically I think the multi national corporations that are run as divisions as opposed to even proper subsidiaries, let alone public companies, could also be of concern.

In reality I learnt more from this trip than I can possibly put down on paper. There was certainly the good, the bad and the ugly, but I suspect this is a theme across everything in India. I have outlined in more detail some observations on energy efficiency regulation and environmental innovation, water, carbon, agriculture and the broader challenges around land acquisition and the incredibly ambitious Unique Identification Program. While there are many issues on sustainability in India that warrant debate, for example corruption, these are some that are less discussed and surprising to me.

Energy Efficiency

The waste aspect I thought was interesting. Consistently people claimed that the Indian population just waste too much. Some of this was maybe due, as one person said, to *"silly government policy"* like free power to the agricultural sector. *"Farmers just leave the water pumps running all night because the power is free"*. The waste is also a result of a lack of awareness about the environmental impact that occurs through people's activities.

However with 35% of the population still without access to electricity, energy conservation emerged as a major policy objective².

¹ What's there in a number?, CLSA Asia Pacific Markets report on the government's UID project, 2011

² International Energy Agency, World Energy Outlook 2010 Edition, p240

In preparing for my trip I was struck by the excellent reporting by companies on their energy use and implementation of energy efficiency opportunities. The reporting rivals any global company. This is driven by the regulation. The Energy Conservation Act was passed in September 2001 and requires large energy consumers to adhere to energy consumption norms and reporting on use and efficiency gains.

This means investors have access to information on electricity purchased and generated in both an absolute sense and per unit, coal and furnace oil used, as well as other forms of energy and the average costs.

While we have comparable regulation in Australia with the Energy Efficiency Opportunities Act, the public reporting is less rich. We have also not seen the innovation in terms of management as a result. Perhaps this is because the cost of power is just so low in Australia.

An example of a good response by an Indian company is Dabur's energy conservations and waste management initiatives. Dabur has established a new boiler technology that uses wet herbal waste from the facility as fuel to generate steam for one plant. At another plant they are using rice husks as a fuel. They are also setting up facilities to use herbal waste from the manufacturing process and convert them into bio-briquettes that can be used as fuel in boilers. The end goal is to ensure that herbal waste is not disposed of in the environment. In meeting the company my impressions were validated. Dabur's approach would challenge many developed markets manufacturing operations on energy efficiency assessment.

Water

I was surprised water did not come up more. Only when I asked did companies admit India's reserves were under huge pressure. I suspect it's just not a priority.

For many of the environmental challenges there either aren't the regulations or there are inadequate resources to enforce them. I was told of the challenges for the Central Environment Ministry to get the states to even accept the legislation, let alone enforce it. Each state is different. Water is the same.

There are positive stories. Water management in Gujarat for example (the poster-child state on all things environment) is leading to some positive environmental, economic and societal outcomes in agriculture. We were told that in Gujarat there have been some innovative approaches to managing salinity in the coastal rural areas that has led to significant improvements in agricultural yield.

There was not much from the companies in terms of innovation. Water seems to get little attention from the corporates despite the fact India, with 16% of the world's population, has only 4% of the world's available fresh water resources³. The infrastructure also has not kept up. We were told that many of the apartment blocks in Mumbai have to have their water trucked in each day. The water pollution challenges are also visibly obvious. Only half of Delhi's population has their waste water connected to the sewers; the rest is disposed into ditches. We also heard of significant challenges with industrial pollution in both the river systems and groundwater.

Water access and security of supply challenges may emerge as serious investment issues in the nearer term.

Carbon

While some of the 'carbon risk' is no doubt managed by default through the positive approach to energy, carbon was remarkably not on the corporate agenda, although it may be we hear about carbon more in Australia than anywhere else in the world at the moment. Few companies talk about carbon management or reduction targets. Politically it's interesting to note that India's pledge post-Copenhagen was to limit its increase in emissions by 11%. Russia was the other notable increase at 8% while China has pledged a reduction of 24% and the US and Australia have pledged reductions of 25% and 23% respectively, all against business as usual projections for 2020.

I suspect India's weak international targets combined with the long list of priorities on the Government's agenda will mean 'carbon risk' will not be material for investors in India for some time. While some energy companies are doing some interesting developments in wind and solar thermal, coal is very much king.

³ Eleventh Five Year Plan 2007-12, Planning Commission Indian Government, Volume III : Agriculture, Rural Development, Industry, Services and Physical Infrastructure; Chapter 2: Water Management and Irrigation; Page 42

Agricultural

“There is no agri-business in India, just agriculture”, Bank executive.

I think this comment sums up the landscape in India. Farms are typically small and family run. Over the generations the farms have become smaller and smaller as they get divvied up amongst the sons. While this obviously presents some challenges in terms of achieving efficiencies through scale, it does give people ownership of their business. As a leading environmental activist outlined, India needs to find its own development pathway. Having 1.2 billion people in need of a livelihood means consolidation of the agricultural sector is not necessarily the best pathway.

The environmental challenges are significant, but there are some good practices coming through as a result of the requirements of the western markets. In tea farming for example, McLeod Russell outlined that they use significantly less pesticides to meet the EuroGap standards. Similarly the demand for Fair Trade has enabled them to make some good improvements in working conditions. Unfortunately the same standards do not apply for production for domestic consumption. However companies like McLeod should be well positioned as the legislative frameworks gradually change.

I also saw some good innovation in the companies servicing the agricultural sector. Most impressively Coromandel International Limited (part of the Muragappa Group) is making some great inroads in the organic fertiliser business. When we met with company they informed us the feedstock is 40% waste from the sugar mills (in the sister company EID Parry), 16% waste from the distilleries (that is surprisingly high in potash) and the remainder is municipal waste. They have a target that, for every two tonnes of chemical fertiliser sold, there will be one tonne of organic fertiliser sold. The reason?; its for the good of the country. Chemical fertilisers strip carbon from the soil so it's bad for the long term soil health and productivity. The Chairman of the Muragappa Group is also the Chairman of Fertiliser Association of India and he is concerned about the ongoing degradation of India's soils.

Land acquisitions and social licence to operate

The importance of a social licence to operate in the context of land acquisition challenges was also a surprise. Land acquisition was the most talked about challenge to sustainable development. It was a theme that cut across sectors. Even the companies with a poor approach recognised this was the biggest challenge.

The Indian land acquisition laws are complicated and challenging. There are frequent debates and confusion over what price land should be acquired at, how much should be forcibly acquired and how resettlement should occur. The challenges, including protests and associated project delays, seem to create the greatest social risk for companies in India.

An ironic positive of the challenges around land acquisition is that companies have to have good relationships with their surrounding community to protect their licence to operate.

The Tata Group is clearly a group of companies with the most focus on community issues. In the book *The Creation of Wealth: The Tata Story*⁴ there are stories of the world-leading approach that the generations of the Tata Group have taken to workers rights and conditions, often extending their engagement to the broader families of employees. Many of the tales of a sound approach were backed up stakeholders, including the staff at the Taj Hotels and the Tata business leader peers. The staff at the Taj spoke so fondly of the way the staff were treated post the Mumbai attacks. Tata continued to pay the 1500 staff, including contractors, full wages for the two years it took to rebuild the hotel. The loyalty that this fosters can certainly not be bought.

The business case for good community engagement can often only be provided relative to what it costs a company when it all goes wrong. Tata Steel and Posco both conceived their high-profile steel projects in Orissa around the same time in 2004-05. Both faced similar opposition from land owners and saw long delays in meeting schedules. However both took very different approaches to how they engaged the community. Tata's approach was based on their long standing approach to community relations. Tata Steel's plant is under way with a commissioning deadline of October 2013, while Posco is still stuck at the land-acquisition stage. Nobody really knows when construction will start.

⁴ The Creation of Wealth The Tatas From 19th to 21st Century, R.M Lama, 2004 The Penguin Group

The ID Program

The much-talked about universal identification (UID) is quite an extraordinary undertaking; looking to offer all Indian's the opportunity to have a unique ID. The 1.2 billion population number makes it sound ludicrous and totally unachievable, though I was told that the guy with the job, Nandan Nilekani (who started Infosys), is the one man who could do it.

The UID program will have the obvious benefits for access to financial services, but it may also address the waste and some of the corruption challenges. For example, economically disadvantaged people could be compensated directly once they can be identified. It also means the compensation will be taxed by less hands before it gets the ultimate recipient.

The Government's initial proposition for the UID was the efficient delivery of welfare services. The ID is referred to as an "Aadhaar". The actual screening seems to be done by the private sector with a number of companies being awarded contracts by the Government. The Aadhaar is not compulsory, however they have become the norm. To not have one will make life more difficult than it otherwise would be.

To get an Aadhaar a resident needs to go to an "Enrolment Camp" that seem to be travelling around the country. Upon registering for an Aadhaar, residents will go through a biometric scanning of ten fingerprints and iris scanning. They will then be photographed and given an enrolment number. Depending on the enrolment agency, residents will be issued an Aadhaar number within 60 to 90 days.

An iris scanner



There have been a total of 11,053,841 issued since the program started in August 2010.

The iris camera performs recognition detection of a person's identity by mathematical analysis of the random patterns that are visible within the iris of an eye. It combines computer vision, pattern recognition, statistical inference and optics. It effectively takes a digital photo of the iris pattern and recreating an encrypted digital template of that pattern. That encrypted template cannot be re-engineered or reproduced in any sort of visual image. The imaging process involves no lasers or bright lights and authentication is essentially non-contact⁵.

The criticisms have, of course, been there. Concerns around privacy, selling of the information, the accuracy of biometrics and the sheer administration involved. If it works, there are opportunities for a number of companies. Finance is the obvious one, with banks being able to offer products to more customers. The Aadhaar allows them to comply with the 'know your customer' rules. The fact that the whole of economy benefits in terms of less corruption is also a positive. Rebates will be able to be credited straight to the accounts of recipients, rather than having to trickle down to the end recipient through many taxing hands. Provision to many other services will also become easier; telcos, energy companies, health care. The list could go on.

⁵ http://uidai.gov.in/index.php?option=com_content&view=article&id=168&Itemid=165

Conclusions

Considering the approach companies take to ESG issues is potentially more insightful in India than many other markets. Besides the obvious materiality of corporate governance and corruption, other broader ESG issues also present risks and opportunities for investors. The scale of the population and democracy means a social licence to operate is more important than in China, with its centralised command and control economy. Impending pressures around water access, security and quality of supply may mean there are some long tail risks. Innovation in energy efficiency and the potential of the UID program present significant opportunities over the long term. Investors ignoring ESG issues are certainly missing some of the most interesting aspects of Indian companies and also perhaps the most material investment risks and opportunities.

cfsinstitutional@colonialfirststate.com.au

Regional Managing Director, Australia and New Zealand

Joanna Davison +61 2 9303 7007

Institutional Business Development and Consultant Relationships

Matt Russell +61 2 9303 7024

Ali Karmali +61 2 9303 6070

Investment Specialists

Tracey McNaughton +61 2 9303 2695

Trent Koch +61 2 9303 2695

Chris Robertson +61 2 9303 0002

Institutional Relationship Management

Liz Krajewski +61 2 9303 2927

Daniel Bristow +61 2 9303 6311

Helen Squadrito +61 2 9303 6142

Hugh O'Neill +61 2 9303 6116

Simon Good +61 3 8628 5681

Harry Moore +61 3 8618 5332

Nadene Moore +61 3 8628 5615

Disclaimer

Product Disclosure Statements (PDS) and Information Memoranda (IM) for the funds issued by Colonial First State Investments Limited ABN 98 002 348 352, Commonwealth Managed Investments Limited ABN 33 084 098 180, and CFS Managed Property Limited ABN 13 006 464 428 (collectively CFS) are available from Colonial First State Global Asset Management. Investors should consider the relevant PDS or IM before making an investment decision. Past performance should not be taken as an indication of future performance. No part of this material may be reproduced or transmitted in any form or by any means without the prior written consent of CFS. This material contains or is based upon information that we believe to be accurate and reliable. While every effort has been made to ensure its accuracy we cannot offer any warranty that it contains no factual errors. We would like to be told of any such errors in order to correct them. This material has been prepared for the general information of clients and professional associates of CFS. You should not rely on the contents. To the fullest extent allowed by law, CFS excludes all liability (whether arising in contract, from negligence or otherwise) in respect of all and each part of the material, including without limitation, any errors or omissions.

This material is intended only to provide a summary of the subject matter covered. It does not purport to be comprehensive or to render specific advice. It is not an offer document, and does not constitute a recommendation of any securities offered by CFS. No person should act on the basis of any matter contained in this material without obtaining specific professional advice. Colonial First State Global Asset Management is the consolidated asset management division of Commonwealth Bank of Australia ABN 48 123 123 124.

Copyright © (2011) Colonial First State Group Limited.
All rights reserved.