Aligning the Interests of Business and Society – A Proposed Research Program

Background and Context

From the early-1990s up until the GFC, there was widespread agreement throughout the international business and investment communities that the fundamental economic objective of every listed company should be to maximise shareholder value. In parallel with this, an incomplete understanding saw many business leaders begin to overlook the interests of non-shareholder stakeholders as they strived to meet this governing corporate objective.

In the period post the GFC, there has been a transition towards a more balanced stakeholder-oriented view of the firm. But as this transition gathered momentum, many people lost sight of an important truth. Even under a business paradigm that gave absolute primacy to the interests of shareholders, the real economic objective of the leaders of listed companies from an investor perspective was never to *maximise shareholder value* or even to *create shareholder wealth* per se. It was to build an *enduring institution* with the ability to create wealth for its shareholders *on an ongoing basis.*

The very nature of this more complete and appropriate articulation of a company's economic obligation to its shareholders, means that the way a company journeys towards meeting it, can be just as important as eventually getting there. This is because the way a company goes about creating shareholder wealth has an enormous impact on its ability to continue to do so *on an ongoing basis*. If non-shareholder stakeholders do not benefit in a fair and equitable manner from their relationship or their interactions with a company, then it will be impossible for the company's leaders to build an *enduring institution* that can create wealth for shareholders *on an ongoing basis*.

Research completed when writing '*Customer Value, Shareholder Wealth, Community Wellbeing*' (Palgrave Macmillan 2017), indicates that whether consciously or not, some of the most successful listed companies are run in ways that suggest they don't set out to maximise short-term profits; or even to try to drive up their share price by exceeding profit expectations over the short-to-medium term. Instead, they appear to be run as if their leaders are trying to build *enduring institutions* with the ability to create value for customers and wealth for shareholders *on an ongoing basis*. This can only be done successfully over the long term if the wellbeing of all stakeholders is preserved or enhanced along the way.

The same research suggests this type of behaviour can be evident in successful listed companies, irrespective of whether they are operating under a shareholder primacy mindset or with a total stakeholder mindset. This is because with a long enough time horizon and the right understanding, there is little difference between the two approaches – since the longer the time horizon, the more the interests of all stakeholders align.

The problem however, is an incomplete understanding in relation to these matters among many people in positions of influence in the business community, in the investment community and in the business press. The actions of Unilever Plc in launching a buy-back, cutting costs and increasing dividend payments following a bid from Kraft-Heinz in early 2017, provides an excellent example. There are many who believe these actions were in the long-term best interest of Unilever's shareholders. But the findings from a pilot study conducted as a precursor to the research proposed in this document, suggest the opposite may be true – despite a significant increase in share price over the short term.

The Need for Research

This paper has two roles. Firstly, it provides a summary of findings from preliminary research conducted jointly by *The KBA Consulting Group* and the *Maturity Institute*. That research uncovered an important link between improvement in *Organisational Maturity* – an evidence-based assessment of overall organisational health – and the ability of companies to continue to create shareholder wealth in ways that enhance the wellbeing of all legitimate stakeholders.

This paper is also a proposal that seeks funding from leading corporations, institutional investors and other interested parties to expand the preliminary research described – initially to provide coverage of all companies in the ASX100 and FTSE100 indices. Over time, it may be expanded to cover more companies listed on those two exchanges; as well as those in the S&P100, the NASDAQ100, the DAX30, the CAC40 and the TSX – and potentially those in the NIKKEI, the STI and the Hang Seng indices as well.

Many groups are now arguing that companies must focus more on the long term and pay greater heed to the needs of other stakeholder groups. However, such arguments are mostly philosophical or assertive in nature. The research program proposed will almost certainly provide an evidence-based economic justification for an explicit focus on seeking to meet the needs of all stakeholders. This is essential if the business community, the investment community and the wider community are to all come on board.

The research should also unlock crucial insights as to what is required of business leaders in setting out to build mature, enduring institutions; plus actionable paths forward for most companies. To make use of these insights, it will be important for each Board to know where their company stands in terms of both *Organisational Maturity*, and the shape of the *Bow Wave of Expected Economic Profits* embedded in their company's share price and market capitalisation, as well as how both indicators have changed over time.

Once the summary findings of this research become public, they could well play a key role in the way corporate governance policy evolves, and potentially impact significantly on the interpretation of the fiduciary duties of Directors of listed companies. This is becoming even more likely in the light of what has already been revealed in the first few public hearings of Australia's *Banking Royal Commission*.

The findings from the proposed research are also expected to provide the basis for a more meaningful and more actionable dialogue between investors and the Boards of listed companies, consistent with the responsible ownership principles that are now being adopted by many institutions (such as those of Hermes Investment Management for example). They are also likely to provide powerful ammunition for Boards when dealing with activist shareholders and other short-term capital market players, whose interests often do not align with those of the company or its long-term shareholders.

The Maturity Institute and the Notion of Organisational Maturity

The *Maturity Institute* (www.maturityinstitute.com) is a global, not-for-profit, professional body; established to encourage the development of effective, whole of system leadership and management within corporate, investment and regulatory environments. It provides a unique, evidence-based approach to assessing organisational health, which is termed *Organisational Maturity*, leading to the creation of integrated, long-term *societal value*. A book entitled '*The Mature Corporation*' (Cambridge Scholars Publishing) will be released in early 2019.

KBA and the Idea of a Bow Wave of Expected Economic Profits

The KBA Consulting Group (www.kba.com.au) is an IP-rich boutique consulting firm which helps Boards and executives build enduring institutions that create value for customers and wealth for shareholders on an ongoing basis. Its approach includes looking at listed companies through an economic performance lens and expressing their economic value in terms of a *Bow Wave of Expected Economic Profits*.

A book by KBA's principals entitled '*Customer Value, Shareholder Wealth, Community Wellbeing*' (Palgrave Macmillan, 2017) shows how the *EP Bow Wave* construct can be used by Boards and executive leadership teams setting out to construct companies that create real or authentic value for customers; build significant wealth for shareholders; and do both in ways that deliberately set out to enhance the wellbeing of all stakeholders (thereby contributing positively to *societal value* over the longer term).

Understanding the EP Bow Wave

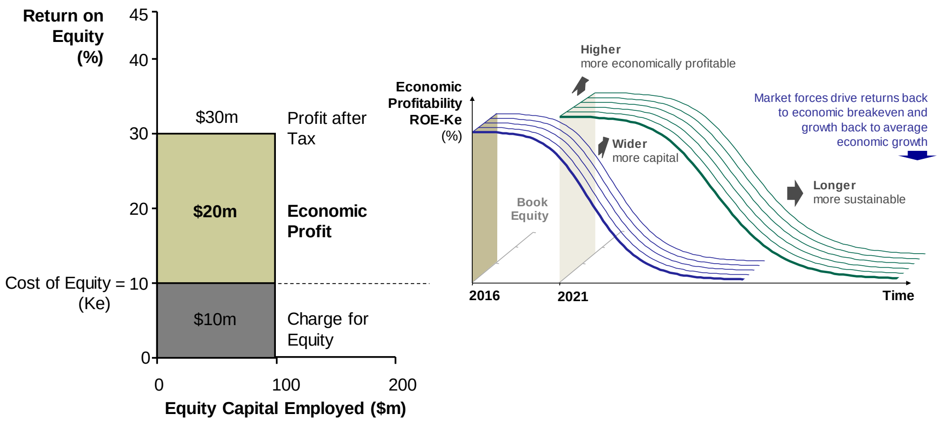
The notion of a *Bow Wave of Expected Economic Profits* embedded in the *intrinsic economic value* of all listed companies, and which underpins their share prices and market capitalisations, emerged from a seven-year development effort focused on identifying a bridge linking the *product and service market performance* produced by management with the *capital market outcomes* experienced by shareholders.

Defining that bridge in terms of an *EP Bow Wave*, constituted a material breakthrough in applied corporate finance and business economics.

Appendix A contains a detailed description of the *EP Bow Wave*, how it underpins *intrinsic value*, and how enhancing the shape of the *EP Bow Wave* leads to both *intrinsic value* uplift and the creation of wealth for shareholders. It also touches on how this can be done in a way that enhances value for all stakeholders, thereby making a positive contribution to *societal value* over time.

A simple illustration of the *EP Bow Wave* construct is provided in Figure 1.

***Figure 1**. The EP Bow Wave Construct*



Shaped like a child's slippery slide, the *EP Bow Wave* lets us demonstrate how wealth is created in the *capital market*, when management find a way to make their company's *EP Bow Wave* higher, wider or longer, through the way they participate in the *product and service market*.

It can be used to determine *intrinsic value* and as such, constitutes an improved way to think about company and business valuation. It can also be used to 'reverse engineer' the *EP Bow Wave* and the associated *EP* stream that must be delivered to underpin the share price and *market capitalisation* of any listed company at any point in time.

Summary of Preliminary Research Findings

As work has progressed with the *EP Bow Wave* construct over the past few years, it has unlocked far more understanding than was initially anticipated. Three insights that have emerged from recent research are particularly significant. Together, they provide a strong economic justification for a much greater focus on the long-term; and demonstrate that true economic success for a listed company requires that the needs of all legitimate stakeholders be met. These include customers, shareholders, suppliers, employees, the wider community and the environment.

The First Insight. *A Focus on the Long Term is the Key to Ongoing Shareholder Wealth Creation*

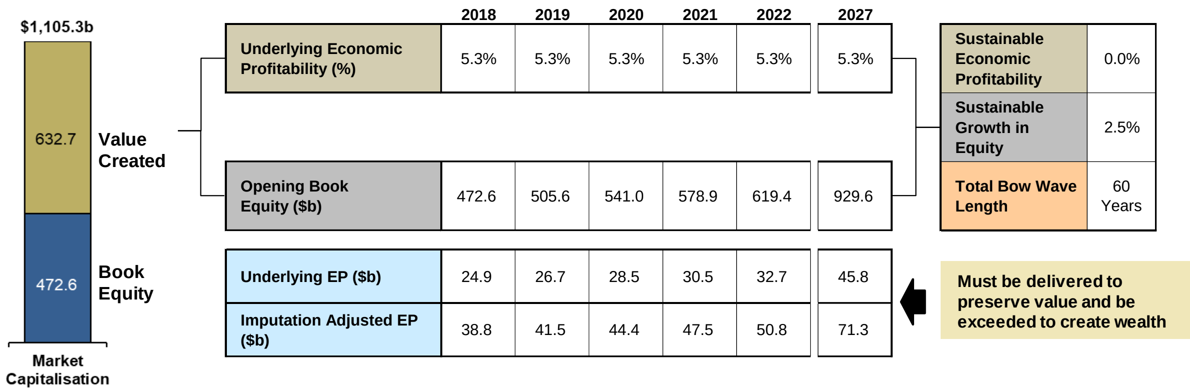
The *intrinsic value* of a listed company can be defined as the sum of the capital contributed by shareholders and the economic value created by management. Management's contribution takes the form of the *EP Bow Wave* the company is expected to deliver. It is evident in the company's 'intrinsic' *Market to Book (M:B) Ratio*.

The *EP Bow Wave* construct also allows us to 'reverse engineer' the required *EP Bow Wave* that must be delivered to justify the current share price and *market capitalisation*. In this case, the contribution required of management is evident in the company's 'observed' *M:B Ratio*.

In both cases, the *EP Bow Wave* construct lets us express *M:B Ratio* more meaningfully in terms of its three underlying drivers, namely expected returns, expected growth and the sustainability of both.

Figure 2 presents the aggregate *EP Bow Wave* embedded in the combined market capitalisation of the top 120 ASX-listed industrial companies as at 31 December 2017, as well as their aggregate *M:B Ratio*.

Figure 2. *Expectations Embedded in the Market Cap of the Top 120 ASX-Listed Industrials – 31 Dec 2017*



The 'observed' aggregate *M:B Ratio* of 2.3x ($1,105.3b divided by $472.6b) shown in Figure 2, comes from a required aggregate *EP* stream with economic profitability (the height of the *EP Bow Wave*) expected to be maintained at an average of 5.3 per cent for the next ten years, earned on an equity capital base that is expected to grow from $473b to $930b over the same time frame (the width of the *EP Bow Wave*). After that, economic profitability is expected to fall gradually back to zero over 50 years (so the total length of the aggregate *EP Bow Wave* is 60 years) while at the same time, growth is expected to fall back to average economic growth of 2.5 per cent.

Shareholder wealth is created, and a higher *M:B Ratio* is observed in the *capital market*, when the *EP Bow Wave* underpinning the share price and *market capitalisation* becomes higher, wider and especially longer.

Maintaining or enhancing the length of the *EP Bow Wave* is particularly important. This cannot be done *on an ongoing basis* and therefore wealth cannot be created *on an ongoing basis* (particularly over periods spanning 50-60 years) unless all stakeholders are looked upon as allies in creating value for customers and wealth for shareholders over the long term, and a conscious effort is made to ensure that all benefit appropriately from their interaction with the company.

This is because; if the *EP Bow Wave* required to be delivered implies relatively high returns and growth sustained over a long time period of time (i.e. a high, wide and long *EP Bow Wave*), and non-shareholder stakeholders don't benefit appropriately; then there is every chance that customers will turn away, competitors will prevail, and regulators or even law enforcement authorities may step in – as we have seen in a number of countries in recent years, with Australia's *Banking Royal Commission* being the latest example. Such outcomes can result in a contraction in the *EP Bow Wave* leading to the destruction of shareholder wealth.

Contrary to what many believe, wealth cannot be created *on an ongoing basis* simply by seeking to improve profitability or even economic profitability, which means focusing solely on trying to increase the height of the *EP Bow Wave*. Focusing on this one dimension can produce a higher *EP Bow Wave* over the short-term. But it often becomes narrower and shorter within a relatively short period of time, leading once again to the destruction of shareholder wealth. It also tends to result in non-shareholder stakeholders being regarded as adversaries in the pursuit of a higher profitability over the short term, rather than as allies in the creation of customer value and shareholder wealth over the longer term.

***The Second Insight**. Successful Companies Don't Create Wealth by Exceeding Existing Expectations*

Extensive research conducted using *Pairs of EP Bow Waves* constructed at the beginning and the end of various measurement periods, demonstrates that many truly successful listed companies can be considered enduring institutions that create wealth for shareholders not once, but *on an ongoing basis*.

Analysis using *Pairs of EP Bow Waves* shows that there are always two potential sources of wealth creation that exist for every listed company over any measurement period. These are:

- The wealth created from the delivery of an *EP* stream that exceeded the expectations in place at the beginning of a given measurement period, and
- The wealth created from any increase in expectations during that measurement period, in relation to the *EP* to be delivered beyond the measurement period.

What was observed when *Pairs of EP Bow Waves* were constructed for the ASX100, the FTSE100 and the S&P100 when undertaking research for '*Customer Value, Shareholder Wealth, Community Wellbeing*', was top performing companies that succeed in creating wealth for shareholders *on an ongoing basis*, tended not to do so by outperforming existing expectations. Instead they created wealth by continually harnessing innovation to build new capabilities leading to the establishment of new and higher *EP* expectations, which they then delivered over time.

This was particularly evident when we looked at capital market performance over an extended series of rolling three-year periods.

When the largest 120 ASX-listed Industrials were examined over five rolling three-year periods ended 31 December 2016, it was found that on-average, none of the wealth created by the 49 top performing companies arose from exceeding existing *EP* expectations. It all came from establishing new expectations that were then met over time – and more than half of it came from an increase in the length of the *EP Bow Waves* that needed to be delivered to underpin rising share prices and *market capitalisations*.

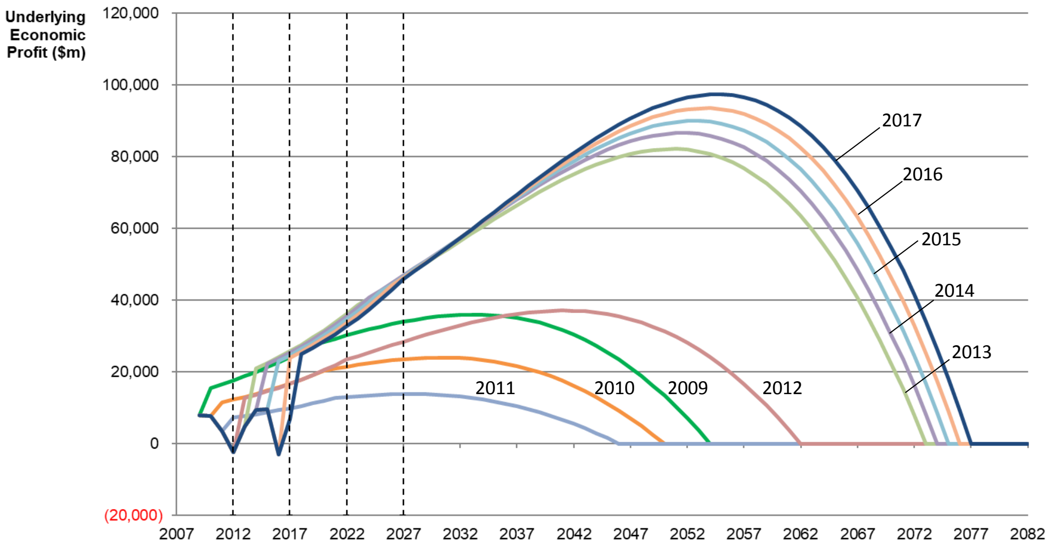
***The Third Insight.** Most Companies Have an 'Innovation Premium' Embedded in their Share Price*

Examining the *Progression of EP Bow Waves* required to be delivered in order to justify rising share prices over time, reveals that for many listed companies, around 30 per cent of their market capitalisation can be attributed to *EP* expectations associated with products, services or businesses that don't yet exist.

Success in harnessing innovation and in building the new capabilities necessary to underpin this significant component of the value already embedded in a company's share price and market capitalisation, can only arise from an explicit focus on the long term.

We can explore this insight in more detail by 'reverse engineering' the profile of the *EP Bow Wave* required to underpin the aggregate market capitalisation of the top 120 ASX-listed industrials and examining how it has expanded since the GFC. Figure 3 shows that the peak annual *EP* outcome required to justify this aggregate market capitalisation in December 2017, was seven times the level that existed in 2011 and nearly three times that which existed in 2012.

Figure 3. *Progression in the Aggregate EP Bow Wave for the Top 120 ASX Listed Industrials*



We can disaggregate each *EP Bow Wave* in Figure 3 into the *EP* expectations arising from the economic attractiveness of the markets in which the companies compete, a component arising from their competitive position, and the 'remainder' that is required to equate to market capitalisation. The 'remainder' must come largely if not entirely from innovation, focused on developing new products, services or businesses that don't yet exist and in some cases are well over the horizon.

Figure 4 on the next page looks in more detail at the picture in December 2011, when less than two per cent of the aggregate market capitalisation of $601b was attributable to *EP* expectations associated with products, services or businesses that did not then exist, and which would need to be developed over time through innovation.

The areas between the lines represent the incremental *EP* streams in each case. The blue line on the right represents the 'reverse engineered' *EP Bow Wave* corresponding to aggregate market capitalisation in 2011.

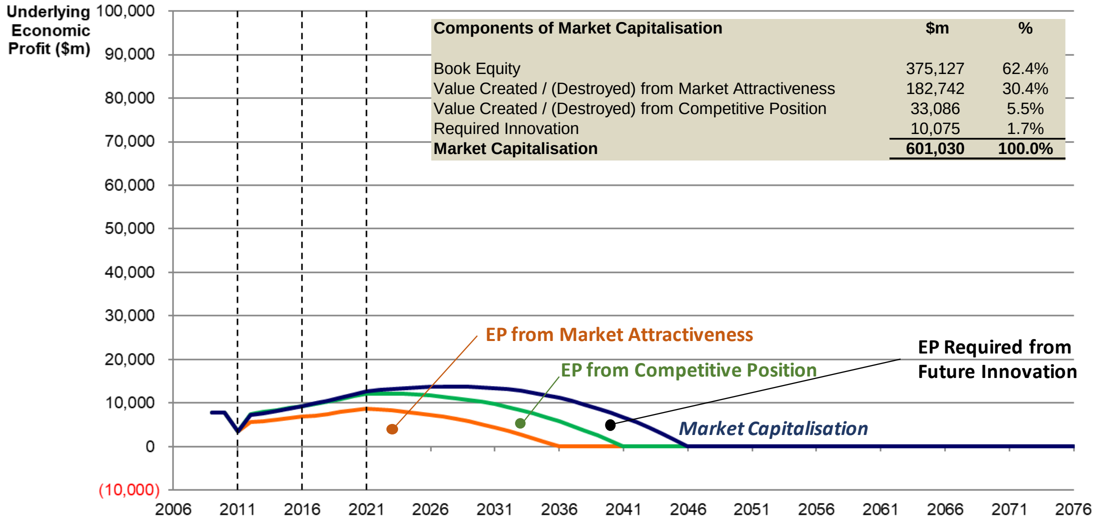
The situation has changed dramatically since 2011.

Figure 5 shows the picture in December 2012. 'Reverse engineering' the *EP Bow Wave* required to justify the aggregate market capitalisation of $741b in 2012, indicates the expected *EP* stream needed to peak at three times the peak level expected a year earlier, and the component that needed to be developed from future innovation had grown to nearly 17 per cent of aggregate market capitalisation.

By December 2013, the component required from future innovation had grown to 30 per cent of aggregate market capitalisation and has remained close to that number ever since. The picture in December 2017 is shown in Figure 6.

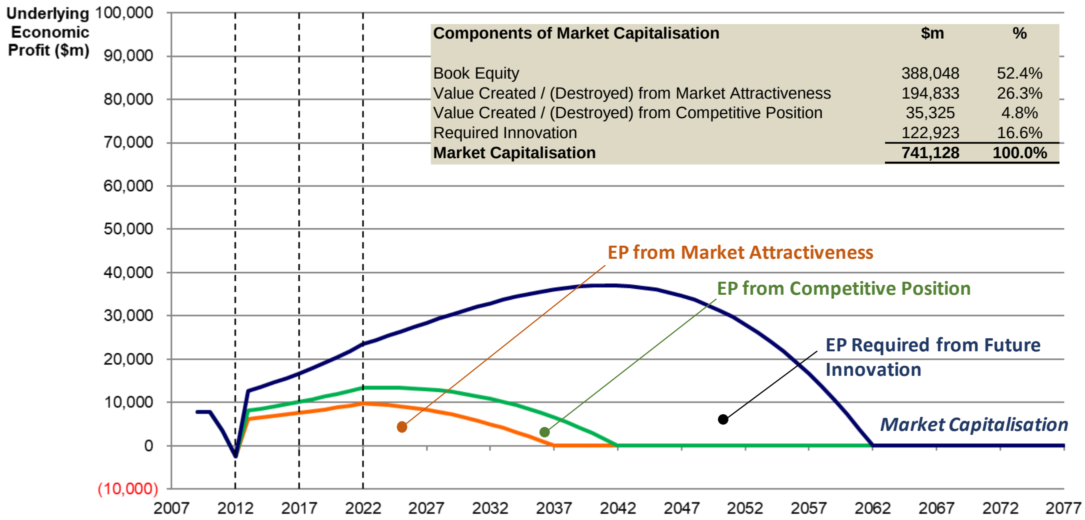
There is a very real question for investors and for Boards as to whether the capabilities necessary to underpin this component of future *EP* expectations actual exist in many companies.

Figure 4. *Components of the EP Bow Wave and Market Cap for Top 120 Industrials in December 2011*



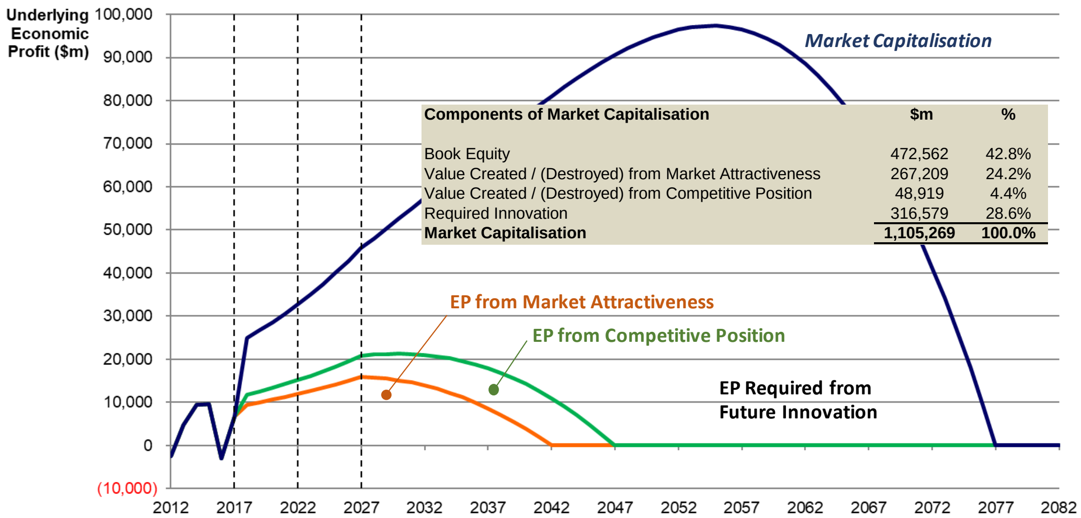
Components of Market Capitalisation	$m	%
Book Equity	375,127	62.4%
Value Created / (Destroyed) from Market Attractiveness	182,742	30.4%
Value Created / (Destroyed) from Competitive Position	33,086	5.5%
Required Innovation	10,075	1.7%
Market Capitalisation	**601,030**	**100.0%**

Figure 5. *Components of the EP Bow Wave and Market Cap for Top 120 Industrials in December 2012*



Components of Market Capitalisation	$m	%
Book Equity	388,048	52.4%
Value Created / (Destroyed) from Market Attractiveness	194,833	26.3%
Value Created / (Destroyed) from Competitive Position	35,325	4.8%
Required Innovation	122,923	16.6%
Market Capitalisation	**741,128**	**100.0%**

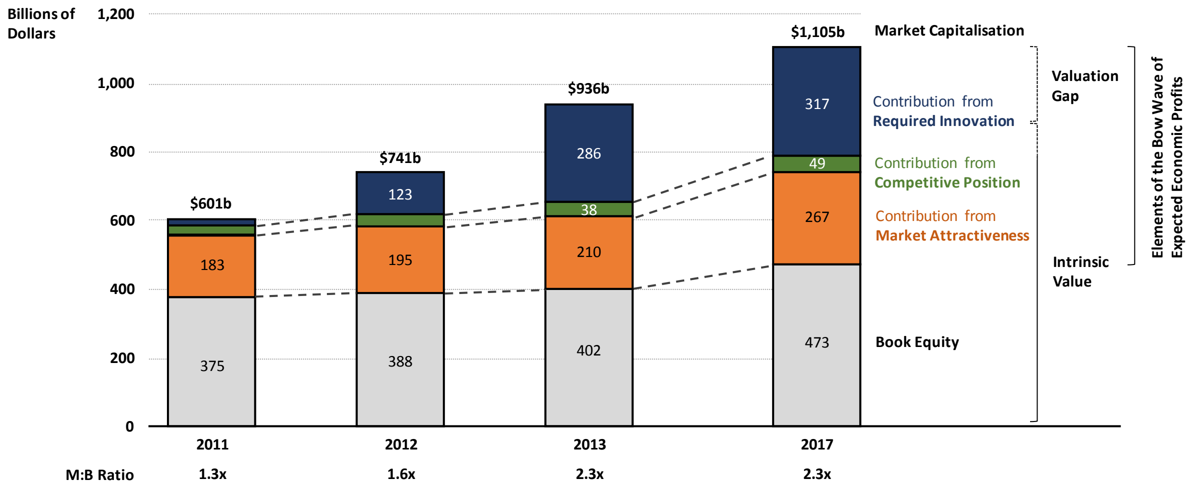
Figure 6. *Components of the EP Bow Wave and Market Cap for Top 120 Industrials in December 2017*



Components of Market Capitalisation	$m	%
Book Equity	472,562	42.8%
Value Created / (Destroyed) from Market Attractiveness	267,209	24.2%
Value Created / (Destroyed) from Competitive Position	48,919	4.4%
Required Innovation	316,579	28.6%
Market Capitalisation	**1,105,269**	**100.0%**

How the picture has changed over time is summarised in Figure 7.

***Figure 7**. Components of the EP Bow Wave and Market Capitalisation – 2011 to 2017*



The first three components of aggregate market capitalisation represented by the columns in Figure 7 comprise b*ook equity* or *book value*, plus the contributions arising from *EP* expectations associated with the economic attractiveness of the markets in which the companies compete, and their competitive positions in those markets. These all form part of the underlying *intrinsic value* of the business. The *EP* expectations associated with any *embedded innovation capability* will also form part of *intrinsic value*. The remainder required to add up *market capitalisation* can be thought of as a *valuation gap.*

There seem to be two ways to interpret the overall picture portrayed in Figure 7. A 'glass half empty' interpretation suggests there may now be a significant valuation risk associated with the current market capitalisation of many ASX-listed companies. A 'glass half full' interpretation is that companies need to invest in building the capabilities necessary to close the gap between their *intrinsic value* and their *market capitalisation*. Because so much of this *valuation gap* relates to the need to underpin *EP* expectations that are very long-term in nature (as is evident in Figure 6), this gap can only be closed by acting in a manner consistent with the long-term best interest of all stakeholders.

The research proposed may well expose a similar situation in the London Stock Exchange

Utilising this Understanding to the Benefit of Both Business and Society

There is a significant opportunity to utilise this breakthrough in understanding in a way that benefits both business and society. The key is to communicate the new understanding in a manner that captures the imagination of leaders within both the business community and the investment community – and which potentially gets the attention of political leaders as well. For that reason, the insights presented must be supported with solid research, and the way they are presented must offer a positive path forward, rather than just pose a problem with no clear solution.

Before outlining the program of research that we plan to undertake with ASX100 and FTSE100 companies (and for which we are seeking funding from the business and investment communities in both countries) there are three other important pieces of the picture that we need to communicate.

The first is to explain the concept of an *Organisational Maturity* assessment, as measured by an *OMINDEX* rating. The second is to demonstrate what can happen when there is an incomplete (or even worse an incorrect) understanding dominating the behaviour of key players in the equity capital markets. The thwarted bid by Kraft-Heinz for Unilever Plc in early 2017, provides an excellent illustration of what can happen when this is the case. The third is to demonstrate how the *EP Bow Wave* can shed light on the notion of *societal value* when informed by an *OMINDEX* rating.

The Organisational Maturity Index

The *EP Bow Wave* construct lets us assert that it is impossible to preserve wealth by delivering the long *EP* streams that underpin the intrinsic value and market capitalisations of better performing listed companies; or create wealth by enhancing those *EP* streams; unless a company has a well-functioning organisation, a strong innovation capability, and all legitimate stakeholders benefit in an appropriate manner from their association with the company.

It is crucial to know if the right organisational capabilities are in place, and at the same time be able to determine the extent to which the needs of all legitimate stakeholder are being met.

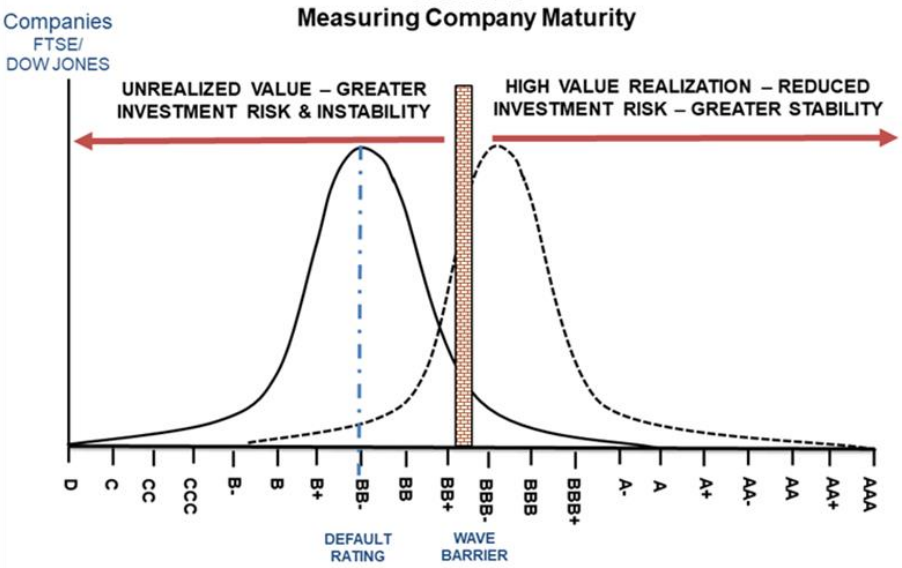
These organisational attributes underpin the company's expected *EP* stream, its intrinsic value and its market capitalisation.

We can now demonstrate the degree to which this is the case because of a breakthrough in thinking in the form of the *Maturity Institute's OMINDEX* rating.

Organisational Maturity is an innovative but powerful concept developed by the *Maturity Institute*. It is first and foremost an indicator of the extent to which a company realises a purpose of producing the best quality product or service at the best cost, without undue harm (such as negative social or environmental outcomes). It focuses on the organisation's capability for managing itself and its environment as a whole system, while embedding a focus on never-ending improvement.

OMINDEX rating provides an assessment of *Organisational Maturity*, based on a detailed examination of ten pillars or organisational attributes that provide a basis from which to compare and rate a company's ability to create value and manage risk from human capital. It is also an indicator of the extent to which the needs of all stakeholders are being met. It measures a company's progress along an *OMINDEX* scale similar in appearance to a conventional credit rating scale (from D to AAA), as illustrated in Figure 8.

***Figure 8**. Plotting Organisational Maturity on OMINDEX*



The *OMINDEX* scale is symmetrical, with 20 equal (5 per cent) gradations from D (5%) to AAA (100%). A high rating on the *OMINDEX* scale indicates focused and coherent leadership, together with high management capability and organisational agility, achieved through engaging everyone working in and with the organisation. This includes the role played by non-shareholder stakeholders.

The dividing line separating 'immature' and 'maturing' companies is represented by the value-risk threshold between BB+ and BBB- . This is shown as a 'wall' in Figure 8. It is the same 'cut off' point in credit rating that denotes investment grade status.

Preliminary research suggests there is a causal link between OMINDEX rating and the shape of a company's *EP Bow Wave*, and as *OMINDEX* ratings improve, the shape of the *EP Bow Wave* is enhanced and *intrinsic value* increases. This means that within the same industry, a higher *OMINDEX* rated company will tend to a have a higher *intrinsic value* than a lower *OMINDEX* rated company. At the same time, the *EP* stream that underpins its share price and market capitalisation can be considered more 'secure', so the gap between a company's *intrinsic value* and its *market capitalisation* will be reduced. Of course, this will only be the case if the needs of all legitimate stakeholders are being met. Importantly, the *OMINDEX* rating also provides an indicator of the extent to which this is the case.

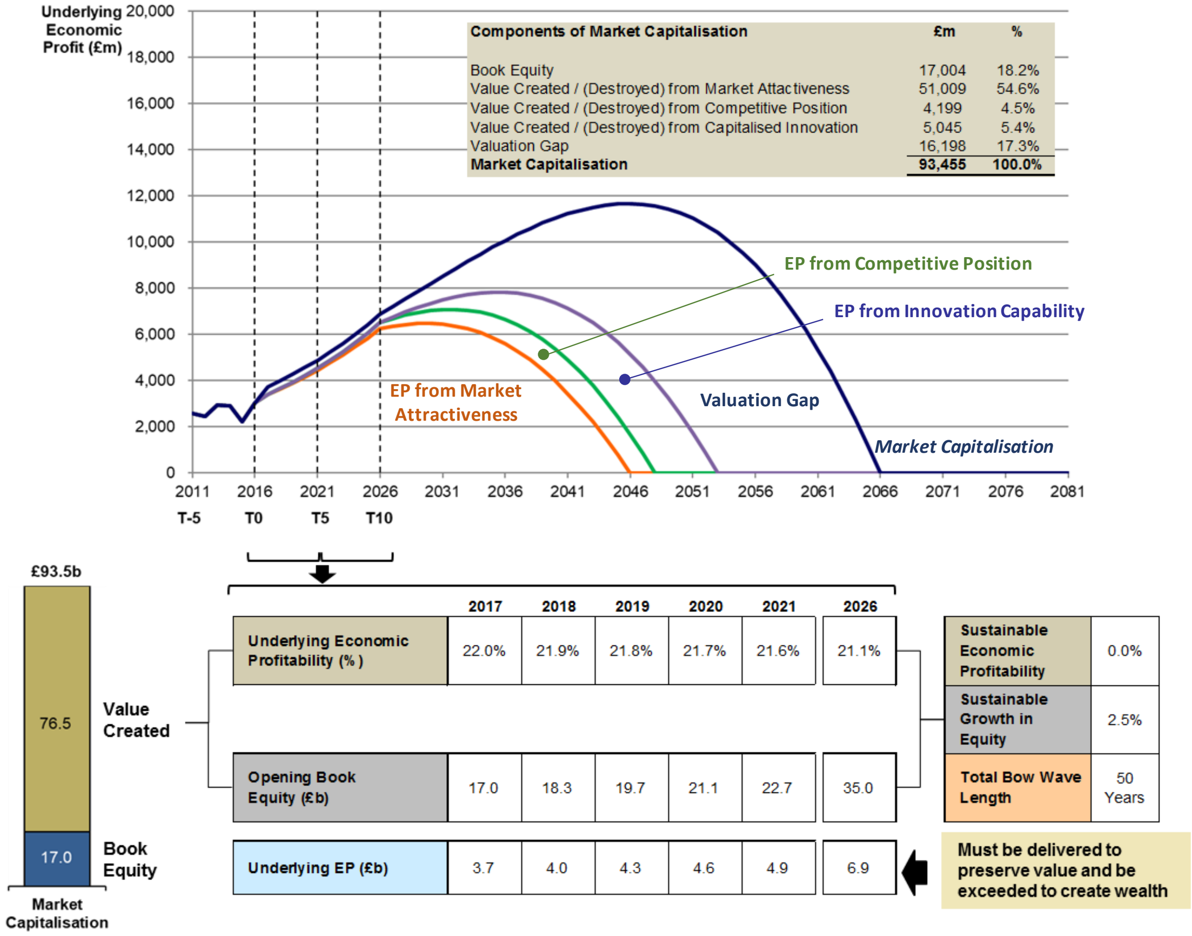
This breakthrough is significant. If confirmed by the full research, it will demonstrate that improvement in *OMINDEX* rating is both a social good and a key factor in long-term commercial success.

Having this understanding is crucial for Boards, for long-term investors, as well as for the wider community – because it tells us whether the share price and market capitalisation of a listed company are 'legitimate'. It does this by revealing the extent to which they are underpinned by an *intrinsic value* that is in turn underpinned by the right organisational capabilities and 'health'. The absence of this understanding can be quite problematic for both companies and investors, as is demonstrated in the Unilever case below.

The Kraft-Heinz Bid for Unilever Plc

Figure 9 shows the *EP Bow Wave* embedded in the share price and market capitalisation of Unilever Plc on 31 December 2016 (just prior to the Kraft bid), including a build-up of *EP* expectations from market attractiveness, competitive position and an assessment of embedded innovation capability (using a conceptual framework described in the Appendix B).

Figure 9. *EP Bow Wave Build-Up for Unilever, 31 December 2016*



Market capitalisation was £93.5b and the *EP* stream required to underpin this was based on an expectation of high returns (*ROE-Ke* > 20%), solid growth (with the equity capital base on which those returns were expected to be earned doubling in size over ten years) and a required *EP* stream that would peak at nearly £12b around 2045 and remain positive until 2065. This resulted in an observed *M:B Ratio* of 5.5x, which is an high number for a company like Unilever.

The build-up for the December 2016 *EP Bow Wave* in an '*intrinsic value'* sense is shown in the text box in Figure 9. The contribution to Unilever's *intrinsic value* from participating in markets with attractive economics was £51.0b, or 54.6 per cent of market capitalisation. The contribution from the company's somewhat advantaged competitive position was an incremental £4.2b or 4.5 per cent of market capitalisation. Importantly, the *OMINDEX* rating process enabled the contribution to *intrinsic value* from capitalised innovation potential to be assessed at £5.0b, or 5.4 per cent of market capitalisation. (The *OMINDEX* rating for Unilever in 2016 was BBB-, which put it on the right side of the 'wall' in Figure 8.)

Although management may not have been aware of it at the time, there was still a significant gap in the *EP* expectations required to justify Unilever's market capitalisation in December 2016. This valuation gap of £16.2b or 17.3 per cent of market capitalisation represented a fundamental challenge for Unilever's management at that time. It also indicated a material downside valuation risk for shareholders.

The Kraft-Heinz bid was pitched on the basis that there was a significant short-term value uplift potential within Unilever that could be accessed with improved capital and operating efficiencies – effectively reducing investment in the business and returning the proceeds to shareholders. This rationale was simplistic. Actions like those proposed by Kraft-Heinz and its backers can drive up the share price of an acquisition target in the short to medium term, as traders and short-term capital market players exploit the misguided belief that such 'improvements' can all be sustained. However, the combination of an *Organisational Maturity* assessment and the *EP Bow Wave* construct lets us demonstrate clearly that such actions can erode or undermine the organisational capabilities required to meet *EP* expectations over the longer-term and in the process, destroy significant shareholder wealth.

An understanding of the *EP Bow Wave* construct informed by the *OMINDEX* rating would almost certainly have strengthened the resolve of both the Board, and the company's long-term shareholders, in resisting the bid.

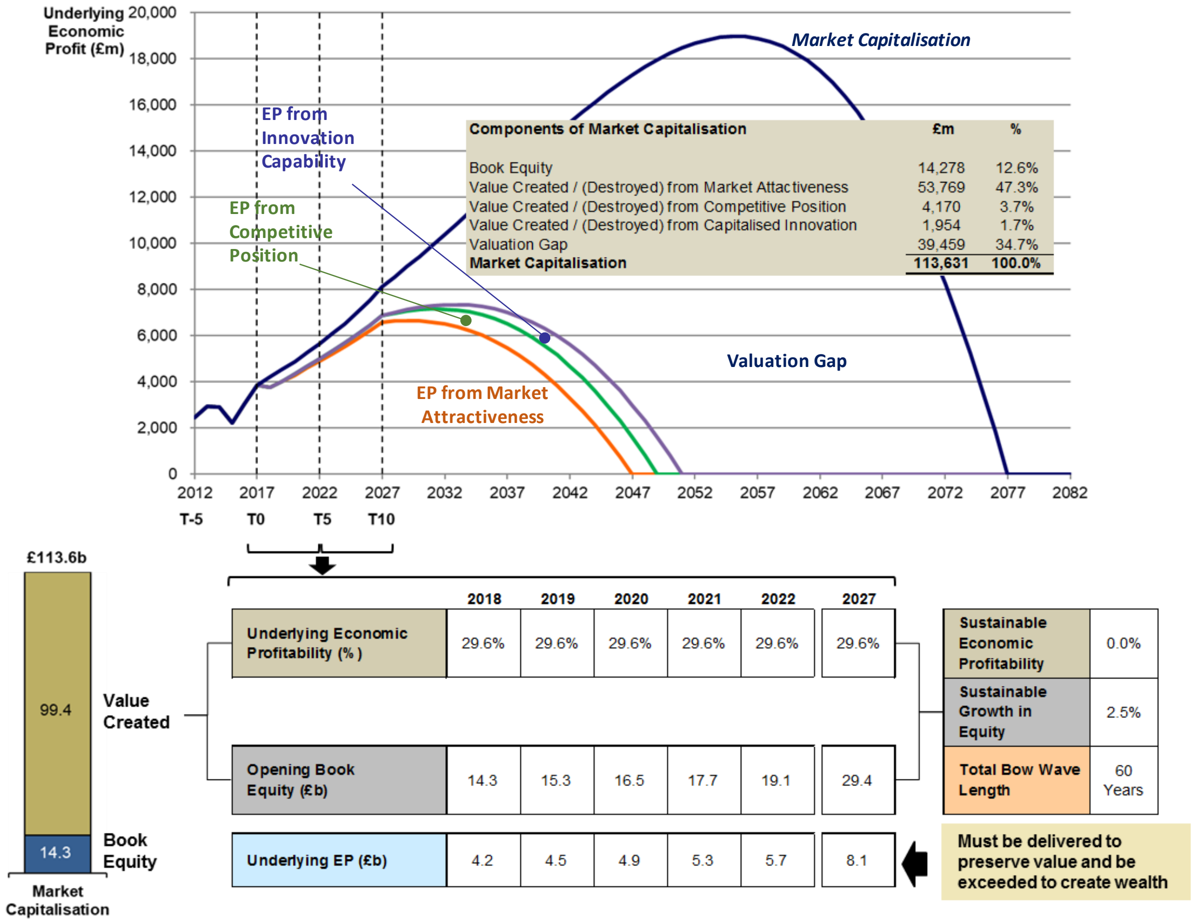
Ultimately, the price paid by Unilever to secure its independence and repel the Kraft bid in early 2017, included taking some of the steps that Kraft-Heinz may have instituted had the acquisition gone ahead. They included a buy-back, an increase in dividend and the promise of higher margins through aggressive cost reduction. These measures were initially well received by the capital markets. Unilever's share price and market capitalisation both increased significantly over the 12 months to 31 December 2017 – and the associated *EP Bow Wave* that needed to be delivered expanded dramatically, as illustrated in Figure 10.

Post the bid, the *EP Bow Wave* required to underpin Unilever's new and higher share price was not only ten years longer than a year earlier (which perversely, implies that the market thought the business was more capable and more sustainable post the bid), but the level of *EP* required to be delivered had increased significantly with a peak some 50 per cent higher than expected before the bid. It's 'observed' *M:B Ratio* as at 31 December 2017 was 7.9x, which is extremely high for a business like Unilever.

So how did a cost reduction program combined with a €5b buy-back plus a higher than planned dividend payout, lead to such an outcome? *The short answer is: 'through an incomplete understanding on the part of the investment community'.*

Other than the reduction in capital arising from the buy-back, the build-up of the *EP Bow Wave* reveals two main changes. Firstly, the assessed value associated with an embedded innovation capability fell by more than 50 per cent as a result of an *OMINDEX* reassessment and downgrade to BB+. Secondly, the valuation gap more than doubled to a figure close to £40b, or nearly 35 per cent of market capitalisation.

Figure 10. *EP Bow Wave Build-Up for Unilever, 31 December 2017*



Once again, there are two ways to view this. Either there was a good deal more valuation risk associated with the Unilever share price and market capitalisation as at 31 December 2017 (and it fell 10 per cent during the period to mid-March 2018); or Unilever needs to revert to the strategy it was pursuing prior to the bid, and continue to invest to build the innovation capability necessary to underpin its new and higher share price, market capitalisation and embedded *EP* expectations.

Many commentators have claimed that the bid was good for Unilever. The evidence provided by an *EP Bow Wave* analysis informed by an *OMINDEX* rating suggests the opposite may be true. At the very minimum, the jury is still out.

OMINDEX Rating, the EP Bow Wave and the Concept of Societal Value

Shareholder wealth is created in the sense that an uplift in *intrinsic value* is achieved, when management acts in a manner that causes the *EP Bow Wave* to become higher, wider and especially longer.

Societal value is created when this is done in a way that enhances the wellbeing of everyone involved.

We know from both a conceptual and an empirical standpoint, that maintaining or enhancing the length of the *EP Bow Wave* is particularly important. This cannot be done *on an ongoing basis* – and so wealth cannot be created *on an ongoing basis* – unless all stakeholders are looked upon as allies in creating value for customers and wealth for shareholders over the long term, and a conscious effort is made to ensure they benefit appropriately from their involvement with the company.

We also know that wealth cannot be created *on an ongoing basis* simply by seeking to enhance returns (either *ROE* or *ROE-Ke*). An increase in share price might be achieved over the short-term by actions aimed solely at enhancing returns, as evidenced in the Unilever case study. But an increase in share price achieved in this way is often not sustained. It certainly looks unlikely to be sustained in the case of Unilever. Instead, the focus must be on continually seeking to enhance the volume under the *EP Bow Wave*. A singular focus on improving returns (or increasing the height of the *EP Bow Wave*) is likely to result in non-shareholder stakeholders being thought of as adversaries in the pursuit of a higher profitability over the short term, rather than as allies in the creation of customer value, shareholder wealth and societal wellbeing over the longer term.

This understanding means the *EP Bow Wave* can potentially shed quite a bit of light on the concept of *societal value* – the enhancement of which is fundamental to the purpose and intent of the *Maturity Institute* and *KBA*.

Properly understood, management's obligation to investors is to build an enduring institution that can create wealth for them *on an ongoing basis*. How they go about this matters a great deal. The most effective way is to embrace customer value creation and shareholder wealth creation as joint and mutually reinforcing objectives. These joint goals must then be pursued in tandem, in ways that enhance the wellbeing of all legitimate stakeholders – including the wider community and the environment. When they do this, *societal value* is enhanced. But, their ability to do this depends on the capabilities and the 'health' of their organisation – the state of which can be assessed on the *OMINDEX* scale.

In thinking about what is involved in a company succeeding in this endeavour, it is useful to reflect on the fact that whether consciously or not, every company (through its Board and executive leadership team), makes a choice between two mutually exclusive paths or approaches to business. The first is to seek to create wealth by truly serving customers and ultimately the wider community. The second is to try to appropriate wealth by exploiting customers and other stakeholders. It boils down to a question of whether a company's intent is to serve society, or to exploit society.

People and businesses do make mistakes. So, having chosen the more noble of the two paths, it is entirely possible the outcomes that arise from time to time might not always be a true reflection of that underlying management intent. But with the intentions themselves, the choice is black or white. There are no shades of grey.

Taking this one step further, it is much better if this choice is made consciously rather than unconsciously. In this way we can 'build in' good behaviour through noble intent, rather than having to 'inspect out' poor behaviour through regulation, through the courts, or through other mechanisms like Australia's *Banking Royal Commission*. How this is done is outlined in the last few chapters of *Customer Value, Shareholder Wealth, Community Wellbeing* (Palgrave Macmillan 2017).

When a company does light a 'beacon of noble intent' and set about building a mature, enduring institution, it can create real value for customers, build significant wealth for shareholders, and enhance the wellbeing of all its legitimate stakeholders. When it does, the value or benefit provided to non-shareholder stakeholders manifests in many forms.

These include more and better forms of employment with enhanced personal development opportunities, more balanced relationships with participants in its supply chain, and a willingness and a capability to engage in innovation which in turn enhances value for customers and drives economic growth. In this way, *societal value* is enhanced. In parallel with this, the consequences for shareholders of their company operating in a manner that produces this *societal value* is captured in the *EP Bow Wave*, the resultant *intrinsic value* and ultimately in *market capitalisation*.

With the correct understanding, by setting out to do the right thing by society, companies will also do the right thing by shareholders. At the same time, with the correct understanding, by setting out to do the right thing by shareholders, companies will also do the right thing by society. The problem is, many people in positions of influence in the business and investment communities do not have this understanding. One of the most important outcomes of this research is to articulate that understanding in a way that is underpinned with extensive and evidence-based research.

Proposed Program of Research

The findings from a pilot study of nine FTSE100 FMCG companies completed by *KBA* and the *Maturity Institute* in early 2018 suggest that there is a causal link between *OMINDEX* rating and the shape of a company's *EP Bow Wave.*

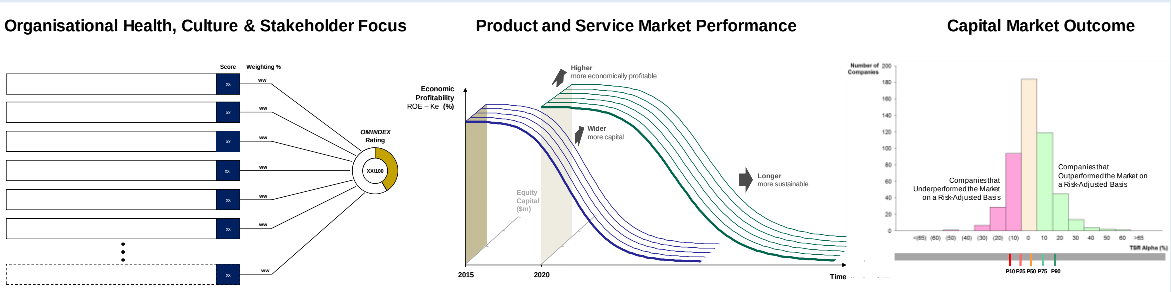
Our opening hypothesis based on the pilot study (and evidenced in the Unilever case study) is there is a strong causal link between *OMINDEX*, the shape of the *EP Bow Wave* and therefore *intrinsic value*; and that improvement in *OMINDEX* over time will enhance the shape of the *EP Bow Wave* leading to an uplift in *intrinsic value* and ultimately in shareholder wealth – achieved in ways that enhance the wellbeing of all stakeholders.

The program of research proposed aims to further explore and calibrate:

- The relationship between *OMINDEX*, the *EP Bow Wave, intrinsic value* and *market capitalisation*;
- The extent of the gap between *intrinsic value* and *market capitalisation*; and
- The relationship between change in *OMINDEX,* and change in the shape of the *EP Bow Wave,* as well as the change in *intrinsic value* and *market capitalisation*;

It also seeks to establish a clear and quantifiable nexus between organisational health and commercial success, as evident in the combination of good outcomes in both the market for a company's products and services, and the market for shareholder capital – as illustrated the Figure below.

Linking Culture and Organisational Health with Product and Capital Market Performance



It will produce a range of outputs, including analyses similar to that illustrated in this document for Unilever Plc, by examining the *OMINDEX* and the *EP Bow Wave* over time for ASX100 and FTSE100 companies.

This research has the potential to create a shift in understanding that will benefit both business and society – initially in Australia and the UK.

We are seeking funding to facilitate this ground-breaking work.

Companies or institutions that choose to contribute to this endeavour will receive a detailed report covering the entire ASX100 and FTSE100, as well as a specific hands-on analysis of their own company in the case of corporate sponsors, or their specific active portfolio in the case of institutional investors. Both will be presented in the context of the results for the entire study.

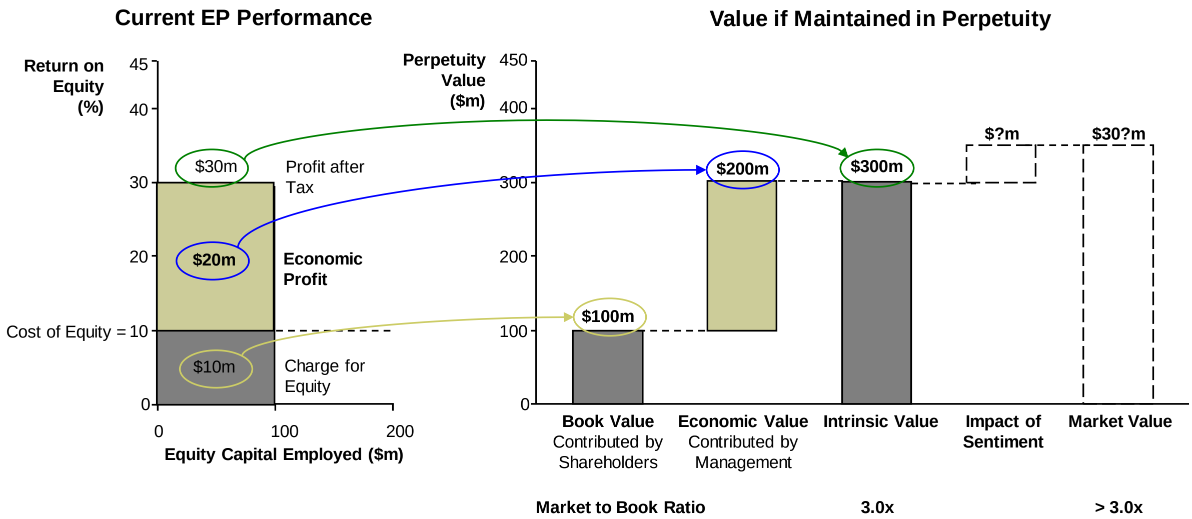
We will also share summary findings with a range of stakeholder groups, including government, regulators and academia in both countries.

Appendix A. Understanding Economic Value in Terms of a Bow Wave of Expected EP

Three Perspectives on the Economic Value of a Listed Company

Most investors understand there are three main ways to think about the economic value of a listed company. The first is *book value*, which is the value recorded in the balance sheet. It comprises mainly contributed capital and retained earnings. The second is *market value* or *market capitalisation*. This is the value investors place on a company at a point in time, given the strategy being employed by its management team. The third is underlying *intrinsic value*. This is an assessment of value developed from an informed view as to future returns, growth and the sustainability of both; free of the often-capricious impact of market sentiment. Each of these three perspectives is illustrated in Figure A1.

Figure A1*. Three Perspectives on the Economic Value of a Listed Company – an illustration*



Intrinsic Value

The *intrinsic value* of a business can be expressed as the present value of expected future *cash flows*, or in terms of *book value* plus the present value of expected future *economic profits (EP)*.

Both *cash flow* and *EP* account for *profit* and *capital employed*. *Cash flow* is *profit* less change in *capital employed*. *Economic profit* is *profit* less charge for *capital employed*. In this document, we want to focus on intrinsic value expressed in terms of *EP*. Will begin by defining *EP*.

Economic Profit is calculated as shown on the left-hand side of Figure A1. Its calculation is shown in more detail in Figure A2. It is defined as:

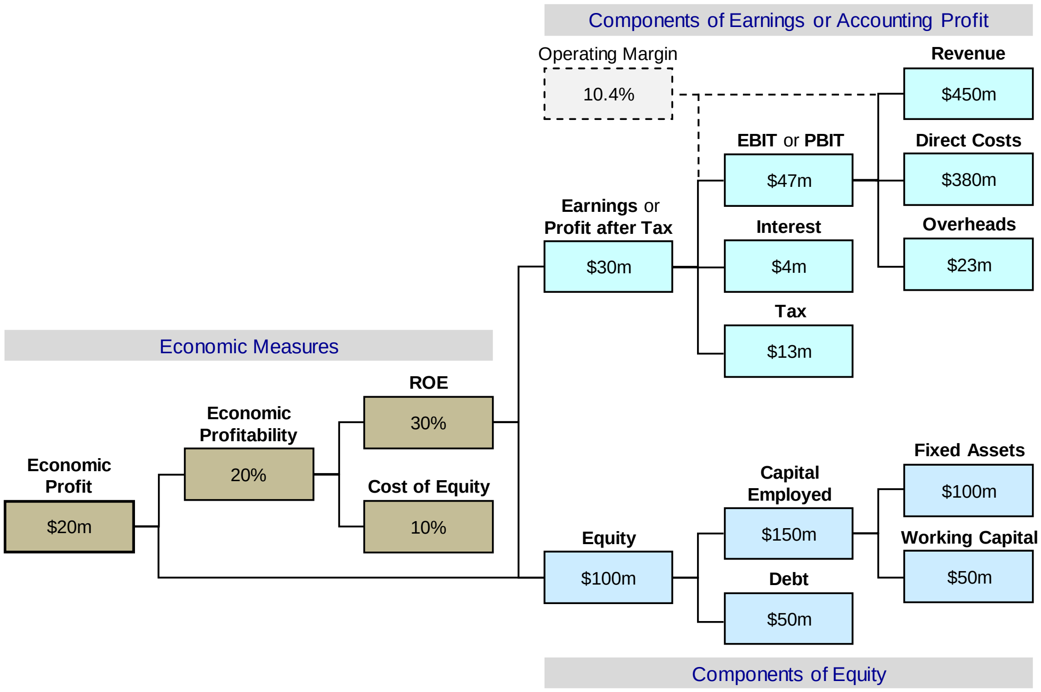
Economic Profit = *Profit After Tax* (PAT) – Charge for *Equity Capital*
= PAT – Ke x Equity
= **$20m**

[Where **Ke** is the *Cost of Equity Capital*, calculated using the *Capital Asset Pricing Model. Ke for Unilever Plc used in the case study is 8.7%. This is the return required by shareholders over the long run in order to preserve wealth.*]

In Figure A1, the *intrinsic value of shareholders' equity* is defined as:

Intrinsic Value of Shareholders' Equity = PV of Expected *Equity Cash Flows*
= *Book Value* + PV of Expected *EP*
= **$300m**

__Figure A2__. Defining Economic Profit – an illustration

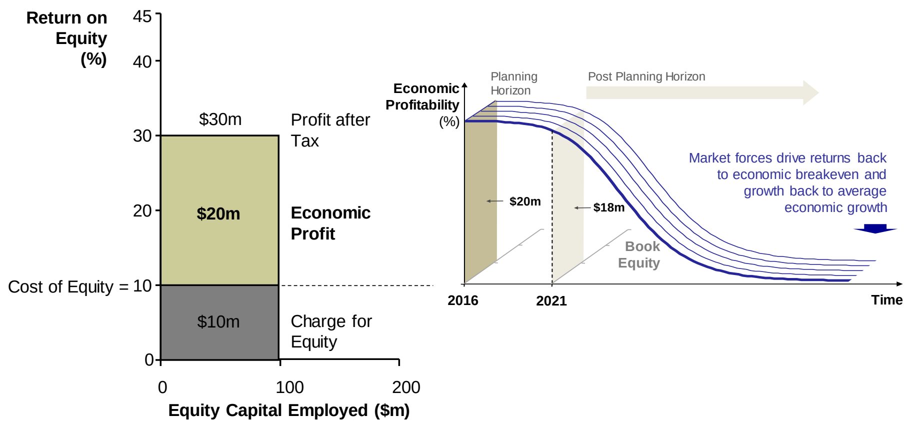


The EP Bow Wave

The illustration of value on the right-hand side of Figure A1 assumes perpetuity *cash flow* and *EP* streams. While useful for illustrative purposes, there are few if any perpetuities in the real world.

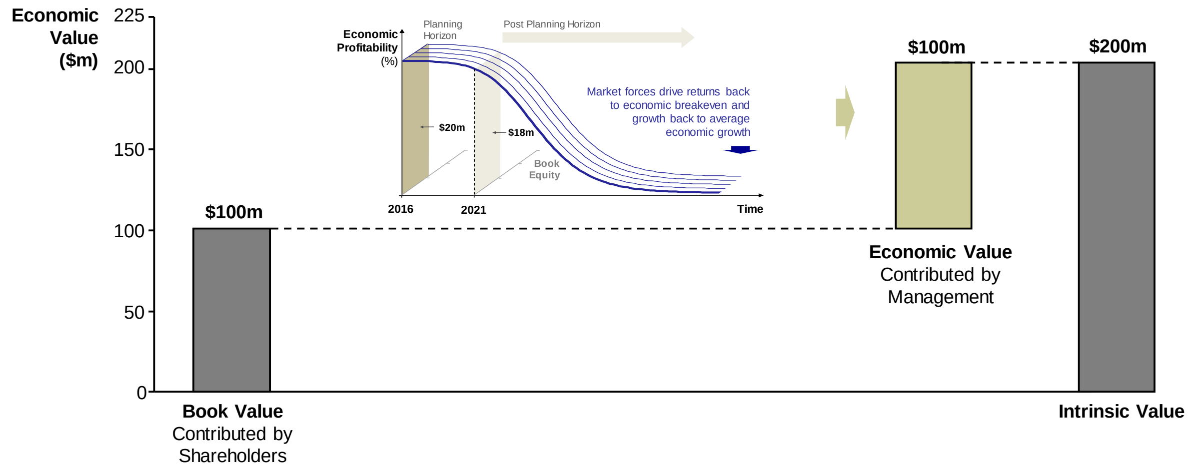
In a competitive market, economic forces will drive returns down to the cost of capital, or economic profitability (*ROE-Ke*) back to zero over time. They also drive growth back towards average economic growth. This gives rise to the idea that the intrinsic value of a listed company is driven by a *Bow Wave of Expected Economic Profits.* The *EP Bow Wave* construct is illustrated in Figure A3.

__Figure A3__. The EP Bow Wave Construct – an illustration



An ability to deliver the *EP* stream illustrated on the right-hand side of Figure A3 will confer an intrinsic value on the business equal to the *book value of equity* or *equity capital employed* plus the present value of the *EP* stream represented by the *EP Bow Wave*. For illustrative purposes, let's assume the intrinsic value is actually $200m, made up of $100m of *Book Equity* and $100m arising from the present value of the expected *EP* stream, which is represented by volume under the *EP Bow Wave* in Figure A4.

Figure A4. *Defining Intrinsic Value in Terms of an EP Bow Wave – an illustration*



Wealth is preserved in the capital market when management succeed in delivering the *EP* stream embedded in their company's *EP Bow Wave*. Wealth is created when management find a way to make the *EP Bow Wave* higher with better returns, wider through greater growth, or longer through actions that lead to greater sustainability.

It is important to appreciate that it is not just about higher returns. There are many things management can do to enhance returns in the short term – such as raising price, reducing cost or constraining capital investment. In many cases, the increase in return (*ROE-Ke*) arising from such actions will not be sustained. While the *EP Bow Wave* may become higher, there is a significant chance that it will also become narrower or shorter (or both). This will reduce the volume under the *EP Bow Wave*, destroy shareholder wealth and at the same time is likely to impact negatively on other stakeholders.

Figures A5 and A6 provide an illustration of what happens when management does succeed in enhancing the shape of their company's *EP Bow Wave*. Starting with the blue *EP Bow Wave*, a new and higher value strategy devised and adopted by management can result in a new (green) *EP Bow Wave* that is marginally higher, but also wider and somewhat longer. For a high return business like that illustrated, with an *ROE* that is 20 per cent greater than *Ke*, making the *EP Bow Wave* wider or longer is likely create more wealth for shareholders than by seeking to make returns (*ROE-Ke*) higher. And actions that make the *EP Bow Wave* wider and especially longer, are more likely to involve doing things that benefit all stakeholders. In most cases, actions that result in a higher, wider or longer *EP Bow Wave* will arise from initiatives that involve some combination of increased output, reduced economic cost, increased revenue and increased quality (i.e. from the *Maturity Institute's OCRQ Framework*).

Figure A5. *Enhancing the Shape of the EP Bow Wave – Comparing Two Different Periods*

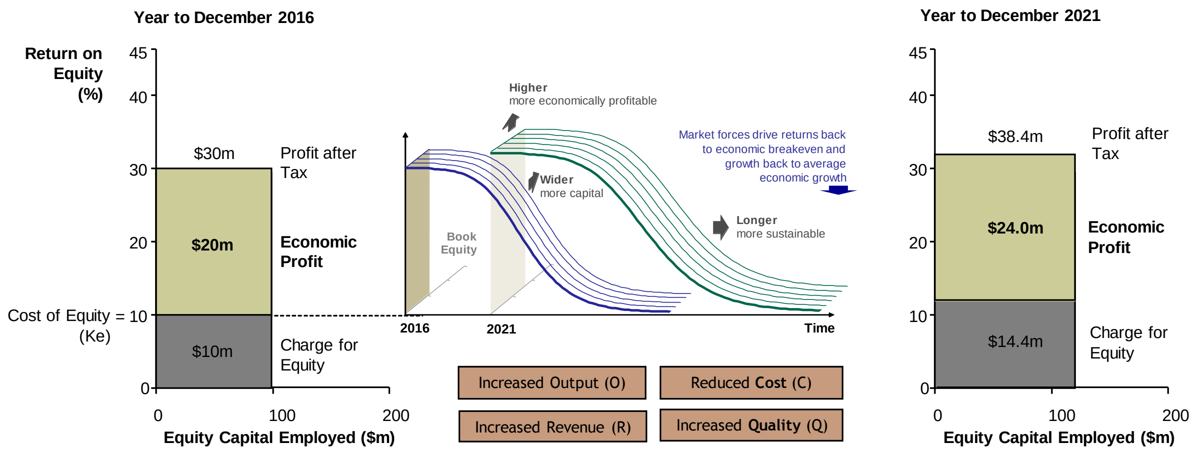
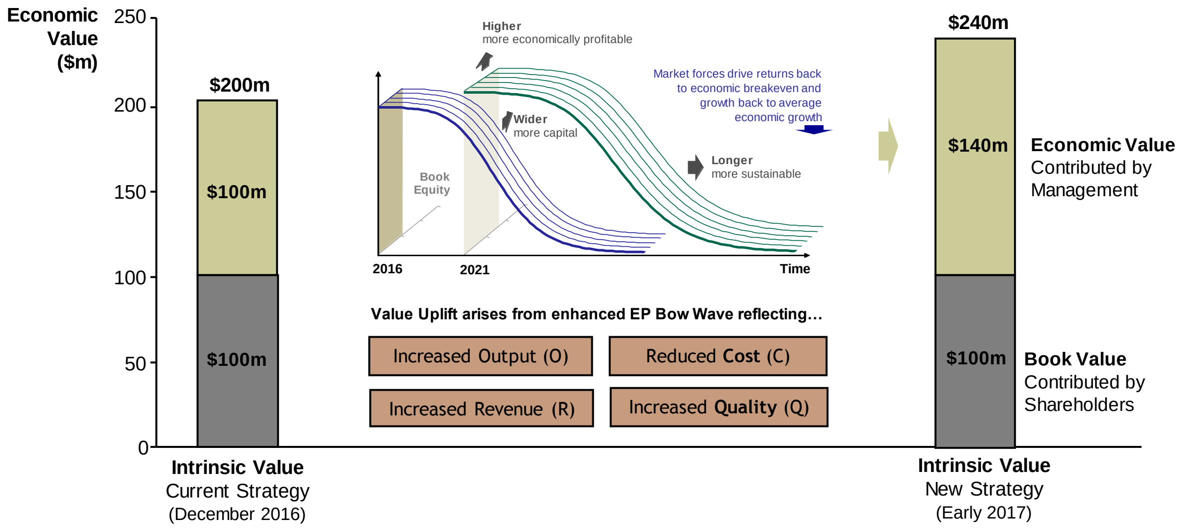


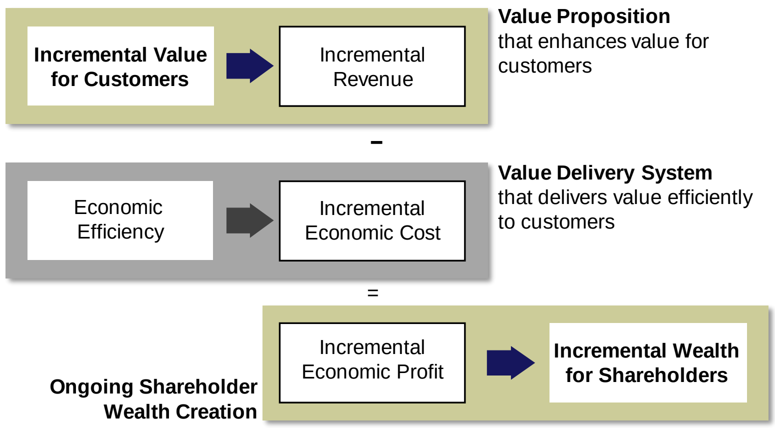
Figure A6 presents a more complete picture – showing how a change in intrinsic value arises from adoption of a new strategy (in this case in early 2017) that led to a higher, wider and longer *EP Bow Wave*. The increase in intrinsic value is equal to the present value the incremental increase in *EP* between the blue and the green *EP Bow Waves* in Figure A6. Once again, the new strategy will impact the business in an operational sense primarily on the four *Maturity Institute* dimensions of *OCQR*.

Figure A6. *Enhancing the Shape of the EP Bow Wave – Comparing Two Different Strategies*



It is important to recognise that it is necessary to have a systematic approach when setting out to build a mature and enduring institution that can create real (as distinct from artificial) value for its customers, plus significant wealth for its shareholders, and do so in ways that enhance the wellbeing of all legitimate stakeholders. In most cases, the best way to go about this is to embrace customer value and shareholder wealth as joint and mutually reinforcing objectives, and to pursue them in tandem within each individual customer segment. This means setting up a cycle of customer value creation and shareholder wealth creation as illustrated in Figure A7, in each segment.

Figure A7. *An Enduring Cycle of Customer Value and Shareholder Wealth Creation*



Effective use of this cycle can lead to a continual improvement in the shape of the *EP Bow Wave*. However, to ensure an optimal outcome whereby customer value and shareholder wealth are created in ways that enhance the wellbeing of all legitimate stakeholders (and therefore the mechanism leads to the continual enhancement of *societal value* over the longer term), it is important to ensure that:

1. The type of value created for customers is *real* as distinct from *artificial*. *Real customer value* means the value or benefits embedded in a product or service, the consumption or use of which enhances the long-term wellbeing of the customer or end consumer. *Artificial customer value* on the other hand, means value derived through the satisfaction of a desire, which may have been created through a clever marketing campaign with no thought given to wellbeing;
2. Economic efficiency is recognised as nothing more than the link between customer value creation and shareholder wealth creation – and not an objective in its own right; and
3. The way the company goes about creating *real customer value* leading to *ongoing shareholder wealth creation* must ensure that the wellbeing of all stakeholders is enhanced (or at least preserved). This includes ensuring there are no negative ‘externalities’ that flow from the company’s activities.

Appendix B. Disaggregating the EP Bow Wave

The *EP Bow Wave* construct lets us disaggregate the value of a company into Equity Capital Employed plus the present value of an EP stream expressed in terms of future returns, growth and the sustainability of both. The EP stream represented by the bow wave can also be thought of in terms four components:

- *Market attractiveness* – the 'endowment' component of the EP steam arising from participating in markets with attractive economics
- *Competitive position* – an incremental EP stream arising from higher returns or growth stemming from a competitive position built up over time (such as in a company like Toyota), or established more recently through technological superiority or innovative thinking (as in a company like Tesla).
  When looking at an entire market, this component will be zero. The incremental EP earned by companies with a competitive advantage will be offset by economic losses incurred in companies with a competitive disadvantage.
- *Innovation capability* – an incremental EP stream arising from the existence of an ability to unlock and harness ongoing innovation (beyond that attributable to current business and product portfolios).
  The assessment of this is formed from the OMINDEX rating.
- *Valuation gap* – the EP stream associated with any gap that must be made up to underpin or justify current market capitalisation.

The first two components can be determined using the framework illustrated in Figure B1.

***Figure B1**. Strategic Position Assessment Framework*