Business as an Opportunity to Serve Society

A cornerstone principle underpinning a more noble and more sustainable business paradigm

Denis Kilroy and Marvin Schneider

Two important and closely aligned streams of thought are currently gathering momentum in the international business and investment communities, as well as in the political arena in many countries. The first is the understanding that being in business is an opportunity to serve society – not an opportunity to exploit it. The second is the realisation that a strong focus on serving society is an essential ingredient in long-term business success.

Some Background

As is documented in some detail in the preface to our book *Customer Value, Shareholder Wealth, Community Wellbeing*, the founders of KBA decided in 1994 to leave value-based management pioneers *Marakon Associates* and set up KBA with a clearly articulated intent. This was to help clients develop the capabilities required to build enduring institutions that could create value for customers and wealth for shareholders *on an ongoing basis*, and to do so in ways that enhanced the wellbeing of all legitimate stakeholders, including the wider community and the environment. Our view was that *"the legacy of good business leadership [was] an enduring institution that not only outlive[d] the tenure of the [existing] board and executive team, but which prosper[ed] well into the future as a result of the decisions taken and the capabilities established during their tenure."*

Such thinking was seen as somewhat radical 24 years ago. But in recent years, our perspective has not only become acceptable, it is now seen by many as bordering the mainstream. The clearest signal yet of how acceptable it has become was in the strapline for *Andrew Ross Sorkin's* DealBook article in the *New York Times* last month: ***'BlackRock's Message: Contribute to Society or Risk Losing Our Support***'.

A Confluence of Opinion

BlackRock Chairman *Larry Fink* is not the only powerful voice calling for businesses to make a conscious choice to act in the long-term best interest of all stakeholders – and nor was he the first. There are now many voices, with the majority of the more articulate ones being in the UK and Europe. They include *Lynn Forester de Rothschild* of The Coalition for Inclusive Capitalism, Hermes Investment Management CEO *Saker Nusseibeh* and McKinsey & Company's *Dominic Barton*. However, as head of the world's largest fund manager, *Larry Fink's* voice is particularly powerful. His annual letter to CEOs carries weight. The essential message in his 2018 letter is captured in the following quote.

"Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate."

© 2018, The KBA Consulting Group

Those three sentences contain different words to those we used back in 1994. But their intent is exactly the same. This is important. The ability of any company to serve a social purpose arises almost entirely from the conscious intent of its leadership team. And what matters most is the nobility of that intent.

A Sound Purpose Arises from a Noble Intent

Customer Value, Shareholder Wealth, Community Wellbeing is the first in a series of three books that in combination, posit a new and more socially responsible business paradigm. The second book in the series, *Noble Intent, Clear Purpose, Better Leader*, is still in draft form. Its purpose is to provide a philosophical underpinning for the material contained in the first book.

One of the most significant messages in the first book is that the purpose of business is not to maximise shareholder value or even create shareholder wealth *per se* – and it never has been. The fundamental goal of the leaders of every listed company is to build an enduring institution with the ability to create value for customers and wealth for shareholders *on an ongoing basis*. The moment we 'get' this, it becomes apparent that the way we go about creating customer value and building shareholder wealth matters quite a lot. This is because the way we do it determines our ability to do it *on an ongoing basis*.

This simple conceptual breakthrough, which is underpinned strongly by the *EP Bow Wave* construct (about which we have written many times) leads to a number of crucial realisations.

The first is that to improve short-term capital market outcomes, companies must focus on enhancing long-term product and service market outcomes – not short-term performance. This is a particularly important realisation that emerges largely from the understanding provided by the *EP Bow Wave* construct. Unfortunately, a combination of poor design and a lack of understanding mean the approach to executive reward employed in most ASX and LSE listed companies, tends to focus management attention mainly on achieving short-term performance goals. Fortunately, new thinking on the topic of executive reward contained in *Godfrey Remuneration Group's* Remuneration Insight 103 provides a simple yet effective way to put this very significant problem behind us.

The second realisation is that customer value creation and shareholder wealth creation need to be embraced as joint and mutually reinforcing objectives. Once adopted, they should then be pursued in tandem at the level of an individual needs-based customer segment. A needs-based customer segment is a group of customers whose needs are so similar that they can be served in a way that is value-creating for the customer and cost effective for the company. It is also a group of customers for which an enduring cycle of customer value and shareholder wealth creation can be established.

The third realisation is that it is important to have a noble intent which gives rise to a sound business purpose. The notion of 'business purpose' has gained a lot of momentum in recent years. But the concept of business purpose can at times be a bit nebulous. More important than a clear purpose, is having a noble intent sitting behind it. We can illustrate this by focusing on the process of creating customer value and shareholder wealth *on an ongoing basis* within a needs-based customer segment.

When setting out to create customer value and shareholder wealth *on an ongoing basis*, it is essential to think clearly about the type of customer value you are setting out to create. It is possible to think about customer value along a spectrum. At one end is *real* or *authentic* customer value. At the other is *artificial* customer value. *Real* customer value is value or benefit embedded in a product or service, the consumption or use of which enhances customer wellbeing. *Artificial* value is value derived by satisfying a desire created by a clever marketing campaign, with no thought given to customer wellbeing.

The fourth realisation is that all stakeholders must be seen as allies in the creation of customer value and shareholder wealth over the long term, rather than as adversaries in the pursuit of stretch Earnings or EPS targets over the short term. Staff or employees are a particularly important stakeholder group in this context. The people in the organisation need to be seen and treated as assets to be developed, not as costs that might be eliminated. This mindset is crucial to building an enduring institution.

Economic Underpinning

Most of the voices chiming in and agreeing with the notion that being in business is an opportunity to serve society, tend not to come from an analytical, financial or economic perspective. There are exceptions, but more often than not their background and expertise is in corporate governance, corporations law or culture change. Those that do come from a financial or economic stance, tend to draw on empirical studies linking a longer-term focus to better business performance.

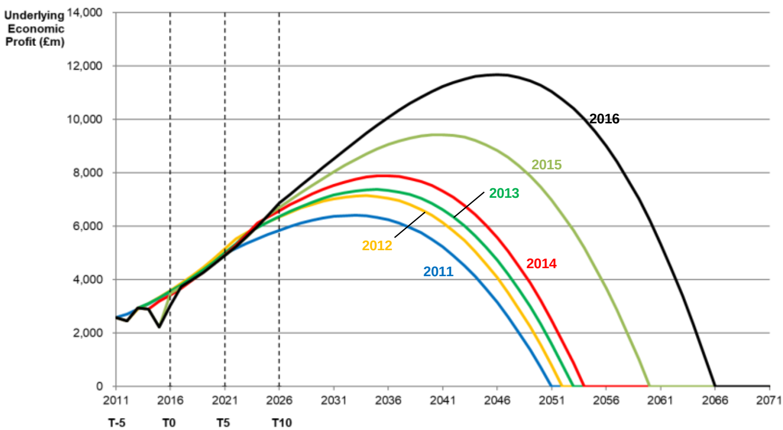
Our approach is different. We had a philosophical view at the outset that being in business was an opportunity to serve society. But we have only ever asserted this from an evidence based economic perspective.

Commencing in 2003, we spent many years seeking to establish a sound and replicable economic underpinning for our philosophy on business. There were many breakthroughs along the way. The main one was the emergence of the *EP Bow Wave* construct around 2012. This is documented in full in Customer Value, Shareholder Wealth, Community Wellbeing and in summary form in this address to the *Governance Institute of Australia* annual conference in 2015.

The *EP Bow Wave* enabled us to build an accurate, meaningful and actionable bridge linking the *product and service market performance* produced by management, with the *capital market outcomes* experienced by investors.

Figure 1 illustrates a series or progression of two dimensional *EP Bow Waves* for Unilever Plc as at 31 December from 2011 to 2016. What we see is a company that has tended to either just meet or slightly underperform EP expectations each year over that period. But it also took action each year that led to the establishment of a set of new and higher EP expectations to be delivered in the future.

***Figure 1**. Progression of EP Bow Waves and TSR Alpha Outcome for Unilever Plc*



Let's focus for a moment on the *EP Bow Wave* as at 31 December 2016. This tells us that in December 2016, investors were expecting Unilever to produce a growing stream of economic profits that would peak at nearly £12 billion in 2046, and then remain economically profitable for another twenty years. That's 30 years to peak performance and a 50 year stream of economic profits. It's likely that only a very small proportion of the people who will be working at Unilever in 2046 would have been with the company in December 2016. So what can we conclude from this picture?

EP is expected to grow four-fold over a period of 30 years. That will not be easy as the forces of competition continually work to drive EP to zero. It will be impossible without continually creating new capabilities and harnessing innovation to come up with new or enhanced products or services that deliver value to customers.

More than 75 per cent of the wealth creation that has accrued to the shareholders of Unilever as a result of the change in shape of the *EP Bow Wave* over the past five years, came from making the business more sustainable with a longer *EP Bow Wave*. We see the same picture over and over again with better performing companies. But many of the products that will generate this large and very long EP stream (and which justify the share price in December 2016 and therefore the wealth already created) have not yet been developed.

The creativity and innovation required to develop these products are uniquely human endeavours. New products are not the outcome of an automated process devoid of the human spirit. They require an engaged workforce that feels safe and respected – not one that is fearful for their jobs.

Ultimately, the real key is to be able to enhance the customer franchise – and to do so continually. This means seeking constantly to increase the value or benefit delivered to customers (much of which will come from new or improved products), then pricing it appropriately and delivering it efficiently. It does not mean focusing mainly on short-term financial performance. As was the case with many other top-performing companies, Unilever destroyed wealth by failing to meet market expectations over the five years to 31 December 2017. But it more than offset this by establishing new EP expectations to be delivered in the future.

Large, long and growing EP streams like that of Unilever must also be delivered in a social responsible manner, and the best way to do this is to set out to create *real* as distinct from *artificial* value for customers.

If we set aside the philosophical aspect for a moment, then from a purely economic perspective, we know that when a company behaves inappropriately and customers begin to desert it, its EP can fall quickly and its *EP Bow Wave* can contract even faster. This happens because of the way the capital markets 'capitalise' future EP expectations.

This phenomenon is likely to become even more significant as '*millennials'* begin to account for a greater and greater proportion of sales. They are far more discerning than previous generations when it comes to what they buy, and the relationship between the products and services they consume, and the impact their consumption has on society and the environment.

Synthesis

It will be difficult for Unilever and many other strong companies with similarly shaped *EP Bow Waves*, to deliver the long EP streams already embedded in their share prices and so preserve shareholder wealth. It will be even more difficult to create wealth, and particularly to create wealth on an ongoing basis, unless they are focused on creating *real* or *authentic* value for customers in the first instance. In the same way, it will be difficult for companies with shorter *EP Bow Waves* to extend them to 50 or 60 years, without a focus on creating *real* value for customers.

It will be difficult for both groups of companies to come up with the products or services that deliver that *real* or *authentic* value for customers, unless employees are valued and treated as assets to be developed by their employer, rather than as costs that might need to be eliminated. And it will be impossible for either group to get there unless all stakeholders are viewed as allies in the creation of value over the long term, rather than adversaries in the pursuit of short-term earnings targets over the short term.

All this adds up to a long-term focus. Wealth is created by taking action that leads to a higher, a wider and especially a longer *EP Bow Wave*. And the longer the time horizon, the more the interests of all stakeholders align.