Aligning the Interests of Business and Society

Why no company can meet its true economic obligation to shareholders unless it enhances wellbeing for all stakeholders

Denis Kilroy and Marvin Schneider

Early indications suggest Australia's 'Banking Royal Commission' might be triggering a change in attitude of Australians – not only towards the country's Banks, but also towards the wider business community. This shift is reminiscent of what occurred in Europe and the UK in the wake of the GFC, and reflects a legitimate expectation that businesses should always act in a manner consistent with the long-term best interest of society. Contrary to conventional thinking, this is not just about businesses honouring their 'social licence to operate'. Once we have the right understanding, it becomes clear that no company can meet its true economic obligations to its shareholders unless it also seeks to enhance the wellbeing of all its genuine stakeholders.

Some Background

Prior the GFC, there was widespread agreement that the fundamental economic objective of every listed company was to *maximise shareholder value*. In conjunction with this, an incomplete understanding saw many business leaders overlook the interests of non-shareholder stakeholders as they strived to meet what they perceived to be their governing corporate objective.

In the period since the GFC, there has been a transition towards a more balanced stakeholder-oriented perspective. But as this transition gathered pace, many people lost sight of an important truth. This truth was that even under a business paradigm that gave absolute primacy to the interests of shareholders, the economic objective of the leaders of listed companies from an investor perspective was not to *maximise shareholder value*. Nor was it to *create shareholder wealth* per se. It was, and it continues to be, to *build an enduring institution with the ability to create wealth for its shareholders on an ongoing basis*.

The very nature of this more appropriate articulation of a company's economic obligation to its shareholders means the way a company journeys towards it, can be just as important as eventually getting there. This is because the way a company goes about creating shareholder wealth has a huge 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 way 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), revealed that whether consciously or not, some of the most successful listed companies internationally 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 are run as if their leaders really are trying to build *enduring institutions* that can create value for customers and wealth for shareholders *on an ongoing basis*. But this is only possible over the long term if the wellbeing of all stakeholders is enhanced.

The same research suggests this type of behaviour is evident in successful listed companies, irrespective of whether they are operating with 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. The longer the time horizon, the more the interests of all stakeholders are aligned.

An Incomplete Understanding

The problem however, is an incomplete understanding in relation to these matters among those in positions of influence in the business community, in the investment community, and particularly in the business press. This is clearly evident in the response of all these groups to the actions of Unilever Plc when it launched a buy-back, cut costs aggressively and increased dividend payments after it thwarted a bid from Kraft-Heinz in early 2017.

Many believe the actions of Unilever in the wake of the bid were demonstrably in the interest of shareholders. The company attracted plaudits from the business press and other commentators for the action it took – and to be fair, the Board probably had little choice. But the findings of a pilot study covering nine London-listed FMCG companies (including Unilever) conducted by KBA in conjunction with the UK's *Maturity Institute*, suggest that ultimately, the opposite may be true. This is despite a significant increase in share price over the short term.

This pilot study uncovered an important link between *Organisational Maturity* (an evidence-based assessment of overall organisational health) and *intrinsic value;* and between change in *Organisational Maturity* and *shareholder wealth creation*. It also revealed a way to identify those companies that had developed the ability to create wealth for shareholders on an ongoing basis, in ways that would enhance the wellbeing of all legitimate stakeholders. This was achieved by integrating the *Maturity Institute's OMINDEX Rating* with *KBA's EP Bow Wave* construct, in the manner illustrated in the Unilever case study discussed below.

There is a lot behind an *OMINDEX Rating*, but in its most aggregated form, it measures a company's 'overall organisational health' in a manner similar to a credit rating – from D to AAA. As *OMINDEX Rating* increases, *intrinsic value* rises, narrowing any gap between *market capitalisation* and underlying *intrinsic value.*

The pilot study will now be expanded into a significant research program covering all FTSE100 and ASX100 companies, as described in this more detailed version of the Unilever case study, which also doubles as a proposal seeking support from companies and institutional investors to fund the next stage of the research.

The research is expected unlock crucial insights as to what is required of business leaders to build mature, enduring institutions. It will do this by calibrating the link between improvement in *Organisational Maturity* and *shareholder wealth creation*, and by establishing key markers for companies and investors to assess progress along the way.

The Kraft-Heinz Bid for Unilever in Early 2017

Figure 1 shows the *Bow Wave of Expected Economic Profits* embedded in the *market capitalisation* of Unilever Plc at the end of December 2016 (just prior to the Kraft bid). It includes a build-up of *EP* expectations arising from the attractiveness of the markets in which Unilever participates, its competitive position in each market, and from its embedded innovation capability, as assessed using elements of the *OMINDEX* rating process.

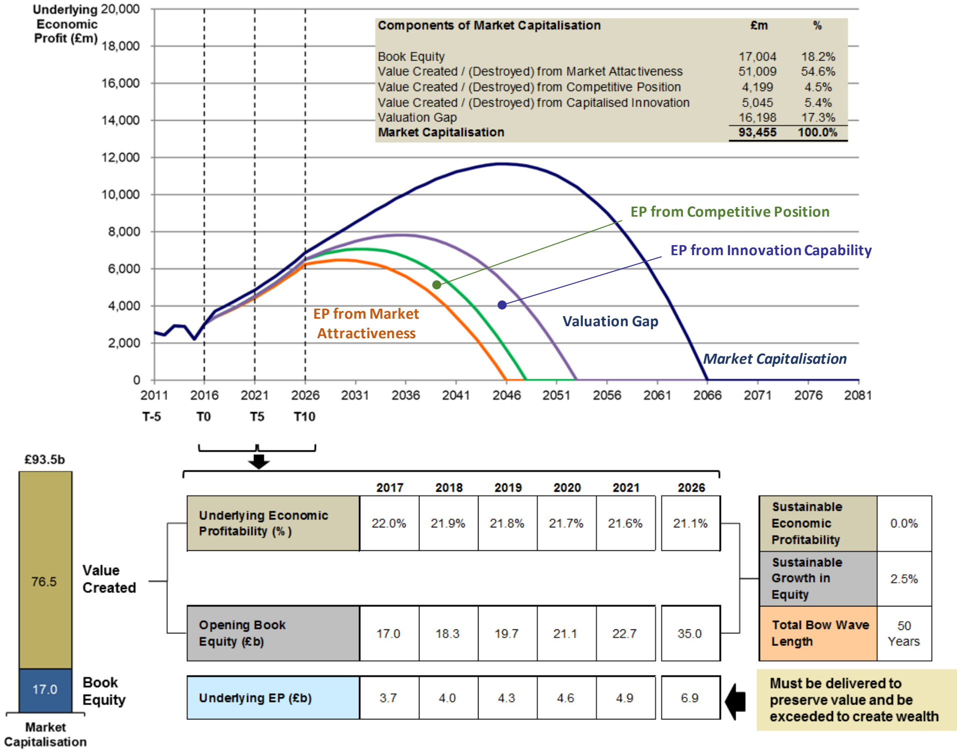
Market capitalisation was £93.5b and the *EP* stream required to underpin this was based on an expectation of high returns (*ROE-Ke* > 20%), solid growth (with the equity capital base on which those returns were expected to be earned doubling in size over ten years) and a required *EP* stream that would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

The build-up for the December 2016 *EP Bow Wave* is shown in the text box. 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 a capitalised innovation capability to be assessed at £5.0b, or 5.4 per cent of *market capitalisation.*

Although the company 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 gap of £16.2b or 17.3 per cent of *market capitalisation* represented a significant challenge for Unilever's management and a material downside valuation risk for shareholders.

The Kraft-Heinz bid was pitched on the basis that there was a lot of short-term value uplift potential within Unilever that could be accessed through improved capital and operating efficiencies – effectively reducing investment in the business and returning the proceeds to shareholders. This rationale was simplistic.

Figure 1*. EP Bow Wave Build-Up for Unilever, 31 December 2016*



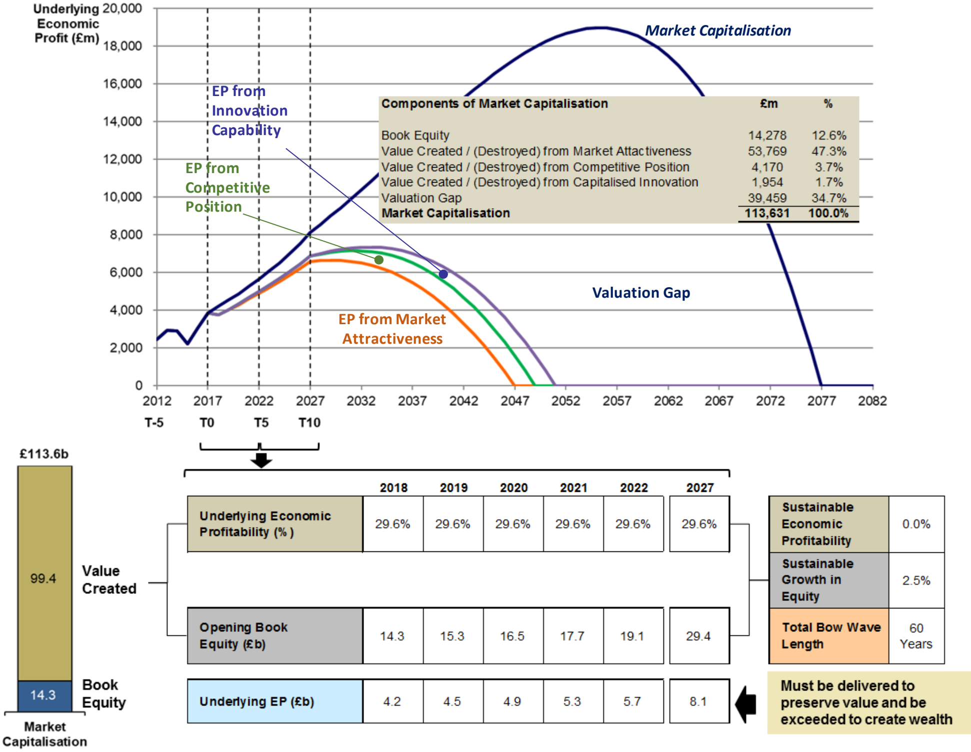
Actions like those proposed by Kraft-Heinz and its backers can drive up the share price of almost any acquisition target in the short to medium term, as traders and short-term capital market players exploit the misguided belief that such ‘improvements’ can all be sustained without undermining or eroding the ‘human capital’ that is so crucial to long-term business success. However, the combination of an *Organisational Maturity* assessment and the *EP Bow Wave* construct lets us demonstrate that such actions can also erode the capabilities (both individual and organisational) that are required to meet *EP* expectations over the longer-term. In the process, they can destroy significant shareholder wealth.

While Unilever’s Board rejected the bid, an understanding of the shape of the company’s *EP Bow Wave* informed by its *OMINDEX rating* would have strengthened its resolve in doing so. It would almost certainly have garnered the support of the company’s long-term shareholders in rejecting the bid as well.

Ultimately, the price paid by Unilever to secure its independence included taking some steps that Kraft-Heinz may well have instituted had the acquisition gone ahead. They included a buy-back, higher dividends and the promise of improved margins through aggressive cost reduction. These steps were initially well received by the capital markets, with the share price increasing significantly over the 12 months to the end of December 2017. But the new *EP Bow Wave* that needed to be delivered to justify this new and higher share price and *market capitalisation* had expanded dramatically, as shown in Figure 2. It was not only ten years longer than a year before (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 was now expected to peak at a level some 50 per cent higher than that expected a year before.

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’.*

***Figure 2**. EP Bow Wave Build-Up for Unilever, 31 December 2017*



Synthesis

Other than the reduction in capital arising from the buy-back, the build-up of the *EP Bow Wave* in Figure 2 reveals two main changes. The assessed value associated with an embedded innovation capability fell by more than 50 per cent as a result of an *OMINDEX* reassessment leading to a downgrade from BBB- to BB+. And the valuation gap doubled to a figure close to £40b, or nearly 35 per cent of market capitalisation.

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 is more likely to be true. At the very minimum, the jury is still out.

Shareholder wealth is created in the sense that an uplift in *intrinsic value* is achieved, when business leaders act in a manner that leads to an improvement in the shape of their company's *EP Bow Wave*. *Societal value* is created when this is done in a way that enhances the wellbeing of everyone involved. Doing the latter is the only way the former can be achieved *on an ongoing basis*. Now more than ever we need to embed this understanding in the way all listed companies operate – starting with the thinking of their leaders.

The KBA Consulting Group

The KBA Consulting Group
Tel. +613 9024 8288
www.kba.com.au