The KBA Consulting Group Maturity Institute OMS Organizational Maturity Services LLP

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 what they believed to be their 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, a polarity began to emerge between the advocates of the so-called *shareholder primacy paradigm*, and those who advocated a rather different and seemingly more holistic business philosophy centred on the pursuit of *societal value* and *stakeholder wellbeing*.

Contrary to widespread belief, this polarity is completely artificial. It has arisen entirely as a result of an incorrect understanding as to how wealth is *really* created in listed companies, and particularly how it is created *on an ongoing basis* in the most successful ones.

The corporate misconduct that gave rise to the GFC, as well as the many more recent examples of inappropriate corporate behaviour, can ultimately be traced back to the same widely-held but nonetheless totally incorrect series of beliefs as to how wealth is created in listed companies. When compounded by self-interest, this misunderstanding has spawned a series of highly inappropriate behaviours by or on behalf of corporations. In some cases, their actions have quite literally devastated the lives of ordinary people throughout the world.

It need not be so, and it need never happen again. Companies must continue to act in a way that creates wealth for their shareholders. Many have a significant proportion of their equity held by pension and superannuation funds, the ultimate beneficiaries of which are often the same ordinary people adversely affected by corporate misconduct.

It is time to think again – and the first step must be to embed a proper understanding of how wealth is *really* created by listed companies in the minds of business leaders, as well as in leading institutional investors, the business press and the leaders of civil society. When we have that understanding in place, it becomes abundantly clear that …

- The true economic obligation of a listed company to its shareholders is to build a mature, enduring institution that can create wealth for its shareholders *on an ongoing basis* – not to maximise share price over the short term. An explicit focus on the long term is key.
- It is entirely possible to align the interests of shareholders with those of all the legitimate or genuine stakeholders in a listed company, and this includes the wider community and the environment.
- Not only can we align the interests of all legitimate stakeholders, we find that *the only way* to create wealth for shareholders *on an ongoing basis* is to ensure that all these stakeholders benefit in an appropriate manner from their association or their interactions with the company.
- The way a company chooses to go about creating shareholder wealth is the primary determinant of the amount of value or benefit that accrues to (or is confiscated from) society at large as a direct result of the economic activities of that company.
- Being in business can and indeed should be considered an opportunity to create wealth by being of service to society – not an opportunity to appropriate wealth by exploiting customers, suppliers, staff, the wider community or the environment. Such an understanding is entirely consistent with the successful establishment of a mature, enduring institution.

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*' 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 legitimate stakeholders (thereby contributing positively to *societal value* over the longer term).[1]

Summary of Preliminary Research Findings

In early 2018, preliminary research was conducted jointly by *KBA* and the *Maturity Institute* seeking to determine if there was a link between *Organisational Maturity* and the ability of a company to create wealth for shareholders *on an ongoing basis*, in ways that also enhanced *societal value*. It focused on nine London-listed FMCG companies and established three important preliminary findings.

1. There is a direct and quantifiable link between *Organisational Maturity* (an evidence-based assessment of overall organisational health) and the ability of a company to create wealth for shareholders *on an ongoing basis* in ways that enhance wellbeing for all legitimate stakeholders.
2. It is possible to quantify the additional wealth created as a consequence of a company making a conscious choice to go about the creation of shareholder wealth in ways that also enhance *societal value*. It is also possible to quantify the shareholder wealth destroyed as a result of choosing to turn away from this approach to wealth creation.
3. It is possible to use this understanding to calculate the *societal value* contributed or confiscated by the economic activities of any company over a given measurement period.

The Need for Further Research

The primary purpose of this paper is to serve as a proposal that seeks funding from corporations, institutional investors and other interested parties, to expand the research already completed by *KBA* and the *Maturity Institute*.

The intention is to cover all companies in the ASX100 and FTSE100 indices. Over time, this is likely to be expanded to cover more companies listed on the ASX and the LSE; as well as companies 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. They lack a proper economic underpinning and are distorted by a widespread misunderstanding as to how wealth is *really* created in successful listed companies.

[1] Real or authentic customer value constitutes value or benefit embedded in a product or service, the consumption or use of which enhances the wellbeing of the customer or end-consumer. Artificial value is value derived through the satisfaction of a desire created through clever marketing, with no thought given to long-term wellbeing.

The purpose of the planned research is to build on preliminary work already completed, to:

- Further calibrate our understanding of the link between organisational health and shareholder value, and between improvement in organisational health and shareholder wealth creation;
- Apply the methodology we have developed to calculate the incremental or additional wealth created for shareholders as a result of companies setting out to meet their economic obligation to shareholders in ways that enhance the wellbeing of all legitimate stakeholders, and so contribute to community wellbeing and *societal value*.
- Be able to calculate the *societal value* contributed by or confiscated through the economic activities of any listed company over a given measurement period.

In answering these questions, the research is also expected to unlock crucial insights as to what is required of business leaders in setting out to build mature, enduring institutions. However, to make use of these insights, it will be important for each Board to know:

- Where their company currently stands in terms *Organisational Maturity*;
- The shape of the *Bow Wave of Expected Economic Profits* embedded in their company's current share price and market capitalisation; and
- How both indicators have changed over time.

This information will be crucial for leaders of the business community and the investment community.

For business leaders, it will provide the clarity and the evidence they need to be able to make a conscious decision to go down the path of building a mature, enduring institutions capable of creating value for customers and wealth for shareholders on an ongoing basis, in ways that also enhance *societal value*.

For institutional investors, it will provide the evidence base and rationale they need to preference the allocation of investment funds towards such companies.

For the leaders of civil society, it will be possible to calculate the total societal benefit of both these things occurring, which could ultimately provide an important input into future public policy decisions – potentially including preferential tax treatment for companies or shareholders of companies that create significant *societal value*.

The findings are also expected to provide the basis for a much more meaningful and actionable dialogue between institutional investors and the Boards of listed companies, consistent with the principles of responsible ownership that many investors are now adopting.

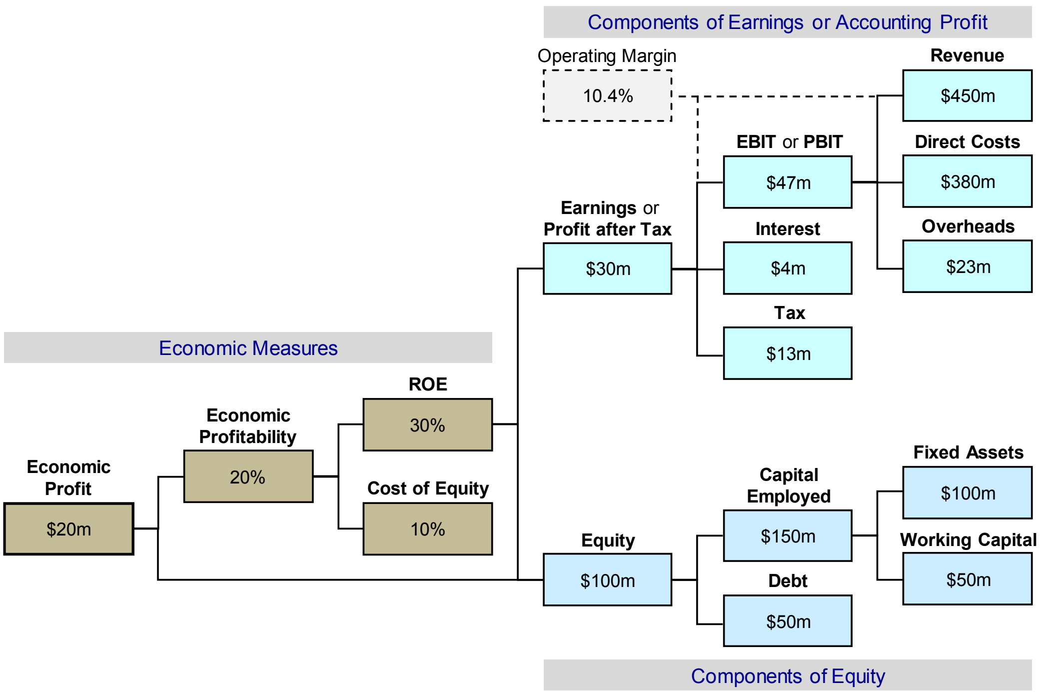
They are also likely to provide powerful ammunition for Boards when dealing with activist shareholders and other short-term capital market players, whose interests often do not align with those of the company, its long-term shareholders and its many other legitimate stakeholders.

Understanding the EP Bow Wave

The notion of a *Bow Wave of Expected Economic Profits* embedded in the *intrinsic value* of all listed companies (and which underpins their share prices and market capitalisations), emerged from a seven-year development effort within KBA 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.

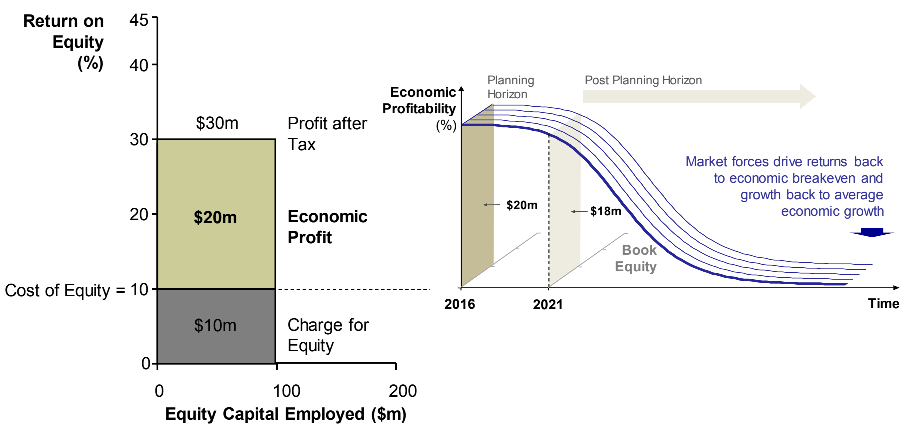
To understand the concept of the *EP Bow Wave*, and then unlock its power, we need to begin with a definition of Economic Profit (EP). EP is the residual profit remaining after applying a charge for equity capital employed, as illustrated in Figure 1.

***Figure 1**. Defining Economic Profit – an illustration*



In a competitive market, economic forces will tend to drive returns down to the cost of capital, or economic profitability (*ROE less the Cost of Equity, Ke*) back to zero over time. They also drive growth back towards average economic growth. This gives rise to the idea of a *Bow Wave of Expected Economic Profits* as illustrated in Figure 2.

***Figure 2**. The EP Bow Wave Construct – an illustration*



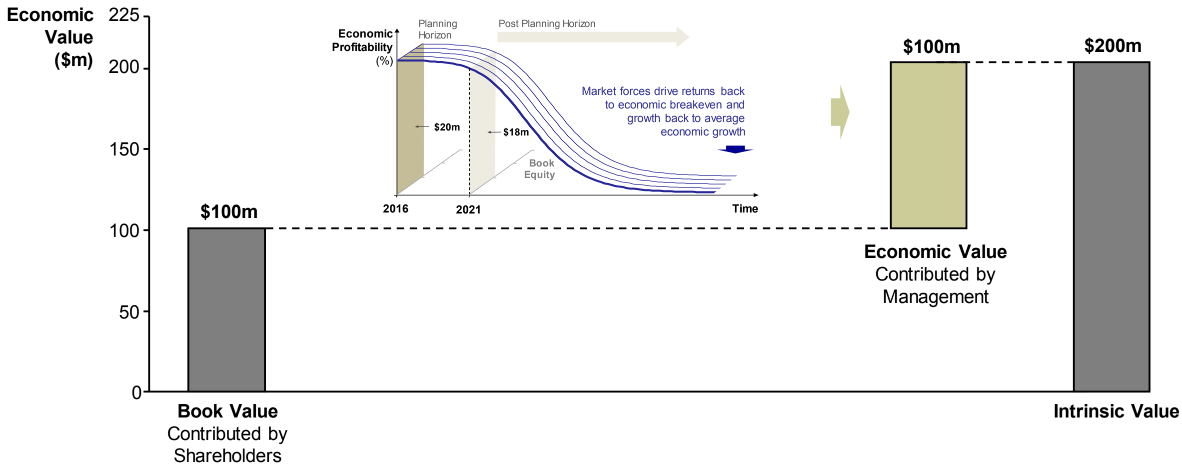
Shaped like a child's slippery slide, the *EP Bow Wave* has three dimensions. These are:

- Expected returns or economic profitability (*ROE-Ke*) represented by the height of the *EP Bow Wave*;
- Expected growth in the capital base on which that return is earned, as represented by the change in the width of the *EP Bow Wave*; and
- Sustainability, or the time over which the company is expected to be able to maintain a positive *EP stream*, as represented by the length of the *EP Bow Wave*.

An ability to deliver the *EP* stream illustrated on the right-hand side of Figure 2 will confer an *intrinsic value* on a 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* – as illustrated in *Figure 3*.

For illustrative purposes, let's assume the *intrinsic value* is \$200m, made up of \$100m of *Book Equity* and \$100m from the present value of the expected *EP stream* represented by volume under the *EP Bow Wave* in Figure 3.

***Figure 3**. 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 they 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 from the way they participate in the *product and services market*.

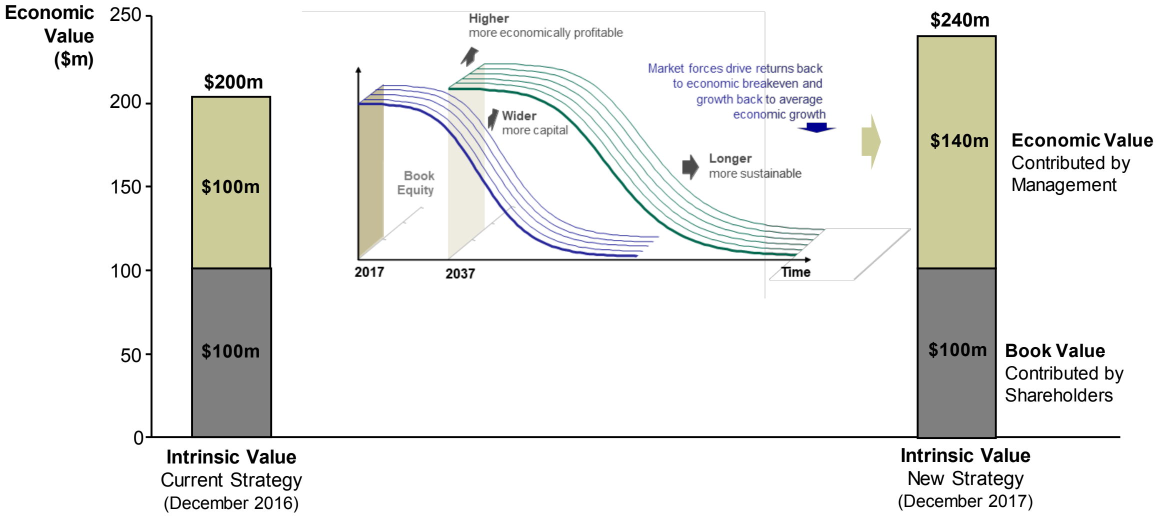
It is important to appreciate that wealth is not created simply though higher returns. There are many things management can do to enhance returns in the short term – such as raising price, reducing cost or constraining capital investment. In many cases, the increase in return arising from such actions 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 is likely to impact negatively on other stakeholders at the same time.

Figure 4 provides 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.

The resultant change 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 4.

Figure 4. *Enhancing the Shape of the EP Bow Wave – Comparing Two Different Strategies*



Understanding Organisational Maturity and the *OMINDEX* Rating

It is impossible to deliver the long *EP streams* that we now know underpin the market value of many listed companies, unless there is a well-functioning organisation (including a sound culture and robust governance processes), a strong innovation capability, and all legitimate stakeholders benefit from their association with the company. These organisational attributes underpin the company's expected *EP* stream, its intrinsic value and its market capitalisation.

Consequently, it is important 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.

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* concept of *Organisational Maturity,* and its companion indicator the *OMINDEX* rating.

Organisational Maturity is an innovative but powerful concept that 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 an appropriate 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.

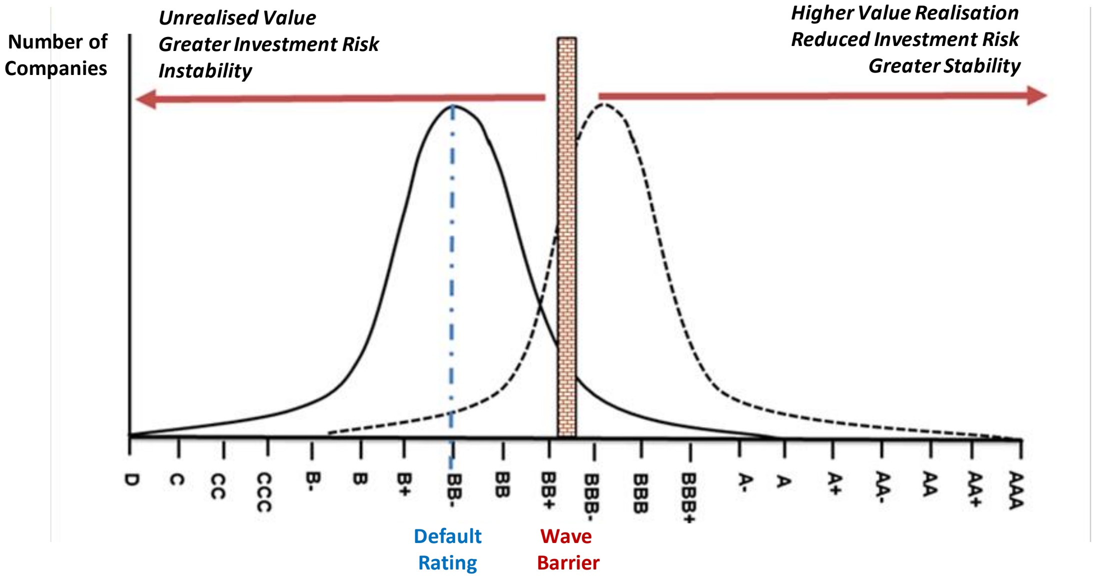
OMINDEX rating provides an assessment of *Organisational Maturity*. It forms a basis from which to compare and rate a company's ability to create value and manage risk through the effective use of human capital. It is also an indicator of the extent to which the needs of all stakeholders are being met. It measures a company's progress along a scale similar in appearance to a conventional credit rating scale (from D to AAA), as illustrated in Figure 5 on the next page.

The *OMINDEX* scale is symmetrical, with 20 gradations from D to AAA. A high rating on the *OMINDEX* scale indicates focused and coherent leadership, together with high management capability and good organisational agility. A high *OMINDEX* rating also indicates value created for shareholders will be created ways that also enhance *societal value*.

The dividing line separating 'immature' and 'maturing' companies is represented by the value-risk threshold between BB+ and BBB- . This is shown as a 'brick wall' in Figure 5. It is the same 'cut off' point that in credit rating denotes investment grade status.

The default rating is BB-. This is where the bulk of companies are believed to lie.

Figure 5. *Plotting Organisational Maturity on OMINDEX – an illustration*



Preliminary research has enabled *KBA* and the *Maturity Institute* to identify a causal relationship linking *Organisational Maturity* and the shape of a company's *EP Bow Wave*. This has been achieved by defining a neutral point at which *Organisational Maturity* has no impact on the *EP Bow Wave* (either positive or negative). This neutral point is located at an *OMINDEX* rating of BB-.

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 relative *intrinsic value* than a lower *OMINDEX* rated company. In a well-informed and well-attended capital market, this should translate into a higher share price and higher market capitalisation.

Linking OMINDEX Rating, the EP Bow Wave, Market Capitalisation and Societal Value

The concept of *Organisational Maturity* and its relationship to *shareholder value*, *shareholder wealth creation* and the creation of *societal valu*e, is illustrated in Figure 6. It is brought to life in the three case studies to follow. The key point to understand is that improvement in *Organisational Maturity* and *OMINDEX* rating is both a social good and an important factor in long-term commercial success. A company that is committed to going on the journey to becoming a mature, enduring institution is likely to create more wealth for shareholders than other comparable companies – and do so in ways that also enhance societal wellbeing. Therefore, *societal value* is likely to be maximised through Boards and executives committing to the 'maturity journey' and institutional investors preferencing the allocation of investment capital to those companies.

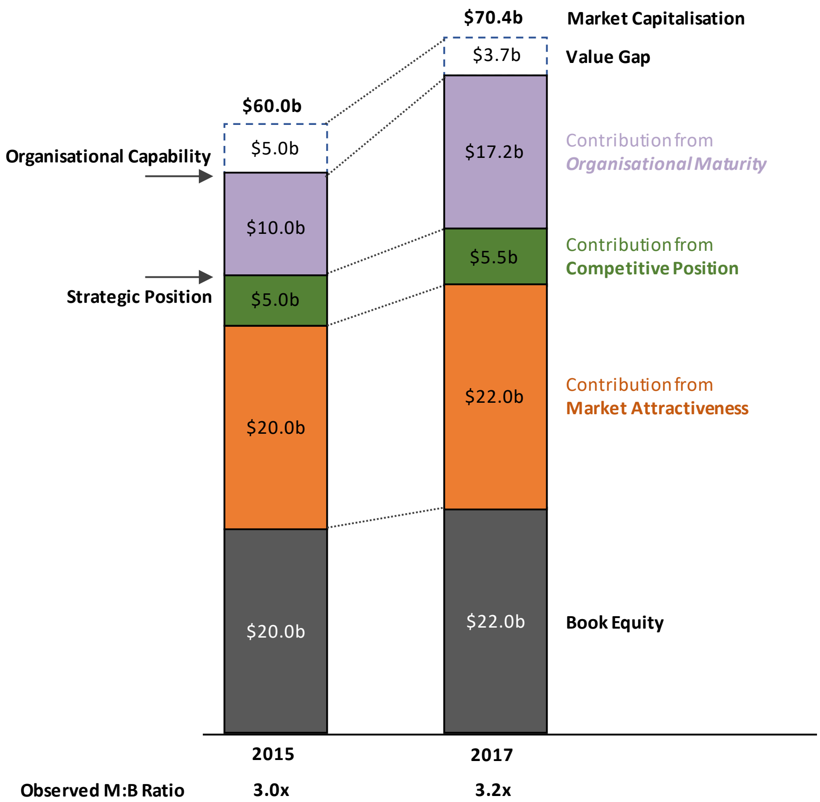
Figure 6 presents an illustrative valuation of a listed company at two points in time, broken down into the primary valuation building blocks that we can now identify with the help of the *EP Bow Wave* construct informed by the concept of *Organisational Maturity*. Each building block has a corresponding *EP stream*.

The first or grey-shaded building block is book equity, or the equity capital employed and captured in the company's balance sheet. This comprises capital contributed by shareholders plus retained earnings. The second or amber-shaded building block is the component of market capitalisation that arises from the attractiveness of the markets in which the company participates with its product or service offerings. The third or green-shaded element is that component of market value arising from any structural competitive advantage that the company has built. This stems from the combination of any unit cost advantage, and any customer value advantage which would confer a right to charge a price premium.

The sum of the first three building blocks represents the value of the strategy the business is pursuing. However, there is more to the story. The purple-shaded block represents the component of value arising from *Organisational Maturity*, including embedded organisational capabilities (which in turn incorporates any embedded innovation potential). The sum of these four elements represents the value of the company incorporating its full capability as an organisation – including its potential to preserve value by holding back the forces of competition.

The gap between the value of the company including its full capabilities as an organisation, and its market capitalisation, represents the value of a further *EP steam* the market is expecting the company to deliver, but which is associated with products, services, businesses or capabilities that do not yet exist. Where such a gap exists, it represents a challenge for management. It is an expectation already embedded in the share price that must be delivered to preserve wealth for existing shareholders.

***Figure 6**. Build-up of Components of Market Capitalisation – an illustration*



In Figure 6, we have constructed an example in which the value of the business increases from $60.0b to $70.4b and the M:B ratio increases from 3.0x to 3.2x over a period of two years. In this illustration, the largest component of value uplift is derived from an increase in *Organisational Maturit*y – reflected in an improvement in *OMINDEX* from BB+ to BBB, indicating an assessed improvement in the overall state of the organisation. At the same time, the size of the *value gap* fell by $1.3b.

Importantly, the value increment associated with the improvement in *Organisational Maturity* will have arisen from activities that not only created shareholder wealth, but also served to enhance *societal value*. So the difference between these two figures ($7.2b) represents the wealth created for shareholders over the two years, arising from activities that also enhanced *societal value*. Applying an appropriate multiplier to this figure of $7.2b will provide a robust estimate of the company's contribution to improvement in the wellbeing of society at large, or *societal value*, over the two years.

The research program will apply this framework to measure both the shareholder wealth and the s*ocietal value* created by a large cross section of UK and Australian listed companies as a result of each operating at (or achieving an improvement in) its assessed level of *Organisational Maturity*. The outcome of the research will provide a powerful incentive for Boards and investors to embark on the 'maturity journey'.

Case Study A. *Bow Wave Progression in the Top 120 ASX-Listed Industrial Companies*

As part of its ongoing research program, KBA constructed a series of aggregate *EP Bow Waves* for the top 120 ASX-listed industrial companies (excluding resource companies and real estate investment trusts).

The aggregate *EP Bow Waves* required to be delivered in order to deliver the aggregate market capitalisation of these companies is provided in Figure 7. It shows that the peak annual *EP* outcome required to justify this aggregate market capitalisation in December 2017, was five times the level that existed in 2011 and more than three times that in 2012.

***Figure 7**. Progression in the Aggregate EP Bow Wave for the Top 120 ASX Listed Industrials*

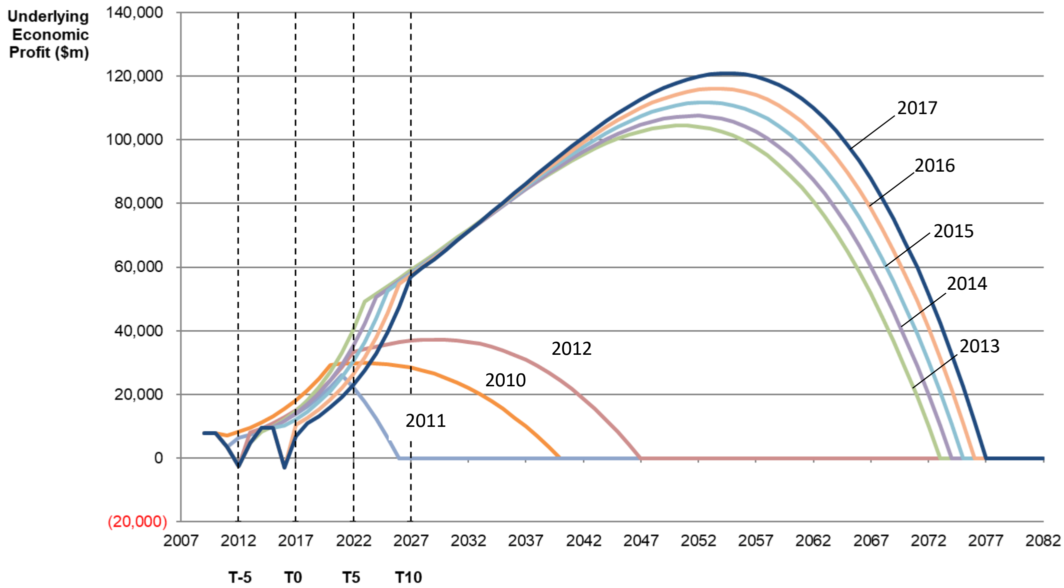
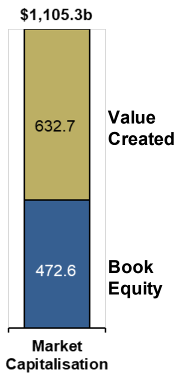


Figure 8 shows the three dimensions of the 2017 *EP Bow Wave* illustrated in *Figure 7.* Economic profitability was expected to increase from 2.3 per cent to 6.6 per cent over the next ten years, capital employed is expected to double, and the *EP stream* is expected to remain positive for 60 years. This is quite an expectation, since over the long term, an EP of zero represents good performance.

***Figure 8**. Expectations Embedded in the Market Cap of the Top 120 ASX-Listed Industrials – 31 Dec 2017*



	2018	2019	2020	2021	2022	2027
Underlying Economic Profitability (%)	2.3%	2.6%	2.9%	3.3%	3.7%	6.6%
Opening Book Equity ($b)	472.6	505.6	541.0	578.9	619.4	929.6
Underlying EP ($b)	11.0	13.2	15.9	19.1	22.9	56.9
Imputation Adjusted EP ($b)	20.7	24.0	28.0	32.6	38.1	85.8

Sustainable Economic Profitability	0.0%
Sustainable Growth in Equity	2.5%
Total Bow Wave Length	60 Years

Must be delivered to preserve value and be exceeded to create wealth

We can disaggregate each *EP Bow Wave* in Figure 7 into the same components of value employed in Figure 6 and this is done in the figures on the next page for 2010, 2012 and 2017. In each case, there is a component arising from market attractiveness, a component from competitive position and a component from *Organisational Maturity*.

***Figure 9**. Components of the EP Bow Wave and Market Cap for Top 120 Industrials in December 2010*

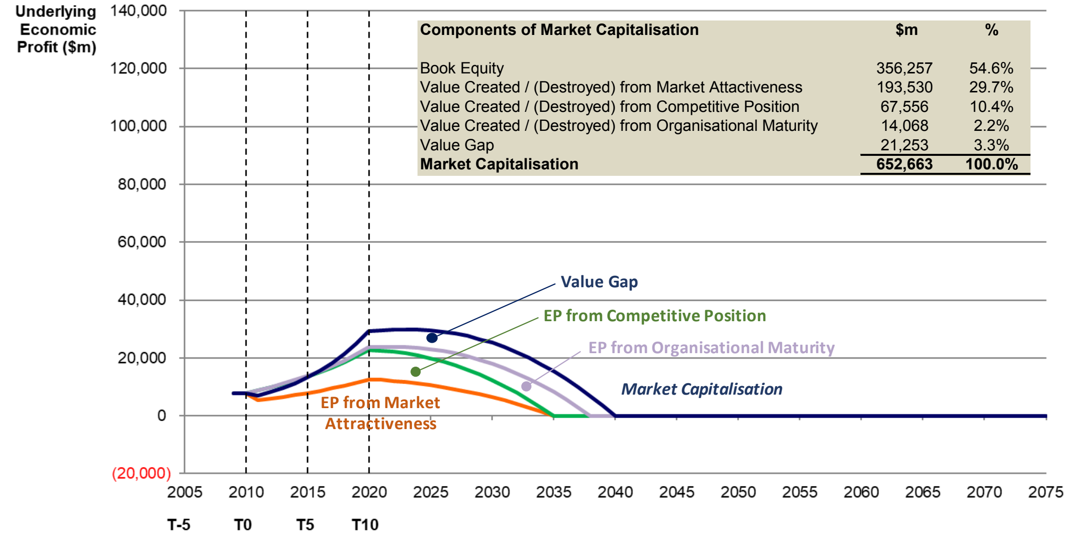


***Figure 10**. Components of the EP Bow Wave and Market Cap for Top 120 Industrials in December 2012*

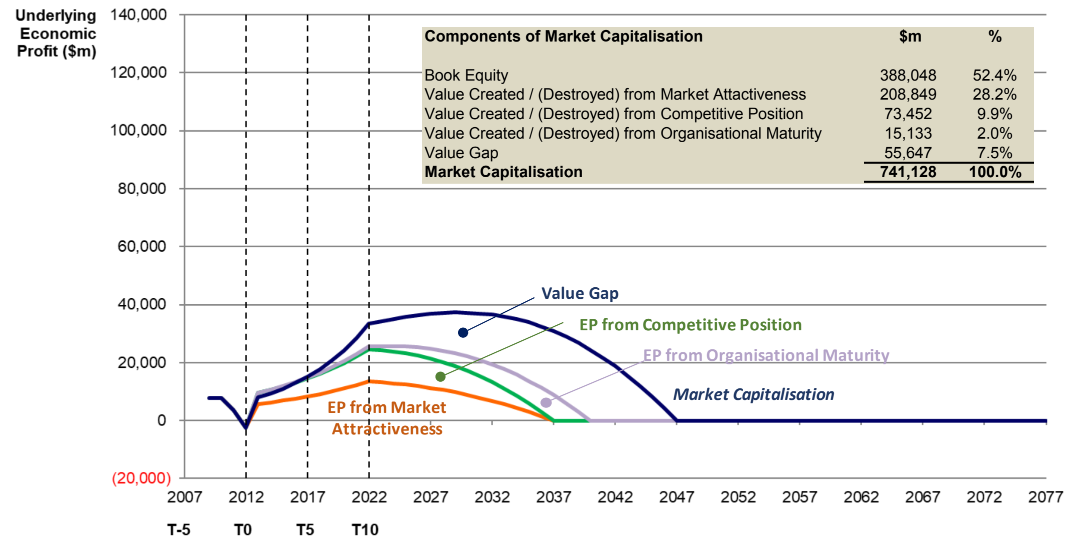
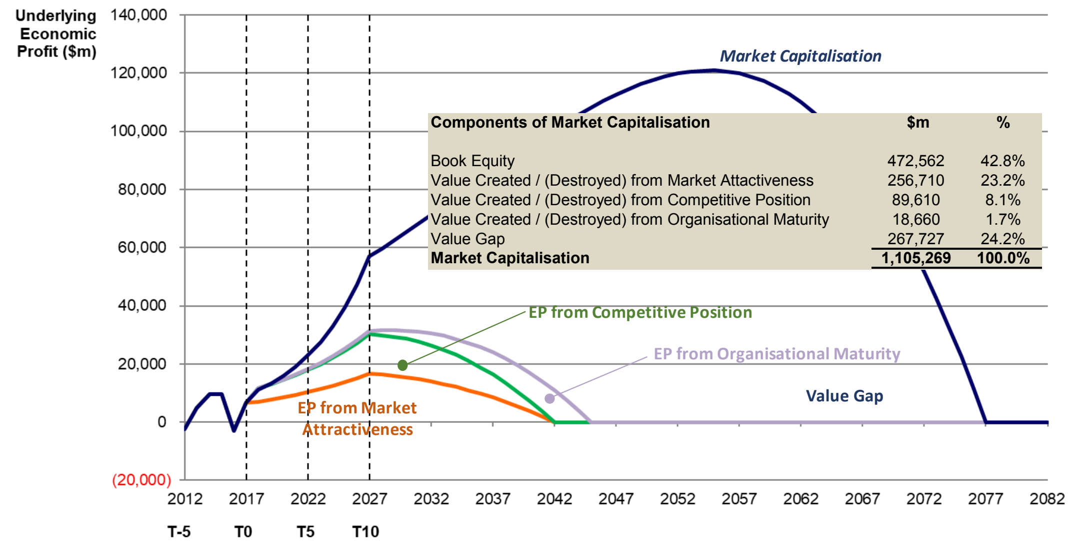


***Figure 11**. Components of the EP Bow Wave and Market Cap for Top 120 Industrials in December 2017*



In 2010, just over three per cent of the aggregate market capitalisation of $652b was attributable to EP expectations associated with products, services, businesses or capabilities that did not then exist, and which would need to be developed over time through a combination of innovation and organisational capability creation. But by December 2017, the component required from future innovation and organisational capability creation, had grown to nearly 25 per cent of aggregate market capitalisation

There seem to be two ways to interpret this picture. 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 must invest in building organisational capabilities (and particularly the innovation capabilities) necessary to close the *value gap*.

Because so much of this *value gap* relates to the need to underpin *EP* expectations that are very long-term in nature, this gap can only be closed by acting in a manner that enhances the wellbeing of all legitimate stakeholders. This means systematically enhancing *Organisational Maturity* and creating both shareholder wealth and *societal value* along the way.

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

Case Study B. *The Kraft-Heinz Bid for Unilever Plc*

Figure 12 shows the progression of *EP Bow Waves* for Unilever from 2010 to 2017. With the exception of the very significant shift in profile between 2016 and 2017 – a period during which Unilever was subjected to and then thwarted a bid from Kraft Heinz – the picture portrayed is one that in most cases would tend to suggest a company that is building shareholder wealth quite steadily and systematically.

Figure 12. *Progression of EP Bow Waves for Unilever – 2010 to 2017*

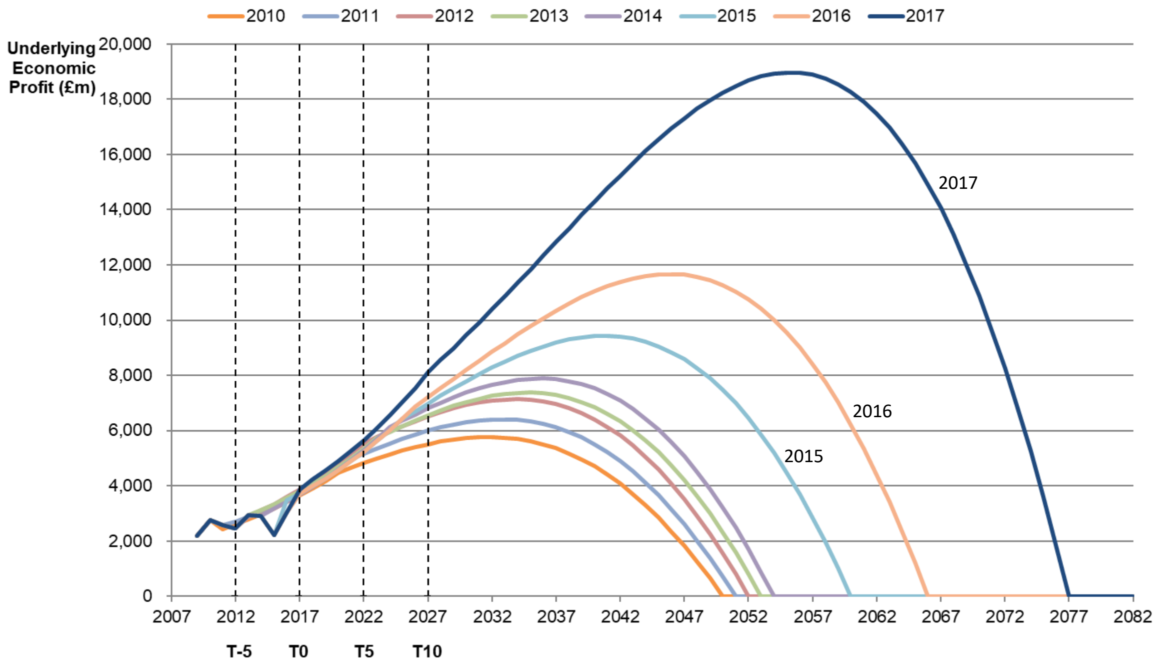
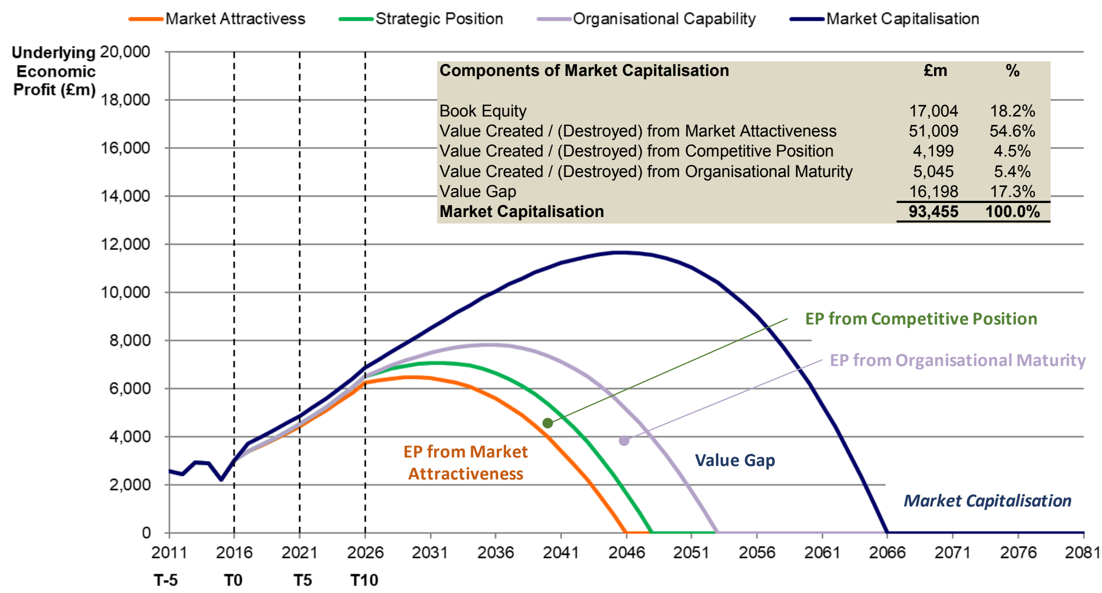


Figure 13 on the next page shows the EP expectations embedded in the share price and market capitalisation of Unilever Plc on 31 December 2016 (just prior to the Kraft bid), including a build-up of *EP* expectations from market attractiveness, competitive position and *Organisational Maturity*, using the components of value introduced in Figure 6.

The build-up for the December 2016 *EP Bow Wave* is shown in the text box in Figure 13. The contribution to Unilever's value from participating in markets with attractive economics was £51.0b, or 54.6 per cent of market capitalisation. This is a very high figure relative to book equity. 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 from *Organisational Maturity* (including capitalised innovation capability) 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' and some distance to the right of the default or neutral position of BB- in Figure 5.)

Figure 13. *EP Bow Wave Build-Up for Unilever, 31 December 2016*



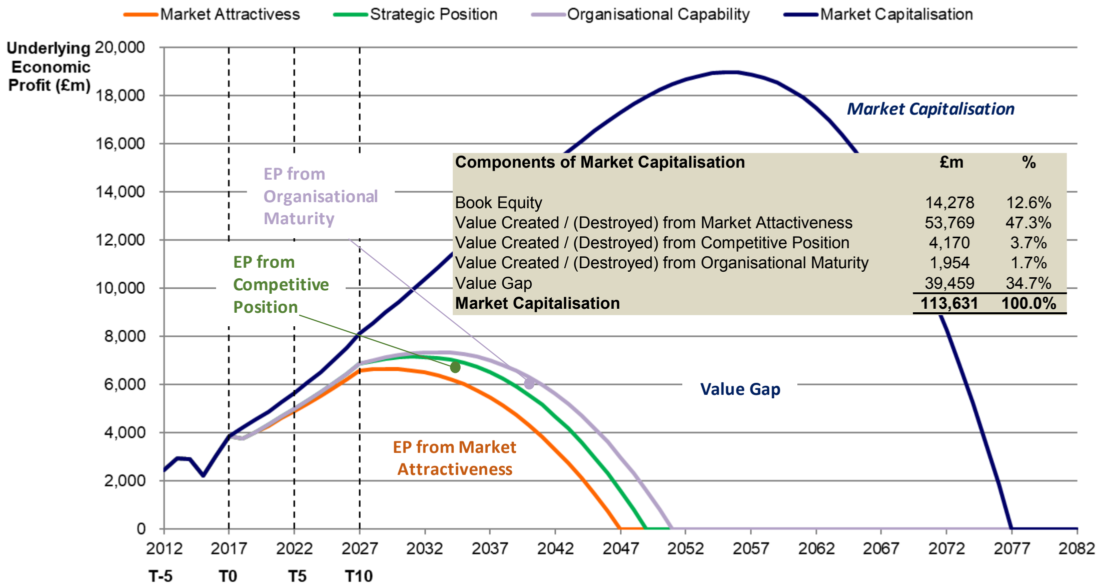
Although management may not have been aware of it at the time, there was still a significant gap in the *EP* expectations required to justify Unilever's market capitalisation in December 2016. This *value gap* of £16.2b or 17.3 per cent of market capitalisation represented a fundamental challenge for 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 undermine or even erode 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 an *Organisational Maturity* assessment 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, 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 generally 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 14.

Figure 14. *EP Bow Wave Build-Up for Unilever, 31 December 2017*



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 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 contribution to value from *Organisational Maturity* fell by more than 50 per cent as a result of a new and lower *OMINDEX* rating of BB+. Secondly, the *value gap* more than doubled to a figure close to £40b, or nearly 35 per cent of market capitalisation.

A summary of the change in the components of Unilever's market capitalisation between December 2016 and December 2017, is illustrated in Figure 15. The bridge between the two is summarised in Figure 16.

Figure 15. *Build-up of Components of Unilever Market Capitalisation*

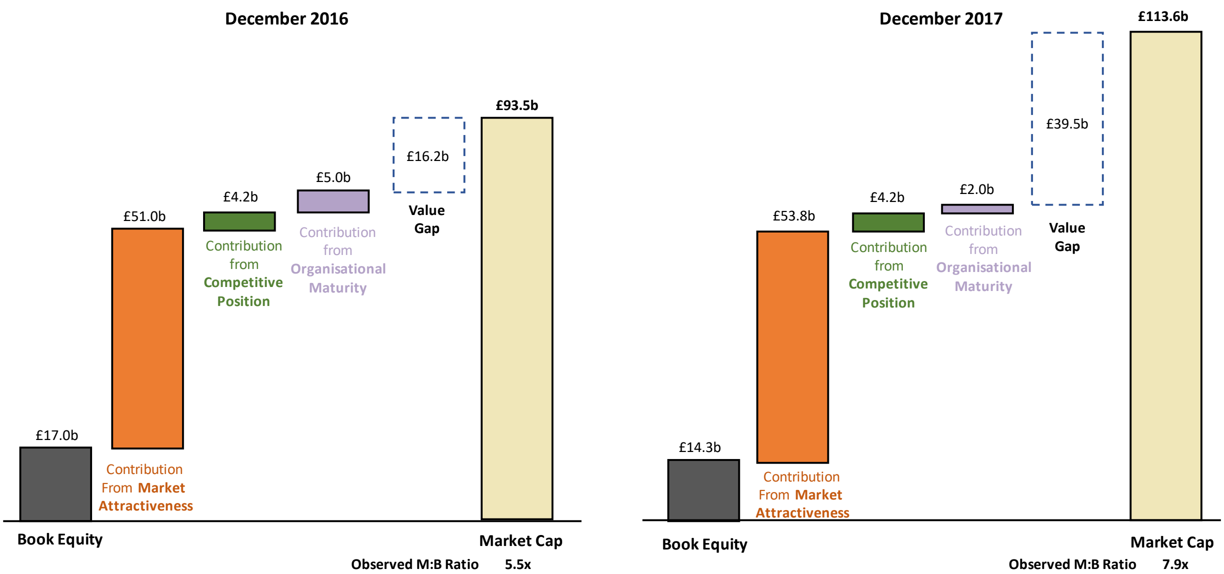
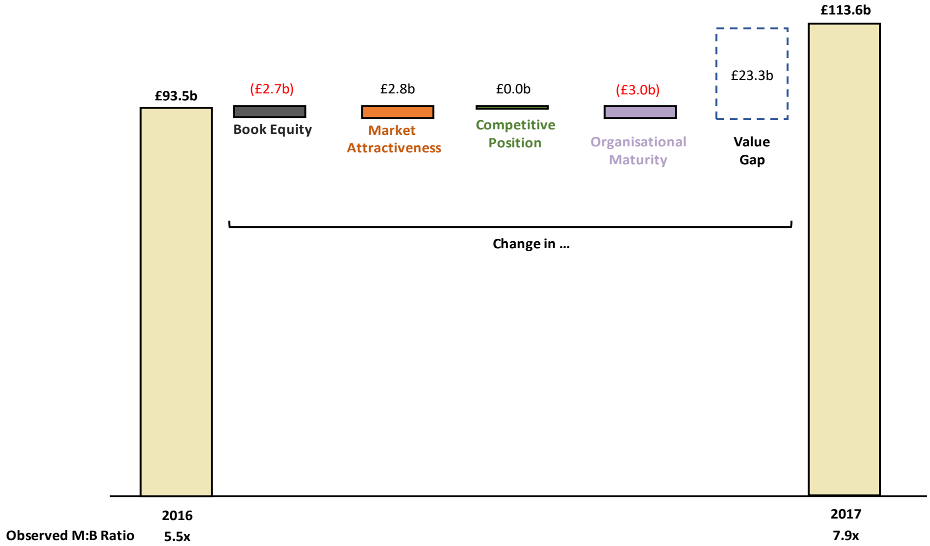


Figure 16. *Bridge Between Unilever's 2016 and 2017 Market Capitalisation*



A doubling of the *value gap* combined with a halving of the contribution to value from *Organisational Maturity* represents a most interesting picture. Short-term capital market players would have done well from this outcome. But the company and its long-term shareholders were worse off, and so was society.

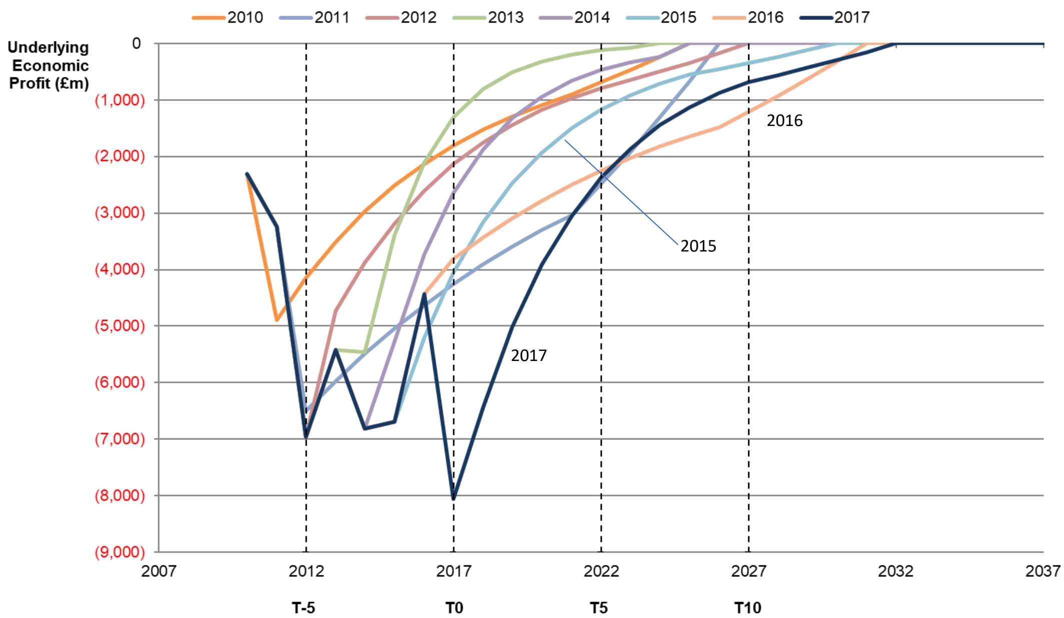
As was the case with the ASX Industrials in *Case Study A*, there will always be two ways to interpret these events. Either there was a good deal more valuation risk associated with the Unilever share price and market capitalisation as at 31 December 2017; or Unilever needs to revert to the strategy it was pursuing prior to the bid and continue to invest in innovation, and in building the capabilities 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 *Organisational Maturity* assessment suggests the opposite may be true. At the very minimum, the jury is still out.

Case Study C. *Barclays Bank Plc*

Like all Britain's major commercial banks, Barclays has been economically unprofitable since the GFC, with a ROE well below its Cost of Equity (Ke). Figure 17 presents its *EP Bow Waves* from 2010 to 2017.

Figure 17. *Progression of EP Bow Waves for Barclays Bank – 2010 to 2017*

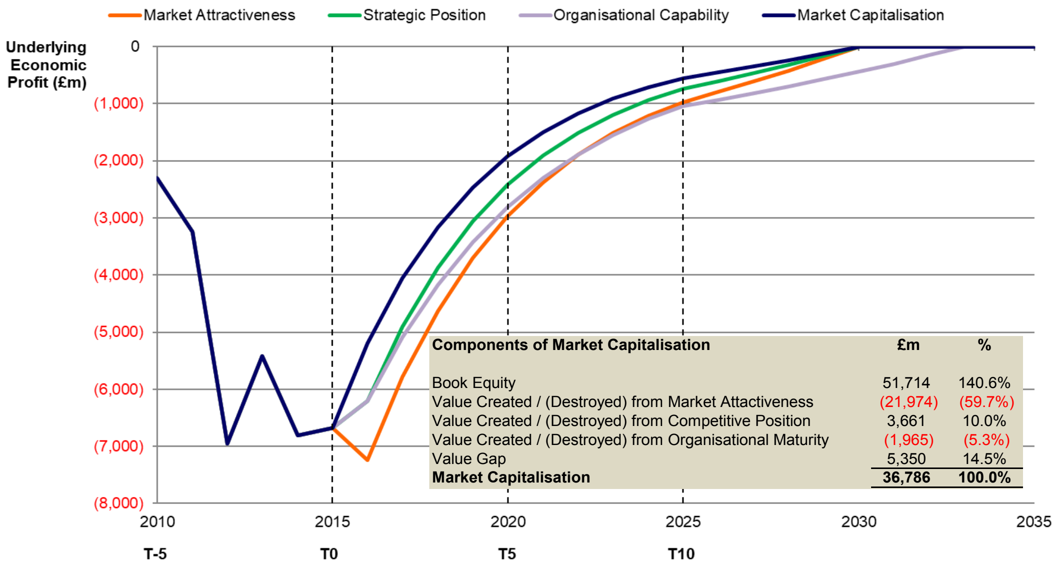


The picture presented in Figure 17 shows that, unlike Unilever which is highly economically profitable with a M:B ratio of 7.9x, Barclays is extremely economically unprofitable with a M:B ratio of 0.7x.

When a company is economically unprofitable, a longer *EP Bow Wave* is a bad thing. It means the market is expecting the business to remain economically unprofitable for longer. This will always translate into a lower M:B ratio – bearing in mind that economic breakeven (EP = 0) will translate into a M:B ratio of 1.0x (market capitalisation equal to book equity).

The build-up of the Barclays *EP Bow Wave* for December 2015 is illustrated in Figure 18.

Figure 18. *EP Bow Wave Build-Up for Barclays Bank, 31 December 2015*

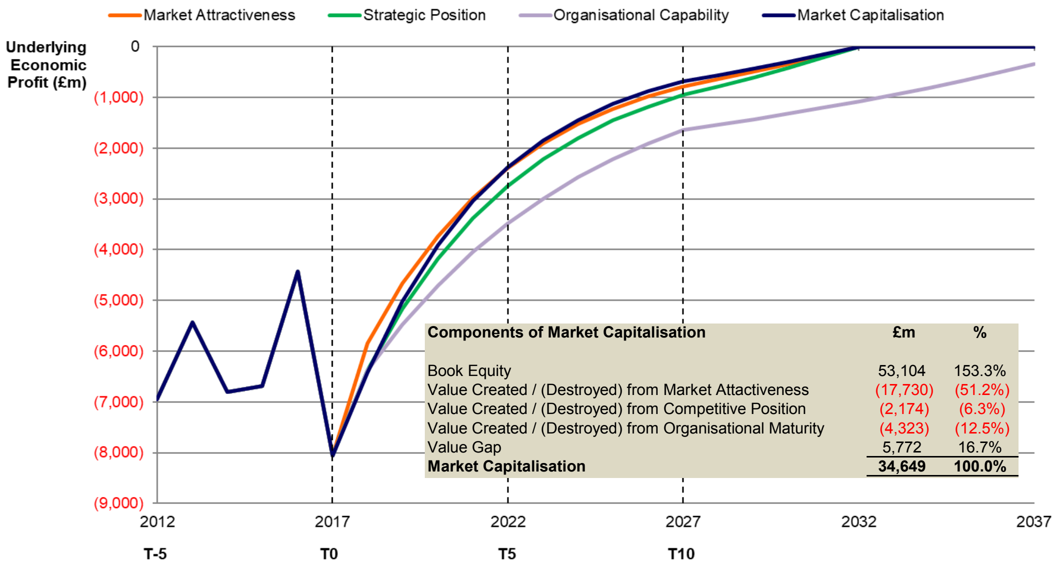


The contribution to market capitalisation from book equity in December 2015 was £51.7b. This was eroded significantly by the impact of participation in an economically unattractive market.

Barclays was able to achieve higher returns than its competitors in the years leading up to 2015, so it is reasonable to assume that it had a slight competitive advantage, and this made a positive contribution to value. But a low *OMINDEX* rating of B- (below the neutral position of BB-) meant the contribution to value from *Organisational Maturity* was negative. As a result, Barclays had a *value gap* of £5.3b.

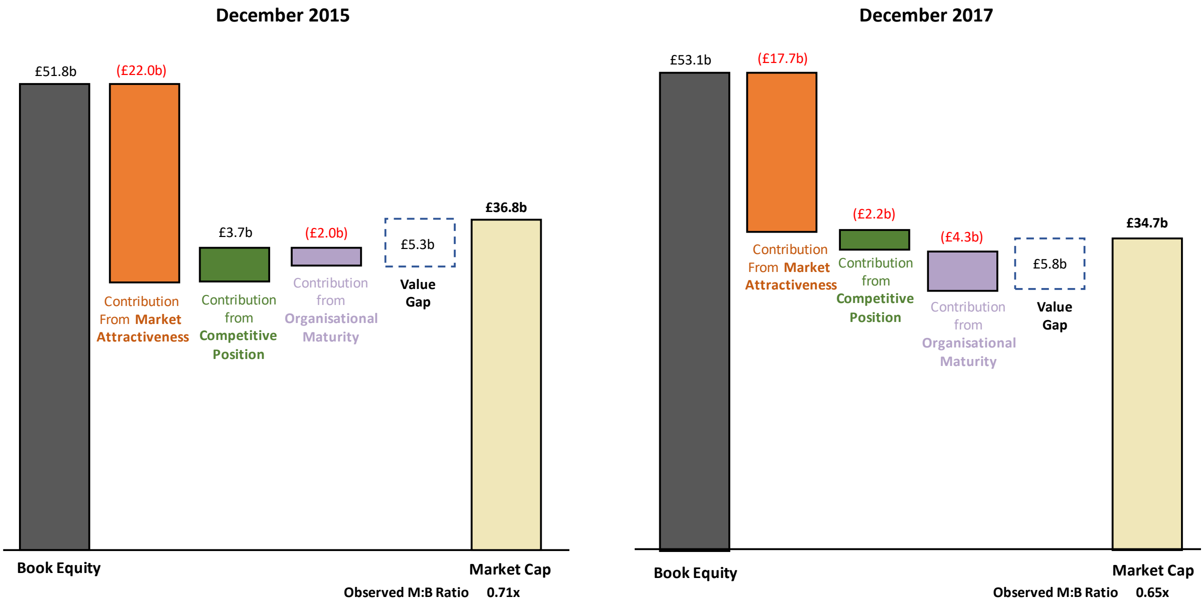
While the picture did not appear to change much in aggregate over the two years to 2017, crucially Barclay's organisational maturity assessment went backwards, with an *OMINDEX* downgrade to CCC+.

Figure 19. *EP Bow Wave Build-Up for Barclays Bank, 31 December 2017*



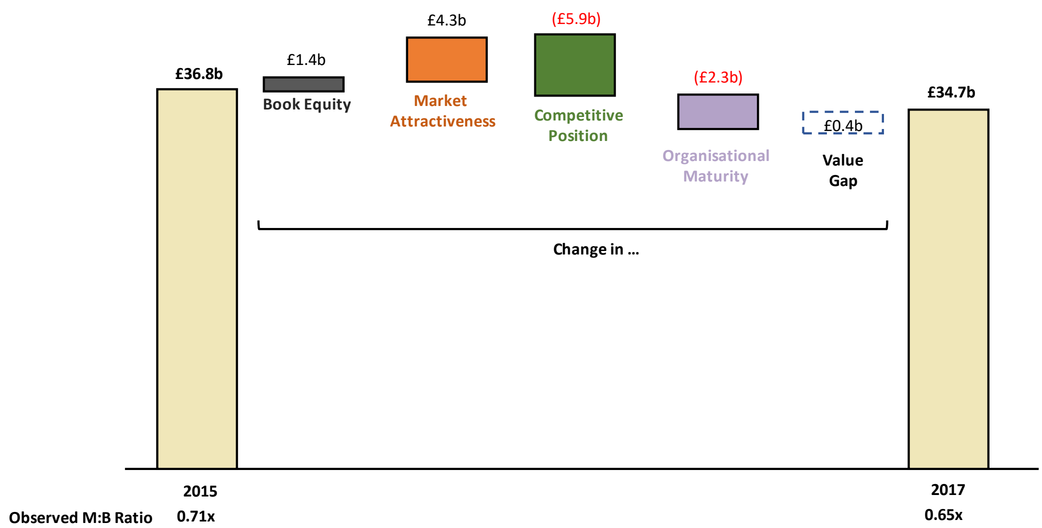
A summary of the change in the components of Barclay's market capitalisation between December 2015 and December 2017, is illustrated in Figure 20.

Figure 20. *Build-up of Components of Barclays' Market Capitalisation*



A value bridge linking the two is summarised in Figure 21.

Figure 21. *Bridge Between Barclays' 2015 and 2017 Market Capitalisation*



The picture for Barclays is very different to that of Unilever, but both pose serious challenges for investors and their respective Boards. While the *value gap* remained much the same for Barclays, the most significant problem is the *OMINDEX* downgrade underpinning a doubling in the wealth destruction arising from a lack of *Organisational Maturity*.

This component of wealth destruction in the build-up of Barclays' market capitalisation also constitutes a drag on *societal value*.

Synthesis

Shareholder wealth is created 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 already know from both a conceptual and an empirical standpoint, that maintaining or enhancing the length of the *EP Bow Wave* is particularly important – especially with companies that are already successful. However, the *EP Bow Wave* can only be enhanced *on an ongoing basis* – and so wealth can only be created *on an ongoing basis* – if three conditions hold.

- Firstly, there is an explicit focus on the long term. Truly successful listed companies that create wealth for shareholders on an ongoing basis, tend not to do so by outperforming short-term financial performance expectations. They create wealth by harnessing innovation and building new capabilities. These lead to new and higher *EP* expectations which they then deliver over time.
- Secondly, all legitimate stakeholders must be looked upon as allies in creating value for customers and wealth for shareholders over the long term, and a conscious effort must be made to ensure they benefit appropriately from their involvement with the company.
- Thirdly, there must be a well-functioning organisation in place underpinned by a sound culture and robust governance processes, which in combination provide the conditions required to establish and maintain a strong innovation capability.

Mature, enduring institutions have all these attributes, and their existence means that when such companies set out to create shareholder wealth, they will enhance *societal value* at the same time. These companies are characterised by the fact that they create wealth by being of service to society.

Unfortunately, in seeking to propagate this understanding we must confront a widespread lack of understanding as to how wealth is *really* created in listed companies. Despite many business leaders appearing to hold a contrary view, we now know that wealth cannot be created *on an ongoing basis* simply by seeking to enhance returns in the market for a company's products and services. Such actions might deliver an increase in share price over the short-to-medium term (as evidenced in the Unilever case study). But an increase in share price achieved in this way is often not sustained. The focus must be on continually seeking to enhance the volume under the *EP Bow Wave*.

Mature, enduring institutions don't seek to maximise short-term returns in this way in an effort to drive up their share price. Such behaviour reflects a preparedness to create wealth at the expense of society. It also tends to create future financial performance expectations that will prove difficult to deliver.

There is growing interest in the idea of corporations adopting *societal value creation* as both a purpose and a business objective. Years of work by *KBA* and the *Maturity Institute*, using the concepts of *Total Stakeholder Value* and the *EP Bow Wave* construct, now make it clear how shareholder wealth can be created in ways that enhance *societal value*, as well as how this can become a legitimate business objective for every listed company.

Properly understood, management's true economic obligation to investors is to build a mature, enduring institution that can create wealth for them *on an ongoing basis*. How they go about this matters a great deal. 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*. It is also the primary determinant of the amount of value or benefit that accrues to (or is confiscated from) society at large, as a direct result of the economic activities of that company.

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 power and influence in the business and investment communities, do not have this understanding. One of the most important outcomes of this research will be to articulate the correct understanding in a way that is fully supported with extensive empirical research.

Our preliminary research has already demonstrated that in a mature, enduring institution, the creation of shareholder wealth can be a logical and natural consequence of setting out to create *societal value*.

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 Organisational Maturity as measured on the *OMINDEX* rating scale, and the shape of a company's *EP Bow Wave.*

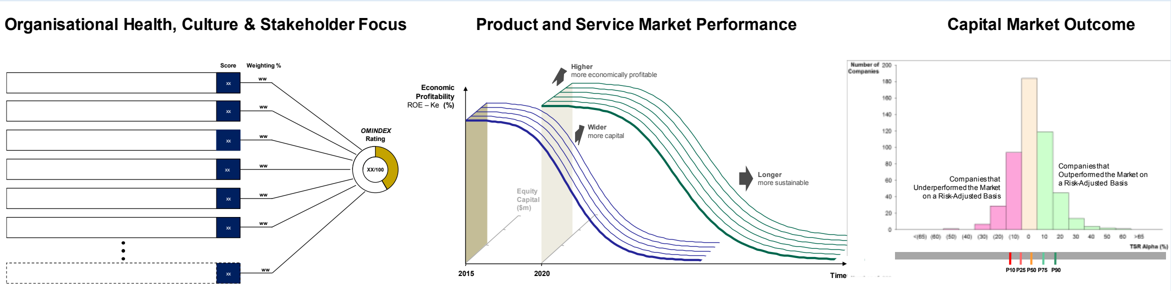
Our opening hypothesis based on the pilot study is there exists a strong causal link between *OMINDEX*, the shape of the *EP Bow Wave*; and that improvement in *OMINDEX* over time will enhance the shape of the *EP Bow Wave* leading to an increase in shareholder wealth – achieved in ways that enhance the wellbeing of all stakeholders.

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

- The relationship between *OMINDEX*, the *EP Bow Wave* and *market value*;
- The extent of any *value gap* that may have emerged over time; and
- The relationship between change in *OMINDEX and* change in the shape of the *EP Bow Wave,* as well as the change in *market value.*

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 ASX-listed industrials, Unilever and Barclay's Bank, 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.