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Stakeholder capital: a catalyst for business success

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Stakeholder management matters

On 11 July 2016, the *Financial Times* reported that Chinese state media had lambasted Ikea for its "arrogance" and "irresponsibility" for not conducting a full recall on the mainland of furniture that has allegedly led to a number of children's deaths (six since 1989) in the US.[1] According to the US Consumer Product Safety Commission, the particular furniture is prone to topple over and crush toddlers if not anchored to the wall. Ikea's initial response was that there would be no recall of the products in question in China, because they conformed to local regulations, and there had been no reports of child deaths. Approximately 24 hours later, the same newspaper reported that Ikea would recall 1.7m dressers sold in China.

The reason that Ikea, within a 24 hour period, had completely reversed its position, is because stakeholders matter — more so today than they ever have. In bygone days, a company's defence that it had complied with local regulations would have been an adequate defence in the court of public opinion. No longer. In an increasingly globalised and transparent competitive environment, stakeholder expectations of companies have risen exponentially; the bar is being raised continuously. Today, the standard by which companies are judged is global best practice.

We are living in a world of radical information transparency *and* instant mass communications capability. The former means that what happens in a far-flung corner of a company's operations can now be detected and analysed by any number of affected or interested parties. The latter means that any resulting critiques of corporate malfeasance can be easily transmitted, via social networks, to global audiences. This transmission is now instantaneous, cost-free, and frictionless. Today, it is not a question of whether companies need to engage stakeholders,[2] but how. In today's world there is simply no place for a company to hide.

Inflection Point Capital Management's core investment thesis is our belief that a series of powerful secular global megatrends, combined with the accelerating velocity of change in global markets, is creating an entirely new set of alternative risk/return drivers and competitive imperatives for companies. Two of the most important of those megatrends are the dramatic increase in both stakeholder standards and power, and the unprecedented information and communications tools with which they are now equipped. The way in which a company manages its stakeholders is a powerful indicator of the overall quality of its management.

1 http://www.ft.com/cms/s/0/e9a5356a-4710-11e6-8d68-72e9211e86ab.html#axzz4Ejq8747s

2 Stakeholder: a person, group or organisation that has interest or concern in an organisation; Stakeholders can affect or be affected by the organisation's actions, objectives and policies (business dictionary.com)

What is Stakeholder Capital?

Stakeholder capital is about how a company interacts with key stakeholders and how it manages stakeholder relations. The "capital" equates to the value, brand, and reputation that is built or lost as a result of good or bad stakeholder management.

How businesses succeed is changing. Whereas Milton Friedman claimed in 1970[3] that the business of business is business, today's businesses are subject to far more regulation and public scrutiny.

Companies have over decades recognised the interdependence between a company's success and stakeholder management. However, historically, corporate social responsibility (CSR) has been seen as a philanthropic add-on with a parallel set of objectives not directly related to the core business. This has now changed, with the focus of companies now clearly on integrating CSR into core business operations. This trend is reinforced by the fact that standards of reporting in various jurisdictions to an increasing degree encompass information on environmental and social factors that are material to business operations.[4]

Business success now requires positive management of social and environmental outcomes, which are influenced by a broad group of stakeholders including:

- National governments and Parliaments
- Regulators and standard setters
- Suppliers
- Local communities
- Clients
- Employees and future employees
- Trade unions
- Shareholders
- Bondholders
- Other companies
- International organisations
- Academic institutions
- Media

Medium- to longer-term competitive advantages can be achieved through a broader orientation towards stakeholders including communities, suppliers, customers and employees. One example is the way employee attitudes are changing. Employees and prospective employees of a company are in many cases seeking a larger degree of purpose from their work. They want to be proud of the company they work for. External surveys such as *Fortune's Best Companies To Work For*[5] and regional lists like *Great Place To Work*[6] are not only indicators of workforce attraction, retention, and motivation, but a testament to the power of transparency.

3 Friedman, Milton (1970):"The Social Responsibility of business is to increase its profit" in The New York Times Magazine, September 13, 1970

4 In the UK, Companies Act Requirements in respect of the Strategic Report and the related FRC Guidance state amongst others that: "Disclosures about the environment, employees, social, community and human rights issues are required when material". France has recently introduced Article 173 of the Energy Transition Act that encompasses a large set of dimensions under which climate risk should be analysed and reported, and requires that specific information be disclosed by companies—for the use of financial investors—on their strategy for addressing transitions to a low-carbon economy.

5 http://fortune.com/best-companies/

6 http://www.greatplacetowork.co.uk

CASE STUDY **Coca-Cola**

In 2015 Coca-Cola provided $1.5 million funding to the Global Energy Balance Network (GEBN), which according to the NGO's now-removed website "aims to create that network by using science to help address the obesity crisis in the United States and around the world". According to the New York Times, Coca Cola had committed to provide close to $4m in funding. The NGO's website was registered to Coca-Cola, which was also listed as the site's administrator. In the face of growing health concern about the impact of sugar, however, and with threats of sugar taxes and increased regulation, the Global Energy Balance Network, as leaked emails revealed, aimed to be "Akin to a political campaign, we will develop, deploy and evolve a powerful and multi-faceted strategy to counter radical organizations and their proponents." The launch of the Network led to a howl of protests, including from the chairman of the nutrition department at Harvard's school of public health and thirty-six fellow scientists that criticised the Network for spreading "scientific nonsense." The University of Colorado subsequently announced that it was returning a $1 million gift from Coca Cola. The Network has now been disbanded and the website shut down.

The entire episode provided a classic illustration of the importance of careful, strategic stakeholder engagement, and the potential reputational damage which can be caused by failing to do so and associating its brand with the *wrong* sort of stakeholder. Coca Cola was taught a valuable lesson; investors will be watching to see how well it has learned it.

CASE STUDY **Nestlé**

Nestle was hit by a scandal in 1974 over promotion of bottle feeding which discouraged breast feeding in poor communities, which again led to infant illness and death. Nestlé's response was that their critics should focus on doing something to improve unsafe water supplies, which contributed to the health problems associated with bottle-feeding. A Swiss court at the time found Swiss NGO's headline "Nestlé Toten Babies" to be libellous. The court also warned Nestlé that if the company did not want to face accusations of causing death and illness through sales practices such as using sales reps dressed in nurses' uniforms, they should change the way they did business. This was the start of a long-running campaign with Nestlé boycotts spreading from Switzerland and the UK to the US. Where does Nestle stand today?[7] Today Nestlé is one of the world's largest packaged food companies. With a very complex supply chain Nestlé continues to face scrutiny over product safety and quality, its procurement and labour practices, and business ethics. The company has been making strong efforts and significant improvements in its sourcing policies and standards in the last few years, including introducing a code of conduct and monitoring suppliers to verify compliance with international labour standards. The focus of NGOs for Nestlé has shifted from bottle feeding to palm oil. Nestlé still faces challenges in monitoring and controlling its large and complex supply chains, but has increased capacity to do so through its focus on stakeholders and internal risk management.

CASE STUDY **Unilever**

Unilever has a strategic approach to managing relations and generating reputational capital with key stakeholder groups. It has also actively developed numerous partnerships at the national and international level to advance its sustainability goals. Chief Executive Paul Pohlman has been recognised repeatedly on the international stage for his success in driving a sustainability ethos throughout the entire company, as well as forming myriad external stakeholder partnerships. The resulting stakeholder capital creates a form of "reputational

7 Information on the history of the Nestle milk scandal is taken from an article in the Guardian Professional (https://www.theguardian.com/sustainable-business/nestle-baby-milk-scandal-food-industry-standards)

insurance": because of Unilever's generally strong reputation and partnerships, stakeholders are much more prepared to "cut the company some slack" when things go wrong. There is, however, an associated downside to this: Unilever has set the bar for itself at an extremely high level, and so it has more to lose when it fails to meet its own standards. A key challenge for Unilever is maintaining the integrity of its own corporate brand across its sprawling global operations. Despite having some of the strongest responsible marketing and product labelling policies in the industry, Unilever faces huge challenges to consistently manage risks across all the regions in which it operates. In July 2016, for example, Unilever was fined by the Australian competition watchdog for putting a logo on its ice creams presenting them as approved by school canteens, when this in fact was not the case. Unilever has also been criticised over its lobbying practices in the UK through funding government scientific advisors examining carbohydrates and sugar, though it has recently withdrawn from a leading industry lobbying group, citing its intention to work with like-minded companies. As investment analysts, what is important to us is not the fact that Unilever put a foot wrong in these cases; such missteps are inevitable with a company of Unilever's size and complexity. What's important (and encouraging) to us is the fact that the company had the agility, learning capacity, and organisational humility to fix the mistakes.

Does Stakeholder Management Add Value?

In the modern world, business is subject to constant disruption. A key to success is the ability to "scan the horizon", in order to understand the challenges that a business must deal with in the future. Critical to this, is the ability to build dialogues, relationships, and alliances — all of which require time and patience. The ability to identify opportunities largely depends on interaction and collaboration with key stakeholders.

For businesses, there is upside in working strategically with key stakeholders, and downside in ignoring or working against the same stakeholders. We would argue that the level of scrutiny, accountability and transparency that companies are subject to will only increase in future. Thus – companies who want to succeed in the long run need to get serious and strategic about how they engage key stakeholders. Furthermore, they can no longer expect to hide bad behaviour or to actively uphold bad behaviour through disinformation.

As the Coca-Cola, Unilever and Nestlé case studies demonstrate, even companies with strong brands are not immune to ongoing stakeholder challenges. Indeed, the very strength of those brands makes such companies particularly inviting targets for NGOs and other critics. The question is not whether the company is faced with challenges — we would argue that while the specific challenges may differ, all companies have stakeholder challenges that have the potential to impact their businesses. The question is rather, how is the company responding in relation to its particular challenges? Will a company's stakeholder relationships add value and competitive advantage, or will they impair it?

Having identified key stakeholders, and having established a dialogue with them, makes the difference when an issue arises in how it is tackled and therefore whether the issue will fade away or grow bigger and unmanageable. Readiness does not help prevent the unavoidable, but it does help to manage the unexpected. In a radically changing competitive landscape, companies need to engage stakeholders more, and they need to engage new and different stakeholders depending on which markets they operate in.

Over the last decade a clear consensus has developed that corporate social responsibility matters.[8] We are currently in the midst of a major paradigm shift in business: from an ethos which gave unambiguous primacy to shareholders, to an emerging new model of stakeholder capitalism, where shareholders of course remain vitally important but no longer have a monopoly on board and senior executive attention.

8 In 2008 the *Economist* produced a special report on CSR, stating "One way of looking at CSR is that it is part of what businesses need to do to keep up with (or, if possible stay slightly ahead of) society's fast-changing expectations. It is an aspect of taking care of a company's reputation, managing its risks and gaining a competitive edge (by) being 'embedded' in the business, influencing decisions on everything from sourcing to strategy…In time it will simply be the way business is done in the 21st century." Quoted from Professor Bryan Horrigan, Corporate Social Responsibility in the 21st Century, Debates Models and Practices Across Government, Law and Business, 2010, p6.

Investors must analyse stakeholder management

The growing significance of stakeholder management to long term shareholder value means that it is an item that investors must systematically assess in order to understand which companies have the values, commitment, systems and processes to manage stakeholders. Our view is that stakeholder management is the route to shareholder value.

IPCM's investment process systematically assesses a company's Organisational Capital. We expect leading companies to have board and executive level sustainability governance mechanisms; strong stakeholder relations with regulators, local communities, supply chain and others; good customer satisfaction levels; and external partnerships. The sum of this will show how strong a company's stakeholder capital is. And it must be continually renewed and reinvigorated.

Although it is not possible to predict every issue that will become the focus of stakeholders, it will be increasingly important for investors to be able to differentiate which companies will be best placed to manage challenges that are put in their path.

Strategically Aware Investing™

We believe that investment success involves finding better managed, more agile and forward-looking companies, with sustainable competitive advantages, at attractive valuations. Companies' ability to manage these megatrends-driven risks and opportunities better than their competitors is an increasingly robust proxy and leading indicator for their strategic management and execution capabilities. We call this approach Strategically Aware Investing (SAI). This approach integrates traditional financial considerations with more qualitative factors, such as companies' strategic management and execution capabilities and their ability to profit from a number of secular global megatrends.

In today's world, only 20-25 % of a company's true risk profile and value creation potential can be uncovered using traditional financial analysis. Our proprietary 5-Factor Model consists of 'non-traditional' drivers of risk and return. Our five factors are:

- Environmental Sustainability
- Human capital
- Organisational Capital
- Innovation capacity
- Adaptability and responsiveness

We believe that Organisational Capital (our term for stakeholder capital) is of particular importance in assessing management quality and, in turn, a company's competitive and financial prospects. As part of this factor we consider a company's:

- Stakeholder relations with regulators
- Supply chain management
- Local community relationships
- Customer relationships
- Human rights performance

At Inflection Point Capital Management, we are persuaded that a systematic and consistent assessment of individual companies' organisational/stakeholder capital relative to its peers can create a monetizable information advantage for our investor clients. It is one of a number of "non-traditional" risk and return drivers which are becoming increasingly critical to companies' competitiveness and, in some cases, their very survival.

About Inflection Point Capital Management

Inflection Point Capital Management UK Ltd was established in 2009 by Dr Matthew Kiernan. On 21st November 2014, the UK's Financial Conduct Authority granted Inflection Point Capital Management UK Ltd authorisation to provide advice on investments. Prior to founding IPCM, Dr Kiernan was the founder and Chief Executive of Innovest Strategic Value Advisors. Prior to that, he was the first Director of the World Business Council for Sustainable Development in Geneva.

Inflection Point Capital Management's mission is to help support our clients to deliver superior long term risk adjusted returns. In doing so we aspire to mobilise the enormous power of the financial markets, and help redirect investment flows to promote – rather than undermine – the necessary global transition to a more environmentally and socially sustainable economy.

Our mission

Our mission is to help support our clients to deliver superior risk adjusted returns. In doing so we aspire to mobilise and leverage the enormous power of the financial markets, and help redirect their investment flows to promote — rather than undermine — the necessary global transition to a more environmentally and socially sustainable economy.

The fundamental logic underpinning our work is deceptively simple:

- Major multinational companies arguably have greater environmental and social impacts than any other institution in contemporary society.
- Those corporations' priorities and behaviour are heavily influenced by the expectations and requirements of their major institutional investors — the providers of their financial "oxygen supply".
- Change the priorities of the investors, and one inevitably changes the priorities — and behaviour — of the companies themselves.
- If sustainability factors could be systematically — and credibly — injected into investment analysis, major corporations would be forced to improve their performance on environmental, social, and strategic governance (ESG) issues dramatically.

Our Partners

La Française Inflection Point

La Française Inflection Point is a member of the La Française Group, which is in turn part of one of France's largest not-for-profit cooperative banks, Crédit Mutuel Nord Europe. La Française Group was originally established in Paris, France, in May 1975 as the Union Française de Gestion (UFG). La Française Inflection Point was established in December 2013 as a joint venture between La Francaise Group and Inflection Point Capital Management UK Ltd. La Francaise Group holds a 51% interest in LFIP, and Inflection Point Capital Management UK Ltd holds 49%. La Française Group is an investment & asset management firm managing over €50 bn whose primary share-holder is the Caisse Fédérale du Crédit Mutuel Nord Europe (87.8%), the holding company of the Group Crédit Mutuel Nord Europe (CMNE), one of France's largest cooperative banks.

Crédit Mutuel Nord Europe

La Française Group's primary shareholder is the Caisse Fédérale du Crédit Mutuel Nord Europe (87.8%), the holding company of the Group Crédit Mutuel Nord Europe. Company directors and employees hold the remaining shares (12.2%). Crédit Mutuel Nord Europe is a French non-listed cooperative banking network consisting of 2,100 local cooperatives and mutual funds, grouped into 18 regional federations. It is France's biggest bank for non-profit associations, employing over 4,500 staff and is provides banking services to one out of every three self-employed professionals, and is the 2nd largest banker for farmers. The cooperative belongs to its 7.5 million shareholder members who elect the 24,000 directors of the local mutual banks. This democratic governance structure ensures that the whole of Crédit Mutuel is controlled from the bottom up. The members' shares make up the company's capital.

Financial Warning

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Inflection Point Capital Management is a new, sustainability-driven investment advisory boutique. A research-driven organization, IPCM builds directly on the knowledge base and experience of its predecessor company, which had been ranked by the Thomson Extel survey of institutional investors as the #1 research firm in the world in the sustainability space. IPCM has offices in London and representation, or representatives, in New York, Toronto & Melbourne..

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