UK Business What's wrong? What's next?

Creating value for shareholders and society through a focus on purpose, values, relationships and the long term

Executive summary

tomorrow's company

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Part I: What's wrong?

Over the past few decades, UK business has made significant progress in many areas – from better governance to leading in global industries. We should be proud of this success, but not complacent, as there are a number of trends that can no longer be ignored.

The UK government is struggling to cut the deficit and grow the economy, due to a lack of spending by companies

- For the last few decades the corporate sector, rather than borrowing money to invest, has been a net saver in the economy, and to an increasing degree. In 2014, non-financial corporations made net savings (pre-dividends and buybacks) of 7% of GDP, or £107bn.
- To compensate for this the government has had to perpetually boost the economy. It has run a budget deficit in 30 of the last 35 years, cut interest rates from mid-teens to 0.5%, and is now directly increasing credit with quantitative easing. Despite these measures, the economy is still stalling, and entering the next recession, the government will have few policy levers left to pull.
- This has led to a fragile economy where growth has been sustained by increasing debt and asset prices. Part of the solution is to encourage companies to start spending and investing. For the government to reduce its deficit, the corporate sector must reduce its surplus.

The focus on short-term financial outcomes is because companies are being squeezed between pressures to return cash to shareholders and cut prices for customers

- Profits distributed to shareholders have increased; the distributed income of UK non-financial corporations has risen from 14% of GVA (gross value added) in 1990 to 18% in 2014.
- Competition is the driving force behind capitalism, but our stakeholder analysis suggests that we are benefiting as consumers, while losing out as employees, suppliers and shareholders. For example, discount supermarkets push down prices with collective purchasing power, but at the same time push down wages, worsen supplier payment terms and lower returns on capital.

The pressure to deliver short-term outcomes has led to a decline in long-term investment

- Investment in fixed assets (ex-construction) has fallen from 11% in 1997 to 8% in 2014, versus 12% for the USA in 2014. Investment in R&D was 1.6% of GDP in 2012, versus the Euro Area of 2.1% and USA 2.8%.
- This is creating a lack of investment in crucial areas such as infrastructure, housing, antibiotics and renewable energy. We are not allocating capital to tackle the major challenges we face.

Employees are too often seen as assets to be sweated, not people to be nurtured

- Employee engagement is low: only 49% of people would be likely to recommend their company as an employer to others.
- Real wage growth is stagnating: it averaged 2.9% in the 1970s and 1980s, 1.5% in the 1990s, 1.2% in the 2000s, and -0.1% so far in the 2010s.

Altogether, this is leading to a failure in terms of both company performance and public trust

- Given low employee engagement and investment, it is not a surprise that labour productivity is 15% below the G7 average.
- Or that public trust remains low – only 32% of people trust business leaders to tell the truth.
- The irony is that despite the increased focus on shareholders and cash returns, total shareholder returns have been poor. The 20-year real-return on UK equities is now the same as long-term government bonds; the only other period that this was the case was in the 1920s and 1930s.

The problems are connected; the short-term focus is failing our companies and economy
A short-term approach is contributing to a range of problems. Too often, these problems are treated in isolation, when in reality they are connected by the way companies try to achieve success.

With a focus on short-term outcomes, businesses are becoming more efficient in their operations – but at the expense of developing areas that drive long-term success. We are squeezing the goose, and act surprised when it lays fewer golden eggs.

UK house builders – a misallocation of capital

It is widely acknowledged that the UK has a housing crisis, with a shortage of homes and house prices that damage economic activity. The three largest house builders are Barratt Developments, Persimmon and Taylor Wimpey. Together they build almost 40% of the 115,000 new homes built each year by private developers. However, for the last reported financial year they returned a total of £840m to shareholders in dividends and buybacks. This could have built around 5,000 new homes, and they plan to continue to increase cash returns to shareholders going forward.

We have a problem if our largest house builders do not undertake profitable investments to solve our housing crisis, but instead pay larger dividends. This is a misallocation of capital created by the misguided desire to return cash to shareholders irrespective of investment opportunities.

Part II: What's next for leaders?

The good news is that an alternative business approach already exists. Instead of the current focus on short-term incentives, targets and profit, it focuses on purpose, values, relationships and the long term. This isn't an easy path; it takes conviction from business leaders to withstand significant short-term pressures, but it can ultimately lead to greater success. It will be more successful when supported by boardrooms, investors and government policy (see Part III for more detail).

This alternative approach has been advocated by Tomorrow's Company for 20 years, together with other organisations and business leaders, such as Blueprint for Better Business. It can be articulated in a number of ways, but at Tomorrow's Company we summarise it with three principles, and call it the Tomorrow's Company approach (see Part II for more detail).

1. A purpose beyond profit and a set of values that are lived through the behaviours of all employees to create a self-reinforcing culture.
2. Collaborative and reciprocal relationships with key stakeholders – a strong focus on customer satisfaction, employee engagement and, where possible, collaboration with suppliers, alongside working with society.
3. A long-term approach that embraces risk – investing long term and embracing disruptive innovation.

These principles apply differently to each company. The following section has a **list of questions** to help business leaders think about how they may apply them to their business.

Encouragingly, the ideas behind the Tomorrow's Company approach have been growing in acceptance, with genuine progress in many areas. However, too often there has been more talk than action, often because of considerable headwinds and the difficulty in adopting a longer-term approach.

The most impressive business leaders meet short-term pressures while maintaining a focus on the long term. They follow words with actions, and align core operations to their stated purpose and values. These actions publicly show the priority of values over short-term profit. In short, it is not about speeches, stated values, corporate social responsibility, or managing reputation – it is about actions in the core of the business.

For some examples of ways to translate these principles into action, see chapter 3 for a full list.

- Increase spending on areas that drive long-term value rather than returning cash to shareholders.
- Spend time and money on improving employee engagement and well-being.
- Reward and recognise values and behaviours, as well as outcomes.
- Align executive pay with the remuneration of all employees so that it supports the company's purpose, values, relationships and investment horizon.

Mounting evidence and examples (ch. 3)

Supporting this approach is a growing body of evidence and examples:

- Studies show that people are not only motivated by money, but also by a desire for purpose.
- Recurring scandals show the importance of values and culture in managing risk.
- The evidence is clear that employee engagement and well-being leads to increased productivity and company performance.
- There are growing examples of collaboration with suppliers creating more value than 'arm's length' transactions.
- Studies of long-term successful companies find characteristics common to the three principles.

Relevance for a changing world (ch. 4)

In addition to mounting evidence from retrospective studies, there are reasons to believe that the coming changes in technology, societal attitudes, the environment and economy are increasing the importance of a business approach focused on purpose, values, relationships and the long term.

- Accelerating technological change and disruption is increasing the need for long-term investment that embraces risk. It is also increasing the need to promote employee creativity through greater autonomy.
- For companies to succeed in the future they will need to play a greater role in solving the problems that society faces, including environmental degradation, poverty and the abuse of human rights. In some instances, this will involve companies acting collectively and often in partnership with civil society.
- In the light of all these changes, the next generation is demanding a greater sense of purpose from business and the positive contribution it makes to society. In the future, companies will increasingly need a clear purpose that is embodied in all their actions. This will be demanded by employees, customers and savers.

Part III: What's next for ownership, governance and government policy?

Part I explains the problems we can no longer ignore in UK business, while Part II puts forward an alternative approach to business success as part of the solution. Part III looks at how ownership and governance structures, as well as broader government policy, can support this approach.

The best examples of the Tomorrow's Company approach are often from privately owned companies. Therefore, encouraging companies to think more carefully about their choice of business form can support the adoption of this approach. Alongside this, listed companies often face the greatest obstacles, which could be reduced by reforms and changes in behaviour through the investment chain.

Encouraging change in listed companies (ch. 5)

Listed companies are critical to the UK economy, accounting for 16% of private sector employment and 47% of domestic investment. They also suffer most acutely from the problem of short-termism.

There is a perverse and mutually reinforcing cycle of short-termism, from savers and asset owners to fund managers and CEOs. This is made even more complex by a web of intermediation and advisors. There are four key themes of change to address this: simplification; long-term incentives; more in-depth investment analysis; and re-thinking corporate governance structures. These elements are already being advocated by a number of organisations such as Focusing Capital on the Long Term, as well as being highlighted by reports such as the Kay Review.

1) Simplification – less intermediation and lower cost

The current investment chain from savers to companies is long and fragmented. Each step adds cost and disconnects savers from how their money is invested. Simplifying the investment chain would help to lower costs and provide savers with a greater connection to their investments.

2) Longer-term and aligned incentives

The majority of savers and asset owners have long-term time horizons, but through intermediation, this is shortened to yearly targets and monthly assessment. This would be most successfully addressed through longer-term incentives at each stage of the investment chain.

- **Asset owners have the opportunity to drive change from the top** – Asset owners are in the ideal position to affect change, as they have long-term time horizons and the greatest power by allocating funds at the top of the investment chain. This could be achieved by the development of different mandates to asset managers, taking management in-house and adjusting asset allocation decisions. The recent Law Commission interpretation of fiduciary duty is helpful in this regard.
- **Incentivising fund managers to be stewards** – The business model for fund management is currently based on charging a management fee on the promise of outperformance that in aggregate it cannot deliver. As a result, the business model is under pressure. Instead, savers would benefit if management fees were spent on engaging and supporting companies in creating long-term value. This would involve a shift in focus for fund managers from fighting for a larger slice of the pie to growing the size of the pie. This can be achieved in at least five ways: anchor shareholders; collective research and engagement; a greater stewardship role for passive funds; disruptive investment models; and longer-term incentive structures for fund managers.
- **Lengthening executive pay horizons** – Longer-term executive pay structures would help reduce the incentives for management to focus on short-term share price movements.

3) Less noise, more in-depth analysis

Long-term incentives are reinforced by having a deeper understanding of the long-term implications of decisions. The problem is that across financial markets there is often more noise than reasoned debate. The quality of decisions would benefit from better information and more in-depth analysis. There are three steps to achieving this:

- **Increased company disclosure** – The ability of investors to assess broader factors that impact in the longer term, such as culture and environmental impact, is helped by having a wider information set. This is already being championed by initiatives such as integrated reporting and the development of new approaches to management accounting, such as the General Management Accounting Principles promoted by CIMA.
- **Broadening the analyst toolkit** – Increased disclosure will be more effective when there are the analytical tools to use it. This would help analysts and fund managers move beyond purely financial analysis, towards assessing factors such as employee engagement, strength of supplier relationships, and the relationship between culture and risk. This can be partly achieved by adjusting financial training courses and employing analysts with a greater diversity in prior experience.
- **Structure of research and analysis in financial markets** – These changes would be enhanced by increasing the time and resources that are dedicated to analysing this broader information set. Currently, the division of research across financial markets creates an abundance of shallow analysis, when instead we need more in-depth analysis. This could be achieved by restructuring the way research is split between the sell-side, buy-side and independent providers.

4) Re-thinking governance

Reforming structures in the investment chain is important, but power ultimately lies with the board of directors. Over the last few decades, governance reforms have typically followed scandals, placing greater expectations on non-executive directors to protect the company and its shareholders against excessive risk. As a result, there is a growing concern that non-executive directors have insufficient time and resources to deliver everything that is expected of them, leading to a focus on value protection rather than value creation. This concern is echoed by non-executive directors themselves.

As a result, it is time to take a step back and re-think our governance structures. Has our governance system become overly focused on risk mitigation? Do non-executive directors have the time, resources and connection with the business to deliver what is expected of them? Does the focus for governance need to shift towards encouraging entrepreneurial leadership?

Greater diversity in business forms (ch. 6)

Encouraging greater diversity in business forms is a good idea for the following reasons:

- Many of the best examples of the Tomorrow's Company approach are found outside the listed sector, from family to employee ownership and social enterprises.
- All companies are different and would benefit from having a business form that supports each of their company's specific purpose, values, relationships and investment cycle.
- Change is often driven by disruptors – this can be achieved by supporting the next generation of companies in forging their own path, not following the mistakes of current incumbent companies.
- The internet and global trade is enabling smaller companies that exist and rely on a wider ecosystem; the era of the mega-corporation may be over.

In previous work (*Tomorrow's Business Forms 2013*), Tomorrow's Company has found that entrepreneurs and business owners are not always aware of the diversity of business forms available to them, especially at times when they seek an exit. Too often companies gravitate towards the same homogenous business forms. Increasing awareness of the alternatives would help address this.

The government can help encourage diversity in business forms. Here are three examples:

- Encouraging employee ownership by removing barriers and introducing tax incentives.
- Adopting a stewardship approach to privatisation – rather than simply selling shares to the public, the government could form a trust that holds shares on behalf of retail investors and provides them with a stronger collective voice.
- Ensuring public procurement is not solely focused on price, but also on a company's governance, ownership, stakeholder relations and time horizon.

A coherent government policy to encourage investment and build healthy companies

Cutting public spending is not the only route to deficit reduction, it also requires the adoption of policies that encourage companies to increase spending through a focus on purpose, values, relationships and the long term. This would also help increase productivity, real wage growth, employee well-being, public trust in business, and then as a result lead to higher shareholder returns.

Too often, it is assumed that the focus on short-term profit is unavoidable; as if this is the way that business has always been, and will always be. In reality the history of companies shows us that the ownership structures, purpose and approach to success of our companies has been constantly evolving. The one thing we know for certain is that it will continue to change. The question is: in what direction? The key argument in this report is that influencing and shaping that direction is critical to tackling many of the challenges that our society and economy faces.

The first step is to recognise that encouraging a different business approach is a key part of the solution. This would help to create a set of policies across a range of areas, from tax, procurement and governance codes, to credit creation and infrastructure investment. In doing this, the government could consider some of the following statements:

- Tackling productivity may require increased stewardship throughout the investment chain.
- Increasing public trust in business not only requires ethical behaviour, but also more inspiring stories where companies tackle the big challenges facing society.
- Business investment and net spending has fallen over the last few decades despite consistent reductions in interest rates and corporation tax. Policies that increase short-term profit are often a poor means of encouraging long-term investment.
- Commercial bank credit creation has been directed towards mortgages instead of business loans. As a result, we have dangerously high house prices and a lack of business investment.
- How companies are owned and governed has a significant impact on the decisions they make and hence on the economy in total.
- The criteria by which the government makes procurement decisions has a significant impact on the corporate landscape. Purely focusing on cost may contribute to the short-term focus.

Agenda for action – key questions

From 20 years of experience in working with companies, we offer some high level questions to help business leaders on their journey to focusing on purpose, values, relationships and the long term.

1. **A purpose beyond profit and a set of values that are lived through the behaviours of all employees to create a self-reinforcing culture**
   - Has the company's purpose and values been clearly stated and consistently communicated across stakeholder groups? Is there a consistent story of value creation told to shareholders, employees, customers and the public?
   - How much time and money is invested in embedding the purpose and values, and fostering the right culture?
   - What actions have senior management taken that clearly show their commitment to the stated purpose and values?
   - To what extent are performance management systems and financial rewards aligned with the purpose and values? If there is a tension, how is it managed?

2. **Collaborative and reciprocal relationships with key stakeholders**
   - What stakeholder relationships are critical to success? How are we working to build long-term mutual value in these relationships? What is our current short-term priority between stakeholder groups, and how has this changed over time?
   - What are we doing to increase employee engagement, voice and well-being?
   - Are employees given autonomy where possible? How many key initiatives have been instigated by a less senior individual in the organisation?
   - How is the desire to incentivise short-term profitability balanced against the need to build customer satisfaction and loyalty?
   - What is our role in contributing to the health of our industry ecosystem? How do we balance fighting for our share of the value chain with working to increase the total value of the industry?
   - What is the greatest challenge facing society in our industry, and how is the company helping tackle this?

3. **A long-term approach that embraces risk**
   - How are we balancing the need for short-term competitiveness and financial outcomes against the need to invest long term? How do we balance profit and dividends against investment? Have all investment options been exhausted before cash is returned to shareholders?
   - Where could we increase spending that would deliver a long-term return? For example, equipment, technological automation, R&D, IT security, health and safety, training, employee well-being and stakeholder relationships.
   - What are the potential future scenarios for the industry in 10 years' time? How does the current strategy and investment plan prepare the company for these scenarios?
   - What are the disruptive business models in the industry? How are we engaging and learning from them? What is the strategy if they gain significant traction?
   - How many projects have failed? How was this dealt with? How is the need to discourage failure balanced against the need to encourage risk taking?
   - How will continuity in leadership be achieved? Is there active succession planning? Is a broad management team beneath the executive being developed who will become the future leaders of the company?

In addition to questions for business leaders, here are some specific questions to directors, investors, policymakers and regulators.

Boards of directors

For all boards

- Do we have a clear vision of the company's purpose, values, key relationships and balance between the long and the short term?
- Do we have sufficient information to make an assessment of this?
- Does the allocation of boardroom time enable a full discussion of this information?
- How does the structure of pay, rewards and recognition support this vision?
- Does the current business form support the company's purpose, values, relationships and investment cycle?

For boards of listed companies

- Does disclosure align with the purpose, values and business model? Does it provide analysts with sufficient information to make an assessment of the broader drivers of value?
- What are we doing to attract and build relationships with long-term shareholders?

Asset owners – pension trustees, endowments, wealthy individuals

- What is the time horizon for the mandates and performance metrics of fund managers? Does this help support a long-term approach?
- Have we allocated funds to disruptive investment models that invest long term with lower fees?
- Have we requested our investment consultants to advise us on how to invest in a way that supports stewardship?
- How are we increasing the interaction we have with our beneficiaries? How are we helping them gain a closer connection to how their money is invested?

Analysts and fund managers

- How does investment analysis incorporate wider factors such as culture, employee engagement, supplier relationships, long-term investment and industry disruption?
- What training is provided to support this type of analysis?
- What information sources are used to go beyond the financial statements?
- How is time allocated between analysing short-term news flow and quarterly results, versus long-term strategic issues?
- What issues are we engaging with companies on? Are we, where appropriate, pressing companies to adopt a focus on purpose, values, relationships and the long term?

Policymakers and regulators

- Do we have a clear overall strategy to promote the long-term creation of value by companies? Do we review whether the corporate system is in aggregate producing the desired outcomes?
- Is there a coherent policy across all government activity on encouraging companies to increase spending and investment?
- What industries are net borrowers and which are net savers? As existing industries move from net borrowing to net saving, what new industries will take their place as net borrowers?
- Where can government help in the creation of new investment opportunities? For example, in helping coordination, investing in infrastructure and R&D.
- Does company law and governance codes strike the right balance between risk mitigation and entrepreneurial leadership?
- How could procurement criteria be used as a driver for change?

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