

# **21CC**

## **21<sup>st</sup> CENTURY CAPITALISM** ***The Change From Inside***

### ***Vision Paper: Real Shareholder Value***

*Sustainability is not breaching through the vested interests of Capitalism. Meanwhile, Capitalism is destroying itself. This paper explores a synthesis between both problems and interests by a 'Paradigm Shift' from inside Capitalism*

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## **About the author**

*Roland J.I. Menke has been working for 23 years in the field of Corporate Finance & Business Development.*

*After getting his university degree in business economics and his post graduate degree as registered financial controller he started as a banker with NIBC in The Hague. Subsequently, he worked for 9 years as financial director for the multinational Royal Nedlloyd. With his substantial experience in international turnaround and M&A-processes within Nedlloyd, he started his own business in 1997 Menke Corporate Finance & Venture Capital. Furthermore, he has been the financial & strategic advisor for more than 15 years to his family business, a successful medium-sized construction company*

*Besides almost 25 years of focus on the 'P' for Profit, he has been driven for some 10 years by the notion of sustainability. This is reflected a.o. in this paper, which is based on his current doctoral research.*

*At present he spends a lot of time in creating support with pensionfunds, multinationals, banks, chartered accountants and political parties for the advocated 'Change from Inside'.*

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# ***Real Shareholder value***

## ***The Free Planet problem of Capitalism***

From the start of the credit crunch there has been a call for a new form of sustainable capitalism. Governments have taken clear steps to direct and assume the general responsibility for the revolution toward a more sustainable world. It is evident from recent research that climate and energy agreements between governments and the industrial sector do not work. Within the context of the intended sustainability measures, the industrial sector is demanding governments to ensure an international competitive 'level playing field'.

Businesses, pension funds and other institutional investors have a significant self-interest in playing a prominent role in the sustainability revolution. The sombre future scenarios for life on our Planet put forward by renowned institutions such as the IEA, World Bank, MIT, IPCC, WNF etc. have significant consequences for the shareholder value of businesses. By discounting future business cash flows, shareholder value effectively calculates the future back to now. However, the discounted cash flows do not include the effects of business activities on the Planet leading to the aforementioned sombre future scenarios. Whilst the Planet's resources such as fertile land, fresh water, fishing grounds, good living environment, biodiversity, stable climate etc. are becoming increasingly scarce, the use of them still has no price in an economic sense ('Cost of Planet'). Until now our Planet has been available free of charge and has therefore been drained without limit.

Due to the increasing scarcity of resources, this assumption of a free Planet is no longer tenable and is even unethical towards ourselves as humans, because it is a threat to our very existence. From a business perspective it is therefore unwise to ignore this Cost of Planet. The impact of the Cost of Planet on shareholder value should be a serious boardroom issue for businesses, pension funds and other institutional investors; maximisation of shareholder value is, after all, the main driving force behind the current Anglo-Saxon capitalist system.

## ***The Huge Power of Capitalism***

Maximisation of shareholder value links seamlessly to the oldest and most dominant part of our brains, the hypothalamus; a combination of neurological and behavioural research shows that this is where the strongest human impulses reside, including status orientation, the lust for power and greed. A manager in a business who is good at maximising shareholder value is awarded a higher position (which appeals to status and power) and a higher salary (which appeals to greed). Capitalism is thus being driven by 1 billion of the strongest human impulses in the 1<sup>st</sup> world, while appr. 5,5 billion people worldwide would like to jump on the bandwagon, with the Chinese and Indian population up front. This explains the intrinsic power and success of capitalism, which is considered to be the best system ever. Her power is also her weakness. Capitalism is self-destructive because of the unchanging and unrestrained character of our strongest human impulses.

## ***The Weakness of Sustainability***

Sustainability primarily lacks such a similar universal driving force and therefore it does not breach the vested interests of capitalism. The Cost of Planet make the Real Shareholder Value visible and this links sustainability up to the power of capitalism.

## ***Capitalism is destroying itself***

What is the relationship between Cost of Planet and shareholder value? Our Planet is 'the super machine' which forms the basis for all life and human activity. Yet it is precisely this super machine which is being swiftly eroded, due to the fact that each year we use 1.4 times more of the Planet than it produces. This is the so called overshoot factor (Living Planet November 2009). Deforestation, desertification, chemical pollution of water and air, erosion of the fertile topsoil, decreasing fresh water supplies, decreasing supplies of rare metals and declining biodiversity are the consequences. Whilst the productive part of our Planet is declining increasingly faster, the world population will increase from 6.5 billion to 9.2 billion in 2050 with a higher average consumption level than today. Our strongest human impulses are unrestrained and the media continuously appeal to them on the basis of status anxiety (de Botton) and the theory of relative incomes (Layard). As a consequence we have ended up with an increasing number of people in an endless consumption spiral. A food, water, energy, biodiversity, climate and environmental crisis will be the consequences (The World Bank). Mankind is quite literally eating into its greatest and most fundamental capital: The Planet.

Mankind eating into its fundamental capital also has serious consequences for businesses. After all, without a habitable planet there will be no People, not to mention Profit. Increasing inhabitability as a consequence of the aforementioned demographic developments is going to increasingly inhibit business activities. People generally and in their roles as employer, employee, consumer and investor will be forced to spend more time on survival, first of all in the 3<sup>rd</sup> world and later globally. Food, energy and water shortages as well as environmental, political and climate catastrophes all reduce employability, productivity and also the availability of operating staff. The diminishing availability of staff, but also water, energy, rare metals and raw materials and increasing environmental pollution threaten business continuity.

These developments relating to raw materials, energy, food, water, biodiversity, environment and climate and their effect upon staff not only damage the production process but also consumers' disposable incomes, so that businesses are also going to experience increasing problems with their sales. In addition the costs which arise from climate change (€ 10,500 billion - IEA) and other crises will have to be borne.

The IEA recently established that, despite all of the political intentions, a de facto "unchanged policy" still exists. The continuous upward trend in the world's overshoot factor is a clear and simple signal in this respect and it is in line with the estimates that we need more than 3 productive planets by 2050 to support ourselves. Although intolerable, this is the result of the aforementioned consumption spiral. Profitability and thus shareholder value and capital available for investment will fall during the course of these developments. This is precisely where the interests of businesses, pension funds and other institutional investors lie in playing a prominent role in the realisation of a sustainable world and paying attention to the Cost of Planet. The Cost of Planet and its effects on shareholder value are inescapable. Indeed, more than that, the effect on shareholder value is here already, it has just not yet been made visible.

## ***Synthesis between the interest of Capitalism and Sustainability***

Adopting the Cost of Planet as an investment criterion simultaneously solves the problem of capitalism i.e. 'how can it stop the destruction of Real Shareholder Value and of itself as a system' and it solves the problem of sustainability i.e. 'how can it develop a power as huge as capitalism', so that sustainability finally breaches vested interests? It's interesting to see that the fiction of the free Planet is at the heart of both problems and that this fiction can be abandoned through Cost of Planet.

## ***Determination of the Cost of Planet***

How are the Cost of Planet to be determined? They consist of a volume and a price component. The scientifically based measuring system of the 'Ecological Footprint' has existed since 1996 (Rees & Wackernagel). The Footprint measures the quantity of productive land and ocean which is necessary to produce the natural resources for our consumption and infrastructure, together with the space which is required to absorb CO<sub>2</sub> emissions and waste. The space and energy usage, expressed as the number of hectares used annually, can be calculated for every product, service, individual, business, organisation or country. This is the Footprint ([www.footprintnetwork.org](http://www.footprintnetwork.org)). The EU Commission qualifies the Ecological Footprint at this present time as the best measuring instrument of sustainability related to the Planet.

The Footprint is a good management tool with a view to the crises referred to earlier. This is because the Footprint reflects the effects on food production (productive hectares), on climate and energy (the CO<sub>2</sub>-Footprint comprises appr. 40-50% of the Ecological Footprint), on the difference in welfare between the 1<sup>st</sup> and 3<sup>rd</sup> worlds (Footprint scale per country), on biodiversity, on water usage (Water footprint) and on the environment (productive hectares required for the absorption of waste).

In addition to this, the Footprint is an outstanding global means of communication for sustainability related to Planet due to its simplicity and uniformity. Everyone, from businesses and pension funds to consumers, NGO's and governmental authorities can work with the Footprint and speak the same language. Businesses have all the information required to determine their own Footprint at their disposal within their systems. In the UK, the Footprint is already stated on product packaging.

What is lacking is the price per hectare per year, which triggers the question: 'What is the value of our Planet?' The value of the Planet is ultimately indeterminate as this value is infinitely great, varied, immaterial and immeasurable. The capitalist system on the other hand, precisely due to its restricted scope, does offer guides for value determination. And since this system determines a large part of human activity, value determination from this perspective seems is relevant.

From the capitalist perspective, the Planet is 'merely' a production resource. It is the underlying super machine, with its 13.4 billion productive hectares (Living Planet Report 2008), which puts us in the position to generate global annual GNP which in 2008 amounted to \$ 60,115 billion (World Bank). This is the current 'assumed perpetual earning capacity' of the Planet and therefore also the 'value at risk', which will be lost if the productive hectares on our Planet are reduced to 0 in the extreme case. Given the unpredictability and the irreversibility of changes to complex eco-systems in conjunction with the irreplaceability of our Planet and its resources we can allow no calculation of probability in respect of the consequences of our current actions. A worst case approach is wise here, if only to clarify the seriousness of the situation.

The utilization costs of the Planet from this strictly capitalist perspective therefore amount to \$ 4,500 per ha/year ('Cost of Planet'). This is an immediately usable simplification of the results of the valuation model which is currently the subject of doctoral research.

The increasing overburdening of the Planet's limited productive capacity is a fact and this raises the question not so much if but when the Cost of Planet will be recognized as an additional investment criterion within shareholder value thinking.

## **Reporting the Cost of Planet**

How can we make the Cost of Planet definitive and visible? This can take place relatively simply by adding two lines to current corporate annual accounts as follows:

### **Corporate Annual Accounts**

	<b>Sales</b>		
-/-	<b><u>Operating costs</u></b>		
	<b>Operating Result</b>		
-/-	<b><u>Tax</u></b>		
	<b>Net Result</b>	→ <b>Traditional Annual Accounts</b>	→ <b>Profit</b>
-/-	<b><u>Cost of Planet</u></b>	→ <b>Ecological Footprint x \$ 4,500.00/ha/year</b>	→ <b>Planet</b>
	<b>Social Result</b>	→ <b>Social Annual Accounts</b>	→ <b>Profit &amp; Planet</b>

## **The Change from Inside through Real Shareholder Value**

The insight of no longer considering the Planet to be free is a real breakthrough. The result is that the abstract and intangible concept of sustainability is valued in monetary terms as far as the Planet is concerned. In this way, sustainable business performance can be measured and managed in a uniform manner, as a result of which real-time and mutual comparisons between businesses become possible. The Cost of Planet entail a change to the hard core of the capitalist system: Business performance is now measured in terms of Profit and Planet and this implies that we are no longer steering the complex 21<sup>st</sup> century with a profit-formula from the Middle Ages.

Existing socially responsible business reports based on GRI-guidelines and social annual reports must remain intact, since these contain numerous relevant qualitative indicators, both related to 'Planet' and 'People'. The Cost of Planet approach adds a new, money based dimension to existing socially responsible reporting.

The Cost of Planet are a relevant investment criterion because of the aforementioned capitalistic self-interest and thus they are an integral part of shareholder value thinking. Reporting on the Cost of Planet in corporate annual accounts means that the Real Shareholder Value suddenly becomes transparent. This has a major impact on the allocation of the tens of thousands of €//\$-billions in pension fund and institutional investments, precisely due to their focus on long-term shareholder value. With this re-allocation of invested capital, pension funds and institutional investors exercise pressure on the business sector, as a result of which sustainability and a reduction in the Cost of Planet become a top business priority; the attraction and retention of equity finance is a business' lifeline, which is exactly the reason why CEO's & CFO's spend approximately 30% of their time on investor relations.

The Cost of Planet are, by the way, sufficiently high to prevent businesses from arriving at social profits through high net profits. Social profit can only be achieved by a strong reduction in the Footprint. The majority of businesses will see a social loss to a greater or lesser extent, which is linked to reality. After all, we find ourselves literally in a situation of 'social loss'.

Now that we can make visible what businesses actually earn from a social point of view, a PR and image effect will also come about in addition to Real Shareholder Value thinking. We saw what happened previously with Shell Brent Spar, Nike child labour and PGGM arms trade, but what does this mean for the image of a business which makes € 200 million financial net profit, but simultaneously shows a social loss of -/- € 1 billion?

### ***Products get their true prices***

On the one hand businesses will have to drive down their Footprint and thus their Cost of Planet in their international production and purchasing chains. On the other hand they will have to charge their remaining Cost of Planet in their range of products and services. In this way products are sold for their true price. Now that the true energy prices can be calculated, it will become evident that sustainable solar and wind energy is cheaper than energy derived from fossil fuels. This means a breakthrough in accelerated investments in sustainable energy and other innovative sustainable technologies.

### ***Bonus and Greed only realizable through Care for the Planet***

Social profit is becoming the new mantra, the new status symbol. A bonus for high social profits is still possible, but only achievable through care for the Planet i.e. by reduction of the Cost of Planet. As mentioned before, greed cannot be changed, as it is based in the oldest part of our brains. However, by broadening the focus of managers from pure Profit to Planet & Profit, the direction of greed is shifted.

Greed does not bring us happiness either. Studies (Veenhoven et al.) show that individual happiness in the 1<sup>st</sup> world is declining. This contrast is explained by status anxiety and the theory of relative incomes. These phenomena mean that we no longer simply want to own more in an absolute sense, but that we ideally wish to own more than the next person: The neighbour, the colleague and the advertising role model. This leads to an endless rat race with decreasing happiness. Now the true product prices reveal the Cost of Planet, our individual obsession with growth and materialism also shifts. This could therefore also benefit the individual happiness of citizens; beyond the empty pursuit of consumption.

### ***Interested parties: Pensionfunds, Institutional Investors and Businesses***

The influence of businesses on a sustainable revolution is very high. The origin of the global Footprint is entirely the direct or indirect result of business activities and can therefore be excellently influenced by them. In addition, businesses have the financial resources available, the innovative capability and the power to create a sustainable world. Noreena Hertz, David Korten et al. have demonstrated convincingly that the global commercial sector wields the real power and not governments or consumers.

In a word, the power to be unleashed rests with the commercial sector, in which pension funds and other institutional investors play a specific and crucial role. With their focus on long term shareholder value they have a strong incentive to recognize the very substantial risk related to the fiction of the free Planet and to base their investment choices on Real Shareholder Value. This investment approach by pensionfunds and other institutional investors gives the commercial sector the definitive stimulus to drive their business on the basis of Real Shareholder Value creation.

## **21<sup>st</sup> Century Capitalism**

The Cost of Planet may only seem to be an innocuous reporting item. However as an investment criterion it has an enormous cash effect due to the reallocation of pensionfund and other institutional investors' assets to businesses with a low Cost of Planet. This leads subsequently to a change in purchasing, production and sales processes by businesses. In time it is conceivable that the Cost of Planet will be invested in cash by businesses in a sustainable investment fund.

The abundancy of cheap money lies both at the basis of the credit crisis and the aforementioned sombre future scenarios. In time it is inevitable that the Planet's Footprint-capacity will develop into an increasingly dominant means of payment, parallel to money, due to increasing scarcity. After all, this Footprint-capacity is truly scarce when compared to money.

Through the Cost of Planet as an additional investment criterion, sustainability permeates the heart and the capillaries of capitalism and latches onto its power. With the legal introduction of Cost of Planet to annual accounts, governments will break through non-sustainable, short term thinking and they will be meeting the demands of the commercial sector for an international 'level playing field'. At the same time governments will release a strong tailwind from the pensionfunds, other institutional investors and the commercial sector in the intended revolution towards a sustainable society. In essence, this introduces a sustainable form of capitalism, in which self-interest and social interest converge.

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*This article is an excerpt from his current doctoral research*

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