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The Fallacy of the Shareholder-Centric Business Model

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Foreward

Last week Ronnie Moas, the founder and Head of Research at Standpoint Research, fired an alarming wake-up call for investors when he issued a highly politicized research report stating he is blacklisting Philip Morris, Apple, and Amazon on "moral and ethical grounds". It is hard to deny that Philip Morris is responsible for millions of deaths of its customers, Apple should lead by example and use some of the $150 billion in cash it is sitting on to enhance the livelihood of its foreign factory workers, and Amazon could spare some cash to improve the working conditions in its warehouses. I totally agree with his blacklisting of Philip Morris as I do not know how any portfolio manager can consciously justify investing in a company that intentionally harms the health of its own customers. Although he was a bit extreme in using high-profile names such as Apple and Amazon as scapegoats for his political statement, he did admit: "*There are dozens (if not hundreds) of companies I would like to put on my Blacklist…*"

I admire Mr. Moas for having the confidence and conviction to come out and publicly take a stand for what he believes. As you know, I started Brady Capital Research to research companies making a positive difference in the world. Instead of just taking a VALUE-based approach (i.e. looking for growth, value, or GARP stocks), I take a VALUES-based approach. But unlike Social Responsible Investors (SRI), I proactively search for companies with VIRTUES rather than negatively screening for VICES. Call it Positive Investing. But I am honestly finding it quite challenging to realize my dream to "find a way to invest in good companies" and put together a "Positive Investing" portfolio of companies. I have spent a considerable amount of time researching the negative side of the Social Capital equation but I have not had the confidence to come out and publish what I believe, until now…

When I came across John Mackey's brilliant essay on Conscious Capitalism back in the spring of 2011 and started to research the concept of the stakeholder model, I came to realize the fallacy of the shareholder-centric business model. And with this revelation, I started to question the finance profession itself, as it seemed like a lot of what I had obediently learned while studying Commerce and for the CFA (Chartered Financial Analyst) exams was predicated on Milton Friedman's assumption that:

"*There is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game…*" – Milton Friedman, American economist

And as a qualitative-oriented analyst, I was a big believer in assessing a company's competitive position using Porters' Five Forces and a company's sustainable competitive advantage using the Economic Moat framework. But as it turns out, a large part of this was based on a fallacy…

Executive Summary

Social Media is Creating a Revolutionary Force of Highly Connected and Empowered Stakeholders. Social media is empowering the former silent majority to: 1) influence, expose, and disseminate their views; and 2) self-organize and join forces on a common cause.

Empowered Stakeholders Will Start Destroying Traditional Exploitive Economic Moats. The newly empowered base of consumers, employees, suppliers, citizens, and communities will soon start to take revenge and destroy the following traditional economic moats of companies that have profited at their expense: 1) Low-Cost Producer; 2) High Switching Costs; 3) Intangible Assets; and 4) Network Effect.

The Social Revolution Will Lead to a Structural Shift in Companies' Underlying Risk and Growth Profiles. The Social Revolution will create a high level of fragility for companies who derive their competitive advantage through exploiting their stakeholders, leading to a higher than expected risk profile and lower than expected growth profile.

Negative Social Capital Needs to Be Factored Into the Valuation Equation. The current financial and valuation framework is misleading as it does not take into account the impact of a company's Negative Social Capital on its future risk profile nor its growth prospects.

The traditional shareholder-centric business model is a fallacy. The Social Revolution is coming and company management and investors need to wake up and heed the following:

A. Social Media is Creating a Revolutionary Force of Highly Connected and Empowered Stakeholders
B. Empowered Stakeholders Will Start Destroying Traditional Exploitive Economic Moats
C. The Social Revolution Will Lead to a Structural Shift in Companies' Underlying Risk and Growth Profiles
D. Negative Social Capital Needs to Be Factored Into the Valuation Equation

A. Social Media is Creating a Revolutionary Force of Highly Connected and Empowered Stakeholders

Social media is a new catalyst, which is turning the silent majority into a revolutionary force of highly connected and empowered stakeholder relationships. Social media exchanges are acting as catalysts to accelerate the formation of weak ties, leading to the formation of bonding, bridging, and linking capital between and among a company and its various stakeholder constituencies. While the growth in the individual and corporate users of Facebook, Twitter, and LinkedIn and the emergence of new social exchanges such as Google+ and Pinterest will increase the number of actual nodes, the more important fact is the growth in the number of connections within and between the different social networks.

This increasing level of connectedness is leading to the empowerment of stakeholders as social media provides them with a platform to:

- **Influence, expose and disseminate** their views on a company's products and/or services, how a company treats them or other stakeholders, and how a company's business activities impact society and the environment
- **Self-organize and join forces** on a common cause to gain support from others and lobby for regulatory reform and change

Management and investors that still believe in Friedman's traditional view that companies should focus solely on maximizing value for shareholders will soon face a rude awakening.

B. Empowered Stakeholders Will Start Destroying Traditional Exploitive Economic Moats

The companies most at risk in the new Social Era are those with the following characteristics:

- **Corporate Personality** – Machine-Like
- **Corporate Social Attributes** – Opaque, Inauthentic, Indifferent
- **Level of Trust**: Low Trust
- **Mindset Towards Stakeholders** – Exclusionary and Short-Term Transactional
- **Treatment of Stakeholders** – Exploitive
- **Treatment of Society & Environment** – Regulatory Compliance and Corporate Social Responsibility

The newly empowered base of consumers, employees, suppliers, citizens, and communities will soon start to take revenge and destroy the following traditional economic moats of exploitive companies that have profited at their expense:

1. **Low-Cost Producer**
2. **High Switching Costs**
3. **Intangible Assets**
4. **Network Effect**

1. Low-Cost Producer

If a company derives cost advantages by exploiting its direct stakeholders (customers, employees, suppliers) or its activities generate negative societal and environmental externalities, it is at risk of being criticized and exposed through social media. It is also likely to face an environment of increasing regulations as concerned citizens use social media to join together to protest and lobby for change. As a result, in the new Social Era, the following cost advantages may no longer serve as economic moats, but as potential Social Capital Liabilities:

- **Unique world class asset** – if it produces negative environmental externalities
- **Location of resources close to customer base** - if it produces negative environmental externalities
- **Process advantages** – if it leads to losing focus on best needs of customers
- **Manufacturing outsourcing** – if it exploits supplier base
- **Customer service outsourcing** – if it leads to loss of connection with customers' needs/concerns

In addition, companies with the following scale-based cost advantages now face a rising threat of substitutes:

- **Large distribution networks** – social exchanges enable customers to bypass the middleman and build relationships and connect directly with suppliers. As a result, companies with high fixed cost infrastructures may find themselves at a competitive disadvantage if they start to see attrition in their customer base.
- **Domination of niche market** – social exchanges are facilitating the rise of open-sourced, freemium, and user-generated business models. As a result, companies whose competitive advantage is vested in their power to control information and audiences are at risk of being disrupted by these new decentralized competitors.

As we move from the Knowledge Era to the Social Era, we expect to see accelerated depreciation in the value of the following forms of intangible assets:

- **Brand name** – the underlying value of a company's brand name is depreciating as user-generated sites and social media platforms have reduced search costs and a new long tail is emerging. In addition, social media will expose inauthentic companies who have relied on traditional advertising and PR campaigns to portray a positive image for their company and the products and/or services it offers. This threatens to erode the value of companies that have built wide moats based on years of heavy investment in advertising campaigns.

- **Corporate reputation** – the underlying value of a corporate reputation is depreciating as individuals now have the power to expose the truth about how a company treats its customers, employees, suppliers, the environment, and society. This poses a significant threat to the investments the company has made in carefully crafting a positive image through traditional advertising and PR campaigns.

- **Patents** – as patents are artifacts of innovation, we expect to see their value erode as social exchanges such as LinkedIn accelerate the formation of bridging capital between individuals creating an increased open-sourced and collaborative environment, which leads to a rise in innovative new products.

- **Regulatory licenses** – although regulatory licenses can make it difficult for competitors to enter a market, if a company's activities generate negative societal or environmental externalities, concerned citizens can use social media to join together to protest and lobby for change. This could lead to a disruption in the company's operations, increased operating costs, reduced growth opportunities, or a revocation of their regulatory license.

- **Physically addictive products/services** – although companies that offer physically addictive products or services are great from a business model perspective (high frequency of use results in a long-term recurring revenue stream), they now face the risk of a rising regulatory environment if their use harms the health of the individual, communities, or society.

3. High Switching Costs

As social media empowers customers to complain, protest, and rally together against companies that try to exploit them and extract excess rent, the competitive advantage and value of having a captive customer base that faces high switching costs is much less than it used to be and could turn into a Social Capital liability. In addition, companies that used to benefit from tight integration into their clients' businesses are now at threat of being disrupted by open-source, user-generated, and freemium business models.

4. Network Effect

The key principal underlying the network effect is that more buyers lead to more sellers, leading to more buyers and a positive virtual circle, leading to greater liquidity. But in order to benefit from the network effect, a company needs to operate a closed network. The new Social Era is giving rise to more and more open networks, which poses a disruptive threat to companies with closed networks.

The Social Era also creates a dark side to the network effect, highlighting the fallacy of Porter's Five Forces, which assumes a competitive and adversarial relationship with stakeholders (i.e. Bargaining Power with Buyers, Bargaining Power with Suppliers) and gives no consideration to negative externalities. Companies that exploit their stakeholders and generate negative societal and environmental externalities are at risk of a negative network effect if complaints, criticisms, and protests lead to attrition in their customer, employee, and supplier base resulting in a contraction in their stakeholder ecosystem.

C. The Social Revolution Will Lead to a Structural Shift in Companies' Underlying Risk and Growth Profiles

As the world becomes more transparent and connected, the collective power of the individual will start to emerge from the depths of the earth. This will shake up the soil of the stakeholder root systems and cause massive tremors and shifts in the ecosystem of the corporate forest. Unlike a black swan event, which is unpredictable by nature, this revolutionary force of highly connected and empowered stakeholders will gradually start to disrupt the corporate world. As Nassim Taleb remarks in his new book "Antifragile: Things that Gain from Disorder", *"you can state with a lot more confidence that an object or a structure is more fragile than another should a certain event happen."*

The Social Revolution will create a high level of fragility for companies who derive their competitive advantage through exploiting their stakeholders because, for the first time ever, the exploited have a voice and are empowered to join together and fight back. This will expose the fragile companies that have a shallow stakeholder root system and rip and tear at their thin, narrow, and fragmented roots, making them more vulnerable to external risks and stunting their future growth.

As shown in Figure 1, we expect the overall risk profile of companies with Negative Social Capital to rise as they face increasing economic, pricing, commodity price, consumer trend, innovation, labor, supplier, product liability, and environmental liability risks.

Figure 1: Impact of Social Capital on a Company's Individual Risk Factors

Risk Factor	Negative Social Capital - Increasing Risk
Economic	Lose share of wallet
Pricing	No connection so reduces pricing power
Commodity Price	No loyalty - high price elasticity of demand
Consumer Trend	Increases if don't listen to customers
Innovation	Increases - not able to create communities
Labor	Strike/disruption - increase costs/reduce flexibility
Supplier	Supply chain disuption - slow down/stop production
Product Liability	Increased reputational risk
Environmental Liability	Increased compliance exp/capex, contract loss risk

Source: Brady Capital Research

In addition, we expect their growth to contract as they face increased risk of customer, employee, and supplier attrition resulting from negative sentiment and protests of the company's exploitive behavior. Although they may attempt to offset this through acquisitions, this is a much more costly and riskier form of growth.

D. Negative Social Capital Needs to Be Factored Into the Valuation Equation

As we enter the new Social Era, Friedman's traditional view that companies should focus solely on maximizing value for shareholders is an increasingly risky proposition for companies as it fails to recognize the rise in connectedness and empowerment of the former silent majority of consumers, employees, and partners.

The income statement assumes a linear relationship between a company's inputs and its outputs with the underlying objective of the company being to maximize profit by maximize revenue and minimize costs. But this simplistic mechanistic formula will no longer work in the new Social Era. The balance sheet is also deficient. On the asset side, although the balance sheet does reflect the value of goodwill, it is only an accounting entry made at the time of acquisition that reflects the excess of purchase price over book value, and as it does not amortize over time, it fails to account for the potential growing obsolescence risk posed by rapid technological and structural change. Although other customer-related intangible assets, such as brand value and corporate intellectual property, are amortized over time, there is uncertainty whether the accounting treatment reflects the reality. The biggest deficiency is on the liability side of the equation, as nowhere on the balance sheet does it acknowledge the negative value of social capital liabilities resulting from a company's weak and untrustworthy relationships with consumers, employees, and suppliers nor the negative impact it has on society and the environment.

The current valuation framework is highly misleading as it seduces investors into overpaying for fragile companies with Negative Social Capital, while blinding investors to opportunities to establish stakes in antifragile companies with Positive Social Capital. This new reality is not reflected in traditional valuation metrics such as profit-based ratios such as Price-to-Earnings (P/E), Enterprise Value-to-EBITDA (EV/EBITDA), and Price-to-Cash Flow (P/CF). These metrics are too myopic as they do not factor in how a company's stakeholder relationships will impact its future value creation/erosion prospects. Price-to- Book Value (P/BV) is even more limiting. Although it worked back in the Industrial Age, it does not reflect the fact that nearly 80% of companies' value is based on intangible assets, nor does it reflect the inherent liability of companies with Negative Social Capital. And Dividend Yield (Dividend/Stock Price) is perhaps the most misleading as the sustainability of the business model of many cash-cow companies is questionable in the new Social Era.

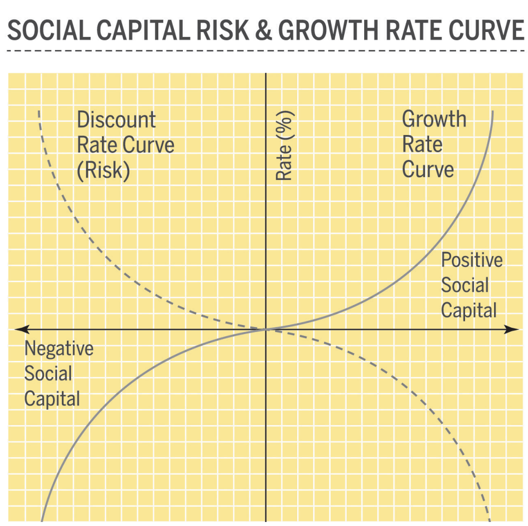
A better and longer-term valuation methodology, as shown in Figure 2, is the Discounted Cash Flow (DCF) model, which calculates the Net Present Value of a firm's projected free cash flow. The two key variables to a DCF are its growth rate (g) and discount rate (k).

Figure 2: Net Present Value = Free Cash Flow / (k-g)

$$NPV = \left\{ \frac{\text{FREE CASH FLOW}}{\text{Discount Rate (k)} - \text{Growth Rate (g)}} \right\}$$

The problem is that most investors measure k as a function of beta, which is simply the mathematical measure of the volatility of its stock price. However, we believe a more accurate economic reflection of a company's discount rate is to measure it as a function of a company's level of Social Capital (either Positive or Negative). Although a company's Social Capital with its stakeholders is an intangible asset that, unlike goodwill, does not show up on a company's balance sheet, investors need to factor it into their analysis and valuation process as it will impact the company's implied discount rate and growth rate. As shown in Figure 3, we expect that companies with Negative Social Capital will experience an upward shift in their discount rate curve and a downward shift in their growth curve.

Figure 3: Social Capital Risk and Growth Curve Chart



Source: Brady Capital Research

This would negatively impact the company's valuation as illustrated by this simple calculation. For example, a mature company that is currently producing $1.00 in free cash flow with an assumed 10% discount rate and a 2% growth rate would be valued at $12.50 ($1.00/(10%-2%)). But if that company's Negative Social Capital was factored in and its assumed discount rate was increased from 10% to 12% and its growth rate was reduced from 2% to 0%, its Net Present Value would decline by a third to $8.33 ($1.00/(12%- 0%)).

Conclusion

Company management and investors who believe the shareholder-centric business model will still prevail in the new Social Era of transparency, connectedness, and stakeholder empowerment would be wise to heed the following words of wisdom from Richard S. Tedlow in his book "Denial":

"Denial is seductive because it can work in the short term. Occasionally it works in the long term, but that is rarely true in business."

As the Social Revolution gains hold, the economic moats of exploitative companies will start to erode. This will result in a structural shift in their underlying risk and growth profiles, leading to a rapid deceleration in valuation. Consequently, we believe the current financial and valuation framework is misleading as it does not take into account the impact of a company's Negative Social Capital on its future risk profile nor its growth prospects.