tomorrow's company

The need and opportunity for business to lead post Brexit

Whether you were for leave or remain, the result of the referendum is a wake-up call for business and political elites. Business lost its voice in the debate because people sensed that the system is not working for them. Many of these concerns are justified. In this period of political uncertainty, it is critical that businesses do not retreat into cost cutting, but instead invest and tackle issues that have been ignored for too long. This is not only vital for our economy, but also presents an opportunity for business to show leadership and regain the public's trust.

In this paper Tomorrow's Company sets out some simple actions that companies could take to provide this leadership. This paper and list of actions has been produced through discussion with the Tomorrow's Company community, though this does not imply endorsement.

Business lost its voice because it is not working for society

There were many warnings to voters from businesses and business organisations about the risks and consequences of a 'Leave' Vote. They came from trade associations, the CBI, the banks and major companies operating in or investing in the UK. Yet it would appear that the voice of business was largely ignored. Perhaps this was because of poor communications. Perhaps this is just part of lower trust in all elites and institutions. Perhaps it was because people were hearing the voice of 'big business' which they associated with BHS, Sports Direct, tax avoidance and excessive pay. According to research in 2014 only 32% of people trust business leaders to tell the truth.[i] The more significant and worrying inference is that people sense that big business does not work for them, and as such do not trust business leaders when they talk about the wider benefits of business activity. As Tomorrow's Company wrote in a recent report, UK Business: What's Wrong? What's Next?, many of these concerns are true.

- 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.[ii] These trends look worse for lower income groups.
- Employee engagement is low: only 49% of people would be likely to recommend their company as an employer to others.[iii]
- UK business investment is worryingly low. Investment in fixed assets (ex-construction) has fallen from 11% in 1997 to 8% in 2014, versus 12% for the USA in 2014.[iv] Investment in R&D was 1.6% of GDP in 2012, versus the Euro Area of 2.1% and USA 2.8%.[v]
- 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.[vi]
- 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.[vii]
- In contrast to these poor outcomes executive pay has increased significantly. The ratio of executive to average worker pay has increased from 47 to 148 times between 1998 and 2014[viii].

Given these outcomes it is no surprise that public trust in business is low. Too many businesses focus on short-term profit and returning cash to shareholders. Too many turn their backs on the opportunity to invest long-term to the benefit of shareholders, employees and society. For example;

- GSK last year returned £3.9 billion to shareholders but invested only £3.1 billion in R&D, despite recording a 14% internal rate of return on R&D investment.
- In the last reported financial year, the UK's three largest house builders, Taylor Wimpey, Barratt Developments and Persimmon, returned £840 million to shareholders, despite reporting returns on capital of 25%-30%, and wide acknowledgement of a housing shortage.
- Even Unilever, the poster child for responsible business, is arguably an example of capital misallocation. In 2015 Unilever's capital expenditure was €2.1 billion versus dividends paid of €3.3 billion, and reported ROIC (return on invested capital) of 18.9%.

The decision to leave the EU has been taken. It is time to look ahead. More than ever the UK needs companies that invest to tackle big problems and through this inspire employees and the public.

If people are to feel that the system is working for them, boards and investors have to make long term decisions that are calculated to meet the future needs of shareholders, staff and society, and not simply the present and often conflicting demands of current shareholders or serve the interest of current executives.

Time for business to lead, invest and take risks

It has become a cliché that uncertainty is bad for business, bad for investment, bad for employment, bad for trade.

The statement is true, but also self-fulfilling. Instead of accepting the negative consequences of uncertainty, there is an opportunity for companies individually and in partnership, to lead the way towards more certainty. In Tomorrow's Company we believe that business can and must be a force for good in society. So, in this position of uncertainty, let us look to the combined creativity, resources and leadership of business to chart a way forward that can minimise uncertainty and increase confidence and faith in the future. Brexit may have been a wake-up call for business elites. It is also an opportunity for them to show leadership and to regain the public trust that has been lost.

In this period of uncertainty, we can't afford to have our companies recede into cost cutting and hiring freezes. Instead, we need companies investing, helping mend divisions in society and taking risks. No matter what the outcome of negotiations with the EU, the UK will need to invest in training, R&D and infrastructure.

This will require business leaders to put their head above the parapet and lead opinion with actions. It will mean taking calculated risks. It will involve collaboration within key strategic industries, and between those industries and the government and investment community. It will mean making the case for long-term investment. It will require strong and clear communication to a disillusioned public about the role of business in tackling societal problems. It will require courage in acknowledging public concern and taking difficult steps to tackle issues such as executive pay. It is often shocks that prompt change and reform. Our businesses should see Brexit as an opportunity to show leadership, not a reason to retreat.

The new government has also shown a renewed interest in making business work for society and encouraging investment. Alongside this, Brexit may also open up the possibility of more radical change in government policy. This presents an opportunity for companies to work with government on shaping policy and regulation.

Actions for business leaders

Below is a list of actions that business leaders could take in this period of uncertainty to help grow our economy and regain the public's trust. People need to see that business is working for them, and that business leaders are being paid to make it work for them. There was broad agreement that this requires companies to increase investment and to tackle executive pay. Other key themes were the need to create certainty, restore trust, forge new links abroad and listen to the public's concerns.

1) Reduce dividends and buybacks, not investment, wages or employment
The ultimate owners of companies are the public, albeit through a long chain of intermediation. It is in the public's interest for companies to keep hiring and investing. We are all worse off if budgets are cut to protect dividends or help executives achieve short term profit targets. Where Brexit uncertainty leads to lower profit, or where new spending is needed, the short-term cost should be borne by shareholders, not employees, customers or investment. This will benefit shareholders and other stakeholders in the long term.

2) Make a public commitment – ideally at industry and regional level – to increase investment in the UK economy and in the skills of its people
The UK already has worryingly low levels of business investment, which we cannot afford to see fall further. To help address this companies in a particular industry or region could make a positive statement about their contribution and investment in the UK economy, rather than warning about moving jobs overseas. For example, GSK announced it was investing £275m in the UK to expand its production capacity.

There is no shortage of areas to invest from infrastructure to R&D to training:

- The UK is a global leader in scientific research, but this IP is not always commercialised as effectively as it could be. More company investment would help.
- The UK is a service driven economy where the value of most companies is made up of their people. Investing in training should be a key driver of long-term value.
- Beyond training for employees, companies could increase collaboration with further education, regional and local government, and the Treasury to make a radical increase in the number of apprenticeships and training courses. Such courses might be offered especially in parts of the country where employment is threatened by the withdrawal of company investment in the light of Brexit.
- We live in an age of technological disruption; to succeed companies need to invest in higher risk projects that could lead to disruptive change. Companies could adopt a venture capital mind-set for a certain portion of investment.
- One specific example is the housebuilding industry. At a time of national housing shortage, it seems a particularly worrying market failure that housebuilders are reported to be putting investment plans on hold.

Across all areas and forms of investment there is a need for this to be balanced across the UK. One cause of the disconnect between business and society is that the voice of business is often conflated with the voice of 'big business' based in London and the City. To counteract this a commitment to invest would be more effective if it were to be targeted throughout the UK, not just in London.

3) Make a bold and public commitment on executive pay

Excessive executive pay has been ignored for too long. It reduces public trust when people see the pay of those at the top increasing while their own wages stagnate. Too often it is not clear how the incentives in executive pay align with the broader interests of employees and society. Sometimes executive pay encourages short-term cash returns to shareholders, instead of long-term investment. And the link between pay and performance is also too weak, with too many instances of payment for failure. A visible and determined move to tackle these issues would make the greatest difference to bridging the gap between business elites and society.

Tinkering with rules and hoping for gradual change will not break through the noise and hence will not shift the public's perception of business leaders. In order to start to recover public trust in pay there are two practical steps companies could take. The first would be to change the remit of the remuneration committee and the second for executives to voluntarily and publicly reduce or redistribute their pay.

Change the terms of reference of the Remuneration Committee – Pay is a by-product of the choices a company makes about the kind of culture, attitudes and behaviours it wants to encourage. Pay should never be seen in isolation. It is therefore illogical and dangerous to have a remuneration committee with a narrow focus on the pay of those at the top. Boards wanting to restore trust could extend the terms of reference of the Remuneration Committee so that it covers the remuneration of all employees, the culture of the organisation, and the recruitment and retention of talent. The aim of these reconstituted remuneration committees would be to create remuneration schemes that increase the sense of shared risk and reward.

This would then provide a solid foundation for reporting to shareholders and stakeholders about the company's rationale on pay across all employees. This would likely include the pay ratio which the government is looking to make a requirement, therefore companies could pre-empt this.

This change would not only help restore public trust but also improve the motivation of employees. A report by CIPD in 2015, *The view from below: What employees really think about their CEO's pay packet,* found that 60% of employees think CEO pay levels are demotivating.

Leading by example – Where the pay of those at the top is concerned, there are opportunities to show leadership and hence to regain the public's trust. It is now widely recognised that senior business leaders are rarely driven by the need for more money, but by public recognition in comparison with their peer group. If their opposite numbers are being paid a larger sum, it is considered a reflection on their merit if they are paid less. Somehow this cycle of competition for status through high pay needs to be broken. One effective action would be if business leaders announce that they will reduce their pay – as Richard Pennycook of the Co-operative Group did recently. Another would be to or donate a portion to charity, or even to offer to match charitable donations by employees contributing to Give as You Earn Schemes. Another would be for a proportion of that pay to be donated into a fund which was held in trust for all employees, along the lines of the employee trust set up by Handelsbanken. See Tomorrow's Business Forms for a case study.

4) Support community initiatives
As highlighted before, too often the public sees business as 'big business' and the City. Businesses can appear as global behemoths that have little connection to the communities they operate in. There are already a large number of community initiatives for companies to support and engage with, such as Business in the Community. Engaging with these initiatives will help companies support and gain the trust from the local communities where they operate. For example;

- Increase corporate funding for apprenticeship schemes, especially in less successful economic areas. This would be most effective in collaboration, for example, given the known skill shortages in the housing industry, the leading housebuilders could work together with each other and with nominated colleges of further education and industry training bodies to divert funds that would otherwise end up as share buybacks so that they were invested in industry training schemes.
- Identify and work closely with the organisations best placed to help channel social investments – e.g. Community Foundations, Local Enterprise Partnerships.
- Support programmes that encourage pupils and students to become entrepreneurial – e.g. Young Enterprise.
- Form long-term relationships with and fund a local academy or college of further education.
- Allocate one week of each employee's time to volunteer in the local community or other public benefit initiatives.

5) Shorten supplier payment terms
For many small businesses long payment terms can be a significant challenge. The government has been increasing the pressure on large businesses to shorten payment terms. The Prompt Payment Code was set up in 2014 to set minimum standards for payment of suppliers. This currently has a maximum of 60 days, with a desire to work towards 30 days. A simple action would be to move from the minimum 60 days to the suggested 30 days now.

6) Build overseas connections
Currently companies in the UK can rely on the European Single Market to trade throughout Europe. After the negotiations this may change and it may become harder to trade with Europe and consequently more important to trade globally. Whatever the outcome of the negotiations companies can help build connections overseas to establish trading partners and connections in countries.

7) Don't wait for politicians to act, form industry collaborations to tackle joint problems
Business leaders do not need to wait for politicians to act, there are numerous examples of companies forming collaborations with peers and civil society to tackle common problems. Many of these are highlighted in Tomorrow's Company's research in UK Business: What's Wrong? What's Next and Tomorrow's Global Company.

8) Articulate a clear purpose that is embedded throughout the culture of the organisation
Business leaders often talk in the cold language of returns on investment and profit margins, this does little to inspire employees or the public. Without ignoring the importance of the financial rationale, business leaders win more trust where they show their passion for the purpose of their organisation and contribution it seeks to make to the world.

Where companies do articulate a clear purpose there is often a gap between this and the reality of the business. Executives and boards could do more to assure themselves that the stated purpose and values have been embedded throughout the organisation.

9) Reform governance structures – stakeholder representation and resources for non-executive directors
The government looks to be placing a new focus on the effectiveness of corporate governance structures, as captured in a speech by Theresa May just before she became Prime Minister.

"I want to see changes in the way that big business is governed. The people who run big businesses are supposed to be accountable to outsiders, to non-executive directors, who are supposed to ask the difficult questions, think about the long term and defend the interests of shareholders. In practice, they are drawn from the same narrow social and professional circles as the executive team and – as we have seen time and time again – the scrutiny they provide is just not good enough. So if I'm prime minister, we're going to change that system – and we're going to have not just consumers represented on company boards, but workers as well."

Companies could either wait for regulatory changes, or they could start tackling these issues voluntarily. One issue is to ensure that the voice of stakeholders is heard within a company's governance structures. This does not necessarily mean representatives on the boards, as this could be achieved in a number of ways;

- Form a stakeholder or employee advisory committee to the board
- Allocate more time for non-executive directors to meet employees throughout the organisation and wider stakeholders
- Allocate time for executives to spend time on the front-line

Another key issue is the effectiveness of non-executive directors (NEDs). Tomorrow's Company has been highlighting that our current governance structures are at risk of placing unrealistic expectations on NEDs given the time and resources they have available. Companies could help tackle this by paying NEDs to dedicate more time to the company, allocate more time to meet wider stakeholders and make more resources available for the NEDs.

Actions for investors and financial intermediaries

Investors could do more to support companies in adopting the actions outlined above. A few in particular are worth highlighting

1) Executive pay
Investors often vote for executive pay packages that the ultimate beneficiaries of the investment funds would not support. Instead investors could be more forceful in pushing for executive pay packages that align pay with performance, and help bridge the gap with society.

2) Long-term investment
Investors sometimes encourage a short-term focus that prioritises cash returns to shareholders over investment and security for employees. Instead, investors could encourage companies to undertake long-term investment.

3) Asset owner capital allocation
Companies in the UK are in aggregate saving £100bn per year. This is partly because large companies are over-returning cash to shareholders, but it is also because financial markets are not effectively deploying this money into new investments. Too often dividends from our largest companies are reinvested in government bonds, rather than higher growth small companies. This problem has become more acute post the financial crisis as banks have pulled back from lending to business due to adverse regulatory risk-weightings.

The UK would benefit if asset owners, such as pension funds, invested their capital to meet the needs of the economy, rather than only to meet regulatory requirements and match liabilities. This would likely lead to an increase in funding for small and medium sized companies, rather than investing in government bonds.

One way this could be achieved would be by more collaborative action between asset owners and companies. Pension funds and insurance companies could pool assets into new investment vehicles to invest in specific industries, themes or regions.

Tell us what you think – take our survey

Work with us to inspire and enable business to be a force for good, join our community.

Tomorrow's Company is an independent non-profit think tank that exists to inspire and enable companies to be a force for good. We believe business can create more value for shareholders and society by adopting an approach that focuses on purpose, values, relationships and the long term.

We aim to achieve this through the strength of our community – a group of individuals throughout the corporate and investment landscape who believe in change. Tomorrow's Company supports this community in their implementation of this approach, and the community provides the practical grounding to research and a network of advocates to achieve wider impact. In doing this we combine provocative thought leading research, with practical agendas that can be adopted in business and investment. Outlined below are a number of our current work streams. Please contact us if you would like to be involved.

Governing Culture – As part of the FRC's Culture Coalition, and in partnership with the City Values Forum, we are about to publish a practical guide for boards seeking to assess, nurture and develop the culture of their organisation. We will be continuing this theme going forwards.

Good Governance Forum – The focus for the Good Governance Forum in 2016 is on opportunity and risk aversion in the boardroom and how this can be overcome. There is a growing concern that boards too often focus on mitigating risk and avoiding downsides, rather than embracing the risk necessary to capture opportunities.

Stewardship Alliance – Working together with a group of companies, asset managers and asset owners, we are looking at how the incentives and resources for stewardship can be increased through the investment chain.

A new map of the UK economy – In our recent report, UK Business: What's Wrong? What's Next? we highlighted that the lack of business investment and consequent net corporate saving is not only a problem for our companies, but also creates dangerous macroeconomic imbalances. We are building a new map of the UK economy that will help show the interconnections between company decisions and macroeconomic stability. This will form the basis for engagement with business leaders on what they can do to support the economy.

Funding SMEs and disruption – Due to more onerous capital requirements, banks are reducing lending to small businesses. This is being partly offset by new alternative forms of finance such as direct lending from insurers, as well as P2P and crowd based platforms. However, most evidence indicates there is still a shortfall. We are building a comprehensive picture of the current sources of finance and possible solutions.

For more information, please visit: www.tomorrowscompany.com

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[i] Ipsos MORI trust in professions data, 2014.
[ii] For data to 2000s – ONS, An Examination of Falling Real Wages, 2010-13, January 2014. For 2010s – ONS, Labour Market Statistics, February 2016.
[iii] CIPD, *Employee Outlook Autumn 2015*, October 2015.
[iv] OECD Statistics, Dataset: 8A. Capital formation by activity ISIC.
[v] World Bank Data.
[vi] ONS Blue Book, DTAL, DSVZ, NVDC, CURR. UK non-financial corporations net borrowing/lending before distributed income to shareholders.
[vii] Dimson, Marsh and Staunton, Credit Suisse Global Investment Returns Yearbook 2016.
[viii] High Pay Centre, "The State of Pay: High Pay Centre briefing on executive pay".