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COMPANY PURPOSE: WHAT SHOULD SHAREHOLDERS THINK ABOUT IT?

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A revolution seems underway. The bedrock of capitalism, shareholder value maximisation, is questioned by scholars, politicians and even business men. In its recently published "**Statement on the purpose of the corporation**", the Business Roundtable endorsed a stakeholder capitalism and initiated an international debate on the social responsibility of companies. France has gone even further: under the new **article 1833** of the French Civil Code, a corporation that is "constituted in the common interest of the shareholders" must be managed "in its own interest taking into consideration the social and environmental implications of its activity". Until then, France was apparently more favourable to shareholder value than the Anglo-Saxon countries that are so often presented, **wrongly**, as the champions of shareholder capitalism. Inspired by the **Notat-Sénard Report** (*"L'Entreprise, objet d'intérêt collectif"*), the PACTE Law seeks to break with this logic. It even allows companies to "specify their purpose" in their articles of incorporation, which are "made up of the principles with which the company is endowed and in respect of which it intends to allocate resources in the realization of its activity".

This notion of "purpose" which for the Notat-Sénart Report is not reducible to profit and should guide board decisions, is part of a wider and globalized debate on the **crisis of capitalism**, the rise of inequalities, climatic urgency, and the growing need for new generations to find a **meaning** that is not purely materialistic and individual.

But, contrary to what several pundits have written, this "new" philosophy should not worry shareholders.

THE STOCK PRICE DEPENDS ON A LONG-TERM PERSPECTIVE

First of all, it is necessary to recall that the "purpose" (the definition of which we will return to later), the mission of the company, its culture, the links that it maintains with its ecosystem, the social implications and environmental issues it faces and, more generally, its long-term strategy, are not novelties or discoveries for investors.

The decision to invest is based on an estimate of the future returns and risk of the company's activities, which are always assessed over the long term. Since 2005, the weight of the first 10 years of projected cash flows of French companies represents 60% of the market capitalization on average, and this share has tended to decrease since 2016. The market value of a company is therefore made of 40% of the cash flows it will be able to generate beyond 10 years.

The **growing disconnect** between the market value and the book value of assets mostly reflects the proportion of intangibles in investors' calculations. Investors clearly go beyond short-term financial information: many companies that are showing a loss or even no activity ("unicorns", biotech companies...) are generously valued by the market.

This collective intelligence of the financial market is not incompatible with the short-term behaviour of some of its actors. It is a fact that not all investors have the same interest in non-financial and long-term information. But the market efficiency is based precisely on the diversity of managers' information acquisition and decision-making strategies:

- around 40% of the world's market capitalization is managed by **mechanical investors** (index or quasi-index funds, ETFs, etc.). They have a limited interest in business fundamentals. Although they cannot easily get out of their holdings, they are nevertheless interested in their governance and in the environmental and social aspects of company's strategy when making their voting decisions at general meetings. They apply a "**voice over exit**" principle.

- 40% are managed by traders. Their logic is opportunistic and consists above all in trying to anticipate price movements from the company's news flow, analysts' coverage, competitors' initiatives, other investors and speculators' sentiment, etc. Company fundamentals hardly play a role in this reasoning. Traders are clearly in a short-term logic.

- 20% are managed by intrinsic investors whose investment and divestment **decisions** are the result of a conviction regarding the company's ability to create and maintain a competitive advantage and ensure the resilience of its business model. These minority **fundamental investors** are **critical** to the share price because, even if they rarely invest, their daily buying volume is **7 to 30 times** greater than that of traders during their investing period. They also bring many **positive financial features** to companies (lower volatility and lower cost of capital, higher returns, etc.).

Stating that financial markets are short termist is therefore a **caricature**. Even if some investors are clearly short term oriented, share prices are essentially driven by the expectations of the most fundamental of them.

INVESTORS, AVID CONSUMERS OF NON-FINANCIAL INFORMATION

As the share price ultimately captures the expectations of the most sophisticated investors, clearly presenting one's **investment case** becomes essential. The value of a company depends on how investors have understood the implicit and explicit promises made by the management. Before accusing shareholders of neglecting non-financial performance or over relying on short-term results, companies must reflect on how they have communicated their strategy and if they have sufficiently prioritised their dialogue with investors who matter, i.e. those who are best able to price company fundamentals.

The quality of the strategic information communicated to the market is an essential element in the price discovery. From this point of view, investors have benefited from increasingly demanding regulations, particularly in France. As early as 2001, the **New Economic Regulations Act** required listed companies to publish information on the social and environmental consequences of their activities. These disclosure obligations were broadened by the decree implementing the **Grenelle 2 Law** and then by the **2015 law on energy transition**. Finally, the transposition of a 2014 European directive gave birth to the **extra-financial performance declaration**, which now replaces the previous mechanisms. At the international level, numerous initiatives have been launched to offer companies more and more precise and sophisticated extra-financial references (GRI, SASB, IIRC, ...).

The amount of information available has enabled investors to implement an ever-growing integration of Environmental, Social, and Governance (ESG) factors into their strategies and decisions. It is estimated that 45% of asset managers have an integration process in place and 45% are working on it. Utilization of this extra-financial data is no longer reserved for so-called socially responsible investment (SRI). All other asset classes seek to benefit from it..

Passive funds or quantitative funds use this data provided directly by companies or, indirectly, through the independent ratings that have emerged in recent years (Vigeo/Moody's, MSCI, Sustainalytics, REPRisk, Oekom/ISS, Ethifinance/Qivalio). Even if their methods are criticized, their ratings are integrated into valuation models and have an influence on investment decisions and therefore on share price.

The intrinsic investors have always been fond of non-financial information to put the company performance in a long-term strategic perspective. Most portfolio managers invest in a company only after meeting its management. This face to face opportunity allows them to access a unique insight into the company strategy and the ability of its executives to execute on it.

ACTIVE AND ENGAGED INVESTORS

But investors are not just avid consumers of extra-financial information. They are also influencers who want to affect corporate behaviour. They do so voluntarily or by obligation.

This objective is obvious at the annual general meetings and in the regular dialogue between issuers and investors. Most managers have put in place voting and engagement policies that include an ESG dimension.

The most vocal are State Street and BlackRock, whose presidents send an annual letter to the CEOs of their investees to encourage them to manage for the long term and therefore to be concerned about the consequences of their activities for the wider environment. Most of the major funds have been quite specific about what they expect in terms of ESG from the companies in which they invest. In particular, they want the variable compensation of the executive officers to be partly linked to the achievement of extra-financial objectives related to ESG considerations.

During the dialogue they have with the secretary of the board or a director to discuss the resolutions to be presented at the next AGM, they try to assess the consistency between strategy, ESG policy, culture, financial and non-financial indicators, and remuneration.

This engagement is also necessary to fulfil their own obligations or promises. In 2006, under the sponsorship of the UN, the largest institutional investors developed six "Principles for Responsible Investment" designed to better align their investment policies with wider social and societal goals, principles they commit to respect and the application of which they must communicate annually. Today, the signatories comprise 2300 funds and represent $82 trillion in assets under management. From 2020, the introduction of indicators aligned with the TCFD (Task Force on Climate-Related Financial Disclosure) will be mandatory for all signatories.

Next to this global initiative, there are also more limited ones. For example, the International Finance Corporation of the World Bank has developed an "Impact Investment" method (Operating Principles for Impact Management) that its signatories, some sixty investment funds, pledge to apply. As another example, pursuant to Article 173 of the Energy Transition for Green Growth Act, French asset management companies must publish information on how they take into account environmental, social and governance quality objectives in their investment and risk management policies.

Various guides have been proposed by professional bodies (**Association Française de Gestion** and **France Invest**) to help investors implement this regulation. These reporting requirements imposed on investors have a direct impact on companies.

It must therefore be recognized that investors have played an important role in the growing consideration of social and environmental factors by companies. A vertuous circle has begun. The gradual enrichment of extra-financial data and their ever-wider dissemination has enabled the financial community to refine the analysis of companies. While for a long time it was difficult to demonstrate that companies' efforts with respect to ESG were valued by the market, contemporary studies confirm that virtuous firms benefit from an **advantage** over those that engage less with ESG principles. Even better, investors are showing increasing maturity in this area: they are able to **distinguish** between indicators that are strategically relevant (defined as a result of a **materiality analysis**) and those that are not.

The incentive of the PACTE Law for a company to define its purpose and the obligation to consider environmental and societal issues is therefore part of a virtuous logic whose benefits are clear and are gradually being recognized by investors. This trend is likely to amplify, provided that certain conditions are respected.

FINANCE IS NOT THE ENEMY

First of all, the promotion of this idea should not be used as a pretext for making finance the enemy. Even if the Notat-Sénard report does not fall into this trap, the prioritization of the stakeholders too often has the stated objective of countering the influence of investment funds accused of being short-sighted. This approach is misleading as well as counterproductive because it goes against the interests of our society.

It is misleading because it is based primarily on ideological prejudices used opportunistically to feed an anticapitalistic debate, particularly vigorous since the last financial crisis. Its popularity does not make it more valid.

One must not confuse the holding period of a share with the motivation that pushed the investor to buy it. What is essential is that the price correctly reflects the fundamentals of the company, regardless of the average holding period of the shares. As mentioned before, share prices are eventually determined by intrinsic investors concerned with the long term of the company. The "fairness" or "realism" of a company market value depends on the nature of its shareholding, which is based on the characteristics and quality of the company's communication. Communication that focuses on long-term fundamentals **reduces** the proportion of opportunistic investors to the benefit of longer-term investors.

Recurrent debates about the generosity of dividend distribution policies or the adverse economic consequences of share buybacks are equally misleading. Disregarding **financial realities**, commentators confuse dividend with shareholder's remuneration, comparable to that of the employee, whereas, in fact, it in no way enriches its holder. Similarly, share buybacks are accused of reducing investment in a self-deprecating logic that is detrimental to long-term economic and social development, although this analysis is belied by all academic studies.

Ostracising finance is also a miscalculation. Like it or not, companies cannot exist without funding. While it is still possible to resort to debt, only shareholders accept the risk of losing everything. Moreover, as soon as the size of its operations (investment or transforming acquisition) has to be increased sharply and rapidly, the financial market becomes an unavoidable tool. It can of course be rejected and private equity funds can be given priority, but this entails having to accept even greater demands for profitability and more invasive governance (which is not necessarily bad!).

Nevertheless, it will be difficult to attract external capital without offering competitive long-term profitability, especially since funds have a fiduciary responsibility to their clients. Good intentions should not make us forget the economic reality: we must not reject shareholders but give them satisfaction in the long term.

In addition to those financial considerations, the active presence of shareholders has a beneficial effect on governance and transparency. As discussed above, the purpose of the regular shareholder dialogue between funds and issuers is to encourage companies to adopt virtuous behaviour in both governance and ESG. The impact of shareholder engagement certainly depends on the seniority and experience of the stewardship team of the investor. Yet, the maturity and efficiency of these teams are growing. Although this external pressure can sometimes be annoying for the company, it does have some virtue.

This renewed alliance with finance is even more critical from a global point of view. Investment needed for implementing the energy transition and achieving the UN's Sustainable Development Goals is gigantic. A general overhaul of capitalism will require the mobilization of not billions of dollars, but trillions, as explained by a World Bank **report** issued at the Addis Ababa conference in 2015. Public resources will not be enough. Private resources will be the key and are found primarily in large investment funds. To the extent that they become aware of the issues and mobilize to contribute to more sustainable development, it would be counterproductive to indict them. Better make them **allies** than enemies.

COMPANY PURPOSE: A STRATEGIC FRAMEWORK

The second condition for this "revolution" of purpose to be valued by investors is that it becomes indicative of the company's competitive advantage.

There is no consensus on what "purpose" is and how best to define and express it. Whether it is short and practical like that of **Michelin** or long and conceptual like that of **Atos**, it is up to each company to determine, explain, and comment on it in a concrete way so that investors understand its meaning and usefulness. Slogans, generic wording, and consultant mumbo jumbo should be avoided. And its inclusion in the statutes is not enough, because its expression will be too summarized for its contents to be completely clear.

Investors' primary interest is the **strategic framework of the company**, which covers three dimensions:

1. *"foresight"*: the opinion of management on how macro trends will affect the industry, future customers' needs, relevant technologies, competitive structure, etc.;

2. *"insight"*: tangible and intangible assets, human and tangible assets, key skills and unique resources available to the company. It corresponds largely to the company's business model and culture;

3. *"cross-sight"*: company's links with its eco-system, its partners, and society in general.

The company's "purpose" must therefore be precise enough for investors to appreciate the chances of success of the company's strategy. Like all other managerial concepts, which are similar in one way or another (mission, vision, vocation, culture, values, purpose, etc.), it must be complemented by a detailed and consistent explanation and be concretely embodied in action to be fully credible.

The clear expression of a strategic framework is not obvious. In many cases, executives do not feel the need to state it because they believe its elements are intuitively or implicitly validated as part of their strategic process. However, as soon as a structured approach is adopted to clarifying this framework, one quickly realize the difficulty of explaining it in a logical and convincing way.

In the search for an operational purpose, companies will face a challenge: to think holistically within organizations often dominated by silos which limit their ability to project themselves into the future and imagine how they will create value in the long run.

The development of an integrated report is one way to start this process of reflection. Designed by the International Integrated Reporting Council, this type of **report** aims to explain in a holistic way how the company intends to create and share value. It is based on a prior integrated thinking which consists of identifying the main mechanisms for long-term value creation (strategic vision, organization and governance, strategic resources and business model) and to specify their linkages and implementation (links between ESG and strategy, capital allocation, etc.) and the expected results in terms of competitive advantages, opportunities and risks.

The complexity of this reflection is not the only difficulty faced by companies that embark on this process. They must also set up an organization and reporting systems that allow them to monitor the progress of their strategies by focusing more on leading indicators than lagging indicators.

Identifying and quantifying the links between extra-financial performance and long-term value is a complex subject that must also be addressed. In this respect, companies will usefully draw on the progress made by investors in their ESG integration work. It is important to close the gap between a quite sophisticated finance world and business practices. A recent **PwC Report** stresses that even when companies have a robust story to tell, the information provided is too weak to allow investors to understand and analyse performance.

THE KEY ROLE OF THE BOARD OF DIRECTORS

The third condition for the success of this new philosophy, probably the most important, relates to the centrepiece of governance: the board of directors. It is indeed up to directors to define or, at least, validate the strategic framework of the company, materialize it in an integrated report and, where appropriate, summarize it in a "corporate purpose" presented to the general meeting if the company decides to include it in its bylaws. By defining a broader social interest and by creating this concept of "purpose" which should at least be expressed in a strategic framework, the PACTE Law strengthens the board's responsibility in determining strategy.

This essential skill often escapes the board. According to a McKinsey **study**, only 10% of the directors surveyed admit to fully understanding the dynamics of their industry and only 21% believe they have a full understanding of their company's strategy. The resulting frustration is sometimes expressed (albeit with great diplomacy) in the conclusions of annual board evaluations.

Operationalizing the concept of "corporate purpose" implies that the board becomes a real arbitration body between the short and the long term, between the various stakeholders and investors, a body that will work to improve the competitive advantage of the company, the resilience of its business model and demonstrate that ultimately, the business creates value for its loyal shareholders.

The board's independence must also be reinforced to limit agency conflicts, which tend to emerge when the management can discretionarily drown shareholders' interest into a collection of objectives. Investors will carefully consider the board's ability to ensure that they are not ultimately forgotten or overlooked and that the company remains shareholders-friendly.

Therefore, several issues have to be addressed by boards willing to fully embody "the tone at the top".

1. **Directors skills and thus board composition** to develop a collective and independent reflection and mindset on the company strategy and its consequences from a value creation standpoint. It is a question of organizational structure that is not easy to solve quickly. A regular refreshment of the board is requested to align it with the ever-changing strategic challenges of the company.

2. **Information and decision-making processes**. Behavioral science offers an analytical framework to identify usual dysfunctions in boards and appropriate solutions to mitigate them. Boards should use available techniques to avoid classical cognitive biases as much as possible (pre-mortem, devil's advocate, systematic options, experts, routines for questioning the status quo, etc.).

3. **Board agenda and priorities**: a board can easily be overwhelmed by its legal duties. It cannot properly address every single issue it is theoretically responsible for. Boards must dedicate most of their energy and time to address the most essential questions. For shareholders, those questions are: strategy, risk management and capital allocation.

Each board should therefore reflect on the governance architecture it wishes to put in place. Governance story is as much important as equity story for investors. The "G" of ESG acronym should come first because the effective and fair consideration of the social, environmental and societal dimensions of the company depends on it.

As far as investors are concerned, they must develop ESG integration further to improve their investment decisions and better implement their voting policies at the AGM. To this end, large teams of ESG and governance specialists are hired, not to mention IT specialists or quantitative finance experts who focus on integrating extra-financial data into their financial models.

The profitability of these teams is not obvious. Several models to optimize engagement (collective engagement, resources pooling, outsourcing to specialized intermediaries or other funds, etc.) are currently tested. Investors must avoid mechanical approaches (ratings, use of unstructured data in AI models) or intermediated processes (voting advisory services) to the detriment of more customized approaches which are the only way to take into account companies' specificities.

The legitimacy of investors on these issues depends on the consistency of shareholder's engagement practice. If governance and strategy are key competitive advantage drivers and, by definition, unique because company-specific, relying excessively on mechanical or standardized analysis is unfounded. Investor credibility relies on a truly personalized engagement and the ability to make decisions (voting and investment) discarding "good practices" or politically correct recipes.