Measuring long-term value

Nothing is more practical than a good theory

Interview with Barend van Bergen, EY Global Long Term Value Methodology Leader and Monique Donders, Country Manager, BlackRock, the Netherlands

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Measuring long-term value: nothing is more practical than a good theory

Barend van Bergen is EY Global Long Term Value Methodology Leader and an Assurance Partner with EY – United Kingdom. He has over 20 years of experience advising companies on measuring, managing and communicating the impact and long term value they create for investors and other stakeholder groups.

In addition to his client work, he is a member of the EY team working with the Coalition for Inclusive Capitalism on the Embankment Project for Inclusive Capitalism (EPIC).

Recently there has been a lot of focus on short-term pressure in our capital markets and a lively discussion around value creation and corporate reporting. It is time to update how we value companies and measure their impact on all stakeholders, not just shareholders.

Even in the shareholder-oriented United States, there is a growing awareness that a one-sided focus on short-term profit targets may work out well for certain investors and directors, but ultimately costs economic growth and jobs. That is why super investor Warren Buffett and CEO Jamie Dimon of JPMorgan Chase have recently pleaded in favour of abolishing quarterly guidance on result expectations, because it may encourage short-term behaviors too strongly[1]. Boards, executives and investors are stressing the need for a better balance between the short and long term. That said, long-term value creation is too often regarded as a vague concept. There is a real need for better and company-specific elaboration.

The Embankment Project for Inclusive Capitalism (EPIC) offers a market-based framework and indicators with which long-term value creation can be measured and communicated. This article outlines the background and core elements of the EPIC project.

[1] *Warren Buffett and Jamie Dimon join forces to convince CEOs to end quarterly profit forecasts*, CNBC, 2018

More balance needed between short and long term

More and more parties see the value and necessity of a better balance between the short and long term in politics, media and business. The current economic system has brought much good, but it has also led to social and economic inequality and too great a burden on the environment. Research also shows that it has led to economic damage. For example, prosperity that is concentrated in a small group leads to less economic growth. Whereas these considerations used to be an academic debate, nowadays more and more market participants speak about the importance of the long term. But how do you make the concept of long-term value creation tangible? Of course, a crucial tool here is to make factors that create value in the long term measurable.

Four challenges

Against the background of the increased focus on the long term, organisations face four major challenges. Firstly, trust in institutions (including companies) has fallen to low levels. That is a matter that companies must actively tackle. To do this, they need to be able to express their value in more than just financial terms. For example, what is their contribution to the economy and broader society, both now and in the long run?

A second challenge is the increasing amount of available data. 90% of all data on earth has been created in the last two years. This allows organisations to measure things that were previously immeasurable. Organisations will need to be able to tell their own story clearly and well. If they don't, other parties will do so, based on their own interpretation of available data.

The third challenge is the growing role of intangibles in a company's value. In the past, 80% of the market value of a company could be read off the balance sheet. Nowadays, on average, only 48% is on the balance sheet. And companies in Silicon Valley on average only have 10% of their value on the balance sheet. So companies now have a greater need to be able to express their intangible value and how it contributes to long-term value in a better way.

The fourth challenge is conflicts of interest or dilemmas in the investment chain. For example, pension funds frequently claim that they are working for the long term, but in reality they still judge them too much on the basis of short-term criteria. This is partly because they do not know how to measure long-term value creation. There is no adequate vocabulary and as a result people fall back on traditional financial indicators. Investors are also primarily focused on achieving financial objectives and much less on long-term value. It is clear that there are numerous dilemmas in the investment chain.

The genesis of the EPIC initiative

Measuring long-term value is therefore fundamental to achieve a better balance between the short and long term and to be able to tackle the four challenges. Accountancy firms can play an essential role in this. After all, they have more than 100 years of experience in measuring, reporting and auditing financial value. But they too need to get to work to remain relevant in the 21st century. In the 2016 book *The End of Accounting*, Baruch Lev and Feng Gu state that the world of accounting is not very innovative for many reasons, despite the fact that the developments outlined above require fundamental changes in the way that value is measured. However, this topic was barely on regulators' agenda. That is why there was a need for an initiative from – and for – the market, together with companies and investors.

In March 2017, the topic became very prominent during the takeover battle between Kraft Heinz and Unilever. This was an important moment in the financial world. Unilever CEO Paul Polman succeeded in convincing investors that the premium being offered was far too low, because Unilever creates a lot of value in the long term. However, it turned out that this value was not sufficiently measurable. The appropriate language and indicators were missing. This was one of the reasons why the EPIC project was started.

> "Accountancy firms also need to get to work in order to remain relevant to their customers.

The EPIC project in a nutshell

EPIC is 18 months project that brought together The Coalition for Inclusive Capitalism, EY and 31 companies, asset managers and asset owners, with approximately USD 30 trillion of assets under management, in pursuit of a single goal: to identify and create new metrics to measure and demonstrate long-term value to financial markets.

Together, they have developed 63 indicators and Long Term Value Framework that helps organisations to measure and communicate long-term value creation.

The recently published final statement of support signed by The Embankment Project for Inclusive Capitalism (EPIC) participants underlines the importance of measuring four key value drivers of long-term, sustainable growth: talent, innovation, social goals and corporate governance.

For more information, see: epic-value.com and ey.com/longtermvalue

The results of the report

The EPIC report provides a set of agreed upon indicators that can be used in four value categories (financial value, consumer value, human value and social value). Parties in the entire chain agree that those categories are relevant for long-term value.

What is unique about the EPIC project is not that indicators have been defined in the first place, but that the 31 parties have agreed on 63 indicators that are thought to have a link, correlation or causal relationship with long-term value creation.

However, the indicators do not constitute a ready-made solution. Companies must think for themselves about which specific indicators they want to use and present, based on their specific circumstances. To do this they can use the methodology that has been developed in the report. The set of 63 indicators is a good starting point.

The step-by-step plan also indicates clearly which indicators can be omitted.

So it helps to report in a more targeted way. It therefore should not lead to more reporting, but to better reporting. It proves: nothing is as practical as a good theory.

Next steps

Of course, the EPIC project does not offer a complete answer to the economically and socially relevant question of what the right balance is between value creation in the short and long term.

The framework and the indicators will help companies to explain how their investments in talent, innovation, social objectives and corporate governance create value for investors and other stakeholders. This brings the company-specific development of long-term value creation one step closer.

Of course, there is still a lot of work to be done, but the private sector can make an important contribution to this.

We, therefore, invite investors and companies to use the results of the EPIC project in their business operations and management. This can be done, for example, when shaping and implementing investment mandates, refining strategic plans and communicating value creation to stakeholders.

Furthermore, we hope that more companies will participate in the next stage of EPIC, which will start later this year.

It is time for a common language

Monique Donders is Country Manager at BlackRock in the Netherlands.

Her team supports, among others, banks, asset advisors, pension funds and insurance companies. Monique was previously Head of Institutional Client Business in the Netherlands at BlackRock, Head of Group Risk Management at Robeco and Professor of Financial Risk Management at the University of Maastricht.

BlackRock is convinced of the importance of using a common language for measuring long-term value, which is why BlackRock participates in various initiatives working on the development of such a common language. The EPIC project is one of the initiatives in which BlackRock participates. Barend van Bergen (EY Global Long Term Value Methodology Leader, who is closely involved in the EPIC project) interviewed Monique Donders about long-term value and the need for change.

Asset managers often suggest that the short term prevails too much, while we all believe that the long term is important?

That's right. As an asset manager, we invest in companies on behalf of our clients and regularly call on them to invest in their company for the long term instead of, for example, short-term thinking and paying out profits. However, sometimes the regulatory framework also influences short-term thinking. For example, pension funds have a long-term focus almost by definition because of the duration of their obligations. But every year they have to determine on the basis of their coverage ratio whether they will reduce pensions or not. If the supervisor supports the philosophy of long-term value creation, they should also ensure that the supervisory framework is consistent with this. This is not always the case. But it is a complex discussion, because you also want to avoid undesirable value transfer between generations.

To what extent does BlackRock itself have a focus on the long term?

BlackRock has a strong focus on long-term value creation because more than two thirds of our customers are long-term investors, such as pension funds and insurance companies. As an asset manager we are a fiduciary to our clients: we do not have our own balance sheet and act solely in the interest of our clients, namely the asset owners. That means that we almost automatically focus on the long term. Our CEO and Chairman Larry Fink sends a letter to CEOs of listed companies every year. The main message is that he calls on CEOs to invest for the long term and to communicate this with all stakeholders. In this way we defend our customers' interests: if these companies do well, they represent good investments for our customers. Thus, striving for long-term value creation also contributes to a better retirement provision for participants in a pension fund.

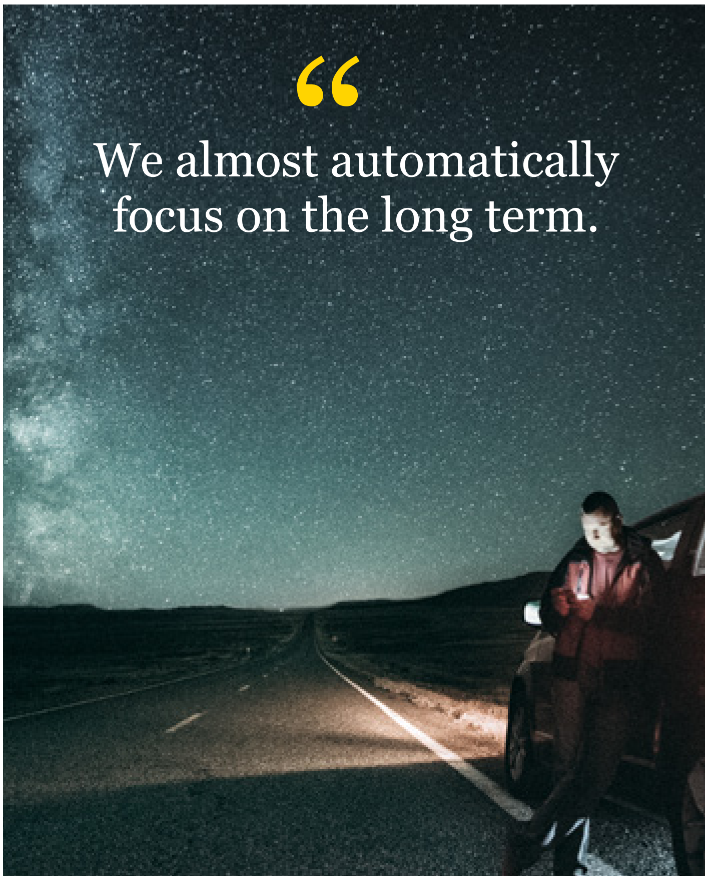
“Sometimes the regulatory framework also influences short-term thinking.

To what extent are short-term financial objectives in conflict with social value creation?

It is important not to see financial objectives and social long-term value creation as opposing goals. In his last two letters, Larry Fink pointed out that every company must have a framework to stay on track in this harsh economic climate. This starts with integrating a higher goal for the company, the so-called purpose. What is the legitimacy of the company and how is that reflected in the revenue model and business strategy?

Can you explain that further?

When a company really understands what their purpose is and they are able to communicate it, they work with a focus on their targets and with a strategic discipline, both of which are needed to make a profit in the long term. Purpose leads to the alignment of management, employees and society. It gives direction to the company's culture, provides a framework for consistent decision-making and ultimately also contributes to maintaining long-term returns for the company's shareholders. For BlackRock, financial objectives and social long-term value creation are two sides of the same coin.



In a perfect world, financial targets and social goals are the same. But there are also situations where these two values are not dealt with at the same time and where conflicts and dilemmas arise. What is your view on that?

An example: the tobacco industry. From a social point of view, you might not want to invest in that sector, but the industry has performed very strongly in recent years. It is a complex discussion. If customers do not want to invest in it for reasons relating to social values, they can let us know and we will take that into account. As a global player, however, we do not see it as our task to completely prohibit our customers from investing in such sectors.

Can you elaborate further?

The Netherlands are ahead of many other countries in the area of sustainable investing. So we do not alienate Dutch customers when we don't invest in the tobacco and weapons industries. However, we are not only active in the Netherlands and we do alienate our customers in other places if we take a moral stand. And in some countries, as a fiduciary manager, you are obliged to strive for the best returns for your customers.

But there are also areas that are somewhat less one-dimensional and controversial, for example energy transition or diversity. Entering into a dialogue with companies in which we invest can certainly have an effect there.

Our investment stewardship team has important dialogues, not always in public, with companies whose strategies we want to understand better. As a large long-term investor, we are in an excellent position to have those conversations. And those conversations are more effective if we speak the same language, in other words: if we agree on the way in which relevant non-financial data is measured.

Why does BlackRock participate in projects such as EPIC?

We want to make a constructive contribution to the debate on long-term value, both from a practical context and together with the other 30 EPIC participants. The world will witness the biggest shift in wealth in human history: US$24,000 billion going from baby boomers to millennials. This shift in prosperity and changes in investors' preferences will lead to an increasing importance of the environment, society and the governance of companies (ESG) for the economic valuation of companies.

This is one of the reasons why BlackRock invests heavily in improving the available data and analysis methods to measure these factors and we are integrating them fully into our investment platform.

How does EPIC help with this?

For our active investment strategies, we asked all fund managers to formulate clearly how they include this non-financial data in the construction process of their portfolio. A consistent set of criteria to measure non-financial data contributes to the quality of this process.

The EPIC step-by-step plan is in line with how BlackRock thinks about creating long-term value as an investor and as a fiduciary for its clients, who in turn are often long-term investors. We therefore warmly welcome the commitment to formulate a long-term strategy. Better and consistent reporting, embraced by a large number of parties, is better for every investor. It is very important to speak a common language. The fact that the relevant language doesn't exist distracts us from the essence of the matter. It provides an excuse not to participate because we cannot measure it. A consistent and coherent framework such as EPIC is very useful.

How will you continue with this?

We continue to work on integrating non-financial data in our Aladdin system, the platform that we use throughout the entire organisation for portfolio construction, risk management and reporting to customers. We are also developing more and more solutions for customers who have a basis for the use of ESG-related information.

In addition, we are becoming more active in communicating how BlackRock as a company embraces the focus on long-term value creation.

To what extent can boards and supervisors contribute?

Boards must focus on the strategic direction of the companies, and therefore on the balance between the short and long term. We expect them to actively enter into dialogue with management about their purpose, the role of investors and other stakeholders and how this reflects in long-term value creation. Supervisors should explicitly include long-term value creation in their supervisory framework and not only assess short-term objectives.

Projects such as EPIC provide a common language and indicators so that companies can communicate in a concrete way about their policies and future plans.

This helps investors make investment decisions and helps other stakeholders to form an opinion about the company.

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