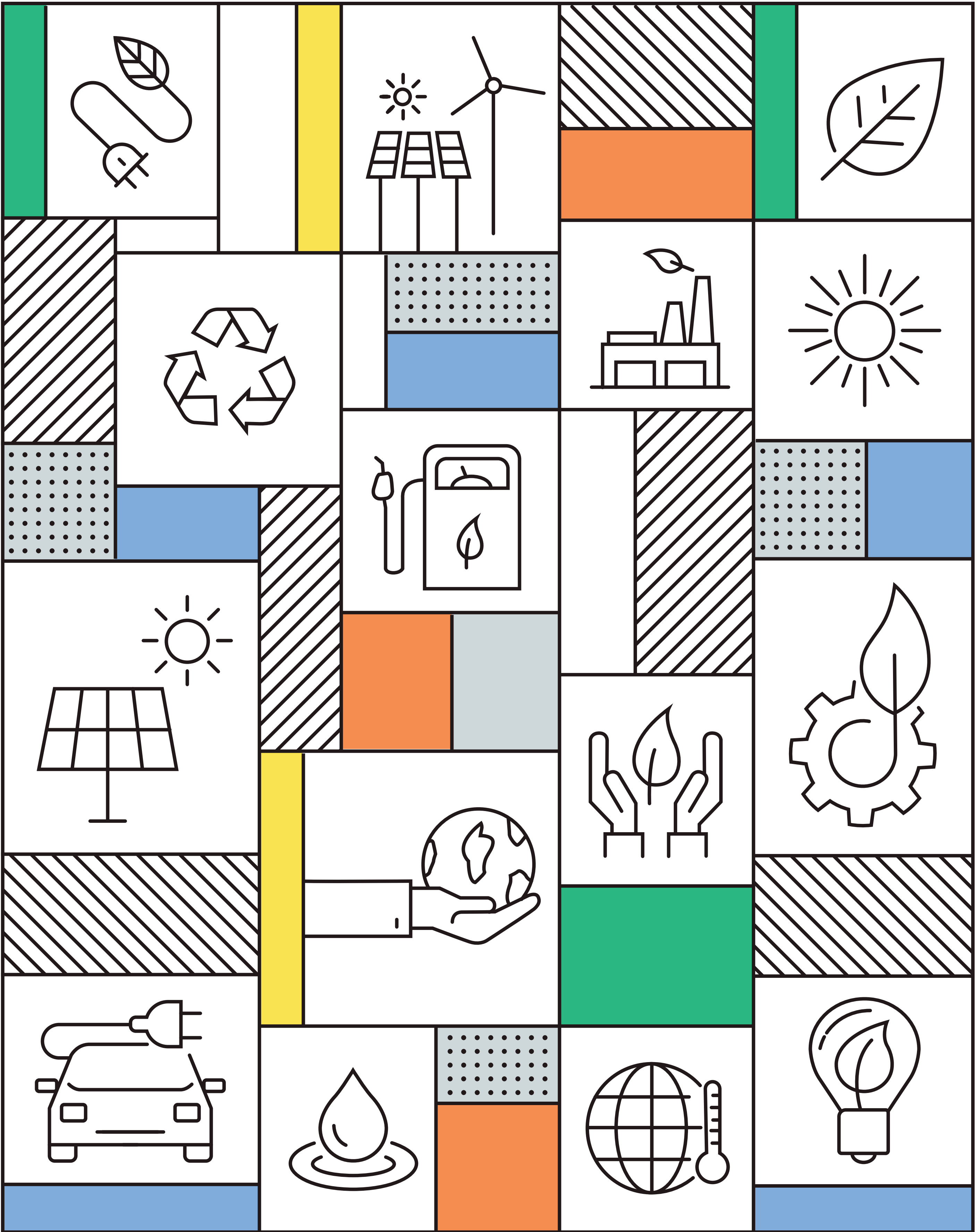

VIRTUOUS CAPITAL:

How to Measure Business's Contribution to Society

Annual budgets and sustainability reports provide some hints, but capital commitments are far more telling of a company's true character.

by Roger L. Martin, Alison Kemper and Rod Lohin

IT TURNS OUT, we've been looking in the wrong place.

For years, we've looked for more and more transparency about companies' environmental, social and governance (ESG) behaviour to help us better understand risk-mitigation strategies and even related opportunities. Given the lack of anything better, we've focused on annual reports, expense budgets and sustainability reports, looking for exposure to risks like climate change, lack of diversity or shocks like COVID-19. Ratings organizations like **MSCI** and **Sustainalytics** have appeared on the scene to collect and sell this data. Nevertheless, companies have still surprised investors, regulators and customers with unforeseen ESG — and fundamental core business — performance failures.

In this article we will argue that a company's contribution to society is most powerfully expressed by its capital commitments, or what we call its 'virtuous capital'. That is, a company's virtue is not adequately documented in its income and expense statements or even in its sustainability reports: Its commitment to virtue needs to be clearly evident on its balance sheet.

Annual budgets and sustainability reports indicate what is happening now and, at best, give a hint of what's to come. They may tout innovative sustainability projects or programs. They might even highlight strong performance in ESG ratings and competitions. However, they provide little information about sizable, long-term commitments to do things better — i.e. more sustainably or more equitably.

Capital commitments tell a different story — something far more central to what a company is and will be. As noted by Harvard Professor **Pankaj Ghemawat** in his book *Commitment*, companies are what they commit to do for years in the future

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through their allocation of capital. Companies use budgets to purchase the resources that improve processes, adopt better technology and reduce expense budgets. They lock in a company's production and operating choices for years to come. These commitments are 'sticky' — much harder to redirect than those in small, short-term budgets and projects.

So, instead of focusing on short-term projects and signals, we should look more to companies' capital budgets to understand their long-term sustainability-related commitments. We should look for the scale and the duration of their investments. Most of all, we should better understand alignment between the company's intent to be more virtuous and its capital commitments.

Exhibits A and B: British Petroleum and Statoil

The failure of former CEO **John Browne** to meaningfully transform **British Petroleum** (BP), the company that would go on to give the world Deepwater Horizon, illustrates the power of capital to make or break good intentions. Browne announced in a 1997 speech at Stanford's Graduate School of Business that BP had repositioned itself as 'Beyond Petroleum', arguing that "If we are all to take responsibility for the future of our planet, then it falls to us to begin to take precautionary action now." It was probably the boldest statement in this direction by a globally consequential company of the time.

On March 7, 1999, BP bought **Solarex** for $45 million, becoming the largest solar company in the world. While it publicized this as a giant step forward, careful observers noticed that it occurred a week after BP had spent $26.5 billion to buy **ARCO** to become the second biggest oil company in the world.

While Browne did invest capital into renewable energy sources that went beyond petroleum, his existing balance sheet plus the vast majority of new capital investment was stuck in traditional petroleum assets. His biggest capital asset by far was BP's giant treasure trove of proven and probable reserves.

Indeed, BP reduced its level of investment in new oil and gas fields immediately after Browne's speech. However, by the end of 1999, BP had returned to prior levels of spending to acquire oil and gas reserves. In 2000, the year it purchased ARCO, it booked more than $16 billion dollars in costs for acquiring oil and gas assets. In fact, BP's 1999 Annual Meeting was disrupted by **Greenpeace**'s demand that it cease investing in oil and start to develop its solar assets.

There is no doubt that transitioning Beyond Petroleum was an exceptionally difficult goal to achieve. Had Browne actually stopped investing in further oil exploration, he would have signalled that proven and probable reserves were no longer worth pursuing economically and therefore the reserves on BP's and every other energy company's balance sheet were worth much less than their indicated value. The result would have been a massive write-down of these 'stranded assets' — something too painful for Browne or any other oil and gas CEO of the time to contemplate.

While Browne's intent was apparently virtuous, BP's conventional oil and gas exploration investment program stranded its capital in oil rather than reflecting a shift beyond petroleum. Capital drove actions, including deep drilling for oil underneath the Gulf of Mexico — and will continue to drive its actions. BP's intent, rebranding and actions were simply not enough to turn the tide of its capital commitments, which remained focused on traditional petroleum.

Recently, new BP CEO **Bernard Looney** announced a plan to shift BP from an oil company to an 'integrated energy company'. BP publicly committed to cut oil and gas production by 40 per cent within a decade, stop exploring for fossil fuels in new countries and reduce emissions to zero by 2050 or sooner. However, of BP's $15.2 billion in capital investment in 2019, it had still only managed to shift three per cent towards renewables. As a result, to many observers the new plan sounds like a retread of Beyond Petroleum. BP's story shows that without the commitment of capital, a company's desire to achieve better social or environmental outcomes simply can't succeed.

Not all such stories end in failure. In 2017, **Statoil**, Norway's majority-state-owned oil company, stated its intent to shift 20 to 30 per cent of its assets to renewables by 2030. Like BP, it rebranded, calling itself **Equinor**. There is no doubt that state ownership gives it more flexibility to strive for virtuous objectives. Nevertheless, consistent with its promises, Equinor continues to explore oil and gas and at the same time work on investing in more renewables. For example, it has developed the capacity to store carbon in offshore wells, sold off oil fields in New Zealand and bought oil fields off the coast of Brazil.

It is inking deals to provide zero carbon electrical networks in the UK, and is acquiring permits to drill in the North Sea. It also purchased **General Electric**'s EV charging network, invested in **Chargemaster** (a company that provides both equipment and an EV charging network), **United Wind**, **Oxford Photovoltaics** and other solar and flywheel projects.

Its return on capital employed ('ROCE') is now at 17 per cent, up from 3.5 per cent in 2016. Its strategy appears to be to maintain a diversity of investments until it sees one becoming illiquid, as is the case in New Zealand's offshore oil. Its high ambitions and moderate commitment mean that it can attract shareholders and employees who favour divestment from carbon, but still maintain a revenue stream from its existing holdings and expertise in oil and gas. It hasn't overpromised, and it has delivered. Its capital matches its commitments.

How to Be More Like Statoil and Less Like BP

Investors and even some governments are signalling their interest in accelerating more companies to follow a more virtuous path by exploring new investment instruments, innovative ownership models, a range of new public policies and incentives, as well as pushing for better disclosure about virtuous capital commitments.

Following are four strategic categories to consider for leaders ready to take their organization in this direction.

1. RISK REALLOCATION: OPPORTUNITIES FOR FINANCIAL ENGINEERING

The capital markets are taking notice of companies seeking to shift to more virtuous business models and behaviour. In recent years, green bonds and other innovative debt instruments have helped fuel fast change. These bonds, issued by governments, private investment funds or sometimes directly by companies, can help companies finance their virtuous capital requirements.

Initially, as indicated by the name, green bonds have helped fund investments in environmentally sustainable technologies or processes such as renewable power or more efficient building retrofits. In some cases, they are offered with lower interest rates or more flexible terms in order to meaningfully lower the upfront cost of making the virtuous capital investment.

The green bond market has been rapidly growing, with another $257.7 billion issued in 2019 according to the **Climate Bonds Initiative**. Other related bonds (sometimes called Social Bonds, Sustainability Bonds, ESG bonds or SDG bonds) are also being offered for initiatives that have social or blended goals in mind.

Another option: While governments issue green bonds for capital projects, in many situations it might be more cost-effective to float loans directly to companies. A government could use its balance sheet to subsidize the cost of a corporation making a desirable investment rather than engage in the activity on its own. For example, it might be more efficient and cost effective for a government to provide inexpensive capital to a corporation to build and run a recycling operation than for the government in question to build and run the operation itself. The U.S. **Environmental Protection Agency** and many development banks worldwide use such a business model.

2. DIFFERENT FORMS OF OWNERSHIP: SPIN-INS, LOCAL CO-OPS, AND EVEN STATE-OWNED ENTERPRISES

High risk is an understandable barrier to any investment in innovation, whether virtuous or not. In the mainstream capital markets, institutional investors want profitable growth at the lowest possible risk. They would rather buy profitable growth at a premium — by having their investee buy profitable and growing smaller companies at lofty valuations — than having their investee invest directly in a risky and as-yet-unproven innovation. Nevertheless, investors are sometimes willing to accept moderate risks for promising projects, investing up front and securing opportunities for further investment (or even buyouts) later. One model that might be employed for high-potential social initiatives is 'spin-ins'.

This represents a new twist on the famous **Cisco Systems Inc.** 'spin-in' innovation pioneered by former CEO **John Chambers** in the mid-1990s. As Cisco grew from a start-up to a giant in routers and switching gear, Chambers realized that he had neither the capital structure nor the incentive structure necessary to make the risky kinds of innovative investments within Cisco that were being made all around him by Silicon Valley start-ups. So he sent a team of his finest engineers out of Cisco to create a start-up in a territory of interest to Cisco, funded entirely by Cisco. If they succeeded in creating a great product, Chambers would 'spin-in' the company by buying out the stakes of those

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former Cisco employees and bringing those employees and their successful innovation back into the fold. During a 20-year period, Chambers spent almost $3 billion spinning-in successful start-ups by the group. Outside observers commented that spin-ins were 'responsible for nearly every breakout product Cisco has ever had'.

Elsewhere, **Unilever**'s acquisition of **Ben & Jerry**'s has been characterized as a successful, if difficult, deal. Unilever bought the ice cream company not just to sell premium ice cream, but to gain the feisty little company's activist capabilities and social brand equity. Unilever has gone on to acquire other green companies, including **Seventh Generation**, a cleaning products company, and **Pukka Herbs**, a UK producer of organic tea blends, allowing it to enter new markets and shift some of its value chain into a more virtuous stream. Buying these companies has allowed Unilever to accelerate its movement into virtuous capital, benefiting from its acquisition targets' early risks and learning.

3. GOVERNMENT INCENTIVES AND SUBSIDIES

Governments can play a big and productive role in reducing the inherent risk by guaranteeing a market for the product of the virtuous capital investment. The German government provided a reduction in risk for renewable energy investors by offering 20-year contracts to pay a guaranteed tariff above the market price of as much as $0.574/kWh (in 2004) and as little as $0.0892/kWh (in 2014) for new projects generating up to 10 megawatts per year of renewable energy. This took the single biggest risk out of renewable energy investment. Put simply, the government guaranteed a market. Unsurprisingly, there was sufficient renewable energy investment to ensure that Germany would purchase all the desired demand. This, of course, also helped with the second duality by helping various German renewable energy producers get down the renewable energy learning curve, which helped create more successful German players in that emerging global industry (e.g. **CropEnergie**, the leading European manufacturer of sustainably produced bioethanol, and **Global Pvq SE**, a fast-growing small cap producer of photovoltaic cells and solar systems).

In addition, governments can use the tax code to lower the after-tax cost of investment by allowing accelerated depreciation for virtuous capital investments. Part of the high cost of capital investments is that unlike expenses, which earn 100 per cent of their tax benefit in the year of the expense, capital investments earn the tax benefit only slowly over time as the asset is depreciated or amortized. Fully accelerated depreciation, which for tax purposes treats a capital investment like an expense, lowers the after-tax cost of the investment by increasing the immediacy and therefore the value of the tax savings associated with it.

India has had accelerated depreciation allowances for wind power investments for many years, driving significant investment. It was not until the introduction of the **Jawaharlal Nehru National Solar Mission** in 2010 that solar power gained similar treatment. However, when the accelerated depreciation benefits were removed in 2012, new wind installations fell by nearly half and solar installations dropped as well (see **Figure One**). The government of Prime Minister **Navendra Modi** reintroduced both in 2014, allowing the country to exceed its targeted wind capacity for 2017. Similar drops have been seen in developing economies too, such as recently in Norway and Canada.

4. BETTER DISCLOSURE ABOUT VIRTUOUS CAPITAL

To date, understanding a company's virtuous capital commitments hasn't been easy. Most balance sheets do not yet clearly reveal which assets and capital expenditures relate to positive contributions to society or reduced risk to the environment (and which do not). Disclosure must also allow for appraising acquisitions and divestments of companies and technologies meant to drive profits in a more ethical or sustainable way. The accounting standards and regulatory requirements related to environmental risks and liabilities are still developing, led by the **Task Force on Climate-Related Financial Disclosures** and by a large coalition of academics and institutional investors actively petitioning the **Securities and Exchange Commission** for new rules that would make U.S. capital markets more efficient.

The answer to this fundamental challenge is clearer disclosure of capital commitments related to positive contributions to society and the environment. This will take clearer requirements by activist investors, exchanges and ultimately by regulators. Even rankers would like clearer information about capital commitments.

As **Kevin Ranney**, Director of Product Strategy and Development at **Sustainalytics**, recently said: "It would be great if investors and others could incorporate information about the sustainability implications of capital expenditure into their

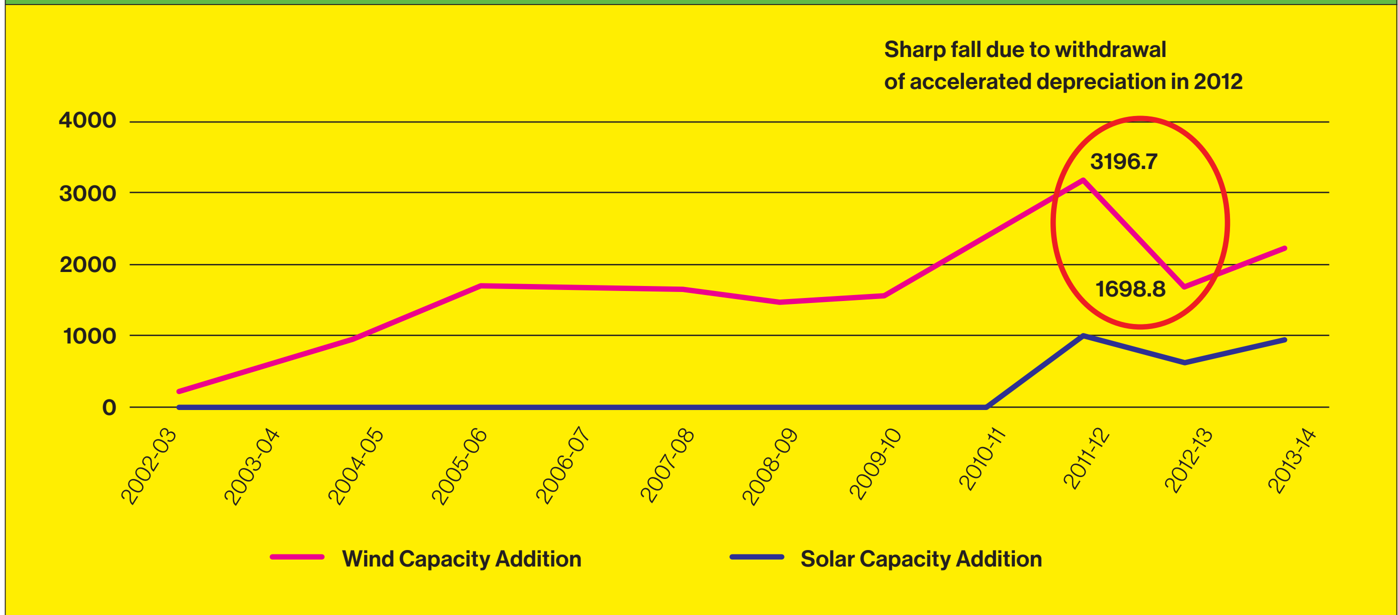


FIGURE ONE

analysis of companies." However, he also noted the difficulty of collecting this information in a systematic, comparable form across companies. Clearly, this is a challenge worth addressing.

The Evolution of Corporate Virtue

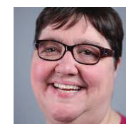
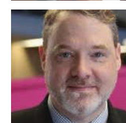
We believe that the corporate world and the world that it serves are ready for the next evolution of corporate virtue: virtuous capital. More than anything else, capital expenditures chart a company's path and prove that it is doing more than *saying* it's making a contribution — it's investing in it. This is the kind of proof that investors, regulators, consumers and even employees are looking for.

Larry Fink, CEO of **BlackRock**, the world's largest investment management company with $6.5 trillion in assets under management, has made this clear in a succession of annual letters to CEOs of the companies in which BlackRock has invested. He has clearly stated that he needs to know the long-term plan, the commitments and investments that each company is making. In his famous 2018 open letter to CEOs he wrote: "ESG risks are going to be a formidable component of investing over a sustained period of time. We want ESG risk management to be a tool that every manager is looking at as a reference point. We have to create the metrics for every company. I hope we are part of creating them; that's one of our ambitions."

Fink has since followed up with even more emphatic statements about BlackRock's commitments to sustainable investing — going so far as to sell companies that don't meet this standard.

In closing

Research by financial analysts and academics alike increasingly supports the notion that companies that behave virtuously (read: responsibly and sustainably) are more likely to succeed. These companies are more likely to make more meaningful positive contributions to society, generate stronger profits, positively engage government and other regulators, and generate more loyal customers and employees. In doing so, they satisfy the needs of more and more investors like BlackRock while helping to shape the world for the better. What could be more virtuous than that? ***RM***

Roger L. Martin is a Professor Emeritus at the Rotman School of Management, where he served as Dean from 1998-2013. His latest book is *When More Is Not Better: Overcoming America's Obsession with Economic Efficiency* (Harvard Business Review Press, 2020). He is currently ranked second on the Thinkers50 list of the world's most influential management thinkers. **Alison Kemper** (Rotman MBA '04, PhD '07) is an Assistant Professor of Entrepreneurship at Ryerson University's Ted Rogers School of Management. **Rod Lohin** is Executive Director of the Michael Lee-Chin Family Institute for Corporate Citizenship at the Rotman School of Management.