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New World Capital

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#04

Part 4 of 8

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NEW WORLD CAPITAL

By Max Drannikov

CFIO – FAST FORWARD 2035
INTRODUCTION

Business today is facing what is perhaps the greatest combination of challenges seen in a century. Capitalism is under attack, with confidence in the current economic system at an all-time low, and new laws and regulations on the horizon. Geopolitical changes, falling personal wealth, volatile resource markets, climate change and shifts in the centres of economic power will exert tremendous pressure on the future business environment.

While these international factors shape the global market, organisations also need to keep ahead of the increasingly fast pace of change in operating conditions. They are doing this by innovating at ever increasing rates – the average number of patent applications in the US rose five-fold between 1985 and 2009.[1] Adoption of these new technologies means the amount of data is exploding, with the number of servers expected to grow 10 times and number of files by 75 times over the current decade.[2] And the impacts of some technologies, such as social media, are only just starting to be understood.

What does the way the world is turning mean for today's CFOs? How can they prepare for this cacophony of change?

To start with, we think the CFO of the future will need to combine finance and information skills to become an executive who delivers valuable business intelligence. This new role will evolve into the chief finance and intelligence officer, or CFiO.

But the future for business is not so much about what the CFO will be called as about the external pressures that will impact their role – and how they will change their role.

[1] US Patent Office

[2] http://www.emc.com/collateral/about/news/idc-emc-digital-universe-2011-infographic.pdf

Tomorrow's CFiOs will need to be ready for the real game changers – what we see as the main pressure points that will shape the world of business in 2035.

Partly this is so they can ensure they are ready for the challenge; that they're suitably equipped to be able to engage with the brave new world that the coming decades will bring.

But it is also because we believe the mega trends we have identified will have a fundamental impact in shaping the role of the CFiO of the future.

Engaging with these trends can help build a better idea of how the business world will look in 2035, and how the changes between now and then will shape the CFiO's role.

Forecasting is a dangerous game. You may agree with our ideas; you may not. That's not relevant here. Our purpose is to get everyone thinking about the main ideas and issues that will create the global market of 2035, and to open the debate and encourage discussion around these topics.

We want you, our clients, to be involved in this debate. We want to be alongside you as you consider the areas your businesses will need to focus on in order to continue to be global leaders in 2035 – to consider how to negotiate the obstacles and make the most of the opportunities in order to guide your organisations to greater growth and prosperity over the coming decades.

In this, essay #4 in our Fast Forward series, we now look at another of those emerging trends; the creation of new, tradable markets as traditional capital becomes increasingly scarce.

In the period from now to 2035, capital faces a perfect storm of challenges. Geopolitical changes, aging populations, falling personal wealth, volatile resource markets and shifts in the centres of economic power will fundamentally change what kind of capital is raised, who it is sourced from, and how it is managed.

We have already started to see a shift in fund-raising patterns with corporates obtaining capital from providers outside traditional financing systems such as customers, suppliers, individuals and companies from non-financial industries.

While this trend will continue, I believe that the search for capital will spread out into new and exciting areas. As the post-industrial society finally comes of age, I believe that leading contenders as the new capital base will be people and ideas.

Employee share ownership that we see today will take greater hold as individuals' desire to have a bigger say in the organisations in which they work becomes aligned with these organisations' need for direct capital injections. In fact I believe that it will become so normal for employees to take a direct stake in their employers that non-employee shareholders will be in the minority.

But the more fascinating transition will be in the creation of the two related capital sources: human capital and intellectual capital. While these forms of capital do exist in today's post-industrial business world, until now companies have been unable to impute a value to them and grow their businesses using them as a foundation. This will change as companies realise that their pool of talent and ideas forms the most appropriate capital base for service economies in an environment in which more traditional sources of capital have dried up.

Human and financial drivers will come together to form a new return on employee capital model which will completely overturn the traditional value chain which the CFO currently oversees. As a result, the CFiO of the future will need to have a new combination of talent, innovation, investment and capital management skills in order to produce returns on capital for the employees and societies with which his corporation operates.

Capital crisis

The prosperity of the late 20th century is a thing of the past, and in the years between now and 2035 we can see that the world will face turbulent times. By 2035 regional wars, natural disasters and economic instability may well have drained traditional capital from all corners of the globe.

The spectacular growth in the global economy over the past 20 years will soon seem like a distant dream. This boom was made possible by, among other things, the unlocking of capital from emerging markets in China, India, the former USSR and Eastern Europe.

However, there is no obvious next wave of capital to be exploited to support the same quantum of growth enjoyed over the past two decades. Emerging giants such as China and India are reaching a new level of economic maturity in which the initial benefits of their opening up have been exhausted and the costs of their inputs, especially labour, move closer to those of developed economies.

The exploration of new natural resources will lag behind admittedly lower but still positive pace of growth, creating commodity shortages. Analysts forecast that prices of natural resources will be high and volatile over the coming decades as global demand continues to soar in the face of limited supplies.[3] In these circumstances the opportunity to invest in physical assets and natural resource reserves may no longer exist; these assets could well be locked up by sovereign investment funds and powerful corporates.

Companies are already starting to adapt to this new capital-scarce reality by turning to alternative sources of credit in a world where banks are reluctant to lend. Research from the Federation of the Small Businesses in the US has found that of the 15,000 financial institutions lending funds to companies, only half are banks while the other half are credit unions.[4]

Alternative credit and investment models are also starting to take hold in the UK. These platforms operate outside financial institutions to create marketplaces where companies have direct access to investors. Equity crowd-funding websites such as Crowdcube allow individuals to invest in businesses, while peer-to-peer lending exchanges such as Zopa and Funding Circle create a direct link between savers and borrowers. While these platforms currently only provide a small proportion of the funding business needs, they are becoming increasingly important. In fact Andy Haldane, head of policy at the Bank of England, recently suggested that peer-to-peer lending could replace high street banks as a source of business funding.[5]

Recognising the wealth generators

These general trends are taking place against the backdrop of societies made unstable by the economic crises of our day, with great swathes of populations left disillusioned by the western shareholder capital return models. These models often reward the stock

[3] A new era for commodities, McKinsey Quarterly, November 2011
[4] Non-bank lending on rise for UK SMEs, Financial Times, 9 April 2012
[5] Peer-to-peer lenders gain traction, Financial Times, 30 March 2012

EMPLOYEES WILL NOT BE REGARDED AS A CLASS OF PROPERTY "OWNED" BY THE ORGANISATION, A COMMODITY TO BE TRADED.

owners – individuals and organisations who generate their wealth in a passive manner by trading shares rather than by actively contributing to and adding value to a company. The reality is that employees are the real wealth creators, but the current shareholder model hardly recognises nor rewards this.

I believe that in the post-crisis period as we start to reassess the way in which the fruits of the capitalist system are shared we shall see a move away from what Marjorie Kelly has described as the "economic aristocracy", in which generating wealth depends on having wealth to invest, to a more democratic economic system, where reward is based on results.[6] This system will reflect the reality of the modern knowledge economy in which worker created intellectual capital is the only wealth generator. Employees will no longer see the results of their labour be expropriated by investors but will prosper based on their productivity and their contribution to the organisation's growth.

This movement will start with organisations reassessing how they think of their employees. Some already talk in terms of their employees as being their greatest assets. However only a few organisations, such as Formula 1 racing teams and UK Premier League football teams, recognise the capital value of their leading players. Instead financial statements all over the world categorise employees under costs. The implication is that staff act to reduce corporate returns – in a strict interpretation of a company's accounts, their presence can in a strange way be seen as working contrary to a business's profit motive.

I believe that this situation of seeing employees as a cost and not an asset will change. But it will not follow the Formula 1 example. Employees will not be regarded as a class of property "owned" by the organisation, a commodity to be traded. Instead they will be regarded as investors who invest their time, their energy, their knowledge and their intellectual capabilities to the benefit of the organisations they work for. This shift in attitudes will be accompanied by a more democratic and open form of corporate governance through which employees will be viewed as members of the organisation rather than outsiders who sell their labour to it.

Assigning a value to human capital

The re-assessment of the role of employees will lead to new capital models, the most exciting of which will be predicated on the return on employee capital. This revolutionary idea is that corporates will raise capital through their talent base.

[6] The Divine Right of Capital, Marjorie Kelly, Berrett-Koehler, 2001

By 2035 today's war for talent will have escalated and turned into a truly global conflict as traditional geographic boundaries are further broken down. The drying up of other capital sources combined with this global war for talent will see organisations unlocking the capital potential of their human and intellectual resources.

These sources of capital will be more appropriate to the post-industrialised world in which service providers create more value than the producers of physical goods. And, in the capital squeezed world of 2035, these models may be the only ones capable of attracting direct investment from an increasingly disenchanted populace.

The war for talent means that the fight to secure the services of the brightest and best will start before individuals start their careers. I believe that potential employees will be assessed for their future investment potential on the basis of their academic achievements. An investment grade will be allocated to them in the same way as it would be for a financial product, with future earnings cash flow used to determine future investment returns. Effectively this will work in a similar way to any other financial products – the only difference is that in this case the underlying product is the individual and their human capital. These new instruments will allow young talented individuals to trade their future earnings potential years before any return can be expected. Leading universities could even get in on the act, teaming up to create a unified rating standard that could convert academic achievements into investment potential grades.

These talent-based assets could be traded, either by existing investment firms, which have the tools and techniques to perform the valuations and execute trades, or by new entrants to the market. Employer companies may get in on the act, expanding their human resources functions to deal in these financial products directly.

Trading places

Whatever form these products take, marketplaces will spring up in which these products – people's services – are traded. Although some forums for service providers exist today, they are non-value based. The true innovation will be in service providers having individual ratings, a "mini-Moody's", that enable them to better reflect the value that they can add to organisations and therefore to trade their services better.

These services can be traded externally or within the corporate environment if people prefer. In time there may even be a move towards derivate products based on service providers, so the individual can effectively

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repackage their capabilities. However this works out, the main point is that service providers will have direct access to a return based on their contributions to the business.

The issue of how people fit into this idea needs careful thought. On one side, individuals do not want to feel that they are tradable assets. On the other, this model gives individuals a greater sense of involvement in the final result of their work. It can make labour more mobile and dynamic – something that is particularly relevant in the age of nano-corporates and pop-ups.

Just as markets will arise for human capital, they will also evolve for intellectual ideas. There are a number of examples of these online collaborations from a network of experts, and although they are currently not the norm the trend towards greater collaborations is clear.

People with ideas want to deal directly with the organisations that want to use their innovations, and vice versa. This concept leverages on the democratisation that was promised by technology, particularly the Internet, in connecting people directly so that a greater share of the value created would go to those responsible for it.

This diversification of resource pools means that even more than today, the CFiOs will need to be able to play on the international arena, for example with technical resources from emerging markets with strong academic institutions and management expertise from western economies. This could potentially lead to the creation of a global market in ideas that could be run through new democratised means.

Taking a stake in the business

In the future, employees will be able – and indeed expected – to invest in their own companies directly; if they don't have investment funds they will earn the ownership of their companies on the basis of "value created". The methodology for measuring this created value at individual employee level will require careful and creative thinking and the future CFiO is likely to be the person leading this.

The challenge for the CFiO will be in setting rewards that are more clearly linked to the value creation model. Organisations will need to have a much more transparent system with a value hierarchy which makes it clear precisely how value gets created by all members of the firm, from shop-floor workers to the executive board.

Organisations will need agile models with lightning speed decision-making processes to arrive at speedy valuations in a transparent and democratic manner so that employees understand the assessment of value created and how this value is being assigned to them.

The uptake of social media within organisations means that the process will be self-regulating and so more likely to be trusted – vital in an era in which business and finance will be struggling to regain stakeholder trust.

Nano-corporates come into play here as having the right knowledge base in a basic core structure can enable organisations to grow beyond their core business, creating pop-ups in an opportunistic way to take advantage of fast-shifting market circumstances.

An employee ownership model is already followed in some limited liability partnerships and, most famously in the UK, at the retailer John Lewis. I believe that the model has not been followed by many other organisations because over the past two decades of high growth vast amounts of capital have been unlocked internationally through the collapse of previous command and control economies or major advancements in technology. This capital has been "used" and there is not an obvious replacement. In addition financial institutions' value-creating models are being heavily challenged through the financial crisis and will be much less efficient due to post-crisis overregulation.

New world capital for a new global age

In the years leading up to 2035, I believe that there will be a major shift in the understanding of capital – what comprises an organisation's capital, how it is sourced and how it is managed.

Fundamental to this shift will be a new approach to employees. No longer will they be viewed as expense items, as costs that sit heavy on the business. Instead they will be seen as part of the essential asset structure of a service-based economy in which intangibles rule the roost and fixed assets are increasingly seen as embarrassments.

New world capital will be a truly global phenomenon, leveraging on the battle for talent and ideas that is spreading across the international stage. It will demand a new level of transparency between investors and firms. This will depend on new technologies that can respond to lightning speed changes and can transmit them in a democratic way through emerging social media platforms.

Future CFiOs have a fantastic opportunity to lead their organisations in redefining the future new capital agenda. To best understand and exploit this, these executives will need a new combination of talent, innovation, investment and capital management skills – and the imagination to be innovators in the ongoing battle for capital and growth.

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ON THE RIGHT TRACK?

Questions to reset your assumptions

- [ ] Have you ever raised capital from providers outside traditional financing systems such as customers, suppliers, physical or legal entities from non-financial industries?
- [ ] As the post-industrial society finally comes of age, what share of future capital will be coming from your employees and their ideas?
- [ ] Do you measure the future value of your current pool of talent and ideas?
- [ ] Does the phrase 'Employees are our main Asset' feature in your annual report, or corporate value statement? If yes, how do you measure their return to the company, and how do you assess the corporate return to them?
- [ ] Do you believe that knowledge is a 'proper' capital asset in a post-industrialised world and do you manage it accordingly?
- [ ] Do you believe we will be running low on 'traditional capital' in 2035 due to regional wars, natural disasters, and lack of new sources of traditional capital?
- [ ] In 2035, do you envisage your employees being accounted as a P&L Cost or Balance Sheet Asset?
- [ ] In 2035, can you imagine post graduates converting their academic achievements into financial products that will give them necessary capital boost at the beginning of their careers?
- [ ] Do you believe that in 2035, that every employee from CEO to the most junior member of staff will be rewarded on the basis of value created?

Biography

By Max Drannikov

In 2012, I worked for KPMG in the UK in the Management Consulting practice. I worked with my client CFOs in helping them manage their drive towards efficiency and effectiveness whilst balancing the regulatory pressures of the industry... exciting!

Today, in 2035, I am the head coach of KPMG's newly established Talent Investment Management Team.

My team consists of a small number of permanent staff who help clients to cut through complexity of New World Capital. They are supported by a group of highly skilled freelancers. We buy a share of the freelancer's time on the market based on their skills and the talent investment grade. They are typically a group of highly motivated individuals who are remunerated on the basis of the agreed percentage of the Value Earned. This allocation is decided by the entire team vote via our social media style portal called Capital(IS)US, which is directly connected to our HR and payroll systems. Each member of the team has their unique Asset number; sometimes I still make a slip of the tongue and call this a Payroll Expense Code, which amuses my team as if they saw a car which still has a petrol engine next to the electric one.

Once the project is over and a new one is on the horizon, I need to go back to the transfer market in order to rebalance my team: to sell the skills I no longer need and to buy the talent required for my next engagement. In fact, I have just finished a transfer deal for my most valuable crowd-funding expert, Frenchman Hugo Prost and swapped him, indeed with profit, for the German Talent Exchanges set-up guru, Dr. Hendrik Koffman.

We are extremely busy as our clients – CFiOs, are facing unprecedented complexity in balancing the shortages of old world capital against the fast growing market for talent investments and democratisation of corporate models. But something gives me a lot of confidence in the future for myself and my clients, perhaps because I believe there is a quantum of growth ahead of us, but more importantly that I have the A-team*, that is the best-experienced and motivated team in our new and exciting world!

* The A in the 'A-team' in 2035 stands for 'Asset'.

Contact us:

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