

Keynote Speech Donald Kalff

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It is a privilege to stand in front of you. As you might have seen in the invitation, I spent part of my formative years in the US, and I am presently a senior fellow at the Wharton School. This puts me in the enviable position of providing Americans with a European perspective and introducing Europeans to American thinking.

You might also have seen that over the past seven years, I have drawn attention in books, articles and presentations, to the ugly side of capitalism, and I have put forward proposals to make true capitalism more resilient to financial capitalism. I have also consistently challenged Dutch and European policies to improve their competitiveness.

Tonight I would like to draw your attention to an issue that is particularly close to my heart: the attacks on both sides of the Atlantic on the enterprise.

In particular, I think the time has come to issue a warning that enterprises that operate in the Netherlands are subjected to more, and more conflicting, pressures than their competitors in the US and elsewhere in Europe. This has nothing to do with the lively public debates initiated in this country by a well-educated and critical population. Rather, these are pressures that influence the way Dutch-based companies conduct their business in a profound way.

I will conclude my contribution tonight by pointing in a different and more productive direction.

Let me, by way of introduction, first share my views with you regarding entrepreneurship, in the hope of course that you will find my perspective appealing.

Modern complex societies cannot thrive without their institutions, ranging from the judiciary to the elementary school and from the hospital to the social security system. Each institution is properly legitimized, both culturally and in law. I see the enterprise as another indispensable institution. The entrepreneurs among us have taken on the unique assignment to create economic value.

In doing this, they deserve our support. They are the cornerstone of our economy, and it is good to remind ourselves that the achievement of our social and political aims depends on the surplus that creative and committed entrepreneurs generate. Entrepreneurs are a special breed. They cannot resist the temptation to seize opportunities that are apparently not seen by others. Of course, the days are over when a single bright idea will carry the day. By and large entrepreneurs integrate tested technologies into products and services that add to the value creation process of the customer. In doing so, they are keenly aware of their dependence on the professionals and craftsmen who form the backbone of their organization. Modern entrepreneurs are team builders. In building their enterprise, they rarely focus on their private wealth. Most of all, they treasure the independence of their enterprise, which is required to survive and prosper in a complicated world. They build their enterprise for its own sake, and they take pride in what they are doing.

Ryanair and Southwest Airlines are using the same aircraft as their competitors, the network airlines such as Air France-KLM and Delta, but they are able to build far more efficient sales, operational, and maintenance organizations by offering their customers a product that is totally different from the product of the established airlines. They have revolutionized both the leisure and the business markets through superior insight into their customers' true priorities.

Moreover, modern entrepreneurs are highly sensitive to the conditions that have to be met before a product can be launched.

The commendable efficiency of Ryanair and Southwest Airlines and the appeal of their products would still not have been enough to unsettle the likes of Air France and Delta had they not tapped into the opportunities offered by regional airports and regional authorities, whose financial incentives often made a crucial difference in adding destinations.

Truly advanced entrepreneurs like IKEA and Apple go two steps further by co-designing the production processes of their suppliers, and by co-producing the final product with the help of their customers. In the case of IKEA, customers take on the most expensive part of the distribution chain and generally enjoy assembling the product. In the case of Apple, customers can personalize their iPhones and iPads, which makes the proposition far more valuable.

That's the good news.

The truth has to be faced, however, that many large companies on both sides of the Atlantic, with notable exceptions, have lost their entrepreneurial zeal. It is estimated that in the US only six percent of total revenues are generated by new products. In Germany, this percentage is eight.

It is also a fact that the growth engines of modern western economies are in dire straights. The large and expanding financial services industry has taken a tremendous battering, bringing the housing industry down with it. Retail is shaky. The pharmaceutical industry, once the most promising sector of all, is in disarray and Internet companies, despite the largest customer bases that have ever been created, still rely on fickle advertisers to make ends meet and have yet to demonstrate sustained value creation.

This is puzzling since large companies employ the best and the brightest, they sit on impressive piles of cash, they control the distribution and marketing channels of the world, and they can allocate production of their products at will. Furthermore, they own most of the intellectual property that the world has generated, and eighty percent of world trade consists of deliveries between subsidiaries of large companies.

This is even more puzzling in the United States, where companies benefit from the most benign business environment imaginable. There is no American politician that is not deeply committed to free enterprise. The United States is home to the best universities and the most productive scientists in the world. Capital markets are deep and highly sophisticated. The labor market is extraordinarily flexible. American companies operate in a large, homogeneous market for products and services. They can rely on a single legal system, and business can be conducted in one, maybe two, languages. This contrasts sharply with their European

competitors who still face considerable barriers selling services across borders, and have to cope with twenty-seven markets and legal systems and almost as many languages.

Of course, the analysis of competitiveness is bewildering in its complexity, let alone trying to improve it, but we are so involved in this process that we have lost sight of the foundations of the way we conduct our business. It is in this arena that I wish to make a contribution.

Something is holding us back. We need an explanation as to why we are not much further ahead than we are. Why are we stuck with dismal growth rates at a time when we can build on simultaneous technological revolutions in IT, in energy efficiency, and in biotechnology a treasure trove that is unrivalled in history. I sense that our statistics present the sum total of impressive value creation, to a large extent undone by value destruction.

I contend that the two enterprise models that prevail in the Western world, the Anglo-Saxon, or shareholder model, and the European or stakeholder model are both undercutting entrepreneurship, albeit in very different ways. Both models are based on distinctive world views that crystallize into different but internally consistent forms of governance, management, organizational structure, decision making, and remuneration. These models are part and parcel of the business culture on both sides of the Atlantic, and are supported and defended by powerful parties with a considerable interest in their survival.

There is no hope that I can summarize the contents of the two books that I wrote about this subject, but let me give you an example of a serious flaw in each of the two models.

Let's look at the shareholder model first.

Whereas in the past American companies enjoyed a highly symbiotic relationship with the stock market, a transparent mechanism to bring the supply and demand for capital together, the ground has shifted.

The enterprise has been put into a straightjacket by investors, investment bankers, stock traders, strategy consultants, financial analysts, and the financial press. They find it inconceivable that companies can be managed in any other way than the Anglo-Saxon way. Only believers in the system can be appointed to positions of high responsibility.

The pursuit of shareholder return on investment, nothing more and nothing less than the increase of the stock price over the shortest period of time corrected for dividends, has become the dominant objective for listed companies.

In addition, the consensus among these special interests is that a persistent, preferably double-digit growth in profit per share will cause the stock price to go up.

By bowing to these pressures, enterprises incur considerable damage. The first problem is that the stock price no longer reflects the value of the enterprise. The efficient-market hypothesis that stipulates that the stock price reflects all that is known about the company and its future prospects, and is therefore a correct and just reflection of the value of the company, has been invalidated by the stock market booms and busts of 2001 and 2008. With the stock market producing the wrong signals, corporate initiatives and capital are misdirected.

Moreover, the link between profit per share and the stock price is at best tenuous, and declared dead by reputable firms like Deloitte and BCG. Yet, many remuneration packages are tied to profit per share, and management has, on average, four years to put their stamp on the company and cash in. Given these constraints, they can be forgiven for concentrating on the optimization of a ratio, profit per share, rather than being entrepreneurial and bringing the company to a structurally higher plain by investing in people, plant, and partnerships. In optimizing a ratio, first-grade math dictates the engineering of the decrease of the denominator in the form of stock-purchasing programs. In addition, an increase in profits in the short and medium term is only possible by cost-cutting and mergers so as to cut more costs at the expense of investments that can take years before they contribute to the bottom line. No one can tell how many opportunities are wasted because of this mechanism.

Let me now look at a fundamental problem with the stakeholder model.

It sounds appealing enough to ask the enterprise to take the interests of all parties that are affected by its actions into consideration. The problem is that we live in a world where all interests organize themselves to increase the pressure they can exercise. Recognition is the name of the game, with the ultimate aim to become embedded in policy-setting processes. When circumstances change and the interests erode, they have every reason to hold on to positions of power on behalf of their dwindling membership but also on behalf of the good offices of the interest group and the ambitious professionals who occupy the group. At the same time, room must be found for newcomers. In short, special interests tend to accumulate. The history of trade unions in this country is a case example. Fifty years after trade unions, employers associations, and the Dutch government came together to lift the country out of its post-war economic misery, the unions, deeply embedded in policymaking at all levels, still exercise considerable leverage despite a much reduced membership. Meanwhile, white collar unions and even unions for mini-entrepreneurs have entered the scene and have fought successfully for their place in the sun. Just as an aside, unions pretend to be more moderate than they actually are. The rule of thumb that companies can afford wage increases in line with productivity improvement and inflation assumes that market forces will not erode margin increases, and that price increases can be passed onto the customers

Moreover, special interests have two cards to play. They can play the company card and the regulatory card. The first game is fair enough, because special corporate circumstances can be taken into account in forging compromises. The regulatory card is more harmful, since incidents lead to calls for an investigation that is bound to unearth more cases which then give rise to demands for regulation and, of course, the monitoring of compliance. So-called iron rings are forged, linking special interests to specialist civil servants and specialized parliamentarians. The influence of knowledgeable and committed minorities is large, and at the end of the day the enterprise is encumbered by regulation that is only partially relevant, if at all.

These are two examples, among many, that both models constrain the enterprise from reaching its potential. Future possible cash flows are sacrificed to serve special interests. This is an insidious process, since unrealized cash flows do not show up in corporate accounts.

Both models also have in common the fact that nobody looks after the interest of the company as a whole. For all intents and purposes the enterprise becomes an orphan. In my view the enterprise should not be the fiefdom of the shareholder. In my view the enterprise cannot fall

victim to its stakeholders. The enterprise is a working community, not a community of interests. It would be in our interest to treat these communities with more respect.

I now arrive at my observations about the Netherlands. Apart from the UK, we are the country in Europe with the strongest Atlantic orientation. This is repeatedly visible in our foreign policy choices but also noticeable in the way we conduct business. On the other hand, we have an impressive tradition of accommodating very different interests, and the stakeholder model and the so called 'polder' model have common roots. It is here that two serious threats manifest themselves. With companies exposed to both shareholder and stakeholder pressure, the burden on management to justify corporate policies becomes heavy, and the risk of alienating either or both stake- and shareholders becomes significant.

Also, no matter how much criticism can be heaped on the shareholder and the stakeholder models, the internal consistency of these approaches is undeniable. As consensus seekers or opportunists, the choice is yours; Dutch managers are tempted to look for the middle ground by deriving appealing features from both models, while running the risk of ending up with the worst of both worlds.

Let me finish by offering an alternative direction which helps to underscore the economic reasons for setting the enterprise free from special interests.

If the legitimacy of the enterprise is the creation of economic value, the obvious questions that follow from this are: Where, how, and by whom can destruction of value be prevented and additional value be created?

I see four different sources.

The first source is the preservation of operational integrity, along with the quick and cost-efficient reduction of damage when the unpreventable occurs. It turns out that organizations, and not just people, can improvise. When an aircraft develops a technical problem and is delayed, the ripple effect throughout the airline's operations during that day is dampened by sensible steps in many different corners of the organization.

A second important source is productivity improvement, or, more precisely, what economists call multifactor productivity improvement. Due to an ill-understood combination of formal and informal rules, and formal and informal communication, departments improve efficiency year after year after year. The two-hundredth aircraft of a particular type is built much faster than the twentieth plane, without any additional investment.

Improving in both domains helps the company to realize its economic potential. This is the world of the much-underestimated operational manager.

The third source is then the increase in corporate economic potential. This is the world of investments in people, in cooperation, in tangible assets, and in partnerships, and also investments in product improvement, and in the development of markets for existing and improved products. This is the world of the general manager, who not only makes decisions, but who also keeps an eye on their implementation, a phase during which much value is destroyed or preserved.

The fourth source is the entrepreneur who exercises his best judgment as to the composition of the product portfolio, who adjusts the organizational structure if and when required, and who perpetually improves the quality of decision making throughout the organization. On that basis, he can identify and appoint the best general and operational managers. Finally, he is the one who decides on the financial framework and makes sure the company is properly financed at the lowest possible cost.

Building an enterprise that can generate economic value on a sustained basis takes years. It is a highly subtle game, whereby newcomers need to be integrated, division of tasks and responsibilities need to be formalized bit by bit, and the lessons learned need to shape future decision making. It takes time for informal networks to grow so as to smooth the path to effective and efficient operations. The result is a "Gestalt," a social system, whereby the elements derive their meaning partially from their connections with other elements, and whereby the whole is more than the sum of its parts. To tap each of the identified sources of economic forces, a rich and comprehensive picture of the organization's capacities and the markets is required. Only then can interrelated problems and opportunities be tackled by a coordinated set of actions.

It follows that, for the sake of value creation, each and every company needs to follow its own developmental path and that the pressure to benchmark comes at a high price

Another consequence of this view is that the company is inherently unknown to the outside world. This helps to explain why it takes so long before newcomers feel at home and start to make meaningful contributions. It also explains why consultants are so ineffective in fostering change, and why eighty percent of all mergers and acquisitions end in failure.

This is why shareholder and stakeholder influence both need to be curtailed. A little bit of knowledge is a very dangerous thing to have. Shareholders and stakeholders are not in a position to gauge all the consequences of the concessions they obtained from the entrepreneur and his organization. They take what they can get and cynically leave it to the enterprise to pick up the pieces.

Social and political forces are far too feeble to counter the pressures by the many who have an interest in the status quo. Only economic forces will be strong enough, and there is nothing better than independent and therefore well-functioning enterprises to show the way.

