Social capital: a new strategic play for investors

Most investors are unaware that social media is ushering in a social capital revolution, and that this will change the underlying risk and growth profiles of companies

By **Barbara Gray**

Social media is leading to the creation of a new form of appreciating equity called social capital. This will accelerate the value creation/erosion process for companies. As a result, investors need to start looking beyond traditional quantitative analytical and valuation metrics. When they do, they will find that so-called 'heart and soul' stocks offer long-term strategic investors a good play on the appreciating value of social capital.

Social capital is the new and appreciating equity

Social capital has four investment characteristics:

- Liquidity - Facebook, Twitter and LinkedIn are global, dynamic, 24/7 social exchanges that convert a company's stakeholder relationships into highly liquid assets and/or liabilities called social capital.
- Time horizon - social capital is a new form of equity that will appreciate in value as Facebook, Twitter and
- LinkedIn's user bases continue to grow, new social exchanges such as Google+ emerge and corporate penetration and usage increase, and the number of user connections within and between the exchanges grows.
- Regulatory and legal - social media provides concerned citizens with a platform to self-organise, increasing their bargaining power to push for regulatory and legal changes and reform.
- Unique characteristics - social media empowers the individual with a platform to influence, expose and disseminate.

Social media is still in its infancy, as both corporations and individuals have yet to realise the full potential of social exchanges. According to a report produced by the Centre for Marketing Research at the University of Massachusetts Dartmouth, entitled *The 2011 Inc 500 Update*, currently 74% of Fortune 500 companies are on Facebook, 73% are on LinkedIn and 64% are on Twitter. Individuals are just starting to 'like' and 'follow' companies on Facebook and Twitter, and are discovering this new way to interact with them.

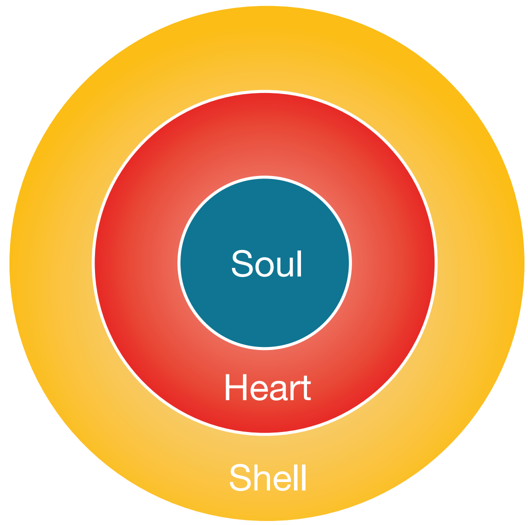
However, investors should be wary of looking exclusively at metrics such as the number of 'likes' on Facebook or the number of followers on Twitter. As companies ramp up their social media marketing efforts, many are creating artificial social capital by resorting to deals/discounts, contests/sweepstakes and marketing campaigns to incentivise consumers to 'like' them in order to grow their customer base. Although a company may appear to show a high level of growth in its social media metrics, what matters in the end is the authenticity and strength of its relationship with these customers. Investors should look at a company's quantitative metrics in conjunction with qualitative factors such as sales tactics, brand enthusiasm and community engagement.

The social revolution is upon us

The concept of a social revolution is not as radical as it may first appear. For instance, *Time* magazine recently named "The

This article is sponsored by the Intangible Asset Finance Society's Secretariat and is an extension of the discussion held at the Society's Mission Intangible monthly briefing of 3rd February 2012. The objectives of the Society (www.iafinance.org) are to increase the visibility, transparency and value of intangible assets through education, advocacy and the promulgation of standards. IAM *magazine is the media partner of the Society. In each issue,* IAM *magazine publishes a contribution from the Society on a noteworthy intangible asset finance matter.*

Table 1. **Layers of a company's stakeholder relationships**



Protestor" as its Person of the Year 2011. And as evidenced by the rapid expansion of the Occupy Wall Street movement around the world and the recent Stop Online Piracy Act online protests, social media allows grass-roots movements to build momentum at a level of intensity and pace never witnessed before, and greatly increases their clout and bargaining power. It is to be expected that consumer advocacy groups, environmental and human rights activists, and other concerned citizen groups will start to employ social media to apply unprecedented levels of pressure to bring down the heads of government agencies and organisations, and succeed in pushing through changes to laws and regulations.

In the words of US economist Milton Friedman: "There is one and only one social responsibility of business - to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game." However, social media is changing the rules of that game so that companies can no longer risk taking this advice and focus solely on maximising value for shareholders at the expense of their other stakeholders. As Michael E Porter and Mark R Kramer proposed in an article entitled "Creating Shared Value" in the January-February 2011 issue of the *Harvard Business Review*: "The purpose of the corporation must be redefined as creating shared value, not just profit *per se*. This will drive the next wave of innovation and productivity growth in the global economy."

Social media is the catalyst for the social revolution. That social revolution will lead to an increase in legal and regulatory reforms, which in turn will erode the economic moats of companies whose competitive advantage is derived from exploiting constituents in their stakeholder base. This will increase their risk profile, reduce future growth opportunities and result in the creation of negative social capital. A company's negative social capital with its stakeholders is an intangible liability that, unlike goodwill, does not show up on the balance sheet. However, from a discounted cash-flow valuation perspective, the simultaneous increase in a company's assumed discount rate and decrease in its expected growth rate will lead to a negative multiplier effect and contraction in the company's value. As a result, investors should adopt the principle of socially responsible investment and start looking at extra-financial issues such as environmental, social and governance (ESG) risk factors.

Look for companies with heart and soul

On a more positive note, the social revolution will foster a new source of competitive advantage for 'heart and soul' companies whose business strategy is focused on building higher levels of social capital for their stakeholders. These heart and soul stocks offer long-term strategic investors a good play on the appreciation of social capital over the next decade.

As shown in Figure 1, companies can be

visualised as having up to three layers - all companies have an outer shell, some have a heart and a select few have both heart and soul:

- Shell - the basic outer layer of a company is its shell, which represents the utility value proposition (financial and functional elements) that its product or service offers to stakeholders.
- Heart - some companies go one level deeper and have heart, which represents the emotional connection that stakeholders have with the company's brand.
- Soul - the companies with the deepest level of stakeholder relationships are those with soul, which represents the strong psychological attachment that stakeholders have for the company's greater purpose.

Chipotle Mexican Grill (CMG-NYSE), lululemon (LULU-NASDAQ), Starbucks (SBUX-NASDAQ) and Whole Foods Market (WFM-NASDAQ) are examples of companies with heart and soul, as they each meet the following criteria – the 'Four Cs':

- Conception – the founder planted the seeds for the movement inspired by a greater purpose and conceived the company through passion.
- Core values – the greater purpose leads to a more authentic set of core values that serves to better guide the company.
- Community – the movement attracts a community of cult-like followers from individuals who believe in its greater purpose and are seeking to align their values with those whom they buy from, work for and do business with.
- Cultivation – the organic growth strategy preserves the cultural DNA and further strengthens the strong stakeholder foundation.

Conception

What differentiates a heart and soul company is its origins: the founder planted the seeds for the movement inspired by a greater purpose and conceived the company through passion. As the heart and soul company is imprinted with its founder's DNA, 'nature' is a key influencer.

In 1980 John Mackey planted the seeds for his Whole Foods Market movement, inspired by the mission to "help support the health, well-being, and healing of other people and the planet". In 1987 Howard Schultz started his Starbucks movement to "inspire and nurture the human spirit – one person, one cup and one neighborhood at a time" by buying the six-unit coffee shop chain from its founders. In 1993 Steve Ells began Chipotle Mexican Grill inspired by the simple philosophy that food served fast need not be a traditional "fast-food experience"; this vision has since evolved to change the way that people think about and eat fast food, guided by his mission of "Food With Integrity". In 1998 Dennis Wilson, inspired to "create components for people to live a longer, healthier, and more fun life", started his lululemon movement.

So although competitors may attempt to 'nurture' their companies by copying companies such as lululemon or Chipotle Mexican Grill, their efforts will not be successful, as they are missing the 'nature' element: their original DNA. The unique DNA and greater purpose of a heart and soul company create an enduring, non-replicable intangible asset, which results in a wider economic moat.

Core values

While all companies tout their core values, many of the core values cited are generic and inauthentic, as they do not reflect the reality of what the companies do and how they actually operate and treat their various stakeholders. However, the greater purpose of heart and soul companies leads to a more authentic set of core values that serves to better guide them. The differentiating element in the list of values statements for heart and soul companies is how original and descriptive they are in articulating their core values, and how many of the core values go to the greater purpose or soul of the companies and speak to the interests of all stakeholders.

Community

The greater purpose and authentic core values of these heart and soul companies attract a cult-like following from people who believe in the movement's greater purpose and are seeking to align their values with those whom they buy from, work for and do business with.

Cultivation

In order to preserve their cultural DNA, most heart and soul companies make a conscious strategic decision to maintain control over their operations. They achieve this by pursuing a business model of corporate-owned stores as opposed to franchising. In addition, they elect to grow mainly through organic means rather than by acquisition.

How heart and soul create value

The highly authentic and strong stakeholder

Action plan A

Heart and soul stocks offer long-term investors a good play on the appreciating value of social capital. This is because:

- The strong and authentic stakeholder foundation of a heart and soul company will convert into a high velocity of social capital as the company leverages the enthusiasm/deep psychological attachment to its brand/greater purpose.
- Social media will accelerate the value creation process for a heart and soul company by serving to lower its risk profile and act as growth catalyst for the company to drive sales productivity, expand geographically and launch new concepts.

To identify a company with heart and soul, investors need to ask whether it meets the following criteria - the 'Four Cs':

- Conception – a greater purpose?
- Core values – authentic core values?
- Community – cult-like followers?
- Cultivation – organic growth strategy?

equity of heart and soul companies will prove to be a highly valuable asset now that the social revolution is upon us. With the new social media platforms, heart and soul companies will be able to fully capitalise on their existing authentic and strong stakeholder relationships by leveraging the high level of enthusiasm and support for their brands and their greater purpose. The increase in the flow of knowledge between the companies and their stakeholders will work to improve access, learning and trust between participants, attracting new customers and strengthening relationships with existing customers and its other stakeholders, and will further advance the movement.

Social media will accelerate the value creation process for heart and soul companies by serving to reduce the risk profile and act as a growth catalyst for companies to realise the following three opportunities:

- Grow comparable store sales – social media will act as a catalyst to drive sales productivity by increasing loyalty from existing customers and attracting new customers while reducing the following risk factors: economic, pricing, commodity price, consumer trends, environmental and product liability, regulatory and technological.
- Expand geographic footprint – social media will act as a catalyst to accelerate grass-roots marketing initiatives by leveraging existing stakeholder networks to create a positive network effect to attract new customers, employees and business partners in the markets they are looking to expand into, while also serving as an intelligence source to reduce the risk of development.
- Launch new concepts – social media will allow heart and soul companies to leverage their existing strong stakeholder relationships to introduce and launch new concepts while the dynamic 24/7 two-way conversation flow serves as a valuable feedback loop.

From a discounted cash-flow perspective, the simultaneous decrease in a company's assumed discount rate and increase in its expected growth rate could lead to a positive multiplier effect and expansion in its value.

A socially conscious play on companies with a greater purpose

In addition to attracting attention from strategic long-term investors looking to play the appreciation in social capital, investor demand for heart and soul stocks will increase among institutional investors with a socially responsible investment mandate and individual investors seeking alignment with their personal values.

Heart and soul stocks offer an attractive investment opportunity for institutional investors with a socially responsible investment mandate. Instead of just focusing on socially responsible investment from a fiduciary or social change perspective, and screening out the companies that fail the ESG criteria and generate negative externalities, it makes sense to start looking for companies with a greater purpose using the 'Four Cs' criteria. Heart and soul companies are an ideal fit for socially conscious investors, as they have a greater purpose beyond profit, a set of authentic core values that will serve to guide them and a balanced stakeholder network. They contribute positively to society and create positive externalities, as they are desirable employers, are actively involved in making their communities a better place to live and care for the environment.

Meanwhile, social media is empowering consumers to conduct their own due diligence on companies and their products and services, instead of just relying on and trusting traditional advertising. This is leading to a structural shift in consumer behaviour from passive to active, as they seek to buy products and services from companies that reflect their personal values. Over the next decade, this rising base of empowered consumers may start to look beyond their wallet to their piggybank. This could lead to a structural shift in investing from passive to active, as investors start to scrutinise their portfolio holdings and look to invest their hard-earned savings in companies whose corporate values resonate with their own personal values and have a greater purpose. *iam*

Barbara Gray, CFA, is an equity analyst with Brady Capital Research
barbcfa@gmail.com

Research disclosure

As per Section 8.25 of the Ontario Securities Commission's Companion Policy 31-103CP Registration Requirements and Exemptions, Somedios Partners Inc (dba Brady Capital Research) is exempt from the requirement to register as an adviser, as our advice is not tailored to the recipient. We note that this article is educational and thematic in nature, and the ratings on the four companies in our case study provide only our quantitative and qualitative assessment of each company's depth of stakeholder relationships and are not a recommendation to buy or sell the security.

As in accordance with Section 8.25(3), we disclose that Barbara Gray has a long position in the shares of the following issuers mentioned in this article:

- Chipotle Mexican Grill, Inc (CMG-NYSE)
- lululemon athletica inc (LULU-NASDAQ, LLL-TSX)
- Starbucks Corporation (SBUX-NASDAQ)
- Whole Foods Market, Inc (WFM-NASDAQ)

Any opinions contained herein are our own as of the date hereof and are subject to change without notice. The information contained herein is for information purposes only and this article is not, and is not to be construed as, an offer to sell or a solicitation of an offer to buy any securities. The information and opinions contained herein have been compiled or derived from sources believed reliable, but no representation or warranty, expressed or implied, is made as to their accuracy or completeness. Somedios Partners Inc accepts no liability whatsoever for any loss arising from any use of this article or its contents.