Building on Mutual Success in the Knowledge Economy: a Response to the Government's Consultation on Knowledge Funding

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Mutual business models are well placed to exploit the potential of Internet and Web technologies to bring together dispersed, independent producers and consumers ... Employee ownership is a form of mutuality which should flower in the knowledge driven economy.[1]

Introduction

Organisations based on co-operative principles are flourishing in the "knowledge economy." Poptel, which provides ISP and ASP services, is an industry leader.[2] St Luke's,[3] an employee-owned firm, is an award winning advertising agency. Smile,[4] owned by the Co-operative Bank, is one of the most successful Internet banks. While services such as Co-op Online[5] and Oxford, Swindon & Gloucester Co-operative Society's home shopping services[6] are leading the retail movement's entry into e-commerce.

The 'Mutual Advantage' is based on two principles that underlie the economics of the knowledge economy. First, in the knowledge economy the key assets are intangible assets, often contained in the memory and skills of a firm's employees. As a direct result, we are seeing a rapid increase in the use of employee ownership models by firms in the knowledge economy. These models not only increase productivity but also greatly improve employee satisfaction and retention rates. Second, business strategies in the knowledge economy focus on new types of relationships with consumers. These strategies recognise the importance of affinity, of 'competing on affiliation', and understanding that 'relationships are now assets'.[8]

On employee participation and relationship marketing, the co-operative approach is a natural. However the mutual sector struggles with the financial structure of the Internet world. The new economy is one of rapid growth, and requires large amounts of investment. In the knowledge economy, a high percentage of a company's value is in intangible assets. Often less than 10 per cent of a company's value is in tangible assets. Financing rapid growth in intangible assets requires equity.

Is it possible to create new co-operatives in the space opened up

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by the Internet and new digital technologies? Our answer is 'Yes, but to make it possible we need to rethink some of our co-operative structures and we need to create new financing mechanisms.' This paper outlines some of the current discussions within the co-operative movement on new financing mechanisms and the implications for government policy. It begins with an elaboration of the economy case for mutuals in the knowledge economy. While there are many social arguments for increased funding of mutuals, this paper bases its case on the potential economic advantages.

The knowledge economy

Knowledge-based companies are chiefly characterised by high up-front development costs, which typically rely heavily on inputs from human capital, followed by very low marginal costs of production and short product life cycles requiring continuous development.

For the business model concerned, these features very often produce increasing returns to scale - as opposed to the diminishing returns characterised by most 'old economy' business models.

Knowledge-based and increasing returns business models are largely found in the high tech arena. This includes a diverse list of industries, such as computers, pharmaceuticals, software, telecommunications equipment, fibre optics, and Internet companies.

The nature of competition in knowledge-based industries is different, however - because the economics are different. In knowledge-based industries, the product of human capital is so important. "In this milieu, management becomes not production oriented but mission oriented. Hierarchies flatten ... people need free rein. The company's future survival depends upon them. So they ... will be treated not as employees but as equals in the business of the company's success. Hierarchy dissipates and dissolves."[9]

Employee ownership

The UK Employee Ownership Index (EOI),[10] published by Capital Strategies, continues to outperform all the major indices over the long term. An investment of £100 in the EOI in 1992 would now be worth £667, while the same investment in the FTSE All-Share Index would be worth £244. (Results are for end of 2nd Qtr 2000)

The US National Centre for Employee Ownership[11] recently re-examined twelve major studies of employee ownership. The report concluded:

Researchers now agree that "the case is closed" on employee

> ownership and corporate performance. Findings this consistent are very unusual. We can say with certainty that when ownership and participative management are combined, substantial gains result. Ownership alone and participation alone, however, have, at best, spotty or short-lived results.

An independent academic study that reviewed the evidence on employee-ownership and also found:

> There is strong evidence that employee stock ownership, *when - but only when - combined with participation,* does increase productivity. Put another way, stock ownership and participation tend to reinforce each other ... An EU-sponsored study concluded 'both econometric and more informal studies suggest that combination of financial with decisional participation can have significant beneficial effects.[12]

The effectiveness of Employee Share Ownership Plan (ESOP) models is well documented. The first major study of the effect of board-based stock options found that the companies experienced a 16 per cent to 18 per cent increase in productivity.[13]

A high proportion of firms in the knowledge economy include employees in their ownership structure. In technology companies on the US West Coast, for instance, it is the norm to offer all employee stock options because companies that don't have a hard time attracting good people.

While many Internet Firms recognise the importance of employee-ownership, the importance of linking ownership and participation is often under estimated. A leading expert on organisations, Edward E. Lawler III writing in *Pay Strategies for the New Economy,* argues that

> Stock tends to be a motivator only when ... significant employee involvement in the operations of the enterprise exists ... Involvement is crucial.[14]

Evidence from the US and the UK demonstrates that employee attitudes to the share scheme are of prime importance. The 'sense' of ownership' is the crucial factor in determining the effect that a share scheme will have on the motivation and commitment of the employees.[15]

Another study[16] found that the impact of a share scheme is limited by the fact that it will in most cases be only a small part of the management-worker relationship. Employee attitudes and the effect of share ownership are likely to be determined by the way that the employees view their overall relationship with the company. In other words, the greater the employees' sense of ownership, the greater the impact on motivation, commitment and productivity. Another study concluded: "Opportunities for participation in decision making are more important than ownership per se in generating feelings of ownership."[17]

In successful Internet companies the management tends to flat structures, with direct informal relationships and use of teams. The management and ownership approach results in employees regarding the business as a collective adventure, generating enthusiasm and dynamism. Employee-owned businesses address these issues by involving all employees in a mutual structure.

The nature of the knowledge economy requires firms to engage employees more deeply than ever before. The evidence indicates that firms that involve employees in ownership and decision-making have higher productivity, and higher share prices. Mutual models of employee-ownership are designed to combine ownership and participation; as such these mutual models will play a significant role in the developing knowledge economy.

Customer loyalty

In the emerging Internet market place, customers are mobile as never before. The Internet is a powerful tool: it strengthens relationships, improves communications with customers; increases organisational learning about customer needs and increases responsiveness. Building customer loyalty requires building relationships, often based on shared values, and creating a sense of membership and identity. Web sites say hello to users by name, and track their preferences. Some e-commerce sites sign up 'members' who become 'co-buyers'.

Frederick Reichheld studied 'The Loyalty Effect'.[18] He concluded that the combination of economic factors means that the value of loyalty is often greater on the Internet than in traditional businesses. Acquiring on-line customers is expense, making loyal customer more valuable. Customer referrals are a lucrative source of new business, and "the word of mouse spreads even faster than the word of mouth".

Studies of the new economics of information[19] argue that the pursuit of competitive advantage among web sites will drive them towards closer affiliation with customer interests. The knowledge economy provides the consumer with a wealth of information. The consumer's challenge is to sort through this mass of data. Suppliers offer web sites to help find the consumer's best buy. However for the consumers, the question is 'Can they trust these sites to be unbiased'? Consumers will increasingly seek sites that reflect their interest and values, sites that have credibility and can be trusted. Building this trust requires two-way interactions with consumers.[20]

Consumer co-operatives are organised by and for their members, who come together to provide a shared service from which they all benefit. Co-operatives begin with a strong sense of common purpose, a sense of shared need among members. To succeed as businesses, co-operatives require the regular and repeat sales to their members. Member/customer loyalty is built and maintained by focusing on this common purpose and mutual gain.

Successful co-operatives tap into their members' know-how and ideas. By involving their members, successful co-operatives unlock the ideas of customers and employees, a critical element in the emerging knowledge economy. Building loyalty and tapping member knowledge requires a cultural and a management style that promotes a sense of membership and collaboration among staff, suppliers and customers. Co-operatives succeed only when a dynamic participatory culture is in place.

As Leadbeater concluded: "Mutuality is far from dead and buried. Quite the opposite; mutual networked organisations ... could be among the most dynamic in the new economy."[21]

The funding gap

The twin issues of employee involvement and customer loyalty are a strong argument for mutual businesses to be major players in the knowledge economy. Why are there not more? The major stumbling block is finance. Traditionally the co-operative sector, particularly the retail sector, has built up its assets over decades from member investments and trading activities. In the technology sector, particularly those businesses associated with the 'new economy', financing operates in a completely different way and on completely different timescales to those of the traditional co-operative sector.

Shares

The UK Employee Ownership Index (which includes firms that are more than 10 per cent owned by their employees and listed on the stock exchange) out performs the market. But there is a trade off. To raise equity on the stock exchange, firms must dilute their employee ownership, yet it is this same ownership that increases productivity. Thus by seeking to sell shares on an open market, mutuals must sacrifice some of their competitive advantage.

Loans

An alternative to selling shares is borrowing. After more than seven years' experience of employee ownership lending, The Unity Trust Bank, reported that its bad debts from lending were sharply less than for its lending to conventional business.[22] However, in the knowledge economy firms need equity, to finance intangible assets and to be the risk capital required by growth businesses.

Tax credits

The government is supporting employee ownership through programmes such as the new All Employee Share Ownership Plan. However the programme does not apply to all mutuals. Furthermore it does not support up-front equity investment. It is based on profit sharing and monthly wage deductions. Growth companies need up-front equity.

New approaches

In response the co-operative movement is developing new investment instruments. Financial innovations are appearing in the movement including Mondragon's internal accounts, the democratic ESOPs in the US, co-operative ESOPs in Quebec, and Employee Benefit Trusts in the UK. Similarly the 'New Generation Agriculture Co-operatives' have adopted a share structure. There is also a growing interest in and examples of Stakeholder co-operatives. These form a member association, contribute capital and apply special rules for voting rights and distribution of benefits.

Many companies have two classes of stock: common and preferred. Normally, common stock has voting rights in proportion to liquidation rights, and preferred stock has no voting rights, but receives a higher priority than common stock for receiving both dividends and the surplus from a liquidation. These are not the only types of stock that can be created - a class of stock is just the combination of equity, voting, and resale rights that are attached to it. Employee-owned companies are more likely to have a variety of classes of shares because they will usually want more complex control and benefit arrangements.

Social Investment Market

As the mutual sector develops these new financial instruments, will they find a market?

The knowledge problem

Part of the challenge is educating investors. Most investors do not understand employee ownership or are even aware of the economic performance of these businesses. There is a knowledge gap, which creates profit opportunities. (It is rare for an investment fund to consistently out perform the market.) Given that the knowledge economy exploits information, an innovative product may be feasible.

However there is a second component of the Knowledge Problem. With conventional shares, investors have a means of dealing with ineffective management. Although they rarely use these voting rights, their existence helps to keep management on their toes, as they fear a take over or shareholder revolt. (An event that even the management of the London Stock Exchange experienced recently.)

Potential investors in employee owned firms ask 'how do they intervene if something goes wrong?' At least two options are being explored. Either shareholder agreements, or covenants in preference shares that provide special voting rights . when the company misses agreed targets or financial indicators.

The social investor

The Social Investment Forum[23] estimates that nearly one in eight dollars held with investment institutions are either in ethically screened portfolios, or subject to share voting policies, which incorporate social responsibility criteria. This helps to explain why UK industry commentators now expect funds in ethically screened portfolios to grow as much as five-fold in the next few years.

The economic advantages of employee ownership are clearly seen in the increased productivity and impressive stock market performance. These firms also have positive social impacts. "Survey results generally indicate favourable perceived effects on employee attitudes in such areas as job satisfaction."[24] Nobel Laureate James Meade acknowledged employee ownership companies provide more stable employment in the face of economic fluctuations.[25] While research by the US National Centre for Employee Ownership found that America's ESOP firms create more jobs than non-ESOP firms.[26]

For Social Investors, concerned about employment issues, job creation and retention, employee owned firms will be attractive.

Corporate venturing

Within the UK, there is growing interest in Corporate Venturing, whereby large firms invest in small innovative companies. This is supported by research that shows firms with a combination of corporate and venture funding outperformed those funded by venture capitalist organisations alone.

Establishing a venturing division is popular in larger firm as a means

- To build expertise in an industry
- Keep promising staff from leaving in favour of a start-up
- To inject the vigour and flexibility of a small firm into a larger organisation.

The government is encouraging corporate venturing with new tax credits. Companies engaged in corporate venturing can obtain tax relief of 20 per cent on money held in shares for at least three years.

Large co-operatives, as social investors, have the option of establishing their own corporate venturing divisions. This may be an important strategic initiative to build co-operative expertise in key parts of the new economy.

Building links

Capitalising on the success of mutual models in the knowledge economy is dependent on finding the 'right investors'.[28] Reichheld speaks of the need to have the 'right investors', who provide a foundation of stable ownership that frees management to attend to long-term value creation. This is similar to the 'relationship investing'[29] concept favoured by Warren Buffett whereby a long-term relationship is built between the investor and the company. Investors hold their share for the long term and work with management to improve corporate performance. Firms build investment relationships by educating investors, working with institutions that avoid investment churning and attracting the right core investor.

The mutual sector needs a new intermediary[30] to mobilise finance for mutual firms operating in the knowledge economy and manage the investment relationships. Such an intermediary would operate two funds:

a) An investment fund that invests in listed firms similar to those in the UK Employee Ownership Index.
b) A venture fund to invest in the early stages of new mutuals. This might be a Venture Capital Trust listed on the stock exchange.

The intermediary would channel money from social investors, a growing segment of investors, into new mutuals. These new investment funds could also attract large co-operative organisations.

The intermediary's role would also:

a) Include a 'market strategy' that would focus on educating investors on the nature and performance of innovative mutual firms.
b) Be the core investor in mutual firms, working with management to improve corporate performance. Venture Capital Investment Funds tend to invest in industries that they know. This fits well with the new thinking on co-operative development. For example: the Oxford Mutuality Taskforce's work on co-operative clusters, Social Enterprise London's development focus on particular growth areas. Recent IPPR seminars have also discussed the need to segment the social enterprise sector. One of the innovations of the Mondragon bank was an enterprise division within the bank that is directly involved in the start-up of new co-operatives. A Mutual Venture fund could play a similar role for co-operatives in the knowledge economy.
c) Protecting investors by holding rights to intervene in decision-making (by voting rights and appointing directors) should the mutual business experience difficulties. The intermediary would need to develop a pool of experienced managers to drawn upon, possible coming from other firms in the sector.

Conclusion

Knowledge-based companies need to foster an environment in which they can adapt to the changing demands of the market place. According to Arthur,[31] "Adaptation, in the proactive sense, means watching for the next wave that is coming, figuring out what shape it will take, and positioning the company to take advantage of it. Adaptation is what drives increasing-returns businesses, not optimisation."

The model for mutual success in the knowledge economy that we are suggesting therefore has a lot going for it. We are emphasising employee participation and a close link between company and customer. In a knowledge-based business how else is a company going to stay in touch with its market unless it is able to adapt to its changing needs, unless the company is able to listen to its customers, and unless employees are empowered to hear this message and act on it?

In order to stay close to its customers a company needs to have a conversation with them. And in order to anticipate and meet their changing needs (and respond to competitive threats), a company needs to foster creativity and innovation amongst its employees.

Paul Plsek joins this debate by adding, "most traditional management theory is about how to establish order and control through the actions of a few people at the top of an organisational hierarchy. This management instinct, one that we have all learned, may be the biggest factor holding back progress in our organisations."[32]

The secret to overcoming this is to unleash the employees. Allowing them to work within a seamless interface between both management and customers that, in itself fosters creativity, adaptation, innovation and commitment, which is the asset. But why does employee participation in our context work so well? The answer lies in the flat, responsive, participatory structure it suggests. It is naturally mutual. But it is also naturally knowledge-based because the economics of knowledge-based markets demand the kind of structure we are suggesting. The requirement is for information to flow freely between customers and employees. It has to be acted upon. Only in this way can a company best serve the current interests of its customers, their future interests and the interests of future customers. If this objective is achieved, the interests of all stakeholders in such a company - including investors - will be met because a durable franchise will be created.

Government policy

What are the implications for government policy on financing the knowledge economy?

- Companies don't compete on the basis of just price or product anymore, but on the basis of entire business models. This is particularly true in the knowledge economy. **The government should recognise and support efforts to build new business models. This includes new ownership and finance structures.** Existing government support programmes, loan funds and tax credits, assume a very traditional share structure. The new economy is generating successful businesses based on innovative ownership structures. Government policy needs to reflect an understanding of these new business models.
- There is a gap in financing firms based on wide employee ownership and co-operative principles. Studies show the economic benefits of these models, particularly in the knowledge economy. **Government policy, in recognition of the economic advantages of these new business models,**

should support efforts to close this funding gap.

- The mutual sector, as with other sectors, needs to be resourced by a fund that has a deep knowledge of the sector. **Government support for new investment funds should favour challenge funding and not a new national institution.** This will allow for sector-focused funds. (Funds that operate across regions would be of value. They could complement and co-operate with DTI supported regional funds.)
- The funding gap in the knowledge economy in general and the mutual sector in particular is for equity finance. **A new knowledge funding loan guarantee scheme is not a priority. The focus should be on new equity funds.**
- Linking finance to mentoring and business support is advantageous, provided the intermediary truly has an in depth knowledge of the sector. **In addition to seed capital for new equity funds, the Knowledge Fund should provide seed revenue funding for integrated mentoring and business support services.**

Bob Allan has advised co-operatives and social enterprises around the world for twenty years. His current work focuses on 'the new development paradigm' and e-mutuals Including the digital divide. He welcomes comments on this article to bob-allan@beeb.net. Poptel staff and representatives of other co-operative organisations participated in consultations related to this paper.

Notes

1 Leadbeater C & Christie I, To *Our Mutual Advantage* DEMOS 1999
2 PC Plus have named Poptel the UK's most reliable Internet Service Provider (ISP). The magazine gave Poptel's combined services an overall rating of 98.22% - higher than any other UK ISP. With the fastest download speeds, Poptel's Internet service was shown to be available 99.46% of the time. By 1999, Poptel was amongst the UK's top 20 Internet companies in terms of financial performance.
3 See http://www.stlukes.co.uk
4 See http://www.smile.co.uk/
5 http://www.co-oponline.co.uk/
6 http://www.osg-co-op.co.uk/ordering/index.html
7 Evans, P; and Wurster, T; *Blown to Bits: How the New Economics of Information Transforms Strategy,* Harvard Business School Press, Boston 2000
8 *Digital Capital* page 192
9 W. Brian Arthur: "Increasing Returns and the Two Worlds of Business,"

Harvard Business Review, July-August, 1996 (under the title "Increasing Returns and the New World of Business").
10 The UK Employee Ownership Index was launched by Capital Strategies to tack the performance of UK quoted companies with a significant degree of employee share ownership. See http://www.capitalstrategies.co.uk/press/210800.htm
11 http://www.nceo.org/library/corpperf.html
12 Heller, F; Pusic, E; Strauss, G; and Wilpert, B; *Organizational Participation, Myth and Reality* page 34
13 *Inc.* August 2000 page 112
14 Lawler, Edward E *Pay Strategies for the New Economy* page 242
15 The first part of this section draws from a research summary prepared by the TUC Share Ownership, productivity and company performance Feb 1999
16 *The Impact of Economy Democracy: Profit Sharing and Employee Shareholding Schemes* Poole and Jenkins 1990 London Routledge
17 *The Perception and Effects of Share Ownership: Empirical Evidence from Employee Buyouts.* Pendleton, Wilson and Wright British Journal of Industrial Relations 36:1 March 1998
18 Reichheld, F; *The Loyalty Effect: The Hidden Force Behind Growth, Profits and Lasting Value,* Harvard Business School Press, Boston 1996 and *E-Loyalty* in Harvard Business Review, July-August 2000
19 see for example Evans, P; and Wurster, T; *Blown to Bits: How the New Economics of Information Transforms Strategy,* Harvard Business School Press, Boston 2000
20 Modal, M, *Now or Never: How Companies mush change Today to Win the Battle for the Internet* Customer, Orion Business Books, London 2000
21 Leadbeater C & Christie I, To *Our Mutual Advantage* DEMOS 1999 page 110
22 Oakeshott, Robert *Jobs and Fairness: The Logic and Experience of Employee Ownership* page 685
23 http://www.uksif.org/publications/article-2000-08/frameset.shtml
24 Heller, F; Pusic, E; Strauss, G; and Wilpert, B; *Organizational Participation, Myth and Reality* page 194
25 Gates, J *The Ownership Solution* Penguin Press London 1998 page 65
26 Gates, J *The Ownership Solution* Penguin Press London 1998 page 65
27 A report published by London Business School and Helsinki University
28 Reichheld, F; *The Loyalty Effect: The Hidden Force Behind Growth, Profits and Lasting Value,* Harvard Business School Press, Boston 1996
29 see Hagstrom, R *The Warren Buffet Way,* Wiley 1995 pages 254-256
30 The current co-operative development funds focus on small loans to small co-operatives. For example ICOF's largest loan is £50,000. There is a role for this type of lending. However the movement also needs investments funds that can invest in medium size businesses.
31 W. Brian Arthur: "Increasing Returns and the Two Worlds of Business," Harvard Business Review, July-August, 1996 (under the title "Increasing Returns and the New World of Business").
32 Paul Plsek: "Some Emerging Principles for Managing in Complex Adaptive Systems."