Trust and Value Creation

Article by Professor Low Buen Sin

Nobel laureate Kenneth Arrow stressed that “virtually every commercial transaction has within itself an element of trust, certainly any transaction conducted over a period of time.” Without trust, the market would not be able to function well, and the cost of doing business would be very high.

The 2008 Global Financial Crisis (GFC) is often cited as an example of a collapse of trust. At the time, former US Secretary of Labour Robert Reich noted in US News, “the fundamental problem isn’t lack of capital. It’s lack of trust. And without trust, Wall Street might as well fold up its fancy tents.”

The loss of trust during the GFC has even given birth to blockchain technology, with its main purpose to embed trust in commercial transactions.

Trust is invisible and fragile. Trust is also a vital and valuable asset for businesses. It is an expectation that a firm will perform actions that are beneficial, or at least not harmful, to its stakeholders, regardless of the ability to monitor those actions. Such an expectation takes time to earn, and it certainly cannot be forced.

A firm that is highly trusted by its stakeholders is likely to reap value from this precious asset. We will look at how this is achieved.

Explicit and implicit contracts

According to contract theory and the theory of the firm, we can view a firm as a nexus of implicit and explicit contracts between shareholders and other stakeholders. Each group of stakeholders supplies the firm with critical resources or efforts in exchange for claims outlined in explicit contracts and suggested in implicit contracts.

Take, for example, the employment contract between the firm and its employees. The explicit contract spells out the terms of employment, including job responsibilities, wages, leave entitlement, among others. At the same time, the implicit contract is an understanding between the firm and its employees, such as providing opportunities for employees to develop themselves for possible career progression, or the promise to retrain and redeploy them to new roles when their current roles no longer exist. These are often not part of any formal agreement.

When a large firm enters into a long-term contract with its supplier, it often requires the supplier to make fixed and intangible assets investments to fulfil the contractual obligation. The firm may endeavour to alleviate the supplier’s concerns of the firm reneging on the agreement after the supplier has made the required investment. It can do so by establishing mutual dependency via explicit contracts such as most-favoured-supplier clauses, exclusive territories, or patent pools. However, a large proportion of contracts are still implicit, for example, the promise to be fair if market conditions change or product changes.

When a customer buys an expensive branded durable such as a car or a bag, there is an implicit contract between the firm and the customer that the firm will continue to invest and build the brand image. When we buy “xiaolongbao” from Din Tai Fung, a can of Coca-Cola, or a Big Mac from McDonald’s, there is an implicit contract that we have with these firms. The implicit contract

promises us a consistent quality and taste, or the “secret recipe”.

Unlike explicit contracts, implicit contracts are nebulous and have little legal standing. Firms can default on their implicit commitment without legal recourse from other stakeholders. As such, the value of implicit contracts depends on other stakeholders’ expectations about a firm honouring its commitments.

For firms that have a stronger reputation for keeping their commitments associated with the implicit contracts, stakeholders are likely to have stronger incentives to contribute resources and effort to the firm and accept less favourable explicit contracts than stakeholders of less trustworthy firms.

These theories suggest that the interests of shareholders and other stakeholders in a hightrust firm are in greater alignment than those of shareholders and other stakeholders in a low-trust firm. Hence, they are more likely to contribute to the firms’ superior long-term financial performance

Does it pay to invest in trust?

The theoretical argument is intuitive and logical. But does it pay for a firm to invest and build trust with its stakeholders? Is there evidence that investing in trust can lead to better financial performance and valuation for the firm?

One of the challenges in establishing a causal relationship between the trust level and the firm’s financial performance is the measurement of trust.

Academia regards a firm’s corporate social responsibility (CSR) activities as a good measure of the trust level that a firm has with its stakeholders.

A World Business Council for Sustainable Development report on CSR by Holme and Watts in 2000 states that: “For any company, giving a high priority to CSR is no longer seen to represent an unproductive cost or resource burden, but, increasingly, as a means of enhancing reputation and credibility among stakeholders – something on which success or even survival may depend.”

In recent years, using a firm’s CSR activities as a measure of the firm’s trust level, several empirical studies show a causal relationship between the trust level with the firm’s financial performance. See box, “Does it Pay to Invest in Trust?”.

Does it Pay to Invest in Trust?

It is a widely accepted view among practitioners that CSR generates trust, which in turn creates value.

Examining a large sample of mergers in the US, researchers set out to study whether trust creates value for the acquiring firms' shareholders (Deng, Kang and Low, "Corporate Social Responsibility and Stakeholder Value Maximization", *Journal of Financial Economics 110*, 2013).

The authors found that high-trust acquiring firms realised higher merger announcement returns and larger increases in post-merger long-term operating performance. Mergers by high-trust acquiring firms also took less time to complete and were less likely to fail than mergers by low-trust acquiring firms.

Mergers are likely to unsettle key stakeholders in a firm because they put the continuity of existing long-term relations between the firm and its stakeholders at stake and sometimes force stakeholders to renegotiate their contracts with the newly combined firm. Thus, a firm's reputation for fulfilling its implicit contracts with relevant stakeholders and maintaining continued relations with them is crucial to a merger's success.

In a McKinsey report, *Why Mergers Fail*, (*McKinsey Quarterly* 4, 2001), Bekier, Bogardus and Oldman found that key employees or customers may leave during a merger's transition period if the management team fails to effectively handle stakeholder relations.

As a result, the combined firm could suffer a reduction in firm value. To the extent when high-trust acquirers undertake mergers that benefit firm stakeholders, their mergers are likely to lead to greater stakeholder satisfaction than mergers by low-trust acquiring firms. Thus, the shareholders of high-trust firms benefit more from the mergers.

Another study (Lins, Servaes and Tamayo, "Social Capital, Trust and Firm Performance", *Journal of Finance* 72, 2017) found that during the GFC, the trust between a firm and both its stakeholders and investors pays off when the overall level of trust in firms and markets suffers a negative shock.

From a shareholder perspective, if high-trust firms are perceived as more trustworthy, investors may place a valuation premium on these firms when their overall trust in the market is low. From the perspective of employees, creditors, customers, and other stakeholders, they are more likely to help high-trust firms weather a negative shock, given that such firms displayed greater attention to fulfilling their implicit contracts with stakeholders in the past.

Their study found that high-trust firms had stock returns that were four to seven percentage points higher than low-trust firms during the financial crisis period. These high-trust firms also experienced higher profitability, growth and sales per employee relative to low-trust firms, and these firms were able to raise more debt.

Trust and value creation

In summary, trust is a valuable and vital asset for firms. It enhances the value of implicit contracts embedded in a firm's contracts with its customers, employees, suppliers, creditors, regulators, and other stakeholders.

The stakeholders of these high-trust firms are likely to have stronger incentives to contribute resources and effort to the firm and accept less favourable explicit contracts than stakeholders of less trustworthy firms. As such, these high-trust firms will enjoy better financial performance and higher valuation.

Firms should understand that high stakeholder trust is the bedrock of business success. Such trust can be built through CSR.

As Naill Fitzgerald, CEO and co-chairman of Unilever told The Guardian (2003), "Corporate social responsibility is a hard-edged business decision. Not because it is nice to do or because people are forcing us to do it…, but because it is good for our business…. More and more people are looking at companies and ask themselves if this is an organisation whose values they share. This is a hard-edged business issue."

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