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Valuing social responsibility programs

Most companies see corporate social responsibility programs as a way to fulfill the contract between business and society. But do they create financial value?

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Companies face increasing pressure from governments, competitors, and employees to play a leading role in addressing a wide array of environmental, social, and governance issues—ranging from climate change to obesity to human rights—in a company's supply chain. Over the past 30 years, most of them have responded by developing corporate social responsibility or sustainability initiatives to fulfill their contract with society by addressing such issues.[1]

Gathering the data needed to justify sustained, strategic investments in such programs can be difficult, but without this information executives and investors often see programs as separate from a company's core business or unrelated to its shareholder value. Some companies have made great progress tracking operational metrics (such as tons of carbon emitted) or social indicators (say, the number of students enrolled in programs) but often have difficulty linking such metrics and indicators to a real financial impact. Others insist that the effects of such programs are either too indirect to value or too deeply embedded in the core business to be measured meaningfully: for example, it can be very hard to separate the financial impact of offering healthier products from the impact of other aspects of the brand, such as quality and price.

Yet many companies are creating real value through their environmental, social, and governance activities—through increased sales, decreased

[1] We have chosen to use the term "environmental, social, and governance" because more common terms, such as "corporate social responsibility" and "sustainability," have a narrower connotation. The term environmental, social, and governance is also increasingly used by investors to refer to a broader set of programs that we observed in the companies mentioned in this report.

Environmental, social, and governance programs can create value in many other ways that support growth, improve returns on capital, reduce risk, or improve management quality

costs, or reduced risks—and some have developed hard data to measure even the long-term and indirect value of environmental, social, and governance programs.[2] It's not surprising that the best of them create financial value in ways the market already assesses—growth, return on capital, risk management, and quality of management (Exhibit 1). Programs that don't create value in one of these ways should be reexamined.

How environmental, social, and governance programs create value

The most widely known way that environmental, social, and governance programs create value is by enhancing the reputations of companies—their stakeholders' attitudes about their tangible actions—and respondents to a recent McKinsey survey agree.[3]

Moreover, it has long been clear that financially valuable objectives—such as better regulatory settlements, price premiums, increased sales, a reduced risk of boycotts, and higher retention of talent—may depend, at least in part, on a company's reputation for environmental, social, and governance programs that meet community needs and go beyond regulatory requirements or industry norms.

However, environmental, social, and governance programs can create value in many other ways that support growth, improve returns on capital, reduce risk, or improve management quality. Breaking out the value of these activities enables companies to communicate it to investors and financial professionals.

Growth

Our case studies highlighted five areas in which these programs have a demonstrable impact on growth.

New markets. IBM has used environmental, social, and governance programs to establish its presence in new markets. For example, the company uses its Small and Medium Enterprise (SME) Toolkit to develop a track record with local stakeholders, including government officials and nongovernmental organizations (NGOs). In partnership with the World Bank's International Finance Corporation, India's ICICI Bank, Banco Real (Brazil), and Dun & Bradstreet Singapore, IBM is using the service to provide free Web-based resources on business management to small and midsize enterprises in developing economies. Overall, there are 30 SME Toolkit sites, in 16 languages. Helping to build such businesses not only improves IBM's reputation and relationships in new markets but also helps it to develop relationships with companies that could become future customers.

New products. IBM has also developed green data-center products, which help the company grow by offering products that meet customers' environmental concerns. A new collaboration between IBM and the Nature Conservancy, for example, is developing 3D imaging technology to help

[2] To better understand the relationship between environmental, social, and governance activities and value creation, we surveyed 238 CFOs, investment professionals, and finance executives from a full range of industries and regions. The survey was conducted in conjunction with a survey of 127 corporate social responsibility and sustainability professionals and self-described socially responsible institutional investors that were reached through the Boston College Center for Corporate Citizenship. Both surveys were in the field in December of 2008. To get a bottom-up view, we also constructed case studies of 20 companies with leading environmental, social, and governance programs in a number of industries.

[3] See "Valuing corporate social responsibility: McKinsey Global Survey Results," mckinseyquarterly.com, February 2009.

Exhibit 1

Quantifiable value

The best environmental, social, and governance programs create financial value for a company in ways that the market already assesses.

Value in environmental, social, and governance (ESG) programs

Growth	**New markets**	• Access to new markets through exposure from ESG programs
	New products	• Offerings to meet unmet social needs and increase differentiation
	New customers/market share	• Engagement with consumers, familiarity with their expectations and behavior
	Innovation	• Cutting-edge technology and innovative products/services for unmet social or environmental needs; possibility of using these products/services for business purposes—eg, patents, proprietary knowledge
	Reputation/differentiation	• Higher brand loyalty, reputation, and goodwill with stakeholders
Returns on capital	**Operational efficiency**	• Bottom-line cost savings through environmental operations and practices—eg, energy and water efficiency, reduced need for raw materials
	Workforce efficiency	• Higher employee morale through ESG; lower costs related to turnover or recruitment
	Reputation/price premium	• Better workforce skills and increased productivity through participation in ESG activities • Improved reputation that makes customers more willing to pay price increase or premium
Risk management	**Regulatory risk**	• Lower level of risk by complying with regulatory requirements, industry standards, and demands of nongovernmental organizations
	Public support	• Ability to conduct operations, enter new markets, reduce local resistance
	Supply chain	• Ability to secure consistent, long-term, and sustainable access to safe, high-quality raw materials/products by engaging in community welfare and development
	Risk to reputation	• Avoidance of negative publicity and boycotts
Management quality	**Leadership development**	• Development of employees' quality and leadership skills through participation in ESG programs
	Adaptability	• Ability to adapt to changing political and social situations by engaging local communities
	Long-term strategic view	• Long-term strategy encompassing ESG issues

advance efforts to improve water quality. This project applies IBM's existing capability in sensors that can communicate wirelessly with a central data-management system in order to provide decision makers with summaries that improve water management. At the same time, it also addresses an important environmental need—and creates a new business opportunity for IBM.

New customers. Telefónica has been developing new products and services geared to customers over the age of 60. To help overcome what the company calls a "knowledge barrier," it has collaborated with associations for older people in an effort to introduce retired men and women to the benefits of new technologies—for example, teaching them to communicate with grandchildren living abroad. The company meets a social need by helping this population use modern technologies and services while building a customer base in an underpenetrated market.

Market share. Coca-Cola has shown how a company can use enlightened environmental practices to increase its sales. Its new eKOfreshment coolers, vending machines, and soda fountains are far more environmentally friendly than the ones they replaced: they not only eliminate the use of hydrofluorocarbons (greenhouse gases) as a refrigerant but also have a sophisticated energy-management device that Coca-Cola developed to reduce the energy these machines consume. Together, these innovations increase the equipment's energy efficiency by up to 35 percent. The company highlights the benefits to retailers—especially the financial savings from energy efficiency—and requests prime space in their outlets in return for providing more efficient systems.

Innovation. Dow Chemical has committed itself to achieving, by 2015, at least three breakthroughs in four areas: an affordable and adequate food supply, decent housing, sustainable water supplies, or improved personal health and safety. All have a connection to an existing or planned Dow business. The company has already made progress in its Breakthroughs to World Challenges initiative, for example, by utilizing its understanding of plastics and water purification to supplement its venture capital investment and loan guarantee support to a social entrepreneur in India who has developed an inexpensive community-based water filtration system. The initiative's ultimate goal is a new business model to sell new products at reasonable prices, meeting social needs while contributing to Dow's bottom line.

Returns on capital

We have seen companies generate returns on capital from their environmental, social, and governance programs in several ways—most often through operational efficiency and workforce efficiency.

Operational efficiency. These programs can help companies realize substantial savings by meeting environmental goals—for instance, reducing energy costs through energy efficiency, reducing input costs through packaging initiatives, and improving processes. Such efficiencies often require upfront capital investments to upgrade technologies, systems, and products, but returns can be substantial.

Novo Nordisk's proactive stance on environmental issues, for example, has improved its operational efficiency. In 2006, the company set an ambitious goal: reducing its carbon dioxide emissions by 10 percent in ten years. In partnership with a local energy supplier, Novo Nordisk has identified and realized energy savings at its Danish production sites, which account for 85 percent of the company's global carbon dioxide emissions. It uses the savings to pay the supplier's premium price for wind power. In three years, the effort has eliminated 20,000 tons of carbon dioxide emissions, and by 2014 green electricity will power all of the company's activities in Denmark. In this way, Novo Nordisk is not only reducing its emissions, increasing the energy efficiency of its operations, and cutting its costs but also helping to build Denmark's market for renewable energy.

Workforce efficiency. Best Buy has undertaken a targeted effort to reduce employee turnover, particularly among women. In 2006, it launched the Women's Leadership Forum (WoLF), which shows groups of female employees how they can help the company to innovate by generating ideas, implementing them, and measuring the results. These innovations—which largely involve enhancing the customer experience for women by altering the look and feel of Best Buy stores and modifying their product assortment—have significantly boosted sales to women without decreasing sales to men.

Besides fostering innovation, the program helps women to create their own corporate support networks and encourages them to build leadership skills by organizing events that benefit their communities. In the program's first two years, turnover among women decreased by more than 5 percent annually.

Risk management

Companies often see environmental, social, and governance issues as potential risks, and many programs in these areas were originally designed to mitigate them—particularly risks to a company's reputation but also, for example, problems with regulation, gaining the public support needed to do business, and ensuring the sustainability of supply chains. Today, companies manage many of these risks by taking stands on questions ranging from corruption and fraud to data security and labor practices. Creating and complying with such policies is an extremely important part of risk management, though one that isn't likely to be a source of significant differentiation. But leading companies *can* differentiate themselves by going beyond the basics and taking a proactive role in managing environmental, social, and governance risks. Such an approach can have an important and positive financial impact, since negative environmental, social, and governance events can have significant potential cost.

Regulation. In most geographies, regulatory policy shapes the structure and conduct of industries and can dramatically affect corporate profits, sometimes dwarfing gains from ordinary operational measures.[4] It is therefore critically important for companies to manage their regulatory agenda proactively—ideally, by having a seat at the table when regulations for their industries are contemplated and crafted. To build the necessary trust with regulators and to secure a voice in the ongoing discussion, it helps to have solid relationships with stakeholders and a reputation for strong performance on environmental, social, and governance issues.

Verizon, for instance, very actively manages its relationships with stakeholders and strives to establish regular contacts and strong ties with policy makers. To help formulate sound—and favorable—energy and climate policies, the company has also sponsored research on the way information communications technology promotes energy efficiency. They sponsored the research behind the *Smart 2020*[5] report, for example, which report explains in detail how this technology, together with broadband Internet connections, can help the United States to reduce carbon emissions by 22 percent and reliance on foreign oil by 36 percent by no later than 2020.

Public support. To operate in a country or business, companies need a modicum of public support, particularly on sensitive issues. Coca-Cola, for example, has been proactive in identifying the risks to its business posed by water access, availability, and quality. In 2003, Coca-Cola began developing a risk-assessment model to measure water risks at the plant level, such as supply reliability, watersheds, social issues, economics, compliance, and efficiency. The model helped Coca-Cola to quantify the potential risks and consequently enabled the company to put sufficient resources into developing and implementing plans to mitigate those risks. It now has a global water strategy in place that includes attention to plant performance, watershed protection, sustainable water for communities, and building global awareness. Their actions help avoid potential backlash over water usage as well as potential operational issues from water shortages.

[4] See Scott C. Beardsley, Luis Enriquez, and Robin Nuttall, "Managing regulation in a new era," mckinseyquarterly.com, December 2008.

[5] *SMART 2020: Enabling the Low Carbon Economy in the Information Age*, The Climate Group and the Global eSustainability Initiative (GeSI), 2008.

Supply chains. Some companies have moved beyond focusing on the risks from the day-to-day practices of their suppliers and now consider the suppliers' long-term sustainability as well. Under Nestlé's Creating Shared Value strategy, for instance, a business has to make sense for all its stakeholders. As an example, Nestlé works directly with the farmers and agricultural communities that supply about 40 percent of its milk and 10 percent of its coffee. To ensure its direct and privileged access to these communities, Nestlé promotes their development by building infrastructure, training farmers, and paying fair market prices directly to producers rather than middlemen. In return, the company receives higher-quality agricultural ingredients for its products. These strong relationships also give Nestlé's factories a reliable source of supply, even when the overall market runs short. When the price of milk powder soared in 2007, for example, Nestlé's direct links to farmers mitigated its supply and price risks in certain parts of the world and protected the interests of all stakeholders—from farmers to consumers.

Management quality

CFOs and professional investors often see high-performing environmental, social, and governance programs as a proxy for the effectiveness of a company's management. They may be onto something. In our observation, these programs can have a strong impact in all three areas that investors typically consider important: leadership strength and development, both at the top and through the ranks; the overall adaptability of a business; and the balance between short-term priorities and a long-term strategic view.

Leadership development. IBM's Corporate Service Corps sends top-ranked rising leaders to work pro bono with NGOs, entrepreneurs, and government agencies in strategic emerging markets. The program has already improved the leadership skills of its participants in a statistically significant way; raised their cultural intelligence, global awareness, and commitment to IBM; and given the company new knowledge and skills. In a recent evaluation, nearly all participants indicated that their involvement with the corps increased the likelihood that they would stay at IBM.

Adaptability. Companies flexible enough to meet unforeseen challenges—for instance, by remaining in countries or communities during times of crisis or conflict—often reap long-term benefits, such as strong relationships and credibility with local communities. Environmental, social, and governance programs are one way to boost this kind of resiliency. Cargill, for example, is currently maintaining its presence and operations in Zimbabwe under difficult conditions; instead of paying its local employees in the country's very unstable currency, it compensates them with food parcels and fuel vouchers. The company makes similar long-term investments in local communities in the other 66 countries where it operates.

A long-term strategic view. Companies that take a long-term view use environmental, social, and governance activities to anticipate risks from emerging issues and to turn those risks into opportunities. Novo Nordisk, for instance, manages itself according to principles of a triple bottom line—an economically viable, environmentally sound, and socially responsible approach to business. The company, for example, has not only made investments to prevent, diagnose, and treat diabetes and to build up the related health care infrastructure but has also used these investments to strengthen its position in mature markets and to develop its business in new ones.

Assessing value

Although many executives and investors believe that much of the impact of environmental, social, and governance programs is long term and indirect—and thus nearly impossible to measure—our research suggests otherwise. Companies *can* directly value the financial effects of many such programs, even in the short term; the impact of environmental programs, for example, can often be measured quickly with traditional business metrics such as cost efficiency. Companies that understand the pathways to value and identify the short- and long-term effects of environmental, social, and governance programs will succeed in defining a few targeted metrics to assess them (Exhibit 2).

One such company, Telefónica, having found that its customers' purchasing decisions and loyalty are driven in part by perceptions of its environmental, social, and governance activities, decided to integrate the results of an annual reputation survey into its business strategy. Since then, Telefónica has identified its reputation shortfalls, aligned its business strategy with efforts to close them, created

Exhibit 2

Direct and indirect dividends

Environmental, social, and governance programs can have direct and indirect financial effects on companies.

Example of environmental, social, and governance (ESG) program: Campbell Soup's partnership with American Heart Association

Business driver	**Effect of ESG programs on business driver**	**Financial impact**	
		Direct	Indirect
Food and beverage innovation	• New products	Increased sales	
Access to and relationships with retailers	• New sales opportunities with current retailers	Increased sales	
	• Stronger relationships with current retailers		Goodwill
	• Access to new retailers	Increased sales	
Brand portfolios and brand loyalty	• New customers and stronger consumer loyalty	Increased sales	
	• Better brand awareness, preference, and image		Goodwill
Relationships with consumers, nongovernmental organizations (NGOs), and other influencers	• New sales opportunities created through trusting partnerships		Goodwill
	• Lower risk of attack from vocal representatives of NGOs		Avoidance of risk

Source: Interviews with Campbell Soup executives; McKinsey analysis action plans to improve its reputation (for instance, by developing new products and services or adapting existing ones), and monitored any improvement. This approach has helped the company to improve its reputation, and the corresponding sales, in a significant way. An internal study shows that in 2006 and 2007, 11 percent of the change in the financial performance of the company reflected changes in its reputation.

UnitedHealth is another company that has assessed the impact of its environmental, social, and governance work. Its social responsibility dashboard includes metrics for workplace engagement, ethics, and integrity; supplier diversity; environmental impact; employee–community involvement; stakeholders' perspectives on social responsibility; and community giving. All of these metrics track the company's progress in meeting its social mission: helping people live healthier lives. Currently, UnitedHealth's board and senior executives use the dashboard to measure the company's performance and to guide discussions on future priorities, programs, resources, and results. In the future, the dashboard will be made available to customers and other public audiences to demonstrate the company's environmental, social, and governance commitments and progress.

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Companies need broad legitimacy in the societies where they operate if they are to sustain their long-term ability to create shareholder value. Equally important, society depends upon big business to provide critical economic and other benefits. This relationship forms the basis of an overarching contract between business and society. Over the past few years, responses to the social, environmental, and governance concerns of politicians, regulators, lawyers, and consumers have reshaped the core businesses of major companies in many sectors: agribusiness, chemicals, fast food, mining, oil, pharmaceuticals, and tobacco, to name just a few. As the social contract has come under more and more pressure, companies are realizing that they just can't ignore environmental, social, and governance issues.

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