Drivers of long-term business value

Stakeholders, stats, and strategy
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Executive summary

STAKEHOLDERS have always mattered to a company. However, in an age of increasing transparency, any stakeholder—including many that may not have been considered stakeholders a few years ago—can act, and many do.¹ How stakeholders view a company, what they expect of the company, and how they understand the company’s impact on society and the environment matters to business value. A growing number of shareholders agree. For example, positive community relations have had a significant effect on mining companies’ financial valuations, emerging as a key factor in production alongside investments in capital and labor. Today, a broader range of stakeholders are raising the bar on business performance.

Determining the value of environmental, social, and governance (ESG) issues to multiple stakeholders is becoming central to how many companies craft their sustainability strategy and report on their performance. This opens the door to a new vision of the business objective: enlightened value maximization, which seeks greater alignment between various stakeholders to generate long-term business value.

If a business’s objective is to seek and maximize total value for all its constituents, then it is essential to understand what value means for stakeholders, and what value a company gains (or loses) from how stakeholders (including shareholders) perceive its actions. Stakeholder perception of value itself is not based solely upon objective outcomes but also in part upon social constructs, such as whether the company follows the UN Declaration of Human Rights. Stakeholders may also be biased regarding a company’s ESG performance, viewing it through their own lens based on how they perceive risk.

Without a deeper understanding of stakeholder judgment, a company risks being adrift in a vast sea of information, facing difficulty in crafting a strategic response and mapping a course to long-term business value creation. This paper seeks to shed light on stakeholders, taken as a whole, and when they might have a material economic impact on the company and thereby impact valuations. While demonstrating that ESG performance does matter for financial valuation in the near term, statistical evidence also points a way to long-term business value creation—not only for senior executives but also for shareholders who seek to identify companies that are committed to creating long-term value.
Friedman vs. Freeman

In 1962 Nobel laureate Milton Friedman declared, “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, which is to say, engages in open and free competition without deception or fraud.” Simply put, Friedman was saying that maximizing shareholder value is the business objective. Managers can choose to pursue activities with a social angle, including investments in “shared value,” as long as these generate profit.

Two decades later, Edward Freeman laid out his stakeholder theory of corporate management: Stakeholders include any group or individual that can affect or is affected by the achievement of an organization’s objectives. He professed that even as a company pursues profitability, it needs to create “as much value as possible for multiple stakeholders, without resorting to trade-offs.” Freeman believes that the business objective should be to augment the greater good for the many. Stakeholder theory is commonly used as an argument for why the interests of stakeholders, such as communities and employees, should be considered along with those of shareholders.

In the United States, the debate on the role of business in society dates back at least to the Great Depression, when two legal scholars squared off in the Harvard Law Review. One argued that the corporation is solely the property of its owners (that is, shareholders) and should be managed in their interests. The other contended that a corporation is a social institution that also bears a social responsibility. Today, as we emerge from the Great Recession, advocates for the “greater good” of business continue to argue that a company needs to earn its social license to operate every day and that unsustainable business practices will ultimately fail. On the other hand, challengers of the stakeholder-centric view of the corporation cite Friedman.

If the unity of the corporate body is real, then there is reality and not simply legal fiction in the proposition that the managers of the unit are fiduciaries for it and not merely for its individual members, that they are... trustees for an institution [with multiple constituents] rather than attorneys for the stockholders.”

—E. Merrick Dodd, Jr., Harvard Law Review, 1932

A new goal: Enlightened value maximization

Not everyone accepts the dichotomy, however. In the view of noted business and finance scholar Michael Jensen, if the focus is on long-term performance, then the apparent contradiction is resolved. According to Jensen, “It is obvious that we cannot maximize the long-term market value of an organization if we ignore or mistreat any important constituency.” Enlightened value maximization means that a business should “get the most out of society’s limited resources” while returning greater value to society, that is, maximizing total value creation for all important constituencies of the
firm (investors, employees, customers, suppliers, and local communities). \textsuperscript{7} Business value is created in a context that is based on what both the company and its stakeholders value. \textsuperscript{8} Consequently, the pursuit of stakeholder value and a healthy environment helps a business maximize its financial value.

In practical terms, Jensen’s vision means a business can, and should, adopt a broader approach to value maximization for a wide range of stakeholders, not just shareholder value. Specifically, enlightened value maximization incorporates value created for employees (through HR policies), for the community (through investment in the community), for suppliers (through resource efficiency gains), and for the environment (through ecosystem enhancement and protection), among many others. There is no one-size-fits-all strategy, however. Each company’s strategic objectives will vary according to its industry, business model, value proposition, product portfolio, and competitive playing field.

A second practical implication of Jensen’s vision is that when senior managers consider the interests of their stakeholders, including shareholders, these interests need not be at odds. Any trade-offs between a company’s various stakeholders ought to be resolved, at least in part, by focusing on the business objective of \textit{long-term} value maximization; as we explain later, better alignment can increase market value. Management needs to consult with representatives of key stakeholder groups (internal and external) and consider how, when, why, and by how much an ESG issue might impact the business. \textsuperscript{9} Identification of key stakeholders also needs to consider the company’s industry, business model, value proposition, product portfolio, and competitive playing field.
Stakeholders: The new scorekeepers

WHEN Freeman first proposed his stakeholder theory in 1984, the concept of corporate social responsibility was not well formulated, nor was there much talk of sustainability in the private sector until the 1992 Earth Summit. Scientific understanding of and ability to measure the impact of industrial activity on the planet and public health were nascent. Without the Internet, our global society was much less transparent.

Today the situation could not be more different. We are tracking the rise in greenhouse gas (GHG) concentrations in the atmosphere, we can measure toxic chemicals in human blood and in the foods we consume, and we are counting the demise of many species.

A wide range of stakeholders are keeping score of corporate impact on society and the environment, and, by seizing the megaphone of the Internet, challenging corporate leaders to reframe their objectives and beliefs.

There are innumerable examples of how stakeholders impact a company’s operations, from regulatory pressures to consumer boycotts and concerns over labor issues, including those in the supply chain. A company’s business partners (for example, suppliers, logistics partners, retailers, and other large customers with multiyear contracts) are also making new demands of management. In many cases, this can impact valuation and for several years, particularly when business disruption occurs. Research of 827 incidents of supply chain disruption finds a drop of up to 40 percent in stock returns of the companies making the announcement. In fact, much of the underperformance occurs in the year before the announcement, on the day of the announcement, and during the following year—showing that the stock market anticipates the bad news (sometimes six months in advance). Furthermore, these are long-tailed risks that can lead to deteriorating performance for at least two years after the disruption and are often associated with lower operating income and sales growth, and higher costs.

The research also finds an average 13.5 percent higher equity risk, particularly in the firm-specific component of risk. For some companies and some ESG issues, such risks may affect at least 5 percent of the company’s revenues—a commonly used threshold to determine what is financially material and ought to be disclosed.

Freeman’s definition implies that virtually anyone and anything can affect or be affected by the decisions and actions of a company. Yet not all ESG issues raised by stakeholders

Figure 1: Process of ESG materiality creation

Graphic: Deloitte University Press | DUPress.com
are likely to be material to a company, though many may be relevant. Figure 1, drawn from our prior research, shows how materiality can be applied in the context of ESG issues, starting with the action of stakeholders based upon their perception of a company’s ESG performance. Here the probability (P) of stakeholder action (for example, a protest) is conditional on whether the stakeholders perceive a company as either creating or destroying (what they) value: P(action)|P(value creation or destruction). We suggest that those ESG issues with the greatest probability of having a material impact on the company and its valuation in a given time frame should be disclosed, in other words, those issues that lie on or above a materiality frontier—the border between issues likely to be material or not (see figure 2).

Beyond the likelihood of financial impacts due to business interruption (described earlier), consumer boycotts, or loss of license to operate, there can also be reputational or brand impacts. These may not pose a direct threat to a company’s cash flow but may affect enterprise value, even if these impacts are below the materiality frontier. They should therefore also be carefully evaluated in a materiality determination. Given research on market value, it is likely that valuation impacts associated with the brand exceed those associated with reputation. In the remainder of this paper, we explore how stakeholders (including shareholders) can impact a company’s cost of doing business, license to operate, reputation, and brand value.

**ASK YOURSELF:**
Which ESG issues are the most likely to be material for my company?
How do my company’s business model, industry, reputation, media presence, brand, and sustainability program maturity influence which ESG issues may be material?
Statistics: Business on sustainability

While enlightened value maximization has a certain logical appeal and may be required in today’s transparent and information-rich world, it raises an obvious question: Do shareholders and business leaders reflect this in their beliefs and behaviors?

Shareholders

There are signs that shareholders increasingly pay attention to ESG performance. Since the United Nations Principles for Responsible Investment (UN PRI) were introduced in 2006, over 1,000 financial services firms (including asset owners, investment managers, and professional service partners) have signed on, jointly managing over $30 trillion in assets. In 2012, nearly one out of every nine dollars under professional management in the United States ($3.74 trillion) fell under socially responsible investment—11 percent of the $33.3 trillion in total assets under management in the United States. Since 1995 the responsible investment category has seen steady and exponential growth.

Many commentators believe we are reaching the tipping point where investor interest in corporate ESG performance is sufficient to affect valuations. Several years ago, researchers predicted that this is more likely once 20 percent of managed funds incorporate aspects of corporate ESG performance, which was predicted to cause a drop in stock prices of firms with poor ESG performance and an increase in their cost of capital. Today the combined $30 trillion in UN PRI signatory assets under management constitutes approximately 20 percent of the world’s capital. We should not be surprised to see changes in market value based upon ESG performance.

Indeed, statistical analysis of the response to new information on a company’s environmental performance reveals that the average capital market participant is already paying attention. An MIT research study of publicly traded US companies over a 30-year time span (1980–2009) showed that stock prices dropped an average of 0.65 percent within the two-day window following the release of negative environmental news—possibly driven by investor expectations that the company will face diminished cash flows. Furthermore, investors reacted more strongly to negative environmental news with each passing decade.

Positive news on a company’s environmental behavior produced an average increase of 0.84 percent in stock price. However, over time, positive investor response to good environmental news has been tapering off. This suggests that shareholders are increasingly biased against companies with poor environmental performance, and less impressed with (that is, more demanding of) stronger performers. This behavior seems to be tracking a skewed view of value that has been identified in many situations by researchers in behavioral finance—a concept we build on later in this paper.

Underlying these changes is the growth in data on corporate ESG performance, along with greater data accessibility. The number of “green” business news stories grew from less than 160 in 2000 to over 1,700 in 2007. Research on users of ESG data on a Bloomberg terminal shows that equity and fixed-income investors are interested in ESG performance.
and GHG emissions in particular. Both sell-side firms (broker dealers) and buy-side firms (hedge funds, insurance firms, pension funds, and money managers) are interested in ESG performance and are trying to integrate ESG data in valuation models.

Shareholders interested in ESG performance today have many more investment options. The first ESG tilted index, the Domini 400 Social Index, was launched in 1990. Today, there are many more sustainability indices issued by private index providers (such as Dow Jones or MSCI) and by world stock exchanges (see figure 3). Many stock exchanges issue a sustainability index to specifically encourage corporate disclosure of non-financial performance and ESG indicators in particular.

Growing shareholder interest is also evident in the number of shareholder resolutions filed targeting an ESG issue (see figure 4). The 35

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**Figure 3. Growth in sustainability indices**

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Source: World Federation of Exchanges, Deloitte analysis

Graphic: Deloitte University Press | DUPress.com

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**Figure 4. Trends in shareholder resolutions targeting ESG issues**

Source: Institutional Shareholder Services, a division of MSCI Inc.; Deloitte analysis

Graphic: Deloitte University Press | DUPress.com
lead filers in 2011 collectively managed over $500 billion in assets. In the 2011 proxy season, resolutions addressing social and environmental issues comprised the largest portion (40 percent) of all shareholder proposals that came to a vote. Furthermore, 31.6 percent of all corporate responsibility resolutions got at least 30 percent shareholder support—a level at which many boards begin to respond. Most of these resolutions called on companies to issue a sustainability report and disclose more information on exposure to climate change risks.

According to empirical research, shareholder resolutions can pressure companies in the S&P 500 index to increase ESG disclosure more effectively than regulations can. Companies targeted by a shareholder resolution are 62 percent more likely to disclose GHG emission data, especially if their industry is already under scrutiny for GHG emission levels and has been targeted by multiple resolutions. In contrast, the likelihood of GHG disclosure is only 24 percent when a company is faced with the possibility of regulated disclosure of GHG emissions (at the state level).

Corporate managers

The perceived importance of sustainability is resonating with business leaders. A recent Deloitte survey of 208 global CFOs from 10 countries found that over 70 percent are currently fully or periodically involved in all aspects of sustainability strategy and governance at their firm. The majority believe that sustainability factors have an impact on compliance and risk management, and foresee changes in financial accounting and reporting. Over 75 percent of surveyed CFOs view communicating on sustainability issues to shareholders and institutional investors as important.

A survey of UN Global Compact member CEOs found that 93 percent view sustainability as a critical driver of their company’s future success, and up to 81 percent responded that

**ASK YOURSELF:**

Do shareholders consider my company’s ESG performance in their investment decisions?

Do shareholder resolutions increasingly target my company or my industry peers?

Do I think stakeholders (increasingly) impact shareholder preferences and affect my valuations?

Can I influence my valuations by disclosing ESG information?
sustainability is an important factor in strategy and operations. By 2020, these CEOs expect sustainability to be fully integrated into corporate capabilities, processes, and systems, and across global supply chains and subsidiaries. Motivated to build their company’s brand, trust, and reputation, these CEOs believe sustainability activities can positively impact their company’s valuation by driving revenue growth and reducing costs, though making that connection is still opaque for most managers. Most CEOs surveyed have difficulty communicating the value proposition for ESG management to financial analysts.

Similarly, 70 percent of 3,000 corporate executives surveyed say that sustainability is permanently on their management agendas, despite current economic uncertainty. Driven by investors, NGOs, consumer preferences, and rising social media platforms, two-thirds of respondents believe that a commitment to sustainability is necessary to remain competitive. Similarly, three-quarters of respondents to another recent global survey believe companies should consider socially responsible investors and NGOs when crafting their sustainability strategy (see figure 5)—with good reason. Preliminary research indicates that when shareholder activists file a resolution related to a company’s environmental performance, its financial performance—measured with Tobin’s Q ratio (market value divided by book value of assets)—declines. We can deduce that the average investor believes the company is riskier and a less attractive investment.

In combination, these research findings indicate that ESG performance is influencing shareholder beliefs and behaviors. This is reflected in changes in share price and cost of capital, and it may also be changing the beliefs of corporate leaders.

Figure 5. Influencers of sustainability strategy and policy

Source: GlobeScan/sustainability survey 2012
Graphic: Deloitte University Press | DUPress.com
Finding the value in ESG management is becoming central to how many companies craft their sustainability strategy: very much in the spirit of enlightened value maximization. Based on its experience with stakeholders, ABN AMRO adopted a value-based framework (see figure 6). The bank traced its trajectory from the late 1990s, when it was targeted by NGOs (for example, Friends of the Earth, known as FOE) for its investments in mining and paper companies, to a growing commitment to the protection of forests and sensitive ecosystems. In 2003, ABN AMRO partnered with other banks to set up principles for financing projects in the mining, forestry, and energy sectors, culminating in the Equator Principles on the management of social and environmental risks in project finance. ABN AMRO identified a shift from value destruction to loss avoidance (that is, risk management) and to value creation with new product development in carbon markets.

The question is: How might this same journey appear to stakeholders? Stakeholder judgment is likely to be based on perceptions of how a company’s actions either add or destroy value. Adopting Jensen’s line of questioning: How do stakeholders perceive better or worse performance on a variety of ESG issues? Given this perception, how will they respond to changes in ESG performance? Can these decisions be anticipated, or are stakeholder actions unpredictable?

Decades of scholarly work in behavioral sciences (for example, behavioral economics and behavioral finance) finds that certain cognitive biases—summarized in prospect theory—are prevalent in any number of situations a human being can find herself in. Stakeholders, like all humans, make their judgments based on predictive cognitive biases and emotional reactions. How we make decisions in real life is not always rationally optimal. These biases can, according to research at INSEAD, help us understand how stakeholders perceive a company’s ESG performance:

- **Reference dependence**: Perhaps the most important tenet of prospect theory relative to stakeholder judgments of corporate ESG performance is that people do not judge value in terms of absolute states or outcomes, but rather in terms of gains and losses relative to a reference point. Thus stakeholders are likely to view a company’s ESG performance relative to their own reference point or target level. Sometimes they may be satisfied; other times, they may remain critical because the company’s performance is below the reference point.

- **Loss aversion** (losses hurt more than gains feel good, because people have a
hard time giving up something) and diminishing sensitivity (each incremental change in gains and losses is valued less). The first tenet implies that stakeholders tend to be more concerned when a company’s ESG performance falls relative to a preferred level. The second tenet implies that a company that improves its ESG performance from a very low level—for example, increases energy efficiency—will be rewarded more than another one that is already performing at a higher level of energy efficiency and makes a similar-sized improvement. These two tenets lead to a value function that is curved rather than a straight line, as shown above.

Sustainable finance

Let’s take another look at the challenge large global banks could face with respect to their investment decisions, this time from the perspective of stakeholders and prospect theory (see figure 7). Projects such as China’s Three Gorges Dam, Indonesian palm oil plantations, the Camisea Gas Project in Peruvian Amazon, and the Chad-Cameroon pipeline galvanized activists, who launched a full-blown international campaign against funding of large, rainforest-destroying projects. Citigroup was targeted in 2000 with protests on university campuses and in front of the bank’s branches across the globe. In 2003, activists gathered in Italy to draft the Collevecchio Declaration on Financial Institutions and Sustainability.

By 2003, the banks were ready to act, and drafted the Equator Principles, as noted earlier. Citi started negotiations with Rainforest Action Network (RAN) and agreed to partially cancel the financing of the Camisea pipeline project. By 2004, Citi reached the reference point prescribed by the activists, when it came to an agreement with RAN to cease funding any operations that risk degrading primary forests. Other financial institutions quickly followed. In 2005, JPMorgan Chase established an investment policy that included “no-go” zones, such as sensitive ecosystems, and set as priority the financing of Indonesian forests certified by the Forest Stewardship Council (FSC). Based on this information we can even say that Chase moved above the reference point adopted by the activists, when it came to value creation.

By 2006, 40 banks had adopted a revised version of the Equator Principles. The sustainable banking mandate was extended beyond protecting forests to addressing climate change with strategies such as carbon footprint reductions and investment in renewable energy.

Thus, in the perception of bank leadership and the NGO community, the banking industry moved from value destruction to greater value creation by adopting policies targeting issues of importance to stakeholders in the
area of project finance and adding another business objective: pursuit of opportunities in climate change.

Old-growth forests

Another example serves to illustrate how important reference points can be to understanding stakeholder perception of a company’s ESG performance. In the early 1990s, RAN, together with Greenpeace and the Natural Resources Defense Council, launched a campaign against the destruction of old-growth forests, targeting the Fortune 500 companies. These stakeholders wanted them to cease using or buying pulp and paper products sourced from old-growth forests. In other words, the reference point adopted by the stakeholders was “no old-growth wood” (see figure 8). Some Fortune 500 companies, such as Kinko’s and IBM, stopped using wood and paper products from old-growth forests, moving closer to the stakeholder reference point by 1997. Home Depot—at the time the world’s top seller of old-growth wood products—refused, remaining below the reference point. Starting in 1997, activists increased the pressure on Home Depot, until the company committed to phasing out products using wood from endangered forests and environmentally sensitive areas in 1999. Home Depot, along with other

Figure 8. Old-growth forest case

Source: Deloitte analysis
Graphic: Deloitte University Press | DUPress.com
major home improvement retailers, committed to preferential purchasing of wood certified to the independent FSC standard, thereby exceeding the original reference point adopted by the activists—no old-growth wood.

As of 2000, Home Depot adopted a proactive approach to how it sources wood products. Between 2000 and 2003 the company pulled out of $90 million in purchases from vendors in Indonesia and other Southeast Asian countries whose supply chains could not be validated. From 2000 to 2002, Ron Jarvis, VP of merchandising and sustainability, traveled the world to understand Home Depot’s suppliers and their forestry practices. Upon his return, he convened a meeting of key stakeholders and shared his findings on where Home Depot sourced its wood (of which 95 percent comes from North American forests). That experience showed that Home Depot knew more than many stakeholders about the issue, and has become a valuable resource with deep knowledge of forestry practices around the world.

The process of “stakeholder value creation” can be tied to improvements in a company’s financial value. Empirical research finds that stakeholder responses to a company’s actions can affect its social license to operate as well as company valuations. Asking why the value of one gold mine can differ so greatly from another, Witold Henisz and his collaborators at Wharton tested whether stakeholder engagement (conflictive or cooperative) could explain why the market valuation of 19 gold-mining companies traded at a 72 percent discount rate compared with the net present value of the gold they owned (calculated based upon the amount of gold in the ground, the cost of extraction, and the world price of gold). The researchers found that measures of stakeholder relations and country risk were worth twice as much as the value of the gold. Furthermore, support from the local community, government, and civil society could reduce the discount placed by financial markets on the net present value of the gold controlled by these 19 firms from 72 percent to as low as 12 percent. The research indicates that investing in the social license to operate is an important input factor to production for gold-mining companies.

Conversely, it has been shown that poor ESG performance tends to reduce stakeholder value, as evidenced by the drop in property values around a polluting plant. A widening “value gap” between an industrial operation and the surrounding community is inviting trouble.

In all likelihood, analysis would identify and quantify a similar process of joint stakeholder and shareholder value creation (or destruction) in industries with a large local environmental and social impact, such as extractives, mining, forestry, or utilities.

ASK YOURSELF:
Is my company’s ESG performance compared to particular reference points adopted by my stakeholders?

Do I find that there are certain ESG issues where I cannot seem to win—that is, ideal-state or zero-state?

Is my company constantly being pushed to a higher level of ESG performance?
Stakeholder value: A moving target

In addition to the challenge of identifying what level of performance stakeholders really care about (that is, the reference point), companies have to consider that stakeholders are likely to look at ESG performance from constantly shifting vantage points, or “reference states.” To understand what a reference state might be, let’s start with the status quo. Most managers tend to refer to their company’s past performance, that is, the status quo, in their communication to stakeholders. Stakeholders, however, will instead tend to compare a company to its industry peers and other norms such as regulatory standards and industry policies. An action or investment undertaken by the company that exceeds the norm is more likely to be perceived as a gain in stakeholder value. For example, JPMorgan Chase established an aspirational goal through its “no-go” policy against lending to projects that threatened sensitive ecosystems. What was an aspirational goal for one company can become an industry norm (see figure 9), as more companies agree on industry-specific policies—for example, the Equator Principles.

Sometimes stakeholder demands, such as the ideal of carbon neutrality, can be very disruptive, because they fundamentally challenge the company’s business model. One example is the “zero-state” situation, such as the local community in water-scarce areas questioning the very presence of the company. Similarly, stakeholder demands led companies selling baby products containing bisphenol A (BPA, an endocrine disruptor) to withdraw these products from store shelves. It is very difficult for companies to overcome these types of zero-state situations, where stakeholders are expressing a value set that is defined by absolutes: right or wrong. Stakeholder support for the precautionary principle is also an expression of such a value set. It is wise to acknowledge that such situations will arise and may require changes in corporate strategy.

Figure 9. Race to the top

- **Status quo**
  - Past performance
  - % reduction target

- **Industry norm**
  - Average performance

- **Aspirational goal**

- **Ideal state**

- **Zero state**

Graphic: Deloitte University Press | DUPress.com
Strategic consideration 1: Know your stakeholders

Investors and their advisors tend to treat ESG management as a downside risk, in part because it is costly to companies and the upside has been harder to show. Because people are more risk averse on losses, ESG performance below stakeholders’ (including shareholders’) reference point is likely to be more financially material than performance above the reference point. Recall that over the past 30 years investor response to positive environmental news has been diminishing, whereas investors are punishing companies more for negative news, as shown by steeper drops in stock price in more recent decades. We might deduce that as strong ESG performance increasingly becomes the norm, it is harder to impress even the average shareholder, who has also become more risk-averse to negative environment news.

Another equally important question is when the stakeholder response reaches a tipping point or threshold and poses a financially material risk to the company. We can deduce that this point occurs somewhere between nascent discussions and outright media campaigns, boycotts, or shareholder resolutions. For guidance we refer to the policy life cycle, as set forth by Maxwell, which identifies various phases of an ESG issue, starting with issue identification and limited awareness (see figure 10). As the ESG issue infiltrates various segments of our society, goes viral on social media, and flashes across traditional news media, the financial impact for an affected company tends to increase.

The first thing to note in figure 10 is the difference in costs to the company between the traditional policy life cycle—where activists and NGOs push regulators and legislators to govern company actions—and the private policy life cycle. The private policy life cycle is driven by activists who engage directly with companies and can force change and impose costs—via protests, media campaigns, and boycotts—more dramatically than regulations.

Figure 10. Policy life cycle

Source: Adapted from Maxwell, 2010

Graphic: Deloitte University Press | DUPress.com
Consider, for example, the consumer response to the fish-consumption advisory issued by the US Environmental Protection Agency (EPA) in 2001 to warn of high mercury content in certain species. Many US consumers stopped buying fish, even fish deemed safe by the EPA, and canned fish sales plunged by 50 percent.44 Similarly, even though the US Food and Drug Administration concluded that bisphenol A (BPA, an endocrine disruptor) was safe in 2006, after several national newspapers reported on the potential dangers of BPA to infants and children, mothers stopped buying baby products containing BPA. While the scientific evidence of BPA risks remains inconclusive, large retailers, manufacturers, and finally, regulatory agencies effectively eliminated baby products containing BPA in North America and Europe by 2009.

A similar phased framework for understanding how to prioritize an ESG issue was developed by Novo Nordisk45:

1. Latent: Weak evidence, little awareness
2. Emerging: Focus of NGO campaign and research
3. Consolidating: Awareness moves into public and media; strong evidence in support
4. Institutionalized: Case for issue has been made, accepted, and addressed as part of business norms or regulations

Second, private policy dynamics are speeding up in an age of social media and Internet connectivity, which has significantly reduced the costs of mobilization. For example, on September 29, 2011, Bank of America announced its plan to charge a monthly $5 debit card fee starting in 2012. Within a month, the bank backed off due to intense pressure from various stakeholders, including opinions on Twitter and Internet petitions.46

Based on the empirical record, various factors appear to influence stakeholder behavior and impacts on the business:

- Common stakeholder targets tend to be large companies in consumer products that are financially sound and heavy polluters.47 Activists also tend to target companies with a strong brand or those that are considered leaders within their industry.48

- Stakeholder protests targeting labor (for example, fair labor practices) or consumer issues (for example, product safety or performance) with more media coverage tend to have a greater negative effect on stock returns than do boycotts alone.49

- Companies with an already tainted reputation are even more susceptible to the negative effects of media attention.50

- Activists prefer to target firms that have signaled a desire to change, and often confront them with greater demands.51 Once a company has signaled a willingness to act, the bar can rise even more.

- Companies that have been targeted by a shareholder campaign, or whose industry peers have been targeted, will likely be targeted again. Similarly, boycotts are often repeatedly targeted at companies in the same industry, particularly large companies with a strong reputation. In fact, the impact on sales is less than the impact on a targeted company’s reputation.52

**Strategic consideration 2: Adapt**

One challenge for a company is how to move across an inflection point to where it is no longer perceived as destroying value on a particular ESG issue. To navigate this territory, companies need to identify how stakeholders perceive a particular ESG issue—as relative to an external norm, industry peers,
an aspirational level, ideal state, or as a zero (unacceptable) state. Managers also need to understand the reference point espoused by stakeholders on the ESG issue, which can be quantitative (for example, tons of emissions, quantities recycled, money invested) or qualitative measures of management practices (for example, labor policies).

Prospect theory tells us that the highest value gain is likely when a company moves from below-threshold ESG performance to above, as stakeholders value this transition highly. Due to “diminishing sensitivity,” companies need to work harder for each incremental gain in stakeholder value. The long-run goal should be greater consensus between the business and its stakeholders around an ESG issue, because it creates value for both—that is, enlightened value maximization.

**Strategic consideration 3: Disclose strategically and cultivate your ESG halo**

Information is money, a relationship that applies quite often when it comes to ESG disclosure. Researchers have known for over 20 years that companies that disclose more (mandated) financial information have lower capital constraints, for the simple reason that disclosure reduces transaction costs to investors.53 Similarly, voluntary disclosure on sustainability and corporate responsibility may lower the cost of equity capital for companies with stronger ESG performance that invest in employee relations, environmental policies, and product strategies. Companies that seek to reduce their cost of capital have found that ESG disclosure can help. ESG disclosure tends to attract institutional investors with a long investment horizon. Companies with strong ESG performance have increased analyst coverage and improved forecast accuracy. Conversely, companies with poor ESG performance are less likely to maintain profitability due to regulatory, customer, and investor pressure.54

Furthermore, issuing a steady stream of positive and credible ESG performance news can create a *halo effect* and insulate the company somewhat from future activist pressures and a possible drop in stock price.55 Once a company has exceeded the ESG performance threshold through prudent actions, stakeholders are much more likely to be positively inclined to the company, and may even help it uphold and strengthen its ESG halo.56 This opens up new opportunities. The company can move from risk management to creating value both for its stakeholders and its investors. However, it can pay to watch the company you keep. If a competitor in your industry falters, then it is likely that activists and shareholders will monitor your company more closely and even drive down your company’s market value. Thus, investing in industry policies, industry associations, and benchmarking with your industry peers is a good way to maintain a solid level of ESG performance and protect against the negative events that inevitably arise.
NOT long ago, business operations were grounded in the assumption that ESG issues are not financially material, because the impacts are sometime in the future and of little consequence to current business success. As we have shown, this assumption is no longer supported by statistical evidence for a growing set of ESG issues and companies. There is value in these numbers, as evidenced by growing shareholder interest and market value effects. Stakeholders are keeping score, and companies are expected to increasingly see an impact on financial performance.

More corporate leaders are broadening their understanding of business risks—some more proactively than others. However, many managers have yet to shift their frame of reference in terms of ESG performance evaluation and disclosure. Much of the information disclosed in today’s corporate sustainability reports is self-referencing and hard to interpret. An assessment of what level of ESG performance is better or worse cannot be judged relative to the company’s own internal standard or its past performance, because it does not include value creation for multiple stakeholders. We suggest that the stakeholder’s reference point is as important as, if not more important than, that espoused by managers.

A sound strategy requires an understanding of human nature and the biases that we bring to all decisions. With an understanding of prospect theory and stakeholders’ reference points and reference states, it should become easier to predict and prevent long-tailed ESG risks. Stakeholder engagement may well help protect your license to operate and strengthen your ESG halo. Success is built, in part, upon a more holistic approach to an ESG issue, such as recognizing that child labor management is tied to educational opportunity. Finally, as more managers realize that management of ESG issues is an input factor to production and not an ad hoc undertaking and become more transparent on performance, we can expect risk reduction and lower cost of capital. Stakeholders do not merely challenge the business model; they identify opportunities for value creation.
Drivers of long-term business value

Endnotes


13. http://www.sec.gov/interps/account/sab99.htm#foot2, “One rule of thumb in particular suggests that the misstatement or omission of an item that falls under a 5 percent threshold is not material in the absence of particularly egregious circumstances, such as self-dealing or misappropriation by senior management. The [SASB] staff reminds registrants and the auditors of their financial statements that exclusive reliance on this or any percentage or numerical threshold has no basis in the accounting literature or the law.”


20. Caroline Flammer, Corporate social responsibility and shareholder value: The environmental consciousness of investors, MIT Sloan School of Management, 2011. From 1980 to 1990, the average abnormal return associated with negative environmental news was -0.42 percent, decreased to -0.66 percent during 1990–2000, and further to -1.12 percent during 2000–2009.


26. Ernst & Young, Shareholders press boards on social and environmental risks—Is your company prepared?, 2011.


28. Deloitte, Sustainable finance: The risks and opportunities that (some) CFOs are overlooking, 2011. CFOs were surveyed in Australia, Brazil, China, France, Germany, India, South Africa, United Kingdom, and United States. Participating companies had average annual revenue of $17 billion; none had annual revenue below $2 billion.

29. UN Global Compact/Accenture, “A new era of sustainability: UN Global Compact-Accenture CEO study 2010.” Survey of 766 CEOs around the globe and extensive interviews with 50 of the world’s leading CEOs.


31. “GlobeScan/SustainAbility survey 2012.” 642 sustainability experts, the majority with more than 10 years of experience in sustainability, from corporate, government, non-governmental, academic/research, service/media, and other organizations in 77 countries, completed an online questionnaire during December 2–19, 2011.


36. Lankoski, Smith, and Wassenhove, Judgments of stakeholder value: Advancing stakeholder theory through prospect theory.

37. Witold J. Henisz, Sinziana Dorobantu, and Lite Nartey, Spinning gold: The financial returns to external stakeholder engagement,


39. Lankoski, Smith, and Wassenhove, Judgments of stakeholder value: Advancing stakeholder theory through prospect theory.

40. Under the precautionary principle, the burden of proof that any action or policy will not cause harm to the public or the environment falls on those taking the action, even where scientific consensus is lacking.


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43. Lyon, Good Cop, Bad Cop: Environmental NGOs and Their Strategies Toward Business.


51. Baron and Diermeier, “Strategic activism and non-market strategy.”

52. King, “A political mediation model of corporate response to social movement activism.”


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