



How Virtue Creates Value for Business and Society

Investigating the value of environmental,
social and governance activities



BOSTON COLLEGE
CARROLL SCHOOL OF MANAGEMENT
Center for Corporate Citizenship

Boston College Center for Corporate Citizenship

The Palace Museum in Beijing wanted to bring Chinese culture and history to a broader audience. In response, IBM created the 3D Virtual Forbidden City seen here, a means for a worldwide audience to explore Chinese culture and history through a first-of-a-kind, fully immersive, three-dimensional virtual world that recreates a sense of space and time in the Forbidden City as it was centuries ago during the height of the Ming and Qing dynasties.



Contents

Overview of the Research	1
Introduction	2
The Value Creation Potential of Environmental, Social, and Governance Activities (ESG)	5
The Trouble with the Numbers	17
Creating, Assessing and Communicating Value	22
Conclusion: The Path to Valuing Corporate Social Responsibility and Sustainability	32

Overview of the Research

This report is based primarily on interviews with twenty companies from 11 industries, and a *McKinsey Quarterly* global survey of CFOs, investment professionals, and Corporate Social Responsibility and Sustainability professionals.

The research is based on 135 in-depth interviews with executives from a broad range of functions, including CSR professionals, human resources, environment, strategy, finance, and investor relations. We would like to thank all of these people who generously contributed their time to be interviewed and to help develop the case studies that served as the basis for this research. Every effort was made to include examples from each of the participating companies in this paper including: AMD, Aveda, Best Buy, Campbell Soup Company, Cargill, The Coca Cola Company, Dow Chemical Company, General Mills, GlaxoSmithKline, IBM, Intel, KPMG, Marks & Spencer, McDonald's, Nestlé, Novartis, Novo Nordisk, Telefonica, United Health Group and Verizon.

The global survey was in the field in December 2008 and includes responses

from 238 CFOs and investment professionals from the full range of industries and regions. The survey was conducted along with a simultaneous survey of 127 corporate social responsibility professionals and socially responsible institutional investors reached through Boston College's Center for Corporate Citizenship.

The research team from the Boston College Center for Corporate Citizenship consisted of Philip Mirvis and Kwang Ryu.

We would like to thank IBM for its many contributions to this effort. IBM's leading practitioners provided insight and information on best practices throughout the entire process. In addition, IBM was central to developing the partnership between McKinsey & Company and the Boston College Center for Corporate Citizenship.

Finally, we would like to thank McKinsey & Company for conducting the interviews and surveys, developing the fact base, and leading the analysis on which this report is based.



Zhengjun Wang, who owns nine cows and six calves, has been supplying milk to the Nestlé plant in Shuangcheng, North-East China, since 1990. A Nestlé project in the milk district now provides farmers with proper manure storage facilities, which reduces impact on water sources and also creates a biogas energy source for farmers' homes



Introduction

In an age of globalization, social, environmental, and political changes, ranging from climate change to obesity, are presenting companies—and societies—with unprecedented challenges. Companies are under pressure from governments, society, and employees to play a leading role in developing society-wide solutions to many of these challenges. In response, most companies have developed corporate social responsibility or sustainability initiatives over the past 30 years. These initiatives attempt to fulfill business's contract with society, by addressing an increasing array of environmental, social and governance issues.¹ Executives, investors, regulators, and the public have seen such programs prevent

or mitigate corporate scandals and build corporate reputations, while also having profound positive social and environmental impacts, making these programs ever-more important to all stakeholders. In the current economic downturn, with public trust in business at an all-time low,² the benefits of these programs are even more valuable as public appetite for government regulation of business grows, and the expectation that businesses address global challenges increases.

Nonetheless, sustained, strategic investment in such programs can be a difficult to sell even in normal economic conditions—they are generally considered as separate to core business and many of their benefits are viewed as unre-

¹ For more background on the social contract between business and society, see: S. Bonini, L. Mendonca and J. Oppenheim, "When Social Issues Become Strategic," *The McKinsey Quarterly*, March 2006; S. Beardsley, S. Bonini, L. Mendonca, J. Oppenheim, "A New Era for Business," *Stanford Social Innovation Review*, Summer 2007.

² 2009 Edelman Trust Barometer shows that 62 percent of the public across 20 countries "say they trust corporations less now than they did a year ago." In America, the figure is 77 percent, which is the highest it has been over the 10 years Edelman has tracked trust.

lated to shareholder value. Such investment may seem even more challenging in the current financial environment. This report, however, shows that there are clear financial reasons for companies to invest—these programs can generate direct financial returns of as much as 3 to 1, and quantifiable shareholder value (some investors think 11 percent or more of total value). Overall, companies that excel in their social, environmental, or governance programs see improved performance in each of the standard dimensions that investors use to assess value: growth, return on capital, risk management, and management quality.

To excel, targeted strategies and implementation are as important here as everywhere else in a business. Our research shows that social, environmental and governance programs must align closely with a company's core business and capabilities. They should also create real growth opportunities and manage for risks to the company arising from these issues. Beyond that, companies will only reap their program's full financial rewards if they

can understand the value they are creating and communicate that value to the markets. Therefore, it is critical for companies to establish metrics and track the impact of such programs on value—which few are able to do today.

This report illustrates some of the ways that the most advanced companies have created value from their environmental, social, and governance programs. It also explains why such programs are so hard to assess quantitatively, and lays out a framework for how companies can develop programs strategically, meaningfully assess the value they create, and communicate that value internally and externally.

Given social expectations, most companies cannot function without these programs. The choice they have is to manage them well or poorly. Implementing successful program will not only help companies, but, by encouraging additional investment and focusing their core strengths on society's challenges, will also create more value for society.

Box 1: Defining ESG

There are many overlapping terms for programs that companies undertake to meet society's expectations. The most widely recognized are "Corporate Social Responsibility (CSR)," and "Sustainability." (Other often used labels for such programs are "Corporate Responsibility" and "Corporate Citizenship.") Because CSR can have a connotation of focusing solely on social programming and philanthropy, and Sustainability can have a connotation of focusing solely on the environment, we have chosen "Environmental, Social and Governance," or "ESG." This term is also increasingly used by investors to refer to the broader set of programs that we observed in the companies referred to in this report.




These programs have their roots in corporate ethics and philanthropy, addressed through codes of conduct and corporate community relations activities. Their scope expanded in the 1970s and 80s, primarily in response to scandals and criticisms levied at businesses, to encompass workforce diversity, occupational health and safety, the effects of unsafe products on consumers, and the effects of corporate activity on the environment. As ESG continued to evolve, it grew to include human rights and supply

chain working conditions in the 1990s, and expanded further to include governance, transparency, and public health concerns in the first decade of this century. In the current economic setting, ESG programs can be understood even more broadly, to include the fundamentals of the social contract between business and society--the basis of trust and reputation--as well as specific programs. The exhibit shows in detail what some of these issues are for the high-tech industry, as an example (Exhibit Box 1).

Exhibit Box 1

The ESG environment in which the high-tech industry operates has opportunities for value creation on various issues

ILLUSTRATIVE

Issues/opportunities description	
<p>Environmental</p> 	<p>E-waste</p> <ul style="list-style-type: none"> Production of toxic waste such as chemicals or heavy metals needs to be addressed by the industry <p>Water</p> <ul style="list-style-type: none"> The large amount of clean water consumed in the production process that could be reduced/recycled <p>Energy consumption and climate change</p> <ul style="list-style-type: none"> Growing public concern about global warming (e.g., datacenter energy consumption doubled from 2000–05) needs to be addressed Technology can be a source of energy efficient solutions
<p>Social</p> 	<p>Digital divide</p> <ul style="list-style-type: none"> Increasingly large difference in digital literacy and access in the developed and developing countries requires the industry to find in a solution <p>Product health and safety</p> <ul style="list-style-type: none"> The prevalence of issues such as children playing violent video games must be addressed head on <p>Human rights in the supply chain</p> <ul style="list-style-type: none"> Offshoring and outsourcing production are leading to reduced control over labor conditions and product safety, but companies must remain vigilant
<p>Governance</p> 	<p>Privacy and identity theft</p> <ul style="list-style-type: none"> The public expects companies to protect them from these risks <p>Internet access and transparency</p> <ul style="list-style-type: none"> There is an increasing demand for unrestricted internet access that companies must balance alongside safety and transparency concerns

SOURCE: Team analysis

The programs that can address such issues include:

- Philanthropy: Contributing to issues important to the larger community
- Social and environmental investment: Addressing social and environmental issues that affect the company and stabilize or ensure long-term markets
- New market or business development: Creating new revenue streams through ESG activities
- Business basics: Improving ongoing core activities through ESG activities



Verizon's targeted services, such as its videophone service for hearing impaired people, not only help customers but also result in sales rates that are twice as high as traditional service calls made by this customer segment.

The Value Creation Potential of ESG

Since the 1970s, ESG's prominence has grown within corporations (see Exhibit Box 1); however, questions as to whether they create real financial value has long been an open question. The majority of published academic studies find a positive empirical link between corporate social and financial performance. Most studies are, however, undermined by inconsistent definitions and poor data quality, making it difficult to reach a definitive conclusion.³

Given this difficulty, we decided to turn to investors and companies themselves to better understand the relationship between ESG activities and value creation. We examined overall value creation from a top-down perspective, by surveying

CFOs, investors, and ESG professionals⁴ to understand their views. We also examined the question from a bottom-up perspective, by constructing case studies of 20 companies with leading ESG programs across multiple industries.

The short answer is: ESG programs can create significant, quantifiable financial value. The results of the McKinsey survey indicate agreement among CFOs, investment professionals, and ESG professionals that these programs create measurable shareholder value. Our case studies of companies across industries provide further evidence of positive value creation and give us an understanding of the many ways in which value is created.

³ For a review of studies on the linkage between CSR and financial performance see: J.D. Margolis, H.A. Elfenbein, and J.P. Walsh, "Does it pay to be good? A Meta-analysis and redirection of research on the relationship between corporate social and financial performance," *Harvard Business School Working Paper*, 2007.

⁴ The Boston College Center for Corporate Citizenship defines 'ESG professionals' as senior corporate executives with dedicated responsibilities for managing corporate citizenship issues and staff in the areas of community and public affairs, communications and reporting, and/or environmental health and safety. For the purposes of this document, we will refer to these respondents as 'ESG professionals' and to the programs we are discussing as environmental, social, and governance or 'ESG programs'.

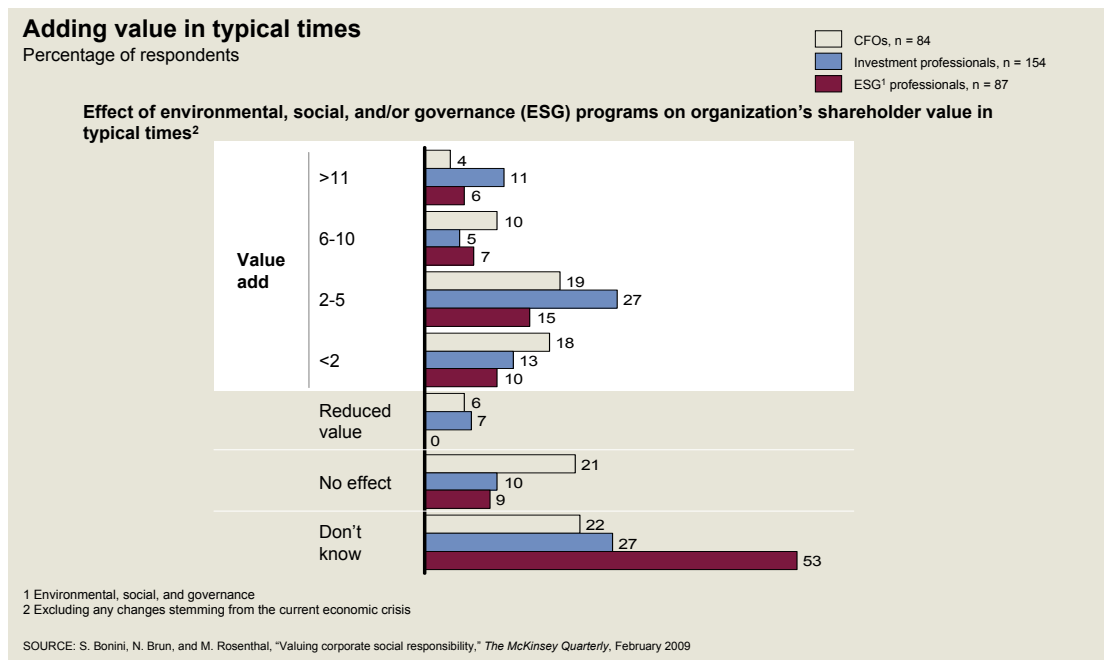
Insights from CFOs, investors, and ESG professionals

The McKinsey survey of CFOs, investment professionals, and corporate social responsibility professionals from around the world explored whether environmental, social and governance programs create value and, if so, how much value. It also examined how respondents thought value is created and their expectations of how these programs' contributions to value will change. The analysis shows

that CFOs and investment professionals believe ESG efforts create financial value in typical times (Exhibit 1).⁵

Across the board, respondents strongly agree that maintaining a good corporate reputation or brand equity is the most important way these programs add value. Most also see employee attraction, retention, and motivation as another important factor (Exhibit 2). In the midst of the current economic crisis, respondents indicate that governance programs make the most contribution to value in the short term (Exhibit 3).

Exhibit 1



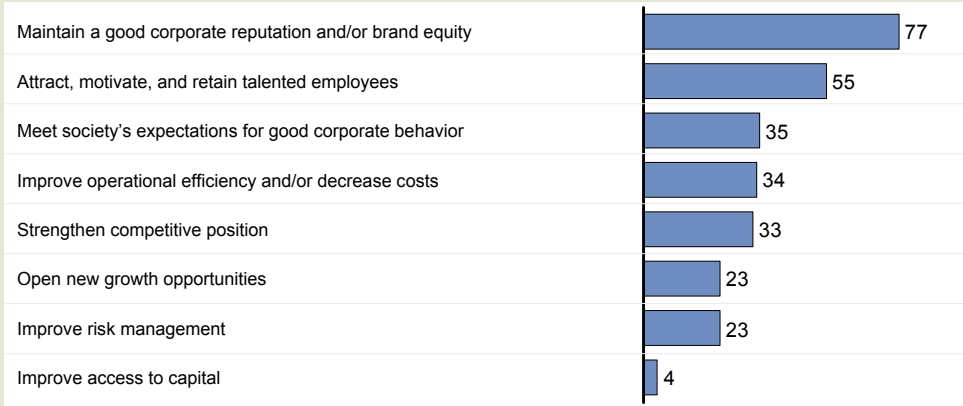
5 This survey was conducted in December 2008 and includes responses from 238 CFOs, investment professionals, and finance executives from the full range of industries and regions. The survey was conducted in conjunction with the Boston College Center for Corporate Citizenship. McKinsey simultaneously surveyed 127 ESG professionals and socially responsible institutional investors. The institutional investors are members of the Sustainable Investment Research Analysts Network, who are dedicated to advancing the concept, practice, and growth of socially and environmentally responsible investing.

Exhibit 2

Where value add comes from

Percentage of respondents,¹ multiple choice answers

Ways in which ESG programs improve a company's financial performance²



¹ Including CFOs, investment professionals and ESG professionals
² Excluding any changes stemming from the current economic crisis

SOURCE: S. Bonini, N. Brun, and M. Rosenthal, "Valuing corporate social responsibility," *The McKinsey Quarterly*, February 2009

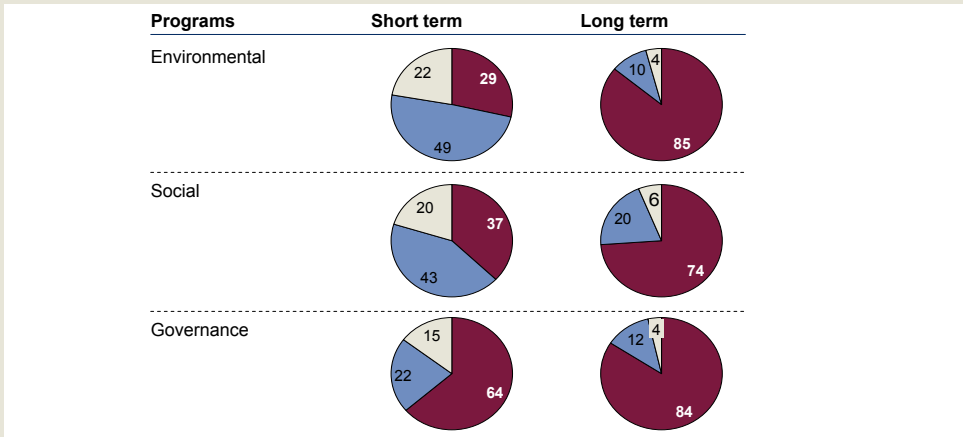
Exhibit 3

Contribution of ESG programs to shareholder value

Percent of respondents,¹ n = 150

Negative/substantially negative
 Neutral/can't evaluate
 Positive/substantially positive

Rating of contribution of given program to shareholder value in the short and long term²



¹ Figures may not total 100%; rounded figures only
² Respondents who answered 'don't know' are not shown

SOURCE: S. Bonini, N. Brun, and M. Rosenthal, "Valuing corporate social responsibility," *The McKinsey Quarterly*, February 2009

In the longer term, some two-thirds of CFOs, investment professionals, and ESG professionals believe that the shareholder value created by environmental and governance programs will increase relative to their contributions prior to the crisis. Expectations of social programs are more modest; half of respondents say they will contribute more value.

Companies creating value from ESG

Our interviews with companies with leading ESG programs provided insight into how they consciously create real financial value from ESG, while also maintaining or improving the social or environmental impact of their programs. In each of the dimensions of value the market typically assesses—growth, return on capital, risk management, and quality of management—we have found ESG programs making contributions. Building or maintaining a good reputation is the most widely known way in which ESG affects drivers

of value (see Exhibit Box 2), but there are also many others (Exhibit 4).

Growth

Our case studies highlighted reputation, and four other areas where ESG has a demonstrable impact on growth: new markets, new products, new customers/market share, and innovation.

New markets: IBM has used ESG activities to establish a footprint in new markets by developing a track record with local stakeholders (e.g., government officials and NGOs) through programs such as the Small and Medium Enterprise (SME) toolkit. The SME toolkit provides free web-based resources on business management for small and medium enterprises in developing economies, in partnership with the International Finance Corporation of the World Bank and with partners such as India’s ICICI Bank, Banco Real in Brazil, and Dun & Bradstreet in Singapore. Over-

Exhibit 4

Pathway to value from ESG along four dimensions

ILLUSTRATIVE

Growth	New markets	▪ Gain access to new markets and market share through exposure from ESG programs
	New products	▪ Create products to meet unmet social needs and increase differentiation
	New customers/market share	▪ Use ESG to engage consumers and build knowledge of expectations and behaviors
	Innovation	▪ Develop cutting edge technology and innovative products and services for unmet social or environmental needs that could translate to business uses, patents, proprietary knowledge, etc.
	Reputation/differentiation	▪ Foster brand loyalty, reputation and goodwill with stakeholders by engaging with them on ESG programs
Return on capital	Operational efficiency	▪ Enable bottom line cost savings through environmental operations and practices (e.g., energy and water efficiency, less raw materials needed)
	Workforce efficiency	▪ Reduce costs generated by employee attraction and turnover by using ESG to build morale ▪ Develop employees’ skills and increase productivity through participation in ESG activities
	Reputation/price premium	▪ Develop reputation on ESG that garners customers’ willingness to pay price increase or premium
Risk management	Regulatory risk	▪ Mitigate risks by complying with regulatory requirements, industry standards, and NGO demands
	License to operate	▪ Facilitate uninterrupted operations and entry in new markets using local ESG efforts and community dialogue to engage citizens and reduce local resistance
	Supply chain/security of supply	▪ Secure consistent, long-term, and sustainable access to safe, high quality raw materials and products by engaging in community welfare and development
	Reputational risk	▪ Avoid negative publicity and boycotts by addressing ESG issues
Management quality	Leadership development	▪ Develop leadership skills and improve employee quality through ESG participation
	Adaptability	▪ Build ability to adapt to changing political and social situations by engaging local communities
	Long-term strategic view	▪ Develop long-term strategy encompassing ESG issues

SOURCE: Team analysis

all there are 30 SME toolkit sites in 16 languages. Building the capacity of these businesses not only improves IBM's reputation and relationships in new markets, but also plants the seeds for the SMEs to become potential future customers.

New products: Verizon's wireless business had been exploring products for the elderly when it teamed up with the company's Corporate Responsibility group, which was thinking about how to better serve the disabled. Armed with input from disability and senior advocates, the company designed "The Coupe", a phone created specifically to address the unique needs of these two demographics. The product launched in 2008 and sold 400,000 units, remained on backorder for months, and is into its second wave with "The Knack", which has already sold 100,000 units. In addition to the new device, Verizon Wireless also created a senior calling plan, which brought 100,000 new customers. Wireless spending by the senior segment increased by 100 percent from 2007 to 2008. Marrying a social need with product innovation has opened up a whole new customer base for Verizon.

On the green front, IBM has developed green data center products, which have spurred business growth by offering customers products that meet their environmental concerns. A new effort with The Nature Conservancy is developing a 3D imaging technology to advance water quality efforts. The effort leverages IBM's existing capability in sensors—which can link wirelessly to a central system that manages data and translates it into useful information for decision makers—and applies that capability to water, a new area of business opportunity and environmental need.

New customers: Telefónica has been developing new products and services specifically geared toward the population of customers above the age of 60. In an effort to overcome what Telefónica terms as a 'knowledge barrier,' it has developed a training program in collaboration with elder associations. Telefónica offers a free training course, taught by retired people to their peers, about how to use new technologies, and introduce them to some of the benefits; for example, being able to communicate with grandchildren living abroad. Participants are taught to use Telefónica services and devices, and the program allows the company to build a customer base in an underpenetrated market. It also allows the company to meet a social need by training this segment of the population on how to use modern technologies and services.

Novo Nordisk provides another example of developing new customers. Their 'Changing Diabetes' platform supports the company's long-term aspiration to defeat this disease by finding better methods of prevention, detection, and treatment. Supporting the implementation of the UN Declaration on Diabetes, the company's efforts focus on encouraging health policymakers to put diabetes higher on their agendas, educating healthcare professionals and people with diabetes to improve diagnosis, care and self-management, and raising awareness in communities to drive prevention of diabetes. In emerging economies such as India, China, and Bangladesh, Novo Nordisk has engaged long before the disease took on a national scale by helping build clinics, national diabetes programs, systematic education for doctors, nurses and patients, and comprehensive patient support initiatives. For instance, the company was behind the first Chinese language website for people with diabetes and

sponsored a national TV program that raised awareness of diabetes and how to prevent or manage the disease to millions of Chinese. To date, 380,000 healthcare professionals around the world have been trained in diabetes, the majority in Asia. In China, the company has earned market leadership, with a market share well above 70 percent.

Market share: Coca-Cola provides a different sort of example of increasing volumes through environmental practices. Coca-Cola has developed new, 'eKOfreshment' coolers, vending machines, and soda fountains for retail locations that are far more environmentally friendly than the existing ones—they eliminate the use of HFCs⁶ as a refrigerant in insulation material and refrigeration systems, and reduce energy consumption by using a sophisticated energy management device developed by Coca-Cola (which reduces indirect carbon emissions from power plants). Together, these innovations increase energy efficiency by up to 35 percent. The company has highlighted the benefits—especially the financial savings from energy efficiency—to retailers and, in turn for providing more efficient equipment, has asked for prime space in their outlets.

Innovation: IBM is also an example of a company that creates innovative social solutions and feeds those innovations back into its business. The Palace Museum in Beijing wanted to bring Chinese culture and history to a broader audience. In response, IBM created the 3D Virtual Forbidden City, a means for a worldwide audience to explore Chinese culture and history through a first-of-a-kind, fully immersive, three-dimensional virtual world that recreates a sense of space and time

⁶ Hydrofluorocarbon (HFC) are a category of greenhouse gases commonly used as refrigerants.

in the Forbidden City as it was centuries ago during the height of the Ming and Qing dynasties. The project was a significant benefit for the Palace Museum, and it was a test bed for new virtual worlds technology that could later be adapted and sold to clients, provided a means for developing new employee skills, and had positive reputational impact. It has been used to close a number of key business deals in the virtual worlds area.

The Dow Chemical Company has encouraged innovation through its 'Breakthroughs to World Challenges' initiative. By 2015, Dow has committed to achieving at least three breakthroughs that will significantly improve the world's ability to solve the challenges of: affordable and adequate food supply, decent housing, sustainable water supplies, or improved personal health and safety. All of these areas have a connection to an existing or future planned Dow business. The objective is to meet these global needs by building on Dow's ability to develop new technologies with innovative chemistry, manufacturing processes, or delivery mechanisms. The company has already made progress by investing in a new, inexpensive water filtration system that utilizes Dow's understanding of plastics and water purification, and created a partnership with a social entrepreneur in India to collaborate on distribution and sales mechanisms. The end result of this initiative will be the development of a new business model to sell these new products at reasonable prices to the communities that need them, thus meeting a social need while also contributing to Dow's bottom line.

Return on capital

We have observed companies generate return on capital from their ESG activities in several ways, most frequently through

operational efficiency and workforce efficiency.

Operational efficiency: ESG-driven programs can help companies realize substantial savings from their efforts to meet environmental goals in areas such as: reduced energy costs from energy efficiency, reduced input costs from packaging initiatives, and process improvements. Creating these efficiencies often requires capital investment upfront to upgrade technologies, systems, and products. Companies such as Dow, which have done this strategically, can see a significant return. As part of its 2005 Environmental, Health and Safety goals, Dow invested \$1 billion over 10 years to reduce its energy consumption and improve its efficiency. The company has by now seen savings of \$7 billion from improved energy efficiency and the reduction in waste water produced in its manufacturing processes, and it is continuing to develop new innovations to push this effort further.

Novo Nordisk has also taken a proactive stance on environmental issues that have led to operational efficiency. In 2006, Novo Nordisk set an ambitious goal to achieve an absolute 10 percent reduction of its CO₂ emissions in 10 years. Lean production, energy efficiency, and conversion to renewable energy were the three levers, and in partnership with a local energy supplier Novo Nordisk designed an innovative model to ensure that the target will be met. The partnership is based on the energy supplier helping to identify energy savings at Novo Nordisk's Danish production sites, which account for 85 percent of the company's global CO₂ emissions. In return, Novo Nordisk earmarks financial savings to pay the supplier's premium price for wind power. In 3 years, an accumulated 20,000 tons of

CO₂ have been saved, and by 2014 the company's entire activities in Denmark will be powered by green electricity. In addition to reducing emissions and increasing the energy efficiency of its operations, Novo Nordisk is helping build the market for renewable energy in Denmark.

Workforce efficiency: General Mills has taken a targeted and strategic approach to reducing employee turnover, particularly among minority groups, by uncovering and addressing the underlying causes and then continuing to monitor progress through employee surveys. One example is a \$500,000 ESG program, 'Celebrating Communities of Color,' that provides \$10,000 seed grants to organizations serving communities of color. General Mills communicates about the program throughout the company and all employees have the opportunity to volunteer. The ESG efforts, along with strong and focused efforts to retain and develop employees, have helped General Mills significantly reduce the turnover of minority employees.

Best Buy has also undertaken a targeted effort to reduce employee turnover, particularly among women. In 2006 it launched the 'Women's Leadership Forum' which brings together groups of female employees and teaches them how to become innovators for Best Buy by brainstorming ideas, testing execution, and measuring results. These innovations have been largely centered on enhancing the customer experience for women through altering the look and feel of the store and modifying the product assortment, and have succeeded in significantly boosting sales to women. In addition to fostering innovation, the program helps women build a network that will support them at the company, and encourages them to build leadership skills by orga-

nizing events to give back to the community. In the program's first 2 years, turnover among women decreased by more than 5 percent each year.

Risk management

Environmental, social and governance issues are often seen by companies as potential risks. Many ESG programs were originally designed to mitigate these risks, particularly with regard to reputation, but also in the areas of: regulation, license to operate⁷, and supply chain or security of supply. Today, most companies manage many risks presented by ESG issues through policies on issues ranging from corruption and fraud to data security and labor practices. Creating and complying with these policies is an extremely important part of risk management in this area, although it is unlikely to be a source of significant differentiation. Beyond these basic practices typically covered by ESG policies, leading companies can differentiate themselves by taking a proactive role in managing ESG risks.

Regulation: In most geographies, regulatory policy shapes the structure and conduct of industries and can have a dramatic impact on corporate profits—impact that can dwarf gains made by normal operational measures.⁸ It is therefore critically important for companies to proactively manage their regulatory agenda—ideally having a seat at the table when future regulation for their industry is contemplat-

ed and crafted. Having strong relationships with stakeholders and a reputation for strong performance in environmental, social, and governance areas helps companies build the necessary trust with regulators to secure a voice in ongoing discussions. Verizon, for example, takes a very active role in managing its relationships with stakeholders and works to have regular contact and strong relationships with policy makers. Verizon has also been active in sponsoring research on how information communications technology (ICT) promotes energy efficiency in order to assist policy makers in formulating sound—and favorable—energy and climate policy; for example, the Smart 2020 report detailed how broadband and ICT can help the U.S. reduce carbon emissions by 22 percent and reliance on foreign oil by 36 percent by 2020.

License to operate: Coca-Cola has been proactive in identifying the risks to its business of 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 be able 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.

Supply chain/security of supply: Some companies have moved beyond considering the risks of the day-to-day practices of suppliers to also considering the

⁷ License to operate is not a legal license, but a grant of permission to undertake trade or carry out a business activity based on an agreeable social contract between company and society.

⁸ "To shape regulation, companies will have to make it a core element of their strategies and move regulatory affairs from the exclusive domain of legal, technical, and public-relations experts to the agenda of the CEO and the top team": S. Beardsley, L. Enriquez, and R. Nuttall, "Managing regulation in a new era," *The McKinsey Quarterly*, December 2008.

long-term sustainability of those suppliers. Nestlé, for example, is following a 'Creating Shared Value' strategy where business has to make sense for all stakeholders involved. As an example, for about 40 percent of its supply of milk and 10 percent of its coffee, Nestlé works directly with farmers and agricultural communities who bring their agricultural production to Nestlé factories. To ensure this direct and privileged channel, Nestlé promotes development in farming communities by building infrastructure, training farmers, and paying fair market prices directly to producers, rather than middlemen. Nestlé's involvement in capacity building of local farmers ensures higher quality agricultural output as inputs to Nestlé products. The strong relationships also give a reliable source of supply to Nestlé factories, even when the overall market may experience shortages. In 2007, for example, the price of milk powder on the world market soared. By having direct links to farmers, Nestlé was able to mitigate the supply and price risks in certain parts of the world and to ensure reliable value for all stakeholders from farmers to consumers.

Similarly, Cargill has also developed extensive efforts to engage in the local economic development of the agricultural communities that supply its products, by offering training, new technologies, and transparent pricing. For example, Cargill has been investing in the cotton ginning business in East and Southern Africa and built closer relationships with cotton farmers and cooperatives to improve the quality and productivity of their crops and support improved agricultural management practices.

Another way companies think about the long-term sustainability of their supply chains is exemplified by McDonald's,

which has gone to great lengths to ensure the quality, security, and sustainability of its fisheries. The company's Global Fish Board governs a sustainable fish sourcing policy, which outlines criteria for sustainability in the areas of fishery management, fish stock status, and environment and biodiversity. An NGO, Sustainable Fisheries Partnership, rates every fishery that McDonald's sources from against those criteria and the Global Fish Board uses that information to work with suppliers on improvement plans or move purchases to more sustainable fisheries if needed. This is part of a larger effort to ensure the sustainability of the company's supply chain and to enhance its reputation as a responsible steward of the environment.

Management quality

The McKinsey survey highlighted that CFOs and professional investors see the existence of high-performing environmental, social, and governance programs as a proxy for how effectively a business is managed; more than 80 percent of both groups say that it is "to a large degree/somewhat" true.

When assessing management quality, investors typically consider three key aspects including: leadership strength and development, both at the top and through the ranks; overall business adaptability; and a good balance of short-term priorities with a long-term strategic view. ESG can have a strong impact across all three areas, as exemplified by some of the companies we observed.

Leadership development: IBM's Corporate Service Corps sends top performing emerging leaders to work pro bono with NGOs, entrepreneurs, and governmental agencies in strategic emerging markets. They work in teams on projects where

information technology is used to foster growth and economic development. The program promotes global integration of IBM employees, while also building leadership skills and goodwill in local markets. The program has already seen statistically significant improvements in five areas: global leadership skills, cultural intelligence and global awareness, employee retention and commitment to IBM, new knowledge and skill contribution to IBM, and intrapersonal growth. In a recent evaluation nearly all participants indicated that participation in the Corporate Service Corps increased their likelihood of staying at IBM.

KPMG has used employee engagement in ESG activities as a tool to strengthen recruitment, retention, and international mobility. The particular focus at KPMG is the application of employees' core skills and capabilities—in the fields of audit, tax, and advisory—to some of the major challenges facing the world. For example, KPMG has partnered with the Millennium Cities Initiative to advise nine mid-sized cities across sub-Saharan Africa on how to achieve the Millennium Development Goals.⁹ Since 2007, KPMG employees have produced business investment reports presenting the challenges and opportunities in these cities and KPMG has provided a full-time employee to develop business networks. This engagement not only meets a social need but provides opportunities for employees to expand their skills and gain international exposure.

⁹ The Millennium Development Goals (MDGs) are eight international development goals that the United Nations member states and international organizations agreed to achieve by the year 2015. They include reducing extreme poverty, reducing child mortality rates, fighting disease epidemics such as AIDS, and developing a global partnership for development. See <http://www.un.org/millenniumgoals/> for more information.

Adaptability: Companies that are flexible enough to respond to unforeseen challenges, such as remaining in countries or communities during times of crisis or conflict, are often able to reap long-term benefits. They are also able to secure relationships and credibility with local communities. ESG is one way to boost resiliency. Cargill makes a long-term investment in the local communities within the 66 countries where it operates, which has allowed them to sustain operations, even during times of political turmoil. For example, Cargill is presently maintaining its presence and operations in Zimbabwe, and is working with local employees to compensate them creatively—in the form of food parcels and fuel vouchers—due to the country's unstable currency.

Long-term strategic view: Companies that take a long-term view use ESG activities to anticipate risks and create opportunities from emerging environmental, social, and governance issues in the markets where they operate. Novo Nordisk takes a long-term view of their business, and manages it according to principles of 'Triple Bottom Line,' which dictate an economically viable, environmentally sound, and socially responsible approach to business. Its diabetes platform illustrates the concept: Novo Nordisk has positive social impact by investing in preventing, diagnosing, and treating diabetes and building healthcare infrastructure, while also strengthening its position in mature markets and building its business in new markets.

Box 2 Reputation: the known impact

Reputation results from the perception stakeholders form of a company’s tangible actions. It is a key to value generation because, over the long term, it shapes the behavior of critical stakeholders such as regulators, customers, and employees. It has long been clear that a strong reputation for ESG programs that meet community needs and go beyond regulatory requirements or industry norms can be a factor in financially valuable outcomes. These outcomes include better regulatory settlements, price premiums, increased sales, reduced risk of boycotts, and better talent retention, to name a few—in other words, reputation has impact across all the key value drivers of growth, return on capital, risk, and management quality (Exhibit Box 2). Below are highlights of the impact of a good reputation on growth, return on capital, and risk; the areas where it has the most tangible effect.

Exhibit Box 2

Components of trust and reputation can be broken down and linked to value drivers and metrics

Value driver	Reputation with ...	Pathway to value	Metrics
Growth	Customers/ consumers	<ul style="list-style-type: none"> Access to new customers Loyalty of customers 	<ul style="list-style-type: none"> Number of customers Frequency and amount of purchase Years of service to customer Survey of whether customer uses competitors and sources of motivation
		<ul style="list-style-type: none"> Attraction of employees Quality of employees 	<ul style="list-style-type: none"> Acceptance rate of job offers Ranking schools for matriculation
Return on capital	Future employees	<ul style="list-style-type: none"> Retention of employees Motivation of employees 	<ul style="list-style-type: none"> Cost of training new employees Retention rate over time Productivity levels of employees Employee survey on ESG, motivation and loyalty
	Employees	<ul style="list-style-type: none"> Retention of employees Motivation of employees 	<ul style="list-style-type: none"> Cost of training new employees Retention rate over time Productivity levels of employees Employee survey on ESG, motivation and loyalty
Risk management	Regulators	<ul style="list-style-type: none"> Compliance and risk management Shaping future regulations 	<ul style="list-style-type: none"> Cost saved by compliance or favorable regulation Number of major policy conversations where invited Percentage of relevant new laws where company had a seat at the table
	NGOs	<ul style="list-style-type: none"> Risk management Partnerships 	<ul style="list-style-type: none"> Cost saved by scandals avoided New customers or deals won through partnership with, or endorsement by, NGO of company’s responsibility

SOURCE: Team analysis

Growth: Building reputation and trust with key stakeholders such as regulators and NGOs can lead to growth through market access, particularly when entering new markets. In the pharmaceutical sector, many companies have been building their reputations in part through partnerships with international health organizations and NGOs to donate and distribute drugs in developing countries. One good long-term example is GSK, which has since 1998 been an active partner in one of the world’s biggest public health initiatives—an effort led by WHO to eliminate the lymphatic filariasis (LF) disease, which affects more than 120 million people, primarily in developing countries. In addition to the positive social impacts of moving to eliminate this disease, the company’s commitment to this area has helped establish trust in its relationships with regulators and others, and they are able to have a seat at the table in conversations that they would not otherwise garner.

Companies can drive increased sales at the same time as building reputation with ESG initiatives. Best Buy is building a stronger reputation by addressing a growing consumer concern—in 2008, the company launched an e-waste recycling program to provide customers with the opportunity to bring many of their old electronics to Best Buy stores to be recycled. The program was designed with customer convenience in mind but has generated additional positive effects for Best Buy, including positive press and positioning the company as an environmental leader among consumers and regulators. The program leads to growth by increasing foot traffic in stores and creating incremental additional revenues for Best Buy.

Return on capital/price premium: Developing a good reputation on ESG also leads to a willingness among customers to pay a price premium. Aveda is an example of a company whose entire brand equity and image has been built on high-performing, plant-based products and sustainable business practices, anticipating by several decades the growing public concern about the environment. This brand proposition has been a driving factor in Aveda's ability to maintain a strong position at the high end of the market. Customers are willing to pay a premium for Aveda's products because of their natural ingredients and Aveda's commitment to environmental and social responsibility. In turn, Aveda's partner salons and spas remain loyal affiliates because of the holistic approach Aveda takes to their businesses, including sustainable professional products, focused customer service and professional training, and partnering with them in philanthropy during 'Earth Month.' This approach has resulted in clear business success: 55 percent of the fastest growing 200 salons in the U.S. are Aveda-exclusive, and 79 percent of Aveda's global business is with salons that exclusively use the brand, in contrast with an industry practice of 'cherry picking' products from multiple manufacturers' lines.¹⁰

Risk: When a company is considered culpable of environmental, social or governance missteps, it can be extremely costly in terms of negative publicity, halted operations, or lost sales. Reputational problems, moreover, can take a very short time to blow up but take years to overcome. In some cases, the company under attack may not be the most culpable, but simply the most visible. The stronger a company's reputation is with key stakeholders such as citizen groups, the media, regulators, and nonprofits, the more likely it is to be given the benefit of the doubt when questions arise or to have the chance to work out problems with stakeholders before they escalate into public view.

Intel has been successful in engaging local stakeholders and building trust with local communities by being responsive to community needs. The company has formed community advisory panels at its major sites that allow members of the local community to engage with senior Intel business leaders on topics the community wants to hear about. These panels have allowed Intel to be proactive about managing concerns, avoid zoning delays and fines, and benefit from tax incentives established by local communities.

¹⁰ 'Salon Today', Aveda press release.



Novo Nordisk's Changing Diabetes platform sponsored a Star Search television program in China to put diabetes on the public agenda in order to raise awareness and prevention.

The Trouble with the Numbers

While our research shows that companies can create significant value from ESG, and that investors believe there is value in these activities, there are many challenges that prevent companies from properly measuring value creation and inhibiting investors from fully taking these activities into account in their valuations. Yet measuring value is crucial. First, because it will help companies themselves understand the value ESG can create, which will help them commit resources to the most valuable programs. And second, because when companies understand the metrics most valuable to investors they can communicate them and get full credit in the markets for their ESG efforts. The barriers to good metrics that came to light in our research are: 1) the difficulties companies have with tracking data; 2) the inability of investors to obtain the data most useful to them; and 3) inappropriate metrics and indices.

Tracking data

Companies are trying to track at least some of the benefits of ESG but they have difficulty converting their metrics into financial data. Many companies have made great progress tracking operational metrics (e.g., tons of carbon emitted) or social indicators (e.g., number of students enrolled in a program), but they still cannot track financial impact. The area in which most companies are trying to track the impact of ESG is on brand value and corporate reputation, with 78 percent of ESG professionals surveyed stating that they track this impact. In addition, 63 percent of ESG professionals account for the role ESG plays in cost savings and 59 percent in giving advantages versus competition through differentiation. However, on the dimensions where ESG has a more indirect impact, companies indicate a much lower emphasis on tracking the impact of ESG, with less than 40 percent tracking revenue generation from ESG

and only 12 percent looking at the impact of ESG on share price. Overall, companies are inclined to measure revenue preservation, not the financial upside.

A recurrent explanation from companies we interviewed as to why they do not track financial impact was that contributions are too ‘indirect’ to value (because they often focus on reputation) or the effects are embedded into parts of the core business—for example, many food and beverage companies embed nutrition considerations into their products and 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. These issues make it difficult to determine the financial contribution of an ESG portfolio. Consequently, several companies we interviewed see the hurdle of trying to develop data on ESG that meets SEC standards as nearly impossible.

The challenge of measuring the financial value of ESG may be the reason why only about one in five CFOs fully integrate environmental, social, and/or governance considerations into their evaluation of corporate projects.¹¹ Most integrate it ‘somewhat’, though nearly one in five CFOs do not consider it at all.

The right value for investors

The challenges faced by companies affect the ability of the financial markets to account for the value of ESG. While our survey shows that professional investors see ESG programs as having a financial impact—indeed, a larger share of them do

so than CFOs—only 11 percent fully take it into account when valuing companies. Like CFOs, they identify a lack of data as the primary problem.

Another issue is that markets by and large focus on the short-term value creation of companies,¹² while the value created by ESG activities is often perceived by companies as longer term. As we heard from the director of Investor Relations at one company, “Analysts are focused on the short term because their remuneration and fund return’s objective are short term ... and ESG activities do not have short-term value.”

Our survey shows, however, that many CFOs and investors believe these programs do have short-term value—indeed, more investors do than CFOs. Nonetheless, the combination of the common wisdom that these programs only have long-term value with the perception that investors are only interested in the short term may lead many CFOs to focus their public communications almost solely on the short term and not on ESG at all. This may leave even the most interested investors with no direct source of information.

Using metrics and indices

Neither companies nor investors have the information they need—and seem to want—so why not turn to some of the many indices and public ESG metrics systems? They do not work either.

The biggest challenges cited by companies with current metrics and indices of ESG is that each measures its own objectives (e.g., labor standards, environment),

¹¹ S. Bonini, N. Brun, and M. Rosenthal, “Valuing corporate social responsibility,” *The McKinsey Quarterly*, February 2009

¹² For more information see: P. Hsieh, T. Koller, and S.R. Rajan, “The misguided practice of earning guidance,” *McKinsey on Finance*, Spring 2006.

which are not necessarily in line with a given company's strategic priorities for ESG. Nor are they in line with the four dimensions on which companies and investors define financial value. As a result, not only are these indices not relevant to financial value creation for many companies, they can actually steer companies that strive to 'check all the boxes' astray, by increasing the likelihood that their ESG activities will be fragmented, will not be strategic, and will not make use of companies' core capabilities. All this, in turn, ensures that these programs create less value for society. (See Exhibit Box 3 for a more detailed assessment of current metrics and indices.)

Indeed, the McKinsey survey showed that most CFOs and investors do not find ex-

isting metrics and indices particularly useful, with the exception of certification or accreditation standards, which roughly half felt were useful. ESG professionals found this type of index most useful; 60 percent of them also found that reporting guidelines were valuable and 40 percent saw value in indices developed by financial and reputation companies. The disconnection between CFOs and investors versus ESG professionals on how useful these indices are, reflects a different set of priorities—for ESG professionals, the indices provide measures of a number of ESG elements, including social and environmental impact, that they find useful for other purposes, even though the indices are not useful in assessing financial value creation—the measure CFOs and investors are most interested in.

Box 3: The Challenge of using existing indices to assess financial value creation

As ESG programs have developed, a plethora of indices, codes, and metrics have been developed to evaluate the success and impact of ESG. These tools, which focus on a variety of objectives, from assessing human rights risks to toxic chemicals waste emissions, have been extremely valuable in pushing companies to ensure that their ESG programs consist of more than simply writing a check. As these tools have grown in prominence, however, they have also become increasingly prescriptive, and many companies focus solely on achieving a high score. In addition to the issues mentioned above, this is often an extraordinarily time consuming effort that directly replaces time that ESG professionals would otherwise spend on designing and managing their programs.

Given the importance of having good metrics for value creation, we have evaluated the degree to which existing metrics and indices make links between the success of ESG programs and the value they create for companies.

We evaluated a range of existing indices:

- Indices developed by financial index companies to create a list of socially responsible companies, mainly used by investment professionals to help create screened investment vehicles
- Rankings and data produced by SRI information providers, with a focus on risk behavior, that enable investors to evaluate companies according to social practices

- Reputation indices produced by media/polling/PR firms to provide external stakeholder views on citizenship performance and are largely of symbolic value to companies
- ESG-related standards created by industry coalitions, independent think tanks, or NGOs to facilitate independent verification of environmental/labor standards and processes that aim to establish a consistent and credible approach to citizenship reporting
- ESG initiatives and learning networks to enable companies to share and develop best practices relating to citizenship policies and processes.

We examined a sample of 15 such indices along six dimensions:

- Captures opportunities as well as risks
- Distinguishes financially material issues (e.g., financial impacts)
- Avoids the problem of ‘noise’
- Covers a full range of ESG issues
- Includes financially quantifiable data
- Adapts to different types of company/industry.

We found that while existing indices can be extremely valuable in assessing the dimensions on which they primarily focus, virtually none of them account for the financial value of ESG programs, which we view as a major omission. *The McKinsey Quarterly* survey has confirmed this analysis—70 percent of all respondents would like to see metrics that quantify the financial impact of programs.

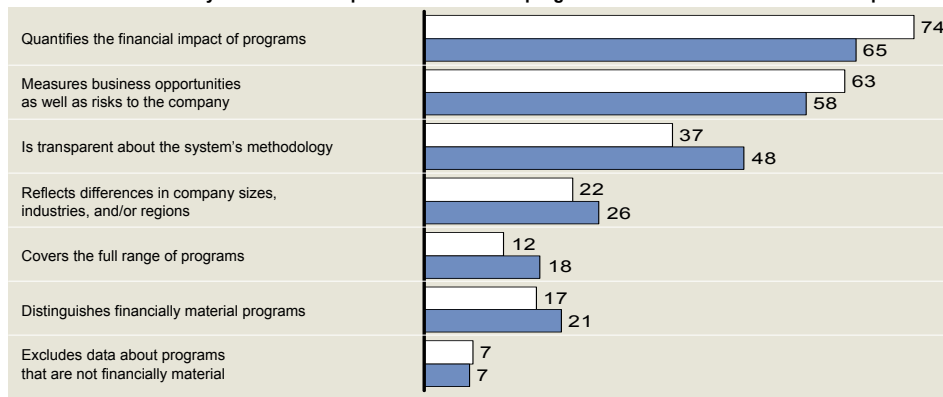
Exhibit Box 3a

Expectations for a relevant metric system

Percentage of respondents, multiple choice answers

☐ CFOs, n = 84
 ■ Investment professionals, n = 154

Potential features of a system to rate the performance of ESG programs to understand their financial impact²



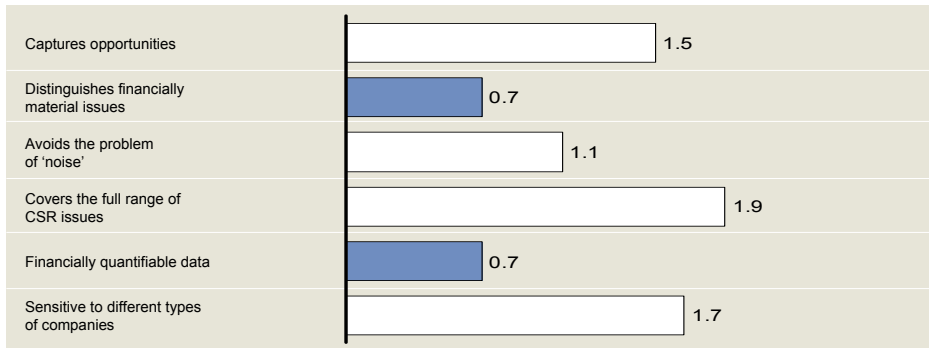
¹ Respondents who answered 'none of the above' or 'don't know' are not shown
² Excluding any changes stemming from the current economic crisis

SOURCE: S. Bonini, N. Brun, and M. Rosenthal, "Valuing corporate social responsibility," *The McKinsey Quarterly*, February 2009

Exhibit Box 3b

The weakness of most metrics is a failure to distinguish financially material issues and provide financially quantifiable data

Average score of the range of metrics systems assessed against six criteria
Points (score 0–3 points on each issue)



SOURCE: Team analysis



Mrs Asso Koffi (left) owner of a cassava plantation from which Nestlé purchases supplies, with Pondo Kouamé, head of Nestlé agricultural services in Côte d'Ivoire. Nestlé is supporting government and UN efforts in West Africa designed to increase the quantity and quality of production, as cassava plays a vital role in employment of African farmers and in feeding millions of people throughout the continent

Creating, Assessing and Communicating Value

We observed leading companies that create significant financial value with their ESG activities. But even companies that do effectively create financial value do not typically assess that value through quantitative metrics. And very few effectively communicate value to the market.

In the following section, we discuss how companies can create value and begin to think about capturing that value through metrics. We also offer some thoughts on communicating the financial value of ESG activities. Exhibit 6 illustrates this process for the food and beverage industry, using The Campbell Soup Company as an example.

Creating value

Several of the companies we interviewed can be considered leading edge in terms of creating value from strategic ESG activities. Our analysis of these companies, as well as information drawn from previ-

ous research, allowed us to identify 10 best practices necessary to create strategic and financially valuable ESG. The practices fall into four broad groups: prerequisites for strategy, strategic design, organization, and implementing ESG programs (Exhibit 5).

Prerequisites for strategy

To begin the process of designing strategic ESG, companies should examine the social issues facing their industry, key stakeholders, and key business drivers along the dimensions of growth, return on capital, risk mitigation, and quality of management

Addressing key issues: Marks & Spencer (M&S), for example, sought to address the key issues facing the retail industry when it established Plan A in 2007. Plan A is a strategy that commits M&S to address 100 issues related to their business across the areas of climate change, waste, sustainable raw materials, fair

Exhibit 5

10 best practices for creating value from ESG

Best practices	Description	
Fundamentals	1 Address key issues facing the industry	▪ Target industry-specific risks and related social needs
	2 Identify and engage stakeholders	▪ Identify stakeholders and actively manage relationships
	3 Align with core business strategy	▪ Build upon and create synergies for the company's overall strategic objectives
Strategy	4 Utilize core competencies	▪ Target areas of impact that a donation or individual volunteer is unable to accomplish and that utilize company's expertise
	5 Take a long-term perspective	▪ Take a consistent approach that is tied to the company's long-range competencies
	6 Create opportunities and manage risks	▪ Invest in social issues that could become future business opportunities ▪ Maintain compliance with regulation and NGOs ▪ Engage in influencing relevant policy developments
Organization	7 Ensure strong leadership support	▪ Generate active support from CEO, board, and senior leadership
	8 Embed into the strategy, organization, and culture	▪ Integrate ESG into business processes and strategy ▪ Ensure cross-functional support and dedicated staff to manage programs that are not embedded ▪ Build ESG into the company culture and employee expectations
Implementation	9 Select appropriate partners	▪ Enhance existing business relationships and help to establish critical new ones
	10 Set clear goals and manage like a business	▪ Set clear priorities, objectives, and milestones to manage like any other part of the business ▪ Establish, prioritize, track, and communicate metrics ▪ Ensure adequate investment (financial and human resource)

SOURCE: Team analysis

partnerships, and health. M&S has made Plan A part of its brand proposition for customers who are increasingly concerned about these issues but do not know how to engage with them in their daily lives. Plan A also further cements M&S status as an ESG leader in the UK.

Engaging key stakeholders: Telefónica has been exploring a range of ways to engage its key stakeholders, particularly customers, trade unions, and NGOs, in the ESG issues most critical to the business. For example, the company has sponsored online discussions on specific questions or subjects related to ESG, bringing customers and employees or business units into the dialogue. Telefónica strives to have an ongoing, two-way dialogue with the stakeholders who are most relevant to their business, which allows the company to understand and respond directly to those interests when

developing strategy.

Intel has also been extremely effective in engaging local stakeholders (see Box 2 for details), and has built a strong reputation in communities. Intel conducts detailed community perception surveys on environment, citizenship employee relations, and community involvement. Intel's major manufacturing sites compare scores and share best practices.

Aligning with core business: To align with the core business strategy, companies develop programs that relate to their industry and leverage their core assets. One of the ways Telefónica has done this is by developing a new interpretation service that allows hearing impaired customers to use sign language and have it interpreted through new videoconferencing technology. This allows hearing impaired customers to more easily communicate

with hospitals, libraries, emergency services, and others. New services such as these not only fill a social need but also open the potential for new customers.

Verizon's phone designed specifically for elderly and disabled customers, described earlier, has been highly profitable and has also brought new customers to Verizon. Other targeted services, such as Verizon's videophone service for hearing impaired people, not only helps customers but also result in sales rates that are twice as high as traditional service calls made by this customer segment.

Strategic design

Once the prerequisites for strategy are met, to set effective strategy for ESG, companies need to draw on their core competencies, take strategic bets on social and environmental issues with a long-term perspective, and aim their strategies at creating opportunities from these issues.

Leveraging core competencies: Leveraging core competencies makes it likelier that a company will create the greatest social or environmental value, as well as financial value, by making it necessary that ESG programs are relevant to the business. IBM provides a good example of leveraging its distinctive competency of developing innovative technology to meet social needs with its work for the Forbidden City Virtual Museum in China, described earlier in this report.

Taking a long-term perspective: Taking a long-term perspective is especially important for ESG strategy given that many social and environmental issues play out over long timeframes. The most successful companies look at how these issues will evolve, and use ESG as one way to make targeted strategic 'bets' to move

ahead of regulation or consumer preferences. Dow's sustainability program, mentioned earlier in this report, is a good example.

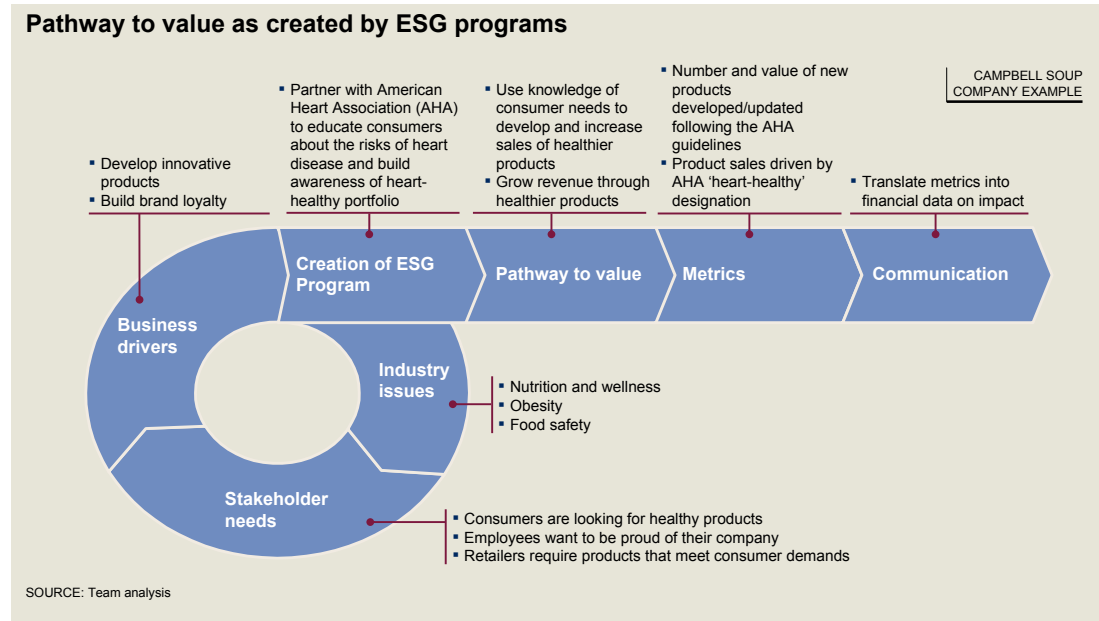
Going beyond risk management to create opportunities: For many companies in the food and beverage sector, public concern over obesity represents a potential business risk. McDonald's has managed to turn this risk into an opportunity by launching a wider array of menu options, providing nutrition information in user-friendly and innovative formats, and strengthening its Global Children's Marketing Guidelines to further unify the company around a common set of principles for communicating with children. This holistic approach lets the company build credibility with a broad range of stakeholders and expand its consumer base.

Organization

A good strategy without the necessary organizational support can still fail. The two organizational elements that our research indicates are fundamental are also mutually reinforcing: strong leadership support for ESG and embedding ESG into strategy, organization and culture.

Ensuring strong leadership support: In order for ESG to be given sufficient resources and have the ability to deliver on its strategy, it, like all other initiatives, needs vocal support from leadership. The CEO of Campbell Soup Company has made ESG a key priority for the company, and added it as one of the company's core strategic goals, which has raised the profile of ESG. Each of the core corporate strategies is afforded company-wide visibility in employee, investor and public communications, and is also addressed in business unit strategic plans and the company's annual balanced scorecard that is linked to incentive compensation.

Exhibit 6



At Verizon, a Corporate Responsibility Council had existed for 5 years, but was recently reinvigorated and reconfigured with support from the CEO and now includes senior leaders and decision makers from across all business units who have mobilized the ESG agenda by identifying corporate responsibility priorities and appointing working committees to champion their implementation.

Similarly, IBM has long benefited from CEOs, senior executives and board members who publicly tout the importance of ESG activities and fund it accordingly, including maintaining the corporate citizenship budget through recessions.

Embedding strategy, organization and culture: Intel has taken a unique approach to integrating ESG into the culture of the company: 4 percent of employees' bonuses are correlated with Intel's environmental performance. For Nestlé, 'Cre-

ating Shared Value' is integral to how the company does business, and cannot be extracted into a series of programs. IBM's ESG strategy and culture is well-known externally. As a positive result, some employees now cite the company's ESG culture and programs as a key factor in their decision to join IBM.

Implementing ESG programs

Beyond strategic and organizational considerations, it is also critically important for companies to successfully implement their ESG strategies. While there are many factors involved in successful implementation, most are typical of any business initiative, while two are particularly important to ESG: selecting appropriate partners and setting clear goals and managing ESG activities like a business.

Selecting appropriate partners: Many companies partner with NGOs and other stakeholders for their ESG initiatives. It is

important to pick partners who are not only related to a company's business but who have a public platform or credibility. Novo Nordisk has formed an enterprise ecosystem that connects its people with healthcare professionals, patients, local communities, investors, regulators, universities, NGOs, and the media in ongoing discussions about and partnerships in the treatment of diabetes. In turn, there is a strong trust of the company, for example with doctors, that translates into a preference to prescribe their products over competitors, when medically appropriate.

In another area, AMD, a microprocessor design company, has developed strategic technology partnerships with NGOs engaged in the development of social issue games through its 'AMD Changing the Game' program. AMD supports the NGOs in teaching teens to create video games with social content, and the program is designed to leverage AMD's expertise in graphics controllers, which are used in advanced gaming applications. Participants explore the power of video games to help effect social change and are developing critical skills in science, technology, engineering, and math. AMD has also used the program to build relationships with education leaders and governments to demonstrate the positive effects educational gaming can have on children.

Setting clear goals and managing like a business: For many companies, ESG and philanthropy activities are a scattered group of unrelated initiatives—though most companies would never run any other part of their business in such an unfocused manner. When IBM refocused its business in 1994 and became a service-and-solutions provider rather than a technology hardware company, it also restructured and focused the company's

philanthropy to have a clear mission and organization. IBM's ESG today has a clear strategic focus, clear goals and some innovative metrics such as documenting growth in intellectual capital, data on employee community service, and links to growing businesses in growth markets.

Another good example is Dow, which has set clear environmental, health, and safety goals since 1996. Indeed, the current set of 2015 Sustainability Goals for Dow (focusing on water supply, food supply, housing, personal health, energy, climate change and protection of the environment) are the 'second generation' of goals in this area, and build on a set of goals that ran from 1996 to 2005. The initial goals had a clear set of operational improvement targets to prevent EHS incidents and increase resource productivity, and the company regularly measured and publicly reported on metrics.

Assessing value

Even when companies have effective ESG programs, we have shown how difficult it is for them to assess the value of those programs with metrics. Below we describe the typical pathways through which ESG programs create value. We also explain how companies can overcome the perception that ESG programs all have long-term, indirect, and 'immeasurable' impact, and we have highlighted some companies that have successfully assessed the impact of aspects of their ESG programs. Lastly, we have highlighted some examples of specific metrics companies can use to track the impact of ESG activities.

Articulating the pathways to value allows companies to unwind the specific ways in which ESG activities contribute to the business, along the dimensions valued by the market: growth, return on capi-

tal, risk management, and management quality. Companies can then examine where their ESG programs have the most impact, and assess whether that impact is aligned with business priorities. This analysis allows companies to set priorities and make resourcing decisions for ESG programs based on their value creation potential as well as their social impact potential. Articulating the pathway to value can also serve as a proxy when hard numbers are unavailable for assessing the impact of ESG programs.

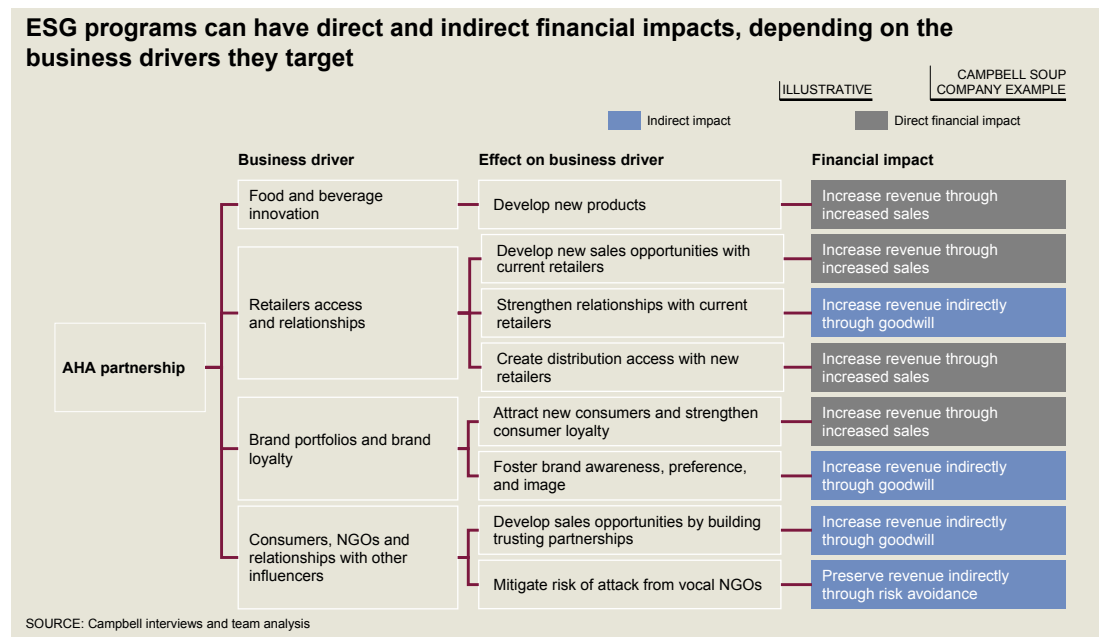
Though many executives and investors believe that much of an ESG program’s impact is long term and indirect, and thus nearly impossible to measure, our research suggests otherwise. Companies can directly value the financial effects of many of these programs, even in the short term. For example, the impact of many environmental programs can be quickly measured with traditional business metrics such as cost efficiency.

Companies that understand the pathways to value, and identify the nature of the impacts from ESG programs (i.e., short or long term) will be able to define a few targeted measurements that will allow them to assess their efforts (Exhibit 7).

Some companies have been successful in overcoming the barriers of measuring even long-term or indirect value. For example, Telefónica uses metrics to track the long-term and indirect value created by its ESG activities. Telefónica tracks and manages its reputation with customers, whose purchasing decisions and loyalty the company has determined, are driven in large part by the company’s reputation, which, it believes, is driven in part by perceptions about its ESG activities. Telefónica integrates the results of an annual reputation survey into its business strategy by identifying areas for improvement, aligning its business strategy with identified reputation gaps, building action plans to improve its reputation (e.g.,

Exhibit 7

ESG programs can have direct and indirect financial impacts, depending on the business drivers they target



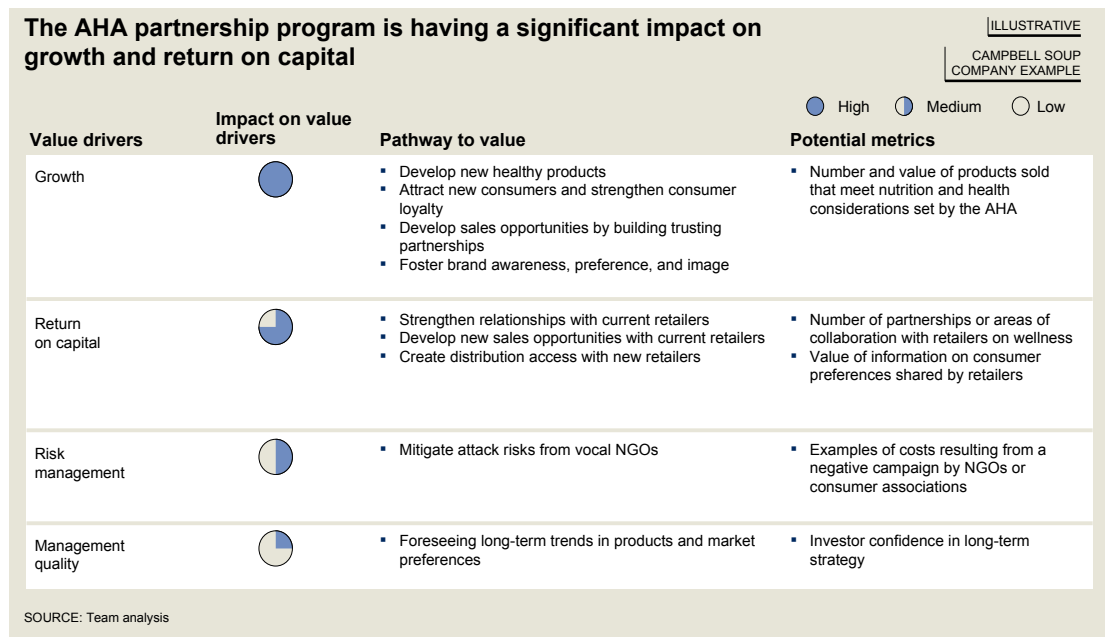
developing new products and services or adapting existing ones to meet identified needs), and monitoring improvement. This approach has allowed Telefónica to see real improvements in reputation, and in corresponding sales. Indeed, an internal study at Telefónica shows that in 2006 and 2007, 11 percent of the changes in the company’s financial performance can be explained by variation in corporate reputation. Interestingly, the company also determined that in Latin America the impact of reputation, including ESG, is on average five times greater than the impact in Spain.

UnitedHealth Group has also made efforts to assess the impact of its ESG work through creating a social responsibility dashboard. The dashboard includes: measures of workplace engagement, ethics and integrity, supplier diversity, environmental impact, employee community involvement, stakeholders’ perspectives on social responsibility and community

giving. All of these track progress toward the company’s social mission of helping people live healthier lives. Currently, the tool is shared with UnitedHealth Group’s board and senior executives to measure performance and guide discussion on future priorities, programs, resources and results. In the future, the tool will be made available to customers and other public audiences as a way to transparently demonstrate the company’s ESG commitments and progress.

Identifying the pathway to value and the nature of the impact of ESG allows companies to identify specific metrics to assess the impact of ESG on the financial value. In addition to creating and prioritizing a list of metrics, it is helpful for companies to be able to explain how each metric ties to one of the four dimensions of value (Exhibit 8). Doing this will allow companies to communicate where their ESG programs are creating value even in cases where exact numbers are unavailable.

Exhibit 8





Nestlé agronomists and Colombian producers share best practice methods for coffee-drying, just one of the sustainable agriculture topics discussed as part of a week-long exchange of ideas and learning under the Nespresso AAA Sustainable Quality Programme

Communicating value

If very few companies quantify fully the financial value of their ESG activities, even fewer effectively communicate that value to the market. Consequently, many companies are not getting credit in the market for their ESG work. While part of the problem may lie with the short-term focus of investors, our research uncovered some internal barriers to communicating value at the ESG professional level and CFO level. Once these internal barriers are addressed, companies will be much more able to meet the needs of mainstream investors, who our research shows are eager for such information.

There are a number of reasons that companies have not attempted or succeeded in communicating financial value to the markets in the past. The first is an organizational capability challenge for many companies. Many ESG professionals come from outside the business ranks of a company, and as a result, many do not

have the training in finance to develop valuation metrics for their ESG programs. Our survey verifies this point—over 53 percent of ESG professionals said they ‘don’t know’ the amount of value created by such programs, in contrast to CFOs and investors, 75 percent of whom were able to estimate an amount. Ninety percent of ESG professionals believe that ESG drives value in the long term; they are just unable or have not attempted to determine how much.

Another challenge is that the mandate of ESG professionals is frequently social or reputational, and they are often brought on to ensure that the company is ‘doing the right thing.’ As a result, it may not be expected that they also consider the financial implications of ESG. Many ESG professionals have also expressed hesitation in highlighting the financial value created ESG, for fear of undermining the public goodwill they are trying to build

from ESG if they also highlight any commercial benefits.

Perhaps in part, due to a lack of financial information from the ESG professionals, CFOs lack a full understanding of the nature and extent of the value created by ESG. Consequently, they do not communicate it to the market. Other reasons are likely that CFOs see less shareholder value in ESG than investors, and that they view its value differently from investors. The McKinsey survey shows that 50 percent of CFOs view ESG in terms of compliance, whereas investment professionals understand ESG more broadly, to include changing business processes (e.g., changes to purchasing or performance management systems, redesign of factory processes to minimize waste) and the long-term strategy of the company. As a result, CFOs, and by extension, investor relations groups, have not been

the best ambassadors of ESG to the financial markets. In addition, several investor relations professionals mentioned that they only supply the information specifically requested by investors, and very few mainstream investors ask about this topic—perhaps because they have often found that companies cannot provide them with useful information.

All this implies that CFOs need to be more aware of their company’s ESG programs and well versed in the pathways to value. This requires greater engagement with ESG professionals. Even if the market is not specifically asking for this data now, if CFOs are able to present a compelling explanation of the additional value created by ESG, our survey analysis shows that investment professionals are eager to listen.

In addition to building capabilities, there is much that companies can do to en-

Exhibit 9

Communicating the value of ESG across stakeholders

ILLUSTRATIVE

Stakeholders	Objectives	Message
Investors, analysts	Obtain credit in the market for strategic ESG programs	<ul style="list-style-type: none"> ▪ Dollar figures on financial impact of ESG activities <ul style="list-style-type: none"> – Prove that ESG creates value and is big enough to matter ▪ Contribution of ESG to value drivers for core business, that is already understood and measured <ul style="list-style-type: none"> – Prove the value of ESG activities by demonstrating specific impact on business drivers such as access to new markets, capital efficiency, license to operate, etc.
Internal management (e.g., CFOs)	Maintain financial and strategic support for ESG	
Employees, NGOs, influencers	Highlight aspects of ESG that will motivate these stakeholders to have a relationship with the company	<ul style="list-style-type: none"> ▪ Social impact and focus of ESG activities ▪ Linkage to core competencies of business <ul style="list-style-type: none"> – Demonstrate the unique ability to create specific ESG impact ▪ Compliance with government regulations and SRI standards ▪ Stakeholder engagement
Socially responsible investor community	Acknowledge social responsibility of the company and invest in company stock	<ul style="list-style-type: none"> ▪ Social impact and focus on ESG activities ▪ Linkage to core competencies of business <ul style="list-style-type: none"> – Demonstrate the unique ability to create specific ESG impact ▪ Contribution of ESG to value drivers for core business, that is already understood and measured ▪ Compliance with government regulations and SRI standards ▪ Stakeholder engagement

SOURCE: Team analysis

hance their communications on the value of their ESG programs. First, it is critical that companies tailor their communication about ESG to each of their audiences. Companies are becoming increasingly effective in using ESG reports, index rankings, and other tools to communicate with most interested stakeholders, including NGOs, regulators, employees, and SRI investors (Exhibit 9).

Companies are not, however, communicating with the mainstream financial markets in their own language—a wide margin of investment professionals in the survey requested ESG data that was communicated in straightforward financial terms. To communicate with the financial community, companies should integrate reporting of the financial impact of ESG into their regular annual report and standard communications with investors. The extent of communication about ESG should roughly mirror the weight of its financial value contribution, as Novo Nordisk does. Novo Nordisk has been leading the pack in terms of developing an inclusive reporting approach since 2004. Its performance on sustainability-driven programs and impact is integrated into its annual report to shareholders, which includes financial and non financial met-

rics. This is effective because not only are these programs given attention relative to their impact, but it is clear to investors and other readers how ESG programs are integrated into the core business.

For most companies, putting in place systems to assess ESG activities and communicate the results may take time. While we believe companies should strive to develop these results, they can go a long way in communication simply by articulating to the market the pathways to value for their ESG activities as well as financial returns when they are able to capture them.



IBM's Corporate Service Corps sends top performing emerging leaders to work pro bono with NGOs, entrepreneurs, and governmental agencies in strategic emerging markets. They work in teams, like this one in Ghana, on projects where information technology is used to foster growth and economic development. The program promotes global integration of IBM employees, while also building leadership skills and goodwill in local markets.

Conclusion: The Path to Valuing Corporate Social Responsibility and Sustainability

Companies need broad legitimacy in the societies in which they operate if they are to sustain their long-term ability to create shareholder value. Equally important, society depends upon big business to provide a set of critical economic and other benefits. This relationship forms the basis of an overarching contract between business and society. Responses to social, environmental, and governance concerns over the past few years—whether on the part of politicians and regulators, lawyers or consumers—have reshaped the core business of major companies in numerous sectors, from fast food and pharmaceuticals, to oil, mining, chemicals, tobacco and agribusiness. As the social contract has increasingly come under pressure, companies have realized that ignoring ESG issues is not an option.

The choice for companies today is how to manage their activities across a wide

range of ESG issues. Companies can choose to see this agenda as a necessary evil—a matter of compliance or a risk to be managed while they get on with the business of business—or they can see it as an opportunity, a new way to think about value, since it is possible to create significant financial value from ESG, while creating value for society at the same time. In order for companies to manage ESG programs in a strategic manner that enables them to create financial value from these activities, they will need to manage it like other aspects of the business—with metrics and proper communication to the financial market. Without increasing the level of rigor in measurement and communication, the value creation efforts will lack the necessary credibility to be sustained in the long term—to the detriment of shareholders and of society.

Selected Reading

Boston College Center for Corporate Citizenship Publications

- Morgan, G., Ryu, K. and Mirvis, P.H. Leading corporate citizenship: Governance, structure, systems, *Corporate Governance: International Journal of Business in Society*, 9(1): 39-49, 2009
- Richards, B. and Wood, D. The Value of Social Reporting: Lessons from the evolution of social reporting at seven companies, Boston College Center for Corporate Citizenship, 2009
- Kinnicutt, S. and Mirvis, P.H. Structure and Strategies, Profile of the Practice 2008: Managing Corporate Citizenship, Boston College Center for Corporate Citizenship, 2008
- Waddock, S.W., Mirvis, P.H. and Ryu, K. United Nations Global Compact Leading Companies Retreat: Summary Report, Boston College Center for Corporate Citizenship, 2008
- Corporate Responsibility & Sustainability Communications: Who's Listening, Who's Leading, What Matters Most? A publication of Boston College Center for Corporate Citizenship, Net Impact, World Business Council for Sustainable Development and Edelman, 2008
- Googins, B.K., Mirvis, P.H., and Rochlin, S. Beyond Good Company: Next Generation Corporate Citizenship, New York: Palgrave, 2007
- Wood, D. and Hoff, B. The State of Non-Financial Reporting, Boston College Center for Corporate Citizenship, 2006
- Weiser, J., Kahane, M., Rochlin, S. and Landis, J. Untapped: Creating Value in Underserved Market, San Francisco: Berrett-Koehler, 2006

McKinsey publications

- Bonini, S., Brun, N. and Rosenthal, M. Valuing corporate social responsibility, *McKinsey Quarterly*, Feb-2009
- Beardsley, S., Enriquez, L. and Nuttall, R. Managing regulation in a new era, *McKinsey Quarterly*, Dec-2008
- Bonini, S., Mendonca, L. and Rosenthal, M. From risks to opportunities: How global executives see socio-political issues, *McKinsey Quarterly*, Oct-2008
- Bonini, S., Chênevert, S. The State of Corporate Philanthropy, *McKinsey Quarterly*, Feb-2008
- Bielak, D., Bonini, S. and Oppenheim, J. CEOs on Strategy and Social Issues, *McKinsey Quarterly*, Oct-2007
- Bonini, S., McKillop, K. and Mendonca, L. The trust gap between consumers and corporations, *McKinsey Quarterly*, May 2007
- Bonini, S., Mendonca, L. and Oppenheim, J. When social issues become strategic, *McKinsey Quarterly*, 2006

Other academic references

- Y. He, Z. Tian, Y. Chen, Performance Implications of non-market strategy in China, *Asia Pacific Journal of Management*, 2007, 24: 151-169
- Margolis, J.D., Elfenbein, H.A. and Walsh, J.P. Does it pay to be good? A Meta-Analysis and redirection of research on the relationship between corporate social and financial performance, Harvard Business School Working Paper, 2007
- Luo, X., Bhattacharya, C.B. Corporate Social Responsibility, Customer Satisfaction, and Market Value. *Journal of Marketing*, Oct-2007, 70: 1-18
- Wu, M.L. Corporate social performance, corporate financial performance, and firm size: A meta-analysis. *Journal of American Academy of Business*, 2006, 8 (1): 163-171
- Schinetz, K., Epstein, M.J. Exploring the Financial Value of a Reputation for Corporate Social Responsibility During a Crisis, *Corporate Reputation Review*, 2005, 7(4): 327-345
- Allouche, J., Laroche, P. A meta-analytical investigation of the relationship between corporate social and financial performance, *Revue de Gestion des Ressources Humaines*, 2005, 57: 18-41
- Orlitzky, M. Schmidt, F.L. and Rynes, S.L. Corporate social and financial performance: A meta-analysis. *Organization Studies*, 2003, 24: 403-441
- Goll, I., Rasheed, A.A. The Effect of Environment on the Relationship between Social Responsibility and Performance", *Academy of Management Proceedings*, 2002



BOSTON COLLEGE
CARROLL SCHOOL OF MANAGEMENT

Center for Corporate Citizenship



Learning, Practice, Results. In Good Company.

The Boston College Center for Corporate Citizenship is a membership-based research organization associated with the Carroll School of Management. It is committed to helping business leverage its social, economic and human assets to ensure both its success and a more just and sustainable world. As a leading resource on corporate citizenship, the Center works with global corporations to help them define, plan and operationalize their corporate citizenship. Through the power of research, management and leadership programs, and the insights of its 350 corporate members, the Center creates knowledge, value, and demand for corporate citizenship.

www.BCCorporateCitizenship.org

Boston College Center for Corporate Citizenship 55 Lee Road, Chestnut Hill, MA 02467

Phone 617-552-4545 **Fax** 617-552-8499 **Email** ccc@bc.edu **Web site** www.BCCorporateCitizenship.org