Adding Value: The Business Case for CSR

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PUBLISHED BY ark GROUP

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is published by Ark Group

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www.ark-group.com/bookshop

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ISBN: 978-1-78358-030-9 (hard copy)
978-1-78358-031-6 (PDF)

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ARK2374

Chapter 1: The business rationale

Risk and reputation management

The business rationale for CSR is much debated, especially amongst those who align with the Chicago-based economist Milton Friedman who wrote in an article[1] that 'the social responsibility of business is to increase its profits'. His view was that 'Only people can have responsibilities. A corporation is an artificial person and in this sense may have artificial responsibilities, but "business" as a whole cannot be said to have responsibilities, even in this vague sense.' However, this statement was amplified in the article with the perspective that the responsibility of corporate executives 'is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom.'

However, that article should be seen in the context of 1970, when the Cold War was still at its height and the war in Vietnam focused American minds on its potential threats in Asia. Since that time, the rise in the size and power of corporations has been significant. Perhaps the best way to view the size of these corporations is to consider the largest corporate losses of all time. AOL Time Warner posted a loss of US$98.7 billion in 2002 and AIG posted losses of $99.3 billion in 2008 (in the midst of the global financial crisis). By comparison, these losses are greater than the combined 2011 GDP of the 11 smallest EU states (out of a current total of 27).

When corporations have losses bigger than the GDP of small states, then they are capable of wielding significant global power. It is hardly surprising that onlookers start asking about the extent to which these corporations are acting in an ethical and responsible manner. This concern is amplified when corporations are found to have acted in a manner that may be perceived as not being focused on their actions' impacts on other parties.

Examples of such actions include BP's Gulf of Mexico disaster in 2010, McDonalds' litigation against individuals who were concerned about its animal welfare policies in the 1990s, Mattel's apology to China over its pursuit of suppliers when it recalled toys in 2007, and Shell's approach to the disposal of its Brent Spar oil rig in 1995. All of these examples involved governments or NGOs, and resulted in deterioration in these companies' corporate reputation (and in some cases, a share price drop).

Example 1: Shell and Brent Spar

Brent Spar was an off shore oil storage installation that operated in the North Sea's Brent oilfield from 1975–1991. At this point, Shell sought to decommission it, and reviewed its options over the next four years, with input from independent experts. In 1995, it gained legal permission from the UK government to dispose of it by sinking it in the deep Atlantic (which involved reviewing the proposal with other potentially impacted nations).

At that point Greenpeace first occupied Spar, calling it 'a toxic time bomb'. After having been removed from Spar, they then called for a boycott of Shell across continental Europe. This boycott included the call to damage 200 Shell service stations in Germany (some of which were firebombed and one attacked with guns).

Greenpeace's actions persuaded local governments to change their position on deep-sea disposal and Shell was forced to review its options. This was despite independent audits confirming that Shell's approach had considered all environmental impacts and Greenpeace accepting that some of its claims had been inaccurate. As a consequence of Shell holding public discussion about the options available, in 1998–99 Shell chose to decommission the installation and convert it into a 'Ro-Ro' ferry quay in Norway.

The Chairman of Shell UK acknowledged that Brent Spar was damaging to its reputation and that 'we needed to change our approach – not just to offshore decommissioning in the UK, but to how we conduct all our operations everywhere'.

What could it have done differently?

In the early 1990s, it is probably fair to say that the powers of NGOs such as Greenpeace were underestimated. While Shell had the support of independent scientists for its deep-sea disposal proposals, at the outset it did not communicate the extent of its diligence[2]. Hence when it announced its intentions, the public was relatively easily persuaded that a global corporation was acting only with its interests in mind. Shell did not win public acceptance. When the full impact of public opinion was felt, Shell became very transparent and co-operative in its review of the options. If this approach had been adopted at the outset, including discussing its intentions with parties (other than the governments with whom it had a legal obligation to set out its proposals – including Germany), then it would have avoided much of the public opprobrium it suffered.

Mattel and the toy recall

Mattel is the toy company known for its Fisher Price and Barbie products.

Its toy recall programme began in August 2007, when it recalled over one million Chinese-made toys because of the use of lead-based paint in these products. The lead was at extremely high levels, in some case at 180 times the US permitted levels.

Approximately two weeks later, Mattel recalled over 18 million toys because they contained strong magnets that could detach and be ingested by small children. Mattel issued statements putting the blame on its Chinese manufacturers. Following the recall, the managing director of one of its Chinese suppliers hung himself in his factory.

In late September 2007, Mattel's Executive Vice-President for worldwide operations met in Beijing with China's product safety chief. In his statement, accepting full responsibility for the magnet recalls, he said 'the vast majority of those products … recalled were the result of a design flaw in Mattel's design, not through a manufacturing flaw in China's manufacturers … Mattel takes full responsibility for these recalls and apologises personally to you, the Chinese people, and all … customers who received the toys.'

In October 2007, following yet another recall, the BBC[3] reported that Mattel's profits had fallen by one per cent over the previous three months. Mattel admitted spending over $40m on activities related to its product recall. Its share price fell by 25 per cent between April and August 2007.

In late 2008, Mattel made settlements of $12m relating to the use of lead-based paints and in mid-2009, it paid a fine of over $2m to the US Consumer Product Safety Commission for violation of the Federal lead paint ban – although it did not admit any wrongdoing on its part.

What could it have done differently?

Mattel's actions should have involved a greater degree of transparency (apparently, it had been alerted to the lead-based paint issues in early June but had not filed a full report until nearly seven weeks later). Its supplier assurance approach involved an independent third party series of audits, and it appears to have assumed that this absolved it of any blame. However, in a commercial relationship, there is a shared responsibility between buyers and suppliers and some early acknowledgement of this would have gone a long way to reducing its reputation impacts.

Mattel's blame-shifting over magnets was unacceptable and affected both its commercial reputation and its relationships with governments (alongside US Federal actions, the EU's Toy Safety Directive of 2009 was introduced to improve the safety of imported toys, following the EU Commission's involvement in the Mattel recalls).

In a PR crisis such as this, a critical aspect is to demonstrate a corporation is in control of its actions. The blame shifting helped to suggest that Mattel was not in charge of its own quality control, and it was this that adversely affected its reputation. This suggests that, at the outset, there was insufficient internal review of the processes involved. The first step should have been to understand the problem fully, and then to communicate the necessary corrective actions.

What has changed since 1970 is that public opinion has come to see corporations as responsible for their actions if they impact on third parties, and expects them to take action to ensure that all parts of their operations act in a responsible manner. Milton Friedman's article would not likely have the same acclaim if it was published today, although his argument is still used today by those who are concerned with the possible use of CSR by governments.

This discussion highlights that the key rationale for CSR lies in the area of risk and reputation management and that the target for such management needs to be those groups or bodies that are seen by the corporation to be its key stakeholders. This needs to be seen in two lights – while inappropriate actions can affect a corporation's reputation, so too can excessive CSR publicity (often known as 'green-washing') because its target audience can often see through the veil of 'do-gooding' and will question the substance behind it. It is also important to recognise that developing a good reputation for its CSR activities can represent a significant benefit to a corporation amongst some of its stakeholder groups, such as potential employees.

Will CSR drive revenue?

This focus on risk and reputation is somewhat at odds with the arguments that existed in the earlier days of CSR that being more responsible will lead to customers deciding to buy a corporation's products

in preference to those of other suppliers – this is often paraphrased as 'it pays to be green'. However, experience shows that while customers may be attracted to 'green products', this attraction will not overcome significant price disadvantages.

A survey of US consumers by GfK[4], the German-owned global research company, showed that while US sales of environmentally-friendly products exceeded $40 billion, consumers are becoming more resistant to the exhortation to buy 'green' if it involves additional cost. Drops of 5–12 per cent were seen in the percentage of consumers willing to pay more for environmentally-friendly products, and the reasons are interpreted as being that consumers are pushing back at the over-hyping of such products, coupled with the lack of substantiation of the marketing claims.

Nevertheless, where there is a clearly defined programme that focuses on suppliers who meet certified social and environmental standards, then this will attract specific customer segments that have a specific interest in these issues. An example of such a programme is the Fairtrade movement that certifies suppliers (usually of commodity products, and typically from the developing world). The idea is that these suppliers receive a price premium for their products (although this cannot be clearly identified). While there may be only a small price premium for Fairtrade products, the impact of this movement on the retail market has been significant. In 2008, the value of sales of Fairtrade products exceeded $3.98 billion. Sales in the UK suggest this growth has continued at a rapid pace. In 2011, UK Fairtrade sales amounted to £1.32 billion, which represented growth of 85 per cent on 2008 levels and 575 per cent since 2004[5].

If the business rationale does not lie entirely with the result of increased revenue, then how do investors consider a corporation's CSR and how does its presence affect its share price performance?

CSR and investors

CSR has been a highly fertile area in the investment community. This is largely because of the evolution of socially responsible investment (SRI) funds that developed portfolios of shareholdings in corporations that were deemed to operate to high CSR standards. The US SIF[6] estimates that SRI funds in the US now represent $3.74 trillion out of total funds in the US market of $33.3 trillion (around 11 per cent). As an indication of the growth of this market, US SIF claims that in 1995, there were 55 SRI funds with $12 billion in assets, while in 2012 there were 333 mutual SRI funds with assets of $640.5 billion. The equivalent study on the European market, undertaken by EUROSIF[7], shows total SRI-related funds of $8.8 trillion by the end of 2011, with the most active countries being France and the UK.

SRI involves several aspects that are different from 'normal' fund management. First, the choice of equities will involve some form of screening, either positive or negative. The former may focus on corporations with positive impacts such as good employer–employee relations, while the latter may seek to eliminate corporations that operate in specific spheres, such as tobacco retailing, or that operate in countries that are subject to human rights abuses.

All such screening includes evaluation of investment portfolios based on environmental, social, and governance (ESG) criteria. The extension of evaluation criteria to include governance occurred in 2007 with the updating by the Association of British Insurers (ABI) of 'The ABI's Responsible Investment Disclosure Guidelines'[8] following the changes in reporting requirements for

UK Listed companies as a result of the UK's Companies Act 2006. This extension is important because, for the first time, governance of CSR activities was seen to be an integral part of the overall process.

In addition to the screening, fund managers are expected to be advocates on ESG issues in the corporations in which they are investing, and to conduct an on-going dialogue with executives on these corporations.

A major contributor to the development of SRI has been the services and indices that assess corporations' CSR performance. These services are offered by investment analyst firms of practitioners. These firms work on behalf of both fund managers, providing SRI investment advice, and on behalf of clients who wish to take account of SRI issues in their investment decisions. Such clients include pension funds managing the portfolios of religious bodies, as well the funds of trade unions and specific employment categories, such as those in the teaching and medical professions. Such firms include Vigeo, which is a leading ESG rating agency. In 2012, Vigeo moved from providing advice to its clients to developing its own ESG indices[9]: Vigeo World 120; Vigeo Europe 120; Vigeo France 20; and Vigeo UK 20. Its intention is to work with NYSE Euronext to develop and distribute a new range of indices based on its research.

In addition to analysts' SRI research, an increasing trend has been the provision of ESG information by the electronic investment information providers. One example is Bloomberg, which provides information (including its ESG 3000 global index, made up largely of non-US companies). Thomson Reuters, Bloomberg's main competitor, provides similar information through ASSET4, which provides ESG information based on over 250 key performance indicators. As with the information provided via SRI analysts, this electronic information is only available to licence holders within investment firms.

However, the leading indices published by investment analyst firms on behalf of major stock exchanges are the Dow Jones Sustainability Index (DJSI) and the FTSE4Good.

DJSI[10] has been published since 1999 and was the first sustainability benchmark. It publishes five groups of indices – DJSI World; DJSI Europe; DJSI North America; DJSI Asia Pacific; and DJSI Korea. It is regarded as the foremost index, both because of its rigour (covering all ESG aspects in a formal survey manner – undertaken for Dow Jones by SAM Indexes in Zurich) and because annually it selects and deselects corporations based on their assessed sustainability performance. Once assessed, included in each index are those corporations that are the largest in their respective Dow Jones index based on free float market capitalisation. As an example of the addition and deletion of corporations, below is the analysis of the 2012 index changes.

Index	Additions	Deletions	Total constituents
DJSI World	41	41	340
DJSI Europe	17	23	166
DJSI North America	17	16	140
DJSI Asia Pacific	14	15	154
DJSI Korea	3	3	52

Table 1: DJSI 2012 Review results – changes in constituent members

Source: DJSI review presentation: http://www.sustainability-indices.com/images/review-presentation2012_tcm1071-343085.pdf

Each index is split into super sectors, which themselves contain a number of individual sectors. Leaders for each super sector (such as BMW for automotives and parts) tend to be based in Europe or Asia Pacific; in 2012, none came from North America. This may be partly explained by evidence from a recent Conference Board report[11] that stated that the sustainability disclosure rate of US companies was around 10 per cent, compared with 19 per cent in a similar sample of mainly non-US companies.

The indices are used as the basis for portfolio selection by fund managers with a DJSI licence – in 2012, there were 55 such funds, based in 15 countries, with total funds under management of $6 billion.

FTSE4Good is another exchange-based index – in this case, covering the London Stock Exchange (and the Johannesburg Stock Exchange Socially Responsible Investment Index (JSE SRI) using criteria based on those used by FTSE4Good). FTSE4Good is unlike DJSI in that it does not require an annual corporate submission. Instead it uses Ethical Investment Research Service (EIRIS) to evaluate its participants. It offers indices covering Global, European, US, Japanese (benchmark only), and UK markets. A criticism of FTSE4Good has been its links with some bodies with specific views – UNICEF has an ex officio membership of FTSE4Good policy committee (it receives profits from the index series as a form of donation), as is the Breast Milk Substitutes Expert Committee (at one time, marketers of breast milk substitutes were excluded from FTSE4Good membership). Other excluded corporate categories included corporations involved in tobacco production, weapons manufacture, uranium mining, or nuclear power.

Corporations can be excluded if they fail to meet criteria[12] relating to environmental and climate change, human rights and labour rights, or countering bribery matters. As an example of FTSE4Good's approach, the human rights and labour rights criteria require corporations to have statements that show they adhere to standards such as the International Labour Office (ILO) core labour standards (or alternatively that they are signatories to SA8000 or the UN Global Compact or have a policy supporting the OECD Guidelines for Multi-national Enterprises). In this respect, given that FTSE4Good was established for 'ethical investors', it takes a different stance from DJSI, which seeks evidence of practical operational approaches rather than being a signatory to international standards. The constituents of the indices are reviewed semi-annually. In March 2011, there were 894 constituents in the Global index (an increase from 743 at its launch in 2001).

Does CSR deliver for investors?

The issue of whether CSR can improve factors such as total revenue was addressed earlier. However, the real question is whether having CSR integrated into a corporation's business processes will impact upon share value performance. Two studies indicate the way in which CSR policies and practices can impact on share values.

The first study was conducted by New Amsterdam Partners[13], a small US asset management firm, with about $2.5bn of funds at the end of 2011, of which those based on ESG principles amounted to about 25 per cent of its total assets. Their research focused on whether all aspects of responsible investing are equally important for stock analysis, and addressed stock returns (the main parameter affecting the performance of investment managers) and return on equity (ROE), which is a surrogate for business performance.

The study showed that ESG overall scores have predictive power over total stock returns and financial performance measured by ROE. Good companies (those with more strengths than weaknesses in ESG) tend to have higher medium to long run (three- to five-year) returns and ROE. Within the overall ESG score, corporate governance scores are the best predictor of stock returns, especially over the longer three- to five-year horizons. The study also found social scores have a greater positive impact on subsequent operational results in terms of ROE.

The second study[14] was undertaken by academics at Harvard and London Business Schools, and took a longer term perspective – 20 years. It used DJSI data as its sample base. The study showed that corporations that had voluntarily adopted environmental and social policies over a long time (which the writers described as *High Sustainability* corporations) had fundamentally different characteristics from corporations that had almost none of these policies in place (described as *Low Sustainability* corporations). Of particular significance is that the *High Sustainability* corporations significantly outperformed the *Low Sustainability* corporations over the long term in both stock market and financial performance. Perhaps not surprisingly, the study also found the *High Sustainability* corporations were more likely to have members of the board with responsibilities for sustainability, together with sustainability-related metrics being used as the basis for executive remuneration.

In addition, these corporations were more likely to have organised procedures for stakeholder engagement, have longer-term orientation, and provide better measurement and disclosure of non-financial information. In contrast, *Low Sustainability* corporations were thought to reflect the traditional model of corporate profit maximisation where

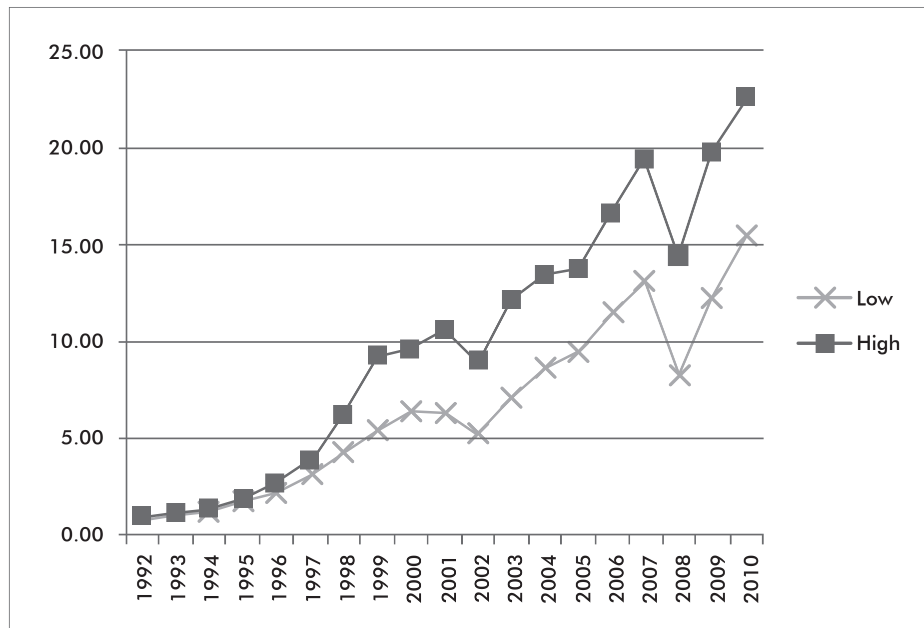

Figure 1: Evolution of $1 invested in the stock market in value-weighted portfolios

social and environmental issues are often predominantly regarded as externalities. The study commented that while over the 18-year period the *High Sustainability* corporations dramatically outperformed the *Low Sustainability* ones, the results suggest that this is only long-term performance and that those hoping to gain a competitive advantage in the short-term are unlikely to succeed by embedding sustainability in the corporation. Indeed as can be seen from the chart on page 9, which shows the evolution of $1 invested in the stock market in value-weighted portfolios, the gap in terms of share value performance begins to widen after five years, and expands continuously through to the end of the 18-year period.

Some conclusions

The key business rationale for a corporation to have effective CSR policies and practices in the short term lies within the areas of risk and reputation management. If the corporation operates in a sector where CSR is prevalent, then this is likely to be a requirement for revenue development, but may not necessarily afford a preference for that corporation with its customers and clients. Demonstrating strong CSR credentials is important for corporations that are listed and which are likely to be the focus for SRI evaluation. The value derived from such a demonstration will depend upon the investor relations department demonstrating the business value added to potential investors rather than relying upon the quality of the communication of CSR reports.

However, over the longer term (typically five years plus) then the studies quoted do demonstrate that CSR and corporate governance will deliver both enhanced corporate financial performance and shareholder value improvement. While the studies do not attempt to explain the reasons behind such improvements, discussion with the likes of Michelle Clayman, Managing Partner of New Amsterdam Partners, suggest that the focus of CSR and corporate governance is upon detailed evaluation of internal processes, with longer term considerations in hand, which lead to the corporation's culture being modified to take these considerations into account. This thought is built upon in the Harvard Business School working paper when it describes the *High Sustainability* corporations as having a longer-term orientation and a better focus on non-financial performance (which may be thought of as the 'flesh upon the bones' of the financial performance).

The Alliance Boots case study following this chapter focuses on how this corporation uses both financial and non-financial information to improve overall business performance.

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