London Business School

Can Corporate Social Responsibility Increase Firm Value? Some New Evidence

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The ESG-Performance Relationship

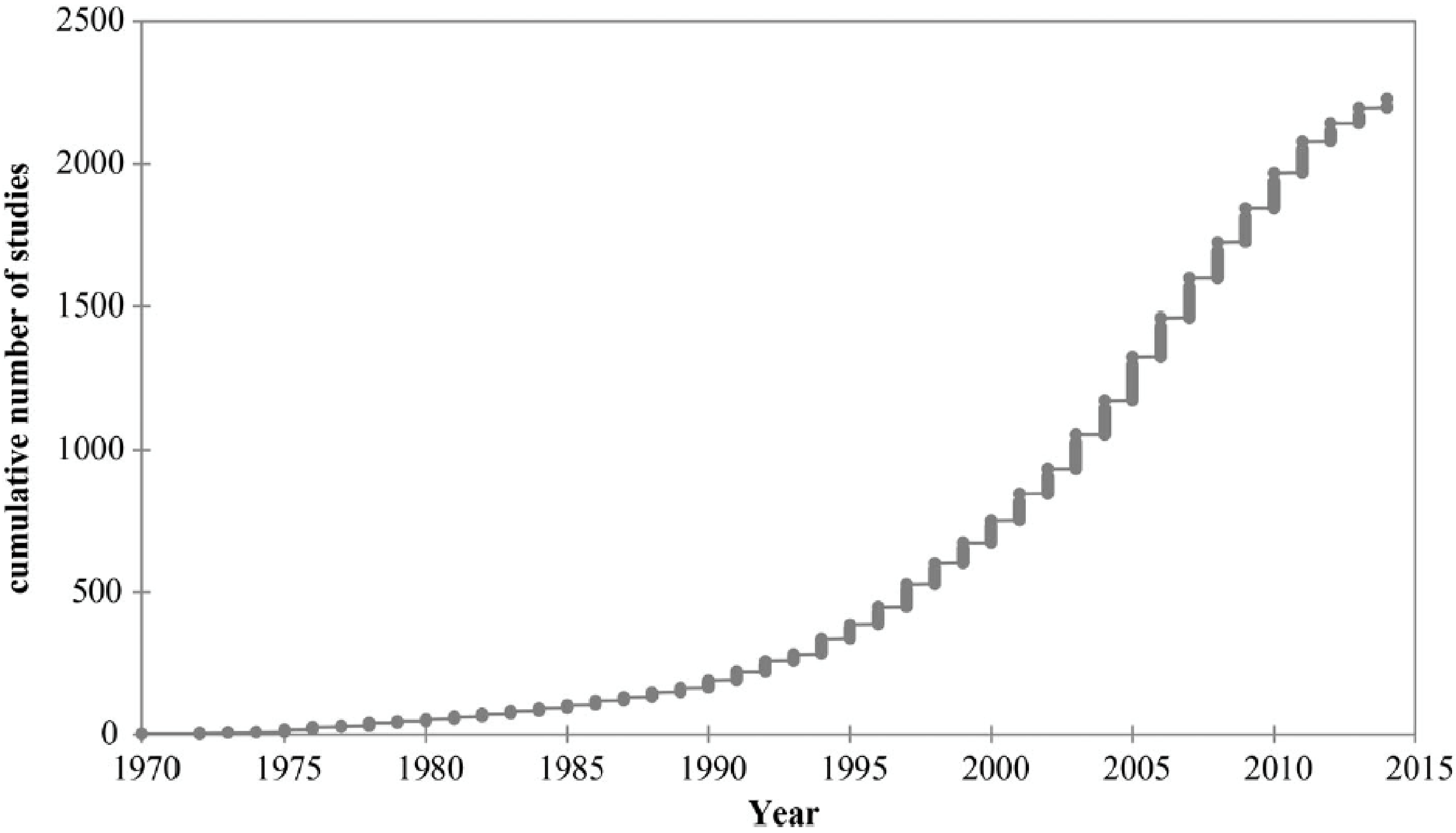


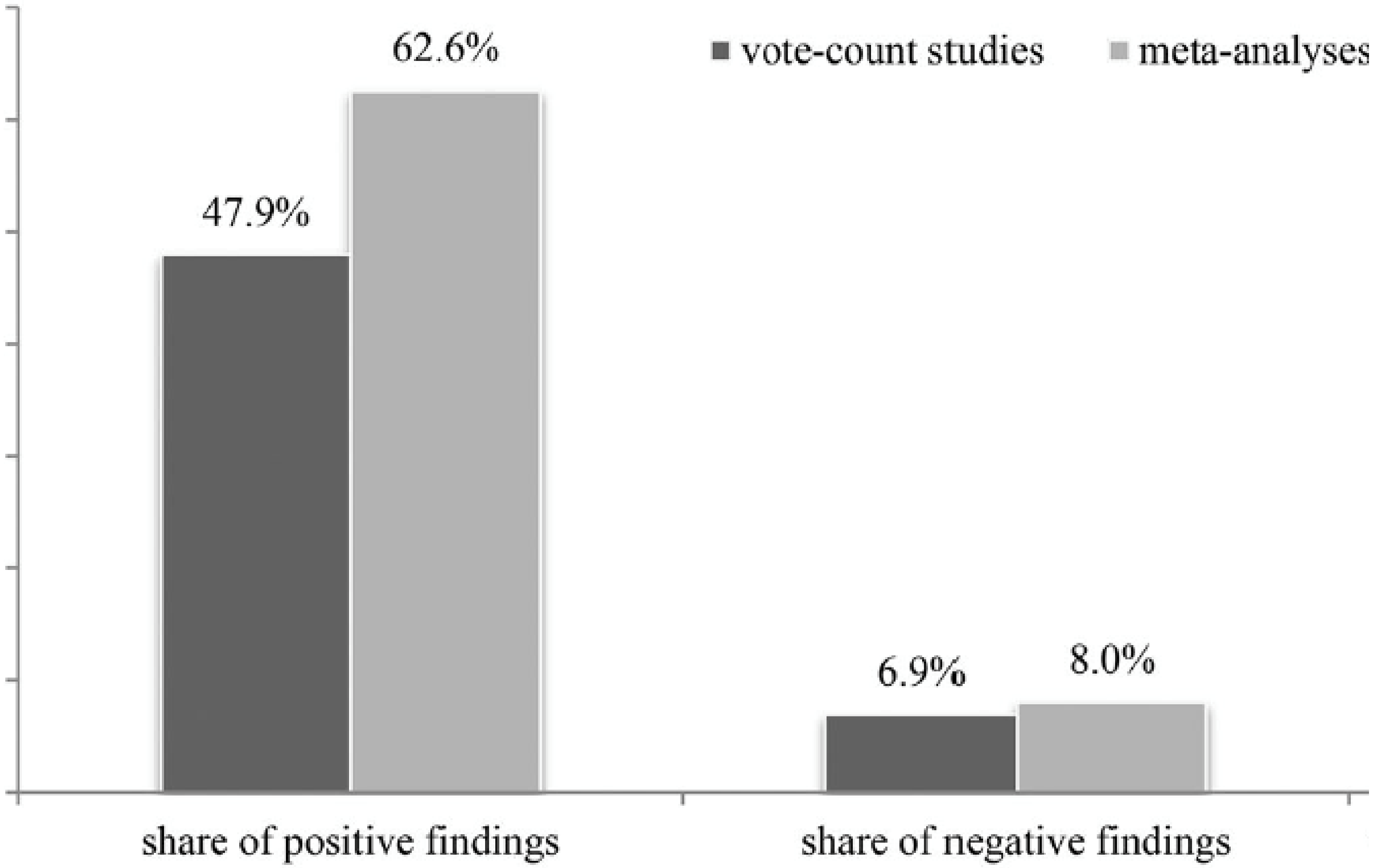
Figure 1. Estimated number of empirical studies on the ESG–CFP relation over time.

CFP = **C**orporate **F**inancial **P**erformance

ESG (data) = **E**nvironmental, **S**ocial, and **G**overnance (data) – Measures of Sustainability

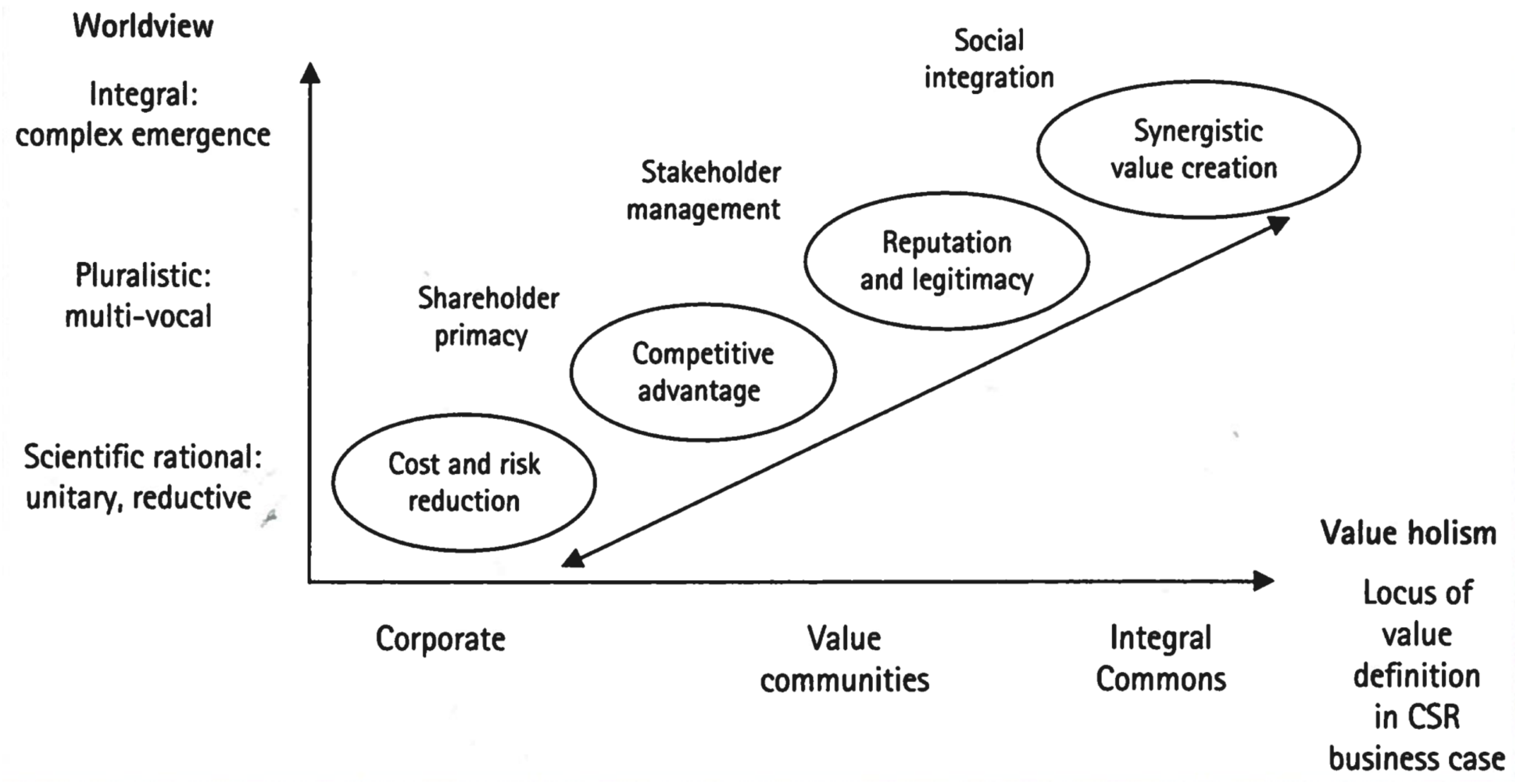
Source: Friede, Gunnar, Timo Busch, and Alexander Bassen. "ESG and financial performance: aggregated evidence from more than 2000 empirical studies." Journal of Sustainable Finance & Investment 5.4 (2015): 210-233.

The ESG-Performance Relationship



Source: Friede, Gunnar, Timo Busch, and Alexander Bassen. "ESG and financial performance: aggregated evidence from more than 2000 empirical studies." Journal of Sustainable Finance & Investment 5.4 (2015): 210-233.

An evolving understanding of corporate engagement



Source: Grance, A., McWilliams, A., Matten, D., Moon, J., and Siegel, D.S., 2009 *The Oxford Handbook of Corporate Social Responsibility,* Oxford University Press

From CSR to Sustainability

"The capacity of the business organization to serve purposes that include not only economic but also environmental and social criteria"

(Bansal, 2005; Berry & Rondinelli, 1998; Crane & Matten, 2010; Freeman, et al. 2010; Zollo et al. 2015)

Associated with the recognition that the business organization is one of the most powerful potential sources of the solutions to (most) sustainability issues even though business activity is also recognized as one of the root causes of the current social and environmental crises

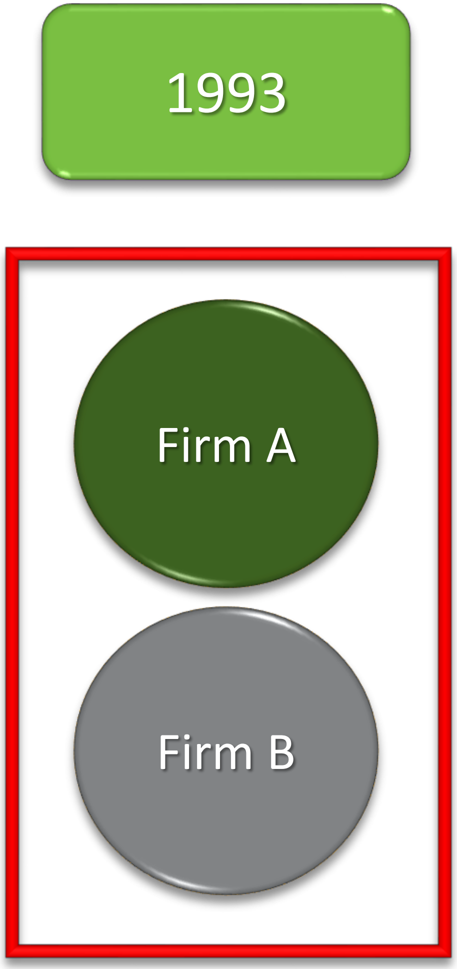
The ESG-Performance Relationship

"The current state of the art on the empirical evidence seems to point to a **positive *causal* linkage** between the development of sustainability oriented practices and mind-sets and long-term financial performance"

(Zollo et al. 2015; Laplume et al. 2008; Edmans, 2012; Eccles et al., 2014, Flammer 2014)

Role of the Corporation in Society

Back to 1993

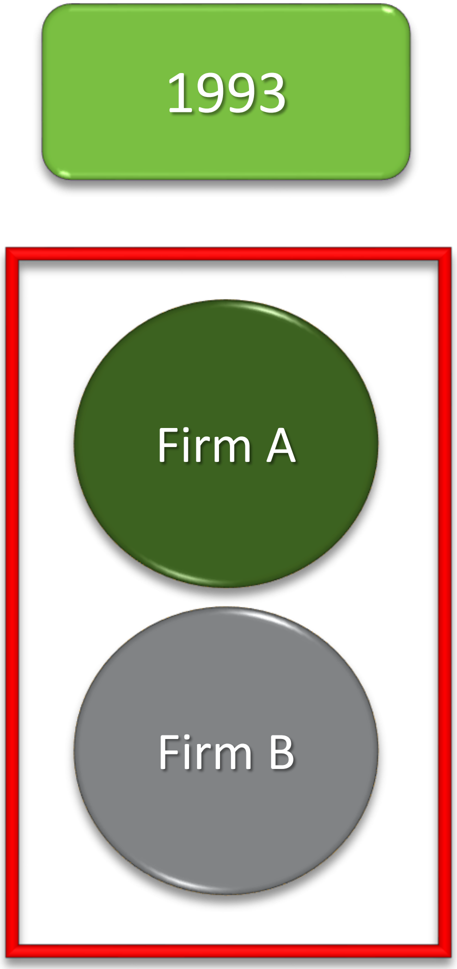


In 1993, Firm A and Firm B were *statistically identical* in terms of:

- Industry membership
- Total Assets
- Return on Assets
- Leverage
- Turnover
- Market to Book

Source: Eccles, Ioannou and Serafeim, *Management Science*, 2014

Corporate Policies

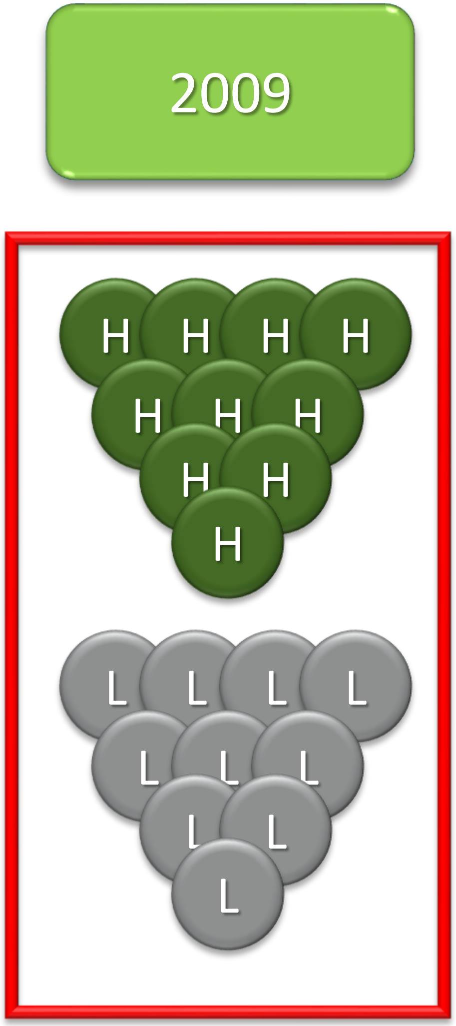


EXCEPT that Firm A had an ***explicit emphasis*** on employees, customers, products, the community, and the environment as part of their business model.

In other words, Firm A had adopted several ***corporate policies*** that reflected a culture of sustainability whereas Firm B had not.

Source: Eccles, Ioannou and Serafeim, *Management Science*, 2014

Fast forward to 2009



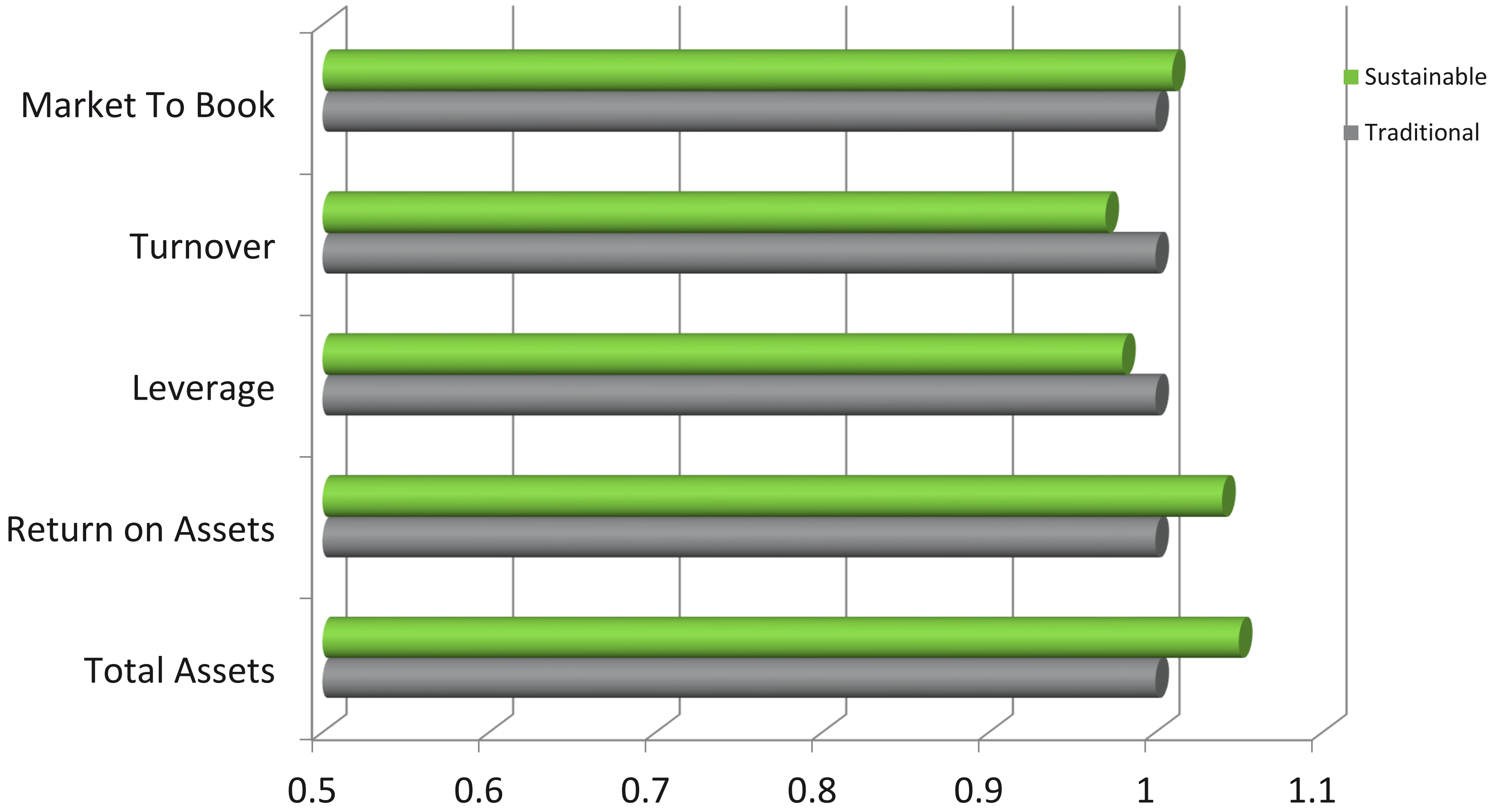
We chose 90 such pairs from the United States, representing in total 180 of the largest US corporation.

Key Question: ***What happened by 2009?***

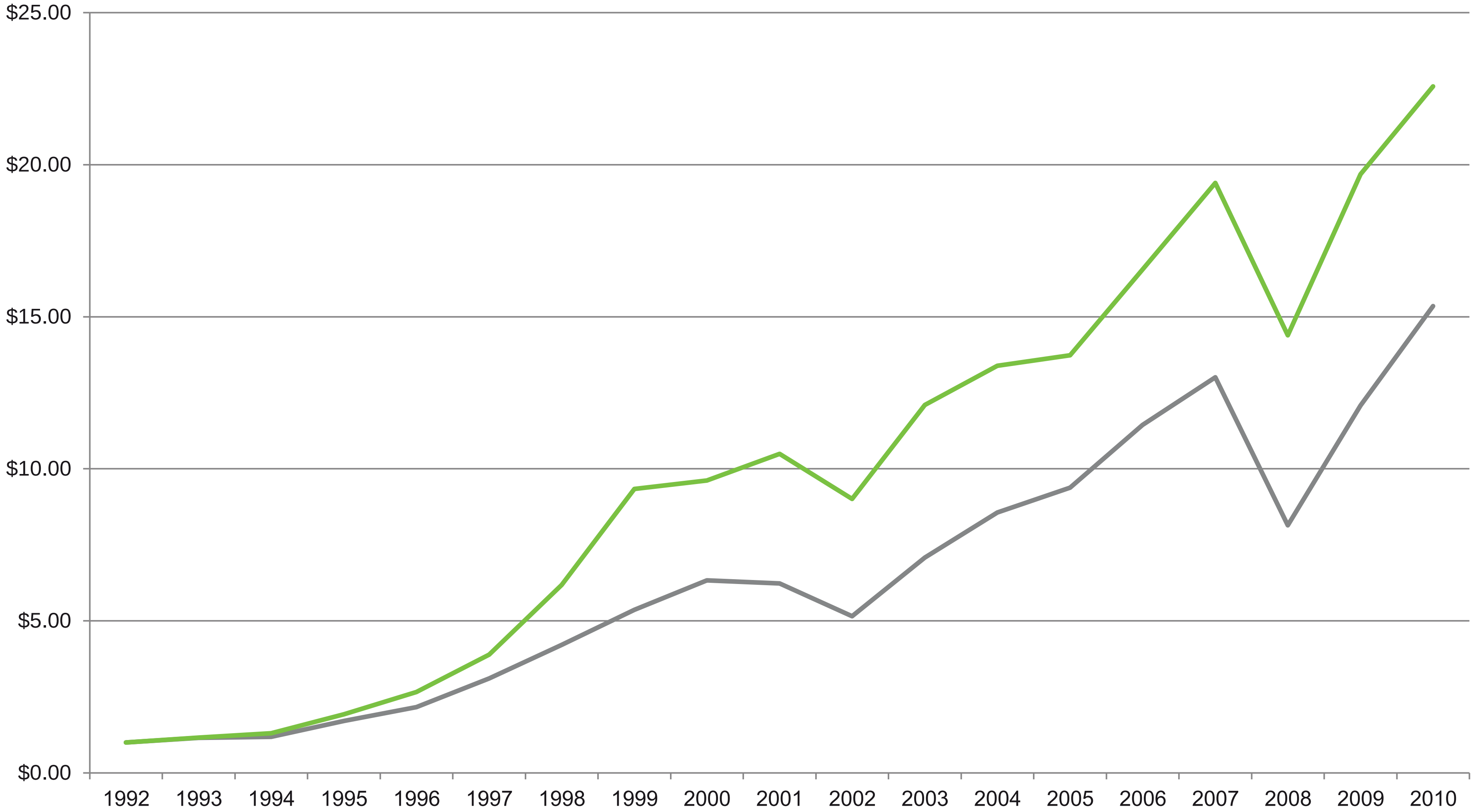
Remember: in 1993, these pairs of companies looked almost identical on everything except corporate policies relating to Sustainability.

Source: Eccles, Ioannou and Serafeim, *Management Science*, 2014

Two Groups of Firms in 1993



Buy-and-Hold Stock Returns (value-weighted)



Investing $1 in the beginning of 1993 in a value-weighted portfolio of *High Sustainability* companies would have grown to **$22.6** by the end of 2010. In contrast, investing $1 in a value-weighted portfolio of *Low Sustainability* companies would have only grown to **$15.4** over the same period.

Source: Eccles, Ioannou and Serafeim, *Management Science*, 2014

Abnormal Stock Returns

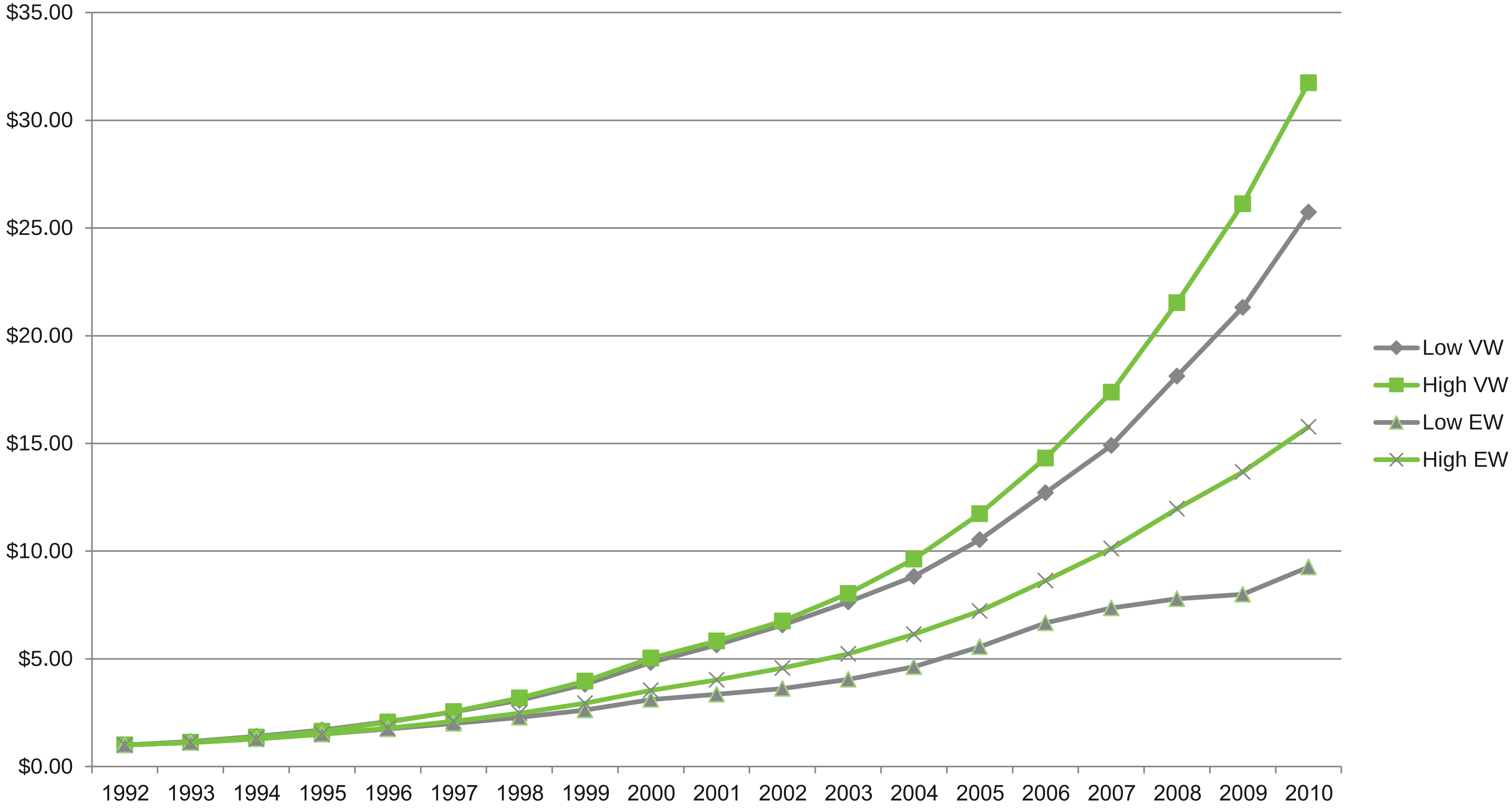
Four-factor model based on Fama-French (1992) and Carhart (1997)

	Value-weighted				*Equal-weighted*			
	Sustainability (ESG Integration)							
	Low		**High**		**Low**		**High**	
Parameter	*Estimate*	*p-value*	*Estimate*	*p-value*	*Estimate*	*p-value*	*Estimate*	*p-value*
Intercept	0.0059	<.0001	***0.0096***	***<.0001***	0.0039	0.004	***0.0057***	***<.0001***
MKTRF	0.9839	<.0001	0.9360	<.0001	0.9977	<.0001	0.9557	<.0001
SMB	-0.2076	<.0001	-0.1776	0.002	0.1598	0.001	0.0366	0.367
HML	0.1982	0.001	-0.2727	<.0001	0.4053	<.0001	0.2204	<.0001
UMD	-0.0156	0.642	-0.0266	0.427	-0.1436	<.0001	-0.1239	<.0001
N	216	216	216	216	216	216	216	216
Adj R-squared	85.6%		86.6%		88.9%		91.0%	

Annual abnormal performance is higher for the *High Sustainability* group compared to the *Low Sustainability* group by **4.8%** (significant at less than 5% level) on a value-weighted base and by **2.3%** (significant at less than 10% level) on an equal weighted-base. Also, the *High Sustainability* portfolio significantly outperforms the control portfolio in **11 of the 18** years, and exhibits **lower volatility.**

Source: Eccles, Ioannou and Serafeim, *Management Science*, 2014

Return-on-Equity



Investing $1 in book value of equity in the beginning of 1993 in a value-weighted (equal-weighted) portfolio of *High Sustainability* firms would have grown to **$31.7 ($15.8)** by the end of 2010. In contrast, investing $1 in book value of equity in the beginning of 1993 in a value-weighted (equal-weighted) portfolio of *Low Sustainability* firms would have grown to **$25.7 ($9.3)** by the end of 2010.

Source: Eccles, Ioannou and Serafeim, *Management Science*, 2014

Sustainability and Capital Markets

Analysts' Recommendations

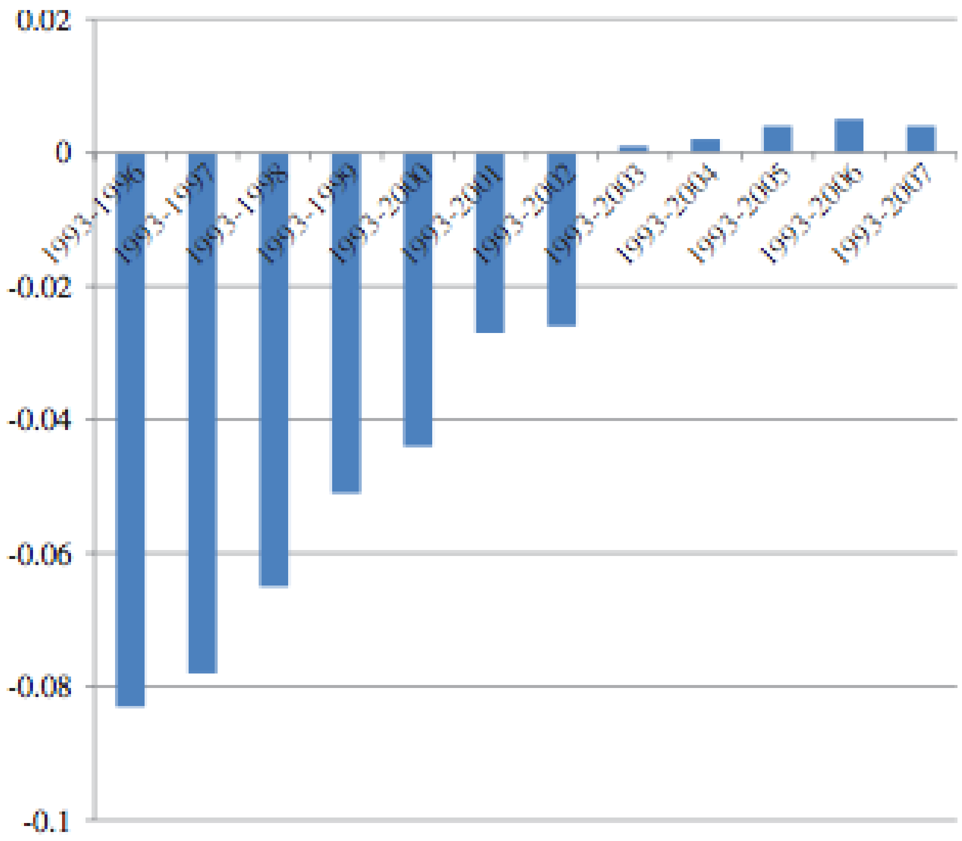


Figure 1. Estimated coefficients on CSR strengths (see Table 4, panel B)

- **Pessimistic** recommendations in earlier periods
- **Neutral towards optimistic** recommendations in later periods
- Analysts of **higher experience** first to shift their recommendations
- Analysts of **higher status** brokerage houses first to shift their recommendations

Ioannou, I. & Serafeim, G. "The Impact of Corporate Social Responsibility on Investment Recommendations: Analysts' Perceptions and Shifting Institutional Logics", 2015, SMJ

Two Models of the (Public) Corporation

The Principal Agent Model

(Low Sustainability (Traditional) Companies)

The Team Production Model

(High Sustainability (Sustainable) Companies)

Sustainability and Organizational Structure

Source: Eccles, Ioannou and Serafeim, *Management Science*, 2014

Identifying Sustainable Organizations

Corporate Governance

Sustainable organizations are characterized by **distinct governance mechanisms**, reflecting the joint interests of all stakeholders of the corporation. They more directly involve the Board of Directors in sustainability issues and link executive compensation to sustainability objectives.

Specifically, they are more likely to:

- Assign formal responsibility around sustainability to the Board of Directors
- Form a separate board-level Sustainability Committee
- Use monetary incentives to focus executives' efforts on non-financial (i.e. ESG) aspects of corporate performance. Hence, they link executive compensation to ESG metrics.

Source: Eccles, Ioannou and Serafeim, *Management Science*, 2014

Identifying Sustainable Organizations

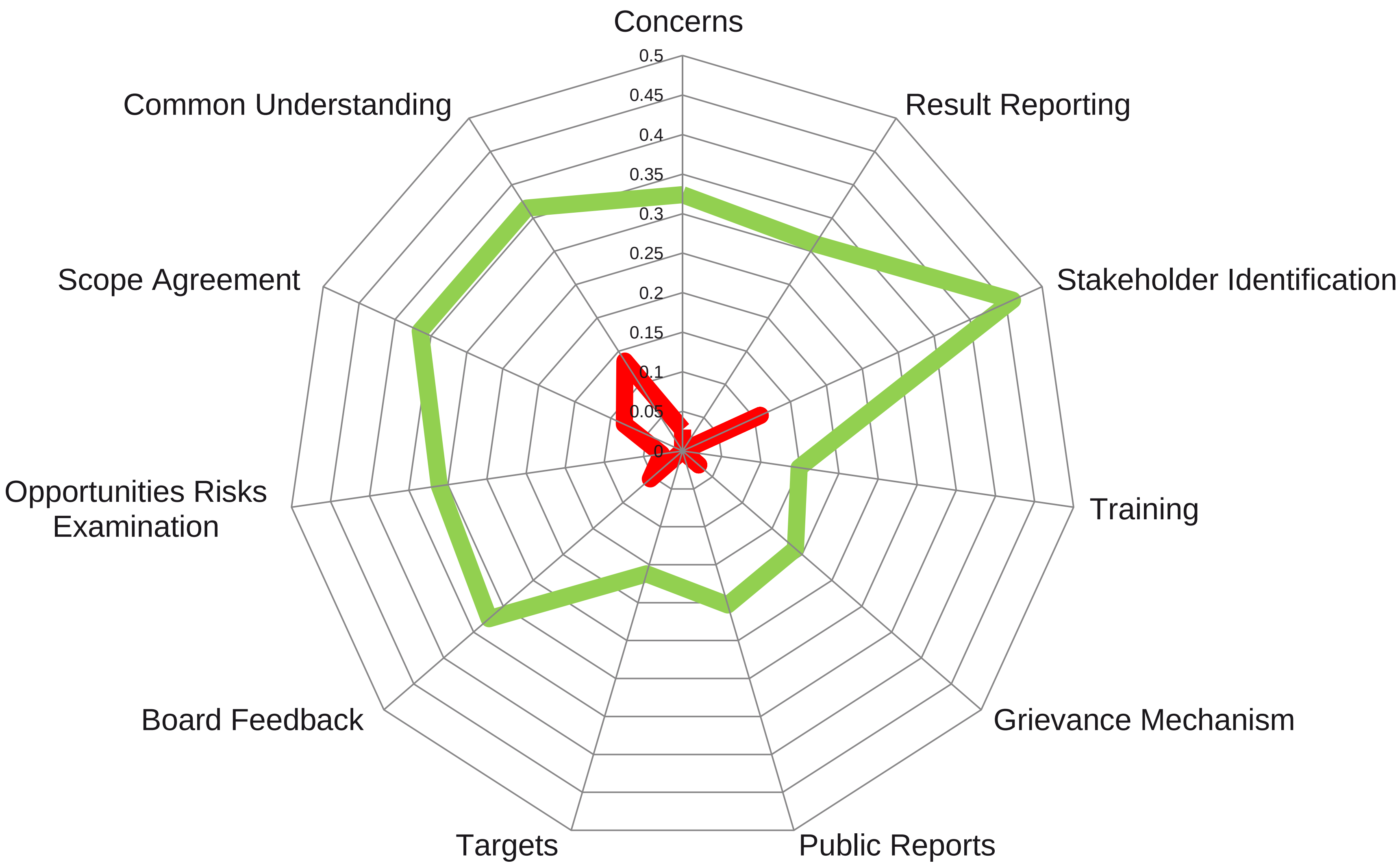
Stakeholder Engagement

Sustainable organizations are **distinct in their stakeholder engagement model:** they are more focused on understanding the needs of their stakeholders, making investments in managing these relationships, and reporting internally as well as externally on the quality of their stakeholder relationships. Hence, they are **more proactive, more transparent, and more accountable** in the way they engage with their stakeholders. For example, they:

- Train their local managers in stakeholder engagement practices,
- Perform their due diligence by undertaking an examination of costs, opportunities and risks
- Ensure that all stakeholders raise their concerns
- Develop a common understanding of the nuances of a focal issue with their stakeholders
- Agree on the targets of the engagement process
- Provide feedback from their stakeholders directly to the board
- Make the results of the engagement process available to stakeholders and the public

Source: Eccles, Ioannou and Serafeim, *Management Science*, 2014

Stakeholder Engagement



Source: Eccles, Ioannou and Serafeim, *Management Science*, 2014

Identifying Sustainable Organizations

Decision Making Time Horizon

Sustainable organizations are **effective communicators of their long-term approach:** not only do they speak in terms of the long run, but in fact, they are persuading long-term investors to invest in their stock. Specifically, sustainable organizations are more likely to:

- Have conference call discussions with sell-side analysts whose **content is relatively more long term** as opposed to short-term focused (i.e. the ratio of the number keywords used in the conference calls that characterize time periods of more than one year over the number of keywords that characterize periods of less than one year.

- Attract **dedicated rather than transient investors** (i.e. they are more likely to attract investors that have low turnover and more concentrated holdings rather then investors that have high portfolio turnover and highly diversified portfolios).

Source: Eccles, Ioannou and Serafeim, *Management Science*, 2014

Identifying Sustainable Organizations

Transparency & Accountability

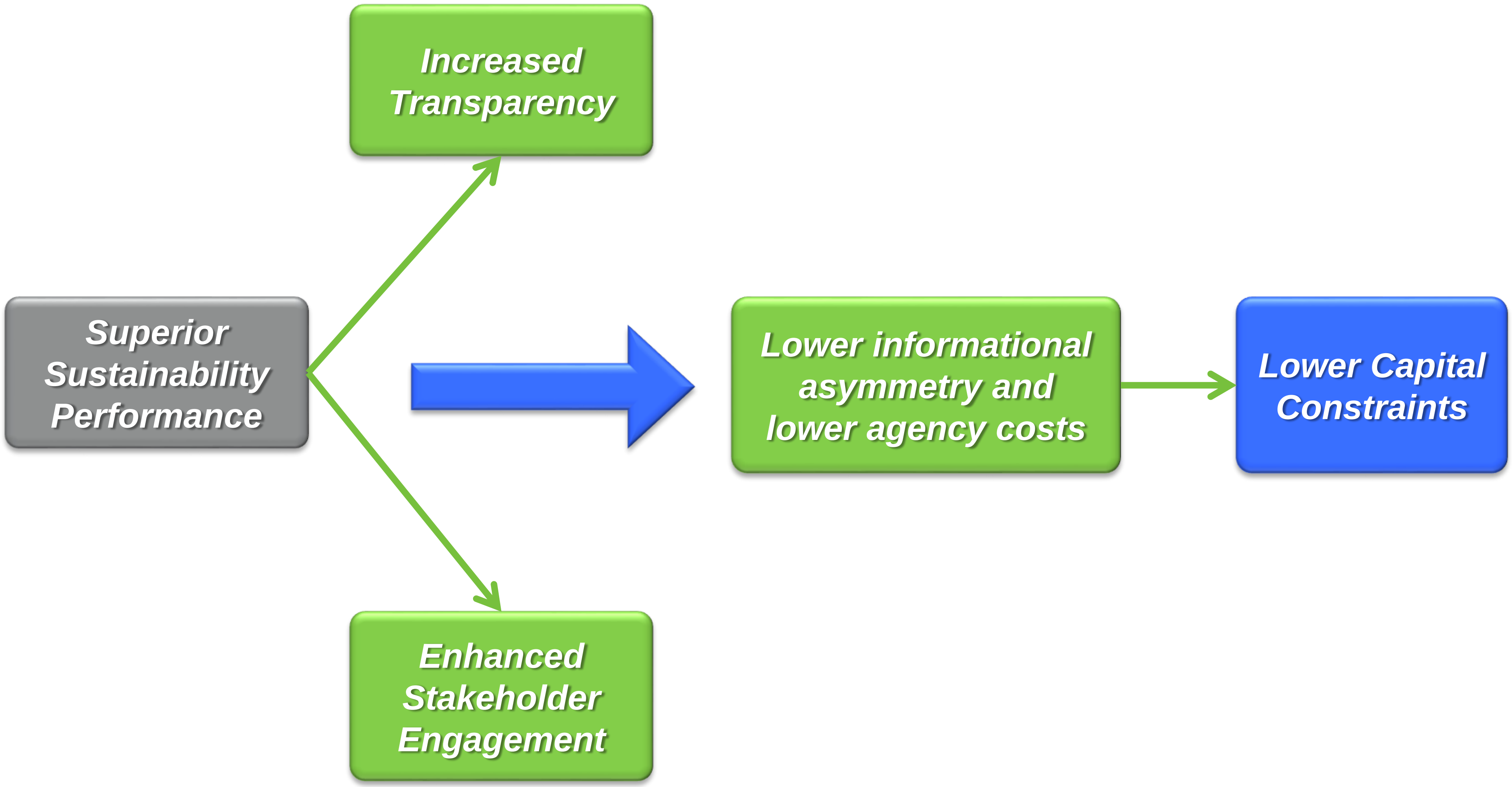
Sustainable organizations are more likely to **measure information** related to key stakeholders such as employees, customers, and suppliers, and to increase the credibility of these measures by using **auditing procedures**. They do not only measure but also **disclose relatively more and higher quality nonfinancial data**. For example, they are more likely to:

- Use environmental monitoring systems in the certification/audit/verification process of suppliers
- Use human rights supplier standards such as forced labor, slave labor, and child labor
- Have an external third-party conduct an audit of the corporate sustainability report
- Develop a common understanding of the nuances of a focal issue with their stakeholders
- Perform better on both Bloomberg and Thomson Reuters disclosure quality scores
- Issue sustainability reports that cover their entire global activities
- Integrate ESG issues with their financial reporting
- Use an about equal number of financial and nonfinancial keywords in their analysts calls

Source: Eccles, Ioannou and Serafeim, *Management Science*, 2014

Sustainability and Capital Markets

Access to Finance: Intuition



Source: Cheng, Ioannou and Serafeim, *Strategic Management Journal*, 2014

Sustainability Value Creation Mechanisms

- Brand Loyalty and Corporate Reputation
- Better access to Finance
- Social license to Operate, Risk Mitigation
- Employee engagement and retention
- Recruitment of Talent
- Avoid future adverse regulatory impacts
- Long-term relationships with stakeholders
- Innovation

Sustainability and Structure

Source: Eccles, Ioannou and Serafeim, *Management Science*, 2014

Starbucks – Howard Schultz

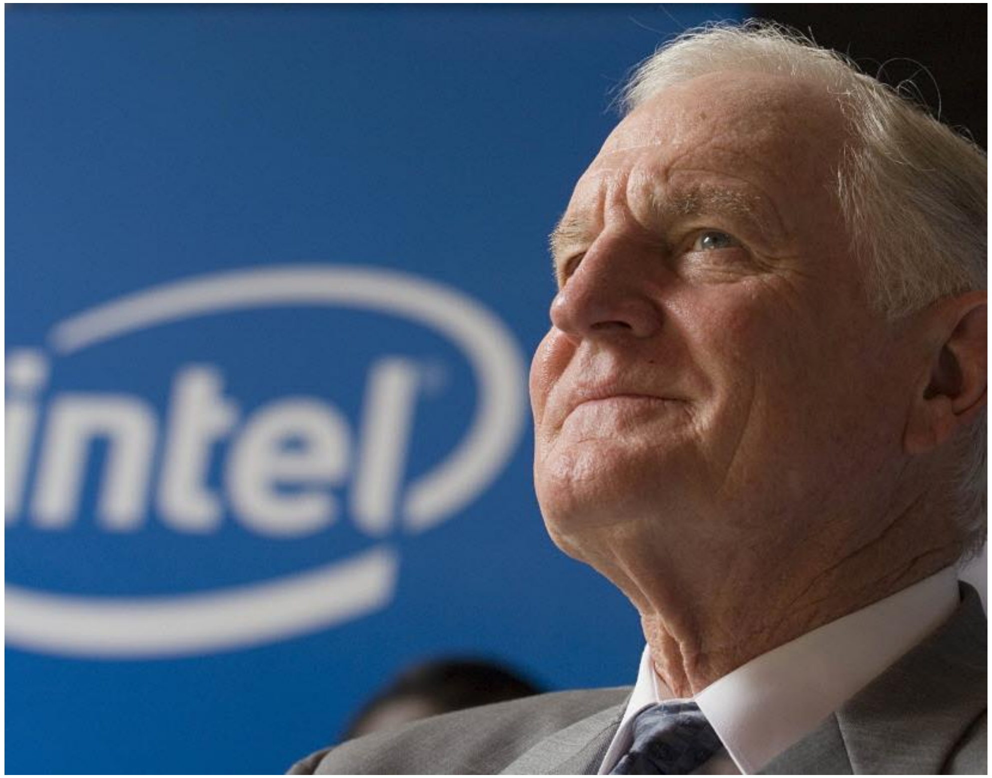
"Now is a time to invest, truly and authentically, in our people, in our corporate responsibility and in our communities. The argument—and opportunity—for companies to do this has never been more compelling"

Huffington Post, 2008

Intel - Craig Barrett

"You can't save your way out of recession - you have to invest your way out […] We look at our CSR activities in pretty much the same way: you can't just do them in good times and then just forget about them in bad times and hope to get any results."

Fortune 2009



Intangible Resources in Times of Crisis

Efficiency and Innovativeness

Adaptation to Shifting Needs, Demands & Expectations

Organizational Resilience

Source: Flammer and Ioannou (2016), The Dog That Didn’t Bark: Long-term Strategies in Times of Recession

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What did US firms do during the Great Recession?

Companies significantly **reduced:**

- Size of Workforce
- Capital Expenditure

Companies **maintained:**

- R&D Investments
- Sustainability Investments

Source: Flammer and Ioannou (2016), The Dog That Didn't Bark: Long-term Strategies in Times of Recession

Performance in Recovery (2010-2011)

	Return on Assets	Net Profit Margin
Companies that did **not** reduce *R&D Investments*	+ 34%	+ 67%
Companies that did **not** reduce *Sustainability Investments*	+ 9%	+ 23%
Companies that did **not** reduce *R&D **and** Susty Investments*	+ 53%	+ 78%

Source: Flammer and Ioannou (2016), The Dog That Didn't Bark: Long-term Strategies in Times of Recession

Concluding Remarks

- In recent years, academic research has provided causal evidence for the link between sustainability and corporate financial performance. The "business case" is unequivocally established.

- Becoming a sustainable company though involves a fundamental shift from the principal-agent model of the corporation to the team-production model, suggesting that the transition towards sustainability needs to focus on (a) corporate governance and incentives, (b) stakeholder engagement, (c) transparency and accountability and (d) a long-term horizon for managerial decision-making.

- Sustainability generates value through a number of mechanisms; an important one is access to finance in capital markets. Evidence shows that the investment community increasingly recognizes and rewards truly sustainable companies.

- Also, maintaining investments in sustainability (as well as innovation), especially during times of economic crisis, generates valuable intangible assets that enhance competitiveness in the long-run.

- The challenges of building a sustainable company cannot be understated. Sustainability requires profound and genuine commitment from executives and a fundamental organisational transformation.

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Thank You

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