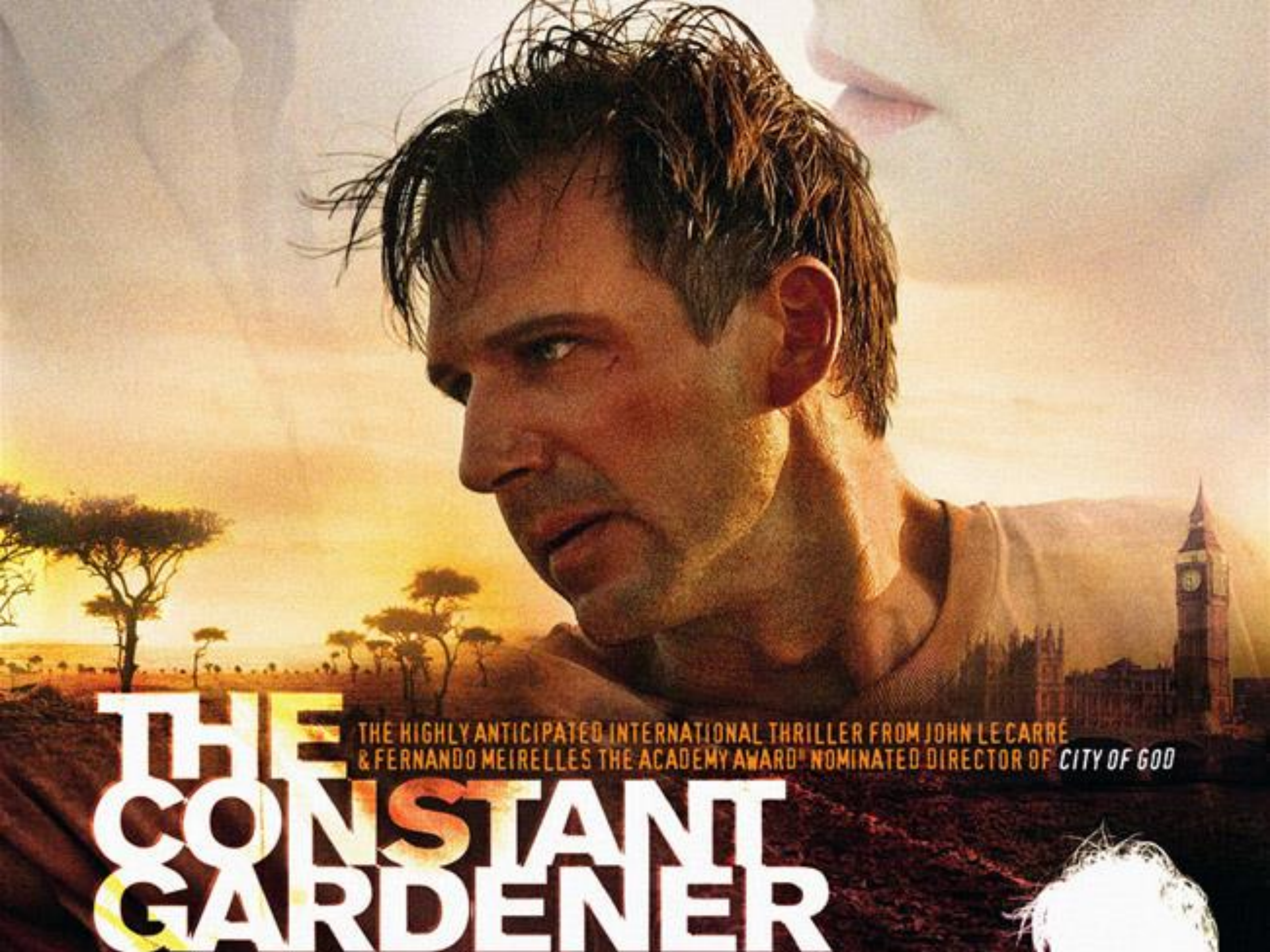
How Great Companies Deliver Both Purpose and Profit

Alex Edmans
Mercers School Memorial Professor of Business
www.growthepie.net | @aedmans

March 2020

I. The Idea


THE HIGHLY ANTICIPATED INTERNATIONAL THRILLER FROM JOHN LE CARRÉ
& FERNANDO MEIRELLES THE ACADEMY AWARD® NOMINATED DIRECTOR OF CITY OF GOD
THE CONSTANT GARDENER

vodafone

m-pesa

Tax and our total contribution to public finances

The amount of tax paid by large companies is a matter of significant public debate and scrutiny.

Individuals and companies have legal obligations to pay tax; but those obligations do not extend to paying more than the amount legally required. Companies also have a legal obligation to act in the interests of their shareholders. Vodafone's shareholders include many of the investment funds relied upon by tens of millions of individual pensioners and savers.

At the same time, individuals and companies must meet their responsibilities to contribute to the funding of public services and infrastructure, without which societies cannot operate effectively.

Achieving a transparent and effective balance between those obligations and responsibilities is therefore integral to operating sustainably.

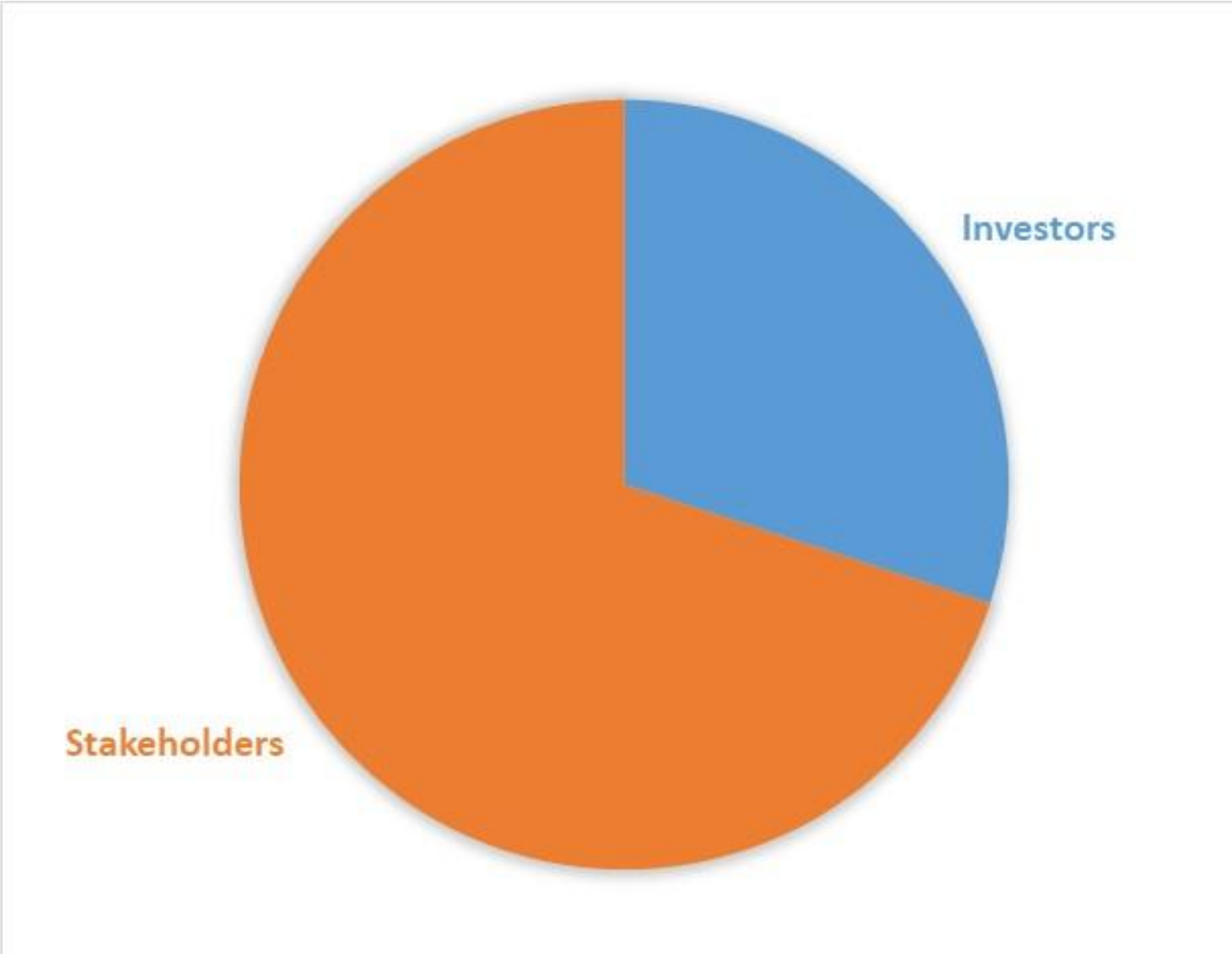
£11.1 billion

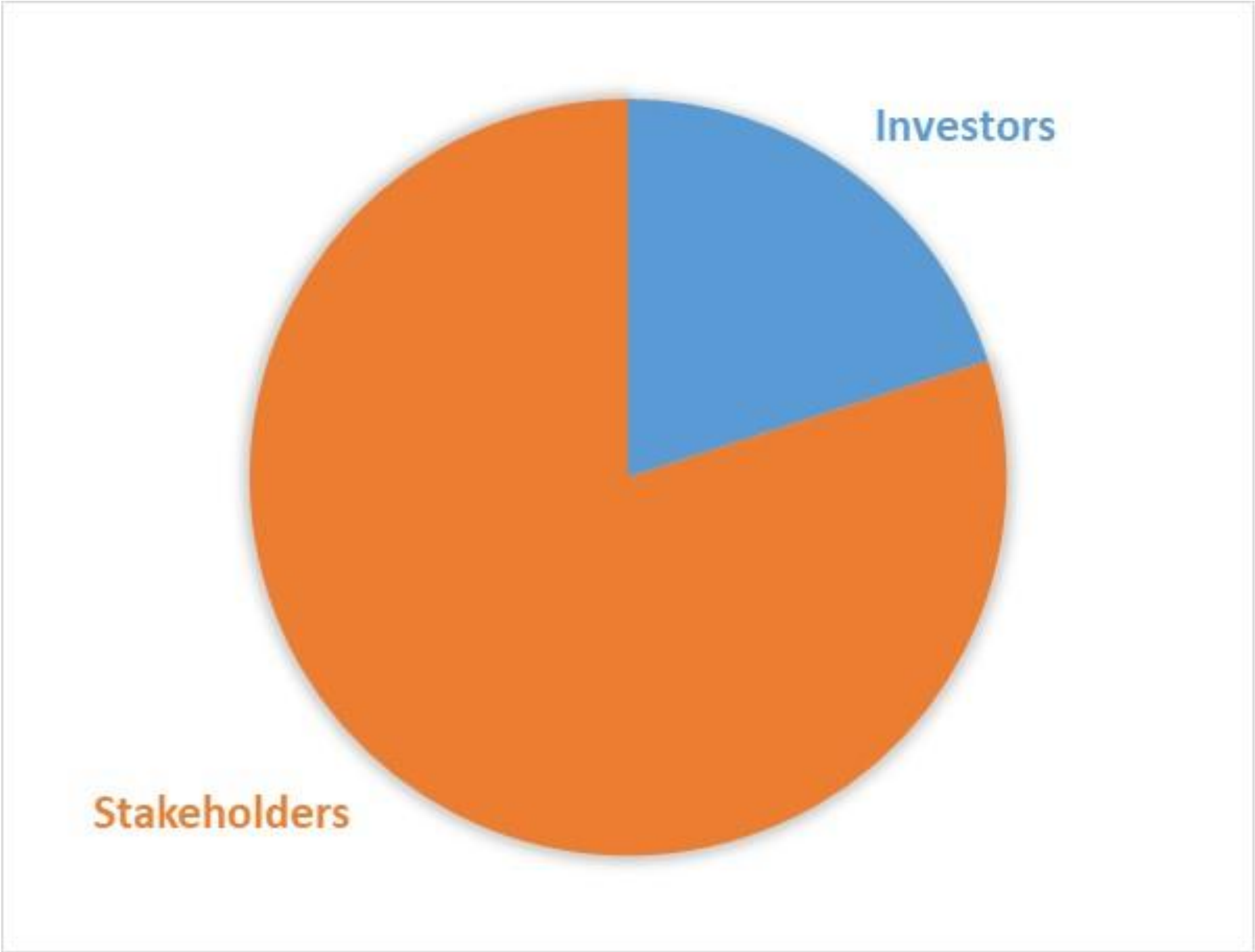
In 2011/12, Vodafone contributed more than £11.1 billion in cash to the public finances in our countries of operation.

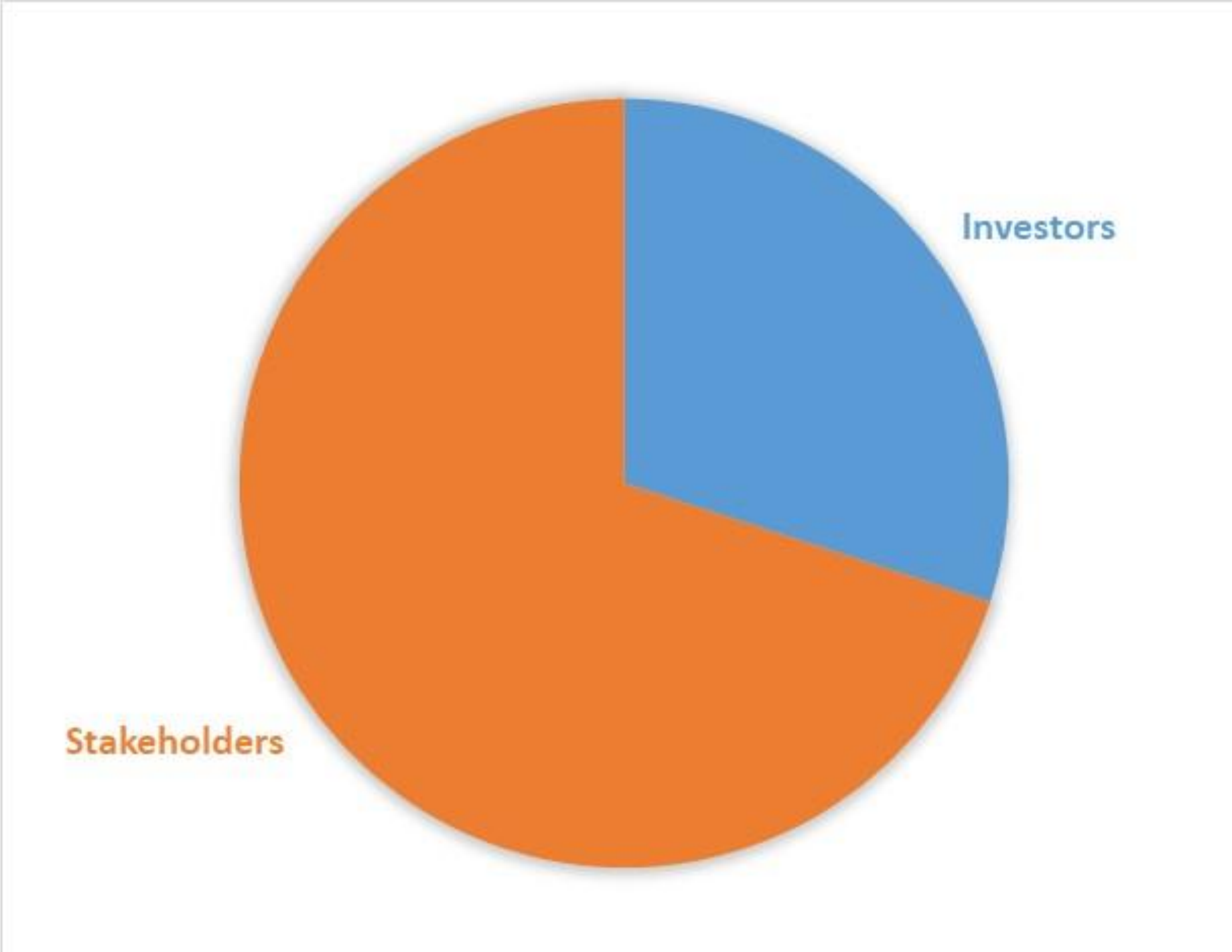
- Corporation tax is paid on profits, not on revenues. If a company makes little or no profit – for example, as a consequence of declining sales, competitive market conditions or a period of intense capital investment, particularly if funded through borrowing, it will generally incur lower tax charges than another similar company with higher profits. This approach is common to all countries as without it, companies enduring periods of low profitability would be faced with disproportionate tax demands and significant disincentives for investment in infrastructure. In a number of Vodafone's markets, including the UK, the cost of acquiring radio spectrum from the government, high operating costs, substantial levels of capital expenditure and sustained competitive and regulatory pressures have a significantly negative effect on the profits of our local businesses. In addition, in some markets, other taxes that are levied on revenue (together with non-taxation-based contributions such as spectrum fees) have the effect of depressing profit and so reducing corporation tax liabilities
- Taxation is local. Taxes generally fall due wherever profits are generated, and the tax liabilities that arise as a result are decided under the rules of the country that is host to the business in question. So, for example, a company operating

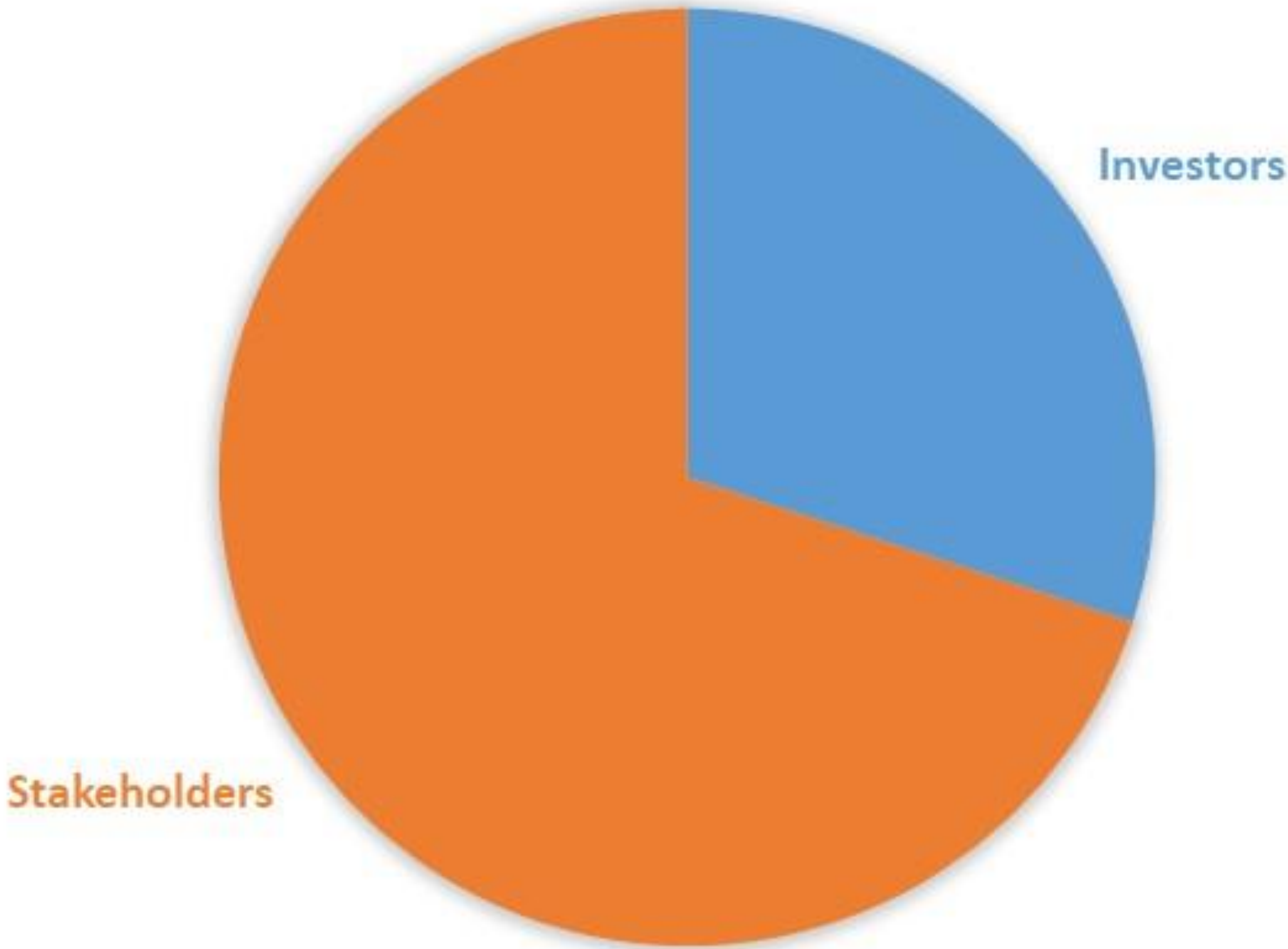
Vodafone

- Which of these decisions created most value for society?
- Which of these decisions, if not taken, would have led to most public outrage, or worsened Vodafone's CSR rating / reputation?


Investors
Stakeholders


Investors
Stakeholders


Investors
Stakeholders


Investors
Stakeholders

Pieconomics is an approach to business that seeks to create profits only through creating value for society

II. The Evidence

Large-Scale Academic Studies

- Margolis and Walsh (2003) review numerous academic studies, all using large-scale data
  - Majority of studies find that social performance is positively correlated with financial performance
- Correlation does not imply causation
  - Social performance causes financial performance?
  - Financial performance causes social performance?
  - A third variable (e.g. good management) causes both?

A New Approach

- How to measure performance? Future stock returns
  - If social performance were caused by high profits, stock price would already be high today, so should future stock returns should not be higher
  - Allow controls for risk
- How to measure social performance? Many existing measures are:
  - Self-reported: management's response to surveys
  - Based on superficial measures

The "100 Best Companies to Work For"

- Studies one dimension of social performance: employee welfare
  - Four areas: credibility, respect, fairness, pride/camaraderie
- Published in a book in 1984 and 1993, then every year from 1998 in *Fortune*
- Started paper in Feb 2006

I thank Alon Brav, Henrik Cronqvist, Ingolf Dittmann, Florian Ederer, Xavier Gabaix, Rients Galema, Simon Gervais, Itay Goldstein, Adam Grant, David Hirshleifer, Tim Johnson, Mozaffar Khan, Lloyd Kurtz, Andrew Metrick, Milt Moskowitz, Stew Myers, Mahesh Pritamani, Luke Taylor, Jeff Wurgler, Yexiao Xu, David Yermack, and seminar participants at the China International Conference in Finance, FIRS, NYU Conference on Financial Economics and Accounting. Oxford Finance Symposium, Socially Responsible Investing annual conference, George Mason, MIT Sloan, National University of Singapore, Reading, Rockefeller, Rotterdam, UBS, Virginia Tech, Wharton, and York for valued input. Special thanks to Franklin Allen, Jack Bao, John Core and Rob Stambaugh for numerous helpful comments, and Amy Lyman of the Great Place To Work Institute for answering several questions about the Fortune survey. James Park provided superb research assistance, and Daniel Kim, Rob Ready and Patrick Sim assisted with data collection. I gratefully acknowledge support by the Goldman Sachs Research Fellowship from the Rodney White Center for Financial Research.

Peer Review

- Submitted to journal A in January 2008, rejected
- Submitted to journal B in June 2008, rejected
- Submitted to journal C in December 2008
  - Resubmitted in August 2009
  - Re-resubmitted in June 2010
  - Accepted in December 2010
  - Published in September 2011

The “100 Best Companies to Work For in America” beat their peers by 2.3-3.8%/year over 1984-2011 (89%-184% cumulative)

III. Implications for Practitioners

Implications for Practitioners

- Companies: Creating stakeholder value is an issue for CEOs, not CSR departments
- Investors: A company’s stakeholder capital is a financial issue for all investors, not a non-financial issue for “socially responsible” investors
- Citizens: Pieconomics is a way of restoring trust in capitalism – and citizens can play their part

IV. Putting It Into Practice

Companies (1)

- How is this different from what companies are doing already?
- Milton Friedman: “the social responsibility of business is to increase profits”
  - Pieconomics vs. Enlightened Shareholder Value
  - Stakeholders are important, but only as an *instrumental* way to increase profits
    - Evaluate investment in stakeholders using NPV
  - A responsible business is *intrinsically* motivated by the desire to create social value
    - Shift in thinking will lead to far more investments being made, especially intangible ones

Companies (2)

- How should companies make decisions?
  - If not NPV, then “anything goes”
- Investment shouldn’t be unconstrained
  - A responsible business “*creates profits through* creating value for society”

Decision Making Under Pieconomics

- Principle of multiplication
- Principle of comparative advantage
  - Purpose: how is the world a better place by your company being here?
  - Vodafone: "To connect everybody to live a better today and build a better tomorrow"
  - Coca Cola's Project Last Mile vs. charitable donations
- Principle of materiality
  - "Our purpose is to serve customers, workers, suppliers, the environment, and communities while generating a returns to investors"
  - Engie's closure of Hazelwood

		Extractives & Minerals Processing	Financials	Food & Beverage	Health Care	Infrastructure
Dimension	General Issue Category	Click to expand	Click to expand	Click to expand	Click to expand	Click to expand
Environment	GHG Emissions					
	Air Quality					
	Energy Management					
	Water & Wastewater Management					
	Waste & Hazardous Materials Management					
	Ecological Impacts					
Social Capital	Human Rights & Community Relations					
	Customer Privacy					
	Data Security					
	Access & Affordability					
	Product Quality & Safety					
	Customer Welfare					
	Selling Practices & Product Labeling					
Human Capital	Labor Practices					
	Employee Health & Safety					
	Employee Engagement, Diversity & Inclusion					

Sustainability Accounting Standards Board Materiality Map

The Importance of Materiality

- Khan, Serafeim, and Yoon (2016):
  - ESG data from KLD (now MSCI ESG)
  - Firms that score high on all issues outperform by 1.5%/year, insignificant
  - Firms that score high on material issues and low on immaterial issues outperform by 4.83%/year

Investors

- Stock selection: stakeholder capital is financial
- Engagement / activism grows the pie
  - Focus: have a specific issue to talk about, and a specific goal to work towards
    - Based on comparative advantage
  - Collective engagement
    - Investor Forum's framework. Sports Direct collective engagement led to industry-wide engagement in apparel sector

Citizens

- The power of agency
  - Stock selection: as investors, employees, customers
  - Engagement: Abdul Durrant and Sir John Bond
- It's companies' responsibility to unleash "citizen energy"
  - Customers
    - Patagonia's Common Threads Initiative
    - Lego's Ambassador Programme
  - Employees
    - New Belgium Brewing Company's "Bright Ideas"

IV. Conclusion