About Our Team

FSG is a mission-driven consulting firm supporting leaders in creating large-scale, lasting social change. Through customized consulting services, innovative thought leadership, and support for learning communities, we help foundations, businesses, nonprofits, and governments around the world accelerate progress by reimagining social change. To learn more, please visit www.fsg.org.

Enel Foundation is a non-profit organization focusing on the crucial role of clean energy to ensure a sustainable future for all. By developing partnerships with pre-eminent experts and institutions across the globe, leveraging on the vast knowledge of its founders, Enel Foundation conducts research to explore the implications of global challenges in the energy domain and offers education programs to the benefit of talents in the scientific, business and institutional realms.

Founded in 1908 as part of Harvard University, Harvard Business School is located on a 40-acre campus in Boston. Its faculty of more than 200 offers full-time programs leading to the MBA and doctoral degrees, as well as more than 70 open enrollment Executive Education programs and 55 custom programs, and Harvard Business School Online, the School’s digital learning platform. For more than a century, HBS faculty have drawn on their research, their experience in working with organizations worldwide, and their passion for teaching to educate leaders who make a difference in the world, shaping the practice of business and entrepreneurship around the globe.

The Shared Value Initiative is a global community of leaders who find business opportunities in societal challenges. The Initiative connects practitioners in search of the most effective ways to implement shared value. Operated by FSG, the Initiative shapes this emerging field through peer-to-peer exchange, market intelligence, strategy and implementation support, and shared value advocacy. Learn more and join the community at www.sharedvalue.org.

The research included in this report was made possible through funding from the Enel Foundation, Suzano, and Yara. We thank them for their support but acknowledge that the findings, conclusions, and recommendations presented in this report are those of the authors alone, and do not necessarily reflect the opinions of the Enel Foundation, Suzano, and Yara.
In the years since Michael Porter and Mark Kramer published “Creating Shared Value” in the Harvard Business Review we have seen an increased level of sophistication from shared value practitioners around the world. There is a growing recognition that the success of a company cannot be divorced from the wellbeing of the communities in which it operates. Many corporate leaders have become adept at developing and implementing shared value strategies that create competitive advantage through social impact. And yet, they struggle to communicate the financial benefits of their social impact to investors.

With the publication of “Hybrid Metrics: Connecting Shared Value to Shareholder Value” we introduce a new approach that combines companies' social and environmental impact with standard measures of financial performance, making the connection between the two explicit.

This project was borne out of an ongoing conversation among the Enel Group, a shared value global energy company, social impact consultants at FSG, faculty at Harvard Business School, and members of the Shared Value Initiative (SVI). The SVI is dedicated to supporting corporate leaders around the world in implementing shared value through collaboration, mutual learning and pioneering research, such as this report, that bring shared value to life.

The project also benefited from insights from shared value companies Suzano and Yara International, as well as a group of prominent advisors from the investment community. We would like to thank the Enel Foundation, Suzano, and Yara International for generously funding this research and for making the findings available to the public.

Hybrid metrics are still in the nascent stages, but the benefits and potential they hold are promising. We hope this report inspires companies, analysts, and investors to experiment with this concept and bring us closer to demonstrating the causal link between social/environmental and financial performance — underscoring the importance of creating shared value.

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Corporate leaders and investors increasingly recognize that a company’s social and environmental performance affects its long-term economic results and competitive position. Shared value strategies and many other sustainability initiatives enable companies to differentiate themselves from competitors, enter new markets, develop new products, strengthen their supply chains, increase productivity, and lower costs. Yet few companies effectively communicate the financial benefits of their social impact to investors.

This omission results from a longstanding but illusory historical divide between social/environmental impact and economic performance. Public companies have long been required to disclose extensive, standardized, and rigorously verified data about their financial performance, but those requirements have rarely been extended to environmental, social, or governance (ESG) factors. Despite many recent advances in the adoption and sophistication of social and environmental impact reporting, most of the voluminous social and environmental reporting systems available are highly inconsistent, lack external verification, and were never designed to convey material financial implications to investors. We are left with two separate narratives: one telling how profitable a company is, and the other highlighting whether the company is good for people and planet, with no clear way to discern which company is most profitably doing the most good.

This outdated divide between social/environmental and financial reporting creates three major problems. First, investors cannot accurately understand how a company’s sustainability or shared value strategies are creating shareholder value, and therefore miss an important dimension of
corporate performance that can affect future earnings. Second, although the impact will eventually be realized in companies’ long-term financial performance, investors end up mispricing securities in the near term, and management teams are not rewarded by a timely increase in market capitalization when they create shared value. This produces a strong disincentive for both investors and corporate leaders to prioritize social or environmental impact in their day-to-day decision-making. Finally, even if managers want to give weight to those societal priorities, the absence of any decision-making framework that includes social and environmental impact together with its economic consequences prevents them from finding the optimal solutions.

This report is an initial attempt to explore a new approach based on the development of hybrid metrics that combine social and environmental impact with standard measures of financial performance in order to make the connection explicit. The Italian power company Enel, for example, has an explicit strategy to shift from fossil fuel to renewable power generation, which increases their profitability and reduces risk. One could therefore calculate the EBITDA variation in relation to the reduction in carbon intensity. If validated, this ratio could be compared against industry peers to determine which utility is most profitably managing the shift to renewable energy, or used to predict changes in future earnings based on planned investments in renewables during the current transition phase. Similar hybrid metrics could link profitability to health outcomes for healthcare companies or to nutritional value for food and beverage companies. They could also link employee productivity to wages and benefits in service and retail industries, or cost of goods sold to labor conditions in the supply chain for
clothing companies. Social issues such as these are particularly important at a time when many companies are awakening to the deep racial inequities embedded in their traditional operating models. These connections will only be meaningful, however, if a clear causal relationship is demonstrated between the change in social/environmental performance and the financial results.

If our hypothesis is correct that social and environmental factors do affect financial performance, it should be possible to create a few meaningful, comparable, and externally verifiable hybrid metrics in every industry, enabling investors, analysts, and corporate managers to factor social and environmental impact directly into conventional financial analyses and avoiding an endlessly expanding list of newly invented measures and reporting requirements. Hybrid metrics could help fill out the emerging architecture of social and environmental impact reporting, increasing the accuracy of earnings forecasts and rewarding top-performing companies with higher P/E ratios, especially in an investment world increasingly driven by quantitative algorithms. They can also create a better internal decision-making framework to optimize social and financial outcomes.

We can already discern a growing trend among leading companies toward incorporating social and environmental impact data in investor presentations. Developing reliable hybrid metrics that connect social and environmental performance to financial results, however, requires a fundamentally different approach among companies, investors, and analysts. Current government disclosure requirements and the risk of litigation may discourage companies from reporting novel metrics or forecasting the longer-term impact on earnings. Within companies, it requires much closer collaboration between business unit managers and those in charge of sustainability, finance, strategy, and investor relations. For analysts and asset managers, it necessitates a deeper understanding of social and environmental trends and the ability to integrate that knowledge into conventional security analysis. It also requires attention to longer-term performance in addition to quarterly earnings. These changes are not simple, yet many of them are already underway at leading companies and asset managers.

The most fundamental change required, however, is to shift the mindset of corporate leaders and investors from thinking of social and environmental performance and financial performance as two sets of independent variables that address two separate audiences, and to recognize instead that they are highly interdependent. Social and environmental impacts have financial consequences and financial decisions create social and environmental impact.
This report is an early effort to demonstrate the potential of closing the social-financial divide, building on the critical efforts of the many people already working to create more consistent, streamlined, and financially material ESG reporting. In this context, the development of hybrid metrics could have the potential to more clearly reflect the causal linkage between social/environmental and financial performance. We include a framework that describes both the practices and the enabling conditions that are necessary for companies to develop and report on such metrics, as well as guidance for investors and analysts on changes necessary to effectively interpret this information. Each industry and, at least initially, each company, may need to develop its own highly transparent metrics, and it will take some time for them to become accepted, standardized, and comparable across companies. Much more careful research will be required to develop and validate the kinds of hybrid metrics we propose, but we have already seen indications that more clearly communicating the economic value of social and environmental performance can influence analyst and investor perceptions of company valuations.
THE EVOLVING LANDSCAPE OF CORPORATE, SOCIAL, AND ENVIRONMENTAL IMPACT REPORTING
The ubiquity and limitations of ESG reporting, rating, and indices.

Over the past two decades, corporate reporting on environmental, social, and governance factors (ESG) has become the norm. Among the 250 largest corporations in the world, the percentage reporting on ESG increased from 35% to 93%, including 86% of the S&P 500. The vast majority (82%) use the Global Reporting Initiative (GRI) framework to organize their ESG data.

This increasing disclosure has been the result of steady pressure from NGOs, government mandates, and socially conscious investors. By the end of 2018, nearly $31 trillion in assets were managed under some form of responsible investment strategies, a 34% increase in just two years.

The GRI framework was developed to standardize social and environmental reporting, enabling rigorously measured and comparable information across companies within an industry. It was never intended to convey the financial significance of social and environmental impact to investors, and its comprehensive approach to documenting every social and environmental impact inevitably includes many factors that are not material to the economic performance of the company. The GRI was also designed to hold companies accountable for reducing their harmful impacts on society and the environment and does not always enable companies to report the positive impact that they can create through shared value strategies. For example, the Brazilian pulp and paper company Suzano, discussed below, can report reductions in its carbon emissions from manufacturing, but nowhere in the GRI framework can it disclose the positive effect of carbon sequestration that comes from its many acres of fast-growing eucalyptus trees.

In addition to GRI reporting, investors often give weight to various ESG ratings and indices that attempt to distinguish the most socially responsible and sustainable companies. Unfortunately, each rating and index uses different definitions of social responsibility and sustainability, and, as a result, they demonstrate very little consistency. A 2019 study found a correlation of only 30% between the ratings among leading data providers including MSCI, Sustainalytics, Bloomberg, and RobecoSAM (compared to 99% correlation among credit rating agencies). An even greater variance is found among the 125 different data providers in the world that each have their own definitions of socially desirable behavior. The voluminous disclosures required by GRI reporting and the many different surveys sent out by other proprietary rating systems quickly consume extensive time and corporate
resources, leading scholars to encourage companies to “take control of the ESG data narrative by proactively shaping disclosure instead of being overwhelmed by [external] requests.”

In some cases, rating and disclosure systems merely ask whether policies are in place regarding controversial issues, but do not measure the company’s actual performance on those issues. Companies may get equal credit for acknowledging issues, even when they are not equally good at addressing them. Finally, there is no mechanism to demonstrate the causal connection between social/environmental factors and economic performance. Some factors that appear to correlate with improved economic performance — such as the number of women on the corporate board — are highly important measures of social performance, but there is as yet little understanding of exactly why they influence financial results. Even though the correlation may hold over time, without understanding the causal relationship, it would be an unreliable guide for investing.

These flaws in the current ESG reporting and rating structure have made it impossible to reliably reconcile social/environmental and financial performance. Most investment firms that consider ESG factors rely on these flawed ratings as the best data available, even as they acknowledge the inconsistency, policy focus, and limited evidence of causality. Unable to directly connect ESG data with economic performance, investors use ESG ratings not as a meaningful predictor of corporate performance but as a very blunt instrument that serves as a general proxy for risk and a final “green screen” in their selection process to eliminate poorly rated companies.

The growing linkage between social/environmental and financial reporting.

Along with growing the prevalence of ESG reporting, awareness of the link to financial performance is also increasing. Blackrock CEO Larry Fink’s most recent annual letter to CEOs stressed the imperative of reporting on the effects of climate change, predicting a fundamental reshaping of finance from its long-term impact on the financial performance of all major companies. By 2017, 78% of the world’s largest 250 companies included some social or environmental indicators in their financial reports, almost double from 44% six years earlier, and 67% provided at least some external assurance of their data’s accuracy (although the majority of this assurance is limited to selective data). With its action plan on Sustainable Finance, the European Union took a clear step towards the evolution of corporate reporting. The plan includes the Non-Financial Disclosure Directive — requiring disclosure of social and environmental metrics — the EU Taxonomy, the EU Benchmarks, and the Green Bond Standard. All of these will cause a major change in the information available to investors about companies regulated by the EU. The EU Taxonomy, in particular, will also deeply affect companies’ reporting. These are promising developments, but do not
yet clearly explicate the connection between social/environmental and financial performance.

Many nonprofit organizations are working creatively and diligently to make the connection more explicit, and, although the social-financial divide has substantially narrowed, it has not yet closed. The Sustainability Accounting Standards Board (SASB) has worked with companies to identify the most material social and environmental factors in each industry. SASB’s standards are increasingly being adopted, particularly by U.S.-based companies, although they were not developed to comply with EU regulations and have had less acceptance outside the U.S., a limitation that SASB is working to overcome. New research has demonstrated that the companies that focus their sustainability efforts on the material issues identified by SASB outperform their peers, delivering superior shareholder returns of 3% to 6% annually. The few investment firms that conduct proprietary research to identify companies that derive material economic benefit from a distinctive approach to sustainability issues have substantially outperformed the market, but they remain rare outliers and their deep company-specific research is not easily duplicated or translated into broadly applicable algorithms.

Many other efforts are also underway. The Task Force on Climate-related Financial Disclosures (TCFD) is developing methodologies for companies to disclose climate-related financial risks. The Impact Management Project is coordinating efforts to provide complete standards for impact measurement, management, and reporting. CEOs brought together by the World Economic Forum are advocating for standardized and comparable ESG metrics. CERES has quantified the economic risk facing carbon-dependent businesses. The International Integrated

“Companies spend a lot of time on sustainability reports that are targeted at a range of stakeholders, but few investors read and rely on them in their investment processes. We hear often that investors don’t care about sustainability; the issue is that the sustainability information isn’t in a form they can process efficiently.”

—Sarah Keohane Williamson FCLTGlobal
**Reporting Council** has encouraged companies to include material social and environmental impact metrics in their annual reports. And the **Impact Weighted Accounts Initiative** is working to create financial accounts that monetize different types of social and environmental impact. Despite all these worthy efforts, very few companies yet describe any clear, consistent, and direct linkage between social/environmental and financial performance in their investor communications.

We do know, however, that social and environmental performance can influence financial results, especially for companies that pursue shared value strategies. Enel, the Italian electrical utility, is shifting a majority of its power generation to renewables, which offer a faster return on investment, more consistent earnings and a better EBITDA margin than fossil fuel power generation plants. Walmart increased wages, training, and benefits for its hourly employees, and saw workforce productivity and same-store sales increase, while turnover costs decreased. Yara, the Norwegian fertilizer company, has a distinctive competitive position and higher profit margin than the industry average because its customized fertilizer mixes and technical support increase yields for smallhold farmers while reducing harmful fertilizer run-off and deforestation. In Brazil, Suzano’s business model of utilizing fast-growing planted eucalyptus trees instead of traditional, old-growth native forests to produce pulp gives it a faster harvesting cycle and a cost advantage while also sequestering millions of tons of carbon from the air that hardwood pulp producers cannot match. Yet this is not explicitly factored into earnings projections.

Early anecdotal research suggests that shared value companies such as these tend to outperform their peers.\(^{14}\) Yet, it is only in the last 18 months that we

**DESPITE ALL THESE WORTHY EFFORTS,** **VERY FEW COMPANIES YET DESCRIBE ANY CLEAR, CONSISTENT, AND DIRECT LINKAGE BETWEEN SOCIAL/ENVIRONMENTAL AND FINANCIAL PERFORMANCE IN THEIR INVESTOR COMMUNICATIONS.**
have found any examples of companies clearly communicating the economic importance of their social and environmental impact in standard investor briefings. We hypothesize that communicating the economic benefits of shared value strategies more directly to investors would reduce the number of earnings surprises and the dispersion of earnings forecasts, as well as improve the company’s P/E ratio relative to peers. Our preliminary research, described in Section 4 below, is consistent with this assumption, although a comprehensive analysis is beyond the scope of this study and these improvements in corporate reporting are still too recent and rare to reliably confirm this effect.
DEVELOPING HYBRID METRICS
We propose that the integration of social/environmental and financial reporting could go still further by developing *hybrid metrics* that directly link social/environmental and financial performance. A virtue of this approach is that it uses existing financial metrics that enable traditional tools of security analysis to be applied while also factoring in social and environmental factors. Before actually adopting them, such hybrid metrics must be verified by thorough quantitative analysis and by establishing a clear causal connection between the social/environmental impact and financial results. Mere correlation may be misleading without understanding the underlying cause and effect.

For a company like Enel, as noted above, the economics of renewables explain why EBITDA increases as carbon intensity\(^{15}\) declines and the relationship is likely to remain consistent over time. One could therefore create a performance metric that links decreases in carbon intensity directly to increases in EBITDA that would have predictive value for future earnings and could be compared across the industry. As the company increases the percentage of power generation from renewables, investors should see a corresponding increase in EBITDA and reduction in volatility of earnings.

Enel has long described its shift to renewables in its sustainability reports and taken pride in its efforts to advance the SDGs, but only in the last six months has management made this information a key part of its Enel Capital Markets Day presentation by focusing on the theme “sustainability = value.”
Investor communications in late 2019 and early 2020 clearly highlighted the specific financial value driven by the renewables business model, including revenue, profitability, and a risk indicator. From the time of the Capital Markets Day presentation in November 2019 to February 2020 (after which most stocks started to plunge because of the COVID-19 pandemic), Enel's share price increased almost 24% and the company reached their highest ever market capitalization. Management attributes much of the improved stock valuation to this shift in communicating the economic implications of the company's renewables strategy. Given the clear causal connection, it may be possible to go still further and create a hybrid metric that directly links improvements in EBITDA and ROCE and reductions in the cost of capital with reductions in carbon intensity.

These hybrid metrics, once vetted, should also enable comparisons and the development of common standards across companies within an industry. For example, if the increase in earnings for every 1% decrease in carbon intensity were higher at a certain company than at a competitor, we could conclude that the former has achieved greater efficiency than its competitor in its renewables business, a factor that will become increasingly important as the industry continues the shift to renewables. If the company is also decreasing carbon intensity more rapidly, the difference in earnings between the two companies should accelerate. Of course, EBITDA is also affected by different lines of business, as well as operational efficiencies unrelated to power generation and one-time transactions such as acquisitions and divestitures. Ideally, one would identify the financial metric most closely linked to the social/environmental impact — in this case that might be the gross margin on power generation — which, at least hypothetically, would offer a more meaningful and causally related hybrid metric.

For example, we calculated a hypothetical hybrid metric of “EBITDA/CO₂ intensity” for three energy companies in the chart of Figure 1A below. According to the data, if one were to select the utility that is most rapidly decarbonizing it would be Engie, even though the company's profits have actually declined. Iberdrola, which is the second fastest in decarbonization and received the strongest ratings according to many ESG scoring systems, also comes out significantly better when one considers decarbonization and profit together, suggesting a win-win of environmental impact and financial performance and validating the sustainability ratings. Enel comes out in between, decarbonizing more slowly than Engie but doing so more profitably.
On the other hand, if one looks at the compound annual growth rate of change in profit and decarbonization (“EBITDA CAGR/CO₂ intensity CAGR”) across the three companies shown in Figure 1B, the hybrid metric would suggest that Enel is moving more rapidly along the combined profit/decarbonization continuum, suggesting that the company may catch up to Iberdrola over time.

Static hybrid metrics compare the financial benefits from sustainability measures already achieved relative to industry competitors, while hybrid metrics that rely on changes over time, such as decreasing carbon intensity, offer a forward-looking orientation that could potentially be used to predict the potential impact of sustainability targets on future financial performance. The metric that is best suited will probably vary based on the company’s strategy and the ultimate goal of the investor communication, although a good hybrid metric should be valid and consistent across an industry. The significance of the social/environmental component may also change over time. Once the energy industry has shifted entirely to renewables, the EBITDA/CO₂ hybrid metric will no longer be relevant.
Hybrid metrics may also be valid only within certain limits. For example, the correlation that Walmart found between raising hourly compensation and increasing productivity makes sense for lower wage levels, but would probably not hold true if wages continued to increase indefinitely. A hybrid metric that links wages and productivity in retailing, therefore, would only be valuable within a specific range.

Hybrid metrics may show negative correlations as well as positive ones. For automobile companies, a hybrid metric that links profitability to gas mileage of cars sold might show that their profitability is heavily dependent on SUV and truck sales that consume more fuel, even if the company’s manufacturing is less carbon intensive or its overall fleet has lower average mileage. This would give a much more explicit way of assessing company exposure to the risk of carbon regulation and the potential cost of shifting to a carbon-free economy than the current ESG ratings or an analysis of the company’s overall carbon footprint. Figure 2 lists a few other potential hybrid metrics that might apply in different industries. Considerably more research will be required to define and test the most meaningful hybrid metrics in each industry.

It is important to note that we are not suggesting that hybrid metrics replace GRI reporting or other ways of tracking corporate social and environmental impact. Narrowing the focus to a few key hybrid metrics for investment analysis will not excuse companies from responsibility for other aspects of their social and environmental footprint. Governments, NGOs, and socially responsible investors will still hold companies accountable for all of their social and environmental impacts, whether or not they are material to shareholder returns.
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<th>Sector</th>
<th>Hybrid Metric 1</th>
<th>Hybrid Metric 2</th>
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<tr>
<td><strong>Energy</strong></td>
<td>EBITDA</td>
<td>CO(_2) Intensity</td>
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<td><strong>Crop Nutrition</strong></td>
<td>EBITDA</td>
<td>Yield per Hectare</td>
</tr>
<tr>
<td><strong>Retail</strong></td>
<td>Cost of Goods Sold</td>
<td>Value of Waste Avoided</td>
</tr>
<tr>
<td><strong>Pulp and Paper</strong></td>
<td>Revenue</td>
<td>Tons of CO(_2) Sequestered</td>
</tr>
<tr>
<td><strong>Pharma &amp; Medical Devices</strong></td>
<td>EBITDA</td>
<td>Contributions to Daily Adjusted Life Years</td>
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<tr>
<td><strong>Service Industries</strong></td>
<td>EBITDA</td>
<td>% of Workforce Above Living Wage</td>
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<tr>
<td><strong>Chemicals and Industrial Production</strong></td>
<td>Cost of Raw Materials</td>
<td>Tons of Recycled Plastics Used</td>
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<tr>
<td><strong>Financial Services</strong></td>
<td>Revenue per Customer</td>
<td>Financial Well-being</td>
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Finally, hybrid metrics can guide corporate strategy and decision-making by bringing the societal and business outcomes into the same analytical framework. Discovery Ltd., a health and life insurance company based in South Africa, has developed a distinctive business model that rewards its members for engaging in healthier behaviors, such as exercise, better diet, and preventive care. The incentives have been shown to change behavior, leading to 15% lower medical costs and an eight-year longer life expectancy, which in turn increases Discovery’s profit margin. To calculate how much the company can spend in member incentives, Discovery has developed an equation that links the cost of incentives with the resulting changes in behavior and improved health outcomes, along with the cost savings to the company from reduced medical bills. This analysis helps guide management decisions about the viability of new incentives and product offerings. See Figure 3 for the Discovery hybrid equation.

**Figure 3: Mathematics of Discovery’s Shared-Value Insurance: Model for Creating and Sharing Value**

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<tr>
<th>Value</th>
<th>Incentive</th>
<th>Δ Behavior</th>
<th>Δ Health Outcome</th>
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<td>Member</td>
<td>Member</td>
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Much more work will need to be done to develop hybrid metrics. In addition, if hybrid metrics are to take hold, companies and investors will need to confront several normative factors in the capital market system that currently impede the linkage of social/environmental and financial performance through various policies, practices, and deeply embedded mindsets. For example, companies are often advised by legal counsel not to disclose any data unless it is legally required. Only three U.S. companies out of the S&P 500 voluntarily include sustainability data or a link to such data in the business or strategy sections of the 10-K filings with the SEC. Regulatory requirements to disclose social and environmental impact data are increasing, especially regarding climate change, but as yet only France and South Africa now require extensive disclosure.

Figure 4 lists some of the most prominent obstacles to meaningfully connecting social/environmental impact to shareholder value within existing U.S. capital market norms.
FIGURE 4: SYSTEMIC BARRIERS FOR CAPTURING SHAREHOLDER VALUE

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<th>Capital Market Systems</th>
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<td>Companies</td>
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### Policies & Standards
- **Government disclosures** often require reporting on short-term, traditional financial metrics
- Overabundance of **inconsistent standards** and rating systems
- Risk of **litigation against SEC registered companies** if long-term projections do not materialize
- Metrics on social and environmental impact **not verified by auditors**
- **Compensation** driven by short-term asset growth
- **Quarterly reports** primary input into company analysis
- Reliance on **third party and/or assurable metrics**
- Social and environmental impact only **mitigates risk**
- Prioritizing social and environmental impact is a **breach of fiduciary duty**
- ESG **expertise not high value** for analysts

### Practices
- **Sustainability and finance/investor relations operate in silos**
- Structures for tracking and reporting social and environmental impact **separate from financial results**
- **Social and environmental impact about reputation**
- Risk of **peers copying** if report on competitive advantage
- Communication should gear towards **Wall Street and sell-side analysts**

### Mindsets
- **Driving profit and driving good are not connected**
- **Small, publicized positive efforts** from companies rewarded without consideration of broader impact
- **Risk of** legal exposure against SEC registered companies if long-term projections do not materialize
- Metrics on social and environmental impact **not verified by auditors**
- **Compensation** driven by short-term asset growth
These obstacles cannot be overcome all at once, but must co-evolve as investors, companies, analysts, rating agencies and governments increasingly zero in on the social impacts that will materially affect a company's future earnings. This is especially true as many in the investment community still hold on to the notion that nonfinancial factors are not relevant to valuation models and investment decisions. Regulatory frameworks, required disclosures, safe harbors against the risk of litigation, auditor verification of social impact, standardization of impact metrics, mental models that connect social and financial outcomes, and a focus on longer-term investment horizons must all gradually improve to pave the way for the meaningful translation of social performance into timely and useful guidance for investors.21

It is within companies and investment management firms, however, that the biggest changes will be needed to collect and utilize the data to support the application of hybrid metrics. The following sections propose a framework for what companies must do differently in order to provide the necessary data to inform analysts and investors, as well as recommended changes on the part of investors and analysts to properly interpret the information.
A FRAMEWORK FOR COMPANIES TO IMPLEMENT HYBRID REPORTING
The Shared Value Frontier.

To be certain that a company will derive an instinctive and significant competitive advantage from its social/environmental impact, we believe that the social and environmental impact must be intentionally managed in ways that create shareholder value and competitive advantage. Companies that pursue shared value strategies, therefore, can best support the development of meaningful hybrid metrics.22

The Shared Value Frontier, shown in Figure 5, categorizes companies by the depth and clarity of their commitment to shared value. Companies will not always fit onto a single level, as different divisions or aspects of their operations may fit into different levels.

At the bottom level, many companies still see social and environmental performance primarily as a matter of regulatory compliance or as a way to protect and enhance the company’s reputation.

Such companies are often characterized by:

1. Philanthropic and social initiatives that are disconnected from the business
2. Social initiatives that do not meaningfully contribute to overall corporate profitability
3. Undifferentiated sustainability practices typical of their industry
**FIGURE 5: THE SHARED VALUE FRONTIER**

Shared value companies at the frontier find opportunities for long-term competitive advantage through shared value.

**PREVAILING PRACTICES**
Company social and environmental efforts viewed primarily as a mechanism to enhance reputation, mitigate risks, or "do good" without a connection to business, industry, or strategy.

Companies adopting social and environmental goals but not communicating results to investors.

**EMERGING BEST PRACTICES**
Adherence to emerging best practices that are necessary, but not sufficient to convey the full potential to create financial value from social and environmental strategies:

- Clear understanding of industry materiality of social and environmental issues using standard framework
- Development of long-term plans which include how social and environmental strategies will improve returns over time
- Effective tracking of the return on social and environmental strategies by identifying any monetary benefit

**SHARED VALUE FRONTIER PRACTICES**
Prioritization of social and environmental strategies that contribute to a company’s unique strategic positioning:

- Distinct value proposition through differentiation and innovation
- Tight link to core business model
- Clear contribution to significant revenue and profitability
At the second level, companies have adopted emerging best practices by focusing their efforts on improving the narrower set of social and environmental factors that are material to their business, often as a matter of compliance with regulations or in an effort to minimize the negative externalities of their business model. They also tend to take a longer-term view and find that, even within a 2- to 5-year time horizon, social and environmental issues have a significant impact on financial performance. These companies can often identify a monetary benefit or reduction in risk as a result of their social or environmental activities, although most of these activities tend to converge toward industry standards and so do not create a long-term competitive advantage for a given company.

At the top level are shared value companies that have built a differentiated approach to societal issues into their strategy and competitive position, often by adopting a social purpose that goes beyond merely generating a profit and considering the welfare of all stakeholders. Embracing such a purpose can be the most important first step in beginning the shared value journey, promoting racial equity, and uncovering the links between social/environmental impact and economic performance.

These companies are characterized by a distinctive value proposition that includes both financial and social/environmental dimensions, a tight link between their social impact and their core business model, and superior profitability compared to others in their industry. Danone, for example, is alone among major food and beverage companies in having eliminated all unhealthy foods from its product line and focusing on nutritional value as its key competitive advantage. It is these shared value companies that will have the strongest story to tell.

“The vast majority of companies talk about these issues in a philanthropic way. When we look for information, it’s easy to find the great ways that they’re giving money away. That’s what companies lead with and it lends itself to glossy pictures in a report. The harder work is to get into how these issues impact their core operations.”

—Daniel Roarty
Alliance Bernstein
investors and the clearest line of sight between their social and environmental performance and the shareholder value they create. These are also the most promising companies to implement hybrid metrics in their investor reporting. Doing so, however, will require adjustments to a number of internal corporate practices described in the stages of hybrid disclosure shown in Figure 6.

**The Stages of Hybrid Disclosure.**

Among shared value companies, we have identified three increasingly sophisticated stages of development in communicating the economic value of their social and environmental impact to investors, along with a number of necessary enabling conditions. We have identified a number of leading companies at Stage 1, a handful of pioneering companies at Stage 2, and very few companies indeed that have yet achieved Stage 3. Whether or not companies choose to develop hybrid metrics, moving up the Stages of Hybrid Disclosure will be important to effectively communicate the economic value of social impact to investors.
Companies can communicate the shareholder value of shared value strategies through increasingly advanced steps.

**BEST PRACTICES**
- Utilize frameworks that focus on materiality (e.g., SASB, TCFD)
- Provide clear narrative in investor materials on how social and environmental strategies drive economic opportunity with research-based claims
- Measure the social and environmental impact of social and environmental strategies

**Enabling Factors**
- Consistent integration of key functions related to operations, sustainability, strategy, finance, and investor relations
- Concrete and actionable 3-5 year plans for reaching social/environmental goals
- Company-wide endorsement and top management buy-in

**GOOD**
1. Communicate clearly defined shared value strategies

**BETTER**
2. Communicate the financial value driven by shared value

**BEST**
3. Communicate social and financial impact of shared value in quantitative and comparable terms

**BEST PRACTICES**
- Articulate the causal link and relative contribution of shared value business models to key financial metrics such as EBITDA, revenue, margins, and growth
- Utilize and communicate metrics that directly combine financial returns with social and environmental impact and are comparable across companies

**Enabling Factors**
- Rigorous and transparent methodologies that are disclosed to investors

**Enabling Factors**
- External verification of data and methodologies
- Emerging common industry-wide standards
Stage 1: Communicate Clearly Defined Shared Value Strategies.

Companies at this stage have an important message to communicate to investors and analysts about the way that their shared value strategies will affect their business. They have a defined process and rationale for determining and communicating how their social and environmental efforts are material, such as by using SASB’s materiality analysis or similar industry-wide standards. Such industry-wide frameworks are useful because they give investors external verification that the specific social issues are material to the industry. However, these frameworks can be limiting because they do not clarify the unique value proposition of a specific company within the overall industry.

To take this a step further, companies can develop and communicate their own distinctive materiality framework. Nestlé, for example, has developed a materiality matrix in which they position issues that impact individuals and families, communities, and the planet relative to the degree of stakeholder engagement and potential business impact. Communicating the results of these assessments provides clarity for investors on why a company has focused on specific issues and greater insight into the connection of these issues to both business and societal needs. Companies at this first stage may also report on these material factors in their regular investor communications and explain how these factors affect the business, although in qualitative and directional rather than quantitative and precise terms.

A growing number of companies have reached this stage, although those that do have only begun doing so in recent years. If companies do not deliver the message that their shared value activities create shareholder value through these regular communication channels, it is unlikely that investors will understand the economic significance of these activities or reward the company by factoring those advantages into the price of the company’s stock.
communication channels, it is unlikely that investors will understand the economic significance of these activities or reward the company by factoring those advantages into the price of the company’s stock. Merely including social and environmental progress in a standalone section of investor reports, as in many examples of integrated reporting, is not sufficient to convey the financial significance of these factors to investors.

In February 2020, for example, Suzano made the decision to highlight its new sustainability strategy directly in its Suzano Day presentation for investors, including long-term goals related to being even more carbon positive, the growth of new markets as a more environmentally beneficial replacement for plastic and other petroleum derivatives, and ensuring that 200,000 people in the regions where it operates are lifted and maintained above the poverty threshold. In his remarks, the CEO made clear that Suzano sees these efforts as core to its entire corporate strategy, yet the specific financial implications were not quantified.

Companies at this stage, like Suzano, do not just describe broad aspirational sustainability goals that are decades away, but also regularly report on measurable progress. The best measures of progress not only track outputs, such as funds spent or farmers trained, but clarify the outcomes for people and ecosystems, such as increased yields or reduced deforestation for the farmers trained. This kind of reporting proves to investors that a company is making consistent progress against its social and environmental goals in ways that are important to the business.

“Quarterly calls are too often focused on look-back short-term financials. But the value is in the future long-term cash flows and that’s where purpose, stakeholders, and ESG are so crucial.”

—Daryl Brewster
CECP
In Becton Dickinson’s (BD) quarterly earnings presentation, for example, the company provides investors with a specific rationale for why its sustainability focus will drive future commercial success, with regular updates on its sustainability progress, although without explicitly tying that progress to quantitative financial targets. (See Figure 7 for an excerpt from BD’s 2019 Q4 earnings presentation.)

This kind of reporting is only possible when there is a company-wide understanding of the link between social/environmental and business strategies, and sufficient collaboration between the sustainability team, the finance team, and the investor relations team. In most companies, sustainability has limited interaction with finance and investor relations, and the lack of coordination and communication is a significant practical barrier to building the message into shareholder communications. Internal surveys or focus groups can help identify gaps in data collection, coordination, and reporting.

To make this integration possible, companies can also shift reporting structures to ensure a direct connection between these functions. At Enel, for example, Sustainability now has a dual reporting line to the Innovation and Finance & Control departments. Companies can also create cross-functional roles or teams that can identify and track the progress of new dedicated shared value business lines. At Yara, the Food Chain and Global Solutions division was created following engagement among sustainability, strategy, and finance to identify new areas of opportunity.

“For so many companies their sustainability strategies are set in one place, their execution is in a different place, and finance is in another place. They’re not set up to actually track that financial benefit as tied back to their sustainability strategy. They’re not talking about it to their investors because they don’t themselves know.”

—Professor Tensie Whelan
NYU Stern School
These steps do not happen by chance — they are the result of a concrete and actionable plan for shifting internal awareness, increasing communication, and articulating clear societal goals that are embedded in the business model and have company-wide endorsement, especially from the CEO and board.

As noted earlier, this level is still considered best practice in the field today, and using narrative reporting to tie the financials to the shared value metrics is a key interim step in moving towards the development of more tightly linked hybrid metrics. A recent report from CECP’s CEO Investor Forum and Professor Tensie Whelan offers guidance on best practices for including narrative reporting on ESG progress tied to financials in quarterly earnings calls.

**Stage 2: Communicate Financial Value and Strategic Positioning.**

At the second stage, companies not only refer to social/environmental and financial factors in their investor communications, but include specifics about the financial significance of those factors. Companies at this level measure the direct financial benefits driven by
social and environmental strategies, including cost savings and revenue generated. Communicating these numbers requires first identifying what the right financial metrics are through close coordination between strategy, sustainability, and finance teams and developing a consistent system for tracking results over time.

BD, for example, has gone further in this direction in presenting its five-year plan at CECP’s CEO Investor Forum. The company invests heavily in public-private partnerships in emerging markets to identify unmet healthcare needs for which they can design products and then work with local universities and government agencies to train clinicians on their use. This distinctive approach has given the company a clear advantage in emerging markets, and the company has communicated to investors that, as a result, it anticipates $500 million in incremental revenues over next two years.

Once identified, companies should track the associated financial impacts from these strategies on a consistent basis, for example, by updating a consistently reoccurring slide in each quarterly investor presentation, making it clear to investors that these social and environmental strategies are not discrete initiatives but are core to ongoing corporate strategy and economics.

Companies at this advanced stage go beyond SASB’s materiality analysis to clarify how their shared value efforts differentiate them from other companies and how they expect such differentiation to confer a meaningful competitive advantage.

Starting in 2018, Yara began clarifying why their crop nutrition business model, which is devised of a differentiated portfolio of premium products delivered to farmers by on-the-ground agronomists

“For so many companies their sustainability strategies are set in one place, their execution is in a different place, and finance is in another place. They’re not set up to actually track that financial benefit as tied back to their sustainability strategy. They’re not talking about it to their investors because they don’t themselves know.”

—Professor Tensie Whelan
NYU Stern School
with region-specific crop knowledge, provides high value for the company, the farmers, and, by reducing excess fertilizer usage and deforestation, for the environment. These products, which Yara sells at a higher volume and price than competitors, lead to greater crop yield and earnings for farmers and higher revenue for Yara, explaining why Yara’s net income is nearly 20% higher than the industry average. Yara is clear in its communication about not just the benefits but why they are uniquely positioned to deliver these benefits through their product portfolio, business model, and specific expertise. (See Figure 8 for an excerpt from Yara’s 2019 Capital Markets Day presentation.)

Similarly, when Unilever reported progress on its Sustainable Living Plan to investors, the company stated that its sustainable brands grew by 69% faster than the rest of the business and delivered 75% of the company’s total revenue growth.

Communicating quantitative data about shared value, like any other financial disclosure, requires a high degree of transparency in communicating how the information has been calculated and the rationale for any projections of future financial results to ensure that investors accurately understand the reliability and predictive value of the information. Of course, it must also include the necessary caveats and qualifications to safeguard the company in making forward-looking statements.

**Figure 8: Yara Investor Presentation**

*We are uniquely positioned to create value*

<table>
<thead>
<tr>
<th>Competitive landscape</th>
<th>Yara’s competitive edge</th>
<th>Proof points</th>
</tr>
</thead>
<tbody>
<tr>
<td>Most of Yara’s peers are mainly producers, with limited on-farm presence.</td>
<td>Unique global presence and farmer interaction</td>
<td>Sales to +160 countries</td>
</tr>
<tr>
<td>Yara is positioning to both have a global footprint and strong market presence.</td>
<td></td>
<td>+60 countries with operations</td>
</tr>
<tr>
<td>Peers with market presence do not have global reach.</td>
<td></td>
<td>9,000 fully branded retail outlets¹</td>
</tr>
<tr>
<td><strong>Unrivaled global agronomic crop knowledge</strong></td>
<td></td>
<td>Sales to 20 million farmers</td>
</tr>
<tr>
<td>Unrivaled global agronomic crop knowledge.</td>
<td></td>
<td>870 sales agronomists on the ground</td>
</tr>
<tr>
<td>Pioneered agricultural growth and production for 114 years.</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Crop-specific nutrition solutions based on a differentiated and sustainable product portfolio</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Crop-specific nutrition solutions based on a differentiated and sustainable product portfolio.</td>
<td></td>
<td>Global #1 in nitrates and NPK</td>
</tr>
<tr>
<td><strong>Integrated business model</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Integrated business model.</td>
<td></td>
<td>Global optimization of production and market margins, reduces volatility</td>
</tr>
<tr>
<td><strong>New innovative business models</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New innovative business models.</td>
<td></td>
<td>Digital farming and value chain collaboration initiatives with leading global partners</td>
</tr>
</tbody>
</table>

¹Owned and operated by external parties.

---

**Hybrid Metrics:** Connecting Shared Value to Shareholder Value
We have found very few examples of companies communicating such specifics, and note that the examples we have found are all within the past 18 months, suggesting that this is emerging as a nascent level of best practice that we can expect to grow in the near future. There are also emerging resources to track and prove the monetary impact of sustainability advances, including the Return on Sustainability Investment (ROSI™) methodology from NYU Stern’s Center for Sustainable Business. The ROSI framework leads companies through identifying material ESG issues for the sector (based on SASB) and the related sustainability initiatives, identifying both tangible and intangible economic benefits from those changes, and then quantifying and tracking these benefits.

**Stage 3: Communicate the social/environmental and financial impact of shared value strategies in quantifiable and comparable terms.**

Step 3 builds on the prior steps and presents a promising new frontier to which companies can aspire. This level goes further in articulating the causal link between sustainability efforts and financial performance, as well as the significance of this link to the company’s most important financial metrics, such as revenues, margins, earnings, and growth rates, enabling the company or its analysts to construct hybrid metrics that directly link social/environmental and financial performance in ways that can be compared across companies.

In its most recent Investor Presentation in March 2020, Enel moved to more clearly highlight how sustainability is integrated into its business model and drives economic value. Analyst and investors have reacted very positively to Enel’s growth and overall direction on sustainability following this shift. (See Figure 9 for excerpts from Enel’s presentation.)

Companies may not want to be quite so explicit in revealing their strategy or they may face a potential legal exposure if they present nonstandard data that leads investors to anticipate future performance which fails to materialize. While these risks are real, our research suggests that they may be rooted more in corporate culture than any carefully weighed considerations that impede communication to shareholders.26
**Sustainability Value**

We have focused our capital allocation on renewables...

**Generation capex: 2015 vs 2019**

- 2015: 4.6 €bn (% Development Capex: ~70%)
- 2019: 5.1 €bn (% Development Capex: ~80%)

**Renewable and Thermal Production (TWh)**

- 2015: 244 (36% RES Capacity / Total: ~40%)
- 2019: 203 (49% RES Capacity / Total: ~50%)

1. Excluding nuke (30.8 TWh in 2015 and 26.3 TWh in 2019)

**Profitability of generation enhanced by decarbonisation**

**Global Power Generation EBITDA (€bn)**

<table>
<thead>
<tr>
<th>Year</th>
<th>EBITDA</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY 2019</td>
<td>6.2</td>
</tr>
<tr>
<td>2019E</td>
<td>5.7</td>
</tr>
<tr>
<td>2022</td>
<td>7.1</td>
</tr>
<tr>
<td>Nuke</td>
<td>0.5</td>
</tr>
<tr>
<td>2019</td>
<td>6.2</td>
</tr>
<tr>
<td>2022</td>
<td>7.6</td>
</tr>
</tbody>
</table>

**Main KPIs**

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Production (TWh)</th>
<th>Total Capacity (GW)</th>
<th>Gross Margin/MWh (€/MWh)</th>
<th>OPEX/MW (€/MW)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2019</td>
<td>229</td>
<td>84</td>
<td>41</td>
<td>39</td>
</tr>
<tr>
<td>2022</td>
<td>249</td>
<td>91</td>
<td>44</td>
<td>33</td>
</tr>
</tbody>
</table>

1. Excluding managed capacity
2. 2022 in real terms
Alternatively, it may be preferable to avoid this risk by leaving it to external investment analysts to create and interpret such hybrid financial/social metrics based on company disclosures of the underlying data. Incorporating standard financial metrics should also increase the willingness of outside auditors to provide assurance about the accuracy of these hybrid measures and enable analysts to more adeptly incorporate them into their forecasts. Ultimately, the questions of strategy, liability, and verification will need to evolve on a case-by-case and industry-by-industry basis until methodologies have been standardized.

As noted earlier, it is important to show a clear causal relationship between the two components of the hybrid metric, as well as the potential limits of its range. One can find correlations and construct ratios between all kinds of different data points, but the metric will only be meaningful if the connection between the social/environmental and financial variables is clearly understood. To pressure-test the connection between variables, companies can analyze whether the correlation holds true across multiple years of internal data, as well as in comparisons to competitors.

It will take considerable work on the part of companies, investors, and analysts, to develop and reliably interpret hybrid metrics, beginning with the most material factors identified by SASB or other industry-wide standards, and then refining them based on the company’s competitive position within the industry. Ultimately, however, we must translate social and environmental performance directly into standard financial measures of performance if we are to close the divide between social/environmental and financial reporting.

“Most companies disclose some aspects of their behavior and certain metrics (own carbon footprint), but not the specific product impact. The product impact tells us what will happen as the company grows. We think that companies that can measure and communicate this well create competitive advantage.”

—Daniel Roarty
Alliance Bernstein
Linking social and environmental impact to standard financial performance metrics seems far more reliable and informative than using newly invented metrics such as Social Return on Investment, Net Benefit, or Total Return that do not clearly convey the economic significance to investors nor fit into ordinary security analysis. Investors already struggle to determine what is most meaningful within an endless sea of ESG data and ratings, while companies are saddled with ever-more-numerous social and environmental reporting obligations. Hybrid metrics have the potential to reduce, rather than expand, the volume of relevant data for both companies and investors, while offering the potential for investors to make better informed decisions and for companies to see the price of their stock more rapidly reflect the economic value of their positive impact on the world.

In an effort to link environmental, social, and governance metrics with financial performance, Danone announced in February 2020 that it would begin pricing carbon emissions into its quarterly earnings, reporting on carbon-adjusted EPS. The new measure is calculated based on the estimated cost per share of the tons of greenhouse gas the company generated in 2019, which is then subtracted from its regular earnings per share. The calculation shows that carbon-adjusted earnings per share grew more quickly than regular EPS in 2019. Danone made this change while announcing significant investments in product improvements and capital expenditures designed to address climate change, which are expected to “deliver in the mid-term a consistent mid-to-high single digit recurring earnings per share growth.” (See Figure 10 for an excerpt from Danone’s presentation.)
For Yara, a hybrid metric might combine increases in profitability with increases in crop yields, such as \( \Delta \text{EBITDA}/\Delta \text{Yield per Hectare} \), since the increased yield is what justifies Yara’s higher prices and margin, increasing farmer earnings and the supply of food without increasing deforestation. One could therefore link Yara’s earnings directly to reductions in deforestation or reductions in poverty among smallholder farmers. This linkage will set Yara apart from competitors as the world accelerates the fight against climate change, searches for ways to bring more people out of poverty, and strives to provide food for a growing population.
The scarcity of companies at the upper stages of the Hybrid Disclosure Framework and the limitations of this study prevent us from any comprehensive analysis to confirm that stock performance and analyst predictions respond to the types of disclosures we are recommending. Discussions with our expert advisors (listed on Page 4) offer anecdotal support to confirm our hypotheses. Our research has also turned up a few examples that are at least consistent with our argument. While not in any way conclusive, we hope these initial results will provide a starting point for deeper examination.

After initial review of more than 75 companies, we selected 21 prototype companies, highlighted in Figure 11, and divided them into four categories, explained below:

First, we divided companies into “business as usual” and shared value companies. “Business as usual” companies have not incorporated social and environmental factors into their competitive strategies, even if they may engage in robust philanthropic and CSR activities, while shared value companies have at least one material business strategy focused on creating shared value. We would expect more positive earnings surprises for shared value companies as the significance of shared value is often overlooked by investors. For business as usual companies, we would expect relatively accurate analyst forecasts as the social and environmental impacts do not have a material effect on earnings.

Next, we differentiated shared value companies based on their level of investor communication in the Hybrid Disclosure Framework. Stage 1 companies have robust shared value strategies but either are not communicating them to investors or are communicating them only in vague qualitative terms without clearly communicating the economic implications. We would expect greater dispersion of earnings forecasts for Stage 1 companies because the company is not giving analysts enough information to understand the significance of shared value strategies.

Stage 2 & 3 companies lead the field in communicating shared value to investors by clearly demonstrating at least one practice in Stages 2 or 3 of the hybrid disclosure framework.
Our analysis yielded several initial findings, highlighted in Figure 12. First off, we found that shared value companies reported more frequent positive earnings surprises than their business as usual competitors, surpassing earnings estimates 66% of the time, compared to non-shared value competitors who reported positive earnings surprises only 54% of the time. This finding is consistent with prior analysis and is consistent with our key hypothesis that the financial and competitive advantages of shared value companies are often undervalued. We had expected that companies at the top two stages would have fewer earnings surprises than those at Stage 1, but weren’t able to detect such a difference.
We did find, however, that companies at the top two Stages of Hybrid Disclosure had a much lower variation in analysts' earnings estimates. The average scaled forecast dispersion was nearly three times as high among the Stage 1 companies. This could suggest that explicitly communicating the economic value of social and environmental impacts can help analysts and investors better understand the financial value of shared value strategies, reducing disagreement and confusion about earnings expectations.

We also found that companies at the top two Stages benefited from P/E ratios that were on average 40% higher than their industry norms. For all of these initial findings, however, it is important to acknowledge that many other factors affect earnings surprises, forecast dispersion, and P/E ratios.
ROOM TO GROW FOR INVESTORS
Corporate disclosures are only meaningful to the extent that investors are able to interpret them. Investment approaches are incredibly diverse, of course, ranging from the social impact-driven and bottom-up research firms such as Generation Investment Management and the Alliance Bernstein Sustainable Global Thematic Fund to broader market index funds and the ever-growing share of algorithm-driven trading. Actively managed funds and research analysts are best positioned to meaningfully interpret and act on hybrid metrics that convey shared value strategies, but if our hypothesis is correct, sooner or later all types of investors and analysts will need to integrate a deeper understanding of social and environmental issues with financial analysis and industry expertise.31

The few investors who have been able to identify strong signals of successful shared value strategies have consistently outperformed the market. Figure 13 shows an overview of the outperformance of shared value and sustainability focused funds. In its first 10 years the average return for Generation’s global-equity fund was 12.1% a year, more than 500 basis points above the MSCI index’s growth rate.32 Over the past seven years, the AB Sustainable Global Thematic Fund’s 10.46% annual return beat the MSCI ACWI by 4.47 percentage points, outperforming 93% of peers.33

As this dynamic becomes better understood in the market, we expect to see investors moving towards more socially oriented and hands-on strategies to chase these returns in an otherwise increasingly

“We use [SASB] as a starting point, but we like to narrow to 2 or 3 elements that will really drive a company forward and for that we need more information directly from the company.”

—Eoin Murray
Federated Hermes
competitive investment world. This will require significant changes in internal practices by analysts and investors as well as broader changes in capital market systems described earlier.

**FIGURE 13: SELECTED INVESTOR RETURNS**

Our research suggests the following best practices for analysts and investors to more accurately connect social and environmental impact to financial performance:

- **Integrate analysis of social and environmental factors from the start:** Identify shared value opportunities through industry-by-industry analysis in light of social and environmental trends. PIMCO, for example, develops forward-looking ESG-driven sector frameworks by industry, built on company disclosures and proprietary trend analysis instead of relying on external ESG ratings. This will likely require new types of expertise and training for investment analysts.

- **Look beyond the standard environmental numbers:** Integrate uncommon sources in analysis and dig deeper into the shared value frontier in less understood areas. Go beyond climate and clean energy to assess competitive value of the S in ESG and other E-related factors including waste, water, and biodiversity. Look to the next wave of opportunities to address societal transformations that may disclose novel drivers of shareholder value.
• **Drive towards longer-term thinking:**
Incorporate longer-term trends in social and environmental factors into the security selection process. Use staff incentives, such as 3-year remuneration and promotion cycles rather than quarterly returns. Take the customer on a journey of long-term investment highlighting 10-, 5-, and 3-year portfolio results.

Recommended systemic and field-wide changes:

• **Support common standards of materiality, but look for differentiated strategies:**
Encourage companies to use common standards (such as SASB and TCFD) as a first step to understand areas of materiality, but know it is just the starting point and make sure to expect clarity on strategic differentiation and actual social and environmental outcomes, rather than stated company policies and the financial impact of shared value strategies.

  — **Challenge and question companies:**
  Ask companies the hard shared value questions (e.g., the role of reduced carbon impacts in improving their profitability), challenge the C-suite to communicate shared value strategies, and push for alignment of compensation to social impact as well as economic performance. A new generation among asset owners and in corporate board rooms may welcome such challenges.

  — **Encourage analysts and rating agencies to become more effective arbiters of critical information:**
Encourage analysts to discuss shared value strategies in more depth and to provide shared value projections when companies are unwilling to offer forward-looking disclosures. Push rating

“Investors need to figure out a way to ride the J curve of an industry transformation towards sustainability—you can’t ask for a 10-year strategy and then push companies on a quarterly basis for results that will take much longer to materialize.”

—Katherine Brown
WEF
agencies to make their scores more sensitive to shared value factors and longer terms risks and opportunities.

— **Push for the inclusion of shared value factors and comparisons across intelligence providers:** Solid analysis and decision-making will be much easier if a wide range of sources includes comparative performance measures for company strategies or products with a shared value focus. The NYU Stern CSB Sustainability share index, for example, compares sustainable consumer product performance to standard product performance, finding 5.6 times faster growth among sustainable products.
We believe that investors can improve the accuracy of their earnings projections and companies can improve their near-term market capitalization by better articulating to investors why their social and environmental strategies create value for shareholders. This requires first that companies approach material social and environmental issues as a source of differentiation and competitive advantage through strategies that create shared value. Second, it requires that they consistently communicate, through normal investor presentations and reports, how their shared value efforts provide competitive advantage relative to others in their industry and will affect future earnings. This requires a set of enabling practices within companies aligned with the three Stages of Hybrid Disclosure and, in particular, improving the coordination among those in charge of sustainability, finance, and investor relations.

Finally, we see an opportunity for companies to create hybrid metrics that directly combine improvements in social and environmental impact with changes in standard financial indicators, such as EBITDA, ROCE, COGS, and the like, for use as both internal decision-making guides and for external reporting. Once appropriately devised and tested, hybrid metrics can more easily be integrated into security analysis and trading algorithms, as well as capital allocation decisions by the company, with greater standardization and verification than prevailing ESG ratings. They can bring out new information about the relative profitability among companies within an industry and also inform predictions of future earnings in light of trends in social and environmental issues. Initially, each company may need to identify the hybrid metrics that are most meaningful and where the causal connection between impact and economic performance is clearly understood as a first step toward standardized and comparable hybrid indicators within industries. This approach, and the development of hybrid metrics, go well beyond current best practices in ESG ratings, integrated reporting, and materiality assessments to more fully overcome the historical divide between social/environmental and financial reporting. The few leading companies that have already started to make these shifts in investor materials have seen positive responses, but these changes are very recent and many innovative company social and environmental strategies that improve economic performance are still going unrecognized by investors.

Moving in this direction not only requires thorough investigation of causal links and a profound understanding of complex interconnections, but also requires significant changes in practice among investors and analysts, for whom the competencies and capabilities
necessary to integrate a deep understanding of sustainability into security analysis are still rare. **While still nascent, we believe that this approach offers a world of opportunity for investors to improve returns, for managers to optimize decision-making, and for companies to be rewarded for their positive impact in a timelier way that will encourage greater adoption of shared value strategies and accelerate progress toward a healthier, more equitable and sustainable world.**
Endnotes

1 Shared Value is defined as policies, practices, and competitive strategies that improve a corporation’s economic performance while simultaneously improving social or environmental conditions in regions where the company operates. Throughout this report, shared value is also sometimes used more broadly to include sustainability initiatives that have a material impact on a company’s economic performance and competitive position. See Michael E. Porter and Mark Kramer “Creating Shared Value”, Harvard Business Review, January-February 2011.


3 See for example the Business Roundtable statement on the purpose of a corporation to serve all stakeholders.


6 See, for example, policies in South Africa, France, the United Kingdom, Sweden, Germany, and the European Union Non-Financial Reporting Directive.


13 See Generation Investment Management, discussed in section 5 below, as an example of rigorous original research about environmental performance leading to outsized financial returns.


15 Carbon intensity is defined as the unit of carbon emitted per unit of production. In the case of electrical utilities, for example, it is the tons of carbon per gigawatt of power produced.
From a methodological point of view it is important to note that validating this or any other hybrid metric would require accurate statistical analysis of time series of a significant sample of companies, which is beyond the scope of this work.

MSCI rated Iberdrola AAA from 2016 to 2019 and only upgraded Enel to AAA in 2019. Sustainalytics gives Iberdrola an Environment score of 6.5/100 and Enel an Environment score of 8.9/100 (lower is better).

Since reduction in CO2 is a benefit, the negative numbers need to be converted to positive numbers in calculating the ratio.

Intel, The Clorox Company, and GE.


For evidence that these trends are already underway see Rebecca Henderson, Reimagining Capitalism in a World on Fire, April 2020.

For many examples of shared value activities, see the annual Fortune Magazine “Change the World” list and the case studies available at www.sharedvalue.org and on the Harvard Business School Publishing website.

As described in “Creating Shared Value” in Harvard Business Review, shared value can benefit companies in three ways:

1. Innovations in products that enable the company to meet social needs or reach underserved markets. VisionSpring, for example, has developed inexpensive, adjustable eyeglasses that enable people to overcome near-sightedness and astigmatism without having to see an optometrist, enabling them to reach billions of customers in emerging markets.

2. Improvements in productivity in the value chain. Walmart as noted earlier has increased employee wages and benefits, which resulted in increased productivity and lower turnover. The company has also saved billions in energy costs by redesigning its stores and logistics systems.

3. Strengthening the competitive context. The computer networking company Cisco created a distance learning program that has trained more than 4 million people around the world to become network administrators who can maintain their customers’ networks.

For more information on how purpose can be developed and implemented through shared value, see the Purpose Playbook developed by FSG and the Shared Value Initiative.

Nestlé 2018 materiality assessment, Nestlé.

Our focus on comparing firms within the same set of industries helps to account for industry-specific norms around disclosure.


From an environmental perspective, one would also want to ensure that the increased yield per hectare is not the result of excessive use of fertilizers and pesticides or poor water management.


33 Data provided by Alliance Bernstein and Morningstar for seven-year period ending 4/30/20.