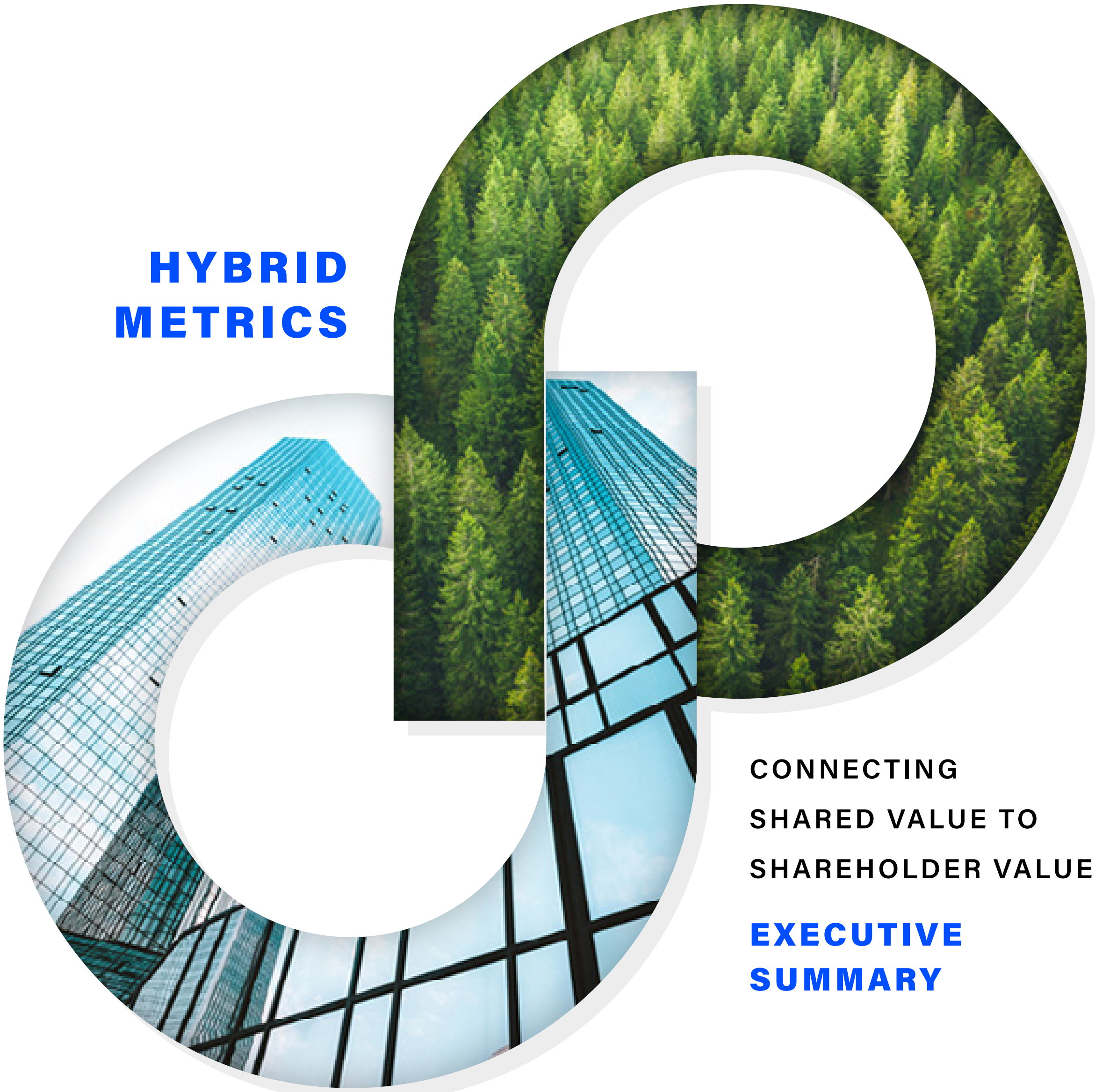
HYBRID METRICS



CONNECTING SHARED VALUE TO SHAREHOLDER VALUE

EXECUTIVE SUMMARY

FSG
REIMAGINING SOCIAL CHANGE

enel Foundation

HARVARD BUSINESS SCHOOL

Shared Value Initiative

FSG: MARK KRAMER, NINA JAIS, CARINA WENDEL, ERIN SULLIVAN, KERRY RODRIGUEZ
ENEL FOUNDATION: CARLO PAPA, CARLO NAPOLI, FILIPPO FORTI

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.

September 2020

Executive Summary

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[1] and many other sustainability initiatives enable companies to differentiate 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.

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

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.

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 to incorporate 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.[2] 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.[3]

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.

SOCIAL AND ENVIRONMENTAL IMPACTS HAVE FINANCIAL CONSEQUENCES AND FINANCIAL DECISIONS CREATE SOCIAL AND ENVIRONMENTAL IMPACT.

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.

2 The same degree of cross-departmental collaboration is required for the development of long-terms plans. Brian Tomlinson and Michael P. Krzus, "Method of Production of Long-Term Plans" (January 25, 2019). CECP: Strategic Investor Initiative White Paper No. 3.

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