



## CSR AT THE EDGE OF COMPETITIVENESS

The combination of the current macroeconomic factors and the need to implement practices that enable positioning make sustainability a strategic imperative for any business aiming to be competitive.

# A world in full speed process of transformation



Climate change, population ageing and water scarcity are just some of the structural challenges we will need to address over the next hundred years. These and other imbalances at macro and micro level cast doubt upon the management models implemented to date and point to an urgent need for change.

This article seeks to draw attention to the imbalances that will affect the balance of power both at a local and global level, changing the dynamics of the markets and the way organisations interact with their different stakeholders. These changes will ultimately determine the survival of businesses and other actors, highlighting the need to adapt the strategic frameworks to a social and economic context in continuous transformation.

The application of Corporate Social Responsibility (CSR) practices as a way of rising to the challenge of sustainability is a viable option to tackle such growing matters. This fourth issue of *RSEARCH* seeks to show how CSR is set to become a competitive tool for business success.

Over the course of the following pages, we develop the business case for CSR. This rationale for social responsibility presents a solution to two major challenges. Firstly, it seeks to adapt

to the profound structural imbalances whose impact on business is set to increase to the point of compromising the sustainability of economies, businesses and society. And secondly, it provides a response to the endless need for innovation in organisational models, processes, products and services. From this perspective, levers for value creation will evolve from the obsession with achieving competitive advantages to the capacity and speed of response to the challenges and needs of stakeholders.

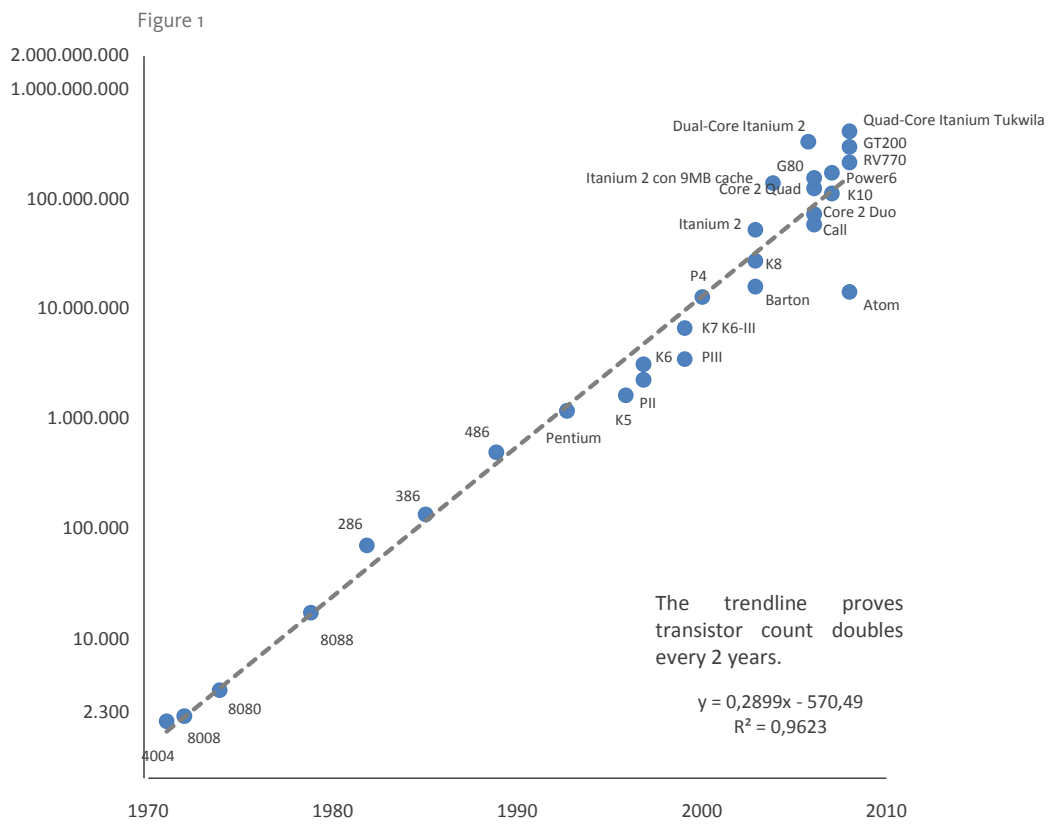
This article attempts to transform these concepts into tangible figures and has hence analysed financial metrics to support the business case for CSR. Several studies have attempted to connect CSR to business competitiveness at a qualitative level (see the 2011 Forética Report, *Observatorio de Informes*). In our case, we explore the relationship between the two from a quantitative point of view. Using a battery of 15 financial indicators applied to the 19 super-sector leaders of the Dow Jones Sustainability World Index and their respective sectors, we shall see how sustainability can play a key role in business success, given that most of these companies reach levels of valuation and profitability above their sector average.

# Macroeconomic factors

In 1965, co-founder of Intel Gordon Moore stated that the number of transistors in integrated circuits doubles approximately every two years. This means that science is capable of doubling the computing capacity of computers in a 24-month period.

Over the past 45 years, this foresight has grown from being a bold assumption to an empirical law whose trend remains unquestioned to date.

## MOORE'S LAW CPU TRANSISTOR COUNT 1971-2008



This transformation has laid the foundations for great leaps of progress and development – not only regarding technology, but also in economic and social grounds. As we shall see, we live in a world in full speed of transformation.

However, the pace of transformation is often greater than the capacity of human beings – and the planet itself – to adapt to the changes it generates. This leads to tensions and structural imbalances that threaten the sustainability of our social, economic and environmental models.

Globally speaking, these imbalances require a determined response from two angles. At macro level, economic and political actors

must work side by side to define a roadmap to mitigate and, if possible, stem these threats. At micro level, innovation in processes, products and services is presented as the main tool to tackle this series of challenges, forcing us to continuously search for solutions to a wide and growing range of problems.

We will now describe five secular trends that reflect this uniformly accelerated change: a transformation towards an urban planet, the economic convergence of emerging countries, population ageing, water scarcity and climate change. Unfortunately, they are advancing at a rapid pace and will accompany us for the next hundred years or more.



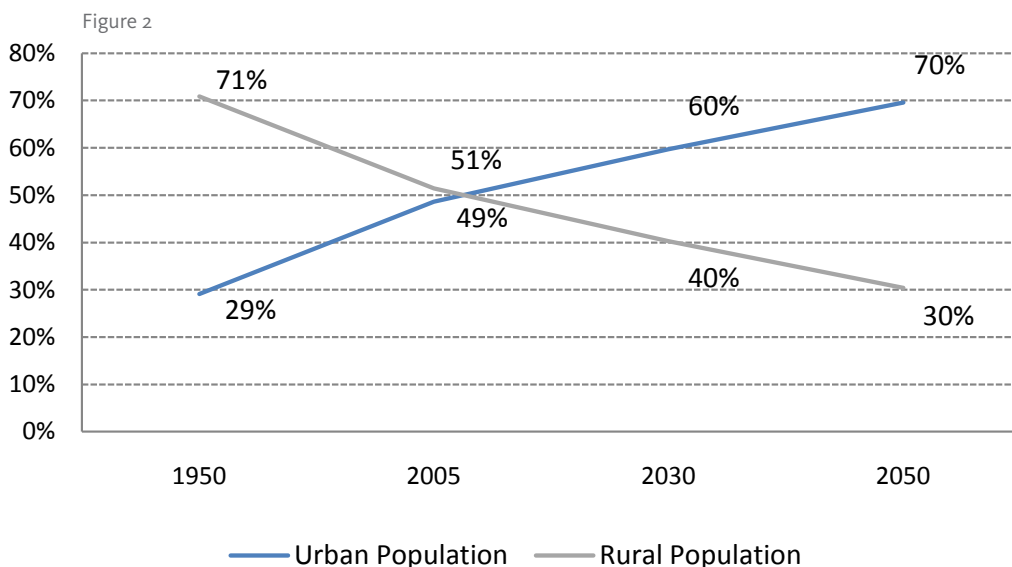


# An urban planet

The first trend we observe is that the world has entered an urban millennium. In less than one hundred years, the proportion of global

population living in urban environments compared to rural settings has been reversed.

## URBAN VERSUS RURAL POPULATION IN THE WORLD



Source: own elaboration based on data from United Nations.

This is good news a priori because it allows large groups of people living in disadvantaged settings to access other environments where they can find new opportunities for their development, such as employment, education and security. Moreover, the new urban populations benefit from an enhanced supply of basic services, such as infrastructure, public transport, electricity, sanitation and drinking water. Lastly, larger economies of scale facilitate access to more sophisticated consumer products at more affordable prices.

Nonetheless, if this transition is not planned in an orderly fashion nor conceived on a long time scale, its consequences could make the

rural exodus somewhat unsustainable. For example, the African continent is currently the region with the lowest rate of urbanisation but an abrupt change is expected to occur. By 2030, the urban population in Africa will exceed the total population of Europe. The question is: are African cities ready to take in this volume of inhabitants and respond to their infrastructure, employment and security needs?

The consequences of this phenomenon will be as eloquent as the change itself, but will differ significantly between developed and developing countries.



Overall, in the 50 least developed countries, 78% of the urban population lives in slums, under precarious conditions without property titles over the land they live on and vulnerable to eviction, often occupying highly polluted areas and exposed to environmental hazards, and in crowded spaces where mobility is inhibited. If urban growth in least developed regions is not accompanied by a plan to make it sustainable, urban poverty will only increase.

Other macroeconomic impacts resulting from urban development include the use of land for residential purposes instead of agricultural production (key to the development of these economies) and a significant increase in environmental impact as a result of greater consumption, a rise in waste generation and the destruction of forests.

On the other hand, a more urban lifestyle in developed countries will also have a range of consequences, from an increase in what could be termed “urban diseases” (unsustainable levels of stress and related conditions such as infertility, depression, obesity, etc.) to the sudden insufficiency of infrastructure due to excess demand, and many other important effects.

Ultimately, the quality of urban life is closely related to number of inhabitants. Several studies show that cities of more than 5 million people undermine quality of life because of expansive growth. Indeed, the largest cities in terms of population – Tokyo, Jakarta and New York – are at the bottom of the quality of life ranking, which is topped by Vienna, Zurich and Geneva, all smaller cities.

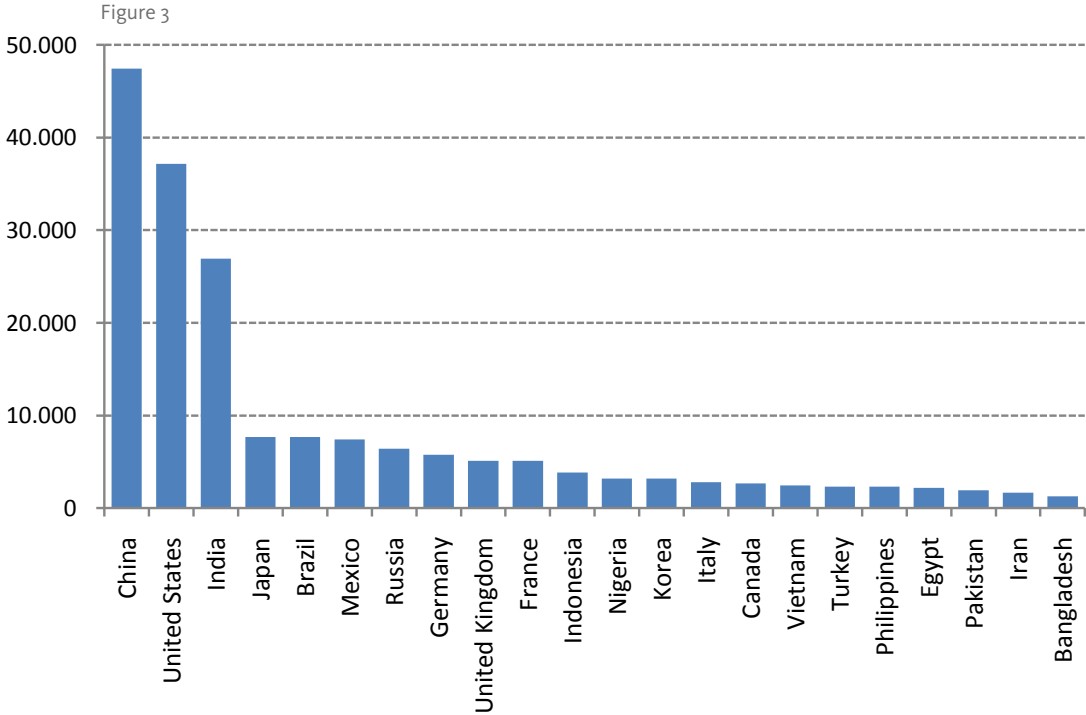
Companies can help tackle the negative consequences of rapid urban population growth. Firstly, on an internal level, they can adapt working environment in order to minimise the impact of stress and other conditions, as well as taking a firm stance against illegal employment, which contributes to the precariousness of vulnerable groups. Secondly, in its external dimension, the private sector can back education and training projects in local communities through employee volunteering and contribute to the development of local entrepreneurial projects by integrating them into the supply chain.

# Convergence of emerging countries

Over the past ten years, the global economic outlook has been marked by unprecedented growth in Brazil, Russia, India and China (BRICs), which together account for 30% of global GDP growth and now represent one quarter of the international economy (in terms of purchasing power).

Not only will this trend continue, it will actually be accentuated. According to estimates by investment bank Goldman Sachs, in 2050 these four economies will be among the largest in the world and an emerging economy will overtake the United States for the first time ever.

**THE WORLD IN 2050**  
GDP 2005 US\$bn



Source: own elaboration based on data from Goldman Sachs.



The fact that three of the four largest economies are located in Asia is generating a political turn towards the region. Given the relevance of these countries in a range of economic issues, there is an unquestionable need to include them more actively in the design of global policies, which is reinforced by their role as engines of regional growth.

At company level, this scenario will necessarily make strategic decision-making more complex, as these countries become engines of demand growth and purchasing power. The economic growth in these regions is even sufficient to offset the slowdown in the development of traditional economies, as has occurred in the recent global crisis. In particular, commodity-producing industries will see demand increase significantly, and will have the opportunity – if

not the challenge – to adapt their strategies to the needs of a growing middle class.

Therefore, for any global company seeking to respond to future trends, investing and stepping up its presence in emerging markets is a key element within its overall strategy.

The development of these economies will also require an enormous amount of capital investment, coupled with an intensive use of energy and natural resources. This brings us on to the topic of climate change and points to the need for a low-carbon development.





## Climate change

The concept of climate change refers to a statistically significant variation in the mean state of the climate (average)<sup>1</sup> or in the distribution of events (variability) persistent for an extended period of time (decades or more), as opposed to individual weather events.

Its impact on natural systems is expected to cause an increase in global average temperature, a rise in sea levels, and changes in the seasonality and variability of rainfall.

According to the Intergovernmental Panel on Climate Change, it is very likely (probability of more than 90%) that the global warming of the past 50 years cannot be explained solely by natural causes and it is also very likely caused by anthropogenic concentrations of greenhouse gases (GHGs). Indeed, human emissions of GHGs rose by 70% between 1970 and 2004, mainly due to the use of fossil fuels and changes in land use (use of nutrients for agriculture, deforestation, etc.).

<sup>1</sup> The state of the climate covers a range of climatic variables such as temperature, volume of rainfall, frequency of droughts and floods, etc.

## Consequences of climate change

- Loss of biodiversity
- Reduced agricultural productivity
- Extreme weather events, storms and floods, with more people at risk and major damage
- Increased scarcity of water and higher concentration of droughts in middle latitudes and semi-arid climates
- Increased malnutrition and number of people at risk of death, illnesses and accidents caused by extreme weather events
- Climate refugees
- Economic losses due to weather disasters

An underlying contradiction of this phenomenon is that there is a strong imbalance in the binomial responsiveness/vulnerability to climate change. Sub-Saharan Africa, small islands such as Caribbean countries and Asian deltas are the most exposed regions due purely to geographical reasons. They are also particularly vulnerable to water scarcity, malnutrition, falling agricultural yields and flooding since they are less able to cope with their consequences.

The private sector has a golden opportunity to make a significant contribution to the struggle against climate change. Firstly, through the technological innovation needed

to nurture and build a low-carbon economy by implementing cleaner production processes (waste management, water and paper consumption, energy efficiency, environmental quality of products). Secondly, by encouraging the public to make responsible and informed consumer decisions. And lastly, through the transfer of technology and the necessary processes for implementing clean development mechanisms<sup>2</sup>.

<sup>2</sup> "Clean development mechanisms" refers to an instrument created by the Kyoto Protocol designed to help developing countries to achieve sustainable development while Protocol signatory countries meet their commitments to reduce GHG emissions (developed countries and countries in transition to a market economy). Specifically, an "investor country" allocates private capital to projects intended to reduce emissions in a "recipient country", collaborating in its low-carbon development through the transfer of clean energy. In return, it obtains credits that are subsequently included in the total emissions it has undertaken to reduce on its ratification of the Protocol.

# Water scarcity

Two thirds of the surface of our planet is covered by water. However, only 2.5% of world's water is fresh and, within this small percentage, only 0.4% is available to human beings. In other words, water per se is a scarce resource.

Everything points to the fact that the water crisis will only get worse, since the availability of potable water per capita is declining: over the past 30 years, this index has fallen by 50% and it is estimated that per capita supply will fall another 30% over the next 20 years. This is explained mainly by anthropogenic causes. In addition to the phenomenon of the scarcity of fresh water, irrational consumption, pollution (especially that caused by urban, industrial and agricultural waste) and poor maintenance of water management infrastructures in both developed and less advanced countries, all have an impact. In summary, this crisis can be attributed to the inefficient management of a scarce resource.

From a macroeconomic perspective, the water crisis can only be solved by rationalising its use. Indeed, one of the principles of the Dublin Statement on Water and Sustainable Development (1992) argues that this resource should be regarded as an economic good, since only then will it be possible to ensure its equitable and efficient use. Some economists consider that this could be achieved by incorporating the scarcity of the good into its price, together with the real costs of its consumption. The latter should reflect the costs associated with investments in infrastructure, logistics and transportation. There is currently a significant gap, regardless of our geographical location, between the price of water and its effective cost, which has led to its irrational consumption both by individuals and in its application to productive activities. It is also of utmost importance to reduce pollution, promote sustainable water use and protect the status of water resources.

## The water crisis

- 1.2 billion people have no access to potable water
- 7 billion people in 60 countries will face water scarcity by 2050
- Domestic water consumption in developed countries is around 6 times that of developing countries (500-800 litres per person per day as opposed to 60-150 litres)
- 66% of the population whose water needs are not met live in Asia and a further 27% live in Africa

## Basic data on pollution

- 2 billion tonnes of human waste are dumped into rivers every day
- 60% of the world's major rivers are severely polluted, with the consequent degradation of their ecosystems
- Only 5 of Europe's 55 rivers are considered pristine
- 50% of the population in developing countries is exposed to polluted water

The private sector plays a key role in combating water scarcity, with considerable leeway in its policies on water consumption and waste management. The agricultural and industrial sectors are particularly significant in these two areas. Depending on the market under consideration, the importance of the two sectors is inverted, based on the level of industrialisation

and the importance of agriculture in the economy of the region. These sectors also have the ability to raise awareness among their employees in order to promote responsible consumption practices in the communities where they do business.



# Demographic change

Demographic change is one of the biggest challenges facing the developed world. Population ageing, the impending retirement of baby boomers and declining birth rates are threatening the balance of our socio-economic systems.

While the ageing of society is a sign of increased quality and life expectancy, the absence of a replacement generation is leading to serious consequences that could ultimately result in a loss of competitiveness among developed economies.

From a social point of view, longer life expectancy combined with a declining birth rate is inverting the population pyramid and substantially increasing the dependency ratio. This affects the sustainability of public spending as it requires greater spending on health and welfare and puts an increased burden on the pension system – more pensioners for a lower number of social security contributors.

In Spain for example, according to figures from the European Commission, there was one inactive person for every three active people in 2004. By 2050, it is estimated that every active person will have to maintain two inactive people.

Economically, demographic change will limit the entry of young people to the labour market, while the bulk of the workforce will be comprised of older people. Companies must face the challenge of maintaining their competitive edge with older staff, with the ensuing impact on their ability to innovate. Experts argue that this could lead to falling productivity levels, reducing the international competitiveness of a country. Furthermore, this labour market deficiency will probably spark a “talent war” with out-and-out battles to win over the candidates with the greatest potential.





Sustainable policies are a valuable weapon for companies to tackle the challenges of demographic change. Policies of work-life balance can stimulate the birth rate, and a human resources management based on equal opportunities, diversity and social inclusion will reduce the pressure on the public pension system. The benefit for business will lie in greater dialogue between generations and the possibility of adapting the portfolio of products, services and customer relations to the specific preferences of each age group.

## Global comparison

Over the coming years we will witness a decline in the populations of Europe, Japan and other developed regions. At the other end of the scale, population growth will be concentrated in Asia, Africa and South America, the regions with the highest concentration of young people.

As the data show, this is due to the birth rate of a country being inversely proportional to its degree of economic development. For example, in the EU-15, this rate was around 13 births per thousand inhabitants in 2008. By contrast, other socio-political systems reveal very different figures: Costa Rica, 17.71 and Angola, 44.09.

## CSR as a solution

The challenge around macroeconomic factors described so far lies precisely in their “macro” nature. The distance between the subject and the phenomena discussed above generates a false sense of security. Hence, the lack of identification with the problem leads to a lack of identification with its solutions too.

However, recent research by MIT Sloan Management Review in collaboration with the Boston Consulting Group (BCG) has highlighted a strong consensus among more than 1,500 international business leaders on the pivotal role that should be played by the private sector in solving global challenges in the long run. Thus, as we have attempted to explain, every company from small businesses to multinationals can make a contribution to yield results that will naturally vary in scale and scope.

The financial crisis, the social changes affecting consumer and labour markets, and the conflicts over scarce resources set trends in the private sector. Such factors, in turn, combine with macroeconomic trends. The complex, secular and interrelated nature of these challenges is what signals them as the fundamentals of CSR, the ultimate frontier of innovation.

Combining new organisational and technological practices that can be harnessed to meet the challenge of sustainability is thus indispensable for surviving in an increasingly competitive business environment. In short, behind CSR lies a golden opportunity to innovate, create value and bolster the competitiveness of any organisation.



# Micro factors

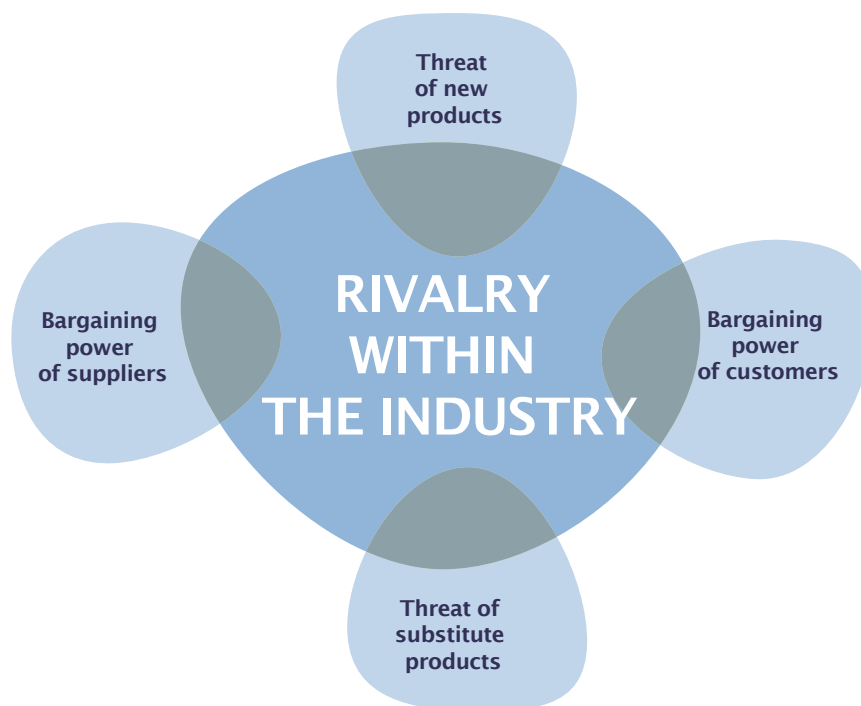


## Beyond Porter

Since the 1980s, the theories of economist Michael Porter have gained more and more ground in the area of business strategies. Porter's contribution to the management community has been invaluable, generating models and developing fundamental theories for business management.

The starting point of his theories is that a company can define its strategy based on competitive advantages, obtained primarily by offering a standardized product at a low cost or a differentiated product whose uniqueness is perceived by consumers, who will then be willing to pay a premium.

The need for competitive advantages is determined by the rivalry of the market. Porter's Five Forces model states that five forces combine to determine a company's competitive position in its industry: the bargaining power of suppliers and customers, the threat of substitute and new products, and the degree of rivalry between the companies within an industry. The aggregate strength of these vectors determines the ultimate potential benefit: the more intense the competition in the industry, the less the potential benefit that can be obtained by operating in it.





The key lies in understanding that the degree of competitiveness within an industry is not merely dependent on the competitors that form it but also on the interaction between these five forces. A company's performance can thus be explained by the structural characteristics of the industry to which it belongs.

A successful company is one that imposes itself on the competition, establishing itself as the dominant company in the segment in which it operates. This position is reached by fiercely confronting each of the determining forces of its industry:

- Strengthening barriers to prevent the entry of new competitors.
- Defeating existing competitors.
- Undermining the bargaining power of suppliers.
- Wearing customers down through its relative pricing power.

However, the obsession with creating competitive advantages turns the natural goal of increasing market share into a competitive spiral that can in occasions put a sector in the red and threaten the sustainability of the very industry. Given that there can only be one lowest-cost competitor in a market at any one time, this spiral of price rationalisation comes with considerable risks. By continuously operating on the profit margin in order to compete at lower costs, results obtained are highly likely to be below the industry average. The obsession with obtaining an ever-increasing market share turns products into commodities: whenever a design emerges as a winner, competitors in that market must imitate it, commoditising the product in order to meet a standardised set of customer requirements, making supply uniform and undifferentiated. Lastly, a product-centric approach also leads companies to neglect their global perspective by losing control over important variables such as environmental impact or their supply chain.

These trends can be illustrated by describing the case of Mattel, a prime example of loss of control over the production chain. This leading toy producer with a track record spanning 75 years was named and shamed in August 2007, when it was announced that some of its toys were dangerous because they contained paint with excessive levels of lead and magnets that could easily be pulled off. The toys had been manufactured in China and might have dodged the company's quality control measures. As a result, Mattel was forced to recall nearly 20 million toys in just a few months.

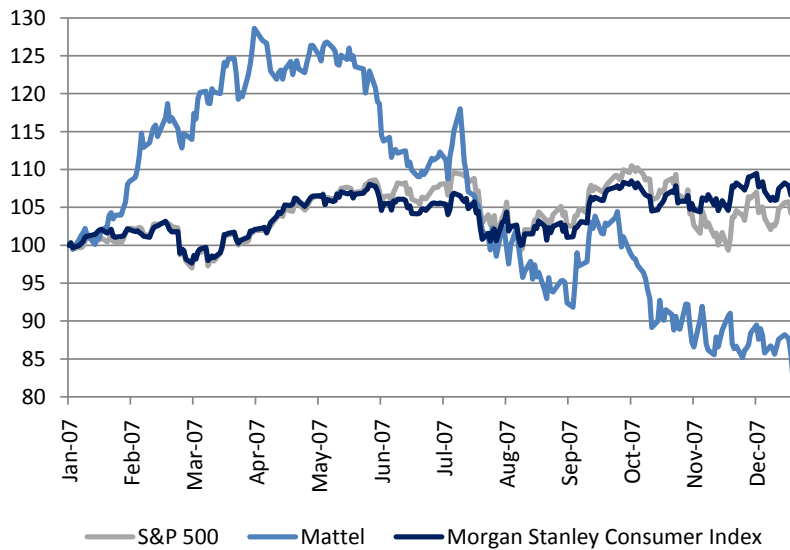
The products were recalled at a significant cost, which caused Mattel's shares to take a nose-dive. These eventually lost 38% of their value and did not recover until 2009. American and Chinese regulations were also amended to introduce tougher safety measures, automatically generating an increase in production costs necessary to ensure compliance with recently implemented safety standards. Mattel's reputation was hit hard, especially given the political dimension of the issue. The CEO of the company was called to testify in U.S. Congress and publicly apologise to the Chinese authorities.

Like many global companies, Mattel had transferred 65% of its production to China. However, the quality controls in place proved not to be strict enough, even though the company had taken the precaution of using its own factories instead of outsourcing production. In a market with a vulnerable target (children) and global reach, product safety is critical. However, the lack of checks and controls in the production and supply chains led to a worldwide controversy, putting the company under the scrutiny of the media and arousing the indignation of the public.

In brief, this case shows that the obsession with rationalising costs and increasing market share can lead a company to neglect core elements of its operations, such as product safety and risk management.

## 2007: A DISAPPOINTING YEAR FOR MATTEL SHAREHOLDERS

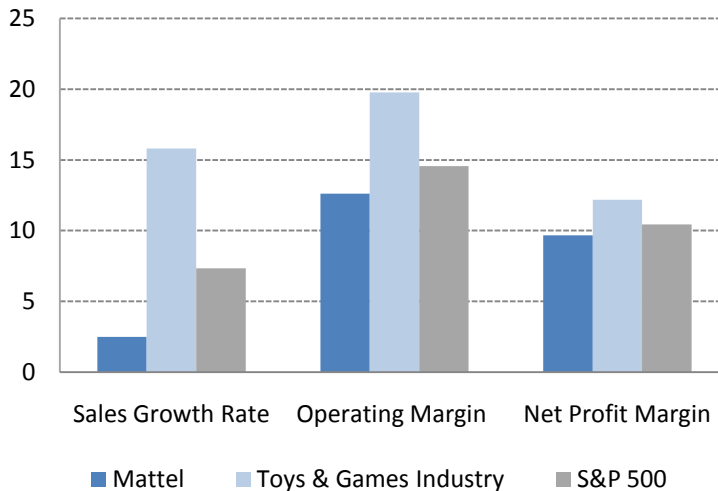
Figure 4



Source: own elaboration based on data from Yahoo Finance.

## 2011: FINANCIAL INDICATORS' AVERAGE OVER THE LAST 5 YEARS SHOW A SLOW RECOVERY

Figure 5



Source: own elaboration based on data from Reuters.

The company's development has been rather negative from a stock market point of view and 2007 turned into an agonising year for its investors, in which it recorded a severe decline in stock valuation. According to Reuters, Mattel has grown substantially below the toy and games industry in recent years (2.49% annually versus 15.47%). However, its high geographical and product diversification have softened the impact on financial performance and allowed the company to regain its market valuation.

In the end, the situation proved to be just a temporary shock to the company. However, it is without doubt a lesson to be learned not only for Mattel but for all economic activity. Lack of attention can wipe out a large company. It would not have been the first time and it certainly would not have been the last.



# Innovation in strategic management

During the 1980s and 1990s, Porter's Five Forces model did an excellent job when it came to identifying and exploiting competitive advantages for businesses. However, continuous innovations in technology, society and economics have rendered the model insufficient for explaining the success of certain companies as opposed to others. A more advanced model seems to be required these days.

In particular one factor of change has been essential: communications revolution, which has narrowed the link between companies, customers, suppliers and supporting industries, significantly altering profit levers.

Management strategies no longer focus on the product and the industry, as Porter claimed; instead, they revolve around stakeholders and the creation of a competitive network system. This is achieved by creating value chains based on the integration of supply. Around each product, a network is set up of complementary products and services developed by business partners other than the company itself. Thus, each company seeks to develop a web of supporting industries or complementors to improve its competitive position, making sure that it does not compete alone, but rather in the company of its partners.

The main stakeholders are, logically, customers. Satisfying and retaining customers become key objectives and take precedence over the management of the portfolio of products

and services. We are thus moving away from a standardised offer aimed at a large and uniform customer base and moving towards knowledge and satisfaction of the specific needs of different consumers. This new paradigm is therefore based on a deeper understanding of customer expectations.

The strategy will focus not only on the industry in which Porter's company is immersed but also on ensuring the industry to be complemented by those in which the customers are in turn immersed, extending the scope to provide a wider coverage to their needs. The initial value proposition is reinforced by the interaction between the consumer, the product and the complementors. A balanced ecosystem is formed whereby the customers themselves exclude competitors, since they no longer have any reason to switch brands. The strategy, far from being one of war, becomes a union in which stakeholders are made essential partners.

Lastly, under this new scenario lies the challenge of incorporating information uniting the customer and the brand, through ICTs, by the means of detailed metrics and meticulous segmentation. Alliances with complementors will enhance product value and create a unique bond with customers. Innovation will, in turn, require joint developments with suppliers and complementors, stakeholders and, most especially, customers, if companies are to occupy a central position in this ecosystem.

# Sustainability, the innovation frontier

As previously discussed, competition based on market share and costs is no longer viable. It is necessary to broaden the focus and incorporate into the business those stakeholders relevant to its development. Nowadays, dialogue, collaboration and knowledge are basic pillars of the strategy that companies must adopt in order to hold on to their competitive position. By doing so, companies will forge links between themselves, their customers and complementors, allowing them not to retain customers but to captivate them.

This paradigm shift, from war to union, from “dominant position” to “ecosystem”, from wearing down customers to their complete inclusion, from “rivalry” to “partnership”, brings us to a common ground with sustainability and corporate social responsibility practices. Given that these too are based on recognising the value of stakeholder engagement and the potential behind partnerships, among other aspects, we are in essence talking about paradigms with common core ideas.

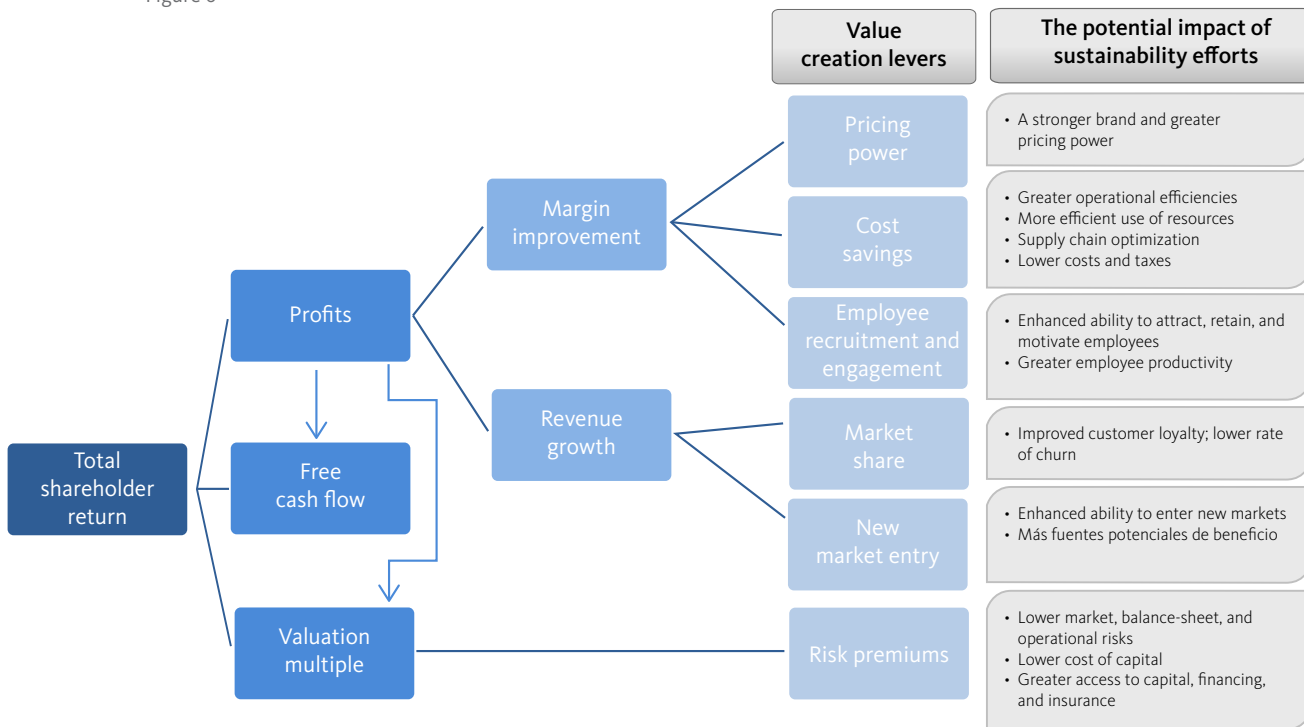
Adapting the way we do business to responsible criteria can thus lead a company to define strategies aligned with innovative management and the creation of networked systems, as explained. This is precisely what places sustainability in the frontier of innovation.

In addition, the solution to the macroeconomic challenges analysed at the start of this article – which we consider to be the cornerstone of CSR – will be interdisciplinary in nature, making it especially critical to collaborate effectively with different stakeholders. This argument goes hand in hand with the idea that the move towards bond-based management supports sustainability.

Moreover, the potential impact of sustainability on each of the different dimensions of a business is its main strength when it comes to valuing its contribution to competitiveness.

The research by MIT Sloan Management Review cited above proposes a value creation chain in which sustainability efforts have a potential impact on each of the levers of value creation for shareholders. For example, one of the most intuitive impacts of sustainability is brand building, which allows for greater flexibility in setting prices. An efficient use of resources, the underlying premise of responsible production, leads to cost savings. This continues as we move through the different elements of the chain, ultimately achieving better margins, higher revenues and greater returns for shareholders.

Figure 6



Source: own elaboration based on data from MIT Sloan Management Review.

In short, the value proposition of sustainability is based on the possibility of integrating it into every area of the business (Finance, Marketing, Purchasing, Production, R&D, and HR) and subsequently gauging its performance with measurable financial results.

On to a different matter and considering the consumer perspective, the results of a survey conducted by Havas Media on 30,000 people in nine countries across four continents reveal a strong correlation between a brand's "meaningfulness" and its perceived sustainable performance (the more sustainable the brand is perceived to be, the more meaningful it becomes to consumers).. In fact, almost 80% of the 1,000 plus companies surveyed for the 2011 Forética Report viewed increased customer loyalty as a result of their sustainability strategies, which ultimately strengthen and/or differentiate brand reputation. The report even shows how this relevance affects purchasing decisions: 45% of Spanish rule out and/or try to avoid products considered "irresponsible", while 21% prefer responsible products and 16%

are even willing to pay a premium for them. These data point to a pressing need to forge bonds with customers – as detailed above – with the aim of leveraging this brand meaningfulness to motivate consumer decisions favouring the company.

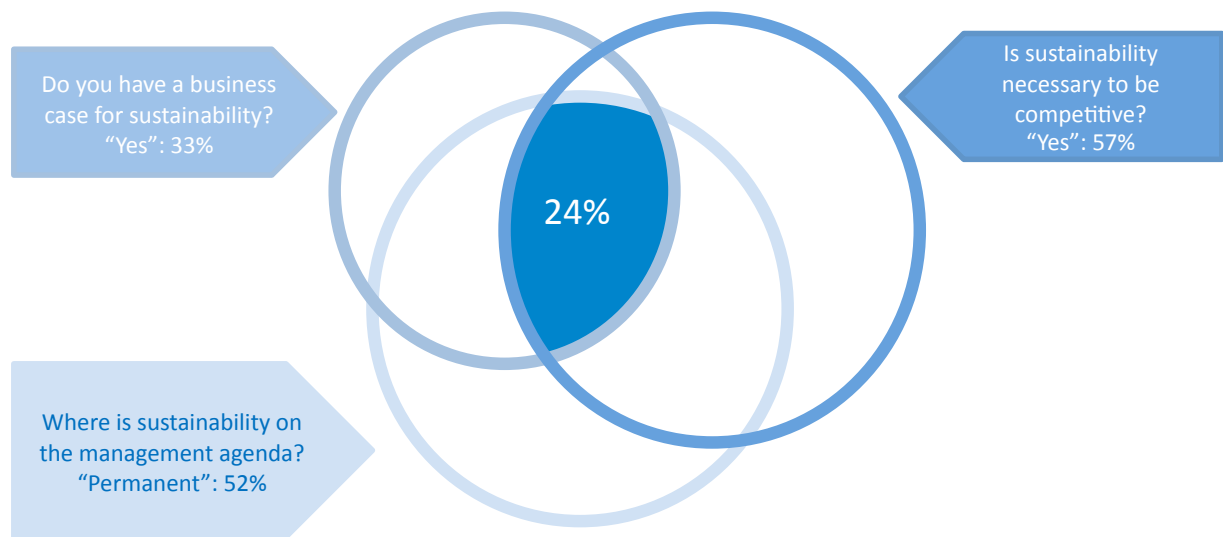
However, responsible practices are not always successfully put in place, as its implementation gives rise to a number of challenges. According to more than 50 opinion leaders interviewed for the MIT study already cited, there exist two main obstacles: firstly, overcoming the scepticism that comes from obsolete mental models (Porter's, perhaps?), and secondly, measuring, tracking and reporting on sustainability efforts.

Hence, the fact that consumers are clearly in favour of CSR is not reason enough for companies to adopt a stance on the implementation of sustainability criteria, given that their application involves addressing the challenges mentioned plus adapting to changes entailed along with a new organisational culture.

Indeed, there is no consensus in the international management community on the effect of sustainability on the levers of value creation, as evidenced by another MIT study on the senior management of global companies. The results of this analysis indicate that, although there is a consensus that sustainability not only contributes to competitiveness but that it is necessary and hence permanently present on the management agenda, only 33% of respondents have a business case for sustainability. Thus, no more than 24% of the sample agrees with all three propositions.

The challenge of successfully implementing sustainability and extending its application across different markets and regions will therefore require the development of a range of skills and management tools. A trade-off will be required between short-sighted expectations and long-term impacts, coupled with furthering innovation in management models and strategic practices. The key, however, will lie in implementing a systems approach through alliances and partnerships allowing companies to work with various stakeholders, integrating the necessary holistic perspective to sustain a competitive position in current market conditions.

Figure 7



Source: own elaboration based on data from MIT Sloan Management Review.

# Conclusions

A wide range of arguments support CSR's value proposition. Hence, there is a business case behind the implementation of responsible practices supported by reasons specific to the company that implements them – and by others. The combination of macroeconomic factors (climate change, water scarcity, the convergence of emerging countries, urban development and demographic change, among others) and the need to overcome micro-economic models that no longer guarantee positioning make sustainability a strategic imperative for any company seeking to be competitive these days.

This article has been written using reliable information on the structural challenges afflicting society, but also from the point of view of the authors regarding the competitive value of CSR. This perspective in particular is nonetheless shared by the leading think tanks on business strategy, as demonstrated by the numerous studies cited. We do hope to have provided sufficient evidence to show how significant the contribution of sustainability can be to the competitiveness of a company if it is implemented in alignment with the core business. We therefore trust that associating

social responsibility and competitiveness will lead to a focus of CSR from a strategic management angle.

In all events, it can be contradictory to talk about sustainability and competitiveness, since the former brings us into the realm of dialogue while we generally associate the latter with an outdated conception of markets as spheres of rivalry. It would therefore be more coherent to talk about the link between sustainability and business excellence, as suggested by the recent publication on the subject by the Directorate-General for Enterprise and Industry of the European Commission.

In conclusion, as clearly stated by the latter body in its Competitiveness Report, the factors justifying CSR from an economic perspective are dynamic by themselves and have a tendency to intensify: the various social and environmental challenges, employee expectations, consumer awareness and the nature of innovation processes. CSR will thus enable companies to achieve the business excellence to address these processes while keeping up the pace of progress in the long run.





# Sustainability for Financial Geeks

## Executive Summary

As part of our search for a quantitative link between sustainability business practices and competitiveness, we have analysed the companies identified as CSR champions from a financial perspective. We have performed a comparative analysis on the 19 companies classified as super-sector leaders by the Dow Jones Sustainability World Index (hereinafter, DJSIL), using data from their respective sectors with 15 financial ratios covering 5-year periods.

The following boxes highlight the major financial strengths and weaknesses of this pool of companies.

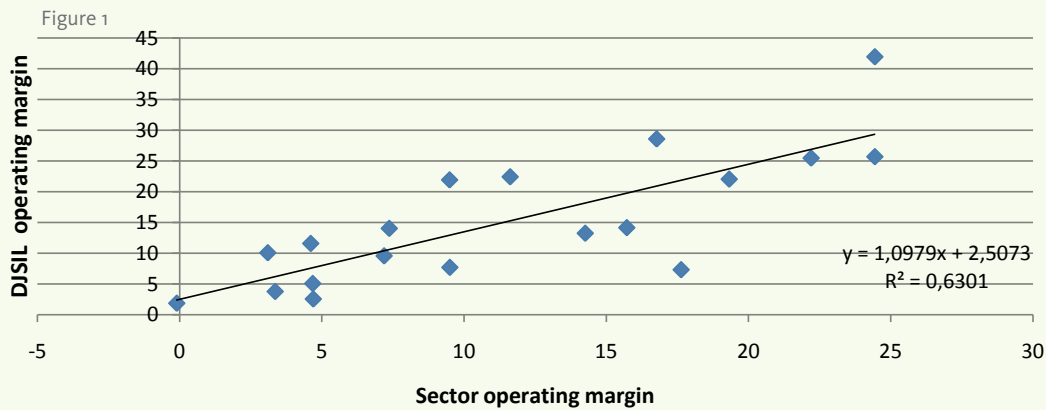
The sources of information used for this work were the following: Reuters, Bloomberg, UBS WMR, FactSet, Dow Jones Sustainability Indexes -as for April 2011- and Forética.



# Margins

Operating margin and net profit margin are specifically significant when it comes to assessing the performance of a particular business. DJSil companies reach higher operating margins than their respective sectors, generating a median deviation of 15 points more. However, net margins show that CSR champions give up a large portion of the premium obtained for a greater use of financial leverage in order to finance their business.

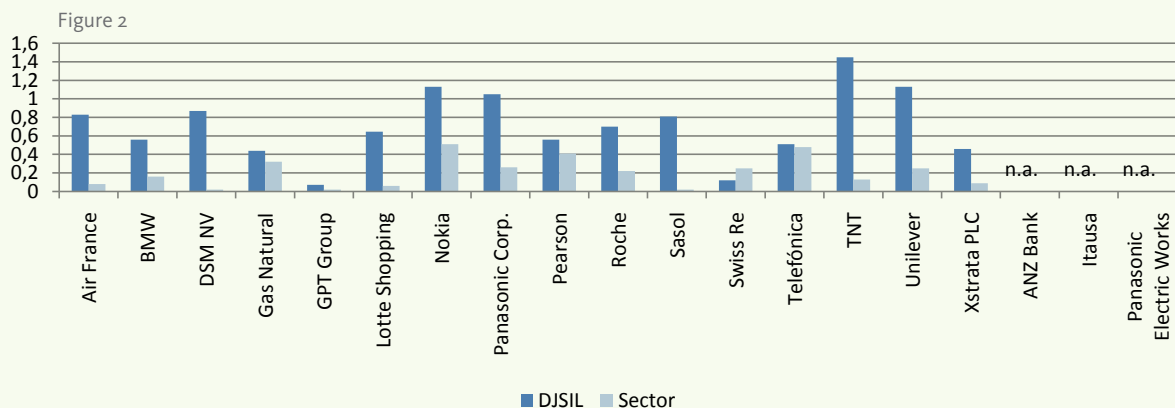
## OPERATING MARGIN - LDJSI vs. SECTOR



# Efficiency

Leading sustainability companies are more efficient than their respective industries, minimising their cost structure with a higher asset turnover. The average turnover in selected companies is 0.71 times their sales, compared to a sectoral average of 0.20. In other words, they generate higher income with fewer resources.

## ASSET TURNOVER

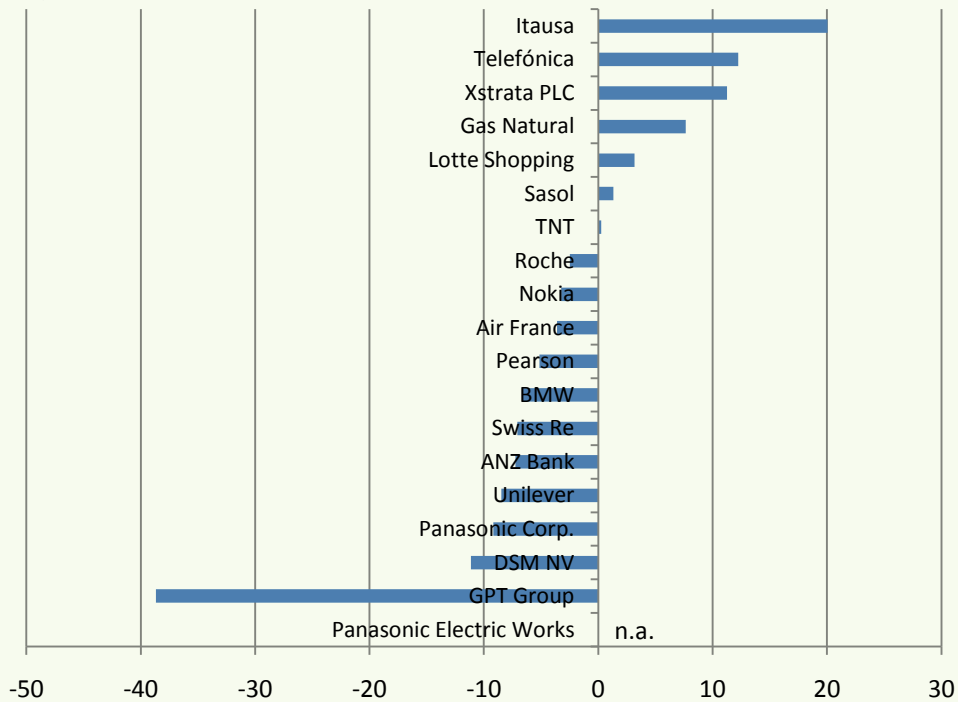


## Sales growth

If there is one weak point in the selection of DJSil, it is the evolution of their sales over the past five years in comparison with their respective sectors: no more than 39% of the companies have outgrown their competitors in the sector. Growing below average entails a considerable risk as in the medium term it may result in a loss of leadership and market share.

### DEVIATION OF ANNUAL GROWTH RATE OVER THE LAST 5 YEARS

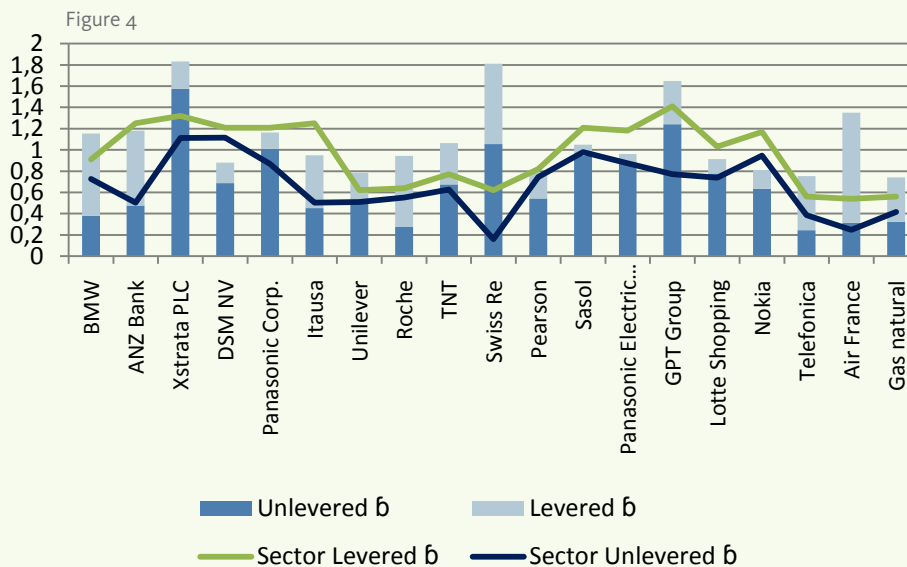
Figure 3



## Risk factors

DJSIL companies have a much higher debt than their respective sectors in 63% of cases (median deviation of +186%). This implies that the risk associated with their level of debt (levered beta) is higher than that of their sectors. Nonetheless, their company-specific operational risk (unlevered beta) is more moderate than that of their competitors. In short, their increased appetite for debt “artificially” magnifies their investment risk profile. This need not necessarily be negative since, as we shall see, debt can have a positive effect on the cost of capital of a company. In any case, this preference for debt indicates increased confidence in the viability of the business, both in the company itself and among its funders.

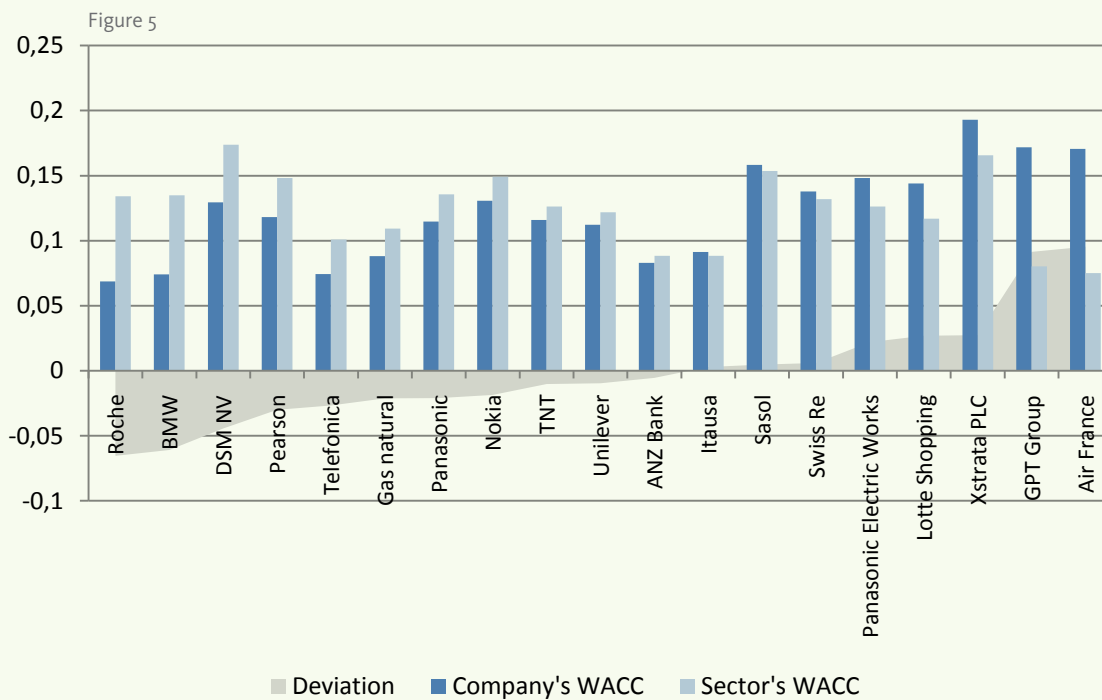
### RISK FACTORS: LEVERED AND UNLEVERED BETA



# Cost of capital

The cost of capital determines a company's market value: the lower the cost of capital, the more the company is worth, and vice versa. Of the total CSR champions, 58% benefit from a lower cost of capital than their sectors (7.9% below average), due to their greater openness to external financing.

## COST OF CAPITAL -LDJSI VS. SECTOR



This indicates that DJISL companies, starting from a slightly lower business risk than their sectors, are capable of reducing their financing cost by means of a more efficient funding mix, incurring debt without compromising their viability. They therefore have greater potential for creating shareholder value.



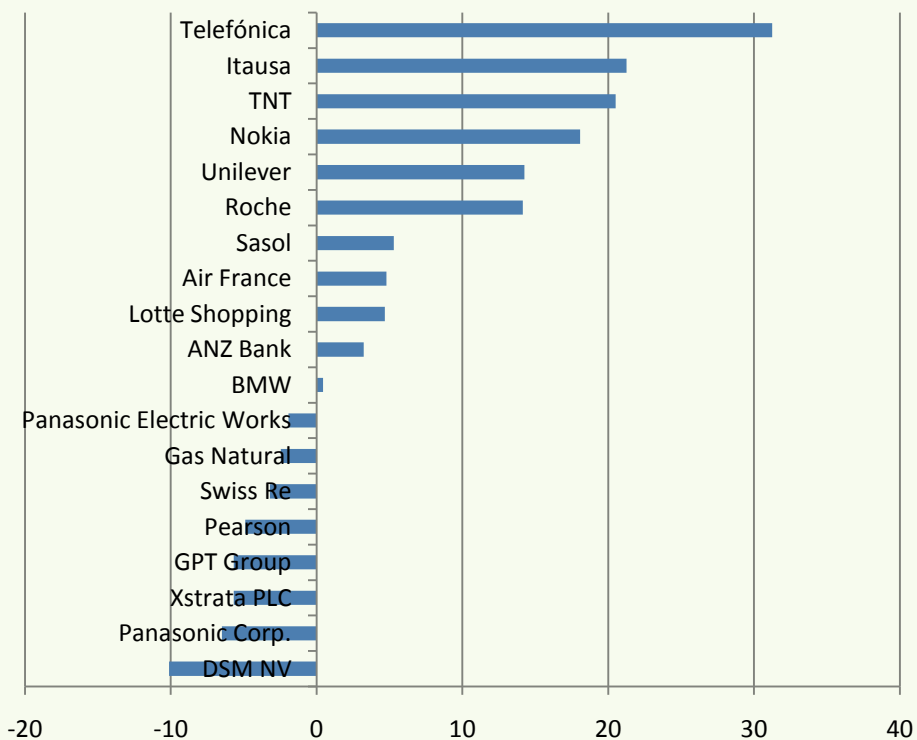
# Profitability

The return on total assets (ROA) indicates that sustainable companies are in a position to generate returns on assets in line with their competitors, obtaining a ratio of 5.49% compared to the 5.20% of their industries.

In contrast, the pool of companies beat the sector in terms of return on equity (ROE). Despite of the fact that in only 57.9% of the cases DJSIL appear to have a higher return on equity that their respective sectors, median deviation indicates a higher return for selected companies. Thus, they generally produce higher returns for shareholders.

## DEVIATION OF ROE

Figure 6



In short, with a return on assets similar to their industries', the stronger fundamentals of their business (better-than-average operating margins) allow DJSIL companies to lever into a more efficient and profitable financial structure.

## Valuation ratios

Having analysed different indicators, we ought to ask ourselves how the markets interpret these variables. Do they really assign value to such statistics?

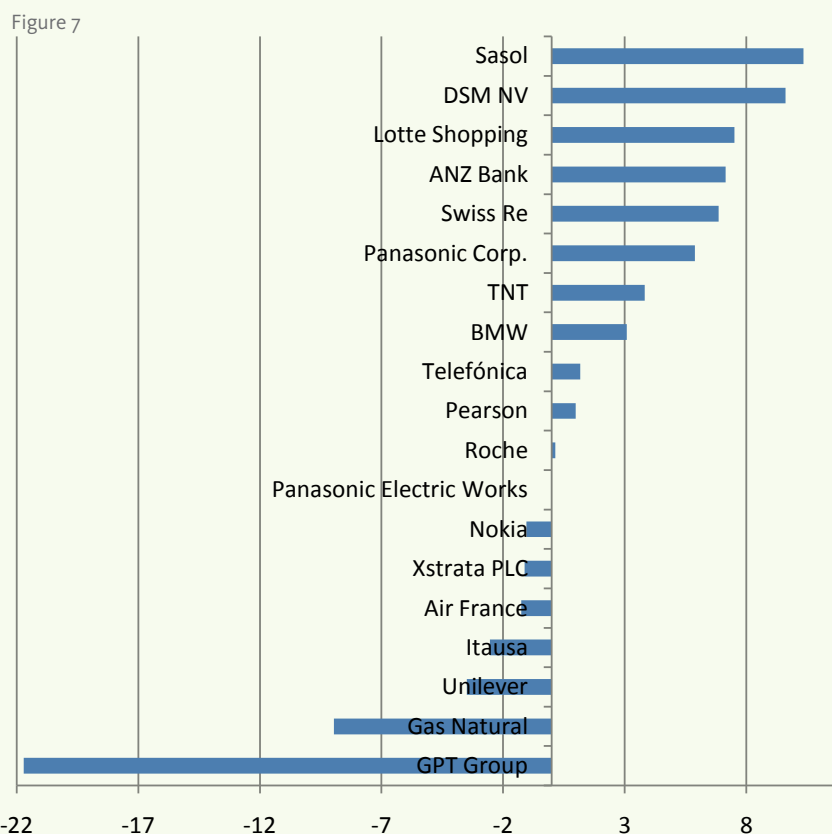
The P/E ratio (ratio between share price and net profit per share) is higher for 61% of these companies. Thus, one Euro of earnings generated by a sustainable company is worth more than a Euro of its competitors.

Moreover, the relationship between the price of company's shares and their book value (P/BV) indicates that sustainable companies' intangible assets are worth more than their respective sectors' (a ratio of 2.35 times versus 1.31). In other words, the market attaches differential value to brands, innovative capacity, and quality of management team among other intangible assets of these companies.

The variable in which the DJSI's ability to create added value is most obvious is the price/cash flow ratio, indicating how much an investor pays for every euro of cash flow: a total of 61% of the companies trade at a premium of 1.85x.

Shares from the mix of selected companies thus trade with a significant premium when compared to their respective sectors, revealing a greater confidence in these companies' management and their ability to generate greater future growth.

### DEVIATION OF P/CF



## DJSIL and value creation

Thus far, the analysis reveals a strong link between sustainability champions and a stronger financial performance, since a more competitive position can be observed throughout the scorecard below, where the aspects in which the DJSIL outperform their sectors are highlighted in green.

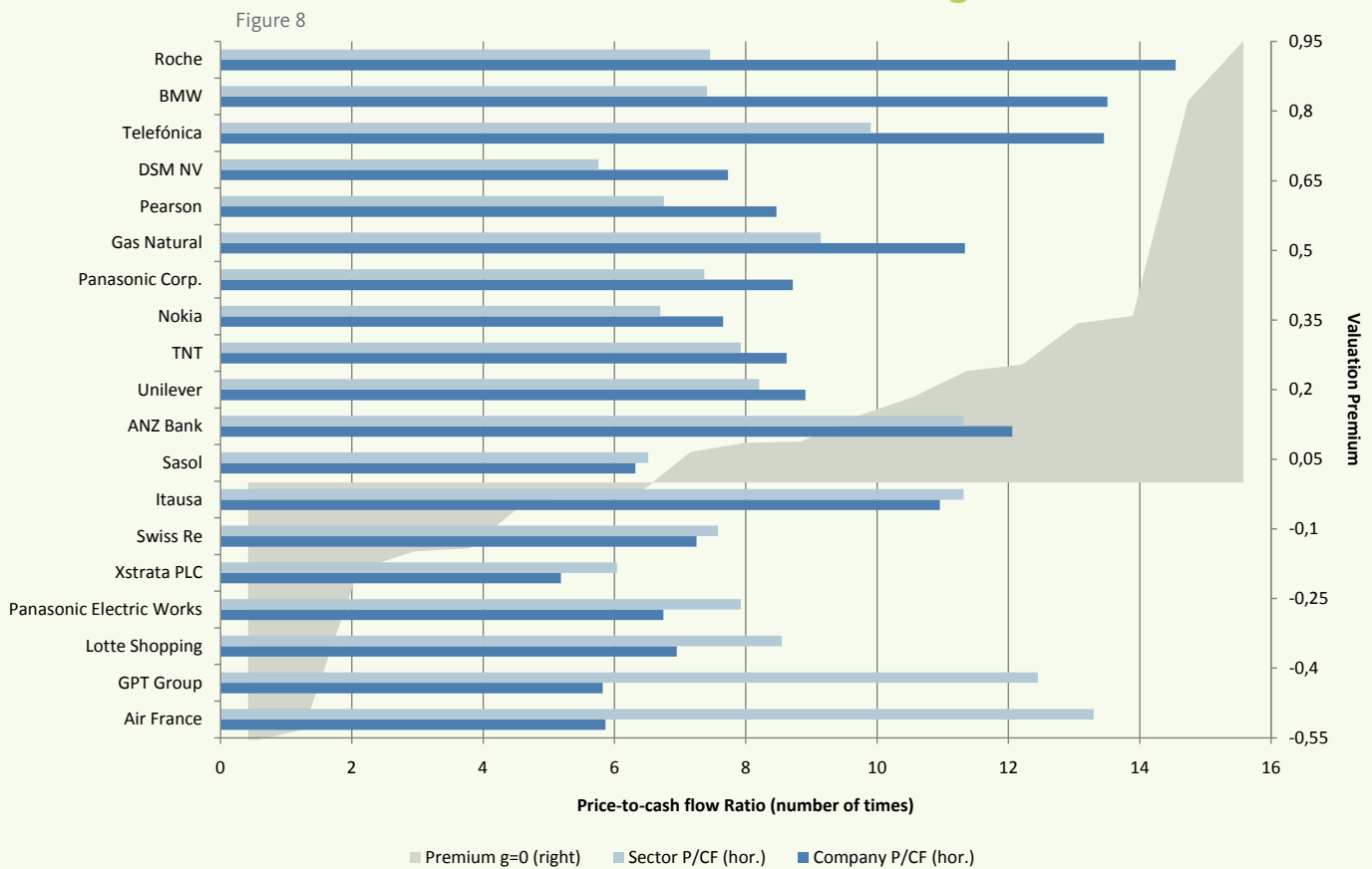
Dimension	Indicator	% of companies performing better than their sectors	Median Deviation	Mean Deviation
Margins and Efficiency	Operating Margin	73.7%	14.9%	146.1%
	Net Profit Margin	68.4%	43.4%	91.6%
	Asset Turnover	93.8%	276.9%	816.3%
Growth Rates	Sales growth	38.9%	-40.5%	11.3%
	Implicit growth	61.1%	3.7%	15.2%
Risk factors and Cost of Capital	Unlevered Beta	57.9%	-3.4%	-0.7%
	Levered Beta	47.4%	17.0%	24.5%
	Debt to Equity	63.2%	23.0%	185.6%
	Effective Tax Rate	63.2%	-7.1%	-22.8%
	Cost of Capital	57.9%	-7.9%	3.8%
Profitability	ROA	57.9%	23.9%	39.4%
	ROI	53.3%	2.1%	30.8%
	ROE	57.9%	27.4%	59.8%
Valuation Ratios	P/E	61.1%	28.0%	228.0%
	P/BV	57.9%	28.6%	105.5%
	P/CF	61.1%	24.0%	185.4%

In conclusion, sustainability champions benefit from a greater potential for the value creation, in comparison to their respective sectors.

# Valuation premium

This extra capacity to create value, clearly distinctive of companies selected, is ultimately reflected in their stock-market value. The analysis shows that, assuming zero growth, the valuation premium of sustainable companies is higher, as indicated in the figure below. Consequently, the market would pay more for the shares of sustainable companies than those of their industries, under equal growth conditions.

## VALUATION PREMIUM GIVEN $g=0$



For more detailed financial and technical information on this analysis, readers may refer to the document [“Sustainability for financial geeks. Lessons learned from the leaders of Dow Jones Sustainability World Index”](#).

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