

# Do Principles Pay?

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# Social & Environmental Impacts

- All corporations have environmental & social impacts
- But today these are on the agenda to a degree never seen before
- A matter of concern to many top managements

# Why?

- Four factors
- 1. 'Rolling back the frontiers of the state'
  - Rhetoric of the Thatcher/Reagan era – deregulation & privatization.
  - Lead to transfer of environmental & social decisions from state to corporate sphere
  - In environmental arena, continued under Bush 2

# Why?

- Four factors
- 2. Globalization
  - Most western companies now operate or source in LDCs, where social & environmental legislation is non-existent or un-enforced
  - Companies have to choose what environmental & social standards to work to – local or home

# Why?

- Four factors
- 3. Actions of NGOs and consumers
  - NGOs monitor corporate actions in environmental, social fields. Organize boycotts, vocal criticism in media
  - Consumers increasingly interested in provenance of what they buy

# Why?

- Four factors
- 4. SRI funds
  - About 10% of all professionally managed money is in SRI funds
  - Additionally we have pension funds, endowments that are concerned about social & environmental performance of companies in which they invest

# Consequence -

- Many corporations are now 'over-complying'
- Going beyond what is legally required of them in social, environmental areas

# Examples of 'over-compliance'

## 1. BP Amoco and climate change

- In 1997 – before Kyoto was signed – John Browne made speech accepting reality of and responsibility for climate change
- Pledged to reduce BP's CO2 emissions by 10% - and did so
- Lobbied for action on GHG emissions



# Examples of 'over-compliance'

## 2. International banks and the Equator Principles

- 2002/3 RAN and others campaigned against infrastructure projects in LDSs on grounds that they harm environment, local populations
- 2003 most major western banks agree to EP setting standards for impacts of project finance operations

# Examples of 'over-compliance'

## 3. Nike, GAP and the Fair Labor Association

- Nike and other footwear and apparel companies now monitor employment conditions at subcontractors
- Considerable cost – though not always as effective as we might wish

# Examples of 'over-compliance'

## 4. Starbucks, shade-grown and fair trade coffee

- Coffee growing traditionally destructive of rainforests
- SBX moved to shade-grown and in partnership with CI offer premium for environmentally friendly coffee

# Why over-comply?

- Related to two shortcomings of the market
  - Externalization of costs and
  - Distributional conflicts
- Classic weaknesses of the market mechanism, where corporate and social goals are not aligned

# Alignment of interests

- *What's good for General Motors is good for America* ("Engine" Charley Wilson, CEO of GM)
- Taken as an outrageous statement – but in fact true if markets are working well
- Just the invisible hand at work

# Financial benefits

- Avoiding conflicts has financial payoffs:
- Risk Management
  - Avoid law suits
  - Avoid consumer actions
    - Shell & Brent Spar
    - Nike & sweatshops
  - Enhance brand image

# Financial benefits

- Recent UBS equity analysts report suggests that pollution be treated on balance sheet as “contingent liability”

# Financial benefits

- Waste reduction – Dow, BP
- Employee turnover – Starbucks
- Cost of capital – role of Socially Responsible Investment (SRI) funds
  - “The Price of Sin”, Hong and Kacperczyk
- Consumer responses – may be willing to pay for environmental or social qualities



# Market Studies

- Can stock market behavior explain over-compliance?
- Can consumer buying decisions explain over-compliance?

# Hamilton

- JEEM 1995. Event study of impact of first U.S. EPA TRI data on stock prices.
  - Clear negative impact on stock prices of companies in TRI.
  - Less for companies known to be polluters
  - Greater the more chemicals released
- Note – this is not illegal pollution

# Hamilton

- Clearly capital markets penalize toxic releases – confirmed by later studies
- In U.S. interpret in terms of legal liabilities
- Similar results Argentina Chile Mexico Philippines Korea
- As class actions not feasible in these countries may be regulatory concern too.

# Konar & Cohen

- Look at Market-to-Book as function of
  - Many controls
  - TRI data
  - Environmental law suits
- Again find clear relationship between market value, emissions in TRI and law suits.

# Dowell Hart & Yeung

- Relation of Market-to-Book to environmental performance of US-based multinationals.
- Performance – environmental standards used. 3 cases – i. uniform standard higher than US everywhere, ii US standard everywhere and iii lower than US where permitted

# Dowell Hart & Yeung

- After allowing for various other effects find a correlation between Market to Book and environmental performance.
- Looked for lagged relationship to clarify causation but no results
- Environmental measure self-reported and eccentric

# Hong & Kacperczyk

- Look at “sin stocks” – alcohol, tobacco & gambling
- Find that relative to financial performance they are undervalued, equity capital costs are high
- These companies have higher than expected debt to equity ratios – debt markets affected less than equity markets

# Hong & Kacperczyk

- Bottom line – activities of SRI funds can raise cost of capital to firms of which they disapprove



# Consumer behavior

- May reward over-compliance
- Hiscox & Smyth – two experiments in major NYC department store.
- In each took two competing product lines, both made under good environmental & labor conditions.

# Consumer behavior

- Prominently labeled one as socially & environmentally benign, not the other.
- Sales of labeled good rose, even when price increased 10%. Dropped slightly at 20% rise.
- Reversed the labeling and sales pattern reversed.

# Consumer behavior

- Reinhardt et al: study Patagonia's switch to organic cotton and associated price rise of about 10%.
- Use mail order data base to study demand response to price rise when explained as a consequence of switch to organic cotton
- No drop in demand when prices rose

# Consumer behavior

- Responses to FSC, MSC certification
- Not much evidence that individuals respond but
- Some major buyers are responding – e.g. Unilever, Wal-Mart, Ikea

# Interpretation

- Capital markets seem to feel that externalization of costs must be paid for somehow.
- Consistent with the idea that CSR is an important element of risk management

# Interpretation

- Hamilton's TRI study and its successors suggest capital markets penalize pollution and that this is not only a matter of legal liability.
- Other studies suggest correlation between environmental performance and Market to Book but are unconvincing on causation issues and lack micro structure.

# Interpretation

- Some evidence that consumers respond to data on firm's social and environmental performance but as of yet limited.

# Fisman Heal & Nair

- Basic results
  - CSR may raise valuation
  - CSR may have more impact on profits when brand image important
  - Correlation between CSR ratings and advertising spending
  - CSR relative to other firms may be what matters to consumer



# Data

- CSR data from KLD Research and Analytics (also Innovest)
- Compute from KLD database an index  $V$  of visible CSR – CSR that affects the community in which a firm operates.

# Who does V-CSR?

- V-CSR is dependent variable, in 1, 2 mean for 4-digit SIC code, 3, 4, 5 & 6 use company-level data
- Ad is median ad/sales for 4-digit SIC for 1990-2000
- OB fraction shares held by outside blockholders
- OB B fraction of shares whose voting is influenced by a board member – hedge & VC funds
- Gov is IRRC metric based on statutes

	1	2	3	4	5	6
Ad	<b>2.235</b>					
HHI		- .045				
O B			-.076		<b>.742</b>	
Gov				-.121	.116	
OB*Gov					<b>-1.614</b>	
OB B						-.131
C/A	-.078	- .213	.127	.073	.176	.129
L(sales)	<b>.074</b>	<b>.107</b>	<b>.079</b>	<b>.089</b>	<b>.088</b>	<b>.082</b>
Obs	302	107	2719	6282	4270	2719
R <sup>2</sup>	.15	.10	.40	.34	.41	.40

Dependent – CSR. All have industry & year FE. **Red – sig @ 1%**

# CSR & Firm Performance

- DV is  $1 + \log(\text{mtb})$  in 1, 2: in 3, 4 it is RoA.
- All include year & industry FE,  $\log(\text{sales})$  as control with slope changes allowed at quartiles

	(1)	(2)	(3)	(4)
CSR	-0.003	<b>-0.007</b>	-0.007	-0.037
Advertising*CSR		<b>0.128</b>		<b>0.948</b>
Observations	7017	5956	7032	5989
R-squared	0.32	0.32	0.55	0.51

Dependent is firm performance

# Advertising & CSR

- Derivative of firm performance with respect to CSR is  $-0.008 + 0.121 * \text{adv}$ .
- For median adv and above this is positive: for low adv this is negative

# Product market competition

- DV is RoA in 1, 2:  $\log(\text{MtB})$  in 3, 4, 5, 6
- AvCSR is average value of CSR for each 4-digit SIC code in each year.
- All include  $\log(\text{sales})$  and year and industry FE at 4-digit SIC level

	1	2	3	4	5	6
CSR	.001	.005	.004	.056	.024	.076
HHI* CSR	-.008		-.008	<b>-.064</b>		<b>-.059</b>
AvCSR* CSR		<b>-.011</b>	-.004		<b>-.042</b>	-.030
Obs	2276	7222	2276	2275	7228	2275
R <sup>2</sup>	.35	.33	.35	.51	.55	.51

Dependent is firm performance



# Implications

- When average CSR is low, increase in CSR raises performance. As average CSR goes up, impact of an increase in CSR falls and becomes negative
- In competitive industries CSR raises performance. As concentration level rises, effect of an increase in CSR falls and becomes negative.

# Implications

- Advertising explains over-compliance
- Its impact on valuation depends on advertising
- CSR relative to competitors matters
- CSR matters more in competitive industries

# Conclusions

- Capital markets penalize poor performance on environmental, social issues
- Reflects operation of legal, political systems –
  - courts
  - **NGOs**
  - **consumer activists**

# Conclusions

- Stock market & brand value seem affected positively by CSR performance
- Environmental performance is becoming an element of corporate strategy along with marketing
- Need more micro studies of consumer responses to environmental, social performance

# Conclusions

- Pressures for 'good behavior' are real and do to some degree police corporate behavior
- But there are exceptions –
  - Tobacco
  - Logging