Stakeholder Optimization will be the basis of Competitive Advantage for the 21st Century

by Harvard's Bishop William Lawrence University Professor Michael E. Porter, based at the Harvard Business School, and William F. Achtmeyer, Chairman Acropolis Advisors and Founder and Former CEO of The Parthenon Group

Over the past year, there have been a number of articles about the shortcomings of ESG measurement systems and ratings with scant discussion on solutions. Our view is that while the ESG movement has its flaws and inconsistencies, it is not going to disappear. Quite the contrary. With the SEC finally getting into the act last year, along with the European regulators well before them, we fully expect that the ESG movement, along with the so-called stakeholder capitalism movement, are here to stay.

We have developed a strategic framework that integrates these "social" metrics with traditional economic and business metrics to form a holistic picture of a company's stakeholder performance both absolutely and relatively to the industry in which the company competes. We incorporate the foundational principles of our academic and advisory work into this framework while recognizing that every company has a unique set of challenges and opportunities. Adopting our Acropolis Advisor's 21st Century Stakeholder Capitalism Optimization Framework will require a different mindset. It represents a step-function and thought process change but draws upon familiar and well-established strategic concepts.

Our framework embraces two cardinal principles. One is Shared Value[1]: doing good while simultaneously making a greater profit. Conventional wisdom continues to think of "doing good" as a **moral obligation**, *without regard* to its impact on profit. However, such thinking creates a zero-sum game, taking money away from the shareholder and giving it away to other stakeholders and/or society. This is an *inherently unsustainable approach for businesses in a truly competitive world*. No one would invest in such an entity. The other principle is competitive advantage. To succeed in business, companies need to find an edge. We believe our approach will help in this quest for differentiation.

[1] See HBR Jan/Feb 2011 article title *Creating Shared Value* by Michael F. Porter and Mark R. Kramer

Our 21st Century Capitalism Stakeholder Optimization Framework (see insert 1) examines the interplay among *business strategy* (rooted in competitive positioning and advantage), *social impact initiatives*, and *economic returns*. Only when we recognize how these three elements **work in concert** does true stakeholder synergy come about. For a company to be enduringly successful, all stakeholders need to be aligned with a company's purpose and its strategy. Relevant societal objectives must be an integral part of the business strategy, not the subject of a separate exercise that gets tacked on only after the strategy is fully baked or ends up as a glossy sustainability report completely divorced from the economic and business metrics supporting the business strategy.

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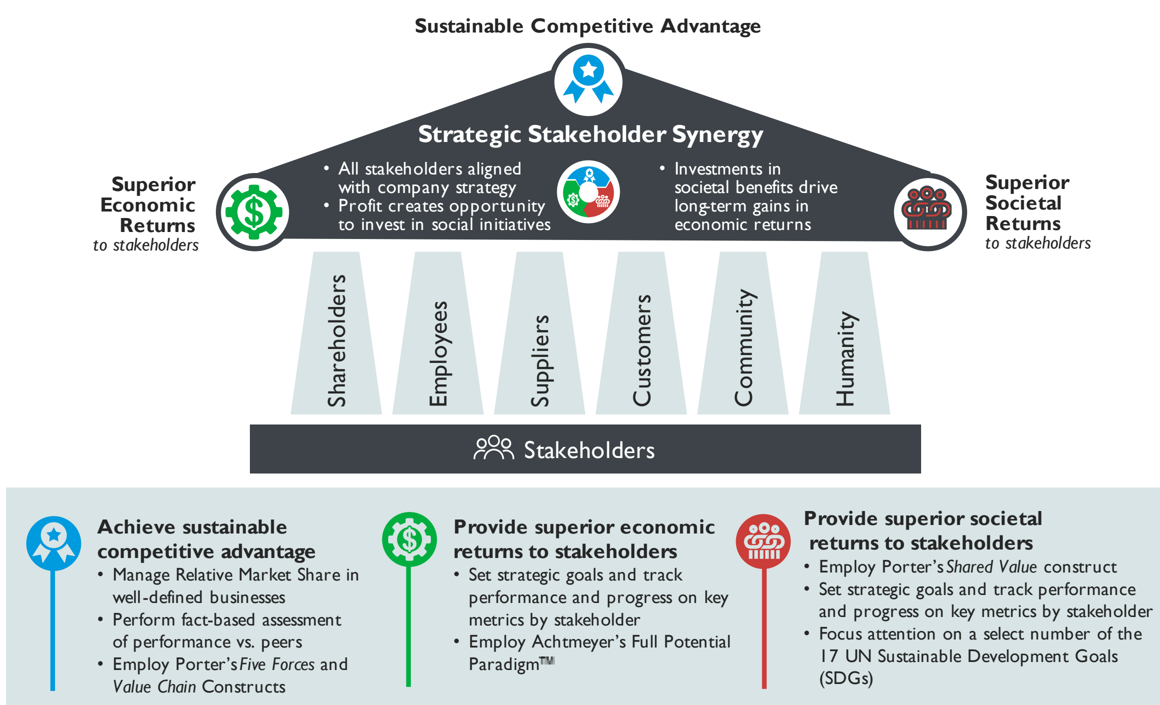
21st Century Capitalism Stakeholder Optimization Framework



Thermo Fisher Scientific, under the leadership of Marc Casper over the past 14 years, is a prime example of a company where purpose, strategy, and key priorities are seamlessly aligned and where significant economic value is being created for all stakeholders. Thermo competes in the Life Sciences and Diagnostic Tools. When Casper became CEO in 2009, Danaher, with revenue of $11 billion, was the market leader with $1 billion more than Thermo. At year-end 2022, however, Thermo, at $45 billion, was $12.4 billion larger than Danaher, notching a staggering 1120% total shareowner return which exceeded its closest competitors (Danaher and PerkinElmer) by over 15,000 basis points. Importantly, Casper also enjoys an 89% employee approval rating by *Glassdoor* and a Net Promoter Score® of 34, which is in the industry's top tier. Moreover, *Sustainalytics* rates Thermo as *low risk* with respect to ESG issues. Serving the world of science, Thermo's corporate purpose is to "enable our customers to make the world healthier, cleaner, and safer." In addition to enabling Covid-19 testing and the development and production of vaccines and therapies, most of Thermo's products contribute to social good while generating very attractive margins and profits. As a special initiative, Thermo spends millions of dollars and volunteer hours annually to support and promote STEM education. This is not simply eleemosynary but is central to Thermo's culture and self-interest, since it employs a significant number of STEM graduates. In sum, Thermo strikes a very laudable balance amongst its stakeholders.

In implementing the 21st Century Capitalism Stakeholder Optimization strategy development concept and methodology, business leaders decide how a company can credibly and sustainably achieve competitive advantage in its products and/or services, while *also* assessing the needs of each stakeholder. Utilizing Porter's Five Forces and Value Chain constructs, together with Achtmeyer's Full Potential Paradigm™[2] (FPP), business leaders can determine the extent of competitive advantage that can be attained over the planning period, and the resources required to sustain this advantage.

Addressing the needs of each stakeholder requires not only determining the nature of their needs and desires but, equally important, the most suitable measurement of stakeholder satisfaction. For shareholders, Total Shareholder Return (TSR) is a typical starting point. For employees, measures of retention or level of engagement are common (e.g., *Glassdoor's* gauge of whether an employee would "recommend the firm to a friend"). For customers, Net Promoter Score® (NPS) is broadly employed. For suppliers, that could be a version of NPS. *Know the Chain* is often an objective outside measurement source for suppliers. And for a company's local community, it could be the level of respect for the company, measured by direct surveys.

[2] Achtmeyer's Full Potential Paradigm™ is an analytic construct which helps companies understand the levers that need to be pulled to increase their market value. To learn more, see *The Stress Test Every Business Needs*, by Jeffrey Greene, 2018, Chapter 12.

For each stakeholder's ultimate measure of success or "objective function," there will likely be 2-5 major drivers that must be a focus of management attention. For TSR, we use the core FPP™ drivers of margin, revenue growth, relative market share, and valuation multiple factors.[3] For employee engagement, drivers could be workplace environment, diversity, compensation, etc. For customer NPS, it could be online access, service quality, product quality, price, etc. For suppliers, it could be price, payment terms, distribution ease, etc. And for communities, it could be volunteer services, payments to the Community Chest or local hiring, etc.

Concurrently, company leaders must identify the intersections between company strategy and opportunities that help mitigate social challenges. The strategic imperative for a company is to identify opportunities where smart business choices also create social good. And where are the opportunities to advance societal needs while creating superior economic returns? This is the essence of Creating Shared Value. As a starting point, we recommend a close examination of the relevant U.N. Sustainable Development Goals (SDGs) and sub goals that intersect with the company's core strategy. For example, when Target added solar panels to its stores, it reduced carbon emissions from conventional sources of energy while saving money via rebates and reduced maintenance costs. Target's solar panel initiative would align to the 7th UN SDG on Affordable and Clean Energy. Every Tesla car that rolls off the production line will improve the environment due to its elimination of internal combustion engines, while also increasing the company's profits. The Tesla car aligns with the 9th UN SDG on Industry Innovation and Infrastructure, which includes sustainable transport. Increasing the number of women and underrepresented minorities to match the demographics of the localities of a company's operations has shown to improve retention and lower recruiting costs. To this end, many companies are working feverishly to get their diversity, inclusion, and living wage programs implemented. Diversity and inclusion align with the 10th UN SDG on Reduced Inequalities.

When there is a direct link between a company's strategy and societal benefits, profit and social impact become synergistic, not contradictory, as much current thinking about capitalism wrongly assumes. The more synergies that can be identified, the more a company's social impact increases its profitability. By examining the consequences of strategy using the lens of each stakeholder, rather than just

[3] The latter are more fully described in HBR's 6 Factors that determine your Company's Valuation. October 25, 2022, written by John Trustman, an Acropolis Advisor partner.

shareholders, the opportunity to identify powerful areas of company innovation rises significantly, as evidenced by the annual Fortune magazine's "Change the World" list of companies (see insert #2).

(insert #2)

Fortune's Change the World List

	2022	2021	2020	2019	2018	2017
1	PayPal	The Vaccine Makers	The Vaccine Makers	Qualcomm	Reliance Jio	JP Morgan Chase
2	Alibaba	Envision	Alibaba	MasterCard	Merck	DSM
3	Walmart	Costco	PayPal	BYD	Bank of America	Apple
4	Discovery	Santander	Nvidia	TE Connectivity	Inditex	Novartis
5	Qualcom	Viatris	BlackRock	Walmart	Alibaba	Leap Frog Investments
6	EssilorLuxottica	Mercedes Benz	Zoom	Santander	Kroger	Ant Financial
7	Nubank	PayPal	Safaricom	Centene	Xylem	Walmart
8	Northvolt	KCB Group	Regeneron	Bank of America	ABB	Toyota
9	AIA Group	Bank of America	Walmart	Schneider Electric	Weight Watchers Int'l	Johnson & Johnson
10	Shubham Housine	Renew Energy	Serum Institute of India	Terracycle	Hughes Network Systems	Yara

Companies in green type are multiple year winners

Insert #2: Learning from Fortune's Change the World List

This important list reveals a wide range of companies from a wide range of industries and geographies. Those companies with multiple mentions on the list are shown in green. With the exception of Walmart, Bank of America, Alibaba, PayPal, Santander, and The Vaccine Makers, there have been 43 different companies that broke into the top 10. The criterion for selection is exacting. A company must demonstrate material Shared Value creation and cannot repeat its standing on the list unless it demonstrates a new, innovative form of social benefit, that generates incremental profit in subsequent years.

In 2020, the work of the vaccine makers is obvious in terms of its social consequence and impact. #2 Alibaba turned its electronic trading platform into a hub for sourcing personal protective equipment. #3 PayPal raised wages by tens of millions while lowering the cost of employee benefits while doubling profits. Finally, #4 Nvidia produced semiconductors that helped some scientists win the Nobel Prize for creating 3D views of viruses. Each company has a great "shared value" story which demonstrates the enormous power of capitalism in creating social benefits.

The 21st Century Capitalism Stakeholder Optimization Dashboard

Most important, our 21st Century Capitalism Stakeholder Optimization Framework is intentionally designed to *optimize* outcomes across stakeholders. No stakeholder should "win" at the expense of the others. Consequently, short term thinking cannot dominate decision making. Optimization also implies that a company needs to constantly adjust and iterate its business strategy to ensure that the needs of all stakeholders are balanced. Without question, adopting the philosophy of Shared Value will provide a company with the best chance to achieve as close to an optimal outcome as possible.

When the precepts of 21st Century Capitalism Stakeholder Optimization are followed, a fundamentally new approach to assessing corporate performance emerges. We portray this in what we term the 21st Century Capitalism Stakeholder Optimization Dashboard (see insert #3).

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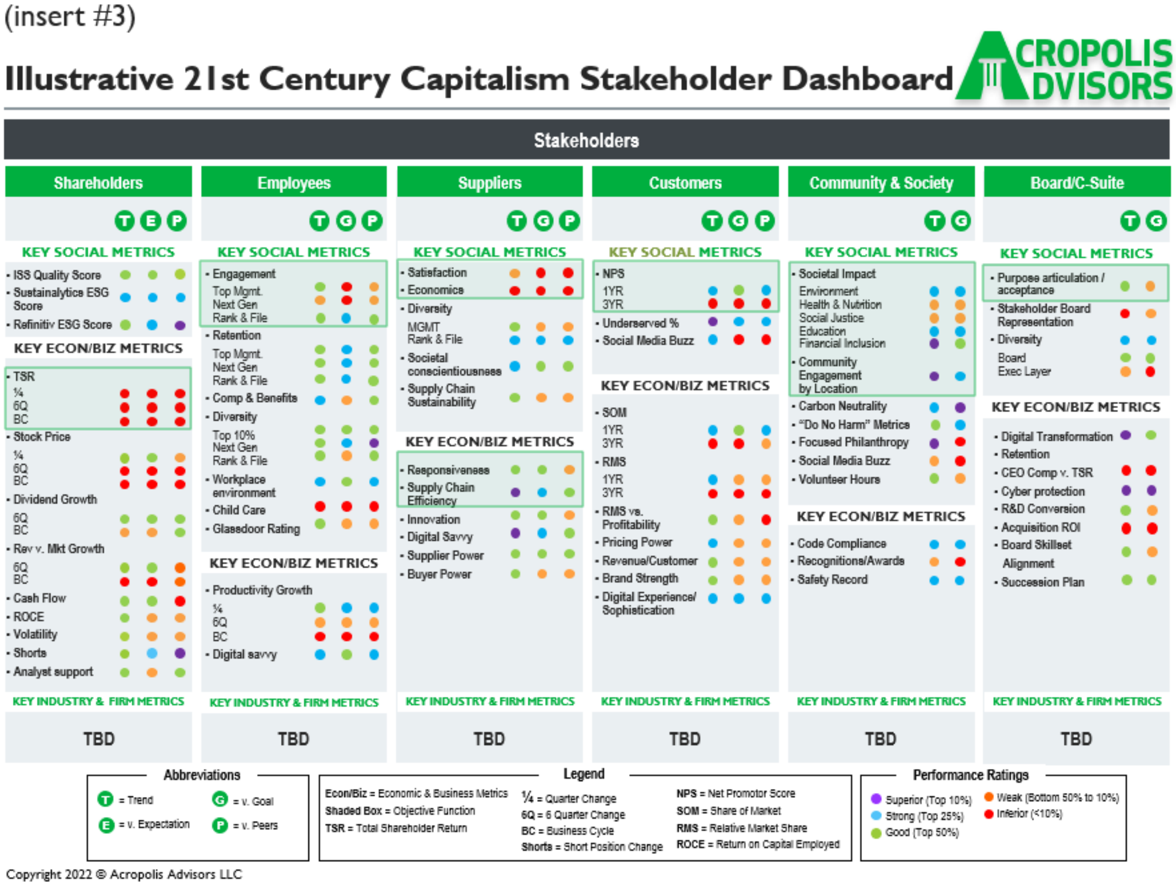

Insert #3: Illustrative 21st Century Capitalism Stakeholder Optimization Dashboard

There are both economic/business (labeled Econ/Biz) and social metrics for each stakeholder. Importantly, these metrics should only be included that have a relevance to the overall performance for each stakeholder. If Total Shareholder Return (TSR) is the "objective function" for shareholders, then all of the metrics delineated below it should contribute to that outcome. The same goes for Net Promoter Score (NPS) for customers or "Engagement" for employees, assuming these are the objective functions for customers and employees, respectively. In this dashboard, the objective functions are in the shaded green boxes. Performance ratings are denoted by the colored dots. Top ratings are in purple, followed by blue, green, orange, and red. Ratings are determined by a standard bell curve with 10% allocated to top (purple) and bottom (red) performers, 25% to the next outer tiers, and 30% to the middle tier (green.) Within the Community/Society column is a summary metric on "do no harm" which would draw upon the ESG measurement system metrics that track if companies are practicing any injurious policies that lead to environmental, safety, and employment injustices.

This new corporate performance dashboard is organized by stakeholders: shareholders, employees, suppliers, customers, community/society, as well as corporate leadership -- Board of Directors and C-Suite executives. For each stakeholder: there is a "universal" dimension and an industry/firm-specific dimension. The "universal" dimension examines metrics that apply to most businesses around the world. The industry/firm-specific dimension focuses on metrics unique to the strategy and issues of a particular corporation. Where possible, each metric should examine current performance through three lenses: (1) performance versus historical performance, (2) performance versus analysts' expectations for shareholders, or performance versus the strategic plan for all other stakeholders, and (3) performance versus competition.

Users of this dashboard can quickly discern where there are opportunities for improvement and where outstanding performance is being achieved. Through regular reviews by management and the board, steps can be taken to address all areas of concern to help optimize performance across stakeholders.

When we have shared this 21st Century Capitalism Stakeholder Optimization Framework and Dashboard with CEOs, Board Directors and major investors, they have often been immediately captivated and keen to embrace this approach and its underlying concepts. Why the enthusiasm? In a word, this approach is ***holistic***. The dashboard helps to illuminate answers to three fundamental questions:

- *Is the corporation better off than its last reporting period?*
- *Is it on or off plan?*
- *Is it performing better than competition?*

We expect that any hesitancy shown by companies in adopting our 21st Century Capitalism Stakeholder Optimization Framework and Dashboard will not reflect concerns with its conceptual integrity, or an inability to obtain the required data, but a reluctance by business leaders to lay bare some of their most potent performance measurements. Yet the current proliferation of data through the internet and social media as well as independent industry sources already undermines most attempts at opacity. Furthermore, it is reasonable to anticipate regulatory pressure for greater transparency in these areas. Jack Brennan, the former CEO of Vanguard, commented that "I could easily see the SEC demanding reporting like this in the next three to five years." And, in fact the SEC announced in mid-March 2022 their recommendations for climate change metrics.

We had the opportunity to test drive our dashboard (insert #4) with a well-known corporation that ranks in Fortune's top 300 firms with revenue of over $10 billion and a market capitalization of over $25 billion. It has received numerous honors from being the best-of-the-best for employee inclusion to a top ranking on human rights to receiving an Energy Star by the EPA. Like many corporations, they began to produce a sustainability report only a few years ago and would readily admit that they are at the beginning stages of reaching some of their long-term goals on various environmental and social initiatives. They recently kicked off their Scope 3 program which is the most challenging of the GRI reporting requirements on emissions. The CEO is one of the most highly respected CEOs in the world and is renowned for generating significant long-term value for shareholders and exceeding the expectations of the other stakeholders. Like Thermo's Mark Casper, this CEO epitomizes "shared value" leadership.

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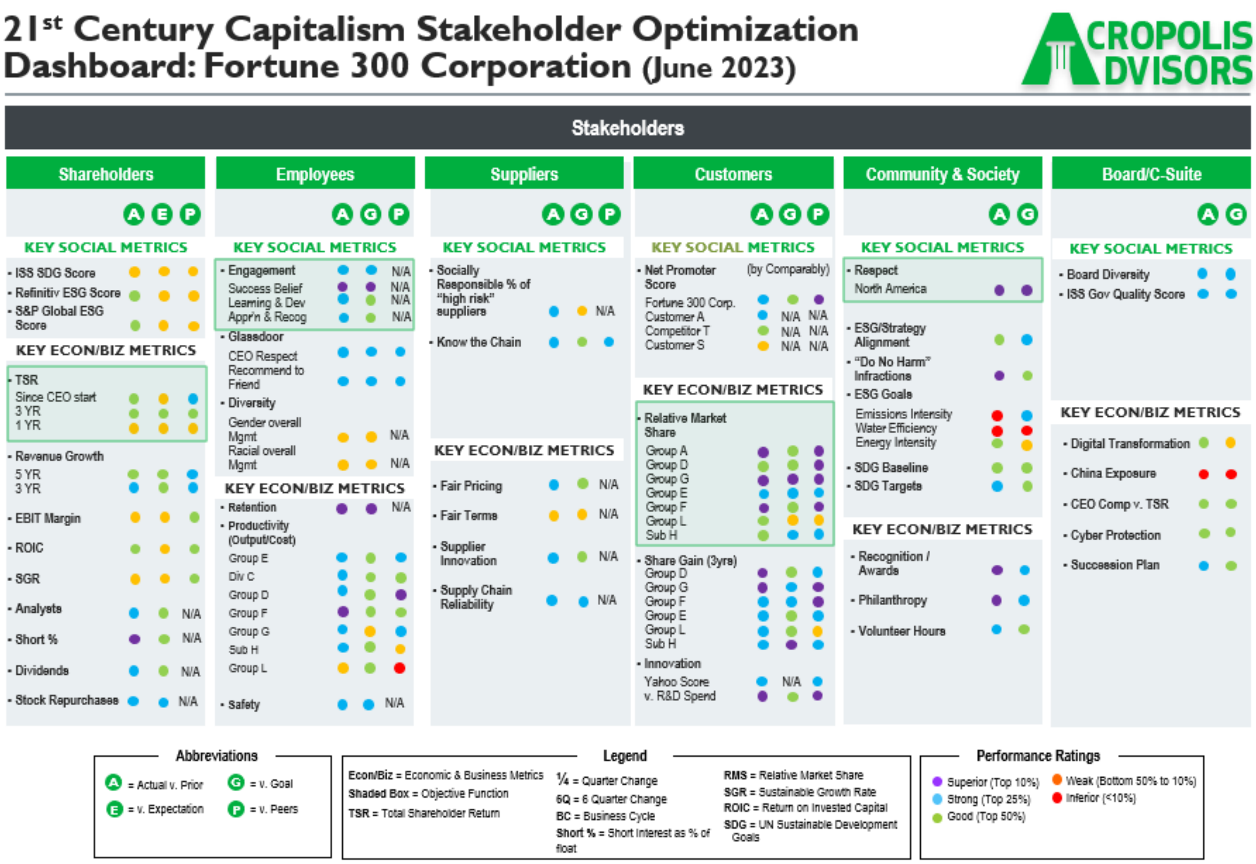

The dashboard for this company reflects a few obvious takeaways. First, for shareholders, the corporation has mirrored the S&P 500 over the past three years and over the tenure of the CEO. Only in the last year has the company fallen off pace. However, analysts are bullish on future performance. Second, employees give high marks with respect to engagement while achieving industry leading levels of productivity. Customers are quite satisfied with the company as evidenced by a Net Promoter Score® that rivals Apple, along with exemplary market share gain and relative market share performance. While there is no company which competes across all or most of its portfolio businesses, when we examined performance versus the competitors at the division or group level, our disguised example performed favorably. What is definitely the case is that the investments and initiatives the company is making on the social front are not coming at the expense of generating outstanding levels of revenue growth.

Finally, it is early days on the sustainability front, although it is notable that the company feels strongly that their corporate strategy and sustainability goals are tightly aligned. The internal data suggests that the company's ESG Goals are "work in progress" and that the outside evaluations are average, except for a strong ISS Governance Quality score. Unfortunately, none of these metrics reveal how significant are the environmental and social contributions of the company's products that are produced by the company. A major flaw of the ESG measurement systems and rating is that they only measure emission outputs from the company and their suppliers. For instance, they do not measure the impact on customer emission usage. This company has a product which has reduced pollutants by 4 billion tons over the past 50 years. Were those benefits to be factored into this company's ESG scores, it would become a model ESG company by any standard.

Most important, this dashboard allows management and the board to focus the organization on critical areas for improvement and gives enough information to understand if its commitment to benefit all stakeholders is being achieved. With the exception of the company's China exposure (a growing risk factor), it would appear that this corporation is achieving a commendable level of performance across all stakeholders. The company's CEO commented, "this is very helpful in identifying problem areas and delineating the most important social and economic metrics and how well we are serving each stakeholder." As intended this dashboard raises "why" and "how" questions. It does not attempt to provide solutions.

Conclusion

The job of the CEO is inherently multidimensional in terms of strategic priorities as well as financial and social dimensions of performance. One size does not fit all. Stakeholder Optimization is not a “woke” zero-sum game that promotes subsidizing social benefits at the expense of satisfying shareholders. Rather, 21st Century Capitalism Stakeholder Optimization integrates “doing good while doing well” to produce a higher order of capitalism. We should evaluate a company through the prism of how well it performs versus peers not only on Total Shareholder Return, but on such metrics as employee engagement scores, Net Promoter Scores, UN SDG contributions, and other relevant social benchmarks over a five-year period. We are expanding the scope of “competitive advantage” from product/service differentiation, cost leadership, and technology superiority to also include advantage in creating Shared Value across all Stakeholders.

Stakeholder satisfaction measures should be a combination of familiar business metrics, such as productivity, market share and employee retention, along with widely used ESG metrics as well as custom metrics that may need to be designed for Shared Value assessment. Everything related to inputs and process is window dressing, and not relevant to the exercise of performance assessment, which is all about outputs and results. Any company worth its salt will have such information at its fingertips and should report it publicly. If corporate purpose and strategy are compelling and clear, the results will reflect that **all stakeholders** benefit economically and socially. If the results are murky, so will be corporate purpose, strategy, and stakeholder value creation.

We see the CEO as the master of tradeoffs. To succeed, he/she must have a mindset of *steadfast realism and tenacity*. The former provides the insight to formulate the right purpose and corporate strategy, while the latter offers the power to lead the company’s major constituencies towards a common set of goals. Along the way, the CEO must make constant course corrections to strategy based on new information, recognizing that corporate purpose is immutable if properly defined, developed, and endorsed by all stakeholders. At the end of the day, the allocation of human and financial capital will determine the outcomes stipulated above. Responsibility for these choices’ rests solely with the CEO. To properly implement the strategy of a company involving a multitude of economic and social components takes time, yet the current rate of turnover of S&P 500 CEOs is 6.9 years. This represents barely enough time to fully implement a newly developed strategy. Assuming the CEO is making consistently positive progress on the company strategy, Boards of Directors would be wise to think of the CEO's tenure in terms of ten plus years. Stakeholder Optimization in the 21st Century is an ongoing and complicated exercise.

What we are proposing is a novel approach to strategy development. CEOs must meet the threshold needs of all stakeholders, and then some, if they want to be true winners. Integrating business strategy with sustainability strategy is equally important. This requires a rigorous data-driven approach and an exciting but new way of thinking. GM's Mary Barra received kudos for her bold announcement in March 2018 that GM would be dedicated to "Zero Crashes, Zero Emissions, Zero Congestion" and would commit to an all-electric fleet by 2035. While a catchy rallying cry, how realistic was it? In contrast, Toyota has taken a much more measured view of producing a mix of hybrid and all electric vehicles by the 2030's and 2040's. GM's aspirations require seismic changes outside the company's control, whereas Toyota's ambitions are rooted in events that it can control. Investors have responded by providing Toyota with a markedly higher total shareholder return of 47% over the period since Mary Barra's announcement of the Zeros versus GM's TSR of 16%.

The business world is made up of market leaders and market followers. The market leaders must take the baton and lead others to embrace the 21st Century Capitalism Stakeholder Optimization Framework and Dashboard. Standing back to watch events unfold is already a risky play. The tide is coming in, notwithstanding current efforts to restrict investment managers from utilizing ESG data in making their portfolio decisions. Given the variations and opaqueness of ESG ratings, we fully support these restrictive efforts. However, the regulators are on the move. European regulators started mandating climate change reporting over a decade ago, while the SEC says it will finalize its proposed climate change regulations this year. Even Private Equity firms are getting into the act, with the Carlyle Group and CALPERS leading the way. It is only a matter of time before we see regulations move from the *E or Environment* column to the *S or Social* column, in the form of diversity reporting and other items.

Will CEOs step up or wait? We firmly recommend stepping up. And, if businesses collectively embrace our approach, not only will they succeed but capitalism will endure because of its major benefits to humanity. Those companies who wait risk having to play catch up and may never again regain their standing among their peers who elect to move their organizations aggressively forward into the 21st Century.

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Michael E. Porter is the Bishop William Lawrence University Professor at Harvard Business School and author of numerous books and articles on business strategy, competitive advantage, and advancing society. He is also a co-founder of strategy consultancy Acropolis Advisors.

William F. Achtmeyer is Chairman and Managing Partner of Acropolis Advisors. He founded The Parthenon Group in 1991 and served as Chairman and CEO for 30 years. Prior to Parthenon, Bill was a senior partner at Bain & Company.
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