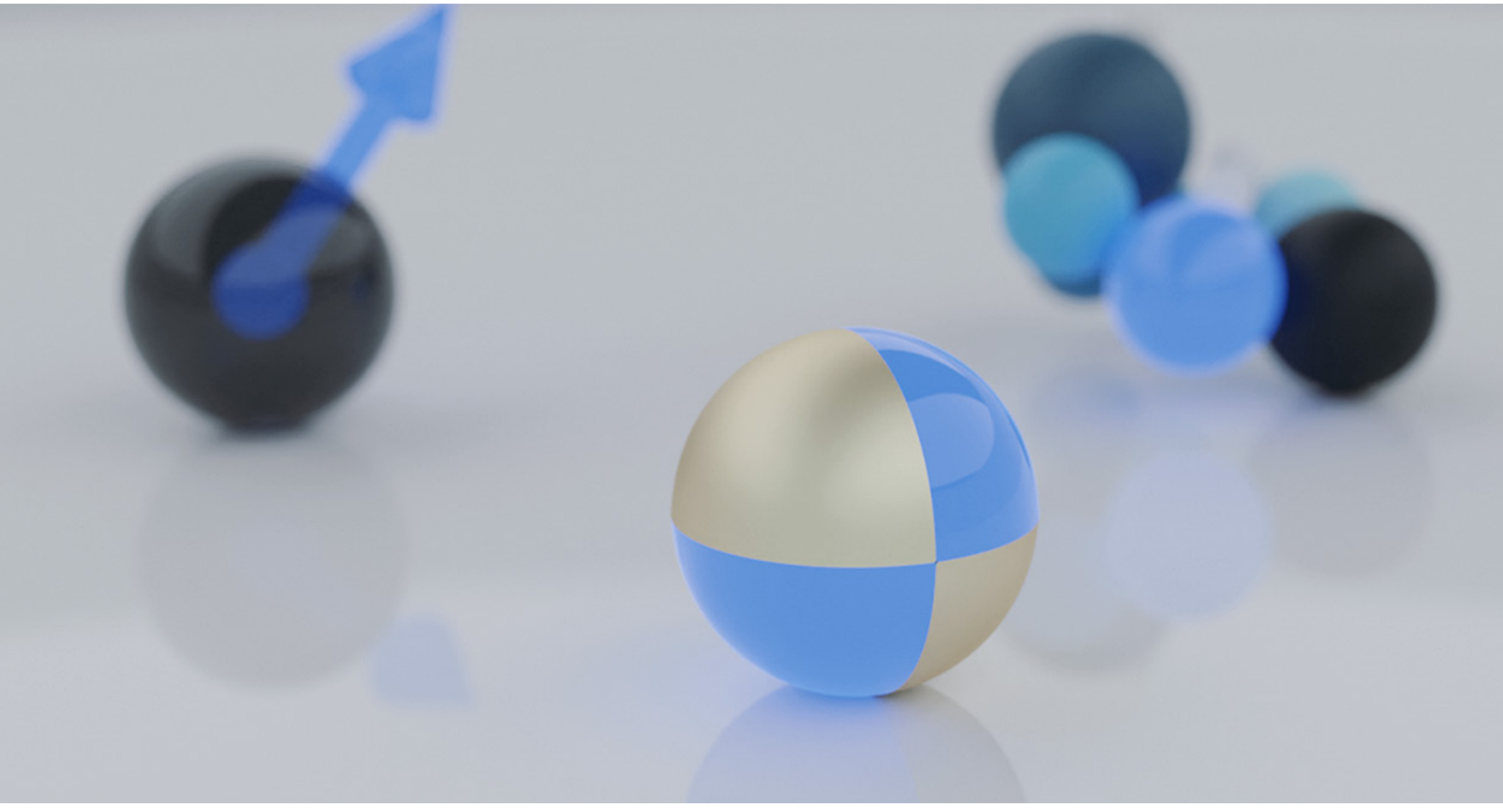
Strategy & Corporate Finance Practice

Putting stakeholder capitalism into practice

What does it mean to embrace stakeholder capitalism? Two experts explain the rationale and the steps.



January 2022

'Stakeholder capitalism' is the buzzword du jour for business practices that strive to achieve more than profits and a high stock price. But what does benefitting all stakeholders really entail? What trade-offs do companies have to make? And how do business leaders put the aspiration into practice? In this episode of the *Inside the Strategy Room* podcast—the second in a series on meeting the challenges of environmental, social, and corporate governance (ESG) demands—two experts lay out the case for stakeholder capitalism. Dame Vivian Hunt is a senior partner who serves clients on a broad range of strategy topics. Bruce Simpson is CEO of the Stephen A. Schwarzman Foundation and senior adviser to McKinsey on ESG and purpose. This is an edited transcript of the discussion. For more conversations on the strategy issues that matter, follow the series on your preferred podcast app.

Sean Brown: First, what is stakeholder capitalism and how does it differ from the capitalism that most corporations practice today?

Bruce Simpson: The real issue is the trade-offs between short-termism and long-termism. Eighty percent of CFOs tell us in surveys that they would reduce discretionary spending on potentially high-NPV [net present value] activities like R&D and marketing to achieve short-term earnings targets. They are literally sacrificing the long term for the short term. Yet research shows companies that think long-term—meaning five to seven years ahead—substantially outperform, achieving 47 percent higher revenue growth over a 15-year period, for example.

Stakeholder and shareholder interests do align in the long term. If you have happy employees, collaborative suppliers, satisfied regulators, and devoted consumers, then they will help you deliver higher benefits over a longer-term period. It is hard to satisfy everybody in the short term; you may have to make trade-offs, for example, between purpose and profit. But in the long term, we don't believe this trade-off exists.

The crystalizing concept here is purpose-driven ESG. Companies wondering how to deliver on the long-term stakeholder goals should start by asking the questions, "What is our purpose? What would the world lose if our company disappeared?" If you are a bank and you don't exist tomorrow, could other banks provide your products and services, or is there some differentiating benefit you bring that can shape your strategy, inspire your people, and steer the company at critical moments?

Sean Brown: How should those core benefits inform a company's ESG priorities and stakeholder commitments?

Bruce Simpson: At one level, ESG is simply a checklist conveniently bucketed under environmental, social, and governance benefits. It provides measurement and metrics, however. Purpose-driven ESG links a core benefit the company brings to the world to its ESG priorities. Extractive companies tend to be weaker in the environmental space, so they need to focus on that vulnerability, but they bring a social benefit to some remote parts of the world in the form of wages. Labor practices are probably the number one issue in America today. Are employees earning a living wage? Focusing on employing historically underrepresented people and helping them advance could deliver a major impact as well.

Then there is governance. If you want to make a mess of things, then forget about governance. We have seen companies make statements in support of Black Lives Matter but at the same time lay off frontline employees while doing a share buy-back, not paying their fair share of taxes, and increasing CEO compensation. That would be a trifecta of how to get this wrong. You need an integrated approach.

Sean Brown: How can companies ensure that all their ESG initiatives are understood by the outside world and their stakeholders support them?

Bruce Simpson: When the US Business Roundtable made the famous statement about stakeholders being as important as shareholders, it was criticized for not engaging with stakeholders first. It is a very big deal to know what's on the minds of stakeholders. You need to have antennae out into the media. You

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need to understand what people are saying about you because that is the best way to discover your vulnerabilities. Your harshest critics will focus on those vulnerabilities, which you have to tackle to be authentic and credible. We would argue that it starts with your own employees. We have seen an inverted pyramid on governance: if your employees are not satisfied with where the company is going, they will go to social media, and you will read about that in the press.

Vivian Hunt: Business leaders can have the best intentions but get the stakeholders’ perspectives wrong, and the technology platforms available today mean that those feedback loops can be immediate. That’s why it is more strategy than tactics to get this link to purpose and ESG right.

Sean Brown: Why has stakeholder capitalism emerged as such a big issue now?

Bruce Simpson: Ninety-two percent of people want corporations to promote an economy that serves everyone, but only 50 percent believe that large companies are delivering on that goal. If you want to hire Generation Z, they will ask tough questions about what you are doing for the planet and for society. Almost 40 percent of consumers today are boycotting a product or service, not because they are unhappy with the performance but because of that company’s social stance. The forces are moving very strongly in this direction, and CEOs tell us that they are spending half of their time on this topic right now.

Sean Brown: Can you elaborate on how stakeholder capitalism links to value creation?

Vivian Hunt: Our research and experience strongly link stakeholder capitalism to traditional sources of value. Companies viewed as more sustainable can charge price premiums, and 80 percent of consumers would switch brands if price and quality were equal but one product was more aligned with their values.

Policy and regulatory alignment is another area. Having a closer, more collaborative relationship with regulators can give companies more freedom and opportunities for growth. Some problems within value chains or society are so broad, no one company can, or even should, take on the responsibility for solving them. Rather, industry can collaborate with regulators to come up with innovative solutions, as in tackling food waste in the grocery and packaged-goods industry. Fintech is another example where changes are happening so quickly that we need to keep the regulators with us to deliver the best offerings and growth. Regulatory changes can affect 30 or 40 percent of your EBITDA, so you need to factor them in.

One aspect that is particularly important for slower-growth economies is productivity. Most people will need to work longer and in jobs that are going to be more technology-enabled. How do you find a productivity uplift? That could be as simple as higher employee engagement and lower attrition or new ways of working and upskilling.

Sean Brown: Next to shareholders, customers have long been the primary stakeholders that companies focused on. Would it make sense to start with them in terms of priorities?

Vivian Hunt: It is important to recognize the broad range of roles that a single customer may have. Customers may narrow or broaden how they engage with you over time. They are also citizens and taxpayers. They may have someone in their household who is a member of your supply chain. They also look at your community engagement—particularly in times of crisis—and loyal customers can become dissatisfied with your policy on environment or community engagement. So, it's important to recognize that any single stakeholder can be in multiple roles. Customers are a credible place to start, but if you only think about them in terms of price points and sale volume, then that is probably too narrow a lens.

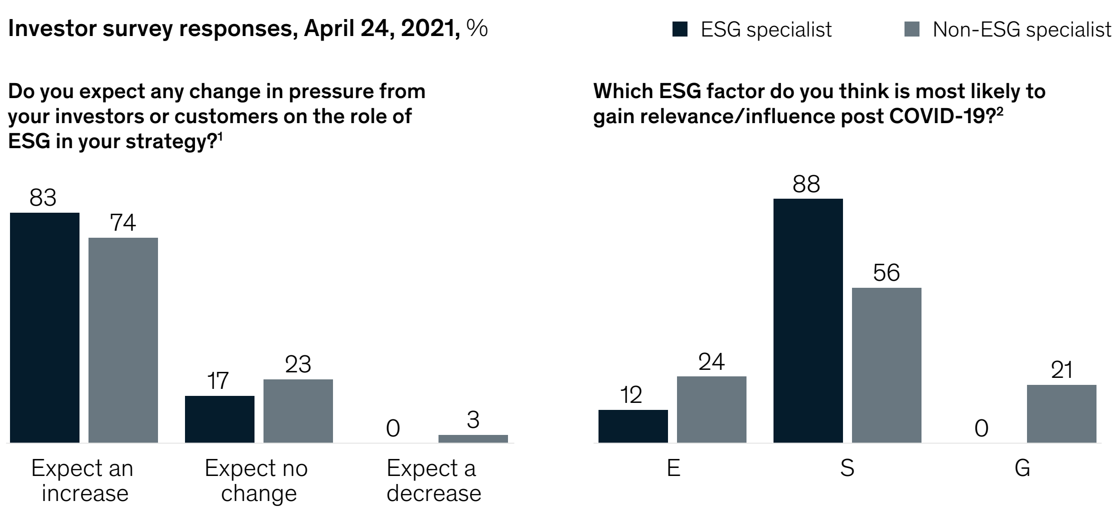
Sean Brown: The COVID-19 crisis put the societal issues higher on the corporate agenda. Has that affected companies' broader ESG strategies?

Vivian Hunt: None of us was fully prepared for COVID-19, but the issues it highlighted are not new. Now you have the time to plan. As Bruce pointed out earlier, priorities shift within the ESG agenda. The approach around "E" and sustainability is much more systemic today than it was five years ago. Now, building structure and capabilities around "S" is on many business leaders' minds, as well as on the minds of their employees and customers: Where am I spending my money or working? How is the company looking after its broader value chain? It's not to say that E or G is not important, but right now, a systematic approach to employee benefits, diversity, and community engagement are at the forefront (exhibit).

Exhibit

'S' is becoming increasingly material for ESG specialists.

Investor survey responses, April 24, 2021, %



[1]Environmental, social, and corporate governance.
[2]Figures may not sum to 100%, because of rounding.
Source: Procensus investor survey, Morningstar

Sean Brown: Should companies pick one area to focus on or ensure they cover all the ESG bases?

Vivian Hunt: There are minimum ESG practices that are about risk management and playing defense. Regulatory compliance would be the absolute minimum. Basic wage transparency is another element, as is having a robust approach to ESG. But there is a new normal at a much higher level of sophistication, and recognizing that the bar has risen is the first step. The second step is focusing on one or two things at one time. What distinctive things can you do that will grow the pie in terms of value and reputation?

Bruce Simpson: You touched on an important question, which is, "Where are we most vulnerable right now?" Tackling that is a must strategically. If, for example, the pay of frontline employees is so low they cannot put food on the table, you need to address that.

Sean Brown: Do you think companies have responsibilities to society in areas that may not directly affect them and their stakeholders?

Vivian Hunt: There are moral and cultural reasons as well. Issues like the wealth gap: what is the net disposable income of not just my employees but the households they are in? The impact of technology and the gig economy, even before COVID-19, has caused real wages to fall in some areas. Companies worry about investors pointing out CEO pay, but increasingly, those investors are looking at the differential—the spread between the highest and the average or lowest-paid workers.

Mental health is another pertinent example. Everyone, if they are honest, has struggled with their health, wellness, and productivity during the pandemic, and companies can do much about that, such as increasing the amount and flexibility of resources. We have a client that doubled their mental-health and wellness budget during the pandemic and has retained that increase. People self-manage and self-declare, but the company tracks, confidentially, and if someone seems to be struggling, they reach out to the employee. Gender participation and racial and cultural inequity are other massive sources of productivity leakage. My grandmother used to say, "If a pipeline is leaking, you don't blame the water." Business leaders have to ask themselves, "What is wrong with the pipeline? How can we build a stronger pipeline so we can keep women and historically unrepresented groups?"

Sean Brown: What about pitfalls in this arena? Are there specific missteps you have seen companies make as they try to embrace stake-holder capitalism?

Vivian Hunt: We encourage clients to learn from the experiences of others. Some companies, for example, announced bold goals: "We will try to increase women's participation to 30 or 40 percent of the company." But they didn't have a plan for getting there and were unable to meet those goals, causing the leaders embarrassment. If companies lead with messaging and PR, we will see them being held accountable. Media outlets are already doing indices tracking to see how well companies keep their promises.

Another potential pitfall is not building on your strengths. You cannot copy your competitors; you have to build on what Bruce calls your superpowers—the things you are uniquely good at that you want to be famous for. One other mistake I will highlight is not tracking short-term progress in addition to medium- and long-term gains. You need to break down your objectives. If you are working toward gender parity or mitigating your environmental footprint, that takes time. The markets and your stakeholders will be patient if they know you are making progress, so you must also have short-term objectives. No aspect of business is just "trust me and see." You need metrics and evidence along the way.

Sean Brown: Let's shift to the how. How should companies approach this journey of embracing stakeholder capitalism?

Bruce Simpson: It starts with exploring your world. Every company had a purpose when it was created, and that purpose went well beyond making a profit—profits were an output of delivering on its purpose.

Many companies may need to listen to that great past. As for the present, what is exciting to your employees? In a world where 70 percent of the workforce is not actively engaged, imagine the uplift if those people came to work not just bringing discipline and obedience but also creativity and collaboration. Then define your contribution: where are you most vulnerable? You have to bring your negative outliers at least up to the industry average, as Vivian mentioned.

Next, focus on your superpower. There's a common saying, "Where do your strengths overlap with the world's needs? Therein lies your vocation." You should focus on that vocation and embed it into the business. The embedding is very important because it makes it measurable and definable in ESG terms, and you had better embed it before you talk about it externally. "Purpose washing" criticism has come up recently, largely because companies make external pronouncements before they put their house in order to execute some of those initiatives.

When we do ESG teardowns for clients, we create a baseline. How do you stack up on the various metrics along the E, S, and G dimensions compared to your competitors? That shows you where you are strong and where you are weak. Vivian talked about diversity but only about half of US companies report on their diversity, so that will not be picked up by the ESG rating agencies. We then help clients define the sources of value—the biggest risks but also the opportunities.

Sean Brown: How do you make the corporate purpose meaningful to individual employees, beyond just communicating that this is what we stand for?

Vivian Hunt: We all want to have a sense of purpose in our work. Someone might ask you, "How could you possibly work at an oil and gas firm?" Well, if you want to mitigate and apply innovation to industries with heavy carbon footprints, you need smart people working there. The sense of team goals and working toward positive change results in more

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meaning for individuals. When employees' work aligns with their team's and their own sense of purpose, that leads to increased retention. Interestingly, the UK has a database tracking gender parity that more than 10,000 companies participate in. Its highest users are not the media but people applying for jobs who want to see how their potential employers stack up.

Bruce Simpson: To build on that, a survey we just did showed that 85 percent of senior executives feel they can live their purpose in their day-to-day work, but 85 percent of frontline workers do not, which means their purpose comes from something other than work. As a result, they probably are not bringing their best selves to work. How do you design frontline roles so that people's work aligns with their personal purpose and what excites them?

Sean Brown: You mentioned that there are ESG practices that are table stakes, but the bar is rapidly rising. What should companies do to get to that next level? Where should they start?

Bruce Simpson: Measure your current ESG footprint—that's crucial. Then discover the magic: What is the essential strength that you bring, which is understood and felt by your employees and stakeholders and everybody can get excited about? Then make that a strategic differentiating factor.

Vivian Hunt: I agree. Understanding, in collaboration with your stakeholders, where you are in concrete quantitative as well as qualitative terms and how your purpose is linked to your strategy is absolutely where I would start. From there, you make choices. You don't take on a full all-singing and all-dancing ESG strategy. You pick one or two areas where you can make a difference, develop capabilities, then expand from there.

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