Putting a price tag on corporate social responsibility

By Theo Varmaelen

INSEAD professor Theo Vermaelen makes his case for CSR equity carve-outs.

Corporate social responsibility (CSR) remains a misunderstood, sometimes controversial issue - in spite of the fact that numerous companies have adopted CSR policies. Critics of CSR programmes argue that a CEO who wants to do “good” should do so with his/her own money, not with other people’s money. For example, in 2009 Goldman Sachs gave US$1 billion to charity. This, however, was not shareholders’ money but employees’ money: the company stated it would give this money to charity at the expense of bonuses.

Doing good with shareholders’ money could be justified under two conditions. First, a business case can be made for the CSR initiative, i.e. because it can be seen as a smart public relations move, it can actually increase shareholder value. Second, the company should make it clear in advance to investors that the company’s objective is not simply to make money, but also to do good. This way the company will attract the right investor clientele. In this case investors will have no reason to complain that the company was dishonest about its corporate goals.

The business case for CSR

A company that states its concern for social responsibility issues such as the environment may attract consumers with a green conscience which will increase revenues. Like-minded workers who think it is important that their employer has a CSR policy will work harder and/or accept a lower salary than if the firm had no such policy. The CSR initiative may generate government subsidies or tax credits and prevent government regulation aimed at imposing CSR policies. And, finally, the cost of capital, or more precisely, the cost of equity, may go down.

To understand the cost of equity argument, think of the widely used capital asset pricing model, the model that says that the cost of equity is equal to the risk free rate plus a risk premium where the risk is measured by beta. The intuition is that people don’t like risk, so they require a higher return for taking risk. But suppose there are some investors who care about the company’s CSR rating. These investors would, ceteris paribus, require a lower rate of return, the larger the company’s CSR rating. So a company could create shareholder value through a CSR programme that attracts investors who are less financially demanding.

Note that some advocates of the business case for CSR (typically, asset managers promoting socially responsible investments) claim that stock returns of more socially responsible companies are higher, not lower, than other companies. They are implicitly assuming inefficient markets, i.e. the market only adjusts slowly to the fact that the company has become socially responsible. In an efficient market dominated by socially responsible investors, stock prices would rise around the announcement of the CSR policy but subsequent long-term returns would be lower. So far, the evidence of CSR on long run stock returns is inconclusive, perhaps because in order to do statistically meaningful tests you need very long test periods. Some studies show that more socially responsible companies are more profitable. However, there is a difference between correlation and causality: an alternative interpretation is that profitable companies have excess cash and can afford to waste more money on CSR initiatives.

Attract the right investor clientele through equity carve-outs

When Google went public, it announced it would give a certain percentage of its profits to charity. Investors could incorporate this information in the pricing of the stock and therefore would not be unpleasantly surprised by the transfer of company funds to charities. In other words, Google was transparent with its investors, a condition for ethical behaviour. The problem is with how to move unexpectedly to a CSR policy that may lower shareholder value after the company has gone public. For example, an oil company may be under pressure from some of its shareholders to move into alternative energy, although the management of the firm and the majority of the shareholders strongly believe these are negative net present value (NPV) projects. Specifically, the Wall Street Journal reported in May 2008 that the Rockefeller family was putting pressure on ExxonMobil's CEO to move into alternative energy and show more concern about global warming. According to the Wall Street Journal, one of the main motivations was "to remove the stain of oil from the Rockefeller name". ExxonMobil's CEO was reported to resist the move because he believed the majority of the shareholders wanted the company to stick to its core business, oil and gas.

I believe the solution here is the equity carve-out. In an equity carve-out ExxonMobil would set up a separate subsidiary devoted to alternative energy. The subsidiary would have its own management and stockholders which would include the parent company that would be granted a controlling stake in the subsidiary. The actual funding for the subsidiary would come from new investors who believe in alternative energy for economic or non-economic (green conscience) reasons, such as the Rockefeller family. The result would be that if the alternative energy subsidiary fails, all the losses will be borne by the new investors. If the initiative succeeds most of the gains will accrue to the new investors, but also to the investors of the parent company through their controlling stake. Moreover, to the extent that this move will be perceived favourably by the customers and employees of the parent company (i.e. as argued supra) such that additional benefits may accrue to the shareholders of the parent company.

As a final example of a (potential) equity carve-out driven CSR policy, take the case of McDonald's Corporation. Although McDonald's has a market capitalisation of $75 billion (which is about 6 times book value), it feeds 50 million people a day, it employs 400,000 workers and it paid US$2 billion taxes last year, it is often the target of environmentalists and CSR advocates. In an attempt to respond to this criticism Mc Donald's Japanese subsidiary launched a campaign "Saving the Earth, One Big Mac at a Time": it offered to sell hamburgers at half-price to any client that signed a pledge to fight global warming. If this activity was simply a smart marketing move (selling products below costs initially, to attract new consumers who will pay the full price later on) then of course this initiative is consistent with shareholder value maximisation. On the other hand, if this was a shareholder value-destroying activity, an argument could be made that this initiative should have been financed by a specially designated CSR subsidiary that raised money from investors who believe in man-made global warming – call it "McEthics." This way the company would respect the trust of the investors in the parent company who bought shares in McDonald's because they believed the company promised to maximise shareholder value.

From CSR to EDP

I believe a lot of misunderstanding about CSR is the result of the emotionally heavily loaded term "social responsibility". It gives the impression that firms who do not have a CSR program are socially irresponsible. But for me it is difficult to understand why a company such as McDonald's, that creates hundreds of thousands of jobs around the world, provides a product that people want to buy and makes a profit, and pays billions in taxes doing it, is less socially responsible than the wind farm producer who plans to put hundreds of ugly wind turbines along the beautiful coast of Normandy and Brittany, who has to be subsidised by taxpayers' money and who increases energy bills for all French people, rich and poor alike.

I would therefore propose a name change: don't call it Corporate Social Responsibility but Externalities Driven Policies. Some of these policies create shareholder value and others don't. But by being transparent, not only to customers and workers, but also to shareholders, a lot of the antagonism that exists today between proponents and opponents of CSR could be avoided.

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