THE COSTS AND BENEFITS OF CALCULATING THE NET PRESENT VALUE
of Corporate Diplomacy

By Witold J. Henisz
Deloitte & Touche Professor of Management
The Wharton School, University of Pennsylvania

Witold J. Henisz is the Deloitte & Touche Professor of Management in Honor of Russell E. Palmer, former Managing Partner at The Wharton School, University of Pennsylvania. He received his Ph.D. in Business and Public Policy from the Haas School of Business at University of California, Berkeley. His research examines the impact of political hazards on international investment strategy including efforts by multinational corporations to engage in corporate diplomacy to win the hearts and minds of external stakeholders in support of their organizational mission.

KEYWORDS

- STAKEHOLDER ENGAGEMENT
- CORPORATE DIPLOMACY
- COSTS AND BENEFITS
- FINANCIAL RETURNS
- NET PRESENT VALUE

This article aims to demonstrate how social, political and environmental risk management can be integrated into a financial framework. To do so, corporate diplomats must use the same tools and performance indicators that their counterparts in operations, marketing or finance use. The financial valuation, both in terms of avoided cost and net value added by acceptability strategies appears to be a necessary condition to have them leave their siloes and gain acceptance across an organization.

INTRODUCTION

Despite the mounting evidence that understanding and addressing the concerns of external stakeholders such as government officials, regulators, communities and NGOs is a critical driver of strategic success for companies, particularly in emerging markets, there remains a widely held perception that such efforts constitute a giveaway of hard-earned returns that management will come to regret in the future. These operationally- or financially-minded critics view the "tree-huggers" sitting together in the executive dining room as temporary invaders on their terrain whose influence the company will soon regret. They view the CEO's commitments at Davos and other international events to be unfunded liabilities.

The voice of such critics strengthens during periods of cost pressure or intense competition when managerial attention is focused on cost efficiencies and potential low-impact redundancies. In recent years, as the price of minerals and oil and gas have plummeted, investments in stakeholder relations previously argued to be essential to generate value from risky deposits and fields have been slashed. Staff in government affairs, community affairs and sustainability have borne far more than their share of cutbacks.

A common pattern emerges in which managers begin with an overly optimistic forecast for a new investment that ignores the full range of concerns of and potential costs associated with external stakeholders. The investment is approved and the true nature of reality is slowly realized. Additional costs will have to be borne, additional concessions made to external stakeholders and the pace of investment will have to slow. Often, the revised returns remain profitable and the company's revised strategy includes many of the elements of corporate diplomacy. However, when prices come under pressure and, especially, when a *new leadership team arrives, these investments and changes in plan are viewed with scepticism. They are compared explicitly or subconsciously to the original plan which promised far greater returns with lower up-front costs. No matter that the original plan was naïve in its assumptions and impossible to realize on the stakeholder landscape that existed in reality. New managers want to prove themselves to be adept at the turnaround and to right the ship that has strayed off course and must be seen to do so quickly. They slash the add-on investments and headcount of staff in the corporate diplomacy functions. In so doing, they reduce the long-term value of the asset but show a short-term improvement in the financial balance sheet. By the time the true costs of their short-sighted management strategy is revealed, they have likely moved on to their next position.*

It is absolutely critical to guard against such short-term pathos that corporate diplomats be able to prove the net present value of their investments. It is not enough to tell stories or point to historic write-offs. They need to be able to calculate using the same tools, key performance indicators and financial models that their counterparts in operations, marketing and finance use that their investments are not "nice to haves" but are core to the long-term value of the asset.

1. THE NEED FOR CORPORATE DIPLOMATS TO EMBRACE THE DOMINANT LOGICS OF THEIR ORGANIZATIONS

In order to survive business downturns, the corporate diplomat must successfully integrate their insights and value proposition into the dominant systems and logic that drive business decision-making. They must abandon hopes of transforming or supplementing the existing systems or convincing their peers of the virtues of corporate diplomacy as an end in and of itself. Instead they must accept the dominant logics of their organizations and embed corporate diplomacy within them.

1.1. THE USE OF DISCOUNTED CASH FLOW (DCF)

Put simply, to win workplace arguments involving the allocation of scarce funds for material investments and payroll, you must quantify your evidence in terms of the return on those investments. Companies use discounted cash flow (DCF) analyses to evaluate potential investments, consumer surveys to assess new products and click-through studies to track online ad campaigns. Stories matter too — we humans are storytellers and make sense of the world by shaping facts into narratives. But stories alone will not convince colleagues — unless those stories are supported by numbers.

Corporate diplomats too often ignore numbers. They assume that moral appeals or dire prophecies will sway colleagues. Those can help. Companies care about right and wrong, and we all learn from mistakes. But those alone will not beat spreadsheets, and they will not build company wide support for stakeholder engagement, especially in times of tight budgets. In an influential review of Newmont Mining's social responsibility practices, law firm Foley Hoag wrote that engagement is still seen as "voodoo" by professionals from other fields[1]. Marketing and human resources departments have embraced the tools of the social sciences to improve the precision of their analyses and to make their cases more convincing to colleagues. Corporate diplomats must follow, quantifying costs and benefits and providing credible estimates of how their programs can yield financial returns.

A DCF analysis is the standard way of making that sort of estimate. The term may seem forbidding, but anyone who can plug numbers into a spreadsheet and understand what those numbers mean can learn to do a DCF analysis. A day-long seminar will teach the basics. As a bonus, you will learn that the estimates emanating from the finance department are not as precise as they seem; the final number, positive or negative, depends partly on the assumptions. One of the key assumptions is where you draw the line on counting costs and benefits. It is simpler to look at direct short-term costs and benefits, and short-term estimates are typically more accurate.

In the construction industry, advocates of investing in energy conserving design and materials were originally stymied by a convention to focus the DCF analysis only on the period of construction and not on subsequent operation. Poorly insulated structures will typically be cheaper to build, but, on account of the greater need for air conditioning and heating, more costly to operate. Until the convention shifted from pricing buildings based on their lifetime operating costs, the green building movement struggled to go beyond principled rhetoric, while study after study showed that customers were choosing poor designs. The introduction of life-cycle cost accounting transformed practice, not because it changed the facts but because it empowered key decision-makers in finance and accounting to take those facts into consideration.

A similar revolution is underway in addressing the environmental costs of production of goods and services. Companies such as furniture maker Herman Miller, IT services provider SAP, and retailer Walmart, have found that efforts to reduce waste and resource use yield high economic and social returns. The Economist Intelligence Unit[2] highlighted the successes of these companies and others:

- Forrester Research found that Herman Miller's efforts to improve sustainability generated a 32% annual return on investment;
- Walmart's calculations revealed that a 5% reduction in packaging would translate into $11 billion of cost savings, of which it would capture $4.3 billion;
- 3M saved $1.7 billion through its pollution prevention pays (3Ps) program since it was introduced in 1975. The program seeks to prevent pollution upfront by reformulating products, manufacturing processes, redesigning equipment, and recycling and reusing waste from production;

1 See G.A. Smith and D. Feldman, Newmont Community Relationships Review (Washington, DC: Foley Hoag LLP, 2009; www.beyondthemine.com/pdf/CRRGlobalSummaryFULL-EnglishFINAL.pdf, accessed December 10, 2013).

2 Economist Intelligence Unit, Corporate Citizenship: Profiting From Sustainable Business (London: The Economist, 2008).

- FedEx aims to convert its entire 35,000 vehicle fleet to electric or hybrid engines. To date 20% have been converted, which has already reduced fuel consumption by over 50 million gallons;
- Procter & Gamble seeks to create an estimated $20 billion new product line in detergents that are effective in cold water.

Corporate diplomats must embrace the DCF analyses that many of them have long decried for not incorporating the true costs and consequences of short-term business decisions. But their DCF analyses will encompass not only longer (and thus more realistic) periods, but also secondary costs and benefits related to the stakeholders they have long championed. Sceptics will always argue that it is cheaper to ignore community complaints. They can do this successfully only if the data available shows short-term costs and ignores long-term benefits. Imagine a similar debate ten years ago at Walmart about reducing packaging or at FedEx about reducing fuel. Progress requires that someone makes a business case using the same tools and models that went into decisions to purchase computers, buy planes or build warehouses. Once corporate diplomats can calculate the likelihood of continued confrontation with stakeholders, and the costs and lost opportunities that confrontation brings, costs and benefits will look very different.

"ONCE CORPORATE DIPLOMATS CAN CALCULATE THE LIKELIHOOD OF CONTINUED CONFRONTATION WITH STAKEHOLDERS, AND THE COSTS AND LOST OPPORTUNITIES THAT CONFRONTATION BRINGS, THE COSTS AND BENEFITS OF ACCOMMODATION WILL LOOK VERY DIFFERENT."

1.2. JENSEN'S WORK: INTEGRATING STAKEHOLDER COSTS AND BENEFITS INTO TRADITIONAL DCF MODELS

They can then break down the barrier between those who emphasize shareholders and those who stress stakeholders. One of the academics who has done the most to champion a shareholder focus within corporations is Michael Jensen of Harvard Business. Yet in a 2002 paper [3], Jensen said: *"We cannot maximize the long-term value of an organization if we ignore or mistreat any important constituency. We cannot create value without good relations with customers, employees, financial backers, suppliers, regulators and communities."* He argued, though, that without means to translate the costs of mistreatment into firm value, stakeholder theory fails to give concrete guidance to managers. Instead, he proposed "enlightened value maximization" as a decision-making criterion, and argued that it was identical to an "enlightened stakeholder theory." Jensen said that managers should *"spend an additional dollar on any constituency provided the long-term value added to the firm from such expenditure is a dollar or more"*. In essence, the challenge that Jensen presented to corporate diplomats is how to incorporate stakeholder costs and benefits into the traditional DCF models, which omit them.

3 M. Jensen, "Value Maximization, Stakeholder Theory and the Corporate Objective Function," Business Ethics Quarterly 12 (2, 2002): 32-42.

The IFC, in partnership with the Norwegian Ministry of Foreign Affairs, Deloitte, The Multilateral Investment Guarantee Authority (MIGA), Rio Tinto and Newmont Mining, has developed a freely available online net present value (NPV) project management tool that rises to the challenge posed by Jensen. It can be downloaded at www.fvtool.com[4].

"OUR TAKEAWAY: ANY CASH FLOW PROJECTION THAT DOES NOT INCORPORATE THE COSTS OF STAKEHOLDER CONFLICT IS AS INADEQUATE AS ONE THAT OMITS COMMERCIAL OR TECHNICAL RISKS."

2. MANY EXISTING STUDIES DEMONSTRATE THE POSITIVE ASSOCIATION BETWEEN SOCIAL AND FINANCIAL PERFORMANCE

Increasingly, company- or project-level evidence shows that numbers support the case for stakeholder engagement and that companies that ignore outside stakeholders do so at their peril.

2.1. THE COST OF IGNORING STAKEHOLDER ENGAGEMENT

A 2009 Goldman Sachs study[5] examining the largest capital investment projects in the world highlighted that the time for new projects to be completed doubled between 1998 and 2008. More delays were caused by stakeholder and sustainability problems (70%) than commercial (63%) and technical (21%) ones. On average, the largest 230 projects in 2009 were 20 months behind schedule and 135% over budget compared with the 2006 forecasts for these same projects. Work by Ed Merrow at the Independent Project Association comes to a similar conclusion. Projects that score best in what he calls "front end loading" (i.e., up-front definition of the project including the mechanisms to manage conflicts between stakeholders' objectives and goals), come in on budget and on-time whereas those that score poorly are 26 months late to completion and over 50% over budget. A 2012 Accenture study[6] of the projects in mining and metals likewise found that two-thirds were more than 25% over budget and that regulatory and stakeholder-related issues accounted for nearly half of the delays.

Similarly, in a study[7] with Sinziana Dorobantu and Lite Nartey, I found that, for the 19 publicly traded gold-mining companies, the amount by which investors discounted the cash flow projections of a mine was highly correlated with the degree of stakeholder conflict or cooperation. We were able to estimate DCFs for the 26 mines owned by these companies. If investors and analysts had ignored stakeholder opinions, then the market capitalization of these firms should have equaled the NPV of their future cash flows.

What we found differed starkly. The average firm had a market capitalization equal to only 22% of its DCF projections. In other words, when these companies told investors that they had discovered gold that would generate $1 billion of new value, investors increased the companies' average market capitalization by only $220 million. Next, we coded over 20,000 newspaper articles, which contained over 50,000 reports of stakeholder actions or statements that connoted conflict or cooperation. We coded each of these stakeholder events on a conflict–cooperation scale and found that amount of the investor discount was strongly correlated with our conflict–cooperation measure. When we adjusted the DCF projections using our measure as a proxy for higher costs or lower revenues, we found that the investor discount ranged from a high of 99% for firms with the worst stakeholder conflict to as low as 13% for companies with the highest levels of stakeholder cooperation. This finding demonstrates that investors and analysts tracking a stock are monitoring the media and updating their estimates of cash flow, the opening dates of new mines, and company costs, based upon stakeholder actions covered in the press. The long-standing complaint by managers that investors do not pay attention to their efforts simply does not stand up. Our takeaway: any cash flow projection that does not incorporate the costs of stakeholder conflict is as inadequate as one that omits commercial or technical risks.

While the magnitude of the returns to corporate diplomacy that we found in our sample of publicly traded small capitalization mining companies is certainly above the average available to most firms, other studies have corroborated the finding of consistent positive returns. These include Eccles, Ioannou & Serafiem (2011) who found that a basket of leaders on environmental and social performance financially outperform a basket of laggards by 4-6% per annum. Schnietz and Epstein (2005) and Albuquerque, Durnev and Koskinen (2014) show that firms with higher environmental and social performance are less susceptible to risk and crises with the latter study finding a reduction in β of up to 4%.

As a result of these benefits on average and in crises, better performing firms have a 40-45 basis point advantage in costs of finance (Schneider, 2011; Oikononmou, Brooks & Pavelin, 2011; Goss & Roberts, 2011) and are more likely to receive an investment grade rating (Goss & Roberts, 2011). Consumers reward such companies with higher sales growth and price premiums (Haimueller & Hiscox, various) and higher retention rates (Du, Bhattacharya & Sen, 2011). Workers in these firms are more productive (Tonin & Vlassapoulos, 2014), less likely to quit (Vitaliano, 2010), willing to work for a lower wage (Burbano, 2014) and are more engaged in their jobs (Wong, 2011; Grant, various).

4 A similar approach is advocated by T. Bekefi and M.J. Epstein "Integrating Social and Political Risk into Management Decision-Making" (Mississauga ON: The Society of Management Accountants of Canada & New York, NY: The American Institute of Certified Public Accountants), 2006.

5 Goldman Sachs Group, 230 Projects to Change the World, 2009 (www.borsaitaliana.it/bitApp/view.bit?lang=it&target=StudiDownloadFree&filename=pdf%2F78052.pdf, accessed December 13, 2013).

6 See Accenture, Achieving Superior Delivery of Capital Projects: Accenture Global Survey of the Metals and Mining Industry, 2012 (www.accenture.com/SiteCollectionDocuments/PDF/Accenture-Capital-Projects-Report-Metals-Mining.pdf, accessed December 10, 2013).

7 W.J. Henisz, S. Dorobantu and L. Nartey, "Spinning Gold: The Financial and Operational Returns to External Stakeholder Engagement," Strategic Management Journal (in press 2014; http://onlinelibrary.wiley.com/doi/10.1002/smj.2180/abstract, accessed December 10, 2013).

2.2. INCREASING AWARENESS EVEN IN THE FINANCIAL SECTOR

In the financial sector, where skepticism is relatively strong, the evidence of a positive association between environmental and social performance and financial performance continues to mount. Surveys of financial institutions reveal that as much as 10% of all credit losses involved environmental issues (Scholz et al., 1995). One German bank's rollout of stronger Environmental Social Risk Management (ESRM) practices reduced error in risk classification by 23% (Weber et al., 2010). Companies that receive credit from banks with stronger ESRM practices outperform peers on stock market (Aintblain, 2007). Environmental concerns are associated with a higher cost of debt financing and lower credit ratings whereas proactive environmental practices are associated with a lower cost of debt (Bauer & Hann, 2010). Banks also face a large and growing number of lawsuits of financial institutions for environmental liabilities (Coulson & Dixon, 1995). 14% of all US commercial banks incurred clean-up costs on property held as collateral and 46% have suspended lending to certain sectors with high potential liabilities (Jeucken, 2001).

As a result, financial institutions with stronger environment and social risk management practices are found to enjoy higher ROA and lower loan losses (Simpson & Kohers, 2002), higher ROA and growth in assets (Hu & Scholtens, 2012), faster growth and stronger performance in Lebanon (Elie, 2011) and India (Hossain & Reaz, 2007). Their ESRM practices service as a signal of quality to peers, lenders and investors (Schotlens & Dam, 2007) attracting less price sensitive customers (Matute-Vallejo et al., 2010) and helping them to gain market share and suffer fewer NGO attacks (Watchman, 2005) as well as higher yield spreads especially over longer maturities (Coleman et al., 2006).

The importance of Environmental and Social Governance is now recognized and highlighted by the largest financial investors including Larry Fink, Chairman and Chief Executive Officer of BlackRock: *"Investing in innovation and future production, developing talent and ensuring robust supply chains are among the many environmental, social and governance (ESG)- related management actions that enhance a company's ability to generate long-term financial returns. Businesses that fail to make sufficient investments in the future can doom themselves to irrelevance."*

In 2015, BlackRock entered into a partnership with Ceres to develop a novel integrated approach to considering ESG factors as part of a long-term investment strategy. Ceres President Mindy Lubber notes: *"21st century companies and their shareholders are facing an increasing array of ESG challenges that can affect business and investment results. Climate change, water scarcity, community conflicts, resource depletion, supply chain breakdowns,*

worker well-being and economic inequality, coupled with instantaneous communication, can all present material risks and opportunities to businesses. Sustainability has become an imperative for successful corporations, and a variety of studies have shown that companies with strong sustainability cultures outperform their laggard peers. The business case for integrating ESG issues into mainstream investment practices has never been stronger. More than ever, investors are actively engaging with their portfolio companies on ESG issues as part of their fiduciary duty and also to protect the long-term value of their assets."

As a result of this collaboration, BlackRock seeks novel mechanisms to consider the strategic impact of ESG factors for long-term value: *"We actively seek to integrate environmental, social and corporate governance issues into our investment process. We believe that ESG factors are often a signal of management quality, particularly over the long term. The CGRI team partners closely with colleagues in BlackRock portfolio management to help raise awareness of potential risks, such as exposure to companies that are more likely to face litigation or reputational harm as a result of poor management of the impact of their operations on the environment or society."*

BlackRock is not alone. According to a PRI survey, while 57% of CEOs believe that their sustainability reports set out the business case for environmental and social governance and 38% believe they quantify the returns to these investments and 47% recall discussing them on quarterly earnings calls, the investors covering these firms have a very different perception. Only 9% are satisfied with current reports' ability to set out a business case. Only 7% believe that business case includes a quantification of returns and only 27% recall the senior management discussing these topics on quarterly earnings calls. 82% want better information from companies on how environmental and social risks are identified and quantified in financial terms (PwC).

3. CAPTURING THE BUSINESS VALUE OF SUSTAINABILITY

Hopefully, the pressure imposed by BlackRock and other investors in quarterly earnings calls to explore the link between ESG practices and long-term value will lead to a shift not only in company-level reporting but, more importantly, in management practices. The shift will take time and substantial effort. Gathering data needed for a specific DCF analysis is, of course, harder than talking about its importance or highlighting the benefits of doing it well. Doing so demands an upfront investment of scarce personnel time and requires support from bosses.

3.1. STARTING WITH EASY-TO-QUANTIFY DATA

You do not have to do an exhaustive analysis on the first attempt. Start small, gathering the easy-to-quantify data and feeding that into the early estimates. Build from there. A 2013 Accenture study[8] surveying CEOs on sustainability highlights the potential benefits of even simple approaches: 63% of CEOs surveyed believed that sustainability would transform their industry within five years, and 76% believed that embedding sustainability into core business functions would drive revenue growth and new opportunities. But the CEOs also reported that they struggled to *"quantify and capture the business value of sustainability."* 37% of them reported that this lack of a clear link to business value was hindering further action.

3.2. EXAMPLES OF MAIN RELEVANT DATA

Among the readily quantifiable costs that one will want to include are:

- Direct costs, including staffing, capital investments and raw materials both initially and over a project's life
- Overheads or other hidden indirect costs

One should also consider the less obvious cost reductions and revenue enhancements that a project might generate. Possibilities are:

- Revenue lost (gained) due to:
  - Lower (higher) consumer willingness to pay
  - Production stoppages or delays (accelerations in the timeline)
  - Ease of entry into markets due to new government regulations or policies that respond to opponents' (supporters') pressures
- Staffing expenses, including:
  - Managers to oversee engagements after a conflict
  - Engineers to redesign controversial plans and government affairs or regulatory staff to repermit after redesign
  - Guards to protect personnel and property when tempers flare
  - Lawyers and lobbyists to provide representation in proceedings or investigations
  - Higher training and recruitment costs as well as retention costs at corporate sites that have seen conflicts
- Insurance, risk management and compliance expenses, including fines and penalties
- Depreciation for property, plant and equipment (PP&E) that goes obsolete during delays and repairs for PP&E damaged during conflicts
- Higher PR expenses stemming from particular disputes

Many corporate diplomacy initiatives become easy to justify once their direct benefits and costs have been accurately measured and tracked. With accurate data, they become analogous to the well-known cases where expenses incurred in reducing waste delivered quick paybacks through lower costs for supplies, packaging and disposal. Many more corporate diplomacy initiatives may generate positive returns once their indirect benefits are considered, though indirect benefits will always be difficult to pin down.

CONCLUSION

The real benefits to this process for companies, however, will not be in merely calculating a return on investment or satisfying the demands of external investors. Certainly, those are important short-term goals. What happens next within the company will be far more important. Quantifying financial benefits helps to show how intelligent measurement and tracking can improve the effectiveness of engagement and how the benefits of diplomacy flow to the bottom line. This transforms the dialogue about corporate diplomacy from one in which sceptics demand a justification for current costs to one in which they work with corporate diplomats to jointly identify new opportunities to create value.

It transforms the management of corporate diplomacy from a peripheral "nice to have" to a core strategic concern of the entire senior management team. Showing colleagues that corporate diplomacy can create financial value will turn some sceptics into evangelists, who return to their departments and lobby on behalf of corporate diplomacy. Their employees, in turn, begin to explore for shifts in management practices or strategies or entirely new practices that address the concerns of external stakeholders and deliver shareholder value. Suddenly, innovations emerge in operations, finance or security as well as government affairs, communications or sustainability. The act of using a common model and toolkit creates an artefact around which cross-functional collaboration and problem solving can readily mobilize. The act of calculating the "net present value" finally allows the discussion to get beyond whether the net present value is positive or negative and onto the collaborative exercise of pursuing enlightened self-interest for shareholders and stakeholders alike.

8 Accenture, The UN Global Compact-Accenture CEO Study on Sustainability 2013: Architects of a Better World (www.accenture.com/Microsites/ungc-ceo-study/Documents/pdf/13-1739_UNGC%20report_Final_FSC3.pdf, accessed December 10, 2013).