Imperial College Business School | Leonardo Centre on Business for Society

Corporate Sustainability and Shareholder Returns: The Role of Business Impact Maturity

Executive Summary

This report tackles the well-known question of the relationship between (social and environmental) company sustainability performance, and shareholder returns. Despite several decades of scientific studies on the question, there is still little consensus on the nature (correlation or causality?), the sign (positive or negative?) and the direction of causality (which causes which?) in this relationship. Moreover, ESG (Environment and Social Governance) ratings are known to provide a poor, subjective evaluation of company sustainability performance.

The novelty of our approach consists in the explanation of financial performance as a function of the type of sustainability initiatives put in place by companies. The fundamental assumption is that specific types of sustainability behaviour will have a positive influence on shareholder returns, other behaviours will have no appreciable influence, and others will have negative influence. The same approach has been successfully applied to the study of environmental performance.[1]

The implication of our approach is that the quest for the relationship between financial and sustainability performance, which dominated the scientific, business, finance, and policy debate for decades, becomes a lot less relevant. What really matters is to understand the drivers of both dimensions of performance, especially those related to the type of sustainability initiatives that companies are willing and able to launch. To this end, we develop the concept of **Business Impact Maturity (BIM)**, which is defined as *the progressive alignment of business purpose, strategy, structure and culture to the creation of systemic wellbeing through stakeholder integration and ecosystem partnership capabilities*.

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In other words, we assume that the development of sustainability strategy in response to the evolving stakeholder expectation is necessary but not sufficient.

It is the progressive convergence and integration of stakeholders' interests and voice with the company strategic processes, governance structures and shared beliefs that really matters. Our approach borrows from the concept of maturity proposed by developmental psychology, which includes (at lower levels) the appropriateness of behaviour vis-à-vis societal expectations, but then eventually expects more mature individuals to be able to align what they know is appropriate with their own values and with the purpose they give to their own life. Similarly, businesses are expected to go beyond aligning with stakeholder and societal expectations, and progressively integrate their voice in the way corporate purpose and identity are expressed in decisions and behaviour for systemic wellbeing.

Empirically, we test this set of ideas using our unique **GOLDEN Sustainability dataset** of about **1 million** initiatives identified with NLP (Natural Language Processing) algorithms in about **50,000 reports** issued by **12,000 companies** (including about 2,000 privately held ones) from more than 60 countries, over about 3 decades. We use the behavioural characteristics of these initiatives together with the group of strategic stakeholders that the initiative aims to benefit or satisfy. We expect that the larger the proportion of strategically relevant (high maturity) initiatives, such as new product development and organisational change, the more positive the risk-adjusted returns to shareholders are, vis-à-vis unweighted market returns. By the same token, the higher the advocacy nature (low maturity) of such initiatives, the lower the risk-adjusted returns in absolute terms and relative to unweighted market returns. Markets should reward companies that prioritise strategic action over reputational action. We test these expectations by analysing the risk-adjusted returns (Sharpe ratios) of portfolio signals constructed with 983 North American and European companies over 13 years and find robust support. Sharpe ratios of portfolio signals related to strategically relevant initiatives grow from 0.628 (with low presence of such initiatives) to 0.753

[1] Cenci *et al.*, *Nature Communications*, 2023

(high presence), much higher than the unweighted market returns of the same portfolio (0.64). **This translates in a 2.67% excess, risk adjusted, yearly returns, or 40,58% cumulative excess returns over the 13-year observation period**.

On the contrary, ratios of portfolio signals related to advocacy initiatives fall from 0.704 (low advocacy) to 0.64 (high advocacy). This means that the higher the presence of companies focusing on advocacy behaviour in the portfolio, the lower the risk-adjusted returns.

Finally, the **risk** connected to the high strategic relevance and low advocacy initiative portfolios (both related to higher maturity behaviour) is lower than the risk associated with their high advocacy (low maturity) alternatives. This implies that **there is no risk premium to be paid for higher return portfolio signals related to high maturity and low advocacy actions**. It is also worth noting that these results, on superior returns and lower risk levels, are confirmed also in comparison to some of the most widely used ESG ratings, including LSEG (formerly Refinitiv). This report then builds on the results of the financial returns analysis to introduce a broader approach to assess a company's BIM level on a 5-level scale, key dimensions related to purpose, strategy and organisation. The five levels are defined on the basis of the way a company's leadership responds to, and consequently acts on, two fundamental questions:

1. **What type of value do we want to create in this company?** The answer varies from a narrow focus on economic value to a progressively broader notion of well-being, which includes also psycho-physical, social/environmental, and personal development dimensions of well-being.
2. **Who does the company aim to create that type of value for?** Again, the answer can vary from giving primacy to a single group of stakeholders to a progressively broader typology of stakeholders. Importantly, there are also increasingly mature ways to create value for the chosen group(s) of stakeholders, with a progressively more open and integrative approach to involve them in strategic, innovation and, eventually, governance processes.

The responses to these and related questions on the various aspects of strategy (innovation, cooperation, marketing and growth) and organisation (governance, incentive and control systems, leadership models, culture) define a distinct logic of enterprise corresponding to a given maturity level. They range from a shareholder focused (1), to a risk- focused (2), a sustainable (3), a regenerative (4) and finally a systemic (5) logic of enterprise. Note that, the fact that about 50% of sustainability initiatives are advocacy-oriented means that most companies are in the first two levels. The regenerative, and especially the systemic, logic of enterprise are currently aspirational (at best) and far from being realised for all but a handful of established companies.

What does the combination of the empirical evidence unearthed, and the conceptual development of a comprehensive maturity model imply for businesses, investors, and policymakers? We propose a detailed answer to this question in the Implications section of this report. Concisely, however, we wish to point you to the following takeaways:

- **For business leaders.** There is clear evidence that only some specific types of sustainability initiative contribute not only to improve the company's environmental impact, but the risk-adjusted returns to shareholders. Moreover, we are starting to understand what the fundamental adaptations to the way the company operates are to move to the next level of impact maturity, irrespective of the current stage of maturity.
- **For investors.** The results of the various portfolio analyses with different sorting logics (low, medium, and high levels) related to Advocacy, Preparation and Transformational type of sustainability behavioural signals speak by themselves. They show how important a systematic assessment of corporate sustainability behaviour is to improve both the returns, and the risk profile of the portfolios constructed to add to the standard factors considered (we use the 3-factor model by Fama & French) the additional explanatory and predictive power of sustainability activity.
- **For policymakers.** The implications for the design of positive and negative incentives in public policy interventions are profound. There is now the concrete possibility to design micro-founded sustainable development policies leveraging on the knowledge of what type of business actions are virtuous for the company's stakeholders, including investors, customers, employees, business partners and social communities. This will dramatically enhance both business acceptance and the overall impact of the policy interventions.

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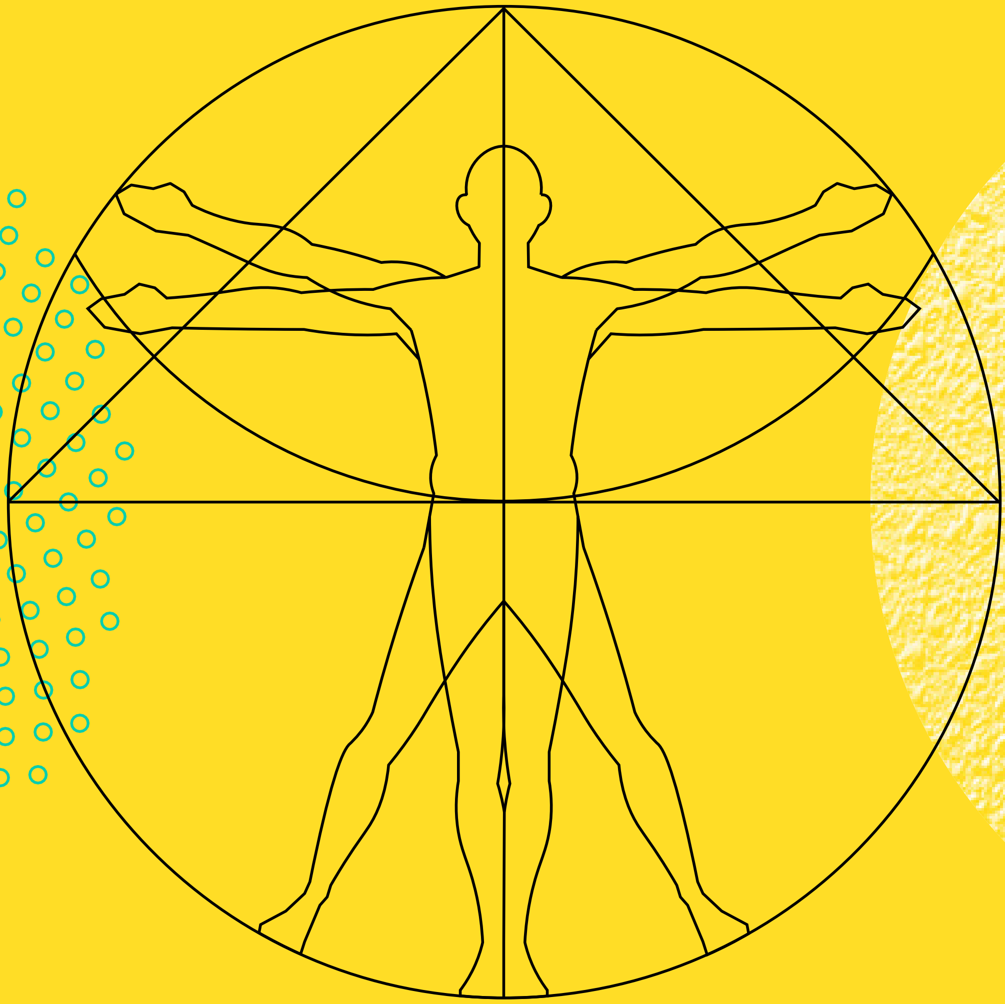

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