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LIGHTS - Sustainability

Navigating business resilience in turbulent times: Integrating extra-financial value for strategic success

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Anna SOUAKRI & Damien FORTERRE
ESCP Business School

ESCP RESEARCH INSTITUTE OF MANAGEMENT (ERIM)

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Unveiling the potential of key value indicators in enhancing strategic decision-making and stakeholder acceptability

Anna Souakri*
Damien Forterre**

ESCP Business School

Abstract

How to reconcile financial performance and ecological and societal commitments? Under societal and regulatory pressure, firms must navigate turbulent times and create value for their stakeholders and the environment while maintaining competitiveness. The Corporate Sustainability Reporting Directive (CSRD) in Europe, effective as of January 2024, requires them to evaluate extra-financial value reflecting their broader impact across their ecosystem and its stakeholders. While some activists argue that financial performance and extra-financial value are irreconcilable – exemplified by recent laws in Texas and Florida banning state ESG investing – we introduce alternative extra-financial value indicators complementing financial ones, and analyze their relationships on a panel of 126 firms to shed light on this apparent dichotomy. By evaluating how extra-financial value influences financial performance, firms can make more informed strategic decisions to reach the optimal configuration. In this way, they can conjointly meet extra-financial commitments and financial performance, and turn a regulatory constraint into an strategic opportunity enhancing competitiveness.

Keywords: Strategic Value Alignment; Extra-Financial Indicators; Integrated Performance; Stakeholders Acceptability; Value-Driven Strategy

*Professor, ESCP Business School and Researcher at Square Management
**Professor, ESCP Business School

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Why do firms benefit from measuring value ?

The Corporate Sustainability Reporting Directive (CSRD) sheds light on previously overlooked extra-financial outcomes, such as diversity initiatives, workforce satisfaction, biodiversity preservation, and anti-corruption efforts. Its dual materiality underscores the need to analyze the reciprocal relationship between companies and stakeholders by integrating both extra-financial and financial value into a comprehensive performance model. This presents an opportunity for companies to assess the alignment of their strategy with the value they aim to create and for who. Value becomes a strategic focal point, transcending the mere alignment with financial performance and encompassing all impact issues and stakeholder contributions.

Central to this is the question of valuing the extra-financial: determining whether and to what extent extra-financial assets and outcomes influence the financial performance of companies. This approach can provide firms with competitive advantages by evaluating comprehensively their strategic capacity (extra-financial resources & competences such as innovation or intellectual capital), showcasing their contribution to the eco-societal transition, measuring and makes traceable the outcomes stakeholders derived from their activity and their responsiveness to their expectations (notion of impact and dual materiality[1]). This can be achieved through the use of extra-financial value indicators corresponding to strategic objectives and prioritized by the firm and its stakeholders, such as intrapreneurial culture, customer loyalty, scientific excellence, brand reputation, societal impact, and more.

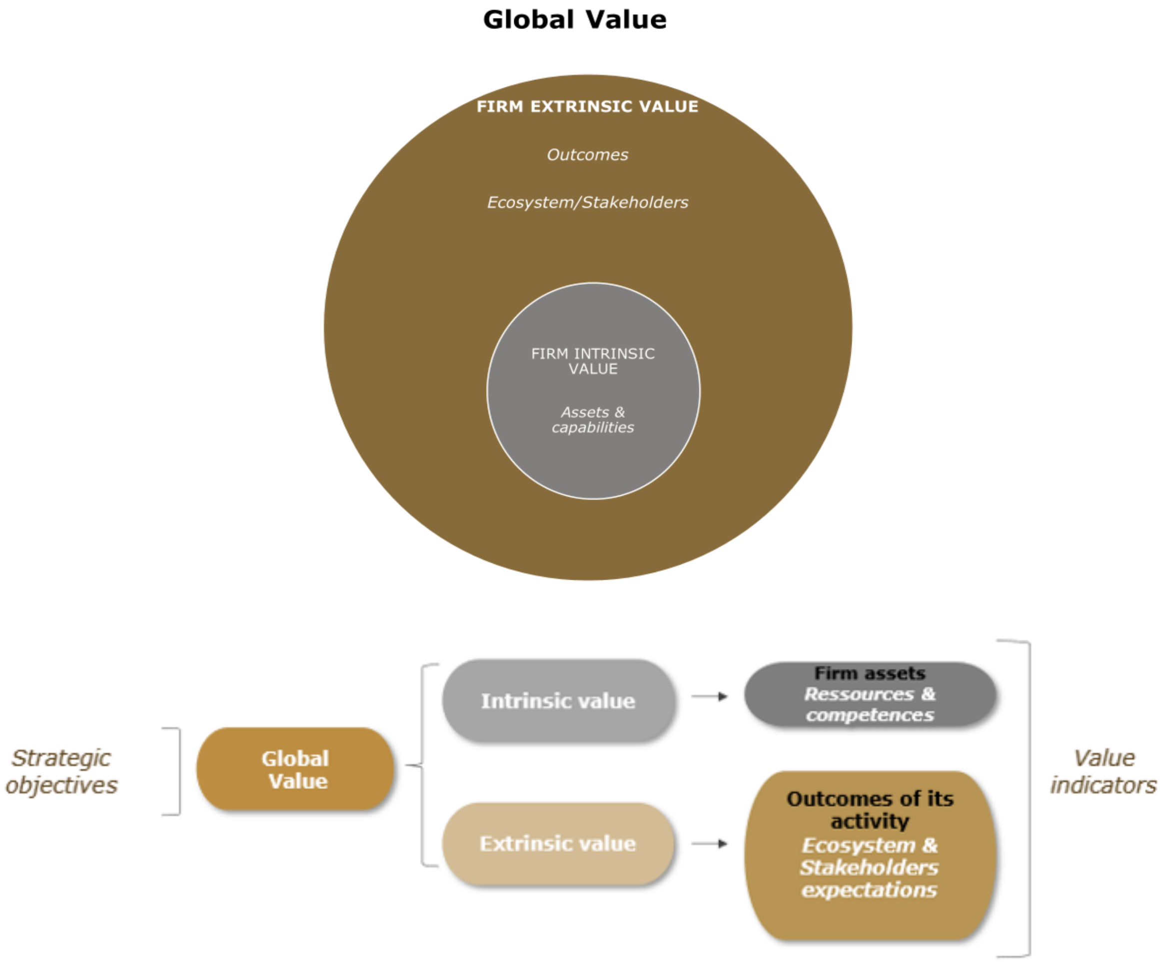
Enriching the performance model with extra-financial value indicators along with financial ones can help firms to address both financial performance and impacts competitively. First, they compel companies to recontextualize their strategic objectives, considering the role of extra-financial dimensions in performance (Medne A, et al., 2022). They enable the valorization of under-utilized dormant assets (intangible ones such as intellectual capital), providing a more comprehensive understanding of the firms' global value and performance. Armed with more information and being able to quantify and track them multidimensionally, managers can counter uncertainty and identify weak signals.

Second, by comparing value indicators with the company's strategic objectives, it becomes easier to identify discrepancies between strategy and its execution, and implement proactive decisions, thereby pinpointing areas for improvement to build resilience (Porter & Kramer, 2018). For instance, if a company's strategy aims to increase its societal impact but indicators of employment contribution show a decline, it means there is a misalignment between strategy and execution. This misalignment could stem from issues within the strategy itself, its implementation, or both, which can be identified by measurable value indicators which have been prioritized (key value indicators, KVIs). Thus, key value indicators score the achievement of prioritized strategic objectives of firms considered embedded into an ecosystem of stakeholders (cf Polanyi, 1964). In this perspective, the intrinsic value of a

[1] While the concept of value and the broader realm of extra-financial factors extend beyond traditional sustainability concerns, we argue that they constitute the predominant portion when considering business priorities.

firm, associated with its material & immaterial assets, interacts with the extrinsic value, which pertains to the outcomes of the firm for its stakeholders within the broader ecosystem. Together, these components contribute to the overarching global value created by the firm (cf *Conceptual model* below inspired from Freudenreich et al., 2020; Froese, T. et al., 2023; EFRAG, 2021).

Conceptual model of firm value



Third, key value indicators facilitate acceptability among stakeholders. They enable the convergence between firms' strategic objectives and their stakeholders' by comparing their respective priorities and identifying the potential discrepancies which could jeopardize the strategy's execution. Decisions and actions such as trade-offs, reorientation of the strategy, convergence workshops gathering stakeholders and firm decision-makers, pedagogy, can be implemented to realize the objectives alignment and obtain acceptability and support from all stakeholders in the execution of the strategy (De Oliveira et al., 2019).

Complementarity of KVIs with KPIs: An integrated model for strategic performance management

In order to assess whether a company is effectively executing its strategy and managing impacts on stakeholders (material issues) while achieving performance, as required by the CSRD (double materiality in a reciprocal relationship between company and stakeholders), KVIs should complement performance indicators in an integrated model. By measuring their correlations, the company can analyze the interdependencies between different areas and activities of the business and the execution of the strategy. For example, it may have a high ROE, but correlated with a negative biodiversity footprint or employee loyalty, or focus on revenue variations without considering customer attrition. For the reputation KVI, the resulting KPI may focus on outcomes of projects and concrete actions taken to improve reputation, such as participating in roundtables or philanthropy; however, reputation depends on other factors besides these projects, such as the unique quality of a product. Hence the importance of measuring KVIs to understand what contributes to reputation and not just listing actions taken in a given year in order to develop new actions. The underlying idea is that there is no unique bijection between one factor and one performance result, and KVIs contribute to enlarge the universe of factors to consider (multi-attribution). For strategic execution, the combination of KVIs and KPIs provides a comprehensive performance management tool aligned with strategic objectives.

Complementarity between Key Value Indicators and Key Performance Indicators

	KPI	**KVI**
Field of application	The company's operational activities _ Measures how a company operates to deliver value to stakeholders	The company's strategic assets_ Measures how a company creates and delivers value to its stakeholders
Approach	Descriptive - answers the how: is the company effectively generating value?	Reflexive - answers the why and for what: for what purpose does the company want to create value, for whom, what mission does it fulfil and to create what type of value?
For who	Stakeholders restricted to the most important (at the very least, only investors)	Broader stakeholders (employees, suppliers, NGOs, environment, shareholders, business community, assessors, etc.)
Logic	Evaluation focused on financial results and ROI	Assessment based on the satisfaction of stakeholders' expectations and their tangible and/or intangible benefits
Metric	Tangible and visible _ operational	Tangible (visible) & intangible
Final materialization	Financial capital	Tangible and intangible capital with a strong emotional and symbolic component
Goal	Optimising and orchestrating resource allocation	Valuing all the company's capabilities (resources & skills) as an indicator of growth potential benefiting all stakeholders
Vision	Downstream _ relates to achieving stakeholder alignment with strategic objectives through activities and the TOM (Target Operating Model)	Upstream _ refers to the strategic alignment of stakeholders with strategic priorities
Object of assessment	Extrinsic value: effectiveness of the TOM in terms of the operational results of the targeted and concrete actions undertaken.	Intrinsic value: transformation of all types of capital into tangible and intangible wealth. Emotional and symbolic dimension.
Time scale	Over a limited period (exploiting the current value creation model)	Medium to long term (develop and realise value creation potential)
Examples	-Distance travelled between customer/plant warehouse - Carrier load factor	-CO2 emissions/carbon footprint

By enabling a multidimensional analysis of company performance, the complementarity of KVIs/KPIs allows for strategic choices to balance profitability with sustainability and satisfy both performance objectives and commitments to the transition. For example, should a company set a CO_2 emissions cap even if it means losing 3 percentage points of revenue in the short term in hopes of gaining more in the medium to long term through energy efficiency and the resulting reputational effect? How much is it willing to lose in profitability without gaining extra-financial value? To find this balance and make trade-offs, it is important to materialize extra-financial value and measure how it influences financial performance.

The impact of KVIs on financial performance

To address this point, we ran a case study with a multinational company (pilot company) belonging to the agrochemical industry. A preliminary qualitative phase made of semi-directive interviews and workshops with several stakeholders (prioritized by the management) led us to retain a set of KVIs from a pre-defined grid built from literature review and secondary sources (e.g: OECD, firms CSR reports). We selected the KVIs which can been proxied by available data, accounting for the lack of clear conception of value indicators and of accurate data. We draw from proxies indications into empirical studies on extra-financial and sustainable issues and secondary sources. We realized a benchmark across 126 companies on a 5-year range and ran a multivariate regression.

Building on literature review, we aggregated the KVIs prioritized by the respondents into 8 dimensions encompassing global value of the company: Cash, Assets, Costs, Resilience, Legitimacy, People, Planet. Accounting for the lack of exact data and difficulty to operationalize extra-financial value, we retained complete data on a couple of proxies KVIs available for each dimension and ran several models for each year. Resilience is measured by financial resilience proxies (liquidity ratios and net debt/EBITDA, gathered from Orbis) and innovation potential (a composite indicator of granted patents/submitted patents and R&D expenses), and Legitimacy is proxied by perceived value by suppliers (short-term debt granted by suppliers) and shareholders (company value as found in Orbis database).

Regression of selected key indicators of value for the year 2021 on Net result in Agrochemical industry

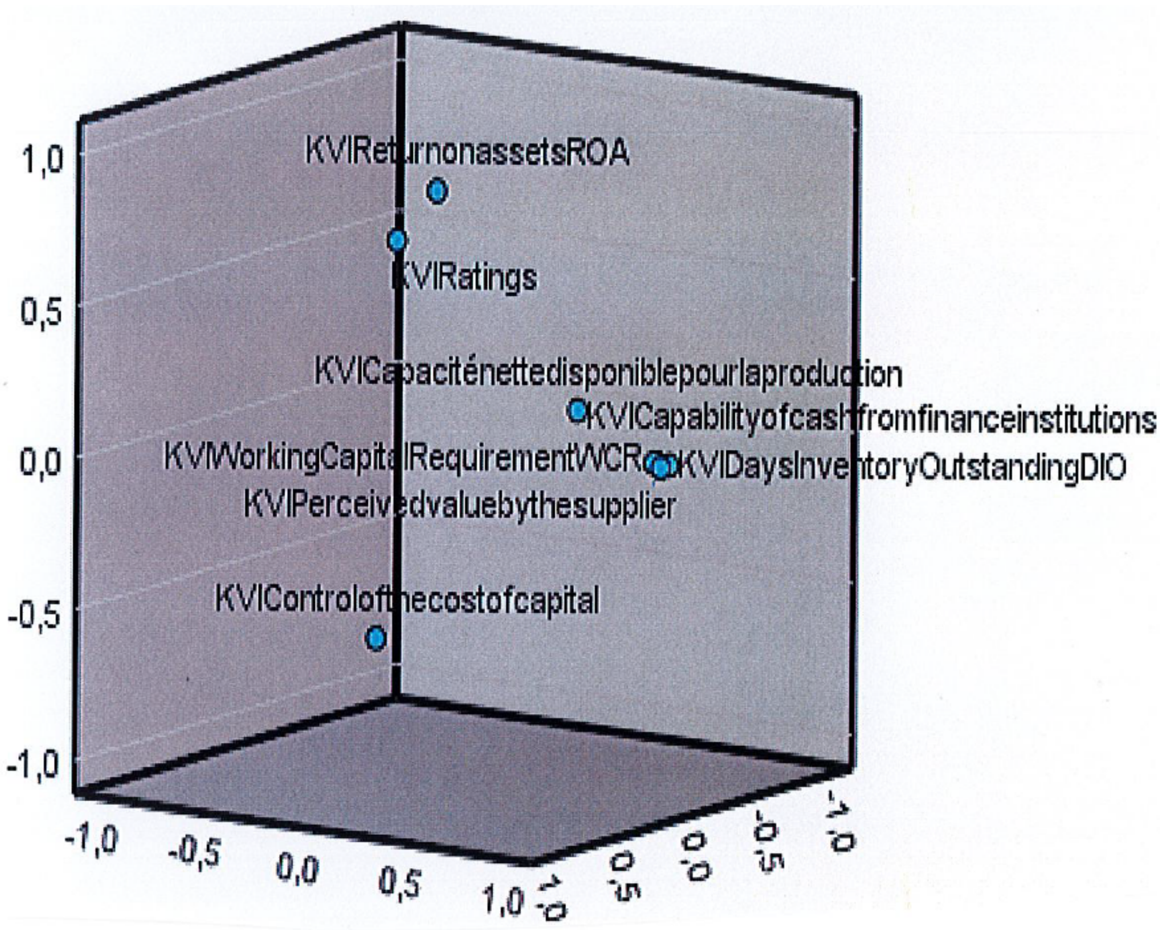
		Coefficients	Standard error	T statistic	Probability	Lower limit for confidence level = 95%	Upper limit for confidence level = 95%
	Constant	67780,5274	6017080,09	0,01126469	0,99118331	-12931331	13066891,8
Resilience	KVI Net debt vs EBITDA	-8939,2364	26040,2537	-0,3432853	0,73687187	-65195,784	47317,3116
	KVI ROI of innovation projects	-67371,453	175327,085	-0,3842615	0,7069966	-446142,59	311399,687
	KVI Ratings	-944080,72	2271787,57	-0,4155673	0,68450427	-5851979,4	3963817,95
	KVI New R&D projects that has been launched successfully	8563231,86	18562756,1	0,46131252	0,65219799	-31539165	48665628,3
Legitimacy	KVI Perceived value by the supplier	-0,2087964	0,25588851	-0,8159663	0,42921753	-0,7616099	0,34401712
	KVI Trust perception Enterprise value	0,12586726	0,03548953	3,54660238	0,00357963	0,04919679	0,20253773

As represented above, we find that for the year 2021 among the KVIs tested, Legitimacy proxied by value perceived by shareholders impacts most significantly and positively the net result; this finding holds consistently across the span of five years. This is not surprising given the pivotal role of key stakeholders perceptions and satisfaction in driving financial performance. So this reinforces the imperative for businesses to prioritize key stakeholder trust in their strategic decision-making processes.

While our results are limited because of the lack of accurate and complete data, they indicate an interesting avenue for research to develop new proxies to operationalize extra-financial value and analyze the historical variation of its impact on financial performance depending on the measures retained.

To complement our linear regression analysis, we performed a principal components analysis (PCA). The results can be visualized on a graph that shows how the companies can be segmented by groups segmentation criterion for identifying homogeneous groups of enterprises based on the primary KVIs that elucidate their net results. As represented in the graph below for the year 2021, a first Axis "Operational excellence" made of the KVIs Days Inventory Outstanding and Capability of cash from finance institutions characterize companies whose net result is mostly explained by their operational excellence; a second Axis "Capital Efficiency" built on control of the cost of capital and return on assets, expressing the firm's ability to effectively manage capital resources to generate optimal returns, capturing both the aspect of controlling costs associated with capital and maximizing returns on assets.

Principal Component Analysis on a selection of key value indicators on a sample of 126 firms from the agrochemical industry, 2021



Thereby, the KVIs can be leveraged to identify strategic groups and take strategic decisions in terms of positioning and potential for differentiation based on value indicators instead of the usual performance indicators. Thereby, companies may pivot on a value-based Blue Ocean Strategy maximizing the value dimensions where they have a significant competitive advantage compared to competitors and widen the gap.

Conclusion

This paper contributes to the ongoing discourse surrounding business strategy and performance by proposing a comprehensive framework that aligns firm strategies with stakeholder expectations. Our analysis underscores the potential for firms to integrate extra-financial considerations into their strategic decision-making processes, thus enhancing long-term success within their ecosystems. By fostering stakeholder acceptability and engagement through a strategic approach to value modeling and indicators, firms can effectively navigate the complexities of the modern business landscape. Ultimately, the recognition of firms as embedded within broader stakeholder networks is essential for enhancing resilience and successfully navigating the ecological transition in today's dynamic business environment.

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