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A New Era for Business

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A NEW ERA FOR BUSINESS

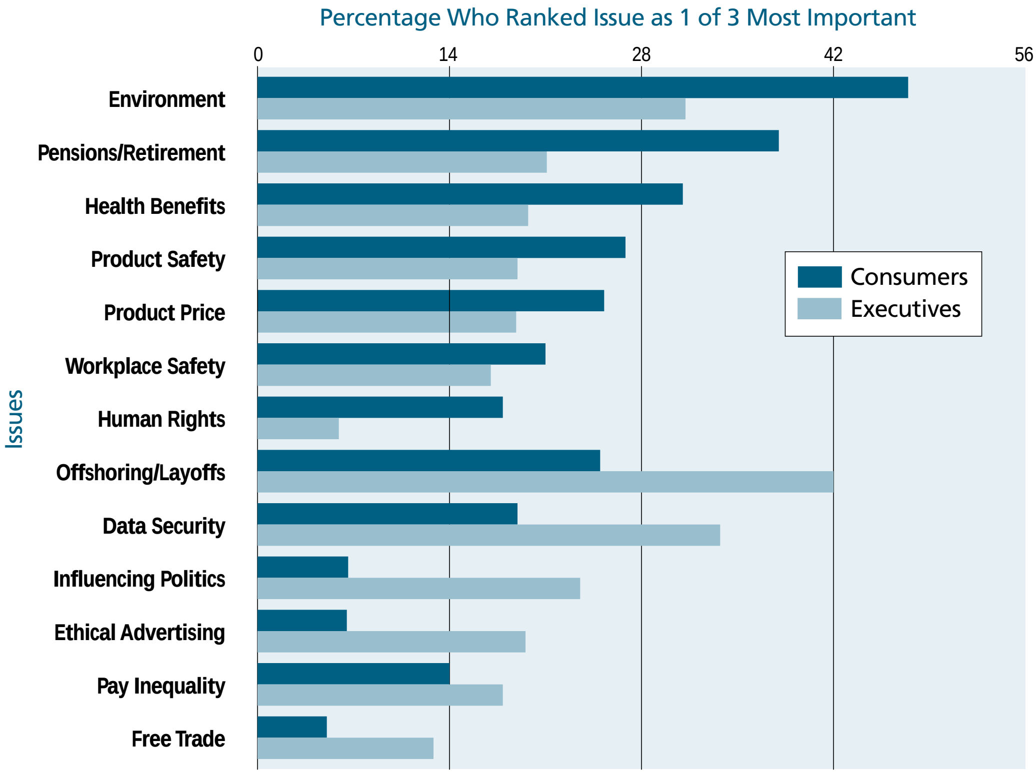
More and more business leaders recognize that their company's future is increasingly intertwined with the needs and demands of society. What many executives don't understand is how best to manage that changing relationship. In this article, McKinsey & Company consultants provide a model for incorporating sociopolitical issues into the strategic decision-making process.

BUSINESSES HAVE NEVER BEEN INSULATED from expectations about their social responsibilities. What is different today is that the issues are far more numerous, complex, global, and fast-changing than ever before. Global warming, childhood obesity, unfair labor practices, air and water pollution – the list goes on and on. The impact that these issues can have on a company's future has also increased – to potentially devastating levels – because today's social activists have more avenues and tools to influence and mobilize public opinion around hot-button issues.

Some business executives are resisting these trends, arguing that a company's obligation to society is only to provide the best return possi-

WHAT KEEPS THEM UP AT NIGHT?

Business executives and consumers worry about different social issues



SOURCE: December 2005 *McKinsey Quarterly* survey of 4,238 global business executives and July/August 2006 survey of 4,063 consumers in the U.S., U.K., France, Germany, Japan, India, and China. Executive data are weighted by GDP of countries to adjust for differences in response rates from various regions.

ble for its shareholders. But more and more executives are taking a strategic approach to the problem, recognizing that the short- and long-term interests of their company and its shareholders are increasingly intertwined with the interests of society, and that the best response is to become more engaged with the issues and activists in the nonprofit and public sectors.

We believe that business does have a strategic interest in becoming more aware of and engaged in sociopolitical debate and issues. The reasons are twofold. First, social and political forces can fundamentally alter an industry's strategic landscape and even torpedo the reputations of businesses that have been caught unawares or are seen as being culpable in creating the problem. Second, companies that are engaged can significantly benefit from these trends, by creating new products, services, and markets for unmet social needs, as well as for new consumer preferences.

The challenge that business leaders face is to find ways to incorporate an awareness of sociopolitical issues more explicitly and proactively into their strategic decision-making processes. Companies must see social and political dimensions not just as risks – areas for damage control – but also as business opportunities. They need to scan the horizon for emerging trends and integrate their responses across the organization, so that the resulting initiatives are coherent rather than piecemeal. (See sidebar to the left for examples of how the sociopolitical concerns of executives and consumers diverge.)

Having worked with many companies around the world, we have learned which areas companies need to master in order to understand and manage these complex sociopolitical issues. We call these the Five R's: risk, renewal, regulation, relationships, and reputation. We have also learned that managing these issues is not a peripheral task to be relegated to public relations or corporate social responsibility departments. Instead, it requires leadership by the CEO and coordination throughout the organization. To succeed in today's smaller, faster-changing, more complex world, business leaders must systematically incorporate an awareness of sociopolitical issues into their strategic decision-making processes.

The Social Contract

Corporations have always had complex relationships with the rest of society. These relationships embrace not only direct stakeholders (shareholders, consumers, government regula-

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tors, and employees), but also, and increasingly, a broader set of stakeholders throughout the rest of society (such as the communities where a company operates, the media, the nonprofit sector, and others).

One way to understand these relationships is to think of them as social contracts – sets of laws, regulations, and obligations that guide corporate behavior. The political philosophers Thomas Hobbes, John Locke, and Jean-Jacques Rousseau first wrote about social contracts, describing the relationship between individuals and society. In contrast, we focus on the relationship between corporations and society.

The Five R's

To manage their complicated contracts with society, companies must master these five areas:

RISK: Predict and handle new risks that result from changing societal expectations

RENEWAL: Approach changing societal expectations as opportunities for growth by creating new products and processes, entering new markets, etc.

REGULATION: Shape short- and long-term policy agendas to reflect both societal expectations and the company's commercial interests

RELATIONSHIPS: Identify how and with which stakeholders to build relationships

REPUTATION: Foster public trust in the company, not just with PR, but also with action

At the formal end of social contracts, laws and regulations govern such areas as shareholder rights, pollution allowances, hiring rules, accounting practices, and the like. When companies violate these laws and regulations, as Enron did, governments can fine or imprison employees and otherwise censure businesses.

Less formally, societies expect companies to comply with obligations such as minimal labor standards along their supply chains. Even if companies are not legally required to observe these expectations, ignoring them can hurt their reputation – as Nike discovered a few years back.

Corporate social contracts may include informal social expectations regarding "frontier" issues, such as obesity. Whereas Americans used to hold people responsible for their own weight, for example, they increasingly see corporations that sell unhealthy products as responsible for an increase in the number of overweight people. Frontier issues raised by small groups of activists evolve into semiformal obligations if the activists gain a critical mass of support, and can become formal laws and regulations if that support becomes sufficiently widespread.

All industries must contend with some social issues, such as transparency. But each industry has its own volatile social issues as well. As a result, social contracts vary from industry to industry, and even from region to region within the same industry.

Large apparel manufacturers such as Nike and Levi Strauss & Co., for example, must reassure society that they are providing safe working conditions and fair pay. Mining companies such as BHP Billiton and Phelps Dodge Mining Co. must assuage concerns about air and water pollution. Within the petroleum industry, companies confront issues in developed countries, such as the United States, different from concerns in less-developed countries where they are increasingly looking for oil reserves. In the United States, companies must contend with the public's demand for lower prices and better environmental practices. In developing countries, they are called upon to stabilize political situations and alleviate poverty.

For a deeper sense of the complexities of social contracts, consider the financial services industry. Many societies expect that financial service firms will not help businesses that are harmful either to the larger business environment or to national security, but will grant equal access to their services. As a result, these societies pass laws, such as the United States' Patriot Act and anti-redlining legislation, to formally regulate firms' activities. Many societies also semiformally expect financial service firms to fund projects that are environmentally and socially sound. In response, several banks developed the Equator Principles and the U.N. Principles for Responsible Investment – voluntary frameworks for incorporating environmental and social analysis into financing and investment. Many societies are increasingly concerned about consumer debt – a frontier issue – and so have begun informally to expect banks not to load their customers with too much debt.

The pharmaceutical industry likewise has a complicated contract with society. Many societies view healthcare as a right rather than a luxury, and so pass formal laws to make drugs widely accessible and reasonably priced. Societies also expect drugs to be safe, and so regulate drug trials, labeling, and packaging. More informally, societies expect pharmaceutical companies to share their goods with the less fortunate during times of crisis. During World War II, for example, the industry produced penicillin to help the war effort. More recently, during the anthrax scare that followed 9/11, the U.S. government seriously considered waiving patent protection for Cipro, the drug thought to be most effective in treating anthrax exposure. At the frontier of the pharmaceutical industry's social issues, societies are increasingly concerned about direct-to-consumer advertising. In response, the industry is beginning to temper its product promotions with health information.

The Five R's

Because social contracts can be so complicated, we came up with a simple way of thinking about their management: the Five R's (see sidebar on p. 59 for a summary of the Five R's). These are the five areas in which companies must develop core competencies if they are to understand and manage these complex relationships.

Risk: Companies must recognize and assess the relative risks of important sociopolitical trends before these trends affect them or their industries. Companies that react late to sociopolitical trends often find themselves swimming against the tide – just to stay in place. Take the case of Monsanto. The company was convinced of the economic and technical advantages of introducing genetically modified crops in Europe. But the public was not persuaded, and the company lost an estimated $1 billion in market value. Merck was hit when the public perceived that the company was aware of, but did not fully disclose, Vioxx's cardiovascular risks. The company ultimately lost more than $250 million in a Texas verdict in 2005 and still faces several other lawsuits.

Renewal: By paying attention to sociopolitical trends, some companies not only avoid societies' sticks, they also enjoy societies' carrots. These companies seize sociopolitical opportunities to renew themselves with new markets and products (see sidebar below for issues that are sparking renewal). For instance, Toyota's response to the public's growing interest in environmentally friendly products, the Prius, has earned the company both profits and public approbation. Coca-Cola is similarly riding the public's desire for health and well-being by offering bottled water, reduced-calorie beverages, and juices. Whereas sales of the company's signature soft drink fell 2 percent between 1998 and 2005, sales of bottled water rose 26 per-

Four Opportunities for Corporate Renewal

These issues are triggering the most innovative products and processes

1 ***Bottom of the Pyramid.*** A growing number of products and services, such as microcredit and mobile telephones, are helping the poor people in less-developed countries who make up "the bottom of the pyramid." For instance, Unilever, in partnership with the NGO Oxfam, now pays local employees 10 percent to 60 percent more than the Indonesian minimum wage, has injected more than $600 million into the Indonesian economy through corruption-free channels, and has developed and published social performance reports that track its progress against the program's goals.

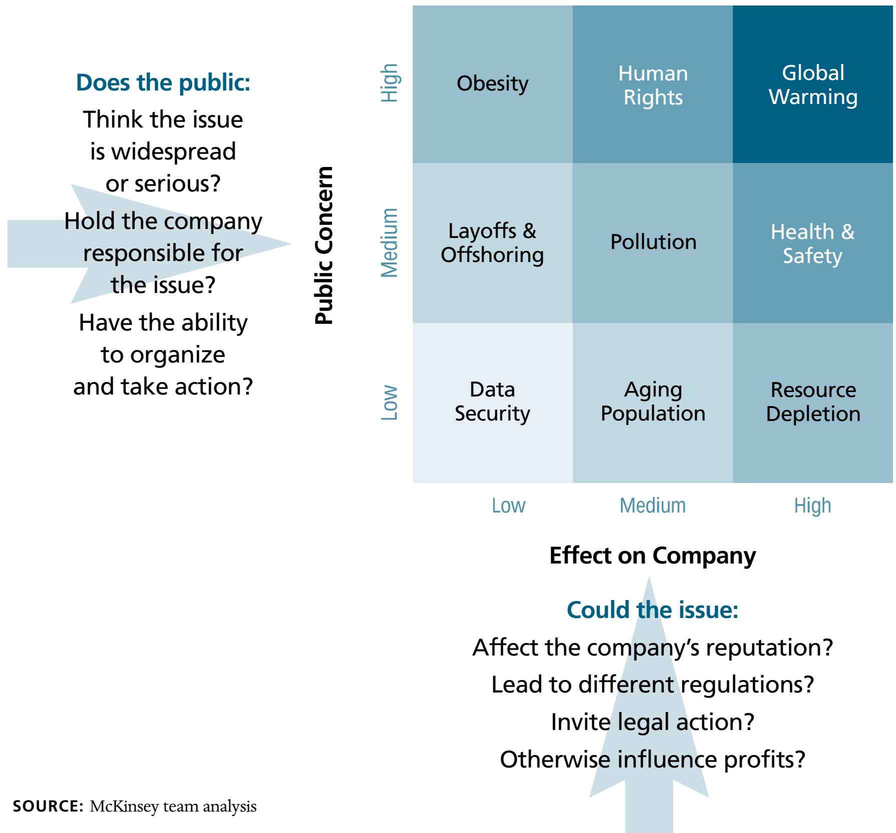
2 ***Environmental Sustainability.*** The issue of environmental sustainability offers perhaps the biggest current opportunity for companies to develop new products. For example, GE's Ecomagination initiative aims to increase revenues from environmentally friendly products and services to at least $20 billion in 2010, and to double investments in green R&D by the same year. Toyota's hybrid automobile has already transformed the company in many stakeholders' eyes. And Wal-Mart recently unveiled a long-term environmental sustainability strategy that includes using 100 percent renewable energy, generating zero waste, and creating sustainable products. Wal-Mart has also set numerous short-term goals, such as reducing the energy used by its stores by 30 percent.

3 ***Public Health.*** Many companies are beginning to recognize that public health is an area where doing the right thing – such as tackling chronic developing-world diseases – helps the bottom line by reducing workforce turnover and absenteeism. In Angola, for example, Chevron has worked with NGOs to give antiretroviral drugs to employees with HIV, as well as to distribute mosquito nets, which help prevent malaria.

4 ***Fair Trade.*** A small, alternative product – Fair Trade coffee – has spawned a large consumer market and spread beyond coffee to include other products. We expect many more deals in this area as leading consumer goods, retail, fast-food, and branded apparel companies acquire specialized "ethical" brands to improve both their reputation and their profits. Some companies, such as The Body Shop and Whole Foods Market, have long benefited from this trend. Recently, large global players have begun to buy Fair Trade companies, such as Cadbury Schweppes' purchase of the chocolatier Green & Black's, and Unilever's purchase of ice cream maker Ben & Jerry's. *–S.B., S.B., L.M., & J.O.*

IN HOT OIL

How a petroleum company might use the heat map to prioritize sociopolitical issues



SOURCE: McKinsey team analysis

cent during the same period.[1] Unilever has earned both accolades at home and new customers abroad by developing new products, as well as by packaging its products into smaller containers for poorer customers in developing nations.

Regulation: Regulation is often considered the esoteric domain of lawyers and lobbyists, yet it determines major components of industry structure, competition, and profitability. In every industry, regulation or the threat of regulation affects important strategic decisions such as capital investment and mergers and acquisitions. It can sometimes enable or even destroy entire business models. For instance, societal concerns about fair competition and affordability have led to tougher regulation of mobile phone pricing. With regulations only getting tighter, leading companies will need to plan longer-term strategies to shape the policy debates that drive regulatory agendas.

Relationships: Sociopolitical trends create opportunities for companies to build new relationships not only with other companies in their industry, but also with NGOs, governments, and other stakeholders. These new relationships, in turn, can inspire new solutions to social problems. Leading energy companies are developing innovative relationships with environmental NGOs. Drug companies are partnering with NGOs and governments to invest in orphan drugs. New coalitions within and across industries have reconfigured value chains in more efficient and sustainable ways. Companies that lead in relationship building, such as HSBC, Nike, and Shell, treat these relationships as strategic assets, and so hold seats on all the public committees in their industry and invest in long-term relationships with major opinion leaders.

Reputation: Companies' reputations are more important than ever. Although positive reputations stem from many actions, negative reputations can result from a single action – and can have catastrophic consequences. Sophisticated companies understand the link between building a great reputation and generating consumer trust. They inspire trust by providing greater transparency, speaking frankly about consumer concerns, and creating metrics to demonstrate progress on them. BP's use of performance measures to demonstrate how the company is reducing carbon emissions is a classic example of this approach.

Prioritize Issues

With so many shifting sociopolitical sands, how can companies best manage their relationship with society? First, companies must prioritize which sociopolitical trends to address. Above is a "heat map" that companies can use to prioritize issues. One dimension of the map is the public's concerns about a particular issue, and the other dimension is the issue's effect on the company, including the issue's short-term, long-term, financial, and reputational costs.

As the heat map shows, companies should pay the most attention to issues that the public cares a lot about and that most affect the company (for example, a petroleum company should prioritize climate change) and less attention to issues that the public doesn't care as much about or that do not affect the company (for example, a petroleum company need not prioritize data security).

After prioritizing their sociopolitical issues, companies should next differentiate between those that require immediate action, those that require active watching, and those that require minimal monitoring. Companies can then treat the most critical issues either as risks to be managed or as opportunities for renewal. In practice, companies often shift their approaches as events unfold, and they may take different stances on different issues.

For example, in the 1990s McDonald's responded to public concerns about obesity mostly by defend-

YOUR FIVE R'S

Does your company have what it takes to manage its social contract?

	Do you know how to…	−−	−	±	+	++
RISK	Identify areas of risk arising from emerging issues?					
	Prioritize risks?					
	Respond to increased risk?					
RENEWAL	Track sociopolitical trends relevant to your company?					
	Feed new business opportunities into your core business?					
	Build new businesses around sociopolitical trends?					
REGULATION	Shape the policy debate driving regulatory agendas?					
	Understand the economic impact of different regulatory scenarios?					
	Cooperate with other companies on regulation and common activities?					
RELATIONSHIPS	Identify and prioritize your business' stakeholders?					
	Develop a long-term strategy to align crucial stakeholder interests?					
	Comprehensively influence external debate?					
REPUTATION	Understand reputation drivers?					
	Integrate classic marketing and reputational brand-building approaches?					
	Create a strategy for shaping external reputation?					

ing its food as nutritious – that is, with risk management. Now, however, McDonald's approaches the obesity issue as an opportunity for renewal, introducing new products such as salads. In general, defensive tactics, such as deflecting criticism with public relations, are less effective than offensive ones, such as developing new markets and products. And so when possible, companies should respond early to emerging sociopolitical issues with renewal.

Collaborate

In many cases, companies should consider collaborating with NGOs, governments, and other companies to manage their sociopolitical relations. For instance, partnerships between pharmaceutical companies and NGOs to distribute antiretrovirals in developing countries can help improve the companies' reputations. Similarly, collaborations between companies that result in self-regulation can increase the public's trust, as well as stave off more costly external, formal kinds of regulation. Large banks' adoption of the Equator Principles, the cola giants' shared rules for marketing soda to children, and mining companies' self-imposed standards for the treatment of indigenous peoples are all examples of successful corporate self-regulation.

The downside of working across different organizations is that it can be time-consuming and slow moving. It took Nike and other companies seven years to establish the Fair Labor Association. In addition, some social issues may simply be too big for industry associations to tackle.

So how do companies determine when to work together and when to go it alone? As a general rule, when companies can capture first-mover advantage (as BP did when its CEO acknowledged the dangers of global warming), cannot afford to collaborate, or are targeted by specific activist campaigns, they should eschew partnerships. But when stakeholders view all companies as equally culpable, when regulation is likely to be imposed on an entire industry, or when individual actions would destroy value, companies should unite in rewriting their social contracts.

Communicate Clearly

Companies must not only understand which issues matter most and reach out to their fellow travelers. To cultivate the fifth R – reputation – they must lead with their actions and develop more sophisticated communications to convey those actions to the public.

Global communications have made obsolete the traditional PR-driven communications model, which relied on glossy messaging and focused on defending the company's current ways of doing things. Managing reputation in today's environment means realizing that everything will ultimately be transparent, and so companies need to get ahead of the communications curve. Rather than yielding to single-issue interest groups, these companies gain trust and respect by insisting on a more complete conversation. As consumers become conscious of the trade-offs companies make between corporate interests and the common good, consumers become more sympathetic to the companies.

AstraZeneca is one company that has learned the value of straight talk. After the U.S. Food and Drug Administration voiced reservations about the side effects of Crestor, a drug treatment for high cholesterol, AstraZeneca adopted the standard industry approach, creating national advertisements that presented the company's side of the case. But it also took the unusual step of posting raw data from clinical trials on its Web site, allowing independent researchers to draw their own conclusions. This was a high-risk decision, because different analyses of the same data set can yield different conclusions. But the company's strategy worked, helping it reestablish public trust and stabilizing Crestor's market share.

Effective communications cannot be the sole responsibility of public relations agents and lobbyists. Companies must undertake concrete activities to improve their reputations. These reputations in turn create a virtuous cycle: Employees live up to the reputation, developing values-based codes of behavior that are much more effective than a rulebook at instilling honesty. Their values and good behavior, in turn, improve the company's reputation. And as a company's reputation improves, its conversations with all of its stakeholders – regulators, civil-society players, potential partners, and customers – become even more positive and productive.

Lead From the Top

Cultivating the Five R's requires CEOs (or in some countries the chairman or president) to take the lead (see sidebar on p. 62 for a Five R's checklist). CEOs are the only people who can credibly lead and manage a company's social and political agenda. They are the only ones who can convince employees, investors, and other stakeholders that the company should move in a new direction. And they are the only ones who can align entire companies around shared social objectives. If companies delegate these issues to anyone below the CEO, internal conflict is likely to ensue. For example, a company whose R&D department is crafting new environmentally friendly products while its regulatory department is fighting limits on CO_2 emissions will feel the tension between its employees.

CEO leadership is also critical because chief executives are often the public faces of their companies. As companies' reputations become more important, CEOs' stances on sociopolitical issues become crucial. When CEOs show their personal commitment to a new program, as when GE's Jeff Immelt committed to the company's Ecomagination program, stakeholders respond positively.

Some sociopolitical goals require changes to entire industries. CEOs must lead these changes if they are to take hold industrywide. Indeed, in the 30 years after World War II, American CEOs launched changes that extended much further than their own industries. These sweeping changes included the Marshall Plan and the Trilateral Commission. There is no reason why today's CEOs should not have a similar impact on the social and political challenges facing the United States and the rest of the world. And although CEOs are often reluctant to meet a critical public, our experience suggests that businesses have consistently gained more from entering the fray than from avoiding it.

Becoming an Agent for Change

A full response to the sociopolitical challenges facing business will require companies to hear from, and speak to, more diverse audiences than they ever have before. To accomplish this, they are hiring leaders from a broader range of fields: the civil service, the diplomatic corps, the formerly feared and shunned NGO sector, the media, and the world of pollsters and political advisers.

But companies must also embrace a broader range of organizational models. Most companies are not prepared to manage their social contracts. By their very nature, social issues flow across the membranes of the whole corporation. They also flow across industries in such a way that it is no longer useful to distinguish between heavily regulated industries, such as telecommunications, and lightly regulated ones, such as retailing. Businesses need new structures and processes that recognize these realities.

Companies are first and foremost agents for wealth creation. By virtue of their scale and global reach, however, they have also become agents for profound social change. As businesses grapple with their new and expanded role, they need to take a more strategic approach so that they may create value for shareholders; attract highly talented, motivated employees; spread a positive form of capitalism; and make the communities in which they work happier and healthier. □

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1 Compound annual growth rates. Source: *The Beverage Digest Fact Book 2006*.