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Strengthening the Link Between CSR and Shareholder Value

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Corporate Social Responsibility for the Energy Industry

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Good afternoon. Today I will be talking about strengthening the link between CSR and Shareholder value. While the consulting that I do in this area covers a broad range of industries I am particularly grateful for the opportunity to discuss these issues with you today. I began my career in the energy industry—in particular working for two of the largest integrated oil companies. I have had the privilege to be exposed to CSR related issues at both Exxon and Chevron during the 70's and early 80's and to consult for a number of oil companies and electric utilities both in the US and overseas.

Topics

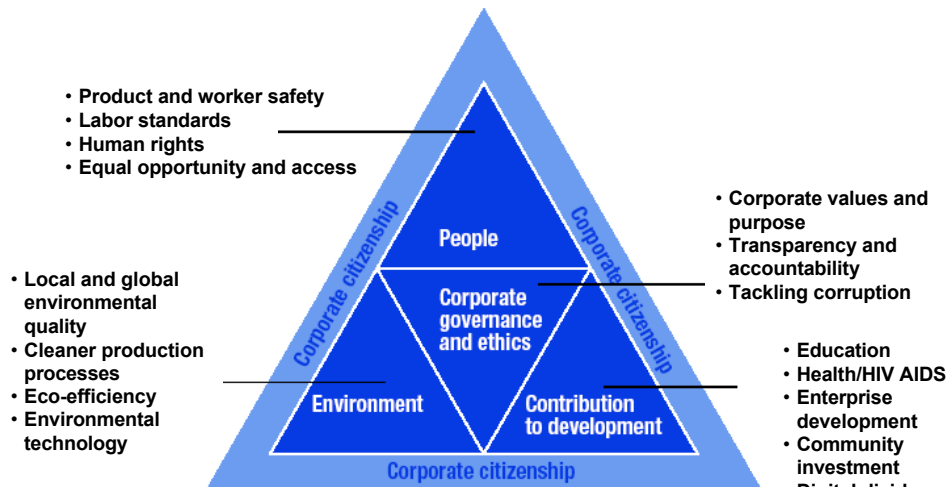
- CSR overview
- Opportunities and threats
- Capturing value

My presentation today is organized into three topics:

- I will begin with an overview of CSR. Here I would like to share a perspective regarding the scope and importance of CSR and I will briefly visit the lessons learned from a history of corporate environmental activity in the US Oil Industry.
- Next I will discuss opportunities and threats from a perspective of informing energy industry strategy and operations with a CSR or stakeholder perspective.
- Last I will discuss how you can take a systematic approach to creating and capturing new sources of value through a CSR lens

CSR deals with a broad range of stakeholder concerns

"Citizenship involves the day-to-day practices of the firm as they impact (and are impacted by) stakeholders. It is in these operating practices that a company's social performance is articulated." -- Waddock and Smith



Source: World Economic Forum CEO Survey on Global Corporate Citizenship

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3

This graphic from the world economic forum is a convenient way to summarize the scope of CSR. The graphic was used to show the scope of corporate citizenship. I like to think of corporate citizenship as CSR in action as suggested by two of the leading academics in this field (Sandra Waddock and Neil Smith).

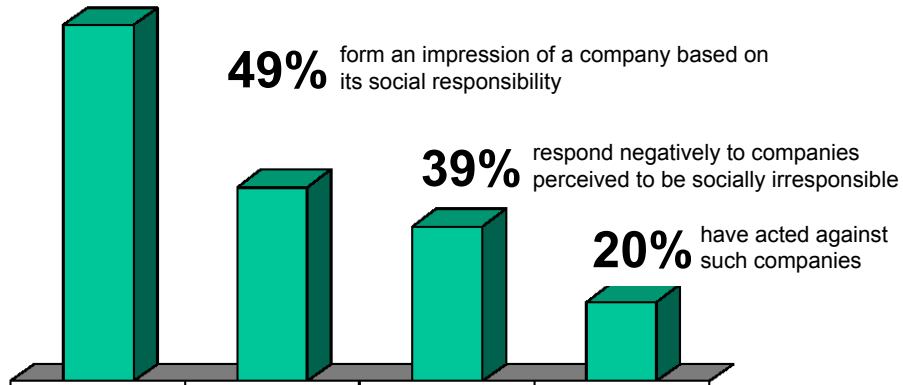
The scope as shown here includes people, corporate governance, environment, and contribution to development. What it represents is a set of stakeholders and related issues that are of increasing relevance to business today. These issues along with those that emerge in the future will pose a range of risks and opportunities for companies in the energy sector.

CSR matters to the public

2001 Corporate Responsibility Survey

(25,000 people in 23 countries)

90% (in USA) want companies to focus on more than profitability (68% globally)



Source: Environics International 2001

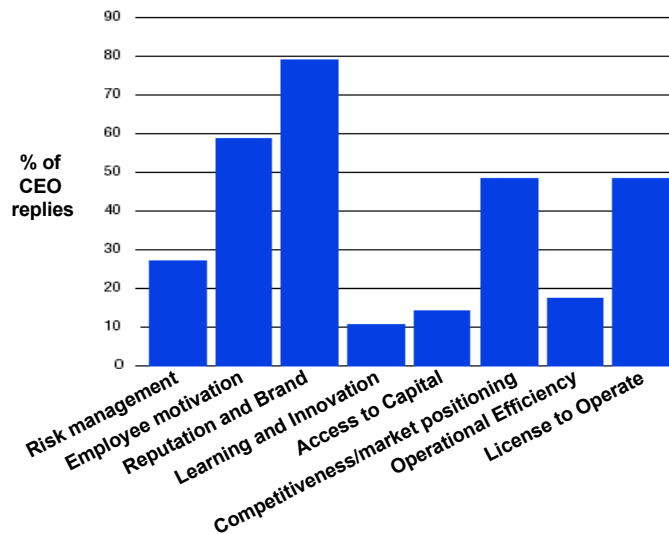
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4

On this slide we make the point that CSR does matter to the general public as well as to a full range of stakeholder groups. While most customers will not pay more for products from responsible companies; increasingly the public is expecting corporations to act responsibly. In today's information rich society, corporate behavior drives reputation which given the large portion of corporate value that is "intangible" in nature is extremely important to shareholders.

CEO view of most important factors in the business case

Overview



Source: World Economic Forum CEO Survey on Global Corporate Citizenship

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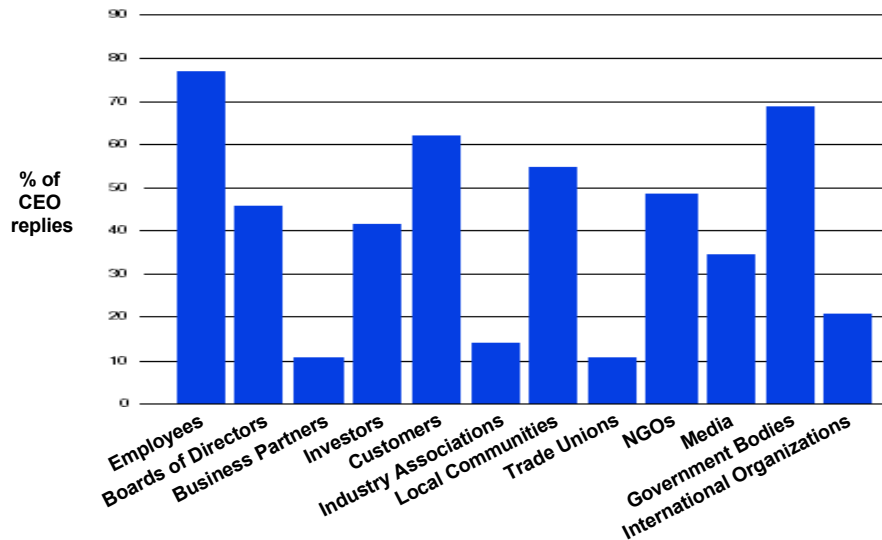
5

CSR also matters to a group of leading CEO. The world economic forum recently surveyed CEOs to get their perspective on the business rationale for corporate citizenship. Eighty percent of the CEOs indicated that a key driver was reputation and brand. The next three drivers to get the most CEO votes were employee motivation, competitiveness/market positioning and license to operate.

Of course the business case for CSR related activities and initiatives is situational. It cannot be separated from your business and operating environment. However, with creativity and foresight you can turn threats into opportunities.

CEO view of stakeholder groups creating the greatest pressures/incentives

Overview



Source: World Economic Forum CEO Survey on Global Corporate Citizenship

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6

When CEOs were asked about which stakeholder groups were most important as drivers or incentives for CSR they cited employees followed by government bodies, customers, local communities and NGO's. Increasingly, leading companies are demonstrating that value can be created through strong relationships with key stakeholder groups and segments most relevant to their business.

Lessons from the last 40 years

Corporate environmental activity: U.S. Oil Industry

1960 -1970	1970 -1982	1982 -1988	1988 +
Industry is the solution	Government is the solution	Industry and government are the solution	Partnerships are the solution
<ul style="list-style-type: none"> Self reliance and technical optimism 	<ul style="list-style-type: none"> Confrontation and law suits NGO's pressure government 	<ul style="list-style-type: none"> Cooperation NGO's pressure government and industry 	<ul style="list-style-type: none"> Partners include trade associations, NGO's, investor groups, government etc.

When industry is out of touch with its stakeholders the result is lose/lose: billions of dollars wasted due to confrontation, cumbersome regulations, excessive litigation, ineffective end-of-pipe requirements, poor allocation of capital, and lost innovation opportunities

Sources: Hoffman - *From Heresy to Dogma*; Porter - *Green and Competitive*

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7

As this slide demonstrates, a proactive approach to stakeholders has not historically been the norm for the oil industry

I believe that the experience of the oil industry and how its corporate environmental activity evolved over the past 40 years is instructive when considering the future of CSR and its potential as a value driver for your company.

This slide summarizes some research conducted by Andy Hoffman when he was at MIT and Northwestern. As described in his book *From Heresy to Dogma* he analyzed industry journals and interviewed industry experts to systematically understand how corporate environmental activity evolved in the US Oil industry (he also did the same for the chemical industry). He divides the last 40 years into four periods as shown on this slide.

My perspective based on my work experience in the oil industry from the mid 70's to the mid 80's echo that the industry was out of touch with the broader society. As pointed out by Porter in his HBR article *Green and Competitive* US industry missed the opportunity to turn its environmental leadership into competitive advantage precisely because for many years we failed to structure our regulatory regime and stakeholder relations in a way that fostered innovation and economic efficiency.

Traditional management approaches do not adequately deal with stakeholders

Overview

Comparing Three Views of Business Value

	Traditional Views		Stakeholder View ²
	Resource	Industry Structure ¹	
Focus	Firm	Value Chain	Firm and All Stakeholders
Primary sources of value creation	Physical assets Human resources Knowledge Technology Financial assets Intangibles	Builds on the resource based view Adds: – Bargaining power vis-à-vis suppliers and customers – Market power vis-à-vis competitors	Builds on the resource and industry structure views Adds: – The value created (or destroyed) for stakeholders as a potential new source of shareholder value – Environmental and social performance as drivers of shareholder value

However, emerging management theory recognizes the value of including stakeholders in the management equation

¹ popularized by Michael Porter

² draws on a growing body of thought-leadership in leading business schools such as Wharton and INSEAD

Traditional management approaches do not adequately deal with stakeholders. They are viewed as outside the core business and a cost to be managed.

Much of the management theory of the 60s, 70s, and 80s is no longer sufficient to deal with today's complexities. In industry after industry business models that once worked are no longer adequate. Likewise a full range of both economic and societal stakeholders are of increasing importance. The emerging stakeholder view of value creation is one key to unlocking additional hidden value.

This slide shows the traditional management approaches in the left two columns and introduces a stakeholder model in the right column. The stakeholder model builds from the resource and the industry approaches.

This concludes the overview where I have tried to show that CSR provides insight into key stakeholders. Current and emerging stakeholder issues will increasingly shape the business environment and will pose a range of risks and opportunities for companies. Leading companies will use this as an opportunity to create competitive advantage.

Now I would like to turn to the risks and opportunities for the energy sector.

Future winners will create value from addressing CSR at two levels

Opportunities
& Threats

Strategic CSR	Operational CSR
Long term; leadership	Medium term; management
Work to address monumental industry/societal challenges; partner with industry, customers, suppliers, governments, NGO's, communities, competitors	Engage with and manage range of stakeholders and issues to ensure investments and operations meet both shareholder and stakeholder expectations
Requires new relationship with analysts and the quarterly earnings game	Requires integration of environmental, social and operational expertise
Result – competitive advantage	Result – higher profitability, license to operate

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9

Future winners will look at CSR as an opportunity at two levels; Strategic CSR and Operational CSR. This slide summarizes what we mean by each. By strategic CSR we are talking about understanding and working to address monumental industry/societal challenges in a way that can create competitive advantage. Operational CSR on the other hand is nearer term in nature. Here issues are more tangible and easier to get your arms around. Actions lead to higher profitability and license to operate.

Lets now take a moment to explore strategic CSR for the energy industry.

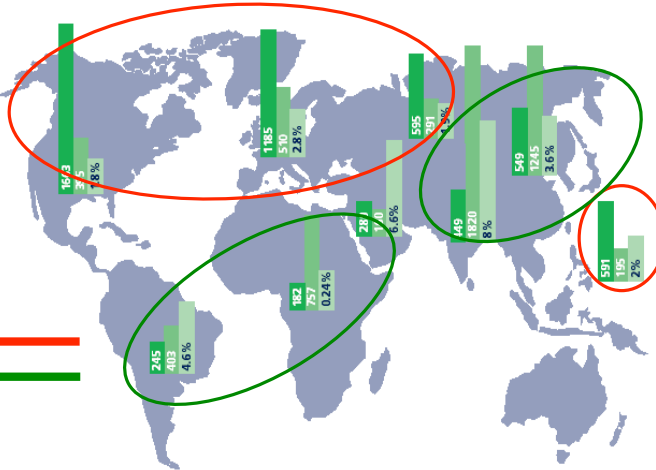
A strategic CSR vision begins with a global view; energy is key to economic growth

Opportunities & Threats

Regional differences in energy consumption and demand growth

- Total energy consumption, ToC
- Population, MM
- Electricity demand growth

- High per capita consumption —
- Low per capita consumption —



Energy usage varies widely:

- In OECD countries 1.1 billion people consume 3.2 tons of crude per year each.
- In non OECD countries per capita consumption is 7 times lower than in North America.

Source: SAM, data IEA/OECD

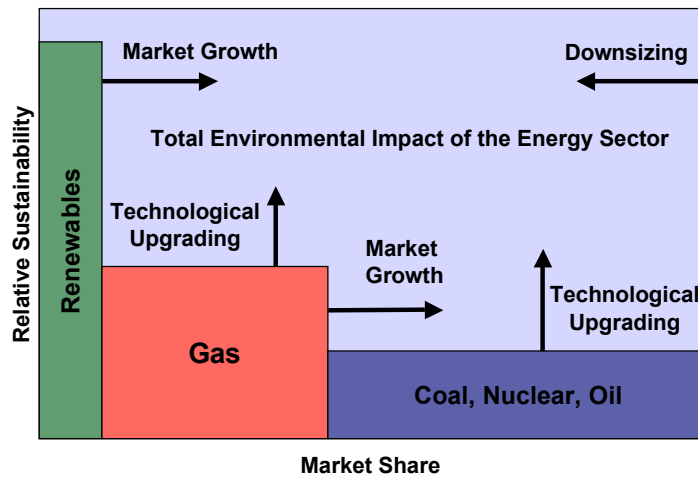
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10

This slide provides a global view of energy and its importance to economic growth. As all of you are keenly aware the OECD countries consume much more energy on a per capita basis than non-OECD countries. In fact in North America consumption rates are 7 times non OECD countries. Given that development is a key priority for non OECD countries and adequate energy is critical for economic growth this causes a huge challenge and presents a huge opportunity.

These global energy needs cannot be met by current energy systems

Opportunities
& Threats



Energy access, efficiency, and health and environmental impacts will drive the industry's strategic CSR agenda

Source: Wustenhagen/Meyer/Villiger, SAM

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11

This slide summarizes the strategic challenge and the opportunity. Global energy needs cannot be met by current energy systems. In our view energy access, efficiency and health and environmental impacts will drive the industry's strategic CSR agenda. These will open opportunities in all sectors as indicated by the arrows on this diagram.

History tells us that in such conditions value migration will create new winners

Innovative business designs that meet customer/stakeholder priorities drive value growth; often at the expense of entrenched players

Innovative Company	Source of Value Creation
Federal Express	Superior logistics and execution
Nucor	Low cost steel production
Wall-Mart	Low cost distribution
Southwest Air	Point-to-point system
Starbucks Coffee	Gourmet coffee as an affordable luxury
Charles Schwab	Low cost distribution
Intel	Rapid product development
Royal Dutch Shell	Managing uncertainty through scenario planning

**When will value migration occur in the energy industry?
Who will be the winners and losers?**

Sources: Slywotzky – Value Migration

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In the last 15 years industry after industry has witnessed disruptive business models. This chart lists a number of well known examples of innovative companies that have created new business models and transformed whole industries. The case of Royal Dutch Shell is of interest in that Shell through it use of scenario planning was able to move from being one of the weakest of the seven sisters in the early 70’s to one of the strongest in the early 80’s/

The question for those of us in the energy industry is when will global factors such as those we have been discussing lead to new winners and losers and how will we fare

Leading players in the auto and energy industries are exploring alternatives

Opportunities
& Threats

- World Business Council for sustainable development sustainable mobility project
- GM's fuel cell initiative
 - Driven by the challenge of mobilizing China
 - A smarter automobile with drive by wire and modular construction
- Iceland's goal to become the first hydrogen economy
- Accenture's vision for a transition to hydrogen fuel
- Shell's current scenario planning includes an innovative energy future

Disruptive technologies can create major shifts in the competitive landscape. Established players must find ways to experiment and learn - often in new market niches with different economics.

Leading players in the auto and energy industries are already exploring energy alternatives. This slide lists a number of these many of which you are likely familiar with. While some of these examples could be dismissed as relatively tiny investments it is instructive to note the success requirements for disruptive technologies identified through leading research at Harvard Business School. Established player must find ways to experiment and learn if they are to succeed with disruptive technologies. These technologies by definition are not immediately successful with core customers and must be introduced to specific market niches with different needs and economics. Hence it is easy for others to dismiss or overlook such activities as not being important until it is too late.

CSR issues also suggest a range of operational opportunities and threats

Opportunities
& Threats

		Oil and Gas Example			
		Exploration and Production	Transport	Refining And Distribution	Marketing
Threat	Opportunity				
✓	✓	XXX	XXX	XXX	XXX
✓	✓	XXX	XXX	XXX	XXX
✓		XX	XX	XX	XX
✓	✓	X	X	X	X
✓	✓	X	X	X	X
✓	✓	X			
✓	✓	XX	X		
✓	✓	XX			
✓		X		X	
✓				X	X
✓	✓	X			X
✓	✓			X	XXX

Source: Innovest, UNEP, SVP analysis ©2003. Sustainable Value Partners, Inc.

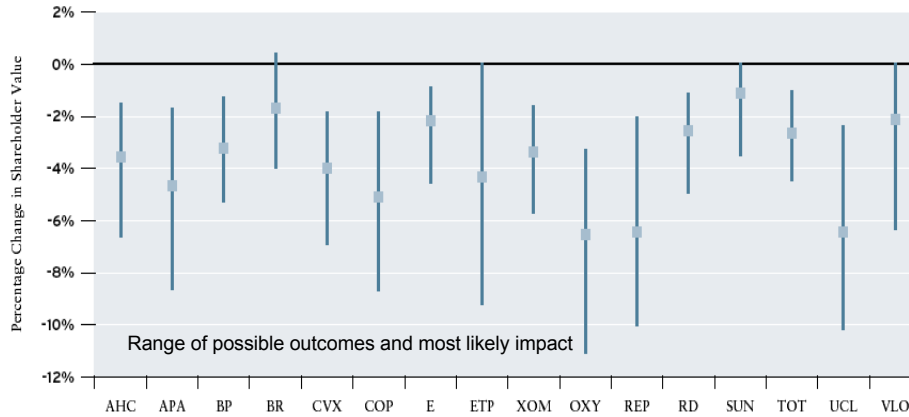
14

Now let's switch gears and take a look at opportunities and threats at the operational level. This slide lists a number of opportunities and threats for the oil and gas industry. On the slide we list a number of issues, indicate whether they are likely to pose opportunities, threats or both and also, indicate the parts of the value chain that are most affected.

CSR issues can represent a significant threat to shareholder value

Opportunities
& Threats

Combined Financial Impact of Climate Policies and Restricted Access to Reserves



Source: WRI Changing Oil, 2002

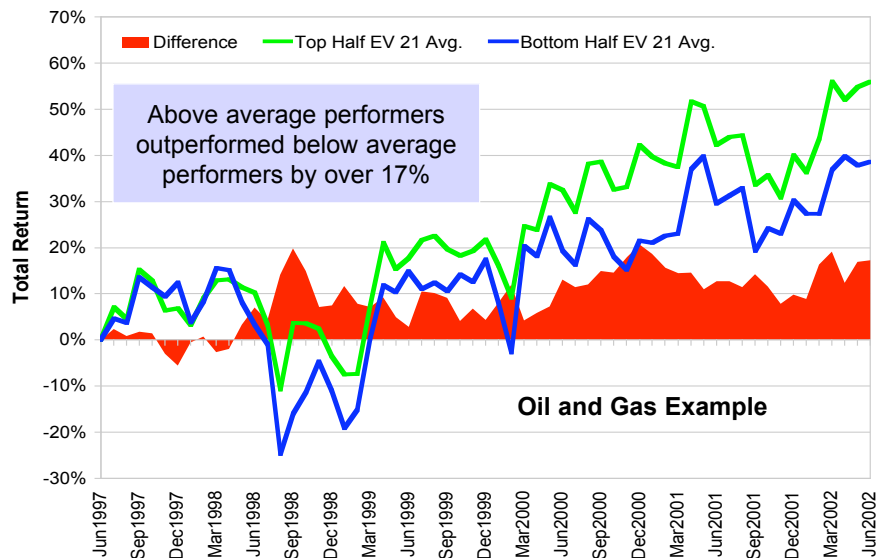
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15

CSR issues can represent a significant threat to shareholder value. This slide shows the results of an analysis performed by WRI and published in a report entitled Changing Oil. This slide shows the magnitude of possible and most likely financial impact of climate policies and restricted access to reserves. Each oil company has a different risk profile. The range of impacts depend upon the particular companies operations and policies. According to this analysis, at the extreme these policies could drain shareholder value by as much as 10%.

Leaders in CSR create more shareholder value

Opportunities
& Threats



Source: Innovest EV21 ratings of Integrated Oil & Gas Sector Companies, 2002

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16

On the positive side, Innovest, a financial rating firm has determined that companies with above average performance on their Eco 21 ratings create more shareholder value than those with below average ratings. The red indicated the difference in performance gap of more than 10%.

While this correlation does not prove cause and effect, we believe that case studies can provide insight into how leaders do in fact deliver new value through CSR.

Examples of operational-level CSR opportunities

Opportunities
& Threats

- Better capital investment decisions through stakeholder assessment and carbon pricing
- Improved resource productivity and energy efficiency throughout the value chain (e.g. alternatives to flaring)
 - May require finding alternative sources of capital
- Safe access to sensitive exploration/production sites through stakeholder approaches that respect and protect biodiversity and indigenous peoples
- Technical innovation and stakeholder approaches to reducing remediation costs and risks and to maximize real estate value
- Access to emerging markets requiring a smaller footprint and appropriate delivery mechanisms

This slide lists some examples of operational level CSR opportunities that can enhance financial performance. These include improved capital investment decisions, improved resource productivity, improved and perhaps faster access to sensitive exploration/production sites, remediation cost savings and new market opportunities an example of which I will briefly discuss next.

Case example: Shell broadens LPG market in Sri Lanka

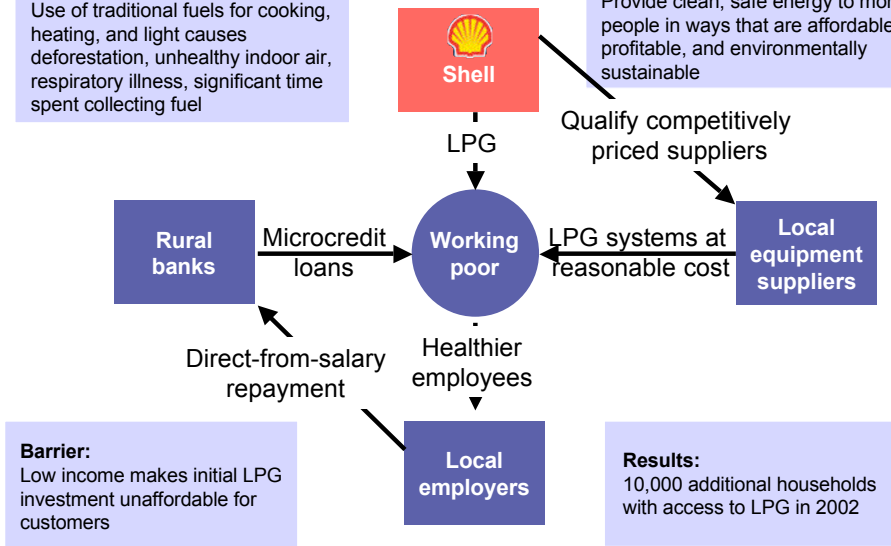
Opportunities
& Threats

Societal Problem:

Use of traditional fuels for cooking, heating, and light causes deforestation, unhealthy indoor air, respiratory illness, significant time spent collecting fuel

Business Opportunity:

Provide clean, safe energy to more people in ways that are affordable, profitable, and environmentally sustainable



Source: Shell

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18

In this example Shell was able to introduce LPG as an alternative to kerosene and firewood in rural Sri Lanka. Use of LPG helps to reduce deforestation and pollution. Open fires can contribute to poor health and respiratory problems in women and children. The benefits of switching from kerosene or firewood to LPG are many. There is less smoke and fewer accidental fires. Furthermore, using LPG creates more free time as fuel gathering, along with collection of food and water, in poor regions can take the entire day, everyday.

In the rural areas of Sri Lanka, the use of firewood and kerosene is widespread and the average household income is low. It is tough for people to find the initial capital for LPG-based equipment, such as stoves or lamps.

By tailoring its market offering to local needs, Shell provided 10,000 Sri Lankan households with access to LPG for the first time in 2002. To supply simple, affordable domestic LPG packages, they developed partnerships with distributors and rural banks to secure credit terms for customers; worked with local companies to agree direct-from-salary repayment schemes for their staff; and identified a number of competitively-priced equipment suppliers that offer customers an affordable deal.

Most companies make at least one big error when implementing CSR

Capturing
Value

Discipline	Description of Error
1. External focus	Do not effectively segment stakeholders. Poor understanding of business impacts on stakeholder value and stakeholder impacts on business value.
2. Anticipation	Are caught off-guard by changes in society. Ineffective anticipation of future issues. Slow to identify and act on opportunities and threats.
3. Goal setting	Do not adopt effective CSR goals to focus and guide efforts and resources. Avoid the tough issues.
4. Initiative design	Do not develop innovative cross-functional solutions that create both shareholder and stakeholder value.
5. Business case	Lack a compelling business case that wins the attention and commitment of business unit managers.
6. Value capture	Do not mobilize the line, implement cross functional solutions and deliver on CSR promises.
7. Feedback/ learning	Measurement is not effective and does not result in useful feedback and learning from CSR results.
8. Capacity building	The necessary understanding and mindset is not built throughout the organization.

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19

We will now shift gears one more time. We have argued that CSR is important and have discussed strategic and operational level opportunities and threats. However the challenge for most companies is to systematically use CSR as a lens for value creation. In our experience, most companies make at least one big error when implementing CSR. Such errors keep them from consistently realizing the value creation potential. In essence, CSR is typically not yet managed with the same discipline and rigor that are applied to other parts of the business.

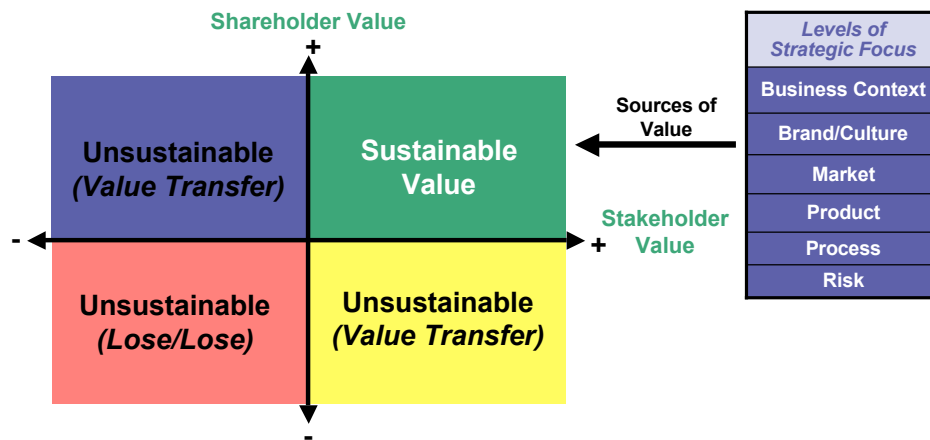
On this slide we list eight common errors one for each of eight required disciplines. While I will not take the time to discuss each of these now however I will highlight two common errors. The first (number 2) is a failure to anticipate changes in stakeholder expectations. Companies are caught off guard by changes in society because they have been ineffective in anticipating future issues and slow to identify and act on opportunities and threats. In fact, many of the companies that are leaders in CSR today have gotten their precisely because such failures led to a wake up call.

The second is item 6 a failure at value capture. A common error in this area is one where those worried about CSR issues are unable to mobilize the line and implement cross functional solutions to deliver CSR results. CSR needs to inform business activity – the failure is when CSR is managed in a separate and un-integrated manner.

To avoid these errors and to systematically use CSR as a lens to inform the business a systematic approach is useful. On the next slide I will discuss some components of one such an approach.

To be effective, a value-driven approach to managing CSR is required

Capturing Value



Sustainable Value = Value that is Positive for Shareholders and Stakeholders

On this slide we introduce a shareholder stakeholder matrix. The matrix is used to map value creation for a business, plant or project. The green upper right quadrant represents value that is positive for both shareholders and stakeholders. We call this sustainable value. Positive value for important stakeholder groups contains hidden sources of future shareholder value. An obvious example is customer loyalty. Other examples include gaining community and governmental support for key projects.

Conversely, when operating in the blue quadrant where value is being transferred from stakeholders to shareholders you are at risk of stakeholder backlash.

Moving a business, product, plant or project into the green quadrant requires innovation and creative action. We find it useful to look for these actions by directing attention at one or more levels of focus as indicated on the right side of this slide.

The levels of focus are further explained on the next page.

Sources of stakeholder and shareholder value can be found at six levels

Capturing Value

Levels of Strategic Focus	Sources of Value at Each Level
Business Context	Changing the “rules of the game” so that sustainable strategies are both feasible and competitive.
Brand/ Culture	Gaining competitive preference, license to operate, and employee motivation through creation of positive stakeholder value.
Market	Addressing new markets driven by customer and societal needs using new business models designed through stakeholder partnerships.
Product	Using stakeholder value as a driver of product innovation.
Process	Reducing energy, waste or other process costs and improving quality for customers and stakeholders
Risk	Achieving investor recognition and customer preference by meeting stakeholder expectations for responsible behavior.

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21

Here you can see each level of focus with an explanation of the sources of value. It is easiest to read this starting at the bottom. At the most basic level the approach is to manage risk and meet stakeholder expectations for responsible behavior. The next level is process, this includes efforts to improve eco-efficiency and quality. At the product level we refer to product innovation to meet stakeholder needs. The business context level is also worth pointing out. This refers to changing the rules of the game so sustainable strategies are both feasible and competitive. In some cases this could be helping to shape the regulatory or industry environment. It could include partnerships with stakeholders or helping to build capability in the value chain.

A shareholder value driver matrix helps to identify business value

Capturing Value

Example: Affordable LPG Service (Shell) *Value Drivers*

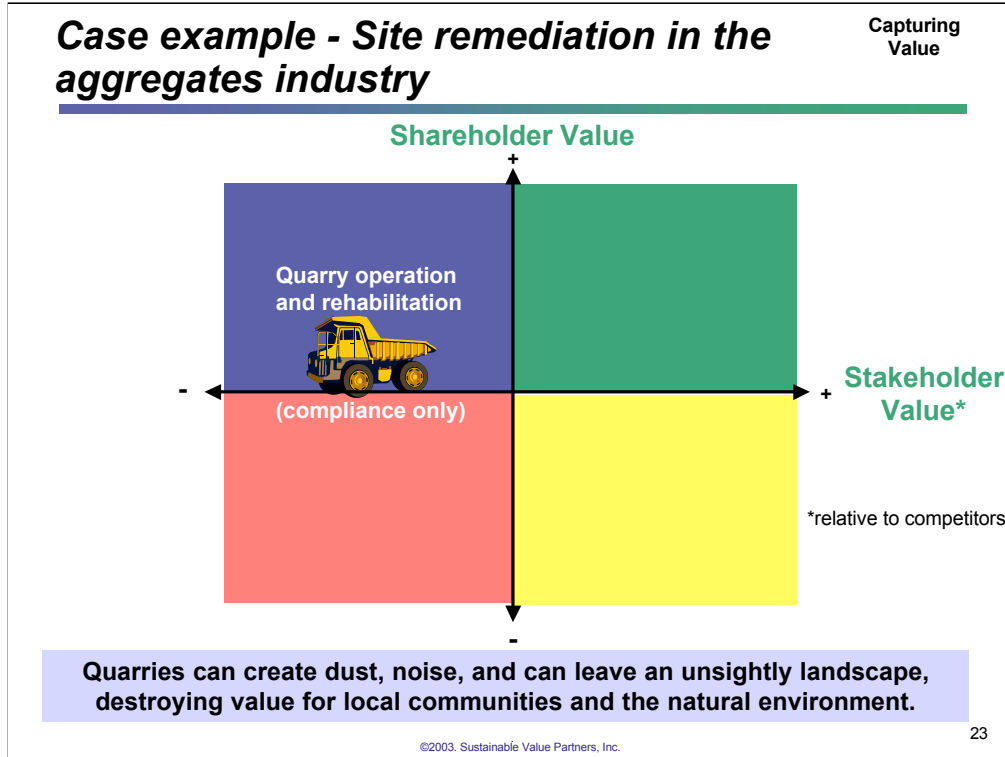
Levels of Strategic Focus	Profitability	Capital Efficiency	Cost of Capital	Growth	Intangibles	Market Confidence
Business Context			Help business partners get established (Micro-credit)			
Brand/Culture			Attraction of socially responsible investors?		Building strong local partnerships Strengthened reputation due to societal value	Perception of foresight, attention to social value issues, and innovation
Market				Access to previously unserved segment of market	Learning on creating service and business models for emerging markets	
Product				Expand use of LPG Creation of innovative product/service package that builds demand		

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22

The levels of focus can be used to help build the business case for specific action. In this case we have mapped the Shell LPG case example against four of the levels of focus on the left side. Across the top we have included the drivers of shareholder value. The first four drivers are in-fact economic values added, a popular way to represent and manage shareholder value. We have also added two drivers that are increasingly being managed and are particularly relevant for CSR initiatives. These are intangible value and market confidence.

For the Sri Lanka case we have identified eight value sources. These include access to previously un-served market segments and creation of innovative product service package to build demand.

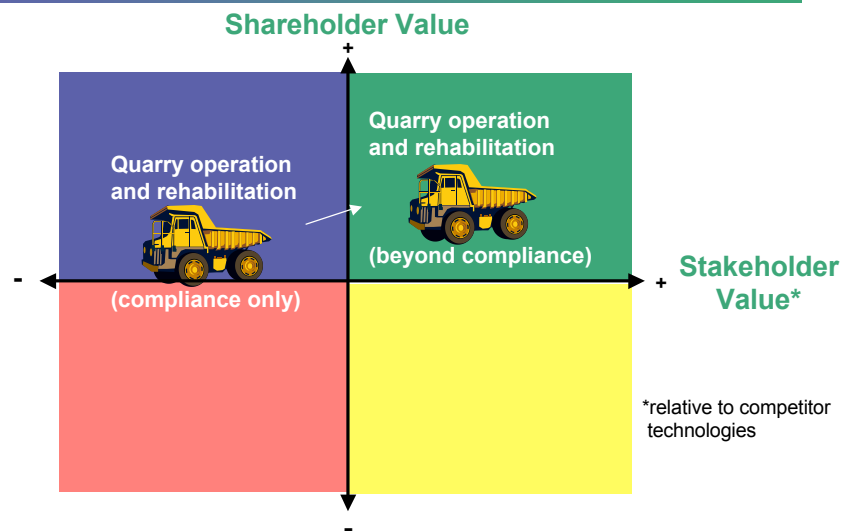


I would like to briefly touch on one more case. This one deals with site remediation in the aggregates industry.

For this example I would like to compare two companies. The first is one with a compliance orientation that focuses internally, attempting to operate its quarries at lowest cost, avoiding interaction with local communities, doing only what is required by law to deal with dust and noise pollution, and considering quarry restoration as a necessary expense, to be done as an exercise in minimal compliance. Individual quarry managers are evaluated solely on their profitability. Avoidance of legal problems is expected, but the unspoken rule is that violations of regulations are acceptable, as long as you don't get caught.

Companies that go beyond compliance can create positive value for communities

Capturing Value



By exceeding minimum compliance, an aggregates company can create value for local communities and the environment, leading to new sources of profit.

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24

The second company operates with standards for dust and noise control that are beyond compliance levels. This company co-designs its quarry rehabilitation plans with local communities, and restores and rehabilitates spent quarry land through re-forestation and re-introducing plant and animal species.

The first company is placing shareholder value at risk through ignoring stakeholders. The second company creates positive stakeholder value through its strategy.

Quantifying shareholder value from innovative site remediation

Capturing Value

Sources Of Value		Cash Impact
1. Permit related advantages (improves profitability)	■ Longer duration permits add years of cash flow	
	■ Permits closer to markets lower transport costs	
	■ Shorter permitting process lowers costs	
2. Reduced risk of community opposition (increases expected profitability)	■ Avoid higher raw materials cost or in worst case cement plant closure	
3. Higher land values (increases capital efficiency)	■ Reclassification from agricultural to higher valued land status (residential, urban, wetlands)	
4. Eco-efficiencies (improves profitability)	■ Overburden moved only once	

Winning companies systematically incorporate sustainable value by integrating CSR initiatives into their core business practices.

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25

In turn, this positive stakeholder value drives multiple benefits:

- More favorable permitting terms (faster permit approvals for extensions, longer duration permits)
- Higher land values once the spent quarry site is sold
- Reduced risk of community opposition to quarrying activities
- Quarry licenses for more desirable locations than its competitors, reducing transport costs.

All of these benefits translate directly to bottom line profitability and measurably increase shareholder value. These kinds of benefits can only be discovered through proactively focusing on stakeholder value -- incorporating social and environmental stakeholders into the thinking process of the firm

In summary, you can capture shareholder value from CSR by mastering eight disciplines

Disciplines	Key Attributes
1. Understand your current value position	Understand where and how the company is creating or destroying shareholder and stakeholder value
2. Anticipate stakeholder expectations	Track key trends, identify emerging issues, and anticipate new stakeholder expectations
3. Set sustainable value goals	Establish vision and goals regarding how to create additional value for shareholders while reducing negative impacts and/or creating value for stakeholders
4. Design value creation initiatives	Identify sources of value and design initiatives to capture shareholder and stakeholder value
5. Develop compelling business case	Build a business case and obtain the resources needed to capture shareholder and stakeholder value
6. Capture the value	Undertake activities and implement initiatives to capture shareholder and stakeholder value
7. Validate results and capture learning	Measure progress, track and validate results in capturing shareholder and stakeholder value
8. Build capacity	Develop the mindset, capabilities and skills needed to capture shareholder and stakeholder value

In summary, strengthening the link between CSR and shareholder value requires a disciplined approach to understanding and managing stakeholder value.

For example, in order for our “beyond compliance” aggregates company to succeed they needed to understand which stakeholders really mattered, how they impacted them, and the business implications of this.

They used the opportunities and threats arising from stakeholders to inform business strategy and operational actions and they integrated a beyond compliance logic into their business system. They managed opportunities and threats arising from stakeholders just as you did any other important business issues.

You too can do this effectively by mastering the eight disciplines of sustainable value presented on this slide. Importantly you must effectively diagnose (disciplines 1 and 2), prescribe (disciplines 3-5) and execute (disciplines 6-8).