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How to Create a Stakeholder Strategy

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Summary. Lately companies have come to recognize the limitations of the view that they must create value only for shareholders. Recognizing that every stakeholder has an impact on other stakeholders—engaged employees improve customer satisfaction, which in turn spurs... **more**

Most people will readily agree that the first responsibility of business leaders is to grow the long-term value of their companies. But that's where the agreement ends and the debate begins: What is value, and how should it be measured and managed? Is a company's value maximized by being shareholder-centric, customer-centric, employee-centric, or some-other-stakeholder-centric? In a complex system where every stakeholder influences other stakeholders' outcomes—highly engaged employees improve customer satisfaction, which in turn helps accelerate profitable growth, and so on—are any stakeholders safe to neglect?

Hundreds of high-profile CEOs—including 181 who signed a 2019 Business Roundtable statement on the purpose of the corporation—are pledging to lead their companies for the benefit of all stakeholders: customers, employees, suppliers, communities, and shareholders. Few, however, have disclosed explicit strategies for how they will do that. Most seem to be relying on intuitive approaches, which are hard to scale up and sustain because they're based on leaders' gut feelings about what matters most rather than specific criteria that can be codified to make delegated decision-making consistent and aligned with leadership's strategic intent. Worse, when leaders whose personal visions have guided their companies leave their organizations, they take their intuitive strategies and commitment with them.

But the good news is that firms can use data—which is increasingly accessible and rigorous—to craft and implement effective growth strategies that recognize the complex interdependencies among stakeholders, create mutual benefits for them, and increase the net value generated collectively for their constituents. This article will explain how. It will also describe how to translate such strategies into organizational goals and measure and manage progress toward them.

Better Tools for Measurement

For a long time the argument against holistic stakeholder strategies has been that you can't create value across all dimensions of performance without hurting shareholder value. But a decade's worth of data shows us that this is simply not the case.

In recent years dozens of firms have helped substantially improve the quantity and quality of publicly available data about companies' impact on their stakeholders. For example, firms such as London Stock Exchange Group/Refinitiv and Institutional Shareholder Services developed standardized ways to measure the level, quality, and sustainability of financial results and shareholder returns. Data on customers has improved with the help of Bain & Company's Net Promoter Scores, J.D. Power's ratings on satisfaction, and the American Customer Satisfaction Index. Glassdoor and Payscale have produced mountains of data about employee engagement and compensation. Firms such as Sustainalytics and MSCI have gathered deep data on companies' impact on their communities. And with greater access to high-quality data, independent rating agencies such as the Drucker Institute, Just Capital, and the Embankment Project for Inclusive Capitalism began to conduct sophisticated analyses of the complex relationships among stakeholder interests.

All that data was clear: The companies that create the greatest total value across all dimensions of performance don't do so at the expense of shareholder value. For example, the Drucker Institute's annual rankings, published in conjunction with the *Wall Street Journal,* combined with S&P Global analyses, show that a portfolio of the 200 most effective creators of stakeholder value in the S&P 500 Index consistently delivers total shareholder returns as high as those of the entire index. In addition, over the past decade the 100 companies on the S&P/Drucker Institute Corporate Effectiveness Index, which consists of S&P 500 firms that are the best at creating value through "excellence in employee engagement and development, customer satisfaction, social responsibility, innovation, and high-quality earnings," delivered total shareholder returns that were more than 200 basis points higher per year, on average, than those of the S&P 500.

Just Capital's data suggests the same thing. Since 2016 the nonprofit has been rating companies in the Russell 1000 Index on their impact on workers, communities, shareholders, customers, and the environment. Those in the top 50% of its rankings in each industry are included in the Just U.S. Large Cap Diversified Index, whose returns have topped the Russell 1000's returns by 6.55% since its inception. Some venerable companies in the index, such as Procter & Gamble (founded in 1837) and Merck (founded in 1891), create consistently high value for multiple stakeholders. It stands to reason that such firms are more likely to generate long-term shareholder value than flashier companies rife with burned-out employees and distrustful customers.

Stakeholder Strategies in Practice

Now let's explore how companies can harness data to create and execute successful stakeholder strategies, following a three-step process. We'll use the experiences of a company we'll call Health Tech, a composite of several firms we have advised over the past five years, to illustrate how it works.

Health Tech is a provider of medical equipment such as imaging machines, advanced surgical tools, cardiac devices, endoscopic products, and patient-monitoring systems. It has been a darling of Wall Street—mostly because it has grown by expanding its product line through rapid innovation. But in 2018 its CEO, Brian Ward, was disappointed and surprised to find that Health Tech was near the middle of the pack on ratings of more than 800 companies by both Just Capital and the Drucker Institute. His first inclination was to dismiss the findings as flawed or agenda driven. But anticipating that his board of directors might start asking questions, he decided to develop a convincing response about why the ratings were wrong. To do that, he first needed to delve into how Just Capital and the Drucker Institute developed them.

Step 1: Make sense of outside perspectives. Your goal is simply to understand how rating agencies see your company. Each one thinks companies should be maximizing something, although what it is may differ by agency. The agency determines the end objective (such as social justice, management effectiveness, or brand value), develops criteria to determine if a firm is achieving it (and assigns different weights to each), and then evaluates and ranks all firms. Ratings will vary by agency and may not fairly assess your strategy. However, you need to understand them.

Exploring outsiders' perspectives on your company will help you overcome confirmation bias and perhaps uncover valuable data sources. But you don't need to accept them as gospel. Instead you should ask, Does this assessment fairly depict our current performance relative to other companies? If not, what's wrong with it? What questions does it raise about our strategy, its future success, and required adjustments?

With a focus on architecture, graphic elements, and line work, Nina Papiorek's photographs convey a sense of minimalism and organization within an urban environment.

Looking for answers to these questions, Ward decided to see how Health Tech compared with its leading competitor, an older and larger company we'll call Global Medical. When he reviewed the relative rankings, he was shocked: They indicated that Health Tech was creating substantially less value for its system of stakeholders than Global Medical was.

To get a clearer read on the differences, Health Tech set out to calculate a net value creation score for both companies.

- First it used multiple-criteria analysis tools (which help users compare apples and oranges by creating a common currency) and converted the Drucker Institute performance data (which shows each firm's deviation from the average stakeholder score) into a scale from positive 100 (for extraordinary value creation) to minus 100 (for severe value extraction).
- It then plugged in the Drucker Institute's weights for all stakeholders (for example, in 2019 customers were weighted at 15% and shareholders at 21%) and multiplied the converted performance scores by the weight in each category to get the units of value created for each. For instance, Health Tech's customer performance rating of 33, multiplied by the 15% weight, yielded a score of 4.95 in that category.
- Finally, all the individual category scores were added together to create the net value scores.

Those scores showed that while Health Tech generated a lot of short-term value for shareholders and some for customers, for other stakeholders—its unhappy workforce, its communities, and its suppliers—it was actually *extracting* value. Overall, it created only five units of net value. Global Medical, in contrast, created 56. While it created only 14 units of short-term value for investors, it generated 15 for its engaged and productive employees, 14 for its satisfied and loyal customers, 10 for its collaborative suppliers and partners, and five for its communities. For the first time, Ward began to wonder if Global Medical had a long-term competitive advantage.

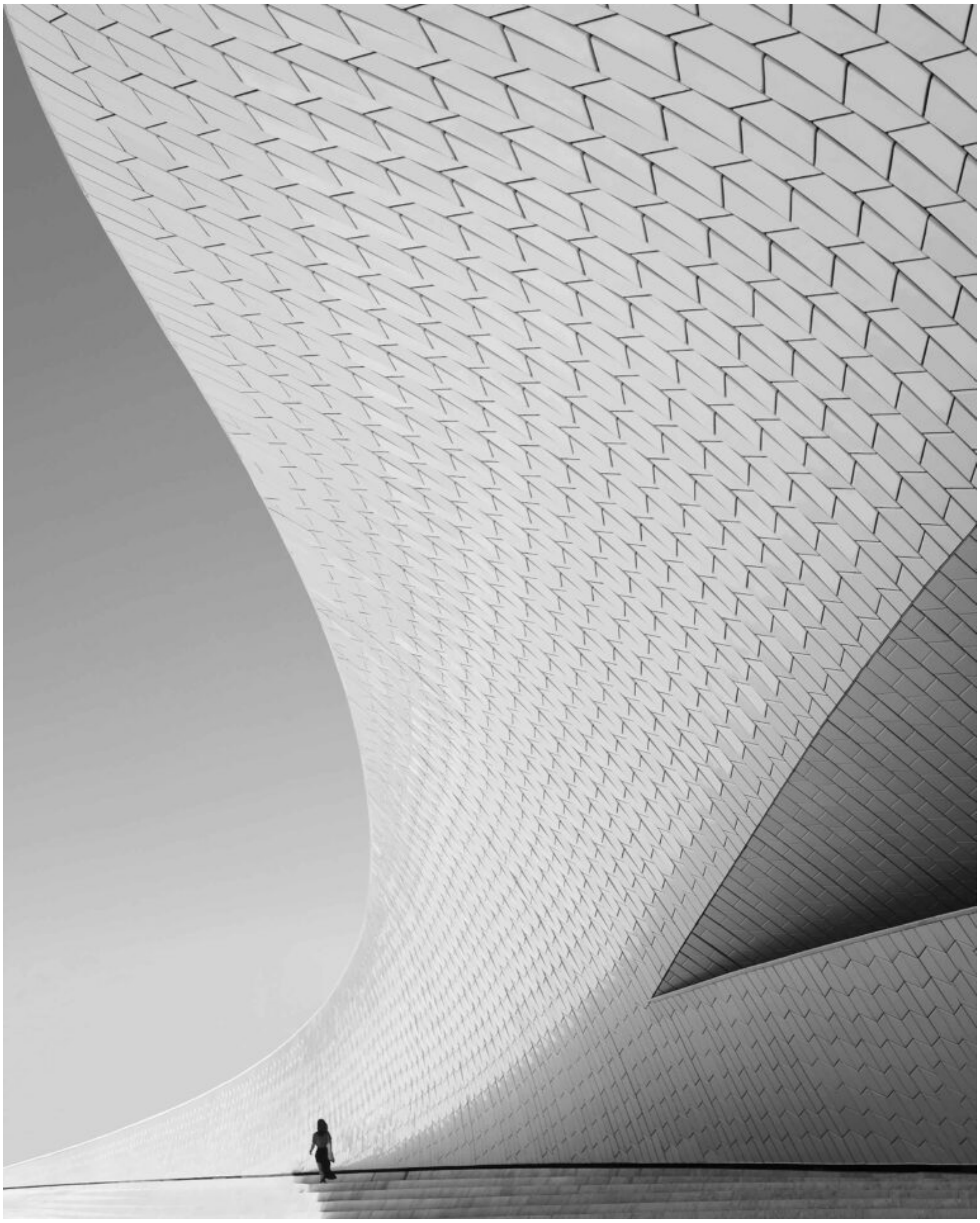
But was that picture accurate? To see whether it was, Ward asked a group of six people, including several C-level executives, to dig further into the ratings and their original data sources. The team also explored the ratings of stellar performers in other industries to understand what great performance looked like. According to the Drucker Institute, Microsoft's scores on innovation and overall effectiveness, for example, have increased more than any other company's since the institute began ranking companies, in 2017. The team saw that Microsoft's CEO, Satya Nadella, had been emphasizing the importance of integrated value creation for all stakeholders. "One of the things I've recognized is that the CEO's job is to figure out how to harmonize the multiple constituents who are all important," including investors, customers, employees, partners, and governments, Nadella told Jessi Hempel in her LinkedIn podcast *Hello Monday.* Ward and his team also studied Procter & Gamble, the only company that has scored in the top 15% to 20% of all companies on all performance dimensions in all six years of the Drucker Institute's ratings. Maintaining those scores has been no small feat: P&G has faced antagonistic clashes with activists (including shareholder Nelson Peltz) but has stayed true to its stakeholder strategy and continued growing value—even during a change of its top leadership.

That's not to say that Ward and his team took all this data at face value. For example, third-party scores are at best imprecise in measuring B2B customer satisfaction because it's expensive and time-consuming to survey such buyers. If Health Tech invested in producing its own valid customer ratings, like NPS, however, that would give it more accurate results and insights into its value creation.

Step 2: Create your own stakeholder strategy. As part of this process, you must move beyond public rankings that assign the same weight to all stakeholders of all companies and that rely only on publicly available data. You need to bolster external data with insider insights and analyze the interdependencies among your particular stakeholders. Once you've done that, you can begin crafting your stakeholder strategy, which should provide a clear description of your company's purpose, establish criteria for evaluating progress toward it, determine priorities among stakeholders, and measure value creation for each stakeholder group.

At first Ward and his team hoped that the outside analysis presented a skewed perspective. With customer satisfaction, for example, they found that third-party raters focused mainly on patients, who were the easiest customers to survey, though few of them even knew what medical equipment was used in their care. Health Tech had more customers than that to worry about. It had to understand how physicians and their teams felt about using the equipment and how hospital administrators felt about purchasing it. The team set up interviews with customers in those groups, which revealed that Health Tech's engineers were creating bells and whistles for its products that added little perceived value but increased prices and reduced ease of use and reliability. Because of that, medical teams and hospital administrators were dissatisfied with Health Tech and considering other suppliers. And they weren't the only unhappy stakeholders: Internal surveys confirmed the outside agencies' findings that employees' dissatisfaction was high.

With these sobering insights, Ward and his team focused on understanding the connections among stakeholders. For example, which management practices were causing employee frustration? How did that, in turn, affect value creation for customers, and what impact did that have on financial results? They had never attempted to understand the links among stakeholders or to prioritize and weight the importance of various stakeholders when trying to resolve conflicting interests. In the past they'd just automatically favored investors over everyone else.



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Again, the team began with external benchmarks but found them confusing. For example, in 2022 Just Capital gave employees a weight of 44%, while the Drucker Institute gave them only 19%. Studies of top-performing companies also revealed differing priorities. Take Costco, whose cofounder and former CEO, Jim Sinegal, faced constant pressure to reduce value for his customers and employees and transfer more to shareholders. He refused, famously explaining the company's strategy to the Motley Fool this way: "We've got essentially four things to do in our business: We have to obey the law, we've got to take care of our customers, take care of our people, and respect our suppliers. We think if we do those four things, pretty much in that order, that we're going to do what we have to do in the long term, which is to reward our shareholders. We think it's possible to reward them without paying attention to those four things in the short term, but if you don't pay attention to them in the long term, we think you stub your toe somewhere along the line." That prioritization is explicitly spelled out on Costco's website to this day. Virgin Group's founder, Richard Branson, has a different point of view: "If you can put staff first, your customer second, and shareholders third, effectively, in the end the shareholders do well, the customers do better, and [you] yourself are happy," he told *Inc.* magazine. The lesson is not that every company should be like Costco or Virgin. There is no one "right" stakeholder strategy.

Health Tech's team decided that stakeholder priorities and weights should reflect the company's own objectives and actual experience. So, using nearly a decade of data on all stakeholders, the team created a simulation model that could approximate the interdependencies among the stakeholders. It helped Health Tech understand how changes in the value produced for one stakeholder changed the value produced for others over time and identified the actions that would create the greatest net value for all stakeholders going forward.

The team's analysis triggered intense discussions in the leadership group about Health Tech's strategy, the appropriate weights for various stakeholders, and how to measure and manage value creation for each group and for the company as a whole. The leaders decided to change the firm's mission statement from "Our goal is to deliver top-quartile financial results by developing industry-leading innovations" to "Our mission is to help health care providers improve the lives of patients by creating a business system that grows long-term value for all our stakeholders." Using statistical techniques such as multivariate regressions, the team created weights for each stakeholder, which took into account three factors: the company's ability to change the stakeholder's results, the stakeholder's direct impact on business results, and the stakeholder's impact on other stakeholders that, in turn, affect business results.

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Experiments and statistical analyses showed that investments in customer value had the greatest impact on other stakeholders and on net value creation, while investments in local communities had the least impact and longest lags. So the team decided to give customers a weight of 30%, employees 25%, shareholders 20%, suppliers 15%, and communities 10%. It then identified four to six criteria for developing a performance score for each stakeholder (again, on a scale from minus 100 to plus 100). By multiplying the stakeholder's weight by its performance score, the team could easily calculate the units of value created for each stakeholder and for the entire company. Health Tech then set minimum acceptable performance scores for each stakeholder and a goal of increasing its new proprietary net value creation score from 10 units of value to 45 units in the next three years.

After two years of work, the company's leadership had traded a vague strategy asserting that good stakeholder outcomes would come from maximizing shareholder value for an explicit strategy that aimed to grow net value for its stakeholders by 35 points. On paper, it was a beautiful plan. The next step was to make it work.

Step 3: Create systems to sustain your stakeholder strategy. To succeed a strategy must be able to outlast the enthusiasm and tenure of any individual executive. This means you need to (1) ensure that the entire company understands it, everyone's role in it, and how individuals' goals affect all stakeholder goals, and (2) institute disciplined routines for decision-making and execution. To establish an enduring operating model, Health Tech focused on five key things:

Building a culture that embraced the stakeholder strategy. This started with the board. In an age when activists for shareholders, employees, and the environment are winning board seats, Ward believed it was vital for his board to understand the strategy and its rationale. After all, the directors would ultimately need to explain and defend it. Ward also decided that he had to change the makeup of the board to better represent all stakeholders and help the company better serve them. Several general directors were replaced with experts in customer experience, employee engagement, and supplier partnerships.

Ward also created new metrics for his senior team that captured overall value creation and the results for individual stakeholder groups. Because the metrics were still evolving, he hesitated to overhaul incentives and compensation packages to reduce the emphasis on shareholders and increase the focus on other stakeholders. But he did add a separate bonus tied to net value creation for the company's top 250 executives and led monthly reviews of the scores.

Designing organizational structures that increased cross-stakeholder collaboration. Ward decided to add experts in behavioral science, business processes, technology, and agile innovation to the small stakeholder-strategy team. He eventually made the team part of the strategy department that reports to the CFO. That way, it became a natural part of strategizing and budgeting.

Establishing new processes that helped grow stakeholder value. Ward and the CFO asked all business units to begin their quarterly business reviews with descriptions of their value creation trends and targets. They also changed the process for investment proposals. In the past proposals had made only financial forecasts. Now major proposals had to project the impact on stakeholders. If tough trade-offs were necessary, they would be made using the priorities and weights defined by the strategy.

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That approach guided Health Tech's difficult choice to continue testing on animals, for instance. Because the company's stakeholder strategy puts the highest weight on customer value and patient satisfaction, leaders made the decision to continue accepting the financial and social risk of animal-testing facilities as an unavoidable cost of prioritizing the patient until simulated tissue could come close to matching live tissue in its value for product design, manufacturing, and training. Health Tech also decided to proactively communicate such decisions to relevant stakeholders and work with them on better solutions.

Redesigning business processes to support stakeholder strategies. Ward understood that people will generally do what a system makes easiest and most rewarding. So he and the CFO asked the stakeholder team to identify business process improvements that would have the greatest impact on net value creation.

The team started by developing better ways to collect feedback about stakeholders' needs, satisfaction, and frustrations with Health Tech. Medical teams and hospital administrators said they wanted more-reliable products and fewer unneeded software features. The team increased customer collaboration with product development teams to fulfill those wishes. Employees said they were frustrated by the bureaucratic approvals required for things such as warranty repairs and urgent service calls. The team gave them greater autonomy to do the right thing quickly and created a program that recognized employees who were "stakeholder champions," publicized their contributions internally and externally, and gave them awards like cash and vacations. For suppliers, the team created "prime partnership" programs and open platforms for collaborating on breakthrough innovations.

Communicating honestly to attract the right stakeholder segments. As Health Tech studied its stakeholder data in greater detail, it found that average scores for each stakeholder were hiding high satisfaction among some segments and low satisfaction among others. Health Tech had always segmented its customers (for instance, into neonatal patients versus adults and teaching hospitals versus urgent care centers), but it had never considered segmenting other stakeholders such as employees and investors. Many of Health Tech's investors, for example, wanted revenue growth far more than they wanted engaged employees. Many employees wanted pay increases far more than they wanted to improve the lives of patients or fellow team members. So Ward and his team decided to segment all stakeholders, prioritize each segment's importance to the Health Tech system, be forthright in communicating the new value proposition to everyone, and attract the right segments and minimize the others. They changed the company's investor reports and conferences to highlight stakeholder value successes and began meeting with investment funds that favored stakeholder capitalism. They revised recruiting messages and employee evaluation criteria to stress empathy for patients and fulfillment through collaborative teamwork.

All those efforts have begun to pay off. The company's rankings by third parties have improved over the past four years. More important, the firm's own net value creation metrics have improved. Two years after setting the goal of raising its score from 10 to 45, Health Tech has lifted it to 42, with the greatest increases coming in customer and investor value. Employee value has also improved slightly, but more through better delegation and reduced bureaucracy than significant increases in base compensation. Also, as the company refines its understanding of the causal relationships among stakeholder outcomes, its weighting system has evolved.

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A July 2019 survey of 1,026 adults commissioned by *Fortune* found that two-thirds of U.S. adults now think a company's primary objective should be making the world a better place. According to the 2022 Edelman Trust Barometer, adults around the world believe businesses can be unifying forces in society and so should step up to shape more-balanced policies on jobs, technology, wage inequality, climate change, discrimination, immigration, education, and health care. They want businesses to grow value for all stakeholders.

But this is not simply a worthy aspiration. Companies that create strategies to benefit all stakeholders and establish systems for implementing them build businesses that are more successful and resilient. They reduce the risks of customer defections, employee turnover, loss of shareholder confidence, community protests, harsh regulations, and competitive disruptions—any of which can be crippling. Moreover, as executives at companies that have adopted stakeholder strategies, such as Costco, Microsoft, and P&G, can attest, a stakeholder-based approach to running a business can make leadership roles more meaningful and rewarding.

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