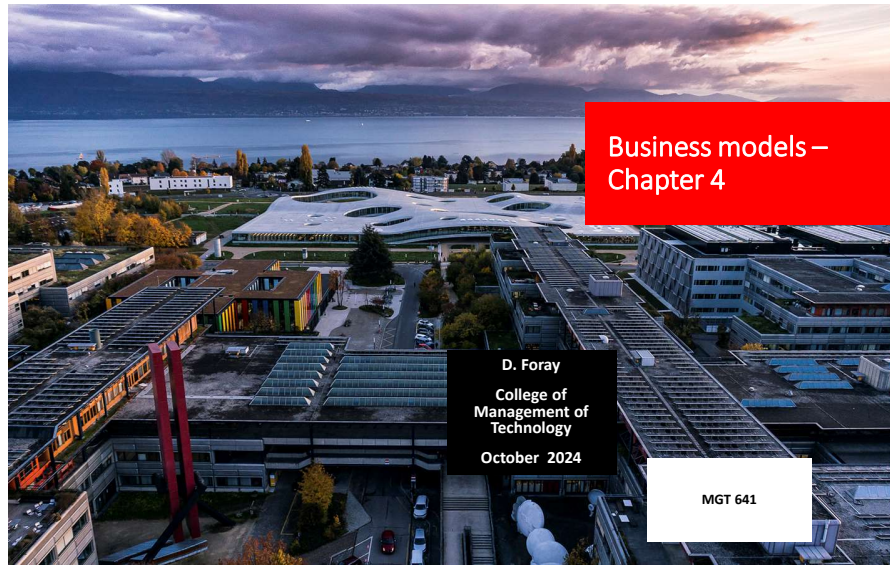
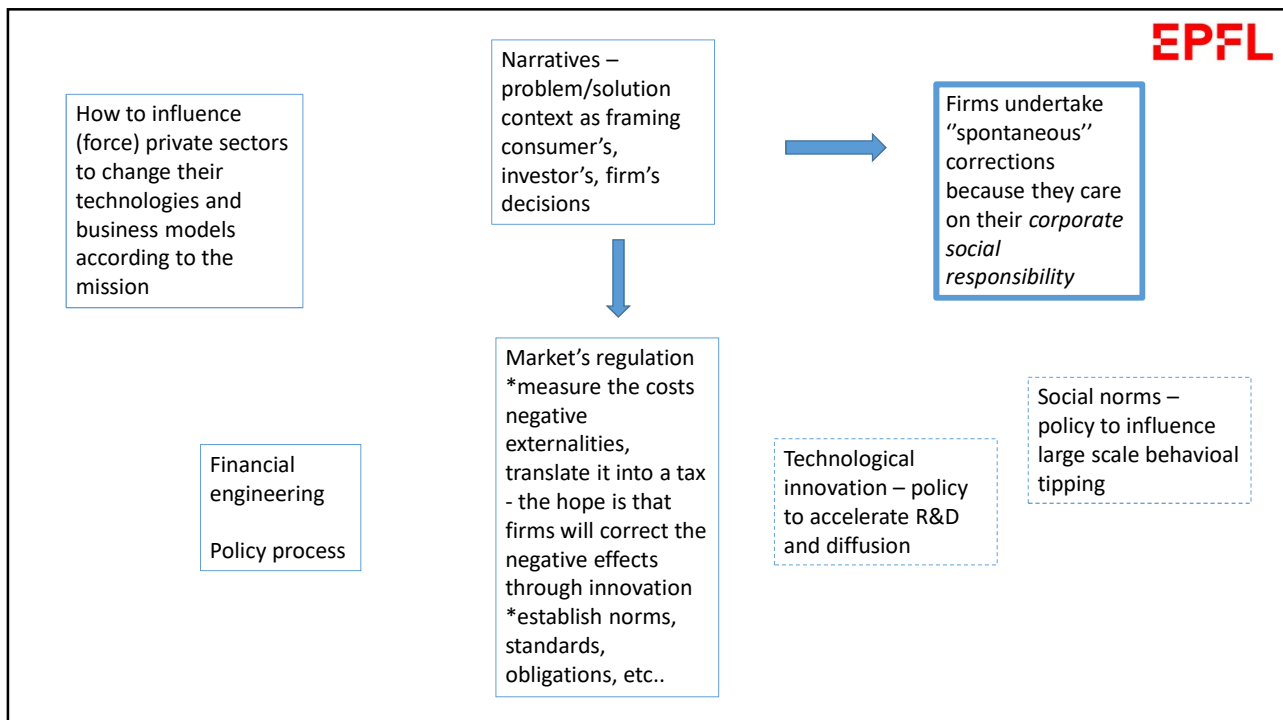




■ Ecole
polytechnique
fédérale
de Lausanne



The business of business

EPFL

- *The only social responsibility of business is maximizing profits* – these profits – if only returned to the firm's owners can THEN be put to charitable purposes
- *The business of business is profit*
- This was old days (Milton Friedman in 1970): Instead of firms behaving responsible and earning lower profits, they should maximize profits – returning incremental profits to shareholders who could then use these extra proceeds to support charities of their own choices

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The business of business is not only business

EPFL

- **Narratives** (alignment) influence firm's strategic decisions
- Societal demand for Corporate Social Responsibility (CSR)
- Environmental – Social – Governance standards (for firms) (ESG)
- Principles of Responsible Investments (for investors) (PRI)

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The business of business is not only business

EPFL

- Emergence of *for profits* - hybrid organisations
 - It is standard to see *for profit* businesses pursuing double-bottom line objectives
 - CSR as a strategic asset – ‘insurance’ against negative firm’s event, reputational & moral capital
- At the same time, *non profits* are increasingly adopting business methods
 - Managing situations characterized by rising costs, more competition for donations and grants, and increased rivalry from for profit firms entering the social sector
 - Typically : public-private partnerships for product (healthtech, cleantech, etc..) development
- Hybrid models: a consequence of society’s demand for CSR and for efficient social operations!
- Objective of this lecture – developing a framework for thinking about mixing social goods and business objectives – a framework on new sorts of model innovations involving **trade-offs** between financial gains and social impacts

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In your mission?

EPFL

Need for better business models – better trade off between financial gains and social impact

- Cement
- Transportation & mobility services
- Fast fashion
- Meat industry
- Real estate - tourism companies
- Taxi companies
- Pharma
- Energy producers and distributors
- Agriculture
- Social networks
- Publishing companies

Framework

EPFL

- F = financial output
- S = social output – precise nature (environmental, social) can vary
- 3 organisations
 - Business: generates F but can sacrifice some F for S
 - Charities: generates S but can sacrifice some S for F
 - Investors: agents with financial capital who have preference over S or F output
- A business model: description of a particular tradeoff involved by an organisation and how the other activity (S for business, F for charities) is selected

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EPFL

- Business firms try to do well financially while producing social goods
- Non profits explore new trade offs between social impact and financial gains
- Investors' optimal choice

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True tradeoff for business

EPFL

- Hotels encourage guests to hang their towels to be reused rather than washed each day – it might have an environmental impact but this is also an effective mechanism to lower hotel's operating costs – *no tradeoff! But win win opportunities*
- Assume that such *win win opportunities* have been exhausted – new models try to manage situations in which achieving social goals comes at the expense of profits:
- Patagonia launched a campaign telling customers not to buy new jackets when the old ones still had use – *tradeoff!*
- The Body Shop works to end animal testing of cosmetics (which will generate higher development costs) – *tradeoff!*
- A shoe manufacturer contributes to a child labour initiative in Vietnam – *tradeoff!*

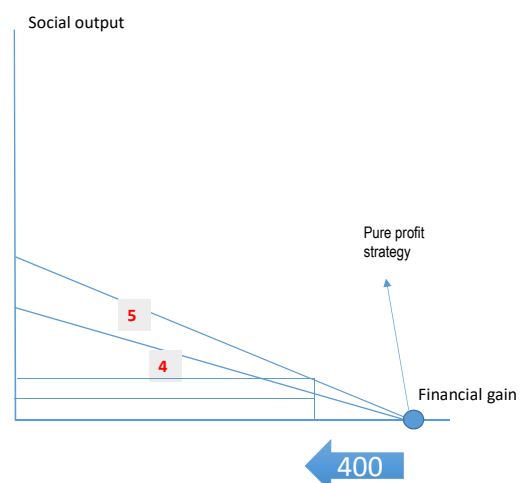
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Business firms explore new tradeoffs between social and financial gains

EPFL

Business models - the slope of the line describes the rate at which financial gain is sacrificed to obtain additional social gains

Bm 4, 5 describe business firms tradeoffs : the slope of the line describes the rate at which financial gain is sacrificed to obtain additional social output
Bm 5 > Bm 4 - anything 4 can do, 5 can do better



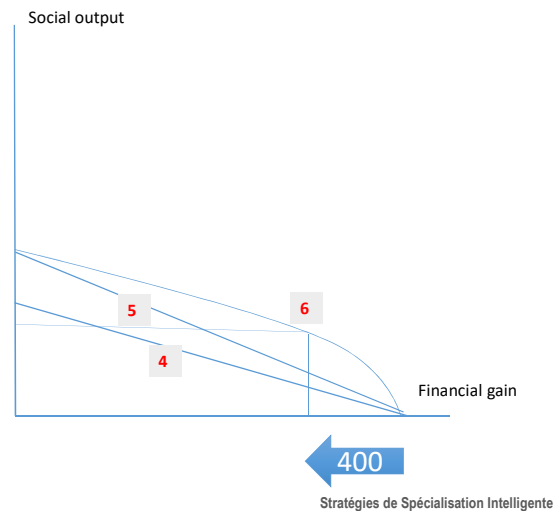
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Business firms explore new tradeoffs between social and financial gains

EPFL

Initially $Bm_6 > Bm_4 \text{ \& } 5$ – then decreasing returns to the non core activities – searching for more social outputs costs more in terms of financial gains
 Bm_6 – decreasing returns to the non core activities

How to select the social activity to get an optimal tradeoff?



Many possibilities for choosing the social activity

EPFL

- S is fully disconnected
- S is connected through some fundamental aspects
 - Similarity/complementarity
 - Vertical differentiation
 - A social activity to correct the very effect of the business activity
- A fashion firm with headquarter in Milano supports educational initiatives in the south of Italy
- A pharma invests in neglected diseases R&D
- A refrigerator manufacturer produces both commercial and low cost products
- A shoe manufacturer address child labor initiative
- A natural resource extractor address environmental quality
- A cosmetics firm works to end animal testing

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Many possibilities for choosing the social activity

EPFL

- « Optimal » social cause addressed through CSR are the ones that have the strongest complementarities between S and F activities
- Mechanisms for such complementarity
 - Spillovers, synergies, economies of scope (e.g. neglected diseases)
 - Vertical differentiation (e.g. low cost refrigerator, microfinance) -
 - Information asymmetry: the manager of a shoe factory in Vietnam has better information about child labour conditions than outsiders
- A key normative prescription: CSR is best directed at those causes which are most directly impacted by the normal operation of business
 - In case of remediating « bads », firms are better positioned than non profits since the firm may itself be the perpetrator of the « bad » - however huge implications on the future of the concerned firm

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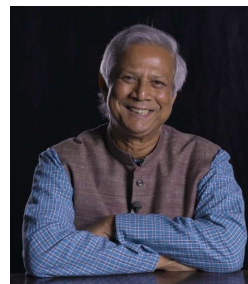
In your mission?

EPFL

- | | |
|--|---|
| <ul style="list-style-type: none"> • « Optimal » social cause addressed through CSR are the ones that have the strongest complementarities between S and F activities • Mechanisms for such complementarity <ul style="list-style-type: none"> • Spillovers, synergies, economies of scope (e.g. neglected diseases) • Vertical differentiation (e.g. low cost refrigerator, microfinance) - • Information asymmetry: the manager of a shoe factory in Vietnam has better information about child labour conditions than outsiders • A key normative prescription: CSR is best directed at those causes which are most directly impacted by the normal operation of business <ul style="list-style-type: none"> • In case of remediating « bads », firms are better positioned than non profits since the firm may itself be the perpetrator of the « bad » - however huge implications on the future of the concerned firm | <ul style="list-style-type: none"> • Cement • Transportation & mobility services • Fast fashion • Meat industry • Real estate - tourism companies • Taxi companies • Pharma • Energy producers and distributors • Agriculture • Social networks • Publishing companies |
|--|---|

- Business firms try to do well financially while producing social goods
- Non profits explore new trade offs between social impact and financial gains
- Investor's optimal choices

Non profits cases: various tradeoffs



Non profits explore new tradeoffs between social and financial gains

EPFL

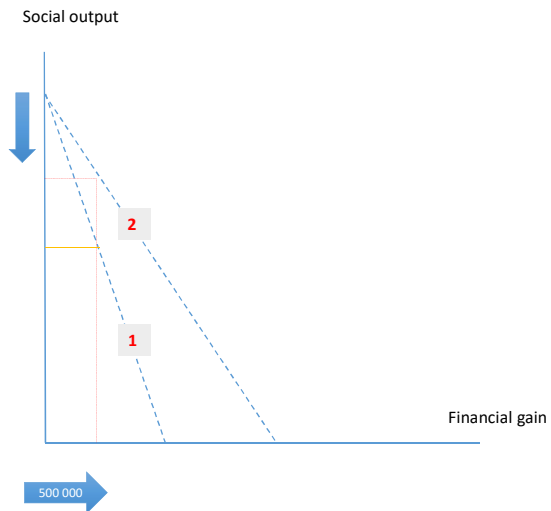
Sm 1, 2 describe non-for profits (philantropy) tradeoffs : the slope of the line describes the rate at which social output is sacrificed to obtain additional financial gains

e.g. Sm 1 involves a constant tradeoff between S and F

Sm 2 > Sm 1 - anything 1 can do, 2 can do better:
For the same level of financial gains, Sm 2 sacrifices less social outputs

Sm2 improves operational efficiency

Sm1 sacrifices the most costly social output



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Non profits explore new tradeoffs between social and financial gains

EPFL

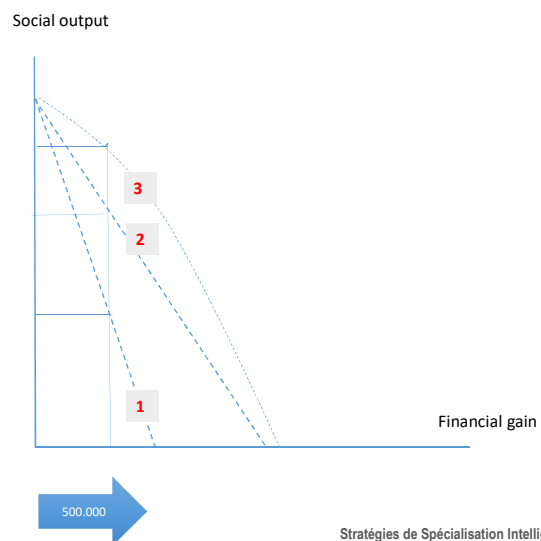
Sm3 –is initially very flat
i.e. sacrifices very little social output to generate first financial gains

Sm3 > Sm 1 & 2

then decreasing returns to the non core activities –
searching for more financial gains costs more in terms of social gains

The sacrifice of S by Sm3 implied by moving along the line 3 reflects the concern that increasing commercialisation leads to reduced social output to a large extent because it may distract management attention or cause a deviation from the organization's mission

Making philanthropy more business-like is a big mistake – Larry Kramer – President of the Hewlett Foundation

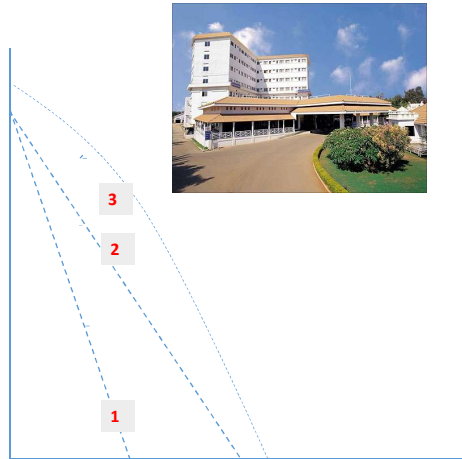


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Low cost heart surgery in India – exploring the tradeoff

EPFL

Bangalore-based Narayana Hrudayalaya Hospitals (NHH) which is setting up Rs 600 crore (Rs 6 billion) Health City in Bangalore, announced that they plan to build low-cost heart hospitals across India with collective capacity of 30,000 beds in the next 5-7 years time.



- Narayan Hrudayalaya Hospital Bangalore
- Application of Ford's management principles: economies of scale and specialization can radically reduce costs
 - 1000 beds
 - 40 surgeons and 600 operations/week
 - Price: about \$1200 (vs \$ 20-100000 in US)
 - Creation of a health insurance scheme that cover 2.5 million of people
 - Sliding scale of fees is used so that richer patients subsidize poorer ones
- The entire enterprise is profitable given how many poor people it treats
 - 7.7% profit after taxes (compared with an average of 6.9% in US private hospitals)

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EPFL

- Non profits explore new trade offs between social impact and financial gains
- Business firms try to do well financially while producing social goods
- **Investor's optimal choices**

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Investors

EPFL

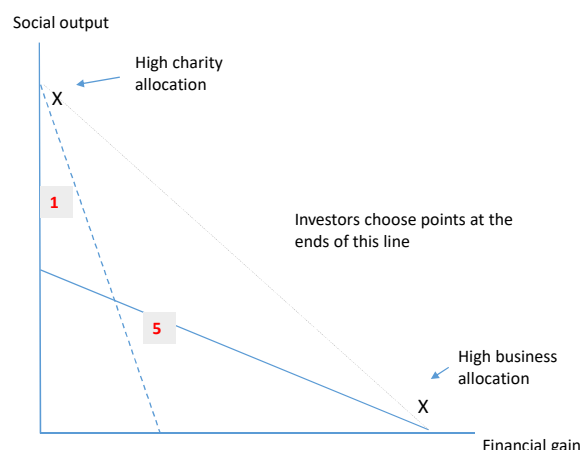
- Investors are agents with financial capital who have preferences over S and F output.
- Many private charitable foundations operate with a clear orientation towards certain social goals while managing large pools of investment capital that provide operating income for the foundation
- Alternatively, investors can be private equity or VC funds, in which case their investment choices may reflect the underlying preferences of their limited partners, many of whom are foundations, university endowments or family investment offices
- They take the existing business models as given and allocate capital in order to maximize their utility.

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Investors and optimal strategies

EPFL

- In the Friedman spirit, investors can optimally combine a pure-play charity and a pure-play corporation.
- Business models involve constant tradeoffs
- It is optimal for investor both to direct the charity to ignore F and maximize S, and at the same time, direct the business to ignore S and maximize F
- The 'X' marks on the line represent potential allocations of overall investment to S and F, with the upper 'X' representing a high social output allocation and the lower 'X' representing a high business output allocation

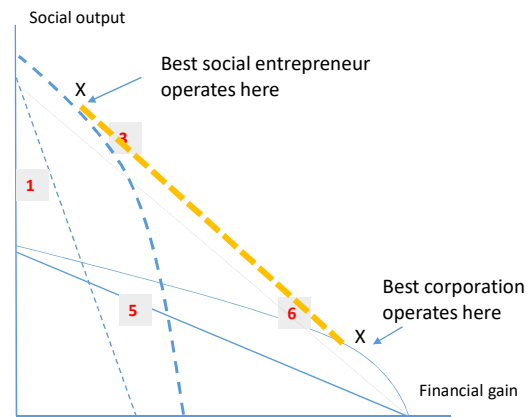


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Investors and optimal strategies

EPFL

- The ends of dashed line in green are no longer optimal because they are dominated by combinations of points that lie along the regions of business models 3 and 6 that are above the dashed line.
- The new 'X' marks denote the approximate behaviors of hybrid organizations, a CSR-oriented corporation and a profit-minded charity.
- The optimality of these points is given by the fact that they represent the endpoints of the highest line connecting the two business models
- The new dashed line in bold orange dominates the original line in green. It connects the two optimal 'X' marks



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Take home

EPFL

- « Optimal » social cause addressed through CSR are the ones that have the strongest complementarities between S and F activities
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- Transportation & mobility services
- Fast fashion
- Meat industry
- Real estate companies, tourism
- Autonomous driving companies
- Pharma
- Energy producers and distributors
- Agriculture
- Publishing companies

Recommended reading : Nilsson & Robinson

