THE *effect* OF EXTERNALITIES

Companies need to understand the external impact of what they do in order to effectively manage the corporate and societal value they create

TO SUCCEED IN TODAY'S business environment, companies increasingly have to measure, understand and proactively manage the value they create or reduce for society, the environment and shareholders. To achieve this, companies need to better understand what is termed as 'externalities'. What was previously understood to be external is rapidly being internalised whether through regulation such as taxes or pricing, changing market dynamics including resource shortages, or more frequent and impactful stakeholder pressure. Historically, externalities have had little or no impact on the cashflows or risk profiles of most companies. For this reason, externalities have been largely excluded from the measurement of corporate value.

However, this disconnect between corporate and societal value is disappearing. The operating landscape of business is being transformed by economic, social and environmental mega-forces such as globalisation, digital connectivity, the financial crisis, population growth, the growing global middle class and climate change. As a result, externalities are increasingly being internalised, bringing new opportunities and risks with significant implications for corporate value creation in the 21st century.

For example, some of the externalities that could be created by an electronics company that sources electronic components from suppliers; assembles them into devices such as tablets, laptops and mobile phones; and then sells them on to retailers and institutions such as schools and hospitals would include:

- **Supply chain (upstream)** The company might create positive externalities by buying components made with metals that have been recycled from discarded mobile phones that would otherwise have gone into a landfill. At the same time, it might create negative externalities if its suppliers' factories discharge hazardous chemicals that affect the health of local communities.
- **Company operations** Positive externalities would be created if the company invests in education and training for its workforce, thereby creating a more skilled society. Negative externalities would be created if workers were injured in accidents on the assembly line.
- **Use and disposal of products (downstream)** The company's products could create positive externalities, for example, if they were used for energy efficiency, education and learning or medical purposes. On the other hand, if the devices the company manufactures are disposed of in landfill sites rather than being recycled, this would create negative externalities because of the detrimental effects on land use and potential ground and water pollution.

Companies today are experiencing an acceleration in the rate and intensity of internalisation with direct implications for the cashflows and risk profiles that drive corporate value creation. Companies therefore need to identify and quantify externalities, recognise what is driving internalisation and understand the potential effects on corporate value. By utilising tailored techniques such as the' True Value Methodology', companies are able to adopt a practical approach that businesses and their investors can use to understand their externalities, anticipate the effects of internalisation on corporate value and develop response strategies that protect and build corporate value while also enhancing societal value creation.

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