Sustainability is at a tipping point: How should companies respond?

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The focus on environmental, social and governance issues has gathered pace in recent years. The final destination is likely to be a transformation of how corporates operate, writes Richa Pathak, an Innovation Catalyst within Citi’s Global Innovation Lab.

Environmental, social and governance (ESG) issues have gained increased prominence since the adoption of the United Nation’s Sustainability Development Goals in 2015. Several CEOs have committed their companies to a net zero carbon economy by 2050 while funds managed in line with ESG principals are growing rapidly and mainstream investors are increasingly incorporating ESG criteria into their investment models.

Forward-thinking companies are redefining a modern standard for corporate responsibility and adapting to changing times and evolving consumer preferences. In August 2019, 181 CEOs committed to lead their companies by targeting profit with purpose and on stakeholder value rather than shareholder value alone. And these consumer preferences can change very quickly. For example, increasingly frequent extreme weather is raising awareness of climate change and its financial risk and cost implications while the recent media focus on plastic waste demonstrated how quickly public opinion has evolved. Similarly, more and consumers are considering buying electric vehicles or switching to car-sharing or subscription models.

As reported widely in the media, Unilever’s CEO has challenged its business heads to justify their products on a circular basis — or risk the threat of them being discontinued — to preempt anticipated changes in consumer opinion. Automotive companies are refining their EV strategy and offering towards achieving the net zero emissions target by 2030, consumer companies are redesigning product packaging, while in the mining sector companies are investing to switch to more environment-friendly extraction processes.

At the same time, disruption in many business sectors is accelerating the change in attitudes. For instance, Tesla’s success in the electric vehicle (EV) market has spurred almost all mainstream auto manufacturers to develop EV products. Similarly, many fossil fuel companies are diversifying their portfolios to include renewables, wary of the potential negative implications of stranded assets and the opportunities in wind and solar power.

The regulatory imperative
Regulatory requirements have been important in moving ESG up the agenda for corporates. Within the European Union, two initiatives — the 7th Environment Action Programme (EAP) and the adoption of circular economy principles — are especially important.

1 Source: https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans
The 7th EAP guides European environment policy until 2020 and has three overarching goals:

- Protect, conserve and enhance the EU’s natural capital.
- Turn the EU into a resource efficient, green and competitive low-carbon economy.
- Safeguard EU citizens from environment-related pressures and risks to health and well-being.

The EU has also established various initiatives and strategies aligned to circular economy principles, with the goal of stimulating Europe’s transition from a ‘take-make-waste’ linear economy towards a circular economy, focused on resource recovery and product re-usability. These include:

- A Circular Economy Action Plan that seeks to ‘close the loop’ of product lifecycles, including circular design of products, turning waste into resources, and creating a market for alternative and reusable raw materials.
- A strategy for plastics in a circular economy, including enhancements to facilities for recycling (to improve efficiency and quality) and a ban on 10 single-use plastic items most often found on Europe’s beaches.
- A low carbon economy roadmap, with a commitment to reduce greenhouse gas emissions by 40% by 2050 compared to 1990 levels.
Quantifying sustainability as a strategic risk and cost factor

The fast-changing regulatory environment in relation to ESG presents potential challenges and risks for corporates in the EU. It is essential for companies to keep abreast of developments in order to remain compliant, avoid financial penalties and invest in transformational infrastructure to retain shareholder confidence. The repercussions of non-compliance can be significant.

For instance, as recently reported in the media, Brazil’s major iron-ore mining company posted losses in the first quarter of 2019, driven by $4.5 billion in compensation expenses relating to the bursting of an earth dam holding iron mining waste. Several prominent institutional investors also sold their holdings in the company as a result of the incident, leading it to commit to investing in improving its extraction processes.

As outlined in the risk and cost framework in figure 1, firms need to define an action plan to comply with requirements within stated timelines and model the cost of on-going compliance. As a next step, companies must review their business and operational models end-to-end. This may reveal a need for fundamental changes to business models, including potential reconfiguration of supply chains in line with circular principles, and the adoption of eco-design principles that champion resource recovery and product re-usability. Corporates will also need to devise their own ways of measuring sustainability risk and of monitoring its impact on business performance and share price. Guidelines such as the Taskforce for Climate related Financial Disclosures and carbon pricing regimes are useful references for measuring and monitoring sustainability risk.

Ultimately, corporates need to model the financial value generated by pursuing their sustainability strategy, in terms of expense savings, return on investments in future-ready infrastructure, products and processes, and the incremental financial value of newly harvested resources from waste, into a net present value equivalent metric. This can then be tracked and reported to shareholders as part of regular updates on business strategy: ESG considerations will thus become just another component of business as usual.

Integrating sustainability into business strategy

Once companies have got to grips with the risk and cost implications of sustainability, they can start quantifying anticipated savings and incremental returns from financial investment into a sustainable future business model. Rather than seeing ESG as a corporate social responsibility activity, corporates can look at the opportunities on offer, both to enhance their reputation among consumers and take advantage of new markets and growth opportunities.

As outlined in the C.O.R.E. framework in figure 2, corporates need to evaluate their operating model end-to-end including organisational culture, operations, RD&I activity and emissions footprint, to identify areas for transformational changes required to switch to a sustainable business model in the future.

One of the greatest challenges relating to ESG is to evolve corporate strategy so that waste is treated as a resource which offers potential savings throughout the supply chain. Operating processes need to be remodelled and redefined in order to close the loop from linear to circular models. At the procurement stage, reusable raw materials need to be regenerated from recovered waste, potentially creating cost savings by lowering procurement volume. Next, at the production stage, operational processes need to be redesigned to optimise usage of materials. Throughout the supply chain and distribution stages, corporates need to reconsider their relationships with partners, and find smart ways to optimise capacity and transportation networks.

Determining future business success

Transitioning to a more sustainable – or even circular – model can seem daunting given the scale of the change required. However, by developing a business strategy framework that aligns corporate strategy with ESG requirements, companies can transform their culture (setting out a vision to mobilise the workforce), operations (to shift from linear to circular models), research (to apply eco-design principles) and emissions (to reduce waste).

Moreover, however complex the details of the business transformation required, the guiding questions that will likely determine future business success are straightforward:

- Is it circular: Where does it end up?
- Is it viable: What does it cost, save and return?
- Is it long-term: How does is solve the problem and not postpone it to future generations?

Emerging technologies can do much to help companies achieve their ESG objectives. For example, machine learning can help optimise logistic operations in order to reduce emissions of greenhouse gases (GHGs), enable smarter use of GHG-heavy production processes and more accurately predict demand to cut down on waste.

Most importantly, corporates should recognise that they do not have to embark on this transformation alone. The drive towards greater sustainability has prompted unprecedented collaboration between companies – including between business rivals. Citi can also help its clients to prepare for a more sustainable future and connect with others seeking the same goals.

This article is based on An Insight into ESG Regulation driving Corporate Activity, a report by Richa Pathak.