How strategic is your sustainability strategy? Really?

VLERICK BUSINESS SCHOOL

HOW STRATEGIC IS YOUR SUSTAINABILITY STRATEGY? REALLY?

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1 INTRODUCTION

Sustainability has become an important topic on the strategic agenda of most firms. Business is facing great demands from all sorts of stakeholders today due to the world's enormous societal challenges: climate change and its consequences (like water scarcity), social inequality and injustice, poverty, depletion of natural resources, to name just a few. And people are expecting businesses to play a bigger role in addressing these societal problems.[1]

Firms have responded by setting up numerous sustainability initiatives – often captured under the label of ESG (Environment, Social, and Governance). But for many firms, the journey towards becoming more sustainable is a tough one. Despite good intentions, the implementation of corporate sustainability programmes has been slow at best, and sloppy and ineffective at worst.[2] We believe that a major reason firms struggle to transform towards sustainability is that these sustainability programmes are insufficiently embedded in the company's core strategy.

In this paper, we analyse why this is a problem and what managers can do about it. More specifically, we propose a new approach to managing your sustainability initiatives, one that is more grounded in strategy.

2 SUSTAINABILITY JOURNEYS DISSECTED

Sustainability is a complex and diverse topic. A question that managers frequently ask is: Of all the different things that our organisation could do, where should we focus our attention? And how should we implement those sustainability initiatives?[3]

Although the literature is extremely fragmented, we've found several authors that propose a step-by-step approach centring around: redefining the company's mission, vision and purpose, identifying the most relevant sustainability topics through a materiality assessment, defining KPIs and deriving targets, implementing programme management to put the sustainability initiatives into practice, and, finally, communicating about the progress of the results through internal and external reporting.[4]

TWO SIGNIFICANT DRAWBACKS

We recognise the value of step-by-step approaches, but we believe these methods have two significant drawbacks that hinder the effective implementation of sustainability programmes.

First, materiality assessments indicate which topics should be prioritised, but they fail to help you set the level of your sustainability ambitions. Organisations need to reflect on their overall sustainability goals first and explicitly establish a company-wide ambition level before setting separate ambitions for each initiative.

The second issue is that the current approach to sustainability often results in a lengthy list of loosely connected activities, which makes it difficult to align them with your company's strategy. This poses a problem because isolated sustainability programmes inevitably compete for resources and attention with other initiatives within the company. Moreover, when sustainability initiatives are treated as stand-alone programmes, it becomes harder to secure the support of senior and middle managers. Therefore, organisations need to consider how to integrate their sustainability strategy with their core strategy.

We will explain how firms can define company-wide sustainability ambitions in *Section 3*. In *Section 4*, we present a framework that lets you know if your sustainability initiatives are linked to your company's core strategy and contribute to your competitive advantage.

> “Sustainability often results in a lengthy list of loosely connected activities

3 PURPOSE AND SUSTAINABILITY AMBITIONS

A typical strategy process starts with a review of your company's mission and vision. In recent years, the topic of corporate purpose has taken a more prominent role in these discussions. Purpose addresses the question: Why are you here? What is your impact? What is your reason to exist? What would the world lose if you were no longer here?

Building a sound sustainability strategy is impossible without a fundamental discussion of your purpose. Nowadays, many companies claim to have some higher purpose beyond profits. However, integrating sustainability into your mission and purpose requires more than having your leaders make powerful speeches or your marketing team create lofty mission statements on your website.

If strategy is about creating value, then purpose defines for whom this value is created and the nature of that value. Here, value doesn't refer to quarterly profits, but rather to the long-term value your firm generates for various stakeholders – employees, customers, suppliers, the broader environment, and shareholders. This perspective aligns with those of prominent academics (such as Harvard Business School's George Serafeim and Alex Edmans from LBS) and business leaders, including Paul Polman (former CEO of Unilever) and Larry Fink (Chairman and CEO of BlackRock), who maintain that firms should create value for society at large, not just for investors. There is substantial academic evidence supporting the financial benefits of this sustainable approach in the long-term – known as 'the business case for sustainability'.[5] These leaders offer additional reasons why sustainability should play a central role in your mission, vision, and purpose: apart from the instrumental motivation (the business case), there is also an ethical motivation ('it's the right thing to do'), a stakeholder motivation ('others are asking us to do it'), and a political motivation ('we have a public responsibility') to focus more on stakeholder than on shareholder value.[6]

STAKEHOLDERS

Creating a purpose-driven organisation requires identifying which stakeholders your company wants to serve: Which stakeholders are particularly material to your company? Who do you consider first among equals when difficult trade-offs need to be made? You should also reflect on how your company wants to serve these key stakeholders. Companies should not try to tackle every societal problem or grand challenge. Don't react to whatever sustainability issue happens to be the flavour of the month, but focus on those issues that the company is particularly well-placed to solve. It helps if you can make the business's impact on society as clear as possible. A good purpose is a focused one. Consider Tony's Chocolonely. Its purpose is to make all chocolate 100% slave-free. The company focuses on its partner cooperatives in Ghana and Côte d'Ivoire, where 1.5 million children are working in illegal circumstances. Tony's wants to make a positive impact where the problems are the worst. Compare this with Coca-Cola's purpose: "To refresh the world. Make a difference." This purpose statement is too broad and too generic: it lacks focus and probably doesn't provide clear direction to managers and employees.

> “ Sustainability should play a central role in your mission, vision, and purpose

Creating a meaningful purpose implies understanding your stakeholders' concerns. Therefore, it's good to establish an open and continuous dialogue with them. The main idea is that you should not only create value for stakeholders but also with stakeholders. Try to identify what's on your stakeholders' minds. Build antennae to understand what these stakeholders say about you. That's the best way to discover your vulnerabilities and identify what sustainability topics to focus on.

Furthermore, it's important to specify your company's ambition level when you integrate sustainability into your mission and purpose. *Figure 1* lists the various sustainability ambitions that you can include in your corporate purpose statements.

Figure 1: Sustainability ambitions and purpose statements

REGULATORY COMPLIANCE

The minimum sustainability ambition level is to comply with the existing laws and regulations, but nothing more. Organisations that adhere to this ambition level usually see ESG as a distraction from the core business and an added cost. There's really no ambition at all to become more sustainable; these companies stick to the bare minimum of what's required and, for these firms, shareholder interests are significantly more important than stakeholder interests.

It's sad to see that some companies don't even match that Olympic minimum of sustainability. We all know companies that have used practices to boost short-term financial targets at the expense of long-term growth and sustainability. Think about Turing Pharmaceuticals, which raised the price of one of its medicines by 5,500%.[7] Enron, Wells Fargo, Uber, and WeWork are other famous examples in this respect. It's no surprise that those companies don't talk much about sustainability in their mission and purpose statements.

PHILANTHROPIC CORPORATE SOCIAL RESPONSIBILITY

Some firms' purpose statements define sustainability mainly as engaging in philanthropic corporate social responsibility. Firms give back and donate money to charities or invest in local community projects. These companies dialogue with their stakeholders and do a lot of reporting. They also launch corporate policies on ethical issues. While all these initiatives are laudable, this view of purpose is rather defensive, and all too often it focuses on initiatives that are situated in the periphery of the company's core business.

DO LESS/NO HARM

That changes when your purpose is to do less harm or no harm at all. If your company expresses such a purpose statement, your goal is to take more responsibility for your company's impacts on the environment and the wider world. The term 'externalities' refers to the costs or benefits that are caused by one party but financially incurred or received by another party. Firms that emit greenhouse gases create negative externalities. Do less harm – or no harm at all – is about reducing or minimising the negative impacts that firms create. 'Do less/no harm' can often be found in the purpose statements of companies in polluting industries (like fuel and energy, fashion, transport or construction) or of firms that produce harmful products (like tobacco and alcohol). Firms might invest in those initiatives because they reduce the cost base or help improve the company's reputation. Some firms may even differentiate from their competitors with more ecological products. Ørsted is a great example: its purpose is to create a world that runs entirely on green energy. Compare this with BP's purpose statement: "Our purpose is reimagining energy for people and our planet. We want to help the world reach net zero and improve people's lives. We will aim to dramatically reduce carbon in our operations and in our production, and grow new low carbon businesses, products and services." These intentions are good but less ambitious than Ørsted's purpose.

DO GOOD: CREATE VALUE FOR STAKEHOLDERS AND SOCIETY

When the positive externalities outweigh the negative ones, organisations create positive returns for all stakeholders. This is what the concepts of 'net positive' and 'growing the pie' are all about: they're about generating positive value for multiple stakeholders – even putting the stakeholders' needs first.[8] Shareholders may benefit, too. Profits may rise as a by-product of investing in stakeholders – improving working conditions for employees, reducing environmental footprint, pioneering more sustainable products for customers, etc. We've already referred to Tony's Chocolonely's purpose to make all chocolate 100% slave-free. Unilever is another company that embraces the purpose of 'do good' and expresses this in its purpose statement: "Our purpose is to make sustainable living commonplace."[9]

SOLVE PROBLEMS OF THE WORLD

The final sustainability ambition level is when your purpose is solving some of the world's most urgent problems. At this level, companies don't start from their existing business in which they reduce harm or actively do good; instead, they take a grand societal problem as the starting point and build a business around it. The Ocean Cleanup's aim is to rid the world's oceans of plastic. The company adds: Our aim is to put ourselves out of business once the oceans are clean. Another example is MobileSchool.org, an organisation that uses its experience with complex and competitive street communities to increase the sustainable development of youth and business communities.

If you want to connect with stakeholders and investors, it's good to have your ESG initiatives anchored in your purpose. But that's not enough: firms need to move from good intentions (words) to actions (deeds). And these actions are better linked to a clear and well-defined sustainability strategy that builds the bridge to effective actions.

4 A STRATEGIC PERSPECTIVE ON SUSTAINABILITY STRATEGIES

After companies have redefined their mission and purpose, the next step is to make choices about which sustainability topics to address. As we've said, companies typically use double materiality assessments to generate a list of the most material sustainability topics. In our view, there is both a positive and a negative aspect linked to this approach. The positive aspect is that it helps organisations make choices on sustainability issues. Given a company's limited resources, it's better to select and focus on those materialities that matter.[10] The negative aspect is that your sustainability issues are not necessarily linked to your company's core strategy. It is not just because a particular issue is important or has an impact on your financial results that it should be part of your strategy.

Decades ago, Michael Porter wrote that operational effectiveness is not strategy. That was the time that companies were implementing new management recipes – such as Lean, quality management, outsourcing, and time-based competition. In Porter's view, operational effectiveness means performing similar activities better. Strategy, however, is about performing different activities or performing similar activities in different ways. Only then are you able to build a competitive advantage.[11] Strategy requires firms to make choices on where to play and how to win. These choices define the boundaries for your organisational activities.

Today, sustainability could be the new 'operational effectiveness.' Many firms pursue it and commit massive amounts of resources to it. Yes, sustainability – just like operational effectiveness and strategy – is needed to achieve superior performance.

But do the firms' sustainability efforts really lead to differentiation and unique positions? We doubt it. That's why we are introducing a new perspective to sustainability management, one that is more rooted in traditional strategic management.

3 LEVELS OF STRATEGY
3 STRATEGIC APPROACHES TO SUSTAINABILITY

Larger organisations typically develop strategies at 3 different levels: the corporate, the business unit, and the functional levels. Corporate strategy defines the organisation's overall scope and outlines how a corporate parent can create value for the constituent businesses. A corporate strategy defines which business units fit the corporate portfolio and which do not. The business units also need a strategy – a business (unit) strategy – that specifies how these units should compete in their particular markets and build a competitive advantage. Once the competitive strategies are defined, firms then formulate functional strategies, which outline how the various functions – such as HR, finance, sales, operations, R&D or IT – contribute to the implementation of the business unit strategy.[12]

We found that firms link their sustainability strategies to these 3 levels of strategy. Most firms' sustainability programmes are situated on the functional level. Some companies go further and see sustainability as a core element of their business strategy. A third set of firms even rebuild their corporate portfolio by launching new, more sustainable business units and divesting business units that do not align with their sustainability ambition level.

Companies must determine whether their sustainability strategy is targeted at the functional, business, or corporate level. This decision is crucial as it influences the potential of the sustainability strategy to serve as a competitive advantage, ultimately defining how 'strategic' it truly is. Additionally, firms face unique implementation challenges when applying sustainability strategies at each respective level.

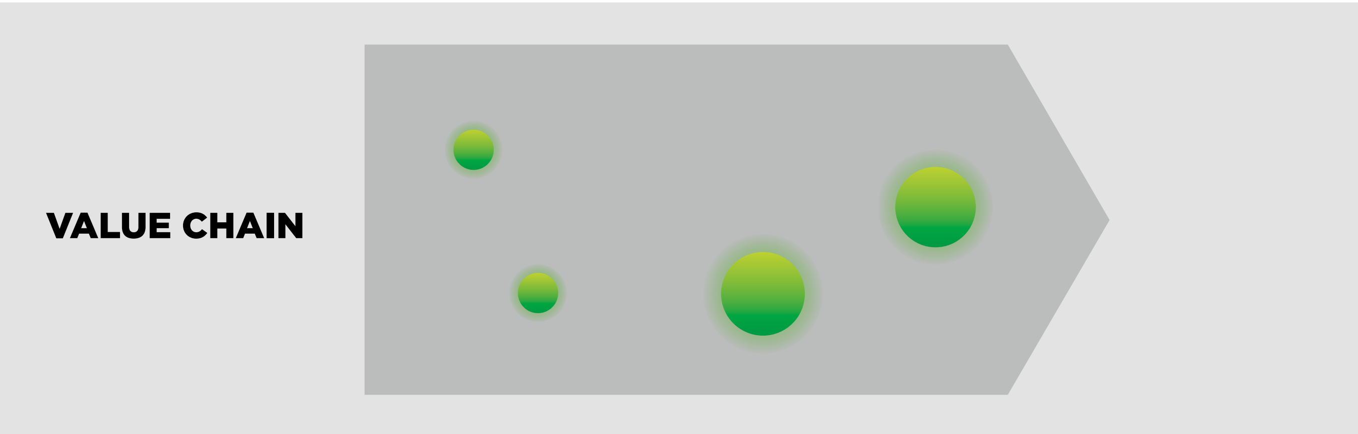

Figure 2: Sustainability at the functional level

LEVEL #1: SUSTAINABILITY STRATEGY DEFINED AT THE FUNCTIONAL LEVEL

This is the standard approach for most companies in which sustainability initiatives are introduced in different parts of the value chain – operations, supply chain, HR, legal, public affairs, and so on. Companies that want to do less/no harm typically adopt this approach.

Often, the industry in which a firm competes determines which departments in the value chain are most impacted. Therefore, companies need to understand which ESG issues affect the industry's performance, as different industries have very different sets of material issues.[13] For example, in the fashion industry – an industry that has garnered attention for unsustainable environmental and social business practices – companies like Zara and Chanel have taken initiatives in the supply chain (e.g., sourcing of more sustainable materials) and the production departments (e.g., cleaner production technologies, reduced water use, more ecological packaging). In the chocolate industry, the focus is on reducing the environmental footprint and on social issues in the supply chain. Other industries put more attention on other topics like waste reduction, deforestation, or diversity, equity, and inclusion (DEI).

While we recognise that all these efforts contribute to a better world, there are two major problems with a functional sustainability strategy. The first is that, in this approach, a sustainability strategy is nothing more than a very elaborate action plan – not a strategy. The second is that sustainability initiatives are insufficiently integrated with the company's business strategy and might create further trade-offs between costs, time, and performance.

When your sustainability strategy is defined at the functional level, it's considered to be a detailed plan for achieving environmental, social and governance goals.[14] Sustainability experts immediately add an unavoidable set of key performance indicators (KPIs) and targets to that list. But a plan is not a strategy. A strategic plan tells you what the organisation will do. Strategy, however, is about what your company is not going to do – it's about setting boundaries for your activities. Companies without a strategy find it difficult to decide what to do and what not to do. As opposed to a strategy, the problem with a plan is that there is often no coherence across the multiple actions. The initiatives do not reinforce each other but are a set of isolated actions that tackle different sustainability issues. The sustainability programmes – often labelled sustainability strategies – are added to the existing pile of a company's programmes. All this leads to an action overload, where it's unclear how all these initiatives support your competitive advantage.

The second problem with functional sustainability strategies is that they are not linked to the company's business strategy. A firm's sustainability strategy focuses on realising the environmental and social goals, while the business strategy aims to achieve the economic/financial goals.

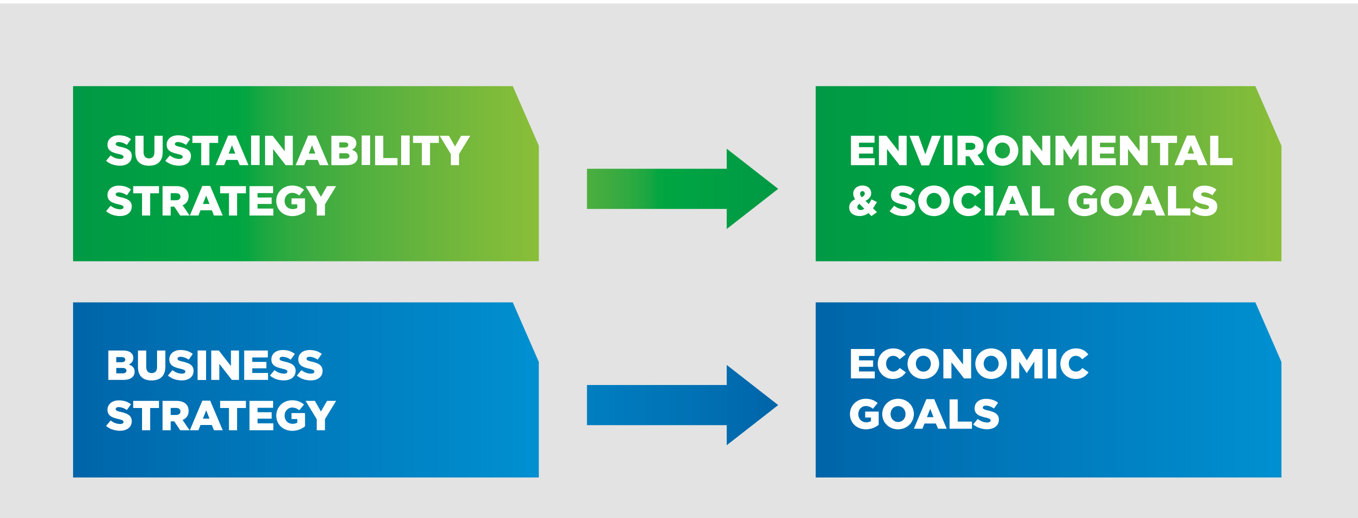

Figure 3: Sustainability strategy versus business strategy

Having two distinct strategies within an organisation can lead to significant conflicts between the teams pursuing sustainability versus economic goals. There is competition for resources, and teams engage in turf wars. Additionally, managers of traditional departments, who are crucial to the success of sustainability initiatives, often do not support them, viewing these efforts as mere add-ons or distractions from their regular responsibilities. These issues are exacerbated when business managers think that economic interests should be prioritised over social and environmental goals. However, this conflict can go in both directions – and, in general, these parallel strategies lead to tensions between economic and sustainability goals.[16]

LEVEL #2: SUSTAINABILITY STRATEGY DEFINED AT THE BUSINESS UNIT LEVEL

Some companies go one step further than launching programmes and initiatives in different parts of the value chain and integrate sustainability as a core element of their business strategy. A strategy outlines where a company wants to play and how it intends to win. The where-to-play decision specifies the company's product/market combinations – what products and services does your company offer to which customer segments. The how-to-win question defines the choices for winning in your competitive arena. It's built around a compelling value proposition – what do you promise to your customers – and backed by a value chain that supports that value proposition. For example, a company that claims to have the best price will have a different value chain than a company that excels in service. Just compare the value chains of the easyJet and Ryanair airline companies with those of Etihad and Emirates.

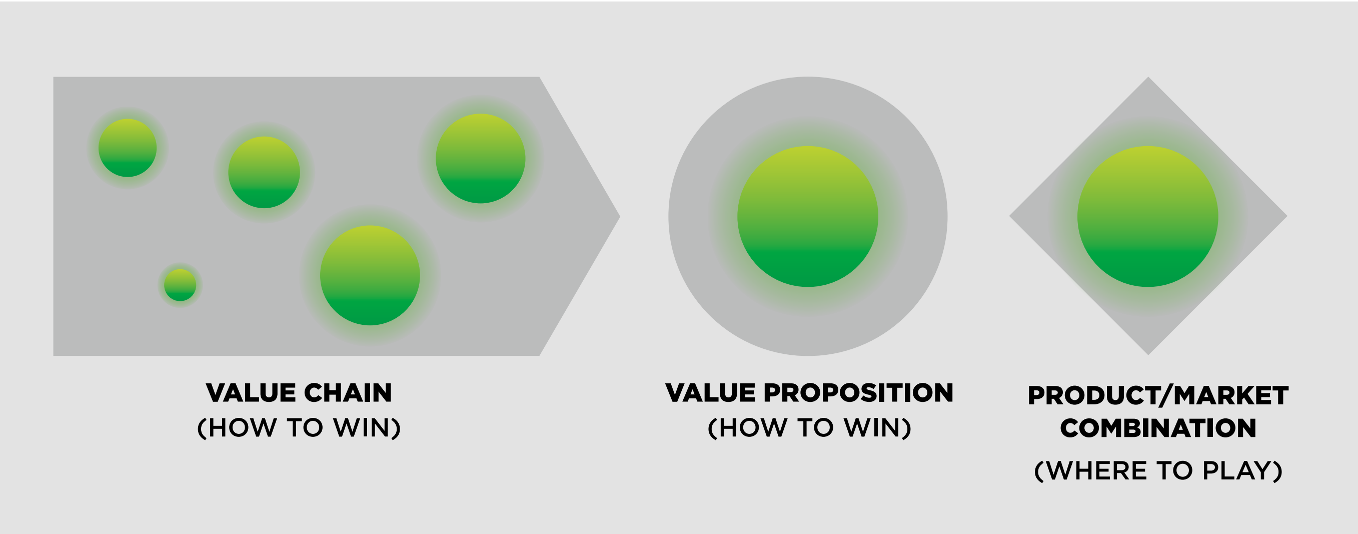

Figure 4: Sustainability at the business unit level

It's not uncommon to put sustainability at the core of your business strategy. Consider Triodos, a Dutch banking group that borrows money exclusively to fund entrepreneurs and projects that contribute to positive social, environmental and cultural change. Another example is Upgrade Estate, a real estate company that – more than any other competitor – focuses on creating societal impact by making the social component of ESG as a core differentiator in its markets. EMMA Safety Footwear, the market leader in the Dutch safety shoes market, uses sustainability as key element in their value proposition, and they developed the first 'circular' safety shoe in October 2017.[17] The firm achieved 100% circularity by the end of 2019, much sooner than its competitors.

In all these cases, sustainability occupies a central element in the company's positioning and its competitive advantage. Sustainability then becomes a central attribute that drives innovation and helps differentiate the company from its competitors. It also enhances the company's reputation with key stakeholders, such as consumers/customers, suppliers, and employees. Firms that have put sustainability at the core of their business strategy create more alignment between their sustainability and business objectives, especially when their purpose is to focus on doing good.

So far, so good. But be aware that a sustainability business strategy also has its fair share of challenges. These challenges can be external, related to the market, or internal.

ORTA Anadolu, a Turkish producer of denim clothing for some of the world's most recognised brands, wanted to compete on circularity. The company redesigned its products and processes but met with various obstacles. Apart from technical challenges, the company also faced challenges in its market. Their market research revealed that consumers aged 16-75 were concerned about social and environmental issues in the fashion industry. ORTA responded by using more recycled fibres. But these fibres decreased production efficiency, often increased energy use and waste, and produced lower quality textiles – thereby raising other sustainability-related issues, and especially the cost of the end product. Customers didn't buy the product – they wanted to buy it at the non-sustainable jeans price, forcing ORTA to reduce its margins.[18]

Challenges can also arise internally. We often think of companies with a sustainable business strategy as sustainable entrepreneurs – such as Tesla, Tony's Chocolonely, and Patagonia. However, some companies could not start from scratch and had to undergo a transformation to become more sustainable. We all know that change management is difficult, making the creation of a sustainable business strategy far from straightforward. Take the case of EMMA Footwear Solutions: when the company committed to circularity, it realised that its business model needed a fundamental change. EMMA had always relied on dealers for distribution – but shifting to a more sustainable model required building direct supply chain relationships with large clients and introducing a radically new shoes-as-a-service concept. This necessitated not only a strategic overhaul but also a cultural shift. The company has launched pilot programmes with large end-clients, but it is still too early to deem the transformation a success.[19]

LEVEL #3: SUSTAINABILITY STRATEGY DEFINED AT THE CORPORATE LEVEL

A last set of firms not only take sustainability to the core of their business strategy, but they transform the entire corporate portfolio, thereby fundamentally transforming the scope of the business and the nature of the group. Signify (the former Philips Lighting), Dutch State Mines (DSM), Neste, and Ørsted are just a few examples of successful corporate transformations. All these companies built a new sustainable business unit, which gradually replaced the traditional core.

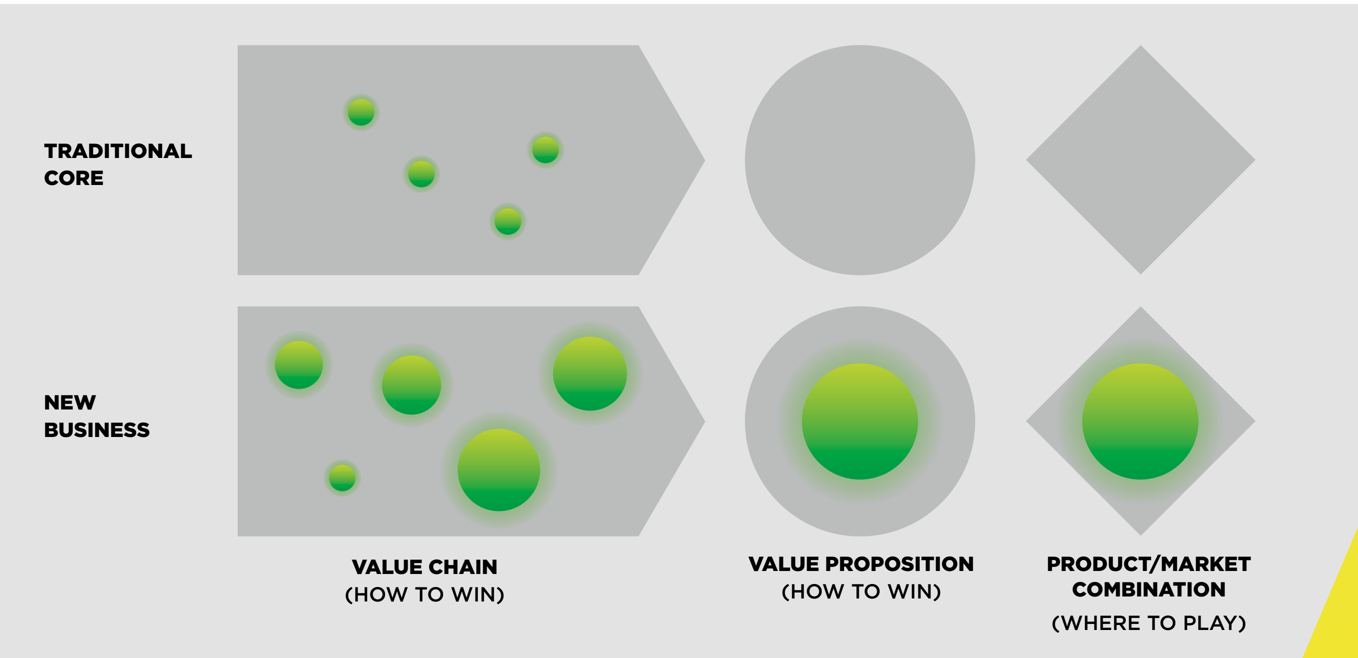

Figure 5: Sustainability at the corporate level

This strategic move is the boldest and most audacious move to more sustainability because building a new sustainable business often involves introducing a new business model into your corporate portfolio. Recent research from McKinsey shows that innovation, including business model innovation, remains a challenging journey: while 86% of the executives surveyed said that innovation was a Top 3 priority, fewer than 10% said that they were satisfied with their organisation's innovation performance.[20]

Starting a new business model outside your core often begins as a strategic experiment, a highly uncertain endeavour fraught with uncertainty and numerous unknowns, despite any prior research you do. There are many risks to address: technological and operational challenges, as well as market risks whereby customers might not be interested in your offering or willing to pay the price for your product or service. Additionally, you will need to overcome significant internal resistance.

OIL AND GAS INDUSTRY

These challenges are aptly exemplified by the oil and gas industry. In mid-2010, the major European oil and gas companies started to diversify their business portfolios to include an array of renewable energies to help reduce carbon emissions – in contrast to their American competitors (who applied a functional sustainability strategy by reducing carbon emissions in their existing plants). In 2022, low-carbon energy investments accounted for 25% to 33% of the European players' total investments.[21]

Why are American O&G companies reluctant to make similar moves, and what prohibits the large European players from going all in and making more significant and bolder investments in renewable energy?

The large O&G companies have a long history of diversification (from coal to oil to petrochemicals, plastics and so on). In the 1990s, they also diversified into electric utilities but then had to pull out because the capital markets reacted negatively. Banks and investment firm portfolio managers indicated that they wanted O&G companies to return to their core business. The second reason the major O&G firms have been reluctant to move into renewable energy is because this is a fundamentally different industry from the traditional extraction and refining business. Moving into renewable energy requires a very different business model – very decentralised and digitised around the customers. It requires a small, distributed system, in which energy is locally produced and used. This differs greatly from the centralised business model that O&G companies have optimised for decades. This was the business of massive oil and gas fields, large ships, crude oil carriers, and pipelines that ship oil and gas to power plants. Furthermore, the culture of O&G companies is miles away from working with end-users.[22]

Despite those challenges, some energy companies have shifted their entire energy production to renewable energy. *Figure 6* shows that those companies have performed well, compared to the 'Oil Majors.'

> While 86% of the executives surveyed said that innovation was a Top 3 priority, fewer than 10% said that they were satisfied with their organisation's innovation performance

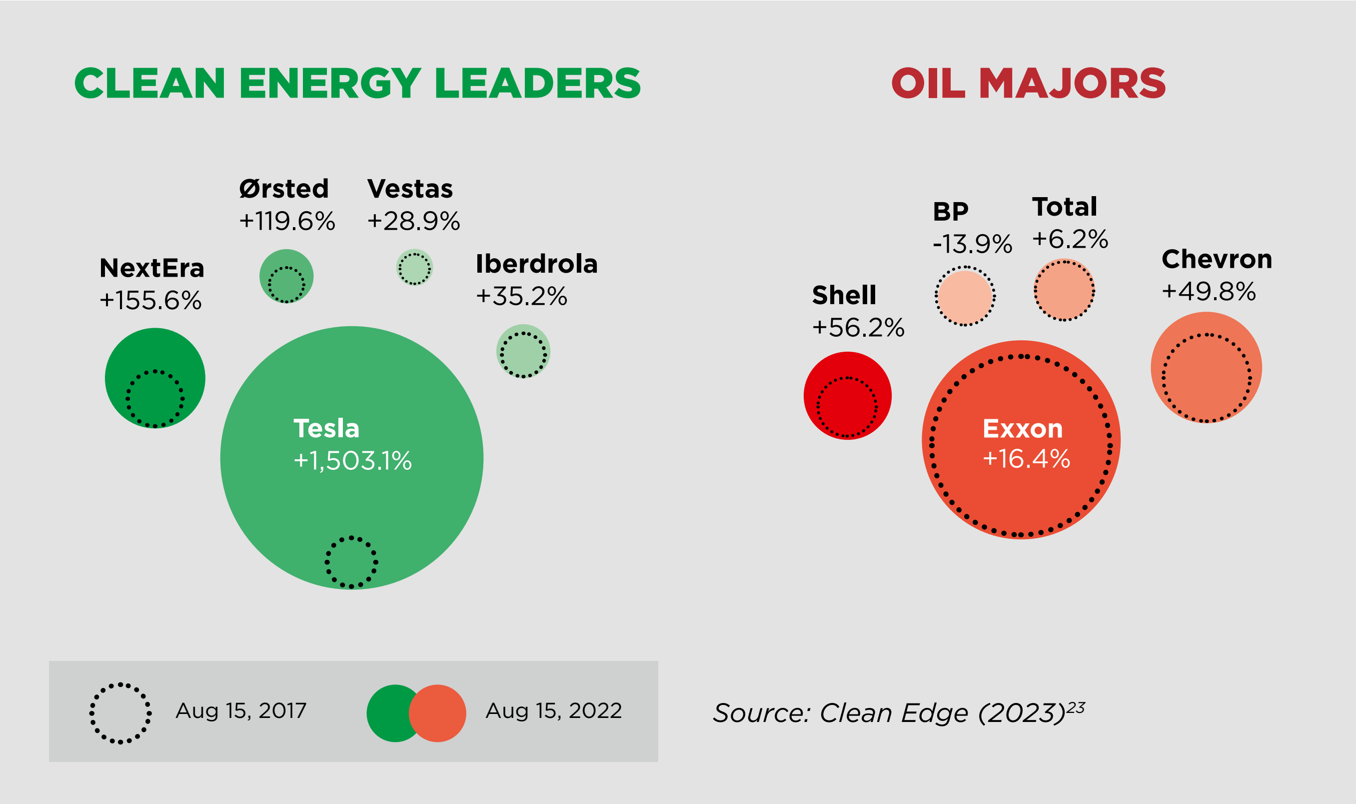

Figure 6: Five-year market cap comparison

But all of these companies encountered numerous challenges in their process of corporate transformation. Here's the story of Ørsted, the Danish multinational energy company. In the late 2000s, it was one of the most coal-intensive power generators in Europe. But in 2008 – after increased stakeholder concerns about a new major coal power project in Germany – the company set out a vision of green energy transformation, called 'Vision 85/15', stating that Ørsted would change its generation mix from 85% conventional, 15% renewable to 85% renewable, 15% conventional. This vision faced internal and external resistance. Fossil fuels were the company's core competence, and employees were proud of their world-class coal power plant efficiency. Many, both internally and externally, saw the transformation as commercially risky.[24] But the management team persevered, developed a new financing model for the industry, and scaled up its wind-power unit, which, in 2012, had consisted of only a few hundred people. The company teamed up with international partners like Siemens to scale the technology and drive costs down.[25]

The shift to a new business model and new corporate strategy has led to significantly better results.[26]

Such huge transformations can only be done successfully when the top team is serious about innovation and really willing to change. This requires your company to transition from prioritising the core business on the agenda to giving equal importance to exploration. The top team also needs to support disciplined experimentation and create the right organisational structures for corporate innovation, giving sufficient autonomy to the new ventures while also building a few crucial linkages with the core.[27]

5 | CONCLUSION

In this paper, we have brought the strategy dimension back into the sustainability discussion. Numerous companies have launched sustainability initiatives, but with modest success at best. We believe that a major reason why firms struggle to effectively transform towards more sustainability is that these sustainability programmes are insufficiently embedded in the company's core strategy. In this paper, we have shown how firms can start the strategy discussion by incorporating a sustainability ambition in their corporate purpose. Then, firms must decide whether their sustainability strategy is targeted at the functional, business, or corporate level. This decision allows for a better integration of your sustainability strategy into your company's core strategy and helps you prepare better for your implementation challenge.

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