WWF

To Whose Profit?(ii): Evolution

Building Sustainable Corporate Strategy

About the Authors

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Joss Tantram was formerly Business Education Manager at WWF-UK. Joss has ten years experience developing sustainability solutions with the corporate, local and central government sectors. At WWF, the main focus of his work over the last four years was to stimulate innovation in understanding environmental, social and ethical impacts and to identify links with improved business performance – the business case for sustainability.

Joss is a recognised expert in corporate reporting, stakeholder dialogue and the development of pragmatic, applied corporate responses to CSR and sustainability. In January 2004 Joss joined Terra Consult as a Partner to develop these areas of expertise as a consultant to the private sector. For further information see **www.terra-consult.co.uk**

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Background

WWF-UK's Business Education Work

WWF's mission is to stop the degradation of the planet's natural environment and to build a future in which humans live in harmony with nature, by:
- conserving the world's biological diversity
- ensuring that the use of renewable resources is sustainable
- promoting the reduction of pollution and wasteful consumption.

WWF believes that an essential part of this mission is to encourage corporate understanding of sustainability issues and to work with the business sector to secure the benefits associated with higher standards of practice in these areas.

The main focus of WWF's Business Education work is to develop new mechanisms to achieve long-term change in business sustainability. WWF-UK works towards this objective by building pragmatic relationships with businesses, working in partnership with leading organisations to explore best practice in business sustainability, and encouraging the creation of innovative tools.

WWF and Business Sustainability

In the move towards sustainability, we contend that companies need to question many conventional business assumptions and models. Sustainability issues affect almost every aspect of business activity, from the definition of company values and the range of factors to consider when developing strategic options, through to the nature and methods of supplying products and/or services, and the way in which business performance is measured. We believe all companies should be brave enough to engage with these concepts.

A key part of WWF's approach is to learn from its work and identify how these lessons can be used for the widest possible benefit. Through its work with forward-looking companies, WWF identifies best practice, promotes the business case for sustainability through the use of concrete examples, and develops programmes for use by businesses of all kinds in order to develop their understanding and learning of as yet uncharted areas on the journey towards sustainability.

Introducing the Project Partners and Acknowledgements

This publication represents the culmination of over two years' research, consultation and collaboration between a broad spectrum of interests in business sustainability. These included six companies; leading-thinkers in business sustainability; experts in corporate strategy, human resources (HR) and, corporate social responsibility (CSR); a top-tier professional services firm; an ethical fund manager, and representatives from the mainstream investment community. We could not have achieved our objectives without the continued assistance and support from the individuals and organisations listed overleaf.

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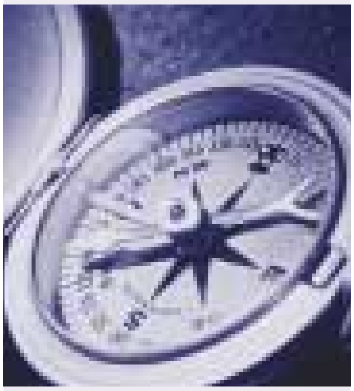


The pursuit of a more sustainable future requires fundamental shifts in attitudes and patterns of consumption by all sectors of society. From a business perspective, a key imperative is to understand the implications that sustainability issues have, both for current business activities and future market opportunities.

Many now argue that sustainability issues will have an increasingly important bearing on the way that companies are run, from the definition of company values and the range of factors to consider when developing strategic options, through to the nature and methods of supplying products and/or services, and the way in which business performance is measured.

WWF believes that in an increasingly complex future market economy, companies that choose to tackle sustainability issues as strategic business concerns are more likely to deliver increased value and long-term success than those which do not. A key challenge facing any company wanting to compete successfully over the longer term is not whether it should incorporate sustainability issues with its strategic thinking, but when and how.

Our research suggests that a growing number of companies recognise that it is not sufficient simply to treat environmental and social impacts as the inevitable consequence of economic growth. For these companies, sustainability concepts offer potentially important new market opportunities, as well as threats.

Our discussions with leading companies also suggest that internal perceptions play an important part in the process. A number have pointed out that, by broadening perceptions of sustainability issues to include notions of business benefit, they have been able to make more compelling arguments for improved company performance in specific areas of business activity.

At the same time, these companies warn that internal cases based purely on direct business benefits may only offer part of the solution. According to Hemscott, the business data provider, intangibles now account for some 27 per cent of total market value for FTSE100-listed companies. By treating sustainability issues as key drivers of both *financial* and *non-financial* value, many argue that companies will secure direct business benefits *and* be better placed to address future market conditions. Conversely, companies choosing to ignore these issues may achieve superior profitability over the short term but may risk destroying value over the longer term.

The focus of this publication is to help companies develop an improved understanding of how sustainability issues can deliver business benefits *and* increase the potential for long-term value creation. Recognising the key role that investor interests play in shaping company practice, it is also designed to encourage a more consistent and responsive dialogue with the investment community in relation to sustainability issues.

In doing so, it builds upon a number of key themes and in business sustainability:

- **Resource availability offers opportunities as well as constraints:** The earth is a finite, complex system. Human demand for, and the consumption of, resources are increasing at an exponential rate. Most companies already view improved resource efficiency as an important means of driving down costs. In addition, the pursuit of alternative resources, alternative markets and patterns of consumption could offer much greater opportunities for value creation.

- **People do matter:** In an increasingly competitive market economy, skilled labour, superior management capability, knowledge and information are key non-financial company assets. Remuneration is one means by which companies attract and retain high calibre staff. People are also motivated by a sense of trust and loyalty. Increasingly, they want to work for organisations that are accountable for their impacts on the environment and society. They want their knowledge and capability to be valued, and they want to buy products and/or services from familiar names and brands they can trust.

- **Traditional business models need to change:** The most successful proxy for assessing the relative importance of issues in a market economy is *money*. In many respects, conventional economic models do not fully address non-financial or intangible drivers of business value. Indeed, they can often result in misleading conclusions about how sustainable certain practices actually are.

- **More strategic responses are required:** A growing number of companies believe that more active consideration of sustainability issues will offer important sources of additional business value, as well as threat. More strategic responses are required if the potential relationships between sustainability issues and business value are to be fully understood.

- **Sustainability issues *are* material business concerns:** Most would accept that investor interests have an important influence over company practice. If companies are to start the process of integrating sustainability issues with their strategic thinking, they also need to convince the investment community that these issues are *material*, both to aspects of business performance and to long-term business success.

- **Sustainable business practices will increase the likelihood of value creation:** Increasingly, institutional investors are applying forward-looking indicators to refine their company valuations. If active treatment of sustainability issues requires superior foresight, management and implementation capabilities, then high standards of performance could be used as proxies for good management in general.

The sentiments expressed in this publication are not simply presented from a non-governmental organisation's (NGO) perspective. The UK Government, for example, has recently announced its formal commitment to a fundamental reform of UK Company Law, and has taken steps to extend the responsibilities of board and non-executive directors through a Revised Combined Code, which applies to reporting years which commenced on or after 1st November 2003.

There is also a growing body of evidence to suggest that the attitudes of some institutional investors are beginning to change, with many starting to price in the costs and liabilities associated with social, ethical and environmental issues. In the main, however, their approaches have tended to be defensive, with reduced ratings for poor performers rather than higher ratings for achievers.

In addition, there are growing calls for new business evaluation tools and techniques which will allow companies to understand and interpret the relationships between concrete measures of business performance and intangibles, such as quality of leadership, brand value, reputation, workplace culture and intellectual capital.

This publication aims to give an additional perspective on some of the key issues and themes governing business sustainability. Each chapter is written with a particular theme in mind, thereby enabling the reader to focus on a particular area of interest, rather than having to read the whole document in one sitting. For ease of reference, our key arguments are presented in the following sequence:

Chapter 1: Rationale
Chapter 2: The Current State of Play
Chapter 3: Basic Principles of Strategy Development
Chapter 4: Building Sustainable Business Strategy
Chapter 5: Communicating the Benefits
Chapter 6: Conclusions.

At the start of each chapter, readers are presented with a table which explains the objectives and intended outcomes in each case. We also provide a summary at the end, together with links to the relevant chapters.

Executive Summary

Sustainability is a Strategic Business Concern

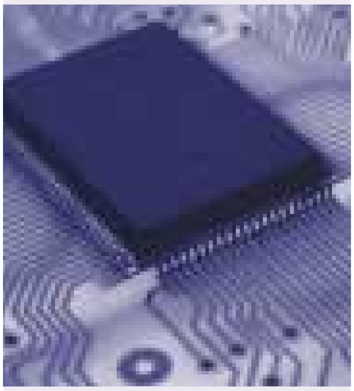
Strategy is a key element of management. It provides the overarching framework under which organisations move forward: a map for new directions; a stimulus to innovation; a guide for tactical decisions. It addresses long-term challenges, threats and opportunities, taking account of anticipated critical developments in society and in a company's markets. WWF-UK has produced *To Whose Profit?*[ii]*: Evolution* to help companies build sustainable strategies and communicate the benefits to investors.

Sustainability is clearly a strategic issue – it is about long-term economic, social and environmental viability. Ignoring these critical elements can result in misleading conclusions about the strategic risks and opportunities that lie ahead, and therefore poorer performance. In other words, WWF believes that integrating sustainability into strategy will help to deliver long-term business success.

Resource use and availability are central to sustainability, as is social equity. Such issues are certain to be important factors in determining the long-term futures of most companies in most sectors. Extractive industries, which are heavily dependent upon resource availability, are the most obvious sector to be affected, along with energy and transport, which are centrally implicated in climate change. But sustainability issues range far and wide: necessary changes in consumption patterns will affect all consumer goods industries, including retailing and advertising. The financial sector will inevitably be affected by the factors that influence its customers, and in the case of the insurance industry, the impacts of climate change are already taking their toll in terms of what can be insured and at what level of premium. Major issues such as forestry depletion and biodiversity loss will affect whole value chains, and will inevitably affect patterns of consumption in future. Likewise, people issues are increasingly important. As business depends more on employee knowledge and initiative, companies need to nurture key non-financial assets such as skilled labour, management capability, knowledge and information.

Sustainability Concepts are Seldom Integrated with Strategy

Business strategy struggles to deal with such intangible drivers of business value and with sustainability risks and opportunities, which means that sustainability and corporate strategy seldom meet. Research by WWF finds that few companies have begun to act strategically with regard to sustainability. While many businesses are addressing issues of resource use and social responsibility, they typically adopt a defensive, short-term approach, thinking in terms of conserving rather than creating value and avoiding risk rather than seeking opportunity. This may obscure strategic options that offer wider benefits and innovative solutions.



The predominant focus of most management action on sustainability is to control operational impacts and risks. This may protect existing business interests or corporate reputation, but may not derive any additional business benefits. In particular, it tends to focus attention on areas of the value chain which often do not offer the greatest potential for sustainability and financial returns. Ignoring the potential benefits from a more sustainable business strategy may mean that a company limits value creation through missed opportunities, even if it avoids destroying value.

These value concepts were introduced in the earlier publication *To Whose Profit? Building a Business Case for Sustainability*, which provided tools to help managers put the case for sustainability in the business terms which senior executives and analysts understand best. Now WWF-UK has taken that work further, showing why sustainability needs to be incorporated in strategic thinking, how that can be done and how it can be communicated.

It argues that a strategic understanding of sustainability issues can deliver business benefits and create long-term shareholder value. Resource and people issues present opportunities and risks, and business models need to change to take account of them. Considering sustainability should change the conventional understanding of business costs and benefits, and open up new potential ends and means of business activity. Sustainability can change the nature of the game and provide new ways for organisations to win.

Integrating Sustainability Concepts

Thinking strategically about sustainability should help companies to develop a big picture that takes account of the context in which the business will have to operate in the long term. It should force managers to identify the key long-term trends which have influenced markets in the past and those which will do so in the decades ahead. Managers throughout the business can then be asked what the trends mean for their operations. Can they be ignored? If not, how could they be a problem – or an opportunity? And what needs to change as a result?

The result should be a strategy which:

- pays more attention to the environmental and social contexts in which the firm operates
- takes account of societal values and expectations
- recognises the potential constraints and costs of climate change, resource wars, social inequality and reputational risk
- examines how positive responses to these constraints might create new strategic options and opportunities to create as well as conserve value
- includes measures of environmental and social performance as well as traditional financial indicators
- creates meaningful and responsive relationships with a broader spectrum of stakeholder interests as a means of building trust and modifying behaviours.

Corporate sustainability already uses evaluation tools which could be (but rarely are) used in strategic analysis. These include environmental management systems, which provide a framework for analysing environmental impacts and achieving continuous improvement against environmental aims and objectives. In most cases, however, such systems are used operationally and without taking account of other (financial) business objectives.

Incorporating sustainability does not always require new approaches to strategy, or even new tools. In many cases, all that is needed is to introduce sustainability concepts as part of the wider set of factors to consider when developing strategic options and choices. Stakeholder analysis is the only tool which may be new to strategists: it can help to evaluate the wider interests that companies will be expected to serve and refine internal views of what is likely to translate into a successful strategy. Otherwise, familiar strategic analysis tools can all be used to address sustainability:

- **PEST** (Political Economic Social and Technological trends) analysis should – but often does not – cover sustainability. It has become PEEST analysis, explicitly inserting Environmental issues in leading companies.

- **Scenario planning** can provide analysis of the implications for the firm of issues such as resource and habitat loss, changing societal attitudes and expectations.

- **Competitor analysis** could include analysis of sustainability issues that affect competitive advantage and identify alternative strategies for value creation.

- **Competency analysis** will provide a detailed understanding of the firm's natural and social capital, alongside its financial and manufacturing capital.

- **SWOT analysis** can be extended to include the new strengths, weaknesses, opportunities and threats posed by sustainability issues.

This WWF report stresses that strategy development is often not a discrete, top-down process. It shows how sustainability can be inserted into other common approaches to strategy development. For example, an outside-in approach based on reading external developments should draw attention to important ecological and social trends.

On the other hand, companies adopting an inside-out approach, using the popular notion of core competencies, can incorporate capability in sustainability as well as conventional competencies. Some strategies develop in a bottom-up fashion, with individual initiatives welling up from inside the company. Such an approach can include local responses to sustainability problems and opportunities, which come together to influence strategy.

This last approach is perhaps the most promising, stimulating a culture of learning about sustainability, experimentation and innovation in products and/or services, processes and production.

Regardless of the approach adopted, the same fundamental questions must be answered, viz:

- What do we want to achieve? (strategic direction)
- What is our current situation? (strategic analysis)
- What options do we have? (strategic choice)
- How are we going to make it happen? (strategy implementation).

Sustainability needs to be, and can be, introduced into each of these stages and this report identifies six key challenges for managers attempting to do this:

1. Raise awareness of relevant strategic sustainability issues.
2. Determine the company's attitude to sustainability, on a spectrum from 'opposition' to 'transformation'.
3. Establish how strategy works in the specific context of their own company, and how far sustainability concepts have been integrated in business practices.
4. Establish what processes are used to manage strategic change, what works and what does not and why.
5. Ensure that the strategic opportunities and threats posed by sustainability issues are included as inputs that influence strategy development.
6. Develop relationships with external stakeholders as a means of achieving a broader consensus about what is material to whom and why.

Selling Sustainability Benefits to Investors

Public companies need to persuade shareholders that they are pursuing winning strategies, but many finance professionals have not yet engaged with sustainability. Companies will therefore need to sell sustainable strategies in terms which analysts and other financial professionals will understand.

A growing number of institutional investors are now turning to more forward-looking indicators as part of their assessments of company performance. Recent research suggests that more than a third of analysts' company valuations are based on non-financial or intangible indicators of company performance.

These aspects will become more important with the impending requirement for companies to include a wide-ranging Operating and Financial Review (OFR) in annual reports. It will encourage analysts to take a broader view of performance and risk, and should provide an opportunity for companies to be more explicit about sustainability strategies and their implications for future business value.

Companies can connect sustainable strategy with four key areas of interest to investors:

- **Earnings:** The most significant element for most investors. If a sustainability strategy can be shown to have a direct impact on earnings, it will be most likely to grab analysts' attention.

- **Equity risk premium:** An important influence on investors' perceptions of share price levels. It may be possible to show that a sustainability strategy will lead to lower risks, and ratings agencies are now awarding sustainability risk ratings in the same way as traditional rating agencies categorise companies' debt quality – with direct impacts on the cost of capital.

- **Shareholder value drivers:** It may not be possible to demonstrate direct impacts on earnings or risk, but companies may nevertheless be able to demonstrate connections with drivers of shareholder value such as capital investment and the cost of capital.

- **Intangible value:** Investors increasingly understand that intangible value is important for corporate success, and many aspects of such value are linked to sustainable strategies, such as leadership, transparency and human capital.

Intangible Value and Sustainability

Sustainability is intimately tied up with intangible value. This element of enterprise value has grown in importance over the past few years. It now accounts for the majority of the stock market valuation of many major companies, especially those with powerful brands such as Coca-Cola, but also the many businesses which rely on the knowledge and skills of their people rather than machinery and other tangible assets.

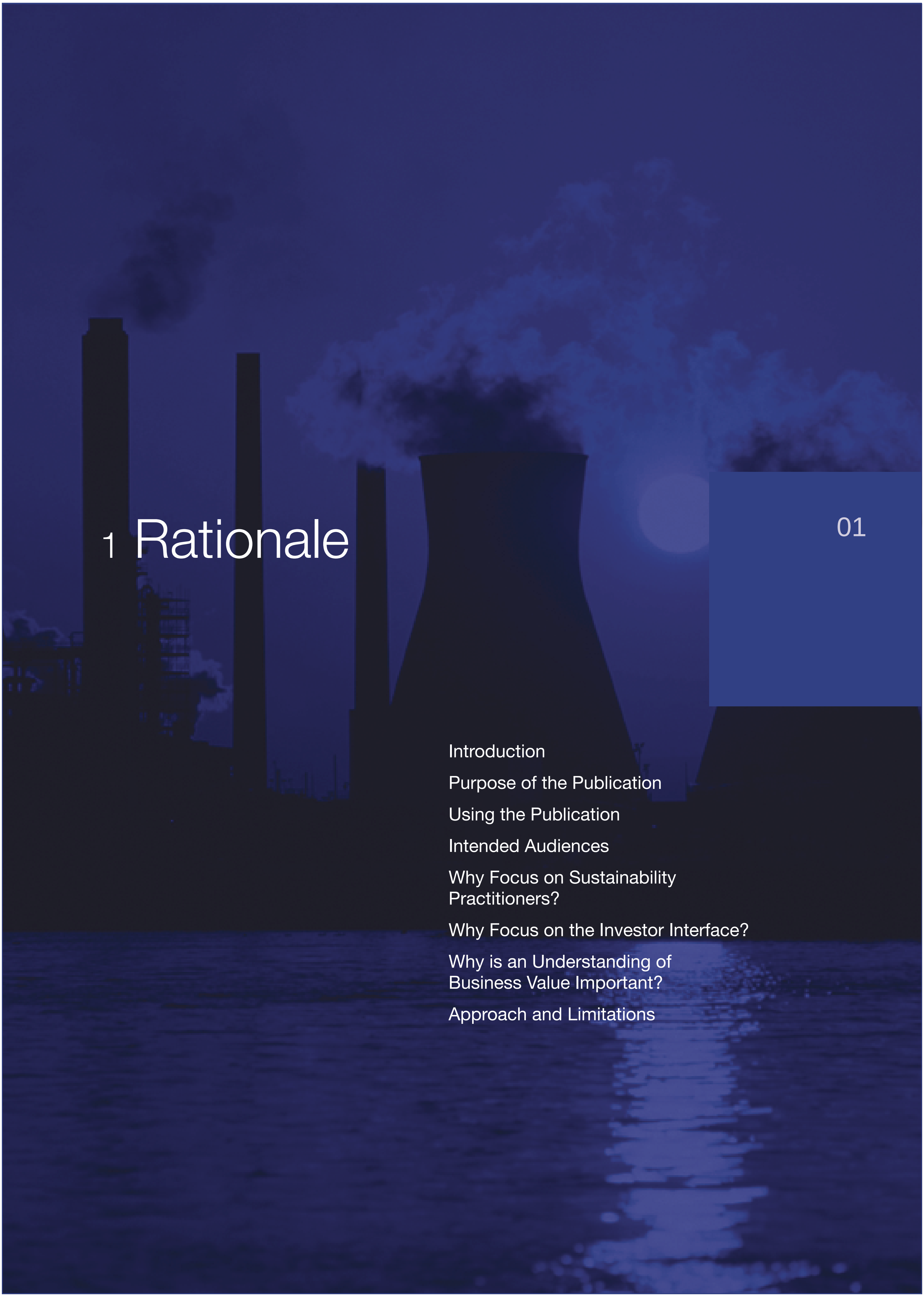
Reputation and trust are important elements. A good reputation builds the loyalty and trust of stakeholders – investors, employees, suppliers and customers. Trust has been shown to be a key pre-condition for the learning and innovation that is increasingly important in the modern economy. In fact, long-term success appears to flow from trusting, flexible relationships with stakeholders.

The link with intangible value is the most compelling argument for many investors and managers for the adoption of sustainable business strategy, especially in sectors that rely on knowledge, information and people.

Strong correlation between sustainable business practices and intangible stock market value has been found in research. For example, Cap Gemini Ernst and Young found that environmental, social and community activity is consistently in their top ten value drivers – which explain up to 90 per cent of variability in market value.

The business world faces increasing demands for sustainability, accountability, transparency and social justice. So moving a company in this direction will improve its reputation, its intangible value, investor confidence in its latent capabilities and, ultimately, its stock market value.

Roger Cowe



01

1 Rationale

1: Rationale

Chapter Summary

Purpose	**Outcomes for Readers**
This chapter aims to: • explain how our thinking has progressed since the launch of our previous publication and the rationale for our current work • describe our approach, its emphasis, intended audiences and limitations • provide a navigation tool for the following chapters.	Using the information in this chapter, readers will be able to: • gain an insight into the rationale for, focus and emphasis of this publication • recognise the importance of 'value' concepts for achieving an improved understanding of business sustainability.

1.1 Introduction

The key motive behind WWF-UK's previous publication, *To Whose Profit? Building a Business Case for Sustainability*, was to encourage wider adoption of sustainability principles within business practice. It did so by presenting an approach that encouraged a more explicit analysis of the potential opportunities and benefits posed by sustainability issues, as well as the threats.

Recognising the genuine problems that many companies face when embarking upon a sustainability programme, we argued that a logical starting point would be to extend perceptions to include notions of business benefit. In this way, more explicit links can be made between company performance in business sustainability and other aspects of business performance. We also suggested that these types of argument could be used to highlight the broader imperatives that companies are trying to address, and their implications for overall business performance.

In 2002, WWF's Business Education Unit embarked upon a six-month consultation exercise to examine the extent to which companies were using these types of argument to encourage the wider adoption of sustainability principles within their own organisations. A number of common themes emerged from the consultation. These are listed in the box below.

Consultation/Workshop Phase: Common Themes

- Many companies support the idea of building internal cases that emphasise potential business benefits in specific areas of activity, although few felt confident about building internal justifications based on the links with overall business performance.
- Most argued that the attitudes of mainstream institutional investors have a key influence over company practice. Both sides need to start treating sustainability issues as a key driver of business performance if more companies are to modify their practices in business sustainability.
- They also suggested that intangible value forms an increasingly important driver of market value. An alternative means of highlighting the strategic importance of sustainability issues might be to emphasise their role as key drivers of both financial and non-financial value.

These were then used to define an initial scope of work for the research, which underpinned this particular publication.

1.2 Purpose of the Publication

This publication is designed to help companies build capacity to address sustainability issues as strategic business concerns. Recognising the key role that investor interests play in shaping company practice, it is also designed to encourage companies to communicate the direct and wider benefits that could be secured, with a particular focus on their implications for long-term value creation.

Together with its companion piece, *To Whose Profit?: Building a Business Case for Sustainability*, this publication aims to help companies:

- examine the extent to which current company practice addresses sustainability issues as strategic business concerns
- gain an insight into the basic principles of strategy development and some of the reasons why conventional value management techniques cannot fully address business sustainability concepts
- explore how strategy works in practice and examine some of the factors to consider when building sustainable business strategies
- uncover some of the techniques that could help companies communicate the intentions and outcomes of company sustainability strategies to the investment community, with a particular focus on their implications for business value.

1.3 Using the Publication

This publication aims to give an additional perspective on some of the key issues and themes governing business sustainability. Each chapter is written with a particular theme in mind, thereby enabling the reader to focus on a particular area of interest, rather than having to read the whole document in one sitting. For ease of reference, our key arguments are presented in the following sequence:

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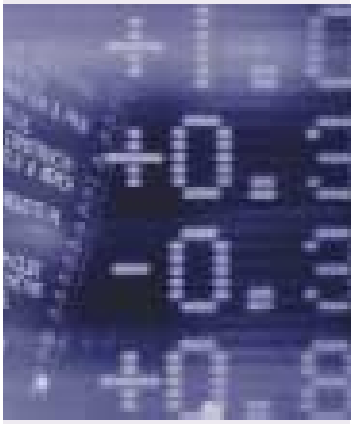
At the start of each chapter, readers are presented with a table which explains the objectives and intended outcomes in each case. We also provide a summary at the end, together with links to the following chapters.

1.4 Intended Audiences

In light of the key objectives described in Section 1.2 above, the publication is designed for the following key audiences:

(i) Sustainability Practitioners: Sustainability practitioners may be senior managers, form part of an in-house team, or be advisers or consultants. For ease of reference, these people are referred to as sustainability practitioners and are treated as the primary audience for this document.

(ii) Executive/Senior Managers: These are taken to mean any manager with primary responsibility for strategy development, planning or implementation. They may be individuals from a corporate or strategic business unit (SBU) function, or functional managers with specific responsibility for developing and implementing product or service strategy.



(iii) Investor Relations: Within the context of this publication, ‘investor relations’ is used as a generic term taken to mean any manager or function charged with communicating the company’s strategic intentions to the investment community, or disclosing information on company performance. They may be senior managers within a formal investor relations department. They can also include individuals from other corporate functions (eg Company Secretary’s Office, Marketing, Public Relations, Corporate Communications, Human Resources or Risk Management).

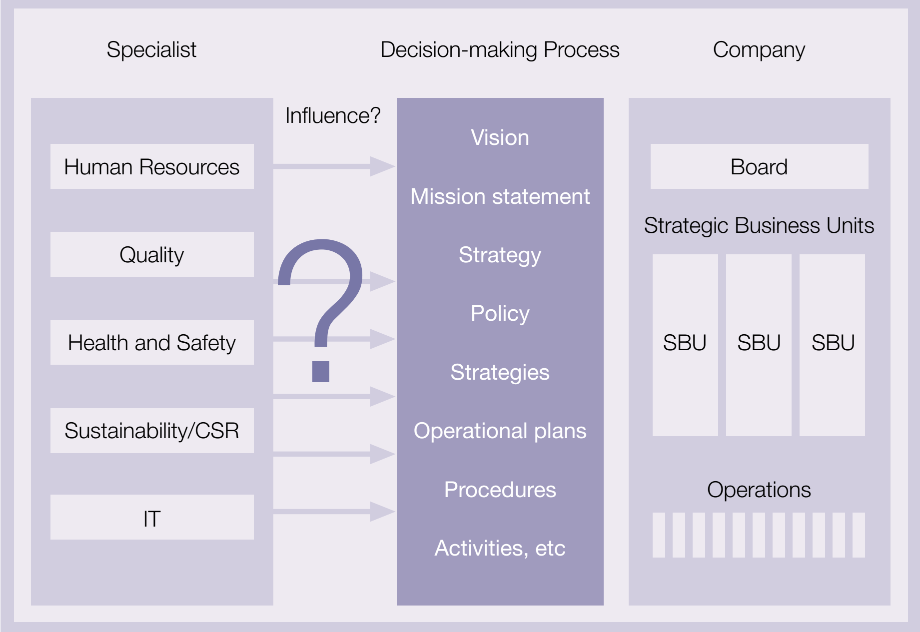
Given the importance of encouraging more positive attitudes and behaviours towards business sustainability issues, the publication may also be of interest to the mainstream investment community, as well as those who influence this key stakeholder group.

1.5 Why Focus on Sustainability Practitioners?

Sustainability practitioners are an important knowledge resource within companies. They provide a key source of expertise and experience of sustainability issues, and are usually responsible for helping to build capacity and understanding within their organisations.

At present, many have to influence managers and functions individually, indirectly, or rely on the success from specific initiatives in order to demonstrate the relevance of the subject to others. This point is illustrated in figure 1 below. Unfortunately, these approaches tend to be piecemeal and can sometimes lead to a mismatch between a company's stated objectives in business sustainability and actual practice (see also Section 2.5).

Figure 1: Specialist Practitioners Roles and Influences



We believe that one important means of achieving more widespread support is to highlight the types of sustainability issue that could have implications in strategically important parts of the business. For this to happen, sustainability practitioners need to understand the principles governing strategy development (see also Chapter 3). They also need to understand how strategy works within the specific context of their own companies (see also Chapter 4).

A second important means of securing more widespread support is to frame the internal cases for improved performance in terms of their implications for *business value* (see also Section 1.7 below). Companies are more likely to treat sustainability issues as 'mainstream' business concerns if they can see how they *create* additional value or *conserve* existing value.

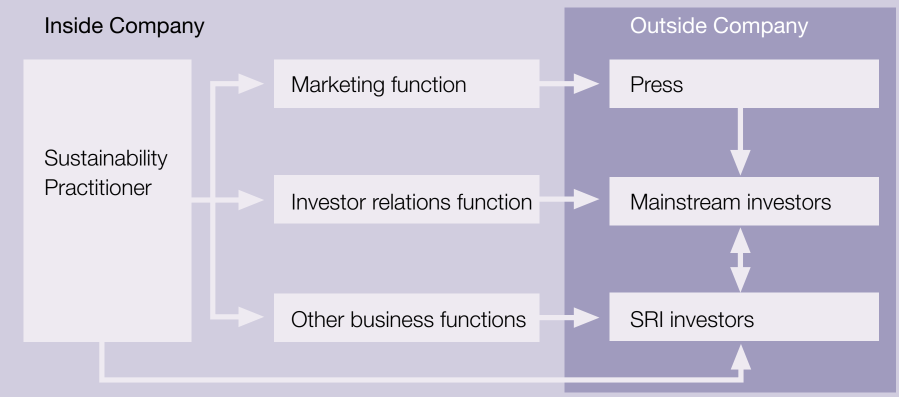
A third important means is to understand how sustainability issues contribute to both *tangible* and *intangible* value. There are now numerous examples where companies have reduced their costs of capital by anticipating a forthcoming regulatory requirement, or have achieved improved cost efficiencies, for example, through environmental improvement programmes. Closer links between sustainability issues and company values, ethics and reputation can also offer an important means of building trust and confidence in the market place. They can also support external perceptions of a company's capacity and capability to deal with future market conditions (see also Section 5.6).

1.6 Why Focus on the Investor Interface?

In determining what amounts to a *business benefit*, it is generally accepted that financial stakeholders, and equity markets in particular, play an important stakeholder role. The *investor interface* is therefore considered a critical mechanism for gaining an improved understanding of how sustainability issues might affect company performance.

If sustainability issues do not feature in discussions about current and future business performance, then they will not be recognised as potential drivers of business success. As is illustrated in figure 2 below, sustainability practitioners usually have direct lines of communication with specialist socially responsible investors (SRI) but do not, in the majority of cases, communicate directly with mainstream investors. Instead, they are heavily reliant on indirect forms of communication, which do not address potential sources of benefit (see also Section 2.9).

Figure 2: Interfaces between Sustainability Practitioners and Investors



1.7 Why is an Understanding of Business Value Important?

One of the key concepts underpinning this and our previous publication is that of *business value*. The paramount aim of any sustainable business strategy should be to identify ways to *create* and *conserve* value simultaneously, while ensuring that actions which *destroy* or *limit* value are avoided.

In business terms, activities that are designed to control business impacts and risks have the effect of *conserving* value; these tend to be viewed as a given in any well-managed company. Conversely, activities that generate additional earnings, or improve cost efficiencies, have the effect of *creating* value.

Accordingly, if a company decides to define a sustainability strategy, but only addresses impacts and risks, it will protect its existing business interests or corporate reputation, but may not derive any additional business benefits. Equally, if a company ignores the potential benefits associated with more sustainable business practice, it may limit value through missed opportunities, or destroy value through inadequate control of impacts and risks.

1.8 Approach and Limitations

The content of this publication has been developed using action research methods. The project itself was completed in three distinct phases:

- **Phase 1:** Three workshops involving six companies, a professional services company and a fund manager to explore the key issues and to refine the focus and objectives of the project.

- **Phase 2:** Detailed third party research and analysis in agreed areas of priority concern.

- **Phase 3:** Consultation and commissioned input from a range of leading thinkers with expertise ranging from corporate management strategy, HR strategy, capital investment and financial rating.

The publication does not claim to cover the entire body of evidence supporting the case for sustainable business practices. We also acknowledge the fact that different sectors of the business community will have very different interpretations of what a sustainable business strategy should actually look like. By encouraging companies to address these concerns as strategic business issues, we can all contribute to the gathering momentum for change.

2 The Current State of Play

2: The Current State of Play

Chapter Summary

Purpose

This chapter aims to:
- consolidate the information from the consultation, workshop and research phases of the project
- provide a snapshot of how the subject is evolving
- describe some of the latest trends in business sustainability
- review current practice from a company and investment community perspective.

Outcomes for Readers

Using the information in this chapter, readers will be able to:
- highlight some of the key barriers and challenges that may be applicable in their own companies
- refine their arguments for developing responses that address potential sources of benefit, as well as threat.

2.1 Introduction

Recent years have seen an explosion of evidence pointing towards a link between sustainable business practices and aspects of business performance. There is also increased evidence that mainstream institutional investors are starting to recognise the strategic importance of some sustainability issues. To date their responses have tended to be defensive [1].

In addition, the evidence from leading companies suggests that considerable progress has been made to extend internal perceptions of sustainability issues to include notions of business benefit as well as threat. For the majority of companies, however, environmental, ethical and social issues are only just beginning to emerge as strategic business concerns [2].

The findings of our research suggest that there is still a wide gulf between company responses to sustainability issues, and the key factors currently shaping overall business strategy and direction. Some of these findings are illustrated in the box below. There are also considerable mismatches between current company practice in business sustainability and what is communicated to external stakeholders.

Consultation/Workshop Phase: Common Themes

- **Focus:** Implementation strategies tend to focus on impact/risk control at an operational level. Any associated benefits are implicit, indirect or of small-scale value.
- **Organisation:** Business responses to sustainability issues are likely to be disjointed. Management responsibility tends to be spread across several functions, eg environment, CSR, risk management, health and safety, HR, etc.
- **Planning:** Few advisers/practitioners are currently involved in strategic management or planning. This appears to be the area of business activity where sustainability issues, notably environmental issues, are felt to be of most direct relevance to long-term business success.
- **Internal Responses:** In those cases where advisers/practitioners are asked to comment on the content of a business/marketing plan, it tends to be at the later stages of formulation. Under such circumstances, responses are likely to be defensive, again with a focus on mitigation/damage limitation.

1 Fuller, J, July 2003

2 Kemp, V, 2001

In this chapter we explore some of the emerging issues and trends that are likely to start influencing attitudes and behaviours towards business sustainability. These are presented in the following sections:

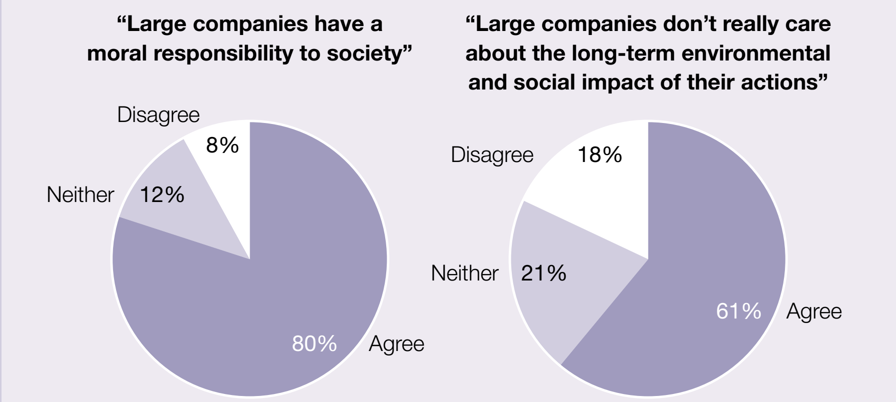
- Corporate Responsibility, Brand Value and Trust
- Strategic Goals and Company Responses
- Industry Sector Responses
- Current Management Focus
- Current Evaluation Tools and Techniques
- Investment Community Responses
- Current Practice and Materiality
- Communicating the Benefits.

2.2 Corporate Responsibility, Brand Value and Trust

Recent years have seen significant improvements in both the volume and type of information that companies disclose in relation to their environmental, ethical and social performance. Yet there is only limited evidence to suggest that the public 'trusts' companies more because they now disclose more information. In fact, quite the opposite appears to be the case in the UK.

According to a recent study by MORI [3], for example, some 80 per cent of the public now believe that "companies have a moral responsibility to society", but nearly two-thirds suggest that "large companies don't really care about the long-term environmental and social impact of their actions" (see also figure 3 below).

Figure 3: Large Companies Care about Social and Environmental Issues?



Base: 1,875 adults 15+ across Britain, July 2002. Source: MORI

These statistics are, in part, a reaction to the recent scandals of Enron and WorldCom, as well as concerns over the remuneration packages offered to executive managers. They also point towards a quite dramatic shift in public expectations and attitudes.

While the evidence of a significant impact on patterns of consumer spending is somewhat mixed, any topic which moves so dramatically up the public agenda will, given the opportunity and knowledge, eventually show itself in behaviour. The potential implications for companies with a high reliance on business-to-consumer relationships are possibly most significant, eg retail, retail banking and service companies. There are also potential consequences for other sectors, notably those

3 Lewis, S, 2003

within the supply chain. Indeed, there are now numerous examples of companies that are looking to build increased trust and confidence by applying their values and principles across their key supply chains. For example, in the UK these include: Marks & Spencer, B&Q, BT and the Co-operative Bank.

In some respects, these trends simply lend more weight to the argument that companies need to get better at persuading others that they care as much about their wider responsibilities as they do about their commercial ones. It is perhaps an over-simplification to suggest that improved disclosure will improve corporate reputation by itself, or increase the likelihood of long-term value creation.

Lewis, S, (2003): *"Consumers are looking for new sorts of brand values. These go well beyond the practical issues of product benefits and further than the emotional and psychological aspects of brand image. Consumers are moving to the top of Maslow's hierarchy of needs and seeking 'self-realisation'. Marketing's understanding of brand's territory needs to be extended into that of 'ethics' and 'beliefs'."*

In order to encourage more positive responses and behaviours, companies must also explore how higher standards of practice in business sustainability might reinforce their company values and brand values.

2.3 Strategic Goals and Company Responses

Many companies acknowledge that their internal processes for defining core business objectives and goals are often separate from those used to define their core objectives in business sustainability. This view is also supported by our research findings, which suggest that relatively few companies actively address sustainability issues as an integral part of their core business strategy.

Many companies operate formal environmental or CSR policies and have defined specific objectives for improved company performance. In the vast majority of cases, these tend to be developed separately from other strategic objectives.

In those instances where more explicit links have been made between sustainability objectives and other business goals, these have tended to focus on achieving legal compliance, or minimising potential sources of impact and risk [4] (see box below).

Consultation/Workshop Phase: Examples where Objectives are Linked

- When they are subject to increased regulatory control or taxation.
- Where they form a significant source of risk or contingent liability.
- When they form an explicit component of the working practices and intentions of individual executives.
- If they have a significant bearing on corporate reputation or brand value.
- If they support a cost control objective with implications for general company practices.

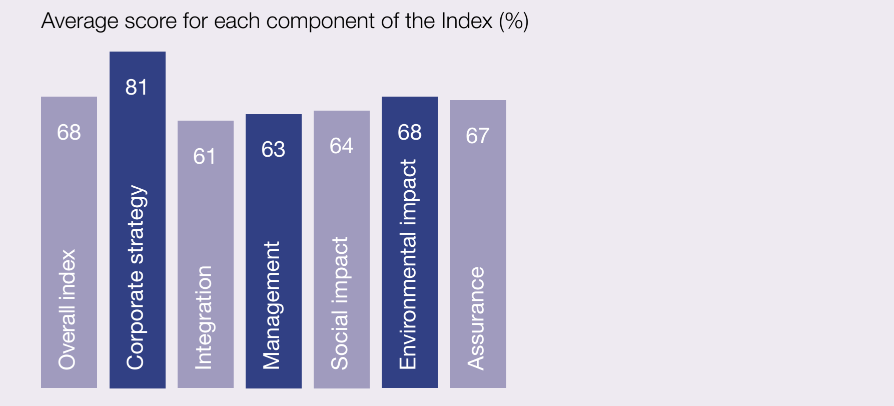
This can lead to an internal misconception that improvements in environmental or social dimensions are unrelated to other aspects of business performance. Worse still, it can support the view that increased expenditure in environmental or social dimensions will detract from other business priorities, thereby limiting or destroying potential business value.

4 Schaltegger, S, Burritt, R & Petersen, H, 2003

2.4 Industry Sector Responses

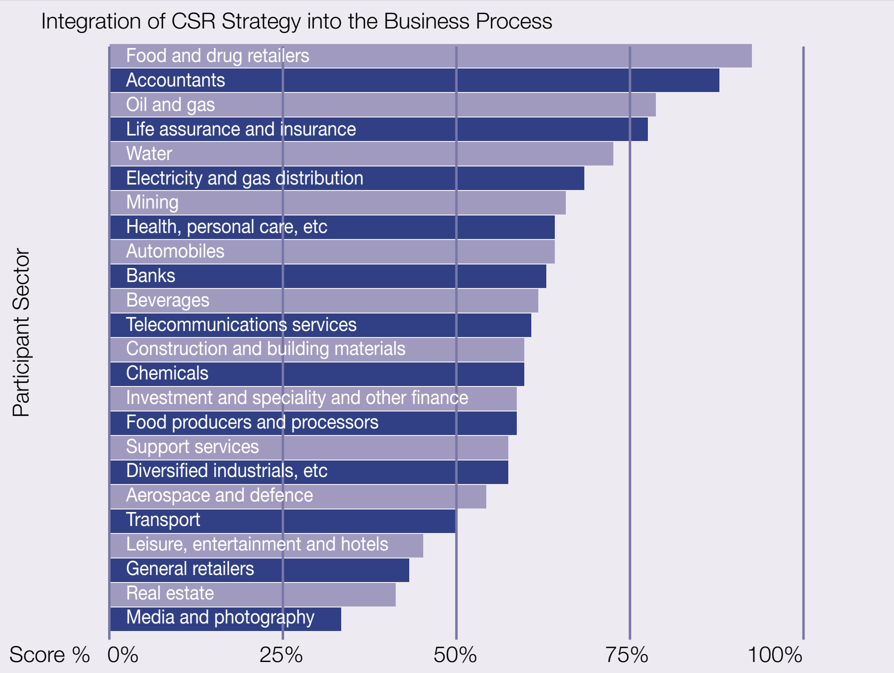
These observations also appear to be borne out by other third party research into current company practice. In its first Index of Corporate Responsibility, for example, Business in the Community (BitC), found that the 'Corporate Strategy' component of their Index achieved a significantly higher score than any other component. Conversely, the 'Integration' component of the Index achieved the lowest average score (61 per cent), suggesting a significant gap between intent and the translation of sustainability objectives into mainstream business practice (see figure 4 below).

Figure 4: Components of Index Model [5]



Closer examination of sector trends suggests that there are also significant differences in performance between different industry sectors, both in terms of company understanding of sustainability issues and their translation into mainstream business practice (see figure 5 below).

Figure 5: Which Sectors are the Most Advanced? [6]



5 Business in the Community, 2003

6 Adapted from *Business in the Community Survey Report*, 2003

The best performing sectors tended to be those dominated by significant contingent liabilities (eg life assurance and insurance), regulatory requirements (eg water) or with a heavy dependence on natural resources (eg mining). This point is illustrated in figure 6 below.

Figure 6: Top Ten Performing Sectors [7]

Given the high average score in relation to the integration of environmental and social issues with internal risk management and internal control programmes (85.1 per cent), this lends further weight to the assertion that the predominant focus of most sustainability strategies at present is to control operational impacts and risks.

This assertion was also supported by the views from the participating companies during the workshop phase of the project. Many suggested that one of the most compelling cases for improved company performance in specific areas of business activity is on the grounds that the issue presents a material business risk.

The main limitation with a defensive approach is that it often obscures strategic options which offer wider benefits or encourage the adoption of more innovative solutions. Options that encourage improved resource efficiency will, of course, generate important bottom line benefits in specific areas of activity, and could under certain circumstances influence the cost and availability of financial capital. Yet the issue would currently need to present a significant and material risk in its own right to be of any interest to the investment community (see also Section 2.8).

2.5 Current Management Focus

There is also evidence to suggest that the current management focus of many companies sometimes obscures the most important sources of opportunity and impact. By way of illustration, we use the example of a major drinks carton supplier [8].

Figure 7 – see opposite – shows the points in the supply chain where the most significant sources of environmental impact and opportunity manifest themselves. The x-axis denotes the scale of the environmental footprint at each stage in the supply chain, whilst the y-axis describes the key stages from raw material extraction through to disposal at end of use. The manufacturing phase creates the smallest environmental footprint, but is of most direct relevance to the company, which manufactures and supplies drinks cartons to the food and drink sector. Figure 8 then shows the current focus for the company's environmental improvement programme.

By comparing the two – see figure 9 – it is immediately apparent that a disproportionate amount of internal time and effort is being spent addressing site environmental compliance issues. Conversely, the areas at each end of the supply chain offer a far bigger opportunity to secure additional benefits, both in terms of environmental and business performance. These have been almost completely overlooked.

7 Business in the Community, 2003

8 Information adapted for use with the kind permission of Environmental Resources Management

Figure 7: Impacts and Opportunities (Environment)

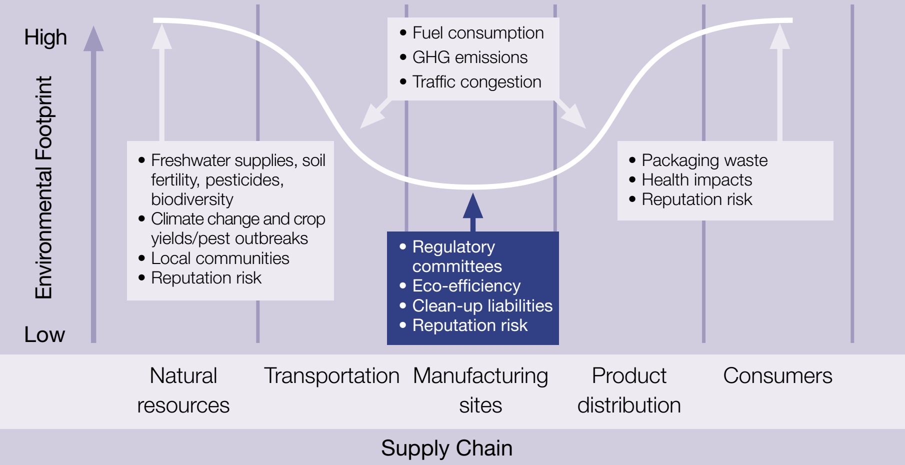


Figure 8: Current Management Effort (Environment)

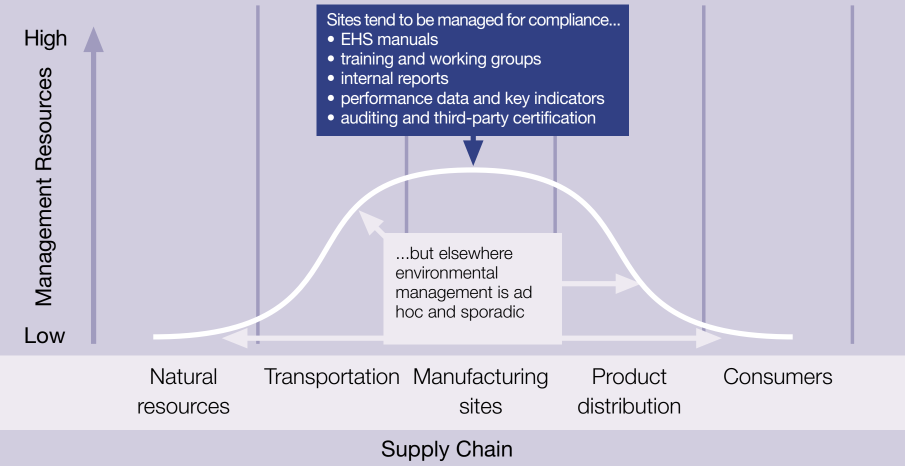
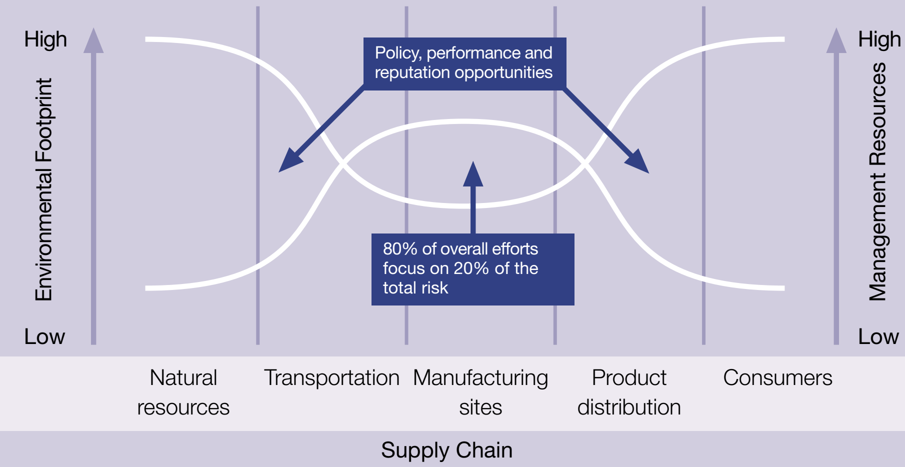


Figure 9: Mismatch Between the Two



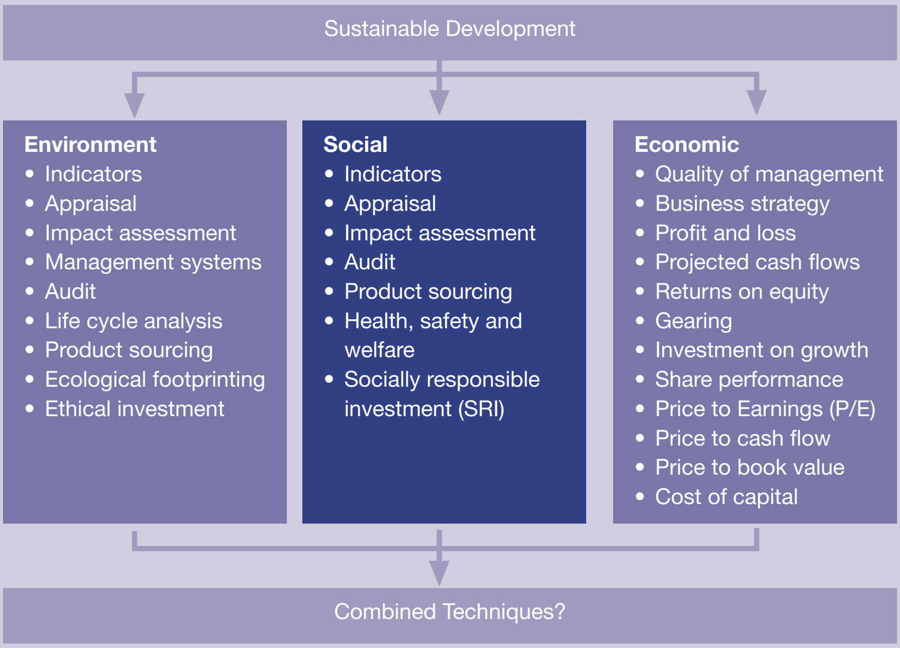
2.6 Current Evaluation Tools and Techniques

The majority of current evaluation tools in business sustainability are actually implementation tools. Environmental management systems (EMS), for example, offer a consistent framework for deciding which areas of activity have the potential to generate significant environmental impacts, and provide the basis for achieving continuous improvement against stated company aims and objectives. In the majority of cases, however, the focus and applications of these systems are operational in nature.

By way of illustration, we use an example from a major UK printer. Here, a key objective of the company's EMS was to reduce key sources of environmental impact **and** secure financial benefits. However, the scoring model used addressed only the potential scale of impact. Of the 45 significant impacts identified by the company, 16 offered explicit opportunities to deliver cost-savings and a further six offered implicit opportunities. None was identified as being of high priority by the scoring model.

Sustainability practitioners are already familiar with a wide range of other environmental and social impact assessment tools (see figure 10 below). As with EMSs, they are not designed for use as strategic planning tools, nor do they enable the relative benefits of improvement programmes to be evaluated across all dimensions of sustainability. To examine how sustainability concepts might affect business value, new or adapted tools are needed (see also Section 4.5)

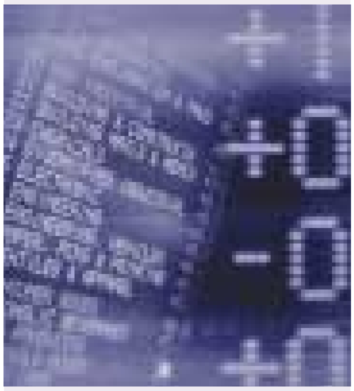
Figure 10: Examples of Current Tools and Techniques



2.7 Investment Community Responses

SRI and ethical funds have continued to grow in prominence. They now account for a larger proportion of the overall market under management and in most cases appear to be performing as well as, if not better than, their mainstream counterparts. In Europe, for example, the total volume of SRI assets has increased by 36 per cent from €11.1 billion at the end of 1999 to €15.1 billion in 2001 [9].

9 Sustainable Investment Research International and CSR Europe, 2002



Claims of superior returns are more difficult to substantiate, as a number of other market factors will inevitably contribute to stock volatility and performance. But even the most resolute of sceptics would find it hard to ignore these trends entirely, particularly when reviewed over a longer timeframe[10].

There is also some evidence that mainstream investment sector attitudes are beginning to change with some mainstream investors starting to apply 'risk/opportunity' premiums to certain types of sustainability issue. UBS Investment Bank, for example, recently announced its intention to train 400 of its bankers, research analysts and legal advisers on how to integrate environmental criteria into their assessments of investment risks and opportunities. When asked to comment, Dr Kiernan, Chief Executive of Innovest stated that:

> *"You wouldn't normally expect investment banks to be doing this... it is borne from the growing recognition that environmental issues can cost companies money, or create it."* [11]

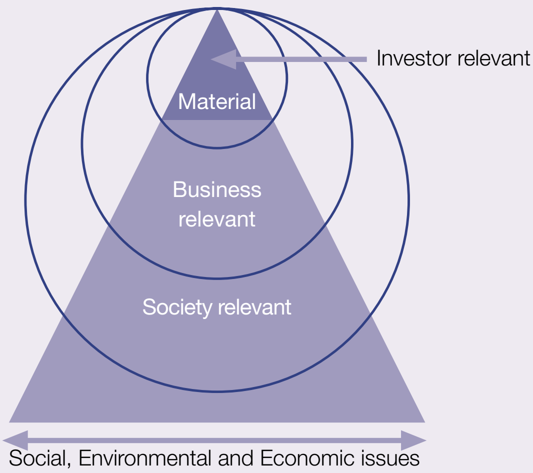
The downside of increased scrutiny is that a disproportionate amount of time and energy may be spent answering queries and protecting reputations, at the expense of more innovative responses to the challenges posed by sustainability issues. This theme is addressed in more detail in Chapter 4.

2.8 Current Practice and Materiality

Traditionally, the investment community has taken a narrow view of the range of factors deemed material to overall business performance, whilst societal expectations have tended to be much wider.

Figure 11: Deciding What Information is Relevant and Material

Align interests of investors, company management and society



Adapted from Sustainability Executive Roundtable

10 Fuller, J, July 2003

11 Targett, S, August 2003

Companies are also faced with increased pressure to improve their disclosure practices in all areas deemed relevant to overall business performance. In July 2003, for example, the UK Government announced plans to introduce new mandatory reporting requirements for large companies. Commonly referred to as the Operating and Financial Review, or OFR, these proposals will require companies to:

> *"...report on matters such as the environmental impact of the company, its relations with employees, customers and others, or future risks and opportunities, wherever these are material to the company."*

At the same time, a number of leading thinkers have suggested that a policy of full disclosure is not necessarily feasible or desirable in many cases. Indeed, full disclosure may actually prove counter-productive if it fails to improve external attitudes and behaviours towards the company concerned. Far more important, perhaps, is the need to secure a broader consensus over what is material, to whom and why.

To address these concerns, leading thinkers in business sustainability are turning their attention to the definition of a generally accepted framework for establishing materiality. In their recent publication *Redefining Materiality*, for example, Zadek and Merme advocate the use of a five-part materiality test, which they hope will gain purchase more widely. This is illustrated in figure 12 below and is summarised in the text that follows.

Figure 12: Proposed Five-Part 'Materiality Test'

- **Test 1: Direct, Short-Term Financial Impacts:** This would include any sustainability issues which have the potential to influence short-term profitability, the direct cost and availability of capital, or are likely to become subject to future regulation or taxation.

- **Test 2: Policy-Related Performance:** This test could be used to gauge the potential mismatch between a company's stated policy aims and objectives in business sustainability and actual performance in practice. This test is felt to be particularly attractive from a risk perspective, enabling assessment to be made of the potential for adverse publicity, litigation or claims.

- **Test 3: Business Peer-Based Norms:** This test, it is suggested, offers an important means of extending definitions of what is material, based on the activities of leading companies, competitors and peers. Analyses against accepted sectoral priorities and concerns will also offer a useful insight.

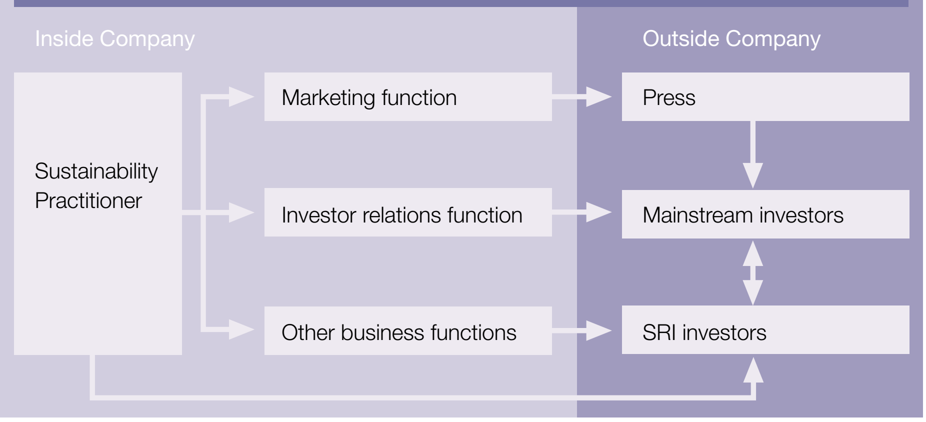
- **Test 4: Stakeholder Behaviour and Concerns:** The fourth materiality test is concerned with the identification of internal company practices, which could have significant impacts on external decisions and behaviours. The main difficulty is deciding which opinions are actually likely to translate into behaviour and which are not.

- **Test 5: Societal Norms:** In many respects, this test offers a more rounded indication of future market conditions and attitudes. In some cases, the scope and emphasis of prospective legislation will dictate these 'norms'. Strong indications can also be identified from the practices of leading institutional investors, or from voluntary codes of practice, such as the UN Global Compact initiative. Increasingly, they will also be influenced by public views on which company practices actually serve the wider interests of society. The responses of many UK companies towards the perceived risks associated with genetically modified foods offers a good example of how public attitudes have influenced particular market offerings.

2.9 Communicating the Benefits

Our research findings suggest that many of the existing mechanisms for communicating the benefits associated with more responsible business practices are sporadic and ad-hoc. Practitioners tend to rely on indirect mechanisms, such as formal disclosure, press coverage, or briefings via those managers who have a more direct interface with the investment community. Some of these interfaces are illustrated in figure 13 below.

Figure 13: Interfaces between Sustainability Practitioners and Investors



Further, the type of information disclosed tends to focus on impacts and risks rather than opportunities to create value. In those instances where benefits are communicated, these typically take the form of ‘anecdotes’, or ‘good news’ stories. This may simply reinforce perceptions that responsible business practices are merely an extension of social philanthropy. [12]

Many sustainability practitioners do have direct contact with the SRI investment community and cite this as a valuable means of influencing mainstream investor attitudes indirectly. However, this approach does have a number of acknowledged limitations, including:

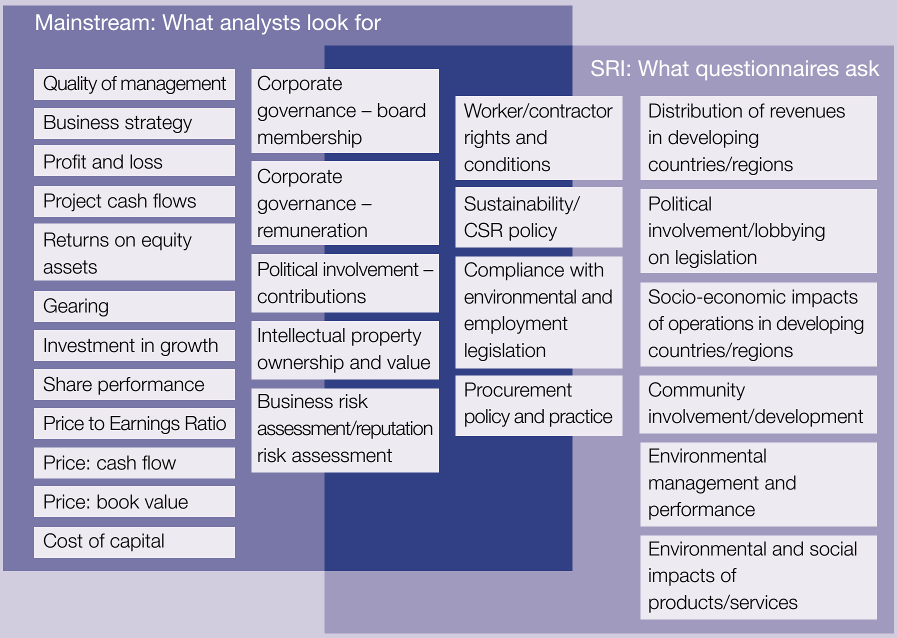
(i) there is limited evidence to suggest that SRI analysts are changing the attitudes and behaviours of their mainstream counterparts

(ii) there are some fundamental differences between what mainstream analysts look for and the types of question SRI analysts ask

(iii) where there is an overlap, the predominant focus is on how responsible business practices conserve value.

Recent research by Arthur D Little [13] also draws similar conclusions. These are illustrated in figure 14 below, with the overlap between the two interests highlighted in dark blue.

Figure 14: Key Topics Addressed by Mainstream and SRI



12 Berkeley, S, 2003

13 Berkeley, S, 2003

2.10 Summary

This chapter has provided an overview of the 'current state of play' in business sustainability. The key observations include:

- There is a growing recognition of the potential business benefits associated with more responsible business practices, but for the majority of companies, sustainability issues are only just emerging as strategic business concerns.

- Some sector patterns are emerging for selected sustainability issues along with a growing recognition of the potential *risk/opportunity premium* in some sectors. To date, however, most company responses have tended to be defensive in nature.

- There also seem to be key differences between company understanding of the key sustainability issues and their translation into practice. This is evident in terms of the current management focus of many companies, and the ways in which existing evaluation tools are used.

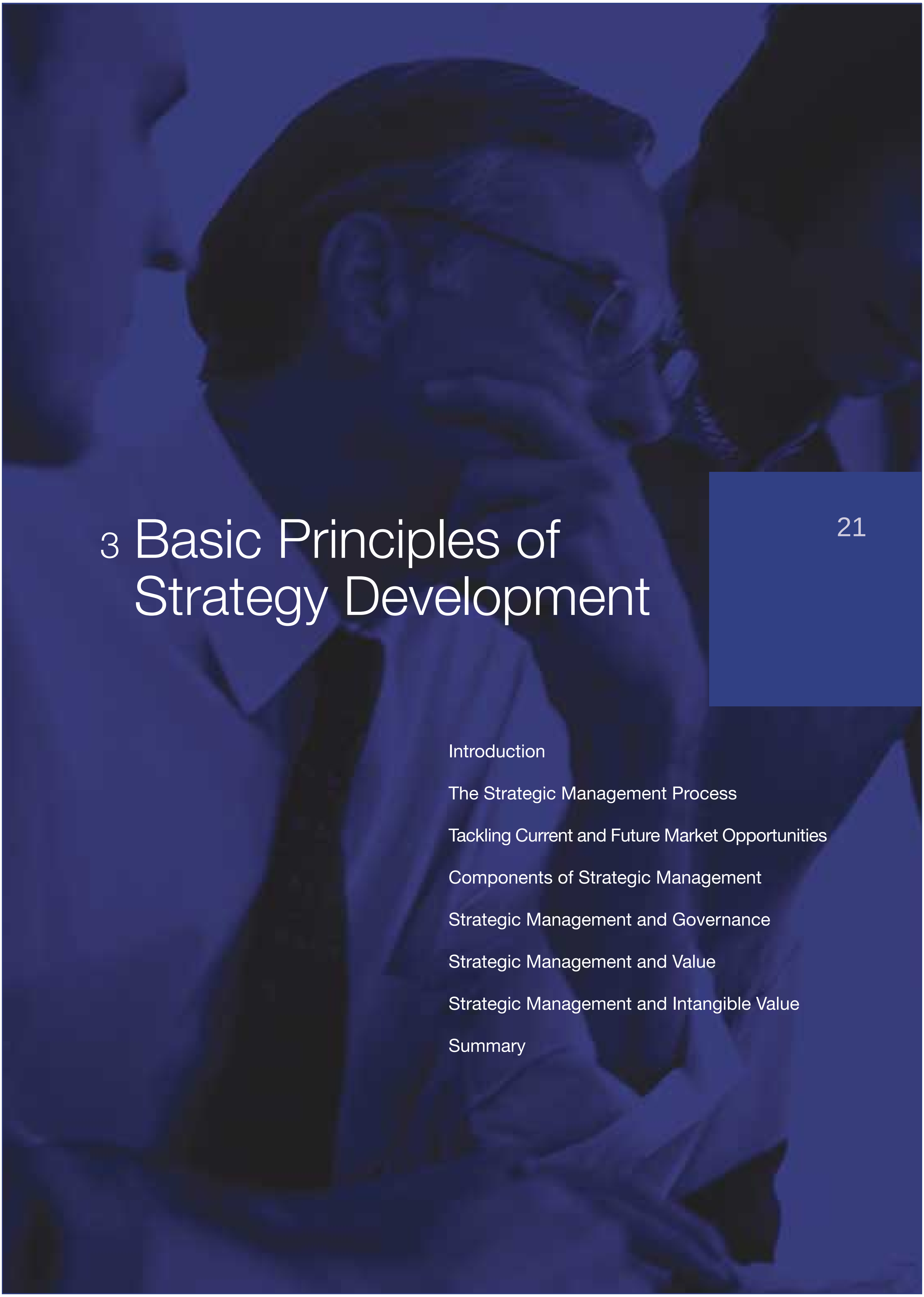
- Despite the growing pressure for improved disclosure practices, there is limited evidence to suggest that more detailed information necessarily improves external attitudes and behaviours towards a particular company. Many cite the absence of a generally accepted framework for determining which issues are material, to whom and why.

- For others, the root problem is a lack of general understanding about how to integrate sustainability concepts with other strategic objectives. A key prerequisite for this is an improved understanding of the basic principles of strategy development.

It is to the subject of strategy development that we now turn in Chapter 3.

20

The Current State of Play



3 Basic Principles of Strategy Development

3: Basic Principles of Strategy Development

Chapter Summary

Purpose	**Outcomes for Readers**
This chapter aims to: • introduce some of the key concepts and themes influencing strategy development • explain how external market conditions and influences affect strategic choices and directions • indicate why conventional value management practices often fail to address sustainability concepts.	Using the information in this chapter, readers will be able to: • improve their own understanding of the basic principles of strategy development • demonstrate how sustainability issues affect 'tangible' and 'intangible' value.

3.1 Introduction

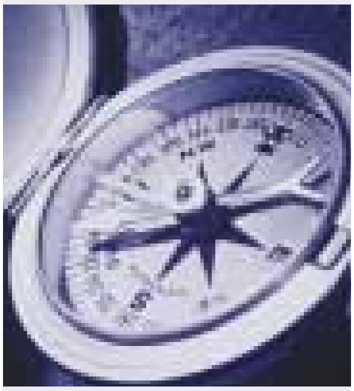
In a competitive market environment, companies have to make strategic choices in order to survive [14]. To prosper over the long term, they must also continue to create financial surpluses that exceed their costs of capital. Further, they must be able to explain the basis for their investment decisions, particularly in areas where projected benefits are complex, indirect or have long lead-times. This is equally true of a sustainable business, which has to meet established criteria of business 'fitness' and adaptability if it is to thrive over the long term [15].

It therefore follows that if a company wants to understand how sustainability issues might contribute to value creation, it must incorporate them into its strategic thinking. In order to demonstrate the inherent value associated with sustainable business practices, it must also communicate how such practices might support or increase the likelihood of value delivery.

Conventional wisdom also dictates that the primary purpose of business is to act in the interests of its owners and shareholders, and to maximise value. However, there is little merit in creating wealth, if this is simply achieved by passing on costs to others, or by introducing other sources of cost, risk and liability, for which the company will ultimately have to pay. For many, the transition towards more sustainable forms of business will mean operating within a framework that is responsible across all dimensions of sustainability [16].

The key arguments in this chapter are presented in the following sections:

- The Strategic Management Process
- Tackling Current and Future Market Opportunities
- Components of Strategic Management
- Strategic Management and Governance
- Strategic Management and Value
- Strategic Management and Intangible Value.



3.2 The Strategic Management Process

Strategic management comprises the decisions which define the longer-term goals and potential direction for a company. They determine the markets which a company wishes to exploit, the core competencies it needs to acquire or develop, and the resources required in order to enter a market and compete successfully.

14 Funk, K, 2001

15 James, P, 2001

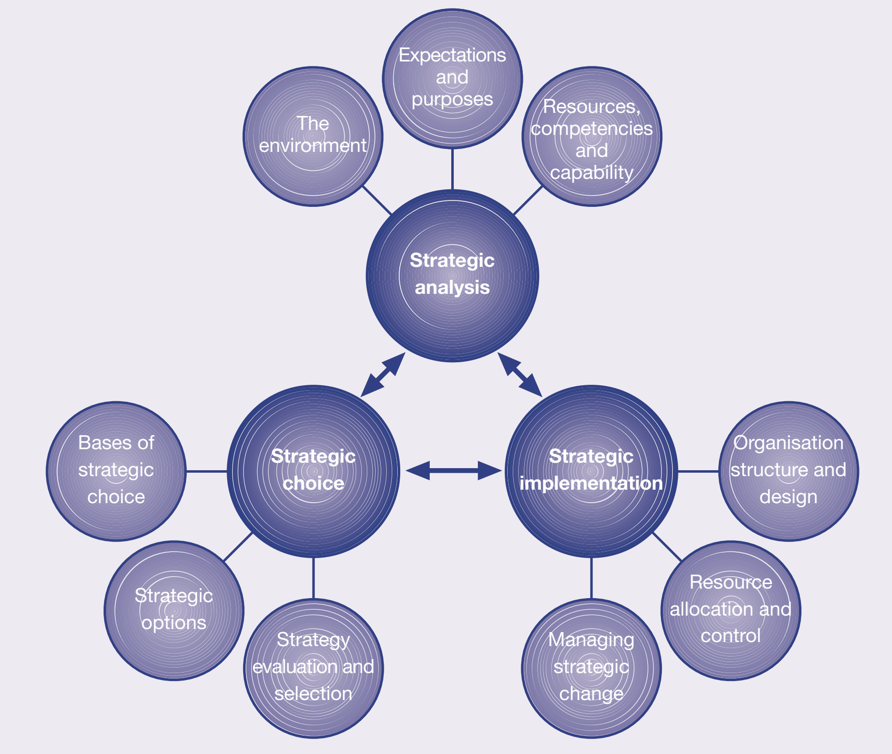
16 Hermes Pensions Management Ltd, 2002

Typically, the vision and values of a company are translated into strategic purpose and direction in three stages:

- **Strategic Analysis:** This defines the strategic position of a company in relation to external market conditions, sources of pressure and expectations.
- **Strategic Choice:** This involves the development of possible courses of action, or strategic choices.
- **Strategy Implementation:** This is concerned with the translation of strategy into action in a way which other companies will find difficult to match.

The potential relationships between these three core elements are shown in figure 15 below.

Figure 15: A Basic Model of the Strategic Management Process [17]



3.3 Tackling Current and Future Market Opportunities

In some respects, strategy can be viewed as the matching of activities of an organisation with the environment in which it operates. This is sometimes referred to as 'strategic fit', and means developing strategy by adapting existing resources and capabilities to achieve optimal market positioning against identified market needs. Under such circumstances, the relative importance of sustainability issues will depend largely on whether companies view them as having any strategic implications for current market positioning. This in turn will dictate whether such issues are considered material for the purposes of communication and disclosure.

17 Johnson, G & Scholes, K, 1999

Consultation/Workshop Phase: Example of Strategy by 'Strategic Fit'

The underlying concept behind IKEA's overall business strategy has always been *"to offer a wide range of furnishing items of good design and function at prices so low that the majority of people can afford to buy them."*

Since 1953 when the first IKEA store was opened in Almhult, Sweden, the company has developed into a global network of stores in 28 countries. Its ability to do this has been helped by its strong internal capabilities in furniture design, store design and logistics, and its ability to expand based on notions of strategic fit.

However, strategy can also involve building upon or 'stretching' existing capabilities. Strategy development by stretch involves the identification and leverage of resources and competencies to create new market opportunities, or to obtain competitive advantage by anticipating future market needs.

Strategy by stretch tends to be a key focus for many leading thinkers and policy-makers in business sustainability. Many now argue that the predominant neglect of sustainability concepts by many companies will impose significant limitations on their ability to innovate products and/or services [18].

For others, the transition towards more sustainable forms of consumption will require radical shifts in the performance of products and/or services. A 'Factor-4' improvement, for example, would mean reducing the amount of resources needed and pollution generated by 400 per cent per unit of production in order to meet the needs of a rapidly growing global population [19].

Consultation/Workshop Phase: Example of Strategy by 'Stretch'

BP offers a good example of a company that is placing renewed emphasis on stretching its capabilities to deliver its strategic objectives. The company now positions itself as a "knowledge-based company with distinctive traditions and leadership positions in many markets." Its current business strategy also emphasises the role of upstream investments and the identification of complementary services, such as renewable technologies, as a means of delivering strongly competitive returns in a sustainable manner.

Central to this philosophy is the belief that value cannot be pegged to any one single target or number, but requires a more balanced view of all the factors which work together to create value for both the short and long term. [20]

3.4 Components of Strategic Management

Strategies exist at several levels within an organisation. Typically, large companies tend to define strategy at three levels:

- **Corporate Strategy:** This is primarily concerned with the overall purpose and scope of a company's activities. For publicly listed companies, corporate-led strategy is heavily influenced by the expectations of shareholders and the stock market.

- **Strategic Business Unit (SBU) Strategy:** Here strategy is about how to compete successfully in a particular market for goods and/or services. Distinct markets may require different strategies in order to achieve competitive advantage.

18 Spangenberg et al, 2001

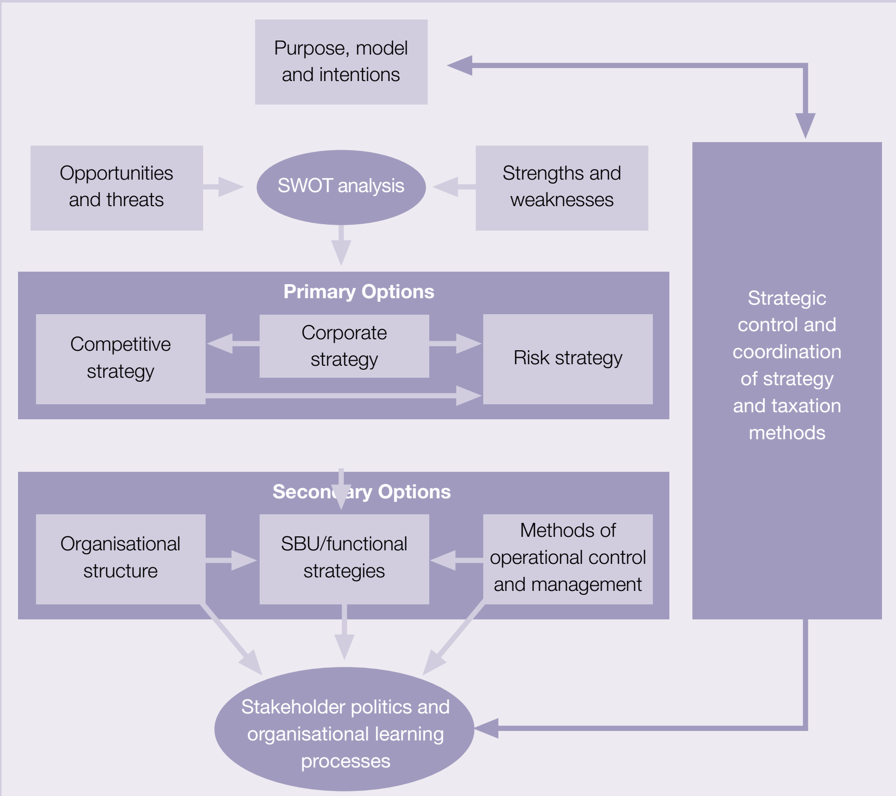
19 Von Weizsacker et al, 1997

20 See www.bp.com for BP's stated strategy as at February 2003

- **Functional Strategy:** This is concerned primarily with how the component parts of a company organise themselves in terms of resources, processes, people and knowledge in order to implement strategic objectives.

In the process of developing strategy, a variety of conventional business analysis techniques are used to identify existing business strengths, strategic opportunities, threats and vulnerabilities. Strategic options are then defined, based on the findings of these analyses. Basic strategy defines the general orientation, defensive or aggressive, whilst competitive strategy shows the extent to which competitive advantage can be gained. Risk strategy then specifies how key risks are to be addressed. The key elements of this process are shown in figure 16 below.

Figure 16: Process and Components of Business Strategy [21]



For companies with devolved or multidivisional structures, strategy development and implementation may be so focused on particular product or market strategies that managers may not even be aware of an overarching corporate strategy. Indeed, in some cases, eg diversified companies, corporate strategy is synonymous with SBU strategy, on the basis that the constituent businesses will operate their product/market strategy to their best potential without interference from the centre.

21 Schaltegger, S & Petersen, H, 2002

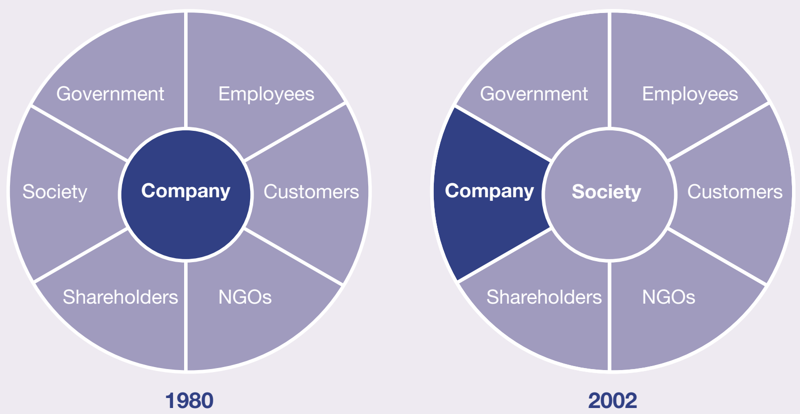
3.5 Strategic Management and Governance

The strategic direction of a company is not just a function of market conditions and resource availability; it is also influenced by the values and expectations of stakeholders in and around the organisation, and the degree of influence they exert [22]. In turn, these expectations and values help determine which issues a company decides are material to its strategic development, and the boundaries it chooses to draw around its activities (see also Section 4.3).

At one extreme, companies may take the view that they are only responsible for the short-term interests of shareholders. This view is gradually giving way to a position where companies are starting to recognise that closer alignment with societal expectations and norms may offer potentially important new sources of value creation. At the other, companies may decide that their ‘licence to operate’ is conditional upon them responding positively to the cultural norms and expectations of society.

To illustrate this point, we draw from the findings of a recent workshop involving senior executives from a multinational energy company [23]. Here, participants were asked to consider whether the role of their company has changed through time. One key observation was that historically the company achieved profitability by focusing purely on capital investment and asset productivity. Accordingly, it perceived its role as being pivotal to other dimensions. A key difference today is that the company’s ability to maintain competitive advantage relies more heavily on its capability to innovate and to work within the accepted norms and values of the societies in which it operates. As is illustrated in figure 17 below, many of the workshop participants now view the company as a sub-set of society.

Figure 17: The Changing Role of Companies



A number of these sentiments are also echoed in the UK Government’s current proposals to reform UK Company Law. These include provisions to extend the statutory duties of directors to include:

> *“A requirement [for Directors] to take account of the long-term as well as the short-term consequences... they must recognise, where relevant, the importance of relations with employees, suppliers, customers and others, the need to maintain a reputation for high standards of business conduct, and the impact of their actions on community and environment.”* [24]

22 Johnson, G & Scholes, K, 1999

23 Information adapted for use with the kind permission of Environmental Resources Management

24 Company Law Steering Group, July 2001

The sentiments are also echoed in the latest revisions to the Combined Code[25]. A key recommendation from the Higgs and Smith Reports is for:

> *"A greater proportion of independent, better-informed individuals on the board, greater transparency and accountability in the boardroom, formal performance appraisal, and closer relationships between non-executive directors and shareholders."*

In addition to the calls for improved accountability within boardrooms, the Government's White Paper *Modernising Company Law*, published in July 2002, includes proposals to make major companies prepare an OFR as part of their annual reports. The OFR would offer a better insight into the main trends and factors underlying the results, as well as those most likely to affect future business performance.

In response to these recommendations, the Accounting Standards Board has published a revised Statement to assist directors in developing these reviews, and to encourage other major companies to apply 'best practice'[26]. The Statement, which has been endorsed by the Financial Reporting Council, the Hundred Group of Finance Directors and the London Stock Exchange, lists the essential features of the OFR and goes on to detail some of the specific sections of the OFR to which these general principles should be applied.

It will be for the directors to decide what information is relevant and material to their operations, financial position and future business strategies[27], but one outcome is clear. As companies and investors turn increasingly towards forward-looking indicators of business performance, we are likely to see increased prominence being given to sustainability concepts.

3.6 Strategic Management and Value

In tandem with the calls for improved disclosure practices, there is a growing recognition that traditional financial metrics provide less and less of the information needed by companies and investors to evaluate business performance. A recent survey of 3,500 companies by Arthur Andersen, for example, found that balance sheet metrics explained 95 per cent of market value in 1978, but by 1998 explained less than 28 per cent of market value[28].

Here we consider how some of these limitations might affect perceptions of the potential links between sustainable business practices and overall business performance. Then later, in Chapter 5, we consider how leading thinking is starting to work towards an agreed framework for the management and measurement of key market intangibles.

Consultation/Workshop Phase:
Some of the Problems with Current Accounting Practices

- Investments designed to reduce environmental impacts at source (eg product redesign) are recorded as costs, whereas investments in *end-of-pipe* technologies are accounted for as assets.
- The balance sheet captures the financial cost of materials supplied, but takes no account of *free resources* (such as air or water), nor does it account for the total resource consumption for any given process.
- Investments in training and development are recorded as costs, but the collective knowledge and experience this creates is not recorded as an asset.

25 Higgs Report, January 2003; Smith Report, January 2003

26 For further information see **www.asb.org.uk**

27 Operating and Financial Review Working Group Terms of Reference, 2002

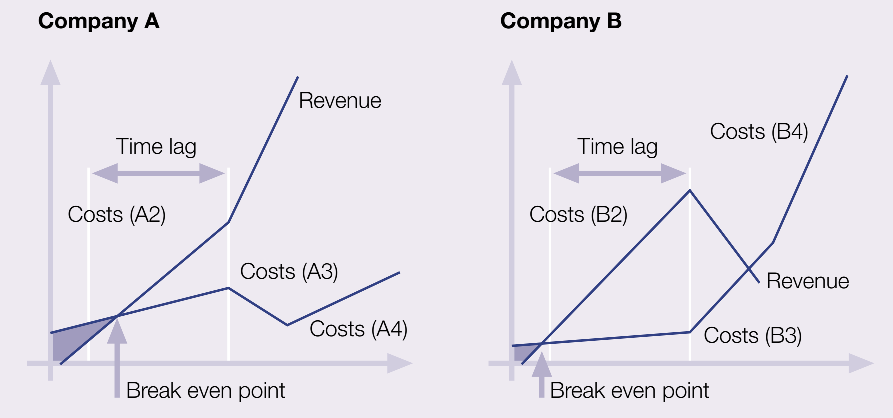
28 cf Standfield, K, 2002

3.6.1 Limitation 1: The Realisation Principle

One of the biggest limitations with traditional accounting practices is that while costs, expenses and losses are recorded immediately, profits are not recorded until they are actually realised. This usually results in a time lag between a change in costs and a change in revenue. Conversely, reductions in operating expenditure will have immediate and positive effects on the *balance sheet*, but may actually limit or destroy future revenue-generating capacity.

Unless companies explain the intentions of their changes in expenditure, the company with a lower cost base will always appear more profitable. It can also create a focus on short-term financial performance at the expense of long-term performance. This point is illustrated in figure 18 below. Here, an increase in expenditure by Company A has led to an increase in revenue. In the case of Company B, a reduction in expenditure made it appear more profitable, but has led to a decrease in long-term market value.

Figure 18: Perceived Long-Term Financial Position of Companies A and B [29]



3.6.2 Limitation 2: Sustainability of Assets

A second important limitation of traditional financial metrics is that they are often unable to reflect the economic sustainability of company assets and may sometimes result in misleading assessments. So, for example, if a company invests in *end-of-pipe* technologies in order to reduce its environmental impacts, these are accounted for as assets. Conversely, if a company attempts to eliminate potential sources of impact at source through design innovation, this will appear as a cost on the balance sheet (see also 'Some of the Problems with Current Accounting Practices' on page 27).

3.6.3 Limitation 3: Inability to Capture Knowledge-Based Assets

The transition from product-based to more knowledge-based economies means that many critical resources are not measured and do not appear on the balance sheet.

Arguably, traditional accounting techniques do attempt to capture and amortise certain types of non-monetary value, for example, in the form of *goodwill*. However, these practices tend to miss the goodwill that exists if the company is not sold, and often fail to address the latent capabilities of a company [30]. More importantly, it is often the latent capabilities and competencies of a company that indicate how well it will respond to future market opportunities and threats, including those relating to business sustainability.

29 Reprinted from *Intangible Management: Tools for Solving Accounting and Management Crisis*, Stanfield, K, 2002, with permission from Elsevier

30 Young, D, 2003

3.7 Strategic Management and Intangible Value

To a degree, qualitative indicators have always been used to build up an overall picture of business performance. Mainstream fund managers and analysts apply a variety of qualitative techniques to establish whether the strategy and capabilities of a company are likely to translate into competitive advantage [31]. Rating agencies, such as Standard & Poor's and Moody, routinely provide information about the sustainability of a company's earnings. Likewise, lenders tend to focus on future cash flows, and will compare known financial risks as they appear on the balance sheet with the potential business risks that may affect future cash flows.

There is also growing evidence that institutional investors are placing more weight on lead indicators as a means of assessing future business performance. Recent research by Cap Gemini Ernst & Young's (CGEY) *Center for Business Innovation*, for example, estimates that over one-third of an institutional investor's valuation of a company is based on non-financial or intangible indicators of company performance [32]. A key contention here is that as investors turn increasingly to forward-looking indicators, the relevance of sustainability concepts will become more apparent.

Recognising their potential importance, the European Commission (EC) launched a significant research project in 2001 to investigate the measurement and reporting of intangibles. The PRISM[33] Project involves six research partners from across Europe to carry out deductive research, and a further five partners to review its potential applications and coordinate appropriate case studies. A further 150 project partners are also involved with commentary on work-in-progress. Approved research findings are now starting to be published and disseminated via the internet [34] (see also Section 5.6).

Many of these views were also echoed during the consultation and workshop phases of the project are also listed below:

Consultation/Workshop Phase: Intangible Asset Categories

- **Latent capabilities:** leadership, reputation, organisational assets, supplier and customer networks, key management processes and in-process research and development.
- **Internal competencies:** core and distinctive competencies.
- **Intangible goods:** brands, know-how, formulas and copyrights.

31 Kemp, V, 2001

32 See also www.cbi.cgey.com for further information on survey findings

33 PRISM stands for: **P**olicy making; **R**eporting and measurement; **I**ntangibles; **S**kills development; **M**anagement

34 For further information, see **www.euintangibles.net/**

3.8 Summary

This chapter has presented an overview of the emerging issues and trends in business sustainability. The key points raised include:

- Many sustainability concepts require actions for long-term change that are by definition strategic in nature. An understanding of the basic principles governing strategy is therefore essential for the integration of sustainability concepts with business practice.

- Many now argue that the predominant neglect of sustainability concepts by companies will impose significant limitations on their ability to innovate products and/or services and create future value.

- Others suggest that there is little merit in creating wealth, if this is simply achieved by passing on costs to others, or by introducing other sources of cost, risk and liability, for which the company will ultimately have to pay. The transition towards more sustainable forms of business will mean operating within a framework that is responsible across all dimensions of sustainability.

- Companies are under renewed pressure to improve their disclosure practices, particularly in areas that may *materially affect* operations, financial position and future business strategies. At the same time, it is now generally recognised that traditional financial metrics provide less and less of the information needed by companies and investors to evaluate business performance.

- It is suggested that more active management of sustainability concepts as potential drivers of intangible value could offer an important means of explaining the relevance of sustainability concepts to overall business performance.

- Further, as companies and investors move increasingly towards forward-looking indicators of business performance, the relevance of sustainability concepts will become clearer.

One key challenge is to understand how strategy works in practice and how existing evaluation techniques might be adapted to accommodate sustainability concepts.
This is addressed in more detail in Chapter 4.

Chapter 5 then looks at some of the techniques that companies could use to communicate the benefits associated with their sustainability programmes, with a particular focus on the potential links with key drivers of business value.

4 Building Sustainable Business Strategy

4: Building Sustainable Business Strategy

Chapter Summary

Purpose

This chapter aims to:

- highlight how an improved understanding of sustainability issues could lend an additional perspective on strategic directions and options
- explain some of the key differences between strategy in theory and strategy in practice
- examine the importance of change management in achieving strategic objectives
- explain how conventional strategic management tools might be adapted to accommodate sustainability concepts
- highlight how external perspective might influence strategy development.

Outcomes for Readers

Using the information in this chapter, readers will be able to:

- determine how strategy works in their own companies
- determine how their own companies manage change
- begin to modify the range of input assumptions that are used to define strategic options and preferred company responses
- identify some of the factors that influence the development of mutually reinforcing relationships with key external stakeholders.

4.1 Introduction

Strategic management is concerned with how organisations achieve their long-term goals. However, in practice experienced strategists, consultants and academics often disagree about nearly every important dimension of strategic management. Strategy is, they say, ‘a contested field’ and one prone to fads, fashions and revisions such that yesterday’s *excellent* organisations and practices are often found to be lacking a few years later.

In this context, it may seem wildly optimistic to say sustainability is different. Nonetheless, that is the premise of this chapter. We believe that sustainability will not be another passing fad. Rather, it is shorthand for a set of related issues which are so fundamental that they will eventually become key drivers of business performance for all companies. *Eventually sustainability will be viewed simply as effective strategy.*

This chapter is designed to assist sustainability practitioners build momentum for sustainable business strategy in their own organisations. It draws from the text and ideas supplied by Dr Stephen Downing of Henley Management College and is arranged in five sections as follows:

- The Key Drivers for Change
- Influencing Strategy in Practice
- Managing Change
- Identifying Appropriate Tools and Techniques
- Understanding External Perspectives.

A series of key challenges for practitioners has also been posed at the end of each section and presented as a series of six steps. These are designed to help practitioners decide the types of initial analyses that might be required as prerequisites for the development of sustainable business strategy.

4.2 The Key Drivers for Change

4.2.1 External Drivers for Change

In our previous publication, it was argued that a number of external influences, or key drivers for change, were starting to exert increasingly significant pressures on the business sector in general terms. These included pressures for companies to:

- extend their roles into the areas traditionally occupied by governments
- support more sustainable patterns of resource consumption
- shift from traditional technologies to less damaging technologies
- accept responsibility for their impact on the wider society and environment
- demonstrate their wider accountabilities through increased reporting
- seek endorsement from stakeholders for their actions.

Our research confirms that most leading companies are already aware of these generic drivers. For these companies, attention is now turning to the ways in which these generic drivers might be interpreted within the specific context of their own companies.

4.2.2 Internal Drivers for Change

Our research has identified a number of common themes that may be particularly relevant to this process:

- **Improving internal perceptions of the timeframes over which action is needed:** Both strategic decisions and decisions concerning environmental and social impact are, by their nature, long-term in perspective. An improved understanding of the dependencies between business practices and their wider environmental and social contexts will inevitably raise questions about resource availability, the efficiency of existing technologies, alternative strategies for products and/or services, as well as the underlying capabilities and competencies of the company concerned. These questions will in turn offer a better insight into the types of response that may be needed, as well as their timing.

- **Deciding which parts of the company need to change:** To date, company responses have tended to be 'sub-strategic' in nature, with a predominant focus on controlling operational impacts and risks. There is still a wide gulf between these responses to the increasingly recognised importance of sustainability issues, and the ability of these issues to inform the strategic direction of companies.

- **Gaining a broader perspective on materiality:** Many companies tend to view stakeholder dialogue initiatives as an extension of market research. They are used to gauge the potential strength of objections and to help companies define appropriate control or damage limitation measures. They are rarely used to inform fundamental questions such as organisational purpose, company values or to achieve a broader consensus over the range of sustainability issues that present material business concerns.

- **Achieving a more coordinated response at the *investor interface*:** By the term *investor interface* we mean the various points of contact between internal company functions and the financial community. If business sustainability issues fail to form part of these discussions, they are unlikely to be treated as strategic business concerns. Likewise, if inconsistent messages are put forward by different parts of the business, the investment community is unlikely to modify its perceptions and behaviours towards such issues.

4.2.3 Understanding the Sustainability Spectrum

Like all big ideas in strategy, sustainable business strategy offers a vision of progress but, unlike many conventional strategy models, does not claim to offer a single blueprint or framework for transforming business practice. Some common trends are nevertheless discernible. Recent research by Dunphy et al [35], for example, has identified six phases of progression in business sustainability. These phases, or waves, are presented in the form of a 'Sustainability Spectrum' (see figure 19 below).

Figure 19: The Sustainability Spectrum

1st Wave Organisation		2nd Wave Organisation		3rd Wave	
Opposition	Ignorance	Risk	Cost	Competitive advantage	Transformation
Rejection	Non responsiveness	Compliance	Efficiency	Strategic proactivity	The sustaining corporation
• Elite seeks profit maximisation and treats all resources as means to that end. • H&S lip service. • Opposition to government and green activists. • Community claims seen as illegitimate.	• More ignorant than oppositional. • Seeks business as usual, compliant workforce. • Ignores any negative environmental impacts.	• Focuses on reducing risk of sanctions for failing to meet minimum standards. • Reactive to community and legal requirements. • Follows route of compliance plus proactive measures to maintain good citizen image.	• Introduces human and environmental policies to reduce costs and increase efficiency.	• Seeks to be employer of choice. • Seeks stakeholder engagement to innovate safe, environmentally friendly products and processes. • Advocates good citizenship to maximise profits.	• Reinterprets the nature of the corporation to an integral self-renewing element of the whole of society in its ecological context – and tries to renew this.
Value destroyers	Value limiters	Value conservers	Value creators		Sustainable business

By adding the four value concepts described in Chapter 1 to the adapted model above, it becomes easier to explain how progress towards becoming a truly sustainable business might translate into different types of business benefit.

- **Value Destroyers and Limiters:** Dunphy et al suggest that very few companies today are actively opposed to sustainability concepts; most are simply ignorant of the issues and non-responsive. They nevertheless risk destroying or limiting value by continuing to ignore these challenges.

- **Value Conservers:** Dunphy et al also suggest that the vast majority of companies currently occupy the second wave. For these companies, responses typically focus on the need to reduce operational risks and impacts, and at company level to protect corporate reputation and image. Improved cost efficiencies may also arise from these types of responses, but these tend to be quite limited in scope.

- **Value Creators:** Third wave organisations are those which are applying sustainability concepts to identify additional or new sources of business value. Typically, these companies will have made an organisational commitment to achieving competitive advantage through the adoption and development of ecologically and socially supportive processes, products and/or services. They are also likely to be applying innovative human and knowledge resource management practices.

35 Dunphy et al, 2003

- **Sustainable Businesses:** At the vanguard of the model are a few companies, which Dunphy et al refer to as ‘sustaining corporations’. These are characterised by companies that are pioneering alternative interpretations of business value and success, and are aiming to develop restorative business practices that contribute positively to natural and social capital.

Key Challenge for Practitioners

Step 1: Identify and achieve a broader consensus over the range of sustainability issues most likely to present strategic opportunities and threats for your own company (key drivers for change).
Step 2: Determine and understand where your company sits on the ‘Sustainability Spectrum’.

4.3 Influencing Strategy in Practice

4.3.1 Overview

The findings of our research suggest that many sustainability practitioners feel they have a limited role in their company’s strategic thinking (see also Chapter 2). They are sometimes called upon to provide views on the potential environmental or social impacts associated with business plans once formulated, but under such circumstances the predominant response is one of risk and impact control and/or damage limitation.

Most also agreed that a basic understanding of the key concepts and themes influencing strategy development is important, but suggested that strategy in practice is not always so clear cut. Some also emphasised the point that, in order to understand whether opportunities have been fully developed and risks mitigated, it is often necessary to focus on actions at an operational level.

In this section, we highlight some of the ways that leading thinkers in business strategy have tried to classify the various dimensions of strategy development in practice. This builds upon the information provided in Chapter 3 and is designed to help practitioners decide which approaches best reflect current practice in their own companies.

4.3.2 Top-Down Strategy

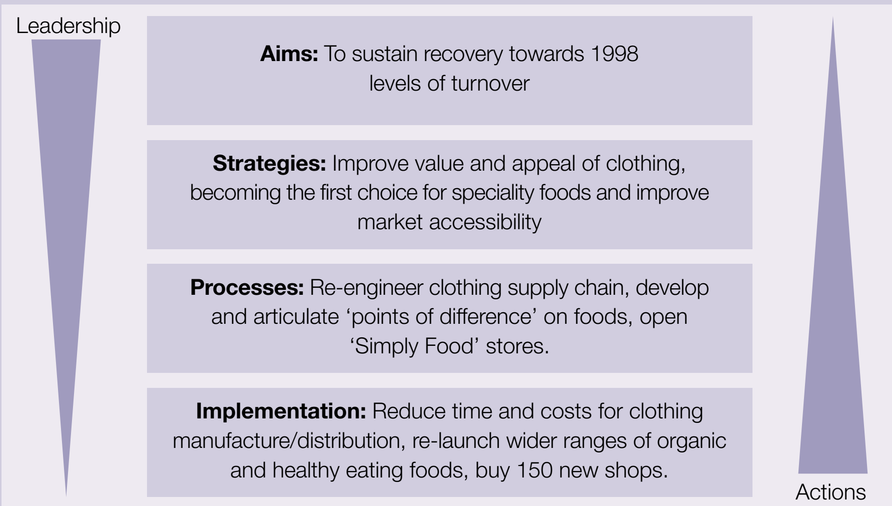
Much of the theory described in Chapter 3 assumes that strategies arise as a consequence of careful analyses and planning, and that strategy implementation follows a logical sequence of steps (see figure 20 overleaf).

Figure 20: The Top-Down Framework

In practice, most would acknowledge that a top-down view of strategy is overly simplistic. People do not always make decisions in a planned or rational way, and top-down initiatives are not always the most effective way to implement strategy. This is good news for anyone who feels excluded from the top-down, designed and planned view of strategy because there are many more ways to influence the development of strategy.

This point can be illustrated using an example from Marks & Spencer (see figure 21 below). Here, *pull* or leadership comes from the top-down whilst the identification and implementation of actions is bottom-up. Each new initiative tends to be judged primarily on its implications for costs, efficiency or risk (eg will ethical trading add too much to operational costs?). The downside with this type of approach is that, unless the combined effects of these actions are communicated back up the chain, there is a risk that strategically important value drivers may be overlooked or misunderstood.

Figure 21: Example Management Model



4.3.3 Ten Strategy Debates

It is also important to realise that 'strategy' is not a synonym for 'plan', rather that strategy is a pattern of actions over time. This will typically be a mix of deliberate and emergent, reactive and unintended actions. Key influences on the pattern of action may be: a Chief Executive Officer (CEO), a plan, an influential planning department, powerful or proactive groups within a company, or indeed key external interests. All of these processes can change the pattern of actions that an organisation takes over time, and hence modify a company's overall strategy.

A number of studies have sought to understand and classify the key characteristics of strategy in practice. One recent study [36], for example, has identified ten key debates in strategy development. These are summarised in figure 22 below.

Figure 22: Ten Key Strategy Debates

Ten Strategy Debates

Strategy Dimension	**Issue**	**Strategy Debate**
Process	1. Strategic thinking 2. Strategy formation 3. Strategic change	Logic vs creativity Deliberate vs emergent Revolution vs evolution
Content	4. Business level strategy 5. Corporate level strategy 6. Network level strategy	Markets vs resources Responsiveness vs synergy Competition vs cooperation
Context	7. The industry context 8. The organisational context 9. The international context 10. Organisational purpose	Compliance vs choice Control vs chaos Globalisation vs localisation Profitability vs responsibility

Source: de Wit and Meyer, 1999

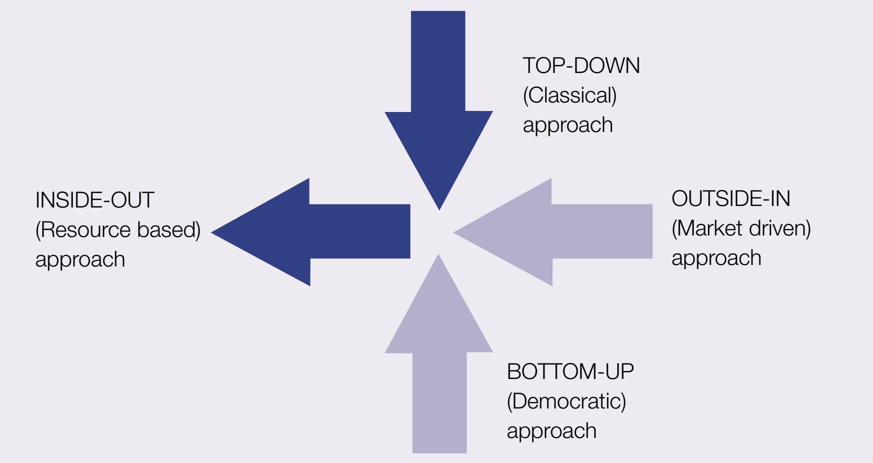
Of these, the debate relating to *organisational purpose* has the most obvious resonance with a number of sustainability concepts. Here, the polar extremes in the debate on organisational purpose are described in terms of a traditional shareholder view versus the broader views and expectations of society.

36 de Wit, B & Meyer, R, 1999

4.3.4 Four Directions in Strategy Development

A simpler way of looking at strategy in practice is to focus on the four main directions in strategy development. These are shown in figure 23 below, followed by a description of the key characteristics of each.

Figure 23: Four Directions in Strategy Development



- **Top-Down Strategy:** This approach was first documented in the 1950s and '60s, aligned to leadership studies. It subsequently stimulated the development of large specialised planning departments. It was influential at a time when organisations were explicitly hierarchical and it was assumed that they could be controlled like a simple machine or system.

- **Outside-In Strategy:** This approach became increasingly influential in the 1980s, and is based on the notion that companies maintain the best fit with a dynamic environment by driving their actions from a close reading of external trends. Under this model, political, economic, social, technological and competitive environment factors have tended to dominate analyses, rather than the additional perspectives that an improved understanding of environmental and social factors might bring.

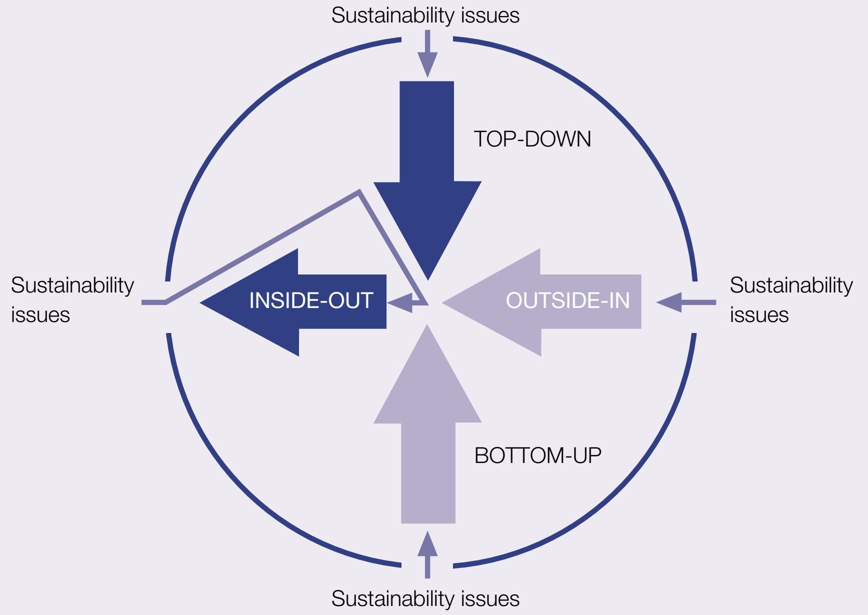
- **Inside-Out Strategy:** This was probably the most influential approach to strategy throughout the 1990s. It is based on the idea that companies gain long-term success by building up unique competencies, which are valued by customers and are very difficult for competitors to copy. These are seen as products of learning and cultures that support knowledge sharing. In turn, some explain these processes in top-down terms of leaders and vision, whilst others explain them in terms of the mass of communication, experimentation and innovation that occurs across an organisation in an unplanned, bottom-up fashion.

- **Bottom-Up Strategy:** This is characterised by numerous initiatives from across an organisation at a functional level, or in a conglomerate at an individual business level. Initiatives are local responses to perceived problems and opportunities, and often have a trial and error, learning by doing, ad hoc quality. Bottom-up initiatives are not planned, integrated or coordinated by leaders at the top of the organisation. Leaders may subsequently rationalise these actions as effective or deliberate strategy.

4.3.5 Incorporating Sustainability Concepts

In the contested field of strategy, action and understanding developed from a bottom-up, outside-in, top-down and inside-out manner are all valid and useful. From the perspective of business sustainability, these concepts also offer an important means of attaching specific sustainability attributes to each identified direction in strategy development (see figure 24 below).

Figure 24: Four Routes to Sustainability



A top-down approach has the benefit of obvious support from the CEO/Chairman/Board. The downside of this approach is that specialist functions are often unable to keep abreast of all the necessary information in complex and dynamic environments. There is also a risk that managers with responsibility for implementing top-down strategy may not feel any sense of ownership, may not see its relevance for their specific area of responsibility, and may not feel motivated to support it.

An outside-in approach can draw attention to the range of external factors that are likely to impose strategic opportunities and threats. It can also be used to monitor the activities of competitors and peers, and offer important insights into best practice that might otherwise be overlooked.

An inside-out approach can stimulate a culture of information sharing and learning about sustainability, and experimentation and innovation in products and/or services, internal processes and production. The development of a unique capability in sustainability in an industry can also be used to highlight the underlying strengths and latent capabilities of a company.

In many ways, bottom-up initiatives offer a more secure basis for change because they start with the ownership and legitimacy that top-down change programmes often find difficult to secure. As was illustrated previously, however, an important limitation of this approach is that if each initiative has to be justified on its own merits, the cumulative benefits for the company as a whole may be poorly understood.

In order to achieve momentum for sustainable business strategy, sustainability practitioners need to ensure that their proposed actions take explicit account of the actual directions in strategy observed in their own companies. They also need to ensure that proposed actions are mutually reinforcing, as several directions in strategy may be occurring simultaneously. In addition, any proposed action must be capable of being implemented. This latter issue is considered in more detail in Section 4.4 below.

Key Challenge for Practitioners

Step 3: Establish how strategy works within the specific context of your own company and assess the extent to which sustainability concepts have been integrated with each identified component of strategy development.

4.4 Managing Change

4.4.1 Overview

As strategy is about achieving goals, change is central to strategy. It is generally accepted that strategic change does not happen simply because it is deemed desirable by one group. Strategic change happens when managers are able to understand and interpret requirements for their own areas of responsibility and implement desired changes.

There is a wide body of research on the subject of managing change. Here we focus on three basic concepts:

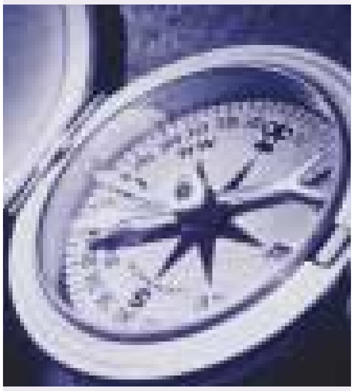
- Top-Down Programmed Change
- Learning Approaches to Change
- Shaping the Strategic Story.

Following the logic of the previous section, there are multiple routes to influence the strategy implementation process. This section will highlight some key features of both programmed and learning approaches to change, and is designed to offer some practical tips or skills that sustainability practitioners may want to apply to their own situations.

4.4.2 Top-Down Programmed Change

The pioneering work of Kurt Lewin in the 1950s and scores of change consultants through subsequent decades have come close to creating a general view of what a top-down change programme involves. Most people working in major organisations will have experienced this type of programme; total quality management, process re-engineering, and implementation of mergers and acquisitions being just three examples.

These programmes of change are often characterised by leaders who have developed a vision and wish to cascade the arguments and vision for change throughout the organisation, with the intention of developing commitment and support for new actions. The key components of these types of programme are summarised in the following table:



Component	Description
Pressure to change	These include the internal arguments that are used to broaden current perceptions and attitudes.
Leadership and vision	These describe new organisational values and direction.
Capable people	This refers to the latent capabilities, skills and competencies that will be required to deliver new organisational values and direction.
Actionable first steps	These comprise easy wins to establish momentum and commitment.
Effective rewards	These are designed to reward desired behaviours, both material and symbolic.
Performance measurement	A system for feedback and continuous improvement.

Advocates of programmed change argue that all of these elements need to be held together by a project management structure for successful change. They suggest that:

- if there is no pressure for change, people will not be interested
- if there is no leadership and vision, people will become disillusioned
- if people lack the appropriate skills, they will become disengaged
- if there are no actionable first steps, people will become frustrated
- if there are no effective rewards, change efforts will not be sustained.

Sustainability practitioners, acting as change agents, can work on the following areas to support the change process:

- creating a sense of urgency for change
- creating a powerful support network
- communicating to build a clear vision
- providing training
- establishing and celebrating short-term wins
- establishing performance management systems.

4.4.3 Learning Approaches to Change

Critics of programmed change point out that 50-70 per cent of all major programmes of change fail to meet their objectives. They emphasise the fact that large-scale programmed change normally fails to deliver the spirit of democratic participation in the process that Kurt Lewin argued was fundamental for successful change. They also point out that very often senior management has worked out a vision, and the cascade process is for communication rather than consultation purposes. The scope for genuine, full, frank and challenging dialogue is severely constrained, and so the opportunity for ownership of the problem and solution is limited. Under these circumstances, the new strategy would not have sufficient organisational 'buy-in'.

A number of studies have sought to highlight alternative approaches to managing change. Peter Senge, for example, first discussed a more organic incremental (step-by-step) approach to change in his book *The Learning Organisation* [37]. More recently, several studies have advanced this case based upon empirical research. These include:

37 Senge, P, 1990

i. *Built to Last* by Collins and Porras (1996)

In their book *Built to Last*, Collins and Porras [38] produced a ground-breaking study into the key performance characteristics and positive performance differences between 18 visionary or 'built to last' companies and comparison companies founded in the same era with similar founding products and/or services. They defined a visionary company as a premier institution which adheres to an immutable core ideology, while stimulating progress through multiple product life cycles and multiple generations of active leaders. More importantly, they found that most of the objectives which galvanised ambitious change lacked the top-down flavour of programmed change. Instead they were characterised by leaders who saw their role as facilitating dialogue and maintaining values. This characteristic, the authors suggested, enabled individuals to feel firmly connected to organisational values and a shared sense of purpose.

ii. *Good to Great* by Collins (2001) [39]

Here, Collins analyses in detail the transformation of eleven companies that managed to achieve exceptional stock market performance for over 15 years. This book rejects most of the principles behind programmed change, which the author highlights as a series of 'myths', including the:

- myth of the change programme and cascading activities
- myth of the burning platform (ie crisis or pressure to change)
- myth of fear driven change
- myth of stock options (ie rewards to ease the process of change)
- myth of revolution (ie that change has to be a discontinuous, shattering break from past practice).

Instead, Collins advocates an incremental learning model used by '*good to great*' company leaders, which he suggests can be applied by any functional manager to build pockets of greatness and encourage learning throughout an organisation. These process *rules* resulted in major transformations in the 'good to great' companies, without anyone identifying 'miracle moments'. Collins further suggests that their "down to earth, pragmatic, committed to excellence process" kept each company, its leaders and its people on track for the long haul.

A key point to note with learning approaches to change is that they often involve long lead-times. On average, these companies engaged in over four years of honest and open debate before they finalised the elements of their simple business models. They also had to apply the models for several years before commentators and city analysts appreciated that a transformation had occurred. In short, there are no quick fixes, and successful change is wider, more organic and takes longer to achieve than typical programmed change.

4.4.4 Shaping the Strategic Story

More recently, a new view has started to emerge, where strategy takes the form of a 'story'. According to this approach, strategic changes are managed by actively encouraging discussions that are designed to give everyone a sense of where they have been, where they are now and where they are going.

These conversations typically revolve around four key questions, which are then used to shape the 'strategic story'. These are shown in the table opposite and comprise:

- direction
- analysis
- choices
- implementation.

38 Collins, J C & Porras, J I, 1994, cited from Graves, S B and Waddock, S, 2000

39 Collins, J C, 2001

Four Key Questions in a Strategic Story		
Direction	1. What do we want to achieve?	
Analysis	2. What is our current situation? (Internal)	 (External)
Choice	3. What options do we have?	
Implementation	4. How are we going to make it happen?	

The automotive manufacturer Honda is often cited as a good example of a learning organisation, where managers see their primary role to be facilitators of constructive dialogue. Many texts on leadership currently focus on the skills of the leader in listening to others' interpretations and stories, and their ability to integrate them into a shared organisational story. Companies such as 3M and Shell now use strategic stories to develop ownership, understanding and commitment.

At the same time, strategic story development requires a commitment to 'walk the talk', because dialogues that are not backed up by actions undermine the trust necessary for change.

In this context, sustainability practitioners may start to see themselves as facilitators of dialogue and honest debate on the additional perspectives that sustainability concepts might contribute to strategic thinking. Some key questions that sustainability practitioners could ask include:

Consultation/Workshop Phase: Key Questions for Internal Managers

- What do these trends mean for your direct area of responsibility?
- What about departments and functions with which you share interdependencies?
- Can you really afford to ignore this?
- Do any of these issues present a significant threat for your direct area of responsibility?
- What about other parts of the business?
- And in the future?
- Can options be identified that tackle the issue and deliver additional business value?
- What needs to change to make this happen?

They may also be in a good position to highlight the lead-times over which many sustainability issues are likely to manifest themselves, as well as the likely scope and timing of company responses.

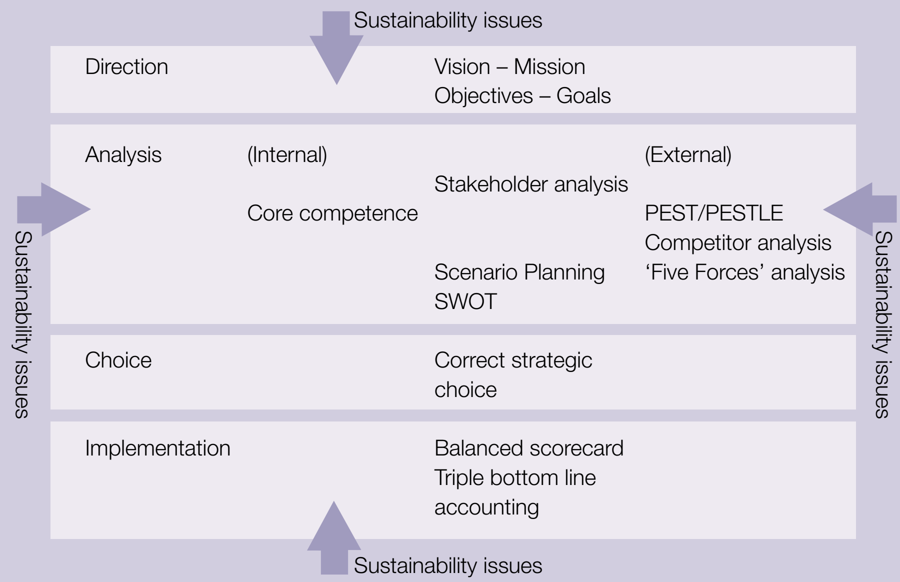
Key Challenge for Practitioners

Step 4: Establish what processes are used within your own company to manage strategic change: what works; what does not; and why.

4.5 Identifying Appropriate Tools and Techniques

It is commonly assumed that new analytical tools and techniques are needed in order to integrate sustainability principles with business strategy. In practice, the analytical tools do not necessarily need to change; rather, companies need to extend their range of *input* assumptions to include sustainability concepts. As is shown in figure 25 below, most of the analytical techniques are already well known. A summary of how some of these tools might support an analysis of sustainable business is then described in the table that follows.

Figure 25: Analytical Tools Supporting Sustainability



Technique	Potential Applications
Vision Tools	These could be used to improve internal understanding of shared values and purpose, both within the organisation and outside it. They also denote greater accountability, transparency and fairness.
PEST Analysis	Traditional PEST analysis techniques are readily adapted to include their wider social and environmental contexts.
Scenario Planning	These techniques offer a useful means of evaluating the additional challenges likely to be posed by sustainability issues. They allow companies to define scenarios that describe different future market conditions, which are then used to identify appropriate business responses. In many instances these are already used to identify the potential future constraints associated with key sustainability issues,

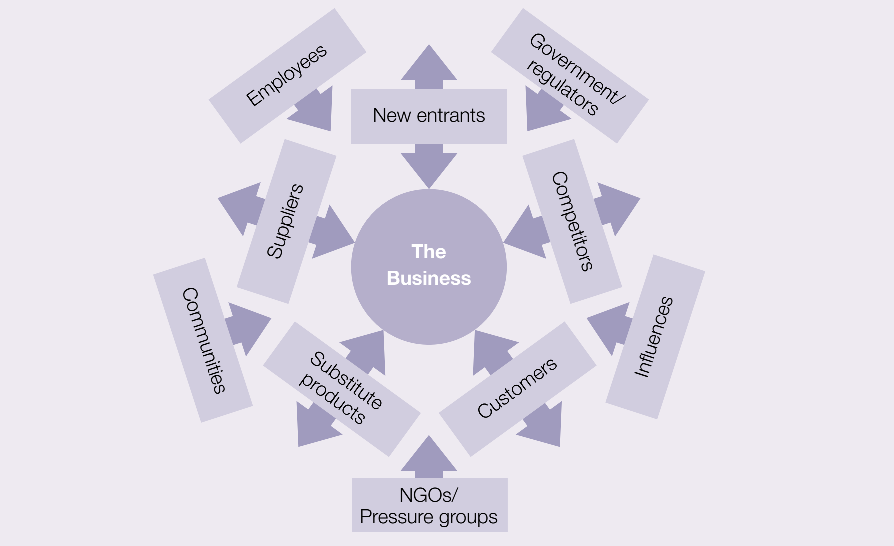
Technique	Potential Applications
Stakeholder Analysis	Effective stakeholder dialogue techniques offer an important means of refining internal company perceptions of the relative importance of key sustainability issues. If applied positively, they can also help to identify new or alternative strategic options that might not otherwise have been considered. They can also serve as proxies for wider societal values and expectations.
Competitor Analysis	Traditional competitor analyses can easily be adapted to enable companies to monitor the performance and standards of practice applied by competitors and peers.
Porter's 'Five Forces' Analysis	This technique enables companies to evaluate the five market forces acting on a company. These comprise: suppliers, customers, competitors, substitute products and new entrants. This technique is easily adapted to include wider market trends and trends (see also graphic overleaf) [40].
SWOT Analysis	Traditional SWOT analyses (Strengths, Weaknesses, Opportunities and Threats) are easily adapted to include the strategic opportunities and threats posed by sustainability issues.
Correct Strategic Choice	This technique is usually applied to strategic options to ensure that the action proposed is consistent with a company's overall business strategy. The same techniques can be applied to test preferred options in business sustainability.
Balanced Scorecard	Traditional scorecard techniques provide measures of performance relating to four aspects of business activity: financial, customer, operational processes and organisational learning [41]. The scorecard can be extended to include environmental and social issues (such as those identified by the tools mentioned above). This would identify sustainability issues that represent strategic business concerns. Appropriate goals and measures can then be developed specifically to address such concerns. The technique is also ideal for combining long-term strategic goals, such as those relating to business sustainability, with economic measures of success.
Triple Bottom Line Accounting	A number of approaches are now being developed that try to address the three dimensions of business sustainability. A key limitation of many of these approaches is that they tend to treat each dimension as a separate activity.

40 Kemp, V, 2001

41 Kaplan, R & Norton, D, 1996

By way of illustration, figure 26 below shows how one well-known business evaluation technique, Porter's 'Five Forces' analysis, might be adapted to accommodate wider market perceptions and trends. A key advantage of adapting this type of technique is that it enables the identification of ideas for generating competitive advantage in areas that might otherwise be overlooked.

Figure 26: Porter's 'Five Forces' Model adapted to include Wider Market Perspectives



Pertinent questions to ask in relation to the additional benefits and sources of advantage that could be gained will include:

i How do key issues affect current relationships with customers?

ii How do key issues affect potential relationships with suppliers?

iii Do key issues make it easier or more difficult for new players to enter the market?

iv Do any of the key issues offer potential barriers for new entrants?

v Do any of the key issues create a demand for alternative or substitute products and/or services?

vi Do any of the key issues offer opportunities to increase cost leverage, either by reducing costs or by differentiating products and/or services?

Key Challenge for Practitioners

Step 5: Ensure that the strategic opportunities and threats posed by sustainability issues are included in the wider set of input assumptions that will influence strategy development.

4.6 Understanding External Perspectives

4.6.1 Overview

As we have seen in Chapter 3, the strategic direction of a company is not just a function of market conditions and resource availability. It is also influenced by the values and expectations of stakeholders in and around the organisation, and the degree of influence they exert [42].

No company that is engaged in developing sustainable strategy can escape the basic principles of economic enterprise. Nonetheless, *To Whose Profit?*[(ii)]*: Evolution* has argued that the risks and opportunity costs of failing to engage with sustainability principles are increasing. Not only do companies that remain disengaged risk becoming misaligned with the general societal move towards increasing corporate responsibility, transparency and accountability but, just as fundamentally, they risk misalignment with the environmental context upon which they depend.

Currently, one way for this misalignment to be understood and identified is within the context of a company's relationship with its key stakeholders, a subject area that has become a major focus for NGOs, companies and sustainability practitioners in recent years. The current focus of such activities has provided companies with a sounding board and articulation of the environmental and social context within which they operate. In this publication we contend that, to date, stakeholder-related activities have taken second place to the mainstream of company business and are, crucially, not valued within the mainstream financial system.

The following section explores stakeholder relations and presents, by way of illustration, a model for the creation and destruction of trust amongst a company's stakeholders. Engaging with stakeholders assists in the identification of risks and opportunities that would not otherwise be identified through discussions with the mainstream investment community or through the conventional application of business management techniques. In turn, these activities support *the internal business case for sustainability.*

4.6.2 Building Reputation and Trust through Stakeholder Relations

A good reputation attracts and promotes stakeholder engagement and thus increases the company's social capital (the resources and opportunities that arise from its stock of contacts). Through time, it is also likely to translate into modified attitudes and behaviours (see also Section 2.2).

The creation of high levels of trust not only benefits a company's external relationships, but also facilitates better internal relationships, and has been shown to be a key precondition for learning and innovation to occur in organisations. A number of leading thinkers argue that companies enjoy long-term success when they establish trusting, flexible relationships with stakeholders [43]. This leads to a flow of process and product innovations over time, which in turn contributes towards a positive reputation. There is a positive reinforcing cycle between trusting relationships, innovation and reputation which provides an excellent opportunity for sustainability practitioners who are challenged to defend their contribution to the bottom line.

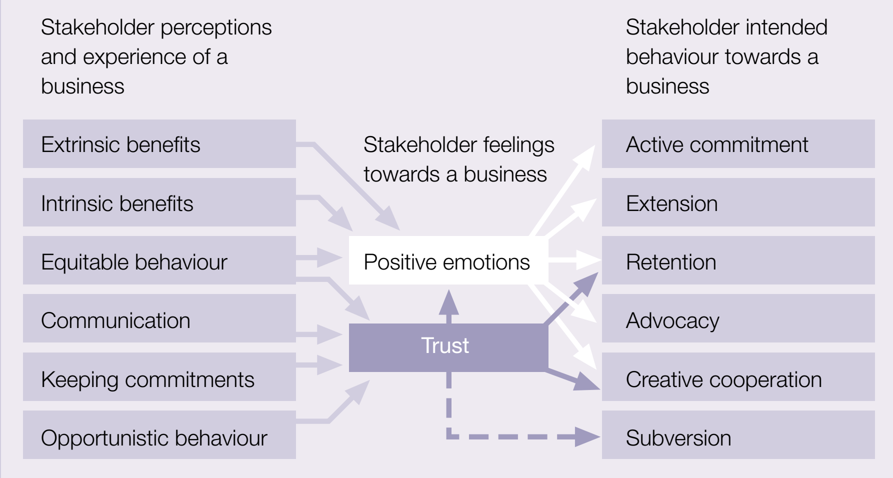
What has become key for sustainability practitioners is their ability to move towards sustainable strategy successfully, whilst maintaining trust amongst their key stakeholders. By way of example, figure 27 overleaf illustrates the key factors likely to influence the development of trust between a company and its key stakeholders. Based on a model developed by Faculty at Henley Management College, the figure highlights relationship issues that are generic to all stakeholder relationships. The model itself has been tested on over 5,000 stakeholders and has proven to be a good predictor of trust and positive emotions amongst employees, suppliers, customers and investors. [44]

42 Johnson, G & Scholes, K, 1999

43 eg Kay, J, 1993

44 MacMillan et al, 2003

Figure 27: The Experience-Feelings-Intention Model of Stakeholder Relationships



The left-hand side of the figure represents aspects of stakeholder experience that sustainability practitioners need to understand and manage effectively. These include:

- **Extrinsic and Intrinsic Benefits:** this refers to both material and non-material benefits received through the mode and methods of the company's relationships with stakeholders.
- **Communication:** this includes how the company informs stakeholders about its activities as well as anticipating, evaluating and responding to their concerns.
- **Keeping Commitments:** this refers to a company's ability to practise both what it has preached and what it has promised in terms of both explicit and implicit commitments (which may arise simply through the development of stakeholder engagement and the consequent expectations which stakeholders form).
- **Fairness:** how stakeholders perceive the equity of organisational behaviour.
- **Opportunistic Behaviour:** an expectation that companies should avoid taking unfair advantage of stakeholders or use their power coercively.

The research with this model shows that positive experiences in the above areas generate positive emotions and trust towards a company. This, in turn, leads to stakeholders behaving supportively towards a company. This is illustrated on the right-hand side of the figure, and includes:

- **Active Commitment to the Company:** a motivation and intention to stay involved
- **Extension:** for example purchasing products and/or services from other parts of the company
- **Retention:** an intention and motivation to remain committed to the company
- **Advocacy:** ie defending the company's reputation when it is challenged by others
- **Creative Cooperation:** for example, in problem solving.

The model also highlights subversion as a stakeholder behaviour that arises when stakeholders' experience of the company in the key areas identified is negative, resulting in negative emotions and a lack of trust. Subversion is manifest in all sorts of behaviours aimed at undermining the organisation and its reputation.

This model and its supporting questionnaire can help managers analyse the key factors that are most likely to underpin the development of effective relationships with key external stakeholders. It also provides a means of measuring the overall level of support for efforts to develop sustainable business strategy, as well as providing an early warning mechanism if relationships start to fail.

Key Challenge for Practitioners

Step 6: Develop meaningful relationships with external stakeholders as a means of achieving a broader consensus about what is material to whom and why.

4.7 Summary

This chapter has highlighted the ways in which practitioners might build momentum for sustainable business strategy within their own organisations. The key challenges for practitioners are summarised below:

Step 1: Identify and achieve a broader consensus over the range of sustainability issues most likely to present strategic opportunities and threats for your own company (key drivers for change).

Step 2: Determine and understand where your company sits on the 'Sustainability Spectrum'.

Step 3: Establish how strategy works within the specific context of your own company and assess the extent to which sustainability concepts have been integrated with each component of strategy development.

Step 4: Establish what processes are used within your own company to manage strategic change: what works; what does not; and why.

Step 5: Ensure that the strategic opportunities and threats posed by sustainability issues are included in the wider set of input assumptions that will influence strategic development.

Step 6: Develop meaningful relationships with external stakeholders as a means of achieving a broader consensus about what is material to whom and why.

The chapter also builds on the contention that strategic management needs to:

- pay more attention to the environmental and social contexts of which the company is a part
- be aware that private power brings public responsibility
- be cognisant of the potential constraints and costs imposed on company behaviour by climate change, social inequality, social problems, reputational risk, resource scarcity and ideological terrorism
- utilise a wide understanding of materiality and new performance measures that accounts for environmental and social performance alongside traditional financial indicators
- be more accountable to diverse stakeholders, and critically accountable to future generations of stakeholders.

In the next chapter, we turn to the issue of how companies might communicate the direct and wider (indirect) benefits associated with their sustainable business strategies.

50

Building Sustainable Business Strategy

5 Communicating the Benefits

5: Communicating the Benefits

Chapter Summary

Purpose
This chapter aims to:
- introduce some of the techniques used by mainstream fund managers and analysts to build an overall picture of business performance and share value
- explore some of the leading thinking on how measures and indicators of business performance might be adapted to accommodate sustainability concepts.

Outcomes for Readers
Using the information in this chapter, readers will be able to:
- decide whether any of the techniques described could be used to communicate the type of benefit to be expected from increased investment in responsible business practices
- encourage more positive attitudes and behaviours towards the treatment of sustainability issues as strategic business concerns.

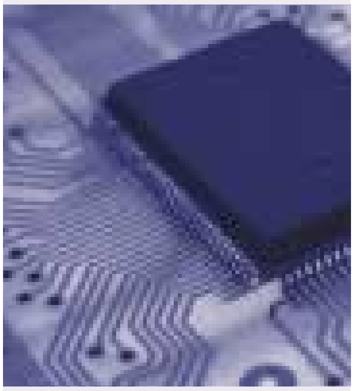
5.1 Introduction

Our discussions with leading companies confirm that sustainability issues are starting to be viewed as potentially important drivers of market value. By extending internal perceptions of sustainability concepts to include notions of business benefit, many have already succeeded in modifying attitudes and behaviours across parts of their own organisations. The downside of partial or piecemeal approaches is that they may do little to change perceptions of the relevance of sustainability concepts to overall business performance and, by extension, share value.

The potential links between sustainable business practices and overall business performance have undoubtedly generated a large body of research, publications and investor activity. Importantly, several sectors of the investment community are now arguing that high standards of performance in these areas provide important lead indicators of future business performance and potential [45]. There also appears to be tacit recognition of the potential risk/opportunity premium associated with sustainability issues; and yet there is still considerable resistance to the use of these concepts when making or recommending mainstream investments.

Kiernan, M (2001): *"Show me a company that can handle these issues well and I'll show you a well-managed company that can also handle the unforeseen future"* [46].

In order to encourage a more consistent, knowledgeable and responsive attitude towards sustainable business practices, it is essential to explain how they might contribute to business performance and value. This chapter is therefore designed to highlight current thinking in this area, and illustrates some of the current evaluation techniques that might be used to highlight potential benefits to the investment community. It should be stressed that these techniques by no means offer a definitive toolkit, but they do provide a starting point for dialogue with the investment community, using terminology and techniques that will be immediately familiar to this key stakeholder group.



5.2 Overview of Current Evaluation Options

When it comes to articulating the benefits of sustainable business strategy, it is probably fair to say that the debate is very long on theory and short on practical evidence. A number of key reasons were highlighted during the workshop and research phases of the project (see box on next page). Notwithstanding these obvious difficulties, it is possible to distinguish four broad categories of evaluation techniques. These are shown in figure 28, together with an outline process for their application. More detailed information on their potential applications is then presented in the sections that follow.

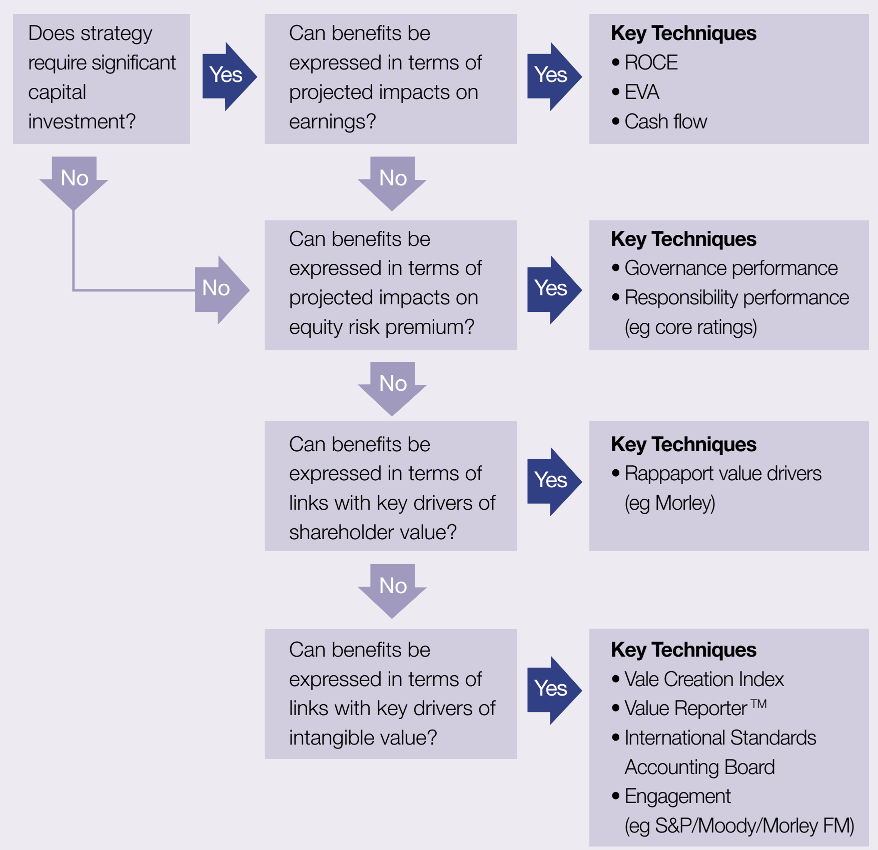
45 eg Hermes Pensions Management Ltd, Innovest, Morley Fund Management, Insight Investment Management Ltd

46 Funk, K, 2001

Consultation/Workshop Phase: Common Themes

- A lack of common understanding of terms and key issues.
- Practical difficulties in determining cause and effect.
- Uncertainties over how societal values and expectations are likely to shift in future.
- Regional variations in attitudes towards sustainability concepts.
- A lack of certainty about when, or if, impacts and benefits might manifest themselves.
- A lack of consensus over the range of sustainability issues for which a company can reasonably assume direct responsibility.

Figure 28: Illustrative Business Performance Evaluation Techniques (by Category)



5.3 Projected Benefits in Terms of Earnings

Mainstream institutional investors and analysts build an overall picture of business performance by combining various analyses. In terms of quantitative measures, *cost of capital* plays a pivotal role in the assessment process, but perhaps the greatest emphasis is on *earnings*, which feature in the majority of calculations. Potential business impacts are then judged primarily in terms of earnings opportunity or threat. Within this context, sustainability issues are unlikely to be considered in isolation, unless they pose a material risk to earnings potential or a significant opportunity for increased earnings.

One means of communicating the projected benefits associated with sustainable business strategies is to use financial measures that are immediately recognisable to the mainstream investment community. These measures may be of particular relevance in those cases where additional capital investment is required to integrate sustainability concepts with overall business strategy. Three possible techniques are highlighted here:

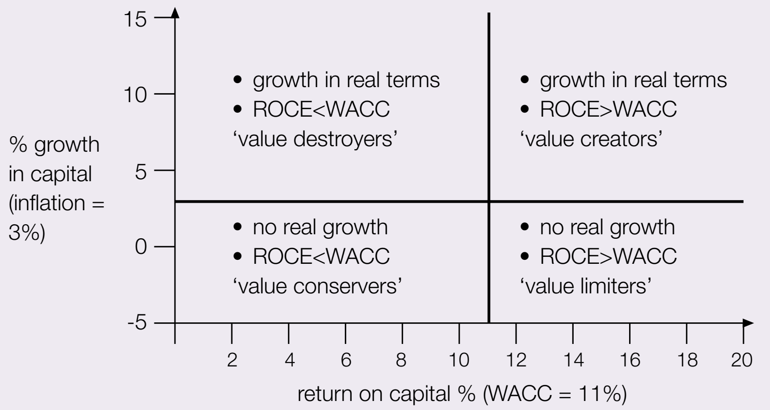
(i) Return on Capital Employed
Business plans will typically show how projected *return on capital employed* (ROCE) is likely to change over the forward plan period. ROCE is defined as pre-tax profit divided by net capital employed. ROCE calculations can be used to assess past, current and planned business performance in terms of its use of capital to generate financial returns. Upward trends in ROCE indicate that a business is thriving. Conversely, downward trends in ROCE may indicate an underlying weakness in the business. One key test is therefore to see whether the strategy in question is likely to have positive impacts on company ROCE.

(ii) Economic Value Added
Many analysts use the *weighted average cost of capital* (WACC) to ROCE comparison and view it as a key indicator of value creation or destruction where a business is growing its capital. The difference between the two is referred to as the *spread*, which can be expressed as a positive or a negative. An alternative term is *economic value added* (EVA).

Generally speaking, a well-run company that is investing in itself wisely should produce a higher ROCE than WACC or positive spread. A positive spread that is strongly in favour of ROCE will tend to point towards an overall business strategy that is *creating value*. If the spread is marginally positive in favour of ROCE, however, this may signal an underlying weakness that is *limiting value*. Conversely, if a company produces a higher WACC than ROCE, or negative spread, its costs of capital are higher than their projected returns. This may signal the need for an overall strategy that *conserves value*. Likewise, any company with a negative spread that persists with an 'all growth is good growth' strategy is likely to *destroy value*.

Spread/EVA is a useful indicator in its own right, but it is also helpful to examine it in relation to other qualifiers of capital growth, such as inflation and return on capital. These potential relationships are shown in figure 29 below.

Figure 29: The Value Matrix [47]



47 Adapted from HSBC James Capel, 1997, quoted in Hughes, A, 1997, "Should Environmental Issues Affect Institutional Investment Decisions", MSc Thesis, University of Bradford, UK

One important application of the value matrix is that it enables companies to determine the best timing for a specific investment programme. Proposals do not necessarily need to generate returns above the WACC, but they will indicate what level of success may be achieved, as compared with the business as a whole.

Furthermore, in those cases where anticipated benefits are likely to take cash flows above the WACC, this offers a strong message that the strategy in question will help reverse a trend. Likewise, in those instances where investment is needed as a defensive action, a comparison with the likely impacts of doing nothing can be used to highlight the intrinsic value of a particular strategy.

(iii) Discounted Cash Flow
Cash flow is the cash left over from sales revenue, after operating and related overhead costs have been met, tax paid and investments made in fixed and working capital. A commonly used method of valuing the projected benefits of an investment is to discount its estimated total cash flow by its cost of capital. Anticipating the fact that cash flows may not be sustained at current rates, the total anticipated cash flow is estimated, and then discounted to derive a net present value of future cash flows.

WACC is often used to discount future cash flows. Equity analysts tend to regard WACC as an appropriate figure to use for discounting because it provides an indication of the minimum required return rate for investments and is company-specific. One possible means of highlighting the direct benefits associated with a sustainable business strategy might be to compare anticipated cash flow with the residual cash flow in the business. This information could then be used to demonstrate the percentage increase in yield that such a strategy is likely to generate.

5.4 Projected Benefits in Terms of Equity Risk Premiums

There are a number of obvious limitations in trying to measure the likely effects of sustainable business strategies in terms of their projected impacts on earnings. Sustainability concepts are by their very nature complex, and potential links may be tenuous or long-term. An alternative approach is to highlight how sustainable business strategies might affect underlying business risks and therefore the equity risk premium that is applied when calculating the theoretical value of a share.

Investors and analysts routinely use models, such as the Capital Asset Pricing Model (capM), to assess the fundamental value of financial assets. In simple terms, if companies want to increase the theoretical value of their shares, they can either increase distributable earnings or lower their risk profile. Quantifiable risks tend to be used in the earnings model, while non-financial risks can be used to qualify the proposed discount rate.

Banks, A (2003): *"The Capital Asset Pricing Model assumes that the theoretical value of a share in a company today equates to the value of the expected future distributable earnings of the company discounted back to the present day."*

Advocates of this type of approach argue that the adoption of high standards of practice in business sustainability will inevitably lead to improved management of material business risks. They acknowledge that market perceptions of improvements are more gradual, and the equity risk premium changes more slowly over time, but suggest that the cumulative effects can be very significant.

An overview of the steps taken by Core Ratings to evaluate the underlying risks in a company is provided below to illustrate this point. Typically, analysts will examine two aspects of performance in business sustainability: governance performance and responsibility performance.

The first evaluation addresses governance performance and is generally viewed as being non-sector-specific. It generally involves an in-depth analysis of the overall quality of management under the following categories:

- governance policy
- business ethics
- approach to risk management
- board and management organisation
- board and executive compensation
- ownership structure and control
- investor rights and relations
- financial disclosure and audit practice.

A rating is then applied from A+ (plus) down to D- (minus) giving guidance to investors on the size of the equity risk premium to allow for governance risk.

The second type of evaluation addresses responsibility performance and is designed to gain an insight into how well a company is managing its material business risks. This type of analysis is highly sector-specific and often company-specific, and involves three key stages. These are illustrated in the table below. A similar rating from A+ down to D- is then applied as per governance ratings.

Stage 1: Identification of Sector- and Company-Specific Risks

This is a mapping of the key issues, impacts and risks for a given company in a given sector, and will typically consider around 250 risks grouped into four main impact areas:

- environmental impacts
- social impacts
- employment impacts
- ethical impacts.

Stage 2: Analysis of the Investment Effect of Sector- and Company-Specific Risks

The sector- and company-specific risks are mapped against a series of *investment value drivers* to determine the relative materiality of the risks to the value of the company's shares or bonds. The principal investment value drivers comprise:

- brand value impairment
- performance of intangible values
- collateral reputation damage
- regulatory interference
- liability to legal actions
- long-term access to people skills
- maintenance of competitive advantage.

Stage 3: Investigation of the Company's Management of the Risks

Having identified what risks a company is running in its business, and determined which of those risks have a potentially material effect on value, the equity risk premium will depend on how well the company is managing those material risks. Typically the following areas will be assessed:

- development of policies
- implementation of policies
- validation and assurance programmes
- performance against indicators
- transparency and disclosure of performance.

5.5 Potential Links with Key Indicators of Shareholder Value

An important limitation with assessments relying on direct measures of benefits in terms of earnings or risks is that many sustainability concepts do not lend themselves to this type of analysis. There are, however, a number of widely recognised proxies of financial value that can be used to highlight the potential links between business objectives in sustainability and the key drivers of shareholder value. In our previous publication we highlighted a study, which used Alfred Rappaport's model for calculating discounted cash flow [48] to demonstrate how key components of business strategy are affected by ethical, environmental and social initiatives. The key drivers considered comprised:

- sales growth rate
- profit margin
- fixed capital investment
- working capital investment
- competitive advantage period
- cost of capital
- cash tax rate (adapted).

A number of institutional investors are also developing similar approaches to highlight the potential links between company performance in business sustainability and the key drivers of shareholder value. Morley Fund Management, for example, has developed an evaluation methodology that seeks to evaluate social and environmental issues from a perspective of probable financial impact. Morley's approach involves five linked stages as follows:

Stage 1: Identify and evaluate sectorally significant social and environmental issues and produce a sector report.

Stage 2: Identify and evaluate the company's business position and management quality.

Stage 3: Assess the impact on shareholder value.

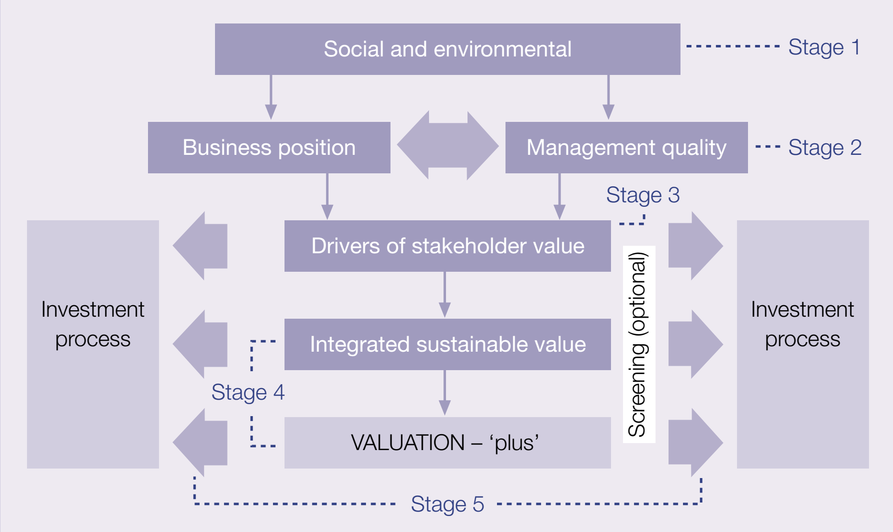
Stage 4: Conduct a scenario analysis and model environmental, ethical and social impacts from a perspective of incremental impacts on valuation.

Stage 5: Derive an investment recommendation and communicate the findings to all fund managers.

Rather than applying normative judgements (ie what should happen), Morley aims to concentrate its efforts on positive analysis (ie what is likely to happen). As a first step, Morley researches how society's values are likely to impact certain sectors, via industry drivers of shareholder value. This information is then presented in the form of a sector report. A summary of this process is presented in figure 30 overleaf.

48 Rappaport, A, 1998

Figure 30: Assessment of Sectoral Trends in Business Sustainability [49]

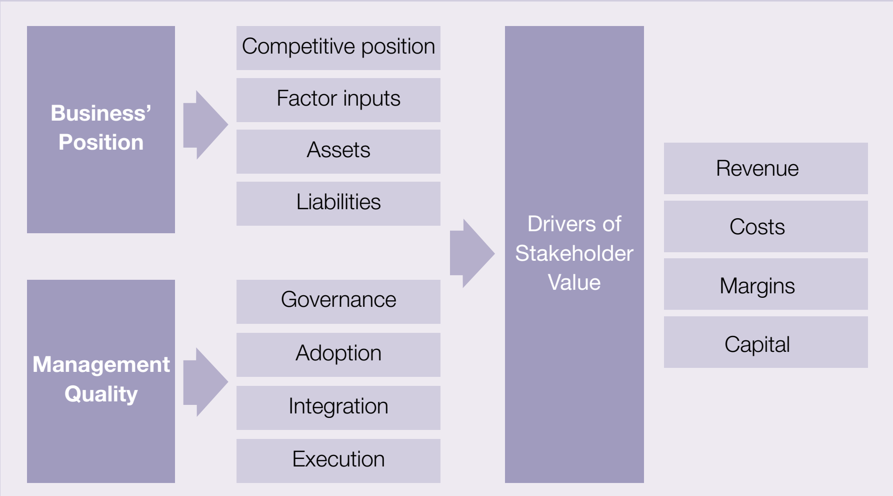


Analysts then carry out a series of assessments to determine the extent to which these sectoral trends apply at individual company level, and to determine the company's management attitudes and responses to these issues. Management quality, for example, is recognised to be a major driver of corporate performance, and is assessed using four broad criteria:

- Governance good practice and appropriate stakeholder engagement.
- Adoption of appropriate policies by evidence of disclosure, policies and practices
- Integration of sustainability issues into business strategy and operations using appropriate objectives (eg alignment of executive compensation), and
- Execution of corporate responsibility strategy, by evidence of performance against objectives and continuous improvement.

This process is summarised in figure 31.

Figure 31: Assessing Sustainability Impacts at Individual Company Level



49 Morley Fund Management, 2003

The output from this process takes the form of a company profile, which is shared with all Morley fund managers and contains:

i a summary of corporate governance issues
ii a record of relevant communications with the company, including engagement notes
iii scenario planning and incremental valuation impact
iv a SWOT analysis in tabular format (Strengths, Weaknesses, Opportunities and Threats)
v an investment recommendation and justification for the recommendation.
vi a risk-weighted sustainability matrix to derive the rating and define the investable universe for the funds.

5.6 Potential Links with Key Drivers of Intangible Value

It is increasingly accepted that traditional financial metrics provide less and less of the information needed by companies and investors to evaluate business performance (see also Section 3.6). There is also considerable evidence to suggest that investors and analysts are giving increased prominence to the role of intangibles as part of their investments and recommendations. Standard and Poor's, for example, states that some 70 per cent of its evaluations of overall business performance are derived from key market intangibles (eg management, corporate status and investment process). This approach, they argue, will provide *"consistent above average volatility adjusted returns relative to other funds in the same sector"* [50].

CIS (2003): *"CIS always seeks to invest in companies with strong market positions in industries with attractive long-term prospects. We aim to ensure they have competent and honest management teams, healthy balance sheets and good historic performance. This goes hand in hand with our responsible approach to investment... We believe this policy will pay off over the longer term. The companies that meet our criteria are the ones we believe could give better than average returns."*

Although an agreed framework for the evaluation and management of intangibles is yet to be developed, the growing body of literature on the subject has been gravitating towards one [51]. Research carried out by CGEY's Center for Business Innovation, for example, suggests that the following factors are most closely aligned with market value [52]:

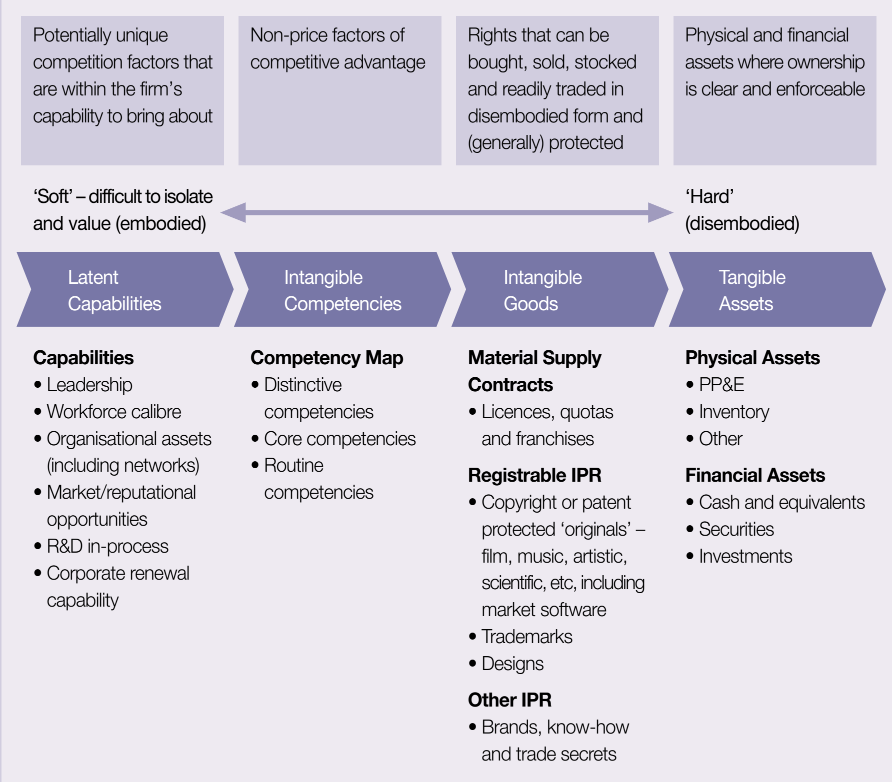
- leadership
- strategy execution
- communication
- transparency
- brand equity
- reputation
- alliances and networks
- technology and processes
- human capital
- workplace organisation and culture
- intellectual capital
- adaptability.

A number of evaluation techniques have also been developed, each seeking to provide a better insight into the range of *value drivers* that are strongly correlated with market value. These include CGEY's Value Creation Index and the ValueReporting™ Framework currently under development by PricewaterhouseCoopers.

50 See also www.funds-sp.com/
51 eg Young, D W, 2003; Bergamini, I & Zambon, S, 2003; Funk, K, 2001
52 Eustace, C & Youngman, R, 2002, "The Shifting Corporate Asset Base", PRISM.

More recently, research carried out as part of the EC's PRISM[53] project has attempted to conceptualise the key drivers of intangible value in terms of four asset groups[54]. These four segments, taken in combination, provide an holistic view of the various capabilities, competencies, legal rights and 'accounting' book assets that constitute the total asset base of a modern company. This shifting corporate asset base is illustrated in figure 32 below:

Figure 32: The New Corporate Asset Base



In many respects, it could be argued that environment and social responsibility are just two components of a wider set of intangibles that contribute to total market value. So why aim for sustainable business practices? Why not simply improve another key driver of intangible value and achieve the same desired effect?

One answer lies in the relative importance of environmental and social factors to each of these drivers. Whilst its relative importance is likely to vary from sector to sector, many have identified strong correlations between sustainable business practices and key drivers of intangible market value. CGEY, for example, found that 'environment' as measured by environmental, social and community sector scores ranks consistently in the top ten value drivers in their Value Creation Index, which explains up to 90 per cent of variability in market value[55].

A second answer lies in the growing body of evidence from the SRI and ethical investment market. These have continued to grow in prominence and they are outperforming many of their mainstream counterparts when viewed over a longer timeframe (see also Section 2.7).

For some sectors, notably those heavily reliant on knowledge, information and people, the most compelling argument for the adoption of sustainable business practices lies in the potential relationships with key drivers of intangible value.

53 PRISM stands for: **P**olicy making; **R**eporting and measurement; **I**ntangibles; **S**kills development; **M**anagement

54 Eustace, C & Youngman, R, 2003

55 Funk, K, 2001

5.7 Summary

This chapter highlights the importance of applying value concepts as a means of promoting the various sources of benefit associated with sustainable business strategies. It distinguishes between four key categories of potential benefit and suggests a range of techniques that might be applied in each instance.

Practitioners can ask the following key questions to classify potential sources of benefit:

- Can benefits be expressed in terms of projected impacts on earnings?
- Can benefits be expressed in terms of projected impacts on equity risk premiums?
- Can benefits be expressed in terms of links with key drivers of shareholder value?
- Can benefits be expressed in terms of their links with key drivers of intangible value?

By using evaluation techniques that are widely recognised within the investment community, companies will be better placed to encourage a more consistent, knowledgeable and responsive attitude towards sustainable business practices. Further more, by highlighting the relative importance of sustainability concepts to non-financial drivers of business value, companies can work towards a position where they are rewarded for adopting high standards of performance in these areas, as well as being penalised for poor standards.

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Communicating
the Benefits

6 Conclusions

6: Conclusions

Chapter Summary	
Purpose This chapter aims to: • summarise the key points raised in previous chapters • reiterate some of the key factors to consider when integrating sustainability concepts with core business, service or product strategies. • indicate suggested next steps.	**Outcomes for Readers** Using the information in this chapter, readers will be able to: • identify a starting point for broadening attitudes and behaviours towards sustainability concepts to include notions of benefit, as well as threat.

6.1 Overview

WWF believes that in an increasingly complex future market economy, companies that choose to tackle sustainability issues as strategic business concerns are more likely to deliver increased value and long-term success than those which do not.

The key motivation behind this and our previous publication, *To Whose Profit? Building a Business Case for Sustainability*, has therefore been to broaden perceptions of sustainability concepts to include notions of business benefit and opportunity, as well as threat. Our ultimate objective is to encourage companies to build sustainable business strategies where sustainability concepts are fully integrated with other core business objectives. In this way, it is hoped that companies will be better placed to communicate the intent of their business sustainability programmes and be rewarded for achieving higher standards of company performance in these areas.

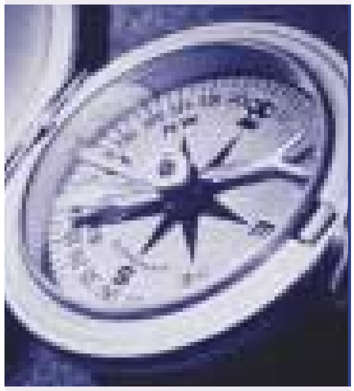
6.2 A Focus on Business Value

Our research confirms that a growing number of companies are starting to frame their internal cases in terms of potential business benefits in specific parts of the business. Many practitioners have also argued that it is easier to secure internal support for specific initiatives if they can be explained in terms of benefits to the business, environment *and* wider society.

> **Reed, DJ (2001):** *"The business case is not a generic argument that corporate sustainability strategies are the right choice for all companies in all situations, but rather something that must be carefully honed to the specific circumstances of individual companies."*

Instinctively, many also support the argument that sustainable business practices will lead to higher share returns. The astonishing growth and performance of many ethical and socially responsible funds also points towards a correlation between sustainable business practices and share performance. However, the external case is still a long way from being proven and, on this basis, most companies are unwilling to use these types of argument to justify wider adoption of sustainability concepts within their own organisations.

One area that has received a lot of interest is that of market *intangibles*. Our research points towards a growing recognition generally that traditional financial metrics provide less and less of the information needed by companies and investors to evaluate business performance. Accordingly, increasing numbers of companies are starting to argue that the adoption of sustainable business practices will increase the likelihood of value creation over the longer term. Likewise, many are starting to suggest that, as investors turn increasingly towards lead indicators of business performance, the relevance of sustainability concepts will become clear.



In order to build cases for sustainable business practices based on their implications for intangible drivers of market value, many acknowledge that more widely accepted measures of intangible value are needed. In the meantime, the work of leading rating organisations, pension funds and professional services firms does provide an important insight into the types of indicators and measures that are likely to be relevant.

It is further suggested that improved communication and dialogue with both the mainstream and SRI community will help gain a wider consensus over the range of sustainability issues most likely to pose material opportunities and threats to overall business performance.

6.3 Sustainability as a Strategic Business Concern

Our research confirms that most companies have made good progress in identifying the range of sustainability issues most relevant to their own organisations. Many now operate formal environmental, governance or social policies and have set specific objectives and targets for improved performance in these areas.

Despite this progress, there is still a wide gulf between company responses to sustainability issues and the key factors currently shaping overall business strategy and direction. There are also considerable mismatches between current company practice in business sustainability and what is communicated to external stakeholders. Most companies would acknowledge that their internal processes for defining core business objectives and goals are often separate from those used to define their core objectives in business sustainability. There is nevertheless some evidence that companies are starting to modify their corporate strategies in response to selected sustainability threats (eg concerns over future resource availability), but to date there is limited evidence of companies actively seeking to define their corporate strategies using sustainability concepts.

Closer examination of sector trends also suggests that there are significant differences in performance between different industry sectors, both in terms of company understanding of sustainability issues and their translation into mainstream business practice.

There is also evidence to suggest that the current management focus of many companies can sometimes obscure the most important sources of opportunity and impact associated with sustainability issues. This situation is not helped by the fact that most of the existing tools and techniques in business sustainability are actually strategy implementation tools, which focus on impacts and risks to environment and society, rather than potential benefits across all three dimensions.

6.4 Building Sustainable Business Strategies

One of the key themes underpinning this publication is that if a company wants to understand how sustainability issues might contribute to value creation, it must incorporate them into its strategic thinking. Strategic decisions define the longer-term goals and potential directions for a company. For many it is the strategic management process that fits most closely with the uncertainties and timescales posed by sustainability concepts.

An important prerequisite for practitioners is to have a clear understanding of how strategy works within the specific context of their own organisations. A second important prerequisite is for practitioners to be aware of the different ways in which strategy is implemented. Most would also accept that it simply is not feasible for practitioners to exert the same degree of influence across all parts of the business. Instead they must find means of building capacity in strategically important parts of the business. Here we argue strongly that many of the business tools needed to achieve this objective are already in common usage within companies. What needs to change is the range of input assumptions that are used to define strategic options and selected preferred responses.

6.5 Communication and Disclosure

Our research does point towards a growing recognition of the potential risk/opportunity premium associated with sustainability issues, particularly for some sectors. Companies are also faced with increased pressure to improve their disclosure practices in all areas deemed relevant to overall business performance, including those relating to business sustainability.

However, a policy of full disclosure is not necessarily feasible or desirable in every case. In some instances it may actually prove counter-productive if it fails to improve external attitudes and behaviours towards the company concerned. Likewise, the downside of increased scrutiny is that a disproportionate amount of time and energy may be spent answering queries and protecting reputations, at the expense of more innovative responses to the challenges posed by sustainability issues.

We contend that it is far more important to understand the range of interests presented by investors, companies and society, and to decide which of these interests constitute material business concerns. In order to encourage broader interpretations of materiality, companies need to explain the key objectives of their sustainability strategies, to be clear about the range of interests they are intended to serve, and to articulate their implications for current and future business value.

A commonly agreed framework has yet to be agreed for achieving this objective. In the meantime, the work of leading thinkers does provide an important insight into how this might be achieved. These could offer a useful starting point for dialogue with both the mainstream and SRI communities.

6.6 Conclusion and Next Steps

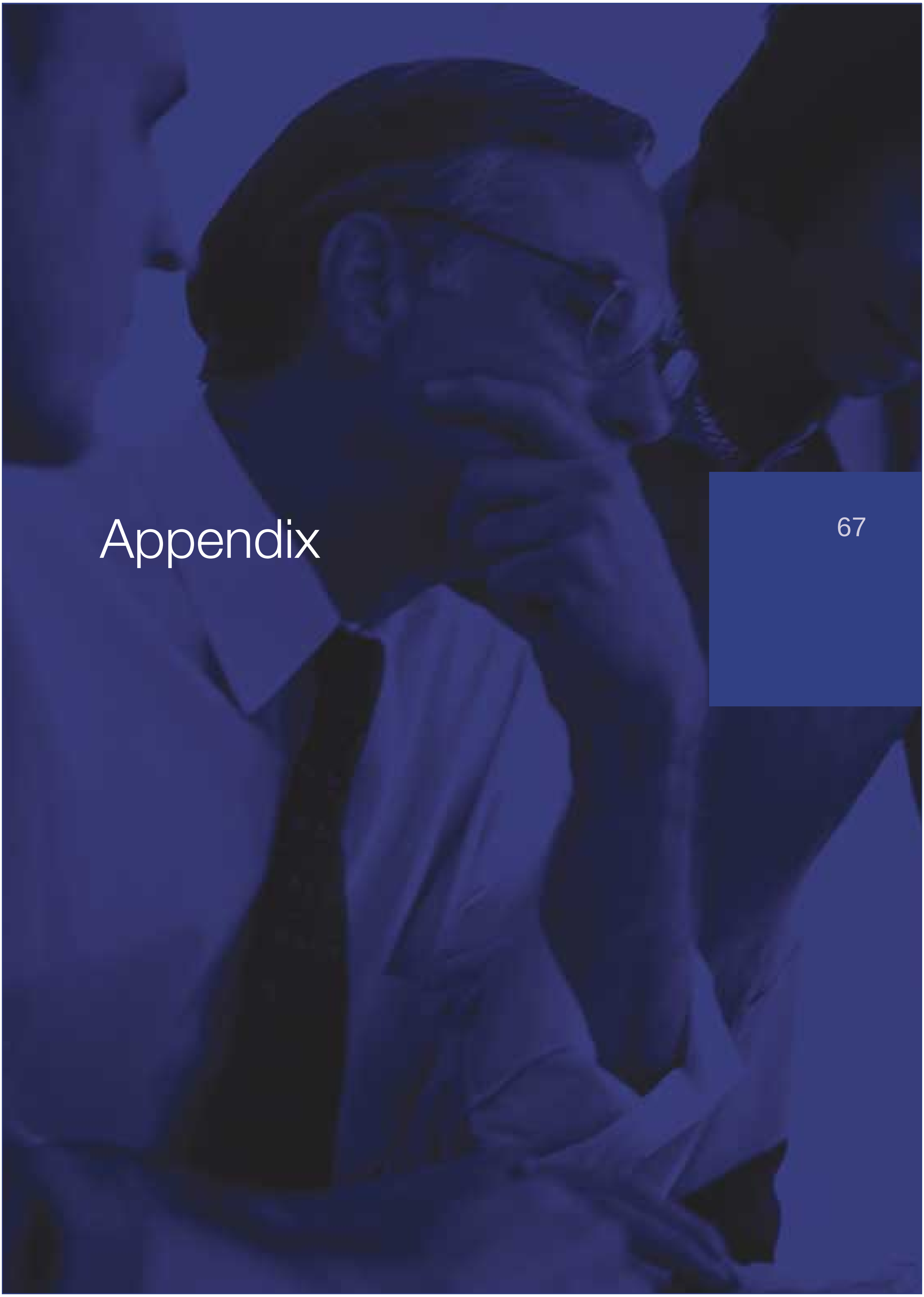
The project team and authors have dedicated more than four years of research and investigation into how sustainability provides opportunities for companies to create business value, as well as conserving it. During that time, and especially during 2003, the authors have been encouraged, not just by the increasingly meaningful responses of companies to these issues, but also by small but significant changes in the way that these issues are understood by the wider investment community.

We firmly believe that it is no longer sufficient for companies and the investment community to treat sustainability as a bundle of peripheral issues that have little bearing on the way that companies are run. There is already a lot of evidence to support the assertion that active treatment of sustainability issues can deliver direct and wider business benefits. There is also a growing body of opinion to suggest that companies which are able to understand the strategic implications of environmental and social issues for their future direction will be better equipped to deal with change and uncertainty.

By treating sustainability concepts as material business concerns, companies will also be better placed to communicate the rationale behind their investments in sustainable business practices. This information can in turn be used to encourage meaningful and responsive dialogue with the investment community regarding the potential risk/opportunity premium associated with sustainability issues.

WWF will continue to stimulate and promote this debate, directly through its work with companies, and through the development of tools and techniques which support further understandings of the links between sustainability and business value to further encourage the integration of sustainability issues into mainstream business and investment practice.

We would therefore welcome your comments and views on the *To Whose Profit?* series of publications and look forward to the next phase of work on this and other related initiatives.



Appendix

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To Whose Profit?(ii): Evolution

Building Sustainable Corporate Strategy

This publication is designed to help companies build capacity to address sustainability issues as strategic business concerns. Recognising the key role that investor interests play in shaping company practice, it is also designed to encourage companies to communicate the direct and wider benefits that could be secured, with a particular focus on their implications for long-term value creation.

Together with its companion piece, *To Whose Profit?: Building a Business Case for Sustainability*, this publication aims to help companies:

- examine the extent to which current company practice addresses sustainability issues as strategic business concerns
- gain an insight into the basic principles of strategy development and some of the reasons why conventional value management techniques cannot fully address business sustainability concepts
- explore how strategy works in practice and examine some of the factors to consider when building sustainable business strategies
- uncover some of the techniques that could help companies communicate the intentions and outcomes of company sustainability strategies to the investment community, with a particular focus on their implications for business value.

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