ESG must Become Sustainable Management

Improving Transparency and Performance in the Environmental, Social and Governance (ESG) Area

In the past years, many companies have dedicated significant efforts to improve transparency and performance in the environmental, social and governance (ESG) area, and launched many initiatives to respond to the pre-eminent climate crisis. However, to truly address the magnitude of the challenge and become frontrunners in a low-carbon economy, companies need to deeply embed sustainability in the heart of their business operations.

Here we are now in the year 2021 and the urgency for change becomes abundantly clear: the maximum global temperature rise of 1.5 – 2°C degrees agreed in the Paris agreement is far from being achieved when looking at the current status of global warming. The average global temperature in 2020 is set to be about 1.2 °C above the pre-industrial level.[1] Scenario calculations show that even to achieve the 2°C target, carbon emissions must already be at their maximum today and must fall rapidly from now on.[2] Therefore, it is fundamental for organizations to become climate neutral by 2030, latest 2040.

It is fair to say that we have learned two key things so far: First, some actions are encouraging, but in sum clearly not fast and decisive enough. Second, the initial impacts of climate change are exceeding expectations, when we look for example at extreme weather events or the rapid snow cover reduction in the arctic regions.

The Covid-19 related decline in 2020 will of course not be able to solve these issues and also not remotely mitigate them. Even with a global pandemic, various lockdowns and limited economic activities over about 9 months, emissions only reduced by 6.4% in 2020.[3] But rather than a small dent in global emissions, we need a steep and persistent glide path to zero. This illustrates how big the challenge will be in the future.

From sustainability agenda to sustainable business transformation

Given these challenges, how can you best set up your company to become a leader in the low-carbon economy, and build a sustainable business and value chain in an agile and bold way, fully in line with the targets of the Paris agreement?

[1] https://news.un.org/en/story/2020/12/1079042
[2] See Christiana Figueres et al.: Three years to safeguard our climate. In: Nature. Band 546, 2017, S. 593–595
[3] https://www.nature.com/articles/d41586-021-00090-3

Figure 1: From sustainability agenda to sustainable management

Aspirational sustainability agenda …	… and beyond: Sustainable management
Create tangible **footprint transparency** for decision-makers	**Focus** on core business processes and decisions with the highest impact on ESG
Put a **price tag on emissions** to incentivize creativity	**Enforcement mechanisms** that embed ESG criteria in scenario-evaluation and decision-making
Use **unconventional approaches** to flatten the curve - Resource efficiency and circular use - Use existing renewable technologies - Invest in new breakthrough technologies	**KPI systems** that enhance performance management with ESG-related metrics (triple bottom-line performance)
Engage employees and external partners	**Operating model** which embeds sustainability across key business areas in a self-governing way, with a strong focus on community, learning and external ecosystems

Clearly, the leaders in the low-carbon economy need to go beyond implementing a portfolio of aspirational sustainability initiatives, such as investments in renewables, resource-efficient operations, and breakthrough technologies. While all of these are important and valuable contributions, the magnitude of the climate crisis requires companies to take an important step further by moving to sustainable management. Deeply embedding sustainability in the core business operations and decision-making processes, in essence how they manage their business. Decisions impacting carbon emissions and other environmental and social aspects are taken in companies every day, and that is where we need to expand the focus of decision making towards external (societal) value creation. The future zero-carbon leaders treat sustainability not only as a sideshow or portfolio of initiatives but deeply integrate it into day-to-day processes and strategic decision making. They do not outsource zero-carbon initiatives to the sustainability function but make it an integral part of any member in the management team.

Zero-carbon leaders integrate sustainability and ESG deeply in day-to-day management processes, first and foremost in strategic decision making

A blueprint for embedding sustainability in the core

While many will agree with the above aspiration, we need something more tangible and practical, an actionable blueprint for embedding sustainability in the core of management. Based on our experience in both business & value chain strategy and sustainability, we think companies need a sustainable management system with the right focus, enforcement mechanisms, KPI systems and operating model as guiding principles:

- **Focus** on core business processes and decisions with the highest impact on ESG
- **Enforcement mechanisms** that embed ESG criteria in scenario-evaluation and decision-making, guided by corporate sustainability targets
- **KPI systems** that enhance performance management with ESG-related metrics (triple bottom-line performance)
- **Operating model** which embeds sustainability across key business areas in a self-governing way, with a strong focus on community, learning, and ecosystems

In the following, we will outline the business processes and decisions with the highest impact on ESG and describe the key enforcement mechanisms that are required to embed sustainability.

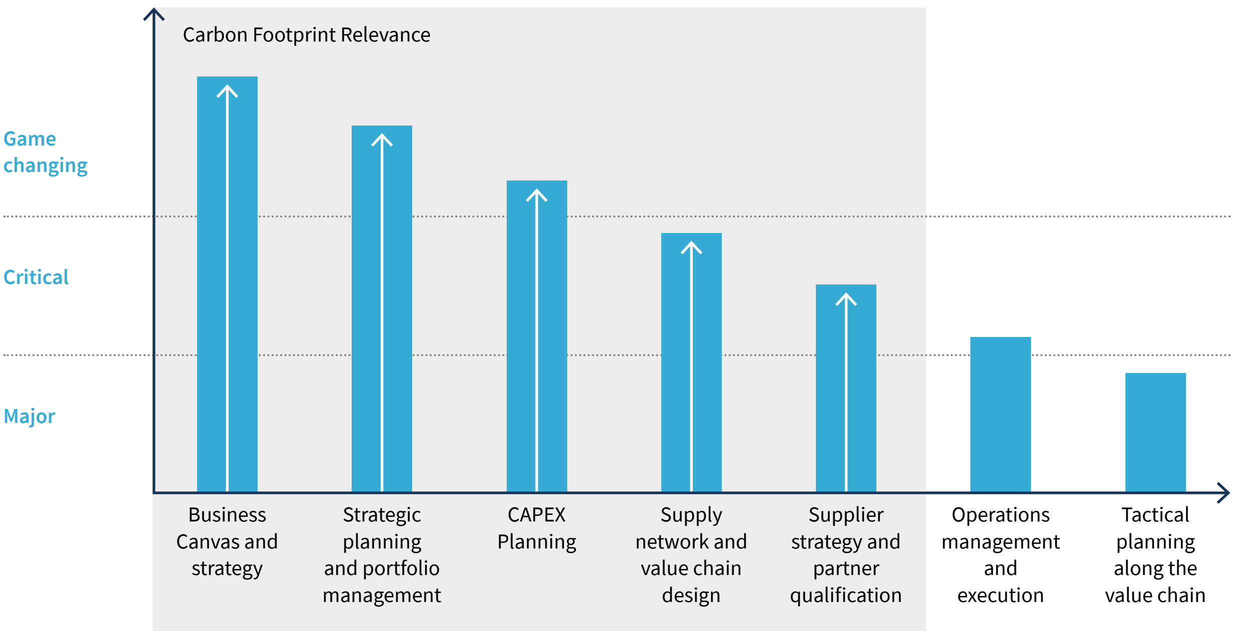
Focus on processes and decisions with the highest impact on ESG

Companies need a pragmatic and focused approach to embed sustainability in their daily operations where it matters most. Rather than perfectionism, we need an 80/20 approach, making the 20% of strategic management processes which drive 80% of emissions fit for carbon zero.

Based on our experience, 5 core management decision making processes typically determine more than 80% of a company's carbon emissions in the mid- to long-term. First and foremost, these processes need to be enhanced to drive for transparency on societal impact, balanced decision making, and incentivization including sustainability targets:

- Business Canvas and strategy
- Strategic planning and portfolio management
- CAPEX Planning
- Supply network and value chain strategy design
- Supplier strategy and partner qualification

Figure 2: Leverage of core management processes for carbon footprint scope 1-3



Right enforcement mechanisms to deeply embed ESG management processes

To successfully embed the ESG perspective in the management processes that matter, companies need to consequentially adapt their ways of working. Embedding ESG is not just a simple add-on or agenda point, but requires new awareness, buy-in, expertise, tools & processes, and collaboration skills not only from general managers, but also from CFOs, business controllers, heads of operations, heads of strategy and business development, and heads of procurement and their respective teams. Figure 3 gives an overview of the key approaches and enforcement mechanisms which will make a difference in transforming the 5 core strategic management processes with the highest impact on sustainability.

Figure 3: Enforcement mechanisms to embed ESG in core strategic management processes

	Key enforcement mechanisms to embed ESG (examples)
Business Canvas and strategy	‣ Integrate holistic external stakeholder analysis, e.g. customers, partners, environment, society ‣ Use unconventional methods (e.g., design thinking) to create out-of-the-box ideas for new business models ‣ Evaluate external (societal) value creation for new business models ‣ Assess and quantify new business model contribution to transitioning to a zero-carbon and circular economy
Strategic planning and portfolio management	‣ Use Portfolio Sustainability Assessment (PSA) methodology to evaluate ESG-performance of segments ‣ Define targets and action plans for entire portfolio, e.g. share of revenue from sustainable products ‣ Differentiate targets and decision thresholds based on sustainability ranking of products/ product groups, e.g. allocation of R&D and CAPEX budgets, targets for internal rate of return (IRR) and contribution margin
CAPEX Planning	‣ Capital investment appraisal including rating of projects' sustainability impact (qualitative or detailed LCA) ‣ CAPEX portfolio analysis: determine share of investments with positive/ very positive ESG impact ‣ Carbon footprint simulation: how does the current CAPEX round impact the zero-carbon trajectory? ‣ Monetizing direct/ indirect impact of sustainability issues as part of NPV appraisals
Supply network and value chain design	‣ Integrating key ESG ratios in network option evaluation, e.g. CO2 emissions, share of recycled materials, average transportation radius, share of local content, used product return ratios ‣ Multi-objective optimization which balances total cost of supply with environmental and social impacts ‣ Integrate ESG-related decision thresholds, e.g. emissions caps or increasing compensation cost
Supplier strategy and partner qualification	‣ Supplier qualifications with clear set of minimum standards/ non-negotiables (e.g. labor standards ILO) ‣ Quantified targets for sustainable practices in % of volume/ spend, e.g. based on certificates/ ecolabels ‣ Automated processes to ensure compliance, linking contract management and execution systems/ ordering ‣ Incentives, penalties and supplier performance improvement programs

None of the above is rocket science, but largely based on existing management tools and approaches. However, it takes a true organizational change effort to align the management team and build the necessary commitment and know-how to actually make the step. Let's illustrate a couple of examples.

Strategic business planning needs to extend its focus to integrate ESG-related issues at the core of decision-making. This includes the introduction of approaches such as the sustainable business Canvas[4], which provides a systematic approach to include sustainability principles and external (societal) value chain creation in business model innovation processes. Similarly, strategic planning of the existing product portfolio needs to integrate the ESG performance of the different portfolio segments in order to systematically set targets for increasing the share of sustainable products and services as well as allocating precious resources like R&D, sales & marketing and capital expenditures accordingly. This can for example build on the Portfolio Sustainability Assessment (PSA) methodology as described by the World Business Council for Sustainable Development (WBCSD)[5], which has been successfully applied by many international organizations, most notably global chemicals players.

Equally important, CAPEX planning requires a significant upgrade with regards to embedding sustainability. The area that requires the most attention is the planning and management of capital expenditures, which are crucial for carbon emission reductions by investments in resource efficiency, circularity, and renewable energy in the next 3-5 years ahead. Thus, they over-proportionately impact the carbon emissions in the two critical decades until 2030 and 2040. The approaches include a systematic rating of the ESG impact across the entire CAPEX-portfolio, which can be done as simplified assessment for small and medium capital projects and as a more extensive Lifecycle Assessment (LCA) for big projects. This sets the basis for a systematic analysis and simulation how the CAPEX portfolio in the current approval process will effectively support the sustainability targets and trajectory. Concepts such as those of the Accounting for Sustainability Program[6] can be used to deeply embed sustainability in capital appraisal processes and CAPEX management.

[4] https://uol.de/f/2/dept/wire/fachgebiete/innovation/en/download/Manual_Sustainable_Business_Canvas__EN.pdf.
[5] https://www.wbcsd.org/Projects/Chemicals/Resources/Framework-for-portfolio-sustainability-assessments.
[6] https://www.accountingforsustainability.org/en/index.html.

To embed sustainability in the core of management, this is not yet sufficient. The enforcement mechanisms need to be complemented with a pragmatic and balanced performance management system and an operating model which effectively integrates the sustainability principles across the entire organization.

People, Planet, Profit – How to embed ESG into performance management

To substantially integrate ESG criteria into decision-making, they need to become an integral part of performance management systems for management and employees. The first step is to bring ESG performance metrics from the world of external sustainability reporting to the center of internal performance management and steering concepts, both on the financial and operations level. This follows the triple bottom line approach introduced in the 1990s, which provides a comprehensive finance and accounting framework based on social, environmental and financial elements.[7] Second, companies need to set up and continuously expand their KPI systems with environmental, social and governance metrics for all key impacted functions. KPIs should include both outcome metrics (e.g., emissions per ton in production) as well as critical driver metrics in line with key improvement areas on the path to climate neutrality (e.g., share of recycled input materials in a certain product line). And third, companies need to focus on enhancing the agenda of core performance management meetings and reviews on a monthly or weekly basis, ensuring that ESG-related challenges become an integral part of these dialogues and trigger the same collaboration, problem-solving, and creativity applied to managing pressing business issues.

Figure 4: Performance Management System for 'Environmental' (as part of ESG)

Governance

Social

Environmental

	Business Strategy	Portfolio & Product design	Operations	Procurement	Logistics
Driver Metrics	Share of strategic investments with positive ESG impact % of innovations including sustainability goals …	% of recycled input materials by type Packaging material recycling rate , e.g. % share PCR Packaging material used per volume/ weight …	Water consumption and % of water re-used Waste by type and disposal method Number/ share of certified facilities, e.g. LEED, BREEAM …	% of spend by key category with certified ecolabel / certificates Suppliers with 100% renewable energy …	Total distance travelled (internal vs. external resources) Mode mix distribution Share of electric vehicles on total fleet …
Outcome Metrics	Revenue share of sustainable products and services Share of CAPEX and R&D invested in sustainable products & services …	Carbon footprint in scope 1/3 (in CO2e) 'Cradle to grave'-emissions of core product lines Number of returns on total product share …	Carbon footprint in scope 1 and 2 (in CO2e) Energy consumption in total and per output unit Share of renewable energy …	Carbon footprint in scope 3 (in CO2e) Use of critical primary materials in tons per unit …	Carbon footprint in scope 1 or 3 (in CO2e) Waste/ tertiary packaging consumed in tons …

Figure 4 gives an overview of what an ESG-based scorecard can look like. Of course, it needs to be designed individually to fit the organization's business model and take into account for its specific situation. For the performance management system to be successful, the metrics must be calculated on a recurring base, drilled down, and allocated to different business areas and departments, and shared within the entire organization so that visibility of the data begins to drive behavior. Additionally, employees should be compensated and bonuses should be granted also based on environmental and social performance. One example is the technology company Apple, which recently announced to incorporate environmental, social and governance elements into their annual cash incentive program.[8]

[7] https://www.economist.com/news/2009/11/17/triple-bottom-line.

[8] https://www.reuters.com/article/us-apple-compensation/apple-will-modify-executive-bonuses-based-on-environmental-values-in-2021-idINKBN29A2MK.

The framework above is intended to be used for annual target setting beyond carbon reduction targets (e.g., reduction of water use) and applied retrospectively to track ongoing efforts against individually set targets on a business unit, function, or corporate level.

The next horizon is to fully integrating ESG aspects into ERP systems, to a degree that every granular transaction is automatically linked to a quantified carbon impact. This will allow a new level of footprint analysis at the product level and detailed optimization of natural resources use in end-to-end processes like design to operate, lead to cash, and source to pay. SAP's Climate 21 initiative follows this vision of embedding sustainability as a new dimension of success in analytical and transactional applications to optimize resources across value chains and the entire lifecycle.[9]

Self-governing operating model with strong focus on community and ecosystem

The organizational basis for sustainable management should be guided by several perspectives. First, sustainability needs to be set up not as a single function, but as an operating principle across the entire organization. Thus, a hybrid organizational model is typically preferred, consisting of sustainability advocates and subject matter experts embedded in all key business units and functions (owning and implementing individual initiatives), and a central sustainability group reporting to the CEO (driving target setting, consolidating and exchange, providing standards and tools, training employees, and linking with strategy and other functions).

The key focus of the sustainability operating model is to embed the right degree of resources, expertise and change management to make a difference in each key business area. Take the procurement function as an example: which resources and capabilities are needed in category management, business partnering, technical support, and procurement operations to continuously develop and implement new concepts that help achieve the sustainability targets for scope 3? Building on a solid representation of sustainability skills in key business areas, the focus should be to create a self-governing approach, with a cross-functional environment and community that enables continuous learning, information sharing, experimentation, and effective collaboration in cross-functional teams.

Lastly, the operating model should be outward rather than inward oriented, with a strong focus on building an external ecosystem of sustainability partners such as customers, suppliers, universities, technology and solution providers, and others. External sustainability advisory boards or expert panels are strong instruments for linking the external ecosystem with decision makers in the organization on different levels.

How to start the change: 10 key questions you should address as a CEO

While change towards a low-carbon economy is increasingly important for all employees and becomes a critical factor for talent acquisition and retention, the changes in core strategic decision making described above need to start with the management team. How can CEOs and other executives effectively drive change and become the engine to establish the awareness, buy-in, expertise, tools, processes, and ways of collaboration that enable sustainable management? From our experience, it is important to ask the right questions to spur action, either in self-reflection or in dialogue with the team:

1. What are our specific sustainability targets for the next years? How do they break down by each contributing business unit or function?
2. What is the share of sustainable products and services in our portfolio? What is our strategy to expand them, prioritizing R&D and marketing spend as well as capital investments accordingly?
3. What share of our capital investments are making a positive contribution to our sustainability agenda?

[9] https://www.climateaction.org/climate-leader-interviews/thomas-saueressig-sap-se-on-can-software-realign-us-with-the-goals-of-the-p.

4. How does the CAPEX portfolio impact our carbon emissions reduction plan?
5. Do we have sufficient know-how and resources in the finance & controlling team to drive towards integration of sustainability into planning and budgeting?
6. How could we transform our value chain and supply network to make outsized contributions to our sustainability footprint? How do we include these scenarios in our operations strategy?
7. What is the sustainability footprint of our supplier base, e.g., scope 3 emissions, water, waste? What level of transparency and understanding do we have on key drivers?
8. Do we effectively inform our supplier management based on ESG-criteria and targets? Do we have specific targets for key drivers, e.g., share of recycled/ secondary material use in certain categories?
9. Does the procurement and quality function have sufficient know how and resources to transform the sustainability footprint of the supplier base?
10. Do we have the right external partnerships and ecosystems in place to challenge existing ways of working and link with the latest innovations?

To become leaders in the low-carbon economy, companies need to go beyond driving a portfolio of aspirational initiatives and deeply integrate ESG into the core management decision-making processes. Deeply embedding sustainability and ESG into core processes such as business model innovation, portfolio planning, CAPEX planning, and sourcing strategy is the key next hurdle, and overcoming it brings an extraordinary return on investment. Rather than investing millions, it's about building awareness, buy-in, and skills within the management team and direct reports, and leveraging new approaches to better make day-to-day decisions from the perspective of external and societal value creation.

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A sustainable value chain is becoming a strategic imperative for companies around the world. With our Competence Center GreenMind², CAMELOT helps clients explore new business and operating models for a sustainable future. Contact us to discuss the next steps on your sustainability journey.

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