EXECUTIVE INSIGHTS

Why the Quest for Sustainability Must Prevail in Times of 'Permacrisis'

Sustainability has been sitting high on the corporate agenda these past couple of years — and with good reason. Pressure to act on the climate crisis, for example, is mounting. Sentiment at COP27 was pessimistic, with global political leaders once more stressing urgency and alluding to the catastrophes due to occur if nothing is done. According to UN Secretary General António Guterres, the world is on the "highway to climate hell" and — even worse — with "our foot on the accelerator".[1] Companies worldwide have been increasingly busy reflecting on how they can adopt a more conscientious approach to doing business.

However, with 2022 being dubbed the year of 'permacrisis', businesses may find that sustainability is competing for bandwidth against other executive priorities, particularly with economic headwinds getting stronger. Turbulent months have become the norm, with pandemic restrictions being replaced by geopolitical instability, rising inflation, muted economic output, and increasing political and economic uncertainty. The temptation is for the sustainability agenda to be pushed aside.

In this *Executive Insights*, we provide guidance on why now is the time to focus on sustainability, including:

- The importance of continuing sustainability agendas and avoiding postponing progress during the economic downturn
- What economic benefits sustainability can bring in this economic cycle and beyond
- Steps to ensure a pragmatic approach to the inevitable trade-offs in the context of uncertainty

Resist the urge to kick the sustainability can down the road — the time to act is now

The window to act on climate change is closing. The UN called this past year a "wasted" one in its October release of the Emissions Gap report, which revealed that the small, incremental changes implemented in the past year have had insufficient impact.[2]

A spate of new regulations will make it much tougher to kick the sustainability can down the road. European firms, for example, face more stringent measures under the Corporate Sustainability Reporting Directive, with its extended scope now covering all large or listed companies.[3] The UK, meanwhile, has this fiscal year become the first G20 country to mandate that its largest businesses disclose climate-related risks and opportunities.[4] Consequently, corporates are increasingly being compelled to report the actions they are taking regarding sustainability. This is no longer a 'nice to have' — it is a must-have.

There are also potential benefits to being a sustainability leader. Attracting talent, driving top-line growth (e.g. through share gain, product opportunities), saving costs and having greater access to financing are all benefits associated with a strong sustainability position. However, given the competing priorities with economic headwinds and several fundamental challenges to tackle, many companies may be questioning whether now is the best time to act on sustainability.

Double down on sustainability to ride out the economic downturn and improve long-term health

Despite these challenges, we have outlined five areas where prioritising sustainability will not only help businesses ride out the downturn, but also position them to thrive in the post-recession rebound. Importantly, acting now can help set businesses up for long-term success.

1. Managing — and exceeding — stakeholder expectations

Expectations across multiple stakeholder groups have shifted, putting pressure on companies to respond.

More than ever, customer expectations are shifting towards sustainability and, consequently, placing pressure on businesses to adapt. Having environmental, social and governance (ESG) programmes in place was found most likely to influence brand loyalty in 65% of millennials and 49% of baby boomers.[5] Business-to-business (B2B) firms are also feeling the pressure from their own customers seeking to progress their own sustainability agenda. With 68% of listed corporates in continental Europe and the UK tying executive incentive plans to at least one ESG metric,[6] it is clear that shareholders value accountability on sustainability issues.

Suppliers, too, are feeling the brunt of the sustainability agenda. With scope 3 emissions targets gaining scrutiny,[7] supplier engagement is becoming increasingly common as companies try to reduce carbon emissions across their entire value chain. Within pharmaceuticals, for example, GSK launched its Sustainable Procurement Programme in September of 2022, pushing its suppliers to disclose emissions and set carbon reduction targets.[8] Jaguar Land Rover, meanwhile, invited its entire global tier 1 supplier network to commit to Science Based Targets initiative (SBTi)-approved targets to reduce greenhouse emissions by 2030. The stringency of mounting regulatory pressures is driving companies to get moving.

2. Attracting and retaining talent against the backdrop of 'quiet quitting' and the 'great resignation'

The challenge for firms to attract and retain the best talent remains greater than ever, as the pandemic by-products of the 'great resignation' and 'quiet quitting' remain prevalent.[9] In fact, many firms have cited lower engagement and decreased productivity following the return to the workplace.[10] Some industries have struggled to recover from the pandemic as they have simply been unable to rebuild their workforces fast enough. In the travel and tourism sector, for example, over 200,000 jobs across the UK are still expected to remain vacant by the end of the year.[11]

A heightened prioritisation of sustainability can help with talent acquisition, engagement and retention. Today's jobseekers value sustainability: In a recent study, nearly 40% of millennials stated they had accepted one job offer over another because the company was more environmentally sustainable.[12] Over the longer term, this trend holds great significance for firms, particularly in enabling companies to recover effectively following a downturn. With millennials and Generation Z forecast to comprise 72% of the world's workforce by 2029,[13] there is an increasing necessity to align with their value sets.

3. Top-line opportunities and future-proofing

When the macroeconomic environment is uncertain, protecting and building long-term top-line growth is critical. Sustainability can underpin top-line revenues through several levers — new products and services, price premiums (in some instances), and market share (defensive and offensive). In L.E.K. Consulting's Global Corporate Sustainability Survey this year, 66% of surveyed businesses viewed sustainability as a major commercial and growth opportunity.[14]

To start with, ESG-linked product and process innovation can drive brand advantage and competitive differentiation, boosting top-line sales. Large companies which have focused on sustainability in the past three years, for example, have been growing sales at twice the rate of those not committed to sustainability.[15]

In some sectors and product niches, sustainability can also help drive top-line growth by targeting customers' willingness to pay and capturing a 'green premium'. In the US, 75% of millennials indicated they are willing to pay more for sustainable products[16] — though this is not always translated into action. In most cases, however, strong sustainability credentials can at least help defend price position and justify passing on inflationary cost pressures, which is especially key in the current economic situation.

Further down the supply chain, investing in sustainability can help companies solidify their position as suppliers of choice. Large original equipment manufacturers (OEMs) are increasingly auditing their supply chain to ensure compliant ESG practices throughout, with the Carbon Disclosure Project recording a 24% increase globally from 2019 to 2020 in large-scale purchasers asking suppliers to disclose environmental data.[17] As a result, suppliers will increasingly need to implement and provide evidence of sound sustainability measures. Doing so can help position them as primary suppliers, hopefully boosting sales, but at a minimum preventing share erosion.

Fundamentally, to protect long-term top-line growth, companies delaying sustainability run the risk of losing sales and customers to those that do place sustainability at the heart of their strategy. Opportunistic firms may even stand to benefit from the ESG shortcomings of rivals and take market share.

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4. Securing cash flow by managing — and optimising — costs

Robust cash flow and careful management of operating costs have always been critical to a business's financial health. The current economic reality has shone an even brighter spotlight on this.

Improving energy efficiency is one lever, for example, by which ESG initiatives can help reduce operating costs — and there are short-term wins available. Walmart, for example, is on track to save $100 million annually simply by centralising how it maintains the equipment in its stores to be more energy efficient.[18]

Other ESG cost-cutting initiatives might include reducing material waste and associated costs and/or decreasing packaging and material inputs. As one example, PepsiCo saved over $20 million a year on utilities and other expenses by treating and recycling water from

its production process.[19] Furthermore, Dell has managed to cut its packaging bill by more than $18 million using new packaging materials (e.g. biodegradable mushroom solutions), thereby cutting 20 million pounds of weight from its supply chain.[20]

While investing in sustainability can require upfront capex, this may be outweighed by offsets from opex. Companies are encouraged to consider trade-offs holistically in light of potential achievable savings.

5. Standing out to investors in a time of need

Firms may need to rely more on external public and private funding to weather the storm. Increasingly, access to funding (both debt and equity) can be enhanced for companies with strong ESG credentials and, conversely, be constrained for companies with weak ESG credentials.

Eighty-seven per cent of businesses now say they feel pressure from investors to increase their ESG reporting.[21] The year 2021 saw green, social and sustainability bonds reach a new global record of over $700 billion in issuances, almost double the 2019 total.[22] Moreover, global ratings agencies now incorporate ESG metrics when underwriting credit ratings.[23]

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When it comes to government support, the green agenda is very much top of mind. The UK, for instance, has earmarked nearly £5 billion of funding to help and encourage domestic businesses to become greener.[24] Meanwhile, on the continent, the EU's Innovation Fund will provide funding of up to €10 billion until 2023 for green projects which contribute to greenhouse gas reduction.[25] Government help is not restricted to funding; it also includes tax breaks and tax-eligible deductions. In the UK, the Climate Change Agreements enable companies in energy-intensive industries to benefit from a reduction of up to 92% on the Climate Change Levy.[26]

With all this emphasis on green funding and investments, financial regulators have unsurprisingly commenced a crackdown on greenwashing. Forty-four per cent of investors cite investments not being what they claim as their biggest worry when it comes to ESG investing.[27] In light of this, the Securities and Exchange Commission (SEC) in the United States, for one, has proposed strict climate disclosure requirements, for example, mandating that funds with names including "green" or "sustainable" disclose how their investments

satisfy such descriptions.[28] The UK's Financial Conduct Authority made a similar move in October 2022.[29] It goes without saying that, more than ever, firms need to show real, credible commitment to sustainability. They can no longer get away with hiding behind marketing campaigns.

The prioritisation of sustainability activities requires a clear and pragmatic approach

With a multitude of possible ESG initiatives, companies may not know where or how to begin. Additionally, because many companies lack sustainability domain experience, it is hard to gauge which initiatives may yield high returns despite significant upfront costs and which may not be worth pursuing.

It is worth noting that companies which have sought to do the right thing from an environmental standpoint (i.e. prioritise environmental impact despite upfront costs) have often been rewarded financially in the long term. For example, companies which switched to renewable energy a few years ago are at a cost benefit today as gas prices skyrocket and the cost of renewables falls faster than expected. On the other hand, companies which delayed such initiatives have lost out — like UPS, which waited to move to an electric fleet.[30] To move from high-level sweeping sustainability commitments to actionable progress with tangible effects, companies can adopt simple prioritisation criteria which consider key benefits and trade-offs.

Figure 1
Guidance steps for prioritising ESG initiatives

Step	1 Identify	2 Assess	3 Weight and score	4 Shortlist activities	5 Sequence and implement
Objectives	• Identify possible ESG initiatives via brainstorming and regulatory/ competitor benchmarking • Initiatives can include both 'reducing the bad' and 'increasing the good'	• Introduce assessment dimensions to help guide prioritisation of initiatives with key benefits and trade-offs in mind • Assess trade-offs of cost/benefit • Further detail in Figure 2	• Weigh the assessment dimensions to the needs and capacity of the business, as well as its maturity and broader market • Score initiatives based on weighted criteria	• Shortlist initiatives based on weighted scores • Overlay additional 'lenses' to scrutinise options (e.g. in recession, likely lower capex emphasised) • Consider timing implications of initiatives — time to implement and time to realise impact • Consider and flag dependencies of different initiatives to aid in appropriate sequencing	• Set up robust roll-out strategy • Implement selected initiatives • Track progress

Note: ESG=environmental, social and governance
Source: L.E.K. research and analysis

Figure 1 offers a guide to how one might approach the prioritisation (as referred to in Steps 2 to 4). Whilst the first step of identifying potential ESG initiatives might be self-explanatory, it is worth noting ideas can be sourced internally or externally via observation of the broader marketplace. Initiatives can also be as much about reducing the bad as they are about increasing the good.

Prioritisation is difficult without further dimensions on which to base decisions. This is where the second step comes in (also depicted in Figure 2). We have identified some dimensions for key benefits and trade-offs of initiatives against which organisations can make an assessment. The key benefits follow the five main areas outlined earlier in this article (i.e. how ESG investment can improve financial health), as well as an added dimension for sustainability impact. This then affords a well-rounded, holistic view of benefits and considerations involved and ensures that chosen initiatives generate meaningful impact across these areas.

Figure 2
Example considerations when prioritising initiatives

ILLUSTRATIVE AND NON-EXHAUSTIVE

Key benefits

Categories	Stakeholder management	Talent	Top-line growth	Cost reduction	Access to funding	Sustainability
Example considerations	• Will this support in achieving ambitious mid-term targets? • Will this help us better engage our suppliers? • Will pursuit of this initiative be viewed as genuine and credible?	• Will pursuit of this initiative 'excite' our organisation? • Is this going to result in increased alignment to jobseeker values? • Can we become the employer of choice in this sector?	• Will we be able to justify a 'green premium' following this initiative? • Will we be able to attract more customers? Increase share of wallet? Avoid share erosion? • Will our ability to operate in more jurisdictions be enhanced following this initiative?	• Do we stand to achieve a one-off cost saving? • Do we stand to benefit with ongoing cost savings? • Will we achieve a significant cost advantage vs competitors?	• Do we qualify for additional public funding via grants and subsidies? • Will investor recognition yield additional opportunity for capital? • Will the cost of our borrowing be lowered?	• Will there be measurable reduction in greenhouse gas emissions, energy consumption or water usage? • How will we monitor our sustainability impact? • How will measures of success change over time?

Trade-offs

Categories	Capex	Opex	Skills	Strategic fit
Example considerations	• What is our current and expected financial condition? • How long is the payback period? • When is the breakeven point?	• What is our current and expected financial condition? • Is this opex going to increase over time? • Are there other costs we need to prioritise?	• Do we have the right skill sets internally? • Do we need to hire externally? • Do we have enough resources available to implement?	• How important are these initiatives for our organisational/ portfolio strategy? • Are these initiatives compatible with our brand and longer-term ambitions?

Source: L.E.K. research and analysis

The assessment of trade-offs follows four identified levers: capex, opex, skills and strategic fit. These trade-off dimensions help ensure initiatives are adapted to and work within a firm's current financial, technical and organisational capabilities, as well as meet strategic ambition in both the short and long term.

Step 3/Figure 1 helps drive the prioritisation further as organisations tailor the process to their circumstances by considering their own situations via the assignment of relative importance or weight and then scoring on a relative scale (e.g. 1-5), for both the key benefits and trade-offs. The weighted sum helps rank possible initiatives.

Step 4/Figure 1 provides a lens through which an organisation can consider prevailing business conditions (e.g. in today's economic climate, flagging large upfront capex). This overlay step allows organisations to stay nimble. As with any programme management, understanding the time to impact of certain initiatives, as well as their interdependencies, is crucial. Keeping an appreciation of the sequencing of initiatives makes both strategic and practical sense.

In the final Step 5/Figure 1, shortlisted initiatives undergo thorough due diligence, and internal board-level buy-in must be secured. When it comes to actioning, tracking progress is crucial to helping smooth future processes and build internal sustainability experience and capabilities.

These steps will help reduce a substantial number of possible initiatives to a more manageable shortlist of attractive and feasible activities.

Conclusion

In summary, despite short-term economic pressures and headwinds, now is not the time to stand still on the sustainability agenda. When considering growth, costs, stakeholder needs, access to funding and talent, it is important to adopt a longer-term vision, and sustainability is a central part of this. Investing in sustainability presents not only multiple short-term benefits which can help weather the economic downturn, but also numerous benefits for long-term growth, increasingly aligned with stakeholders' (customers', investors', governments', suppliers') values — and needs.

For more information, please contact strategy@lek.com.

Endnotes

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