A new business case

How can companies embed sustainability into their operations while also delivering ongoing returns for their investors?

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For many years the prevailing belief was that companies and investors who cared about sustainability were helping to make the world a better place but were giving up financial returns. This framing pitted the tree huggers against the hard-nosed capitalists. It was largely false and played off of stereotypes on both sides.

The world has changed. Research by academics, companies and investors continues to mount, showing that there is no inevitable trade-off between sustainability and financial returns. In fact, sustainability can actually contribute to superior financial performance for both companies and investors. The key to demonstrating this is moving beyond a broad notion of sustainability to one more focused on the material environmental, social and governance (ESG) criteria that create both downside risk and upside opportunity.

Here the non-profit Sustainability Accounting Standards Board (SASB),

▲ **A textile workshop in Narayanganj, Bangladesh. Fair labour practices and good governance of supply chains can make a major contribution to SDG 1 (no poverty) as well as SDG 8 (decent work). Until the Rana Plaza tragedy in 2013, most businesses sourcing textiles from Bangladesh had turned a blind eye to working conditions** founded by Jean Rogers in 2011 and for which I was the Founding Chairman, has made an important contribution. It has identified – for 77 industries organised into 11 sectors – the material ESG issues which affect financial performance. This information is publicly available for free in SASB's 'Materiality Map'.

The map identifies which of 26 ESG issues are 'material' for these 77 industries. The issues are organised into the categories of environment (six), social capital (seven), human capital (three), business model and innovation (five) and leadership and governance (five). The definition of materiality is 'what matters to investors'.

In a world of systemic risks coming from climate change, resource scarcity, income inequality and global supply chains, mainstream investors have come to recognise the value and relevance of ESG. A rigorous academic study *Corporate Sustainability: First Evidence on Materiality* by Mozaffar Khan, George Serafeim and Aaron Yoon of Harvard Business School used SASB's work to show that companies performing well on the material ESG issues for their industry had superior financial performance, measured in both accounting metrics and stock returns.

Material issues and the SDGs

While this addresses the false myth that sustainability is the same as philanthropy, it also begs the question of whether companies are making the world a better place, such as seen through the lens of the 17 Sustainable Development Goals (SDGs). This is what the world cares about, as opposed to what investors care about. Yes, investors increasingly care about the state of the world in which they must earn returns for their beneficiaries. But do material ESG issues for investors have any relationship to the SDGs?

This is a critical question, since it is expected that the private sector needs to invest $2.5–3.0 trillion per year for the 2030 goals to be met.

To address this question, Professors Gianni Betti and Costanza Consolandi of the University of Siena and I mapped all of the material issues for each of SASB's 77 industries to the 169 targets of the SDGs. We published our results in *The Relationship Between Investor Materiality and the Sustainable Development Goals: A Methodological Framework*. What we wanted to find out was whether the ESG issues that matter to investors could contribute to achieving the targets of the SDGs that matter to the world. We found substantial evidence that this is indeed the case.

We also found a great deal of variation. Some sectors (for example, food and beverage, healthcare, and extractives and mineral processing) have much more impact on the SDGs as a whole than others (such as financial services, services and transportation). For financial services, it should be noted that this is just the direct impacts of the sector, not the much greater impacts it has through how it deploys capital.

Some industries have more impact on a given SDG than others. For example, biotechnology and agricultural products are high for SDG 3 (good health and wellbeing) while others, such as consumption and services, are low. There are SDGs for which the private sector as a whole can have substantial impact. The total impact across all sectors is high for SDG 12 (responsible consumption and production) and SDG 14 (life below water), but much less so for SDG 4 (quality education). For the latter, the public sector will have to do most of the heavy lifting.

Some of SASB's material issues have more of an impact on a given SDG than others. For example, the environmental issues of energy management and fuel management are very important for SDG 7 (affordable and clean energy). But the social capital issue of access and affordability and the business model and innovation issue of environmental social impacts on assets and operations are less important.

For SDG 1 (no poverty), the human capital issue of fair labour practices and the leadership and governance issue of supply chain management are very important. However, the business model and innovation issue of environmental social impacts on assets and operations and the leadership and governance issue of accident and safety management are much less so.

Five-step process

So what does this mean for a company that wants to make as much contribution to the SDGs as it can while also providing returns to its shareholders? This can be done through the following five-step process.

In a world of systemic risks coming from climate change, resource scarcity, income inequality and global supply chains, mainstream investors have come to recognise the value and relevance of environmental, social and governance issues

First, the board of directors needs to publish a 'Statement of Purpose'. In this, the board articulates its intergenerational view of the company's role in society. If the board believes the company's only role is to provide steady short-term returns to shareholders, it should simply say so. It can make that judgement as the board. This is the 'purpose is profit' perspective.

But if it believes the company has a broader role to play in meeting the needs of an identified set of stakeholders (it can't be all of them) and that in doing so it enables the company to provide long-term returns, it should identify who these stakeholders are and the time frames under which it will evaluate the impact of the company's decisions on these stakeholders. This is the 'profit through purpose' perspective.

Second, senior management needs to identify what it regards as the material ESG issues of interest to shareholders and then map these to the targets of the SDGs. SASB can be used as a guide, but ultimately each company needs to make this determination for itself. No company can address all the SDGs, or even all targets within one or two SDGs. Any company, no matter how large, has limited resources, so it must therefore have a clear focus on where it wants to have impact.

Third, senior management needs to communicate externally, such as through an integrated report. The report should set out the company's material issues, the SDGs and the targets for which they are relevant. It should also set goals on all of these and report on the company's ESG and impact performance. ESG performance is about a company's activities and operations, and can be reported on from data generated inside the company.

Impact performance is about the externalities the company is creating in the world and requires data from outside the company to put ESG performance in context. For example, there is more positive impact from a wind farm in a region of coal-fired utility plants than one in a region of hydropower. Impact measurement and reporting is still in its infancy but the work of the Impact Management Project can be helpful here.

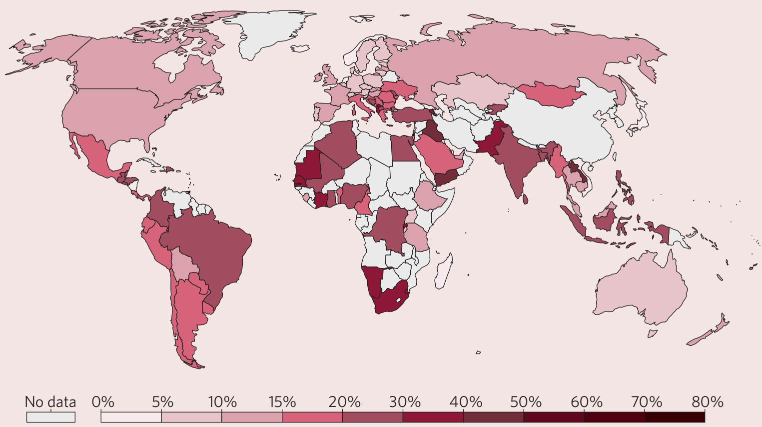
Fourth, the board of directors needs to set senior executive compensation so that it is aligned with the goals and metrics derived in the third step. If senior management is only evaluated and rewarded on financial performance, it is unlikely that these other objectives will be achieved. It is also likely that management will be more focused on the short term. Fifth, senior management and the board need to engage with shareholders and other stakeholders on the company's statement of purpose and its commitments to the SDGs. Through engagement, the company will learn whether it is meeting the expectations of those on whom its own long-term sustainability depends.

Are these steps hard to take? Not in any technical sense. The challenge is in breaking out of the prevailing ideology of short-term profit maximisation. While that may reward current management, it is only taking money away from future generations of management and society as a whole. ●

8 DECENT WORK AND ECONOMIC GROWTH

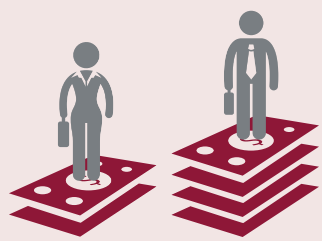
Promote sustained, inclusive and sustainable economic growth, full and productive employment and decent work for all

Share of young people (aged 15-29) not in education, employment or training

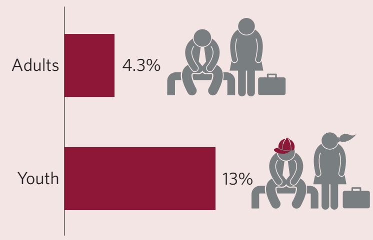


Source: World Bank

Earning inequalities are still pervasive: men earned **12.5 per cent** more than women in 40 out of 45 countries with data

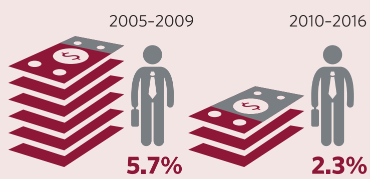


Youth were **three times more likely** to be unemployed than adults in 2017



61 per cent of all workers were engaged in informal employment in 2016

Real GDP per capita growth for LDCs in the period 2010-2016 was only **0.6 per cent higher** than the world average



Although there has been global improvement in labour productivity and unemployment rates, more progress is needed to increase employment opportunities for young people, reduce informal employment and address the gender pay gap

Source: The Sustainable Development Goals Report 2018, UN