The ESG Evolution:

Impacts on the strategic direction of businesses

Our businesses, economies and nations have experienced disruption from events such as the global economic crises and more recently the COVID-19 pandemic.

The world at large, though significantly impacted by these unplanned global events, continues to develop resilient measures in adapting to the effects of these unforeseen events whilst taking into account the growing prominence of environmental, social and governance (ESG) considerations.

The need for businesses to adapt to a changing world cannot be overemphasised, with a steady shift from the singular traditional focus on financial performance measures such as revenue and ultimately profitability to an increased awareness and importance of the processes businesses employ in delivering an output.

ESG, which encompasses environmental, social and governance standards for company operations, has seen increasing prominence in recent times and is expected to have a major impact on businesses.

While nations are putting in place ESG regulations, major funders are beginning to demand companies' ESG strategies and reports before committing to funding.

Stakeholders are demanding that businesses start measuring success not only in terms of profit, but also through environmental sustainability, employee engagement, external partnerships and societal impact. As a result, societal needs and business opportunities are coming together to transform the way companies craft strategy, drive performance and report results.

To operate successfully, businesses will be required to earn trust and deliver sustained outcomes for shareholders, stakeholders and the wider society. Even before COVID-19 upended business and society, the environmental, social and governance (ESG) movement was gaining steam. Far-reaching challenges such as climate change and economic inclusion concentrated the minds of investors and executives on the importance of long-term priorities and non-financial reporting. Then the global pandemic heightened awareness of how interconnected we all are, how rapidly external shocks can work through the global economy, and how central trust and transparency are to the economy's operation.

These crosscurrents are expected to come together to propel the next wave of corporate transformation: the ESG transformation.

Like digital, ESG has the potential to revamp how successful organisations plan, implement and operate. Also like digital, ESG is a sprawling topic, making it challenging for organisations to know where to begin. In the case of digital, that uncertainty led many organisations to start small: they put a toe in, launching pilot after pilot—learning in the process, but also running the risk of being overtaken by more ambitious competitors who were quicker to grasp the opportunity to reimagine their business digitally.

Today, most management teams realise that capturing the true potential of digital calls for an all-in approach—a comprehensive programme in which digital touches all aspects of the company, every business unit and function. Digital does not just enable you to do the same thing faster—it changes what you do.

The same is true for ESG: it gets to the heart of why you are in business, who you are as a company, what your impact on the world is, how you align your business model with the needs of society, what you report, how you engage your people and with your stakeholders more generally. With digital transformation still a work-in-progress for most companies, the notion of tackling another big transition may seem daunting.

We would suggest, though, that deferring the ESG transformation creates the risk that as you rewire your company, you will hard-wire in old value creation models that cannot meet the concerns of your stakeholders and the long-term needs of your business. It also becomes increasingly likely that you will fail to manage very real and material risks and you will find yourself out of step with your shareholders.

An ESG strategy goes beyond simply having a detailed plan contained in a company's strategic document/plan or disclosures in annual reports. It entails embedding the core principles across the lifeblood of the organisation to create sustained value.

Companies must appreciate the perspective of transformation as an investment with returns that far outlive regular short-term initiatives and decisions.

To embark on this journey, decisions and initiatives must be inculcated in all functions of a company's operations. For example a company taking steps to make positive strides in its climate-related agenda may adapt its strategy, finance and incentives, technology, governance and reporting as follows:

Strategy

This can involve setting a clear ambition centred on bold targets, initially aiming for short-term operational emissions reduction targets and eventually planning to become a net-zero company by a target year based on a combination of absolute and intensity-reduction targets. To achieve these goals, the organisation will elevate sustainability to a strategic priority, and identify a set of supporting management interventions, such as a revamped planning process with sustainability at its core. To inform its strategic priorities, the company will need to conduct studies into new energy technologies, in areas such as wind, solar, batteries and hydrogen, along with emission reduction technologies such as carbon capture. Based on the insights from those findings, companies can develop a portfolio strategy out to 2050, showing the rate at which they would need to divest traditional businesses and power sources, and how quickly they would need to replace those with greener options. To create early options, companies may create a venture fund that could identify and invest in promising technologies, through straight investments in some cases and joint ventures in others.

Finance and incentives

Companies can also apply a sustainability lens to future capital investments. For example, before constructing a new facility, organisations had previously conducted traditional financial analyses such as net present value, so that they could determine if those facilities represented the best use of capital. In that analysis, the carbon component was relegated to an afterthought (an internal carbon-pricing mechanism). In driving the sustainability agenda, companies will factor in carbon in a more explicit way, for instance by changing the design and construction methods for new sites, to reduce emissions and support the sustainability goals. Management incentives may also be linked to sustainability performance. As well as creating a similar incentive structure for the entire workforce.

Technology

Digital transformation is not just an analogy for the ESG journey ahead; it is also an enabler of sustainable business practices. Cloud-based ERP systems may be developed to help other partners like suppliers and partners track and reduce their carbon impact as the bulk of a manufacturing company's carbon footprint is in the supply chain, not within the boundaries of the company itself.

Governance and reporting

Companies can make use of technical experts to engage directors on a personal level, answer their questions and clarify technical issues underpinning proposed investments. Companies can change their approach to future modelling for the board, no longer looking solely at financial performance but adding a carbon component. That more holistic measurement approach also influences company reporting, to become significantly more transparent, with a clear definition of sustainability goals and regular updates on progress towards meeting them. The non-financial reporting dimension represents an important difference from digital transformations: in ESG transformations, stakeholders such as investors, regulators, non-governmental organisations, customers and employees will require far more transparency of companies.

Where companies are ahead of schedule in achieving sustainability objectives, those successes can have motivating effects for executives, employees and other stakeholders thereby directing their energies towards the next wave of progress and more ambitious targets.

In addition to the primary traditional focus on climate sustainability, ESG also encompasses societal issues in the same way and for the same reasons. Many companies are already working equally successfully to respond to these issues using the same approach. The ESG transformation journey will focus on both.
As with the digital journey, ESG momentum grows with successful pilots and quick wins that are connected to a bigger whole. Yet the parallels with digital go further. The business landscape is littered with dead and dying businesses that tried to implement digital transformations without thinking through the implications, leading to lost value, disgruntled customers, and executives shown the door. We predict the same for those that do not take a proactive and comprehensive approach to ESG transformation.

The effectiveness of a business' ability to adjust to changing societal values will be dependent on how strategy is determined, performance is managed as well as the metrics management deems valued for reporting internally and externally.

The journey around ESG, though assumed to be in its early stages, promises to be rewarding for companies. The success in this area will be dependent on the existing know-how of businesses and the resilience of management's plans in this area, with the following considerations at the forefront of discussions by management:

- Is ESG oversight and accountability driven throughout your organisation under executive / Board sponsorship?
- Is ESG embedded into your company strategy (including growth / maximising value)?
- Has tax been taken into account in your ESG strategy? If so, has it influenced your tax strategy and communication?
- Are you clear on stakeholder / investor requirements and the level of business model change needed?
- How are you achieving diversity and inclusion in your business?

PwC has specialised in supporting companies to walk this journey. We can set up a free one hour conversation to discuss what matters to you.

Want to know more? Let's talk. You can contact me by sending an email to edward.gomado@pwc.com