Is Being Sustainable Good for Business?

By: Claire Patterson January 2021

Introduction

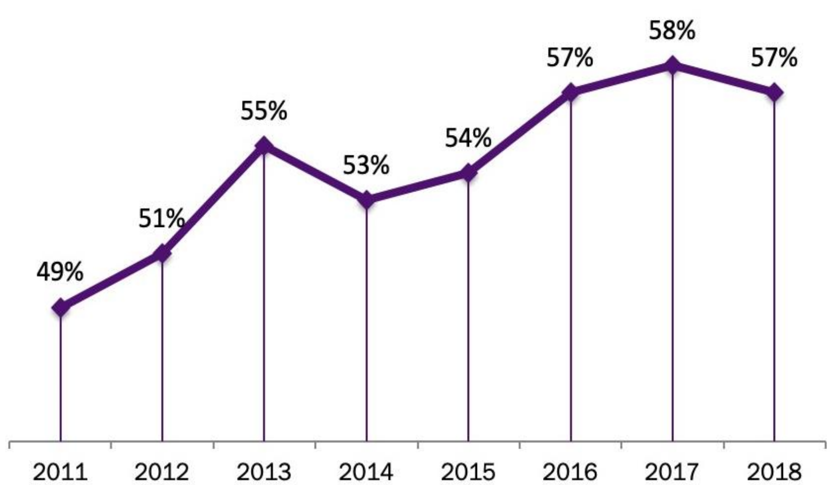
In the business context, sustainability encourages firms to prioritize the long-term environmental, social, and economic impacts of their decisions rather than solely focusing on the short-term profit or loss. With concerns about climate change intensifying year after year, this topic is positioned to be one of the most prominent global issues of the twenty-first century. As a result, businesses face growing pressure to practice corporate social responsibility and implement environmentally friendly practices. The 2015 Paris Agreement on Climate Change, the United Nations' 2030 Agenda for Sustainable Development, and other recent international campaigns all encourage markets and businesses to become greener.

"Developing a corporate culture of sustainability should be understood as a source of competitive advantage for companies in the 21st Century."
– John Danilovich, Secretary General of the International Chamber of Commerce, 20/08/2015

However, there is debate about the effects of a transition to a more sustainable business strategy on a firm's financial performance and strategic direction. Research indicates that (1) consumer preferences are shifting in favor of eco-friendly products and services and (2) companies that score high in Environmental, Social & Governance (ESG) criteria tend to outperform their less sustainable peers. However, there are several common trade-offs and traps that must be mitigated and avoided when making this transition. Thus, while environmentally responsible business practices are undoubtedly becoming a new priority for consumers and investors, it is important to tailor sustainable strategy options to each company's specific position.

Consumer Preferences

Statistics show that people around the world are concerned about many ecological issues and are adjusting their purchasing habits to mirror these interests. A global survey conducted by Nielsen revealed that over 80% of respondents strongly believed that businesses should play a role in protecting nature. This viewpoint was relatively constant across different generational cohorts, genders, and regions. In Canada specifically, the 2014 Tork Green Business Survey revealed that 86% of Canadians were buying green, and 43% were willing to pay higher prices for



Percentage of global Internet users who say they would pay more for sustainable / eco-friendly products. Source: Global Web Index.

goods that are ethically produced. The chart besides clearly shows consumers willing to put more dollars to support the environment.

Thus, companies should expect these ideals to be reflected in purchasing trends as consumers use their buying power to support firms with similar values. Companies can increase their sales, improve reputation, and boost customer loyalty by investing more resources in sustainability efforts. Indeed, as consumer preferences continue to prioritize responsible operations, companies that fail to adapt are at a competitive disadvantage.

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Financial Performance

Defining ESG

Socially responsible investing often involves the consideration of environmental, social and governance (ESG) factors when evaluating investment opportunities. Historically, investment decisions were made on the basis of financial success, and criteria such as revenue and debt ratios were highlighted. Conversely, ESG criteria account for a wide array of issues that are not included in traditional financial analyses but may be relevant to the decision-making process. Examples include evaluating the effectiveness of a firm's health and safety policies, how it responds to climate change, and whether the company culture is conducive to trust and innovation.

Sustainable Investing Advantages

The popularity of ESG investing is on the rise as more and more studies linking corporate sustainability efforts with attractive financial performance are published. Out of 2,200 studies focused on ESG investing, 90 percent concluded that ESG practices had either a positive correlation with overall financial performance or at least no correlation with any harmful ramifications. In Canada specifically, 74% of sustainable funds outperformed their more traditional peers over the first quarter of 2020. Several other notable benefits are listed below:

Higher cash flows – According to Harvard Business Review, from 2006 to 2010, the top 100 sustainable global firms saw significantly higher cash flows from operations compared to control companies

Higher return on invested capital – A report by Vontobel Asset Management found that the top quartile of ESG firms consistently enjoy ROICs that are 5-10 percentage points higher than those of the bottom quartile

Stronger share price performance – Companies that scored in the top third on ESG criteria outperformed stocks in the bottom third by 18 percentage points, per a report by The Wall Street Journal

Lower stock volatility – According to Bank of America Merrill Lynch, firms with the best ESG ratings saw the lowest (32%) earnings per share volatility in the following 5-year period, compared to 92% volatility experienced by the worst-rated firms

Lower operating costs – An Oxford University & Arabesque Asset Management literature review found that 90% of the studies examined concluded that ESG practices lowered the cost of capital for firms

Lower probability of bankruptcy – Per Bank of America Merrill Lynch, an investor who only held stocks with above-average ESG scores would have avoided 90% of bankruptcies that occurred between 2008 and 2016

Thus, corporate sustainability is financially motivated in two ways. First, investors are increasingly using ESG standards to gauge the reliability and profitability of investment options, so companies need to improve their sustainability efforts in order to secure more funding. Second, the favorable relationship between financial performance and ESG factors means that prioritizing sustainability can help a firm gain market share and optimize its competitive position. Although it will take time and training to fully transition to a system that emphasizes long-term resilience rather than short-term profits, this trend is undoubtedly influencing the financial aspects of the business sphere.

Trade-Offs & Traps

If sustainable business practices were universally beneficial, there wouldn't be a global debate about whether or not they are a smart strategic decision. While consumer trends and financial data suggest that eco-friendly initiatives are good for business, there are several potential disadvantages that are worth exploring too.

High Costs

Correctly and effectively reducing the environmental impact of a company's operations typically requires expensive investments that might not pay off for a while. For example, consider a firm that produces clothing and other textile-based goods. Becoming more sustainable could entail supply chain reorganization to prioritize fabrics that are responsibly grown, or perhaps even the installation of renewable energy infrastructure in the company's stores and warehouses. These changes would likely benefit the firm in the long run, but those initial costs can be difficult to afford or prioritize. Also, despite increasing amounts of evidence and industry buzz about sustainability, not all consumers are interested in these topics. As a result, firms must continue to educate the public about the benefits of sustainability, a responsibility that can lead to higher marketing costs.

The Pitfalls of Greenwashing

Greenwashing, a process in which products or services are marketed as more environmentally friendly than they actually are, is a trap that firms often fall victim to. This tactic misleads consumers and enables firms to capitalize on shifting market trends without having to invest the resources required to actually become more sustainable. The practice is illegal in Canada and many other nations and can result in regulatory fines, bad publicity, and decreased consumer trust.

Lessons from the Volkswagen Emissions Scandal

In 2015, the U.S. Environmental Protection Agency discovered that many of Volkswagen's cars possessed software that could sense when the vehicle was being tested and improve performance accordingly. This enabled the firm to receive favorable scores on emissions tests and market their cars as an eco-friendlier option, despite the cars actually emitting much higher amounts of pollution. The scandal resulted in billions of dollars of losses, widespread negative publicity, and a stock price that has still not recovered to its pre-scandal level. This case highlights the legal and branding consequences that can emerge from a false commitment to sustainable practices.

A Time-Intensive Transition

Successfully integrating sustainable practices into daily operations requires long-term planning and synchronization with the firm's overall strategic goals. Environmental and social responsibility doesn't happen overnight, for most if not all sectors of the company must make adjustments to meet new operating and reporting standards. This is such a monumental task that more and more businesses are hiring a Chief Sustainability Officer to oversee the creation and execution of a corporate sustainability strategy. Major companies such as P&G, Mastercard, Tyson Foods, and Ralph Lauren have all made this addition to their C-suites.

Stakeholder Alignment

Reaching consensus on if and how the business should adopt sustainable practices can also be challenging. Each stakeholder has a unique set of priorities and expectations, and firms must be able to balance these various interests and respond to concerns effectively in order to prevent internal conflict and ensure long-term stability.

The Small Business Consideration

Although the aforementioned factors present a challenge to all firms, their disadvantages are particularly acute for small businesses. These companies have far fewer resources than massive corporations and may struggle to absorb the additional costs associated with transitioning to sustainable operations. Considering that around 99.8 percent of Canadian businesses qualify as small- or medium-sized enterprises, the limitations they face serve as a significant hurdle for the industry as a whole.

Final Thoughts

When considering the advantages and challenges associated with corporate sustainability, it is clear that a successful strategy must be tailored to each company's business model and specific needs. Also, the importance of authenticity, transparency, and advocacy cannot be overstated. Sustainable operations require significant resource investments by firms, and those efforts will only be profitable with the support of consumers and financial institutions. Firms that can implement a sustainability program that is tailored to their unique position and effectively communicate the benefits to stakeholders will most successfully capitalize on the internal and external opportunities.

Is sustainability central to your strategic planning efforts?

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