Making Every Step Sustainable

Leadership pathways to sustainability transformation

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Introduction

Today, six years after the Paris Agreement, sustainability has clearly become a topic with an immense daily presence in national and global business discussions – even among the ones that earlier omitted it altogether. Sustainability and ESG have gained increased traction and awareness among investors, boards, corporate leaders, employees and consumers, as well as among public sector decision makers and non-governmental organizations.

The purpose of this publication is to further familiarize leadership with the thought and methods applicable to sustainability transformation. Some organizations are already far advanced, while others are currently taking their very first steps. However, in all organizations the leadership has been compelled to re-evaluate their strategies, business models, operations and investments in new ways.

We invite you to participate in a business-critical journey. "Making Every Step Sustainable" starts by examining the operating environment, its risks and opportunities, continues by assessing the strategies and leadership approaches necessary during a transition, and concludes with proposals on implementing and maintaining change in the organization.

We invite you to participate in a business-critical journey.

In this Thought Leadership discussion, sustainability refers to the corporate responsibility of companies, i.e. how companies can act responsibly in society and undertake activities that relate to ESG. Investors also take ESG factors into account when investing in companies.

Thought Leadership builds on the launch of KPMG IMPACT, KPMG sources and publications, and a management research challenge (hereinafter referred to as "the study") prepared for the Henley Business School in 2021.[1]

[1] A total of 44 one-on-one interviews were conducted. The sampling was based on the assumption that the drivers of ESG transformation might be different in companies representing different sizes, industries and ownership. 25% of the interviews represented the views of middle management and 75% the views of senior management, the board, or business ownership.

Main conclusions

In pathfinder organizations, the leadership has a high level of ambition and the necessary capabilities to drive sustainable growth. All stakeholders matter, but the leadership plays a crucial role in determining the direction and pace of change. Investing in leadership with the vision and the capability and courage to navigate in changing environments will pay off.

But what constitutes good leadership in sustainability transformation?

Sustainability transformation is wide-ranging and fast-paced. High performing leaders invest time in analysing and understanding ESG trends and signals in the business environment. They gain insights into how ESG impacts business and have the courage to make decisions needed and act accordingly.

Leaders create a culture that supports sustainability transformation by reinforcing joint values and shared business goals. Leaders can motivate their people to work together, can create purpose, belief and a commitment to the ESG journey. Seamless co-operation with stakeholders and ecosystems during the sustainability transformation may deliver the desired competitive edge on the market.

Good leaders can utilise ESG data when formulating company strategies and assessing the impact of actions. At this point the shared narratives will start to show the significance and influence of successful sustainability transformation on business performance and value creation. Leaders consistently organise adequate resources to reach the strategic goals set within the sustainability transformation.

Based on study interviews most leaders recognize that ESG should be included in their present corporate strategy. If separate ESG strategies are prepared, these should align with the business strategy. However, some directors still aim for short-term value maximisation. The KPMG 2021 CEO Outlook revealed that in total 24% of the CEOs believe that ESG programmes may even impair financial performance. Due to the COVID-19 pandemic, high attention on climate change and other recent societal changes, the views of CEOs are evolving fast. Because of increased stakeholder pressures to rebuild the business back better, CEOs are embedding ESG into their business strategies.

Leadership facing changes in stakeholder demands

The business landscape is continuously changing and is characterised by different expectations and demands with respect to sustainability issues. The increased emphasis on ESG criteria means that companies need to serve not only their shareholders, but also a broader range of stakeholders, such as customers, employees, investors and regulators.

> **58% of CEOs report increasing demands from stakeholders — such as investors, regulators and customers — for more reporting and greater transparency on ESG issues.**
>
> *- KPMG 2021 CEO Outlook -*

> **56% of consumers report that the environmental and social practices of firms impact their decisions to buy from them.**
>
> *- KPMG Me, My Life, My Wallet 2020 -*

Consumer behaviour

In consumer transactions, the majority of consumers are willing neither to pay any extra for sustainable products or services, nor to compromise quality for sustainability. However, consumers expect that companies will take responsibility and will have no sustainability gaps in their supply chains. A failure to respond to these expectations can have a huge negative impact on company reputation.

For example, a current question in the textile industry is whether consumers are moving from fast fashion to a desire for a clothing rental market, i.e. rented fashion. The same kind of questions are prevalent in the domestic appliance and car industry. Future demand may emphasise value added services, where the product itself is only a by-product.

Business models in which the seller provides not only a product guarantee, but also the option of buying the product back, are already being introduced.

Businesses have a need to understand and predict customer behaviour. Today, data collected from consumers provides companies with the means of both raising awareness of consumer behaviour and gaining more detail. By leveraging this knowledge and establishing digital relationships with consumers, companies may create a better customer experience, more targeted marketing and gain a competitive advantage on the market. However, there will be an increased need for transparency in using the data and a commitment to protect personal information.

Future workforce

ESG has become an important factor in determining how successfully companies can attract, engage and retain employees.

Especially the younger generations are highly aware of environmental and social issues. Their interest in sustainability performance is constantly increasing – as well as their demands for transparency and their expectations that ESG issues will be properly addressed. Corporate responsibility, sustainability performance, "diversity – inclusion – equity" and company values will all be among the top criteria when "young talents" are seeking future positions and assignments.

Companies embrace their leadership role in combatting climate change; now they should mobilize the workforce for the challenge.

- Climate Change and the People Factor, Eversheds Sutherland & KPMG IMPACT 2021 -

Investors and regulators looking into ESG

Investors strongly prioritize companies that score highly in ESG ratings. The costs of finance are and will continue to be higher for those companies not managing all three ESG elements adequately.

Reporting

The financing and investment community (banks, investors, asset managers and rating agencies) factors ESG reporting into its assessment of corporate performance. An increasing number of today's investors take non-financial data as seriously as financial data.

At the moment, there is a lack of consistency and comparability with respect to basic ESG metrics. The number of sustainability standards, reporting frameworks, ratings and indexes is immense, and more are on the way.

- Initiatives such as the establishment of the International Sustainable Standard Board (ISSB) at the end of 2020[2] and the European Commission's proposal in April 2021 for a Corporate Sustainability Reporting Directive (CSRD)[3] will set extensive requirements on large companies' sustainability reporting in the coming years.

- The ISSB is working on IFRS Sustainability Disclosure Standards and is aiming to put sustainability reporting on the same footing as financial reporting with the goal to drive globally consistent, comparable and reliable sustainability reporting. Companies need to monitor their jurisdictions' response to standards issued by the ISSB and prepare for their potentially rapid implementation.

- Meanwhile the CSRD is requiring the company to report on forward-looking sustainability information, including strategy, targets and progress, among others.

[2] IFRS Foundation Trustees, 2021

[3] EC, 2021d

CSR Corporate Social Responsibility

TCFD Task Force on Climate-Related Financial Disclosures

UNGPBHR United Nations Guiding Principles on Business and Human Rights

SASB Sustainability Accounting Standards Board

UNFCC United Nations Framework Convention on Climate Change

CDP Carbon Disclosure Project

SBTs Science Based Targets

GRI Global Reporting Initiative

COP26 Conference of Parties (26th edition)

UNGC United Nations Global Compact

WBCSD World Business Council for Sustainable Development

SDGs Sustainable Development Goals

Examples of key reporting frameworks and initiatives.

Only a global set of standards for sustainability reporting will enable the private sector to make its full, and necessary, contribution to the creation of a sustainable society.

Klaus Schwab
Founder and Executive Chairmen of WEF

Brian Moynihan
CEO of Bank of America (2021)

Risk management

Investors believe that companies measuring, and reporting ESG risks are likely to be managing these risks better and delivering greater long-term value. At the same time, there is a world of commercial opportunities to be exploited, if businesses can adapt to current and future challenges. Failing in ESG related risk management can be severe. Examples of risks relating especially to ESG are:

Reputation - Based on the interviews, many of the organizations addressed reputation as an important driver for sustainability. Companies are today trusted to act responsibly, and therefore a company's reputation and brand can easily be destroyed if transparency is jeopardized.

Legitimacy Product Stewardship - In parallel with the reputational risk, the legitimacy product stewardship, i.e. the social and environmental impact of a product's supply chain throughout its lifespan, is increasingly gaining attention. The product stewardship includes aspects such as whether the raw materials are sourced responsibly, or whether products are recycled properly.

Access to and cost of finance - ESG factors are of increasing importance when financial institutions are assessing credit and market risk. Investors prioritize companies that score high in ESG ratings, indicative to resiliency and creation of longer-term shareholder value. The cost of capital may be higher for those companies not managing ESG appropriately.

Executives see their role in managing climate impacts expanding over the next three years.

- Climate Change and the People Factor, Eversheds Sutherland & KPMG IMPACT 2021 -

The World Economic Forum (WEF) annually prepares an analysis of the top global risks in terms of their likelihood and impact, by surveying global leaders (comprising a total of 841 responses for the 2021 survey).[4] The global risks for 2021 fall into categories such as economic, environmental, geopolitical, societal and technological risks. In terms of likelihood, four of the top five risks were related to the environment, while in terms of impact, three of the top five risks were related to the climate. A decade ago, in 2010, none of the top five risks reported by the WEF by likelihood or impact related to the environment or climate. It is vital that leaders pay extra attention to these risks in their business planning and find effective ways to communicate potential risks to stakeholders.

[4] According to the WEF study, a global risk is an uncertain event or condition that, if it occurs, can cause significant negative impacts on several countries or industries within the next 10 years. Environmental risks may cause increased business costs, disruptions in operations etc. Environmental changes may also provide opportunities for business.

Rank	Top Risks by Likelihood	Top Risks by Impact
#1	Extreme weather (Environmental)	Infectious diseases (Societal)
#2	Climate action failure (Environmental)	Climate action failure (Environmental)
#3	Human enviromental damage (Environmental)	Weapons of mass destruction (Geopolitical)
#4	Infectious diseases (Societal)	Biodiversity loss (Environmental)
#5	Biodiversity loss (Environmental)	Natural resources crises (Environmental)

Economic · Environmental · Geopolitical · Societal · Technological

Figure 1 - Top global risks for 2021 reported by the WEF

Examples of sector-specific pathways

Sustainability affects industries in different ways. Some industries are already highly regulated, or are being affected by new customer behaviour patterns, for example. Others are undergoing a process of enormous transition that are forcing companies to gain new competencies and to pursue disruptive innovations.

The steel industry

The steel industry's main aim is to make the production itself more CO_2-efficient. But how can decarbonization be enhanced in industries such as the steel industry? A global topic for the organizations interviewed is hydrogen, that is an efficient way to reduce feedstock usage and process-related CO_2 emissions. Companies in the steel industry are therefore currently undertaking large investments to reduce their own CO_2 emissions and to increase resource productivity.

> **Emission-intensive companies are heavily investing in new technologies. It remains to be seen how these investments will impact prices and competitive advantage.**
>
> *- Study interview -*

The construction industry

Cement and steel are the most commonly used building materials in the construction industry, and collectively contribute 15% of the total global greenhouse gas (GHG) emissions.

The study observed that the industry in Finland has also been affected by global pressure on its environmental footprint, due to its impact on climate change, resource consumption and water treatment. In response, wood construction is gaining popularity as an alternative building method in efforts to reduce the carbon footprint.

The recycling of construction materials is also a current topic in this industry. Future recycling of concrete may reduce construction costs while providing environmental benefits, such as keeping it out of landfills and replacing the use of gravel. Today, there are also technologies that make it possible to recycle insulation materials like stone, wood and rockwool, e.g. materials that some years ago ended up in landfills.

The energy industry

The energy industry is currently on a transition pathway from fossil-based to zero-carbon-based energy production, in which hydro, wind and solar energy generation will play a crucial role. Reductions in the amount of conventional electricity generation in which electrical energy is produced from coal, oil or natural gas or other sources, will pose a challenge in terms of ensuring sufficient inertia in the power system. Therefore, hydrogen and the synthetic energy carriers produced from it (power-to-X) will play an important role as a storage solution in any electricity system that is rooted in renewable energy sources.

Carbon neutrality in itself will substantially increase energy consumption. In the Nordics alone, it is estimated that the demand for electricity will increase by two-thirds by 2040. Thus, there will be a need to move to green energy and to introduce more energy-efficient solutions as well as a need to find alternatives for energy storage.

The forest industry

The accelerated structural decline in printing paper demand has caused a need for the forest industry to transition away from paper production. It has led to new product innovations, such as the usage of pulp as a raw material for textiles, and the usage of cardboard and paper for packaging, as well as replacing plastics in packaging, disposable plates and cups, etc.

As part of the launch of the EU's new forest strategy, there has been a debate on whether forests should be seen as a source of possible replacement of fossil fuels and thus should be used in everything from chemicals to energy, or whether forests should be treated as carbon sinks that are important for biodiversity.[5]

> **Finland is highly dependent on the forest industry. Decline in paper demand has forced the industry to introduce new ESG product innovations.**
>
> *- Study interview -*

[5] Financial Times, 6/2021

Future-proof leadership in sustainability transformation

Leadership plays a crucial role in deciding the direction a company will take and determining its progress on its sustainability journey. In the midst of transformation and a rapidly changing business environment, what are the key questions leadership should be asking? There are certain guideposts that will help companies to ensure that every step is sustainable.

Assessment

Understanding your starting point and options

Where are we today and where do we want to be in 2030? Such questions should be asked in all organizations in order to understand the magnitude of the gap between present and future aims. The approach taken by the leadership greatly influences an organization's ambition to enhance sustainable growth. The reactive or proactive approaches taken by leadership may be analysed through Willard's (2009) five-stage sustainability intake described below.

DEFENSIVE OR NO AMBITION

"It is not our job to fix the world

Companies in the first stage may cut corners and flout environmental and social regulations, for example. Intelligent companies move away from this stage in order to avoid fines, prosecution and public embarrassment. Others obey the law, but have no interest in sustainability topics, i.e. as long as something is not prohibited, all is OK. These companies may have a weak reputation in terms of social responsibility and their reaction to media criticism.

COMPLIANT

"We will fulfil the reporting requirements, but nothing more

The company acts within the law and regulations. It is not indifferent to sustainability, but it does not have any internal controls, nor plans to integrate sustainability into its organization, strategy, culture or processes.

MANAGERIAL

"Sustainability is a money-saving phenomenon for our company

The company moves to the managerial stage when it realizes that it can save money with proactive operational eco-efficiency, or at least avoid a public relations crisis and discourage new regulations. It reaps low-hanging fruits by, for example, reducing its carbon footprint by using renewable energy and energy-efficient solutions. The focus is on efforts where economic results can be gained fast. This stage may be further elaborated to prepare a sustainability strategy for development programs and to establish key performance indicators for sustainability topics. The objective is to manage risks and opportunities that emerge in operations.

STRATEGIC

"Sustainability provides us with opportunities and competitive advantages

Sustainability is integrated into the company's business strategy and is clearly endorsed by top management. The untapped, creative energy of the employees encourages the proposal and implementation of sustainability-orientated, revenue-increasing opportunities and expense-saving actions. Sustainability expectations are aligned within the company and across the entire value chain. What management may previously have viewed as green costs and risk, they now see as investments and opportunities.

Companies that have fully integrated sustainability into their operations have set future ESG targets and have prepared and communicated roadmaps establishing how they will reach their targets. Roles and responsibilities have been defined and KPIs have been chosen. Sustainability has been taken to an even higher strategic level voluntarily, and its impact on business is noticeable. A holistic view has been taken of the role of sustainability; it is now an integral part of normal business and the value chain.

"It is already obvious that our customers are willing to pay for ESG. The aspects that are more Important than price are quality, durability and energy efficiency. Things happen in the long run, and that is why continuous improvement is important. ESG is part of this development.

- Study interview -

PURPOSE-DRIVEN

"We want to make a better world

Purpose-driven companies contribute to a better world. They take some measures because they are the right things to do, and because these actions are also positive for the company. Sustainability is an integral part of their business strategy.

In purpose-driven companies, individual ESG actions are measured for further improvements, not for reporting purposes. These companies have the courage to act based on signals that are visible on the horizon, and therefore they also are better-prepared than others to address upcoming changes. They take conscious decisions to gain a desired position in future markets rather than decisions aimed purely at short-term profit.

"When responsibility is a value embraced by the company leadership, then it is visible and is truly integrated in our doings.

- Study interview -

Key question for leadership

At which stage of sustainability transformation is our organization?

Strategy

Strategic leadership

In sustainability transformation, companies need to have the courage to look into the future and acknowledge all the signals. Some of them may, at first glance, seem like a threat or a burden – but, if intelligently addressed, may turn into an opportunity. For some companies the transformation will lead to future success, while others will struggle to survive.

High-performing strategic leaders have the ability to

understand signals and trends and predict changes in their operating environment as well as the possible impacts – e.g. tightening regulation, opportunities arising from technological innovations, renewal of business models.

recognize and acquire the capabilities needed. This might involve the ability to apply circular economy skills to processes and systems, as well as to pricing models.

choose and make decisions, and at the same time assess the risks. Leadership has to be agile and willing to challenge the vision and strategic goals, if required. Starting a new business area or investing in a new business unit or technological solution might be risky and costly, but at the same time inevitable. Perhaps the competitors are already using recyclable packaging, selling closed loop products, using self-produced renewable energy, etc.

use the data during all stages of a change. Data is needed in both strategic and operational leadership. Competitive leaders gather data widely from different sources to increase their own knowledge and understanding. The challenge is to find the "right" data to be able to assess the impacts reliably, such as the impact of biodiversity loss on the business.

Key question for leadership

Are we sufficiently future-ready to act?

Transformation

Change management

Transformation is always a process that starts from acknowledgment and ends in reinforcing the change – making it stick. There are three things in particular to pay attention to.

First, good leaders are able to create a value-based culture that appreciates sustainability growth. In good leadership, values are part of the decision-making and daily work. Positive organizational culture is critical to achieving business objectives and goals, whether it is executing a strategy or undertaking change and transformation. In some organizations, an agile and experimental culture is the driving force for sustainable transformation. This will encourage people to innovate new solutions and products and thus the organization might end up with competitive advantages in the market.

Second, as the scale and scope of the sustainability transformation is immense, seamless cooperation as well as shared ambitions regarding the future state are required from various actors. Often companies are part of some networks, ecosystems or clusters that have a common goal. Good leaders use their networks and know how to motivate people to engage in discussions. They know how to utilize all the knowledge and skills available in the networks and how to promote their own values and interests, e.g. when discussing regulatory changes.

Third, good leaders have excellent communication skills. Continuous dialogue commits the parties to the change. Good leaders also know how to engage media and the wider society in the transformation.

Key question for leadership

How do we walk the talk?

Implementation

Organizations have collectively embraced the idea that financial metrics are not the only measures of success. Access to better ESG data is a crucial factor in helping the businesses of today achieve their ESG goals and ambitions, while meeting the expectations and transparency expected by a broad range of stakeholders. To date, many organizations still lack the means to truly seize the agenda because of difficulties experienced in collecting and managing ESG data.

Companies need access to more qualitative ESG data, i.e. broader-based information across the entire spectrum of their business activities, more detailed data, and more sophisticated tools for generating actionable insights.

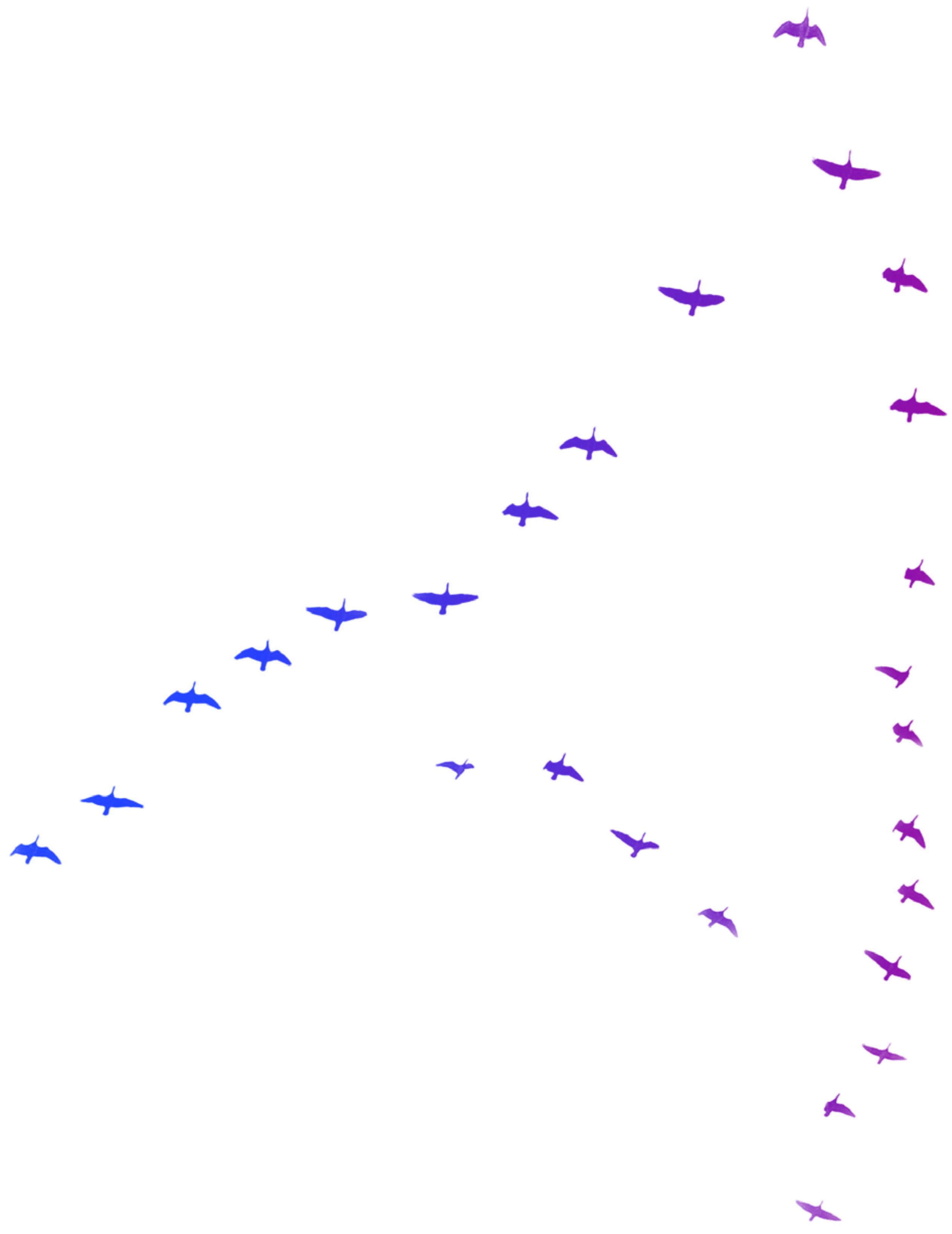
Good leaders can utilise ESG data in value-based discussions and when formulating company strategies and assessing the impact of actions. At this point the shared narratives will start to show the significance and influence of successful sustainability transformation on business performance and value creation.

Leaders can motivate their people to work together, and can create purpose, belief and a commitment to the journey. They will "make things happen" and consistently organise adequate resources to reach the strategic goals set within the sustainability transformation. The expectations of sustainable growth are met by good leaders and leadership.

> **In business what you cannot measure, you cannot change. That is why ESG-focused metrics and evidence-based data are important.**
>
> ***Bill Thomas***
> *Global Chair & CEO,*
> *KPMG International*

Key question for leadership

How successfully are we reaching our targets; what progress are we making?



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