

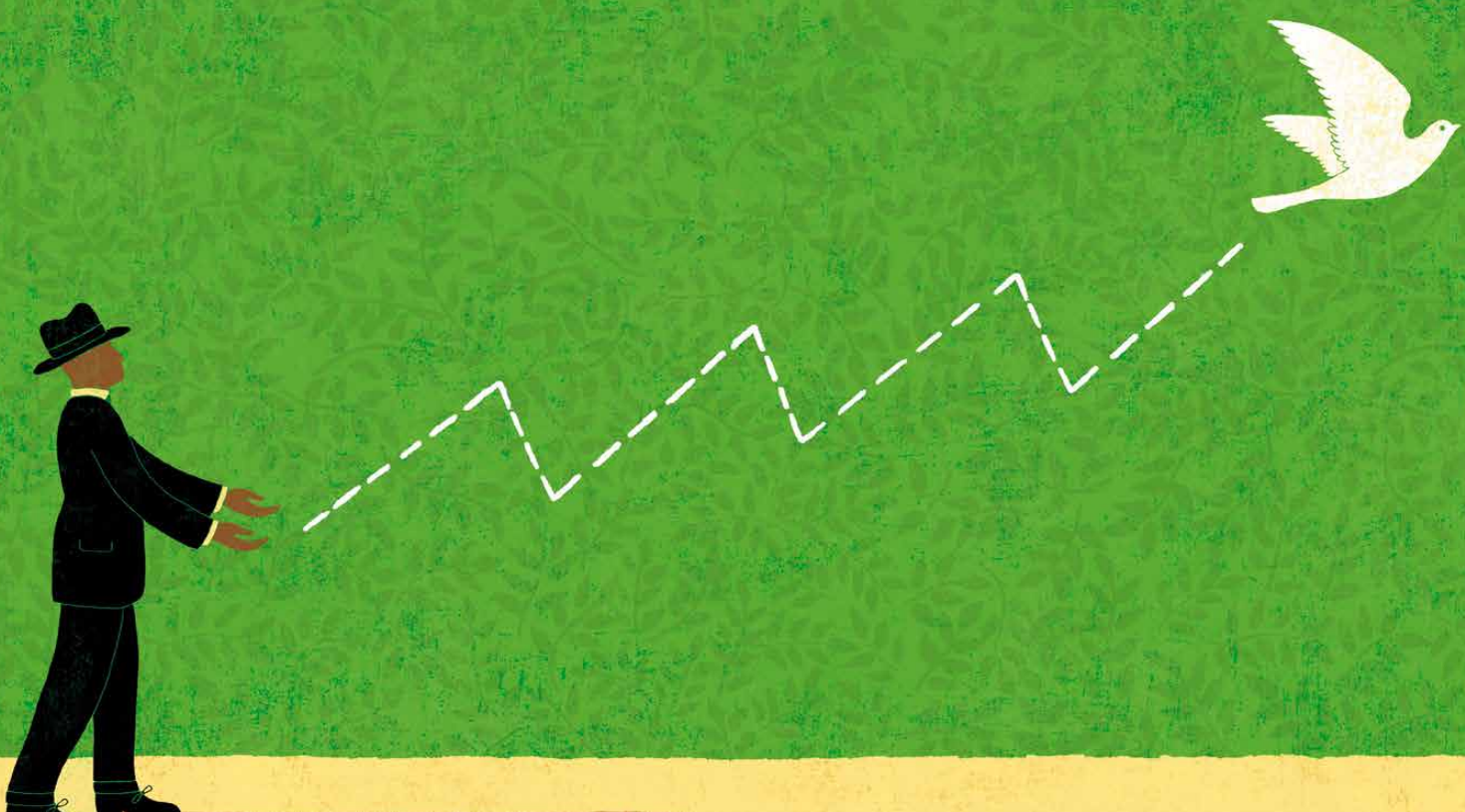


Illustration by James Steinberg

Profits with purpose:

How organizing for sustainability can benefit the bottom line

Becoming a sustainability leader requires big changes, but the effort is worth it—in both environmental and economic terms.

Sheila Bonini and Steven Swartz

Sustainability—a term we use to describe the business programs, products, and practices built around environmental and social considerations—is often seen as a luxury investment or a public-relations device. We think that view is cynical and increasingly untenable. In fact, a growing body of evidence indicates that sustainability initiatives can help to create profits and business opportunities.

McKinsey recently launched a knowledge collaboration with more than 40 companies to understand their sustainability challenges (see sidebar “How we did it”). We sought to develop a set of practical recommendations for companies to capture value from sustainability. In doing so, we found that leading companies pursue sustainability because it

has a material financial impact. The value at stake from sustainability-related issues—from rising raw-material prices to new regulations—is substantial. “Leading on sustainability is driven largely by our desire to grow,” one technology executive told us. “The industry changes so rapidly that we need flexibility.”

Success requires both a structured program to improve performance and a sustainability philosophy. Such efforts often get stuck, especially at the business-unit level, when managers have other priorities. Moreover, given that less than 5 percent of companies do a good job of providing financial incentives or career opportunities for sustainability performance,¹ people may not see the pursuit of sustainability as a way to build their career.

In this article, we discuss the research about the economic benefits of sustainability. Then we detail the organizational practices businesses need to follow to make this work. Finally, we show how moving in this direction can create value. Sustainability is a long-distance journey; the evidence is growing that it is one worth taking.

Sustainability and value creation

Over the past 20 years, the idea of corporate sustainability has become part of mainstream business discourse. Companies in many industries issue sustainability or corporate-social-responsibility reports; executives everywhere pledge allegiance to the idea. Even so, the concept still carries considerable baggage. In a recent report for the UN Global Compact, 84 percent of the 1,000 global CEOs surveyed agreed that business “should lead efforts to define and deliver new goals on global priority issues.” But only a third said “that business is doing enough to address global sustainability challenges.”²

To understand the role of sustainability initiatives in business, we looked at academic studies, investor strategies, and public data on resource efficiency.

We also surveyed and interviewed companies with successful sustainability programs. Our conclusion: sustainability programs are not only strongly correlated with good financial performance but also play a role in creating it.

According to research by Deutsche Bank, which evaluated 56 academic studies, companies with high ratings for environmental, social, and governance (ESG) factors have a lower cost of debt and equity; 89 percent of the studies they reviewed show that companies with high ESG ratings outperform the market in the medium (three to five years) and long (five to ten years) term.³ The Carbon Disclosure Project found something similar. Companies in its Carbon Disclosure Leadership Index and Carbon Performance Leadership Index, which are included based on disclosure and performance on greenhouse-gas (GHG) emissions, record superior stock-market returns. Companies in the Carbon Disclosure Leadership Index substantially outperformed the FTSE Global 500⁴ between 2005 and 2012. Companies in the other index also did better.⁵

How we did it

To create the factual basis for this article, McKinsey canvassed the extensive literature on the organizational practices and financial effects of corporate-sustainability initiatives. We also did our own analysis of resource-efficiency and financial-performance data.

Then we interviewed executives from 40 companies from various sectors, including oil and mining, sneakers, soup, cosmetics, and telecommunications. Research participants were chosen because they had outperformed their industry average across financial and sustainability-performance metrics. We also interviewed experts from universities, nongovernmental organizations, and the financial sector.

Finally, we conducted a sustainability-assessment survey, the seventh of this kind, of almost 40 companies, exploring why and how companies are addressing sustainability and to what extent executives believe it can and will affect their companies' bottom line. We benchmarked the results of these 340 respondents against McKinsey's global-executive-survey database of more than 4,000 companies.

Even more intriguing is recent research by three economists (two from Harvard and one from the London Business School) suggesting that sustainability initiatives can actually help to improve financial performance. The researchers examined two matched groups of 90 companies. The companies operated in the same sectors, were of similar size, and also had similar capital structures, operating performance, and growth opportunities. The only significant difference: one group had created governance structures related to sustainability and made substantive, long-term investments; the other group had not.

According to the authors' calculations, an investment of \$1 at the beginning of 1993 in a value-weighted portfolio of high-sustainability companies would have grown to \$22.60 by the end of 2010, compared with \$15.40 for the portfolio of low-sustainability companies. The high-sustainability companies also did better with respect to return on assets (34 percent) and return on equity (16 percent).⁶ The authors conclude that "developing a corporate culture of sustainability may be a source of competitive advantage for a company in the long run." As careful academics, they note that this research was not done in laboratory conditions, and therefore they cannot claim definitive proof of causality: "confounding factors might exist." But they clearly believe that they are onto something—that it is the sustainability policies themselves that were responsible for the better financial performance of the high-sustainability group.

Additionally, there is evidence that being more efficient at using resources is a strong indicator of superior financial performance overall. We created a metric (the amount of energy, water, and waste used in relation to revenue) to analyze the relative resource efficiency of companies within a sector. On that basis, we found a significant correlation (95 to 99 percent confidence) between resource efficiency and financial performance in sectors

as diverse as food products, specialty chemicals, pharmaceuticals, automotive, and semiconductors. In each sector, there were also a small number of companies that did particularly well, and these were the ones that had taken their sustainability strategies the furthest.

No wonder, then, that investors are increasingly comfortable with the idea of putting their money into socially responsible investment. In the United States, such investment grew by 486 percent between 1995 and 2012, outpacing the broader universe of managed US assets, which grew by 376 percent over the same period.⁷ In the last three years, socially responsible investment has grown by 22 percent; it now accounts for more than 11 percent of all assets under management in the United States (\$3.74 trillion). Globally, more than \$13 trillion is invested in assets under management that incorporate ESG metrics.⁸

With trillions of dollars in play, the professionals have taken notice. The quality and availability of sustainability data has improved, for example, as mainstream data providers such as Bloomberg, MSCI, and Thomson Reuters have begun to offer sustainability-performance data in much-improved formats.⁹

As a result, investors are able to go well beyond "negative screening" (not investing in certain kinds of companies or industries). This approach was inherently limited, and did not lead to higher returns. Now, investors are more sophisticated; they are seeking above-market returns by investing in best-in-class sustainable companies.

Osmosis Investment Management, for example, assesses companies using a proprietary methodology based on relative resource productivity; it has built a portfolio of large companies that has outperformed the market over the past eight years. Goldman Sachs's GS Sustain assesses both market

competitiveness and management quality with respect to environmental, social, and governance performance. Generation Investment Management uses a global research platform to integrate sustainability into investing, taking into account key global issues such as climate change and poverty. All three have delivered above-market returns.

Applying performance management to sustainability

Although sustainability is usually somewhere on the corporate agenda, there are often problems with execution, even in the most committed companies. To find and deliver real strategic opportunities, leaders should consider applying four organizational practices. These principles aren't new—they are associated with performance management, in particular—but they are not often used to address sustainability challenges.

Identify issues and set priorities

Two-thirds of companies in a representative sample from the S&P 500 have more than 10 different sustainability focus topics, and some have more than 30. That's too many: it's hard to imagine how a sustainability agenda with this many focus areas can break through and get the necessary buy-in to be successful. While there are several areas that companies need to comply with, it's better to concentrate on a few strategic themes. Coca-Cola, for example, has set for itself a strategy it calls "me, we, the world," which encompasses its approach to improving personal health and wellness, the communities in which it operates, and the environment. Within this strategy, the company reports making material, tangible progress on metrics related to three specific areas of focus: "well-being, women, and water." The company does not ignore other issues such as climate change and packaging, but it has made it clear that this is where it wants to lead.

To develop a clear set of priorities, it is important to start by analyzing what matters most along

the entire value chain, through internal analysis and consultations with stakeholders, including customers, regulators, and nongovernmental organizations. This process should enable companies to identify the sustainability issues with the greatest long-term potential and thus to create a systematic agenda—not a laundry list of vague desirables.

After extensive consultations, for example, BASF, the global chemical company, put together a "materiality matrix." As Exhibit 1 shows, the chart maps the importance of 38 sustainability-related issues based on their importance to BASF and its stakeholders. (Other companies use similar matrixes.) Such exercises help companies to recognize the most important issues early and then integrate them into management.

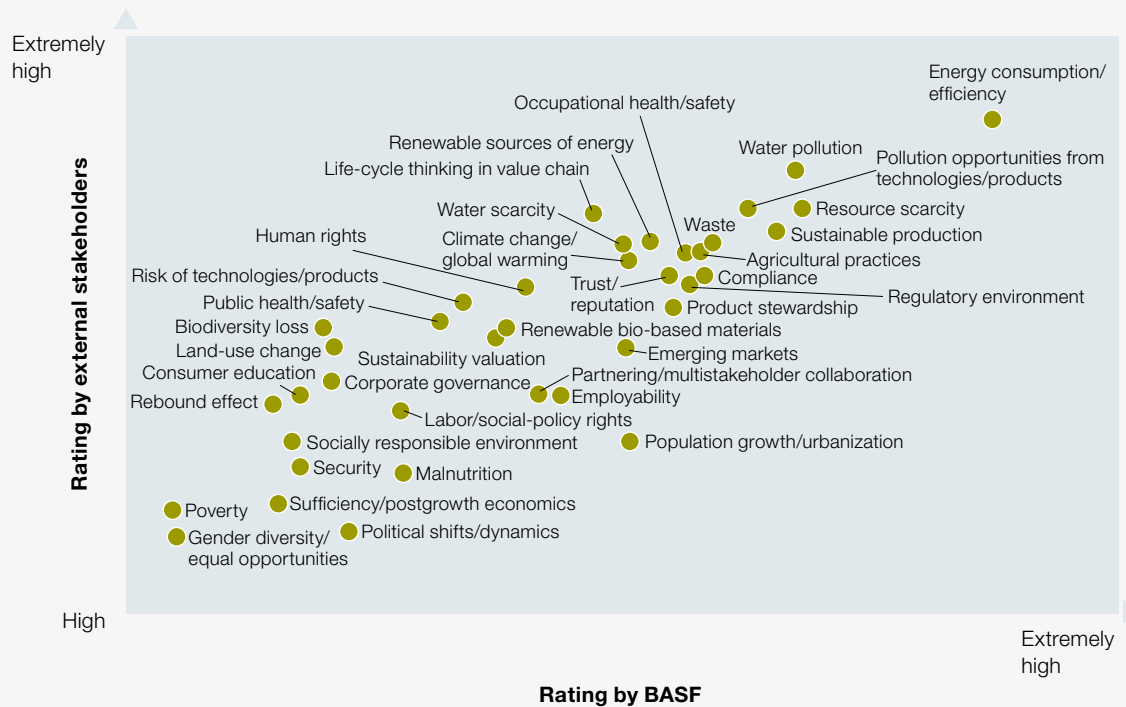
Once the priorities are identified—having no more than three to five is best—the next step is to develop a fact base from which to create a detailed financial and sustainability analysis. Siemens, for example, identified one priority as helping customers to reduce their carbon impact and has created an environmental portfolio of green products and services, including energy efficiency, renewable energy, and environmental technology. In 2013, these generated revenues of €32.3 billion and saved 377 million metric tons of carbon emissions.

Set goals

After completing the initial analysis, translate this information into external goals that can be distilled into business metrics. These goals should be specific, ambitious, and measurable against an established baseline, such as GHG emissions; they should also have a long-term orientation (five years or more) and be integrated into business strategy. And their intent should be unmistakable. One company stated as a goal: "Reduce the impact of our packaging on the environment."

Getting more specific is even better. (Reduce how much? By when? Compared to what?) Here is a

Exhibit 1 One company maps its sustainability priorities.



Source: Company website

stronger approach, from a sustainability leader: “Reduce 2005 carbon dioxide emissions by half by 2015.” It is important to build internal support to meet these goals. Our analysis found that the companies that excelled at meeting sustainability goals made sure they involved the business leaders responsible for implementing them from the start. One global manufacturer we interviewed announced in 2010 that it would reduce GHG emissions and energy consumption by 20 percent. To do so, it set up energy assessments and energy-management plans, established global programs to optimize procurement and building standards, and began to use renewable energy where possible.

Setting ambitious external goals motivates the organization, forces resources to be allocated, and

promotes accountability. An analysis of companies that are part of the Carbon Disclosure Project found that those that set external goals did better on cutting emissions—and also had better financial returns on such investments. Stronger goals, then, seem to encourage innovation; people may feel more motivated to find ways to meet them. Lack of goals is a sustainability killer: “what gets measured gets managed” is as true of sustainability as it is of any other business function. And yet it is not happening. We estimate that only one in five S&P 500 companies sets quantified, long-term sustainability goals; half do not have any.

[Show the money](#)

Almost half (48 percent) of survey participants said that the pressure of short-term earnings

performance is at odds with sustainability initiatives. A constructive response is to make the case that sustainability can pay for itself—and more.

Senior leaders will give sustainability lip service, not capital, if they do not see financial benefits.

“Sustainability metrics can seem like random numbers and don’t do much,” one chemical-industry executive told us. “For our businesses, sustainability efforts have to compete directly with other demands, which means that financial impact is key.” This needs to be done rigorously, reinforced with fully costed financial data, and delivered in the language of business.

Alcoa, a US-based global metals company, incorporates sustainability into how it does business—and how it talks about the company to stakeholders. In one investor presentation, for example, it detailed how its supply-chain simplification sharply lowered labor and energy costs as well as cut GHG emissions, but it was the financial effects that took front and center.

To emphasize that sustainability is a business issue, boards should review goals at every meeting. For each project, specific executives should be accountable for costs and effectiveness. This is, of course, much easier said than done. At Intel, for example, although business leaders were interested in saving water, they saw little financial justification to do so: water was cheap. Advocates of the initiative were able to calculate that the full cost of water, including infrastructure and treatment, was much higher than the initial estimates. Saving water, they argued, could therefore create value in new and unexpected ways. On that basis, Intel went ahead with a major conservation effort. The company now has a finance analyst who concentrates on computing the financial value of sustainability efforts.

Making the business case for sustainability might sound obvious, but apparently it isn’t. Most companies do not communicate the financial performance of sustainability; only a quarter said that the financial benefits of these efforts were well understood.

Sustainability initiatives can be challenging to measure because savings or returns may be divided across different parts of the business, and some benefits, such as an improved reputation, are indirect. It is important, then, not only to quantify what can be quantified but also to communicate other kinds of value. For example, an initiative might improve the perception that important stakeholders, such as consumer groups, nongovernmental organizations, or regulators, have of the company. This can help to build consumer loyalty, nurture relationships, and inform policy discussions.¹⁰

Create accountability

The top reason that respondents gave for their companies’ failure to capture the full value of sustainability is the lack of incentives to do so, whether positive or negative. According to the UN Global Compact, only 1 in 12 companies links executive remuneration to sustainability performance; 1 in 7 rewards suppliers for good sustainability performance. Among the executives we surveyed, 38 percent named lack of incentives and 37 percent named short-term earnings pressure for poor results; about a third said the lack of key performance indicators and not enough people being held accountable were problems.

In this area, a number of companies exhibit good practices from which others can learn, such as tracking data and reporting indicators, including carbon emissions, energy use, water use and waste, and recycling. Even these companies, however, are still working on integrating sustainability-

performance indicators into individual incentives; the only area where most have managed this is with regard to worker safety.

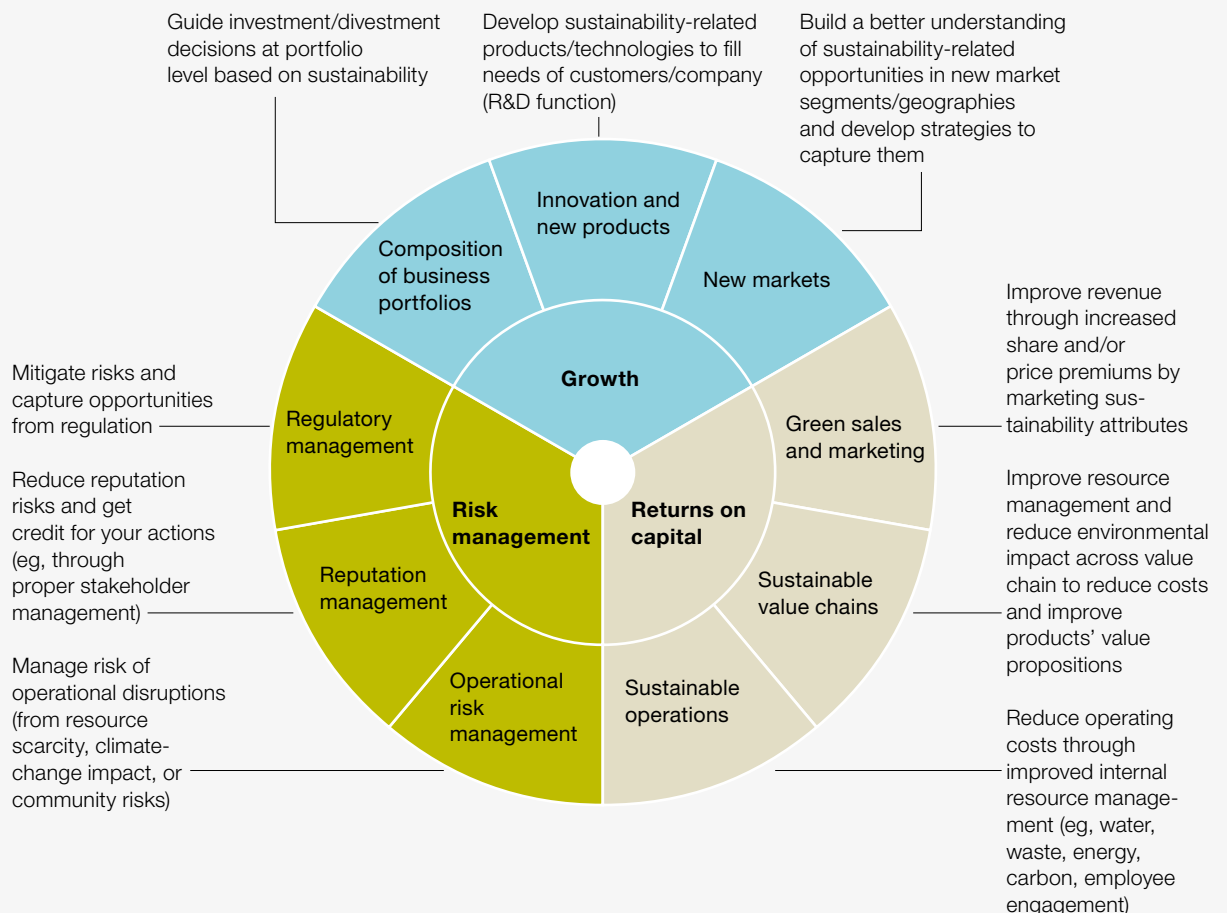
Adidas shows one useful approach. The sporting-goods company breaks down its long-term goals into shorter-term milestones. Its suppliers, for example, are given strategic targets three to five years ahead, as well as more immediate goals to encourage them to focus. The beer company MillerCoors does

something similar. It tracks and quantifies progress in ten areas, including water, energy, packaging, and human rights, using its own sustainability-assessment matrix. The idea is for MillerCoors to understand its performance, in quantitative terms, in areas that are often difficult to quantify.

How sustainability can create value

All the companies we interviewed are pursuing sustainability agendas, and most are making

Exhibit 2 Companies are pursuing sustainability in a way that creates value.



Source: Sheila Bonini and Stephan Görner, "The business of sustainability: McKinsey Global Survey results," Oct 2011, mckinsey.com

aggressive public commitments. Is this just green window dressing? Our analysis says no. Companies are addressing important environmental and social issues in a way that creates value. In previous work, we outlined how leading companies use sustainability initiatives across each of the areas shown in Exhibit 2 to manage risk and to improve growth and returns on capital.¹¹ In this research, we sought to understand how successful companies did it. What these interviews demonstrated is that companies that built sustainability into their operations saw immediate benefits, and that gave them the momentum to do even more, creating the conditions for long-term success.

These leaders told us that they pursue sustainability because they believe it has a material financial effect. The value at stake from sustainability issues can be as high as 25 to 70 percent of earnings before interest, taxes, depreciation, and amortization (Exhibit 3). Sustainability leaders can and do change their business models to respond to major discontinuities, such as higher natural-resource

prices or changes in demand, that create material risks to the business—or opportunities.

Manage risk

More than 90 percent could point to a specific event or “trigger” that got them started, such as consumer pressure or a jump in the price of commodities. More than half cited long-term risks to their business: 26 percent mentioned mitigating reputational risk, and 15 percent each said avoiding regulatory problems and eliminating operational risks.

Two candy giants, for example, are looking to guarantee future supplies of cocoa, an essential ingredient in chocolate, in part by improving the sustainability of their suppliers. Mars is helping smallholder cocoa farmers in the Cote d’Ivoire to increase their productivity by providing access to improved planting materials, fertilizers, and training. It is also investing in research that will help increase the quality and performance of cocoa plants. Hershey’s sends out experts to teach

Exhibit 3 Our research shows that the value at stake from sustainability challenges is substantial.

Impact	Examples	Potential impact, % of EBITDA ¹
Regulation/ reputation	Restricted license to operate Reputational damage based on perceived misuse of resources	70
Rising operating costs	Raw-material costs driven up by supply/demand True cost of water or carbon reflected in prices	60
Supply-chain disruption	Production delay or cancellation due to lack of access Especially significant for “local” resources—water, power	25

¹Earnings before interest, taxes, depreciation, and amortization.

Introducing the circular economy

Martin Stuchtey and Helga Vanthournout

In the traditional linear economy, inputs go in and waste comes out. The circular-economy model, by contrast, is based on reusing resources, regenerating natural capital, and decoupling resource use from growth. We have devoted considerable attention to the circular economy; we believe it has tremendous potential for companies, for economies, and for the environment.

The process begins with design, specifically by making a distinction between a product's consumable and durable components. In the circular economy, consumables are designed so that they can safely reenter the biosphere; one way to do this is to use pure materials that can be easily separated and "cascaded" to the next use. H&M, the global apparel retailer, for example, collects old clothes and works with I:CO, a reverse-logistics provider, to sort them. The clothes are then sold into the secondhand-apparel market or substituted for virgin materials in other products, and the remaining textiles become fuel to produce electricity.

For durable components, such as metals, the preferred options are reuse, remanufacturing, or refurbishment. Such practices have long been the norm for engines and building equipment but are now becoming common

as well for photocopiers, power tools, mobile phones, and passenger cars. More and more industries are discovering that taking back products can reduce costs and strengthen customer relationships. Doing so, however, requires a fundamental shift in thinking—seeing consumers as users and offering them performance, not products.¹

This development is well under way. Car-sharing services are an example; they sell mobility, not vehicles, and each car has multiple users, not a single owner. Philips, the Dutch manufacturer, offers another example. Noticing that major customers were reluctant to make large investments in light of the financial crisis and the rapid shifts in technology, the company began to offer lighting as a service, not a product. "Customers only pay us for the light, and we take care of the technology risk and investment," explains CEO Frans van Houten.

Toward a new industrial revolution

Why should businesses move toward a circular-economy model? First, because global economic pressures, such as rising resource prices and a fast-growing global consuming class, are changing the status quo. Second, because it's good for business. The

savings in materials alone could top \$1 trillion a year. We believe that companies that adopt circular-economy principles will outcompete other actors in a world where scarce resources expose companies to high costs and unforeseeable risks.

The real payoff will come only when multiple players from many sectors come together to figure out how to reconceive manufacturing processes and the flows of products and materials. Capitalizing on these opportunities will require new ways of working. But the benefits, to both business and the environment, are well worth the costs.

¹ For more, see Thomas Fleming and Markus Zils, "Toward a circular economy: Philips CEO Frans van Houten," *McKinsey Quarterly*, February 2014, mckinsey.com.

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best-practice farming methods; its CocoaLink mobile-phone service offers advice and market information. Hershey's is also addressing child labor and school-attendance rates through local initiatives. Both companies aim to have their entire cocoa supply sustainably sourced by 2020.

Take advantage of new business opportunities

Almost half of those interviewed (44 percent) mentioned business and growth opportunities as a reason to get started on sustainability. A number of different business models that embed sustainability are emerging. Electric utilities, for example, are working on ways to make money by helping consumers cut their energy use.

Sustainability also offers an interesting way to scope out product innovations that use fewer resources or that meet specific social needs. Redesigning products and services around sustainability can drastically increase profits or reduce costs (see sidebar "Introducing the circular economy"). Unilever, for example, changed the shape of a deodorant to use less plastic and created a concentrated laundry product that sharply reduces the use of water—innovations they might not have found had they not been thinking about sustainability. DuPont, a diversified science company, began its sustainability operations more than 20 years ago as a matter of risk reduction, but these have turned into a major profit center. Since 2011, the company has invested \$879 million in R&D for products with quantifiable environmental benefits. DuPont has recorded \$2 billion in annual revenue from products that reduce GHG emissions and an additional \$11.8 billion in revenues from nondepletable resources.

Improve returns on capital

Whether the trigger for commitment to sustainability was risk management or growth, most

companies started by improving natural-resource management. In fact, 97 percent of the research participants were taking action on energy efficiency, 91 percent on waste, and 85 percent on water.

For example, Bayer, the German health and agriculture company, developed a resource-efficiency check to improve operations by using by-products and reducing wastewater. The company expects the process to save more than \$10 million a year, and this is not unusual; 79 percent of Fortune 500 companies reporting to the Carbon Disclosure Project had higher returns on their carbon investments than their overall portfolio. Paradoxically, taking such actions may be easier to do in companies that have been slow to embrace sustainability. There are almost certainly "quick wins" ripe for the picking that can bring tangible results and create momentum to do more.

An emphasis on sustainability can also reveal opportunities for process innovations. It is not uncommon for companies to complain that different units do not collaborate well. By its cross-functional nature, sustainability brings different divisions together and provides a common motivation; the result can be new, profitable ideas. Lockheed Martin, for example, wanted to reduce wood waste from packing crates. But as it started on this one modest initiative, it found other production improvements that reduced overhead and resulted in more than \$7.5 million in savings from a \$240,000 investment. Many of the companies interviewed had similar innovation stories but often did not measure the results or attribute them to sustainability. That may help to explain why there is still skepticism about whether sustainability is worth it.



To succeed, sustainability efforts need to be an organizational priority, with clear support from leadership. This is not easy. Fewer than half of the leaders with whom we spoke thought they had a sustainability philosophy that permeates their day-to-day operations, even though their companies considered sustainability one of their top priorities.

Chief sustainability officers have an important role to play in this regard. Although they often do not have the authority to dictate the agenda, they can influence it. This means translating the promise of sustainability into value propositions that make sense to different parts of the company. This takes time and effort. But there is no alternative: for sustainability to spread, business units need to own their part of the agenda.

Becoming a sustainability leader can pay off, but it is not easy. “It’s a perception issue,” one executive told us. “We need to show that it makes good business sense to get over the hurdle.” Fair enough—and the evidence is building that for the best companies, this standard is within reach. ■

⁷ *2012 Report on Sustainable and Responsible Investing Trends in the United States*, US SIF Foundation, Forum for Sustainable and Responsible Investment, 2012, ussif.org.

⁸ *2012 Sustainable Investment Review*, Global Sustainable Investment Alliance, 2013, gsi-alliance.org.

⁹ For example, to track environmental, social, and governance (ESG) factors, Bloomberg has an ESG valuation tool, MSCI has the ESG Impact Monitor, and Thomson Reuters offers Quantitative Analytics.

¹⁰ Sheila Bonini, Timothy M. Koller, and Philip H. Mirvis, “Valuing social responsibility programs,” *McKinsey Quarterly*, July 2009, mckinsey.com.

¹¹ Sheila Bonini and Stephan Görner, “The business of sustainability: Putting it into practice,” October 2011, mckinsey.com.

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¹ In February 2014, McKinsey surveyed 3,344 executives about their companies’ sustainability activities. The respondents represented the full range of regions, industries, company sizes, tenures, and functional specialties.

² *The UN Global Compact–Accenture CEO Study on Sustainability 2013: Architects of a Better World*, Accenture and United Nations Global Compact, 2013, unglobalcompact.org.

³ Mark Fulton et al., *Sustainable Investing: Establishing Long-Term Value and Performance*, DB Climate Change Advisors, Deutsche Bank Group, 2012, dbadvisors.com.

⁴ FTSE Global Equity Index Series, as of January 1, 2013.

⁵ *Sector insights: what is driving climate change action in the world’s largest companies—Global 500 Climate Change Report 2013*, Carbon Disclosure Project, 2013, cdp.net.

⁶ Robert G. Eccles, Ioannis Ioannou, and George Serafeim, “The impact of a corporate culture of sustainability on corporate behavior and performance,” Harvard Business School working paper, HBS Working Knowledge, Number 12-035, November 2011, hbs.edu.