FSG REIMAGINING SOCIAL CHANGE

MANAGING THE ECONOMICS OF IMPACT

The Essential Link between Financial and ESG Targets

Harvard Business Review
SEPT 2022

THE PROBLEM: ESG targets are often missed because financial and ESG goals are not linked. Without understanding and managing the relationship between financial and ESG outcomes, companies miss opportunities to win in emerging markets defined by the "green and just economic transition" and society will not meet climate and other sustainable development goals (SDGs).

No targets on material ESG issues (in line with climate targets or SDGs) and primacy of financials in strategy capital allocation

Targets on material ESG issues (in line with climate targets or SDGs) but the link to financial targets is not established

→ "ESG-intensity of profit" is managed and determines strategic capital allocation to optimize financial & ESG outcomes

→ Lost opportunity for innovation and growth and growing risk of regulatory and reputational sanctions ("social green washing")

→ Leading in transforming business models to advance a "green and just economic transition" in collaboration with public and civil society stakeholders

INSIGHT: Leading companies act on 6 levels to link their most material ESG impact objectives with their financials and meet growing investor and societal expectations on climate and SDG progress:

1. Focus on the handful of **most material ESG impact areas** in line with purpose
2. Start with **strategy, not reporting** along **3 domains of transformation:** product innovation and substitution; product access; operational and value chain footprint
3. **Optimize the "impact-intensity of profit:"** understand & manage the **business model choices** affecting the ESG & financial results
4. Understand the specific **business ecosystem levers** that can break potential trade-offs between ESG & financial outcomes; to focus external collaboration
5. Redesign organizational roles and responsibilities to **integrate operations and sustainability** and the functional expertise needed to optimize outcomes
6. **Bring investors along:** explain the strategies to improve the "impact-intensity of profit"

IN PRACTICE: Understand and **activate the internal and business ecosystem levers** of the different business model transformation strategies to **improve the "impact-intensity of profits."**

Transform business models to address the SDGs	Optimize profit and impact	Internal and business ecosystem levers of combined performance
Product innovation and/or substitution leading to positive impact: ○ **ENEL:** Thermal to renewable energy ○ **Discovery**: Embedding behavioral change incentives in insurance	**Revenue and profit contribution** by product vs. units of environmental or social metric: ○ **ENEL**: Profit vs. gCO_2 / KWh ○ **Discovery**: Profit vs. customer health; safety; savings rates	**Internal choices:** ○ Product innovation; product retirement; tiered pricing **Business ecosystem levers** ○ Open innovation; partnerships with market entry facilitators; cost sharing with governments
Product access extension extends existing product benefits to more people: ○ **BoKlok (Skanska/Ikea):** Extending access to affordable housing	**(Incremental)** Profit per customer vs. customers reached X customer benefit: ○ **BoKlok (Skanska/Ikea):** Profit vs. customer reached X houses sold below affordability threshold	**Internal choices:** ○ Investment in market conditions to enable customer access; tiered-pricing to sub-populations **Business ecosystem levers** ○ Co-investment in market conditions; (advanced) purchasing subsidies
Own operational and value chain footprint management through new activities & technologies changes leading to improved social or environmental outcomes: ○ **Mars Wrigley:** Raising farmers' incomes and reducing GHG emissions and water usage in Shubmint sourcing	**Impact intensity vs. costs:** ○ **Mars Wrigley:** Commodity sourcing cost advantage/cost of ownership vs. environmental or social footprint (gCO_2, water stress, farmer living wage gap, etc.)	**Internal choices:** ○ Investment in value chain practices, skills and technologies; premium pricing for impact-reduced content **Business ecosystem levers** ○ Co-investment in value chain practices, skills and technologies