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How to make ESG real

While ESG is likely to evolve both in substance and name in the coming years, its underlying impulse is here to stay. Here's how companies can take a more systematic and rewarding approach to ESG.

by Lucy Pérez, Vivian Hunt, Hamid Samandari, Robin Nuttall, and Donatela Bellone

The 'how' of a company's environmental, social, and governance (ESG) proposition starts with recognizing what companies should be solving for: maintaining and reinforcing their social license to operate, in the face of rising externalities. Rising scrutiny of how companies address ESG means that a robust approach is more critical than ever, irrespective of whatever name one may choose to give to the attempt to address these externalities, whatever contours one may define for them at a given point, and whatever organizational or governance construct one may put in place for them. Indeed, we believe one may be agnostic to the term ESG but not to its underlying concerns.[1]

Not all aspects of "E," "S," and "G," however, are priorities for all companies, and it is unrealistic to expect that companies do not have to make hard trade-offs within and among ESG dimensions, or that they can lead on every topic. It is therefore instructive to observe companies that approach ESG in a rigorous, strategy-driven, socially attuned way. We call these organizations "forward-looking companies." They make ESG intrinsic to their strategy by defining, implementing, and refining a carefully constructed portfolio of ESG initiatives that connect to the core of what they do. Forward-looking companies also contribute to a competitive landscape where good corporate citizenship is marshaled against existential challenges, not least—but not only—climate change.

When a company determines the dimensions of ESG where it wishes to be good and where it wishes to be excellent, it is making important decisions, with broader second- and third-order consequences. Forward-looking companies approach ESG decisions by seeking to gain a deep, evidence-based understanding of their own business and its broader potential effects. Since by now every major company has begun to embark on an ESG journey, and many have significant programs already under way, it is helpful to

[1] These issues are addressed in detail in the accompanying article, "Does ESG really matter—and why?," by Lucy Pérez, Vivian Hunt, Hamid Samandari, Robin Nuttall, and Krysta Biniek, *McKinsey Quarterly*, August 10, 2022.

consider ESG progress in the context of a maturity curve. The ESG practices of today's large companies generally cluster along three levels of ambition (Exhibit 1).

Being forward looking in ESG necessarily calls for considering the needs of a range of stakeholders and society more broadly. Stakeholder demands are shifting, and these shifts can over time dramatically affect competitive dynamics. Nor is the rate of change linear. As external shocks such as the COVID-19 pandemic and the war in Ukraine have shown, companies find it hard to move rapidly unless they have an ESG framework that is derived from, and deliberately advances, their strategy. Anticipating risks and opportunities and considering what value stakeholders have at stake requires continuous, judicious analysis; ESG is a process, not an outcome (Exhibit 2).

The approach of forward-looking companies is marked by four reinforcing parts of mapping, defining, embedding, and engaging.

The science of ESG mapping

The term "mapping" is used frequently in other competitive contexts. Mapping for ESG requires a thorough and inclusive exercise. The critical analysis is to figure out how the organization's specific business model matches against each ESG dimension.

Exhibit 1

There are three levels of ambition in ESG.

Examples and organizational mindsets are segmented across three levels of an environmental, social, and governance (ESG) practice

Minimum practice

Risk-mitigation and "do no harm" measures

- React to trends affecting industry and business
- Address external vulnerabilities
- Donate resources (financial, in-kind, volunteer)
- Meet and report baseline standards
- Pledge to minimal commitment levels

Common practice

Substantive efforts, mostly outside the core business

- Track major trends affecting the business with contingency plans in place
- Use strengths to deliver increased value across specific ESG goals and metrics
- Comply with voluntary industry standards and perform above industry average
- Create a comprehensive sustainability policy
- Implement inclusive HR practices
- Run strategic, high-impact philanthropic programs
- Engage with stakeholder groups to understand what matters

'Next level' practice

Full integration of ESG into strategy and operations

- Leverage "superpowers" to move sector standards
- Increase social impact via innovation, market, and customer choices
- View ESG as a differentiator and core to overall strategy
- Link clearly articulated leadership areas ("win the game") with purpose
- Embed ESG in capital and resource allocation
- Tie ESG to employee incentives and evaluations
- Improve sustainability outcomes internally and externally
- Ensure that ESG disclosures cover company's full operations

Risk management ⟷ **Impact**

Exhibit 2

ESG is a process, not an outcome.

1 Mapping
- Considering what stakeholders have at stake
- Identifying superpowers and vulnerabilities
- Benchmarking regularly and judiciously

2 Defining
- Considering high jumps and long jumps
- Thinking systematically about ESG trade-offs
- Measuring and assessing

3 Embedding
- Syncing ESG with operations
- Following through on initiatives to ensure impact
- Discerning what the numbers do—and do not—say about ESG

4 Engaging
- Using ESG engagement to sharpen strategy
- Showing investors the business proposition
- Making cadence core to the dialogue

1. Considering what stakeholders have at stake

Comprehensive ESG mapping attempts to take account of who the important stakeholders are and what they value. Purpose is an enabler; it is much easier for a company to operationalize ESG when it has a clearly articulated corporate purpose, moored to the business model. It will not come as a surprise that forward-looking companies actively engage with their shareholders, whose capital is at risk. To unlock opportunities for all of their stakeholders, however, these companies tend to listen to a broad range of constituencies.

Employees rank highly on any list of essential stakeholders. The benefits of engaged employees include heightened loyalty and a greater willingness to recommend the company to others.[2] Engaged customers are also essential. Consumers hold companies and their brands accountable for the impact of their conduct on employees, society, and the environment. Though customer preferences can vary, there are indications about what is likely to matter more for consumers in the years ahead. Our research on Generation Z (born 1995–2010) shows that young consumers are particularly mindful of ethical consumption, transparency, authenticity, and equality.[3] One study found that purpose-driven brands achieve more than twice the brand-value growth of brands that focus purely on profit generation.[4]

2. Identifying superpowers and vulnerabilities

The second element of mapping is to identify a company's superpowers and vulnerabilities. Superpowers are a company's unique capabilities to have differential impact.

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[2] For example, see "More than a mission statement: How the 5Ps embed purpose to deliver value," *McKinsey Quarterly*, November 5, 2020; "Purpose: Shifting from why to how," *McKinsey Quarterly*, April 22, 2020; Aaron De Smet, Bonnie Dowling, Marino Mugayar-Baldocchi, and Bill Schaninger, "'Great Attrition' or 'Great Attraction'? The choice is yours," *McKinsey Quarterly*, September 8, 2021; Arne Gast, Nina Probst, and Bruce Simpson, "Purpose, not platitudes: A personal challenge for top executives," *McKinsey Quarterly*, December 3, 2020; and Naina Dhingra and Bill Schaninger, "The search for purpose at work," McKinsey, June 3, 2021.

[3] Tracy Francis and Fernanda Hoefel, "'True Gen': Generation Z and its implications for companies," McKinsey, November 12, 2018.

[4] Erica Sweeney, "Study: Brands with a purpose grow 2x faster than others," Marketing Dive, April 19, 2018.

Vulnerabilities are the foundational expectations that critical stakeholders will require a company to address, in light of its specific business model. Identifying superpowers and vulnerabilities requires answering questions such as, What do we bring to society that no one else can? What are the areas of dissonance, where we need to change practices to align strategy with our societal impact? What do we do that is irreplaceable? What "home field" advantage do we have? For example, Natura &Co is a Brazilian-based manufacturer and distributor of cosmetics and other personal-care products, with significant operations in Latin America, Europe, and the Middle East. Its superpower is channeling its "home turf" of the Amazon rainforest; it can tap into its highly motivated base of stakeholders to protect biodiversity and advance global solutions to climate change.

Forward-looking companies test and strengthen their ESG proposition by conducting exercises such as an "ESG teardown." Teardowns—dismantling a product or service to learn more and to compare it with the offerings of rivals—have long been used in manufacturing. ESG teardowns analyze what a company is doing now, and why. Frequently, the exercise will surface reasons for some initiatives that include "it seemed like a good idea at the time," or "many companies seemed to be doing something similar." Perhaps these explanations make sense in some cases, yet it is not possible to make a distinctive contribution by merely copying others—and at all events, companies have unique superpowers and vulnerabilities.

Forward-looking companies carefully consider the dimensions in which they have a particular ability to excel and can distinguish them from dimensions where their abilities are comparable to others. For example, a multinational pharmaceutical company may focus on social metrics (such as accessibility and affordability), a renewables company may prioritize environmental metrics (such as reductions in greenhouse-gas emissions, for scopes 1, 2, and 3), and a food company may elevate an equal mix of environmental (emissions reductions, water use, and waste) and social metrics (nutrition, product quality, and safety).

Thorough analysis of ESG quantifies both downside exposure to and upside opportunities. Forward-looking companies measure gaps between their aspirations and achievements. They also focus most intently on mapping how well ESG is reflected in core business practices. One test that all companies can apply after they have arrived at a new ESG strategy is to determine and parse the internal commitments that they have *not* yet met—and to ask why they have failed to meet them. Companies can also inquire about whether board meetings are now being conducted differently, with the company's ESG strategy applied to decision making; whether operating-level meetings are conducted differently; the extent to which ESG considerations are a factor in budgeting, capital allocation, and product choice; and whether some stakeholder groups are expressing particular concerns.

3. Benchmarking regularly and judiciously

Finally, forward-looking companies are exacting about their choices of metrics and peer sets. They are also creative about analyses and research (including the use of research from academia and thought leaders). One informative inquiry tracked the degree to which companies "walked the talk" in their disclosures about broader stakeholders. It found that, controlling for sector-specific effects, stronger stakeholder language about the importance of stakeholders paired with stronger operating performance across a number of metrics over a three-year period.[5]

Forward-looking companies' selection of peer sets is not constrained by traditional categorizations. While corporations may define themselves by sector, a wide range of stakeholders adopt a much broader approach. Prospective employees, for example, look across industries for companies they would consider joining. There is, as well, a layer of nuance in choosing appropriate peer sets. Looking across geographies and industries is often instructive, but different geographies and industries require different analyses.

The choices in ESG decision making

Forward-looking companies recognize that they cannot be distinctive by pursuing every initiative that qualifies as ESG. To the contrary: because they have a clear understanding of their strategy, and their own strengths and gaps, they focus on identifying initiatives that matter most to their business models. ESG is an essential strategic concern, which means it affects how and where a company competes.

1. Considering high jumps and long jumps
There are two critical decisions that companies confront as they seek to enhance their readiness to address externalities along the ESG dimensions. The first is to decide on *high jumps*: the levels a company must reach to meet its ESG bar. This is higher than a regulatory bar, such as disclosure standards, environmental compliance, tax obligations, and wage scales—all of which must be met in every case. ESG is "next level" performance; it addresses, for instance, societal insistence on a living wage, environmental demands for net-zero emissions, and communal principles of diversity. These expectations will likely continue to move higher (even though a degree of volatility is to be expected in this regard as well).

The second step is to decide on a company's *long jumps*: the one or two ESG areas where the company can take a leadership role and, ideally, affect other players in its ecosystem and beyond. Long jumps are reached by drawing from a company's superpowers. Depending upon a company's ecosystem, it may be uniquely positioned to facilitate notable social impact among multiple businesses worldwide. For example, Maersk founded the Mærsk Mc-Kinney Møller Center for Zero Carbon Shipping, which consists of 18 strategic partners from across the shipping value chain that accelerate carbon-neutral solutions for the shipping industry.

The concepts of high jumps and long jumps on the one hand, and superpowers and vulnerabilities on the other, are distinct. While both are rooted in a company's unique business model and endowment, high jumps and long jumps are the *specific courses of action* a company takes in light of its superpowers and vulnerabilities. For example, Walmart has the prominent superpower of a large, robust network of suppliers. It uses this superpower to make a long jump in sustainability. The company instituted Project Gigaton, a collaborative program that enables suppliers to reduce their carbon footprints by a

[5] Ariel Babcock et al., *Walking the talk: Valuing a multi-stakeholder strategy*, FCLTGlobal, January 17, 2022.

collective one billion metric tons (one gigaton) of greenhouse gases by 2030. Thousands of suppliers take part in Project Gigaton by setting targets, reporting on progress, and sharing knowledge. By 2020, the project had already reached more than 40 percent of its goal.

2. Thinking systematically about ESG trade-offs

Forward-looking companies do not ignore trade-offs when approaching ESG. Rather, as they consider their unique business models, they are clear about benefits and costs—including the costs of inaction.

One example is how a company may approach employee compensation. Paying above-market compensation could seem, at first, to be value destroying for shareholders, by potentially reducing investors' returns, particularly in the short term, yet employee satisfaction can clearly drive better financial performance.[6] Many companies find that by treating employees better, including by paying them well, they can not only increase productivity but also foster greater trust. Research suggests that this can become a source of competitive advantage.[7]

Yet capital and time are finite. At some point, investing a marginal dollar in one constituency (say, employees, by means of higher salaries) could require increasing prices for another constituency (consumers). Elevating management time for one ESG initiative (for example, reducing waste) could detract from time that can be spent on other initiatives (for instance, community education). There is no one, clearly marked path that every business can follow. But there generally is a common marker that distinguishes how forward-looking companies execute ESG: they consider thoroughly, choose deliberately, and then act boldly. As part of that approach, forward-looking companies assess scenarios for *not* investing in a given area; they analyze the values at risk to determine the costs of standing still. They recognize that social expectations constantly evolve.

3. Measuring and assessing

A key part of making ESG real is not to measure for the sake of measuring but instead to measure what matters. Effective performance management in ESG, like effective performance management in other contexts, approaches shorter-term metrics with a view toward achieving longer-term, strategic goals. It uses clear milestones, pays careful attention to meaningful KPIs, and elevates objectives that tie directly to the business model (for example, water-use reduction, removal of antibiotics from fresh produce, or replacement of diesel machines with electric machines in warehouses).

Assessing progress is most effective when it is done regularly and, with robust data analytics, information can be updated very rapidly. Companies that have a considered process in place to measure their ESG performance are better positioned to respond even in times of rapid change. As the saying goes, "there are decades when weeks happen, and weeks when decades happen." An informed perspective enables forward-thinking companies to move quickly as realities shift.

[6] For example, see Alex Edmans, "Does the stock market fully value intangibles? Employee satisfaction and equity prices," *Journal of Financial Economics*, September 2011, Volume 101, Number 3.

[7] Alex Edmans, "The link between job satisfaction and firm value, with implications for corporate social responsibility," *Academy of Management Perspectives*, November 2012, Volume 26, Number 4.

The approach to ESG implementation

Just as forward-looking companies make informed choices about ESG based upon their unique business model, they also act purposely to operationalize ESG throughout the organization.

1. Syncing ESG with operations

It can be tempting to approach corporate purpose and then ESG sequentially: that is, to consider that companies should *first* clarify their purpose, and *then* create ESG initiatives that accord with their purpose. But it is rare for large, established companies—which operate under a range of priorities, urgencies, and constraints—to be able to operate in this way. For example, after the big-box retailer Best Buy's former chairman and CEO, Hubert Joly, had implemented a remarkable turnaround at the company, he observed:

"The question is often, 'So where do you start and how do you sequence?' The logical part of our mind would have us start with purpose, then derive the strategy: anchor it in purpose, and transform the organization on that basis.

"My personal experience is different. When we started the turnaround, I was very clear about my philosophy, which was that profit is not the purpose. Purpose is to contribute to the common good. But we did not spend time in the first three years of the turnaround on refining our purpose. We spent the time saving a ship that was sinking, by addressing key operational-performance drivers."[8]

That does not mean that companies should move ESG to the back burner. There are opportunities for companies to think comprehensively about how they can advance major ESG initiatives as part of their core strategic plan, across 5Ps. We have identified key sources of opportunities:

1. *portfolio strategy and products:* the products and services an organization provides, and the "where to play" and "how to play" choices it makes to best serve its customers

2. *people and culture:* the talent—and the talent management approach—a firm deploys

3. *processes and systems:* the operational processes it adapts to meet ESG-related targets

4. *performance metrics:* the target metrics and incentives used to measure what the company wishes to achieve, how it is progressing, and the way it creates and distributes incentives to realize ESG initiatives

5. *positions and engagement:* how the organization aligns its external positions and affiliations to be consistent with, and consistently deliver on, its ESG priorities

Depending upon the company and its business model, the range of key stakeholders can include key regulators and governmental actors, as well as other companies, and the

[8] "Leading with purpose and humanity: A conversation with Hubert Joly," *McKinsey Quarterly*, June 18, 2020.

range of initiatives can be far-reaching. Companies that have demonstrable success in ESG make deliberate choices in this regard.

2. Following through on initiatives to ensure impact
Forward-thinking companies then follow through on their initiatives. When ESG fits squarely within strategy, it is likely to have strong support from stakeholders within and beyond the organization. Consider the clothing and outdoor-gear company Patagonia, which has made protecting the natural environment part of its core mission. Initiatives such as facilitating connections to environmental groups; pledging 1 percent of sales to the preservation and restoration of the natural environment; and using only renewable electricity for its retail stores, distribution centers, and regional and global offices function in concert.

One powerful way companies can follow through is with incentives. This includes monetary incentives; indeed, a growing number of corporations are crafting compensation packages, particularly for senior leaders, that condition a portion of compensation on achieving specific ESG objectives (for example, emissions reductions). But monetary incentives are not the only way to encourage positive behavior, nor always the most effective.

An additional lever is "nudging," which has been validated by behavioral science. Nudges can encourage energy savings and waste reduction, for example, by promoting inclusive behaviors, reminding employees to be mindful of their carbon footprint, or encouraging them to recycle. Forward-looking companies find that by consistently sharing with employees and other stakeholders how the organization is progressing along their prioritized objectives, such as diversity or sustainability—information that can be presented clearly in standardized reports—they can make ESG initiatives part of the business's daily operations. Companies can celebrate teams that deliver on ESG expectations, or they can spotlight employees who contribute measurably to the organization's ESG initiatives.

3. Discerning what the numbers do—and do not—say about ESG
Forward-looking companies find that their ESG metrics become more robust—and more refined—the longer and more consistently they use them. They also think carefully about which external ESG ratings agencies or score providers they should track most closely. The optimum is usually two or three and, in particular, the two or three that are most practicable for a business model and help companies meet their objectives. Forward-looking companies are careful not to conflate achieving high scores with realizing specific, strategic goals.

Developments on ESG metrics are shifting in real time. The US regulatory environment is fluid. Outside of the United States, the International Financial Reporting Standards (IFRS) completed its consolidation with the Value Reporting Foundation in August 2022, formalizing the new International Sustainability Standards Board (ISSB).[9] ISSB houses the Sustainability Accounting Standards Board standards and the Integrated Reporting Framework. Implementation is usually done via the International Organization of Securities Commissions, whose members set standards as listing requirements on their exchanges.

[9] "IFRS Foundation completes consolidation with Value Reporting Foundation," August 1, 2022.

Each of these organizations has a mandate to protect investors and markets. As well, the European Union has asked the European Financial Reporting Advisory Group to propose reporting standards for its Non-Financial Reporting Directive, with a view of materiality on both the investor and civil-society level. Because the European Union supports the IFRS/ ISSB initiative, there is grounds to hope that any overlap between IFRS and the European Union will be limited. Though it is not certain that the trajectory will continue, ratings have been converging. The next, great challenge will likely be impact-weighted accounting that reflects a company's financial, social, and environmental performance.

The engagement and dialogue of social license

While it is *relatively* easy to map and measure how ESG initiatives align with a business model, it is much harder to track—and to analyze—the maintaining of social license.[10] Companies that are focused on making ESG real have learned, first, to encourage open dialogues with stakeholders rather than to shy away from them; second, to speak directly to stakeholder concerns by showing how their ESG efforts connect to and advance the company's strategy; and, third, to maintain a regular cadence in ESG reporting.

1. Using ESG engagement to sharpen strategy
Forward-looking companies think carefully about communications—not just in terms of what resonates with investors, but with a range of stakeholders; and not just communications for the sake of announcing to others but in order to learn, become smarter, and improve as an organization. Employees are a key constituency and are invariably an important source of insight. Companies can also continuously improve by engaging through trade groups and alliances (the choice of which is itself a rigorous and iterative process), both to better inform their own views and to accelerate impact at scale.

Having an informed sense of opinion helps inure companies to becoming overly defensive. Committed performers embrace the reality that engagement can be a little bumpy. Dick's Sporting Goods, for example—the largest sporting-goods retail company in the United States—endured tremendous pushback when it announced in 2018 that it was discontinuing the sale of assault-style firearms and high-capacity ammunition magazines. The company absorbed both immediate top-line losses and a drop in its share price. Yet the company continued to engage openly with consumers, employees, and investors, stuck to its purpose, and soon saw its earnings and market capitalization surpass previous levels.

2. Showing investors the business proposition
Investors increasingly seek more information about and insist upon more accountability for ESG. They also need to know how a company's ESG initiatives complement and strengthen its strategic plan. Forward-looking companies demonstrate clearly how specific ESG initiatives flow into the business model and have hard metrics to demonstrate progress. They can also take committed actions such as establishing a task force to identify and collect ESG data points for reporting, dedicating full-time outreach and communications employees to the investor relations team, thoroughly integrating sustainability into company reports (including the annual report), and describing specific ESG initiatives and performance against those initiatives in investor presentations.

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[10] A call for impact-weighted financial accounts to reflect a company's environmental, social, and financial performance is already building. See, for example, "Impact-weighted accounts," Harvard Business School.

Companies have also incorporated ESG directly into capital raising, particularly by issuing green- or sustainability-linked bonds (SLBs). These securities feature structural or financial provisions on predefined KPIs, measured against sustainability targets. For example, England-based fashion house Burberry announced a medium-term sustainability bond in 2020 to finance sustainability-linked projects. That same year, Novartis priced €1.85 billion of SLBs, linked to specific ESG targets. The key, of course, in choosing whether to use such instruments is to consider how they could complement and advance a company's ESG priorities.

Regardless of capital mix, there are clear advantages to greater transparency. Stakeholders, particularly (but not only) investors and regulators, expect and increasingly demand detailed disclosures. While regulations vary across countries and jurisdictions, the global trend is toward more robust information. Companies that succeed in implementing business-driven ESG initiatives, meeting hard targets along the way, demonstrate to stakeholders that they can build and sustain value in the context of regulatory change. ESG is already core to their operating model.

3. Making cadence core to the dialogue

Finally, forward-looking companies find that not just the quality of interactions with stakeholders and the detail of information shared with them but also the *pace* of communications is essential. Delaying ESG reporting could be interpreted as a signal of lesser commitment.

Meeting a steady ESG cadence is a developable skill, and it is improved the more it is practiced. Mohandas Gandhi once observed that "your actions become your habits; your habits become your values; your values become your destiny." That is very much the case with ESG reporting. When ESG is core to the business model, reporting on ESG becomes part of the ordinary course of doing business. External shocks are less likely to present an undue burden on ESG reporting. Just as well-managed companies have accounting information quickly available because it helps them discern their business performance, forward-looking companies have ESG data at the ready before and during challenging periods.

Most companies are engaged in an ESG journey. But a culture of continuous improvement in ESG is unlikely to take hold at a company unless ESG is not just taken seriously but systematized and tightly linked to the company's purpose. Forward-looking companies approach ESG in a rigorous, evidence-based, and well-considered way. They increasingly and deliberately incorporate and advance ESG considerations as core to their business model—to enable a more sustainable business and to make ESG real. Q

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