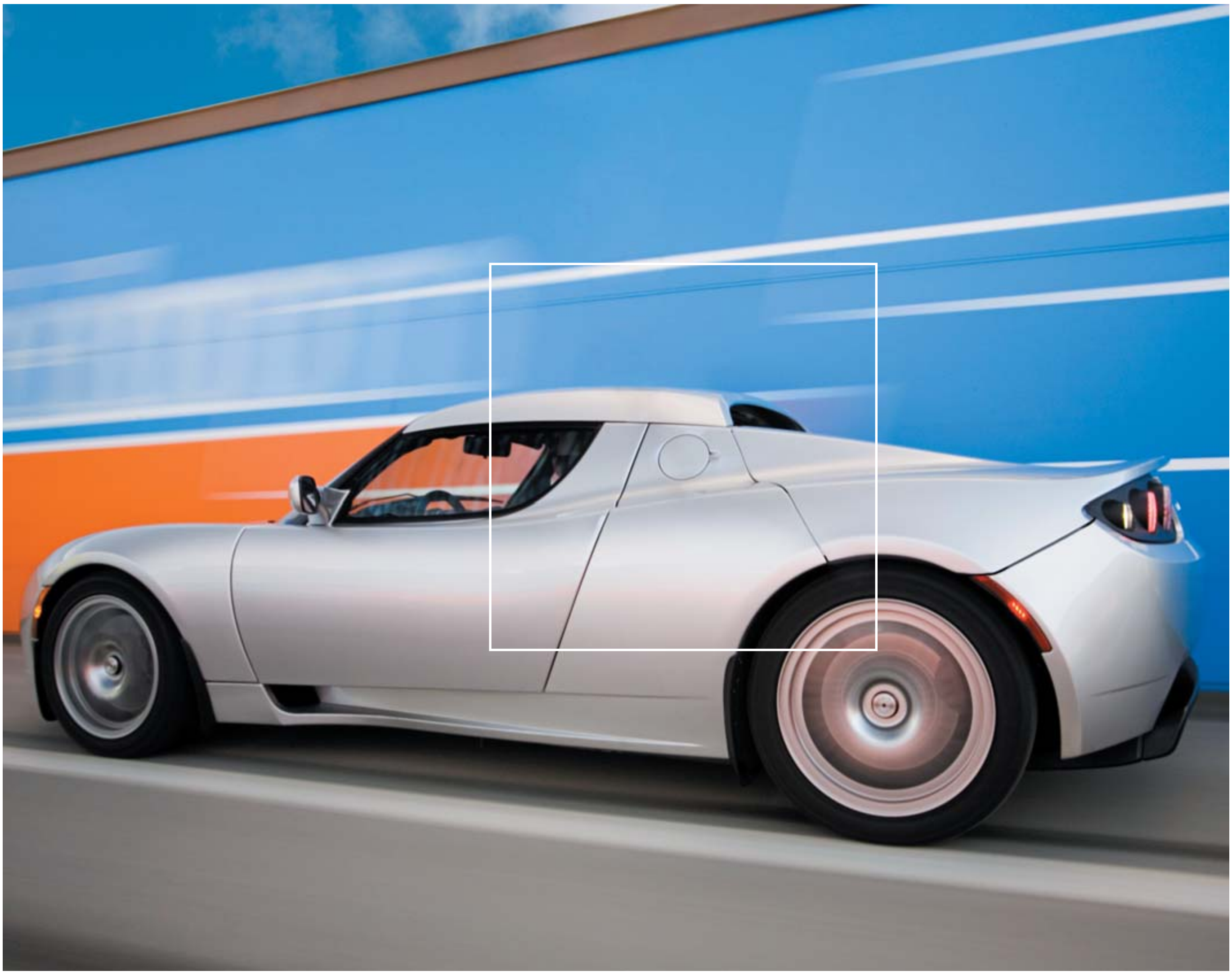
Arthur D Little

Sustainability & Risk

Sustainable Performance Delivered

How to Unlock Value Through Integrity and Innovation



Contents

Authors:

Justin Keeble, Richard Clarke, David Lyon, Davide Vassallo and Matt Jones

Executive Summary – Connecting the Dots

How do companies realise sustainable performance? Having established the connection

Integrity + Innovation = Sustainable Performance

in a previous paper[1], this paper continues Arthur D. Little's exposition of the relationship by showing how companies are making the most of it in the real world.

We focus on four determinants of business value – risk exposure, revenue protection, cost reduction and revenue growth – and examine how companies such as GE, Dow and Novo Nordisk are unlocking these through integrity and innovation.

[1] Integrity+Innovation=Sustainable Performance: the Sustainability Value Formula Arthur D. Little, 2007

Introduction

Two decades have passed since the Brundtland Commission developed the term 'sustainable development' to create a common focus for governments, business and society to prevent present generations profiting at the expense of future ones. But confusion still exists around the concept, its realization and ramifications. To quote sceptic David Henderson:

"Although sustainable development – like corporate social responsibility itself – is an appealing formula, which has indeed been widely endorsed, there are differences of opinion as to what it ought to mean and what it should be taken to imply in practice, while the whole notion is questioned or rejected by some. There is no solid and well-developed consensus which provides a basis for action, whether by governments or by businesses[2]."

Certainly, in Arthur D. Little's view, there are grounds for sympathy with sustainability sceptics. There is still too much talk about sustainability for its own sake, and too little about how it integrates with running a successful business. There is not even agreement about what the term 'sustainability' means.

Too many people still associate it with merely being 'green'. They have yet to recognize that a sustainable business is, in fact, a business that is successful in the short, medium and long term – because it has a broader appreciation of what constitutes **opportunities** for the business, and it manages better than most a wider portfolio of **risks** to the business.

When Arthur D. Little partnered with the World Business Council for Sustainable Development in 1999 to investigate how far 80 companies had progressed towards integrating sustainability into their innovation management, the research found that most of the companies were "part way there" but there was still a long way to go[3].

Five years later, Arthur D. Little studied how far business had moved in terms of being able to identify and grasp the business opportunities presented by integrating sustainability considerations in product and service innovation.

We found that an overwhelming **95% of companies saw potential** in sustainability-driven innovation to create business value, but only a **small minority of companies had actually integrated sustainability** into their business strategy and product/process design[4].

That report highlighted the example of a few leading companies which had reached the point of exploring breakthrough opportunities for their business in sustainability-driven innovation. Some notable successes have been evident, since then, of companies turning the opportunities into reality.

Certain companies (e.g. retailer Marks & Spencer, healthcare specialist Novo Nordisk, telecom service company BT, bank HSBC) have gone even further, achieving outstanding results. Though operating in very disparate sectors, these companies were found – in our most recent publication on this theme[1] – to share two common features: strong **leadership**, and an **intense focus on integrity and innovation**.

Why are integrity and innovation connected? Because:

- Integrity reduces exposure to unwanted risk; protects existing sources of revenue; and together these factors influence the cost of capital.
- Innovation drives cost reduction; stimulates revenue growth; and together these factors influence earnings and cash flow.

No business operates in a vacuum; every decision and every action is influenced by a wide range of forces, both internal and external to the business. Successful business leaders enable their organization to harness the forces that will enhance performance, while optimizing their response to performance-limiting forces.

This white paper provides insight into external/market drivers of sustainable performance, and how companies can enhance the effectiveness of their response to these by strengthening the integrity and innovation dimensions of their business.

[2] Henderson, David, Misguided Virtue: False Notions of Corporate Social Responsibility, Institute of Economic Affairs, London, 2001

[3] Brown, D., Green, J., Hall, F., Rocchi, S., Dearing, A. 'Building a Better Future: Innovation, Technology and Sustainable Development,' WBCSD, 2000

[4] Arthur D. Little Innovation High Ground Report, 2004

Market Drivers for Sustainable Performance

The basic definition of a market driver is any factor (opportunity, threat, risk) external to the company that causes it to change or be changed, leading to better or worse performance.

Market drivers assume many shapes and operate on many different scales. They can be commercial, political or technological; they can be local or global; they can affect a company's – or an entire industry's – short, medium or long term prospects.

From client work and industry analysis, Arthur D. Little has identified the following as key market drivers of sustainable performance for any business:

- Resource costs
- Access to capital
- Competition
- Changing attitudes
- Public accountability
- Public policy
- Expectations of partners
  (in industry, government and society)

Each company has a unique profile in terms of the extent to which specific market drivers govern its ability to achieve sustainable high performance. But every company needs to assess and manage these key market drivers in order to stay the course. And our experience at Arthur D. Little shows that a company's integrity and innovation capabilities are closely connected with its ability to address each driver.

"Each company has a unique profile in terms of the extent to which specific market drivers govern its ability to achieve sustainable high performance."

Conversely, the penalties for not applying integrity and/or innovation properly in business can be severe. A recent example is provided by the events surrounding investment bank Bear Stearns. Research by ECPI (a specialist in environment, social and corporate governance rating and indices for institutional investors) found that the bank was forced to pay $250 million in fines because its market practices allowed hedge funds to make hundreds of millions of dollars in profit at the expense of individual investors. One year later, Bear Stearns became the subject of a probe by the Securities and Exchange Commission followed by a criminal investigation into the collapse of two of its hedge funds and the loss of $1.6 billion. Navigator Capital Partners began legal proceedings, claiming the bank had done too little to prevent the hedge funds' bankruptcy. On the evidence of its market practices and weak corporate governance framework, ECPI downgraded Bear Stearns from its list of companies eligible as responsible investments. The bank's share price, once $140, had dropped to $2 by the time it was sold off to rival JP Morgan.

Corporate Response – Identifying the Right Integrity and Innovation Levers for your Business

Knowing the drivers to be dealt with is one thing. Identifying the levers that will enable your business to do that most effectively is another.

Unfortunately, as another recent publication has shown[5], there is no "one size fits all" solution. The levers that open up new sources of value in the telecoms sector are likely to be very different from those in the chemicals industry.

However, lessons from helping over 1,000 companies to uncover this value over the past eight years suggest three common priorities.

The first is ensuring a robust understanding of the changing attitudes of government and civil society; and how these changing attitudes and concerns translate into potential impacts on the company, its competitive positioning, its technologies and its future business strategy.

The second lies in helping leadership teams to understand the magnitude of these drivers and their potential impact on the business. For example, in 2001, Arthur D. Little told a client in the food industry that "increasing scrutiny related to human rights and labour issues is likely in the food supply chains". Five years later, this scrutiny had become a mainstream issue; with our support the client is now taking advantage of the growth in fair trade products (46% growth in 2007 alone).

The third priority is to ensure the leadership team understands how the company should best respond, either to mitigate the negative impacts or to create strategies to turn these impacts into opportunities.

For example, in 2007, we worked with a leading global transport provider to anticipate a shift in investor sentiment regarding its environmental performance. Growing concern over the environmental impacts of its significant consumption of fuel and related vehicle emissions led the organization to believe a more proactive position was required Over a period of 6 months we worked with the company's leadership team to understand this changing sentiment and how it matched with the company's current performance, and to identify the steps required to reach the optimum position.

We developed a pragmatic action plan to allow the company to exceed investor expectations and be well prepared for the future.

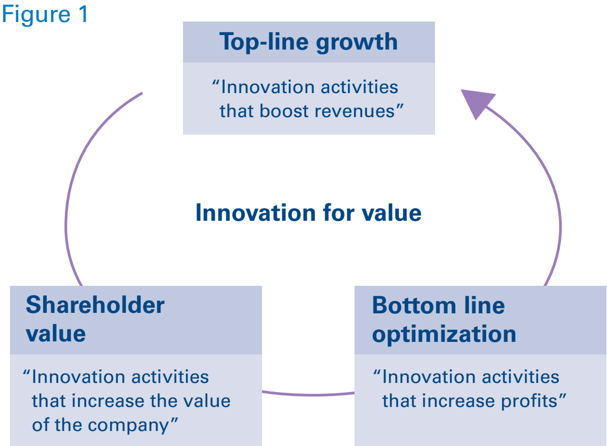
"For example, in 2007, we worked with a leading global transport provider to anticipate a shift in investor sentiment regarding its environmental performance."

Addressing these priorities, step by step, reveals the levers in the business where action in its innovation and integrity dimensions will provide most scope for value creation, in alignment with both external and internal pressures and opportunities.

[5] Innovation for Value, Arthur D. Little, 2007

Decision makers need to recognize the different types of value that can be created (top line, bottom line, shareholder), and decide which type of value creation is most appropriate to their business strategy.

Figure 1



Source: Arthur D. Little

This makes identifying the innovation opportunities and other sources of value in the business more straightforward. It also provides a necessary focus for managing innovation effectively, taking into account the context/sector in which the company actually operates (e.g. is innovation driven by ideas management, is it largely research driven, or does it require analytical thinking across several life cycles?); and the company's own capabilities and values.

The 'puzzle' has many interrelated pieces. Measuring the factors involved can be difficult, and even controversial. On the innovation front, for example, agreement has yet to be reached on the best way to measure technology progress: e.g. some companies use the number of patents they have been granted, while others focus on the number of new products they introduce each year, or on the amount of investment they have made in R&D. Measuring integrity indicators *per se* is less widespread, but more and more companies are assessing and reporting the outcomes of their integrity – i.e. their track record in consistently fulfilling their business principles – as evident in reputation tracking, community relations, etc.

"Measuring integrity indicators per se is less widespread, but more and more companies are assessing and reporting the outcomes of their integrity."

All this complexity makes it difficult to establish a direct "cause and effect" relationship between the value created and the measures of innovation and integrity employed. The solution is not to ignore the complexity, but to acknowledge and work with it[6] – because, increasingly, experience shows that it is possible to increase the value a company creates by actively seeking to enhance the company's performance against those measures.

[6] Chilvers, J.D. & Keeble, J.J. 'Corporate Incentives and Drivers for Innovation in Sustainable Business Practice: an In-depth Study of Aviva plc' Houston Advanced Research Centre, 2002

Applying the Levers

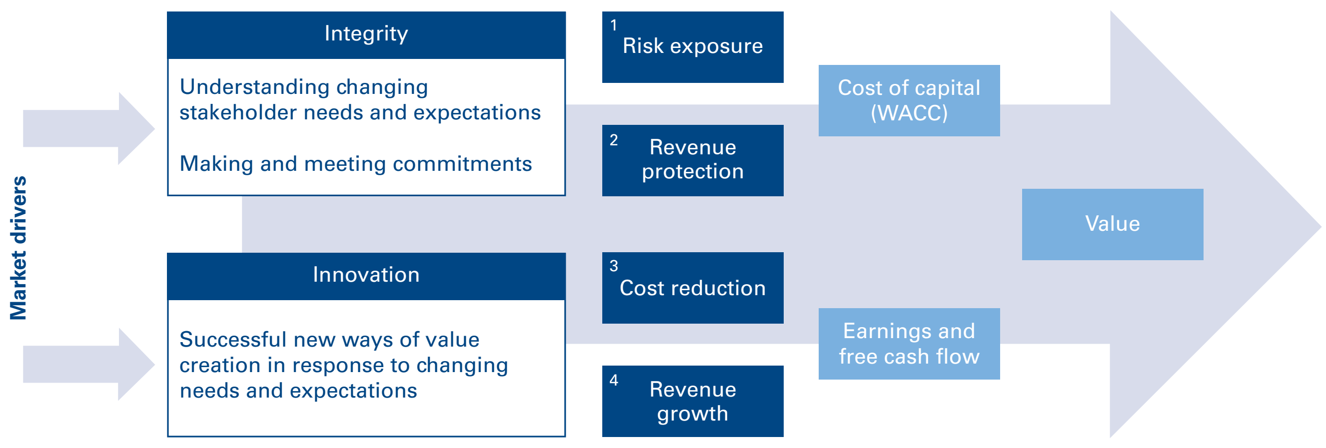
Having identified the priority issues, addressing them in a way that generates an optimal response to the market drivers of the company's performance requires both vision and pragmatism.

Decision makers and key influencers across the organization need to sustain a strong focus on the four key determinants of value – risk exposure, revenue protection, cost reduction, and revenue growth. These directly affect the cost of capital, earnings and free cash flow. In turn, they are profoundly influenced by the way the company manages its integrity and innovation capabilities. As our previous paper highlighted[1] in today's business environment, those who actively and consistently focus on managing these attributes are gaining a strong competitive lead over peers who draw the line at regulatory compliance and/or 'me too' products/services/processes.

In this context, the better you know your own company, the greater your likely success at enhancing integrity and innovation in it. Research (in the financial services sector) has found[6] that, while strategies, tools and techniques might motivate some, they might not be enough to sustain real transformational changes that take companies beyond compliance. Achieving that extra step seems to depend on focusing more on the people (groups and individuals) that make up the organization; understanding better how internal influences and capabilities (especially leadership, corporate culture and individual normative beliefs) relate to corporate decision making; and acting on this understanding to bring about change.

As we noted above, the relative weight of market drivers – and the appropriate response – is unique to each company.

Figure 2: The determinants of value



Source: Arthur D. Little

Examples of business value created in these terms are readily available: e.g. Dow's $4 billion cumulative energy cost savings, or the $3 million savings from just one of Walmart's 60,000 suppliers through reductions in packaging; BT's revenue protection, amounting to some $4 billion, through its approach to responsible business; and Astra Zeneca's revenue growth of $3 million from CO_2 trading.

As well as the nature of the company's operations, organization, assets, etc. and the sector in which it operates, weighting factors include where the company is in its economic cycle: e.g. an economic downturn is likely to warrant more focus on cost cutting, achieving more with less investment, and hence provide stimulus for innovation.

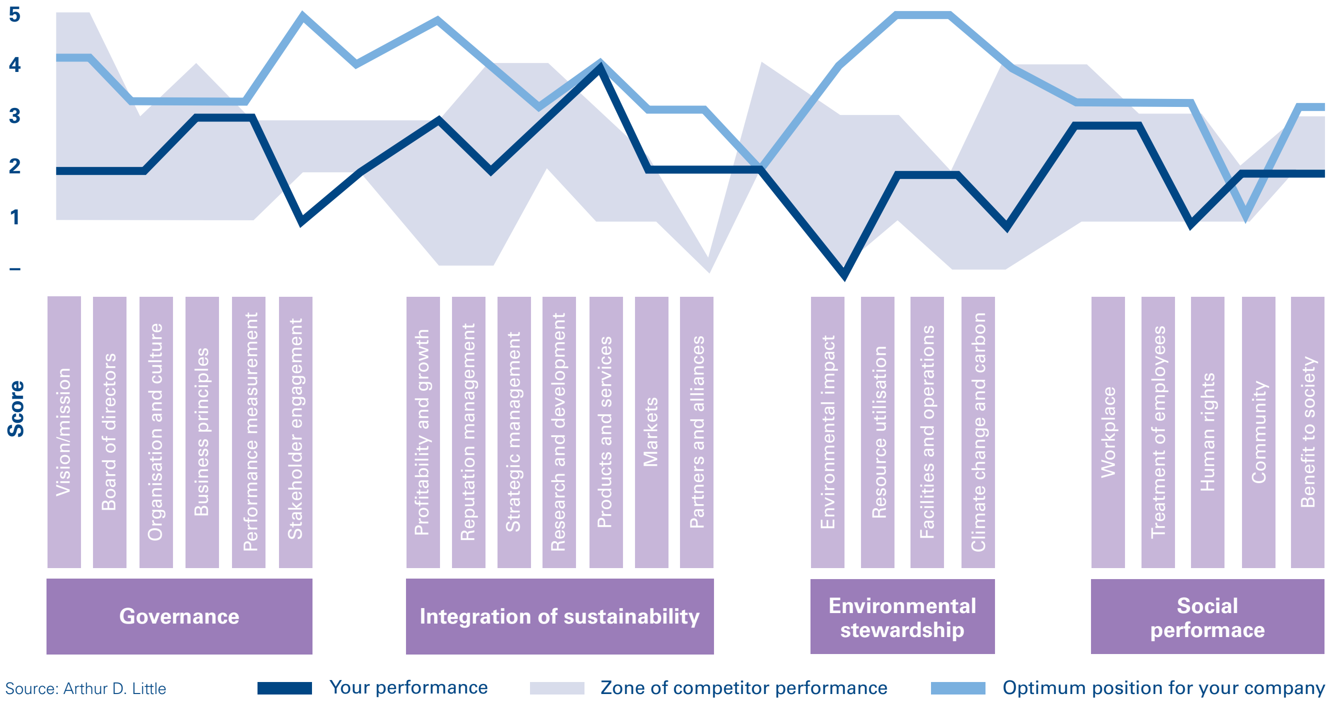
Quite often, the task is one of uncovering value that lies hidden in the organization, rather than trying to find radically new ways of creating it. A number of companies have uncovered very significant value by focusing on more effective management of their sustainability performance – e.g. the billions of dollars revenue generated by GE's Ecomagination initiative, or DuPont's $3 billion savings while reducing its greenhouse gas emissions by 72%.

The sources of this value can be identified through an assessment of the sustainable value of a company's operations and value chain. Having identified the company's priority issues in light of its market drivers, a review of the business through a 'lens' focused on governance, integration of sustainability, environmental stewardship and social performance can identify where advantage is currently being drawn from the way the company addresses each issue and where there are opportunities to create further value.

Each of the available options for creating that value can then be appraised. For example, if reducing CO_2 emissions has been identified as a value creation opportunity for a transport company, the various ways of doing that – increasing freight efficiency, switching the fleet to a different fuel, changing driver behaviors, introducing a new route planning system, adjusting client terms and conditions, etc. – can be costed, compared and prioritized on the basis of how much CO_2 emissions will be reduced.

Companies in nearly every sector are reaping the benefits of a sustainability focus. In retail, Marks & Spencer has demonstrated innovative thinking with integrity through its links with the charity Oxfam. Consumers in the UK and Ireland are encouraged to donate clothes to Oxfam shops by the offer of a discount on subsequent clothing purchases at Marks & Spencer. This helps to divert unwanted material that would otherwise go to landfill, and supports Oxfam's work with poor communities in developing countries.

Figure 3: A review of a business will identify where advantage is currently being taken of these drivers and where there are opportunities for further business value to be captured



Source: Arthur D. Little

Meanwhile, Marks & Spencer has strengthened its brand and its reputation for both business sense and care for the planet.

Mobile telecommunications company 3 Italy, seeking to grow its share of the national market, introduced the 'Rigenerazione 3' concept – a recycled and carbon neutral handset. By upgrading its product portfolio with this 'green' offering, 3 Italy achieved sales growth of approximately 15%, and also free media coverage equivalent to about €15 million worth of advertising. The company succeeded in breaking into a new market segment (LOHAS – lifestyles of health and sustainability). In addition, 11 tons of waste was avoided and about 2,000 tons of CO_2 neutralized in the first 6 months.

In the food and beverage sector, McDonald's has enhanced its sales and broadened its customer base in Germany, France and the UK by responding to local consumers' aspirations to healthier eating. Actions included upgrading the product portfolio with salads and other offerings, integrating bio products into the portfolio, providing nutritional information on every package, and supplying nutritional education sets to customers. The upgraded portfolio generated an increase of over 6% in sales; meanwhile, the McDonald's customer profile has gained a significantly higher proportion of mothers and senior citizens.

Conclusion

Clarity and common sense are still in short supply when it comes to the sustainability of business.

However, more leading companies are demonstrating – through example – how focusing on enhanced integrity and innovation, at the right levels of decision making and in relevant aspects of corporate behavior, yields better business performance that can be sustained over the longer term.

If you have an interest in rethinking the priority issues for your company, in light of the most important market drivers for your business, in order to harness better your company's ability to protect and create revenue and shareholder returns through enhanced integrity and innovation, contact us.

Contacts

If you would like more information or to arrange an informal discussion on the issues raised here and how they affect your business, please contact:

Benelux
Martijn Eikelenboom
+31 10 2018 811
eikelenboom.martijn@adlittle.com

Central Europe
Diethard Buehler
+49 89 38088 780
buehler.diethard@adlittle.com

China
Kurt Baes
+86 13 501060805
baes.kurt@adlittle.com

France
Nicolas Cougot
+33 1 55 74 29 96
cougot.nicolas@adlittle.com

Italy
Davide Vassallo
+39 06 68882 311
vassallo.davide@adlittle.com

Japan
Shimizu Hiroshi
+81 3 3436 8918
shimizu.hiroshi@adlittle.com

Korea
S G Lee
+81 3 3436 8918
lee.sukgeun@adlittle.com

Middle East
Thomas Kuruvilla
+971 4 329 7447
kuruvilla.thomas@adlittle.com

Portugal
Grant Greatrex
+35 1 210 091 500
greatrex.grant@adlittle.com

Singapore/Malaysia
Jeffrey Lai
+60 3 2164 6063
lai.jeff@adlittle.com

Spain
Jesús Ruiz
+34 91 702 74 00
ruiz.jesus@adlittle.com

Sweden
Annette Malmberg
+46 8 5030 6500
malmberg.annette@adlittle.com

UK
London
David Lyon
+44 870 336 6754
lyon.david@adlittle.com

Cambridge
Matt Jones
+44 870 336 6741
jones.matt@adlittle.com

USA
John Brennan
+1 617 532 9500
brennan.john@adlittle.com

The 21st Century Electric Car

Tesla Motors (2003 – Martin Eberhard and Marc Tarpenning) create highly efficient electric sportscars. They combine style, acceleration, and handling with advanced technologies that make them among the quickest and at the same time the most energy-efficient cars on the road.

Arthur D. Little

Arthur D. Little, founded in 1886, is a global leader in management consultancy, linking strategy, innovation and technology with deep industry knowledge. We offer our clients sustainable solutions to their most complex business problems. Arthur D. Little has a collaborative client engagement style, exceptional people and a firm-wide commitment to quality and integrity. The firm has over 30 offices worldwide. With its partner Altran Technologies, Arthur D. Little has access to a network of over 16,000 professionals. Arthur D. Little is proud to serve many of the Fortune 100 companies globally, in addition to many other leading firms and public sector organisations. For further information please visit **www.adl.com**

Our Sustainability and Risk practice supports companies across the world to find performance through integrity and innovation. Our work is rooted in the origins of the firm. Since the days when Arthur D. Little himself advised clients on finding commercial uses for their process waste, we have combined our in-depth sector knowledge and expert advice in business strategy and performance, technology and innovation with a strong track record in advising companies on environmental and social responsibility.

This report is printed on process chlorine free paper
made from 100% recycled post consumer waste.

www.adl.com/sustainableperformance