Sustainable Business Practices

Yes, Sustainability Can Be a Strategy

by Ioannis Ioannou and George Serafeim

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Summary. The accelerating rate of adoption of these practices has also provoked a debate about the nature of sustainability and its long-term implications for organizations. Is the adoption of sustainability practices a form of strategic differentiation that can lead to... **more**

In recent years, a growing number of companies around the world have voluntarily adopted and implemented a broad range of sustainability practices. The accelerating rate of adoption of these practices has also provoked a debate about the nature of sustainability and its long-term implications for organizations. Is the adoption of sustainability practices a form of strategic differentiation that can lead to superior financial performance? Or, is it a strategic necessity that can ensure corporate survival but not necessarily outperformance?

On one hand, there are those who argue that sustainability is spreading as a "common practice" and as such, it may be a necessary condition for *survival*, but it cannot be a sufficient condition for building a competitive advantage. For example, some companies adopt environmental, or water, or waste management systems to exploit cost efficiencies and thus improve their bottom line. Although such systems would typically be considered as adoption of sustainability practices — and so would be included in environmental, social, and governance (ESG) ratings — arguably few, if any, companies would expect to establish a competitive advantage simply by adopting them. Typically, competitors can easily acquire such systems directly from third parties. In this spirit, Michael Porter and Mark Kramer explicitly note in their HBR article on shared value that sustainability, like philanthropy, is "at the margin" of what companies do rather than at the center and therefore these are not practices through which they can achieve economic success. Yet, by adopting common practices (i.e. by being the "same as" peers), a firm can benefit by being recognized as legitimate.

On the other hand, there are those who argue that sustainability can be a strategy that generates a competitive advantage and therefore, results in above-average performance (i.e. "doing well by doing good"). For example, companies that adopt innovative circular-economy-based business models, or adopt practices that enhance employee recruitment, engagement and retention do so to differentiate themselves and therefore, occupy an unexploited or underexploited position through developing a unique and difficult to imitate strategy.

The arguments on both sides conceptually relate to Porter's seminal 1996 article "What Is Strategy?" in which he draws a sharp distinction between operational effectiveness and strategy. He argues that strategy "is about being different" and that "the essence of strategy is choosing a unique and valuable position rooted in systems of activities that are much more difficult to match." Is sustainability then a differentiating strategy or a practice that is bound to spread through imitation and thus, has limited potential to be a basis for a competitive advantage? To what extent have firms in recent years converged in their adoption of sustainability practices? Why have some industries converged faster than others? And, importantly, what are the implications for corporate performance accounting for the industry-level trends in terms of overall convergence on sustainability practices?

In a new paper, we use data from MSCI ESG Ratings, the largest provider of ESG data in the world, for the period 2012-2017 for all companies that appear in the MSCI consistently across all years — i.e. about 3,802 companies — to ensure that our analysis is not contaminated by changes in sample composition. We find that within most industries, sustainability practices have converged over time. This finding implies that, on average, companies adopted an increasingly similar set of sustainability practices during the sample period, raising the possibility that they are becoming common practices and, as such, are less likely to serve as a strategic differentiator and more likely to be a strategic necessity. Moreover, we explore the determinants of inter-industry variation and find that one of the most important factors associated with a higher level of convergence is the adoption of sustainability practices by the industry market leader early in the sample period. Relatedly, we find that there is more convergence in industries where environmental and social issues are dominant, rather than governance issues.

The granularity of the MSCI ESG dataset also allows us to distinguish across sustainability practices and to investigate performance implications. For each industry we identify the set of sustainability practices upon which companies converge over time — which we term “common practices” — and those for which they do not — which we term “strategic.” Our exploratory results confirm that the adoption of strategic sustainability practices is significantly and positively associated with both return on capital and market valuation multiples, even after accounting for the focal firm's past financial performance. In contrast, the adoption of common sustainability practices is not associated with return on capital, but it is positively associated with market valuation multiples.

With our work, we contribute towards moving the broader field of corporate sustainability beyond the narrow focus on the cross-sectional understanding of sustainability practices and the implications for performance, towards developing a more dynamic, complex and multi-level understanding of the adoption of these practices over time. And our results suggest that sustainability can be both a necessity and a differentiator. Some sustainability activities are simply becoming "best practice" and so are a necessity. But the data suggests that some companies are creating real strategic advantage by adopting sustainability measures their competitors can't easily match.

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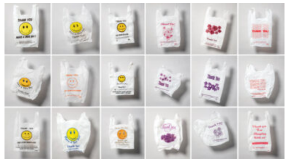

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