

THE QUEST FOR SUSTAINABLE BUSINESS MODEL INNOVATION

By David Young and Martin Reeves

CORPORATIONS ARE MAKING significant progress in addressing sustainability. Most large companies now have a statement of social purpose, many are signatories to the UN Global Compact and support the Sustainable Development Goals, many report progress against material quantitative metrics, and some have joined collaborative efforts to tackle existential environmental or societal issues. Davos 2020 further added to the momentum on stakeholder capitalism, disclosure of progress on environmental, social, and governance (ESG) metrics, and climate response.

These actions are encouraging. We have argued that corporations should optimize for both social and business value, using their core businesses to deliver the financial returns expected by their owners and, in tandem, to help society meet its most significant challenges. To do so, we suggest that leaders reimagine corporate strategy by creating new modes of differentiation, embedding societal value into products and services, reimagining business models for

sustainability, managing to new measures of performance, and reshaping business ecosystems to support these initiatives. While this is a tall order for any management team, the future of the company, our environment, and society depends on doing so.

Limitations of Current Mainstream Approaches

In spite of this progress, few companies have tried to systematically understand the sustainability limits, vulnerabilities, and potential of their current business models and ecosystems. As a result, they risk diminishing their future competitiveness, license to operate, and shareholder returns. This oversight is not entirely surprising. Over the last few decades, managers have relaxed their ambitions regarding sustainable competitive advantage and have focused instead on shareholder returns. The result has been a greater reliance on financial strategies and M&A and a relentless optimization of processes and organization for efficiencies. While such priorities can create shareholder value in the near term, they can also

hide weaknesses in the business model and work against the building of sustainable advantage. And when it comes to issues of sustainability and societal challenges, managers have often treated these separately from core business operations.

We have a long way to go before the two main uses of the S-word in business—sustainability and sustainable competitive advantage—fuse coherently in a way that can guide management thinking and corporate action in the decade ahead. This disconnect is both a wasted opportunity and an urgent social priority. For all the effort to date, we are making little or even negative aggregate progress in essential areas like carbon emissions, even as the societal effects and business impacts are increasingly apparent.

Current approaches have three critical limits: an overemphasis on compliance and reporting, a bifurcation of intent, and a primary focus on the company level.

There has been notable progress in defining metrics for materiality and sustainability and supporting them with increasingly relevant and better-quality data, but this has inadvertently created an overemphasis on reporting and compliance per se, rather than on strategy, action, and advantage. Instead of measuring action and progress against a strategic plan, ESG metrics have become an end in themselves.

This emphasis on sustainability as compliance gives rise to the second issue, the separation of strategy and sustainability considerations. Hence, progress on sustainability metrics is often (and ironically) not closely connected with progress in building sustainable advantage and performance. Quarterly calls and annual reporting emphasize financial returns. Material sustainability issues are considered separately, often in a separate organization with separate reporting and little connection to what drives value in the business.

Generic ESG metrics across industries are too coarse-grained to be closely aligned with any particular firm's capabilities and

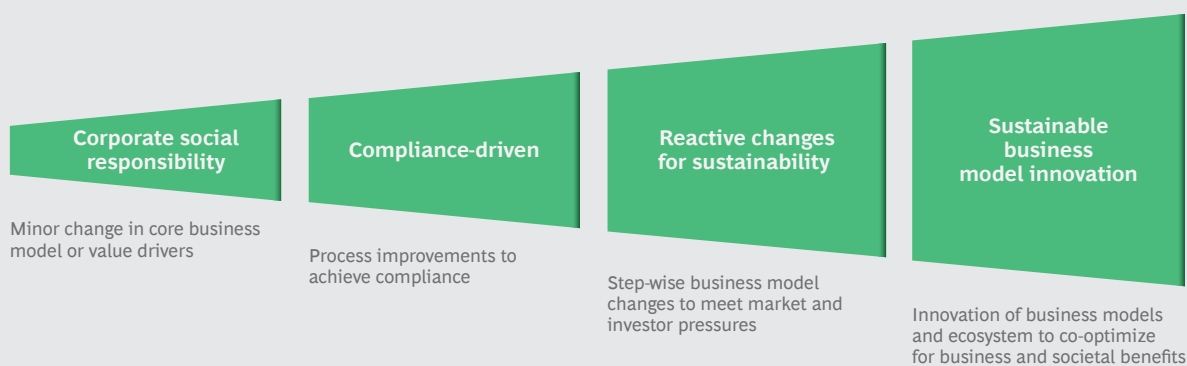
strategy. Materiality metrics attempt to address this by identifying the critical issues by industry. However, industry boundaries are blurring (seven of the ten largest firms in the world are industry-spanning platform businesses), and companies sharing a common end product exhibit increasingly divergent strategies and business models. The emphasis is therefore on reporting at the level of the individual company, sometimes including parts of the supply chain but rarely including the full business ecosystem, the industry, or the broader network of stakeholders—all of which have a role in constraining or enabling advantage and sustainability. This is a critical flaw, since many sustainability issues, like plastic waste or global warming, require collective action. They require the integration and amplification of other participants in an industry's value chains and ecosystem for impact at scale, the adoption of agreed-upon norms and goals to prevent free-riding, and the trust and cooperation of nonbusiness stakeholders.

Exhibit 1 shows the spectrum of company maturity from corporate social responsibility (CSR) to “sustainable business model innovation” (S-BMI), the focus of this article. CSR often does little for either competitiveness or societal benefits at scale. More mature stages include driving compliance through incremental improvement of business processes, undertaking single-point innovations for sustainability in response to new compliance or stakeholder pressures, and ultimately, pursuing sustainable business model innovation. Few companies are positioned on the far right of the spectrum, a requirement for them to win through the '20s.

A New Approach: S-BMI

S-BMI addresses the limitations of current approaches. It builds on traditional business model innovation but applies it to a much expanded context. The basic idea is first to test the company's current business model for sustainability against a broader temporal, societal, and spatial context so that its vulnerability to externalities, its sustainability limits, and its potential to

EXHIBIT 1 | From Compliance to Sustainable Competitive Advantage



Source: BCG analysis.

create new environmental and societal value all become apparent. Second, it explores business model innovations by applying a combination of modular “transformations” to address limits and leverage potentials. Next, it connects business model innovations back to the core drivers of business advantage and financial performance in order to assess how they can deliver both value and sustainability. New models are piloted and tuned to capture advantage in the market and with investors and stakeholders, and to understand what changes are needed in the business ecosystem or at the industry level to create the right context for success.

In this way, strategy and sustainability are jointly considered and become mutually reinforcing, reporting gives way to action, and a company-centric approach gives way to a multilevel approach and new models of competition and sustainable value creation. (See Exhibit 2.) The idea builds on Michael Porter’s concept of shared value, but it unites sustainability and strategy efforts in a common methodology and process, both at the enterprise level and at higher levels.

We already see some leading companies taking ad hoc steps toward transforming their business models for improved performance, better environmental and societal sustainability, and sustainable advantage. But we believe there is far greater potential to be unlocked by applying a structured approach to S-BMI.

The Characteristics of a Sustainable Business Model

A sustainable business model that enables resilience, durability, and value creation through changing business, societal, and investor contexts has the following characteristics:

- It scales effectively without diminishing returns or increasing the risk of failure.
- It increases differentiation and competitiveness.
- It reduces the potential for commoditization.
- It creates an environmental and societal surplus.
- It remains durable against emerging socioenvironmental trends.
- It exhibits network effects that accumulate value and reshape value chains.
- It harnesses or reshapes business ecosystems for advantage and sustainability.
- It increases returns to shareholders and net positives to stakeholders on environmental and societal dimensions.
- It animates the purpose of the company in ways that propel engagement and affinity for employees, customers, investors, and other stakeholders.

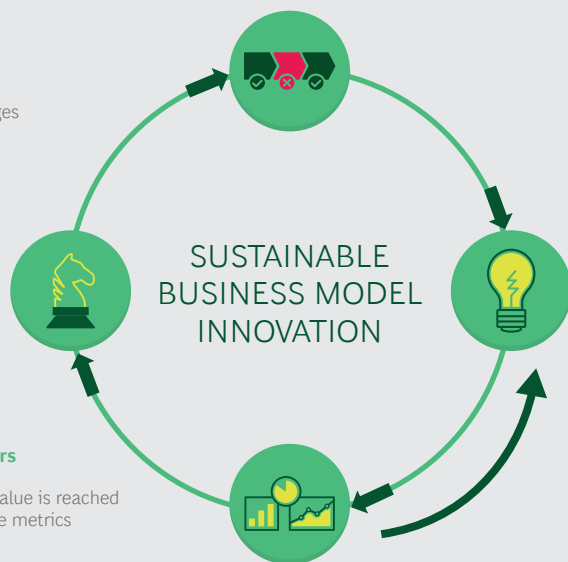
EXHIBIT 2 | The S-BMI Innovation Cycle

Scale

- Capture value
- Refine by geography
- Pursue system-level changes
- Take collective action

Link S-BMI to value drivers

- Evaluate co-optimization
- Repeat until sustainable value is reached
- Set performance and value metrics



Stress-test business model sustainability

- Expand the business canvas
- Extrapolate environmental/societal trends
- Use strategic materiality scenarios
- Scale in multiples

Innovate with S-BMI transformations

- Own the origins
- Own the whole cycle
- Expand societal content
- Energize the brand
- Relocalize/regionalize
- Expand the chains
- Build across sectors

Source: BCG analysis.

These nine properties articulate the goals of S-BMI and form the basis for stress-testing the quality of a business model. The following sections describe how to apply the methodology.

Expand the Business Context

New business insights can come from changing perspectives on the company's boundaries, resources, and time horizons. We suggest laying out the whole of the supply chain, the cradle to grave of the product life cycle, the adjacent business ecosystem, and all relevant stakeholders. Take a systems perspective to see the full ecosystem and market dynamics at work. Within this expanded business context, understand where issues of sustainability, risks, and stakeholder interests intersect with how the company makes money today. Look at how these issues and intersections are evolving over time. These insights should inform a company-specific and dynamic materiality matrix.

We recommend that the corporate strategy center take responsibility for creating and evolving this picture of the larger context of the business, its translation into the corporate dynamic materiality matrix, and a

set of "strategic materiality scenarios" that provoke thinking about the future.

Test the Business Model Against Externalities and Find Its Breakpoints

We recommend developing a range of stress tests that assess the business by considering emerging socioenvironmental trends and strategic materiality scenarios, and by simulating the scaling of the business in multiples of today's activity levels across the value chain.

First, try exploring the implications of taking a current trend to its limits. One example could be investor activism on the company's greenhouse gas emissions or tighter restrictions on plastic packaging. Enrich this exercise by interviewing key stakeholders propelling these trends, including customers, suppliers, analysts, activists, and investors. Understand how the trend could progress and mature and the potential impacts on stakeholders and the business. Is there a potential business advantage relative to competitors? Are there new or amplified risks? What would it take to mitigate those risks, change the dynamics, or exploit new constraints?

There are eight significant trends that we think will shape the societal context for businesses in the decade ahead:

- Escalating investor and consumer activism
- Shared urgency to mitigate the impacts of climate change
- Higher bars on the right to operate
- Radical transparency on ESG performance
- Skewing of capital by investors
- Demonstration of an authentic and powerful purpose
- A premium on good products that do good
- Collaboration for collective action

Ask what each of these trends means for your company, its stakeholders, its industry, and its investors.

Second, go beyond single trends and build strategic materiality scenarios. The goal of this exercise is to help the business envision a very different operating context by colliding rich scenarios with the business model to assess its limits, risks, and opportunities for both financial gain and sustainability. The process starts by taking combinations of dynamics in the expanded business context and amplifying their materiality. In order to precipitate thought-provoking breakpoints, a good strategic materiality scenario has many of the following characteristics:

- It shifts the power dynamics of stakeholders, influencers, and activists.
- It injects new systemic risk into the company's ecosystem and industry.
- It introduces fundamental changes to the basis of competition.
- It fractures or recomposes value chains in the industry or across industries.

- It radically shifts the flow of critical inputs or outputs.
- It changes how investors view the durability of earnings, required investments, or growth and profit prospects of the company or industry.

As an example of such a scenario, imagine that commodity exchanges start to segment trading based on sustainability properties. Imagine what would happen to a metal producer if the London Metals Exchange were to institute a new clean-metals trading market. Or to an agricultural company, should the Chicago Mercantile Exchange embrace new levels of traceability on regenerative agricultural commodities. Or consider the results of widely adopted standards changes. For example, what would happen to a clothing manufacturer if retailers adopted common labeling standards for "sustainable fashion," including product traceability and measures of circularity? Similarly, develop materiality scenarios for key geographic markets. For example, what if the consumer goods operating model for the Indian market in 2025 was water-neutral and carbon-neutral, and companies had to use packaging with 90% recycled content, source all inputs domestically, and certify the national minimum wage throughout its supply chain?

Each strategic materiality scenario will generate a range of business model failures or challenges. Plot these on a matrix with impacts on sustainability intersecting with implications for business performance. The requirements for business model innovation will then become clear.

Third, explore scaling up. Simulate doubling and redoubling activity throughout the business model and value chain and observe stress points and fractures. Such an analysis uncovers hidden constraints and breakpoints in the current business model, possible competitive plays for the company, and the challenges of implementing alternative business models.

Companies generally recognize that scarcity can destroy a company's scale advantage.

es and choke the value chain with significant operational and financial consequences. But shortages can also be a lever for competitive advantage. Companies can use insights into how scarcity shifts over time owing to industry and ecosystem dynamics, market demands, and consumer sentiment to create better strategies and operating models. Surprisingly few companies simulate their business model at different scales under different constraints to understand where it will break down or where new opportunities will emerge—until either actually happens. A 2016 analysis by the Economist Intelligence Unit found that over the previous two years, 43% of companies surveyed had experienced a scarcity of natural resources that created an operational or financial challenge. It also found that 30% of companies claimed that access to land, water, and energy had a “very significant impact” on their operations and finances.

Aside from natural resources, other scarcities can arise and create new externalities. Take, for example, a global food and beverage company that seeks a quick transition away from virgin plastic in its packaging. It discovers that the entire flow of recyclable food-grade PET will meet only a small fraction of its demand, thus constraining its ability to respond to changing consumer sentiment and meet its sustainability aspirations. Or what if an industrial company that seeks to mitigate its environmental footprint through a circular-economy strategy discovers that its main competitor locked in recycled-waste contracts years earlier. Or imagine that a large cereal company wanting first-mover status in offering climate-smart nutrition to the premium segment discovers that too few acres are converting to regenerative agriculture because of a lack of farmer know-how and limited carbon sequestration incentives. Such analyses uncover constraints and breakpoints of the current business model, possible new competitive plays, and the challenges of alternative models.

Throughout the process of stress testing the business model, keep track of where it breaks down relative to the expectations of

shareholders and the interests of stakeholders. This insight informs the next step of the methodology: applying sustainable business model innovations.

Apply Modular Transformations to Remove Fracture Points and Create New Advantage

In this step, test how different combinations of S-BMI transformations can create competitive advantage, change the economics of the business and its ecosystem, and move the company toward resilience and sustainability. Design each of these transformations to create an environmental and societal surplus that translates into business value. Without collective value creation there can be no sustainable value extraction. Below are business model transformations to use as building blocks for S-BMI.

Own the origins. Compete by capturing and differentiating the societal content of inputs to production processes, products, or services. For example, capture those inputs produced with cleaner energy, sustainable sourcing practices, preserved biodiversity, recycled content, inclusive and empowering work practices, minimized waste, digitized traceability, or fair trade. This type of advantage requires advancing the societal performance of the supplier base and its stewardship of resources, communities, and trade flows. Consider PepsiCo’s Sustainable Farming Program, with its long history of ensuring that the company can sustainably source agricultural raw materials. It provides farmers with training and resources to implement best practices for farm productivity and sustainability. Such support creates an environmental and social surplus by enhancing soil health, improving biodiversity, optimizing nutrient and water usage, selecting the best seed varieties, avoiding deforestation, using integrated pest management, and implementing good health and safety practices.

Owning the origins may also require backward integration to ensure fast and complete upstream transformation and then holding and using these new capabilities

for competitive advantage and differentiation downstream. For example, a beverage company recently backward integrated into recycling operations to gain a supply advantage in recycled PET plastics. In some cases, an origins advantage must be built from the ground up by seeding new technologies in the value chain to break open environmental and societal benefits.

Own the whole cycle. Compete by creating societal impact through influence on the whole product usage cycle from creation to end of life. This requires systems analysis to uncover business models that offer the richest competitive and financial options. For example, design the business model for circularity, recyclability, and waste to value. Or create new offerings that enable sharing rather than owning to ensure high utilization of resources and end-of-life value. Other possible moves include constructing enabling infrastructure to facilitate circularity and repurposing, integrating into other value chains to capture societal content, or empowering consumers to choose whole-cycle propositions based on value to people and the planet. Expect to reposition operations, reinvent supply chains and distribution, pursue new backward or forward integration, acquire business adjacencies, or undertake unconventional strategic partnering to achieve such ends.

Expand societal content. Compete by expanding the societal content of products or services on six dimensions of benefit: economic gains, environmental sustainability, lifetime well-being, ethical content, societal enablement, and access and inclusion. Then advocate for new standards, increase transparency and traceability, tune marketing and segmentation, engage customers on the product's broader value and facilitate their involvement in more significant change, and capture value in pricing, share, and loyalty. In business-to-business offerings, help customers integrate the full societal benefits of the company's products, services, and business model into their own aspirations, business model, and product/service offerings.

Danone's "One Planet. One Health." vision focuses the company on having positive impacts on the health and well-being of customers. The company promotes products that hit scientific nutrition targets, sets sales targets on nutritious products, educates some 35 million consumers on healthy diets and lifestyles, trains all its employees on nutrition and hydration, and ensures that everything is done with end-to-end sustainability in mind.

Energize the brand. Compete by digitally encoding, promoting, and monetizing the full accumulated societal value that is embedded in products and services along the entire value chain, from origin to customer and from cradle to grave. Use this data to rethink differentiation, brand experience, customer engagement, pricing for value, ESG reporting, investor engagement, and even new businesses. For example, strengthen the brand with promotions that showcase the business's performance on open, clean, green, renewable, and inclusive attributes of its operations. Build engagement and loyalty by using data on products' environmental and societal footprint to help customers understand how their choices affect the planet and its people.

Proctor & Gamble made news last year when it announced that it was reinventing brand management to "make sustainability irresistible" across its 20 leadership brands. P&G's new approach includes defining a brand-specific ambition, innovating product and packaging to drive sustainable consumption, leveraging the brand to promote sustainable behaviors, reducing environmental impacts across the supply chain, and committing to ingredient transparency. By taking these actions, the company will reset the standard for building and promoting sustainable brands in the decade ahead.

Relocalize/Regionalize. Compete by contracting and reconnecting global value chains to bring societal benefits closer to home markets in ways that stakeholders will value. For example, build local and regional brands that better express local

tastes and societal values while also reinforcing local economies. Or source from smaller local producers to minimize emissions while improving livelihoods. It may also be possible to reimagine production networks against total environmental and societal costs, or to capture local waste streams as new feedstocks into preprocessing. Or restructure today's jobs for micro-work that will employ a broader range of local talent and improve inclusion.

Small changes in the business can have big impacts in local markets and communities. For example, Hindustan Unilever cut its international sourcing of tomato paste from 100% to under 20% by partnering with Bayer and local companies to localize the inputs and de-risk the supply base. The program empowered 2,200 farmers, increased farmer earnings three- to fourfold, and cut crop cycles by one-third.

Expand the chains. Compete by layering onto the value chains of another industry to extend the reach, richness, and societal benefits of products and services for both parties, while at the same time changing the economics and risks of doing so. For example, use the reach of a consumer products distribution system to carry payments and financial services to small merchants; layer one company's health services onto another company's physical supply chain to benefit its workers and their families while expanding markets for health services; or use byproducts from one company's operations as feedstocks into other companies' value chains.

A notable example was an initiative launched by the UN Secretary-General's Special Advocate for Inclusive Finance for Development. It brought together the CEOs of ten global corporations from five industries to identify cross-sector private-private partnerships to accelerate financial inclusion. Companies in consumer products, telecom services, insurance, banking, and payments looked for where their value chains could layer and integrate to expand the benefits of financial inclusion for small merchants, farmers, and women.

Build across sectors. Compete by creating new models that include the public and social sectors, particularly in rapidly developing economies, to improve the company's business, ecosystem, and societal proposition. For example, work alongside government bilateral aid institutions and NGO development organizations to strengthen the agricultural capacity of smallholder farmers as reliable suppliers to the agroprocessing value chain. Or partner with global environmental organizations and governments to promote the reuse of ocean plastics as feedstocks to production systems. One company worked alongside a national government to strengthen and corruption-proof its social safety nets through digitization and electronic payments. In other cases, collective action across sectors is needed, for instance, to restructure recycling systems to enable greater penetration of waste-to-value business models. Extend this into industry coalitions for collective action that reshape broader rights to operate and generate new opportunities.

Royal DSM's Africa Improved Foods (AIF) is a notable example. The company partnered with the public sector, international aid agencies, and local NGOs to tackle nutrition challenges in Rwanda while developing the market for fortified foods. A 45,000-ton-capacity facility employing 300 skilled factory workers was built with co-funding by DSM and international donors. In addition to providing employment, the facility is supplied by over 24,000 farmers, and AIF profits above necessary commercial returns go back to the government of Rwanda. The incremental value of the project over 15 years is estimated at \$760 million; more important, fortified grains and locally branded products will increase the nutritional security of the population. We expect Royal DSM's strategic positioning in a growing Africa to pay off through novel business models that seed the business and help countries meet their SDG goals.

Applying combinations of the foregoing S-BMI transformations to today's business models will stretch strategic thinking and expose opportunities for new competitive

advantages. It will show how the economics of the business and its ecosystem change, and how far the company moves toward sustainability. It will also stimulate ideas for new businesses and forward-looking investment. For example, when one company considered its sustainable business model transformation, it identified 60 related business opportunities. These ideas can load the corporate development and venturing process, offering companies new vectors for portfolio growth and asset development.

Win by Creating an Environmental and Societal Surplus

One crucial underlying concept here is that sustainable business models create and leverage an environmental and societal surplus, by which we mean the accumulation of sustainability assets that can carry secondary value for increasing returns.

Consider an example from the food value chain. An agricultural bank offers preferred financing to farmers for adopting regenerative agriculture and incorporates the net greenhouse gas sequestration into payment terms and offsets, thereby promoting farm sustainability and enabling the bank to accumulate new assets in available carbon offsets. Further along, a cereal producer locks in regenerative-farming suppliers within a preferred radius to create a supplier advantage for sustainable product content, reduced scope 3 emissions, and options in offsets. Finally, to the end market, a consumer company captures and nurtures customers willing to pay a premium for more sustainable products and see-through supply chains, also offering the company behavioral insights as a new asset for the business.

In our experience, environmental and societal surpluses are not limited to consumer chains but are possible across industry sectors, even in primary industries. A case in point is a metals company that further processes the byproducts of its refining operations into roadway aggregates to reduce waste and quarrying demand and improve

roadway longevity. Such hidden environmental and societal surpluses offer new possibilities for creating business value while being good for the environment and society.

Link S-BMI Transformations to the Value Drivers of the Business

S-BMI is iterative, so assess the strength of each new business model transformation by detailing all the ways that it links into the important value drivers of the business, the performance of its value chains, and the strength of its business ecosystem. Then evaluate how well it deals with the risks, brittleness, and fracture points of today's business model, how effectively it scales with increasing returns, and how it expands the options for the future under a range of likely industry and societal scenarios. As the exercise uncovers new limits, go back to the drawing board to further improve the business model by applying additional S-BMI transformations and testing new combinations. The process continues until the business model delivers the most potent mix of business, environmental, and social benefits.

We encourage companies to quickly pilot S-BMIs to refine the necessary process and product changes, sources of advantage, and ways to capture value through marketing, sales, and pricing.

Such S-BMI changes will demand new metrics to gain insights on performance. Throughout the process, we therefore identify the critical parameters that will allow for continuous assessment and improvement and help the company communicate value to its stakeholders and investors. In a sampling of 15 leading public companies' annual and sustainability reports, we found that only 3 had described how their goals in sustainability could positively impact the financial performance of the business. That stands in contrast to an industrial building products company that rethought its business model to deliver carbon-neutral products. In addition to all the classic operating measures, the company set re-

porting metrics for each product's exact contribution to mitigating global warming and communicated why that mattered to the company's competitiveness and customer value proposition. Today, every product the company creates is 100% carbon neutral and it links that explicitly to differentiation and growth.

Explore Enabling Systems-Level Strategy

Many industries today face significant and sometimes existential environmental and societal issues. Solutions are beyond the reach of any one company and therefore place limits on how far it can fully realize the benefits of its S-BMI. Industry or cross-industry strategy and collective action are required, whether in terms of the general goal of cutting greenhouse gas emissions or, specifically, of decarbonizing the metals value chain, eliminating food loss and waste in the food value chain, eliminating single-use plastics in consumer products, or enabling a deep enough recycling system to meet circular-economy objectives. Such system-level constraints will become very clear through the S-BMI process.

Consequently, expect the S-BMI effort to define opportunities for “corporate statesmanship” that identify the shared interests of industry players as a basis for collective action. Further, some solutions will only be possible with industry and government collaboration. Take, for example, the real hurdles facing companies in acting to mitigate climate change. These include uncertainty on future regulation given the poor track record of governments in setting consistent and effective policies. Companies also face high and risky upfront investments to fund innovation. And then there are disadvantages for any company in moving first, which leads to wait-and-see behaviors across the industry even as the risks and costs of inaction rise.

Collaboration can increase the effectiveness and predictability of policy by leveraging objective, fact-based proposals, articulating common interests, de-risking and sharing high-fixed-cost investments and

cross-industry learning, and accelerating impacts by unifying efforts at scale. An example is BDI (the Federation of German Industries) helping German industry assess the most economical lower-carbon pathways. Similarly, the Oil and Gas Climate Initiative created a \$1 billion fund for innovation in carbon capture and sequestration. And going beyond the bounds of a single sector, the European public-private partnership SPRE brings together process industry sectors to fund cross-industry innovations in cement, ceramics, nonferrous metals, minerals, steel, and water.

Such collective action can enable new industry structures and context, mitigating individual company risk while expanding the space for the industry, related new industries, and investors. When correctly defined, rather than limiting competitive moves within the industry, collective action becomes empowering by eliminating the constraints that prevent companies from joining up sustainability and sustainable competitive advantage.

Make the Move from Reporting and Compliance to Action and Advantage

The overall societal context for business has changed. Companies now need to co-optimize for business and social value in order to deliver competitive total shareholder returns in the medium and long terms. The model of companies as economic islands that independently maximize financial value extraction is becoming obsolete. Many companies will respond to the ever-louder calls by investors and stakeholders for more disclosure and higher-quality, reliable ESG data and reporting. But that alone is insufficient to bring the worlds of strategy and sustainability together and secure resilience and durable competitive advantage while also increasing environmental and societal benefits. The continuous practice of sustainable business model innovation is the engine to do so. Leaders pursuing this quest will leave a legacy not only of a better company and better shareholder returns but also of a better society and planet.

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