

Conversations with chief sustainability officers (CSOs) complement our ongoing engagement with the senior management of the companies we invest in. The current backlash against sustainability is proving unexpectedly useful, separating strategies that create durable business value from those that are more performative. Below we share why these conversations matter now and what they can tell us about long-term shareholder value creation.

INTRODUCTION

As bottom-up fundamental investors who are also active owners, we spend a lot of time talking to the management of companies in our portfolios. Typically, these conversations involve the CEO and/or CFO and cover a wide range of financially material issues facing the business. Discussion of sustainability issues will be an integrated part of these ongoing conversations when they are material and properly embedded into business strategy.

Sustainability commitments are under considerable pressure, and the ongoing backlash is separating strategies that create durable business value from those that are more performative. The Chief Sustainability Officer (CSO) often sits at the centre of that distinction. As a complement to our other conversations, engaging the CSO (or equivalent) can help us better understand the details of how sustainability may be contributing to long-term business value, as well as any internal challenges or trade-offs. This deepens our understanding of this subset of investment issues.

WHAT IS ON THE MIND OF THE CSO TODAY

What we are hearing from CSOs across sectors is consistent: the function is undergoing a meaningful and arguably necessary strategic reset. This means pivoting away from focusing on a broad set of stakeholder values to thinking about how sustainability can directly drive business value. This requires intellectual honesty about the trade-offs that are frequently involved in pursuing sustainability, rather than defaulting to the overly simplified “win-win” narrative that incorrectly assumes the most “sustainable” business decision is also the most profitable. If solutions to tough business problems are going to be found, business leaders must first admit that challenges exist.

We have been encouraged by the increasing number of conversations where CSOs are specific about some of these challenges. Number one on the list across industries seems to be the intractable “green premium,” meaning sustainable products or services typically cost more than the non-sustainable equivalent, and

customers are not necessarily willing to pay the higher prices. As an added complication, the performance of sustainable products and services must also be equal or better to drive consumer demand. Sustainability attributes alone are not sufficient for customers to pay the green premium.

The desire to develop more sustainable products or services still exists, in part because regulation may encourage or mandate it. The business opportunity can also be real. Data from PwC¹ suggests that sustainable products have the potential to capture a 6–25% revenue upside from a combination of price premiums, volume increases, and new revenue streams. The question is how to get there. Some CSOs are exploring whether reframing sustainability attributes as a marker of quality or innovation can better drive consumer demand, rather than leading with the sustainability attributes themselves.

CSOs are also aware that for sustainability to be a business driver, they must be highly data-driven, helping to guide the organization to focus on value-chain hotspots for sustainability risk or opportunity, rather than chasing the “decarbonized doorknob,” as one CSO succinctly put it during one of our conversations. Refocusing attention inward on what is directly connected to business strategy and within company control is essential. CSOs acknowledge the important role that standardized disclosure frameworks have played, as do we as investors; however, over time, the external focus had the unintended consequence of obfuscating company-specific materiality. Partially shifting back to internal focus should help businesses derive more value from sustainability over time.

OUR INVESTOR PERSPECTIVE

We believe following these three principles could make the CSO function invaluable.

Sustainability in every sense of the word

We view the recalibration of the sustainability function as a much-needed development. We have always looked for sustainability initiatives to be grounded in

1. Source: PwC “Third Annual State of Decarbonization Report”.

STEWARDSHIP INSIGHTS CONT.

underlying economics, such as projects or products that lower operational risk, drive revenue, or generate cost savings. Several years ago, we observed a temptation on the part of some management teams to pursue projects that were pushed by outside stakeholders, rather than those that had synergies with the existing business.

For example, in 2020, Japanese energy and mining conglomerate ENEOS suddenly proposed spending 85% of its discretionary free cash flow on new strategic investments, including a significant amount on low-carbon technology and services. We were concerned by the size of the investment, lack of synergies with the core business, and management's track record of investing in projects that generated weak returns on investment. We engaged management to advocate instead for targeted high-return investment in clean technology that better leveraged existing operational expertise. In our experience, when a company deviates too far from the pursuit of long-term and sustainable shareholder returns, it usually results in negative outcomes—not just for shareholders, but for all stakeholders.

Pragmatism over ideology

The opportunity for the CSO is to focus sharply on answering the question, “What can sustainability do for the business?,” whether from a risk or a value-creation perspective. The agricultural sector's exposure to physical climate risks means CSOs have typically been acutely aware of the role sustainability can play in supply chain resilience. We recently invested in global chocolate processor Barry Callebaut after conducting diligence on its agroforestry initiatives. Successful agroforestry builds supply chain resilience by preserving the natural environment and generating additional revenue streams for smallholder farmers, helping to preserve access to cocoa beans, upon which the business depends.

The CSO should not be afraid to recommend a change in strategy or speak up if a particular industry standard is no longer fit for purpose. For example, we recently engaged with Dow, a global chemical company, and were encouraged to hear that they have been advocating that the Science Based Targets initiative (SBTi) develop a more realistic standard for the industry. Dow has refused to set an SBTi-aligned target until its concerns are addressed, which we think correctly prioritizes business longevity over short-term reputational gain. That is not to say we are dismissive of SBTi-aligned targets, but ambition should not be

presented as strategy, and accompanying targets should not be misaligned with the operational realities of the company.

Catalyst for innovation

The CSO can be a catalyst for innovation and therefore a partner to the CEO/CFO in solving some of the business' toughest challenges. For example, the growth of data centers requires a massive amount of power which cannot be met through existing grid capacity and legacy technologies alone. In conversations with sustainability leaders in the energy and technology sectors, they likened the current situation to the “whale oil moment.” When whale oil was running critically short in the mid-19th century, the solution did not come from extracting it more efficiently, but from kerosene, an entirely new technology that emerged and made the underlying constraint irrelevant. The suggestion was that some of today's hardest sustainability challenges may be resolved the same way, i.e., through disruptive innovation.

The CSO may be better positioned than the CEO or CFO to research and present ideas for longer-term projects that have the potential to offer attractive returns on investment. In the case of grid capacity constraints, this might involve making strategic and targeted investment in emerging clean technology solutions such as small modular reactors (SMRs) or next-generation geothermal. A conversation with a CSO who is thinking at this level may offer us as investors a sense of where a company is placing its longer-term technology bets, insights that may not always surface in other discussions.

CONCLUSION

The CSOs making the function durable are the ones anchoring it to business economics, speaking honestly about trade-offs, and ignoring external pressure when it does not add business value. That alignment is what shifts sustainability from the cost of doing business into a driver of long-term value. Engaging directly with sustainability teams is increasingly a way to assess which companies are on the right side of that distinction, from near-term capital allocation discipline to longer-horizon bets on technology and supply chain resilience. We will continue to expand these conversations as a complement to our ongoing engagement with management teams.

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