

Session 2 – Managing strategies in an uncertain world

24 May 2022

From awareness to action: a five-step programme with McKinsey & Company. A summary of session 2.

On 24 May, Chapter Zero members and guests joined McKinsey for the second event in a series that aims to turn climate ambitions into concrete boardroom actions. The first session in this series had set the scene of the climate crisis, its impact on businesses, and why boardrooms are a vital piece of tackling this issue. Against this backdrop, this session focused on how directors can help their business shape a strategy that minimises the risks and maximises the opportunities brought in by the net zero transition.

Why is strategy so important?

A strategy is an integrated set of purposeful, hard-to-reverse choices made ahead of time in the face of uncertainty to create and capture economic surplus. This traditional framework may help businesses navigate the net zero transition, but there are increasing questions about whether strategy should work towards holistic goals rather than just economic gain. Directors on not-for-profit boards may already measure success by looking at different types of impact, though participants noted that deciding which standards or metrics are most important in this context can be difficult.

Strategy is vital to success – participants in this session heard that extraordinary strategies tend to produce extraordinary results. A small proportion of businesses reap far greater profits than others, and while the business' starting position is important, effective strategy can help elevate a business into this select group. Certain industries disproportionately earn great profits, but these industries are not static. Directors should consider which industries will shift into this high-return category during the net zero transition, and whether they might guide their organisation to reap these benefits.

McKinsey outlined the following 'big moves' that can help a business stand out amongst its competitors:

1. **Mergers and acquisitions:** This should involve a coherent, programmatic approach rather than ‘bet the business’ deals.
 2. **Resource reallocation:** Ten percent of a business often creates eighty percent of its value, so businesses should allocate resources to these activities.
 3. **Capital expenditure:** Annual capital expenditure to revenue ratio should be higher than the industry median.
 4. **Productivity improvement:** High-performing companies tend to make bigger improvements in productivity than industry averages.
 5. **Differentiation improvement:** A unique brand and outlook can help to draw in consumers, business partners, and talent.
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How will strategy change in a sustainable age?

As explored in the last session, climate change will reshape the economy, opening up new markets and putting others at risk. McKinsey explained that the fundamentals of strategy may not change, but that climate change will create strong headwinds and tailwinds that will have significant impacts on strategy. As such, sustainability must be put at the heart of strategy if an organisation wishes to thrive in the net zero economy.

Capitalising on the net zero strategy will mean playing offense – organisations should decarbonise now rather than later. Reaching net zero will require \$9.2 trillion of investment per year, including \$3.5 trillion of new investment, so boards should position their organisations to harness these new streams of investment. Businesses may also capture green premiums if customers have a higher willingness to pay for more sustainable products despite inflationary pressures or increasing cost of living.

To make the most of these opportunities, businesses must be able to tell this story to their shareholders. Similarly, boards should send a clear message to their executive team that this transition must be a priority. They should work to dispel the fiction that decarbonisation sets a business back financially, as decarbonisation opportunities are often NPV positive or zero cost.

What do directors think?

Prior to the event, attendees were asked to place different businesses of their organisations on a matrix with profitability on one axis and impact on the climate on another axis. This was a useful thought exercise that sparked discussion about how organisations measure success of their different businesses, and how to move into new industries and markets that are set to gain from the net zero transition. Some activities are highly profitable but also cause a large volume of emissions – how should businesses manage this trade-off?

A key question emerged from this discussion – do we need to fundamentally rethink strategy in light of the climate crisis, or can we integrate climate risks and opportunities into existing strategic frameworks? Those who felt that the basics of strategy remain the same likened current climate laggards to past businesses who failed to capitalise on technological shifts and were left behind. Others thought that the climate crisis is so systemic and unprecedented in scale that we may need to rethink fundamental strategic principles.

Attendees also discussed how broader trends such as geopolitical events and government policy can make it harder to take sustainable action in some circumstances, but pose significant business opportunities in others. They also highlighted that shareholders and asset managers must be on board with this transition to enable businesses to act. Public consent is another important aspect of the net zero transition, but businesses must not hide behind public consent or uncertainty when deciding whether to act.

Regardless of the extent to which businesses should reframe strategy, there was clear agreement that most boards must be much more proactive in embedding sustainability across all of their activities. Of course, one effective business strategy will not be enough to mitigate climate change – collaboration, the key theme coming out of the first session, is vital to ensuring that this change is embedded across entire sectors and economies.

In the next session, NEDs will consider how they can translate this broader strategy into high-quality climate action plans. Following that, NEDs will meet in October to discuss how they can motivate organisations and their leadership teams to play offense in the net zero transition.