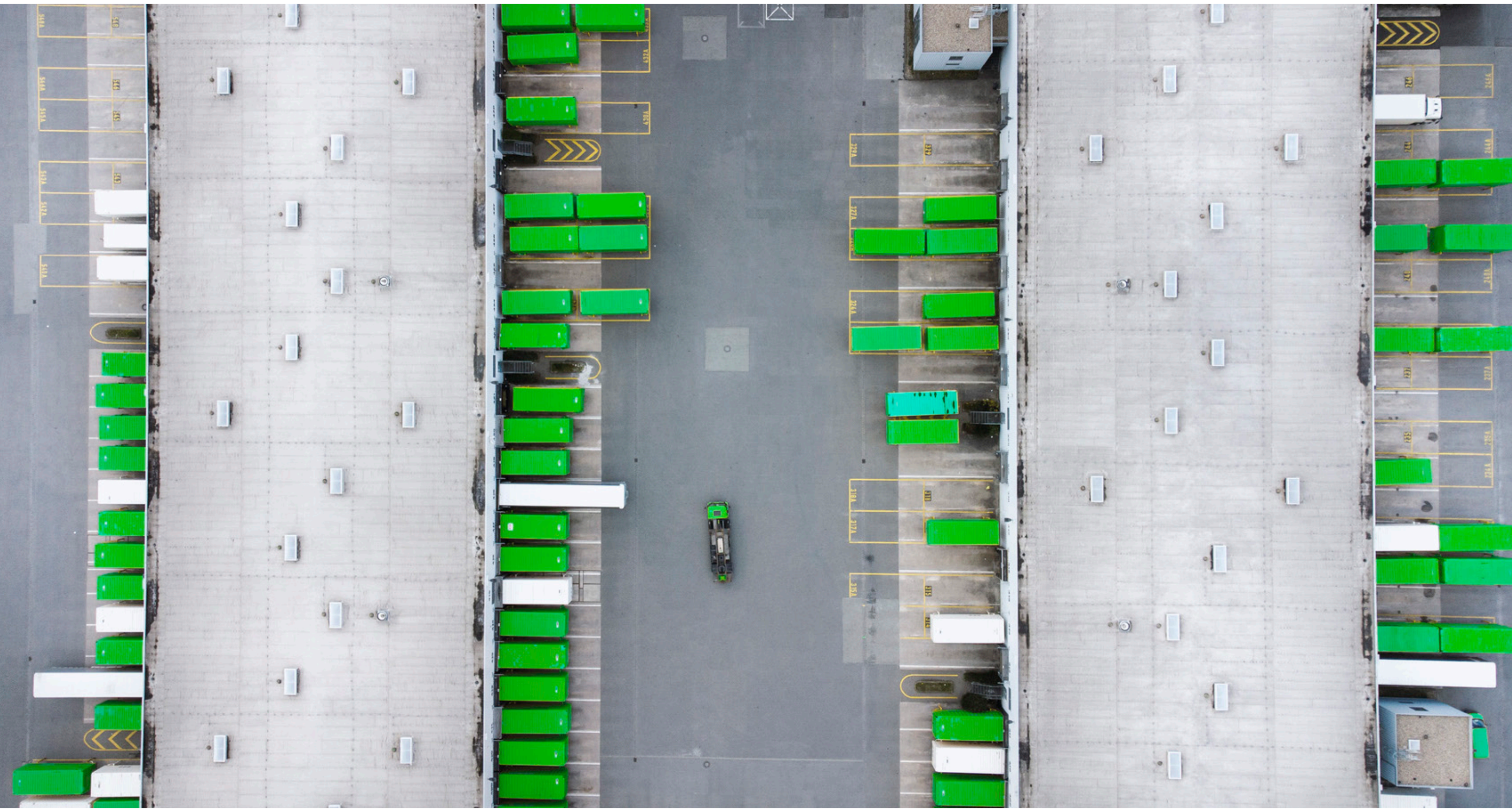
McKinsey & Company

Operations Practice

Buying into a more sustainable value chain

Two-thirds of the average company's environment, social, and governance footprint lies with suppliers. Procurement leaders who take bold action can make a decisive difference in sustainability.

by Celine Cherel-Bonnemaison, Gustav Erlandsson, Ben Ibach, and Peter Spiller



September 2021

Companies have many reasons to focus on environmental, social, and governance (ESG) issues. They may want to satisfy their consumers, who are increasingly choosing brands with strong ESG credentials, even if the prices are higher. Or they may be seeking to stay ahead of ever more stringent regulations. Others react to pressure from banks and investors, want to improve employee engagement, or feel a need to better attract and retain talent. For most organizations, the answer will be a combination of these factors, which together add up to a need to understand and manage environmental impact through every part of the business—in real time.

Leading players are already capturing real benefits from their efforts. Our colleagues' analysis shows that top ESG performers enjoy faster growth and higher valuations than other players in their sectors, by a margin of 10 to 20 percent in each case. Strong ESG credentials drive down costs by 5 to 10 percent, as these companies focus on operational efficiency and waste reduction. Furthermore, ESG excellence reduces transition risk by helping companies stay ahead of changes in regulation and stakeholder sentiment.

ESG leadership begins at home, but it can't stay there. That's where procurement's role becomes so critical. Many companies are already running highly successful initiatives to optimize resource consumption within their operations or engage with their local communities, for example, but the environmental and social footprint of a business extends far beyond its own walls. For most products, 80 to 90 percent of greenhouse-gas emissions are "Scope 3": indirect emissions that occur across the company's value chain, such as embedded emissions in purchased goods and services, employee travel and commuting, and the use and end-of-life treatment of sold products. Of these emissions, two-thirds are usually from the upstream supply chain. Tier-n suppliers are also more difficult to monitor, increasing the risk that poor environmental or labor practices go unnoticed.

Willing, but not ready

As the primary interface with the upstream supply chain, the procurement function has a decisive role to play in shaping an organization's ESG footprint, both directly through purchase decisions and indirectly by influencing product design. When we speak with chief procurement officers (CPOs), it's clear that they understand the significance of their position, but most companies are still struggling to turn that understanding into a clear vision or sustainability strategy for procurement. In a recent survey of 20 CPOs at large European companies, for example, 60 percent knew where they wanted to be but had no aligned sustainability strategy. Only 20 percent said their organizations used sustainability measures as primary criteria in sourcing decisions or supplier reviews. And less than 10 percent said that sustainability was included in category strategies.

When we asked these CPOs why they haven't built ESG into the organization's sourcing DNA, it became clear that most felt they lacked the necessary tools, skills, and data. Seventy percent of our sample said their organizations didn't understand where Scope 3 emissions were generated in their value chain, for example. Ninety percent told us they had difficulty identifying the right actions to move the needle on ESG topics, and almost three-quarters didn't know what ESG targets to set.

Toward the sustainable procurement function

CPOs accept that significant work is required to create the sustainable procurement organizations they need. We believe, however, that many organizations, especially those with mature procurement capabilities, already have robust foundations in place. Most importantly, procurement functions already have rich data on the upstream value chain. They know exactly how much a company buys, where it comes from, and who makes it.

A procurement organization can build on these foundations by taking a holistic approach to the development of new ESG-focused data, processes, and capabilities. Such an approach would involve three basic steps (Exhibit 1), which together make sustainability (and ESG as a whole) simply part of the way the company does business, starting with what it procures and ending with what it sells and how it supports its customers.

1. *Determine the baseline and how far to go.* Understand and quantify the organization's current ESG footprint. Identify the most significant risk areas and improvement opportunities. Determine what matters most in the context of the company's overall ESG agenda. And set goals and targets for sustainable procurement.

2. *Establish the core and drive value-creation initiatives.* Define ESG metrics and policies that will be integrated into the organization's standard supplier selection, procurement, and supply-management processes. In parallel, select a number of top-priority ESG themes and address them via in-depth cross-functional innovation and improvement initiatives, such as collaborating with value-chain partners to decarbonize emissions-intensive areas of the supply chain.

3. *Shift the organization.* Scale up and roll out successful initiatives. Integrate sustainable purchasing practices into the organization. Continuously train the procurement community on sustainable procurement principles and their application. Track performance against targets.

Exhibit 1

Sustainable procurement starts with understanding the starting point and path, and then addressing selected core value-creation themes.

Sustainable procurement plan

How good could we be?

4–6 weeks

Determine the baseline
- Understand overall business sustainability context, strategy, and goals
- Perform benchmark on sustainability performance vs peers and leaders
- Assess the upstream environmental, social, and governance (ESG) footprint

Determine how far to go
- Define vision on where to lead, to match, and to follow; distill core value-creation themes
- Assess value at stake
- Set concrete sustainability ambition for procurement: Where, when, and how far?

How do we get there?

10–12 weeks

Establish the core
- Set up all internal and external policies and guidelines to meet regulatory, customer, and public demands (both current and future)
- Implement principles and initiatives for conscious consumption (eg, rightsizing of specs and volumes to reduce footprints)

Drive value-creation initiatives
- Pilot priority initiatives that enable differentiation beyond foundational requirements, eg:
  - Zero-carbon supply base
  - Circularity and waste reduction in supply chain
  - Zero tolerance on human-rights violations at suppliers

Make it happen

5+ months

Shift the organization
- Continuously sharpen policies and guidelines in line with market expectations
- Structurally embed conscious-consumption principles into all category strategies
- Strengthen core value-creation themes
- Deploy at scale
  - External: embed in category-management and supplier-management, -development, and -collaboration programs
  - Internal: formalize in cross-functional product- and corporate-development projects
- Track external and internal sustainability performance, communicating on impact with stakeholders

Determining the baseline: How good could we be?
You can't start a journey unless you know where you are, and where you want to go. For procurement organizations, there are several ways to address these key questions. To understand the ESG footprint of the supply base, companies can take an internal approach, asking suppliers to provide detailed information on their own ESG impact, both overall and by category. Alternatively, they can use the external data sources offered by specialist ESG analysis and rating companies. Such analyses will inevitably be incomplete, but a top-down evaluation of the supplier base helps procurement organizations take the lead in identifying the most significant risks and improvement opportunities in the upstream value chain.

Many companies also find it useful to benchmark their ESG performance against those of competitors and players in other industries. This can reveal hidden ESG strengths within the value chain, as well as show companies where they need to improve to match or outperform industry norms.

Alongside these top-down analyses, organizations that are serious about sustainable procurement will want to take a deeper dive into the ESG performance of their most important value chains. This can be done by working with key suppliers to conduct an "ESG teardown" of the supply chain, looking at the environmental and social impact of activity through every supply-chain tier.

Using data and analytics, companies are also building upon and evolving practices already used by high-maturity procurement and product development organizations, employing new approaches to look at the impact of their products and services. For example, procurement experts have long been familiar with cleansheet analysis of component and raw-materials costs. "Resource cleansheets" build on that foundation, creating a granular assessment of both monetary cost and carbon footprint for every component and manufacturing step involved in building a product. Over time, this approach generates a common language that the engineering and sustainability

Benchmarking can reveal hidden ESG strengths within the value chain, as well as show companies where they need to improve to match or outperform industry norms.

organization can use to quantify and evaluate materials and technology for their cost and emissions trade-offs (Exhibit 2). Such exercises require good data sources and skilled analysts, but they are a powerful way to pinpoint and reduce major sources of greenhouse-gas emissions.

Building the core, and driving value-creation initiatives

Once procurement leaders understand the ESG footprint of their organization's value chain, they can begin to implement new practices that seek to address risks and capture value-creation opportunities. Many of these procurement practices can be integrated into the organization's standard sourcing and supplier-management processes.

Reinforce that ESG always matters. One consumer products company, for example, decided to take action when it uncovered unfair labor practices at an overseas component supplier. Not only did these practices present a reputational risk to the company, they also threatened the stability of its supply chain, since switching to an alternative supplier created significant delivery delays. The company responded to this issue by introducing a requirement that all potential suppliers provide documentation of their ESG practices as part of its standard RFx (request for x) process. The first time the exercise was run, only seven out of 12 candidate suppliers were able to fulfill the request. Since the cost of mitigating ESG risk through regular checks and audits would outweigh any potential savings offered by

Exhibit 2

By integrating cost and carbon implications, resource cleansheets aid in comparing carbon-abatement strategies.

3 strategies for carbon abatement of medication packaging

Cost impact, € per 100 pieces		**Reduce box weight by 10%**		**Increase tablet density per package**		**Relocate production**	
	Original	New	Change	New	Change	New	Change
Overhead	0.32	0.32	0.00	0.32	0.00	0.18	–0.14
Production	1.38	1.38	0.00	1.40	0.03	1.11	–0.27
Material	1.38	1.31	–0.07	1.27	–0.11	1.37	–0.01
Total	3.08	3.00	–0.07	2.99	–0.09	2.66	–0.42
Net change			**–2.4%**		**–2.8%**		**–13.6%**

CO_2 impact, kilograms of CO_2 per 100 pieces	Original	New	Change	New	Change	New	Change
Overhead	0.01	0.00	–0.01	0.01	0.00	0.01	0.00
Production	1.48	1.47	–0.01	1.51	0.03	1.75	0.27
Electricity	0.02	0.02	0.00	0.02	0.00	0.04	0.02
Material	2.61	2.50	–0.11	2.38	–0.22	2.61	0.00
Total	4.11	4.00	–0.12	3.92	–0.19	4.41	0.29
Net change			**–2.8%**		**–4.7%**		**7.1%**

Abatement cost, € per metric ton of CO_2	Reduce box weight by 10%	Increase tablet density per package	Relocate production
	–583	**–474**	**No abatement**

Note: Figures may not sum to listed totals, because of rounding.
Source: Resource Cleansheet by McKinsey

suppliers without strong ESG systems, the company included the presence of such systems in its primary supplier-qualification criteria for all future sourcing projects.

Other companies consider carbon emissions as part of the RFx process, weighing suppliers according to carbon intensity and their impact on the company's Scope 3 emissions, in addition to criteria such as cost, quality, and delivery performance. More mature companies even apply "internal carbon pricing," creating a profit-and-loss penalty for business units that source products with high carbon emissions.

Core sustainable-sourcing practices should also include demand-side efforts. Simply making internal customers aware of the carbon emissions generated by products and services can encourage lower-impact behavior in areas such as business travel or indirect purchasing. Requiring business units to measure, report, and reduce their Scope 3 carbon footprint can be even more effective in reducing a company's ESG footprint from procured materials and services.

Build sustainability as a standard. Including "sustainability as standard" in procurement processes is an effective way to reduce ESG-related risks and spot opportunities for incremental improvements. It can also help to ensure that procurement teams and their internal customers are aware of the environmental and social impact of purchasing decisions. Where an organization has ambitions to make meaningful changes to its ESG footprint, however, it needs to go beyond the best currently available choices. That requires innovation: sourcing different materials or different manufacturing processes, and collaborating with suppliers in new ways.

Leading procurement organizations are achieving big leaps in sustainability by focusing time and effort on targeted value-creation initiatives. Often beginning with small pilot projects, these initiatives allow teams to explore all of the available options, develop and test new approaches, find out which ones matter most, and then apply them at scale across the entire enterprise and its supply chain—to lasting impact.

At one major consumer goods manufacturer, for example, procurement now orchestrates purchases of electricity from renewable sources for more than 200 offices and production facilities worldwide. The company entered into new power-purchase agreements with renewable-energy suppliers across the globe, securing beneficial pricing by bundling demand from multiple sites. In the next phase of the initiative, it is addressing its Scope 3 emissions by working with major tier-one suppliers to encourage them to make the same transition. As part of that process, it allows those suppliers to source their power through its energy procurement platform.

At another consumer goods player, the procurement organization used an agile sourcing approach to reduce the company's reliance on virgin petroleum-based feedstocks. In a series of weeklong "sprints," procurement teams first conducted a market scan to identify candidate feedstocks produced from alternative sources including recycled plastics and agricultural waste. They then evaluated the economic, environmental, and technological maturity of the most promising candidates before finally developing a detailed business case, cost models, and go-to-market approach for four possible new feedstocks. The effort identified opportunities to reduce annual carbon emissions by around a million tons over a one- to five-year time frame.

Other procurement teams have made significant sustainability gains through expanding collaboration with suppliers. One global retailer pursued a multipronged strategy with agricultural suppliers in emerging markets, which included the introduction of longer-term contracts to encourage capacity investments, and support for the adoption of technologies such as hothouses and drip irrigation. After several years, the effort generated annual savings of more than $300 million as suppliers increased their yields while reducing input costs. At the same time, reducing consumption of water and fertilizer helped to cut risks associated with spikes in commodity prices or water scarcity.

Another company, this time in the pharmaceutical sector, worked with its end customers and distribution partner to replace single-use secondary packaging with a durable, returnable container for temperature-controlled shipments. Careful, user-centric design of the packaging and returns process helped the organizations to achieve a 98 percent return rate, well above their initial target of 80 percent. The project eliminated 500 tons of packaging waste and generated savings of almost $4 million.

Shifting the organization

The final step in the development of a sustainable procurement function is a set of actions that embed strong ESG practices into the organization. Procurement teams will need to learn how to evaluate the ESG credentials of potential suppliers, for example, and how to use carbon accounting principles to compare the impact of different supply options. Scaling up flagship sustainability initiatives into company-wide policies may require investment in new technical skills for supplier development teams, which can then engage with suppliers to educate, evangelize, and address specific capability gaps.

The procurement function will need new tools and data sources, too, to enable ESG supply chain teardowns and resource cleansheeting, or to facilitate the identification of suppliers with favorable ESG footprints or novel technologies that could help the organization achieve its sustainability goals.

Finally, companies will need to track sustainability alongside other targets, and adapt their incentive and performance-management systems to ensure the efforts of procurement teams and internal customers are aligned with the organization's sustainability goals.

As companies seek to reduce the negative environmental and social impact of their activities, they are discovering that many of the biggest risks and opportunities are found in the upstream supply chain. That puts the procurement function at the front line of the transition to sustainable business models. Ambitious CPOs should act now to ensure they have the tools, data, and capabilities needed to support this shift.

To test your readiness, try listing the three ways that the purchasing function could have the largest impact on your company's ESG footprint. What would take to achieve that impact? How could procurement become a primary driver of sustainability within your organization?

Celine Cherel-Bonnemaison is an associate partner in McKinsey's Paris office, **Gustav Erlandsson** is an associate partner in the London office, **Ben Ibach** is a consultant in the Atlanta office, and **Peter Spiller** is a partner in the Frankfurt office.

Designed by McKinsey Global Publishing