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A PRACTICAL APPROACH TO SUSTAINABILITY FOR MIDSIZE GROWTH COMPANIES IN EMERGING MARKETS

Mike Lubrano†
Alexey Volynets*

† Managing Director, Valoris Stewardship Catalysts and author (with George Dallas) of Governance, Stewardship and Sustainability (Routledge and ICGN, 2022).
* ESG Knowledge Management Officer. Environmental, Social & Governance Knowledge & Learning at IFC.

I. INTRODUCTION

Rapidly growing midsize companies are an important segment of Small and Medium Enterprises (SMEs) and are critical providers of employment, innovation, goods, and services in developed and emerging markets alike.[1] In emerging markets, Midsize Growth Companies (MGCs) also accelerate the movement of people and economic activities from the informal to the formal sector.[2] MGCs face many of the same sustainability challenges as larger firms but with less developed organizational capacity and constrained physical, human capital and financial resources. Hence, there is a need for guidance and tools on environmental, social, and business sustainability tailored to the unique organizational and resource characteristics and limitations of MGCs. Building on the International Finance Corporation's (IFC) long-standing work on corporate governance, SMEs, and sustainability in emerging markets, the authors have developed and are currently field-testing a draft Sustainability Assessment and Improvement Tool for Midsize Growth Companies (Tool).[3] The Tool's structure and content are consistent with and reinforce IFC's evolutionary approach to SME governance and institutional development.[4] It focuses on fit-for-purpose, practical solutions that take into consideration the resource and leadership limitations that SMEs in emerging markets typically face.[5]

[1] *See* Abdulaziz Albaz, Marco Dondi, Tarek Rida, & Jörg Shubert, *Unlocking Growth in Small and Medium-Size Enterprises*, MCKINSEY & CO. (July 2, 2020), https://www.mckinsey.com/industries/public-and-social-sector/our-insights/unlocking-growth-in-small-and-medium-size-enterprises.

[2] *See* David Jacoby, *Thinking Big- Midsize Companies and the Challenges of Growth*, THE ECONOMIST (Feb. 2006), https://www.bearingpoint.com/files/BearingPoint_SAP_Economist_Inteligence_Unit.pdf.

[3] *See International Finance Corporation's Guidance Notes: Performance Standards on Environmental and Social Sustainability*, INT'L FIN. CORP. (Jan. 1, 2012), https://www.ifc.org/wps/wcm/connect/5aa6a833-70e5-4188-9be8-1cabc56e4825/Guidance+Notes+to+Performance+Standards+on+Environmental+and+Social+Sustainability.pdf?MOD=AJPERES&CVID=ltRkHM3.

[4] *See id.*

[5] *See id.*

II. THE IFC AND MGCS

The IFC, a member of the World Bank Group, is the largest global development institution focused on the private sector in emerging markets.[6] Working in more than 100 countries, the IFC lends its capital and provides advisory services to create opportunities and markets through private sector solutions.[7] The IFC has long been a leader among financial institutions in promoting environmental and social sustainability and best practices in corporate governance. The IFC's Environmental and Social Performance Standards define IFC clients' responsibilities for managing their environmental and social risks.[8] Many public and private sector financial institutions have drawn from the IFC Performance Standards in developing their criteria. Tools developed by the IFC are the core of the Corporate Governance Development Environmental and Social Framework, the methodology for evaluating and improving corporate governance in emerging markets adopted by virtually every other development finance institution.[9]

Rapidly growing midsize companies play an essential role in economic development. In emerging markets, SMEs generate up to 45% of total employment and about a third of Gross Domestic Product (GDP).[10] Larger, expanding SMEs are also frequently an important bridge between the informal and formal sectors, contributing to the tax base and providing many workers with their first formal employment experience and entry into national social security systems.[11]

[6] *About IFC*, INT'L FIN. CORP., https://www.ifc.org/wps/wcm/connect/corp_ext_content/ifc_external_corporate_site/about+ifc_new (last visited July 9, 2022).

[7] *Id.*

[8] *See Corporate Governance Development Framework*, INT'L FIN. CORP., https://www.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/Sustainability-At-IFC/Policies-Standards/Performance-Standards (last visited July 14, 2022).

[9] *See Performance Standards*, INT'L FIN. CORP., https://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/ifc+cg/cg+development+framework (last visited July 14, 2022).

[10] OECD, ENHANCING THE CONTRIBUTIONS OF SMES IN A GLOBAL AND DIGITALISED ECONOMY 6 (2017), https://www.oecd.org/industry/C-MIN-2017-8-EN.pdf.

[11] *Id.* at 6-7.

Recognizing their critical role in economic development and job creation, supporting vibrant SMEs is an integral part of the IFC's mission. While the IFC does not lend directly to SMEs, it supports their development through a variety of channels, including:

1. Provision of advisory services to SMEs and organizations that support them;
2. Investments in and support to banks and other financial institutions that finance SMEs;
3. Issuance of credit lines and similar facilities to local financial institutions, such as the Global Trade Supplier Finance (GTSF) Program, targeted to SMEs; and
4. Investments in private equity and other investment funds that provide equity and debt financing to SMEs.[12]

III. A KEY DISTINCTION: ESG V. SUSTAINABILITY

The conceptualization of ESG – the lumping together of Environmental, Social, and Governance considerations in the evaluation of businesses – mainly originated with the investment community, and in connection with investments in large public companies.[13] Investors know that good governance is positively associated with company performance and investment returns, especially in the long term.[14] They have likewise come to understand that environmental and social factors may present businesses with severe, often catastrophic, risks. Investors appreciate that for environmental and social risks to be addressed effectively, they must command the attention of the top company decision-makers.

From an institutional investor's perspective, bundling together E, S and G makes sense. Investors traditionally divide investment risks into financial and non-financial categories.[15] Non-financial risks can be conveniently organized under environmental, social, and governance

[12] INT'L FIN. CORP., SCALING-UP SME ACCESS TO FINANCIAL SERVICES IN THE DEVELOPING WORLD (2010), https://www.enterprise-development.org/wp-content/uploads/ScalingUp_SME_Access_to_Financial_Services.pdf.

[13] Georg Kell, *The Remarkable Rise of ESG*, FORBES (July 11, 2018, 10:09 AM), https://www.forbes.com/sites/georgkell/2018/07/11/the-remarkable-rise-of-esg/.

[14] Alexander T. Kraik, *Environmental, Social, and Governance Issues: An Altered Shareholder Activist Paradigm*, 44 VT. L. REV. 493, 535 (2020).

[15] DELOITTE, THE FUTURE OF NON-FINANCIAL RISK SERVICES: BUILDING AN EFFECTIVE NON-FINANCIAL RISK MANAGEMENT PROGRAM 3 (2018), https://www2.deloitte.com/content/dam/Deloitte/nl/Documents/financial-services/deloitte-nl-how-to-build-an-effective-non-financial-risk-management-program.pdf.

rubrics.[16] Investors, especially those in public markets, have come to demand more quantitative measurement of non-financial risks by portfolio companies articulated in accordance with accepted ESG frameworks and reporting standards.[17] These demands, in turn, generate increasing pressure for firms to develop more explicit and robust structures, policies and procedures for the governance, management, and reporting of ESG risk.[18]

But the rationale for bundling E, S, and G together is not always so apparent to the people who run companies, especially owner-managers of SMEs. Experience gained from the IFC and its partners' extensive advisory work with SMEs in emerging markets reveals some common patterns:

- Compliance considerations are rarely sufficient to motivate SME leadership to embrace systematic attention to ESG factors.[19] Rather, perceived business necessity drives priorities.[20]
- Owner-managers of startups are usually too absorbed in demonstrating the business model's viability and achieving scale to take meaningful steps to improve governance, much less systematically analyzing and addressing likely future environmental and social challenges.[21]
- The entry of outside investors, or the exit of one or more founders from active management of the company, is typically an important impetus for formalizing corporate governance.[22]

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[16] *See* USMAN HAYAT ET AL., ENVIRONMENTAL, SOCIAL, AND GOVERNANCE ISSUES IN INVESTING: A GUIDE FOR INVESTMENT PROFESSIONALS 4-5 (2015), https://www.cfainstitute.org/-/media/documents/article/position-paper/esg-issues-in-investing-a-guide-for-investment-professionals.ashx.

[17] *See generally* OECD, ESG INVESTING: PRACTICES, PROGRESS, AND CHALLENGES (2020), https://www.oecd.org/finance/ESG-Investing-Practices-Progress-Challenges.pdf.

[18] *Id.*

[19] Michael E. Porter et al., *Where ESG Fails*, INST'L INV. (Oct. 16, 2019), https://www.institutionalinvestor.com/article/b1hm5ghqtxj9s7/Where-ESG-Fails.

[20] *Better ESG Reporting – A Key to Strengthening Capital Markets*, IFC PERSP., Oct. 2019, at 29, https://www.ifc.org/wps/wcm/connect/3ad10685-0670-4b41-9cce-e379497f97c1/2018-10-09-IFC-Perspectives-Issue-2.pdf?MOD=AJPERES&CVID=mpzuzJr.

[21] N.Y. STOCK EXCH., THE ENTREPRENEUR'S ROADMAP FROM CONCEPT TO IPO 23 (2017), https://www.nyse.com/publicdocs/nyse/The_Entrepreneurs_Roadmap.pdf.

[22] Stanford Seed, *Masterclass on Effective Corporate Governance*, STAN. GRADUATE SCH. OF BUS. (May 10, 2022), https://www.gsb.stanford.edu/insights/masterclass-effective-corporate-governance.

- A company's entrance into new supply chains (particularly selling to multinationals) is frequently a decisive factor in motivating SME (and MGC) management to devote more attention to environmental and social sustainability factors.[23]

Accordingly, many ESG tools and guidance developed by international investors may appear alien or fundamentally misguided to owner-managers of MGCs. They can seem like distractions from the priority risks and challenges that management needs to keep their focus on to run a successful business.

So, enter sustainability, the term we prefer to use in our work with SMEs and MGCs in emerging markets. Sustainability is closely related to ESG, but we believe it is also meaningfully distinct. In practical terms, sustainability is a term that describes running a business – at the highest governance level – to make it more likely to survive and prosper in the long run.[24] Sustainability ensures that the company is taking the proper steps to have reliable and continued access to essential resources and the support of key stakeholders.[25]

Sustainability certainly requires careful attention to environmental and social factors. Still, it incorporates a much broader view of business risks and issues that are paramount for the long-term development of businesses. Meaningful staff engagement is one such example.[26] Most importantly, sustainability starts from the owner-manager's view of the company – inside out, rather than the investor's view – outside in.[27] Sustainability prioritizes those factors that are accepted by the leadership of the firm as relevant to long-term success.

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[23] It bears re-emphasizing here that our work (and the application of the Tool) is very much focused on the particular circumstances of emerging markets MGCs. The business environments in which such enterprises operate are typically characterized by weaker institutions, inconsistent enforcement, and less developed financial markets. Some of the factors noted here (e.g., the weak influence of compliance considerations) might have different degrees of salience in more developed markets.

[24] *See* Robert B. Pojasek, *A Framework for Business Sustainability*, 17(2) ENV'T QUALITY MGMT. 81 (2007).

[25] *Id.* at 81.

[26] Paul Polman & CB Bhattacharya, *Engaging Employees to Create a Sustainable Business*, STAN. SOC. INNOVATION REV., Fall 2016, at 39.

[27] Aaron De Smet, Wenting Gao, Kimberly Henderson, and Thomas Hundertmark, *Organizing for Sustainability Success: Where, and How, Leaders can Start*, MCKINSEY SUSTAINABILITY (Aug. 10, 2021), https://www.mckinsey.com/business-functions/sustainability/our-insights/organizing-for-sustainability-success-where-and-how-leaders-can-start.

IV. THE SPECIAL CASE OF MIDSIZE GROWTH COMPANIES

A. What do MGCs look like?

MGCs are a distinct subset of SMEs worthy of special attention regarding sustainability, especially in emerging markets.[28] In contrast to less dynamic (and typically less formal) smaller enterprises, MGCs have achieved reasonable scale and viability and are poised to experience, or are currently undergoing, a period of significant growth. The market values their products, and the business model has proven workable so far. Their scale and growth prospects are typically the rewards of considerable technological innovation, organization adaptation, and company leadership's laser focus on identifying and exploiting opportunities to produce and sell their core products and services at lower cost and staying ahead of the competition.[29]

For our work on the sustainability of such companies, we define MGCs as firms that have experienced a recent (and often continuing) sustained period of high growth. MGCs typically also exhibit most of the following operational and governance characteristics:

<u>Operational Characteristics</u>

- Have 75 to 250 employees (varies by country and sector).[30]
- Have significant capital requirements. They are in the market for additional capital and strategic partnerships to support further growth.[31]
- Have delegated functions, but concentrated control. Some operational duties have been delegated, but the owner-managers retain complete strategic control.[32] They receive limited strategic input from other executives and specialists, mainly through ad hoc meetings and consultations.[33]

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[28] Albaz et al., s*upra* note 1.

[29] Michael Haynes, *Business Growth Drivers Of Mid-Sized Companies (And Using Them In Your SME)*, Listen Innovate Grow (Dec. 18, 2019), https://listeninnovategrow.com/driving-business-growth-midsize-companies/.

[30] Cam Merritt, *What Size Company Is Considered a Mid-Size Company?*, CHRON (Mar. 8, 2019), https://smallbusiness.chron.com/size-company-considered-midsize-company-71776.html.

[31] *Small and Medium-Sized Enterprises: Characteristics and Performance*, U.S. INT'L TRADE COMM'N (Nov. 2010), https://www.usitc.gov/publications/332/pub4189.pdf.

[32] Jirí Strouhal et al., *SMEs Stakeholders' Needs on Valuation and Financial Reporting*, 16 INT'L ADVANCES ECON. RSCH. 425, 425 (2010).

[33] Albaz et al., *supra* note 1.

- Have organizational structures resulting from ad hoc decisions that exhibit path dependence. Basic organizational structures and lines of authority coexist with a substantial degree of informality (and sometimes intentional ambiguity).[34] Some functions and processes have been professionalized, while others remain "legacy" – "the way we have always done it" or "by the person who has always done it."

Governance Characteristics / Patterns

- Are owner-run. One or two main owner-managers, typically founders, are fully engaged in running the company.[35] Minority shareholders may exist, but they are either employees or related to founders by family or friendship ties.[36]
- Have limited institutionalized management.[37] Management has started to function as a team but often informally and mainly focused on operational issues rather than strategic direction.[38]
- Make decisions informally. Owner-managers make strategic decisions through informal meetings.[39] The company either does not have a board of directors or the board is fully controlled by the owner-managers and their families and friends.[40]
- Exhibit fragmented reporting systems.[41] Management information systems exist in silos. They produce inconsistent data using metrics and formats and are not reconcilable in real-time.[42]
- Have opportunistic, organically developed "piecemeal" internal controls. The overall control environment does not reflect the

[34] *Id.*

[35] *See* Gro Ladegard & Casper Claudi Rasmussen, *Corporate Governance in High-Growth Firms*, 12 CORP. OWNERSHIP & CONTROL 308, 309 (2015).

[36] *See* Samuel E. Neschis, *Reasonable Expectations of Shareholder-Employees in Closely Held Corporations: Towards a Standard of When Termination of Employment Constitutes Shareholder Oppression*, 13 DEPAUL BUS. & COM. L. J. 301, 302 (2015).

[37] Ladegard & Rasmussen, *supra* note 35, at 309.

[38] *See id.*

[39] *See generally* Deborah Sweeney, *Business Basics: Annual Meeting for Small Corporation*, MYCORPORATION, https://blog.mycorporation.com/2016/01/business-basics-annual-meetings-for-small-corporations/ (2019).

[40] *See generally* Mary Ann Cloud, *What is a Board's Role in a Family Business?,* HARV. L. SCH. F. ON CORP. GOVERNANCE (July 30, 2014), https://corpgov.law.harvard.edu/2014/07/30/what-is-a-boards-role-in-a-family-business/ (differentiating between the different size and makeup of boards companies need as they grow).

[41] Mark van Leeuwen, *What Are Information Silos? Business Problems & Organizational Fixes*, VOGSY (Oct. 17, 2021), https://www.vogsy.com/blog/information-silos/.

[42] *Id.*

standards of the "Three Lines" model, which is a popular framework for helping organizations to identify structures and processes that facilitate the achievement of objectives, strong governance, and risk management.[43]

- Have family-member employees.[44] Some members of the founders' families work for the company.

To summarize, MGCs are typically entrepreneur-driven and, to a great extent, still entrepreneur-dependent. This makes them people-dependent rather than process-driven. The demands of rapid innovation and growth, along with the constant threat of competition, impel management and staff to focus first and foremost on what appear to be the most urgent challenges, often to the exclusion of factors that will be crucial to their companies' success over the medium- to long-term. The time pressures, bandwidth limits, resource constraints, and organizational limitations facing their leadership mean that a systematic approach to environmental, social, and economic sustainability has had to take a back seat.

V. THE DIMENSIONS (AND SUSTAINABILITY RISKS) OF GROWTH

What distinguishes MGCs from other medium-sized enterprises is their experience of and potential for growth. The growth strategy and trajectory an MGC pursues are essential determinants of the types and degrees of sustainability risk attendant to its growth.[45] We, the authors, employ one of the oldest and most used frameworks for classifying and analyzing business innovation- the Ansoff Matrix (see below); this is used to illustrate the main dimensions of MGC growth strategies.[46] The Ansoff Matrix distinguishes enterprise growth along two dimensions- (1) market expansion and (2) product expansion.[47]

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[43] THE INST. OF INTERNAL AUDITORS, THE IIA'S THREE LINES MODEL: AN UPDATE OF THE THREE LINES OF DEFENSE 2-4 (2020), https://www.theiia.org/globalassets/site/about-us/advocacy/three-lines-model-updated.pdf.

[44] Xiaowei Rose Luo, *Family Business and SMEs*, 15 MGMT. & ORG. REV. 211, 211 (2019).

[45] *See* Christy Sasser, *Three Strategies To Help Your Midsize Company Grow, Part One*, FORBES (Apr. 26, 2018), https://www.forbes.com/sites/workday/2018/04/26/three-strategies-to-help-your-midsize-company-grow-part-one/?sh=60a58c296a2e/.

[46] *See Using the Ansoff Matrix to Develop Marketing Strategy*, OXFORD COLL. OF MKTG., https://blog.oxfordcollegeofmarketing.com/2016/08/01/using-ansoff-matrix-develop-marketing-strategy/ (last visited Jul. 15, 2022).

[47] Kyle Peterdy*, Ansoff Matrix*, Corp. Fin. Inst., https://corporatefinanceinstitute.com/resources/knowledge/strategy/ansoff-matrix/ (July 7, 2022).

Product Innovation Less to More →

Product Development • Developing novel, but related products or services • Quality improvements (including certification)	**Diversification** • Entering into new products and markets (inc. joint ventures) • Acquisitions of non-competitors
Market Penetration • Designing and adopting new technologies and production processes (including controls) • Incorporating new natural or energy resources into production processes • Tapping new sources of human resources • Acquisitions of competitors • New marketing strategies/ technologies	**Market Development** • Entering new geographies • Identifying and serving new customer demographics • Shifting supply chain patterns (e.g., entering a large customer's supply chain; outsourcing inputs heretofore produced internally)

Market Innovation Less to More →

Each combination of market expansion and product expansion described in the graphic above poses differing types and levels of risk for an organization, with entering new markets usually creating measurably higher chances of failure than developing new products for existing customers.[48] Famous business consultant and educator George Day estimates the risk distribution the following way[49]:

a. Market share capture is the least risky strategy. It assumes growth with the same product(s) in the same market. It is essentially a default strategy: "to continue doing what we have been doing so far," just more of it.

b. Product development increases the risks for the enterprise considerably. Production might entail unanticipated or unfamiliar requirements, the company might not prove particularly suited to making the new product, customers may not like it, and/or there might be strong competitors.

[48] *Id.*

[49] George Day, *Is It Real? Can We Win? Is It Worth Doing?: Managing Risk and Reward in an Innovation Portfolio*, HARV. BUS. REV. (December 2007), https://hbr.org/2007/12/is-it-real-can-we-win-is-it-worth-doing-managing-risk-and-reward-in-an-innovation-portfolio.

c. Market development strategies typically have a higher probability of failure than product development strategies. Moving into new geographies, new demographics, or new categories of customers is generally costly, involves high levels of uncertainty and strains human resources.

d. Diversification, pursuing product innovation and market development at the same time, is by far the riskiest strategy.

Accordingly, the draft Sustainability Assessment and Improvement Tool for Midsize Growth Companies we have developed explicitly considers the particular dimensions of an MGC's current and likely future growth trajectory. It considers sustainability risks and solutions within the context of the company's growth. For example, the Tool's recommendations for companies pursuing growth through product development emphasize enhancing risk governance systems to ensure adequate oversight of environmental risks frequently associated with introducing new technologies. Similarly, MGCs contemplating market expansion are encouraged to beef up their strategic planning process, seek the support of experts with experience in the target market and pay particular attention to the additional social risks that may arise from entry into such markets.[50]

VI. THE SPECIAL CHALLENGES OF SUSTAINABILITY FOR MGCS

Rapid growth creates a set of serious challenges for the economic sustainability of any company. At least half of companies in emerging markets that experience a period of high growth exit the market altogether three to six years after the episode.[51] Rapidly scaling production leads to organizational and managerial inefficiencies and a high concentration of risk in a few select individuals. The objective of our work is to develop a practical resource to help companies avoid the so-called "curse of fast growth" by transitioning to new governance, managerial, and organizational practices that are fit for purpose in light of the company's new size and complexity, building the foundation for its long-term sustainability.

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[50] See *13 Key Considerations Before Expanding The Business*, FORBES (Feb. 24, 2021, 8:10am EST), https://www.forbes.com/sites/forbesbusinesscouncil/2021/02/24/13-key-considerations-before-expanding-the-business/?sh=54f74ccb2906.

[51] ARTI GROVER GOSWAMI, DENIS MEDVEDEV & ELLEN OLAFSEN, HIGH-GROWTH FIRMS. FACTS, FICTION, AND POLICY OPTIONS FOR EMERGING ECONOMIES xx, (2018), file:///Users/jp/Downloads/9781464813689%20(2).pdf.

The long-term sustainability of a company ultimately requires that its leadership devote continuous attention to various business risks and opportunities. Two factors that traditionally have not been included in this analysis systematically, but are increasingly recognized as critical to long-term success, are environmental (such as air, water, and soil) and social (such as employees, customers, and community) sustainability.[52] Midsize businesses face increasing pressure from the government, customers, supply-chain partners, lenders, and others for information about environmental and social (E&S) practices and the impact of their operations and products on the environment and community. Therefore, E&S factors are now prominently featured in sustainability analysis and action planning.

MGCs confront challenges in implementing sustainability that are different from those faced by small enterprises, on the one hand, and larger, more established firms on the other. It is only a slight exaggeration to state that they must grapple with the same environmental, social, and economic threats and possibilities confronting their larger competitors in the product and financial markets, but without the more abundant resources (financial, managerial, human capital) that more established firms can typically count on.

Just as importantly, MGCs must respond to the sustainability challenges presented by growth without the institutional capacity that larger firms possess. As already noted, MGCs are typically entrepreneur- and people-driven. Their existing processes may be workable with the current leadership and senior staffing, but they are unlikely to prove resilient to sudden changes in personnel, strategy, and direction. The strength and sophistication of an MGC's institutional capacity (comprising management, control and governance structures, policies, and practices) must catch up with and keep up with the size and complexity of its operations and the changing nature of the sustainability risks and opportunities it must face.[53]

Increasing institutional capacity and resilience does not mean blindly laying on bureaucratic burdens. When applied to smaller, less-established firms, structures, policies, and processes that might be workable for larger companies can prove wasteful or even

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[52] *See* Natalie Chladek, *Why You Need Sustainability in Your Business Strategy*, HARV. BUS. SCH. ONLINE (Nov. 6, 2019), https://online.hbs.edu/blog/post/business-sustainability-strategies.

[53] GOSWAMI ET AL., *supra* note 51, at xxiii.

counterproductive.[54] The challenge for MGCs is to achieve the same objectives of incorporating consideration of sustainability factors in strategy and operations that their larger competitors should be pursuing, but in ways that are consistent with the entrepreneurial nature of the company and that make the best use of limited resources.[55] For this reason, the approach we have adopted explicitly considers the stage of development of a company's corporate governance and the level of its institutionalization and organizational development. Our approach draws from the IFC's SME Governance Guidebook, which divides SME evolution into four stages (Start-Up, Active Growth, Organizational Development, and Business Expansion).[56] It "specifically addresses the challenges and opportunities faced by SMEs at the various stages of their lifecycles, offering tailored corporate governance recommendations for these smaller businesses".[57]

The common scenarios just described explain why MGCs often fall short along three dimensions in internalizing sustainability principles in their businesses:

1. The sustainability implications of existing business models and activities have still not been entirely identified or thoroughly analyzed by company leadership;

2. Current governance structures, policies, and practices do not adequately incorporate considerations of environmental, social, and economic sustainability factors in strategic and operational decision-making; and

3. Their policies and practices around future growth opportunities remain inadequate to identify and address sustainability risks, and opportunities as the company's activities evolve and expand.[58]

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[54] *See* INT'L FIN. CORP., SME GOVERNANCE GUIDEBOOK, 4 (2019), https://www.ifc.org/wps/wcm/connect/acc873c9-5cb2-42da-aa720b46e6c1b48b/IFC+SME+Guide+2020+Web.pdf?MOD=AJPERES&CVID=n7bAUbZ.

[55] *See id.* at 6.

[56] *Id.* at 11.

[57] *Id.* at v.

[58] *Id.* at 6, 13, 54.

Accordingly, medium-sized growth companies need to tackle two critical tasks if they are to build resilient businesses that will be sustainable over time:

1. Fully identify, analyze and understand the sustainability challenges of existing business models, production processes, and company strategies and adopt sustainability policies and practices that are well-tailored to them (catching up; back-fill); and
2. Preparing themselves to identify and understand the sustainability risks and opportunities they need to anticipate because of: (a) the rapid evolution and expansion of existing ways of doing business; and (b) the future adoption of the sorts of new products, production methods, systems, markets, sources of finance, etc. that will power further growth (moving forward; prospective sustainability).[59]

Proper governance structures, policies, and practices are inherent in any effort to tackle these two critical tasks sustainably.

VII. BUILDING ON IFC'S EXISTING TOOLS AND OTHER RESOURCES

As already discussed, the IFC's SME Governance Guidebook posits four stages of SME evolution:

> Stage 1: Start-Up. Product/service development and market testing are the first priorities.[60]
>
> Stage 2: Active Growth. The need for growth through sales, people, and increasing complexity are the defining features of this stage. This growth remains largely organic, unplanned, and unbalanced.[61]
>
> Stage 3: Organizational Development. Once the organization has grown in size and complexity, it becomes a priority to correct the imbalances and develop the organization through specialization, professional policies, structures, and staff. The

[59] *Id.*
[60] INT'L FIN. CORP. *supra* note 54, at 12.
[61] *Id.* at 15.

focus is on the company itself.[62]

Stage 4: Business Expansion. Additional capital is often needed to take the organization to the next level. When this capital comes in the form of equity, an increase in the number of shareholders necessitates more formality in the corporate governance arrangements.[63]

The SME Governance Guidebook recognizes that companies face different sets of governance risks as priorities at each stage and provides analytical tools and possible solutions to help SMEs address the challenges at each stage and prepare for the transition to later stages.[64] The draft Tool we have developed complements the IFC SME Governance Guidebook's evolutionary approach. It also draws on other important work by IFC and other standard setters, notably IFC's Environmental and Social Management System (ESMS) Implementation Handbook[65], its Internal Control Handbook[66], and the Committee of Sponsoring Organizations of the Treadway Commission (COSO) guidance on environmental, social, and governance risk management.[67] Indeed, one of the main features of the Tool is that it identifies and cross-references existing frameworks, tools, and standards for analyzing and responding to the sorts of sustainability challenges MGCs face.

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[62] *Id.* at 16-17.

[63] *Id.* at 19-20.

[64] *Id.* at 22-24.

[65] *See generally,* INT. FIN. CORP., ENVIRONMENTAL AND SOCIAL MANAGEMENT SYSTEM IMPLEMENTATION HANDBOOK, (2021), https://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/sustainability-at-ifc/publications/publications_handbook_esms-general.

[66] *See generally,* INT. FIN. CORP., INTERNAL CONTROL HANDBOOK, (2018), https://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/ifc+cg/resources/toolkits+and+manuals/internal+control+handbook.

[67] *See generally,* COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION & WORLD BUSINESS COUNCIL FOR SUSTAINABLE DEVELOPMENT ENTERPRISE RISK MANAGEMENT: APPLYING ENTERPRISE RISK MANAGEMENT TO ENVIRONMENTAL, SOCIAL AND GOVERNANCE-RELATED RISKS (2021), https://www.wbcsd.org/Programs/Redefining-Value/Making-stakeholder-capitalism-actionable/Enterprise-Risk-Management/Resources/Applying-Enterprise-Risk-Management-to-Environmental-Social-and-Governance-related-Risks.

VIII. THE DRAFT TOOL

As noted above, we are currently in the process of detailing and field-testing the Sustainability Assessment and Improvement Tool for Midsize Growth Companies. We designed the Tool to be a *governance for sustainability instrument* - adjusted for the realities of MGCs and focused on economic, environmental, and social sustainability. We drew on the lessons of the IFC's long experience with SME development and believe the Tool reflects a tailored, fit-for-purpose approach to corporate governance and environmental and social sustainability in midsize companies in emerging markets:

- The Tool is principally designed for firms that fall into the SME Governance Guidebook's Stage 3 (Organizational Development) or Stage 4 (Business Expansion). Parts of it may also apply to earlier-stage companies with special motivating factors, such as the presence of outside investors or participation in global supply chains. The Tool effectively expands on the SME Governance Guidebook's governance-centric recommendations for these stages with a more in-depth treatment of sustainability issues.
- Reflecting the IFC's evolutionary approach and MGCs' need to prioritize given their resource constraints, the Tool has some characteristics of a progression matrix. The recommendations presented in the Tool progress from the basic to the more sophisticated for each topic.
- The Tool's recommendations focus on high-level, strategic issues that in larger, more established firms typically fall under the purview of the board of directors. While improving an MGC's governance is an important focus of the Tool, we accept that most such companies don't have functional boards of directors (especially in the absence of outside investors). Hence, the Tool's recommendations emphasize the value of building an effective management team through the formalization of a management committee, the hiring of external advisors, and the creation of an Advisory Board that may eventually evolve into a proper board of directors.

- Recognizing that the dimensions of growth discussed earlier and the occurrence of certain events in the life of an MGC increase the salience of particular sustainability risks or create opportunities to address them, the Tool prioritizes specific recommendations in certain special cases, including:
    - Entry into supply chains;
    - Entry of outside investors;
    - Growth through product innovation;
    - Growth through expansion into new markets; and
    - Family ownership and control.

The Tool itself is intended for use principally by business consultants and advisers to companies, including internal sustainability champions.

IX. Conclusion – Evolution of the Tool

The Tool is currently in draft form. It has been introduced to and is currently being reviewed by IFC staff and business consultants in emerging markets where IFC operates for their comments and suggestions. We anticipate that some of these will use the Tool as part of their work with MGC clients. The comments we receive and the experiences from the field tests of the Tool should provide valuable practical feedback that will be translated into improvements in both its structure and content. Although we expect to publish the Tool along with a guide to its use later this year, like the other elements of the IFC's corporate governance, sustainability, and SME tools and guidance, the Sustainability Assessment and Improvement Tool for Midsize Growth Companies will be a living document and subject to periodic review and revision in light of the lessons learned through the experience of its practical application.