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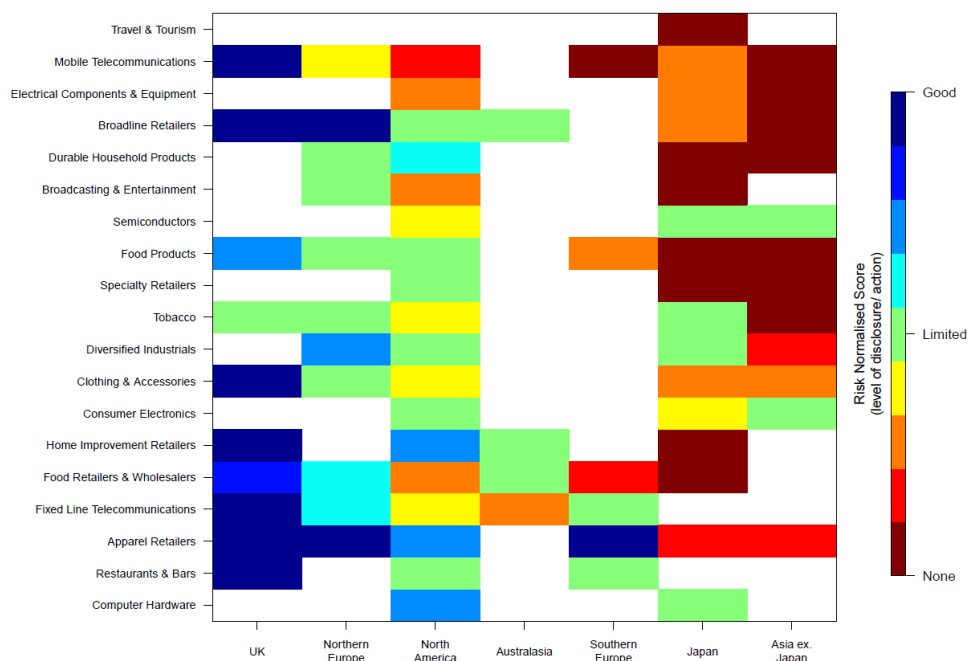
# ESG Research

## Brand value at risk:

## Defusing the supply chain labour reputation bomb

## Summary

- Companies are under increasing pressure to deal with underlying risks in supply chain labour conditions
- Institutional investors have identified supply chain labour risks to be one of the greatest social concerns
- Analysis against the extended FTSE4Good Supply Chain Labour Standards criteria show over a third of companies demonstrating no action to manage their risks
- By understanding the trends highlighted in this report, investors will be better equipped to manage exposure to these supply chain labour risks at a portfolio level



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## Executive Summary

- Companies are under increasing pressure to deal with underlying risks in supply chain labour conditions
- Early media and activist campaigns focused on labour-intensive retail products such as apparel, toys and food products, but have now spread to high technology products such as electronic goods
- A lack of response by companies could represent a real risk to investors should the company's reputation be tarnished by media criticism, which can lead to consumer boycotts and other activities which affect their market value
- Institutional investors who have signed up to the UN Principles of Responsible Investment have identified labour standards within the supply chain as one of the greatest social concerns in their portfolio management process<sup>1</sup>
- In September 2012, FTSE has extended its Supply Chain Labour Standards criteria to additional sectors and companies for the FTSE4Good Index Series and FTSE ESG Ratings
- The number of companies globally for which the FTSE4Good and ESG Ratings Supply Chain Labour Standards criteria apply has doubled from 148 to 356<sup>2</sup>
- FTSE analysis shows that over a third of companies with higher supply chain labour risk exposure levels have demonstrated no action to manage the risk
- Levels of response to potential risk exposure are not homogenous across regions and sectors, with companies domiciled in Asia and Electrical Component and Equipment companies facing particular challenges in addressing these issues
- By understanding the trends highlighted in this report, investors will be better equipped to identify the industry sectors and manufacturing countries where the potential for erosion of brand value is highest.
- This information can then be used in formulating an investment strategy which helps to manage exposure to such supply chain labour risks at a portfolio level

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<sup>1</sup> <http://www.unpri.org/news/2012.09.04%20CH%20press%20release.pdf>

<sup>2</sup> Note that these figures cover companies in the FTSE Developed Index universe.

## A. Introduction

Since the FTSE4Good Index Series were launched in 2001, FTSE has continually worked to enhance the ESG criteria to evaluate companies to reflect investor concerns and company practices - see the figure below. These criteria have been developed with its data partner EIRIS, based on market consultation under the guidance of the independent FTSE4Good Policy Committee, and have taken a risk-based approach to identify companies facing potential ESG risks and to measure the quality of their response.

As the most recent development in this ongoing criteria development process, FTSE has extended its Supply Chain Labour Standards criteria to cover additional companies and sectors for its FTSE4Good Index Series and ESG Ratings.

The purpose of this report is to help investors understand the issue of supply chain labour risks, and how they can utilise the criteria and data in order to identify their risk exposure and formulate an investment strategy to manage these risks.

| Year | Inclusion criteria                                                                      | Sector Specific Criteria    | Product launches                                                |
|------|-----------------------------------------------------------------------------------------|-----------------------------|-----------------------------------------------------------------|
| 2001 | Basic Environmental and Social criteria                                                 |                             | Launch of FTSE4Good Index Series                                |
| 2002 | Strengthen Environmental Criteria                                                       |                             |                                                                 |
| 2003 | Strengthen Human and Labour Rights Criteria                                             |                             |                                                                 |
| 2004 | New Supply Chain Labour Standards Criteria                                              |                             | Launch of FTSE4Good Japan Index                                 |
| 2005 |                                                                                         |                             |                                                                 |
| 2006 | New Countering Bribery Criteria                                                         | New Uranium Mining Criteria |                                                                 |
| 2007 | New Climate Change Criteria                                                             |                             | Launch of FTSE4Good Environmental Leaders Europe                |
| 2008 |                                                                                         |                             | Launch FTSE4Good Ibex Index<br>Launch FTSE4Good Australia Index |
| 2009 |                                                                                         | New Nuclear Power Criteria  |                                                                 |
| 2010 |                                                                                         | New BMS Marketing Criteria  |                                                                 |
| 2011 |                                                                                         |                             | Launch of ESG Ratings                                           |
| 2012 | Enhanced Countering Bribery Criteria<br>Enhanced Supply Chain Labour Standards Criteria |                             |                                                                 |

This report is in five main sections and a further three technical appendices. In the following pages this report covers these five sections:

- Section B: How to identify and interpret sectors with greater risk exposure
- Section C: Understanding what should be expected of companies with risk exposure
- Section D: Reviewing company response levels per ICB Subsector
- Section E: Reviewing company response levels per country
- Section F: Reviewing ICB Subsector VS Regional response levels

The specific enhancements that have been introduced to the Supply Chain Labour Standards criteria as of September 2012 are covered in the three appendices:

- Appendix 1: Explaining the September 2012 enhancements to Supply Chain Labour Standards Criteria
- Appendix 2: Supply Chain Labour Standards Risk Classification methodology
- Appendix 3: Supply Chain Labour Standards Criteria requirements summary

## B. Growing scrutiny of supply chain labour risks across sectors

The supply chain can be described as “the processes from the initial raw materials to the ultimate consumption of the finished product linking across supplier-user companies”<sup>3</sup>. Over the last three decades there has been a movement away from vertical integration - where the final seller also owns and manages all stages of the production of the product – to an outsourced model, where the seller of the finished product out-sources the production stages to external supplier companies. Taking one example, shoe makers now rarely make their own shoes but outsource production, working closely with suppliers globally who follow detailed specifications.

Managing these external supply chains has become a specialist field and the demands made of supplier companies have intensified. This is partly due to increasing competition but also an increasingly rapid product development cycle where suppliers need to be able to switch product specification and delivery rapidly to meet customer and seller demand. For large multinationals the supplier network can be a complex web, comprising first tier suppliers with whom the company has a direct commercial relationship, and then second, third, and fourth tier suppliers further along the supply chain.

Concern over worker conditions in supply chains was a key theme of Naomi Klein’s influential book “No Logo” published in December 1999 and, in the following decade, campaigns on this issue gathered momentum. Early media and activist campaigns on supply chain labour standards targeted companies producing clothing, accessories, footwear, toys and food products which had poor labour conditions in their supply chains. Over the last few years this has spread to other consumer products. Campaigns now attack manufacturers of consumer and office electronics such as televisions, computers, music systems, mobile phones, printers and photocopiers, as well as other product groups such as jewellery, watches, and home products such as furniture, towels and bed linen.

From analysis conducted by FTSE, it is apparent that companies across a broad range of ICB Subsectors<sup>4</sup> source these products from developing and emerging markets (i.e. non-OECD countries) where supply chain labour standards tend to be lower than in other regions. These companies are therefore most at risk of being targeted with supply chain labour campaigns which can generate negative media coverage.

Figure 1 sets out the proportion of large and mid cap companies from developed markets in each ICB Subsector that source these “higher risk”<sup>5</sup> products from non-OECD countries. This figure does not show how companies are managing the issue but the proportion<sup>6</sup> of companies within each Subsector which are exposed to the issue.

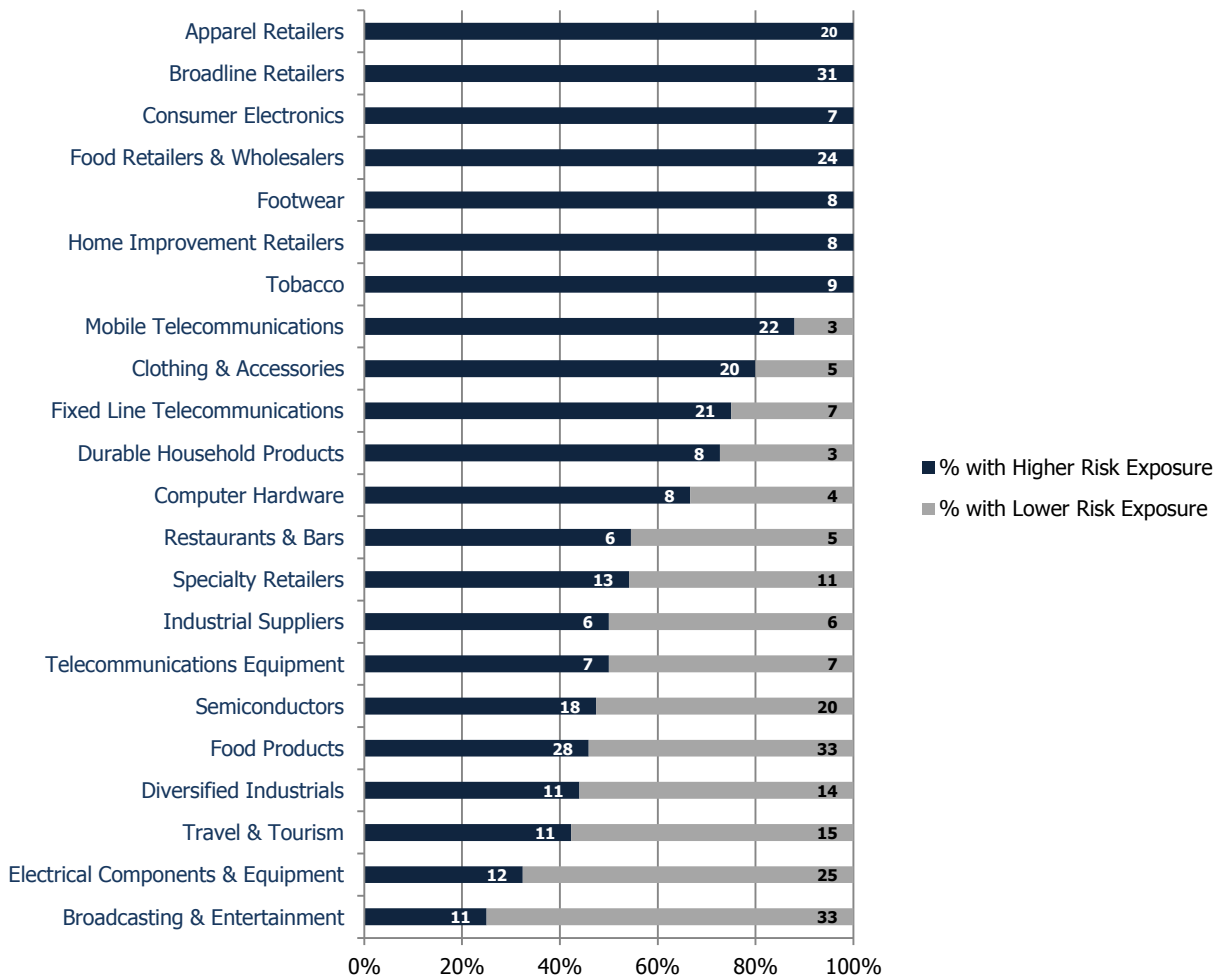
<sup>3</sup> Cox, J.F et al, 1995, APICS Dictionary, American Production and Inventory Control Society, Falls Church, VA.

<sup>4</sup> The Industry Classification Benchmark (“ICB”) is a definitive system for sector and industry analysis which enables the comparison of companies across four levels of classification and national boundaries

<sup>5</sup> See Appendix 1 for the definition of high and medium risk categories which are combined to represent ‘higher risk’.

<sup>6</sup> From the universe of approximately 2000 companies in the global FTSE Developed Index (ie large and mid cap companies listed in developed markets).

**Figure 1:** Supply Chain Labour Risk Exposure levels per ICB Subsector: highest to lowest



Source: FTSE ESG Ratings Risk Category for Supply Chain Labour Standards. Higher risk exposure combines medium and high risk categorisation as defined in Appendix 1. Lower risk exposure refers to companies outside the medium or high categories of risk. Note that ICB Subsectors with five or fewer high or medium risk companies are not displayed here.

Figure 1 shows the proportion of companies in each Subsector which source products from less developed (non-OECD) countries where there are higher supply chain risks<sup>7</sup>. The Subsectors at the bottom of the chart have a majority of companies with lower supply chain labour risk exposure, while those Subsectors at the top are more exposed with the majority of companies selling and sourcing high risk products and using suppliers in countries defined as high risk.

It is important to differentiate between two related but different themes: the labour conditions within a company's own operations (covered by FTSE's Human and Labour Rights Criteria) and within the supply chain (covered by the FTSE's Supply Chain Labour Standard's Criteria). This paper is concerned only with the labour conditions in the supply chain – conditions which are generally considered harder for the company to influence as the problems lie within the outsourced providers. Although industrial sectors such as General Mining may also have underlying labour condition issues, these companies are usually vertically integrated, and their labour issues are covered under the Human and Labour Rights Criteria.

<sup>7</sup> Clothing, accessories, footwear, toys and food products, consumer and office electronics (televisions, computers, music systems, mobiles, printers and photocopiers), jewellery, watches, furniture, towels, and bed linen.

## C. Defusing supply chain labour risks: for companies and investors

In order for companies to deal with their exposure to supply chain labour risks and to protect brands and reputations, companies are expected to develop comprehensive approaches to raising labour standards in their supply chains. Typically this involves setting clear guidelines and policies regarding minimum labour standards that suppliers must adhere to, covering issues such as:

- equal opportunities
- child labour
- forced labour
- worker representation
- health & safety
- working hours
- wages

There is then a need to ensure that these guidelines are applied in practice. As a first step, companies should communicate and train suppliers on these topics. For some this will also involve educating the suppliers regarding the context of these issues so that they are able to effectively and proactively take ownership of these issues. The company should also clearly set out what the disciplinary procedures are for failure or consistent failure to follow the guidelines.

The guidelines that a company sets for its suppliers should be monitored through supplier audits where either the company or a third party assessment firm is used to check that the standards are being followed by organising site visits. In order to prioritise these visits, a risk assessment of suppliers is recommended to ensure that the assessors visit those suppliers likely to have the greatest challenges in aligning their practices with the policy.

Companies exhibiting best practice will also ensure that their buying and sourcing teams are integrally involved in implementing and owning these policies to make sure that they are providing consistent messages to their suppliers. Ideally companies will ensure the buyers are trained in advance of their suppliers on the policy/guideline so their buying practices do not contradict the requirements communicated by the company to the suppliers.

If investors and other stakeholders are to be able to identify companies which are addressing these supply chain issues adequately, transparency and disclosure of such activities is key. If a company proactively sets out its process, explaining what is working and where it is facing challenges in policy implementation, then it creates a far more defensible position than where it is not evident to external parties that they are taking any action. Reports from some companies like Gap and Nike provide an impressive level of honesty about the challenges in managing this issue.

Through applying a risk matrix to identify companies with higher risk exposures, and identifying which companies have or have not made efforts to reduce such risks, it can help investors to make an informed decision and to develop an investment strategy to manage exposure at a portfolio level. This may include identifying companies for engagement, re-adjusting the weighting of companies within a portfolio, or a straight exclusion from portfolios based on failure to meet minimum standards.

For more details on the methodology by which FTSE and its partner EIRIS identify this risk exposure and the response level of each individual company, see Appendices 1-3.

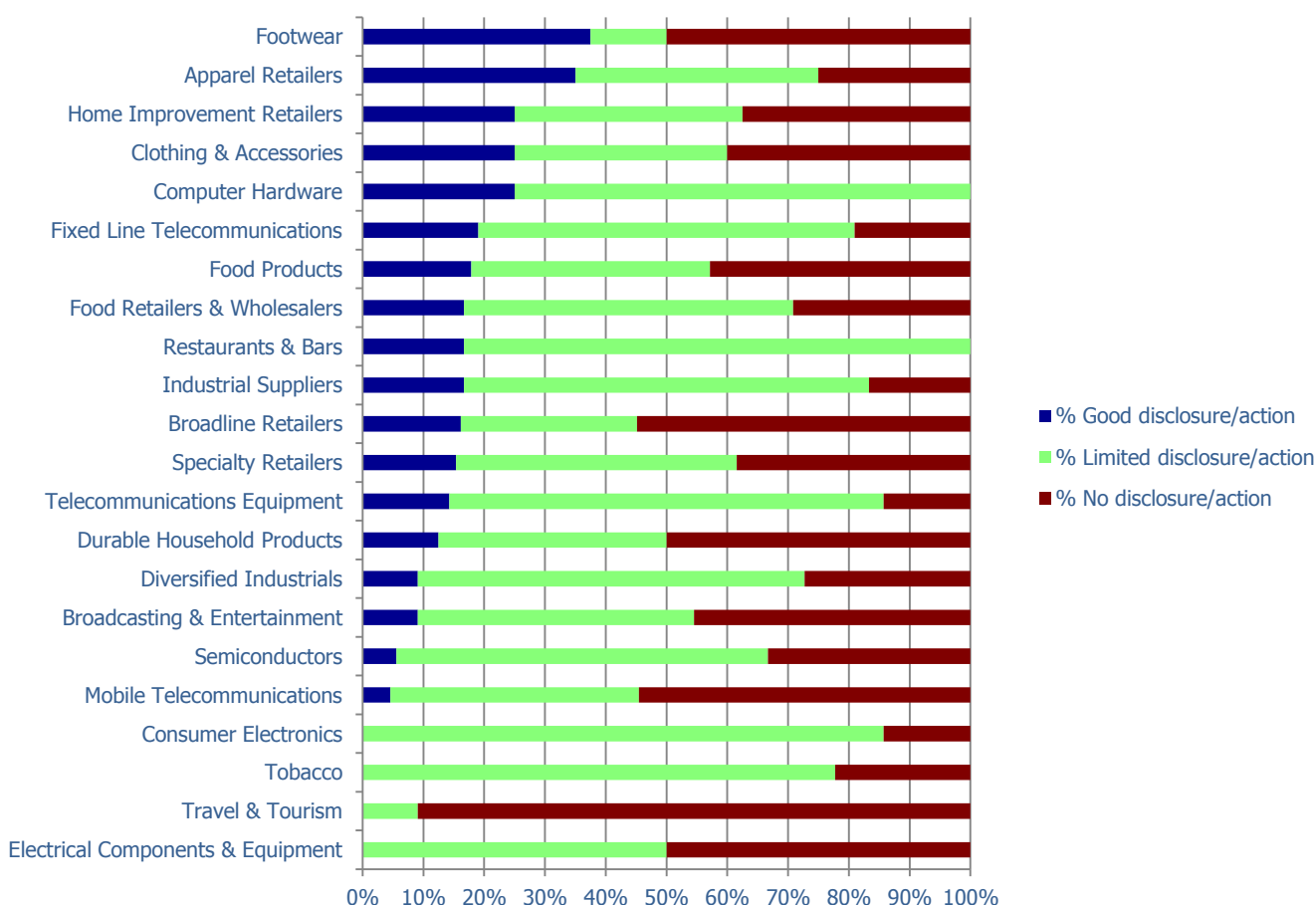
## D. Response levels by ICB Subsector

Based on assessment conducted by EIRIS of companies in the FTSE Developed Index against the FTSE ESG Supply Chain Labour Standards criteria, Figure 2 below sets out the level of response to potential supply chain labour risks across ICB Subsectors. Overall, despite the growing levels of concern and attention, company efforts to manage these risks are still generally poor with over a third of the companies not demonstrating that they are taking any action with regards to labour rights in their supply chain.

Companies in some Subsectors, such as Footwear, are more advanced in implementing strong and thorough supply chain labour management approaches than other Subsectors, such as some parts of the electronics industry. The Subsectors furthest ahead are those that faced the earliest campaigns and criticism, with those that have only started to face scrutiny in recent years are furthest behind.

The response levels also differ according to where the company is positioned within the total supply chain. For example, companies which are included in the Electrical Component & Equipment or Semiconductors Subsectors, who are themselves suppliers to companies in the Computer Hardware or Fixed Line Telecommunication Subsectors, have a poorer overall response rate. This could be partly due to the lower level of stakeholder attention to these companies, driven by the fact that the parent company itself is domiciled in a non-European country.

**Figure 2:** Company response levels: supply chain labour management trends by ICB Subsector



Source: FTSE ESG Ratings Score for Supply chain Labour Standards Sept 2012, where scores for each company range from zero to 5 with 5 being best practice. Good disclosure/action equates to high risk companies scoring 3 and above and medium risk companies scoring 5. Limited disclosure/action equates to any scores above 0. No disclosure/action equates to a score of zero. Note that ICB Subsectors that have five or fewer high or medium risk companies are not displayed here.

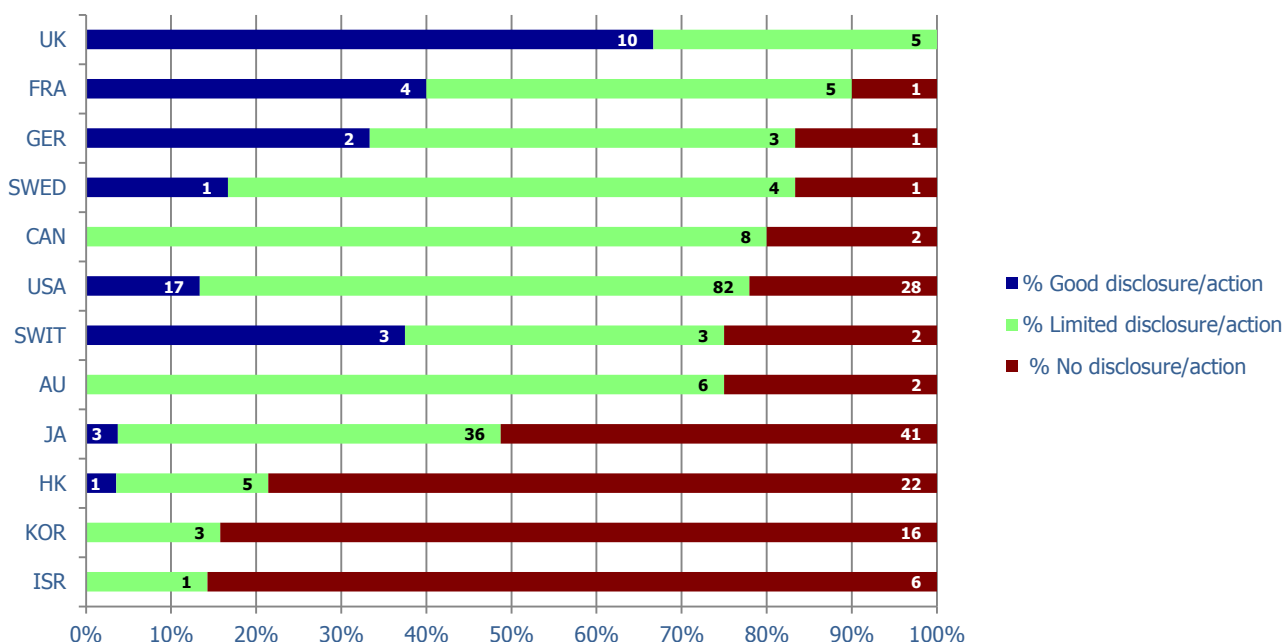
## E. Response levels by country

FTSE's research shows that a company's country of origin is closely related to its response to supply chain labour risks. It is clear from Figure 3 below that European and North American companies are furthest ahead on developing and implementing systems to manage supply chain labour issues whilst Asian markets lag behind. This again is likely to be highly correlated with media coverage and NGO campaigns which have been high profile in Europe and the US but not in Asia.

Within Europe, UK companies have taken the most comprehensive approach to addressing supply chain labour issues, with all large and mid cap companies that have exposure to this risk taking some action. In comparison, in other European countries, some companies appear to have taken no action to address this issue. The strong position of UK companies may reflect a high level of public sentiment and demand, evidenced also in surveys revealing the growth in fair-trade product sales being faster in the UK than any other country<sup>8</sup>.

In Asia, Japan leads Hong Kong and Korea with almost 50% of identified companies responding, whilst in Korea this falls to under 20%. Asian companies with strategies to grow consumer sales in Europe are likely to be most critically exposed to the risk of brand damage, and therefore may wish to manage such risks in advance. Whilst the total number of companies identified as having exposure to higher supply chain risks are lower than the Asian countries above, Israel takes the poorest performing spot as a single country. This is likely to be driven partly by the lack of media attention and partly due to involvement in Subsectors which are lagging behind their peers as set out in Figure 2.

**Figure 3:** Company response levels: supply chain labour management trends per country



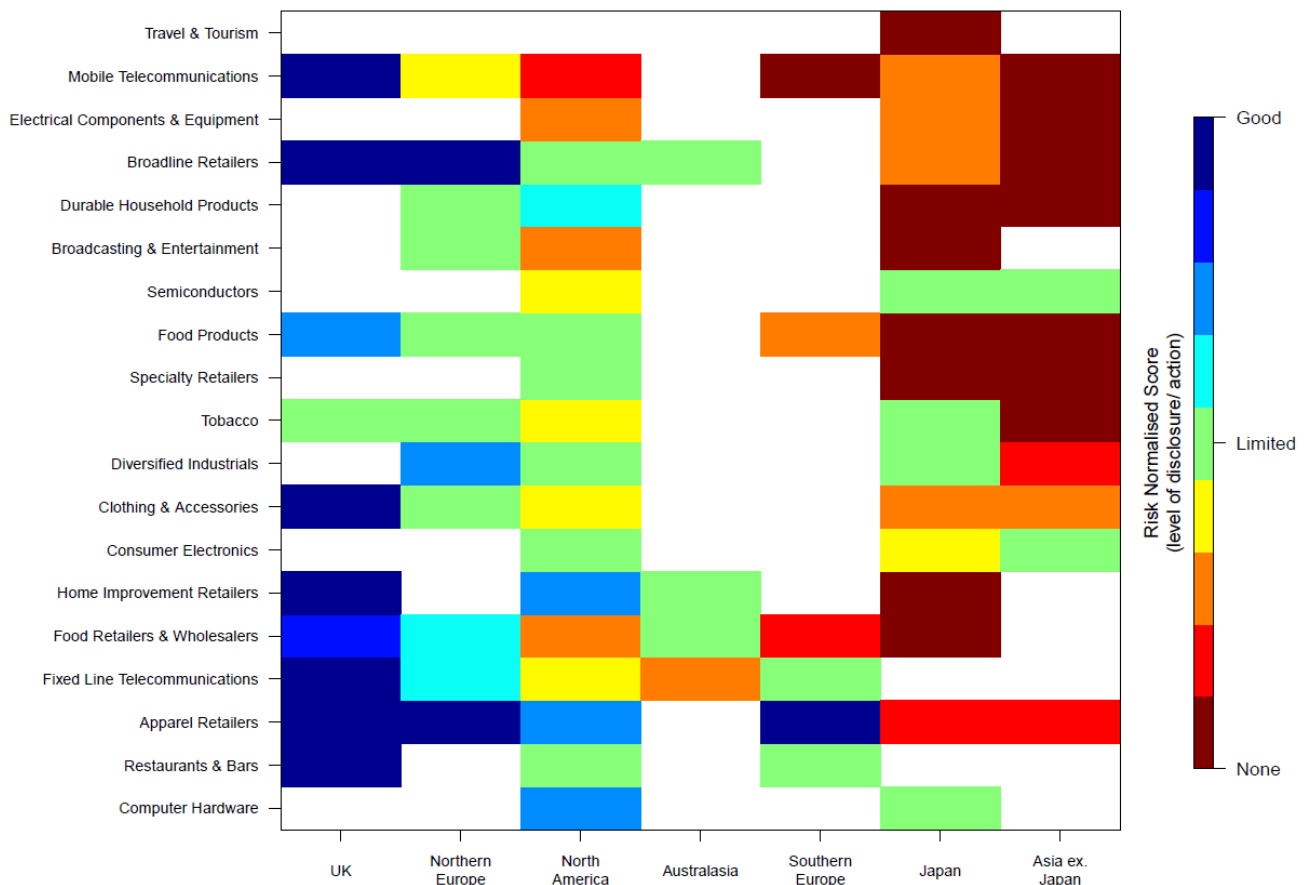
Source: FTSE ESG Ratings Score for Supply chain Labour Standards Sept 2012, where scores for each company range from zero to 5 with 5 being best practice. Good disclosure/action equates to high risk companies scoring 3 and above and medium risk companies score 5. Limited disclosure/action equates to any scores above 0. No disclosure/action equates to a score of zero. Note that ICB Subsectors with five or fewer high or medium risk companies are not displayed here.

<sup>8</sup> Euromonitor March 2012: Green Buying Behaviour: Global Online Survey

## F. Dissecting the Heat Map: ICB Subsector vs Regional responses

The heat map below displays the levels of corporate response to supply chain labour risks by Subsector and selected countries/regions.

**Figure 4:** Comparing Subsector responses across different regions and countries



**Source :** FTSE ESG Ratings Score for Supply chain Labour Standards Sept 2012. Good disclosure/action (dark blue) equates to high risk companies scoring 3 and above. Medium risk companies score 5. Limited disclosure/action equates to any scores above 0. No disclosure/action (dark red) equates to a score of zero. Note that ICB Subsectors with five or fewer high or medium risk companies are not displayed here.

The effect of region appears to be a stronger indicator of corporate response than ICB Subsector: the difference between the best and worst scoring country/region is much greater than the difference between best and worst scoring Subsectors.

Overall, the poorest performing Subsector is Travel & Tourism. However this is not because travel and tourism is necessarily a high risk Subsector but because companies identified as having higher risk exposure are Japanese railroad companies with diversified business activities which include high risk activities such as retailing. The diversified and complex business models of some Japanese companies can pose a challenge when trying to recognise and address potential ESG risks. However, over the last couple of years FTSE has seen an improvement in response to supply chain risks by Japanese trading ("sousha") companies, and therefore expects similar improvements over time in this Subsector.

## Appendix 1

### Assessing the Risk: the FTSE approach

FTSE, with its partner EIRIS, and through market consultations under the guidance of the independent FTSE4Good Policy Committee, continues to enhance the ESG criteria for the FTSE4Good Index and ESG Ratings to reflect investor concerns and company practices. As the most recent development in this ongoing criteria development process, FTSE has extended its Supply Chain Labour Standards criteria to cover additional companies and sectors.

FTSE has developed a two step approach to assessing supply chain risk. The system identifies higher risk companies, and assesses how well companies are managing this issue. Companies manage the issue through setting and implementing minimum labour standards with their suppliers. The risk categorisation methodology is set out in detail in Appendix 2 and the scoring methodology, for assessing how well the issue is being managed, is set out in Appendix 3.

Two risk categories, high and medium, have been created with the high risk category for companies most exposed to this issue. Out of the approximately 2,000 companies in the FTSE Developed Index, 11% (227 companies) are categorised as high risk, and an additional 6% (129 companies) are categorised as medium risk. It is important to note that companies not identified in either of these two categories may still face risks associated with supply chain labour standards, but based on previous media coverage and campaigns are less likely to be targeted due to the nature of their businesses. Over time this is likely to change and the medium and high risk categories will continue to be modified as the situation changes.

The results are summarised in Table 1 below.

**Table 1:** FTSE ESG Supply Chain Labour Standards Criteria: categorisation and coverage following September 2012 enhancements

|                  | High Risk Companies  |                        | Medium Risk Companies |                        |
|------------------|----------------------|------------------------|-----------------------|------------------------|
|                  | FTSE Developed Index | FTSE4Good Global Index | FTSE Developed Index  | FTSE4Good Global Index |
| Before Sept 2012 | 148                  | 34                     | -                     | -                      |
| After Sept 2012  | 227                  | 73                     | 129                   | 39                     |

Note: These figures only cover companies in the FTSE Developed Index universe and FTSE4Good Global Index. Please contact [esg@ftse.com](mailto:esg@ftse.com) for further details on UK All Share Index universe and FTSE4Good UK Index.

### Enhancements at September 2012

Enhancements to the FTSE4Good Index and ESG Ratings Supply Chain Labour Standards criteria take effect from September 2012. This immediately impacts the ESG Ratings of companies identified as medium and high risk, and will also impact the composition of the FTSE4Good Indices over time. Companies in the indices are given a timeline to meet the new requirements so that they will continue to be included in the indices. The following changes have been made to the existing criteria:

### Introduction of medium risk category and criteria

New criteria have been developed for companies identified as medium risk under the Supply Chain Labour Standards criteria. An additional 129 companies have been identified as medium risk, 39 of which are included in the FTSE4Good Global Index and will need to change their responses in order to meet the criteria and continue to be included in the indices.

### **Application of high risk category and criteria to companies sourcing consumer/office electronics**

Due to growing concern and interest, companies involved in consumer and office electronics have been elevated to high risk for Supply Chain Labour Standards. An additional 76 companies have been identified as high risk due to sourcing/selling consumer/office electronics, 41 of which are included in the FTSE4Good Global Index and will need to change their responses in order to meet the criteria and continue to be included in the indices.

## Appendix 2

### Supply Chain Labour Standards Risk Classification

Further details on the criteria and ESG Ratings methodology can be found at the following website –  
<http://www.ftse.com/analytics/ftse4good-esgratings/>

#### Which Companies are Rated on Supply Chain Labour Standards

Companies operating in certain sectors and sourcing from certain countries are considered to have greater supply chain labour standard risk. High and medium risk companies are identified through the following filters:

##### High Risk Companies

Companies must be involved in all three of the below to be identified as high risk:

- High risk product
- Sourcing from a high risk country
- Over exposure threshold

##### Medium Risk Companies

Companies must be involved in one of the scenarios below to be identified as medium risk:

• **Scenario 1:**

Medium risk sector/product and; sourcing from a high risk country and; any level of revenue

• **Scenario 2:**

High risk sector/product and; sourcing from a high risk country and; under exposure threshold

##### High Risk Products

Companies sourcing or selling the following are considered to be high risk: \*

- Agricultural crops: cane sugar, coffee, tea, cocoa, tropical fruit, fresh vegetables, flowers, tobacco
- Consumer products: clothing, accessories, footwear, toys
- Consumer / office electronics: E.g. TVs, computers, hi-fi's, mobiles, printers and photocopiers, power tools

##### Medium Risk Products

Companies sourcing or selling the following are considered to be medium risk:

- Labour intensive consumer products. E.g. Bed linen, towels, furniture, watches jewellery, and electronic components (unless solely for industrial products)

##### Exposure Thresholds

The exposure threshold used to differentiate high/medium risk companies is defined as follows:

- More than one-third of total company revenue deriving from high risk products AND/OR
- More than £100m revenue from sales of high risk products.

##### High Risk Countries

High risk countries are defined as all non-high income countries. These are all countries with the exception of those classified by the World Bank as High Income OECD countries. Details can be found at –

<http://data.worldbank.org/about/country-classifications>

## Appendix 3

### Supply Chain Labour Standards Criteria

Further details on the criteria and ESG Ratings methodology can be found at –  
<http://www.ftse.com/analytics/ftse4good-esgratings/>

#### PUBLIC POLICY

##### Core Indicators

- Publicly available Policy/Code
- Must be specifically relevant to suppliers
- Commitment to:
  - Equal Opportunity
  - Forced Labour
  - Child Labour
  - Freedom of Association & Collective Bargaining
- Policy/Code to cover Health and Safety

##### Additional indicators

- Working hours
- Wages
- Disciplinary procedures

##### Desirable Indicators

- Policy/Code is clearly integrated into the procurement process
- Membership of a relevant initiative dealing with labour standards(E.g. ETI)

#### MANAGEMENT SYSTEMS

##### Core Indicators

- Some audits
- Communication
- Training of relevant employees
- Strategic responsibility for the policy/code
- Non-compliance

##### Desirable Indicators

- Extensive Auditing
- Risk Assessment
- Extensive Communication of policy /code to supplier's employees
- Capacity building or training of its suppliers, and training of its own employees
- Involvement of Buyers

#### PUBLIC REPORTING

##### Core Indicators

The company's Supply Chain Labour Standards policy must be public and the company must publicly report on the following:

- Communication
- Auditing
- Non-compliance procedure
- Training

##### Desirable Indicators

- The proportion of the supply chain monitored or the number of supplier facilities monitored
- Aspects of performance, such as quantitative data on non-compliances and data on supplier performance

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