INTEGRUM ESG

Labour Issues within the Supply Chain

17 August 2023

INTRODUCTION

A company's supply chain can be an obscure element to its business that is difficult to manage and fully understand.

Companies are faced with an array of labour issues throughout their supply chain's landscape that can have devasting consequences financially and reputationally if underestimated or ignored.

A. RISKS WITHIN THE SUPPLY CHAIN

As suppliers are outside of direct operational control of companies they sell to, they may work in ways that are ethically misaligned with the company they directly or indirectly supply to. Although consideration of environmental and operational issues is important to minimise risk to investors, we will explore the social issues within a company's supply chain, specifically labour issues.

Labour issues are an overarching topic that includes forced labour, child labour, discrimination, human rights violations and health and safety issues among others. In order to protect themselves, companies audit their suppliers against standards outlined in labour codes of conduct that they expect their suppliers to adhere to.

If companies fail to comply and a labour issue becomes known, it may result in significant reputational damage down the supply chain which can damage share prices, which we will be discussing in further detail.

B. SUPPLY CHAIN STRUCTURE

Suppliers can be broken down into different 'Tiers' which represent the hierarchy of separation a company has from them.

Tier 1 suppliers work to provide goods and services directly to a company, whereas Tier 2 suppliers conduct business instead with the Tier 1 suppliers. This continues up the supply chain with Tier 3 suppliers engaging with the Tier 2 suppliers and so on.

For a simplified example, in the case of a bookseller, they may purchase books from a printing company, which would be their Tier 1 supplier. The Tier 1 Supplier may have been sold paper by a Tier 2 supplier, who in turn has purchased raw materials in the form of timber from a Tier 3 supplier.

As distance from the holding company in question increases, it becomes increasingly difficult to ensure compliance.

CONSEQUENCE OF LABOUR ISSUES WITHIN A SUPPLY CHAIN

Investing in companies that indirectly fund poor labour issues down their supply chain does impact investees share price negatively. This occurs once a tipping point is reached when either disaster strikes part of the supply chain as a consequence of poor labour practices leading to negative media exposure, or violations are made public through leaked sources to the media.

Being associated to companies in your supply chain that are carrying out poor labour practices runs a more long-term risk. With millennials and younger consumers placing greater importance on ethical and sustainable practices in their purchasing decisions and showing a willingness to boycott brands that do not meet these standards, the negative impact on a company's reputation in the event of a scandal is likely to be even more significant.

Legal enforcement is also becoming a pivotal tool against labour issues in the supply chain. Since the beginning of 2023, the '*German Supply Chain Due Diligence Act*' has been in force in Germany. The new law creates strong regulatory oversight and enforcement and lays down due diligence obligations that are based on the UN Guiding Principles.

Should companies violate their obligations, they can expect to be fined based on the liability size determined by the offence's severity and the company's total turnover.

Similar legislation is currently being considered in the Netherlands, Austria, Belgium and Finland as part of a wider European movement.

While critics argue the legislation falls short of significant change, the move demonstrates that the legislative arena is shifting towards demanding stronger supply chain due diligence from companies and away from voluntary corporate social responsibility. Only companies who are preparing for this legislative shift today will be best protected from these laws.

Addressing labour issues in the supply chain is not only morally responsible but also crucial for maintaining sustainable and resilient business operations. Labour issues left unaddressed can result in strikes, protests, and other forms of labour unrest, ultimately grinding the supply chain to a halt.

In 2019, Apple was faced with severe disruptions when strike action lasting weeks occurred at a key factory in China. The strike caused delays in product shipments and had a significant impact on Apple's revenue as a result.

THE RANA PLAZA TRAGEDY

'*Social washing*' within supply chains does indeed exist, where companies falsely advertise or claim that their supply chains adhere to human rights and social standards while covering up actual social issues.

One example is the **Rana Plaza tragedy in Bangladesh in 2013**.

Rana Plaza was a multi-story garment factory complex that collapsed, resulting in the death of over 1,134 workers and injuring thousands more. Details of the disaster soon emerged that Rana Plaza had been briefly evacuated the day before due to reports of dangerous cracks in the building's façade. The next day, however, workers were ordered to return or face dismissal. For 32 US cents an hour, the workers returned. By 9am, the building complex had collapsed, killing 1,134 people, and trapping 2,500 more injured in the ruins. News materialised that some victims were just 13 years old.

The factory produced clothing for several well-known global brands, including **Mango**, **Primark**, **Zara** and **Walmart**. This incident shed light on the poor working conditions and safety hazards within the garment industry's supply chain in Bangladesh and the confusion of supply chain connectivity as the question asked by companies was, "were our products made in Rana Plaza?" - which could not be immediately answered, showcasing to the world the unchartered labyrinth that is the global supply chain.

Many of the brands associated with Rana Plaza had marketing campaigns and public statements that emphasized their commitment to ethical sourcing, fair labour practices, and worker safety. However, the reality on the ground was drastically different, with workers subjected to unsafe working conditions, low wages, long hours, and limited or no access to basic labour rights.

Following the disaster, the *Bangladesh Accord for Fire and Building Safety* was established to improve worker safety and prevent future disasters in the Bangladeshi garment industry. It was signed by over 200 global brands, retailers, and importers, as well as several global and national trade unions.

Key features and objectives of the Bangladesh Accord included independent safety inspections of factories within participating brand supply chains, transparent reporting of inspection reports, commitment of participating brands to finance and oversee any necessary remediation, and worker participation in the form of health and safety committees and training.

Another of the Accord's key features is that the commitments are legally binding for brands that sign it. Brands are obligated to uphold the safety standards outlined in the agreement and take necessary steps to protect workers' rights and safety.

This proved to be key in holding companies to account, with unions taking one multinational apparel brand to court in 2018 for failing to remedy life-threatening hazards at its factories. The brand agreed to pay $2m to fix numerous safety lapses at 150 of their supplier factories, plus $300,000 to a fund set up by the unions who brought the case to improve pay and labour conditions in global supply chains.

Whilst the brand in question was able to remain unnamed under the terms of the settlement, companies can suffer reputational damage when failing to take labour issues in the supply chain seriously.

When a company's deceptive practices are exposed, it can result in a significant loss of trust and credibility among consumers, stakeholders, and the public. The brand's reputation can be damaged, leading to declining sales, boycotts, and negative sentiment towards the company.

HOW CAN COMPANIES AVOID LABOUR ISSUES WITHIN THEIR SUPPLY CHAIN?

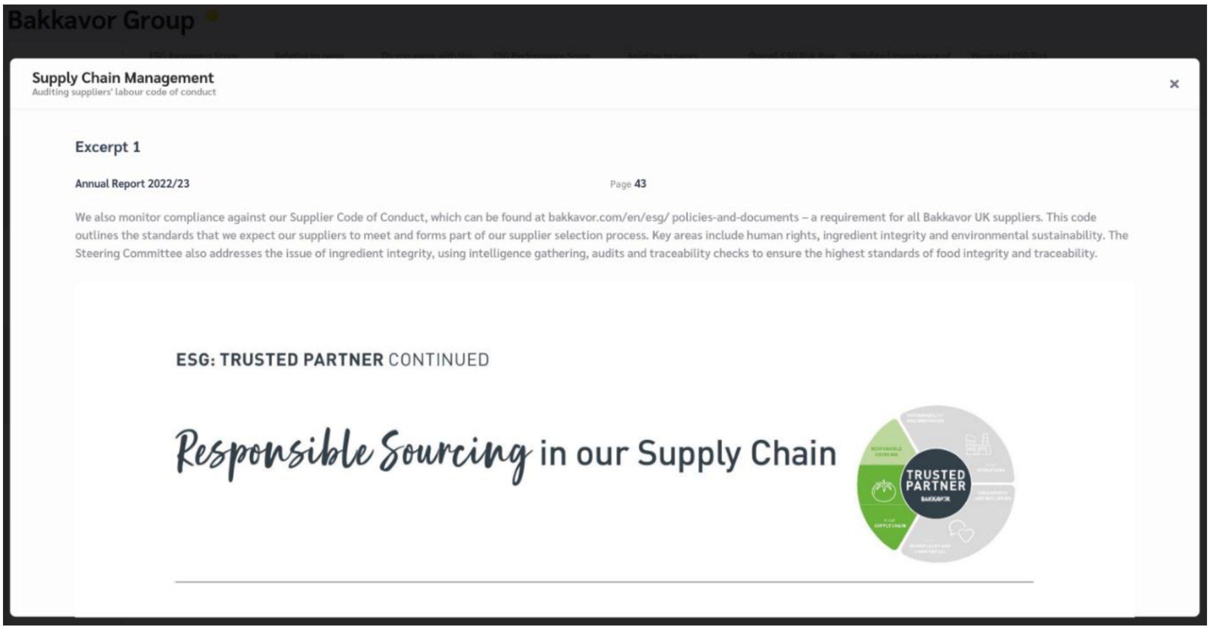
As we have shown, neglecting the workforce throughout the supply chain can lead to significant repercussions for a company's reputation and long-term viability. Instead of adopting a reactive approach that addresses labour issues once they have surfaced, companies should instead, proactively prevent such issues by implementing necessary measures and robust mitigation strategies.

Using the Integrum ESG dashboard, we have identified several effective measures that companies have implemented to manage this ESG risk, which are as follows:

A. SCREENING AND DUE DILIGENCE AT SUPPLIER SELECTION

By undertaking comprehensive due diligence during the supplier selection process, companies can effectively identify and prioritise suppliers with well-established labour policies and practices and those that do not. This due diligence should include evaluating the supplier's track record to identify any instances where they may have fallen short of labour standards and faced criticism as a result.

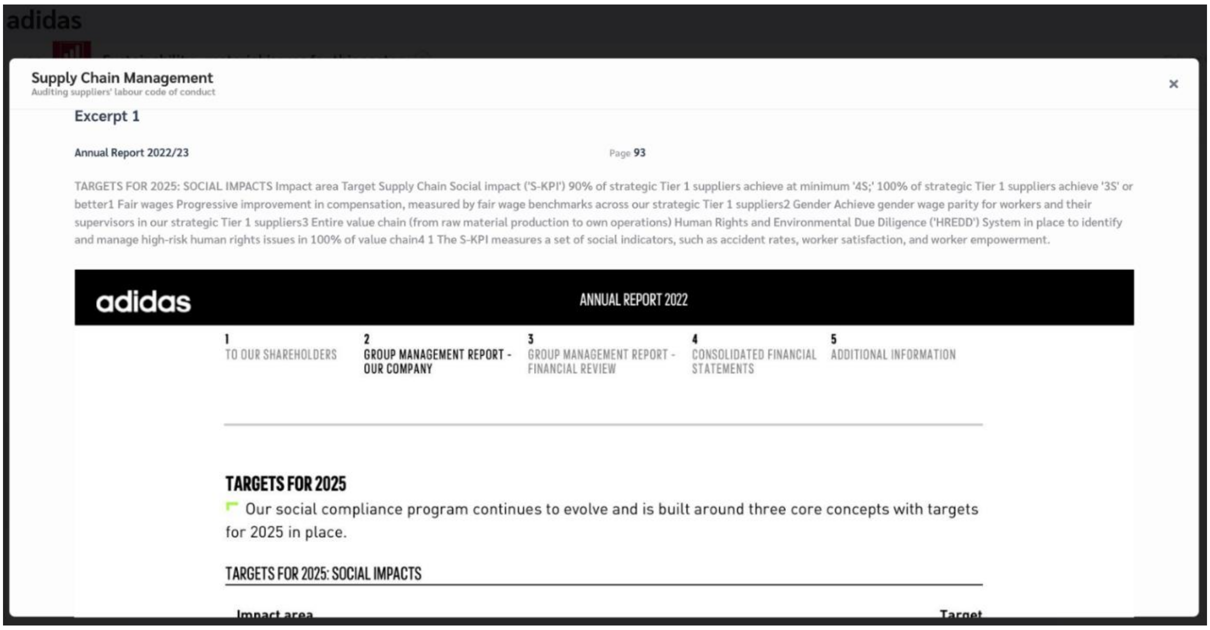
Additionally, companies should develop a comprehensive Supplier Code of Conduct that clearly communicates their expectations regarding labour standards and human rights as seen below in the glass box view for Bakkavor Group. This code should be enforceable through contractual obligations to guarantee suppliers adhere to these standards consistently.



B. CONDUCT REGULAR AUDITS AND ASSESSMENTS TO EVALUATE COMPLIANCE WITH LABOUR STANDARDS

High scores are awarded on our ESG ratings dashboard to companies that disclose the percentage of suppliers audited within the year. These audits can be conducted by both internal and external auditors to ensure unbiased and thorough assessments. In cases of non-compliance, companies should take prompt corrective actions and implement continuous improvement plans to address the identified issues.

Companies with few or no audits completed should establish quantifiable objectives that can be monitored and reported on in the subsequent year. For instance, **adidas** conducted audits on 65% of their supplier facilities in the year 2022, and so have set targets to increase this number to 90% by 2025. These targets assist companies in making auditing an integral aspect of their business strategy.


adidas

Supply Chain Management
Auditing suppliers' labour code of conduct

Excerpt 1

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TARGETS FOR 2025: SOCIAL IMPACTS Impact area Target Supply Chain Social impact ('S-KPI') 90% of strategic Tier 1 suppliers achieve at minimum '4S;' 100% of strategic Tier 1 suppliers achieve '3S' or better1 Fair wages Progressive improvement in compensation, measured by fair wage benchmarks across our strategic Tier 1 suppliers2 Gender Achieve gender wage parity for workers and their supervisors in our strategic Tier 1 suppliers3 Entire value chain (from raw material production to own operations) Human Rights and Environmental Due Diligence ('HREDD') System in place to identify and manage high-risk human rights issues in 100% of value chain4 1 The S-KPI measures a set of social indicators, such as accident rates, worker satisfaction, and worker empowerment.

adidas ANNUAL REPORT 2022

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TARGETS FOR 2025

Our social compliance program continues to evolve and is built around three core concepts with targets for 2025 in place.

TARGETS FOR 2025: SOCIAL IMPACTS

Impact area Target

C. PROMOTE TRANSPARENCY THROUGHOUT THE SUPPLY CHAIN AND IN REPORTING

As seen above, adidas has exemplified transparency in their supply chain management, providing disclosure of their current audit figures and targets. This practice is crucial as it enables stakeholders and investors to evaluate the company's supply chain practices and hold them accountable for meeting these targets.

This accountability mechanism should, in theory, serve as a motivator for adidas to diligently work towards accomplishing their set objectives, thereby avoiding potential scrutiny if they fall short.

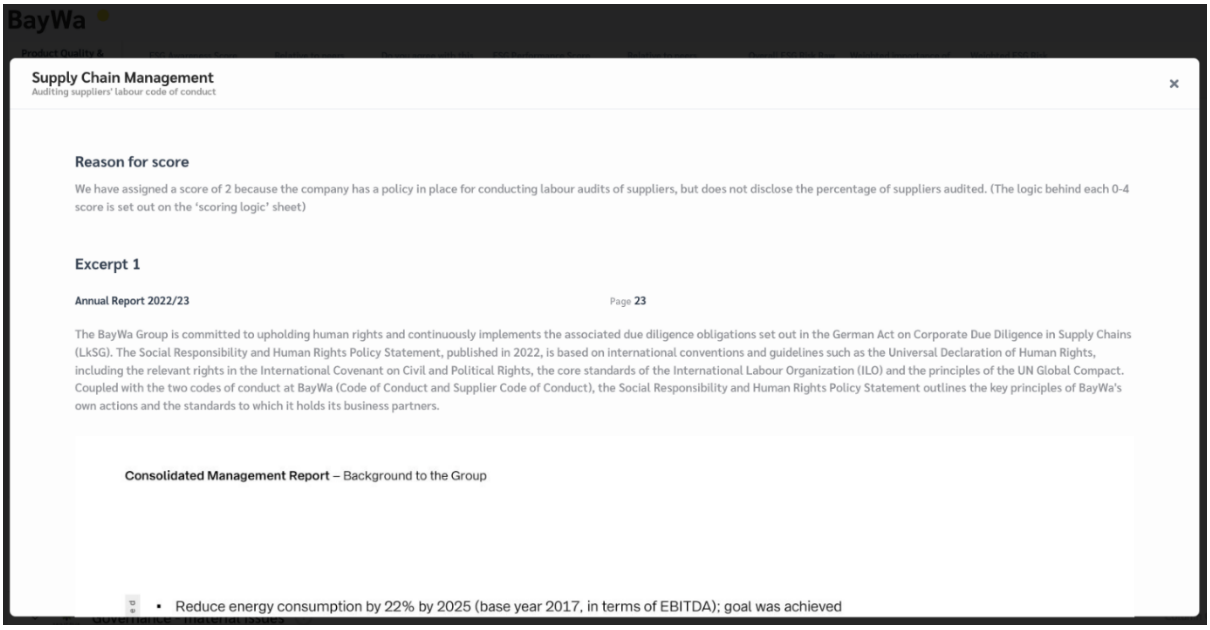
D. SEEK CERTIFICATIONS AND PARTICIPATE IN INDUSTRY INITIATIVES

Various certifications and memberships exist that aid companies in effectively managing labour concerns within the supply chain. There are many such initiatives including the *International Labour Organization (ILO) Core Conventions* which reflects adherence to internationally recognized labour standards, encompassing freedom of association, collective bargaining, forced labour, child labour, and non-discrimination in employment.

By actively seeking these certifications and engaging in initiatives that foster responsible sourcing and equitable labour practices, companies can showcase their dedication to enhancing labour conditions within their supply chain as seen in the example below from BayWa's 2022 Consolidated Financial Statements report. These external certifications serve as a testament to stakeholders, including customers, investors, and employees, assuring them that the company operates with integrity and maintains rigorous social responsibility standards.

The four measures mentioned above (due diligence, audits and assessment, transparency promotion and certification) are just a selection of the numerous initiatives companies can implement to tackle labour concerns in their supply chain.

The wider adoption of these measures across companies is crucial in the collective effort to eliminate labour issues in supply chains. But the implications of not taking these measures will have ramifications for investors.



HOW IS THIS LINKED TO INVESTORS?

To invest in any of the following subsectors such as *Agricultural Products* or *Toys and Sporting Goods*, among many others, is to allow your money to be at risk of supporting poor labour practice within the supply chain.

To lack a proper understanding of company practices within these subsectors regarding material issues within a supply chain, is to neglect both capital and ethical considerations. *But why?*

Companies with supply chain labour issues as material to their business that are not addressing this issue within their corporate management and reporting outcomes, are not engaging with investors on transparency or risk management.

Out of 5800 public companies within the Integrum ESG universe, 1038 companies have the SASB sub-metric '*Auditing Suppliers' Labour Code of Conduct*' from the *Supply Chain Management* metric, as material. For this sub-metric, we look for (1) policies to mitigate the risk, (2) disclosure of number of audits carried out on suppliers regarding labour issues and (3) targets for the future which promotes transparency as mentioned above.

A well-versed and close to home example of supply chain labour mistreatment is observed in the high-street clothing company, Boohoo. In July 2020 news came to light from a supplier factory in Leicester, that poor working conditions and low-rates of pay (£3.50 an hour – less than half the UK minimum wage at the time) for its workers was prevalent.

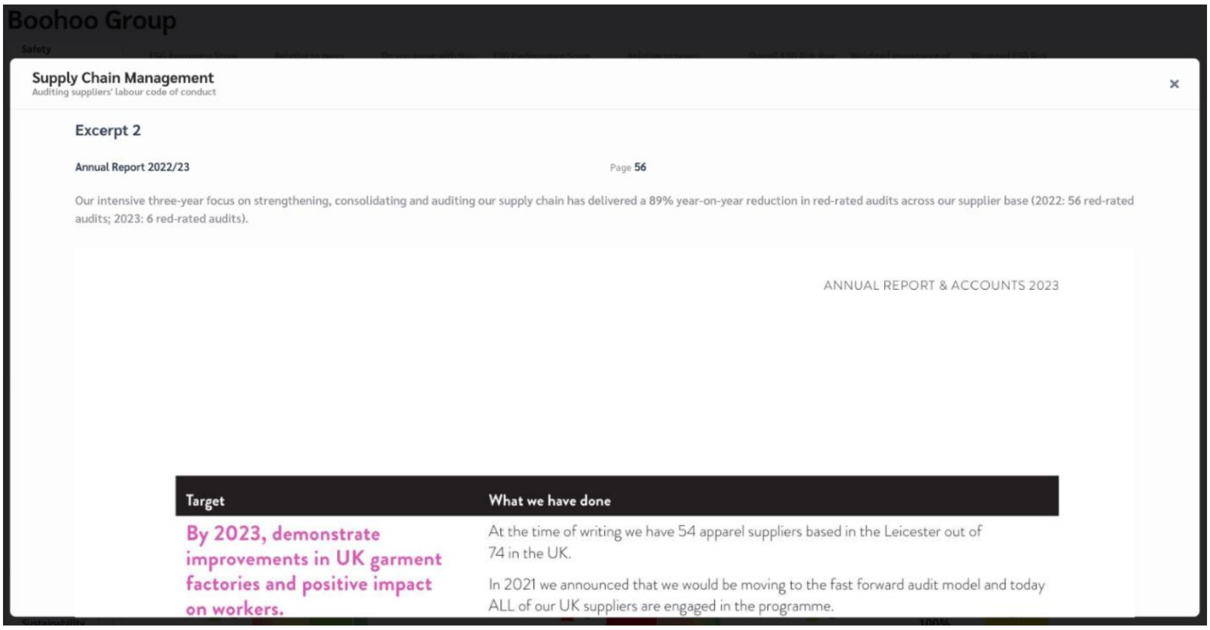
From an independent review from the *Business & Human Rights Resource Centre*, this was confirmed, alongside the findings of poor supply chain management and monitoring from Boohoo. Reputationally damaged, pressure was heaped on the company since the confirmed accusations, to enact change in its supply chain. This materialised in May 2021 when Boohoo linked a £150m bonus scheme to improve factory conditions within its supply chain.

For investors in Boohoo, this human rights abuse became tangible in the form of an immediate 18% drop in share price and a £1.3bn deduction from its value immediately after the accusations. In the three years since Boohoo shares have never returned to their pre-scandal value.

Complex and disguised catalysts of labour exploitation are hard to pin down. Caveat lector, a company's transparency on supply chain labour issues doesn't mean it performs well in this area. For example, Tony's Chocolonely disclosed its high incidents of child labour where it sources cocoa in West Africa which grated against its moral standpoint on ethical branding.

What transparency from companies on these issues does allow, is better informed decisions when allocating funds.

For Boohoo, in 2023, the company only attains an awareness score of 2 out of a possible 4 for this sub-metric, meaning it only has policies regarding this specific issue.



Looking at the glass box, we can see that along with policies, Boohoo has reduced the number of 'red-rated' audits in its supplier base by 89% in the last three years. Although this doesn't align enough to the SASB scoring framework to allow the score to improve, it is insightful information to an investor who will wish to track the company's progress.

WHAT CAN INVESTORS DO TO ENCOURAGE COMPANIES TO MANAGE THIS ESG RISK?

A. STEWARDSHIP

Stewardship, deriving from the Old English word 'stigweard', combining the words 'house' and 'guard'. The origins of this word are still applicable today with its use in the world of ESG investments.

To guard one's possessions, in this case capital, requires close guardianship of how that money is spent to optimise the returns. Investors typically rely significantly on investee company stewardship to enhance business supply chain practices. There are numerous specific tools and activities used for investee stewardship such as engagement with investees (both current and potential) or leveraging roles on the board or on-board committees.

Broader stewardship techniques involve; policy engagement, engagement with standard setters, engagement with industry groups, negotiation with and monitoring of the stewardship actions of intermediaries in the investment chain, e.g. asset owners engaging external managers, limited partners engaging general partners, engagement with other stakeholders, e.g. NGOs, workers, communities, and other rights-holders, and contributions to public goods (e.g. publicly available research) or to public discourse (e.g. through the media) that supports stewardship goals.

Engaging with investees is critical to spark corporate leadership in supply chain management and thereby minimising risks. Monitoring by investors is not enough to lead to purposeful change. Clear two-way dialogue between investor and investee management, with transparent and quantifiable targeted goals, preferably incentive linked, is the engagement that trumps monitoring and enacts change on labour issues and other material issues related to the company.

Engagement on social issues such as labour concerns within the supply chain are most effectively dealt with using a bottom-up approach, targeting individual laggard companies and contacting the sustainability team which is then fed up the chain of command to accountability and management, dispersing a change from the bottom up.

B. COLLABORATIVE & COLLECTIVE ENGAGEMENT

Alongside stewardship, large scale collaboration is also essential when it comes to creating impact regarding company outlook on labour issues within the supply chain. This collective engagement is a vital tool for smaller investors to get their voice heard.

Pooling together limited resources into collective engagement on supply chain labour issues creates more weight to enact change in company practices which is harder for investees to ignore. There are several encouraging investor initiatives, such as the '*Platform Living Wage Financials*' which encourages and monitors investee companies as regards to paying a living wage through their supply chains or '*Investors against Slavery and Trafficking Asia Pacific*', an investor-led, multi-stakeholder initiative engaging with companies in the Asia Pacific region to find and eradicate modern slavery in supply chain operations.

Engagement with policy makers is an indirect tool to bring about change when it comes to labour issues within their investees supply chain. This is building momentum with the EU's '*Corporate Sustainability Due Diligence Directive*' which heralds a new era of supply chain due diligence.

Investors may push for reform, but any kind of long-lasting impact will be achieved by working in cohesion with regulators, investees and civil organisations. Hence, it is of utmost importance to strike a harmonious balance amongst them.

Solving the issue, root and stem, requires a solution at every level. Investors should take a holistic approach by considering the entire supply chain and collaborating with tier 1 suppliers to ensure that ethical standards and labour practices are propagated throughout all levels of production.

CONCLUSION

Placing labour issues at the forefront of investment decisions within the supply chain is not only a moral imperative but also a strategically wise approach for an investors' capital.

Neglecting the indirect impacts of a company, including the labour conditions of their supply chain due to the presumption of it being outside a company's direct operational control, poses a significant risk of severe reputational damage to both the investee company and any investor.

The convergence of heightened consumer demands for transparency and the tightening of regulatory oversight translates into more than just reputational risks for companies; it presents substantial operational and financial risks, particularly when low labour standards persist within their supply chains.

Investors that commit to ethical labour practices by mandating substantial labour conditions to each of their portfolio companies can not only influence real change, but also maintain a competitive advantage in the market by staying ahead of evolving compliance requirements and avoid potential legal liabilities.

Asset owners have the power to drive transformative change through their capital allocation decisions. They can actively support and invest in companies that demonstrate a commitment to fair labour practices and sustainability, thereby influencing industry norms and setting new benchmarks for responsible business conduct.

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