WALTER SCOTT

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ESG Commentary

QUARTER ENDING
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Global Commentary

SECOND QUARTER 2019

COMMENTARY

"Awareness and appreciation of environmental, social and governance (ESG) related issues and opportunities have continued to rise over the quarter". Any quarterly note over the past decade, if not longer, might have begun with that statement; yet it remains entirely valid. Demands placed upon corporations from all stakeholders across E, S and G will continue to rise. From the perspective of any CEO, not only is it probably impossible to meet the expectations of all, there might be regular battles with those 'investors' (speculators) looking for short-term financial gains and with an eye only on quarter-by-quarter results. Alison Brittain, CEO of Whitbread, speaking at The Times' CEO Summit earlier this quarter articulated those pressures succinctly; "I need to be able to look my kids in the eye. You can't keep everyone happy in terms of investors."

As we have stressed in previous reports, retaining a focus on long-term financial success based on sustainable practices requires a strong, supportive culture, and one led from the top.

A meeting with the management of Inditex early in the quarter offered reassurance in regards to its culture and the importance placed on continued improvements, and investment, across its operations both environmentally and socially. The company continues to report noteworthy actions and improvements on its carbon footprint as well as water and electricity usage. The company's efforts to move to zero spillage from hazardous chemicals across its supply chains by 2020 are commendable. But perhaps just as important is where responsibility now lies for these efforts. In July, Pablo Isla will move from his role as Chairman and CEO to become Executive Chairman. In clarifying the particular responsibilities of both Mr Isla and the new CEO, Carlo Crespo (who is currently COO), it is noteworthy that Mr Crespo will have formal responsibility for sustainability, alongside digital transformation. As COO, he has been responsible for both aspects and so his promotion very much reflects the importance of these areas to the company, both of which, in different ways, are critical to the company's continued and long-term success.

Coca-Cola has clear targets in place; to use 100% recyclable packaging by 2025

In June, a member of the Research team joined a small group of investors for two days with LVMH's Louis Vuitton division, a company that, like Inditex, has made concerted efforts to ensure an equivalence of standards across its supply chain. For commercial as well as ethical reasons, traceability across the supply chain is something that has always been important. The company is looking at employing block chain technology to allow the certification of every product, tracking every stage of a product's manufacture, across the supply chain. Peers in the luxury goods sector have come in for strong criticism for the destruction of goods, as part of understandable efforts to control the distribution of product and the integrity of the brand. Louis Vuitton is instead focused on recycling. Its level of unsold inventory is the lowest across the industry thanks in part to products that have been taken apart and all the constituent parts recycled. In explaining this process during the two-day site visit, management placed such efforts in a straightforward context - it is their civic obligation to do so.

This "civic" mind was also referenced in the company's approach to local manufacturing. By way of example, Louis Vuitton established three manufacturing plants in the US several decades ago. Half of the products sold in the US are made there.

The demons associated with sugar and proposed sugar taxes remain very high profile issues, but in a recent meeting with The Coca-Cola Company it was clear that the company is far less concerned about these issues than they were five years ago. From the company's perspective, health ministries have come to realise that taxes are ineffective in dealing with public health problems. More positively, from the perspective of both Coca-Cola and public health, the company has also taken significant and voluntary steps such as reformulating drinks with reduced sugar content and reducing packaging sizes. Today, packaging is perhaps as high profile an issue in the public consciousness as sugar taxes, and the company has clear targets in place; to use 100% recyclable packaging by 2025, and to have 50% of packaging made from recycled materials by 2030.

Managing environmental issues should not simply fall within a company's risk management output

Elsewhere, a member of the team attended the annual CERES conference, another attended a 'Planet Positive' event and from an industry perspective, we are collaborating with peers on the Investment Association's Stewardship Reporting Working Group, which held its first meeting in June.

At the Planet Positive event discussions were led by representatives from UK-based non-violent climate action groups as well as lawyer-activists who are working to establish important legal precedent. Whilst generalising, the impression that climate change groups have given up on one-to-one engagement with companies was an interesting one. Today's tactics are designed to be more effective and higher profile. The goal is to persuade governments to recognise climate change as an 'emergency'. This in turn places a responsibility on governments to introduce legislation which in turn forces corporations to implement change, with legal penalties for failure to do so. The narrative has certainly changed. The talk is no longer of climate change. The narrative has changed to climate catastrophe and climate emergency.

The CERES conference in San Francisco marked the 30th anniversary of the organisation that has been at the forefront of engagement with investors, companies and policymakers on issues around sustainability. The focus this year was very

much on the environment and a call to arms to boards to set definitive targets and improve reporting and just as importantly, to incorporate these factors into the core business strategy. Managing environmental issues should not simply fall within a company's risk management output. Investors, similarly, were called upon to improve engagement with boards on these topics and challenge progress as well as demand better reporting of targets and metrics.

Of course, significant progress has been made across the spectrum of ESG issues by companies, and investors, over recent years. In keeping with that message of more work to do, we don't come out of all our meetings with company management assured of meaningful targeting and a supportive culture.

Regulators, together with sound-bite-hungry politicians, are very concerned about privacy

A meeting with the CFO of Alphabet in May was one such example. The online advertising market remains robust and, from our perspective, concerns of slowing growth have been overplayed. Marks out of ten for corporate culture falls, however, at the other end of the scale. Investors are frustrated about disclosure and share class structures; there has been high profile employee discontent and the occasional strike on the Google campus. And regulators, together with sound-bite-hungry politicians, are very concerned about privacy. With the success that Alphabet has enjoyed and its current scale, knocks are perhaps inevitable. But management's approach to investor communication in the face of these criticisms does little to help, and arguably exacerbates the perception challenge.

We believe the company has been an undoubted success, delivering organic growth quarter-by-quarter, so the company's view that "they just don't get us" is to some degree, understandable. Management also argues that the paranoia that drives innovation, product enhancement and the almost visceral need for constant improvement is the same paranoia about the future that fuels the founders' wish for a cash balance of roughly $100bn, eschewing a more efficient capital structure.

Nestlé's investor day in May was another example of a day that provided reassurance and confidence on many counts but some disappointment on the cultural importance of driving environmental and social improvements. Nestlé has long been able to cite ESG best practice with commendable steps forward in water control, the supply chain traceability of Nespresso originals and child nutrition programmes with Milo and Maggi brands, to list just a few examples. However, its response to the issue of plastic waste was below the standard that we have come to expect from the company, with limited appetite to talk about issues that were not part of the official script. The day was an apt reminder that even for companies, like Nestlé, that are part of every ESG index and highly rated by every ESG research outfit, the challenges and opportunities across the ESG spectrum are only ever work-in-progress.

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