Inrate's ESG Impact Rating: Supply Chain Management

Corporations (Equities & Bonds)

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Content

1. Supply Chains: The New Sustainability Hotspot

1.1. Why Sustainable Supply Chains Matter

In the face of growing public awareness and legal obligations, companies have come to recognize their responsibility in managing risks along their supply chains. Globalization has enabled companies to outsource their production processes to external suppliers and to relocate their production sites. These suppliers in turn may outsource to other subcontractors, leading to complex supply chains that can comprise multiple tiers, hundreds of supplier locations and thousands of individuals. As supply chains become increasingly vulnerable to uncertainties, corporations face difficulties in identifying and managing the environmental and social impacts.[1] In most sectors, risks have proven to be greater in earlier stages of the supply chain. Among the sectors that are particularly vulnerable to these risks are agriculture, food and beverage processing, manufacturing and construction.[2]

Until recently, the focus of supply chain and procurement has been on technical quality, cost effectiveness, speed of delivery and reliability. However, awareness of supply chain risks among stakeholders has emerged because of workforce health and safety incidents, geopolitical conflicts, raw material shortages, environmental disasters and new legislation in areas such as modern slavery and conflict minerals.[3]

As supply chain awareness gains traction, companies are encouraged to monitor the operations of their suppliers and ensure that they meet certain environmental, social and governance (ESG) standards. Failure to identify sustainability issues in supply chains can pose a risk for companies and for that reason transparency and accountability are increasingly prioritized.[4] Notwithstanding the risks, many companies are still in the early stages of developing the tools and practices needed to identify, engage and manage these issues.[5]

There are a growing number of regulations that require businesses to take their supply chains into account ranging from the high-level aspirations of the **Paris Agreement** on climate change and the **Sustainable Development Goals (SDGs)** to the **European Commission's Directive on Non-Financial Reporting**, the **UK's Modern Slavery Act** as well as the listing requirements on several stock exchanges.[6]

In Switzerland, the **Konzernverantwortungsinitiative** (KVO – the Responsible Business Initiative) was launched in 2015. It provides an example of how both the public and the government can work towards achieving more sustainable supply chains. If the initiative succeeds, companies will be legally obliged to incorporate respect for human rights and the environment in all their business activities. This mandatory due diligence will also be applied to Swiss-based companies' activities abroad. The date of the vote has not yet been set.

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[1] Greenbiz 2016: 5 reasons supply chains are the new sustainability hotspot.
[2] EcoVadis 2017: EcoVadis Global CSR Risk & Performance Index.
[3] EY 2016: The state of sustainable supply chains. www.ey.com/Publication/vwLUAssets/EY-building-responsible-and-resilient supplychains/$FILE/EY-building-responsible-and-resilient-supply-chains.pdf
[4] mirova 2014: Engagement: Social Issues in the Supply Chain.
[5] PRI 2017: Managing ESG Risks in the Supply Chains of Private Companies and Assets.
[6] Raconteur 2017: Ensuring your supply chain is sustainable and ethical. https://www.raconteur.net/business/ensuring-your-supply-chain-issustainable-and-ethical

1.2. Main Challenge: Achieving Traceability

Many goods are sourced and produced far from where they are bought and consumed. At each stage in the life-cycle of most products, there are impacts on the environment and on societies. An example of such impacts is illustrated in a recent report unveiling the involvement of major retail brands around the world into modern slavery in the South East Asian seafood industry. In 2015, investigations in Thailand found that many migrant fishers were working on fishing boats in conditions of forced labor.
The migrant fishers were catching so-called “trash fish”, used to produce fishmeal. This then entered the value chains of several products, mainly as food for farmed fish and shrimp, and as a component of pet food.[7] Global retail brands that used the fishmeal ingredient in their products were accused of modern slavery in their supply chain. Amongst others, this case has led to an increasing pressure on companies to combat unethical employment practices around the globe and to reduce the environmental impact throughout their supply chains.

According to CDP’s Global Supply Chain Report 2018, greenhouse gas (GHG) emissions in the supply chain are on average four times higher than those emitted during direct operations. If companies are committed to meet the 2-degree consensus set at the Paris Agreement in 2015, then emissions from the supply chain must be factored into this consideration. However, the operational influence of a company on its associated GHG reductions along their supply chain remains challenging. This is primarily due to the fact that scope 3 emissions, especially in the supply chain, are difficult to associate, track, measure, monitor, and reduce.[8]

These challenges businesses face can be overcome by implementing supply chain traceability. This refers to the ability to map a company’s supply chain thoroughly and to precisely identify the producers along each stage of the supply chain starting from raw materials to finished goods. This has proven to be demanding and requires the engagement and collaboration of various actors along the entire supply chain to trace a product’s history.[9] Traceability helps to ensure and prevent negative social and environmental impact in supply chains. Measuring data and increasing transparency are powerful tools for managing the risks and grasping the opportunities of global supply chains.[10]

Developments in technology and demands for greater transparency from both the private and public sectors urge industries to improve supply chain traceability.[11] They have inspired dozens of cloud services specializing in traceability such as EcoVadis or SourceMap.[12] Technology solutions help companies to get a better understanding of the current performance of their suppliers. They will continue to play an increasing role in supply chain sustainability, offering modular, cloud-based sector specific solutions with the potential to develop into global cluster databases.[13]

Major technological challenges faced by supply chains relate to information sharing and trust e.g. in the reliability of data exchanged by the involved parties. Amongst others, blockchain and the Internet of Things (IoT) have the potential to close important gaps in traceability challenges.

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[7] Verisk Maplecraft 2016: Human Rights Outlook 2016.
[8] EcoVadis 2017: Global CSR Risk and Performance Index.
[9] BSR 2014: How Does Traceability Advance Sustainability in Global Supply Chains?
[10] GRI 2017: Supply chain transparency: A change tool for successful global businesses https://www.globalreporting.org/information/news-andpress-center/Pages/Supply-chain-transparency-A-change-tool-for-successful-global-businesses.aspx
[11] UN Global Compact & BSR 2014: A Guide to Traceability. A Practical Approach to Advance Sustainability in Global Supply Chains.
[12] Greenbiz 2018: https://www.greenbiz.com/article/supply-chain-traceability-steps-level-gap-target-others-map
[13] EY 2016: The state of sustainable supply chains.

Blockchain and IoT (Internet of Things) assist in achieving transparency and traceability in supply chains

The efficiency of a supply chain relies on trust between the different stakeholders. The interaction between blockchain and IoT technologies assists in increasing the traceability and reliability of information along the supply chain.

Blockchain is a digital, distributed transaction ledger that is shared among all participants, not owned by any, and records events and transactions in a secure, immutable, and irrevocable way. In a supply chain, these characteristics help to reduce the number of intermediaries, including the former

keepers of trust along the chain. Cryptology replaces third-party intermediaries as the keeper of trust, with all blockchain participants running complex algorithms to certify the integrity of the whole.

The main purpose of IoT is to link the physical world with the digital world. For the supply chain, it can be a formidable transformative force to address the bottom line by improved efficiency and traceability, as well as by introducing greater differentiation and innovation.[14]

The Deloitte report on using blockchain and IoT in supply chain traceability (2017)[15] identifies four challenges that IoT and blockchain tackle:

- Continuity of information: An IoT-enabled blockchain can address visibility and traceability challenges. Breakthrough blockchain technology enables companies to record every event or transaction within a supply chain on a distributed ledger.
- Accessibility to information: Fast and transparent blockchains will provide the necessary access to information in the future to effectively leverage on the enormous amount of data produced along the supply chain.
- Link between physical and information flows: IoT will link data to the materials and products on the stages of the supply chain where matter is transformed physically.
- Code of conduct violations and fraud detection: Effective processes to detect human rights violations or fraud along the supply chain supported by appropriate technologies will become increasingly important to lower business risks.

1.3. Moving beyond the Audit – Increasing Supply Chain Responsibility

The development of code of conducts in the late 1990s came about because of negative publicity over highly exploitative working conditions in supplier factories. Subsequently, factory-level auditing of labor management appeared to be the key tool to mitigate the risk of a bad reputation.

Empirical evidence has however indicated a significant gap of audits as a truly effective tool for supply chain risk management. A report by Sheffield University even argues that supply chain audits are "ineffective tools for detecting, reporting, or correcting environmental and labor problems in supply chains."[16] Evidence includes disasters such as the Rana Plaza collapse in 2013, in which hundreds of workers lost their lives. Just months before this building's collapse, the facility passed a compliance audit.[17]

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[14] Deloitte 2017: Continuous interconnected supply chain. Using Blockchain & Internet-of-Things in supply chain traceability.
[15] Deloitte 2017: Continuous interconnected supply chain. Using Blockchain & Internet-of-Things in supply chain traceability.
[16] The University of Sheffield (2016) : Ethical Audits and the Supply Chains of Global Corporations.
[17] Forbes 2017: https://www.forbes.com/sites/jwebb/2017/01/16/supply-chain-audits-work-for-corporations-but-not-the-planet-says-new-report/#

Purely auditing systems are failing to accommodate the increasing complexity of global supply chains.[18] Companies have recognized that complex supply chain challenges require collaboration with peers, academia, standards setters and non-profit organizations. In recent years, multi-stakeholder collaborations have proliferated as companies recognize that tackling these issues together is less costly, increases leverage with suppliers, facilitates knowledge exchange and helps enhance credibility.[19]

Companies leading the way have started to cooperate with their suppliers and are expanding their relationships significantly beyond auditing and monitoring. They are achieving this through investing in training and capacity building of their suppliers individually or through industry collaborations.[20] By empowering workers to help themselves and by acting in partnership with suppliers and industry peers, companies can share the responsibility for improving working conditions.[21]

By promoting responsible business conduct, governments and other stakeholders encourage companies to take responsibility for impacts that activities in their value chains have on people and on the planet. According to the **UN Guiding Principles on Business and Human Rights** and the **OECD Guidelines for Multinational Enterprises**, it is the responsibility of a company to map the risks of adverse impacts in their supply chains and to take appropriate measures to prevent or mitigate them.

The **UN Global Compact** promotes tools and resources such as the Self-Assessment Tool, aligned with the UN Guiding Principles on Business and Human Rights.[22]

Multi-stakeholder associations and industry associations are increasingly playing an important role in bringing companies together to collaborate on initiatives focused on improving supply chain issues that a single company can hardly address alone. Collaboration among peers, industry associations, standard setters and NGOs is critical for companies to achieve sustainability in the supply chain.[23]

Multi-stakeholder initiatives push sustainable supply chains

Over the last two decades, the number of multi-stakeholder initiatives (MSIs) has grown rapidly. MSIs are now well established in sustainable supply chain management. A wide range of stakeholders beyond corporations have participated in developing these MSIs, including NGOs, trade unions, academics, and governments, among many others.

Many existing MSIs address industry-specific issues. For example, in the apparel industry several MSIs address labour conditions, including the Better Work Initiative or the Fair Labour Association.

Furthermore, many MSIs also apply to multiple industries. For example, the International Organization for Standardization has issued management system standards, such as ISO 20400, a new standard for sustainable procurement. The UN Global Compact runs an extensive program on supply chain sustainability.

Existing MSIs have undoubtedly helped advance sustainability in supply chains. For example, they have helped raise awareness throughout the supply chain, improved managerial practices, enhanced product traceability, and significantly reduced unsustainable behaviours. However, clear performance expectations, that are linked to the broader sustainability context of the supply chain and backed by enforcement mechanisms, would be required.[24]

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[18] Verisk Maplecraft 2016: Human Rights Outlook 2016.
[19] EY 2016: The state of sustainable supply chains.
[20] EY 2016: The state of sustainable supply chains.
[21] Verisk Maplecraft 2016: Human Rights Outlook 2016.
[22] Great Insights 2016: Sustainable value chains
[23] EY 2016: The state of sustainable supply chains.
[24] Searcy 2017: Multi-stakeholder initiatives in sustainable supply chains: Putting sustainability performance in context

1.4. The Sustainability Payoff

Building and maintaining a resilient supply chain is a key success factor for businesses operating in a globalized and fast-changing world.[25] As mentioned above, consumer awareness is growing around the world and, more recently, the investor community has also started to be progressively vocal about

the business benefits of transparent and sustainable supply chain practices. Responsible supply chain practices help create, protect, and sustain long-term environmental, social, and economic value for all stakeholders involved in bringing products and services to the market. Furthermore, these practices protect the long-term viability of their business, and secure a social license to operate.[26]

By collaboratively working with their suppliers to systematically monitor, measure and communicate the benefits of an environmentally friendlier and more socially responsible business, leading companies are starting to turn supply chain sustainability into a driver of competitive advantage. Companies can offer market differentiation, cut costs, manage risks better and generate new sources of revenue and increase the value of their brand. According to a study of EY companies are increasingly recognizing that the sustainability attributes of their products can result in increased sales, stronger and long-term relationships with customers and easier access to capital.[27]

Companies with responsible supply chain practices not only protect vulnerable workers, but they also guard against legal, reputational, and financial risks. The more companies proactively engage in responsible supply chain management, the better equipped they will be to respond when a disruption such as the growing set of government regulations occurs.[28]

2. Investors eye Supply Chain Risks

The inability to track the origin of products and services exposes companies to hidden and uncontrollable risks. These are typically driven by ESG factors, such as natural resource depletion, human rights violations and corruption.[29] Investors' assets and their performance are similarly exposed to these risks and can affect an investor's reputation.

A recent report by the Principles for Responsible Investment (PRI) calls on investors to put pressure on invested companies to report on ESG risks in their supply chains. The PRI guide advises investors to ask companies detailed questions about supply chain complexity, how ESG issues are embedded into contracts and how people internally are trained in managing those risks. It further advises investors to engage with procurement decision-makers to get answers to more technical supply chain management questions.[30]

Managing ESG factors in supply chains brings both short- and long-term financial benefits to investors. To achieve sustainable returns for clients and beneficiaries, investors need to understand which companies they invest in are leaders and which ones are lacking behind to tackle sustainability issues along their supply chain. To this end, it is imperative for investors to understand the environmental and social impacts of a company.

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[25] EY 2016: The state of sustainable supply chains.
[26] GRI 2017: Supply chain transparency: A change tool for successful global businesses. https://www.globalreporting.org/information/news-andpress-center/Pages/Supply-chain-transparency-A-change-tool-for-successful-global-businesses.aspx
[27] EY 2016: The state of sustainable supply chains.
[28] KnowTheChain 2017: https://knowthechain.org/the-issue/
[29] GRI 2017: Supply chain transparency: A change tool for successful global businesses. https://www.globalreporting.org/information/news-andpress-center/Pages/Supply-chain-transparency-A-change-tool-for-successful-global-businesses.aspx
[30] Supply Management 2017: https://www.cips.org/supply-management/news/2017/november/investors-urged-to-put-pressure-on-companiesover-supply-chain-risk/

3. Gaining more detailed insights with ESG Impact Assessment

While many companies identify the supply chain as the most difficult aspect of their business to make more sustainable, it is also one of the most critical to their success. To minimize investment risks, investors should ensure to invest in companies that are making important strides in creating transparent and sustainable supply chains. But how to detect such companies most efficiently?

In general, a sustainable company must provide products and services that are sustainable in the long term – and the supply chain naturally plays a critical role in this endeavor. To measure the long-term ability and contribution of a company to sustainability, it is not sufficient to focus solely on its annual reports, Corporate Social Responsibility (CSR) or ESG materials, i.e. on what the company reports. It is also not feasible to do thorough analysis by additionally taking a company's controversial behavior in account to its own reporting. In fact, it is indispensable to assess further the intrinsic impact of a company's products and services occurring along their entire life cycles, i.e. from the preliminary work by suppliers to the effects in the use phase up to the end of life of the product or service. Further, a company's willingness and ability to effectively address the ESG and controversial issues it faces has also to be taken into account.

To find out which companies truly contribute to sustainability and analyse their supply chains and understand best how to integrate technological innovations on supply chain management, the ESG Impact Rating by Inrate is the right choice. [31] In addition to a conventional analysis of Corporate Social Responsibility-related material and controversial issues, this assessment measures the sustainability impact of a company overall. The ESG Impact Rating thereby assesses the companies' positive and negative contribution to a sustainable development, thus providing indications on their chances and risks and future success.

[31] Schwegler 2018: Inrate's ESG Impact Rating Methodology - Corporations (Equities & Bonds). https://www.inrate.com/cm_data/inrate_methodology_paper_newdesign_02.pdf.

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