ESG challenges in supply chain management

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New York Life Investments

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ESG risks in supply chains: Connecting the dots

Supply chains are vital to many businesses. As they grow more complex, companies are exposed to a wide range of risks from environmental, social, and governance (ESG) factors. These risks can exacerbate existing supply chain issues and disrupt business operations. If not managed effectively, ESG risks within supply chains can adversely affect a firm's financial performance—including revenue losses and increased expenses, which may ultimately affect investment performance.

People don't tend to pay much attention to supply chains until something goes wrong—for instance, empty store shelves or backordered shipments.

For many firms, ESG risks in supply chains can be larger than the risks they face in their direct operations. For example, a semiconductor manufacturing facility in Asia may experience direct damage from extreme weather due to climate change—disrupting production or transportation routes. Delays in shipping or delivery orders could cause cascading disruptions for a wide range of industries (e.g., computers, smartphones, automobiles, medical equipment) that use semiconductor chips as product inputs. Another example can be seen in the food and beverage industry. For instance, a food manufacturing company that relies on raw agricultural commodities such as fish, rice, and wheat sourced from potentially water-stressed regions, could see production negatively affected by climate changes that cause rising temperatures or sea-level changes that result in the development of toxic algae that impacts water quality. In both examples, supply chain disruption could create shortages of components, finished goods, and/or agricultural commodities that can increase consumer prices—and indirectly impact potential investment performance.

Overall, assessing supply chain issues and their impact is extremely complex, making ESG risks even greater than expected. For example, supply chain issues that had been related to the COVID-19 pandemic and the war between Russia and Ukraine in 2022 had made it a challenge to keep shelves stocked with goods.

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Examples of common ESG risks in supply chains[1]

ENVIRONMENTAL

- Climate change
- Water usage
- Land degradation and deforestation
- Biodiversity loss

SOCIAL

- Human rights abuses
- Violence and conflict
- Community rights violations
- Labor exploitation: Child and forced labor, modern slavery, gender inequality
- Workplace health and safety; discrimination and harassment

GOVERNANCE

- Breach in business ethics: Corruption, bribery, and fraud
- Lack of transparency and governance accountability
- Misleading information about ESG performance

Potential adverse outcomes from ESG supply chain risks[2]

OPERATIONAL

- Disruption of production processes and deliveries
- Higher incidence of product defects and waste
- Greater operational inefficiencies

REPUTATIONAL

- Loss of social license to operate (acceptance by employees, investors, and the public)
- Loss of brand value
- Shifts in consumer loyalty
- Loss of investor and shareholder confidence

REGULATORY

- Failure to comply with current rules and regulations
- Government fines and penalties
- Loss of market access
- Failure to maintain compliance with future regulatory changes

Investment managers require broader awareness of ESG risk factors

Besides the financial consequences of ESG-related disruptions, ESG risks can erode consumer sentiment, employee engagement, and investor confidence—all of which can be difficult for a firm to overcome. For an investor, these financial consequences can contribute to declines in financial performance and the loss of equity value.

The total financial impact of major environmental risks (i.e., climate change, deforestation, and water insecurity) is estimated to cost global suppliers $1.26 trillion over the next five years.[3]

Firms that successfully manage their ESG supply chain risks may see positive results, such as discovering operational improvements and building resilience into their supply chains. Better managing these types of risks can also lead to identifying other ESG risks earlier in the process to help prevent/mitigate risks down the road—all of which can help bolster financial performance.

Financial benefits of better ESG management in supply chains:

- Reduced costs through better risk management
- Better margins from increased labor and operations productivity
- Enhanced continuity of business operations
- Faster adaptation to new regulations and legal requirements
- Increased confidence from investors and stakeholders

Investment managers require broader awareness of the ESG issues that can arise to provide their clients with the most risk-adverse portfolios. Additionally, they should account for supply chain risks when making capital allocation decisions. Individual investors should evaluate investment managers on their approach to assessing ESG risks and opportunities in their investment portfolios.

Case study: modern slavery in the fashion industry

Modern slavery is an umbrella term for a range of worker exploitation issues, including forced labor, debt bondage, and human trafficking. Instances of modern slavery are prevalent in supply chains that extend into emerging economies, where companies benefit from low labor costs but are exposed to social risks due to lax enforcement of worker protection and regulations.

Modern slavery appears in supply chains across different sectors but is common in fashion and apparel industries that employ a large population of workers—including a significant number of women.

In this case study, let's consider a major U.S.-based fashion brand with a significant consumer-facing presence in the retail marketplace. Manufacturing for its apparel is outsourced to suppliers in different parts of the world, such as Southeast Asia, Central America, and the Caribbean.

98% of the workers making apparel earn less than a living wage.[4]

The labor- and social-related risks the apparel brand faces in its supply chain includes:

Operational risk. While the fashion brand relies on its extended supply chain for cost-saving efficiencies, the company is vulnerable to business disruption if production workers go on strike to protest low wages or poor working conditions, or if infrastructure issues occur because of poor quality and safety issues with buildings—like the 2013 Rana Plaza garment factory collapse in Dhaka, Bangladesh.

Reputational risk. As a consumer-facing business, the company relies on its brand presence and reputation to sustain sales and profitability. However, reports of labor exploitation or poor working conditions with a supplier can be tied back to the company—contributing to a loss of consumer trust, brand reputation, and demand for its products.

Regulatory risk. Recent legislative efforts at the U.S. federal and state level have sought to punish the use of modern slavery in all industries. One regulatory action on the state level is the California Transparency in Supply Chains Act, which requires firms doing business in the state to disclose the efforts they are taking to eradicate forced labor and human trafficking.[5]

Assessing risk from an ESG perspective

An investment manager's ESG strategy should consider these social, regulatory, and overall governance-related risks (as well as other ESG risks) in its assessment and valuation processes. When governance risks arise in the supply chains, they can have a downstream effect on the overall quality, delivery, and profitability of the company's products.

Due diligence processes should seek to identify labor-related risks in the supply chain and to understand the efforts the firm is taking to lessen these risks.

THIS ASSESSMENT MAY TRY AND DETERMINE:

- Does the company use suppliers in countries considered high risk for labor exploitation issues?
- Has the company mapped its supply chain across all tiers?
- Does the company have published policies on human and labor rights?
  – Do these policies apply to all suppliers and subcontractors?
  – Are these policies communicated to all suppliers and subcontractors?
- Does the company have a mechanism to track and monitor risks among suppliers in its supply chains?
- Does the company have a grievance mechanism available for internal and external parties?
- How does the company address flagged complaints or non-compliant matters (e.g., corrective action plans or remediation actions) in its supply chains?
- Does the company have an escalation process and a clear link to its Board's accountability for ESG risks?

How should investors approach ESG risks in supply chains?

Investors who are looking to address ESG in company supply chains will want to seek out portfolio managers who are thinking about these risks and assessing the potential impact on the company's investment performance. These risks often are not apparent in fundamental analysis—unless the impact has already occurred.

Key characteristics of skilled ESG investment managers:

Holistic awareness of ESG risks. When evaluating investment opportunities from an ESG perspective, the range and scope of ESG risks are likely to differ by sector and by the countries or regions where its suppliers operate.

Due diligence around supply chain risks. A skilled ESG manager will seek to assess how a company manages its ESG risks and opportunities with its suppliers. For instance, does a company use its leverage to engage with its suppliers—and, if so, how? Are there incentives or joint projects in place to support suppliers in addressing and reporting ESG risks? These types of reviews can take place by evaluating existing corporate policies and risk management procedures related to environmental, social, and governance factors.

Direct engagement with companies invested in (or to be invested). Focus on understanding each company's ESG strategy through meetings and surveys of current and former executives and board members. This is critical in helping evaluate how a company has faced certain ESG challenges, and the extent of the impact realized because of the company's overall management approach.

Data collection, measurement, and financial modeling. Ultimately, an investment manager will want to incorporate their evaluation of ESG risks into their overall financial assessment and valuation of the companies they invest in (or intend to invest in).

Supply chains are just one piece of the ESG puzzle

While supply chains are critical to nearly every company's operation, it is far from the only ESG risk. ESG risks are present at every layer of industry—from the extraction of raw materials to production and manufacturing, to shipping and delivery, to sales, marketing, and retail. Investment managers would be well-served to account for every layer of ESG risk at every level of their organization—growing their portfolios while helping create a better and more sustainable world.

For more information on ESG investing, visit us at: newyorklifeinvestments.com.

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Further, ESG strategies may rely on certain values-based criteria to eliminate exposures found in similar strategies or broad market benchmarks, which could also result in relative investment performance deviation. Opinions expressed are current opinions as of the date appearing in this material only and are subject to change.

1. Source: CDP North America, *Transparency to Transformation: A Chain Reaction*, 2020 CDP Global Supply Chain Report, February 2021 (Page 14). CDP is a popular voluntary reporting framework that companies use to disclose environmental information to their stakeholders (investors, employees, and customers).

2. Source: Crowell & Moring LLP, *ESG Survey: Environmental Performance and the Stakes for Your Business*, December 2021.

3. Source: CDP Worldwide, 2020 CDP Global Supply Chain Report, February 2021.

4. Source: The Lowest Wage Challenge, *State of The Industry: Lowest Wages to Living Wages*, and Fashion Revolution, 2017.

5. Source: State of California, *California Transparency in Supply Chains Act*, 2022.

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